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State Tax Developments: The Best and Worst of 2009

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As last year drew to a close, the state and local tax lawyers at McDermott thought long and hard about some of the more interesting state tax developments of the year. We thought you might also find some of these developments interesting, and created this list of the "Best and Worst of 2009."

Our overriding concern in determining the best and worst was "fairness." Did a particular development reflect an approach that is fair both to taxpayers and the state? Was the development consistent with the clear intent of the statutes at issue? Were taxpayers given sufficient notice of the new position?

The following are what we considered the worst of 2009:

Worst Court Decisions

BELLSOUTH ADVERTISING & PUBLISHING CORPORATION V. CHUMLEY, NO. M2008-0129-COA-R3-CV (TENN. CT. APP. AUG. 26, 2009)

It would be difficult—if not impossible—to find a court decision that says "the statute does not matter, we want revenue" more clearly than *BellSouth Advertising & Publishing Corporation v. Chumley*. In that case, the Tennessee Department of Revenue successfully argued that applying the standard statutory apportionment formula, which uses the all-or-nothing, cost-of-performance approach for determining the portion of service revenue attributable to the state, would not fairly reflect the taxpayer's Tennessee activity. Accordingly, the Commissioner's use of her discretionary authority to impose an alternative apportionment methodology was sustained.

BellSouth Advertising publishes and distributes Yellow Page telephone directories, using third parties to solicit local business to place advertisements in the directories (receipts from advertising sales constitute 95 percent of BellSouth Advertising's revenue), to print the directories and to deliver the directories. Even though a large portion of the businesses that placed advertisements in the Tennessee directories were located in Tennessee, and even though the directories were ultimately delivered to Tennessee consumers, none of BellSouth Advertising's own activities occurred in Tennessee. The parties had stipulated that this was an advertising service and litigated whether the Commissioner could replace the standard statutory cost-of-performance approach to computing the sales factor (which would result in no receipts being attributed to Tennessee) with the Commissioner's own approach of using the portion of BellSouth's advertising receipts that had been paid by Tennessee advertisers. The court, citing the history of the discretionary provision as it appears in the Uniform Division of Income for Tax Purposes Act (UDITPA) and the Tennessee statutes, simply decided that advertising is such a unique business that the Commissioner had the right to use her authority and impose a formula of her own making. The court seems to have based its conclusion on "fairness" grounds, noting that the bulk of advertisers for the Tennessee directory were in Tennessee and the directories were ultimately delivered to Tennessee residents.

We find the court's disregard for the standard statutory approach extremely troubling. By adopting the cost-of-performance approach, the legislature made clear its decision that the location of customers and end-users of a service business is irrelevant when determining the portion of a service corporation's income that should be taxed by the state; all that matters is where the corporation performs its services. The court did not make a persuasive case for the proposition that advertising services were different from other services. Disregarding legislative intent to accomplish what a tax administrator deems "fair" is a very troubling departure from the "rule of law," which is a bedrock principle of American law and justice—and the court should not have tolerated it. Most, if not all, observers would be deeply shocked if tax administrators and state courts approached this issue in a consistent manner; in other words, if an advertising business operates solely in Tennessee but its customers are all outside the state, will that business be afforded a zero receipts factor? That seems quite doubtful.

EXELON CORP. V. ILLINOIS DEPARTMENT OF REVENUE, NO.105582 (ILL. SUP. CT. JULY 15, 2009)

Recently, the Illinois Supreme Court ruled in *Exelon Corp. v. Illinois Department of Revenue* that electricity is tangible personal property. As a result, Exelon and other electric utilities are eligible for investment tax credits to be applied against personal property tax replacement income tax liability. This seems like good news for utility companies, and for Exelon in particular—but, not so fast. The Illinois Supreme Court elected to apply its holding on a prospective basis only. Therefore, despite following all proper procedural guidelines and winning affirmation for its position from the highest court of the state, Exelon's $100 million of proper refund claims were denied. Exelon has filed a petition for *certiorari,* asking the Supreme Court to decide whether the prospective-only application of the court's interpretation violates due process.

UNITED STATES V. TEXTRON INC., NO. 07-2631 (1ST CIR. AUG. 13, 2009)

In a 3-2 decision, the U.S. Court of Appeals for the First Circuit determined that certain tax accrual workpapers were not protected by the work product doctrine. The court indicated that it was applying the "because of" test for determining when documents were prepared in anticipation of litigation (a requirement of the work product doctrine) as that test was described in *Maine v. United States Dep't of Interior,* 298 F.3d 60 (1st Cir. 2002), but in reality the court rearticulated a new standard: were documents prepared for use in possible litigation? The 1st Circuit determined that Textron's workpapers were not produced *for use in* litigation because they were "independently required by statutory and audit requirements and that the work product privilege does not apply."

While the decision creates a troubling new standard for federal purposes (there was already a split between the circuits as to whether the appropriate test for "in anticipation of litigation" was whether a document was prepared "because of" litigation or with the "primary purpose" of litigation), it is also troubling in the state tax arena. First, state departments of revenue request tax accrual workpapers in more circumstances than the IRS does, making the issue one of increasing importance. Moreover, like federal tax accrual workpapers, state tax accrual workpapers are highly likely to reflect the taxpayer's and its attorneys' analysis regarding litigating hazards—this is exactly the type of analysis the work product doctrine is intended to protect. Third, few state courts have defined "in anticipation of litigation" for state tax purposes, and they look to federal law for guidance. The leading state court decision on this issue, *Commissioner of Revenue v. Comcast Corp.,* 901 N.E.2d 1185 (Mass. 2009), a well-reasoned and thoughtful decision which held that tax accrual workpapers were prepared in anticipation of litigation, is at odds with *Textron*. State departments of revenue (within and outside of the 1st Circuit) are likely to argue that the new Textron standard for determining when a document was prepared "in anticipation of litigation" is the correct one for state as well as federal income tax purposes.

Most importantly, however, providing the workpapers to one state department of revenue might result in the waiver of work product protection in other jurisdictions, even where the other jurisdictions have higher standards for determining when work product protection applies.

The dissent, which would have treated the documents as protected by the work product doctrine, indicated that the "time is ripe for the Supreme Court to intervene and set the circuits straight on this issue which is essential to the daily practice of litigators across the country." Textron is currently seeking review by the Supreme Court.

Worst Legislation

ECONOMIC NEXUS

Some of the worst state tax legislation of 2009 was the economic nexus legislation enacted in California, Connecticut and Wisconsin. California, following the lead of Michigan and Ohio, adopted an economic nexus statute based on whether an out-of-state business has a threshold level of sales (*i.e.*, the lesser of $500,000 or 25 percent of the taxpayer's total sales) attributable to the state.[1] Connecticut and Wisconsin, on the other hand, adopted vaguely worded economic nexus provisions designed to broadly tax out-of-state businesses that derive income from the state.[2]

While the economic nexus threshold adopted by California may provide more clarity and certainty for taxpayers than the vaguely worded provisions adopted by Connecticut and Wisconsin, the constitutionality of all three nexus provisions is questionable. The issue of whether the physical presence nexus requirement articulated by the U.S. Supreme Court in *Quill Corp. v. North Dakota,* 504 U.S. 298 (1992), applies for income tax purposes has been litigated heavily throughout the country, but the United States Supreme Court has yet to weigh in on the issue. The enactment of any tax law that may ultimately be struck down as unconstitutional is troubling, especially in light of recent state court decisions that have limited taxpayers' remedies with respect to taxes collected pursuant to an unconstitutional provision. Further, the assertion of economic nexus over an out-of-state business is based on poor tax policy. Only states and localities that provide meaningful benefits and protections to a business should be entitled to tax that business. Businesses earn their income where they employ their labor and capital; that is where they should pay tax. While the desire of states to export their tax burden to out-of-state businesses is understandable, taxation without

[1] Cal. Rev. and Tax. Code § 23101(b) (as amended by L. 2009, ch. 17, § 7)

[2] *See* Conn. L. 2009 P.A. 09-3, § 90 (imposing corporation business tax if a business "derives income from sources within [Connecticut]" or "has a substantial economic presence within [Connecticut]") and Wis. Stat. § 71.22(1r) (as amended by Wisc. L. 2009, Act 2, § 116) (defining "doing business" to include "regularly" selling products or services to or soliciting business from Wisconsin customers).

representation should not be tolerated. Thus, we hope that these provisions will someday be struck down by the U.S. Supreme Court or pre-empted by federal legislation, such as the Business Activity Tax Simplification Act of 2009 (H.R. 1083) introduced in Congress in 2009, which would adopt a nationwide physical presence nexus standard for state business activity tax purposes.

Worst Administrative Position

NEW YORK DEPARTMENT OF TAXATION AND FINANCE REGARDING SALES TAXATION OF APPLICATION SERVICE PROVIDER SERVICES

In a bold and unprecedented move in the sales tax arena, the New York State Department of Taxation and Finance began treating the sale of internet-based services as the sale of tangible personal property (*i.e.,* the licensing of pre-written computer software). With the advent of cloud computing, many traditional services are now capable of being performed over the internet by application service providers. Accordingly, in a string of advisory opinions, activities that looked just like a service and sounded just like a service were instead treated by the Department as the licensing of pre-written computer software subject to the sales tax. The obvious problem is that the Department lacks any legislative authority for taking such a position. Furthermore the Department has demonstrated a willingness to impose this position retroactively on audit. Until successfully challenged, the Department's position with respect to the licensing of pre-written computer software will continue to have profound tax implications for many companies doing business in New York.[3]

VIRGINIA DEPARTMENT OF TAXATION ON THE ADDBACK OF ROYALTIES

Like many separate return states, Virginia enacted an "addback" statute that adds back to income royalties paid to an affiliated entity. An exception to the addback is provided where the recipient of the royalties "is subject to a tax based on or measured by net income... imposed by... another state." The exception is limited to the apportioned percentage of royalty income subject to tax by the other state.[4] Virginia Public Document Ruling No. 09-115 July 31, 2009, holds that the exception applies if the recipient entity files a tax return in a separate return state but does not apply if the recipient entity is required to file a combined or consolidated return in the other state. There is no statutory or policy basis to deny the exception to the addback where the affiliated entity is engaged in business in a combined return state. Where a royalty is paid to an affiliated entity for the use of technology developed by the affiliate in a combined return state, the result is that the measure of income subject to tax in Virginia of the entity paying the royalty includes not only the net income of the affiliate from the royalty but also the cost of developing its technology. The denial of the exception will likely prove to be an ugly self-inflicted wound, as a court would be virtually compelled to hold that the statute, as administered, violates the Due Process Clause and the Commerce Clause of the federal Constitution. The Commonwealth may gain some significant temporary tax revenue from its interpretation, to be followed by a budget crisis at refund time.

The following are what we considered the best of 2009:

Best Court Decision

ACCUZIP, INC. V. DIRECTOR, DIVISION OF TAXATION, DOCKET NO. 005744-2003 (AUGUST 13, 2009) AND *QUARK, INC. V. DIRECTOR, DIVISION OF TAXATION,* DOCKET NO. 004692-2002 (AUGUST 13, 2009)

In a decision involving two consolidated cases, the New Jersey Tax Court held in favor of the taxpayers and ruled that the sale of canned software did not give New Jersey income taxing jurisdiction. Both taxpayers sold prewritten copyrighted software that contained standard licensing language to New Jersey customers. Accuzip did not have a physical presence in New Jersey. Quark had a sales representative working from his home in New Jersey. Relying on *Lanco, Inc. v. Director, Div. of Taxation,* 188 N.J. 380 (2006), *cert. denied,* 551 U.S. 1131 (2007), the Division of Taxation argued that the companies had nexus because they licensed intangible property used in New Jersey.

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[3] *See, e.g., In re National Football League,* New York Advisory Opinion TSB-A-09(37)S (08/25/09); *In re Electronic Mortgage Affiliates, Inc.,* New York Advisory Opinion TSB-A-09(15)S (04/15/09); and *In re XYZ Corp.,* New York Advisory Opinion TSB-A-09(8)S (02/02/09).
[4] Virginia Code section 58.1-402 B.8.a.(1).

The Tax Court rejected the Division's argument and held that AccuZip and Quark: (1) sell tangible copyrighted CD-ROMs containing prewritten software and not intangible personal property; (2) do not own property in New Jersey; and (3) do not derive a substantial economic benefit from New Jersey. Furthermore, the court rejected the Division's argument that the "significant economic presence test" of *Tax Comm'r v. MBNA Am. Bank, N.A.,* 640 S.E.2d 226 (W.Va. 2006), *cert. denied,* 551 U.S. 1141 (2007) should be applied, noting that it has not been adopted by New Jersey and therefore is not controlling. The court held that AccuZip was not doing business in New Jersey and therefore does not satisfy the substantial nexus requirement of the Commerce Clause for the Division to impose a tax based on AccuZip's corporate income. Although the court found that Quark was doing business in New Jersey, the activities of its sales representative were within the protection of P.L. 86-272 and subjected Quark only to the minimum tax. The court said that *Lanco* did not establish economic nexus as the law in New Jersey. It seemed to conclude that *Lanco* was based on the taxpayer owning property, albeit intangible, in New Jersey. This decision was chosen as one of the best of 2009 because it is well reasoned and may thwart other courts' attempts to expand Lanco beyond intercompany trademark licensing arrangements. Despite the Division's decision not to appeal this decision, the Division remains undeterred and officials have indicated that they will not follow it.

IDC RESEARCH, INC. V. COMMISSIONER OF REVENUE, DOCKET. NO. C267868 (MASS. APP. TAX BD. 4/17/2009)

The Commissioner of Revenue could not use the state's IRC section 482-type provision to reallocate accounting, marketing and management fees paid to a common parent by its subsidiaries. The accounting and marketing fees were negotiated and were not imposed by the parent. The Appellate Tax Board held that these fees were at arm's length. Although the management fee was imposed by the parent, the Board held that this fee could not be reallocated because it met arm's length standards and mere control or power to shift income was not sufficient to reallocate income without the actual shifting of income. The Board separately held that the transfer of a logo used by the group was a sham. This opinion gives taxpayers comfort in the commonly used method of having a parent provide services to its subsidiaries as long as the fees are at arm's length and do not shift income.

IN THE MATTER OF THE PETITION OF 1 WORLD TRADE CENTER LLC, TAT(H)07-34(CR) (DECEMBER 3, 2009) (FRED ACKERSON)

The New York City Tax Appeals Tribunal rejected the Commissioner's attempt to impose over $35 million of New York City commercial rent tax, penalties and interest on the owners of the World Trade Center buildings for periods after September 11, 2001, when the buildings were destroyed and the government took over the ruined properties. The building owners were obligated to continue to make payments to the Port Authority despite the destruction of the buildings, and the payments were funded by insurance proceeds. However, the NYC Appeals Tax Tribunal correctly found as follows: "The payments made by Petitioners to the Port Authority after September 11, 2001, did not constitute base rent paid for taxable premises because Petitioners no longer had the right to occupy specific space after the government takeover of the World Trade Center site on September 11, 2001. Thus, the CRT does not apply to those payments."

Best Administrative Position

UTAH STATE TAX COMMISSION PRIVATE LETTER RULING REGARDING "DOING BUSINESS"

The Utah State Tax Commission, in Private Letter Ruling No. 08-013 (May 4, 2009), decided that a company's employees' attendance at a film festival (presumably the Sundance Film Festival) did not cause the company to have nexus with Utah for sales tax or income tax purposes. The corporation, which was in the entertainment business, planned to send several employees to the festival to promote the corporation's businesses and meet with potential customers. The Commission did not treat the festival as a trade show, but extended its existing policy for trade show attendance (*i.e.*, that attending a trade show does not create nexus) to the festival so that the company's attendance at the festival would not create nexus for it.

According to the organizers, the 10-day event in 2009 had an overall economic impact for the State of Utah of $92.1 million, supported nearly 2,000 jobs and generated nearly $4 million in state tax revenue. We consider this decision to be one of 2009's best because the Tax Commission's reasonable approach to nexus recognized that it is in Utah's best interest to encourage attendance at the event and to encourage out-of-state companies to patronize in-state events.

Best Legislation

NEW HAMPSHIRE LEGISLATURE ATTACKS MASSACHUSETTS' EXPANSIVE USE TAX COLLECTION EFFORT

New Hampshire's legislature took on the Massachusetts Department of Revenue's aggressive interpretation of the scope of the Massachusetts use tax vendor collection duty. In *Town Fair Tire Centers v. Commissioner* (Ma. App. Tax Board, 2008), the Massachusetts DOR assessed use tax on the New Hampshire sales of a tire retailer with stores in both states if the customer appeared to reside in Massachusetts. The dealer clearly had nexus with Massachusetts, but it did not collect any tax on sales made in its stores in tax-free New Hampshire. The Massachusetts Appellate Tax Board agreed with the DOR that the use tax collection obligation imposed on foreign retailers' sales "for use" in Massachusetts could apply even when the sale was completed at the New Hampshire store. The Board's ruling (since reversed by the Massachusetts high court) created a presumption that that a tire sold to a customer with a Massachusetts address and license plates would be used in Massachusetts.

The New Hampshire retailers' collective angry reaction to their neighbor's assertion of a tax collection duty on sales completed in New Hampshire led to the 2009 passage of S.B. 5. The statute restricts a New Hampshire retailer from providing any information for a foreign state's sales tax collection efforts on a sale of goods or services that—like Town Fair Tire Center's—is completed in New Hampshire. The retailer may supply the information only if the New Hampshire Department of Justice has examined the foreign state's sales tax structure and certified that it meets some strict requirements. The key requirements are that the foreign state must both require all its residents to file annual use tax returns and also audit at least 10 percent of those returns each year. The foreign state's law must create an irrebuttable presumption that the sale is for use in the state where the sale is completed unless the buyer volunteers that the purchase will be used in its home state.

As a practical matter, no state's tax regime will satisfy the requirements of S.B. 5 and so New Hampshire retailers will violate their state's law by cooperating with a foreign state's audit of transactions that are completed in New Hampshire. When the Massachusetts Supreme Judicial Court reversed the Board in *Town Fair,* it prohibited the DOR from making a presumption that a foreign vendor's sale is for use in Massachusetts if the vendor has reasonable evidence that the buyer resides in Massachusetts. However, the high court indicated that the Massachusetts legislature could sanction such a presumption. The outcome of this border controversy thus remains in the balance pending another volley from the Bay State's legislators.

Best *Amicus* Brief

STATE OF DELAWARE IN *VFJ VENTURES, INC. V. SURTEES,* (CERT. PETITION) NO. 08-916 (U.S. SCT.)

In September 2008, the Alabama Supreme Court upheld the State's application of its "add-back" statute to eliminate deductions for royalty payments made by VFJ to two Delaware affiliates. The Court of Civil Appeals decision, which Alabama's highest court summarily affirmed, rejected VFJ's arguments that two statutory exceptions to the add back applied (unreasonableness and "subject-to-tax") and also held that Alabama's add-back statute violated no constitutional provision.

Proclaiming that "Delaware's sovereign interests are at the heart of this case," Delaware filed an *amicus* brief arguing that Alabama's add-back statute unconstitutionally interfered with Delaware's tax policy decision to use its laws to encourage businesses to locate in Delaware. Delaware noted that while it would welcome state tax climate competition through constitutionally permissible means such as lowering taxes or granting incentives, Alabama's attempt to reach into Delaware and eliminate a tax advantage granted by the Delaware legislature was unwelcome and unconstitutional. Though the Supreme Court regrettably denied VFJ's petition for *certiorari,* Delaware's well-reasoned argument supports further Commerce Clause challenges to other inevitable applications of state add-back statutes.

Best Veto

CALIFORNIA PENALTIES

In 2008, California enacted perhaps the most egregious tax penalty ever devised—the "large corporate understatement penalty" (LCUP), which is a strict liability penalty equal to 20 percent of any understatement of corporate franchise or income tax and is imposed if the taxpayer and its unitary combined report group members have an aggregate understatement of tax in excess of $1 million. In effect, the penalty is imposed on corporate taxpayers simply for "getting it wrong," even if the reporting position is

reasonable and supported by legal authority. The strict liability nature of this penalty has led many corporate taxpayers to substantially overstate their California tax liabilities to cover any unexpected federal adjustments.

In 2009, it took the Governor's veto of a much-needed and otherwise noncontroversial omnibus federal conformity bill (AB 1580 (*Calderon*)) to stop California from imposing yet another penalty—this time by conforming to the federal "erroneous refund penalty" found in section 6676 of the Internal Revenue Code. The erroneous refund penalty is equal to 20 percent of any refund or credit claim in excess of the allowable amount (the "excess amount"). Had this penalty been enacted, the Franchise Tax Board could have imposed the penalty whenever it determined in its sole discretion that the taxpayer's claim for refund or credit of any portion of the excess amount was without a reasonable basis. Imposition of the penalty would have been non-appealable despite the fact that the provision provided no guidance as to what constitutes a "reasonable basis."

Whatever the merits of the erroneous refund penalty in the federal income tax context, as applied in California the opportunity for whipsaw of corporate taxpayers was all too real. Taxpayers who substantially overstated their taxes to avoid imposition of the LCUP in the event of unexpected federal adjustments would have faced a new threat: potential exposure to the erroneous refund penalty if some or all of their corresponding claims for refund or credit were ultimately denied.

Despite strong opposition from taxpayers, the bill containing the penalty provision passed both houses and was sent to the Governor's office for signature. The Governor vetoed the bill, writing in his veto message, "It is disappointing that a multi-year, complex bill on federal tax conformity is damaged when a single provision is inserted at the last minute, especially when the process up to that point had been built on consensus. There are many federal tax provisions that California does not conform with, many of which would be supported by some of the entities involved. Likewise, when there are provisions that others object to, these should be discarded as well."

Best Bill Hamilton Article

"WHAT'S BUGGING ART ROSEN TODAY?" *STATE TAX NOTES* (OCT. 19, 2009)

No explanation required. You can find the article at http://www.mwe.com/info/media/TaxAnalysts_101909.pdf.

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