Vol. 2, No. 4
April 29, 2011

SUTHERLAND

SALT SHAKER

Shaking things up in state and local tax.

IRS Addresses Federal Tax Treatment of SALT Incentives

On March 2, 2011, the IRS released Appeals Settlement Guidelines (ASG) addressing the federal income tax treatment of state and local economic development tax credits and incentives, other than refundable or transferrable credits or incentives.

Many taxpayers have long taken the position that state and local tax credits and incentives (e.g., tax rate reductions, tax credits for job creation or investment, and tax abatements or exemptions) should be treated as a payment to the taxpayer by the state or local government equal to the amount of the credit or incentive, followed by a payment of the tax by the taxpayer in the same amount. Under this approach, the payment to the taxpayer is included in gross income under Section 61 and deductible as a payment of tax under Section 164, but then excluded from income as a non-shareholder contribution to capital under Section 118. As a result, taxpayers claim an expense for the amount of the credit or incentive in exchange for a reduction in the basis of property under Section 362(c). The net effect is a deduction in the current tax year which is not recaptured until the taxpayer disposes of the reduced-basis property or depreciates the property. Often the property subject to basis reduction is non-depreciable real property, which effectively allows a near-permanent deferral of income.

The IRS identified this position as a Tier 1 issue and previously addressed it in Coordinated Issue Paper (CIP) LMSB-04-0408-023 (May 23, 2008). The ASG continues the guidance provided in the CIP and details the IRS position that non-refundable state and local credits and incentives are most appropriately characterized as reductions in liability that do not constitute income under Section 61 and do not give rise to additional deductions under Section 164. The IRS also takes the position that even if the incentives were income, they are not excludable non-shareholder contributions to capital under Section 118. A copy of the ASG is available at http://www.irs.gov/pub/irs-utl/irc-section-118-salt-asg-redacted.pdf.

Remote Vendors Notice South Dakota

The South Dakota legislature recently passed two bills seeking to expand the collection of the state's sales and use tax on sales conducted by out-of-state retailers. The Governor signed both bills into law on March 11, 2011.

Notification Requirements for Out-of-State Retailers – Senate Bill No. 146

Senate Bill No. 146 seeks to "encourage" South Dakota consumers to pay use tax on their purchases from internet and catalog vendors. This approach is similar to that recently taken by Colorado and Oklahoma, both of which passed legislation in 2009 requiring out-of-state sellers to notify their in-state customers that use tax is due. But in January, 2011, a federal District Court issued a preliminary injunction preventing Colorado from enforcing its sales tax notice and reporting regime because there are questions as to whether these laws are constitutional. (See the February 2011 SALT Shaker for more details.)

The new South Dakota law places a burden on out-of-state sellers that do not have nexus with the state, by requiring them to notify South Dakota customers that sales tax has not been collected on the transaction and that the customer must pay use tax to the state.

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SUTHERLAND

Forecast

April's showers of bad legislation will bring May hours of frustration.

Departments

Check out Sutherland SALT Online at www.stateandlocaltax.com

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Remote Vendors Notice South Dakota (cont'd)

Specifically, the seller must provide "readily visible" notice to those customers that use tax is due on their purchase; that the purchase is not exempt merely because the purchase is made over the Internet, by catalog, or by other remote means; and that the state requires the purchaser to report and pay tax on the purchase. For website transactions, this notice must be provided on a page necessary to facilitate the transaction; and in catalog transactions, the notice must be on the order form itself. In addition to these notices, all transactions must have the requisite language on the invoice. Section 6 of Senate Bill No. 146 mandates that non-collecting retailers "may not state or display or imply that no tax is due on any South Dakota purchase" unless the display is accompanied by the notice. However, merely displaying a line item on the receipt that "sales tax" equals zero is considered displaying that no tax is due on the purchase, and therefore, must be accompanied by the notice. Lastly, Section 7 provides that no criminal penalty or civil liability arises out of failure to comply with these provisions.

Among other states considering such legislation, Alabama's House of Representatives recently passed legislation that would require similar notification of use tax liability.

Affiliate Nexus Provisions – Senate Bill No. 147

Senate Bill No. 147 adds affiliate nexus provisions to the state's "doing business" statute. Many states have recently adopted similar affiliate nexus provisions, including Alabama, Georgia, Minnesota, New York, Oklahoma, and Wisconsin.

South Dakota's new affiliate nexus law provides that the following retailers will be considered "doing business" in South Dakota:

- A retailer that (A) holds a substantial ownership interest in, or is owned in whole or in substantial part by, a retailer maintaining an Alabama place of business; and (B) either (i) sells the same or substantially similar line of products as the related retailer in Alabama and does so under the same or substantially similar business name, or (ii) uses the in-state facility or in-state employees of the related retailer to advertise, promote, or facilitate sales by the retailer to a consumer; or
- A retailer that holds a substantial interest in, or is owned in whole or in substantial part by, a business that maintains a distribution house, sales house, warehouse, or similar place of business in the state that delivers property sold by the retailer to consumers.

The legislation also adds to the definition of "retailer": a retailer making sales of tangible personal property to purchasers in the state by mail, telephone, the internet, or other media which has a contractual relationship with an entity to provide and perform installation, maintenance, or repair services for the retailer's purchasers within the state. The legislation includes a broad presumption that a retailer that is part of a controlled group will be presumed to be a retailer engaged in business in the state if a component member of the controlled group is a retailer engaged in business in the state.

South Dakota's, and other states', expansive nexus legislation will lead to years of legal battles that will further define the scope of a state taxing jurisdiction.

SALT PET OF THE MONTH

Marlin a/k/a "Schnoody" Eberle

Meet Marlin—everyone's favorite schnoodle (schnauzer/poodle). Sutherland New York associate Maria Eberle, and her husband George, adopted Marlin four years ago from a local animal shelter. The shelter claimed that Marlin was found on the mean streets and may have been a former gang member. However, he now demonstrates a sophisticated demeanor and enjoys eating filet mignon, wearing neckties, and taking long, leisurely Sunday strolls in Central Park. Marlin has a keen sense for couture fashion and will only chew organic, handmade, dog toys. Strangers often comment on his good looks and charm, only to find out, when they get too close, that he still retains many of the survival skills of his former gang days—earning him the additional nickname "Random Acts of Violence."

Marlin spends most days at home with his little sister Alexa, who was born last July. Although Marlin was not initially comfortable with sharing the spotlight with Alexa, he now totally ignores her and continues to grab the center of attention.

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.

Everything's Bigger in Texas, Including Sales Tax Resale Exemptions

A significant decision by the Texas Court of Appeals clarified the size and scope of the Texas sales tax resale exemption. *Combs v. Health Care Servs. Corp*., 2011 WL 1005419 (Tex. App. Mar. 16, 2011). In *Health Care Services*, the taxpayer purchased tangible personal property and services for use in administering employee benefit programs for the federal government. After paying sales tax on the purchases, Health Care filed refund claims on the theory that the purchases qualified for the sale-for-resale exemption.

Health Care claimed that its purchases made pursuant to its federal government contract qualified for the resale exemption. While title to the purchased property automatically passed to the government, Health Care retained possession of the property. In finding that the purchases qualified for the resale exemption, the court reached the following important conclusions:

- A reseller of property is not precluded from qualifying for the exemption merely because it also provides a nontaxable service, even if the property being resold is used in the provision of the nontaxable services, and even if the contract does not require the seller to purchase the property;
- Failing to provide an exemption certificate does not disqualify the reseller from claiming the exemption;
- A sale-for-resale may qualify for the exemption even where the resale is nontaxable;
- A taxable service may qualify for the exemption despite the fact that there is no subsequent transfer of title to the services; and
- There is no impermissible "double recovery" of sales tax where the reseller's cost reimbursed by the purchaser includes sales tax but the reseller does not separately state or explicitly pass through the sales tax.

Taxpayers making sales to Texas exempt entities should consider the implications of this case as it relates to their operations and consider filing refund claims as appropriate.

Texas "Tweets" Guidance on Sourcing Social Networking Website Revenue

The Texas Comptroller of Public Accounts (Comptroller) took a "members only" approach to determine how revenue derived from website access fees should be sourced to Texas for Texas Franchise Tax apportionment purposes. In Letter No. 201102989L (Feb. 2, 2011), the Comptroller considered the sourcing of revenues derived from a company's social networking website. The social networking website allowed registered users to pay a flat fee to access the website's database, publish information, communicate with other users, and utilize and interact with the website's programs. The Comptroller concluded that such fees were akin to membership fees because customers were charged a flat rate for certain benefits and thus should be sourced to the location of the payor. Franchise Tax Rule 3.591(e)(17) provides that "membership or enrollment fees paid for access to benefits should be considered gross receipts from the sale of an intangible asset and are apportioned to the legal domicile of the payor." Thus, such fees would only be included in the company's sales factor numerator if the legal domicile of the payor is in Texas. This conclusion is similar to that reached by Illinois in General Information Letter No. IT 08-0025 (Aug. 8, 2008), which held that revenues derived from fees collected for membership in an online discount program were properly classified as "intangibles" and should be sourced to the address of the member.

The Comptroller also considered the sourcing of the company's click-through revenue derived from advertisers. The Comptroller classified this revenue as "service income." Service income is sourced pursuant to Franchise Tax Rule 3.591(e)(26) to the location where the service is performed. In determining the "location" for click-through revenue, the Comptroller relied on prior guidance—Letter No. 20305904L (May 16, 2003), which held that "gross receipts from click-through advertising are apportioned to . . . the location of the server that provides the link to the customer to purchase the item from the seller." Accordingly, the sourcing of click-through adverting revenue for Texas apportionment purposes will be based on the location of the online advertiser's server.

We expect that other states will also begin to issue guidance on the sourcing of various types of e-commerce revenue that may not necessarily fit neatly within traditional sourcing rules and guidelines. So check your Sutherland SALT RSS feeds regularly!

Keep on Truckin': Washington Supreme Court Analyzes the Primary Purpose of Vehicle Tracking Service

The Washington Supreme Court recently adopted the "primary purpose of the purchaser" test to determine whether a transaction should be broken down into its component parts or considered as a whole. *Qualcomm, Inc. v. Dep't of Revenue*, Dkt. No. 83673-6 (Wash. Mar. 10, 2011). In *Qualcomm*, the court overturned the state court of appeals and held that a taxpayer's vehicle tracking service was subject to buiness and occupation (B&O) tax as an information service, and not as a network telephone service. The court reasoned that the purchaser was buying an integrated management tool that happened to include data transmission, not a telephone service coupled with tracking hardware and software.

Trucking companies were the main purchasers of the taxpayer's tracking service, which the trucking companies used to track the location and obtain other relevant information about their trucks, such as miles per gallon and operating temperatures. The service involved both the transmission of data (a network telephone service) and the collection, manipulation, and processing of that data (an information service). The taxpayer sought to have the service classified as an information service even though the information service B&O tax rate is higher than the network telephone service rate because the network telephone service is also subject to Washington's retail sales tax (and the information service is not) resulting in a higher overall rate for network telephone service.

Both the Washington State Department of Revenue (Department) and the taxpayer agreed that when a service involves elements of both a telecommunications and information service, the purchaser's primary purpose for entering into the transaction determines the taxability of the sale. The parties disagreed, however, as to the proper level of activity upon which to analyze the primary purpose. The Department asserted that the service should be broken down into its component parts, while the taxpayer asserted that the service must be classified based on the entirety of the transaction. The court agreed with the taxpayer and held that the trucking companies' primary purpose for purchasing the taxpayer's service was to "acquire specific useful information about the trucks on the road," and that this purpose could only be accomplished through a combination of all of the component parts of the taxpayer's service. Simply put, the primary purpose of acquiring useful information does not change simply because the information is delivered by electronic transmission.

UNCLAIMED PROPERTY

The "I's" Have It: Indiana and Idaho Unclaimed Property Developments

Indiana just launched a new unclaimed property compliance enforcement effort that is bringing unwelcome news to some holders. In early April, Indiana sent out formal notices to holders indicating that fines could apply for failure to timely report and remit unclaimed property. In some cases, not only did holders receive the warning notice, but also an actual assessment and invoice reflecting the threatened fines. The letters accompanying these assessments indicated that the holder has 60 days to pay the assessment, including the fine, or demonstrate to the Indiana unclaimed property authorities that the assessment was incorrect. Adding salt to the wound, the letters indicated that failure to comply may subject the company to an audit.

Idaho, on the other hand, recently passed a law that eases the compliance burden associated with reporting unclaimed corporate securities and related distributions. HB 174 (effective July 1, 2011). Idaho's new law makes two major changes to corporate securities reporting: (1) a requirement that the owner is actually "lost" before the dormancy period commences, and (2) clarification of the requirements for reporting unclaimed dividends paid pursuant to dividend reinvestment program accounts (DRIP accounts). Previously, Idaho had a confusing dormancy rule for corporate securities. While an owner's mere inactivity—such as failing to cash distribution checks or failing to otherwise communicate with the holder during the statutory five-year dormancy period—triggered the unclaimed property reporting responsibility, the five-year dormancy period <u>only</u> applied if the holder paid out at least five dividends or other distributions within that time period. Otherwise, the dormancy period continued until five distributions were issued, regardless of the total time elapsed. Now, the dormancy period requires inactivity by the owner for a period of five years, regardless of whether distributions were made, and that the association (holder) does not know the location of the owner during that five-year period. The new Idaho law provides that mail to the owner returned by the post office as undeliverable suffices as evidence that the holder does not know the owner's location.

HB 174 also adds the requirement that the owner is actually lost during a five-year period for purposes of DRIP accounts. Automatic reinvestment dividends are not escheatable <u>unless</u> the owner has not communicated with the association during a five-year period, <u>or</u> five years have elapsed since the association has known the location of the owner, as evidenced by the return of official shareholder notifications or communications by the postal service as undeliverable. Interestingly, the "return of official notifications or communications" begins at the earlier of: the return of the second of those notifications or communications, or the time the holder discontinues mailings to the shareholder.

CALIFORNIA

Slip, Sliding Away: California Legislation Sails Through Committees

As the legislative committee season hits its stride, a host of bills have slipped, slid, or sailed through their first policy committees and the Appropriations Committees in their respective houses.

Mandatory Single Sales Factor/Market Sourcing Passes Senate Governance and Finance Committee. SB 116 (De Leon), which proposes to mandate the current—and elective—single sales factor apportionment formula and impose market sourcing on taxpayers that derive income from sales of intangibles and services, passed the Senate Governance and Finance Committee on March 23, on a party-line vote of 6-3, with Republicans voting "no." The bill is now in the Senate Appropriations Committee awaiting hearing on May 2. **AB 103 (Committee on Budget)** and **SB 79 (Committee on Budget and Fiscal Review)**, both of which are budget trailer bills, contain similar single sales factor/market sourcing proposals and are supported by the Governor. These bills are on Third Reading awaiting a vote on the floor of the Senate and Assembly, respectively, and require a two-thirds vote of both houses of the legislature for passage. If the Democratic majority obtains two Republican "aye" votes in each house, the bill that is sent to the Governor likely will be one of the budget trailer bills, rather than SB 116.

Nexus Bills Click Through Committees. New York-style nexus bills passed the Assembly Revenue and Taxation Committee on March 21 with a 5-2 vote: Democrats voted "aye" and one committee member of each party did not vote. **AB 153 (Skinner)** creates a sales and use tax collection presumption if a remote seller enters into an agreement to provide a commission or other consideration to a California person who refers sales to the remote seller's website. **AB 153** now moves to the Assembly Appropriations Committee. Another nexus expansion bill, **SB 234 (Hancock)**, removes from the state's "engaged in business" statute most of the specific activities that create nexus and extends the state's sales tax nexus reach to the extent permitted by federal law and the U.S. Constitution. Having passed the Senate Appropriations Committee on a vote of 5-3 with Republicans voting "no," the bill is now on the Senate floor. All of these bills require a mere majority vote for passage on the floor of the Assembly and Senate.

Show Me the Money: California Holds Interested Parties Meeting on Deferred Gain Reporting

The Franchise Tax Board (FTB) held an interested parties meeting on March 8 to gather public input regarding the development of a new regulation that will address reporting requirements associated with the transfer of appreciated property to insurance companies. Under California Revenue and Taxation Code Section 24465, taxpayers transferring appreciated property to insurance companies are required to immediately recognize or defer the recognition of gain on transactions that are treated as tax-free for federal income tax purposes. The proposed regulation will prescribe annual reporting requirements for any gains deferred under Section 24465(b).

The FTB sought input on the timing, frequency, and content of notices, as well as which persons should be required to file notices, and document retention requirements. At the meeting, the FTB proposed a reporting regime that would include the following information: (1) name and address of the transferor and transferee; (2) the transferor and transferee taxpayer ID; (3) type of asset transferred; (4) fair market value of the asset transferred; (5) adjusted basis of the asset transferred; (6) gain at the time of the transfer; (7) apportionment factors; and (8) reasons why gain is deferred. Questions arose during the meeting as to whether the transferor or transferee is required to report such information, and whether the apportionment factors for the year of deferral or the year of recognition should be used. The FTB confirmed that the lesser of the two shall be used when calculating the amount of gain to be reported. The FTB will hold a second interested parties meeting to obtain further public input.

Hey Wabbit!: California's Amnesty Puttycat Program

On March 24, Governor Jerry Brown signed into law **SB 86 (Committee on Budget and Fiscal Review)**, a majority-vote bill, which includes a tax amnesty program for taxpayers with underreported income related to abusive tax avoidance transactions and offshore financial arrangements. The amnesty program—which is more stick than carrot—is part of a larger proposal to close the $26 billion gap between spending and revenue in the state budget, and is estimated to raise roughly $200 million due in large part to accelerated revenues. This revenue estimate is as likely to materialize as an Easter bunny carrying a copy of State Taxation (by Jerome and Walter Hellerstein) at your next family picnic.

The tax amnesty program—referred to as Voluntary Compliance Initiative Two (VCI II)—offers a 91-day amnesty period from August 1, 2011, through October 31, 2011, for personal and corporate income taxpayers with liabilities derived from abusive tax avoidance transactions and offshore financial arrangements related to taxable years prior to January 1, 2011, and tax deficiencies that are not final as of July 31, 2011.

The legislation defines an "abusive tax avoidance transaction" as: (1) a tax shelter, as defined in Internal Revenue Code (IRC) § 6662(d)(2)(C); (2) a reportable transaction, as defined in IRC § 6707A(c)(2); (3) a listed transaction, as defined by IRC § 6707A(c)(2); (4) a gross misstatement, as defined by IRC § 6404(g)(2)(D); and (5) any transaction to which Revenue and Taxation Code Section 19774 (the Noneconomic Substance Transaction (NEST) Penalty) applies. An "offshore financial arrangement" is defined as "any transaction involving financial arrangements that in any manner rely on the use of offshore payment cards, including credit, debit, or charge cards, issued by banks in foreign jurisdictions or offshore financial arrangements, including arrangements with foreign banks, financial institutions, corporations, partnerships, trusts, or other entities to avoid or evade income or franchise tax."

Taxpayers that pay all taxes and interest due during the amnesty period are offered a "carrot" and will "hop" out of harm's way by receiving a waiver of most penalties (including the 40% NEST penalty, the new VCI II 100% interest penalty, and the 20% accuracy-related penalty). Two penalties that will not be waived are the large corporate understatement penalty under Section 19138 and the 2005 amnesty interest penalty under Section 19777.5. Taxpayers that participate in the program will also avoid criminal prosecution.

Taxpayers that participate in VCI II will forfeit their right to claim a refund of amounts paid in connection with abusive tax avoidance transactions and offshore financial arrangements under the amnesty program. Furthermore, to retain the forgiveness of penalties offered under VCI II, taxpayers must "fully cooperate in an inquiry" regarding the use of abusive tax avoidance transactions or offshore financial arrangements. If the FTB finds a VCI II participant to be a bad bunny (and less than "fully cooperative" with such inquiries), the FTB may assess any applicable penalties.

Taxpayers that do not participate in VCI II and who have liabilities attributable to abusive tax avoidance transactions or offshore financial arrangements will be subject to a 100% interest penalty, in addition to the standard penalties imposed upon such transactions. If a taxpayer files an amended return correcting the deficiency after the amnesty period but before a notice of proposed assessment is issued, the penalty will be reduced to 50% of the interest payable on the additional tax imposed.

The legislation implementing VCI II also extends the statute of limitations related to abusive tax avoidance transaction deficiencies from eight years to 12 years from the date of filing the return. This extended statute of limitations, which "bugs" many taxpayers, applies to all notices of proposed deficiency assessment mailed to taxpayers on or after August 1, 2011.

Recently Seen and Heard

March 22-23, 2011
ABA/IPT Advanced Sales/Use Tax Seminar
The Ritz-Carlton – New Orleans, LA
Steve Kranz on Jeopardy Assessments and Taxpayers' Rights Advocates

March 30, 2011
Sutherland Webinar: Codified Economic Substance Doctrine: You'll Know It When You See It? A Guide to Navigating the New Economic Substance World
Jeff Friedman and Sutherland Tax Group Partners **Kendall Jones** and **Carol Tello** presented

April 3-6, 2011
TEI Midyear Conference
Grand Hyatt – Washington, DC
Jeff Friedman on Waive or Walk: Considerations for Extending the Statute of Limitations
Marc Simonetti on Audits Gone Awry

April 7, 2011
Strafford Webinar
Jonathan Feldman on Apportioning Service Revenue in Corporate Tax Compliance: Navigating the Latest State Laws and Regulations

April 20-21, 2011
TEI Minnesota Chapter 28th Annual Presidents Meeting
Minneapolis Convention Center – Minneapolis, MN
Steve Kranz on Sales Tax in a Virtual Economy

April 27, 2011
New York State Bar Association 15th Annual New York State and City Tax Institute
Concierge Conference Center – New York, NY
Marc Simonetti on Disclosure Developments

April 27, 2011
TEI Nashville Chapter Meeting
Franklin Marriott Cool Springs – Franklin, TN
Pilar Mata and **Melissa Smith** on Waive or Walk: Considerations for Extending Statutes of Limitations

April 28, 2011
TEI Monthly Call
Steve Kranz on Discussion of Contingent Fee Audits

April 28, 2011
DC Bar State Tax Lunch
DC Bar Conference Center – Washington, DC
Steve Kranz on Legislative Trends and Predictions for the Current Legislative Session

SOUTHEAST

Just Say No: Alabama Legislature Vetoes Department of Revenue's BPT Regulation

In an unusual twist of legislative procedure, the Alabama legislature passed a joint resolution (SJR 4) vetoing an Alabama Department of Revenue (Department) regulation that disallowed a Business Privilege Tax (BPT) deduction for equity investments in subsidiaries.

The saga of SJR 4 relates to *AT&T Corp. v. Surtees*, 953 So. 2d 1240 (Ala. Civ. App. 2006). In *AT&T*, the Alabama Court of Appeals held that the BPT deduction for investments in subsidiaries found in Ala. Code § 40-14A-23(g)(1) was facially unconstitutional under the Commerce Clause, because the deduction was limited to only those subsidiaries doing business in Alabama. The court did not order the deduction to be stricken, but rather remanded the case to the trial court to afford the Department an opportunity to offer a permissible justification for the discrimination. The parties ultimately settled before the court entered judgment on the remedy issue.

Following the resolution of the *AT&T* case, rather than broadening the deduction to investments in all entities, the Department instead adopted a regulation (Ala. Admin. Code. r. 810-2-8-.08) on June 21, 2010, denying the deduction entirely. The Department's regulation was in direct conflict with the statutory deduction and arguably resulted in multiple taxation of the same property.

In response to the Department's actions, the Alabama legislature's administrative agency oversight panel unanimously vetoed the regulation on July 21, 2010. Under the Alabama Administrative Procedure Act, the regulation would be retroactively reinstated unless the legislature confirmed the veto through a joint resolution. On March 17, 2011, Governor Robert Bentley signed into law SJR 4, confirming the veto and putting the final nail in the coffin for the controversial regulation.

It remains to be seen whether the legislature will take further action to correct the presently unconstitutional statute. Taxpayers owning subsidiaries not doing business in Alabama that have historically not qualified for the deduction should consider claiming it when filing BPT returns. We understand that although the Department has already deleted the line item on the 2011 BPT forms where the deduction was previously reported, the Department nevertheless intends to allow eligible taxpayers to claim the deduction following the passage of SJR 4.

Peach State Politics: Georgia Tax Reform Effort Dies on the Vine

Georgia's grand experiment to comprehensively rewrite its state tax code came to an anti-climactic halt on April 11, 2011, when the Georgia House of Representatives adjourned without taking up the tax reform bill. In its final form, the bill was unable to withstand a substantial political attack with uncertainty as to the net revenue impact of the bill and whether changes in the personal income tax calculation would create a tax increase on the middle class.

The 10-month tax reform saga began in June 2010, with legislation creating the Special Council on Tax Reform and Fairness for Georgians (the Council), which issued a comprehensive report on January 7, 2011, generally recommending a transition from income taxes to more broad-based consumption taxes. (See Sutherland Legal Alert, January 10, 2011, for detailed coverage of the Council's report). The original tax reform bill, H.B. 385, was originally introduced to the Special Joint Committee on Georgia Revenue Structure (the Joint Committee) mirroring the recommendations of the Council and intending to be revenue neutral.

Lawmakers worked furiously to develop a tax reform bill that was politically tenable, and the Joint Committee favorably reported a substantially revised version (H.B. 387) to the House on March 30, 2011. H.B. 387 dropped many of the provisions contained in the original bill, but would have still reduced the personal income tax rate to 4.5% and eliminated most personal deductions. The bill also would have expanded the sales tax base to car repair services and casual sales of used cars, exempted energy used in manufacturing from sales tax, and imposed a new Communications Services Tax. However, troubles mounted when the state auditor estimated that the bill would reduce state revenues by $220 million rather than being revenue neutral. A final attempt to reach a compromise by tweaking the personal income tax changes and delaying the effective date of the energy exemption for manufacturers was effectively killed by an 11th hour and hotly debated fiscal report stating the bill would raise taxes on many middle income taxpayers. Proponents of the bill view this as a temporary setback and continue to hope that the House will reconsider tax reform in this summer's planned Special Session or next year's legislative session. Lawmakers have until April 2012 to take up the Council's recommendations.

POLICY AND LEGISLATION

Shades of Gray: D.C. Combined Reporting Legislation Finally Introduced

The Council of the District of Columbia finally introduced legislation that would mandate combined reporting. In 2009, Bill No. 18-409 instructed the Council to adopt combined reporting for tax years after December 31, 2010. On April 1, 2011, the District's new Mayor, Vincent G. Gray, unveiled his proposed budget, B19-0203 "Fiscal Year 2012 Budget Support Act of 2011" (Budget Bill), which includes the long-awaited—and controversial—combined reporting provisions. If the Budget Bill passes as introduced, the District will formally adopt a combined reporting regime effective retroactively to tax years beginning after December 31, 2010. While the Budget Bill does at least offer more details on the District's potential combined reporting regime than the 2009 emergency legislation, several significant issues are entirely absent, and several provisions are problematic. However, the Budget Bill requires that the Mayor adopt regulations necessary for the reporting and enforcement of the combined reporting regime and, therefore, some of the gaps may be filled by the District's Office of Tax and Revenue.

Most, but not all, of the District's proposed combined reporting provisions emanate from the Multistate Tax Commission's (MTC) Model Statute for Combined Reporting and suffer from the same issues as that model. For example, the Budget Bill, like the MTC Model, generally adopts the *Joyce* approach (i.e., treating each separate member rather than the combined group as the taxpayer) rather than the *Finnigan* approach (i.e., treating the combined group as the taxpayer).[1] Using the *Joyce* approach, the Budget Bill requires that each member calculate its own franchise tax liability. This means that tax attributes, such as credits and net operating loss carryovers, are "trapped" within the member of the combined group that generated the credit or loss and cannot be used by the group as a whole. Oddly, the Budget Bill completely fails to address the two issues that gave rise to the original *Joyce* and *Finnigan* cases—calculating the numerator for non-nexus members and the application of throwback.

Public hearings on the Budget Bill will continue through May 6; final passage of the bill is expected by June 7. If the City Council approves the bill and its substantive combined reporting legislation, Congress will review the bill but is unlikely to make changes to the legislation. City Council approval of the Budget Bill, as drafted, is not a foregone conclusion. While Councilmember Jack Evans (Chair of the Committee on Finance and Revenue) favors combined reporting in concept, he has publicly rejected Mayor Gray's Budget Bill due to its other tax increases.[2] With a stand-alone combined reporting proposal unlikely this year, the District's leadership will likely seek a compromise. For a more detailed explanation and analysis of the Budget Bill's combined reporting provisions, see our Legal Alert here.

1 *See* Washingtoncitypaper.com, What's Wrong with Vince Gray?, http://www.washingtoncitypaper.com/blogs/looselips/2011/03/09/whats-wrong-with-vince-gray/ (last accessed Apr. 4, 2011); Press Release, Office of Councilmember Jack Evans, Evans Responds to Mayor Gray's FY 2012 Budget Proposal (Apr. 1, 2011) (on file with authors).

2 *Id*.

Come See Us

May 1-5, 2011
COST Intermediate/Advanced Sales Tax School
Georgia Tech Hotel and Conference Center – Atlanta, GA
Jonathan Feldman and **Maria Eberle** on Manufacturing/ Construction Sales and Use Tax Issues

May 1-5, 2011
COST Intermediate/Advanced State Income Tax School
Georgia Tech Hotel and Conference Center – Atlanta, GA
Michele Borens on Determining the Corporate Income Tax Base

May 2, 2011
TEI Houston Chapter 23rd Annual Tax School
Hyatt Regency – Houston, TX
Diann Smith on Combined Reporting

May 5-7, 2011
National Conference of State Legislatures Spring 2011 Meeting
Colonnade Hotel – Boston, MA
Steve Kranz presenting to various committees and task forces on hot topics in state and local tax and legislative priorities

May 9, 2011
Tax Foundation State and Local Tax Training: Tax Laws and Lobbying for Businesses and Associations
Mayflower Hotel – Washington, DC
Steve Kranz on Current Affairs in Tax Lobbying

May 17-18, 2011
TEI Denver Chapter Meeting
Denver, CO
Michele Borens and **Jeff Friedman** will present

May 18-19, 2011
Georgetown Law CLE 34th Annual Advanced State and Local Tax Institute
Georgetown University Law Center – Washington, DC
Diann Smith on Transparency of State Tax Administration

May 19-20, 2011
Florida Bar Sate Tax Conference
Caribe Royale Resort Suites – Orlando, FL
Michele Borens on Nexus – Update on Recent Developments: Current Standards, Emerging Trends and Significant New Legislation

May 23, 2011
COST 2011 Spring Audit Sessions and Income Tax Conference
Hyatt Regency Tamaya – Santa Ana Pueblo, NM
Jeff Friedman on Top 11 State Income Tax Cases and Issues to Watch for in 2011
Steve Kranz on Dealing with a New Trend: Transfer Pricing Assessments

May 24-26, 2011
Telestrategies Communications Taxation 2011
Steve Kranz on Tax Treatment of Digital Content

June 20, 2011
Interstate Tax Corporation Interstate Tax Planning Conference
Jolly Madison Hotel – New York, NY
Jeff Friedman on How the Interstate Tax System Works and on Jurisdiction and Nexus

June 22-25, 2011
TEI Region VII Conference
Hilton Head Marriott Resort – Hilton Head Island, SC
Jeff Friedman and **Eric Tresh** on State Tax Roundtable – Planning and Techniques

June 27, 2011
IPT Annual Conference
San Antonio, TX
Jeff Friedman on Retroactive Tax Legislation

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