"Shaking things up in state and local tax"

SUTHERLAND SALT SHAKER

FORECAST
Legislative storm expected; chance of rate increases and combined reporting.

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IRS Un*restrained*, Proposes New Taxpayer Disclosure

On January 26, 2010, IRS Commissioner Douglas Shulman unveiled a new initiative that would require business taxpayers to report uncertain tax positions on their annual tax returns. According to Announcement 2010-9 (Jan. 26, 2010), corporations and other business taxpayers with total assets in excess of $10 million would be required to disclose uncertain tax positions that reflect U.S. federal income tax reserves determined under FIN 48 or other similar accounting standards. The initiative would require disclosure of a position for which a financial statement tax reserve must be established, as well as any other position for which no such tax reserve is required because either, the taxpayer expects to litigate the position, or the taxpayer has determined that the IRS has a general administrative practice not to examine the position. Umm, wow.

In the Announcement, the IRS claims that it will continue its current policy of restraint regarding requests for tax accrual workpapers during the course of examinations, although it reminds taxpayers that it has authority to compel the production of such information under *United States v. Arthur Young*, 465 U.S. 805, 815 (1984). The IRS plans to issue proposed regulations and may seek legislation imposing a penalty for failure to file a schedule or to make adequate disclosure. The IRS intends to publish the new schedule as quickly as possible and has invited public comments on the initiative to be submitted by March 29, 2010. Will state departments of revenue take the position that they have the authority to follow suit without state legislation? We will be watching.

Washington State Proposes Anti-Abuse Legislation

The Washington State Legislature currently is considering House Bill 2970 and Senate Bill 6714, which, with all the subtlety of a Mid-Atlantic snowstorm, would change the way the Washington Department of Revenue enforces the tax laws. HB 2970 and SB 6714 give the Department the authority to invalidate "abusive tax avoidance transactions" and to assess a 35% penalty on the additional tax obligation if a taxpayer is found to have engaged in abusive tax avoidance. An abusive tax avoidance transaction is defined as any transaction that lacks economic substance. The total Washington State penalties imposed on perceived abusive transactions could reach 60% (or more).

This legislation would create uncertainty for companies doing business in the state. There are provisions of HB 2970 directing the Department to adopt rules explaining its interpretation of an "abusive tax avoidance transaction," but the uncertainty that is sure to exist in the interim is likely to hinder major corporate investment in the state. This legislation is worth watching – stay tuned.

California Single Sales Factor Interested Parties Meeting

The California Franchise Tax Board (FTB) held an interested parties meeting on January 28, 2010 to discuss the implementation of the new single sales factor (SSF) election. For tax years beginning on or after January 1, 2011, corporate taxpayers may annually elect to use an SSF apportionment formula in lieu of California's three-factor (with double-weighted sales factor) apportionment formula. The FTB held the interested parties meeting to hear from the business community and practitioners regarding the challenges and concerns relating to the implementation of the new law. Some of the issues raised at the meeting included:

- How will the taxpayer make an SSF election?
- Are entities part of a unitary group permitted to make the election on an individual basis?
- Should there be a presumption that the election continues in effect unless changed?
- How will the annual election impact changes to a unitary business group during a tax year?
- How will the annual election impact changes to a unitary business group resulting from an audit?
- How would the SSF election impact NOL carryforwards or carrybacks?

While the interested parties meeting raised more questions than it provided answers, the FTB indicated that it has interpreted the statutory language to permit only one election for all members of a unitary combined group.

The FTB and participants had quite a lively debate about the practical aspects of how the SSF election will be implemented. Much of the discussion centered around whether the election would be a separate form (i.e., the water's-edge election form) or part of the current apportionment form (Schedule R). The FTB plans to prepare for circulation an analysis that will include examples of the ways it proposes to resolve the issues raised during the interested parties meeting.

Join Sutherland at the UPPO Annual Conference

The Sutherland SALT practice hopes you will join us at the Unclaimed Property Professionals Organization's (UPPO) annual conference on March 8-10 in Orange County, California. We are pleased to sponsor this event, which will include presentations by Sutherlanders Diann Smith, on "Determining When You Need Counsel or Other Experts," and Matthew Hedstrom, on "Business to Business, Other Exemptions and When to Use Them." To register, please visit http://www.uppo.org/?page=2010AnnualConf and be sure to mention Sutherland in the "How Did You Hear About Us?" field so that UPPO can notify us that you will be there.

Intangibles in the Property Factor

On January 14, 2010, the New York Division of Tax Appeals issued a determination in *In re Meredith Corporation*, Case No. 822396 (N.Y. Div. of Tax Appeals, Jan. 14, 2010). The Administrative Law Judge held that Meredith – an Iowa corporation engaged in publishing and television broadcasting with no stations located in, or broadcasting into, New York – could not include in its property factor payments for satellite signals made pursuant to licensing agreements. The Administrative Law Judge relied on *In re Disney Enterprises*, Case No. 818378 (N.Y. Tax Appeals Tribunal, Oct. 13, 2005), *confirmed* 830 N.Y.S.2d 614 (N.Y. App. Div. 2007), *aff'd on other grounds* 859 N.Y.S.2d 87 (N.Y. 2008), to determine that the value of an intangible asset cannot be included in the property factor even if the value of that intangible asset derives from tangible personal property.

California FTB Holds Hearing on Costs of Performance

On January 13, 2010, the California Franchise Tax Board (FTB) held a hearing regarding proposed amendments to Cal. Reg. § 25136. Essentially, the changes would amend Cal. Reg. § 25136 to allow for activities conducted by third parties to be included in taxpayers' California costs-of-performance analysis and calculations. Commentators raised questions regarding the effective date of the regulation changes, which is currently not specified. The spokesperson for the FTB stated that it is the FTB's position that the effective date would be January 1, 2008; however, they would investigate whether it could be earlier in response to comments. Other commentators asked for clarification on: (1) changes made to the definition of income-producing activity, (2) additional information on how the FTB would view situations where the taxpayer contracts with a third party and that person subcontracts the service, and (3) clarification on specific language in the examples. The FTB indicated that they would research each of the issues raised and provide written responses addressing all the points. Thus, additional feedback from the FTB is expected very soon.

SALT PET OF THE MONTH

Mark's Oliver

Oliver, named after the Dickens character, was rescued in Atlanta and made the move up to New York after law school (he didn't attend, but his owners did). Quickly adapting to city life, Oliver enjoys daily visits from his dog walker, meeting new dogs, and regular trips to "his" country house in Connecticut for some R&R. Long rumored to be part-Chow, part-Black Lab, a recent Doggie DNA test revealed "Oliver's Twist"– he has a far more elaborate heritage and is half-Chow, half-mix of Lab, Boxer, Jack Russell Terrier, and Poodle. While smart enough to figure out how to open doors, Oliver has unfortunately focused all of his intellectual prowess on one goal: obtaining people food. In this endeavor he is remarkably successful and is, as a result, one happy Sutherland SALT pet.

Recently Seen and Heard

January 20, 2010
Georgia Mining Association and Georgia Industry Association One Day Tax Seminar
Jonathan Feldman on Sales and Use Taxation of Manufacturing in Georgia Past and Present

January 24-29, 2010
COST 2010 Basics School
Jonathan Feldman on Jurisdiction to Tax
Charlie Kearns on Streamlined Sales Tax – Changing the Landscape

January 25-26, 2010
TechAmerica State Government Affairs 2010 Winter Meeting
Steve Kranz on State Taxation

January 28-29, 2010
19th Annual Ohio Tax Conference
Eric Tresh on Multistate Sales and Use Taxation of Outsourced Services With Technology Components

January 29, 2010
National Conference of State Legislatures Task Force on State and Local Taxation of Communications and Electronic Commerce
Steve Kranz on Taxation of Digital Products, Streamlined Sales and Use Tax Governing Board Update, and Main Street Fairness Act

February 2-3, 2010
Governing Outlook in the States and Localities
Steve Kranz on Taxing Business

February 4-5, 2010
National Multistate Tax Symposium
Marc Simonetti on "Sales Factor" With Regard to State Apportionment Issues
Jeff Friedman on Pending State Tax Legislation

February 5, 2010
Tax Analysts Conference on State Taxes on Internet Sales: Are "Amazon" Laws the Answer?
Steve Kranz on the tax policies and constitutionality of state laws intended to tax Internet vendors

Down the Rabbit Hole With the MTC and Sourcing of Services and Intangibles

A transcript of the two recent teleconferences in which Multistate Tax Commission (MTC) representatives considered revisions to UDITPA § 17 would rival the dialogue in a Lewis Carroll book. As Miss Alice said: "It would be so nice if something would make sense for a change." The MTC Income and Franchise Tax Subcommittee recently discussed the possible options for changing the current § 17 rule to a "market" based standard. The problem is that defining "market" and the words that could be used to define "market" is akin to grabbing Jell-O. The Subcommittee's conversation twisted around concepts such as where the benefit is received; where the customer is located; whether the customer received the service where the benefit of the service is received; whether the place of use of a trademark is where the ultimate consumer buys a trademarked good – even when the trademark owner has licensed the mark to a third party and may not even know the end consumer; and what the definition of "is" is. (Okay, we made that last one up.) To give the participants credit, defining "market" for purposes of sourcing services and intangibles has befuddled people for decades – the international tax community is struggling with the same issue and the issue for sales tax purposes contributed to the demise of Florida's attempt to broaden its tax base. The MTC subcommittee intends to have another teleconference to discuss the § 17 amendment alternatives on February 17th at 2:00 p.m. Eastern time.

The risk to taxpayers is that the MTC (and state legislatures) will use vague terms such as "use," "benefit received" and "location of the taxpayer" without actually defining what those terms mean. Without real, meaningful definitions, the stakeholders will think everyone is talking about the same thing, but the actual geographical source envisioned will always be in the eye of the beholder (or more precisely, the enforcer).

What this confusion surely teaches us is that sometimes simplicity is more than worth the cost of perfection. The current income-producing activity rules and costs of performance standard can surely be more easily defined than "market" through reference to existing accounting and financial standards. And, even if the state legislatures determine that a switch to a market concept is necessary in today's economy, a simple set of rules based on records the taxpayer already keeps in the regular course of business – such as customer billing address – may be the best solution. Returning to another Lewis Carroll character: "What is the use of repeating all that stuff, if you don't explain it as you go on? It's by far the most confusing thing I ever heard!" (The Mock Turtle – which, appropriately, is a character based on a British soup made up of animal parts usually thrown away.)

Oklahoma!

In his 2011 Budget Proposal, Oklahoma Governor Brad Henry revealed his intent to begin a "compliance initiative" aimed at collecting sales tax on Internet, telephone or mail-order sales by out-of-state businesses without a presence in Oklahoma, essentially overriding the *Quill* physical presence standard. The Governor appears to be taking this position sans authorizing legislation. The budget includes $95 million in the General Revenue Fund from this initiative. Meanwhile, back at the Legislature, the Oklahoma House of Representatives is considering House Bill 2716, which creates the "Unconstitutional Interstate Taxation Prevention Unit" aimed at protecting Oklahoma businesses from taxation by other states "in a manner inconsistent with the Due Process or the Commerce Clause" of the U.S. Constitution. The bill goes so far as to mandate that this newly created Unit file an action on behalf of an Oklahoma taxpayer against an offending state to prevent that state "from enforcing or attempting to enforce the unconstitutional tax." Ironically enough, this is the very thing the Governor is proposing to do to companies located outside of Oklahoma.

Panelists Debate Click-Through Nexus Laws

On Friday, February 5, Tax Analysts sponsored a roundtable discussion on "State Taxes on Internet Sales: Are 'Amazon' Laws the Answer?" Four panelists headed the lively debate focused on whether click-through nexus laws or the Streamlined Sales and Use Tax Agreement provides the appropriate solution. Scott Peterson, Michael Mazerov, and Sutherlander Steve Kranz agreed that the Streamlined Sales and Use Tax Agreement was the better approach. George Isaacson disagreed, voicing concern over the lack of a one-rate-per-state requirement in the Agreement.

Of great significance during the debate was Michael Mazerov's expressed view that click-through nexus laws could be constitutionally applied to companies who sell via television and telecommunication providers. In the context of interactive television sales, Mazerov stated that nexus is created with an out-of-state advertiser by the in-state presence of an unrelated video service provider – a concept Kranz referred to as "couch potato nexus." Mazerov further opined that nexus with an out-of-state company might be created by an in-state, third-party telecommunications provider if the out-of-state company uses the telecommunications provider to generate phone call sales on a commission basis. Going further still, he said that nexus for an out-of-state retailer might be created by magazines and other publications, which offer mail-in postcard product ordering systems on a commission basis. In fact, Mazerov opined that when any in-state entity is compensated on a commission basis, nexus is likely created for the out-of-state retailer. It is safe to say that if a state were to adopt Mazerov's couch potato nexus, telecom nexus or magazine nexus positions, the business community surely will challenge these aggressive nexus positions.

Oregon Update – The Maximum Minimum Tax

As an update to our article "Oregon Considering Tax Rate Hikes That Would Apply Retroactively," in last month's edition of the *SALT Shaker*, Oregon voters have approved ballot measures that will increase the corporate income tax rate, the personal income tax rate, and the minimum tax on corporations. The rate increases apply retroactively with all changes effective for tax years beginning in ***2009***. The corporate minimum tax, which had been $10, is now based upon a sliding scale that ranges from $150 to $100,000, depending on the sales of the filing group. The top corporate tax rate is increased by 1.3% to 7.9%, and the top marginal rate for personal income tax is increased to 11%, resulting in Oregon having one of the highest personal income tax rates in the nation.

While, as we discussed last month, this retroactive tax increase may satisfy procedural due process, it will create added complexity for financial reporting purposes. What remains to be seen, as states dig deeper into sofa cushions for more revenue, is whether this retroactive tax increase is a one-time act of desperation or the beginning of a trend.

Come See Us

February 10, 2010
TEI Westchester/Fairfield Chapter Boot Camp
Stamford, CT
Marc Simonetti on State Combined Reporting

February 22-24, 2010
COST Sales Tax Conference and Audit Session
Westin Gaslamp – San Diego, CA
Steve Kranz on Electronic Commerce and the Taxation of Digital Products

February 24, 2010
TEI New York Chapter State Taxation Update
Westin at Times Square – New York, NY
Michele Borens and **Mark Yopp** on Nexus
Jeff Friedman and **Matthew Hedstrom** on Combined Reporting
Marc Simonetti and **Richard Call** on Managing State Tax Audits In Challenging Times
Pilar Mata and **Charlie Kearns** on Recent State Tax Legislation and Cases

March 8-10, 2010
2010 Unclaimed Property Professionals Organization (UPPO) Annual Conference
Hyatt Regency Orange County – Orange County, CA
Diann Smith on Determining When You Need Counsel or Other Experts
Matthew Hedstrom on Business to Business, Other Exemptions and When to Use Them

March 24, 2010
American Bar Association/Institute for Professionals in Taxation Advanced Sales and Use Tax Seminar
The Ritz-Carlton – New Orleans, LA
Steve Kranz on State Tax Treatment of Bad Debts and Limitation of Remedies

April 8-9, 2010
DC Bar 2010 Judicial and Bar Conference
Ronald Reagan Building – Washington, DC
Steve Kranz on Don't Get Lost: Navigating an Income or Sales Tax Dispute Through the D.C. Administration and Courts

April 11-14, 2010
TEI 60th Midyear Conference
Grand Hyatt – Washington, DC
Join us at the **Sutherland reception** from 6:30-8:30 p.m. on Monday, April 12

May 20-21, 2010
33rd Annual Advanced State & Local Tax Institute
Georgetown University Law Center – Washington, DC
Marc Simonetti on The Troubled Economy: Losses, Debt, Restructuring, Cancellation of Indebtedness Income, Conformity – A State & Local Tax Perspective

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