"Shaking things up in state and local tax"

SUTHERLAND SALT SHAKER

FORECAST
Political clouds thickening, storms expected.

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New York Issues (Another) Advisory Opinion on Taxability of Financial Advice Services

The New York State Department of Taxation and Finance issued an advisory opinion regarding whether three different financial advice services are subject to New York sales and use tax. N.Y. Advisory Op. TSB-A-10(61)S (Dec. 17, 2010). Section 1105(c)(1) of the New York Tax Law imposes sales tax on receipts from the "furnishing of information" by printed matter, including the collection, compilation, or analysis of information of any kind or nature and furnishing reports on the same. However, the statute excludes from the scope of "furnishing of information": (1) information that is personal or individual in nature; and (2) information that is not or may not be substantially incorporated into reports furnished to others. New York courts have further qualified the first criterion by requiring that an information service be "uniquely" personal or individual in nature.

The Department of Taxation and Finance addressed the provision of pricing information associated with derivatives (referred to as "Service P"). To facilitate this service, information is first purchased and gathered from various public and private sources, stored in a confidential database, culled and refined, and later combined using proprietary and confidential algorithms. The second service ("Service R") relies on the same proprietary and confidential algorithms and database as Service P, but it also involves providing clients with independent valuations determined by the provider's experts. The advice provided is unique to the requesting client, and it is neither stored nor reused. The third service ("Service V") involves providing mark-to-market data, the sub-

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Utah Goes Market for Sourcing of Financial Institution Services

The Utah State Tax Commission has amended its rules for apportioning financial institution receipts attributable to services from a costs-of-performance sourcing rule to a market-based sourcing rule (Utah Admin. R. R865-6F-32(3)(l)). Effective December 9, 2010, financial institutions must include in the sales factor numerator receipts from services not otherwise specifically addressed in the regulation "if the purchaser of the services receives a greater benefit of the services in Utah than in any other state."

The change in sourcing methodology is consistent with Utah's recently amended general corporation apportionment statute, Utah Code Ann. § 59-7-319, which similarly provides for the market sourcing of services (based on where the purchaser receives a greater benefit of the service). The change to market sourcing for financial institutions is another departure by Utah from the Multistate Tax Commission's (MTC) model regulations for the apportionment of financial institution income. The MTC's model regulation currently provides, in Section 3(l), for sourcing of financial institution receipts from services based on where the services are performed, or in the case of services performed in more than one state, on the costs of performing the income-producing activity. Interestingly, the MTC has proposed amendments to its financial institution apportionment regulations, although the section pertaining to the sourcing of receipts from services currently could continue to follow the costs-of-performance sourcing methodology.

Utah's change to market sourcing for services not otherwise specifically addressed in its regulation seems to establish a certain consistency in the sourcing rules for financial institutions, because many of the other receipts addressed in the regulation are also sourced in a way to reflect a taxpayer's market. For example, interest from loans not secured by real property are sourced to the state where the borrower is located, and receipts from credit card receivables are sourced to the state of the billing address of the cardholder.

Iowa Supreme Court Deep-Fries Commerce Clause

The Iowa Supreme Court and Iowa Department of Revenue issued interesting opinions that continue to expand corporate income tax nexus arguably beyond the limitations of the Commerce Clause of the U.S. Constitution.

The Iowa Supreme Court held that physical presence is not a required ingredient of the secret recipe for substantial nexus in the corporate income tax context. *KFC Corp. v. Iowa Dep't of Revenue*, No. 09-1032 (Iowa Dec. 30, 2010). The Department issued a corporate income tax assessment to KFC Corp., which had no employees or property in Iowa. KFC's only connection with Iowa was that it licensed the KFC intangible property to independent franchisees operating or conducting business in Iowa. The Iowa Supreme Court held that, despite this tenuous connection and no physical presence, KFC had substantial nexus in Iowa. First, the court concluded that KFC's licensing of intangibles to unrelated Iowa franchisees was "the functional equivalent of 'physical presence' under *Quill*." Second, the court concluded in the alternative that physical presence is not required to find substantial nexus in the corporate income tax context. The court relied on the "economic presence nexus" principles from *Geoffrey* and its progeny; however it failed to recognize that this was the first of such intangible holding company cases that involved licensing to unrelated third parties. Up to this point, the only "economic presence

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New York Issues (Another) Advisory Opinion on Taxability of Financial Advice Services (cont'd)

ject and extent of which depends on the type of financial product and the needs of a specific client. Service V relies on the same proprietary and confidential algorithms and database as Services P and R, but the service depends heavily on the technical skills and judgment of the provider's experts. Service V may include developing strategies for valuing financial products, revaluing financial products or generating data when available data is otherwise insufficient or nonexistent, and providing follow-up analysis.

The Department determined that Service P is a taxable information service because it fails to meet the exception criteria under Tax Law § 1105(c)(1). With respect to the first criterion, the information provided as part of Service P comes from a common database. Perhaps more importantly, the information archived in the database comes from both private and *public* sources; public information is neither personal nor individual in nature. With respect to the second criterion, the information provided is substantially incorporated in reports furnished to other clients because it is based on the same proprietary formulas and database.

The Department determined that Services R and V are not taxable information services and are not within the list of other enumerated services subject to sales and use tax. While these services bear some similarities to Service P, they require the substantial involvement of the provider's experts. The Department determined that Services R and V are more akin to nontaxable consulting services because the provider's experts apply their skills, experience, and judgment in providing the services.

This Advisory Opinion is the latest demonstration of the shift in the Department's treatment of the taxability of financial advice services, a process that started with Advisory Opinion TSB-M-10(7)S issued on July 19, 2010.

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Iowa Supreme Court Deep-Fries Commerce Clause (cont'd)

nexus" cases that involved transactions with unrelated third parties were in the financial institutions context (*e.g., MBNA* and *Capital One Bank*). Thus, *KFC* may run "afowl" of the Commerce Clause.

Earlier in December, the Department issued an informal opinion resulting in similar consequences. The Department determined that a company had substantial nexus in Iowa despite having no physical or economic presence in Iowa. The company was an out-of-state registered agent, with no property or employees in Iowa, that subcontracted to an Iowa law firm to receive documents for customers located primarily outside Iowa. The Department determined that the company was "exploiting the Iowa market" and, therefore, had corporate income tax nexus in Iowa.

Thus, it appears that Iowa is the latest state to make clear that physical presence nexus does not apply for income tax purposes.

SALT PET OF THE MONTH

Abbie

Meet Abbie, the newest addition to the Sutherland SALT family. New York associate David Pope and his girlfriend, Lacey Zoller, adopted Abbie when the holiday spirit overtook them last month. Although David and Lacey were initially interested in getting a small, apartment-friendly dog, they immediately fell for Abbie, the rescue worker's favorite.

The shelter claims that Abbie is an American and English bulldog mix, but David and Lacey suspect that she is really part bulldog, part pig and part alligator. Abbie is a loud snorer, drools incessantly, and loves to snort, give paw and do "Abbie alligator" rolls around the house to get her belly rubbed. Her long body, short legs, and giant head have convinced David and Lacey that Abbie is actually a special "three-in-one" animal.

Abbie is fairly clueless when it comes to doggie manners. Although she was initially rebuffed with fierce teeth and a solid snap by a large Weimaraner at the dog park, to Abbie, that simply meant "Hey, maybe I moved too fast; let's try that again in about 30 seconds." Her curiosity and persistence have paid off, because the Weimaraner eventually gave up and is now her new best friend.

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.

The Latest ATM Fee, a Sales Tax?

The South Dakota Supreme Court appears to have added the South Dakota sales tax to the list of fees associated with automated teller machine (ATM) usage. *TRM ATM Corporation v. South Dakota Dep't. of Rev*., 2010 SD 90 (December 8, 2010). In *TRM*, an Oregon company that owned, operated, sold, leased, and serviced ATM machines was assessed South Dakota sales tax on transaction processing and surcharge fees received from sponsor banks and core-data companies (parties that serve as intermediaries in the ATM transaction by contracting with card-holders' depository banks to make ATM services available to cardholders).

While TRM conceded the taxability of its transaction processing and surcharge fees under South Dakota's sales and use tax laws, TRM claimed it was not liable for payment of the South Dakota sales tax. TRM made two arguments. First, it claimed that, because there are several intermediaries in the ATM transaction and TRM's activity was not the predominant activity in an ATM transaction, the sponsor banks and core-data companies should be responsible for the payment of South Dakota use tax on the services received from TRM (rather than hold TRM responsible for payment of sales tax). The court concluded that this argument was without merit because the South Dakota sales tax, on its face, applies to the "gross receipts of any person from the engaging or continuing in the practice of any business in which a service is rendered." Because TRM rendered ATM services for other persons in South Dakota and received consideration for those services, the receipts were subject to South Dakota's sales tax.

Second, TRM argued that even if the court concluded that the fees for services performed by TRM were subject to sales tax, the majority of such fees were "pass through" fees received only "temporarily" by TRM and thus were not TRM's "gross receipts." Prior to the audit period, TRM sold most of its ATMs to third-party merchants on whose premises the machines were located. TRM then became contractually obligated to pay the third-party merchants a portion of the transaction processing and surcharge fees received from sponsor banks and core-data companies. TRM claimed that it was not entitled to all of the fees it received, because it was obligated to pay to the third-party merchants a portion of the fees. Therefore, TRM claimed the pass-through fees could not be its "gross receipts." However, TRM never disclosed the specifics of its contractual obligations with the third-party merchants and never claimed any statutory deductions from gross receipts. Accordingly, the court concluded that this argument was without support, in the record, and sales tax was due on all of the transaction processing and surcharge fees received by TRM.

This decision raises the question of whether the result would have been different if TRM had produced its contracts with third-party merchants. If TRM had been able to demonstrate that it had no right to a percentage of the fees, TRM may have been permitted to exclude the pass-through fees from tax. While this case appears to increase the cost of ATM usage in South Dakota, the ramifications in other states may not be widespread because the majority of states, unlike South Dakota, do not tax most services (including ATM-related services).

Recently Seen and Heard

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
Pilar Mata and **Maria Eberle** 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?
Marc Simonetti on Best Practices for Managing Audits & Litigation in Today's Challenging Environment and FIN 48 Disclosures; Discussion of Significant State Tax Litigation Around the Country; and The Economic Substance Doctrine & Reporting of Uncertain Tax Positions, Including Exploring Unintended Impacts on State Taxation

January 6, 2011
TEI Atlanta State and Local Chapter Meeting
Atlanta, GA
Eric Tresh on State Tax Implications of Schedule UTP

Inclusion of Insurance Company in Unitary Return – When Is an Insurance Company "Subject to" Premium Tax?

When is an insurance company "subject to" premium tax? Recently, the Indiana Tax Court answered this question in *United Parcel Service, Inc. v. Indiana Department of Revenue*, 49T10-0704-TA-24 (December 29, 2010), concluding that an insurance company is "subject to" premium tax when it is placed under the authority, dominion, control, or influence of the tax, and not simply when it is required to pay the tax.

In *United Parcel Service*, the Indiana Department of Revenue had determined that UPS should have included the income of two affiliated foreign reinsurance companies in its Indiana worldwide unitary corporation income tax return. UPS, however, maintained that its affiliated foreign reinsurance companies should be excluded because the Indiana statutes provided that there is no income tax on the adjusted gross income of insurance companies "subject to" the Indiana gross premium tax. The Department argued that, because the foreign reinsurance companies never filed premium tax returns or paid premium tax, such companies were not "subject to" the Indiana gross premium tax and should have been included in the UPS return. However, the Tax Court sided with UPS, and concluded that the phrase "subject to" does not mean that one must "pay" the tax. Rather, the phrase "subject to" simply means "that one is placed under the authority, dominion, control, or influence" of the premium tax. Accordingly, UPS was entitled to exclude the income of its affiliated foreign reinsurance companies from its Indiana worldwide unitary corporation income tax returns.

State revenue authorities have struggled with interpreting the phrase "subject to," particularly as it relates to the interplay between corporate income taxes and premium taxes. Many states exempt insurance companies from traditional corporate income taxes by providing an exemption or exclusion for insurance companies that are "subject to" or, alternatively, are "paying" insurance premium tax. As is evidenced by the Tax Court's holding, if a state wanted to limit the exclusion of insurance companies from corporation income tax only if such companies were actually paying the premium tax, the state's legislature could have done so explicitly by limiting the language in the statute such that it only applied to insurance companies "paying" the premium tax. In fact, the exemption statutes in certain states specifically provide exemptions for only those taxpayers actually paying the premium tax.

Interestingly, however, while Arizona's statutes provide an exemption from its corporate income tax for insurance companies "paying" the Arizona premium tax, the Arizona Department of Revenue concluded in a Private Letter Ruling that an insurance company that provided Medicare Part D benefits, the premiums for which were exempt from premium tax under federal law, and therefore did not "pay" any premium tax, was still "subject to" the premium tax and exempt from the corporate income tax. Private Taxpayer Ruling LR08-10, Arizona Department of Revenue (Oct. 27, 2008). Furthermore, Missouri recently amended its exemption statute that had required insurance companies to "pay" Missouri premium tax in order to claim exemption from Missouri corporate income tax. In fact, a 2008 Missouri ruling that addressed the statute prior to the amendment, in sharp contrast to the Arizona ruling, concluded that an insurance company that exclusively provided Medicare Part D benefits, the premiums for which were exempt from premium tax, and thus, did not actually pay premium tax, was subject to the Missouri corporate income tax. Missouri Private Letter Ruling No. LR 5192 (Oct. 22, 2008). Subsequent to this ruling, Missouri amended its exemption statute to provide an exemption from corporate income tax to insurance companies that are "subject to" the Missouri premium tax.

As apparent in *UPS*, some state revenue authorities interpret the phrase "subject to" tax as requiring actual payment of the tax. In addition to its treatment of UPS, the Indiana Department of Revenue also dealt with this issue in the premium tax area as it related to an insurance company that provided Medicare Part D benefits. In Indiana Revenue Ruling 2008-01 IT, the Department concluded that, because premiums for Medicare Part D benefits were excluded from premium taxation under federal law, the taxpayer, an insurer that offered Medicare Part D benefits only in Indiana, was not "subject to" the premium tax and, therefore, not exempt from the corporate income tax. This ruling appears to be contrary to the Tax Court's decision in *UPS*.

The question of who is "subject to" the premium tax for purposes of an exemption or exclusion from the corporate income tax remains unanswered in several states, and this area of law is expected to continue to evolve.

Come See Us

January 23-28, 2011
COST SALT Basics School
Georgia Tech Hotel and Conference Center – Atlanta, GA
Charlie Kearns on Streamlined Sales Tax – Changing the Landscape
Maria Eberle on Jurisdiction to Tax

February 2-4, 2011
Florida Bar Tax Section National Multistate Tax Symposium
Disney's Grand Floridian Resort & Spa – Orlando, FL
Jeff Friedman on Pending State Tax Legislation
Steve Kranz on Sales and Use Tax in the Virtual Economy
Marc Simonetti on Sales, Use and Transfer Tax Considerations

February 11, 2011
TEI New Jersey Chapter Meeting
Meadow Wood Manor – Randolph, NJ
Marc Simonetti and **Jeffrey Serether** on Nexus Issues for Non-Income Taxes

February 22-24, 2011
TEI 2011 IRS Audits & Appeals Seminar: Tax Controversies in a Post-Schedule UTP World
Hyatt Regency Orlando International Airport – Orlando, FL
Marc Simonetti and **Pilar Mata** on State Tax Consequences of Federal Tax Controversies

February 28, 2011
TEI Houston Chapter 23rd Annual Tax School
Hyatt Regency – Houston, TX
Marc Simonetti and **Eric Tresh** on States' Ability to Adjust Income and Expenses

March 6-9, 2011
UPPO Annual Conference
Grand Hyatt – San Antonio, TX
Marlys Bergstrom on Unclaimed Property Developments within the Insurance Industry
Diann Smith on Federal Preemption: When Do Federal Laws Trump the States?

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

Connecticut "WREITS" Guidance for REITs and Economic Nexus

Recently, the Connecticut Department of Revenue Services issued an informational publication explaining its position on the application of the Connecticut Corporate Business Tax on real estate investment trusts (REITs) and revised a previously issued publication on the implications of the state's economic nexus provisions to foreign (non-U.S.) companies.

The Department's newly issued guidelines treat REITs in a manner that is similar to the Internal Revenue Code, but the Department strays in certain areas. IP 2010(21) (Dec. 1, 2010). For corporation business tax (CBT) purposes, REITs carrying on business in Connecticut are subject to tax on their net income under Conn. Gen. Stat. § 12-217 and must file a separate company Form CT-1120. However, unlike the federal treatment, a dividends paid deduction is not allowed for CBT purposes if the REIT is a "captive REIT." A captive REIT is, subject to certain exceptions, a REIT where more than 50% is owned or controlled by a single entity and where the REIT is not regularly traded on an established securities market. On the flip side, while REIT distributions are generally not eligible for a dividends received deduction, the Department explained that Connecticut law provides for such a deduction if the dividend is received (1) from a REIT that was incorporated prior to April 1, 1997, and that had more than $500 million in real estate assets contributed to it prior to that date, or (2) from a captive REIT that is taxable in Connecticut.

In addition, the Department provided apportionment guidance applicable to REITs. Generally, REITs apportion income in the same manner as C corporations (i.e., using the payroll, property, and double weighted sales factors). However, the Department explained that REITs that

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Retailers, Finance Companies and Sales Tax Refunds on Bad Debt – Heads I Win, Tails You Lose

The Arizona Superior Court denied Home Depot a bad debt deduction related to customer credit card transactions. *Home Depot USA Inc. v. Arizona Department of Revenue*, TX 2006-000028 (Dec. 10, 2010). The court reviewed three conditions that must be met under Arizona law in order for a bad debt to be deducted: (1) the transaction upon which the bad debt deduction is being taken was reported as taxable, (2) the debt arose from a debtor-creditor relationship based upon a valid and enforceable obligation to pay a fixed or determinable sum of money, and (3) all or a portion of the debt is worthless. *Id*. In determining whether Home Depot could claim the deduction associated with its private label credit card transactions, the court relied on a decision of the Arizona Appeals Court and interpreted the first and second conditions as limited only to those persons who made the sale and originally reported the tax. *Id*. (*DaimlerChrysler Services North America, LLC v. Arizona Dep't. of Revenue*, 210 Ariz. 297, 302 (Ariz. App. 2005)). While Home Depot made the sales and reported the tax, it did not incur the bad debt directly. The finance company paid Home Depot the amount of each transaction, less a negotiated percentage that included the overall cost of bad debt for all transactions.

Home Depot argued that it and the finance companies that administer the private label credit cards acted as a unit, which entitled Home Depot to the deduction. This argument failed because the record reflected an arm's length business transaction between Home Depot and the finance companies. Also, Home Depot claimed that the denial of the deduction would result in unjust enrichment to the state because the finance company was also denied the deduction. The court was not persuaded and instead focused on whether Home Depot was "impoverished" by the denial of the deduction. The court held that, under the terms of the transaction with the finance companies, Home Depot was not impoverished but would instead get a windfall if the deduction were allowed. Lastly, Home Depot's equal protection claim failed because the court did not find it unreasonable to limit the deduction for a bad debt transaction to the party who actually incurred the loss from it. The fact that no party would ever be able to claim the bad debt deduction for sales tax amounts that had been paid to the state by the retailer, but never received from the purchaser, was irrelevant to the court. Although it is the Arizona courts' interpretation of the state's bad debt deduction requirements, rather than the plain language of the statute, that resulted in the denial of the deduction in this case and the failure of any party to be able to claim the deduction, the court passed the buck and referred this "policy decision" to the legislature.

The Arizona decision follows similar cases in other jurisdictions over the last two years. Courts in Alabama, Ohio, South Carolina, and Washington have all ruled that a retailer could not take a bad debt deduction for payments made through a third-party finance company's credit card. Even when courts ruled in favor of the retailers, as in Michigan and Washington (under an earlier law), the legislatures later overturned the court decisions through new statutory provisions.

In these cases, taxpayers have tried almost every statutory interpretation argument they can make, and the arguments have all fallen on deaf ears. It is unclear when these bad debt deductions would now apply, because the courts' interpretations have eviscerated all meaning from the deduction provisions. This is bad tax policy because it unjustly enriches the state; the purchases are ultimately not being paid for and the state should not be entitled to the tax from the retailer or the finance company when the tax is never paid to them.

While the discussion above focuses on the plight of retailers, the finance companies on the other side of the transactions have fared no better. On January 18, the U.S. Supreme Court denied a petition for certiorari in *Ford Motor Credit Co. v. Dep't of Treasury*, letting stand a Michigan Court of Appeals decision holding that a finance company could not take a bad debt deduction for sales taxes associated with auto loans in default because it did not remit the sales tax to the state. This denial comes on the heels of a similar decision in California. *HSBC Retail Servs. v. State Bd. of Equalization*, CA A125995 (Cal. App. Nov. 18, 2010).

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Connecticut "WREITS" Guidance for REITs and Economic Nexus (cont'd)

meet the definition of "financial services company" pursuant to Conn. Gen. Stat. § 12-218b(a)(6) "can" apportion income under rules applicable to financial services companies (i.e., using a single sales factor). It is unclear whether the Department's use of the word "can" in IP 2010(21) was intended to provide a REIT that meets the definition of "financial services company" with an option as to which apportionment regime to utilize. This flexibility is not available to other financial services companies in Connecticut.

With respect to economic nexus, the Department issued IP 2010(29.1) on December 28, 2010, clarifying the Department's recent explanation of economic nexus legislation in Connecticut and, in particular, the economic nexus implications for certain foreign (non-U.S.) companies. Pursuant to Conn. Gen. Stat. § 12-216a, a company has nexus in Connecticut if the company "has substantial economic presence" that is "evidenced by a purposeful direction of business toward [Connecticut]." The Department's position is that the economic nexus provisions are not intended to apply to corporations that are treated as foreign corporations under the Internal Revenue Code and that have no income "effectively connected with a United States trade or business." While the Department intends to "administratively adhere" to this guidance, it is seeking to amend Conn. Gen. Stat. § 12-216a to clarify any ambiguity.

Washington Court of Appeals Holds Retroactive Application of a Statute Unconstitutional

The Washington Court of Appeals has held that a statutory amendment barring the filing of 24 years of business and occupation (B&O) tax refund claims violates a taxpayer's due process rights and is therefore unconstitutional. *Tesoro Refining & Mktg. Co*., No. 39417-1-II (Wash. Ct. App. Dec. 21, 2010).

Tesoro Refining and Marketing Company (Tesoro), a Delaware corporation, operates an oil refinery in Washington. Tesoro manufactures and sells bunker fuel (a residual fuel oil that remains after gasoline and distillate fuel are extracted from crude oil) primarily to vessels engaged in foreign commerce for consumption outside the territorial waters of the United States.

Prior to 2009, Washington law permitted a company that manufactured and sold a qualifying fuel (such as bunker fuel) to deduct amounts derived from the sale of the fuel against its manufacturing B&O tax liability. Tesoro did not take the deduction on its originally filed tax returns and later filed a refund claim for B&O taxes paid on bunker fuel manufactured and sold from 1999 to 2004. The Department of Revenue denied the refund claim after finding that the deduction applied only to the wholesaler and retailer B&O tax and not to the manufacturer B&O tax. Tesoro appealed the Department's determination to the superior court. While the case was pending, in 2009, the Washington legislature amended the B&O tax deduction statute limiting the applicability of the B&O tax deduction to retailers and wholesalers of qualifying fuels prospectively *and* retroactively. The superior court held that Tesoro was not entitled to the deduction and granted summary judgment to the Department. Tesoro appealed the superior court's decision.

Reversing the lower court's decision, the Washington Court of Appeals concluded that the plain language of the per-2009 B&O tax deduction statute did not restrict the applicability of the B&O tax deduction to wholesale and retail B&O taxes. The court reasoned that, because the statutory language was clear, the Department could not alter the plain language to resolve an ambiguity that does not exist on the face of the statute. As a result, the court concluded that Tesoro was entitled to the B&O tax deduction under the pre-2009 statute.

The court also determined that the retroactive application of the 2009 amendment to the B&O tax deduction statute violated Tesoro's due process rights because it impermissibly attempted to reach back 24 years. The court rejected the Department's contention that the 2009 amendment was a mere "clarification" to the statute and made no change to the meaning of the pre-2009 statute. The court reasoned that the legislature may not apply a "clarification" retroactively for 24 years when it is in direct conflict with the reasonable expectations of qualifying taxpayers. The court further noted that "[t]he direct references to Tesoro's lawsuit [in the 2009 amendment legislative history] and the fact that the 2009 act became effective the day before trial was set to begin evidences the type of improper targeting identified by [U.S. Supreme Court in *United States v. Carlton*, 512 U.S. 26 (1994)]." The court recognized that identifying and correcting significant revenue losses was a legitimate legislative purpose. However, it was not reasonable for the legislature to enact a retroactive amendment spanning 24 years in direct response to a taxpayer's refund lawsuit.

As states continue to feel the effects of the economic downturn, states may attempt to impose retroactive taxes or eliminate taxpayer's rights to refunds vis-à-vis retroactive legislation. Although the *Tesoro* court got it right, challenging retroactive taxation remains difficult as evidenced by recent decisions in *Miller v. Johnson Controls, Inc*., 296 S.W.3d 392 (Ky. 2009), *cert. denied*, 130 S. Ct. 3324 (2010), and *Exelon Corp. v. Dep't of Revenue*, 917 N.E.2d 899 (Ill. 2009), *cert. denied*, 130 S. Ct. 1699 (2010).

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