

SUTHERLAND

SALT SHAKER

Shaking things up in state and local tax.



No Expressions of Goodwill from Arizona Department of Revenue

By Zachary Atkins and Andrew Appleby

An Arizona Department of Revenue hearing officer determined that the gross receipts from a taxpayer's deemed asset sale pursuant to I.R.C. § 338(h)(10), including gross receipts attributable to goodwill, could not be included in the taxpayer's sales factor for corporate income tax apportionment purposes. The taxpayer asserted that goodwill is an intangible asset, and gross receipts attributable to goodwill should be sourced based on costs of performance, which were outside Arizona. The hearing officer noted that Ariz. Admin. Code R15-2D-903 excludes from the sales factor substantial amounts of gross receipts arising from an incidental or occasional sale of a fixed asset used in the regular course of the taxpayer's trade or business. Goodwill is an intangible asset, not a fixed asset, but the hearing officer concluded that the gross receipts attributable to goodwill could not be included in the sales factor because they do not fairly reflect the taxpayer's day-to-day business activity in Arizona. Relying on a legal ruling issued by the California Franchise Tax Board, the hearing officer found "no logical basis for distinguishing between fixed assets and intangibles." *In the Matter of [Redacted]*, Case No. 201200235-C (Ariz. Dep't of Revenue, May 31, 2013).

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California Court of Appeal: ITFA Doesn't Make the CUT

By Saabir Kapoor and Timothy Gustafson

The California Court of Appeal, in affirming summary judgment in favor of the City of Los Angeles, concluded that the taxpayer, j2 Global Communications, Inc., did not produce evidence to demonstrate that its purchase of telecommunications services was exempt from the City's communication users tax (CUT) under the Internet Tax Freedom Act (ITFA). The ITFA imposes a moratorium on the collection of taxes by state and local governments on "Internet access," which is defined, in part, to include the purchase, use or sale of telecommunications by a provider of a service that enables users to connect to the Internet to the extent such telecommunications are purchased, used, or sold to provide such service or to otherwise enable users to access content, information, or other services offered over the Internet. 47 U.S.C.A. § 151, note, § 1105, subd. (5). At issue was whether the CUT imposed on j2's purchase of telecommunications services used in conjunction with its core service offering, eFax, was exempt "Internet access" under the ITFA. In order to provide the eFax service, which enables users to receive faxes in their email inboxes and to send faxes via the Internet, j2 purchased telephone numbers known as "direct inward dials" (DIDs) from third-party telecommunications providers and then assigned a number to a customer. j2 filed a refund claim with the City for the CUT imposed on its purchase of the DIDs, asserting that the ITFA precludes the City from imposing such taxes because the DIDs were used to provide Internet access. The City demonstrated that, although the eFax service requires j2's customers to connect to the Internet in order to access the eFax content and services, it requires them to do so through a third party; thus, j2 itself does not enable customers to connect to the Internet as required under the ITFA. The court agreed with the City and declined to interpret the ITFA's definition of Internet access so broad as to render it "essentially meaningless."

j2 Global Communications, Inc. v. City of Los Angeles, Los Angeles County Super. Ct. No. BC423661 (Cal. App. 2nd July 26, 2013).

Round We Go: Indiana Denies Taxpayer's Intercompany "Residual Profit" Deduction Citing Circular Cashflow

By Todd Betor and Andrew Appleby

The Indiana Department of Revenue issued a Letter of Findings denying a taxpayer's deductions for certain intercompany payments to a subsidiary management company. The taxpayer and its subsidiary management company (Management Co.) entered into an intercompany agreement based on a federal income tax transfer pricing study, which endorsed the "residual profit method." Under the residual profit method, in addition to general payment for expenses and operating costs, the taxpayer paid Management Co. a "residual profit" beyond the "routine profit" that is customary in that business line. The taxpayer deducted the intercompany payments, including residual profits, for Indiana tax purposes. The Department denied the taxpayer's deduction for

the residual profits paid to Management Co, arguing that Indiana Code § 6-3-2-2(m) is synonymous with I.R.C. § 482, so Indiana must permit the deduction that was allowed for federal purposes. The Department focused on the potential windfall for the taxpayer based on circular cash flow. Although there was no actual circular cash flow, the Department posited hypothetical scenarios that could potentially create circular cash flow. Therefore, the Department determined that the taxpayer's residual profits deduction did not reflect the taxpayer's economic realities and denied the deduction. Ind. Dep't of State Rev., [Ltr. of Findings No. 02-20120310](#) (July 1, 2013).

SALT PET OF THE MONTH Annie

Meet Annie, the lovable, six-year-old Sheltie of Sutherland's Managing Partner, Mark Wasserman and his wife, Rebekah. After years of begging, Mark and Rebekah finally gave in and got Annie for their sons, who promised to always feed and take care of her. And while that may not have turned out to be true, the Wassermans love their sweet Annie, who greets them every day as if she has not seen them in years.

The Wassermans think Annie is the most wonderful dog, except for one slight character flaw--she is one of the most easily startled dogs you will ever meet. She is extremely playful and affectionate, but be sure not to make any loud noises, or Annie will run for cover. In fact, her least favorite day of the week is Monday, when the garbage collector makes its rounds and scares Annie into hiding all morning.

Although she is timid, Annie is anything but shy about her love for playing fetch and eating. In fact, she is known to bring her toy to Mark, ready to play, and nudge him until he obliges. She also is sure to remind Rebekah when it is time to be fed, particularly if she realizes Rebekah might be leaving the house soon; Annie will stand guard at the door, barking and blocking Rebekah's path to make sure she receives dinner.

Annie is excited to be the SALT Pet of the Month but asks that you congratulate her very, very quietly!



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 Katie O'Brien Schrack at katie.schrack@sutherland.com.

To Market, To Market: Massachusetts Adopts Market-Based Sourcing of Intangibles, Expands Definition of Taxable Services

By Sahang-Hee Hahn and Timothy Gustafson

On July 24, 2013, the Massachusetts Legislature passed the Transportation Finance Bill ([H.B. 3535](#)) over Governor Patrick's veto, implementing three key changes to Massachusetts' state tax system. To begin, the new legislation requires the use of a market-based sourcing method for sales of intangibles in computing the sales factor of a taxpayer's apportionment formula for corporate excise tax purposes. The new law also expands Massachusetts' sales and use tax base to include "computer system design services," defined as "the planning, consulting, or designing of computer systems that integrate computer hardware, software, or communication technologies and are provided by a vendor or a third party." Finally, the legislation amends the statutory definition of taxable "services"

to include "the modification, integration, enhancement, installation or configuration of standardized software" and to exclude "data access, data processing or information management services." The legislative changes are effective July 31, 2013. [Mass. St. 2013 c. 46; Mass. G.L. c. 63 § 38\(f\), c. 64H § 1](#). On July 25, 2013, the Massachusetts Department of Revenue issued a Technical Information Release to provide initial guidance on the application of the sales and use tax to computer system design and software modification services, including applicable sourcing rules and transition rules for existing service contracts. [Mass. TIR 13-10, Sales and Use Tax on Computer and Software Services Law Changes Effective July 31, 2013 \(July 25, 2013\)](#).

The Show Me (the Allocation) State: Passive, Non-Missouri Source Income Allocable as Nonbusiness Income

By Shane Lord and Prentiss Willson

The Missouri Administrative Hearing Commission held that a telephone company's interest income received from its parent company was passive, non-Missouri source income and thus excludable from apportionable income as nonbusiness income. The interest income at issue was related to a note between the taxpayer and its parent company pursuant to which the taxpayer loaned its parent company excess cash after payment of the taxpayer's expenses. The Missouri Director of Revenue conceded that the interest income was passive but took the position that such income was Missouri source income. The Director argued that even passive, non-Missouri source income was apportionable income for the taxpayer because the apportionment statute for telephone companies does not include a specific provision allowing for the allocation of passive, non-Missouri source income. The Commission disagreed on both points. First, the Commission held

the passive interest income was non-Missouri source income because decisions regarding the use of the loaned funds were made outside Missouri, and the loaned funds were held, used and controlled outside Missouri. The Commission then stated that under the general apportionment statute and Missouri Supreme Court precedent reviewing the statute, income is allocable as nonbusiness income if it is both passive and non-Missouri source income, even though the general statute does not include a specific allocation provision for such income. Consequently, the Commission held that a specific allocation provision is also not necessary to allocate income under the apportionment statute for telephone companies, and thus the taxpayer properly allocated its passive, non-Missouri source income as nonbusiness income. [AT&T Communications of the Southwest Inc. v. Director of Revenue](#), No. 11-1375 RI (Mo. Admin. Hearing Comm'n).

Second Circuit Categorizes Dial-Up Internet Services as Telecommunications for Federal Excise Tax Purposes

By Nicole Boutros and Pilar Mata

The U.S. Court of Appeals for the Second Circuit determined that dial-up internet services were taxable local telephone services when analyzing an Internal Revenue Service bankruptcy claim for federal excise taxes (FET). The taxpayer, WorldCom, Inc., purchased central-office-based remote access (COBRA) services from local telephone companies to provide internet access services to its customers. The COBRA services transferred telephone signals to a local company's switch network and over primary rate interface lines, converting the signals into an internet-ready format used for the taxpayer's services. The court

determined such services were local telephone services subject to the FET because the services provided access to a local telephone system and had the technical capacity to transmit voice communications, even though the taxpayer and its customers were unable to make calls using the services. By categorizing the services as telecommunications, the Second Circuit potentially opened the floodgates to taxing other internet-based services as telecommunications under the FET. [Internal Revenue Service v. WorldCom, Inc.](#), Docket No. 12-803 (2d Cir. July 22, 2013).

Come See Us

September 11, 2013

Strafford Webinar

Maria Todorova on Related-Party Addbacks

September 19-21, 2013

ABA Section of Taxation Joint Fall CLE Meeting

Hyatt Regency – San Francisco, CA

Michele Borens on Transparency Under a Different Light: Discovery, Settlements and Confidentiality

September 19, 2013

Wireless Tax Group Meeting

Omni Barton Creek – Austin, TX

Eric Tresh and **Maria Todorova** will present

October 4, 2013

National Business Institute Sales and Use Tax Seminar

Washington, DC

Charlie Kearns on Recent Developments; Identifying Tax Exemptions, Deductions, Credits and Incentives

October 17, 2013

National Business Institute Sales and Use Tax Seminar

Brooklyn, NY

Andrew Appleby on Resolving Sales and Use Tax Disputes

October 21, 2013

BNA Webinar

Prentiss Willson on Proposed UDIPTA Changes

October 20-23, 2013

Broadband Tax Institute Annual Conference

The Breakers – Palm Beach, FL

Jeff Friedman and **Doug Mo** will present

October 23-25, 2013

COST 44th Annual Meeting

Sheraton Wild Horse Pass – Phoenix, AZ

Jeff Friedman on How to Survive an MTC Audit and Live to Tell About It

Todd Lard on Top 10 Predictions of the Most Important State Tax Litigation and Legislative Issues Over the Next Few Years

Carley Roberts on Understanding the Intangible

October 27-30, 2013

TEI Annual Conference

Hyatt Regency – New Orleans, LA

Marc Simonetti on Because I Said So: Forced Combination, Alternative Apportionment, and Taxpayers' Concerns About State Transparency

Michele Borens on The Art of Settlement with State Tax Administrators

October 28-31, 2013

Paul J. Hartman State and Local Tax Forum

Nashville, TN

Michele Borens on Ethical Challenges in State Taxation

Prentiss Willson on Overlooked Items in Unitary Taxation

November 2, 2013

Tax Analysts Seminar

Washington, DC

Prentiss Willson on Proposed UDIPTA Changes

November 4, 2013

IPT Income Tax Symposium

Renaissance Esmerelda – Indian Wells, CA

Prentiss Willson on Keynote Address, State Tax Policy

November 7, 2013

National Business Institute Sales and Use Tax Seminar

Atlanta, GA

Maria Todorova on Complying with and Enforcing Sales and Use Tax and on Resolving Sales and Use Tax Disputes

November 7-9, 2013

2013 California Tax Policy Conference

The Fairmont – San Jose, CA

Todd Lard on 2013 SALT Cases that Promise to Shake Up the Landscape

Marc Simonetti on To Conform or Not to Conform: What's All the Fuss About?

Carley Roberts on Intangibles: You Can't Touch, But They May Tax

Prentiss Willson on California Chief Counsel Roundtable

November 20, 2013

MACPA/Maryland Bar Association Advanced Tax Institute

Martin's West – Baltimore, MD

Jeff Friedman on National Developments and Trends in State Taxes

Recently Seen and Heard

August 2, 2013

Georgetown Law CLE Advanced State and Local Tax Institute

Washington, DC

Todd Lard on The Presumptive Correctness of Tax Assessments

August 9, 2013

Manufacturers Education Council Annual Ohio Tax Conference

Columbus, OH

Jonathan Feldman on Multistate Tax Issues and Trends and on Nexus

August 25-28, 2013

Midwestern States Association of Tax Administrators Annual Meeting

Oklahoma City, OK

Todd Lard presented

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