2001

Current Developments In Multistate Taxation

John Galloway

D. French Slaughter III

Repository Citation
https://scholarship.law.wm.edu/tax/163

Copyright c 2001 by the authors. This article is brought to you by the William & Mary Law School Scholarship Repository.
https://scholarship.law.wm.edu/tax
# CURRENT DEVELOPMENTS IN MULTISTATE TAXATION

## Table of Contents

<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>I. U.S. Supreme Court Activity</strong></td>
<td>1</td>
</tr>
<tr>
<td>A. J.C. Penney National Bank</td>
<td>1</td>
</tr>
<tr>
<td>B. Topps Company, Inc.</td>
<td>1</td>
</tr>
<tr>
<td><strong>II. Income and Franchise Tax</strong></td>
<td></td>
</tr>
<tr>
<td>A. Unitary</td>
<td>1</td>
</tr>
<tr>
<td>B. Business/Nonbusiness Income</td>
<td>3</td>
</tr>
<tr>
<td>C. Apportionment Factors</td>
<td>6</td>
</tr>
<tr>
<td>D. Limited Partnerships/Limited Liability Companies</td>
<td>10</td>
</tr>
<tr>
<td>E. Nexus</td>
<td>11</td>
</tr>
<tr>
<td>F. Intellectual Property/Related Party Transactions</td>
<td>13</td>
</tr>
<tr>
<td>G. New Legislation – Addback of Royalty Expenses</td>
<td>15</td>
</tr>
<tr>
<td>H. Credits and Incentives</td>
<td>17</td>
</tr>
<tr>
<td>I. State Tax Deductions</td>
<td>19</td>
</tr>
<tr>
<td>J. Net Operating Losses</td>
<td>21</td>
</tr>
<tr>
<td>K. Miscellaneous</td>
<td>21</td>
</tr>
<tr>
<td><strong>III. Sales and Use Tax</strong></td>
<td></td>
</tr>
<tr>
<td>A. Bad Debt Deductions</td>
<td>22</td>
</tr>
<tr>
<td>B. Limited Liability Companies</td>
<td>24</td>
</tr>
<tr>
<td>C. Manufacturing Exemptions</td>
<td>25</td>
</tr>
<tr>
<td>D. Nexus</td>
<td>29</td>
</tr>
<tr>
<td>E. Streamlined Sales Tax Project</td>
<td>30</td>
</tr>
<tr>
<td><strong>IV. Unclaimed Property</strong></td>
<td></td>
</tr>
<tr>
<td>A. Delaware</td>
<td>31</td>
</tr>
</tbody>
</table>
I. U.S. SUPREME COURT ACTIVITY

A. J.C. Penney National Bank (Tennessee)

*J.C. Penney National Bank v. Ruth E. Johnson* – The state of Tennessee requested a review of whether a state, in accordance with the nexus requirements of the Commerce Clause, can impose franchise and income-based taxes for corporations that derive significant economic benefits from regular and continuous activities in the state, even though lacking a physical presence. The U.S. Supreme Court denied certiorari on October 10, 2000.

B. Topps Company, Inc. (Michigan)

*Topps Company, Inc. v. Department of Treasury* – Topps requested a review of the retroactive application of the Michigan nexus standard. The U.S. Supreme Court denied certiorari on October 2, 2000. Previously, the Michigan Court of Appeals held that an out-of-state manufacturer’s due process rights were not violated by retroactive application of *Gillette Co. v. Department of Treasury*, which held that the proper test for nexus under the Single Business Tax (SBT) is *Quill Corp. v. North Dakota* rather than the narrower test of federal P.L. 86-272.

II. INCOME AND FRANCHISE TAX

A. UNITARY

1. California – *Exclusion of Profit Earned from Intercompany Sale of Inventory*

Due to the absence of clear authority, a taxpayer was not required to recognize profits from intercompany inventory sales in its water’s edge combined report. The profits were properly eliminated from the report in the year prior to making water’s edge election (In the Matter of Appeal of Yamaha Motor Corp., U.S.A., California State Board of Equalization, No. 2000-SBE-004, November 2, 2000).

Yamaha Motor Corp. USA ("Yamaha") a wholly owned subsidiary of Japanese corporation Yamaha Motor Company, Limited ("YMC"), filed a worldwide California combined report for the 1988 tax year. During the 1988 tax year, YMC sold a significant volume of inventory to Yamaha. In preparing its 1988 worldwide combined report, the unitary group properly eliminated the YMC inventory profit and reduced Yamaha’s ending inventory by the same amount, resulting in no economic gain for the group.

In tax year 1989, Yamaha elected to report California taxes on water’s edge basis. As a result, only domestic subsidiaries were included in the return. In the same tax year, Yamaha sold the YMC inventory to a third party. Yamaha took the position that because YMC was not included as part of the 1989 water’s edge group, the group
should not include the inventory profit in its combined report. However, the Board of Equalization argued that because Yamaha had not previously recognized gain from the sale of the inventory from YMC to Yamaha, the inventory profit should be included in the 1989 water’s edge combined report.

The Appeals Court ruled that due to lack of statutory authority and guidance from previous cases, ambiguities are to be resolved in the taxpayer’s favor. Therefore, Yamaha is not required to report the inventory profit in its California water’s edge combined report.

2. Illinois – Proof of Each Unitary Element Not Required

The Department of Revenue is not required to prove each element of a “unitary” statute meets the unitary test (Hormel Foods Corporation and Jennie-O-Foods, Inc. v. Kenneth E. Zehnder, Director of the Department of Revenue, Illinois Appellate Courts, First District, No. 1-99-1319, September 29, 2000).

Hormel Foods Corporation (“Hormel”), a Minnesota-based meat processor and manufacturer of food products, filed a separate company Illinois corporate income tax return for one of its subsidiaries, Jennie-O-Foods, Inc (“Jennie-O”). Although Jennie-O is in the food products business, Hormel asserted that its activities with Jennie-O are not fully integrated and do not constitute strong centralized management as defined by Illinois statute. Hormel took the position that Jennie-O should not file as part of its combined Illinois corporate tax return. The Department of Revenue disagreed that Jennie-O should file on a stand-alone basis and assessed Hormel and Jennie-O notices of deficiency.

To determine whether Jennie-O should be included in Hormel’s combined Illinois corporate tax return, the courts reviewed section 1501(a)(27) of the Illinois Income Tax Act which defines a unitary business group. The term unitary business group means, “A group of persons related through common ownership whose business activities are integrated with, dependent upon and contribute to each other. *** Unitary business activity can be illustrated where the activities of the members are: (1) in the same general line (such as manufacturing, wholesaling, retailing of tangible personal property, insurance, transportation or finance; or (2) are steps in a vertically structured enterprise or process (such as the steps involved in the production of natural resources, which might include exploration, mining, refining, and marketing); and in either instance, the members are functionally integrated through the exercise of strong centralized management (where, for example, authority over such matters as purchasing, financing, tax compliance, product line, personnel, marketing and capital investment is not left to each member)”.

Both parties agreed that Hormel and Jennie-O’s activities are in the same general line of business. However, Hormel argued that the Illinois statute defined strong centralized management to include all of the factors listed in the statute (authority over purchasing, financing, tax compliance, product line, personnel, marketing AND capital investment). The court disagreed stating, “enumeration of a list of factors in a statute does [not] imply the exclusion of others unless there is evidence of a contrary legislative intent.” The use of phrases “for example” and “such matters as” show that
the list of items is exemplary only and not exclusive. The court ruled that the Department of Revenue is not required to prove each factor of strong centralized management. Therefore, Jennie-O should be included in Hormel’s combined Illinois corporate tax return.

B. BUSINESS/NONBUSINESS INCOME

1. Alabama – Dividends Received are Nonbusiness When Reflected Against Alabama L/P Interest

Dividends received from a limited partnership were not included in a corporation’s Alabama apportionable income base (Danov Corp. v. Alabama Department of Revenue, Administrative Law Division No. 97-283, December 22, 2000).

Danov Corporation, a Florida based corporation, purchased a 21% limited partner interest in a limited partnership that invested in oil and gas properties throughout the country and in Alabama. Danov had no input into the management or operation of the limited partnership, nor did the commingling of funds occur between Danov and the partnership. Other than the 21% limited partnership interest, Danov conducted no business in Alabama, owned no property in Alabama, and had no employees in Alabama.

Danov filed Alabama corporate income tax returns because the limited partnership had invested in Alabama oil and gas wells. Danov reported its dividend income as allocable nonbusiness income. The Department of Revenue recharacterized the income as business income apportionable in part to Alabama. The Department contended that even if a unitary relationship did not exist between the dividend income and Danov’s activity in Alabama, the income may still be apportioned in part to Alabama because the dividends served an operational function.

The Administrative Law Judge ruled that Danov correctly classified its dividend income from the limited partnership as nonbusiness income. Even though Danov had nexus in Alabama through its investment in the partnership, no operational tie existed between the dividends received and the income produced in Alabama. To apportion the dividend income, a minimum connection between Danov’s out of state business activities and Danov’s Alabama activities must exist. The Administrative Law Judge stated, “Even if the dividends constituted business income, there was no connection between the out-of-state operational functions for which the dividends were used, and Danov’s activity in Alabama”.

2. California – State Supreme Court Rules For Two Independent Business Income Tests

The California Supreme Court found the taxpayer’s pension reversion income to be business income under an independent “functional” test (Hoechst Celanese Corporation v. California Franchise Tax Board, California Supreme Court, S085091, May 14, 2001).
Hoechst Celanese Corporation ("Hoechst") created a pension plan that included several trusts. Hoechst did not own or hold legal title to these assets and could not use the assets to fund any corporate activities. However, Hoechst retained an interest in the surplus pension plan assets. In 1985, Hoechst terminated one of its pension trusts. The surplus assets of the plan reverted to Hoechst and Hoechst placed the assets in its general fund to be used for general corporate purposes. Hoechst classified the plan income as nonbusiness income allocable to New York, its commercial domicile, instead of apportioning the income in part to California. Hoechst contends that California statute applies only a transactional test whereas the Board of Equalization contends that both a transactional and functional test must be applied.

The Supreme Court ruled that California statute imposes both a transactional and functional test. If considering only the transactional test, Hoechst's income would be reported as New York nonbusiness income because Hoechst's termination of its plan assets was not a transaction occurring in the regular course of business.

The Court, in applying both tests, reviewed the functional test which focuses on the income-producing property. The taxpayer's control and use of the property must contribute materially to the taxpayer's production of business income so that the property becomes interwoven into and inseparable from the taxpayer's business. The Supreme Court found that Hoechst's pension plan assets were integral to its business operations. The assets were interwoven into and inseparable from Hoechst's employee retention and recruitment efforts - an essential part of any business operation. In addition, Hoechst had the authority to amend the plan and retain an interest in any surplus pension plan assets. It funded the plan with its business income and used these contributions to reduce its tax liability. Therefore, the Supreme Court ruled that Hoechst should classify the plan income as business income apportionable to California.

The Supreme Court found the reasoning behind an opposite conclusion issued by the North Carolina Supreme Court "questionable in several respects." In Union Carbide versus North Carolina Department of Revenue, North Carolina applied an overly restrictive interpretation of the functional test and appeared to focus on the surplus instead of the income producing property.

3. Illinois – Complete Liquidation Constituted Nonbusiness Income

Complete liquidation of a corporation, whereby the proceeds are distributed to shareholders, constitutes nonbusiness income (Blessing/White, Inc. v. Director of Revenue, and the State of Illinois Department of Revenue, Illinois Circuit Court, Cook County, No. 99 L 51087, January 24, 2001).

Blessing/White, Inc. ("BWI") completely liquidated its capital assets and distributed the proceeds to its shareholders. BWI classified the proceeds as nonbusiness income. The Illinois Department of Revenue disputed this position stating that the income should be classified as business income apportionable to Illinois.
The Illinois statutes require both a transactional and functional test be applied to determine if income is apportionable as business income. Because BWI completely liquidated, the functional test is the applicable standard to review. Section 1501(a)(1) of the Illinois Income Tax Act defined business income as “income arising from transactions and activities in the regular course of the taxpayer’s trade or business and includes income from tangible and intangible property if the acquisition management and disposition of the property constitute integral parts of the taxpayer’s regular trade or business operation.” The Illinois Circuit Court referred to *Texaco Cities Service Pipeline Co. v. Illinois Department of Revenue (1998)*, to determine the definition of “integral” and “operation.” In *Texaco Cities*, the court ruled that the proceeds from the sale were business income. When the sale was completed, *Texaco Cities* remained primarily in the business of providing transportation by pipeline and the sales proceeds were invested back into the business rather than being distributed to shareholders.

In this case, the Circuit Court ruled that the proceeds were not an integral part of the business operation because BWI had no business to continue. Therefore, the proceeds distributed to the shareholders should be classified as nonbusiness income.


The court ruled the sale of an entire line of business may be classified as nonbusiness income (*Lenox Inc. v. Muriel K. Offerman, Secretary of the North Carolina Department of Revenue, North Carolina Court of Appeals, No. COA99-1267, December 5, 2000)*.

Lenox, Inc., a New Jersey based corporation, sold its ArtCarved fine jewelry business and distributed the proceeds to its parent, Brown Forman Corporation. The proceeds were not reinvested or used to pay debt. Lenox classified its proceeds as nonbusiness income. The Department of Revenue classified the proceeds as business income apportionable to North Carolina and assessed a tax on the capital gain from the sale.

North Carolina requires taxpayers to apply both a transactional and functional test to determine whether income is business or nonbusiness. Both Lenox and the Department of Revenue were in agreement that the sale did not generate business income under the transactional test. The sale was an extraordinary transaction not occurring in the regular course of business.

For the application of the functional test, the appeals court reviewed various nonbusiness rulings in various states (*Laurel Pipeline, Kroger, Texaco-Cities Service Pipeline, Polaroid*). Based on these cases, the appeals court found the sale of the ArtCarved fine jewelry business to be nonbusiness income. The Department of Revenue countered that ArtCarved was an integral part of Lenox’s regular manufacturing business. However, the appeals court looked to the “totality of circumstances” and noted that the entire division was sold, the sale marked the cessation of Lenox’s involvement in that business, and the proceeds were not invested or used to cancel debt. Also in their analysis, the appeals court pointed to a footnote.
ruling in Polaroid (and similar wording in Alabama’s recent Uniroyal decision) that liquidation cases are in a category by themselves; the asset and transaction at issue are not in furtherance of the unitary business, but rather a means of cessation.

C. APPORTIONMENT FACTORS

1. Alabama – Subsidiary Imputed Payroll for Factor Purposes

A subsidiary (with no Alabama property or employees) whose sole function is to hold a partnership interest for its parent, included in its payroll factor the administrative fees paid to its parent corporation for employee services provided to the partnership (C&D Chemical Products, Inc., Administrative Law Division, Docket No. CORP-00-288, February 9, 2001).

Church & Dwight Company, Inc. (“C&D”) and Occidental Electrochemicals Corporation (“OEC”) entered into a Partnership Agreement whereby a subsidiary of each company would own a 50% interest in a general partnership. The partnership would manufacture potassium carbonate at OEC’s manufacturing facility in Alabama and sell the product worldwide. C&D formed C&D Chemical Products, Inc., for the purpose of holding its 50% interest in the Partnership. Oxy Carbonate, Inc., a wholly owned subsidiary of OEC, owns the remaining 50% of the Partnership. Pursuant to its service agreement, C&D provides approximately 25 New Jersey employees that perform various marketing, accounting, sales, and other services for the Partnership. OEC provides approximately 25 employees that reside in Alabama to work in the Partnership’s manufacturing facility.

The Partnership is required to pay C&D and OEC an administrative fee for services provided to the Partnership, including employee compensation. The Taxpayer, C&D Chemical Products, Inc. apportioned its income to Alabama using the property, payroll and sales factors from the Partnership. It computed the payroll factors based on the annual amounts the Partnership paid for services provided by C&D and OEC employees. The numerator (Alabama payroll) was the compensation paid for the OEC employees in Alabama. The denominator (everywhere payroll) was the total employee compensation paid to both C&D and OEC. C&D estimated that 25% of its administrative fee received from the Partnership was attributable to the cost of its shared employees that performed services for the Partnership. The Department did not dispute that amount. However, the Department of Revenue determined that C&D Chemical Products, Inc. does not have employees and therefore, should not be permitted to include a payroll factor.

The Administrative Law Judge (“ALJ”) found that Alabama regulation 810-27-1-4-.13(a)(3) which defined compensation as wages and salaries paid to employees is not consistent with the payroll factor definition in Alabama statutes. The ALJ used the American Heritage Dictionary definition of compensation to support his position that C&D Chemical Products, Inc. should include its payments to C&D and OEC in its payroll factor. The ALJ admitted that by excluding the payments from the payroll factor, corporations could manipulate the payroll factor thereby decreasing Alabama tax liability, but was unable to find a stated reason why the payroll factor should be limited to only compensation paid to an employee.
2. Arizona – Computer Software Included in Property Factor

If classified as tangible personal property for federal tax purposes, computer software should be included in the property factor (Arizona Corporate Tax Ruling CTR 01-2, Arizona Department of Revenue, May 1, 2001).

The Arizona property factor includes real and tangible personal property used in the taxpayer's business, but excludes intangible property and expensed items. Arizona bases its classification of real and tangible personal property in accordance with the guidance provided by the Internal Revenue Code.

If computer software is capitalized as tangible personal property for federal tax purposes, the computer software will be treated as tangible personal property in Arizona. If treated as tangible personal property, the computer software should be included in the property factor. The property factor numerator is based upon where the computer software is actually used, not in the state where the original program disk or tape is located.

3. California – Finnigan a Legitimate Apportionment Method

The Court of Appeal ruled that Finnigan apportionment principles are legally acceptable, although not required (Citicorp North America, Inc. v. California Franchise Tax Board, California Court of Appeal, First Appellate District, No. A086925, October 2, 2000).

Citibank, a South Dakota affiliate of Citicorp that handles VISA and MasterCard credit card business, filed as a member of Citicorp's unitary group. Citibank has no physical presence in California, but it does have numerous credit card customers in California. Citicorp amended its 1992 and 1993 California returns and requested a refund for those years claiming that it can exclude the California sales of Citibank from its apportionment factor in accordance with the Joyce decision. The Franchise Tax Board ("FTB") audited the returns and in accordance with the Finnigan rule, recalculated the sales to include Citibank's California sales.

The Joyce rule attributes income to California only if the affiliate generating the income has nexus in the state whereas the Finnigan rule attributes income to California if any member of the unitary group is taxable in the state. California followed the Finnigan rule until April 1999.

The appeals court decided that the FTB may deny the refund claims. Not only did the SBE launch the Finnigan rule with the expectation that many states would adopt the rule, it followed the rule for over nine years with reasonable theories as to its application. In addition, the appeals court ruled that retroactive application of the Joyce rule may not benefit all taxpayers. Therefore, Citicorp may not apply the Joyce rule to prior years.

The United States Supreme Court denied certiorari on June 29, 2001.
4. Maryland - *Single Factor Sourcing for Manufacturing*

Effective for tax years beginning after December 31, 2000, manufacturing corporations that carry on a trade or business in and out of the state of Maryland will be required to apply a single factor sales apportionment instead of the 3 factor double weighted sales apportionment (*House Bill 11, May 18, 2001*). A "manufacturing corporation" means a domestic or foreign corporation which is primarily engaged in activities in Sector 11, 31, 32, or 33 of the North American Industrial Classification System Manual. The NAICS code reported on the Maryland tax return must be consistent with the NAICS code reported to other government agencies.

The new law also requires manufacturing corporations to file a statement describing the differences in taxes owed as a result of using single factor sales apportionment as compared to the three factor apportionment, the volume of sales in the state and worldwide, the taxable income in the state and worldwide, and the book value of plant, land, and equipment in the state and worldwide.

5. New Jersey – *Manufacturer’s Drop Shipment Receipts Sourced to New Jersey*

A Michigan based corporation manufactured knee and hip replacements at its New Jersey facility. Selling to a wholly owned New Jersey subsidiary at the same facility, it drop-shipped directly to the subsidiaries out-of-state customers. The New Jersey Supreme Court determined that the receipts are to be included in the New Jersey numerator for purposes of the Corporation Business Tax (*Stryker Corp., New Jersey Supreme Court, No. A-27, June 14, 2001*).

Stryker has manufacturing facilities in New Jersey and in other states. The New Jersey facility manufactures hip and knee replacements. Stryker sells these products to customers located in the United States through its wholly owned subsidiary, Osteonics Corporation, which operates out of the same facility in New Jersey as Stryker. Osteonics’ computers transmit the customer’s orders to Stryker’s computers. Stryker packs and ships the products directly to Osteonics’s customers without any intervention by Osteonics beyond submission of the orders. Osteonics never takes possession of the products. Osteonics bills its customers, retains a portion of the receipts, and remits the balance to Stryker. The payments from Osteonics to Stryker include a profit to Stryker.

Stryker’s sales do not fall within the definition of “sales of its tangible personal property located within this State”, (N.J.S.A. 54:10A-6(B)(1)) because they do not involve physical shipments made to points within this State. However, the Court held that the income Stryker derived from its sales to Osteonics does fall within the statute, for “all other business receipts... earned within the State...” (N.J.S.A. 54:10A-6(B)(6)) because it represents Stryker’s earnings from its activities conducted exclusively within New Jersey.
Stryker argued that the criterion for allocation of sales receipts to New Jersey is the customer’s location and contended that construing the New Jersey statute to include these receipts in its catch-all language (i.e., other business receipts) is contrary to New Jersey’s destination rule. It further argued that the receipts from its drop-shipment sales cannot be “other business receipts” since they are receipts from sales of tangible personal property.

The Court determined that the statute should not be interpreted as a limitation on the New Jersey’s Division’s right to include Stryker’s receipts in the New Jersey allocation factor. Rather, the catch-all provision should be interpreted to allow the Division to “plug loopholes” in the Corporate Business Tax Act (CBTA). It stated that a drop-shipment transaction should not allow a manufacturer to enjoy an unfair tax advantage over a manufacturer that has chosen not to drop-ship its goods and that, consequently, would be required to include the receipts of the goods that were physically shipped to a wholesaler. The Court further stated that the phrase “other business receipts” should be used to ensure that corporations cannot argue that receipts are exempt from the CBTA simply because an intermediary was involved when the goods and the buyers were at all times within New Jersey. Thus, the Court concluded that Stryker’s receipts are includible in the numerator of the receipts fraction.
D. LIMITED PARTNERSHIPS/LIMITED LIABILITY COMPANIES

1. Georgia – Georgia Nexus for Nonresident Corporate L/P

The Georgia Department of Revenue reversed its position that corporate limited partners with no other connection to the state beyond its ownership in a limited partnership do not have a Georgia filing requirement. The new regulations become effective for tax years beginning on or after January 1, 2002. Georgia Regulation Section 560-7-7-.03, Corporations: Allocation and Apportionment of Income, addresses income tax nexus for limited partners and Georgia Regulation Section 560-7-8-.34 addresses withholding tax issues.

2. Georgia – Disregarded Entity Treated as Separate Entity for Sales and Use Tax Purposes

Effective April 27, 2001, an entity’s federal tax classification applies to Georgia income tax purposes only (House Bill 582, April 27, 2001). Although not specifically stated in the Bill, Georgia law implies that regardless of federal tax treatment, limited liability companies that elect to be treated as disregarded entities for income tax purposes may be treated as separate entities for other tax purposes, such as sales and use tax.


On June 29, 2001, legislation was signed (A.B. 3045) closing an advantage to owners of limited partnerships and limited liability companies in New Jersey. Effective for tax years beginning on or after January 1, 2001, members’ of a limited liability company (LLC) and partners’ of a limited partnership (LP), that is classified as a partnership for federal income tax purposes, are subject to the New Jersey corporation business tax on the income derived from activities of the LLC or LP in New Jersey.

An LLC or LP that does not obtain the consent of its owners must pay corporation business (income) tax liability on behalf of its nonconsenting members or partners’ shares of the business’ New Jersey income on or before the 15th day of the fourth month succeeding the close of each tax year. LLC’s and LP’s must also make estimated payments for nonconsenting members’ or partners’ current year’s taxes on the 15th day of the fourth month of the tax year based on the prior year’s income of the company or partnership.

Exemptions are identified for LLC’s and LP’s listed on the United States national stock exchanges, and qualified investment partnerships, defined as LLC’s or LP’s with more than ten owners, none of whom owns more than 50% of the entity, that derive at least 90% of their gross income from financial transactions, are exempt from the tax payments. For transitional application, the final tax payment for nonconsenting owners for tax years beginning in 2001 is reduced to 45% of the
amount otherwise due. Estimated tax payments for nonconsenting owners for tax years beginning in 2001 are not required.

4. Pennsylvania- Legislation Amends Definition of Corporation and Business Income

Pennsylvania recently enacted legislation (House Bill 334, June 22, 2001) that subjects partnerships that elect to be taxed as a corporation for federal income tax purposes ("check the box limited partnerships") to Pennsylvania corporate taxation. The change is effective for tax years beginning on or after January 1, 2001.

The definition of corporation is amended for Pennsylvania corporate net income and franchise/capital tax purposes to include all entities classified as corporations for federal income tax purposes. Previously, the definition of the term "corporation" did not include a Limited Partnership (LP).

The definition of business income is revised, retroactive to January 1, 1999, to broaden the classification to include income from property if "either the acquisition, the management or the disposition of the property constitutes an integral part" of the taxpayer’s regular trade or business operations. The term includes all income which is apportionable under the constitution of the United States.

The Pennsylvania Department of Revenue (DOR) is currently addressing the administrative matters concerning the entities affected by the law change. For LP estimated payment requirements, the DOR is discussing the guidance on "catch-up" payments for the corporate net income tax going back to January 1, 2001. Suggestions have included a cumulative payments as part of the 3rd quarter estimate (due 9/15/01) for calendar taxpayers) that may be acceptable in order to avoid underpayment penalties. Other suggestions have included a 75-90 day window for allowing LP’s to make retroactive installments for the 1st and 2nd quarters. In any case, LP’s should anticipate a large payment coming due within the next 2 months.

E. NEXUS

1. Massachusetts – Leased Trucks Create Nexus

Massachusetts may impose a corporate excise tax on a foreign corporation that leases vehicles to persons who operate the vehicles inside the state (Truck Renting and Leasing Association, Inc. & Another v. Commissioner of Revenue, Massachusetts Supreme Judicial Court, No. SJC-08308, April 17, 2001).

Adams International Trucks, Inc., a Delaware corporation commercially domiciled in North Carolina, rents and leases trucks to businesses and individuals through its wholly owned division, Ideal Leasing. Adams retains ownership of the leased vehicles but grants the lessees “exclusive dominion and control at all times.” Ideal Leasing provides licensing and registration services on behalf of its lessees. From 1992 through 1996, a portion of Adams’s fleet logged miles on Massachusetts’s roads. The Commissioner of Revenue notified Adams stating that it failed to file
corporate excise returns. Adams filed a complaint arguing that the due process clause and the commerce clause limit the Commonwealth's ability to tax foreign corporations.

The due process clause requires "some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax." The Court ruled that Adams has a minimum connection with Massachusetts. A direct relationship exists between the income Adams earned and the lessee's use of the vehicles. In addition, Adams facilitates the requisite registration and licensing requirements.

Adams also satisfies the commerce clause's substantial nexus requirement. If Adams itself operated its vehicles in Massachusetts, physical presence would be established. Citing *Aloha Freightways, Inc. v. Commissioner of Revenue*, the Court held that a lessee driving trucks in Massachusetts does not dictate a different result.

Because both the due process clause and commerce clause standards were met, Adams was required to file the necessary Massachusetts excise tax returns.

2. Tennessee – *AOL Did Not Have Required Physical Presence*

Sales and use, franchise, corporate excise, and business privilege taxes may not be assessed if a company has no physical presence in Tennessee (American Online, Inc. v. Ruth E. Johnson, Tennessee Chancery Court, 20th Judicial District, Davidson County, Part III, No. 97-3786-III, March 13, 2001).

America Online, Inc. sells computer online services throughout the United States, including Tennessee. For a fee, AOL customers, located anywhere, connect with AOL's main computer in Virginia and then are provided with AOL information services such as email and access to the internet. Third-party payment processors charge customer credit cards or debit bank accounts. America Online, Inc. does not own property in TN, nor does it pay employees to provide services in Tennessee.

The Department of Revenue argued that AOL is doing business in Tennessee and that only a minimal connection to the state is required. Under the Due Process Clause, the acceptance of the AOL contracts in Tennessee is sufficient for minimal contact. However, the Department of Revenue failed to prove substantial nexus under the Commerce Clause. Referring to the *J.C. Penney National Bank* case, the Court reiterated, "The Commissioner has pointed to no case in which the Supreme Court of the United States has upheld a state tax where the out-of-state taxpayer had absolutely no physical presence in the taxing state." Economic presence alone does not subject a taxpayer to Tennessee excise tax.

The Court ruled that the following AOL activities within Tennessee did not create a physical presence in Tennessee: customer dial-in through local numbers, communications equipment leased to and leased by AOL (deemed immaterial, a mere facilitation of network), data network services provided by a subsidiary, distribution of software disks to initially connect a customer to AOL, holding of a copyright
interest in software and licensing the software licenses to customers, and entering into contracts with customers.

F. INTELLECTUAL PROPERTY/RELATED PARTY TRANSACTIONS

1. Massachusetts – State Successfully Attacks Trademark Scheme on Many Fronts

The Massachusetts Appellate Tax Board denied royalty deductions paid to a subsidiary created for tax benefit purposes only (Syms Corp. v. Commissioner of Revenue, Appellate Tax Board, Nos. F215484 and F228324, September 14, 2000).

Pursuant to advice from a boutique firm, Syms Corp transferred its trademarks, trade names and service marks (“IP”) to a wholly owned subsidiary, SYL, Inc. Syms paid royalties for the use of the IP and deducted the royalty payments in the computation of its Massachusetts corporate excise tax returns.

The Department of Revenue disallowed the deductions of the royalty payments stating that the transactions were for tax avoidance purposes only. The Appellate Tax Board concurred and disallowed the deductions for the following reasons: lack of business purpose, lack of economic substance, failure of proper arm’s-length testing and disallowance of payments found not “ordinary or necessary.” In addition, the Commissioner was allowed the power to adjust the income under a state statute analogous to IRC Sec. 482. The ATB sustained penalties because Syms had not consulted a “competent tax expert” at the inception of the plan.

2. Massachusetts – State Concludes Intangible Property Company a Sham

Massachusetts concluded that a Parent Company’s deductions for royalty payments were for tax avoidance purposes only. In addition, the expenses were not ordinary and necessary as defined by Internal Revenue Code Section 162 (Sherwin-Williams Co. v. Massachusetts Commissioner of Revenue, Appellate Tax Board, No. F233560, July 19, 2000).

Sherwin-Williams Co. (“Sherwin-Williams”), an Ohio corporation engaged in the manufacture, distribution, and sale of paints formed two wholly owned Delaware subsidiaries to hold its valuable trademarks. Sherwin-Williams paid royalty fees to the subsidiaries based on a percentage of sales of products bearing the trademarks, and deducted the expenses on its state return. The management of Sherwin-Williams and its trademark subsidiaries overlapped.

Sherwin-Williams filed Massachusetts corporate tax returns and claimed royalty expenses for its payments to the trademark subsidiaries. The Massachusetts Commissioner of Revenue denied the royalty fee deductions in addition to interest payments for one of the subsidiary’s loans, stating that Sherwin-Williams was the true owner of the intangibles for tax purposes.
The Appellate Tax Board agreed with the Commissioner of Revenue stating that Sherwin-Williams provided no valid business purpose in forming the trademark subsidiaries. The Board rejected the following business purposes: the protection and management of trademarks from a hostile takeover and/or creditors, better management, greater financing flexibility, use for acquisition of new businesses, benefits available from Delaware’s corporate law and judicial system, improve profit center analysis, and the enhancement of the taxpayer’s ability to enter into license agreements for the use of the trademarks, thereby maximizing its royalty rates and license fees. In addition, the Board agreed that the transactions between Sherwin-Williams and its trademark subsidiaries were not arm’s length transactions.

3. New York – Sherwin-Williams Cannot Be Forcibly Combined

The Division of Taxation was unable to prove that Sherwin-Williams should be combined with Sherwin-Williams Investment Management Company to prevent distortion (The Sherwin-Williams Company, New York-Division of Appeals, No. 81672, June 7, 2001).

Entity formation occurred for a valid business purpose. Placing trademarks into subsidiaries provided the following: product sales to be tracked for environmental reasons and legal issues, incorporation in a favorable tax jurisdiction, aversion of a hostile takeover through easy trademark sale to a “white-knight,” and better financing through securitization of the royalty’s income stream. In addition, royalty rates were deemed reasonable and intercompany charges were supported at arm’s-length rates.

4. New York – Interest Expense Deduction Disallowed on Intercompany Loan

Ruling that the “economic reality” of the transaction did not support the taxpayer’s position, an interest expense deduction by a parent corporation for interest paid to its subsidiary was disallowed because the expense was directly attributable to subsidiary capital (Matter of Carpenter Technology Corporation., New York Division of Tax Appeals, Tax Appeal Tribunal, DTA No. 816680, April 12, 2001).

Carpenter Technology Corporation (“Carpenter”) formed Carpenter Investments, Inc. (“CII”) in Delaware, as a wholly owned subsidiary for the purpose of protecting Carpenter’s domestic business assets from large liabilities related to business conducted in foreign countries. Carpenter contributed capital in the amount of $300 million to CII and thereafter, CII loaned this $300 million back to Carpenter. The loan was evidenced by a revolving promissory note and an arm’s length interest rate. Carpenter made timely interest and principal payments with respect to the note held by CII. CII paid dividends to Carpenter, which was, in part, based upon income earned by CII from its receipt of interest paid by Carpenter.

New York Tax Law Sec. 208(9)(b)(6) provides that entire net income shall be determined without excluding, deducting or crediting: “in the discretion of the tax commission, any amount of interest directly or indirectly and any other amount directly or indirectly attributable as a carrying charge or otherwise to subsidiary capital or to income, gains or losses form subsidiary capital”.

14
Carpenter alleged that the interest payments were incurred for a legitimate business purpose and since the payments to CII were not incurred to enhance its investment in CII, that such expenses were not attributable to subsidiary capital. The Tax Appeals Tribunal, agreeing with the Administrative Law Judge decision, denied the interest expense deduction and held that the only reasonable explanation for taxpayers’ exchange of assets was that the parent (Carpenter) could obtain a double tax benefit, i.e., it would not have to include the initial investment provided to its subsidiary as part of its entire net income, while at the same time it could receive a deduction for the interest payments it made to its subsidiary.

5. North Carolina – "Naked" Trademark Corporation Has N.C. Taxable Income

A Delaware trademark holding company without significant substance, created by the drop-down of a retailer’s intangibles, was determined to have North Carolina taxable income attributed through intangibles licensing (Secretary of Revenue Decision No. 97-990, North Carolina Department of Revenue, Wake County, September 19, 2000).

A Parent Company primarily engaged in the retail sale of clothing formed a wholly owned subsidiary in Delaware and transferred its domestic intangible property to the new subsidiary. The individual retail stores, including those in North Carolina, paid a royalty fee for the use of the intangible property (including trademarks). In addition, the subsidiary used the royalty payments to loan money to the retail establishments for use in retail operations. The intangible property subsidiaries did not file North Carolina tax returns. The North Carolina Department of Revenue assessed the intangible property subsidiaries for North Carolina income and franchise tax.

The Secretary of Revenue ruled that the intangible holding companies are doing business in North Carolina and therefore subject to corporate income and franchise tax. According to Administrative Rule 17 NCAC 5C .0102, “doing business” in North Carolina includes operating any business enterprise or activity for economic gain, including but not limited to the owning, renting, or operating of business or income-producing property. The intangible property is income-producing property. In addition, the subsidiaries were deemed to be excluded corporations and thereby required to apportion business income with a single sales factor.

G. NEW LEGISLATION REQUIRING ADDBACK OF ROYALTY EXPENSES

1. Mississippi – Addback of Intangible and Interest Expenses

Under the new provisions of Mississippi Code §27-7-17(2)(v)4, taxpayers must add back to taxable income intangible and interest expenses paid to related members.

Intangible expenses and costs, under the revised provisions of Mississippi Code §27-7-17(2), include most costs related to the ownership, acquisition or disposition of intangible property which would normally be deductible under the provisions of
Chapter 27 of the Mississippi Code. Intangible property is defined as patents, patent applications, trade names, trademarks, service marks copyrights and similar types of intangible assets. Some specific expenses or costs related to intangible property that are normally deductible include:

- Expenses or losses related to factoring or discounting transactions;
- Royalty, patent, technical and copyright fees;
- Licensing fees; and
- Other similar expenses and costs.

In computing net income, a taxpayer shall add back otherwise deductible interest expenses and costs and intangible expenses and costs directly or indirectly paid, accrued to or incurred, in connection with transactions with one or more related members.

Interest expenses and costs is defined as amounts normally allowed as deductions, under Chapter 27 of the Mississippi Code, related to the direct or indirect acquisition, maintenance management, ownership, sale, exchange or disposition of intangible property.

The add back provisions will not be applied if the taxpayer can establish one of the following: 1) the transaction giving rise to the expenses was done primarily for a valid business purpose other than the avoidance of taxes and the related party is not primarily engaged in the acquisition, use, maintenance or management, ownership, sale, exchange, or any other disposition of intangible property; or 2) the related party to which the expense was paid, paid that expense to an unrelated party during the same tax year.

2. North Carolina – *Pending Legislative Developments*

*Senate Bill 1005, Budget & Appropriations Legislation (Originally Introduced as Senate Bill 1058)- Tax Proposals Pending*

*Adjustments Pertaining to Trademarks and Royalty Payments*

This proposed legislation would require an adjustment for certain royalty payments between related companies. Royalty payments received for the use of intangible property in North Carolina is considered income derived from doing business in North Carolina.

Royalty payments include expenses, losses, and costs paid, accrued, or incurred for North Carolina royalties and amounts allowed as deductions under IRC section 163 (interest expense) to the extent the amounts are paid, accrued or incurred for a time price differential charged for the late payment of any expenses, losses or costs as described in this legislation. A North Carolina royalty is defined as “an amount charged that is for, related to, or in connection with the use in this State of a trademark. The term includes royalty and technical fees, licensing fees, and other similar charges”.

16
Taxpayers are provided with an option concerning the method by which these royalties can be reported by related members. The royalty payments can be either: 1) deducted by the payer and included in the income of the recipient, or 2) added back to the income of the payer and excluded from the income of the recipient. The first option would require the recipient to file a North Carolina return for the same taxable year that the amount is deducted by the payer. Effective date: Taxable years beginning on or after January 1, 2001.

**Franchise Tax on Corporate-Affiliated Limited Liability Companies**

For a corporation that is a member of a limited liability company (LLC), a percentage of the LLC’s income, assets, liabilities, and equity is attributed to the corporate member and must be included in member corporation’s franchise tax base. The attributable percentage is equal to the percentage of the LLC’s assets that would be distributable to the member corporation upon dissolution. Effective date: January 1, 2002.

**Conformity of Subsidiary Dividends Received Deduction**

This proposed amendment would conform the North Carolina dividends received deduction from subsidiaries to provide for the same deduction as allowed under the federal IRC. Repeals (G.S. 105-130.7(b)) allowing a deduction for all dividends received from corporations in which it owns more than 50%. Effective date: Taxable years beginning on or after January 1, 2001.

**Other Important Provisions**

- Codification of the N.C. Department of Revenue’s expansive interpretation of “doing business” in North Carolina by specifically defining the term as including the receipt of royalty payments for the use of trademarks in the state. **NOTE:** Interestingly, there is no requirement that the royalty payments occur between related companies to establish nexus, clearly setting the stage for a constitutional challenge to the revision.

- Expansion of the definition of “excluded corporation,” which must apportion N.C. income using only a single sales factor instead of the three-factor formula.

- Legislative review of all North Carolina tax credits periodically (every three years) to determine whether to continue them. Effective date: Taxable years beginning on or after January 1, 2003.

**H. CREDITS AND INCENTIVES**

1. **Georgia – New Developments**

   - Job credit
o Tier changes for counties, including addition of a Tier 4 classification.

o Credit amount per job increases:
  • Tier 1: Increased from $2,500 to $3,500 per job.
  • Tier 2: Increased from $1,500 to $2,500 per job.
  • Tier 3: Increased from $500 to $1,250 per job.
  • Tier 4: Credit equals $750 per new job.

o Reduction of employment requirements:
  • Tier 2: Reduced from 15 to 10 new jobs.
  • Tier 3: Reduced from 25 to 15 new jobs.
  • Tier 4: Required increase of 25.

o Health insurance must be available for new jobs. Taxpayer is not required to pay health insurance.

o Change in maximum credit limitations:
  • Tiers 1 & 2: May apply credit against 100% of tax liability.
  • Tiers 3 & 4: May apply credit against 50% of tax liability.

- Investment tax credit and optional investment tax credit now available to qualified taxpayers that operate or invest in a manufacturing or telecommunications facility or support facility in a Tier 4 county.

- Job tax credit of $500 available in addition to applicable county credits for taxpayers who increase port traffic.

- New credit ranging from $2,500 to $5,000 available for companies who establish or relocate headquarters to Georgia.
  - 100 new full-time jobs required.
  - $1 million investment.
  - Elect not to receive other job tax credits.

2. Maryland - New Developments

- Effective July 1, 2000, taxpayers may take a state research and development credit. The credit is equal to 3% of the Maryland base amount of R&D expenses, plus 10% of the amount by which the current year Maryland R&D expenses exceed the base amount. The total credit allowed by the state in any calendar year to all taxpayers cannot exceed $3 million for the 3% credit and $3 million for the $10% credit (Annotated Code of Maryland, 1957, Sec. 10-718).

3. Mississippi – New Developments

- Jobs Credit
o Qualifying businesses expanded to include data or information processing businesses, computer software development businesses, and technology intensive facilities/enterprises.

o Credit equal to $1,000 and $2,000 for new full-time employees paid a salary at least 125% and 200%, respectively, of average annual Mississippi wage.

o Credit for jobs requiring research and development skills increased to $1,000.

- Training Credit
  o Expanded to 50% of qualified training or retraining expenses.

- Credit for companies locating national or regional headquarters in Mississippi increased.

4. South Carolina – New Developments

- Effective July 1, 2001, taxpayers may take a research and development credit. The credit is equal to 5% of qualified expenditures.

- Effective for tax years beginning after June 30, 2001, the jobs credit is expanded to include technology intensive facilities, such as:
  o Firms engaged in design, development, and introduction of new products or innovative manufacturing processes,
  o Database and directory publishers,
  o Software publishers,
  o Computer systems design and related services,
  o Custom computer programming services,
  o Scientific research and development services, or
  o Space research and technology.

I. STATE TAX DEDUCTIONS

1. Ohio – Foreign Dividend Deduction Unconstitutional

Permitting only an 85% dividend received deduction for foreign companies is a violation of the Foreign Commerce Clause of the U.S. Constitution (Emerson Electric Company and Subsidiaries v. Tracy, Tax Commissioner, Ohio Supreme Court, No. 99-1879, October 4, 2000).

Emerson ("Emerson") Electric Company owns several domestic and foreign subsidiaries from which it receives dividends. On its Ohio franchise tax returns, Emerson deducted 100% of the dividends received from domestic subsidiaries and 85% of the dividends received from foreign subsidiaries, pursuant to Ohio R.C. 5733.04(I)(2)(c). Emerson filed an Ohio refund claim stating that the 15% dividend...
received limitation violates the Foreign Commerce Clause. The Tax Commissioner of Ohio denied the refund request concluding that the Commissioner does not have jurisdiction to decide constitutional issues and Ohio’s combined reporting method does not discriminate against foreign commerce.

The Ohio Supreme Court reviewed the Foreign Commerce Clause, which provides Congress the authority to regulate commerce between the United States and foreign nations, and also directly limits the power of the states to discriminate against foreign commerce. The United States Supreme Court also applied these principles to Kraft General Foods, Inc. v. Iowa Dept. of Revenue. In Kraft, the U.S. Supreme Court ruled that Iowa could not disallow a foreign dividend received deduction if permitting a domestic dividend received deduction. However, a number of courts, including 254 Kan. At 38, 864 P.2d at 1186, Caterpillar, 568 N.W.2d at 700-701, E.I. Du Pont de Nemours, 675 A.2d at 87 and Caterpillar Fin. Serv. Corp. v. Whitley (1997), have found that the decision in Kraft applies only to a single entity reporting system and that Kraft does not apply to the taxation of foreign dividends by domestic combination states.

In this case, the Ohio Supreme Court ruled in favor of Emerson. “Ohio’s system of combined reporting does not produce the “tax symmetry” that combined reporting produces in other states.” Disallowing 15% of foreign dividends received to be deducted violates the Foreign Commerce Clause. The Court found Emerson’s refund request to be reasonable.

2. Texas – Statute Interpretation Requires a Deduction from the Apportionment Base to be Given Exemption Treatment; Law Favors Unprofitable Drug Companies

The exclusion of drug and medicine receipts from gross receipts of apportioning capital applies only to the taxable capital base calculation (The Upjohn Company v. Carole Keeton Rylander, Comptroller of Public Accounts of the State of Texas; and John Cornyn, Attorney General of the State of Texas, Texas Court of Appeals, Third District, No. 03-00-00055-CV, October 19, 2000).

Upjohn was unsuccessful in arguing that the earned surplus statutes imply the exclusion of drug proceeds from the Texas apportionment factor numerator without explicitly stating the exclusion as provided in the taxable capital apportionment statutes. The appeals court stated that the exclusion of drug receipts should be viewed in statutory interpretations as an exemption. As such, any interpretation of ambiguity related to the provision should be strictly construed in favor of the state. Upjohn believed that the law related to imposition of a tax and should thus be liberally construed in favor of the taxpayer.

Under a discrimination argument, Upjohn pointed out that because Texas law exempts drug sales from the earned surplus numerator, and a corporation pays on the greater of the earned surplus or taxable capital tax, then Texas only taxes drug companies that are profitable, because unprofitable drug companies will not have an apportionment factor for taxable capital.
J. NET OPERATING LOSSES

1. District of Columbia – Sovran Bank/DC National Bank Entitled to Refund

Company entitled to state net operating loss deduction, even though no corresponding deduction reported on the federal tax return (Sovran Bank/D.C. National, Appellant v. District of Columbia, Appellee; No. 97-TX-2001, District of Columbia Court of Appeals, 731 A.2d 387).

Sovran Bank’s (“Sovran”) parent company elected to file a consolidated federal income tax return for Sovran and its affiliates. Sovran was required and filed separate District of Columbia tax returns. The consolidated federal income tax return (which included Sovran) did not claim a net operating loss (NOL) deduction. Sovran separately reported a loss on the consolidated federal income tax return. Sovran claimed it was entitled to take a net operating loss deduction on its District of Columbia tax return.

Earlier courts, in interpreting section 47-1803.3(14) of the District of Columbia Income Tax statutes, ruled that Sovran was not entitled to an NOL deduction because no corresponding deduction had been reported on a federal tax return for the same period. Under the District of Columbia’s (“District’s”) interpretation of the statute, not only must a NOL deduction be reported on a federal return, but such a deduction must also be taken for the same taxable period as the District of Columbia returns.

The DC Court of Appeals determined that the District’s interpretation would disallow the NOL deduction to virtually all corporations that file consolidated federal returns and ruled that Sovran is entitled to the NOL deduction and therefore should receive a franchise tax refund.

2. Texas – Successor to a Merger and Business Loss

The issue in Sergeant Enterprises, Case No. 96-15475, (currently under litigation) is whether the successor to a merger can use the non-survivors' business loss in computing its Texas franchise tax. No statutory prohibition of the carryforward exists, although the Comptroller’s office has always taken the position that no carryforward is allowed and has reflected such position in its regulations.

K. MISCELLANEOUS

1. Alabama – State and BellSouth Settle

The state and BellSouth have settled the franchise tax refund claims of the Bell companies on about 19 cents on the dollar. BellSouth will receive $4 million in tax credits for the next 10 years, to be applied against property taxes, business privilege taxes, cellular telephone excise taxes and rental/leasing taxes. There are over 2,400 outstanding claims from other companies.

In Matter of Kmart Properties, Inc., January 31, 2000, (currently in Appeals Court), a New Mexico Taxation and Revenue Department hearing officer ruled that royalties received by an out-of-state affiliate from its parent company’s New Mexico operations are subject to corporate income and gross receipts.

III. SALES AND USE TAX

A. BAD DEBT DEDUCTIONS

1. California – Finance Company Allowed a Sales Tax Bad Debt Deduction

The State Board of Equalization ruled that a finance company is allowed to obtain a sales tax refund for sales tax on bad debts attributable to purchased contracts through a financing arrangement (Appeal of WFS Financial, Inc., California State Board of Equalization, Mem. Opin. SR EAA 52-009479 56535, December 14, 2000).

WSF Financial, Inc., a financial institution, was a successor to multiple car sales agreements executed initially between the dealers and purchasers. Under the sales agreements, the purchasers continued to pay sales tax reimbursements as part of their installment payments. Upon a purchaser’s default and after exhausting efforts to collect payment, WSF claimed a bad debt deduction for unpaid balances on its income tax returns. WSF also filed for a refund for sales tax paid on the uncollectible accounts.

The California State Board of Equalization’s audit staff denied the claim for refund stating that only the retailer who sold the property and a successor to the business of the original retailer (if the successor purchased the accounts receivable for full consideration) is entitled to a bad debt deduction. However, upon review of the facts, the California State Board of Equalization ruled that WSF is a successor that paid full consideration for the receivables, and therefore is entitled to the bad debt deduction.

Note: The Governor signed legislation allowing finance companies to obtain such refunds in defined situations (Assembly Bill 599, signed September 23, 2000).

2. Georgia – GMAC Not Entitled to Bad Debt Deductions

The Georgia Court of Appeals ruled that a finance company is not considered a person entitled to seek a bad debt deduction (GMAC v. Jackson, Georgia Court of Appeals, A00A1315, November 15, 2000).
GMAC, an automobile finance company, financed the acquisition of automobiles by dealers and also financed subsequent sales to customers. Through a retail master contract, GMAC was permitted to purchase the financing contracts between dealers and customers at a discount rate. GMAC established a rate of default on these contracts to compute a bad debt deduction and thereafter, requested a sales tax refund for these unpaid balances. The Georgia Department of Revenue denied the refund request stating that a finance company is not an eligible person to claim a bad debt deduction.

The court reaffirmed that Georgia statutes have been interpreted consistently allowing a deduction only to dealers and only under certain circumstances. The installment contracts issued by the dealers and subsequently sold to GMAC did not specify that sales tax is included in the monthly installments. However, at the time of the sale, the installment sales contracts required either trade-ins or cash down payments, which exceeded sales tax due. Therefore, the dealers would have remitted sales tax to the Department of Revenue in the month of sale.

Upon review of the case, the court determined GMAC was not entitled to a bad debt deduction and subsequently denied a sales tax refund.

Note: A 1998 amendment to the applicable statute limits bad debt deductions to assignees of bad credit card debts, thereby implying that the legislature intended to deny the bad debt deduction to assignees of other debt.

3. South Carolina – Advisory Bulletin Discusses Bad Debt Exclusions

*South Carolina Revenue Advisory Bulletin No. 00-07, November 6, 2000,* discusses South Carolina’s sales tax adjustments for bad debts. Effective for debts incurred after 1999, S.C. Code Section 12-36-90(2) has been amended to exclude from “gross proceeds of sales;” the sales price, not including sales tax, of property on sales which are actually charged off as bad debts or uncollectible accounts for state income tax purposes. A taxpayer who pays the tax on the unpaid balance of an account which has been found to be worthless and is actually charged off for state income tax purposes may take credit for the tax paid on a return filed pursuant to this chapter, except that if an amount charged off is later paid in whole or part to the taxpayer, the amount paid must be included in the first return filed after the collection and the tax paid.

Below is a summary of the guidance and answers provided by the Revenue Advisory Bulletin:

- The exclusion for bad debts only applies to debts incurred after 1999. The exclusion does not apply to sales which occurred prior to January 1, 2000, even if it is determined to be a bad debt or uncollectible account on or after January 1, 2000.

- Bad debt is any debt or account receivable arising from a retailer’s sale of tangible personal property of which sales tax has been reported and paid in a prior reporting period and later becomes worthless or
uncollectible for state income tax purposes. The debt or uncollectible account must be a type properly deductible under Internal Revenue Code Section 166.

- Various other provisions address reporting requirements, cash v. accrual basis, and time limitations.

B. LIMITED LIABILITY COMPANIES

1. South Carolina – SMLLCs Treated as Divisions for Income Tax Purposes Also Are Divisions for Sales Tax Purposes

Code Section 12-2-25 provides definitions pertaining to limited liability companies and provides that “single-member limited liability companies which are not taxed for South Carolina income tax purposes as corporations . . . will be ignored for all South Carolina tax purposes.” Therefore, if a SMLLC is treated as a division for income tax purposes, it will be treated as a division for sales tax purposes and the contribution of assets and liabilities to an SMLLC in South Carolina under such circumstances can be performed sales tax free (Private Revenue Opinion No. 00-4, South Carolina Department of Revenue, July 10, 2000).

2. South Carolina – Sale of a SMLLC is Not an Exempt Occasional Sale Unless Discrete Business.

South Carolina sales tax law exempts the sale of assets of an entity if either the taxpayer sells all the assets of a legal entity or the taxpayer sells all of the assets of a discrete business enterprise. However, because single-member limited liability companies are treated as a part of their member for both income and sales tax purposes, if a taxpayer sells all of the assets of a single member limited liability company (not taxed as a corporation for income tax purposes), the limited liability company will not be treated as a separate legal entity. The sale will only be exempt if the business, and the assets associated with that business, constitutes a discrete business enterprise (usually associated with unitary factors). (Revenue Advisory Bulletin No. 01-1, South Carolina Department of Revenue, February 27, 2001).

3. Tennessee – Transfer of Assets to a Limited Liability Company

TN Letter Ruling No. 00-47 addresses the following sales and use tax issues on transfers from a parent company to a newly formed, single member Limited Liability Company (LLC):

- Transfers of assets (excluding motor vehicles, aircraft, vessels, and inventory) to a LLC will be treated as an occasional and isolated sale, not subject to sales and use tax.
- Inventory transferred is exempt if the transferee entity issues a properly executed resale certificate to the transferor.
Motor vehicles transferred to the LLC from the parent company are not subject to sales and use tax, but motor vehicles transferred from subsidiaries of the parent company are subject to tax.

The sale or transfer of used store equipment and fixtures to unrelated purchasers is an occasional sale if the sale of this equipment is not considered in the course of regular business.

Any transfers made by the taxpayer which are exempt due to being occasional or isolated sales are exempt without regard to whether they occur on a semianual or less frequent basis and without regard to the length of any period during which such transfers take place, so long as such transfers do not become the taxpayer’s regular business.

C. MANUFACTURING EXEMPTIONS

1. Alabama – State Employs Physical Ingredient Test

Chief Administrative Law Judge Bill Thompson reversed his previous ruling and concluded that tangible personal property to be used by a manufacturer as an ingredient or component part of a finished product is exempt from the Alabama sales and use tax regardless of whether the ingredients/component parts were intended to become part of or are necessary to the finished product (Carlisle Engineered Products, Inc. versus State of Alabama Department of Revenue, Administrative Law Division, No. U.99-524, August 28, 2000).

Carlisle Engineered Products, Inc., is a manufacturer of plastic automobile parts, purchases molds, barrels, and screws containing titanium, chromium, and iron. Due to heating and shearing during the manufacturing process, miniscule pieces of the titanium, chromium, and iron are mixed with and become a part of the finished product. The miniscule pieces are not necessary ingredients and represent less than one percent of the finished product.

The Department of Revenue contended that the molds, barrels, and screws may not be purchased tax-free and instead should be taxed at the state 1.5% manufacturing machine rate. The Department of Revenue stated the following: (1) the large molds, barrels, and screws are not being resold as small automobile parts; (2) the microscopic pieces of those machines are purely incidental to the final product and therefore, do not add value to the final product; and (3) the miniscule pieces are not intended to become part of the final product. Because Carlisle Engineered Products, Inc. did not depreciate the molds, barrels, and screws for income tax purposes, the depreciable machinery, tools, or product limitation in the Alabama statute was not an issue.

Carlisle Engineered Products, Inc. argued successfully that the molds, barrels, and screws may be purchased tax-free. Regardless of intent, the miniscule pieces of the molds, barrels, and screws become part of a finished product to be sold at retail.

2. Florida – State Revises Machinery & Equipment Exemptions
The Florida Department of Revenue amended machinery and equipment exemption rules to incorporate statutory changes, redefine key terms, and expand the exemption for equipment used by new or expanding businesses. Below is a sample of significant amendments in *Florida Regulation 12A-1.096* over the past two years:

- Raw materials must change in physical composition or physical nature and not be merely repackaged or redistributed.

- Industrial machinery and equipment purchased for use in expanding manufacturing facilities or plant units that manufacture, process, compound, or produce for sale items of tangible personal property at fixed locations in Florida are exempt from any amount of sales tax in excess of $50,000.

- Beginning July 1, 2001, the cost of labor, parts, and materials required to repair industrial machinery and equipment is 75% tax-exempt.

### 3. Georgia — *State Exempts or Replacement Parts*

The Georgia Department of Revenue recently expanded its manufacturing machinery exemption to include repair or replacement parts, such as machinery clothing, molds, dies, and tooling machinery, used directly in the manufacture of tangible personal property (*Georgia Code Section Sec. 48-8-3(34.3) (A)*). The exemption will be phased in as follows:

- 20% exemption beginning January 1, 2001
- 40% exemption beginning January 1, 2002
- 60% exemption beginning January 1, 2003
- 80% exemption beginning January 1, 2004
- 100% exemption beginning January 1, 2005

Regardless of the method of invoicing or billing, the exemption will apply to the first $150,000 of the sales price of each replacement or repair part.

### 4. Georgia — *State Exempts Computer Equipment for High Technology Companies*

*House Bill 1510*, effective January 1, 2001, provides an exemption for computer equipment, including leased equipment, used at high-technology facility. A high-technology facility includes, but is not limited to, a company that is engaged in: providing computer programming and design services; providing data processing services; manufacturing semi-conductors and related devices; and providing telephone and telegraph communications. The exemption applies to the extent the equipment’s cost or the fair market value of leased equipment exceeds $15 million in a calendar year.
5. Kentucky – Applicability of Manufacturing Exemption to Equipment Primarily Located in Non-Manufacturing Facility

The Kentucky Supreme Court overturned the decisions of three lower courts and held that manufacturing equipment located within a retail facility will qualify for Kentucky’s new and expanded manufacturing equipment exemption (Camera Center, Inc., d/b/a Murphy’s Camera and Video and Liberty National Leasing Company v. Revenue Cabinet, Commonwealth of Kentucky, Kentucky Supreme Court, No. 1999-SC-0283-DG, September 28, 2000).

Camera Center, Inc. processes undeveloped film at its retail stores where it also sells film, cameras and supplies. Camera Center, Inc. believed the purchase of its film developing machinery qualified as exempt machinery under Kentucky Code Section 139.470 (11). This exemption for new and expanded manufacturing equipment contained a four-part test, including one test requiring equipment to be installed in "plant facilities in Kentucky". At the time of this case, plant facility did not exclude manufacturing activities located in retail facilities. However, the Kentucky Revenue Cabinet consistently ruled that a "plant facility" meant a manufacturing plant or other facility predominantly engaged in manufacturing operations.

Based on the statute during this case, the Kentucky Supreme Court ruled that the "plant facilities" language was not intended to limit the exemption. The exemption is determined by the function of the equipment, not the location. Therefore, the court ruled that the developing machinery was manufacturing equipment even though located in a predominantly retail store, and thereby was entitled to take advantage of the new and expanded machinery exemption.

Loophole Closed

On March 15, 2001, the Kentucky Governor signed HB 201. This bill provides a new definition of "plant facility" and makes the definition retroactive to September 28, 2000. The bill provides an exemption only for manufacturing equipment that is located in a facility predominantly engaged in manufacturing. Manufacturing equipment such as film developing, food cooking and paint mixing located in a retail environment (i.e. restaurant, grocery store, drug store) will not qualify for the exemption. The bill also provides that refund claims filed after September 28, 2000 must meet the new definition of plant facility.

6. Missouri – State Supreme Court Determines the “Integrated Plant Doctrine” Allows a Parent’s Mainframe to be Exempt as Supporting a Subsidiary’s Manufacturing Activities

A corporation’s purchases of mainframe computers and other materials to expand its manufacturing plant were exempt from Missouri sales and use tax because the computers and materials were used directly in manufacturing products that were intended ultimately to be sold for final use or consumption (DST Systems, Inc. v. Missouri Director of Revenue, Missouri Supreme Court, NO. SC 82797, April 10, 2001).
DST Systems, Inc. performs accounting and transfer agent functions (record keeping and service functions) for approximately 3,000 mutual funds with over 50 million mutual fund accounts. DST creates customized printed materials for its mutual fund clients and charges fees for each package produced. The customized packages are produced by a subsidiary, Output Technologies-Support Resources. The mainframes, which are essential to Support Resources production of the packages, are located at DST’s Winchester Facility rather than the Support Resources printing location. DST takes the position that its purchases of mainframe computers and other materials are exempt from sales and use tax based on function versus location.

The Department of Revenue argued that the mainframes were not considered part of the manufacturing process and that the mainframes and materials were not intended to be sold for final use or consumption. The Department of Revenue based its conclusion on a prior court case where the Missouri Supreme Court denied IBM a sales tax exemption for items sold to DST Systems, as the items were not considered manufacturing equipment.

However, in this case, the Court reiterated that “organizing information through computer technology” is manufacturing. Though the computers and other equipment at the Winchester facility are not used exclusively for the manufacture of customized packages, they are essential to producing the ultimate product. The fact that the printing and the gathering occur at different sites does not cause the equipment and machinery to fail to be used directly in manufacturing. The Court applied the “integrated plant doctrine”. This doctrine encompasses the idea that two corporate entities under common ownership and two activities (data processing and printing) at two separate locations may be combined.

The director also contended that DST does not manufacture a product which is intended to be sold ultimately for final use or consumption. However, unlike IBM, DST demonstrated that it creates customized packaged printed materials for mutual fund clients at a fee and therefore is a retail sale. The equipment was deemed to develop a taxable product for final use or consumption, although Missouri-based customers received only 5% of the product produced, at most. Although the department has since developed a regulation pro-rating the exemption to the amount of “exempt activities,” the Court noted that the governing statute does not require such treatment.

7. Nevada — State Employs a “Primary Purpose, Not “Physical Ingredient” Test

The Nevada Supreme Court held that the “primary purpose” test, not the “physical ingredient” test is the appropriate method to apply in the determination of the taxability of a dual-purpose item. Therefore, items purchased for use in both the manufacturing process and for the contribution of ingredients are not exempt from sales and use tax (Nevada Tax Commission v. Nevada Cement Co., Nevada Supreme Court, No. 33178, September 15, 2000).
Nevada Cement purchases steel grinding balls, steel kiln chains, kiln brick, and castables to assist with the manufacturing process. These items eventually disintegrate and are incorporated into the product. Nevada Cement takes the position that these items are exempt from sales and use tax because they are ingredients, which become part of the final product. Under the physical ingredient test, the aforementioned items would be considered part of the final product and exempt from sales and use tax as a sale for resale.

However, in its ruling, the Court held that the “primary purpose” test should be used to determine the taxability of an item. The Court addressed Nevada statute which defines a retail sale to be “a sale for any purpose other than resale...” Thus, a dual-purpose item cannot meet the resale exemption, because the exemption applies only to those items for which the sole purpose of the purchase is for resale. Nevada Cement’s purchases are for use both in manufacturing and as a contribution of ingredients to the final product. Resale is not the sole purpose of the purchase of the steel grinding balls, kiln chains, kiln brick, and castables. Therefore, these items may not be purchased tax-free.

In addition, the court noted that Alabama, Georgia, Missouri, Nebraska, New York, Texas and Washington all appear to follow the physical ingredient rule, and Arkansas, California, Colorado, Illinois, Ohio and Tennessee follow the primary purpose test.

D. NEXUS

1. Arkansas – Out-of-State Vendors with Significant Connections Must Collect Use Tax

Effective January 1, 2002, out-of-state vendors with significant connections to the state of Arkansas must collect use tax on sales made to Arkansas customers (House Bill 1440, March 21, 2001). The processing of orders electronically or non-electronically does not alleviate the vendor’s responsibility if both the following conditions exist: (1) the vendor holds a substantial ownership interest in a retailer maintaining sales locations in Arkansas or the vendor is substantially owned by a retailer; and (2) the vendor sells substantially similar lines of products as the Arkansas retailer under a similar business name or the Arkansas retailer’s facilities/employees advertise to Arkansas customers. Substantial ownership is defined under Internal Revenue Code Section 267 (more than 50% test).

2. Maryland – Appeals Court Overrules Maryland Nexus Ruling Due to Failure of State to Exhaust Remedies

Original Ruling

Furnitureland, a furniture retailer located in North Carolina, made over 100 deliveries a year to Maryland customers (Furnitureland South, Inc. and Royal Transport, Inc. v. Comptroller, Circuit Court for Anne Arundel County, No. C-97-37872 OC, August
The company did not use a common carrier to deliver the furniture into Maryland; rather, it had an exclusive contract with a private carrier ("Carrier") to deliver furniture, assist with set up and repair, and collect on accounts. Although the company argued that the Carrier was a common carrier, the Court disagreed based on the minor in-home repair work performed by the Carrier. The Court ruled that the Carrier represented an agent for the company and therefore substantial nexus existed under the Commerce Clause.

**Appeals Court Ruling**

Maryland requires that a declaratory judgment be sought only after all administrative and judicial remedies are exhausted (Furnitureland South, Inc. v. Comptroller of the Treasury of the State of Maryland, Court of Appeals of Maryland, May 9, 2001). Following Furnitureland's refusal to submit to a sales tax audit, the Maryland Comptroller filed an action and received a judgment in the Circuit Court. The Comptroller had various enforcement powers prior to such action, including the subpoena of records, demanding the filing of a sales tax return, and judicial enforcement of the requirement to file a sales tax return. In addition, the Comptroller could have sought an assessment and followed the chain of authority up through the Tax Court and to the Circuit Court.

Due to the Comptroller's failure to follow appropriate procedures, the Appeals Court ruled in favor of Furnitureland.

**E. STREAMLINED SALES TAX PROJECT**

The Streamlined sales tax project is an effort by several state governments, with input from local governments and the private sector, to simplify and modernize sales and use tax administration with the ultimate goal of reducing the burden of tax compliance for sellers. The Project addresses uniform definitions within tax bases, simplified audit and administrative procedures, and emerging technologies. Currently thirty-two states are voting participants (legislation passed or governor provided authorization) and six are non-voting participants. The participating states as of this printing are as follows:

<table>
<thead>
<tr>
<th>Participating States</th>
<th>Observing States</th>
</tr>
</thead>
<tbody>
<tr>
<td>Alabama</td>
<td>North Carolina</td>
</tr>
<tr>
<td>Arkansas</td>
<td>North Dakota</td>
</tr>
<tr>
<td>Florida</td>
<td>Ohio</td>
</tr>
<tr>
<td>Illinois</td>
<td>Oklahoma</td>
</tr>
<tr>
<td>Indiana</td>
<td>Rhode Island</td>
</tr>
<tr>
<td>Iowa</td>
<td>South Carolina</td>
</tr>
<tr>
<td>Kansas</td>
<td>South Dakota</td>
</tr>
<tr>
<td>Kentucky</td>
<td>Tennessee</td>
</tr>
<tr>
<td>Louisiana</td>
<td>Texas</td>
</tr>
<tr>
<td>Maine</td>
<td>Utah</td>
</tr>
<tr>
<td>Maryland</td>
<td>Vermont</td>
</tr>
<tr>
<td>Michigan</td>
<td>Washington</td>
</tr>
</tbody>
</table>
IV. UNCLAIMED PROPERTY

A. Delaware – Delaware Aggressively Pursuing Companies for Failure to File Unclaimed Property Reports

State of Delaware officials have initiated a compliance program to determine whether businesses incorporated in Delaware are filing unclaimed property reports with Delaware as required by law. Specifically, companies incorporated in Delaware that have never filed unclaimed property reports in Delaware will likely receive a warning letter from the State of Delaware. The company has 60 days to respond and is required to file unclaimed property reports for property back to 1990 in order to avoid penalties and interest for failure to file. It is important to note that a company is not required to have nexus for tax purposes to be subject to the reach of Delaware’s unclaimed property laws. Merely being incorporated in Delaware is alone sufficient.