

STATE + LOCAL TAX GROUP

New York

Craig B. Fields	cfields@mofo.com
Paul H. Frankel	pfrankel@mofo.com
Hollis L. Hyans	hhyans@mofo.com
Mitchell A. Newmark	mnewmark@mofo.com
R. Gregory Roberts	rroberts@mofo.com
Irwin M. Slomka	islomka@mofo.com
Open Weaver Banks	obanks@mofo.com
Amy F. Nogid	anogid@mofo.com
Michael A. Pearl	mpearl@mofo.com
Richard C. Call	rcall@mofo.com
Ted W. Friedman	tfriedman@mofo.com
Nicole L. Johnson	njohnson@mofo.com
William T. Pardue	wpardue@mofo.com
Rebecca M. Ulich	rulich@mofo.com
Kara M. Kraman	kkraman@mofo.com

San Francisco

Thomas H. Steele	tsteele@mofo.com
Andres Vallejo	avallejo@mofo.com
Peter B. Kanter	pkanter@mofo.com
James P. Kratochvill	jkratochvill@mofo.com
Kirsten Wolff	kwolff@mofo.com

Sacramento

Eric J. Coffill	ecoffill@mofo.com
Jenny Choi	jennychoi@mofo.com
Leslie J. Lao	llao@mofo.com

Washington, D.C.

Linda A. Arnsbarger	arnsbarger@mofo.com
Philip M. Tatarowicz	ptatarowicz@mofo.com

Denver

Thomas H. Steele	tsteele@mofo.com
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**“OCCASIONAL SALES” AND
SINGLE SALES FACTOR
APPORTIONMENT IN CALIFORNIA**

By Eric J. Coffill

For decades, California utilized a mandatory corporate franchise tax equally-weighted three factor apportionment formula of payroll, property and sales, thus assigning a 33% weight to the sales factor. In 1993, California double-weighted sales in the three-factor formula, increasing the weight of the sales factor to 50%.¹ Recently, following a number of unsuccessful attempts over the years by the California Legislature to change the apportionment formula to mandatory use of single-factor sales, the California voters passed Proposition 39 at the November 6, 2012 General Election requiring, for taxable years beginning on or after January 1, 2013, corporate taxpayers to apportion using single-factor sales.² Accordingly, with three possible exceptions,³ current California law relegates payroll and property factor issues to obscurity. For example, a taxpayer with all of its manufacturing capacity (*i.e.*, 100% property) and all of its employees (*i.e.*, 100% payroll) outside of California, but with all of its sales assigned to California, will have a 100% California apportionment formula.⁴

continued on page 2

IN THIS ISSUE

- 1 **“Occasional Sales” and Single Sales Factor Apportionment in California**
By Eric J. Coffill
- 3 **Upcoming Speaking Engagements**
- 7 **State Taxation of Financial Institutions**
By Craig B. Fields and Nicole L. Johnson
- 10 **Applying the True Object Test to Determine the Taxability of Services Involving Telecommunications**
By R. Gregory Roberts and Rebecca M. Ulich
- 14 **Economic Nexus Curtailed—Again**
By Craig B. Fields, Mitchell A. Newmark and Richard C. Call
- 16 **New Incentives Replace California’s EZ Credits**
By Andres Vallejo

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Now, it is *all* about sales. If single-factor sales were not enough, for taxable years beginning on or after January 1, 2013, sales of other than tangible personal property are assigned for sales factor purposes based on a so-called “market” approach, instead of costs of performance.⁵ Also, recall that for taxable years beginning on or after January 1, 2011 California returned to a *Finnigan* approach under which all sales of a combined reporting group properly assigned to California will be included in the California sales factor, regardless of whether the member of the combined group making the sale is subject to California tax.⁶

The trend toward hyper-weighting the California sales factor—now to 100% sales beginning in 2013—continues to increase the tax value of that factor. There have been, and will continue to be, a wide variety of sales factor issues in California and all those issues now take on a heightened importance in terms of tax effect. One such issue, the inclusion in the sales factor of receipts from so-called “occasional sales,” is the subject of this article. As more fully discussed below, California Franchise Tax Board (“FTB”) Regulation 25137(c)(1)(A) generally provides that when substantial gross receipts arise from an occasional sale of a fixed asset or other property held or used in the regular course of the taxpayer’s trade or business, those receipts must be excluded from the sales factor.⁷

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Regulation 25137(c)(1)(A)

Regarding the preliminaries, the sales factor is a fraction, the numerator of which is the total sales of the taxpayer in California during the income year and the denominator of which is all gross receipts everywhere not allocated.⁸ Over the years, and often following in the footsteps of the Multistate Tax Commission, the FTB has promulgated a number of special regulations under the authority of California Revenue and Taxation Code⁹ Section 25137, which provides special rules for apportionment. Such special regulations are not to be taken lightly. If a relevant special formula is specifically provided in the FTB’s Section 25137 regulations (“25137 Regulations”) and the conditions and circumstances delineated in such a regulation are satisfied, the California State Board of Equalization (“SBE”) has held that the method of apportionment prescribed in that regulation shall be “the

standard” by which taxpayers and the FTB are to compute the taxpayer’s apportionment formula.¹⁰ In other words, once found to be applicable to the particular situation, 25137 Regulations “will control.”¹¹

The FTB has promulgated a number of special regulations under the authority of California Revenue and Taxation Code Section 25137, which provides special rules for apportionment.

The FTB’s special regulatory sales factor rules for so-called “occasional sales” are found in Regulation 25137(c)(1)(A),¹² which provides in full:

(A) Where substantial amounts of gross receipts arise from an occasional sale of a fixed asset or other property held or used in the regular course of the taxpayer’s trade or business, such gross receipts shall be excluded from the sales factor. For example, gross receipts from the sale of a factory, patent, or affiliate’s stock will be excluded if substantial. For purposes of this subsection, sales of assets to the same purchaser in a single year will be aggregated to determine if the combined gross receipts are substantial.

1. For purposes of this subsection, a sale is substantial if its exclusion results in a five percent or greater decrease in the sales factor denominator of the taxpayer or, if the taxpayer is part of a combined reporting group, a five percent or greater decrease in the sales factor denominator of the group as a whole.

2. For purposes of this subsection, a sale is occasional if the transaction is outside of the taxpayer’s normal course of business and occurs infrequently.

Accordingly, the key operative concepts under Regulation 25137(c)(1)(A) are: (1) substantial (vs. insubstantial) sales amounts; (2) from an occasional sale; (3) of a fixed asset or other property; (4) which is held or used in the regular course of the taxpayer’s trade or business.

“Substantial Amounts”

While “substantial amounts” is a key term long found in Regulation 25137(c)(1)(A), it was only defined therein by the FTB’s amendments to the regulation filed on January 30, 2001 and operative as of January 1, 2001.¹³ The 2001 amendments added the definition, now found in Regulation 25137(c)(1)(A)(1), that a sale is “substantial” if its exclusion results in a 5% or greater decrease in the taxpayer’s sales factor denominator or, if the taxpayer is part of a combined

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Upcoming Speaking Engagements

October 22 – 25

Council on State Taxation (COST)
44th Annual Meeting/Fall Audit Session
Phoenix, Arizona

- “Don’t Lose Your Case Before it Starts—Managing Compliance and Audits with a View Toward Appeals and Litigation”
Hollis L. Hyans
- “Top 10 Predictions of the Most Important State Tax Litigation & Legislative Issues Over the Next Few Years”
Andres Vallejo

October 30

20th Annual Paul J. Hartman Memorial State and Local Tax (SALT) Forum
Nashville, Tennessee

- “Top Ten Cases To Watch in State Taxation Today”
Hollis L. Hyans
- “Taxation of Services”
Andres Vallejo

November 3 – 6

The Institute for Professionals in Taxation
2013 Income Tax Symposium
Indian Wells, California

- “State Audit Trends—How to Prevail as the States Get More Aggressive”
Eric J. Coffill

November 7 – 9

2013 Annual Meeting of the California Tax Bar & The California Tax Policy Conference
San Jose, California

- “Behave? Ethics in State and Local Tax”
Eric J. Coffill
- “SALT Cases That Promise To Shake Up the Landscape”
Mitchell A. Newmark

November 19

New Jersey Society of CPAs
Multistate Tax Conference
Edison, New Jersey

- “Current Significant Developments in State and Local Taxation Across the Country”
Craig B. Fields and
Mitchell A. Newmark

November 20

Council on State Taxation (COST)
Mid-West Regional State Tax Seminar
Minneapolis, Minnesota

- “Discussion of State Tax Cases, Issues and Policy Matter to Watch—including Certain Federal Legislation”
Eric J. Coffill and Craig B. Fields
- “Latest Trends and Issues in Alternative Apportionment”
Mitchell A. Newmark and Andres Vallejo

December 12 – 13

New York University 32nd Institute on State and Local Taxation
New York, New York

- “Current California Tax Developments”
Eric J. Coffill
- “Due Process—Significant Current Issues”
Craig Fields
- “Alternative Apportionment”
Hollis L. Hyans
- “Current Unitary Tax Issues”
Philip M. Tatarowicz

January 20

2013-2014 Lieb/Preis State Tax Study Group for CPAs
Chatham, New Jersey

- “New Jersey Update”
Mitchell A. Newmark

January 28 – 29

23rd Annual Ohio Tax Conference
Columbus, Ohio

- “Current State of Alternative Apportionment”
Mitchell A. Newmark
- “Preventing & Handling Procedural Problems In Tax Matters”
Mitchell A. Newmark
- “Nexus ... Are *Bellas Hess* and *Quill* Still the Law? Is Amazon the New Test?”
Craig B. Fields

reporting group (*i.e.*, is unitary), a 5% or greater decrease in the sales factor denominator of the group as a whole. The FTB staff’s explanation for the creation of this 5% standard is that “this number reflects staff’s belief that a five percent change in the sales factor denominator is large enough to skew the sales factor in favor of the location of the occasional sale.”¹⁴ The FTB staff went on to explain the 5% calculation “recognizes that it is the clear reflection of the income of the entire unitary group that is in issue and therefore only a substantial change in the apportionment formula of the group as a whole should trigger the occasional sale throwout.”¹⁵ This intersection of apportionment and unitary theory means a unitary analysis is an essential component of an occasional sale analysis under the regulation.¹⁶

A unitary analysis is an essential component of an occasional sale analysis under the regulation.

Aside from the FTB “staff’s belief,” nothing in the regulatory history shows a reasoned basis for the arbitrary, bright-line 5% figure compared to, say, a 4%, a 6%, a 10% or a 20% figure. The FTB staff freely admits that even if the 5% threshold in the regulation is called into play, a taxpayer (or the FTB) still can show the regulation does not properly reflect its activities in California under Section 25137.¹⁷ This admission is consistent with the SBE’s decision in *Fluor Corporation*, which stated that any party wishing to deviate from the method prescribed in one of the 25137 Regulations, when found to be applicable, may do so upon establishing by clear and convincing evidence the regulation “does not fairly represent the extent of the taxpayer’s business activities” in California.¹⁸ Query, is it now easier or harder to demonstrate such fair/unfair representation when the sales factor is the *only* (*i.e.*, 100%) “business activity” used for apportionment, compared to when the regulation was first written at the time of an equally-

weighted (*i.e.*, 33%) three-factor formula or compared to when the regulation was amended to include the 5% threshold at the time of a double-weighted (*i.e.*, 50%) sales factor?

Another amendment the FTB made in 2001 was adding language to Regulation 25137(c)(1)(A) stating that sales of assets to the “same purchaser” in a single year will be aggregated to determine if the combined gross receipts is “substantial.” During the regulatory process, the FTB staff explained this additional language is meant to address transactions that are completed in several steps rather than as one transaction. Although the FTB stated the language is not meant to aggregate unrelated transactions and the reference to the “same purchaser” intentionally “is left without reference to either the single entity or a unitary group context,” the FTB also stated “it is proper to conclude that ‘purchaser’ should be construed to mean individual entity rather than a unitary group.”¹⁹ However, the FTB staff noted that if it appears that what otherwise would be a single sale has been intentionally spread by a taxpayer into multiple sales to multiple members of a purchaser’s unitary group “without a business purpose, the transactions could still be aggregated using a tax avoidance theory.”²⁰

The FTB staff noted that if it appears that what otherwise would be a single sale has been intentionally spread by a taxpayer into multiple sales to multiple members of a purchaser’s unitary group “without a business purpose, the transactions could still be aggregated using a tax avoidance theory.”

“Occasional Sale”

Another key component of Regulation 25137(c)(1)(A) is that, for it to apply, the gross receipts must be from an “occasional sale.” Prior to the FTB’s 2001 amendments, the precise language of Regulation 25137(c)(1)(A) read “an incidental or occasional sale.” The amendment struck “incidental” from the regulation. The FTB’s explanation for removing the term “incidental” during the regulatory process is that:

[S]taff feels the term is not in accord with the regulation’s requirement of substantiality. The term implies that a sale is thrown out if it is merely an afterthought of another transaction. Staff believes that such afterthought types of sale will never rise to the level of substantiality required to trigger the regulation.²¹

Regarding the meaning of “occasional” in the regulation, the 2001 amendments added Regulation 25137(c)(1)(A)(2), which provides that “[f]or purposes of this subsection, a sale

is occasional if the transaction is outside of the taxpayer’s normal course of business and occurs infrequently.”

What is intriguing about this added language in Regulation 25137(c)(1)(A)(2) is the FTB made no attempt to quantify the term “occasional” when revising the regulation. One might argue any such attempt at quantification would be futile as it would be unnecessarily arbitrary (*e.g.*, to create a bright-line that less than “X” number of sales within a tax year is “occasional”), but that same objection could be raised equally to the FTB’s addition of a 5% bright-line test of “substantial” receipts in Regulation 25137(c)(1)(A)(1). While sales/use tax is generally more a slave to rules than is the law regarding multistate corporate income tax apportionment, California sales tax law has long functioned on the general principle that less than three sales within a period of 12 months is “occasional.”²² Instead of quantifying what is an “occasional” sale, the 2001 amendments provide that an occasional sale is one that “occurs infrequently.” The 2001 regulatory history is essentially silent as to the rationale for adding the term “infrequently” or the meaning of that term. Thus, as with the “substantial” language in the regulation, the “occasional” standard requires a thoughtful analysis, on a case-by-case basis, taking into account a wide range of facts and circumstances.²³

Another significant component of the “occasional sale” analysis under the regulation is the language added in 2001 to Regulation 25137(c)(1)(A)(2) providing that “a sale is occasional if the transaction is outside of the taxpayer’s normal course of business . . .” The FTB explains that the definition of “occasional” in the regulation “is premised upon the regulation only applying to sales of property which are outside of the taxpayer’s normal course of business, but, when sold, still give rise to business income” and explains that this concept “is also a reflection of the so-called ‘functional test’ for business income contained in Revenue and Taxation Code section 25120 . . .”²⁴ The functional test is one of two alternative tests found in Section 25120 for business income and includes income from tangible and intangible property if the acquisition, management and disposition of the property constitute integral parts of the taxpayer’s regular trade or business operations.²⁵ What of the alternative transactional test, whose omission is conspicuous? While only explaining the language in terms of the functional test, the FTB’s position likely would be that a sale typically would not be an occasional sale if the gain from the sale was business income under the transactional test.

As with the “substantial” language in the regulation, the “occasional” standard requires a thoughtful analysis, on a case-by-case basis, taking into account a wide range of facts and circumstances.

“Fixed Assets or Other Property”

The last key issue presented under Regulation 25137(c)(1)(A) is what type of property is subject to the regulation. Prior to the amendments in 2001, the regulation expressly applied by its terms only to the sale “of a fixed asset,” which necessarily excluded sales of intangibles (*e.g.*, stock or goodwill). However, in 1997, FTB Legal Ruling 97-1 (“Ruling”) addressed the scope of the regulation and concluded that notwithstanding the fact the language referred only to a “fixed asset,” the regulation similarly also should apply to sales of intangible property because “there is no logical basis for distinguishing between fixed assets and intangibles.”²⁶ However, in apparent recognition of the fact this conclusion expanded the regulation beyond its express language, the Ruling did not purport to amend the regulation itself. Instead, the Ruling reached its conclusion to include intangibles “under authority of [Revenue and Taxation Code] section 25137”²⁷ In other words, the FTB looked to Section 25137 to impliedly write intangible property into the regulation.²⁸

The regulation similarly also should apply to sales of intangible property because “there is no logical basis for distinguishing between fixed assets and intangibles.”

As part of the 2001 amendments, the FTB modified the relevant language of Regulation 25137(c)(1)(A) from sale of a “fixed asset” to “fixed asset or other property” to conform to the conclusion reached in the Ruling. Indeed, while a number of other changes also were made at the time, it appears the driving purpose behind the 2001 amendments was to change the regulation to add the FTB’s position on including intangibles consistent with the Ruling.²⁹ In the same vein, the regulation was amended at that time to expand the examples of sales from “a factory” to “a factory, patent, or affiliate’s stock.” The FTB’s rationale for expanding the regulation to include sales of “other property” was the change reflected the FTB’s position set forth in the Ruling and “[t]here isn’t any logical basis for distinguishing between fixed assets and intangibles in the instant context.”³⁰ The FTB elaborated this same potential for distortion involving “other property” is “especially true if you’re talking about the growth of built-in appreciation, which occurs over a substantial period of time, because taking the gross receipt into account in the year of the recognition event does not reflect the gradual effects of appreciation over several years.”³¹

Interplay Between Section 25137 and Regulation 25137(c)(1)(A)

Note here, again, the continuing issue of the interplay between Section 25137 and Regulation 25137(c)(1)(A) addressing “occasional sales.” As explained above, the SBE’s decision in *Fluor Corporation* states the 25137 Regulations

create “the standard,” yet any party remains free to challenge the application of such a *regulation* under Section 25137. The FTB relied upon this principle and Section 25137 in issuing the Ruling. As also discussed above, the FTB recognizes taxpayers are entitled to take the same approach (*i.e.*, to challenge under Section 25137 the application of a 25137 Regulation). In taking such an approach (and one should always at least *consider* such an approach based upon the application of the regulation to a specific set of facts and circumstances), bear in mind the legal standards for obtaining relief under Section 25137. California law currently states that for a party (taxpayer or FTB) to invoke Section 25137, that party must satisfy a two-part burden of proving by “clear and convincing evidence” that (1) the approximation provided by the standard formula is not a fair representation and (2) the party’s proposed alternative is “reasonable.”³² California law also appears to currently state that Section 25137 only applies “where the particular function or activity is *qualitatively different* from the taxpayer’s principal business and the *quantitative distortion* from inclusion of the receipts of that function or activity . . . is substantial.”³³ However, it is important to bear in mind that the judicial decisional law setting forth these so-called “quantitative and qualitative” approaches all involved application of Section 25137 in the context of gross versus net receipts from various treasury operations. How the language of those decisions impact the application of Section 25137 in other contexts, such as challenging the application of the FTB’s “occasional sale” 25137(c)(1)(A) regulation, and how the merits of showing distortion are to be calculated outside the context of these treasury operation cases are interesting questions and are definitely a fruitful area for innovative thinking.

The SBE’s decision in *Fluor Corporation* states the 25137 Regulations create “the standard,” yet any party remains free to challenge the application of such a *regulation* under Section 25137.

Conclusion

Regulation 25137(c)(1)(A) is just one of many possible examples of issues long lurking in the sales factor computation and just one of many examples of such issues that now take on a heightened importance in terms of their growing potential tax effect under California’s new single-factor sales apportionment formula. Here, one must work through the vagaries of regulatory terms such as “occasional” and “infrequent,” as well as assess the composition of the unitary group. Then, one must consider whether the regulation should not apply in any event under the controlling statutory authority of Section 25137. As with many of such

California sales factor issues, careful *situational* application of this regulation, looking to the specific facts and circumstances of each case, is a sound and recommended practice. ■

- 1 Cal. Rev. & Tax. Code § 25128, as amended by Ch. 946, Laws 1993. There were a number of statutory exceptions to double-weighted sales (e.g., taxpayers that derived more than 50% of their gross business receipts from agriculture, extractive business activity, savings and loan activity or banking or financial activity).
- 2 Proposition 39, entitled the “California Clean Energy Jobs Act,” was approved by 61.1% of the voters in the General Election. California Secretary of State, Statewide Summary by County for State Ballot Measures, available at <http://www.sos.ca.gov/elections/sov/2012-general/ssov/ballot-measures-summary-by-county.pdf>, last accessed October 18, 2013. Proposition 39 also ended a brief period where, for taxable years beginning on or after January 1, 2010, a taxpayer could make an annual irrevocable election on an original return to apportion income using a single sales factor. See 2009 Budget Trailer Bills, SBX3 15, ABX3 15, Laws 2009. The election only was available to taxpayers otherwise subject to double-weighted sales. See Cal. Rev. & Tax. Code §§ 25128, as amended by Ch. 544, Laws 2009; 25128.5, as added by Ch. 17, Laws 2009.
- 3 The first exception continues to be that certain businesses by statute—taxpayers deriving more than 50% of their gross receipts from agriculture, extractive business activity, savings and loan activity or banking or financial activity—must continue to use an equally-weighted three-factor formula. Cal. Rev. & Tax. Code § 25128. The second exception is that taxpayers are always free to petition the FTB to use an alternative apportionment formula if use of a single sales factor does not “fairly represent the extent of the taxpayer’s business activity in this state” Cal. Rev. & Tax. Code § 25137. The third exception involves the pending litigation over a taxpayer’s ability to elect to use the equally-weighted three factor formula under the Multistate Tax Compact (“Compact”) as incorporated into California law. In *The Gillette Company and Subsidiaries v. Franchise Tax Board*, review granted January 16, 2013, S206587, the taxpayer contends the Compact (former Cal. Rev. & Tax. Code § 28008 *et seq.*) was a binding interstate compact and California is bound by its terms unless and until it withdraws from the Compact. Senate Bill No. 1015, enacted on July 27, 2012, purports to repeal the Compact in full on a prospective basis, but the validity of that repeal likely will be the subject of future litigation on the issue of whether such repeal required a two-thirds vote of the California Legislature.
- 4 One reasonably might question the constitutionality under Due Process and Commerce Clause grounds of an apportionment formula that gives no recognition to any value-generating activity of a taxpayer other than sales. The U.S. Supreme Court in *Container Corp. v. Franchise Tax Board* spoke of the need for fairness in the apportionment formula and how the traditional three-factor formula “has gained wide approval precisely because payroll, property, and sales appear in combination to reflect a very large share of the activities by which value is generated.” 463 U.S. 159, 183 (1983). Can it be said that the value of a business always, in all conceivable facts and circumstances, fairly can be measured by looking exclusively at sales activity? See *Hans Rees’ Son, Inc. v. North Carolina*, 283 U.S. 123 (1931). On the other hand, a single sales factor has passed Constitutional muster on at least one prior occasion. See *Moorman Mfg. Co. v. Bair*, 437 U.S. 267 (1978). Further thoughts on this topic will be the subject of a future article.
- 5 Cal. Rev. & Tax. Code § 25136.
- 6 Cal. Rev. & Tax. Code § 25135; see also *Appeal of Finnigan Corp.*, 88-SBE-022-A (Cal. State Bd. of Equal. Jan. 24, 1990). The impact of returning to a *Finnigan* approach is somewhat complicated by the fact that California, for taxable years beginning on or after January 1, 2011, adopted a so-called “factor presence test,” under which, for example, a corporation is doing business in California and taxable simply by having more than \$500,000 of California sales, even if it has no other connection to California and has no physical presence in California. Cal. Rev. & Tax. Code § 23101.
- 7 Cal. Code Regs. tit. 18 § 25137(c)(1)(A).
- 8 The statutory definition of “gross receipts” has changed significantly for taxable years ending on or after January 1, 2011 with respect to a variety of treasury functions, activities and investments. See Cal. Rev. & Tax. Code § 25120, as amended by Ch. 17 (SB 15), Laws 2009, 3d Extra. Sess.
- 9 Unless otherwise indicated, all statutory references herein are to the California Revenue and Taxation Code.
- 10 *Appeal of Fluor Corp.*, 95-SBE-016 (Cal. State Bd. of Equal. Dec. 12, 1995). To the author’s knowledge, there is no precedential California court decision on this issue.
- 11 *Id.*
- 12 Cal. Code Regs. tit. 18 § 25137(c)(1)(A).
- 13 Amendment of Cal. Code Regs. tit. 18 § 25137(c)(1)(A), filed Jan. 30, 2001 (Register 2001, No. 5).
- 14 Cal. Franchise Tax Bd., Staff Report and Recommendation on Proposed Amendments to Regulation 25137(c)(1)(A), Att. D, p. 1 (FTB Staff Report and Recommendation, Definitions For Regulation 25137(c)(1)(A) Text).
- 15 *Id.*
- 16 California courts have generally used two tests to determine whether related business entities are engaged in a unitary business. The first is the “Three Unities Test.” *Butler Bros. v. McColgan*, 17 Cal. 2d 664 (1941), *aff’d*, 315 U.S. 501 (1942). The second is the “Contribution or Dependency Test.” *Edison California Stores v. McColgan*, 30 Cal. 2d 472 (1947). These two tests are alternative methods for determining unity. *A.M. Castle & Co. v. Franchise Tax Bd.*, 36 Cal. App. 4th 1794, 1805 (1st Dist. 1995).
- 17 Cal. Franchise Tax Bd., Staff Report and Recommendation on Proposed Amendments to Regulation 25137(c)(1)(A), Att. D, pp. 1-2 (FTB Staff Report and Recommendation, Definitions For Regulation 25137(c)(1)(A) Text).
- 18 *Appeal of Fluor Corp.*, 95-SBE-016.
- 19 Cal. Franchise Tax Bd., Staff Report and Recommendation on Proposed Amendments to Regulation 25137(c)(1)(A), Att. A, p. 4 (Synopsis of Comments Received During the Regulation Hearing and Staff Responses and Recommendations).
- 20 *Id.*
- 21 Cal. Franchise Tax Bd., Staff Report and Recommendation on Proposed Amendments to Regulation 25137(c)(1)(A), Att. D, p. 2 (FTB Staff Report and Recommendation, Definitions For Regulation 25137(c)(1)(A) Text).
- 22 Cal. Code Regs. tit. 18 § 1595(a)(1). This California sales tax regulation referring to “occasional sales” states that for purposes of determining whether a seller must obtain a seller’s permit, “generally” a person who makes three or more sales for substantial amounts in a period of 12 months is required to hold a seller’s permit.
- 23 While no published, precedential decision has been issued (and is not anticipated), the SBE ruled recently that gross receipts from sales of 13 television stations by a diversified media company were not excluded from the sales factor under Regulation 25137(c)(1)(A) as occasional sales. *Appeal of Emmis Communications Corp.*, SBE Case No. 547964 Meeting of the Bd. of Equal. Transcript (June 11, 2013).
- 24 Cal. Franchise Tax Bd., Staff Report and Recommendation on Proposed Amendments to Regulation 25137(c)(1)(A), Att. D, p. 2 (FTB Staff Report and Recommendation, Definitions For Regulation 25137(c)(1)(A) Text).
- 25 See Cal. Rev. & Tax. Code § 25120; see also *Hoechst Celanese Corp. v. Franchise Tax Bd.*, 25 Cal. 4th 508, 520-26 (2001). The functional test for business income, as compared to the alternative so-called “transactional test,” focuses on the income-producing property and, in applying the functional test, the “critical inquiry” is the “relationship between this property and the taxpayer’s business operations.” *Id.* at 527 (internal quotations and citation omitted); see also *Jim Beam Brands v. Franchise Tax Bd.*, 133 Cal. App. 4th 514 (1st Dist. 2005).
- 26 Legal Ruling 97-1, Cal. Franchise Tax Bd. (Oct. 15, 1997).
- 27 *Id.*
- 28 This same approach was taken recently by the Arizona Department of Revenue, whose comparable regulation refers only to the sale of a “fixed asset.” The Arizona Department of Revenue found FTB Legal Ruling 97-1 “legally sound and persuasive” and concluded a taxpayer’s gross receipts from a (deemed) sale of assets, including goodwill, was excluded from the sales factor. Hearing Officer Decision, No. 201200235, Ariz. Dep’t of Rev. (May 31, 2013).
- 29 See Notice 99-3, Cal. Franchise Tax Bd. Request for Public Comment, Discussion Draft Addition to Regulation 25137(c) (Mar. 29, 1999); see also Cal. Franchise Tax Bd., Regulation Hearing of Proposed Title 18, California Code of Regulations Section 25137(c)(1)(A), Transcript of Proceedings, pp. 5-6 (May 8, 2000).
- 30 *Id.* at p. 6.
- 31 *Id.*
- 32 *Microsoft Corp. v. Franchise Tax Bd.*, 39 Cal. App. 4th 750, 765 (1st Dist. 2006).
- 33 *General Mills, Inc. v. Franchise Tax Bd.*, 208 Cal. App. 4th 1290, 1301 (2012), citing *Microsoft Corp. v. Franchise Tax Bd.*, 39 Cal. App. 4th 750, 766 (2006) and *Limited Stores, Inc. v. Franchise Tax Bd.*, 152 Cal. App. 4th 1491, 1498 (1st Dist. 2007) (emphasis in original).

STATE TAXATION OF FINANCIAL INSTITUTIONS

By Craig B. Fields and Nicole L. Johnson

Taxation of financial institutions is a complex and developing area. As the definitions of a “financial institution” are progressively broadened, a number of corporations are being subject to tax under these complex, and often inconsistent, laws. While bank taxation has never been a particularly uniform practice, there are increasingly difficult issues, including entity classification, nexus, apportionment, combined reporting and due process.

The extent to which states tax financial institutions has broadened due to the evolution of the federal and state bank regulatory regimes. Initially, national banks were immune from state taxation.¹ The power of states to tax national banks gradually expanded from the ability to tax real estate and shares of stock to the imposition of income-based taxes and, eventually, the ability to tax national banks and state-chartered banks equally.² Furthermore, the states’ ability to exercise jurisdiction has changed from only consisting of taxing banks having principal places of business within the state to also including banks having principal places of business outside the state.³ Finally, the definition of a financial institution has been expanded and can now include corporations that predominantly deal in money or moneyed capital, if that corporation competes with banks.⁴

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With these expansions, numerous questions arise regarding if, and how, a multistate financial institution should be taxed in each state. This article addresses the nexus and apportionment challenges in today’s landscape presented by the various state approaches. These issues affect traditional financial institutions, as well as other corporations that now fall within the expanded definitions.

Nexus

With the prevalence of Internet banking and the expansion of financial services offered by financial institutions and other corporations, the assertion of nexus on these entities is an ever-developing area. Prior to the allowance of interstate banking, the locations of a financial institution’s headquarters and its branches were typically the only locations in which the company was doing business and, therefore, subject to tax. However, the analysis is no longer that simple.

In the mid-1980s, the Multistate Tax Commission (“MTC”) undertook a project to draft uniform apportionment regulations for financial institutions.⁵ Along the way, draft regulations regarding nexus were added.⁶ The uniformity project was an attempt to balance the interests of “money-center states” and “market-center states.”⁷ The money-center states were those in which large financial institutions were domiciled.⁸ The market-center states were those in which the significance of customers in the state exceeded the number of financial institutions domiciled there.⁹ The money-center states, such as New York, were focused on taxing financial institutions where the lending decisions were made and the loan management occurred.¹⁰ The market-center states, such as Indiana, sought to tax the income that banks derived from residents of that state.¹¹

While the project was arguably successful in that uniform regulations were developed for the apportionment of income, as we discuss later, the draft nexus provisions were abandoned because it was felt that the nexus provisions could not be “effectively addressed” at that time.¹² With the states left to their own devices, a number of nexus approaches have developed that extend beyond the required physical presence.

Nexus—Economic Presence Standards

Almost 30 years ago, in 1985, the Tennessee Department of Revenue assessed J.C. Penney National Bank on the basis that it was doing business in the State, even though its activities in the State were limited to the solicitation of Tennessee customers.¹³ The Tennessee statute provided that a corporation was doing business in the State if it “[r]egularly engage[d] in transactions with customers in this state that involve intangible property, including loans, and result in receipts flowing to the taxpayer from within this state.”¹⁴ The Tennessee Court of Appeals declined to uphold the assessment when the Department could not point to any case “in which the Supreme Court of the United States has upheld a state tax where the out-of-state taxpayer had absolutely no physical presence in the taxing state.”¹⁵

In *Tax Commissioner of West Virginia v. MBNA America Bank, N.A.*, MBNA America Bank, N.A. (“MBNA”) offered unsecured credit cards to customers in West Virginia.¹⁶ MBNA had no tangible personal property or employees in West Virginia and solicited customers in the State by telephone and mail.¹⁷ The West Virginia Supreme Court of Appeals held that MBNA’s systematic and continuous solicitations and promotion in the State, combined with the significant gross receipts attributable to West Virginia customers was sufficient for the State to subject MBNA to tax.¹⁸

However, just what constitutes the necessary solicitation and promotion is unclear. What if email solicitations were sent to West Virginia residents? What if the solicitation occurred as part of a national advertising campaign that ran advertisements during a nationally televised broadcast?

Even the West Virginia Supreme Court of Appeals struggles with the nexus requirements. In *Griffith v. ConAgra Brands, Inc.*, the court distinguished *MBNA* and prohibited the West Virginia State Tax Commissioner from assessing a corporation that licensed intellectual property to related and unrelated parties.¹⁹ In addition, in his well-reasoned concurring opinion, Justice Benjamin sought to overrule *MBNA*.²⁰ Justice Benjamin argued that if *MBNA* is allowed to stand, it “will continue to linger like a dormant virus in our body of law, threatening to erupt into a full-blown infection.”²¹

Nexus—Presumptions

As initially attempted by the MTC in the draft regulations, some states have endeavored to create more bright-line tests to determine if a financial institution is subject to tax in the state. In Minnesota, absent a physical presence, there is a rebuttable presumption that a financial institution is subject to tax if it has assets and deposits attributable to sources within Minnesota that equal or exceed \$5 million or if it has 20 or more customers in the State.²²

However, even if a financial institution satisfies the presumption, there are arguments that the corporation’s connection to Minnesota would be insufficient under the U.S. Constitution. The Due Process Clause “requires some definite link, some minimum connection, between a state and the [corporation] it seeks to tax.”²³ A financial institution with only 20 customers in a state arguably does not satisfy that test.²⁴ Even though the Tennessee Court of Appeals held that J.C. Penney National Bank’s solicitation of credit cards for customers in Tennessee was sufficient to meet the Due Process Clause, that corporation had between 11,000 and 17,000 customers in Tennessee during the years at issue.²⁵

Another constitutional hurdle is the Commerce Clause, which requires that a corporation have “substantial nexus” with the taxing state.²⁶ Whether having only 20 customers under Minnesota’s presumption would pass that hurdle is challengeable.²⁷ Tennessee’s assessment against J.C. Penney National Bank, with over 500 times that amount of customers, failed to meet the necessary requirements of the Commerce Clause.²⁸

Provisions similar to Minnesota’s can be found in a number of states, including Kentucky and Tennessee. In Kentucky, a financial institution is presumed to be subject to the State’s franchise tax if it obtains or solicits business from 20 or more people within the State or if it has \$100,000 or more in receipts attributable to sources within Kentucky.²⁹

The Tennessee statute provides a number of activities under which a financial institution is presumed to be doing business in the State, including regularly soliciting business in the State and regularly soliciting and receiving deposits

from customers in the State.³⁰ However, the statute should be tempered by the Tennessee Court of Appeals decision that held that an out-of-state credit card bank could only be subject to tax in the State if it had a physical presence.³¹

Apportionment

Another continually developing area is the specialized apportionment provisions that states have enacted for financial institutions. In 1994, the MTC adopted proposed apportionment regulations for financial institutions.³² These provisions reflected the attempt to balance the interests of the money-center states and the market-center states. A number of states have enacted the MTC provisions (which some states have subsequently repealed) or enacted modified versions of the provisions.³³

Apportionment—Property Factor

Under the current MTC apportionment provisions for financial institutions, the assignment of loans in the property factor tends to incite the most angst between taxpayers and taxing authorities. In essence, loans are assigned to the regular place of business of the taxpayer with which the loans have a preponderance of “substantive contacts.”³⁴ The relevant factors for determining “substantive contacts” include solicitation, investigation, negotiation, approval and administration of the loans (“SINAA”).³⁵ The development of these factors shows acquiescence to the interests of the money-center states. Twenty years ago, the SINAA factors generally occurred at the headquarters location of a bank where most lending decisions were made. Indeed, prior to appearing in the MTC’s regulations, the SINAA factors were already part of New York’s taxing scheme for banks.³⁶ However, today the application of the SINAA factors is not so clear cut.

If customers apply for loans through a financial institution’s website, where did the solicitation of those loans occur? One possibility would be where the financial institution developed its advertising campaigns and maintained its website, typically at its headquarters. However, a state may argue that the location where the customer accessed the website is where the solicitation occurred.³⁷ Unfortunately, in today’s world it is no longer as simple as looking to where a postcard advertisement was mailed. And solicitation is only one of the five factors to analyze when determining the assignment of loans.

Financial institutions also face inconsistent provisions with respect to the property factor, as some states have enacted market-based sourcing provisions for the assignment of loans,³⁸ while other states exclude loans entirely from the property factor.³⁹ Financial institutions can easily get whipsawed by the competing interests of states under these provisions. For example, if a customer is located in Minnesota and the financial institution is located in Kentucky, the loan may be assigned to both states.⁴⁰

Apportionment—Sales Factor

As many states turn to a single sales factor formula to apportion income, issues abound with the assignment of receipts based upon the costs of performance. Commonly, different types of receipts are assigned to a state based upon the costs of performance. In Oregon, receipts that are not specifically enumerated are assigned to the location of the income producing activity, based on the costs of performance.⁴¹ For a financial institution, these receipts can include a variety of different fees, including late payment fees and overdraft fees.

If a customer in Oregon is charged late payment fees, in which state is the income producing activity related to those fees? Although it could be argued that the action that generated the fees was the customer's untimely payment, the customer's actions are not considered in the income producing activity analysis as the customer is not the taxpayer.⁴²

Furthermore, the determination of the costs of performance for each type of fee can be difficult. Are the costs of developing the program that automatically assessed the late payment penalty included? What about the costs of cashing the check that included the payment of the fee? In addition, there is a trend among states to apply market sourcing rules to assign certain receipts, even though costs of performance rules have been enacted by the state.⁴³

Conclusion

With the nuances that traditional financial institutions and other corporations face in the area of state taxation, it is important that the ever-changing landscape is monitored. The states are limited by the constraints of the U.S. Constitution in both the assertion of nexus and the apportionment of income. With the resurgence of the Due Process Clause in recent state tax cases, financial institutions and other corporations should analyze whether they have the necessary minimum contacts with a state, as well as the substantial nexus connections of the Commerce Clause. ■

1 *McCulloch v. Maryland*, 17 U.S. 316 (1819).

2 12 U.S.C. § 548.

3 See Hellerstein & Hellerstein, *State Taxation*, Part IV, Ch. 10 (2013).

4 Cal. Rev. & Tax. Code § 23183(a). "Money or moneyed capital" includes coin, cash, currency, mortgages, deeds of trust, conditional sales contracts, loans, commercial paper, installment notes, credit cards and accounts receivable. *Id.* at (b).

5 Final Report of Hearing Officer Regarding Proposed Multistate Tax Commission Formula for the Uniform Apportionment of Net Income From Financial Institutions (Apr. 28, 1994), available at http://www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/Uniformity/Uniformity_Projects/A_-_Z/Final%20HO%20Rpt%20FinInst.pdf.

6 *Id.*

7 *Id.* at p. 5.

8 *Id.* at p. 6.

9 *Id.*

10 *Id.*

11 *Id.* at pp. 3-4.

12 *Id.* at p. 22.

13 *J.C. Penney Nat'l Bank v. Johnson*, 19 S.W.3d 831, 833-34 (Tenn. Ct. App. 1999), *cert. denied*, 531 U.S. 927 (2000).

14 *Id.* at 835, *citing* Tenn. Code § 67-4-806(d)(2).

15 *Id.* at 842.

16 640 S.E.2d 226, 228 (W. Va. 2006).

17 *Id.*

18 *Id.* at 235-36.

19 728 S.E.2d 74 (W. Va. 2012).

20 *Id.* at 86 (Benjamin, J. concurring).

21 *Id.*

22 Minn. Stat. § 290.015, Subd. 2(a); *see also* Cal. Rev. & Tax. Code § 23101(b) (defining "doing business" as a number of different activities, including having "the lesser of five hundred thousand dollars (\$500,000) or 25 percent of the taxpayer's total sales" in the State).

23 *Quill Corp. v. North Dakota*, 504 U.S. 298, 312 (1992), *citing Miller Bros. Co. v. Maryland*, 347 U.S. 340, 344-45 (1954).

24 See Paul H. Frankel, Craig B. Fields and Richard C. Call, *The Due Process Clause as a Bar to State Tax Nexus*, 66 State Tax Notes 343 (Oct. 29, 2012).

25 *J.C. Penney Nat'l Bank*, 19 S.W.3d at 837, 840.

26 *Quill*, 504 U.S. at 312-13.

27 See *id.* at 311 (stating that the Court's prior decision in *Nat'l Bellas Hess, Inc. v. Dep't of Revenue Ill.*, 386 U.S. 753 (1967), "stands for the proposition that a vendor whose only contacts with the taxing State are by mail or common carrier lacks the 'substantial nexus' required by the Commerce Clause").

28 *J.C. Penney Nat'l Bank*, 19 S.W.3d at 842.

29 Ky. Rev. Stat. § 136.520.

30 Tenn. Code § 67-4-2105(d).

31 *J.C. Penney Nat'l Bank*, 19 S.W.3d at 831.

32 MTC Regs., available at http://www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/Uniformity/Uniformity_Projects/A_-_Z/FormulaforApportionmenttoNetIncomeFinInst.pdf, last accessed October 18, 2013.

33 See Ark. Code R. § 26-51-1404; Miss. Code § 27-7-24.5; N.H. Admin. Rules, Rev. 304-10; N. Mexico Code R. 3.5.19.17.

34 MTC Regs. § 4(g)(3).

35 *Id.*

36 NYCCR 19-6.2; Final Report of Hearing Officer Regarding Proposed Multistate Tax Commission Formula for the Uniform Apportionment of Net Income From Financial Institutions, pp. 47-48 (Apr. 28, 1994), available at http://www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/Uniformity/Uniformity_Projects/A_-_Z/Final%20HO%20Rpt%20FinInst.pdf.

37 Such a position, however, would ignore the fact that the definition of "solicitation" in the MTC formula refers to the regular place of business of the "taxpayer," not to any location of the customer. MTC Regs. § 4(g)(3)(A).

38 See Minn. Stat. § 290.191, Subd. 11.

39 See 1 Colo. Code Regs. 201-3.

40 Minn. Stat. § 290.191, Subd. 11(g) (assigning unsecured, consumer loans to the numerator of the property factor if the loans were made to residents of Minnesota); Ky. Rev. Stat. § 136.535(7)(b) (for a financial institution with its commercial domicile in the State, it is presumed that the preponderance of substantive contacts for loans are within the State).

41 Or. Admin. R. 150-314.280(N)(4)(a), referencing Or. Rev. Stat. § 314.665. In addition, it would likely be impossible for a financial institution to determine each customer's actions with such granularity.

42 "Income producing activity" is defined as "the transactions and activity directly engaged in by the taxpayer in the regular course of its trade or business for the ultimate purpose of obtaining gains or profit." Or. Admin. R. 150-314.665(4)(2).

43 See *Vodafone Ams. Holdings, Inc. v. Roberts*, No. 07-1860-IV (Tenn. Ch. Ct. Mar. 19, 2013). Other states have recognized the difficulties of assigning receipts based upon the costs of performance and have enacted market-based sourcing provisions. See Ohio Rev. Code § 5726.05 (effective January 1, 2014).

APPLYING THE TRUE OBJECT TEST TO DETERMINE THE TAXABILITY OF SERVICES INVOLVING TELECOMMUNICATIONS

By R. Gregory Roberts and Rebecca M. Ulich

Throughout the past 20 years, technological innovation has altered the way in which services are provided and has led to the development of an array of new service offerings. Nowhere has this rapid development been more apparent than in the telecommunications context. In an attempt to keep up with this ever-changing technology, many states amended their taxing statutes to define taxable telecommunications services as broadly as possible.¹ This combination of broadly worded taxing statutes and new service offerings has resulted in confusion and debate as to what constitutes a taxable “telecommunications” service. As in the past, the “true object” test has emerged as an effective means of addressing the issue in the sales and use tax context.

This article reviews recent federal case law and decisions in Tennessee and discusses how the analyses in these cases provide an effective means of determining whether a service is a taxable telecommunications service.

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The True Object Test

The true object test has long been applied in sales tax cases.² Traditionally, the test was applied to determine whether a sale involving both a service and an exchange of tangible personal property was taxable. As sales of services are generally nontaxable, the test was applied to determine whether the purchaser’s true object was the service or the tangible personal property. If the purchaser’s true object was the service, then the transaction would not be subject to tax, despite the fact that tangible personal property was transferred as part of the sale. Thus, when a lawyer drafts a contract or an accountant prepares a tax report, although the client receives a document that constitutes tangible personal

property, the transaction is considered to be a sale of a service rather than a sale of property because the client’s true object is the lawyer’s or accountant’s service.³ On the other hand, if the purchaser’s true object was to acquire the tangible personal property, the transaction would be subject to tax.⁴

Although the use of the true object test in the context of telecommunications services may be more complex and nuanced in its application than attempting to separate tangible goods from intangible services, courts have recognized that it is an analogous problem and, therefore, have shown a willingness to apply the test when confronted with the issue of whether a service is a taxable telecommunications service.⁵

Guidance from Federal Case Law

The U.S. Supreme Court’s analysis in *National Cable & Telecommunications Association v. Brand X Internet Services* provides a useful framework for analyzing and applying the true object test in the telecommunications context.⁶

In *Brand X*, the Court found that it was permissible for the Federal Communications Commission (“FCC”) to conclude that cable companies that sell broadband Internet services do not “offer” telecommunications services and, therefore, are not subject to regulation as common-carriers of telecommunications services.⁷

To reach its determination, the Court examined the FCC’s regulatory classification of broadband cable Internet service under the Communications Act, which defines “telecommunications carriers” and “information-service providers.”⁸ Telecommunications carriers are subject to regulation as common-carriers, while information-service providers are not.⁹ These two statutory classifications originated in the late 1970s from the FCC’s rules regarding data-processing services that were being offered over telephone wires.¹⁰ When the FCC developed rules to regulate those services, it distinguished between “basic” service (e.g., plain old telephone service) and “enhanced” service (e.g., computer-processing service that is offered over telephone lines), both of which were defined by reference to how the consumer perceived the service being offered.¹¹

In accordance with these definitions, the FCC issued a ruling concluding that broadband Internet service provided by cable companies was an “information service” but not a “telecommunications service.”¹² Although the FCC acknowledged that cable companies use “telecommunications” to provide consumers with Internet service, the FCC found that the question of whether the cable companies are “offering” telecommunications services turns on the nature of the functions that the end-user is offered and, thus, concluded that cable companies are not offering telecommunications services through their cable modem service because “[a]s provided to the end-user the telecommunications is part and parcel of cable modem service and is integral to its other capabilities.”¹³

The FCC found that the question of whether the cable companies are “offering” telecommunications services turns on the nature of the functions that the end-user is offered.

In reaching its decision, the Court noted that “[t]he question . . . is whether the transmission component of cable modem service is sufficiently integrated with the finished service to make it reasonable to describe the two as a single, integrated offering.”¹⁴ In the telecommunications context, the Court explained that “it is at least reasonable to describe companies as not ‘offering’ to consumers each discrete input that is necessary to providing, and is always used in connection with, a finished service.”¹⁵ Based on this reasoning, the Court upheld the FCC’s ruling because “[w]hat cable companies providing cable modem service . . . ‘offer’ is Internet service . . . —the finished service[], though they do so using (or ‘via’) the discrete components composing the end product, including data transmission. Such functionally integrated components need not be described as distinct ‘offerings.’”¹⁶

Thus, although *Brand X* did not involve a “true object” test, the Court’s focus on the integrated nature of the services offered and on the service that was actually offered to customers, and not on the discrete inputs necessary to provide the service, provides a helpful framework for analyzing similar issues in the sales and use tax context.

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Tennessee

Building on the analysis in *Brand X*, recent cases from the Tennessee Court of Appeals highlight not only the difficulty of determining the taxability of services that involve some aspect of telecommunications, but also the effectiveness of using the true object test to analyze the taxability of such services.¹⁷

Prodigy Servs. Corp. v. Johnson

In *Prodigy*, the Tennessee Court of Appeals found that Prodigy’s services, which enabled customers to (1) access information on Prodigy’s computers that were located in Tennessee and New York and (2) send and receive

e-mail through the Internet, were not subject to tax as telecommunications services.¹⁸

To access Prodigy’s services, Prodigy’s customers installed a software program on their computers.¹⁹ Through this program, Prodigy provided its customers with tax information, computer services and conversion services, which were accessed from Prodigy’s computers located in Tennessee and New York.²⁰ The software also included a link to the Internet, which allowed Prodigy’s customers to send and receive e-mail.²¹ Prodigy’s computers in Tennessee and New York were connected through telephone lines that were leased from common carriers or through services leased from other networks that had their own carrier capabilities or that sub-let to Prodigy the carrier capabilities leased from others.²²

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In reaching its decision, the court observed that Prodigy did not satisfy the State’s definition of a telecommunications service provider for regulatory purposes and, therefore, was not regulated as a public utility.²³ Further, the court stated that Prodigy would not be subject to federal regulation as a telecommunications service provider because the services Prodigy provided are “enhanced” services for federal purposes and, therefore, not considered telecommunications services.²⁴

Accordingly, the court concluded that “telecommunications services were not the ‘true object’ of the Prodigy sale, even if some of the services fit that definition” because: (1) Prodigy’s customers had to supply their own telephone service to access the information on Prodigy’s computers; (2) Prodigy used the telecommunications services as a means of connecting its computers in Tennessee to its computers in New York and, therefore, Prodigy was a consumer and not a provider of telecommunications services; and (3) although Prodigy’s software program allowed its customers to communicate via e-mail through the Internet, this capability is an “enhanced” service that does not come within the definition of a telecommunications service.²⁵

Level 3 Communications, LLC v. Roberts

In *Level 3*, the Tennessee Court of Appeals expanded on its analysis in *Prodigy* in applying the true object test to affirm the trial court’s decision that the true object of Level 3’s services (wholesale dial-up and wholesale broadband Internet services) were the provision of Internet access and

not taxable telecommunications services.²⁶

Level 3 provided two types of Internet services: (3)Connect Modem and (3)Crossroads.²⁷ Level 3's (3)Connect Modem was a wholesale dial-up Internet service and (3)Crossroads was a wholesale broadband Internet service.²⁸ Level 3's customers were retail Internet Service Providers (*e.g.*, EarthLink Communications and America Online) that purchased Level 3's services to enable end-users to access the Internet.²⁹ Level 3's services involved converting end-users' data into Internet Protocol as well as using Level 3's routers and switches at numerous gateways throughout the country.³⁰

In reaching its decision, the court explained that “[w]hen a company's activity does not easily fall into a clear category for tax purposes, Tennessee courts consider the ‘true object’ or ‘primary purpose’ of the company's business to determine whether the goods or services are taxable.”³¹

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Applying the true object test, the court found that Level 3's services were properly classified as enhanced services that are not subject to tax as telecommunications services.³² Citing *Prodigy*, the court explained that “enhanced services” include “the combination of basic service with computer processing applications to [(1)] act on the format, content, code, protocol or similar aspects of the subscriber's transmitted information, **or** [(2)] provide the subscriber additional, different or restructured information, **or** [(3)] involve subscriber interaction with stored information.”³³ As Level 3's services connected end-users “for the purpose of acting on the format, code, and/or protocol of a subscriber's transmitted information by converting their data into IP” and “used routers to get the subscriber's IP packets where they needed to go on the Internet,” the court concluded that Level 3's services were properly classified as enhanced services, which are not subject to tax.³⁴

Thus, despite “acknowledg[ing] that the Internet may involve a form of communication,” the court declined to find that “providing Internet access, or even a component of Internet access, falls within the definition of ‘telecommunications’ for purposes of the tax statute at issue.”³⁵

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IBM Corp. v. Farr

In *IBM*, the Tennessee Court of Appeals reversed the trial court's judgment and held that IBM's wide area network (“WAN”) service was not a taxable telecommunications service because the primary purpose of the WAN was to enable IBM's customers to access information and not to provide communication between users.³⁶

IBM provided WAN service to business customers in Tennessee.³⁷ The WAN was a technological infrastructure that linked the customers' computers so that information on the computers could be accessed remotely.³⁸ Before a customer's data could be stored on the WAN, IBM had to reformat the data so that it could be transferred through the WAN's transmission lines.³⁹ IBM's customers accessed the WAN by using a telephone line and a computer and paid IBM a fee for their use of the WAN.⁴⁰ IBM's customers could use the WAN to retrieve information related to their business but the WAN service had no messaging capabilities.⁴¹

In reaching its decision, the Court of Appeals reviewed its analyses in prior cases and concluded that it is “clear” that “the issue of whether a service is taxable as a telecommunications service does not turn on whether or not a service provides the transmission of information, but whether communication between users of the service was the primary purpose of the service.”⁴² Even where a service included some communication between users (*e.g.*, *Prodigy* and *Qualcomm*), where the communication was not the “true object” of the service, the court found that the service was not subject to tax as a telecommunications service.⁴³ The court also compared IBM's WAN service to *Prodigy's* Internet access service, as both services

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“connected geographically separated computers and allowed users to access information stored on those remote computers” and concluded that “IBM’s WAN service should not be treated differently for tax purposes from the services at issue in *Prodigy*, especially since Prodigy’s service permitted users to communicate with one another and IBM’s WAN service did not.”⁴⁴

Conclusion

As services are increasingly offered electronically over various telecommunications channels and as technology continues to not only change the manner in which services are provided, but also leads to the development of new and different services, analyzing and applying state statutes imposing tax on telecommunications services will become more and more difficult—and more and more important.

By focusing on the finished product offered and not on the discrete inputs that may be necessary to provide the service, the U.S. Supreme Court’s analysis in *Brand X* and the case law that has evolved in Tennessee provide a workable framework that can be used to evaluate and classify services involving telecommunications. ■

1 A common example of a broad definition of “telecommunications service” is a “communication by electric or electronic transmission of impulses” and includes a “transmission by or through any media, such as wires, cables, microwaves, radio waves, light waves, or any combination of those.” Tenn. Code § 76-6-102(a)(31) (2003); see also 72 Pa. Stat. § 7201(rr) (defining “telecommunications service” as “[a]ny one-way transmission or any two-way, interactive transmission of sounds, signals or other intelligence converted to like form, which effects or is intended to effect meaningful communications by electronic or electromagnetic means via wire, cable, satellite, light waves, microwaves, radio waves or other transmission media”).

2 See *Qualcomm, Inc. v. Dep’t of Revenue*, 249 P.3d 167, 172 (Wash. 2011) (noting that “[t]his test is a common one and has been applied in a number of jurisdictions for at least 30 years”).

3 See Hellerstein & Hellerstein, *State Taxation*, Part V, Ch. 12, ¶ 12.08 (2013).

4 See generally *id.*

5 See *Qualcomm*, 249 P.3d at 174 (applying the true object test after observing that, “[w]hile the case before us does not involve an attempt to separate tangible goods from intangible services, it presents an analogous problem” and noting that “[i]t is perhaps even more challenging to attempt a conceptual separation of purpose between providing information services and transmitting information than it is to distinguish whether the true object is a good or a service”); see also Massachusetts Letter Ruling 12-4 (May 7, 2012) (finding that a service that tracks calls and gathers information about customers, advertising programs and employees’ sales performance is not subject to sales tax because the object of the transaction is a telemarketing service and not a telecommunications service).

6 545 U.S. 967 (2005).

7 The issue in *Brand X* was whether the FCC’s ruling in *In re Inquiry Concerning High-Speed Access to the Internet Over Cable and Other Facilities*, 17 FCC Rcd. 4798, 4802-03, P9 (2002), was a permissible interpretation of the statute at issue. *Brand X*, 545 U.S. at 975. Applying the principles set forth in *Chevron U.S.A. Inc. v. NRDC*, 467 U.S. 837 (1984), to review agency interpretations of statutes, the Court concluded that the FCC’s ruling was a reasonable interpretation of an ambiguous statute. *Id.*

8 *Brand X*, 545 U.S. at 975.

9 *Id.*

10 *Id.* at 976.

11 *Id.*

12 *Id.*

13 *Id.* at 988.

14 *Id.* at 990.

15 *Id.*

16 *Id.* at 991. In reaching its decision, the Court explicitly notes that the FCC’s ruling “did not say that any telecommunications service that is priced or bundled with an information service is automatically unregulated” under the common carrier regulations, but rather that the FCC ruling “said that a telecommunications input used to provide an information service that is not separable

from the data-processing capabilities of the service and is instead part and parcel of the information service and is integral to the information service’s other capabilities is not a telecommunications offering.” *Id.* at 997 (internal quotations and citation omitted). Thus, the Court distinguishes its holding in *Brand X* from situations involving separable services or pricing. *Id.*

17 See *IBM Corp. v. Farr*, No. M2012-01714-COA-R3-CV, slip op. (Tenn. Ct. App. Sept. 24, 2013); *Level 3 Communications, LLC v. Roberts*, No. M2012-01085-COA-R3-CV, slip op. (Tenn. Ct. App. Sept. 20, 2013).

18 *Prodigy Servs. Corp. v. Johnson*, 125 S.W.3d 413, 415 (Tenn. Ct. App. 2003).

19 *Id.*

20 *Id.* at 415.

21 *Id.*

22 *Id.*

23 *Id.* For regulatory purposes, “telecommunications service provider” is defined as:

[A]ny incumbent local exchange telephone company or certificated individual or entity, or individual or entity operating pursuant to the approval by the commission of a franchise within § 65-4-207(b), authorized by law to provide, and offering or providing for hire, any telecommunications service, telephone service, telegraph service, paging service, or communications service similar to such services unless otherwise exempted from this definition by state or federal law. Tenn. Code § 65-4-101(c).

24 *Id.* at 418-19.

25 *Id.* at 419.

26 *Level 3*, slip op. at 6.

27 *Id.*

28 *Id.*

29 *Id.*

30 A “gateway” is “a point of interconnection where modems and routers are authenticated so that internet access can be provided to the end-users.” *Id.* at 4.

31 *Id.* at 9.

32 *Id.* at 11.

33 *Id.* (emphasis in original).

34 *Id.* at 11-12.

35 *Id.* at 12.

36 *IBM Corp.*, slip op.

37 *Id.* at 2.

38 *Id.*

39 *Id.*

40 *Id.*

41 *Id.* at 3.

42 *Id.* at 10, analyzing *Qualcomm Inc. v. Chumley*, No. M2006-01398-COA-R3-CV (Tenn. Ct. App. Sept. 26, 2007) (holding that Qualcomm’s service which determined the location and load status of Qualcomm’s customers’ trucks and collected data and made the information available to its customers, was not subject to tax as a telecommunications service because, although Qualcomm’s service also “undoubtedly contains the ability to transmit ‘free form’ text messages,” the court found that “acquiring this capability is not the principal aim of its purchasers”); *Bellsouth Telecomms., Inc. v. Johnson*, No. M2005-00865-COA-R3-CV (Tenn. Ct. App. Oct. 27, 2006) (applying the true object test in holding that charges for voice messaging services were taxable as telecommunications services because the true object was “to facilitate, albeit delayed, the transmission and receipt of a telephone communication”); and *Equifax Check Servs. v. Johnson*, No. M1999-00782-COA-R3-CV (Tenn. Ct. App. June 27, 2000) (finding that “[t]he purpose of the check guarantee services provided by Equifax to its Tennessee merchants was to approve or decline checks written by the merchants’ customers” and that, “[a]lthough this information was communicated via telecommunications, Equifax was not in the business of providing telecommunications services to the merchants . . . the telecommunications used to convey this information had no value to the merchant separate and apart from the check guarantee services provided by Equifax” and, therefore, the merchants’ true object in using Equifax’s services was not the telecommunications services). The Tennessee Court of Appeals also recently applied the true object test in *AOL, Inc. v. Roberts*, No. M2012-01937-COA-R3-CV, slip op. (Tenn. Ct. App. Aug. 12, 2013), in holding that AOL’s purchase of high-speed data transmission services from Sprint was taxable as a sale of telecommunications services. *Id.* at 9-10. In light of the other Tennessee cases discussed in this article, *AOL* appears to be an aberration and is difficult to reconcile with the court’s reasoning in *Level 3*.

43 *IBM Corp.*, slip op. at 10.

44 *Id.*

ECONOMIC NEXUS CURTAILED—AGAIN

By Craig B. Fields, Mitchell A. Newmark and Richard C. Call

Introduction

In a period of 18 months, courts in three states have refused to extend economic nexus approaches to the facts before them, despite prior decisions in those states finding that corporations without physical presence in the state were subject to tax. Most recently, it was the Indiana Tax Court that held, in a published and precedential decision on a motion for summary judgment, that physical presence is required for corporations to be subject to the Indiana corporate income tax and the Indiana premiums tax, which is imposed on insurance companies.¹

The Indiana Tax Court's decision in *United Parcel Service, Inc. v. Indiana Department of State Revenue* confirms that Indiana does not apply an economic nexus approach to corporate income tax.² The *UPS* decision distinguished the Indiana Tax Court's earlier decision in *MBNA America Bank, N.A. & Affiliates v. Indiana Department of State Revenue*, which applied an economic nexus approach to the Indiana financial institutions tax (discussed below).³ Corporations that have wondered whether the *MBNA* decision would apply to the Indiana corporate income tax now have an answer from the Tax Court. Further, the *UPS* decision demonstrates that the tide is changing in the nexus area as Indiana joins the list of states that have recently curtailed economic nexus. Courts are pushing back against economic nexus theories (as well as other nexus theories).⁴ As the list of states rejecting economic nexus grows, the U.S. Supreme Court may be more encouraged to take an economic nexus case.

The tide is changing in the nexus area as Indiana joins the list of states that have recently curtailed economic nexus.

UPS Refuses to Extend *MBNA* to Other Taxes in Indiana

Five years ago, in *MBNA*, the Indiana Tax Court addressed whether a corporation that issued credit cards to customers located in Indiana, but which itself had no physical presence in Indiana, could be subject to the financial institutions tax.⁵ “The stipulated facts in [the] case indicate[d] that, during the years at issue, MBNA had an economic presence in Indiana Thus, during the years at issue, MBNA had a substantial nexus with Indiana for purposes of the FIT [financial institutions tax].”⁶

Despite the *MBNA* holding confirming an economic presence test for the financial institutions tax, the *UPS* court held that “there is no tension between Indiana’s premiums tax and its

corporate income tax because each utilizes a physical presence standard.”⁷ “Furthermore, while this Court has found that an economic presence rather than a physical presence is a sufficient basis for imposition of the FIT, it cannot reach the same conclusion regarding Indiana’s premiums tax.”⁸

While based on statutory rather than Due Process Clause or Commerce Clause grounds, the Indiana Tax Court’s language in a published, precedential decision provides clarity to corporations as to the nexus standard for the corporate income tax and premiums tax, especially for corporations that were unsure of whether the economic nexus standard set forth in *MBNA* applied to the corporate income tax and premiums tax. When combined with the state court decisions discussed below and in our previous articles, *UPS* further demonstrates the changing tide in the state tax nexus area.⁹

Scioto Refuses to Extend *Geoffrey* in Oklahoma

In *Scioto Insurance Company v. Oklahoma Tax Commission*, we asserted that Oklahoma could not impose a corporate income tax on Scioto Insurance Company (“Scioto”) as a result of its licensing of intellectual property to a related party.¹⁰ Scioto was an insurance company organized under the laws of Vermont with no physical presence in Oklahoma. It licensed intellectual property to Wendy’s International, Inc. (“Wendy’s International”) pursuant to an agreement that was executed outside of Oklahoma. Wendy’s International then sublicensed the intellectual property to Wendy’s restaurants, including restaurants owned by third-party franchisees in Oklahoma.

In a May 2012 decision, the Oklahoma Supreme Court agreed with us. The court found no “basis for Oklahoma to tax the value received by Scioto from Wendy’s International under a licensing contract . . . no part of which was to be performed in Oklahoma.”¹¹ It further stated that “due process is offended by Oklahoma’s attempt to tax an out of state corporation that has no contact with Oklahoma other than receiving payments from an Oklahoma taxpayer . . . who has a bona fide obligation to do so under a contract not made in Oklahoma.”¹² The *Scioto* court’s decision was significant because it ruled on Due Process grounds and refused to extend to the facts before it a lower court’s prior decision in *Geoffrey, Inc. v. Oklahoma Tax Commission*, which found economic nexus for a foreign corporation based on the receipt of royalties from a payor that was physically present in Oklahoma.¹³

ConAgra Refuses to Extend *MBNA* in West Virginia

In *Tax Commissioner v. MBNA America Bank, N.A.*, the West Virginia Supreme Court of Appeals held that a corporation that issued credit cards to customers who were located in West Virginia could be subjected to tax despite not having a physical presence in West Virginia because the corporation had a “significant economic presence” in the State.¹⁴ However, in May 2012, in *Griffith v. ConAgra Brands, Inc.*, the court distinguished its earlier *MBNA* decision and refused to find that a corporation licensing intangible property that was displayed

on consumer products sold in the State was subject to the West Virginia corporate income tax.¹⁵ The corporation in *ConAgra* licensed intangibles to related and third-party manufacturers that (1) manufactured products bearing the licensed intangibles outside of West Virginia and (2) sold them to customers located in West Virginia.

The *ConAgra* court found for the corporation on Due Process Clause grounds and, alternatively, on Commerce Clause grounds. For Due Process Clause purposes, the court stated that tax assessments against a foreign licensor “on royalties earned from the nation-wide licensing of food industry trademarks and trade names [did not] satisf[y] ‘purposeful direction’ under the Due Process Clause.”¹⁶ The court alternatively reasoned that “assuming arguendo the elements of the Due Process Clause were satisfied, the assessments against ConAgra Brands would fail under the substantial nexus component of the Commerce Clause.”¹⁷

The Trend Continues in Taxpayers’ Favor

New Jersey is another example of a state court refusing to extend a prior economic nexus decision from its own state to different facts. In *AccuZIP, Inc. v. Director, Division of Taxation*, the New Jersey Tax Court distinguished the facts before it from a prior New Jersey decision permitting the imposition of tax on a company that had no physical presence in New Jersey.¹⁸ In so doing, the *AccuZIP* court reasoned that a corporation’s sales of computer software to customers located in New Jersey did not result in the corporation being subject to corporate income tax.¹⁹

The *AccuZIP* decision is also notable because the Tax Court refused to adopt the “significant economic presence test” set forth in the *MBNA West Virginia* decision. The Tax Court summarized the facts in *MBNA West Virginia* and stated: “The *significant economic presence test* applied in *MBNA* is not binding on this court.”²⁰ We note, however, that the New Jersey Division of Taxation’s published guidance disregards the Tax Court’s explicit ruling and states that the Division “appl[ies] the principles” of the West Virginia *MBNA* decision.²¹

Corporations should not assume that merely because a state has a case applying economic nexus that all assertions of economic nexus by a state taxing agency are appropriate or will be upheld by the courts.

Courts from other states, including Michigan,²² Tennessee²³ and Texas,²⁴ have ruled that a physical presence standard applies to the state’s corporate income tax. Additionally, in the last few years, we have seen courts rein in state taxing agencies’ assertions of nexus on other grounds as taxpayers have successfully challenged such assertions in various

courts.²⁵ These decisions demonstrate that nexus is a case-by-case inquiry based on specific facts and circumstances. Corporations should not assume that merely because a state has a case applying economic nexus that all assertions of economic nexus by a state taxing agency are appropriate or will be upheld by the courts.

The tide is turning. Given the states’ split decisions on economic nexus, the U.S. Supreme Court should, and may be more inclined to, hear the question of whether “substantial nexus” has the same meaning for sales and use tax purposes as for other taxes, although we believe that *Quill Corporation v. North Dakota* previously answered that question in the affirmative for all taxes.²⁶ We look forward to the continued development of this area of state tax. ■

Previously published in substantially similar form in State Tax Notes (Oct. 14, 2013).

- 1 *United Parcel Service, Inc. v. Indiana Dep’t of State Revenue*, No. 49T10-0704-TA-24, slip op. (Ind. Tax Ct. Sept. 16, 2013).
- 2 *Id.*
- 3 895 N.E.2d 140 (Ind. Tax Ct. 2008).
- 4 For further analyses of various nexus theories, see Craig B. Fields, Richard C. Call and Ted W. Friedman, “*Inherited Nexus*” and *Other Extreme Nexus Theories*, 69 State Tax Notes 27 (July 1, 2013); Paul H. Frankel, Craig B. Fields and Richard C. Call, *The Due Process Clause as a Bar to State Tax Nexus*, 66 State Tax Notes 343 (Oct. 29, 2012).
- 5 895 N.E.2d at 144.
- 6 *Id.*
- 7 *UPS*, slip op. at 6.
- 8 *Id.* The Department argued that “a foreign reinsurer need only show that it has a certificate of authority to satisfy the statutory ‘doing business’ requirement.” *Id.* at 7. The Tax Court rejected this notion. *Id.* at 7-8. We agree with the Tax Court’s rejection and do not believe that Due Process Clause minimum connection and purposeful availment or Commerce Clause substantial nexus are satisfied merely because a taxpayer has a certificate of authority or some other certificate to do business in a state.
- 9 See, *supra*, note 4.
- 10 279 P.3d 782 (Okla. 2012). Paul H. Frankel of Morrison & Foerster LLP argued the case before the Supreme Court of Oklahoma.
- 11 *Id.* at 783.
- 12 *Id.* at 784.
- 13 132 P.3d 632 (Okla. 2006).
- 14 640 S.E.2d 226 (W. Va. 2006).
- 15 728 S.E.2d 74 (W. Va. 2012).
- 16 *Id.* at 200 (emphasis added).
- 17 *Id.* at 200-01.
- 18 25 N.J. Tax 158 (N.J. Tax Ct. 2009) (finding *Lanco, Inc. v. Director, Division of Taxation*, 188 N.J. 380, 382 (2006), inapplicable to the facts presented).
- 19 *Id.*
- 20 *Id.* at 186 (emphasis in original).
- 21 New Jersey Division of Taxation, Technical Advisory Memorandum, TAM 2011-6 (Jan. 10, 2011).
- 22 *Guardian Indus. Corp. v. Dep’t of Treasury*, 499 N.W.2d 349 (Mich. App. 1993).
- 23 *J.C. Penney Nat’l Bank v. Johnson*, 19 S.W.3d 831 (Tenn. Ct. App. 1999).
- 24 *INOVA Diagnostics, Inc. v. Strayhorn*, 166 S.W.3d 394, 402 (Tex. App. 2005), citing *Rylander v. Bandag Licensing Corp.*, 18 S.W.3d 296 (Tex. App. 2000).
- 25 See, e.g., *State v. NV Sumatra Tobacco Trading Co.*, 403 S.W.3d 726 (Tenn. 2013); *In re Washington Mutual, Inc.*, 485 B.R. 510 (Bankr. D. Del. 2012).
- 26 504 U.S. 298 (1992).

NEW INCENTIVES REPLACE CALIFORNIA'S EZ CREDITS

By Andres Vallejo

In the June 17, 2013 edition of State Tax Notes, we published an article entitled *Not So EZ Anymore? The Tenuous State of California's Enterprise Zone Credit*, in which we concluded that California's enterprise zone ("EZ") credit program was vulnerable to significant, and possibly fundamental, changes.¹ On July 11, 2013, the Governor signed into law Assembly Bill 93 ("AB 93") and Senate Bill 90 ("SB 90"), which replace California's EZ credit program with three different economic development incentives.² This article describes the repeal of the EZ credit program and provides a broad overview of the new incentives, highlighting some of the differences between the new incentives and the prior EZ credits.

Repeal of the EZ Credits

Sections 23612.2 and 23622.7 of the California Revenue & Taxation Code (as in effect prior to January 1, 2014) provide EZ hiring credits and EZ sales credits to certain taxpayers operating in enterprise zones.³ In very broad terms, the EZ hiring credits permit taxpayers to take a credit against their franchise tax liability equal to a percentage of the wages paid to "qualified employees."⁴ To obtain these credits, the taxpayer must obtain vouchers from local vouchering agencies.⁵ The EZ sales credits permit taxpayers to take a credit against their franchise tax liability for sales and use taxes paid in connection with the taxpayer's purchase of "qualified property."⁶

As a practical matter, taxpayers should submit voucher applications to the local agencies as soon as possible to ensure their applications are processed by the January 1, 2015 deadline.

The EZ credits are complicated to administer and led to a significant amount of litigation. Moreover, there was concern that the credits were not accomplishing their goals of "stimulat[ing] business and industrial growth in the depressed areas of the state," creating a "strong, combined, and business-friendly incentive program to help attract business and industry to the state," helping to "retain and expand existing state business and industry" and creating "increased job opportunities for all Californians."⁷ The concern that the EZ credits were rewarding taxpayers for moving jobs from one part of California to another, or were otherwise benefiting employers that were not creating any new jobs in the State, appears to have come to a head when a local news story focused on two strip clubs that were taking advantage of the

EZ hiring credits without doing anything differently than they had done before the credits were available.⁸

As a result of these concerns, AB 93 and SB 90 were passed to repeal the EZ hiring and sales credits. The EZ hiring credit will only be permitted for qualified employees employed before January 1, 2014,⁹ with these employees being grandfathered in, such that they can still generate credits for their employers for their first five years of employment (even beyond January 1, 2014).¹⁰ The EZ sales credit will apply only to purchases of qualified property prior to January 1, 2014.¹¹ Although these EZ credits previously could be carried forward indefinitely, carryovers related to both credits now expire ten years after the later of the first taxable year beginning on or after January 1, 2014 or the taxable year in which the credit was earned.¹²

Unfortunately, AB 93 and SB 90 are silent as to when employers have to apply to the vouchering agencies to receive vouchers with respect to employees hired prior to January 1, 2014. For this reason, enterprise zones began taking conflicting positions as to the date by which employers had to submit voucher applications to receive the EZ hiring credits for employees hired before January 1, 2014.¹³ Rather than simply remedying this issue by permitting vouchering agencies to receive certifications through a particular date and then allowing the vouchering agencies the time they need to process the applications, Assembly Bill 106, signed by the Governor on September 26, 2013, attempts to remedy the issue by permitting the local agencies to "accept applications for the certification and to issue the certifications up to but no later than January 1, 2015."¹⁴ Of course, by using the same deadline for submitting and approving the voucher applications, this "remedy" only postpones the problem and will require vouchering agencies to set their own dates by which applications must be submitted so that the applications can be processed by January 1, 2015. As a practical matter, taxpayers should submit voucher applications to the local agencies as soon as possible to ensure their applications are processed by the January 1, 2015 deadline.

New Incentive Programs

AB 93 and SB 90 provide three new incentive programs designed to "refocus those tax incentives on creating new, good jobs within those zones and within other areas of the state suffering from high rates of unemployment and poverty," "make California more competitive in attracting new business to the state" and provide California with a tool "to attract and retain high-value employers."¹⁵ The new incentives consist of: (1) a much narrower hiring credit; (2) a partial statewide sales tax exemption on manufacturing and biotechnology purchases; and (3) a program in which taxpayers can negotiate with the State for individual tax credits based on certain enumerated criteria. The sections that follow provide a broad overview of these incentives, focusing on some of the differences between these incentives and the EZ hiring and sales credits.

New Hiring Credit

Like the EZ hiring credit, the hiring credit promulgated by AB 93 and SB 90 permits certain taxpayers to take a credit against their franchise tax liability equal to a percentage of the wages paid to “qualified employees.”¹⁶ However, the new hiring credit differs in a number of respects, for the most part making it more difficult for employers to qualify for the credit. Many of the differences appear intended to remedy perceived issues with the EZ hiring credit (e.g., “sexually oriented businesses,” including strip clubs, are expressly denied eligibility for the new hiring credit).¹⁷ Other differences appear designed to remedy issues that were litigated with respect to the EZ hiring credit (e.g., the “tentative credit reservation” required to be obtained from the Franchise Tax Board (the “FTB”) to obtain the new hiring credit expressly does not constitute a determination by the FTB of eligibility for the new hiring credit, tracking the decision in *Dicon Fiberoptics, Inc. v. Franchise Tax Board*¹⁸ regarding the effect of the vouchers that are required to be obtained from the local agencies to receive the EZ hiring credit).¹⁹ Still other differences appear designed to further to the goals described above. The following list identifies some of the notable differences between the new hiring credit and the prior EZ hiring credit:

- The new credit applies only to qualified full-time employees, whereas the EZ hiring credit applied to both part-time and full-time employees.²⁰
- The new hiring credit is not limited to work performed in former enterprise zones (or LAMBRAs), but also applies to work performed in designated census tracts.²¹
- Unlike the EZ hiring credit, the new hiring credit is limited to taxpayers with an increase in full-time employees in California during the year and the amount of the credit is calculated by reference to such increase.²²
- The new hiring credit inhibits the shifting of jobs from one area of the State to another solely to obtain the credit by requiring most taxpayers to provide to each employee at the original location an offer of employment at the new location with comparable compensation.²³
- Unlike the EZ hiring credit, which could be claimed on an amended return as long as the statute of limitations was open, the new hiring credit must be claimed on a timely filed original return.²⁴
- The new hiring credit generally applies only to otherwise qualified employees that earn at least 150% of minimum wage (currently \$12 per hour).²⁵
- The new hiring credit applies to far fewer categories of employees, including only: (1) employees unemployed

for the prior six months; (2) veterans separated from service within the last year; (3) recipients of the federal earned income credit; (4) ex-offenders previously convicted of a felony; and (5) recipients of CalWORKs or general assistance.²⁶

- The new hiring credit’s carry-forward period is limited to five years.²⁷

As noted above, the majority of these changes make the new hiring credit more difficult to obtain than the EZ hiring credit. However, unlike the EZ hiring credits that could only be used as credits against income attributable to the enterprise zone, the new hiring credits can be used against all of the taxpayer’s income.²⁸

Partial Sales Tax Exemption

Rather than providing a credit against franchise tax liability for sales and use taxes paid in connection with the taxpayer’s purchase of qualified property, AB 93 and SB 90 enacted a sales and use tax exemption for the State portion of sales and use taxes (currently 4.1875%)²⁹ otherwise due on purchases of certain qualified tangible personal property after July 1, 2014.³⁰ In broad terms, the exemption applies to purchases by certain entities of property used in manufacturing, processing, refining, fabricating, recycling or research and development.³¹ As with the EZ sales credit (as interpreted by *Taiheiyō Cement U.S.A., Inc. v. Franchise Tax Board*),³² the partial sales and use tax exemption applies only to property with a useful life of at least one year.³³ The partial exemption is capped at \$200,000,000 of purchases of qualified property and does not apply to property that, within one year from the date of purchase, is removed from California or is converted to a non-qualifying use.³⁴ Unlike the EZ sales credit, the partial sales tax exemption is not limited to property used within an enterprise zone.³⁵

In broad terms, the exemption applies to purchases by certain entities of property used in manufacturing, processing, refining, fabricating, recycling or research and development.

To obtain the partial sales and use tax exemption, the purchaser must provide the retailer with an exemption certificate that includes the date, the signature of the purchaser (or the purchaser’s agent or employee), the purchaser’s seller’s permit number (or a notation that the purchaser is not required to hold a seller’s permit), a description of the property purchased and an explanation of why the exemption applies.³⁶

Negotiated Incentive Program

In addition to the new hiring credit and the partial sales tax exemption, AB 93 and SB 90 establish a fund that can be used to provide negotiated credits against taxpayers' franchise tax liability for tax years beginning on or after January 1, 2014.³⁷ In allocating the fund to individual taxpayers, the State committee responsible for negotiating the credit must take the following factors into consideration: (1) the number of jobs the taxpayer will create or retain in the State; (2) the compensation paid or proposed to be paid by the taxpayer to its employees; (3) the taxpayer's investment in California; (4) the extent of unemployment or poverty in the area in which the taxpayer's project/business is proposed to be located; (5) the other incentives available to the taxpayer in California and outside California; (6) the duration of the proposed project and how long the taxpayer commits to remain in California; (7) the overall economic impact of the proposed project or business; (8) the strategic importance of the taxpayer's project or business to the State, region or locality; (9) the opportunity for future growth and expansion in California by the taxpayer's business; and (10) the extent to which the anticipated benefit to California exceeds the projected benefit to the taxpayer from the tax credit.³⁸ The credit may be carried over for six years.³⁹ ■

1 See Andres Vallejo and Scott M. Reiber, *Not So EZ Anymore? The Tenuous State of California's Enterprise Zone Credit*, 68 State Tax Notes 915 (June 17, 2013).

2 A number of other credits and incentives were also repealed or not continued, including incentives related to local agency military base recovery areas ("LAMBRAs"), targeted tax areas and manufacturing enhancement areas. This article focuses on the EZ hiring and sales credits applicable to corporations.

3 Unless otherwise indicated, all statutory references herein are to the California Revenue and Taxation Code.

4 Cal. Rev. & Tax. Code § 23622.7.

5 Cal. Rev. & Tax. Code § 23622.7(c).

6 Cal. Rev. & Tax. Code § 23612.2.

7 Cal. Gov't Code § 7071(a) and (b).

8 See Kelly Phillips Erb, *As Strip Clubs Pocket Tax Dollars, Lawmakers Target Tax Credits*, Forbes Online (June 4, 2013), available at <http://www.forbes.com/sites/kellyphillips/2013/06/04/as-strip-clubs-pocket-tax-dollars-lawmakers-target-tax-credits/>.

9 Assembly Bill 106 ("AB 106"), signed by the Governor on September 26, 2013, clarifies that the employee must actually have commenced employment prior to January 1, 2014 to be eligible for the credit. AB 106, § 4.

10 Cal. Rev. & Tax. Code § 23622.7(l)(2).

11 AB 93 and SB 90 limited the EZ sales credit to purchases of equipment that was placed in service before the enterprise zone becomes inoperative (*i.e.*, before January 1, 2014). Senate Bill 100 ("SB 100"), signed by the Governor on September 26, 2013, revises this to permit the EZ sales credit for purchases of qualified property prior to January 1, 2014, as long as it is placed in service before January 1, 2015. SB 100, § 10.

- 12 Cal. Rev. & Tax. Code §§ 23622.7(i) and (j)(4), 23612.2(d). Because these provisions are not particularly clear with respect to when the ten-year period commences, AB 106 provides more express authority that the ten-year period for existing credits commences in the first taxable year beginning on or after January 1, 2014 and the ten-year period for credits earned in taxable years beginning on or after January 1, 2014 begins with the taxable year after the taxable year in which the credit is earned. AB 106, § 6(a).
- 13 See, e.g., *Pasadena Enterprise Zone Program Ends Dec. 31, 2013* (Aug. 8, 2013), available at <http://www.ci.pasadena.ca.us/EkContent.aspx?theme=Navy&id=8589937584&bid=0&style=news>, (requiring applications to be submitted by November 20, 2013); *Status of San Diego Regional Enterprise Zone*, available at http://www.chulavistaca.gov/Business/PDFs/EZ%207_13_13%20Status.pdf, last accessed October 18, 2013 (requiring applications to be submitted by December 31, 2013); *Update on Enterprise Zone Program As of 9/18/2013*, available at <http://www.sanjoesea.gov/DocumentCenter/View/19246> (requiring applications to be submitted by December 20, 2013).
- 14 AB 106, § 1.
- 15 AB 93, § 1(d), (e) and (f).
- 16 Cal. Rev. & Tax. Code § 23626.
- 17 Cal. Rev. & Tax. Code § 23626(b)(11)(C)(v). Other categories of employers are also excluded in most cases, including temporary help services, retail trade services and providers of food services, among others. *Id.* at § 23626(b)(11)(C).
- 18 53 Cal. 4th 1227 (2012).
- 19 Cal. Rev. & Tax. Code § 23626(e). Taxpayers must request this tentative credit reservation within 30 days of complying with the Economic Development Department's new hire reporting requirement. *Id.* The FTB has published a list of information that must be submitted to obtain the tentative credit reservation. *New Employment Credit – Frequently Asked Questions*, available at https://www.ftb.ca.gov/businesses/Economic_Development_Incentives/New_Employment_Credit.shtml, last accessed October 18, 2013.
- 20 Cal. Rev. & Tax. Code § 23626(a)(1).
- 21 *Id.*
- 22 Cal. Rev. & Tax. Code § 23626(a)(2) and (b)(2).
- 23 Cal. Rev. & Tax. Code § 23626(a)(3).
- 24 Cal. Rev. & Tax. Code § 23626(a)(4).
- 25 Cal. Rev. & Tax. Code § 23626(b)(10)(A)(ii); *New Employment Credit – Frequently Asked Questions*, available at https://www.ftb.ca.gov/businesses/Economic_Development_Incentives/New_Employment_Credit.shtml, last accessed October 18, 2013.
- 26 Cal. Rev. & Tax. Code § 23626(b)(10)(A)(vi).
- 27 Cal. Rev. & Tax. Code § 23626(j).
- 28 Cal. Rev. & Tax. Code §§ 23622.7(j) and 23626(a)(1).
- 29 *Manufacturing Exemption*, available at http://www.boe.ca.gov/sutax/manufacturing_exemptions.htm, last accessed October 18, 2013.
- 30 Cal. Rev. & Tax. Code § 6377.1.
- 31 Cal. Rev. & Tax. Code § 6377.1(a).
- 32 204 Cal. App. 4th 254 (2d Dist. 2012).
- 33 Cal. Rev. & Tax. Code § 6377.1(b)(7)(B)(i).
- 34 Cal. Rev. & Tax. Code § 6377.1(e)(1).
- 35 *Manufacturing Exemption*, available http://www.boe.ca.gov/sutax/manufacturing_exemptions.htm, last accessed October 18, 2013.
- 36 Cal. Rev. & Tax. Code § 6377.1(c); *Manufacturing Exemption*, available at http://www.boe.ca.gov/sutax/manufacturing_exemptions.htm, last accessed October 18, 2013.
- 37 Cal. Rev. & Tax. Code § 23689.
- 38 Cal. Rev. & Tax. Code § 23689(a)(2).
- 39 Cal. Rev. & Tax. Code § 23689(e).

This newsletter addresses recent state and local tax developments. Because of its generality, the information provided herein may not be applicable in all situations and should not be acted upon without specific legal advice based on particular situations. If you wish to change an address, add a subscriber or comment on this newsletter, please write to Rebecca M. Ulich at Morrison & Foerster LLP, 1290 Avenue of the Americas, New York, New York 10104-0050, or email her at rulich@mof.com, or write to Jenny Choi at Morrison & Foerster LLP, 400 Capitol Mall, Sacramento, California 95814, or email her at jennychoi@mof.com.

ABB v. Missouri
Albany International Corp. v. Wisconsin
Allied-Signal, Inc. v. New Jersey
AE Outfitters Retail v. Indiana
American Power Conversion Corp. v. Rhode Island
Citicorp v. California
Citicorp v. Maryland
Clorox v. New Jersey
Colgate Palmolive Co. v. California
Consolidated Freightways v. California
Container Corp. v. California
Crestron v. New Jersey
Current, Inc. v. California
Deluxe Corp. v. California
DIRECTV, Inc. v. Indiana
DIRECTV, Inc. v. New Jersey
Dow Chemical Company v. Illinois
Dupont v. Michigan
EchoStar v. New York
Express, Inc. v. New York
Farmer Bros. v. California
General Motors v. Denver
GMRI, Inc. (Red Lobster, Olive Garden) v. California
GTE v. Kentucky
Hair Club of America v. New York
Hallmark v. New York
Hercules Inc. v. Illinois
Hercules Inc. v. Kansas
Hercules Inc. v. Maryland
Hercules Inc. v. Minnesota
Hoechst Celanese v. California
Home Depot v. California
Hunt-Wesson Inc. v. California
IGT v. New Jersey
Intel Corp. v. New Mexico
Kohl's v. Indiana
Kroger v. Colorado
Lorillard Licensing Company v. New Jersey
McGraw-Hill, Inc. v. New York
MCI Airsignal, Inc. v. California
McLane v. Colorado
Mead v. Illinois
Meredith v. New York
Nabisco v. Oregon
National Med, Inc. v. Modesto
Nerac, Inc. v. New York
NewChannels Corp. v. New York
OfficeMax v. New York
Osram v. Pennsylvania
Panhandle Eastern Pipeline Co. v. Kansas
Pier 39 v. San Francisco
Powerex Corp. v. Oregon
Reynolds Metals Company v. Michigan
Reynolds Metals Company v. New York
R.J. Reynolds Tobacco Co. v. New York
San Francisco Giants v. San Francisco
Science Applications International Corporation
v. Maryland
Scioto Insurance Company v. Oklahoma
Sears, Roebuck and Co. v. New York
Shell Oil Company v. California
Sherwin-Williams v. Massachusetts
Sparks Nuggett v. Nevada
Sprint/Boost v. Los Angeles
Tate & Lyle v. Alabama
Toys "R" Us-NYTEX, Inc. v. New York City
Union Carbide Corp. v. North Carolina
United States Tobacco v. California
UPS v. New Jersey
USV Pharmaceutical Corp. v. New York
USX Corp. v. Kentucky
Verizon Yellow Pages v. New York
Wendy's International, v. Illinois
Wendy's International v. Virginia
Whirlpool Properties v. New Jersey
W.R. Grace & Co.—Conn. v. Massachusetts
W.R. Grace & Co. v. Michigan
W.R. Grace & Co. v. New York
W.R. Grace & Co. v. Wisconsin

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