"Shaking things up in state and local tax"

SUTHERLAND SALT SHAKER

FORECAST
Legislative storms possible as political tides turn.

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The California Tax Shakeup

Chaos resulting from the California budget crisis reached a crescendo in recent weeks because of a new budget agreement, a bevy of voter referendums addressing tax legislation, and new regulations addressing corporate income tax apportionment issues. In the aftermath of the chaos, California has again significantly modified its corporate income tax apportionment provisions, for the second time in the last two years.

The first major event occurred on October 8, when the California Legislature approved a set of budget bills that were signed by Governor Schwarzenegger. The budget bills included SB 858, which made two significant changes to California's corporate income tax regime: (1) enacted modifications to California's sales apportionment factor sourcing provisions; and (2) imposed a two-year suspension on utilization of Net Operating Losses (NOL) for the 2010 and 2011 tax years.

By way of background, California's costs-of-performance methodology had been repealed (and replaced with market type sourcing provisions) through legislation passed in February 2009; however, the repeal was not set to become effective until January 1, 2011. This change from costs-of-performance to market-based apportionment was made along with the enactment of an election available to most taxpayers to annually choose to use a single sales factor (rather than a formula comprised of property, payroll, and double-weighted sales). SB 858 changes this regime and provides that effective January 1, 2011:

- Taxpayers that do not elect single sales factor apportionment (either because the election is not available or the election is not made) are required to use California's costs-of-performance methodology to source receipts from "other than sales of

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New Jersey Supreme Court Catches a Throwout Case

The New Jersey Supreme Court granted leave to appeal in the *Whirlpool Properties Inc.*, and *Pfizer Inc.* cases to determine whether the New Jersey "Throwout Rule" is facially unconstitutional. *Whirlpool Properties, Inc. v. Div. of Taxation* and *Pfizer, Inc. v. Div. of Taxation*, Dockets A-1180-08T2 and A-1182-08T2 (N.J. Super. Ct. App. Div., July 12, 2010) (leave to appeal granted Oct. 21, 2010). The New Jersey Appellate Division affirmed the New Jersey Tax Court's decision in the consolidated decision holding that the Throwout Rule did not, on its face, violate the Due Process, Commerce, or Supremacy Clauses of the United States Constitution because the statute could operate constitutionally in some instances.

The New Jersey Throwout Rule required taxpayers to exclude (or "throwout") receipts from the denominator of their sales apportionment factor if the sales are assigned to a state where the taxpayer is not subject to tax. The Throwout Rule was effective for tax periods beginning on or after January 1, 2002, and before July 1, 2010.

Many taxpayers have a vested interest in the *Whirlpool* and *Pfizer* cases because of pending appeals and potential refund claims. In addition, many taxpayers and practitioners are interested in the outcome of the case because the Throwout Rule represents the clearest example of extraterritorial taxation on state and local tax. Although New Jersey no longer imposes the Throwout Rule, other states, including Maine and West Virginia, continue to employ similar apportionment rules. If the taxpayers' facial claims ultimately are unsuccessful, the taxpayers likely will pursue challenging the Throwout Rule on an "as applied" basis.

Massachusetts Supreme Judicial Court Says Tax Exemption Should Be Construed Broadly

In an interesting development in the ongoing debate surrounding intended tax benefits, the Massachusetts Supreme Judicial Court affirmed the Appellate Tax Board's ruling that a taxpayer qualified for a use tax exemption and that the Commissioner was not entitled to impose additional requirements on a taxpayer's eligibility for the exemption. *Onex Commc'ns. Corp. v. Comm'r of Revenue*, 457 Mass. 419, 425, 429–30 (2010). *Onex* involved a high technology start-up that developed cutting-edge circuits for use in the telecommunications industry. Onex bought computer software and hardware, laboratory equipment, and furniture and fixtures, and claimed a sales tax exemption on those purchases as a manufacturing corporation. After a lengthy audit, the Massachusetts Department of Revenue issued an assessment claiming that even though the purchases were used directly and exclusively in manufacturing, Onex did not qualify as a manufacturing corporation or as an R&D corporation. The Appellate Tax Board disagreed and held that Onex was engaged in manufacturing and, therefore, its purchases of personal property were exempt from use tax. The Appeals Court affirmed, and the Commissioner appealed to the Supreme Judicial Court.

Under Massachusetts law, taxpayers engaged in manufacturing may be exempt from use tax on purchases of materials, tools, fuel, machinery, and replacement parts that are used directly and exclusively in manufacturing. The crux of the Commissioner's argument was that Onex was not a manufacturing company because it was not "engaged

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The California Tax Shakeup cont'd

tangible personal property" (e.g., receipts from intangibles and services).

- Taxpayers that elect to apportion income via a single sales factor apportionment formula are required to source receipts from "other than tangible personal property" via California's market sourcing provisions.

At the time of enactment of SB 858, the fate of California's single sales factor election—which was not set to become effective until January 1, 2011—was left to California voters through Proposition 24, which would have repealed the election. Proposition 24 was defeated, and therefore the annual single sales factor election survives.

At the same time that California's legislature enacted legislation that modified California's corporate income tax sourcing regime, the California Franchise Tax Board (FTB) issued new proposed regulations for applying its market-based apportionment rules to the sourcing "of sales other than sales of tangible personal property in the state." Under the FTB's proposed Regulation Section 25136, sales of services are generally assigned to California "to the extent the customer of the taxpayer receives the benefit of the service" in the state. However, the proposed regulations provide for a cascading set of rules that considers other differing factors for individual customers and business customers to the extent the location where the "benefit of the service" is received is not determinable. The other factors are more complex rules for business customers. For receipts from intangible property, Reg. 25136 provides for varying rules depending on the type of intangible generating receipts, whether there is a complete transfer of the rights in the intangible, and whether there is exclusive use of the intangible in California or use in multiple states. These receipts may be sourced to California if any of the criteria are satisfied under a tiered methodology.

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in manufacturing" when it purchased the property. The Commissioner argued that, in addition to the statutory requirements for qualifying as "engaged in manufacturing," a company must also have produced at least one finished product, or the company's inputs must have resulted in the fabrication of a finished product by some other entity. The Commissioner asserted that Onex failed the "finished product" test because, at the time of the audit, Onex had not yet produced a final version of its product.

The court began its analysis by stating that it has always construed "engaged in manufacturing" broadly, not narrowly. The court then flatly rejected the Commissioner's proposed "finished product test," noting that it had always relied on a traditional test for determining whether a company was engaged in manufacturing: whether the company was engaged in an "essential and integral" step in the manufacturing process.

The *Onex* decision is significant for two reasons. First, the Supreme Judicial Court broadly interpreted an intended tax benefit—the manufacturing sales and use tax exemption—thereby supplanting the old adage that exemptions are strictly and narrowly construed. Second, the court rejected the Department's attempt to graft on additional requirements to a legislatively provided exemption.

SALT PET OF THE MONTH

Amos

We are pleased to present Amos, the beautiful Italian Greyhound of long-time Sutherland SALT friend John Kinney (Time Warner Inc.) as our November Pet of the Month.

Amos, who is named after the Hebrew prophet and sheep herder, was born in Tennessee to a pair of famous show dogs. Although he is a handsome lad, Amos was relegated to "pet quality" status after it became apparent that he has only one "do-dad" (to quote John). Amos has since directed his talents toward snuggling and insists on sleeping under the covers, even during the heat of summer.

Amos enjoys the good life. As a result of his soy allergy, Amos thrives on a gourmet diet of organic brown rice, beef, olive oil, and parsley (yum!) that John's partner, Omar, prepares specially for him. Not surprising, Amos is obsessed with food and is always hungry despite his slender frame. He has developed a keen passion for squirrels and fire hydrants, and other city aromas.

Amos splits his time among three homes—Brooklyn Heights, the Hudson Valley, and John's ranch in Nebraska—but prefers the Hudson Valley home because the radiators are uncovered and really blast the heat that a 103-degree dog needs. He is also an experienced world traveler, having made numerous visits to Madrid, Burbank, Miami Beach, and Washington, D.C.

SALT Pet of the Month: It's Your Turn!!

In response to many requests, the Sutherland SALT practice invites you to submit your pet (or pets) as candidates for SALT Pet of the Month. Please send us a short description of why your pet is worthy of such an honor, along with a picture or two. Submissions should be directed to Andrea Christman at andrea.christman@sutherland.com.

Georgia Proposes to Shift Rules on Combining Income

On October 28, 2010, the Georgia Department of Revenue proposed to amend its regulation entitled "Shifting of Income" (Ga. Comp. R. & Regs. 560-7-8-.07). This proposed amendment is intended to be a "clarification" of the Department's current authorities to adjust the income between related parties and require combined reporting if other methods will result in distortion of separately reported income under O.C.G.A. § 48-7-58. However, the proposed amendment's language states that the "Commissioner may combine the income of any affiliates in order to compute the net income properly attributable to this state" and appears to significantly expand the Commissioner's authority beyond the limits contemplated by Georgia statutes and case law.

When any taxpayer conducts its business in a manner that distorts the income properly attributable to Georgia, O.C.G.A. § 47-7-58 authorizes the Commissioner to consider the fair profit that would normally arise in the conduct of a trade or business. O.C.G.A. § 48-7-31(e) further grants the Commissioner the authority to equitably determine the net income of related corporations "by reasonable rules of apportionment of the combined income of the subsidiary, its parent, and affiliates, or any combination [thereof]." However, the Georgia Court of Appeals expressly held that such "forced combination" is available only when payments "in excess of fair value" have occurred between the related entities <u>and</u> only if the Commissioner is unable to adjust the intercompany payments to reflect "fair value." *Blackmon v. Campbell Sales Co.*, 189 S.E.2d 474 (Ga. Ct. App. 1972). The Court further held that the predecessor to O.C.G.A. § 48-

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New York Tax Appeals Tribunal Confuses Nexus Rules With Income Sourcing Rules—Constitutional Mashup Ensues

In an unfortunate misapplication of the constitutional nexus rules, the New York Tax Appeals Tribunal has found that two corporations had franchise tax nexus with New York solely because the corporations received income from ownership interests in a 7+ tier entity structure culminating in a pass-through entity that was doing business and earning income in the State. *Matter of Shell Gas Gathering Corp. No. 2 et al.*, DTA Nos. 821569 and 821570 (Sept. 23, 2010). The taxpayers, Shell Gas Gathering Corp. No. 2 and Shell Gas Pipeline Corp. No. 2, were both holding companies that were not themselves doing business in New York. To make a really long story short, the taxpayers, through approximately seven tiers of various ownership interests in various types of pass-through entities, had an indirect interest in an entity, Coral Energy Resources LP, that did business in New York. Coral Energy was a seller and marketer of natural resources and conducted business, owned property, and made sales in New York. A distributive share of the income from Coral Energy's business was ultimately passed-through to the taxpayers.

New York State does not tax pass-through entities, so neither Coral Energy nor any of the various intervening entities were required to pay New York tax. The New York State Department of Taxation and Finance climbed up the ownership chain until it found two corporations—the taxpayers—and assessed them. The taxpayers alleged that they could not be subject to New York's tax because under the Due Process and Commerce Clauses of the United States Constitution, they did not have the requisite nexus with the State. The Administrative Law Judge, and now the Tax Appeals Tribunal, disagreed and upheld the Department's assessment.

There are a number of factors to consider in determining whether a company has nexus with a state solely based on the passive ownership in a pass-through entity. *See, e.g., Revenue Cabinet v. Asworth Corp.*, Nos. 2007-CA-002549-MR, 2008-CA-000023-MR (Ky. Ct. App. 2010), *petition for cert. filed*, (U.S. Nov. 16, 2010) (No. 10-662) (taxpayer seeking review of Kentucky's decision to premise nexus on the ownership of a membership interest in a limited liability company). Issues such as whether the corporation is a general or a limited partner, the control exercised, and the ownership percentage may be relevant to a nexus determination. The Department and the subsequent Administrative Law Judge and Tax Appeals Tribunal decisions, however, did not take these factors into account in considering the connection between the <u>taxpayers</u> and New York. Instead, the Department and the subsequent decisions relied upon the connection between the <u>income</u> at issue and New York. Because Coral Energy earned income that had a New York source, the taxpayers were subject to tax in New York.

In reaching its decision, the Tribunal cited only one case—*Matter of Allied-Signal, Inc. v. New York City Comm'r of Finance*, 79 NY2d 73 (1991). Not only is the legal analysis in *Allied-Signal NYC* of questionable legal validity following the United States Supreme Court's decision under the exact same set of facts in *Allied-Signal v. Director, Div. of Taxation*, 504 U.S. 768 (1992), but the issue in *Allied-Signal NYC* was not whether a company had nexus with the City, but whether the City could tax all of a company's income. Whatever the current legal validity of the analysis in *Allied-Signal NYC*, the opinion is not relevant in determining whether a company is subject to New York's tax.

In the wake of the *Shell* decision, it is not clear when an entity that does not itself have nexus with New York will nevertheless be subject to tax by New York because it receives income from New York source activity. This question is particularly important because New York State's franchise tax on corporate net income has a unique and odd provision that taxes a corporation on its investment income based not on the taxpayer's apportionment formula, but rather on the apportionment formula of the entity in which the taxpayer has invested. So, under the *Shell* analysis, even a company that does no business whatsoever in New York (no sales), could still have a New York franchise tax liability based on its ownership of stock and debt issued by New York taxpayers. Unconstitutional? Yes. A position New York would assert? Likely.

Recently Seen and Heard

October 19-22, 2010
COST 41st Annual Meeting
Sheraton Wild Horse Pass – Phoenix, AZ
Jeff Friedman on Attributional Nexus Developments for State Income, Sales/Use and Gross Receipts Taxes – Reconciling Bellas Hess and Quill with Scripto and Tyler Pipe
Steve Kranz on Contingent Fee and Contract Audits: Addressing a Troubling Trend
Diann Smith on Emerging Issues with Abandoned & Unclaimed Property: It's Not a Tax, But You Own the Audit

October 21, 2010
Stafford Webinar – 80/20 Companies and Foreign-Source Income: State Treatment
Pilar Mata on Navigating States' Tests for Shielding Income and Claiming Deductions

October 24-27, 2010
TEI 65th Annual Conference
Sheraton Chicago Hotel – Chicago, IL
Eric Tresh and **Pilar Mata** on Dangers of Unreliable Intercompany Accounting Issues in State Taxes

October 28, 2010
COST Southwest/West Regional State Tax Seminar
Four Seasons Hotel – Houston, TX
Michele Borens on State Tax Policy Update: 2010 and Beyond – How Will the States Meet Their Revenue Needs?
Michele Borens and **Pilar Mata** on Digital Age SALT Issues – Applying Old Rules to New Technology
Marc Simonetti and **Pilar Mata** on Update on Significant State Tax Litigation Around the Country

November 1-5, 2010
MACPA & MSBA 2010 Advanced Tax Institute
Martin's West – Baltimore, MD
Steve Kranz on National Developments and Trends in State Taxes

November 2, 2010
World Shale Gas Conference
Gaylord Convention Center – Dallas, TX
Scott Wright on Understanding Shale Gas Legal & Regulatory Issues: U.S. State Tax, Energy and Climate Change Policy

November 2-3, 2010
STARTUP State Tax Roundtable for Utilities and Power
Richmond Falls, VA
Eric Tresh and **Pilar Mata** on Jurisdiction to Tax

November 4-6, 2010
The State Bar of California 2010 California Tax Policy Conference
Loews Coronado Bay – San Diego, CA
Pilar Mata on State Tax Issues in a Global Economy

November 8-11, 2010
IPT Advanced Sales and Use Tax Academy
Doral Hotel – Miami, FL
Charlie Kearns on SSTA Implementation: Top to Bottom; Digital Goods

November 9, 2010
Paul J. Hartman State and Local Tax Forum
Loews Vanderbilt Hotel – Nashville, TN
Steve Kranz on Streamlined Sales Tax Project Versus Amazon Laws and Other Techniques Designed to Increase the Reach of State Sales and Use Taxes to Remote Sellers
Pilar Mata on Expense Addbacks and Exceptions

November 9, 2010
Manufacturers Alliance Fall Tax Council Meeting
Westin – Alexandria, VA
Jeff Friedman on Coming Attractions in State Taxation of Multinationals

November 9, 2010
TEI Carolinas Chapter Meeting
Research Triangle Park, NC
Marc Simonetti on State Amnesties and Penalties

November 10, 2010
Michigan Association of Certified Public Accountants Michigan Tax Conference
Rock Financial Showplace – Novi, MI
Diann Smith on Revenue for State Government

November 12, 2010
TEI Connecticut Valley Chapter Meeting
Farmington, CT
Marc Simonetti on SALT Policy

November 19, 2010
NCSL Task Force Meeting
Phoenix, AZ
Steve Kranz on Streamlined Sales Tax Governing Board – Status Report

Kentucky Supreme Court Tells Department of Revenue: 'Open Sesame'

On October 21, the Supreme Court of Kentucky overturned the denial of a taxpayer's document request under Kentucky's Open Records Law. *Dep't of Revenue v. Wyrick*, Case No. 2008-SC-000468-DG (Ky. 2010). Wyrick, an attorney representing a newspaper company on a tax refund claim before the Board of Tax Appeals, sought numerous documents from the Department of Revenue through a pretrial discovery request. When the Board denied Wyrick's pretrial discovery request, Wyrick requested many of the same documents from the Department under Kentucky's Open Records Law. The Department denied most of the request, citing the civil litigation limit in Ky. Rev. Stat. Ann. § 61.878(1) (2010), which provides that "no court shall authorize the inspection by any party of any materials pertaining to civil litigation beyond that which is provided by the Rules of Civil Procedure governing pretrial discovery."

The court required the Department to turn over the requested documents, holding that the Department must disclose public records unless a specific exception to the Open Records Law applies and the civil litigation limit is no such exception. *Wyrick* requires that the evaluation of public record requests occur without reference to ongoing or potential civil litigation. The court went on to hold that it may force disclosure where the Department denied a public records request, but the civil litigation limitation may limit the court's power to grant disclosure if the document "pertain[s] to civil litigation." The Department, however, remains unable to deny a document request on the grounds that it pertains to civil litigation, as this power is left to the courts.

Does *Wyrick* provide future taxpayer-litigants with a roadmap for enhanced pretrial discovery? Taxpayers should consider using open records requests in Kentucky in addition to pretrial discovery, especially if a specific exception is unlikely to apply. The Department may only reject requests that fall within a specific exception. Importantly, this puts the burden on the Department to convince the court that the civil litigation limit is applicable.

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Georgia Proposes to Shift Rules on Combining Income

7-58 contained no independent authority for combining the income of related corporations. *Id*. at 477.

While the current Georgia regulation appropriately states that "if it is found that affiliates are in fact dealing at arm's length…and otherwise dealing with each other as if they were not affiliated, consolidation would not apply," the proposed amendment attempts to provide the Commissioner with carte blanche discretion to "combine the income of any affiliates to compute the net income properly attributable to this state." In so doing, the proposed amendment would inappropriately expand the scope of the Commissioner's authority to require combined reporting. That doesn't sound like a mere clarification!

The Department is accepting comments on the proposed amendment until 10:00 a.m. on December 2, 2010. Written comments must be sent to: Commissioner, Georgia Department of Revenue, 1800 Century Blvd. N.E., Suite 15300, Atlanta, GA 30345-3205. Electronic comments must be sent to regcomments@dor.ga.gov and reference "Notice Number IT-2010-8."

Taxpayer's Solicitation Activities Could Establish Michigan SBT Nexus

The Michigan Court of Appeals ruled that two in-state visits per year by representatives of an out-of-state taxpayer could create nexus sufficient to impose the Single Business Tax (SBT). *Barr Labs., Inc. v. Dep't of Treasury*, 2010 Mich. App. LEXIS 2033 (Oct. 21, 2010). At trial, the taxpayer offered an affidavit by its vice president of taxation stating that its employees did not solicit sales during their infrequent trips to Michigan, but rather visited to "gather information." The Department of Treasury, however, introduced the nexus questionnaires completed by Barr Labs indicating that its employees entered Michigan between two and nine times a year to solicit sales. The trial court found the affidavit to be the most credible evidence and held that Barr Labs' contacts with Michigan were insufficient to establish the requisite substantial nexus under the Commerce Clause and granted summary judgment in favor of the taxpayer.

The appellate court reversed and remanded the case, finding a true question of fact between the affidavit and the nexus questionnaires. The appellate court noted at the outset of its analysis that constitutional "substantial nexus" is met when a taxpayer's in-state physical presence is more than a "slightest presence." According to a 1998 Revenue Administration Bulletin, the in-state solicitation of sales for two or more days in a year creates a rebuttable presumption that an out-of-state company is regularly and systematically conducting in-state business activity and, thus, is subject to the SBT. The court indicated that this nexus standard could apply retroactively, but that the issue of whether the statutory penalty applied depended on the outcome of the case on remand.

This case should be a reminder to taxpayers to give extra consideration to the potential tax consequences of their responses to nexus questionnaires, regardless of how routine they may seem, because they very well may be used as evidence by taxing authorities in future litigation. And, taxpayers should consider responding to a state's request to complete a nexus questionnaire with a narrative description of its activities (rather than checking yes/no boxes).

2010 Midterm Elections

At both the federal and state levels, the GOP won a number of game-changing races that will impact state and local tax policy in 2011 and beyond. Of the 37 gubernatorial races held in 2010, Republicans won 23. All six Republican incumbents won; Republicans defeated Democratic incumbents in two of the seven other incumbent races. Further, the following state legislative chambers switch from "D" to "R" – Alabama (House and Senate); Indiana (House); Iowa (House); Ohio (House); Maine (Senate); Michigan (House); New Hampshire (House and Senate); North Carolina (House and Senate); Pennsylvania (House); New York (Senate); Minnesota (House and Senate); Montana (House); Colorado (House). Only the Oklahoma Senate switched from Republican to Democrat controlled.

These results will affect states' willingness to enact significant state tax legislation, such as combined reporting, sales tax base expansion, and aggressive nexus legislation, to name a few. Of course, Republicans' historical temperance towards new taxes will be juxtaposed against the states' ever-present budget shortfalls. At the federal level, Republican gains may hamper the Main Street Fairness Act because some right-leaning policy groups view the Streamlined Sales and Use Tax Agreement as a "new" tax. Look for a more detailed analysis from Sutherland of the 2010 elections and state tax issues in the near future.

Come See Us

December 3, 2010
COST Southeast Regional State Tax Seminar
Georgia-Pacific LLC – Atlanta, GA
Eric Tresh and **Maria Todorova** on Significant State Tax Litigation Around the Country
Eric Tresh on State Tax Policy Update: 2010 & Beyond – How Will the States Meet Their Revenue Needs?
Jonathan Feldman and **Charlie Kearns** on Evolving Combined Reporting Issues

December 6, 2010
TEI Cincinnati Chapter Tax Seminar
Kings Island Resort & Conference Center – Mason, OH
Pilar Mata and **Mark Yopp** on State and Local Tax Legislation and Litigation Update
Marlys Bergstrom and **Mark Yopp** on Unclaimed Property Developments
Maria Eberle and **Pilar Mata** on Combined Reporting

December 8, 2010
Interstate Tax Planning Conference
Double Tree Hotel – Washington, DC
Michele Borens on The Unitary Concept

December 8, 2010
TEI New York Chapter Meeting
New York, NY
Jeffrey Serether and **Marc Simonetti** on Recent Developments to Non-Income Taxes

December 13-14, 2010
New York University 29th Institute on State and Local Taxation
Grand Hyatt – New York, NY
Jeff Friedman on RAR Adjustments – Are They 'Final'? What Do You File and When Do You File It?
Marc Simonetti on What's Happening Everywhere Today?
Diann Smith on Due Process – Are Pay-to-Play and Internal Hearings the End of the Line? Retained Refunds, Retroactive Laws and Regulations, Harsh Penalties

December 21, 2010
COST Mid-Atlantic Regional Tax Seminar
Tyco Electronics Corporation – Berwyn, PA
Charlie Kearns on State Tax Policy Update: 2010 & Beyond – How Will the States Meet Their Revenue Needs?
Pilar Mata on Best Practices for Managing Audits & Litigation in Today's Challenging Environment and FIN 48 Disclosures
Marc Simonetti and **Pilar Mata** on Discussion of Significant State Tax Litigation Around the Country
Marc Simonetti on The Economic Substance Doctrine & Reporting of Uncertain Tax Positions, Including Exploring Unintended Impacts on State Taxation

January 11, 2011
DC Bar State and Local Tax Series Lunch
DC Bar Conference Center – Washington, DC
Jeff Friedman and **Pilar Mata** on Top 10 2010 Events and 2011 Trends

California SBE Characterizes Gain from "Deemed" Sale of Goodwill as Business Income

In *In re Appeal of Imperial, Inc.*, Case Nos. 472648; 477927 (July 13, 2010), the California State Board of Equalization (SBE) ruled that gain from the sale of stock sold pursuant to an IRC § 338(h)(10) election constituted business income. Imperial, Inc., a Wisconsin S corporation, entered into an acquisition agreement with an unrelated buyer, whereby Imperial's shareholders received cash for their shares. The stock sale was treated as an asset sale for income tax purposes as a result of the IRC § 338(h)(10) election, and as a consequence, the sale was deemed to trigger gain on the sale of goodwill.

Imperial argued that the gain on goodwill constituted nonbusiness income and should be allocated to Wisconsin, where Imperial was headquartered, whereas the Franchise Tax Board argued that the gain was business income under the business income functional test. Under California law, gains realized upon the termination of a business are treated as business income if: (1) the taxpayer has sufficient control over the income-producing property; and (2) the taxpayer's control and use of the property is integral to the taxpayer's regular trade or business operations. The SBE noted that Imperial's goodwill was an asset that was created, managed and disposed of by Imperial in the day-to-day operations of its business from 1959 until the sale in 2003, and that more than 50% of the goodwill's value was attributable to Imperial's customer base, trade names and internally developed software. The SBE concluded that Imperial's goodwill represented the residual value of Imperial's business operations as a going concern after its "hard" assets were valued. The SBE also determined that the goodwill was essential to the viable conduct of its business. For these reasons, the SBE found that both prongs of the functional test were satisfied.

The SBE next addressed whether the gross receipts from the sale were excludable from the company's California sales factor under the incidental or occasional sale exception pursuant to California Regulation 25137(c)(1)(A). The taxpayer sought to include the receipts from the sale of goodwill because it would have reduced its California sales factor. The SBE held that excluding the amount associated with the sale of goodwill was justified because the sale created a substantial amount of gross receipts (more than 60%) relative to the taxpayer's total gross receipts for the year.

The *Imperial* decision is consistent with the Oregon Tax Court's analysis of an IRC § 338(h)(10) sale in *Centurytel, Inc. v. Dep't of Revenue*, No. TC 4826 (Or. T.C. August 9, 2010) (see SALT Shaker, Vol. 1, No. 9, pp. 2-3). In each of these cases, the tribunal analyzed the character of the transaction based upon the deemed asset sale created by the federal income tax election.

Are You a Target? Unclaimed Property Audits

It is no secret that states need money, and many are turning to unclaimed property audits to get it. These audits are low-hanging fruit as they cost the states little to administer because many third-party audit firms work on a 10%-12% contingency arrangement, which can produce fees in the tens of millions of dollars. The only real losers here are the companies placed under audit. Unclaimed property audits frequently are demanding and aggressive.

So, assuming a company has been able to dodge the unclaimed property bullet so far, here are some "red flags" that may increase the risk of a third-party unclaimed property audit.

(1) Everybody Knows Your Name: A Sutherland lawyer was once on a bus at a conference with a bunch of state unclaimed property administrators, and as the bus passed a famous landmark with a large company's name on it, the administrators started asking whether that company had been audited yet! A large company with a well-known name or a manufacturer of a common household product is or will be on an audit list.

(2) People Come, People Go: Companies with a transient work force or a significant number of employees who are paid hourly are often targets. This is one of many reasons why retail is a favorite target. There tends to be a great deal of turnover, which may lead to unclaimed property issues associated with uncashed payroll checks. Employees who are paid hourly tend to have significantly more "reissued" checks because of errors with hours, vacation time accrued, double-time, lost checks, etc. Due to the potential replication of these types of errors, the amount of unclaimed property exposure can be substantial.

(3) It Is So Obvious: Another common red flag for audits is if "obvious" property types are missing from a report. Based on a company's particular industry, there are certain property types that are expected to be reported. For example, a health care provider should always have some patient credit balances to report as unclaimed property and excluding them will serve as an indication that the provider is not compliant. Spending a few minutes to brainstorm the types of industry-specific unclaimed property issues a company should be reporting (and comparing those categories to what is reported) could stave off a thorny unclaimed property audit.

(4) Nothing In This World Is Free: Before claiming unclaimed property from a state, consider whether the company is (or should be) reporting unclaimed property to the state. Sutherland lawyers have received several calls from companies' personnel excited to have found unclaimed property being held by a state only to realize that the same company is not in compliance with the state.

(5) You Are Being Watched: States benchmark unclaimed property reports and audit the results of various industries. As a result, if a state notes that a particular company within a specific industry is remitting significantly less than other companies in the same industry, an audit is likely. States also tend to "move" through certain industries. For example, about three years ago, oil and gas companies were audit targets. Currently, insurance companies are under attack, and a wave of audits are underway.

(6) Your State of Incorporation Is (Almost) Everything: Under the jurisdictional rules of unclaimed property, if the last known address of a payee is unknown or incomplete, the property is reportable to the holder's (company's) state of incorporation. Since the majority of public companies are incorporated in Delaware, well…we think you get the idea. Many companies are considering Delaware's and other states' unclaimed property laws (and the aggressiveness of those states' audit practices) when considering incorporating new or existing businesses.

(7) If You Have Nothing to Say, Don't Say Anything: One of the biggest and most obvious audit triggers is underreporting unclaimed property when it is obvious that the company has more significant unclaimed property owing to the state. Many companies decide they need to "get in compliance" so they just file negative or zero reports with all the states. After all, "There is no way people don't cash their checks!" (If Sutherland had a dime for every time a business unit manager said this, Sutherland would have a lot of dimes). Taking this route routinely produces an unclaimed property audit.

Last Words: A study published in the *Medical Journal of Australia* on December 16, 2009, reported that on a pain scale of 1 to 10 (with 10 the "worst pain imaginable"), students who had a bandage ripped of their arms quickly had an average pain score of 0.92 while those who had the bandage removed slowly experienced an average rating of 1.58. Coming into compliance with unclaimed property laws may result in much higher average pain scales than having a bandage ripped off an arm, but coming into compliance quickly (through comprehensive internal audits and voluntary disclosure agreements) will still be less painful than taking the slow approach (waiting for state audits). All states, with the exception of California, allow companies to enter into some type of voluntary disclosure agreement, which reduces or eliminates penalties and interest, and shortens the "look-back" period.

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