"Shaking things up in state and local tax"

SUTHERLAND SALT SHAKER

FORECAST
Chance of nexus litigation, followed by sunny skies and continued warming.

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New York Corporate Tax Reform

New York State released a draft report on February 26, 2010 of major corporate tax reform that would overhaul the State's current corporate tax structure. The intent of this bill is to be revenue neutral. Following are some of the "highlights" of the 300+ page bill.

Several of the changes relate to expanding the scope of the Article 9A Corporate Franchise Tax – which is the "general" corporate tax. First, Article 32, which imposes the state franchise tax on banks, would be eliminated and banking institutions would then be taxed under Article 9A. In addition, New York State would become a "full" mandatory unitary combined reporting state. New York historically has been a separate company state with combination applied by the state or taxpayer who could prove a unitary relationship and "distortion." In recent years, the state expanded the instances in which combination applies by requiring it if a taxpayer had substantial intercorporate transactions (regardless of distortion). The proposal to adopt "full unitary combined reporting" (as imposed by California and other states) would complete New York's shift away from separate company reporting. Further, the state would adopt economic nexus and assert taxing jurisdiction over corporations not physically present in New York. In addition, the New York combined group would be expanded to include alien (non-U.S.) corporations that have federal taxable income, eliminating the exist-

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MTC Winter Meetings – Irony, Intense Discussion, and a New Project

The Multistate Tax Commission (MTC) concluded its Winter Meetings with two significant developments – draft amendments to sourcing of other than tangible personal property, and a new project to adopt a model affiliate nexus statute for online retailers.

Sourcing of Service and Intangible Receipts

Section 17 of the Uniform Division of Income for Tax Purposes Act (UDITPA) requires that receipts from sales other than sales of tangible personal property are sourced based on costs-of-performance (COP). Several state departments of revenue have argued that COP is not the best method to source these receipts and have undertaken an effort to replace COP with a market-based method. The MTC has taken on this cause and has recommended drafting a revision to section 17.

The MTC's current draft section 17 sources services to a state "to the extent the service is delivered to a customer location in [a] state" and sources intangibles "to the extent the intangible property is used by the payor in [a] state." The proposal also contains a "throwout" rule, which the business community rejects as a flawed apportionment method. Further, the current draft statute fails to define key terms, leaving unanswered questions such as: What do "delivered to," "customer," "customer location," and "use" mean? How are consulting services provided by multistate companies to multistate companies sourced?

Ultimately the MTC made some changes to the draft to allow for proportional sourcing and to address "drop shipment" issues. In addition, the MTC agreed to ask the drafting group to define "use" for intangibles.

Sales and Use Tax Nexus

The MTC decided to undertake a project to draft a model affiliate nexus statute that is a combination of New York's click-through nexus law and Colorado's newly enacted disclosure regime for non-nexus sellers (see article in this issue of *Shaker*).

The National Conference of State Legislatures has expressed concerns about this MTC project, in part due to concerns that this type of legislation undermines the efforts to implement the Streamlined Sales and Use Tax Agreement and federal legislation. Further, the constitutionality of these expansive state statutes is being challenged in court and further litigation is expected.

Consistent Reporting of Business Income – Oregon's *Oracle*

In *Oracle Corp. v. DOR*, TC-MD 070762C (Or. Tax Feb. 11, 2010), the Oregon Tax Court ruled that a taxpayer was not under a duty to report business/non-business positions consistently and was not estopped from claiming that certain income was non-business income in Oregon, but business income in California.

The taxpayer claimed that income from gains on the sales of stock and other corporate assets constituted non-business income for Oregon tax purposes. Or. Admin. R. 150-314.615-(A) requires a multistate taxpayer to disclose inconsistent treatment of business/non-business income in all Multistate Tax Compact Member States in which it is tax-

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New York Corporate Tax Reform *(cont.)*

ing prohibition against including alien companies in a New York combined return.

Some of the other notable changes affect the calculation of the Article 9A Corporate Franchise Tax by eliminating the exemption and by requiring subsidiaries to be included in the combined group. The apportionment of the tax base would be based upon a single sales factor, rather than on the existing three-factor formulas. The sourcing of sales for sales factor purposes would be determined using a market-based sourcing methodology. At the same time, a potential benefit to taxpayers is that the state net operating loss carry-forward would no longer be limited to the taxpayer's actual federal NOL deduction. While many of the tax changes discussed above would likely produce a tax increase, the proposal would attempt to heal some of those wounds by reducing the tax rate from the existing 7.1% to 6.5%.

Finally, it is important to note that there are no proposed changes to the alternative tax provided for under Article 9A that is imposed on a taxpayer's capital base. This tax imposes a 0.15% tax on the unitary group's capital base subject to a $10 million maximum.

The proposal specifies an effective date of January 1, 2011 for the entire bill, including the changes described above.

Consistent Reporting of Business Income – Oregon's *Oracle (cont.)*

able. The Department of Revenue (DOR) argued that the taxpayer failed to disclose that it claimed business income on the gains for California tax purposes and therefore violated a duty of consistent reporting required by the regulation. The DOR also argued that estoppel applied to prevent the taxpayer from claiming inconsistent positions.

The Oregon magistrate rejected the DOR's contentions for a number of reasons, including: the DOR's regulation would require the court to become an expert in the tax laws of multiple states; there are differences among states' laws; the DOR's position would result in limiting the DOR's ability to disagree with the treatment of income by another state; and estoppel was inapplicable.

There is a recent trend by states to require taxpayers to disclose tax positions taken in other states. This case provides solid rationale for arguing that such requests are irrelevant – states do not apply their laws consistently and taxpayers should not be expected to file tax returns consistently.

SALT PET OF THE MONTH

Scott's Collie – Caldwell

Caldwell was selected to join the Wright family and become a Sutherland SALT pet because he was the most spirited and unruly of Collie pups in his litter. He is a loyal companion for Scott's six-year-old daughter Shelby – following her everywhere and sleeping at the foot of her bed, and patiently waiting for the many snacks she feeds him. Caldwell has pulled "Lassie duty" on several occasions, most notably when he shepherded her away from the street when Shelby struck out on an outdoor adventure at age three. Caldwell has his priorities straight – he is quick to leap fences to chase squirrels and climb rock ledges during family hikes, but is dependent upon Scott to lift all 90 pounds of him when getting him into the car.

Recently Seen and Heard

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 when to bring in counsel or other experts in unclaimed property matters
Matthew Hedstrom on business-to-business exemptions, other exemptions, and when to use them

Colorado TABOR Ruling

The Colorado Court of Appeals recently held that a statutory tax rate increase was prohibited pursuant to the Colorado Taxpayer's Bill of Rights (TABOR), despite a state Attorney General's opinion upholding its constitutionality. *Colorado Mining Association v. Huber*, ___ P.3d ___, 2010 WL 547638 (Ct. App. 2010). The lower court had determined that the statutory adjustment to the coal severance tax rate was neither a "tax rate increase" nor a "tax policy change" and thus was not covered by TABOR. The Court of Appeals reversed, holding that a statutory formula requiring a tax increase was prohibited without the TABOR-prescribed voter approval even though the statute was in effect prior to the adoption of TABOR.

The statute at issue (C.R.S. § 39-29-106(5)) was enacted in 1977 and imposed a tax on the "severance" of coal from the earth. Rather than directly imposing a tax rate, the statute set forth a formula requiring that for every one and one-half percent change in the producer price index, the severance tax rate shall be adjusted by one percent. When the TABOR amendment to the constitution was added in 1992, the Department of Revenue (DOR) determined that TABOR precluded any further increases in the severance tax rate without voter approval and maintained that policy until 2008. However, in response to Attorney General Formal Opinion No. 07-01, which concluded that adjusting the tax rate according to a pre-TABOR statutory formula was not a violation of TABOR, the DOR imposed an increase in the severance tax rate from $0.54 to $0.76 per ton. The Colorado Mining Association challenged the new rate as constitutionally forbidden.

The Court of Appeals applied a "simple syllogism" to determine that TABOR was violated by the statutory rate adjustment: (1) TABOR prohibits increasing tax rates without voter approval; (2) applying the statutory formula increased the coal severance tax rate; therefore, (3) TABOR was violated. Notably, the court found it insignificant that the formula was statutorily imposed prior to the enactment of TABOR because "the future tax burden had not even been determined prior to TABOR." It also found unpersuasive the DOR's argument that the increase was the result of external factors out of the government's control. This case serves as a reminder to taxpayers that significant weight should not be placed on all state authorities, including attorney general opinions. Rather, an evaluation of the authority is required to determine its relevance and significance.

Michigan *New* Filing Requirements for Single Member LLC That Apply *Retroactively*

On February 5, 2010, the Michigan Department of Treasury ("Department") issued a Notice explaining the effect of *Kmart Michigan Prop. Servs LLC v. Dep't of Treasury*, 283 Mich. App. 647 (Mich. Ct. App. 2009), *lv. denied*, 772 N.W.2d 421 (Mich. 2009), where the Michigan Court of Appeals found that a single member limited liability company (SMLLC) that is disregarded for federal income tax purposes must be treated as a separate taxable entity for purposes of the former Michigan Single Business Tax (SBT). The *Kmart* decision effectively overturned the Department's position taken in Revenue Administrative Bulletin 1999-9 (RAB 99-9) that SMLLCs treated as disregarded entities for federal income tax purposes would be treated in the same manner for SBT purposes.

In the Notice, the Department concludes that precedence requires to give judicial decisions full retroactive effect even if such decisions are contrary to the Department's own guidance. Therefore, all previously disregarded SMLLCs that followed RAB 99-9 and filed as a division of the owner for SBT purposes, must now file a separate SBT return for all open tax periods. Since previously disregarded entities are considered non-filers for statute of limitations purposes, returns must be filed for all tax years (potentially going back to the SBT's introduction in 1997) for which the previously disregarded entity exceeds the filing threshold. All required returns must be filed by September 30, 2010.

Unclaimed Property Is Always Claimed…. By the State (Not the Federal Government)

Recently, the U.S. District Court for the District of New Jersey, *Rousseau v. United States Department of the Treasury*, 2010 WL 457702 (D.N.J. Feb. 5, 2010), ruled that the states did not have jurisdiction to sue the federal government seeking $15 billion of unredeemed savings bonds as unclaimed property.

In 2004, when New Jersey's State Treasurer became aware of the vast amount of unclaimed savings bonds being held by the U.S. Department of the Treasury. The state's contention was that U.S. savings bonds that have reached maturity but have not been claimed are unclaimed property and should be turned over to the states. Various states joined the lawsuit in an attempt to recover the unclaimed bonds, including Oklahoma, Kentucky, Missouri, Montana and Pennsylvania.

The U.S. Treasury argued that the states' unclaimed property laws do not apply to the unclaimed bonds because the bonds program "is a primary constitutional function of the United States, and the States' attempts to regulate it are barred by the Supremacy Clause." Accordingly, the Treasury filed a motion to dismiss.

In granting the U.S. Treasury's motion to dismiss, the court concluded that the states' involvement would "impermissibly interfere" with contracts between the United States and the owners of the bonds. Interestingly, the judge also noted the states' unclaimed property laws impose "onerous record-keeping and reporting requirements," in addition to civil and criminal penalties that would "impermissibly regulate" the U.S. Treasury notwithstanding the availability of state immunity provisions.

The recent order granting the U.S. Treasury's motion to dismiss is likely only the first shot fired as the states have already filed a notice of appeal. As the case moves forward, there will be important constitutional issues to consider, such as issues associated with the Supremacy Clause, preemption, and governmental immunity.

Colorado's New Sales Tax Reporting Requirements Come With a Whopping Penalty!

In an effort to encourage (or some might say "force") out-of-state retailers to register to collect and remit Colorado sales and use tax, Colorado Gov. Bill Ritter (D) signed HB 1193 on February 24, 2010, which imposes onerous reporting requirements on out-of-state retailers. While HB 1193 was originally drafted and introduced as "New York style legislation" that targeted out-of-state retailers with relationships with in-state "associates," HB 1193 mutated into reporting requirements. HB 1193 requires that every retailer that does not collect Colorado sales tax on sales to Colorado purchasers must comply with the following reporting requirements:

- Notify Colorado purchasers that sales or use tax is due on certain

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Come See Us

March 11, 2010
Sutherland Breakfast Roundtable
Sutherland's Office – Washington, D.C.
The SALT Team on State Taxation – The Role of Congress in Developing Apportionment Standards

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

March 25-27, 2010
The Tax Council 2010 Annual Spring Tax Conference
The Breakers – Palm Beach, FL
Jeff Friedman on State Taxation and International Operations Trends & Dangers

April 8-9, 2010
D.C. Bar 2010 Judicial and Bar Conference
Ronald Reagan Building – Washington, D.C.
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, D.C.
Join us at the Sutherland reception from 6:30-8:30 p.m. on Monday, April 12

April 15, 2010
Strafford CPE/CLE Webinar
Eric Tresh on Apportioning Service Revenue in Corporate Tax Compliance – Navigating the Latest State Laws and Regulations

April 22, 2010
New York State Bar Association 2010 New York State and City Tax Institute
Princeton Club – New York, NY
Marc Simonetti on Disclosure Developments

April 29, 2010
TEI Nashville Chapter Spring Seminar
Nashville, TN
Jeff Friedman and **Pilar Mata** on The Dangers of Unreliable Intercompany Accounting in Separate Company States and Other Issues

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Colorado's New Sales Tax Reporting Requirements Come With a Whopping Penalty! *(cont.)*

purchases from the retailer and Colorado law requires the purchaser to file a sales and use tax return;

- Notify the Colorado Department of Revenue (Department) by January 31st of each year of all sales to Colorado purchasers, including dates and amounts of purchases and category of purchase.

Out-of-state retailers that fail to comply with these reporting requirements are subject to a $5 penalty for failure to notify the customer, a $10 penalty for failure to notify the Department and a $10 penalty for each purchaser not included in the report to the Department.

In light of the fact that the reporting requirements are effective March 1, Colorado issued Emergency Regulation 39-21-112.3.5 ("Regulation") which adds further color to the Department's expectations for the reporting obligations. The Regulation sets forth the language that must be provided on each invoice to a Colorado customer.

As a result of this twist in state efforts to require out-of-state retailers with no physical state presence to collect and remit sales and use tax, further developments on the constitutionality and enforcement of Colorado's reporting is expected.

Georgia Supreme Court Rules for Taxpayer in 338(h)(10) Case

In *Trawick Construction Co. v. Georgia Dept. of Revenue*, ____ S.E.2d ___, 2010 WL 678937 (Ga. Mar. 1, 2010), the Georgia Supreme Court reversed a Georgia Court of Appeals decision and held that gain from a deemed asset sale was not subject to Georgia corporate income tax. The taxpayer was a closely held Florida corporation treated as a Subchapter S corporation for federal income tax purposes. All of its shareholders were Florida residents. Georgia law does not conform to the federal "S" election and requires that all shareholders consent to Georgia taxation before an "S" election is recognized. OCGA § 48-7-21(b)(7). By not making a separate Georgia S election, the taxpayer was a Subchapter C corporation for Georgia income tax purposes.

In 1999, the taxpayer's shareholders sold all of their stock to a third party who agreed to make an election under IRC § 338(h)(10) to treat the transaction for federal tax purposes as a deemed asset sale. The issue before the Court was whether this federal election applied for Georgia income tax purposes and whether the gain on the transaction was subject to Georgia tax. If the election applied, as the Department contended, the taxpayer would have fictionally sold its assets, received the income from the sale of these assets, and distributed the asset sale proceeds to its shareholders. The Department contended that this income was apportionable business income and that the taxpayer was taxed as a corporation. The taxpayer argued that the transaction should be treated as the sale of the taxpayer's stock.

O.C.G.A. § 48-7-21(b)(7) provides that "All elections *made by corporate taxpayers* under the Internal Revenue Code …shall also apply under this article except elections involving consolidated corporate returns and Subchapter "S" elections…" (emphasis added). The taxpayer argued, and the Court agreed, that an IRC § 338(h)(10) election is not made "by the corporate taxpayer" but instead is made by the corporation's shareholders. Therefore, the federal election did not apply for Georgia tax purposes and the transaction was correctly treated for Georgia income tax purposes as the sale of stock by the corporation's shareholders.

However, the Court did indicate that the new shareholders of the taxpayer may not get the benefit of a stepped-up asset basis in stock for Georgia income tax purposes because the S election did not apply. This would result in different basis for the acquired entity's assets for federal and state tax purposes.

Although this case was a matter of first impression in Georgia, the Court's holding is consistent with that of the New York Tax Court in *In the Matter of the Petition of Gabriel S. and Frances B. Baum*, Determination DTA Nos. 820837 and 820938 (Dec. 20, 2007) but inapposite of the holding by the New Jersey Tax Court in *General Building Products Corp. v. New Jersey Division of Taxation*, 14 N.J. Tax 232 (1994).

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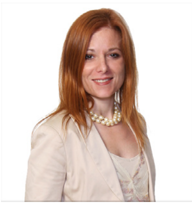

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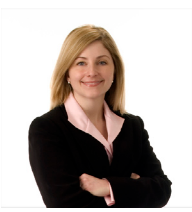

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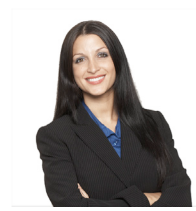

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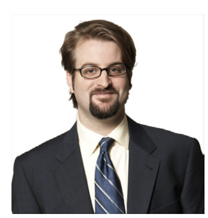

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