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INCOME AND FRANCHISE
TAX DEVELOPMENTS

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I. NEXUS ISSUES[1]

1. *Bridges v. AutoZone Properties, Inc.* Supreme Court of Louisiana, No. 2004-C-814 (March 24, 2005)(rehearing request denied May 13, 2005)

An out-of-state owner of a real estate investment trust that received dividends from the REIT was subject to Louisiana corporate income tax on the dividends because the owner of the REIT had sufficient nexus with the state to satisfy the requirements of the Due Process Clause.

As part of a corporate restructuring the REIT was formed to own the retail stores of an auto parts business. The operations of the retail stores were placed in a separate corporation that in turn leased the stores from the REIT. The REIT distributed the income from the leasing activities to its owners. Both the REIT and the operating company filed Louisiana corporate income tax returns. The operating company in computing its Louisiana taxable income deducted the rents paid to the REIT. The REIT in computing taxable income deducted the dividends paid the owners. The Department assessed the REIT owners contending that the owners had received an untaxed stream of income from Louisiana retail operations.

The Appellate Court held the owners' shares of the REIT did not acquire business situs in Louisiana because they were not acquired by the owner in the course of any business conducted in Louisiana nor was there any indication of share ownership or dividend receipt in the state. The statute provides that intangible property is tax at the legal domicile of its owner unless it has obtained business situs in the state. The owner of the REIT was not qualified to do business in Louisiana, had no property, office or employees in the state. Therefore the owner did not have sufficient nexus with Louisiana to meet the Due Process standards.

The Louisiana Supreme Court citing *International Harvester Co. v. Wisconsin Department of Taxation*, 322 U.S. 435 (1944) reversed the holding of the Appellate Court. In reaching its conclusion in the Supreme Court first addressed the issue of whether the REIT would be characterized as a trust for Louisiana purposes. The Department argued that the REIT is a Louisiana trust that holds property for its beneficiary Auto Zone Properties ("Properties"). Properties as a corporate beneficiary of a Louisiana trust is required to file a Louisiana income tax return. The court in rejecting this argument concluded that the initial certification as a REIT is a federal determination under the Internal Revenue Code. The REIT in issue in this matter was formed as a corporation. That status remains intact and the entry is not converted to a trust by its business operation in Louisiana.

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[1] Special thanks to Marilyn A. Wethekam of Horwood Marcus & Berk Chartered for her efforts in preparing and maintaining this outline.

The court then turned to jurisdictional issue i.e. whether Louisiana has jurisdiction to tax the dividend income of Properties based solely on its investment in the REIT which receives benefits and protection from doing business in Louisiana. The court acknowledged that the nexus requirements of the Due Process Clause control in this matter. (Because the Commerce Clause was not raised as an issue, the court did not address it.) The Due Process Clause requires some definitive link or minimum connection between a state and the personal property or transaction it seeks to tax. The income sought to be taxed must he rationally related to the values provided by the taxing jurisdiction. The court found the REIT had received benefits and protection from Louisiana. Therefore, because Louisiana has helped create the income it is not prevented from taxing its share of the income.

The Plaintiff's request for rehearing was denied because it was not timely filed. However, the chief justice nonetheless noted that the original decision may have been incorrect because it confused tax jurisdiction with personal jurisdiction.

2. *Hobbs v. Treasury*, Michigan Court of Appeals No. 254069 (September 1, 2005). Leave to Appeal pending.

   The Appellate Court overruled the Court of Claims decision that the in-state presence of an independent sales representative does not create nexus prior to RAB 1998-1. The court relied on the *Rayovac* decision that required the retroactive application of the nexus standard.

3. *International Home Foods v. Treasury*, Michigan Court of Appeals Dkt.253748 (October 4, 2005).

   The Court of Appeals held that International Foods could rely on the Department of Treasury's Administrative Bulletins addressing nexus. Thus, Treasury may not retroactively apply the *Gillette* decision to a tax year before the release of the decision if the Treasury had in place an interpretive ruling favorable to the taxpayer's decision. The court distinguished the *Rayovac* decision because the Michigan Supreme Court had not considered a prior Supreme Court decision addressing the retroactive change of an administrative position.

4. Steager v. *MBNA America Bank,* West Virginia Circuit Court No. 04-AA-157, June 27, 2005. (Appeal pending)

   The West Virginia Circuit Court has reversed the Office of Tax Appeals and held a Delaware domiciled bank that provided credit card services to West Virginia customers is subject to corporate net income tax. The lack of physical presence did not matter as the bank generated in excess of the

$100,000 threshold required to establish a statutory presumption of substantial presence. Further, the bank received substantial benefits from the state.

In so holding the court concluded the taxation of the bank did not violate the Commerce Clause tests as set out in *Complete Auto Transit*. The first and fourth prongs require substantial nexus and a relationship between the tax and the state provided services. The court rejected the *Quill* bright line physical presence test concluding it only applies to sales and use taxes. Further, the second and third prong of *Complete Auto* were not violated because the single factor apportionment accurately reflected the bank's West Virginia activities and was fairly related to the income derived in West Virginia. Finally, there was no discrimination because rate of tax was the same for instate and out-of-state banks.

5. *Dillard National Bank v. Johnson*, No. 96-454-III (Chancery Ct. Davidson County) June 22, 2004. (Appeal pending)

The Chancery Court distinguished *J.C. Penney National Bank v. Johnson*, 19 S.W. 3d 831 (1999) and held Dillard National Bank was doing business in Tennessee and was subject to excise and franchise taxes. In so doing the court relied on the principles of affiliate nexus to establish substantial nexus.

Dillard Department Stores, Inc. owned and operated stores in the State of Tennessee. In addition the company owned Dillard national Bank. The bank is a limited purpose financial institution that issues the store's proprietary credit cards. The bank had not physical presence in Tennessee. However, Dillard store employees promoted the card by soliciting customers and providing credit card applications in the stores. Store employees would assist in completing the credit applications. Customers could also use phones located in the stores to directly contact the bank and make payments on their accounts at the local stores. The Chancery Court "concluded these activities constituted a continuous and targeted solicitation within the State of Tennessee to establish and maintain a market in Tennessee with Tennessee residents." In reaching the conclusion the court distinguished *J.C. Penney National Bank* noting J.C. Penney store employees conducted no activities that assisted J.C. Penney National Bank in maintaining its credit card business in the state.

6. *Louisiana Department of Revenue*, Private Letter Ruling No. 04-004, September 13, 2004.

The Louisiana Department has concluded that the statutes do not define the term "commercial domicile." Therefore, based upon case law one must determine where the business is directed or managed. In making that determination one must look at the business's actual commercial practice rather than the corporate structure. Apply that standard to an oil and gas corporation the Department concluded that the managerial decisions were not made in Louisiana even though the company had Louisiana operations. Thus, the company's commercial domicile was not in Louisiana.

7. *A&F Trademark, Inc., etc. v. Tolson*, 605 S.E. 2d 187 (N.C. 2004). Appeal denied 259 N.C. 320 (2005). (Petition for Writ of Certiorari denied S. Ct. Dkt. 04-1625).

Corporations that licensed their trademarks valued approximately $1.2 billion to their parent company but that had no physical presence in North Carolina were subject to North Carolina corporate income and franchise taxes because they were considered doing business in North Carolina. The parent, an Ohio corporation, is engaged in the nationwide retail sale of clothing with related retail companies having 130 locations in North Carolina. The corporations were doing business in the state because North Carolina provided privileges and benefits that fostered and promoted the related retail companies and made it possible for the taxpayers to earn income pursuant to the licensing agreements. The court rejected the taxpayers' claim that physical presence in the state is required for the state to have jurisdiction to tax under the Commerce Clause for purposes of income and franchise taxes. Where a wholly-owned subsidiary licenses trademarks to a related retail company operating stores located within North Carolina, there exists a substantial nexus with the State that is sufficient to satisfy the Commerce Clause.

8. *Lanco Inc. v. Director, Division of Taxation*, Docket No. A-3285-03T1 (Superior Ct. App. Div. 2005) N.J. S.Ct. granted Certiorari January 31, 2006.

The New Jersey Superior Court, Appellate Division reversed the Tax Court and held that physical presence is not required for the imposition of the Corporate Business Tax.

Lanco, Inc. ("Lanco") is a Delaware corporation that owned intellectual property such as tradenames and trademarks. The intellectual property was licensed to Lane Bryant, Inc., a retailer with New Jersey locations. Lanco had no office, employees or property in New Jersey. Lane Bryant paid a royalty to Lanco for the use of the intellectual property.

The Superior Court, Appellate Division in reaching the conclusion rejected the Tax Court's conclusion that the holding of *Quill Corp. v. North Dakota*, 540 U.S. 298 (1992) applied to corporate income taxes. Rather, the court adopted the rationale of *Geoffrey Inc. v. South Carolina Tax Commission*, 437 S.E. 2d 13 (1993) that physical presence was not required to satisfy the Commerce Clause's substantial nexus requirement.

9. *Kmart Corporation. v. Taxation and Revenue Department of the State of New Mexico*, New Mexico Supreme Court, No. 27,269 December 29, 2005. Petition for Reconsideration granted.

The New Mexico Supreme Court reversed the Appellate Court's holding with respect to the imposition of the gross receipts tax on royalties paid by in-state licensees to out-of-state intangible holding companies. The court's decision turned on the fact the statute excluded the granting of a license to use property from the definition of the term "lease". Thus, the transaction was effectively a sale that was consummated outside the State of New Mexico. While the court reversed the Appellate Court's decision with respect to gross receipts it did not reach a decision on the income tax issue raised on appeal. Rather the court quashed the certiorari it had previously granted on the issue and ordered that the Court of Appeals decision sustaining the imposition of income tax be filed concurrent with this decision.

The Court of Appeals ruled that the imposition of gross receipts tax and income tax against a Michigan corporation did not violate the U.S. Constitution. KPI, a wholly owned Michigan subsidiary of Kmart Corp., owns and manages trademarks previously developed by Kmart Corp. The marks include trade names such as "Blue Light Special," "At Home with Martha Stewart," as well as the trade name "Kmart." In 1991, Kmart Corp. transferred ownership of the marks to KPI, and the two corporations entered into a licensing agreement whereby KPI granted Kmart Corp. the exclusive right to use the marks in the United States. In exchange for Kmart Corp.'s right to use the marks, the licensing agreement required Kmart Corp. to make royalty payments to KPI based on 1.1 percent of Kmart Corp.'s gross sales throughout the United States. The licensing agreement was negotiated, drafted, and signed by the parties in Michigan.

Before the Court of Appeals, KPI challenged New Mexico's assessment of state income taxes and gross receipts taxes upon royalties paid by Kmart Corp. to KPI. KPI based its challenge upon five grounds: (1) the state's assertion of jurisdiction to tax KPI violates the Due Process Clause of the U.S. Constitution; (2) the state's assessment of the tax against KPI is prohibited by the Commerce Clause of the U.S. Constitution; (3) the state's tax on KPI's gross income is not authorized by state law; (4) the method for apportioning KPI's income violates state law; and (5) the hearing officer was not independent and impartial and his decision was not timely as required by state law.

KPI contended that it lacked any connection to New Mexico and argued that its corporate business was conducted solely within Michigan. KPI has no tangible property or formal KPI representative located in New Mexico or in any other state other than Michigan. Accordingly, KPI argued that it does not have the minimum contacts with New Mexico that would justify the imposition of any state tax consistent with the Due Process Clause. The court disagreed, explaining that the licensing agreement ties KPI to New Mexico and to other states outside of Michigan where Kmart Corp. has stores. By allowing its marks to be used in New Mexico to generate income, KPI "purposefully availed itself of the benefits of an economic market in the forum state." Thus, the court concluded, New Mexico satisfies the traditional due process standard.

Regarding KPI's Commerce Clause argument, the court explained that, as an initial matter, it must determine whether the physical presence component of the Commerce Clause analysis in *Quill Corp. v. North Dakota* (1992) is limited to the sales and use taxes that were at issue in *Quill* or whether the component applies to income taxes as well. The court determined that the physical-presence component does not apply to income taxes. The court pointed out that, unlike an income tax, a sales and use tax can make the taxpayer an agent of the state by obligating it to collect the tax from the consumer at the point of sale; whereas, a state income tax is usually paid once a year to one taxing jurisdiction and at one rate. Thus, the court continued, collecting and paying a sales and use tax can impose additional burdens on commerce that the U.S. Supreme Court identified in *Quill* and prior opinions. The court concluded that the Commerce Clause analysis of New Mexico income tax is controlled not by *Quill's* physical presence text but by the overreaching substantial nexus test announced in *Complete Auto Transit v. Brady* (1972). The court concluded that the use of KPI's marks within New Mexico's economic market for the purpose of generating substantial income for KPI establishes a sufficient nexus between that income and the legitimate interests of the state and justifies the imposition of a state income tax.

10. *Geoffrey Inc. v. The Oklahoma Tax Commission*, Oklahoma Court of Appeals, No. 99,938 December 23, 2005.

The Appellate Court affirmed the holding of the Tax Commission that the imposition of Oklahoma income tax attributable to royalty income earned by Geoffrey under a licensing agreement which was based on sales within Oklahoma did not offend the Due Process Clause nor burden interstate commerce in violation of the Commerce Clause of the U.S. Constitution.

Geoffrey a Delaware corporation appealed an Order of the Oklahoma Tax Commission imposing income tax on the royalties received from licensing its intangibles. Toys R Us as part of a corporate restructuring in the mid-80’s assigned certain intellectual property to Geoffrey. Geoffrey entered into licensing agreements with Toys R Us for the use of the marks. The royalties for the use of the marks were equal to either twp percent or three percent of sales depending on the mark. The licensing of intangible property was the sole business activity of the company. The company did not maintain an office or have employees in Oklahoma.

The Appellate Court rejected Geoffrey's argument that the Commerce Clause requires substantial nexus through physical presence and that the Due Process requires minimum contacts. In so doing, the court rejected the argument that the *Quill* decision extended the bright-line physical presence test to all taxes. Applying the benefits test, the court concluded that the real source of income was not the agreement but rather the Oklahoma customers and by providing an orderly society in which to conduct business made it possible for to earn the income. The tax is rationally related to the benefits and protections provided by Oklahoma. Further, the Due Process minimum contacts requirement was met because Geoffrey purposefully directed it activities toward Oklahoma.

11. Indiana Department of Revenue Letter of Finding No. 02-0087, April 1, 2005.

The Department of Revenue concluded a trademark protection company that licenses intellectual property to affiliated retail stores doing business in Indiana had sufficient nexus to be subject to the Indiana Adjusted Group Income Tax. Similarly, the interest income received by the trademark protection company on loans made to the affiliated retail stores should be included in the Indiana tax base. In reaching its conclusion the Department citing IC6-3-2-2(a)(5) found the trademark company availed itself of the Indiana markets by licensing the intellectual property to an affiliated company doing business in Indiana. Further, it was determined that proceeds of the loans were partially applied to Indiana and pursuant to IC6-3-2-2.2(c) the interest income earned on those loans are partially applicable to Indiana. Therefore, the Department properly included and apportioned the royalty and interest income.

12. U*nion Tank Car Company v. Department of Revenue*, Circuit Court of Montgomery County No. CV 050370-TMH, April 10, 2006. (Appeal Pending)

An Illinois-based company engaged in manufacturing and leasing railcars is not "doing business in Alabama or deriving income from sources within Alabama" and, therefore, is not subject to Alabama corporate income tax based solely on its lessees' in-state use of some of the railcars. The statutory threshold for imposing the tax is not met, because all of the lease agreements are negotiated and executed in Illinois; the amount of the lease payments are fixed and are received in Illinois; and the manufacturer/lessor exercises no control over where the leased railcars are used.

13. L*egal Letter Ruling No.* CRP-05-003, Pennsylvania Department of Revenue, August 5. 2005.

A foreign limited liability company ("LLC") without physical presence in the Commonwealth of Pennsylvania is subject to the Pennsylvania Franchise Tax because the sales solicitations conducted in the Commonwealth on its behalf create the required nexus. An affiliated company was conducting solicitation activities in the state for the sale of tangible personal property owned by the taxpayer LLC. The Department concluded the affiliate was conducting activities on behalf of the LLC and acting as its agent because the amount of the payments to the affiliate were dependent on the solicitation activities of the affiliate. The fees for management and shared corporate services performed in the Commonwealth by two other affiliates determined on a cost plus basis and thus were arm's-length. These affiliates were not agents or representatives of the taxpayer and their activities did not create nexus between the state and the taxpayer.

14. *Asher, Inc. v. Director, Division of Taxation,* Dkt. No. 004061-2003, New Jersey Tax Court (January 5, 2006).

A Pennsylvania candy manufacturer that did not lease or own any real property in New Jersey was subject to the corporate business tax because the company's delivery drivers' activities included picking up damaged or returned goods and collecting delinquent accounts and those activities were not protected under P.L. 86-272. The drivers' activities were not ancillary to the solicitation of sales and could not be characterized as *de minimis*. Thus, the company lost the immunity of P.L. 86-272. Although the drivers' activities may have helped facilitate the sales because of the quality of service the activities did not help to facilitate the request for sales. The collection of both past and current accounts by the drivers was an activity that was independent of the sales activities and the solicitation of orders. Finally, the Tax Court relied on the fact there was a company policy regarding the pick-up of packages and collection of accounts. Therefore, despite the total number of deliveries the existence of the policy made the activity sufficiently systematic to constitute a connection between the company and New Jersey.

15. *TSB-A-05(17)C* - New York Commissioner of Taxation and Finance, December 12, 2005.

The New York Department of Finance and Taxation has concluded that an out-of-state manufacturer was not subject to the corporate franchise tax even though the company engaged in activities that went beyond solicitation of orders. Engaging in repair activities once every two or three years was a *de minimis* activity that did not subject the company to tax. Similarly, being a defendant in a products liability case was insufficient to create nexus with the state.

16. *Priefert Mfg. Co. v. Washington Department of Revenue,* Washington Board of Tax Appeals, No. 61969 (November 16, 2005).

An out-of-state wholesaler had nexus for Business and Occupation Tax purposes because its representatives made visits to Washington retailers and it presented horse show exhibitions with its team of draft horses in Washington. Priefert is a Texas company that engaged in the manufacture and sale of cattle, horse and ranch equipment for commercial and residential use. The draft horses traveled in the company's trailers which had the company's logo. In addition, the company's sales representative regularly visited retailers in Washington. The Board concluded under the company had physical presence in Washington by virtue of the fact its employees were operating in the state in a marketing capacity.

17. *Secretary of the Department of Revenue and Taxation v. Dell International, Inc. et. al.,* Louisiana Appellate Court No. 2004 CA 1702, December 15, 2005.

The Louisiana Appellate Court has held that the use of independent contractors to provide repair services was sufficient contact with the state to require Dell to impose a use tax on the products it sold in the state. Dell had no property or direct employees in the state. Dell solicits orders from outside the state and the products are shipped from either Texas or Tennessee. The Dell products come with a "return-to-the factory" warranty. The company did provide on-site repair services and contracted with an unrelated third-party to provide those repair services. Dell collected and remitted tax on the service contracts but did not collect use tax on the sale of the products.

The court concluded that the use of independent contractors to provide computer repair services was substantial nexus as it allowed Dell to establish and maintain a market in Louisiana. The court found the third-party repair service provider to be an agent of Dell. The contract terms detailed the services to be provided and Dell retained control over a number of the services. The technician were trained and directed by Dell on how to perform the service call and repairs. The court concluded the extent and nature of the services provided the third-party service providers to Dell's Louisiana customers as well as the impact of the service on the ability to establish and maintain a market was sufficient nexus to create the physical presence that is constitutionally required to impose a use tax collection requirement.

II. UNITARY ANALYSIS

1. *Hutchinson Technology, Inc. v. Minnesota Comm'r of Revenue*, Nos. A04-1245; A04-1247 (Minn. S. Ct. June 9, 2005).

   The Minnesota Supreme Court has ruled that a foreign sales corporation (FSC) may qualify as a "foreign operating company" (FOC) if it meets the tax code requirements. Hutchinson Technology is a Minnesota *corporation* that manufactures and markets computer hard drive components. Hutchinson ran its export sales through a wholly-owned foreign subsidiary, HTI Export, as its nonexclusive distributor, in order to capitalize on certain federal tax benefits.

   Hutchinson filed claims for refunds of corporate income taxes based on its relationship and transactions with HTI Export. The claims assert that Hutchinson was *entitled* to: (i) a subtraction in calculating its net income for "royalties, fees, or other like income" accrued or received from HTI Export; and (ii) a deduction from taxable net income for 80% of dividends deemed paid by the foreign subsidiary. Both issues turned on HTI Export's status as an FSC under federal tax law and as an "FOC" under Minnesota tax law.

   The Revenue Commissioner argued that HTI Export did not qualify as an FOC because it was not a "domestic corporation" as that term is used in the Minnesota law. The court rejected this position, finding that the statute in question *specifies*, without ambiguity, that FOCs are domestic corporations. The court also rejected the commissioner's contention that a corporation must have genuine operations to qualify as an FOC. Thus, because HTI Export qualified as an FOC, the court ruled that, as provided by law, Hutchinson was entitled to subtract a portion of fees received from the company in computing taxable income.

   The court also ruled that Hutchinson was entitled to deduct the deemed dividends from the FOC. As an FOC, the adjusted net income of HTI Export was deemed to be paid as a dividend to Hutchinson under Minnesota law. The Commissioner disallowed the deduction under a provision expressly denying the dividend-received deduction to FSCs. The court agreed with The Commissioner that the statute did not allow Hutchinson to claim the deduction. However, the court agreed with Hutchinson that the statute violates the Foreign Commerce Clause under the U.S. Supreme Court's ruling in *Kraft General Foods, Inc. v. Iowa Dep't of Revenue*, 505 U.S. 71 (1992), where the Supreme Court invalidated an Iowa statute denying a dividend-received deduction to foreign subsidiaries, but allowing it for domestic subsidiaries.

2. *Miami Corporation v. Dept. of Rev.*, Or. Tax, Magistrate Division, Dkt.

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No. TC-MD 021295C, February 17, 2005.

Miami Corporation, a Delaware corporation headquartered in Chicago, operated both within and outside of Oregon as a unitary business and was subject to the statutory apportionment formula to determine its tax liability for tax years 1997 through 1999. Centralized management and a common executive force were demonstrated by the taxpayer's board of directors and the supervisory role performed by an executive vice president of taxes working out of the Chicago corporate office. Economies of scale were present in the taxpayer's appointment of the executive vice president of taxes as a liaison for the Oregon business location, as well as centralization of services such as tax preparation, and routine meetings between its board of directors, and the Oregon business location manager. Lastly, there was functional integration between the taxpayer and the Oregon business location because the Oregon business benefited from integrated functions, particularly in the areas of personnel, finance, and accounting. Although the court determined that the taxpayer did not demonstrate that the apportionment formula was unconstitutional as applied and that, therefore, an alternative formula was not mandatory for tax years 1997 and 1998, it did find that for tax year 1999 the formula as a whole required adjustment to operate fairly by including intangibles in the property factor.

3. *R.R. Donnelly & Sons Company and Subsidiaries v. Arizona Department of Revenue*, State Board of Tax Appeals Dkt. No. 19344-04-1, September 27, 2005.

The Board of Tax Appeals held that three subsidiaries were unitary in nature and were required to be included in the combined return. R.R. Donnelly is engaged in the commercial printing business. Excluded from the unitary group were R.R. Donnelly Receivables, a company that purchases and factors receivables, Heritage Preservation Corporation which holds and manages intellectual property and Caslon, a company that manages investments. The Board rejected the argument that the three companies should be excluded because the companies were not engaged in the primary business and thus were not integrated at the operational level. In the opinion of the Board, the three companies could only be excluded if it were truly independent at the operational level. The facts established that each company was formed with existing assets and could not exist independently from R.R. Donnelly. Therefore, the companies were required to be included in the group.

3. *Letter of Findings No. 02-200400427* Indiana Department of Revenue, January 1, 2006.

A cigarette manufacturer was required to include its subsidiary an intellectual property company in its combined Indiana adjusted gross income tax return. The subsidiary had to be included because it was unitary in nature with its parent. The sole business activity of the subsidiary was the ownership and administration of the parent's trade names and trademarks. The company's income was generated by royalty payments for the use of the intellectual property. The Department concluded this was integral to the manufacture's business and thus was unitary in nature. The combined return was required to fairly reflect the transactions between the companies.

III. TREATMENT OF PARTNERSHIPS AND LLCs

1. *Utelcom, Inc. v. Commissioner of Revenue*, Massachusetts Appellate Tax Board, Dkt. No. C262339, January 31, 2005. (Taxpayer Withdrew Appeal.)

The Massachusetts Appellate Tax Board held that a nonresident limited partner was subject to the Massachusetts utility corporation franchise tax because it held a limited partnership interest in a Massachusetts utility partnership. This ownership constituted doing business for purposes of the Massachusetts utility corporation franchise tax. The limited partner had nexus with Massachusetts because it was subject to tax on its distributive share of partnership income earned in Massachusetts and the business of the partnership was attributable to it.

Utelcom, Inc., a Kansas business corporation, owned a limited partnership interest in Sprint Limited Partnership, a partnership doing business providing telephone service in Massachusetts. The partnership maintained a place of business and owned property in Massachusetts. The Commissioner determined that Utelcom, Inc. (the nonresident limited partner) was doing business in Massachusetts as a utility corporation and assessed additional Massachusetts utility corporation franchise tax for the years at issue. The nonresident limited partner paid the assessment and later filed for abatement. The Commissioner denied abatement.

The Massachusetts Appellate Tax Board held that the nonresident limited partner of a partnership that provides telephone service in Massachusetts was subject to the Massachusetts utility corporation franchise tax. The statute pertaining to utility corporations provides that an entity is subject to tax in Massachusetts if it is doing business in Massachusetts. Since the statute does not define "doing business," the Board looked at the statute regarding excise tax on foreign corporations, which provides that "doing business" means and includes each and every act, power, right, privilege or immunity exercised or enjoyed in Massachusetts as an incident to or by virtue of the powers and privileges acquired by the nature of such organizations. The Board found that this definition is broad enough to include earning income from a limited partnership interest because the receipt of income as an investor constitutes the enjoyment of privileges from a state. The board ruled that the definition of "doing business" in the excise tax statute also applied to the nonresident partner. There was sufficient nexus to tax the nonresident limited partner on its distributive share of income received from the partnership.

The Massachusetts Appellate Tax Board concluded that the partnership attribution rule applied to corporate utility partners that receive distributive share income subject to the utility corporation franchise tax. The Board found that the nonresident limited partner benefited from the attribution rule when the business of the partnership was attributed to it enabling it to obtain the more favorable tax treatment of a utility corporation. Consistent application of the tax provisions requires that the nonresident limited partner also be found to have nexus with Massachusetts by attribution of the business of the partnership to its nonresident limited partner.

2. *Unocal Pipeline Company v. John N. Kennedy,* Louisiana Court of Appeals Nos. 2003 CA 1946 and 2003 CA 1947, December 30, 2004.

The Louisiana Appellate Court affirmed the District Court's holding that Unocal's income from an interest in an unincorporated joint venture was properly characterized or income from a partnership.

Unocal Pipeline Company owned a less than 2 percent interest in the Trans Alaska Pipeline System (TAPS). Initially, TAPS was treated as a tax partnership for both federal and Louisiana tax purposes. Subsequently the partners agreed to "elect out" of partnership treatment for federal tax purposes. Louisiana requires the income from a partnership to be treated differently from the corporate income. Specifically §47:287:92(B)(6) requires partnership income to be allocated to the state where the income is earned. The issue before the court was whether the income generated by the partnership that elects out of the requirements of Subchapter K and similar state law provisions still constitutes income from a partnership for Louisiana tax purposes.

The court in reaching its conclusion looked to both the Louisiana definition of the term "partnership" and the federal authorities interpreting the applicable law. In so doing the court reasoned that an election to opt out of Subchapter K treatment did not caused the organization to cease to be a partnership for all purposes of the Internal Revenue Code. The partnership remains intact and the other section of the Internal Revenue

Code that are not interdependent with Subchapter K are applicable. Therefore, because an unincorporated organization working under a joint operating agreement is a partnership for income tax purposes it follows that the income received from TAPS was income from a partnership even though the partners had elected out of Subchapter K.

Note: Louisiana has amended its statute with respect to entities that opt out of Subchapter K treatment. If an entity opts out of partnership treatment for federal tax purposes the election applies to Louisiana tax as well. L. 2005 H130 (Act 351) is effective for tax years beginning after December 31, 2004. Members of such unincorporated organizations must treat the income as coming from the underlying property in their capacity of the co-owners of the property. The members must realize their share of items of gross income, directly accrue items of credit and direct incur their share of expenses.

3. *Asworth Corporation, HT Forum Inc. and D Aviation Services v. Revenue Cabinet*, Kentucky Board of Tax Appeals, Order No. K-19449, January 27, 2006. Appeal Pending.

The Board of Tax Appeals has held that a corporation that has no property or employees in Kentucky is not subject to tax on its distributive share of partnership income from a partnership doing business in the state. In so holding, the Board rejected the Department's argument that physical presence was not required and the receipt of a partnership distribution from an entity doing business in Kentucky was sufficient to meet the substantial nexus test. It should be noted the statute in effect for the period in issue imposed a tax on foreign corporations owning or leasing property in the state or who had employees in the state. Therefore, based on the statutory language Ashworth was not subject to tax.

Note: The Tax Modernization Plan, H.B.272, Laws 2005 amended the Kentucky statutory nexus standard to specifically provide that taxpayer's are doing business and are subject to the corporate income tax base on holding a general partnership interest in a partnership doing business in the state.

4. *Bell Atlantic NYNEX Mobile, Inc. et al. v. Commissioner of Revenue Services*, Connecticut Supreme Court, No. SC17154 (April 5, 2005)

The Connecticut Supreme Court in reversing the Superior Court concluded that a partnership payment of personal property tax did not entitle the partners to use the credit against their corporation business tax.

Bell Atlantic Corporation and NYNEX Corporation formed Cellco, a general partnership. Each company contributed assets from their wireless communication services. Among the assets contributed were electronic data processing equipment located in Connecticut. Cellco as owner of this equipment paid personal property tax on the equipment to various Connecticut municipalities. As a partnership, Cellco was not subject to the corporation business tax. The partners amended these 1995 returns to claim a credit for the personal property taxes paid by Cellco and requested a refund. The Commissioner denied the refund.

The court in affirming the denial determined the threshold question was whether Cellco was eligible for the credit. The court acknowledges that the federal conduit treatment of partnership attribution has been adopted by the corporation business tax. However, the credit for personal property taxes is limited by statute to a "taxpayer." §12-2171. The term "taxpayer" as it is defined does not include a partnership. Therefore, because Cellco is not a taxpayer it is not eligible for the credit. Under the conduit analysis the character of the tax attribute is determined at the partnership level. Since the partnership is not eligible for the credit there is no corporate business tax attributed to pass through to the partnership.

5. *Manpower, Inc. v. Commissioner of Revenue,* Minnesota Tax Court, No. 7739R, January 12, 2006.

The Minnesota Tax Court held that income from an entity organized and operated in France should be included in the taxpayer's net income subject to Minnesota corporate income tax because the taxpayer elected to treat the entity as a partnership for federal tax purposes. Manpower checked the box under the federal regulations to treat the entity as a partnership. The Tax Court concluded this election created a newly formed domestic entity and as such the entire income of the unitary business was subject to apportionment.

6. *Northwest Energetic Service LLC v. Franchise Tax Board*, Superior Court for San Francisco County No. CGC 05-437721 (April 13, 2006)

The Superior Court has held that the California limited liability company ("LLC") fee scheme is an unfairly apportioned tax in violation of both the Due Process and Commerce Clauses of the U.S. Constitution. In so holding the court concluded the fee imposed by *Rev. & Tax Code* §17492 was a tax that raised general revenue funds and not a regulatory fee. The fee is imposed on any LLC doing business in California or holding a certificate of registration within the state regardless of the LLC's business activity in the state. Because the fee is based on the total net income from all sources worldwide the court concluded it was not fairly apportioned. Thus, the fee failed the third prong of the *Complete Auto Transit* test. The court also concluded the tax failed both the internal and external consistency tests of the fair apportionment prong because if an LLC has no activity in the state the fees reached beyond that portion of the economic activity conducted in the state of California. Further, if every state enacted a similar fee there would be an additional burden on interstate commerce because intrastate companies would only pay one tax and interstate companies would pay tax on the same income in every state in which they were doing business.

7. *Private Letter Ruling No. 05-015*, Louisiana Department of Revenue, December 28, 2005.

A limited liability company that elects corporate status for federal and state corporate income tax purposes is not liable for the Louisiana Corporate Franchise Tax. The election has no effect on the entity's treatment for corporate franchise tax purposes. The entity is treated as a limited partnership for all tax purposes other than the corporate income tax.

IV. BUSINESS PURPOSE AND ECONOMIC SUBSTANCE

1. *In the Matter of Sherwin Williams v. Tax Appeals Tribunal,* Supreme Court, Appellate Division, October 28, 2004. Motion for Leave to Appeal, Mo. No. 182, denied April 5, 2005.

The New York Appellate Division has affirmed the New York Tax Tribunal's holding that Sherwin Williams should be combined with its two affiliated trademark protection companies. In reaching its conclusion, the Court rejected Sherwin William's argument that the statutory distortion requirement should be narrowly construed. The Court acknowledged that if reviewed from Sherwin William's viewpoint the transactions represented a relatively small part of the company's overall transactions. However, a narrow interpretation redirects the purpose of the statute. Further, there were sufficient intercorporate transactions to implicate the statute's rebuttable presumption of distortion.

The question that must be addressed is whether under all of the circumstances of the intercompany relationship present in this matter does combined reporting more accurately represent the true income. In analyzing the issue the Court reviewed the rationale for establishing the trademark companies and concluded there was substantial evidence to support the Tribunal's conclusion the structure lacked economic substance and business purpose. As a result, there was no need to determine if the royalty rates were arm's length rates.

2. *In the Matter of Petition of Hallmark Marketing Corporation*, New York Division of Tax Appeals Dkt. No. 819956 (January 26, 2006). (Appeal pending.)

The Administrative Law Judge (ALJ) has held the Department of Taxation and Finance could not forcible combine Hallmark's distribution company with the out-of-state manufacturing company. In so concluding, the ALJ held Hallmark sustained its burden of establishing the inter-company pricing met the requirements of Internal Revenue Code §482. Thus, the company successfully rebutted the Department's presumption of distortion.

Hallmark Cards is engaged in the design, manufacture and sale of social expression products. Hallmark Marketing, a subsidiary, was the exclusive domestic distribution arm of the products. The products were sold primarily to third-party retailers located throughout the U.S. Hallmark marketing purchased the products from Hallmark Cards. The purchase price was set in accordance with a contemporaneous transfer pricing study. The product's purchase price was arrived at by analyzing the profits earned by comparable third-party companies. Hallmark Marketing's profitability was consistent with that of the unrelated third-party companies.

Hallmark Marketing filed its own New York return. On audit the Department attempted to combine the company with Hallmark Card. The ALJ in holding the companies should not be combined relied on the fact that the inter-company pricing was consistent with the reasonable and flexible approach suggested by Internal Revenue Code §482.

3. *Ruling No. 06-33, Virginia Department of Revenue*, March 22, 2006.

The Commissioner of Revenue has concluded that a corporation was not entitled to an expense deduction for interest paid to its wholly-owned subsidiary because the subsidiary lacked economic substance. The taxpayer filed a separate corporate income tax return deducting the interest paid on an outstanding loan from a wholly-owned subsidiary. The subsidiary was formed in the late 1980's to manage the loans of the taxpayer's affiliates that were located in a number of foreign jurisdictions. As the foreign loans were repaid the funds were loaned to domestic affiliates. The loans were structured as demand notes generally with a floating rate of interest. The loans were not collateralized. In analyzing the economic substance of the company the Commissioner looked to the governance of the company. The officers and directors of the company were similar to those of the taxpayer and there was no evidence that they were fairly compensated for their duties. Further, the company incurred minimal expenses for payroll and rent. The expenses were not commensurate with that of a company with $100 million portfolio. The notes themselves did not meet the statutory safe harbor requirements for intercompany loan transaction because there was no collateral and no penalty for failure to pay. Finally, the Commissioner found neither the taxpayer or the subsidiary incurred any risk in the transactions. Therefore, because the subsidiary does not have a valid economic substance and the intercompany transactions were not conducted at arm's length the Commissioner consistent with the holding in *Commissioner v. General Electric*, 372 S.E. 2d. 599 (1988), has the authority to disallow the interest expense deduction.

V. NET OPERATING LOSSES

A. Mergers and NOLs

1. G*eneral Electric Company v. Iowa Board of Tax Review*, Iowa Supreme Court No. 50104-0458, August 12, 2005.

   The Iowa Supreme Court affirmed the District Court denying a refund resulting from a capital loss carryback. General Electric in 1993 sold an aerospace subsidiary and recognized a gain on the transaction. The gain was characterized as nonbusiness income allocable outside Iowa. The company in 1995 sold a chemical subsidiary and recognized a capital loss on the transaction. For federal tax purposes G.E. carried the capital loss back to 1993 reducing federal taxable income by the amount of the loss. The loss carryback offset the capital gain recognized on the sale. In addition, G.E. amended its Iowa return to reflect the reduction in taxable income and requested a refund. The Department denied the refund arguing the loss must be reduced by the amount of the gain characterized as nonbusiness income. The failure to make this deduction results in a double deduction and would result in the capital loss offsetting ordinary income. This result is prohibited by statute.

   The court in affirming the District Court reviewed the interplay of the term "net income" with the rules governing allocation and apportionment. In so doing the court concluded the statute created a natural order of calculation. First, a taxpayer has to calculate net income i.e. taxable income before net operating losses as computed for federal tax purposes. Federal taxable income is then adjusted to arrive at Iowa net income. Only after Iowa net income is computed does the process of apportioning and allocating that income occurred. The court reasoned that this sequence was logical as the allocation and apportionment rules cannot be used to allocate a "portion" of the whole if that portion was never part of the whole in the first place.

2. *Ronson Corp. v. Director, Division of Taxation*, New Jersey Superior Court Appellate Division, No. A-6776-03T2 (November 21, 2005).

The Taxpayer was prohibited from deducting net operating loss carryovers because the taxpayer had created negative income in the prior years by excluding dividend income. The Taxpayer had deducted its dividends after subtracting the full amount of the NOL carryover. The court concluded that the NOL had been exhausted in a prior year because it was sufficient to offset the dividend income. The statutory and regulatory tax scheme requires the NOL carryover to be calculated without consideration of the NOL deduction itself or the dividend exclusion.

3. *Private Letter Ruling No 05-014*, Louisiana Department of Revenue, December 28, 2005.

The Department has determined that a net operating loss would survive the merger of a Texas corporation into a Texas Limited Liability Company (LLC). The Texas LLC would be treated as a corporation for both federal and Louisiana tax purposes. The surviving LLC could carry forward the net operating loss to offset any Louisiana income generated subsequent to the merger. The net operating loss would be subject to the same limitations on utilization as would have been applied to the corporation.

VI. BUSINESS INCOME

1. *Wesnovtek Corp. v. Wilkins, Tax Comm'n*, 105 Ohio St.3d 312 (May 4, 2005)

The Ohio Supreme Court ruled that loss from the bulk sale of inventory must be apportioned, not allocated, and that the Tax Commissioner need not consider a deviation from the standard apportionment formula if the taxpayer fails to submit an alternative apportionment request at the time the franchise tax report is filed.

The taxpayer sold substantially all of its assets in 1987. Included in the sale was inventory from two automotive-equipment plants located in Ohio and Michigan. In calculating the net-income basis of its franchise tax, the taxpayer allocated to Ohio the net loss realized from the sale of its Ohio inventory. When the taxpayer calculated its apportionment fraction, it did not include a sales factor, in effect ignoring the income from the sale of the inventory.

Ohio law provides that to allocate a gain or loss from the sale of personal property, the gain or loss must arise from the sale or disposition of a capital asset. Because inventory is not a capital asset as a matter of law, the court concluded, any gain or loss from the taxpayer's sale of its inventory was subject to apportionment, and not allocation.

The court ruled, in addition, that the taxpayer erred in not requesting permission to employ only property and payroll factors in the apportionment computation. In so doing, the court observed that the franchise tax law provides that alternative apportionment petitions must accompany the franchise tax report, and reasoned that there was no justification for overlooking the plain terms of the controlling statutory requirement.

2. *J.R. Simplot Co. v. Director of Revenue*, Missouri Admin. Hearing Comm'n, No. 03-1990 RF (May 13, 2005)

The Missouri Administrative Hearing Commission ruled that capital gains from a nonresident's sale of stock in a technology company were not subject to apportionment under the Missouri code. The taxpayer classified the income as nonbusiness income allocable to its state of commercial domicile. The Director of Revenue adjusted the taxpayer's returns to include the gains in apportionable income. The Administrative Hearing Commission sided with the taxpayer, finding that the taxpayer's stock holdings were not part of the unitary business conducted in Missouri, and that the shares were not integral to the taxpayer's operations in the state. Based on these findings, the commission concluded that the income was not subject to apportionment.

3. *ABB C-E Nuclear Power, Inc. v. Director of Revenue*, Missouri Court of Appeals No. WD 65820 (June 30, 2006)

The Appellate Court concluded it did not have jurisdiction over the appeal because the matter involves the construction of the revenue laws of the state. The Missouri Supreme Court has exclusive jurisdiction in these matters. Therefore, the court transferred the case to the Missouri Supreme Court.

The Missouri Administrative Hearing Commission held that a subsidiary corporation's gain from a deemed asset sale under Internal Revenue Code Section 338(h)(10) is nonbusiness income. The Commission found that the sale of assets or disposition of property in complete liquidation of business does not yield apportionable business income because, by definition, the transaction is not in the ordinary course of a taxpayer's business and because the disposition is not otherwise an integral part of a taxpayer's business operations. The Commission noted, in addition, that the subsidiary did not receive any of the proceeds from the deemed asset sale, that the sale was not negotiated in Missouri, and that the transaction did not close in Missouri or otherwise involve any activity in the state.

4. *Medicine Shoppe International, Inc. v. Director of Revenue,* Missouri, Supreme Court of Missouri; No. SC85781, January 25, 2005.

The Missouri Supreme Court has held that interest earned on a Missouri-based subsidiary's daily, non-operating excess funds invested by the corporation's Ohio-based parent is excludable from Missouri corporate income tax. In so doing the Court concluded the income earned from the subsidiary's sweep account is passive investment income earned outside Missouri. Therefore, the income is excluded from net income before applying the single-factor apportionment formula.

Medicine Shoppe is a Delaware corporation with headquarters in St. Louis that provides a system and support services for franchisees of its retail pharmacy business. An investment agreement is maintained with its corporate parent that is located in Dublin, Ohio. In accordance with the terms of that agreement, at the end of each business day, funds in excess of the taxpayer's operating expenses are transferred to the parent's corporate concentration account. The parent then invests these funds for the taxpayer's benefit and pays the taxpayer interest on the invested funds on a monthly basis. The interest income was included in the parent's federal consolidated income tax return, but was excluded from the taxpayer's separately filed Missouri corporate income tax return.

The Director of Revenue, on audit, disallowed the classification of the interest as non-Missouri source income arguing that electing to use the single-factor apportionment formula requires the inclusion of all net income prior to applying the formula. The Court disagreed citing its long-standing holding in *Brown Group, Inc. v. Administrative Hearing Commission* (1983) 649 SW2d 874 that royalty income derived from sources outside Missouri is excluded from the single-factor apportionment formula and, therefore, not subject to tax.

Although Missouri law does not specify a category of income that is excluded from the formula, Missouri's corporate income tax forms conform to *Brown Group* by allowing certain non-Missouri source income, such as interest, dividends, royalties, and rental income, to be excluded from net income prior to applying the apportionment formula. The Court noted that while this interpretation results in the loss of millions of dollars of revenue that it is the current interpretation. The General Assembly is the proper place for amendment of that interpretation.

5. *In re Jim Beam,* California Court of Appeal Docket No. A107209 September 17, 2005. Petition for Leave to Appeal denied January 4, 2006.

The Appellate Court affirmed the Superior Court's decision holding the gain recognized on the sale of Taylor Foods was apportionable business income. In so doing the Appellate Court rejected the taxpayer's argument that the functional test treats a partial liquidation as non-business income even though the assets were used in the unitary business. The Appellate Court held the taxpayer's argument conflicted with the California Supreme Court's decision in *Hoechst Celanese*. In that decision the Court made it clear that the critical inquiry was the relationship between the property sold and the taxpayer's business operations. To adopt the taxpayer's rationale would require the Court to analyze the relationship between the income producing transaction and the taxpayer's business activities such an analysis would be contrary to the California Supreme Court's interpretation of the statutory language.

In addition, the Appellate Court also rejected the taxpayer's alternative argument that the basis in the stock had to be adjusted to reflect the fact the earning of the company has previously been taxed by California. The Court citing the State Board of Equalization decision in *Rapid American* found no statutory authority for adjusting the stock basis.

6. *American States Insurance Company v. Brain Hamer et .al.,* Illinois Appellate Court No. 01L50940 August 27, 2004. Petition for Leave to Appeal denied. January 26, 2005.

The Appellate Court affirmed the Circuit Court conclusion that the gain recognized on the sale of American States was properly classified as non-business income.

American States was owned by American States Financial Corp. ("ASFC") that in turn was a subsidiary of Lincoln National Corporation. In 1997 SAFECO corporation purchased the stock of ASFC. The parties elected to treat the stock sale as a "deemed sale of assets" under IRC §338(h)(10). American States reported the gain on the deemed asset sale as non-business income. On audit the Department re-characterized the gain as apportionable business income.

The Appellate Court reaffirmed that the Act contains two distinct approaches for characterizing a gain realized from the sale of a capital asset, *i.e.* the transactional test and the functional test. The Department acknowledged that the transactional test was not the basis for their determination. The Appellate Court citing the Illinois Supreme Court's analysis in *Texaco Cities Service Pipeline Co. v. McGraw*, 695 N.E. 2d 481 (1998) concluded the cessation of business operation under the functional test would be characterized as non-business income. The court in applying this analysis of the functional test concluded the §338(h)(10) election was a complete liquidation and a cessation of a business. Therefore, the gain was properly characterized as non-business income.

7. *Shakkour v. Bower*, Dkt. No. 99 L 50548 (Ill. Cir. Ct., March 24, 2004), reh'g denied (May 6, 2004), appeal pending, Ill. App. Ct. No. 1-04-1646.

The Circuit Court of Cook County held that Leila Shakkour, a non-resident of Illinois, was not subject to tax on her pro-rata share of a partnership's installment-sale gain from selling substantially all of its assets.

Shakkour held a minority interest in a partnership formed to own trading software and other proprietary trading technologies. In 1992, the partnership sold its assets to Swiss Bank, realizing a substantial capital gain. The partnership postponed dissolution so that it could receive the installment payments from the purchaser. Shakkour reported 100% of her share of the gain on her income tax return filed with her state of residency state. She also filed Illinois non-resident income tax returns for the 1994-96 tax years, but reported her share of the gain as non-business income allocable to her state of residency. The Department of Revenue examined Shakkour's 1994-96 Illinois returns and reclassified her share of the capital gain as business income.

The parties filed cross motions for summary judgment. Shakkour maintained, and the Circuit Court agreed, that the gain was non-business income under *Blessing/White, Inc. v. Zehnder*, 329 Ill. App. 3d 714 (1st Dist. 2002). The Department argued that the partnership's sale of its trading technology was "integral to the taxpayer's regular trade or business operations" (thus satisfying the functional test) because the partnership derived over 80% of its lifetime revenues from the liquidation sale. Specifically, the Department contended that if a partnership is formed for the express purpose of owning an intangible asset, and the sale of that asset generates over 80% of the partnership's total revenues, both the asset and sale would seemingly be integral to the partnership's operations.

The Circuit Court rejected the Department's argument, reasoning that *Blessing/White* and similar out-of-state court decisions hold that if the two-prong test is met, the functional test fails and the gain is non-business income. The Circuit Court found no basis for expanding the two-prong test to include the additional criteria advanced by the Department to overcome the business-income presumption, such as (1) that the asset must be held for a certain term of years prior to sale, or (2) that the gross proceeds from the sale cannot exceed a certain percentage of the asset's lifetime generated proceeds. For these reasons, the Circuit Court concluded that Shakkour was not taxable in Illinois on her share of the gain.

8. *National Holdings, Inc. v. Zehnder*, Dkt. No. 98-CH-443 Circuit Court of Sangamon County (January 11, 2006). Appeal pending

The Circuit Court granted Summary Judgment in favor of the taxpayer holding that as a matter of law the gain recognized on the sale of its U. S. grocery stores did not constitute business income. In so holding the court relied on the decisions in *Blessing White v. Zehnder*, 372 Ill. App. 3d 714 (1st Dist. 2002) and *American States Insurance v. Hammer*, 352 Ill. App. 3d 521 (1st Dist. 2004) which held the gains recognized on the sale of the assets was non-business income because the sales were in liquidation of the businesses. In deciding the gain recognized on the sale of National Tea Market and National Supermarkets, Inc. was non-business income the court looked to two factors: (1) was the sale a liquidation of the taxpayer's business and (2) were the proceeds distributed to the shareholders.

9. *Science Application International Corporation v. Comptroller of the Treasury*, Maryland Tax Court No. 04-IN-00-0632, May 11, 2006.

The Tax Court has held that the gain recognized on the sale of a subsidiary's stock was not taxable by Maryland. Science Application held the stock as an investment and it did not serve as an operational function to the company's business activities. Further the taxation of the gain resulted in income being attributed to Maryland that was out of the appropriate proportion of the business transacted in the state.

Science Application is a Delaware corporation that was headquartered in San Diego. The company provided diversified and technical computer services to both the government and commercial customers on a global basis. In 1995 the company purchased the stock of Network Solutions, Inc. ("NSI"). NSI's primary business activity was providing Internet domain registration services on a worldwide basis. In 1997, Science Application sold 24 percent of it interest in an initial IPO. A second public offering of NSI shares was held on February 2, 1999 and Science Applications reduced its ownership interest to 45 percent. Initially, the $715,850,753 capital gain from the second offering was reported to Maryland. The taxpayer sought a refund and the Comptroller denied the request.

The Tax Court in concluding the gain was not subject to tax cited the Appellate Court decision in *Hercules v. Comptroller*, 351 Md. 101 (1998) holding that to levy a tax there must be some nexus linking the income to the activities within the state. In reaching the conclusion the Tax Court notes NSI had no facilities, employees or operations in Maryland. Further, the company was operated as a distinct business and had minimal arm's length contacts with Science Application. The proper level of inquiry under the *Allied Signal*, standard is the actual connection between the subsidiary investment and the parent. It was evident from the facts that the acquisition of and the ultimate sale of NSI served a purely investment function and that there was no integration of the businesses. The evidence supports the fact that Science Applications acquired NSI for the purpose of selling the company for a profit in an IPO. As a result there is no link between the gain and the Maryland operations.

VII. APPORTIONMENT ISSUES

A. Receipts Factor

1. What are Gross Receipts?

a) Multistate Tax Commission Resolution

On July 27, 2001, the Multistate Tax Commission adopted a resolution, amending MTC Reg. IV.2.(a) to include a definition of "gross receipts." The MTC definition excludes certain proceeds, *e.g*., the repayment of principal of a loan, bond, or mutual fund or certificate of deposit or similar marketable instruments; pension reversions; amounts realized on the federally-unrecognized exchanges of inventory, from "gross receipts" even if the income is included in apportionable business income. The amendment providing a uniform definition of "gross receipts" is an attempt to settle the issue of whether net profits, not gross receipts, from the sale of intangibles are includable in the sales factor.

b) In *re Colgate – Palmolive Co.*, State Board of Equalization No. 152028, November 12, 2002.

A taxpayer that engaged in the manufacture and sale of household products could not include in its sales factor denominator, for California corporation franchise tax purposes, the value added tax on foreign sales in excess of the amount included by the California Franchise Tax Board (FTB) nor the proceeds from short-term investments in Treasury bills, certificates of deposit, commercial paper, and state and local bonds. The taxpayer failed to present evidence that either supported its own calculation of a higher value added tax amount or that contradicted the FTB's methodology. Also, the taxpayer's churning of its short-term investments did not generate receipts that were includible in the sales factor. The taxpayer failed to establish the location of the income-producing activity that generated the proceeds from its investments in intangible property. Moreover, because the taxpayer employed independent contractors to perform a majority of the investment activity, the taxpayer itself did not engage in any income-producing activity that produced gross receipts that could be included in the sales factor. Finally, the taxpayer failed to show how the valuation of its real property based on the property's original cost, rather than on an appreciated value, distorted the property factor or the entire standard apportionment formula.

c) *Mead Corporation v. Illinois Department of Revenue*, Circuit Ct. of Cook County, December 2, 2002. Appeal Pending.

The Circuit Court of Cook County reversed an earlier decision and held that the purposes of computing the sales factor only net receipts from the sale of short-term financial investments may be included. The regulation requiring the use of net receipts did not exceed the Department's authority.

d) *The Limited Stores, Inc. v. Franchise Tax Bd.*, No. A105315, Cal. App. Ct. unpublished July 28, 2005. Petition for Review granted.

The Court of Appeals affirmed the Superior Court concluding that the principal amount of securities held to maturity should not be included in the sales factor. The court based its holding on the fact to include the amounts does not comport with the commonplace understanding of a sale. The return of principal is similar to a "return or allowance" which is excluded from the computation of the sales factor pursuant to Regulation 25134(a)(1)(A).

e) *General Motors Corp. v. Franchise Tax Bd.*, 120 Cal.App.4th 881 (2004). Petition for Review granted. October 13, 2004. No. S127086. Oral Argument held June 2, 2006.

The Appellate Court affirmed the denial of General Motors Motion for Summary Judgment. General Motors originally filed a summary judgment motion, and the Superior Court held a hearing on that motion in December 2002. On February 21, 2003, the parties entered into a stipulation, whereby the FTB conceded that investments sold before maturity constituted gross receipts included in the sales factor. The court then issued an order denying General Motors' Motion for Summary Judgment on the grounds that principal repayment of short term debt does not constitute gross receipts for purposes of the sales factor.

f) *Toys "R" Us, Inc. v. Franchise Tax Bd.*, Cal. Super. Ct. No. 01 AS

04316. California Appellate Court C) 45386, April 5, 2006.

Affirmed Superior Court holding that receipts factor may not include principle.

g) *Microsoft Corporation v. Franchise Tax Board*, Court of Appeal of California, First Appellate District, Division Three, Dkt. No. A105312, February 28, 2005 (not for publication). Petition for Review Granted June 8, 2005.

Amounts representing returns of principal on the taxpayer's short-term investments of surplus funds could not be included within gross receipts for purposes of apportionment under the Uniform Division of Income for Tax Purposes Act (UDITPA). As inclusion of these amounts would severely distort the extent of the taxpayer's California business activity, the Franchise Tax Board (FTB) had the statutory authority to use an alternative, less distortive apportionment method.

Rev. & Tax Code §25137(d) authorizes the FTB to use alternative apportionment methods if the standard methods do not fairly represent the extent of a taxpayer's California business activity. Relying on this grant of authority, the FTB excluded the returns of principal on investments from the taxpayer's gross receipts for purposes of computing the receipts factors. Six employees at the taxpayer's headquarters routinely invested surplus funds in marketable short-term securities, generating a $10.7 million gain during the tax year in question. If the gross proceeds of these investments included the return of principal, however, the taxpayer's proceeds from this activity would be $5.7 billion, far in excess of the $2.1 billion generated by its worldwide business operations. The Court of Appeal held that the FTB's action was both reasonable and authorized under Cal. Rev. & Tax Code §25137(d), as reliance on standard apportionment methods would distort the extent of the taxpayer's California activities given the nearly $5.7 billion in returns of principal. It also noted that many of the taxpayer's securities transactions were not truly sales, as standard apportionment rules contemplate, as they consisted merely of purchases and redemptions of securities. It was not necessary for the FTB to have proposed a full alternative apportionment formula. Using standard apportionment, but with exclusion of the returns of principal, was sufficient under *Rev. & Tax Code* §25137(d).

However, the Court of Appeal did not decide whether returns of principal should be excluded from gross receipts in all instances, an issue that has been considered with varying results by courts in other states, is currently pending before the California Supreme Court in *General Motors*.

h) *Montgomery Ward LLC v. Franchise Tax Bd.*, No. GIC-802767 (Cal. Super Ct. filed Dec. 30, 2002). The Complaint and Answer have been filed.

2. *Walgreen Arizona Drug Co., v. Arizona Dep't of Revenue*, 97 P.2d 896, September 23, 2004. Petition for Review Denied.

The Arizona Appellate Court has held that Walgreens may not include the return of principal on short-term investments in the computation of the sales factor denominator.

The Appellate Court rejected Walgreen's argument that the plain meaning of the phrase "total sales" means all gross receipts including the return of principal on short-term investments. The Department argued that the inclusion of the return of principal would result in a double counting of income. The Appellate Court agreed with the Department and further concluded that Walgreen's interpretation would create a loop-hole for non-domiciliary businesses that was not intended by the legislature as the plain meaning of the statute.

3. *Pacar Inc. v. State of Alabama Department of Revenue*, Administrative Hearing Dkt. No. Corp-04-715, January 11, 2006.

An Administrative Law Judge ("ALJ") has held that sales of trucks to Alabama dealers must be included in the numerator of the sales factor because the trucks were ultimately delivered in Alabama. Paccar manufactures trucks and truck parts outside of Alabama. The company sold the trucks and parts to dealers located in Alabama. The parts were shipped directly to Alabama via common carriers and are not in issue in this matter. With respect to the trucks, Paccar contracted a third-party carrier to pick up the trucks at one of the company's manufacturing locations. Title and risk of loss passed to the dealer at that time. Paccar argued that the truck sales should not be included in the numerator of the sales factor because the trucks were delivered outside of Alabama. In rejecting that argument, the ALJ analyzed the purpose of the sales factor and the language of UDITPA. He concluded that the purpose of the sales factor is only satisfied if the sales are attributed to the state where the property is finally delivered because the delivery state is the state from which the income is derived. Therefore, the Alabama truck sales should be included in the numerator of the sales factor.

4. *Home Interiors & Gifts, Inc. v. Comptroller of Public Accounts*, Tx. Appellate Court No. 03-04-00660-CV, July 28, 2005. Taxpayer's Petition for Rehearing granted and revised decision issued September 22, 2005. Petition for Review filed No. 05-0939.

The Texas Appellate Court reversed the District Court and held the earned surplus throwback rule was not internally consistent and therefore violated the second prong of *Complete Auto Transit* test.

Home Interiors is a Texas corporation that is engaged in the business of purchasing home decorating products and accessories and wholesaling the products to independent contractors. The company sells products in all states and the District of Columbia, but has no business facilities outside Texas. The Texas Franchise Tax is imposed for the privilege of doing business in Texas. The tax is assessed on the greater of a 4.5% tax on net taxable surplus (income based) or a .25% tax on net taxable capital (net worth base). A single sales factor is used to apportion a multistate corporation net earned surplus or net taxable capital. If the corporation is not subject to tax in the purchaser's state the sales are thrown-back to Texas and included in the numerator of the factor.

Home Interiors argued the application of the throwback rule resulted in unfair apportionment and thus is an unconstitutional burden on interstate commerce. The Appellate Court agreed concluding the Texas tax scheme was internally inconsistent. Applying the hypothetical internal consistency test to the integrated Texas franchise tax on an interstate corporation that resides in Texas and is protected by P.S. 86-272 in other states, would be subject to both a tax on capital in one state and on earned surplus tax in Texas. However, a similarly situated intrastate corporation would only be subject to the greater of the two taxes. In reaching that conclusion the Appellate Court rejected the Comptroller's argument that the internal consisting test should be applied to each tax base.

The Appellate Court on rehearing did not alter its conclusion but did suggest the Texas Legislature could resolve the issue.

5. *In the Mater of the Appeal of Galvantech, Inc.*, California State Board of Equalization, No. 288289, February 1, 2006.

Galvantech was a privately held corporation that was involved in the design, manufacturing, and sale of semiconductors. The company was headquartered in California but manufactured its products in Taiwan. The company amended its California returns to remove foreign sales from the numerator of the sales factor. Galvantech argued that the sales were drop shipped by its subcontractors in Taiwan to customers located in the United States as well as to numerous foreign jurisdictions. The SBE in rejecting the company's refund claim held Galvantech failed to establish that it shipped the products to customers from locations outside the United States and that the company was subject to a net income tax in the destination country. Therefore, the sales were properly thrown back and included in the numerator of the sales factor.

6. *Miller Brewing Company v. Indiana Department of Revenue*, Indiana Tax Court No. 49T10-0110-TA-82 (July 27, 2005)

The Indiana Tax Court granted Miller Brewing Motion for Summary Judgment holding that sales of products transported to Indiana by common carrier were not Indiana sales for apportionment purposes.

Miller Brewing's customers submitted purchase orders to the Milwaukee headquarters. The products were produced and prepared for pick-up at one of Miller's breweries outside Indiana. The purchaser had the option of picking up the product, arranging for a third-party common carrier or having Miller arrange for the common carrier. The sales in issue relate to those where delivery was arranged by the purchaser. The Tax Court concluded that when the products were loaded on to the common carrier truck at the brewery Miller transferred possession, title and risk of loss at that point. Therefore, Miller had no right or control over the product or the transportation of the product. Therefore, the delivery took place outside of Indiana.

7. California Franchise Tax Board – Legal Ruling 2003-3, December 4, 2003

The Franchise Tax Board has concluded that dividends are includible in the sale factor only when the holder engages in an activity that constitutes more than the mere holding of intangible property. The mere holding is not an income producing activity. Income producing activity exists when the recipient participates in the management or operation of the dividend payor. The Franchise Tax Board relied on *<u>Rev & Tax Code</u>* §§25120 and 25136 and Regulation 25134 in reaching their conclusion.

8. *Bayer Corp. v. Commissioner of Revenue,* Massachusetts Appellate Tax Board, Docket Nos. F239697, F239698, F245722, September 8, 2005.

The Massachusetts Appellate Tax Board held that income from financing transactions was considered interest income rather than rental income. Because the income was considered interest income, under state law, the receipts were entirely allocated to Massachusetts, the state of corporate domicile. In addition the interest income was excluded from the sales factor for apportionment purposes. If the income had been considered income derived from the rental of tangible property the taxpayer could have included the receipts in the sales factor.

Bayer Corp. was a hardware manufacturer and software developer. It sold and leased equipment systems. Initially, it used third parties for the financing arrangements related to the leasing of equipment. The company subsequently created a subsidiary to handle these matters. The characterization of the lease agreements and related transactions were at issue in the case. Due to the short economic life of the equipment and its low resale value at the conclusion of lease terms, the Massachusetts Appellate Tax Board determined that the transactions were conditional sales rather than leases. In addition, ownership of the equipment by the subsidiary was not established. On its returns, the subsidiary had characterized the income from the transactions as interest income, but included it in its sales factor. The Commissioner, under state law, excluded it from the sales factor. The Massachusetts Appellate Tax Board affirmed the decision of the Commissioner.

9. *General Motors Corp. v. Commonwealth of Virginia*, Virginia Supreme Court No. 032533, September 17, 2004

The Virginia Supreme Court has held that the Department's rule defining "cost of performance" for purposes of apportioning the income of a financial corporation is inconsistent with the statute. The issue is whether for purposes of computing the cost of performance only the costs of activities directly performed by the taxpayer may be included. The Virginia Supreme Court rejected the narrow interpretation and concluded that the statute did not limit the cost of performance to direct costs and could include the costs for activities performed by third parties.

10. *Virginia Department of Taxation* – Tax Bulletin 05-3 April 18, 2005.

The Department will not change its interpretation of the nexus standards until it has fully implemented policy changes attributable to the Virginia Supreme Court decision in *General Motors Corporation v. Commonwealth*.

11. *Indiana Department of Revenue Letter of Finding No. 03-0154*, January 1, 2005.

The Indiana Department of Revenue has determined that an out-of-state business that collected financial market data in California and provided that data to customers throughout the United States including Indiana was subject to the Indiana adjusted gross income tax on the income received from Indiana subscriptions. In so concluding, the Department concluded the subscription fees received from Indiana customers should be sourced to Indiana even though the data collection and other activities related to the performance of the services occurred in California. The income producing activity namely the generation of the subscription fees only occurred when the data was received in Indiana.

12. *Revenue Ruling No. 2006-01IT*, Indiana Department of Revenue, April 1, 2006.

The Department has concluded for purposes of calculating the sales factor that an insurance company was required to source business receipts generated by commission revenues and management fees to the states in which the employee services were performed. The management fees and commissions were the principal sources of business income for the company and were required to be sourced both within and outside the state. The sourcing was based on a ratio of the time spent performing the related services in Indiana to the total time spend performing the services everywhere.

13. *Boston Professional Hockey Association, Inc. v. Commissioner of Revenue*, Massachusetts Supreme Judicial Court No. SJC-09287, January 13, 2005.

The Court determined that the revenue from the Boston Bruins' gate receipts and the licensing of the local broadcasting rights were properly apportioned to Massachusetts for corporate income tax purposes. The fees received for the broadcasting rights to away games were properly included in the numerator of the sales factor because the three licensees were commercially domiciled in Massachusetts and the licenses were deemed to used by the licensees in Massachusetts.

The statute and regulations provide that sales other than the sale of tangible personal property are sourced to the Commonwealth if the income producing activity is performed in the Commonwealth. If the income producing activity is performed both within and outside the Commonwealth the receipts will be assigned to Massachusetts if a greater proportion of the activity is performed in the Commonwealth. The taxpayer argued that the home and away games constituted separate income producing activities. Therefore the costs must be individually analyzed to determine whether any of the receipts should be sourced to the Commonwealth. The Court rejected this argument finding that the income producing activity was the operation of the NHL franchise rather than playing individual games. The costs of fielding and managing the Bruins through the tax year in issue were incurred in a greater proportion in Massachusetts.

With respect to the license fees from the broadcast rights of away games the taxpayer argued that the licenses were used in States outside Massachusetts and as such the direct costs were largely incurred outside the Commonwealth. Thus, a game-by-game analysis was required. The Court rejected the argument concluding that the three licensees were commercially domiciled in Massachusetts and, in accordance with the regulations in effect at the time, the licenses were deemed to have been used in the Commonwealth. However, the fees received from the licensing of the Bruins trademarks and logos should not be assigned to Massachusetts as the licensees are not domiciled in the Commonwealth.

The taxpayer's share of the partnership's revenues derived from licensing agreements with out-of-state affiliated cable television operators was not properly included in the numerator of the receipts factor. This revenue should be attributed to the commercial domicile of the affiliates. The partnership's share of the advertising revenue from advertising placed in sport's programs was apportionable to Massachusetts because 70% of the subscribers were located in the Commonwealth.

Finally, the Court concluded the capitalized value of the fees paid for the use of satellite transponders was not includable in the property factor. The agreement was a service contract rather than a lease.

14. *California Franchise Tax Board – Legal Ruling 2005-1*, March 21, 2005.

The Franchise Tax Board has ruled for purposes of Regulation 25136 the term "personal service" includes any service performed where capital is not a material income-producing factor. In addition, personal services are not limited to a professional service or to a specialized service performed by one individual.

15. *Decision of Comptroller Hearing No. 36,564,* Texas Comptroller February 22, 2006.

The Comptroller has held that interpartnership receipts received by a taxpayer from an operating partner were required to be included in the gross receipts for purposes of calculating the sales factor. The applicable statute requires that partnership gross receipts are included in the in the apportionment formula both in the Texas receipts and everywhere. In so doing the Comptroller rejected the argument that the receipts wee not required to be included because the statute defines gross receipts as all revenues reportable by a corporation on its federal return and the taxpayer was required to report only net partnership income for federal tax purposes.

B. Payroll Factor

1. *Marquette Transportation Company, Inc. v. Finance and Administration Cabinet, Department of Revenue*, Kentucky Board of Tax Appeals, File No. K03-R-27 (Order No. K-19358, June 23, 2005.)

   The Board of Tax Appeals held Marquette Transportation Company was entitled to a refund for the overpayment of estimated Kentucky corporation income tax because the company's payroll factor for previous tax years should not have been adjusted to include compensation paid to employees whose only service performed within the state was their presence on a towboat as it moved along the Mississippi River adjacent to 63 miles of Kentucky shoreline.

   Evidence was clearly established that the towboat employees had a Kentucky "base of operations" within the meaning of the state's payroll factor statute. Although boarding locations were in foreign states and employees carried out their services on the river in an autonomous and independent manner, their services were directed and controlled from the company's Kentucky headquarters through e-mail, sales and safety departments, and barge building decisions.

   However, there was no reasonable basis for concluding that the towboat employees were performing services in Kentucky as required under the payroll factor statute. The boats never stopped in the state for any reason. In addition, Kentucky's border along the river was somewhere in the middle of the flow. Therefore, if the company's boats stayed on the other side of the river, the employees would not have been in Kentucky waters. If the boats straddled the border, employees on one side of the boat would have been in Kentucky, while employees on the other side of the boat would not have been in Kentucky. If all the employees were eating dinner or sleeping as the boat passed Kentucky, no services would have been performed within the state.

2. *Plantation Pipe Line Co. v. Alabama Department of Revenue*, Alabama Department of Revenue, Administrative Law Division, No. Corp. 05-948 (May 23, 2006).

   The Administrative Law Judge held that a multistate corporation correctly included in the payroll factor amounts paid to its parent for services performed by employees who the corporation had transferred to the parent. In 2001, Plantation Pipe Line transferred its employees to one of its parent corporations and paid the parent for the services performed by the employees. The Department took the position the company did not have a payroll factor and eliminated the factor for purposes of computing the apportionment formula. The employees in issues were the same employees that performed the duties as direct employees of Plantation Pipe Line. The ALJ concluded that the employees contributed to the corporation's production of Alabama business income in 2001 to the same extent that they had in prior years. Therefore, the corporation's income producing activities were most accurately attributed to Alabama when the compensation paid by the corporation for the transferred employees were included in the Alabama payroll factor.

C. Modification of Apportionment Formula

1. *U.S. Bancorp and Subsidiaries v. Department of Revenue*, 103 P.3d (Ore. 2005). Petition for Certiorari denied S.Ct. Dkt. 04-1455.

The Oregon Supreme Court reversing the Tax Court concluded that the Department of Revenue had the authority to depart from the standard apportionment formula rule and include a financial organization's intangible personal property in the apportionment formula used to allocate the taxpayer's income to Oregon for tax years 1988 through 1992.

The taxpayer is a unitary financial organization that does business both in Oregon and in other states. Since the taxpayer is a financial organization, the Uniform Division of Income for Tax Purposes Act (UDIPTA) does not apply for purposes of determining apportionment. In its Oregon corporate excise tax returns for 1988 through 1992, the taxpayer applied the standard apportionment formula for financial organizations contained in a rule promulgated pursuant to Or. Rev. Stat. §314.280. Consequently, the taxpayer did not include intangible personal property in its apportionment computations because the applicable definition of "property factor" only included "real and tangible personal property used in the business."

The Department, on audit, determined that the inclusion of the taxpayer's intangible personal property in the apportionment formula resulted in a more accurate allocation of the taxpayer's net income to Oregon. Applying the 1995 version of OAR 150-314.280-(M), the Department included the taxpayer's intangible personal property in the apportionment formula and then assessed additional taxes against the taxpayer for tax years 1988–1992.

The Supreme Court determined that the Department intended to apply OAR 150-314.280-(M) (1995) retroactively, since a separate rule, OAR 150-305.100-(B), already provided that: "administrative rules adopted by the department, unless specified otherwise by statute or by rule, shall be applicable to all periods open to examination." OAR 150-305.100-(B) provided a presumption of retroactive application to all periods open to examination at the time that the Department promulgated OAR 150-314.280-(M) (1995). The Court also determined that the retroactive application of OAR 150-314.280-(M) (1995) did not violate the requirements of due process.

The Oregon Supreme Court also upheld the Tax Court's ruling that the statute of limitations did not bar the notices of deficiency for the 1988 and 1989 tax years. The taxpayer claimed that an extension agreement with the Department was invalid because the Department had received notice of corrections to the taxpayer's federal tax liability more than two years before it entered into the agreement extending the limitations period. The state high court agreed with the Tax Court that the taxpayer had the burden to prove that the extension agreement was defective and the taxpayer failed to prove that the Department had received the federal notices of correction.

2. *Irving Pulp & Paper, Ltd. v. State Tax Assessor*, Maine Supreme Court Dkt. No. Ken-04-580 (August 9, 2005)

The Maine Supreme Court affirmed the Superior Court holding the denominator of the apportionment formula must be computed on a water’s edge basis.

Irving is a Canadian corporation with timber reserves in Maine. The company had no other presence in the United States. Irving sold its timber reserve. The company argued that the apportionment factors should be computed using its worldwide property, payroll and sales. The court rejected the argument concluding the apportionment statute contemplated starting with figures derived from a corporation’s federal taxable income. The use of the worldwide factors would result in a mismatch of factors and the income to be apportioned.

3. *In the Matter of the Petition of Disney Enterprises, Inc. and Combined Subsidiaries*, NYS Tax Appeals Tribunal, DTA No. 818378, October 13, 2005. Appeal pending.

The Petitioner’s combined receipts factor and combined property factor of the business allocation percentage were at issue. The Petitioner licenses and distributes its Walt Disney-related intellectual property worldwide. Licensees pay Petitioner royalty receipts, which it includes in its “everywhere sales” for New York combined receipts factor purposes. On its original returns, Petitioner allocated royalty receipts to the state if the licensee listed a New York address in the licensing agreement.

On audit it was determined that three subsidiaries that were not included in the combined group of the Petitioner and had filed separate returns should be included in the unitary group. As a result, the receipts factor for these tax years had to be adjusted to include receipts of the three subsidiaries.

Each of the three subsidiaries had conducted some business activities in New York. The subsequent addition of these subsidiaries resulted in the inclusion of a significant amount of New York destination sales to the sales factor numerator.

Petitioner first argued that if the royalty income of the third parties had to be included in its net income, that the property factor should be adjusted to include the value of the Disney characters or in the alternative a fourth factor should be created to represent that value. Also, Petitioner subsequently indicated that if the royalty income of the third parties had to be included in its net income, then the sourcing should be changed from the location of licensee identified on the licensing agreement to the manufacturing location. The Petitioner's film library has immense worth. The valuation expert retained by the Petitioner used an income approach to determine the value of the library during the audit periods. In addition, the expert similarly calculated the value of the Disney characters. In his valuation of the characters, the expert did not include use of the characters by affiliated companies. Petitioner in its appeal sought to modify the method used for valuation of its film masters to a fair market value, instead of the lesser value equal to their original cost.

The ALJ concluded that the three subsidiaries could be included in the combined returns and the numerator of the receipts factor should be adjusted accordingly. The ALJ also concluded that the property factor does not include the intangible property assets. In addition, the ALJ pointed out that the Petitioner did not meet its burden to prove that the Commissioner abused his discretion regarding the adjustment, nor did it meet its burden to establish a reason for changing it computation method concerning the sourcing of receipts. The Commissioner believed the original method, using the location in the agreement, was reasonable and acceptable. Finally, the ALJ noted that the fair market value of the film masters could not be used in the property factor since law does not mandate that intangibles should be included in the apportionment formula.

Both Petitioner and the Division of Taxation filed exceptions to the ALJ's decision. The Division filed with concern to the reasoning employed by the ALJ, rather than the outcome.

4. *California Franchise Tax Board Legal Ruling No. 2006-03*, May 5, 2006.

The Franchise Tax Board has issued a ruling that addresses the apportionment of gains resulting from a deemed asset sale made pursuant to IRC §§ 338(g) and 338(h)(10). With respect to the gains recognized as a result of making an election under §338(h)(10) if the selling corporation and the target corporation are unitary in nature then the gains would be apportioned using the combined report that includes the selling corporation and the unitary affiliates.

If an election is made under §338(g), the seller is not party to the election therefore, the seller will treat the transaction as a stock sale. The gain or loss on the sale will be apportionable business income if the subsidiary was unitary in nature. The apportionment method used by the buyer will depend on the following:

1. If Old Target is a separate entity the gain on the deemed asset sale will be apportioned using the apportionment percentage of Old target.
2. If Old target is the common parent of a federal consolidated group and the group remains intact then the gain is apportioned using the apportionment percentage of the group.
3. If Old target is a member of a federal consolidated group but not the common parent, the Old Target is considered to be disaffiliated from the federal consolidated group immediately before the sale. For California purposes, the gain on the deemed asset sale is treated as having arisen after the stock was sold. Therefore, the gain cannot be considered in the selling corporation's combined report. The gain should be reported on New Target's one-day return. Because the one-day return does not include the day-to-day operations there will be no payroll factor. The gain will be apportioned using a sales and property factor. For purposes of computing the sales factor, the sale will not be considered occasional. Therefore, the gross proceeds will be included in the factor.

5. *FedEx Ground Package System, Inc. v. Commonwealth of Pennsylvania*, Commonwealth Court April 17, 2006.

The Commonwealth Court has held the numerator of the apportionment must be computed using average receipts per mile in Pennsylvania. In so doing, the court rejected the Department's long-standing policy that the numerator should be computed using average receipts per mile everywhere. The court concluded the numerator of the transportation factor must reflect only in-state activity.

VIII. INTERSTATE COMMERCE/DISCRIMINATION

1. *Fluor Enterprises Inc. v. Department of Treasury*, Michigan Appellate Court No. 251005 (April 14, 2005).

The Michigan Appellate Court affirming the Court of Claims held unconstitutional the provisions of the Single Business Tax Act that allocate receipts from planning, design or construction services performed out of

Michigan for projects in Michigan because it failed the internal consistency test.

Fluor is an engineering construction and technical services company. The company performed services at its out-of-state facilities for real estate improvement projects constructed in Michigan. In filing the SBT returns, Fluor excluded the receipts for services performed outside of Michigan because the receipts were not in the state for purposes of calculating the sales factor. The Commissioner upheld the assessment including the receipts in the apportionment factor. The Court of Claims reversed the holding.

For purposes of the SBT, sales will be considered in Michigan if derived from services performed for planning, design or construction activities within the state. Fluor argued the receipts were from activities outside Michigan. The Department's argument focused on the fact the services were performed for projects in Michigan. The Appellate Court agreed the receipts were derived from services performed for planning, design or construction activities in Michigan. Section 53(c). However, the Appellate Court held Section 53(c) violated the Commerce Clause because it violated the internal consistency component of fair apportionment formula more than one state would tax business activities performed in one state for construction activities in another.

2. *Dana Corporation v. Department of the Treasury*, Michigan Court of Appeals, No. 255984, (August 18, 2005)

The Appellate Court concluded that the site specific capital acquisition deduction ("CAD") did not violate the third prong of the *Complete Auto Transit* test. The court held the CAD, as in existence in the tax years 1997, 1998 and 1999, was fairly apportioned and did not burden out-of-state businesses. In reaching its conclusion the court cited the Michigan Supreme Court's decision in *Jefferson Smurfit v. Department of Treasury*, 639 N.W. 2d 269 (2001) holding the CAD was not facially discriminatory. The court noted that Jefferson Smurfit raised the apportionment issue and the Michigan Supreme Court's discussion of the *Trinova* decision's conclusion that Michigan may only tax its fair share of interstate transaction supports the holding that the CAD is fairly apportioned.

MISCELLANEOUS DECISIONS

1. *Mississippi Tax Commission v. Murphy Oil USA, Inc.*, Mississippi S.Ct. No. 2003-CA-003250SCT, June 15, 2006.

The Mississippi Supreme Court held the destination theory for sales factor apportionment purposes did not apply to the Franchise Tax. Murphy Oil applied the destination theory to assign sales of its petroleum products to Mississippi for Franchise Tax purposes. The court rejected the argument because the tax is measured by the volume of business in Mississippi and not by the product's ultimate destination. The ultimate destination is not relevant for Franchise Tax purposes. Murphy Oil also argued that the statute violated the first and fourth prongs of the *Complete Auto* test. The court rejected this argument because the petroleum products were stored and metered in Mississippi. Therefore, there was substantial nexus with the state. In addition, because the Murphy Oil received police and fire protection as well as the use of the state court system, the services were fairly related to the franchise tax. Therefore, the Franchise Tax was not unconstitutional.

2. *BankBoston Corp. v. Commissioner of Revenue*, Massachusetts Appellate Tax Board, Docket No. C270546, September 6, 2005.

The Massachusetts Appellate Tax Board concluded that distributions paid to a shareholder by a real estate investment trust ("REIT") did not qualify as a dividends-received deduction for corporate income tax purposes. During the tax years at issue, there was a lack of state legislation concerning taxation of REITs and their shareholders. The Commissioner and subject REIT differed on the whether the REIT was eligible for the deductions, as well as which state statutes should apply. The Commissioner argued that since the deduction was not allowed under federal law, it was not allowed to compute state corporate net income. The Commissioner also asserted that the state adopted the federal method of taxation of REITs, and permitting a state dividend-received deduction for a shareholder would not comport with intent behind REIT taxation. Among its arguments, the REIT set forth that under state law, with some stated exceptions, dividends are deductible for corporate net income tax calculations. While the Board found merit in the arguments of the REIT, it ruled that since a dividend used for a dividends-received deduction was not considered a dividend under federal law. The Board exercised caution in applying federal tax laws to deductions available in Massachusetts, but concluded that Massachusetts followed the federal tax treatment and purposes of such dividends, the deduction was not allowed under state law. The Board also discounted arguments that the REIT had set forth that certain actions of the Commissioner were clear policy statements of the deductibility of the dividends, and even if such statements were made, they would be inconsistent with the applicable statutes.

3. *Redman Homes Inc. v. Surtees*, Alabama Court of Appeals, Dkt. No. 2031079 (November 18, 2005).

The Court of Appeals held the filing of a class action will not toll the statute of limitations for purposes of filing foreign Franchise tax claims because the Taxpayer Bill of Rights was the exclusive remedy for seeking a refund. A number of taxpayers had filed a class action in 1996 alleging the franchise tax statute was unconstitutional and sought refunds for all members of the class. This was a direct refund action against the state. The members of the class argued that the class action tolled the statute of limitations. In May 2002, the Alabama Supreme Court decertified the *Gladwin* class action and required all taxpayers to separately pursue refunds of franchise tax under the Taxpayer Bill of Rights Act. Thus, the taxpayers could not relay on the tolling requirement of the class action statute.

4. *In the Matter of Foster Poultry Farms*, California Stare Board of Equalization, May 17, 2006.

The State Board of Equalization held a poultry farm's electrical substation and primary electrical distribution facility were qualified property for purposes of the MI. In so doing the SBE rejected the Franchise Tax Board's arguments that the property was used in a separate activity of electrical transmission and distribution and not the qualified activity of poultry processing, the property was not used primarily in a manufacturing process because the transmission and distribution of the electricity occurred before the start of the poultry process, the property was not tangible personal property but was other tangible property and the taxpayer was using the property with respect to an intangible and was not altering tangible personal property. The SBE found there was no reason to distinguish the property in issue from substantially similar property that was found to be tangible personal property from purposes of the federal investment tax credit. The company was not in the business of transmitting and distributing electricity but rather the electricity was used in poultry processing. Therefore, the property qualified for the MIC.

5. *Ford Credit International Inc. v. Department of Treasury,* Michigan Court of Appeals No. 258389, April 4, 2006.

The Michigan Court of Appeals has held for purposes of the Single Business Tax a financial corporation was not required to excluded deemed dividends, *e.g.* Subpart F Income and §78 gross-up in the calculation of gross receipts. Ford Credit International ("International") is an international finance company that controls several foreign finance companies. International argued that the term "gross receipts" does not include deemed dividends. The Appellate Court analyzed the statutory language and concluded during the period in issue the phrase “gross receipts” was not a vague phrase or an all encompassing one, rather it was specifically defined as the sum of sales and rental or lease receipts. The term did not include dividends of any type. Further, the receipts in issues have not been received by International and may never be received by the company. The court reasoned that the legislature intended only the money a business actually received to be included in the computation. Finally, because the SBT has adopted the federal definitions and the definitions require an actual distribution the deemed dividends were not dividends for SBT purposes and are not to be included in gross receipts.

6. *AT&T Corp. v. Surtees*, Alabama Court of Appeals, No. 2040908, (June 232006).

The Alabama Court of Appeals has held with respect to Business Privilege Tax (BPT) and Corporate Share Tax (CST) deductions for investments that were limited to only those investments in entities doing business in Alabama was facially discriminatory and a violation of the Commerce Clause. Further, upon establishing that the deduction was discriminatory the burden of proof shifted to the Department to justify the taxation scheme.

AT&T paid BPT for the 2000 through 2002 tax years and CST for the 2000 and 2001 tax years. The Alabama Code allowed corporations paying both taxes to deduct the investment in corporations doing business in Alabama. Thus, AT&T could only deduct its investments if the investment was in the equity of a company doing business in Alabama. The court in reversing the ruling of the Jefferson County Circuit Court concluded to determine if the statute was discriminatory on its face the text of the statute must treat in-state economic interest differently from out-of-stat economic interests in such a way to benefit the instate economic interests and burden the out-of-state interests. Applying this analysis the court concluded that the differential treatment encourages the investment in entities that do business in Alabama to the detriment of those entities that do not do business in Alabama. On its face the statutes place a greater burden on those corporations that do not invest in entities doing business in Alabama. Therefore, the statutes were facially discriminatory and the burden of justification fell on the Department. The court rejected the Department’s argument that the discriminatory tax scheme was to prevent double taxation stating such an explanation fell short of fitting within an acceptable justification and overcoming the strict scrutiny standard required by the United States Supreme Court.