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Summary of 2015 U.S. Supreme Court Decisions

1. ***Comptroller of the Treasury of Maryland v. Wynne*** (No. 13-485, Argued November 12, 2014—Decided May 18, 2015). Under the provisions of Maryland law challenged in this case, taxpayers were allowed to claim an income tax credit for taxes paid to other states; however, the credit could only be claimed against Maryland *state* income taxes owed and could not be used to reduce income taxes payable to Maryland counties. The U.S. Supreme Court held that this limitation violated the dormant Commerce Clause by discriminating against interstate commerce. Under the "internal consistency test," if every state adopted the same tax scheme, interstate commerce would be taxed at a higher rate than intrastate commerce. In addition, the Court determined that Maryland's scheme had the effect of taxing income earned out of state more heavily, making it a de facto tariff.

2. ***Alabama Department of Revenue v. CSX Transportation, Inc.*** (No. 13-553, Argued December 9, 2014—Decided March 4, 2015). Alabama imposed sales and use taxes for diesel fuel consumption on all rail carriers, but not motor and water carriers. The Railroad Revitalization and Regulation Reform Act (4-R Act) prohibits taxes that are discriminatory against railroad companies. The U.S. Supreme Court held that the appropriate comparison class for determining if the tax is discriminatory is the railroad company's competitors, not just commercial and industrial taxpayers generally. However, the discrimination analysis also requires the consideration of any additional taxes assessed upon the competitors which could justify the tax as a rough equivalent.

3. ***Direct Marketing Association v. Brohl, Executive Director, Colorado Department of Revenue*** (No. 13-1032, Argued December 8, 2014—Decided March 3, 2015). Direct Marketing filed suit in federal court challenging Colorado's imposition of a new sales tax reporting requirement for certain retailers that do not collect tax for their sales in Colorado. Under the Tax Injunction Act (TIA), courts "should not enjoin, suspend or restrain the assessment, levy or collection of any tax under State law." The U.S. Supreme Court held that since the notice and reporting requirements occur prior to the assessment, levy, or collection phases, businesses can challenge the reporting requirements in federal courts without running afoul of the TIA. [note: On April 13, 2015, the 10th Circuit ordered a full briefing on the Comity Doctrine and Commerce Clause issues originally raised by Direct Marketing.]

I. NEXUS ISSUES

1. *Rent-A-Center, Inc. & Subsidiaries v. Department of Revenue*, Oregon Tax Court Dkt. TC-MD-111031D (April 23, 2014).

   The Oregon Tax Court held that ColorTyme, Inc., ("ColorTyme") a wholly-owned subsidiary of Rent-A-Center did not have nexus with the State of Oregon and as such was not to be included in the Rent-A-Center combined return. In reaching its conclusion, the Tax Court rejected the Department's argument that ColorTyme and Rent-A-Center were unitary in nature and that relationship was sufficient to create nexus for ColorTyme.

   Rent-A-Center established that ColorTyme was not unitary as there was no centralized management, centralized administrative functions to create economies of scale and there was no flow of goods between the companies. The Tax Court rejected the Department's argument that the 2007 regulatory amendment to the three factor unity test should be applied retroactively to the 2003 tax year. There was clear legislative intent to the contrary. Further, ColorTyme's activities in the State of Oregon did not rise to the level of doing business in the states as that term is defined. Specifically, the only Oregon connection was the receipt of royalties from franchisees. The company did not own or rent tangible property in the state, maintain an office or have employees in the state.

   Finally, the Tax Court did agree that Legacy Insurance Company should be included in the combined return as the company was unitary in nature. The company was headquartered in Bermuda and insured worker's compensation, automobile liabilities and general liabilities of the companies.

2. *L.L. Bean, Inc. v. Levin*, Dkt. 2010-2853, Ohio Board of Tax Appeals, March 6, 2014. (Matter settled.)

   The Ohio Board of Tax Appeals has held that L.L. Bean crossed the nexus bright-line threshold and thus was subject to the Commercial Activity Tax ("CAT").
   L.L. Bean sells its products through catalogs and retail locations throughout the United States. The Ohio sales are made through catalogs and the company's website. The Tax Commission assessed CAT because L.L. Bean's sales exceeded the $500,000 bright-line presence test. In addition, the Commission found L.L. Bean had economic nexus and that physical presence was not required for purposes of imposing the CAT.

   In reaching its conclusion, the BTA did not address L.L. Bean's Commerce Clause arguments because it is the Board's position that it lacks authority to rule on constitutional issues.

3. Southwestern Bell Telephone Company, as successor in Interest to Southwestern Bell Texas Holdings, Inc. v. Director of Revenue, MO, S. Ct. Dkt. No. SC93900, January 13, 2015.

   The Missouri Supreme Court reversed the holding of the Administrative Hearing Commission that Southwestern Bell was not subject to the Missouri Franchise Tax finding the company to be engaged in business in Missouri.

   In 2001 Southwestern Bell Telephone Company underwent a restructuring and created Southwestern Bell Texas Holdings, Inc. Holdings created and was the sole member of Southwestern Bell Telephone Texas LLC ("LLC"). Southwestern Bell Telephone Company then converted to a Texas Limited partnership. Holdings was the 99% limited partner and LLC was the 1% general partners. The Department audited Holdings for the years 2003 - 2005 and concludes that Holding was engaged in business in Missouri through its L.P. interest. Holdings appealed and the Administration Hearing Commission held Holdings was not engaged in business in Missouri because although there are considerable assets employed in the state they were held by the L.P.

   The Supreme Court in reversing the decision states the threshold question was not whether the assets of the L.P. should be imputed to Holdings but whether the company was engaged in business in Missouri. The company is engaged in the same business it was engaged in before the 2001 restructuring. To be engaged in business, the company does not have to directly own any assets in Missouri. Holdings owned a 99% limited partnership interest and no matter where the asset was located, Holdings employed them as the means by which it was engaged in business in Missouri. The Court noted there was no distinction between being engaged in business through a limited partnership or by using the assets directly. The Court acknowledged that it would be difficult to apportion Holdings outstanding shares and surplus but that alone is not sufficient to conclude the company is not subject to tax. The matter was remanded to determine the amount of tax due.

4. *Swart Enterprises, Inc. v. Franchise Tax Board*, Fresno Superior Court No. 13CECG02171, November 14, 2014.

   The Superior Court found that because Swart's interest in a limited liability company was an investment and it was not doing business in California.
   Swart had no connection to California other than the .02% ownership of a limited liability company that was doing business in California. The company filed a refund claim for the $800 annual franchise tax. The court concluded because Swart had no ability or right to manage the affairs of the limited liability company its interest was not like that of a general partner. The mere holdings of an investment interest did not give rise to doing business in California. The court ordered the refund of the $800.

5. *Bridges v. Polychim USA, Inc.*, No. 2014 CA 0307 (LA Ct. App. April 24, 2015).

Polychim was not registered or qualified to do business in Louisiana. The company owned 100% of the stock of an out-of-state corporation and 96.76% of a limited liability company. The wholly-owned subsidiary and the LLC collectively owned a 100% of a general partnership that was doing business in Louisiana. The company for income tax purposes reported flow through income but did not report any franchise tax. The company took the position that it does not meet the incidents of taxation as defined in the statute. Basically, the company argued it was neither doing business in a corporate form nor exercising a corporate charter in the state. The Department assessed franchise tax and Polychim protested the assessment.

The arties filed cross Motions for Summary Judgement. Polychim argued that the holding of *UTELCOM* controlled. The Appellate Court in that matter rejected the Department's attempt to attribute the activities of a limited partnership doing business in Louisiana to an out-of-state limited partner based on a "unity of purpose" theory. The Department argued that the structure was a tax avoidance scheme and the court should apply a "single business enterprise theory" to the entities and the fact the Polychim directors were also the managers of the partnership that effectively Polychim controlled the instate business of the partnership. Further the Department argued that Polychim's corporate domicile was in Louisiana. The Appellate Court rejected the Department's single business enterprise argument as well as the argument that the interlocking managers allowed the company to control the instate business. With respect to the commercial domicile issues the court found a genuine issue of material fact and remanded the case to the trial court for further findings of fact.

II. UNITARY ANALYSIS

1. *In the Matter of the Appeal of Comcast CableVision Corp. of California and* Common *Production Services I, Inc.*, Los Angeles Superior Court Case No. BC489779, March 6, 2014. Order endorsed August 22, 2014. (On appeal)

The Los Angeles Superior Court reversed the Board of Equalization holding that QVC and Comcast had a unitary relationship. Rather, the court found for Comcast concluding that none of the unitary tests were satisfied despite the fact Comcast owned 57 percent of QVC. The court, however, upheld the Board and found the $1.5 billion termination fee was apportionable business income.
The California State Board of Equalization in a 3 to 2 unpublished decision had held that Comcast was unitary with the majority-owned QVC and that the break-up fee received as a result of a failed merger with MediaOne was properly characterized as business income apportionable to California.
The first issue addressed by the SBE was whether Comcast was unitary with QVC. Comcast owned a 57.5% interest and Comcast officers sat on the QVC Board and were officers of the Company. QVC was managed by the officers who

were in place prior to the Comcast acquisition. Comcast argued the relationship did not meet the three unities test nor did it meet the contribution and depending test. The SBE concluded these were alternative tests and the failure to meet one is not conclusion that a unitary relationship does not exist. The Board members who voted against Comcast relied on the flow of value between the companies, citing the ability to pay the executives with options and overlapping board members. Thus, the view of the majority was the contribution and dependency tests were met. The Superior Court reversed this conclusion.
With respect to the termination fee, the Board adopted the FTB's position that it was apportionable business income. In support of its position, the FTB argued that Comcast has built the business through acquisition and, in fact, the termination fee was nothing more than lost profits from the business. Thus, the transactional test was met. Further the merger agreement was relevant property that was integral to Comcast's business. Therefore, the functional test was met. In reaching this conclusion, the SBE rejected Comcast's argument that the termination fee was a "once-in-a-lifetime" transaction and as such, did not meet the transactional or functional tests. The court agreed with the SBE that the fee was apportionable income.

2. *AIG Insurance Management Services, Inc. v. Vermont Department of Taxes*, Superior Court Dkt. No. 589-9-13, July 30, 2014. (On Appeal)

The Superior Court reversed the determination of the Commissionee of Taxes and held Mount Mansfield Company, Inc. was not unitary in nature which AIG's operation for the 2006 tax year.

AIG filed an amended return for the 2006 tax year to remove Mount Mansfield which owed the Stowe Ski Resort ("Stowe"). The Department rejected the exclusion of Stowe and denied the refund. The court in reaching its conclusion applies a unitary analysis e.g. looked at the relationship between Stowe and the other AIG business operations. The evidence set forth established that Stowe operated as a discrete business operation. AIG's general lines of business involve general insurance; life insurance and retirement services; financial serving, and/or asset management. AIG owns no business similar to Stowe. The court found that the record did not support the fact that an unintegrated business provided value to the AIG group. While the company had contact with AIG, that alone was not sufficient to support a unity finding.

3. *In The Matter of the Petition of Knowledge Learning Corporation and Kindercare Learning Center, Inc.*, New York Tax Appeals Tribunal Nos. 823962 and 823963, September 18, 2014.

The New York Tax Appeals Tribunal has reversed an Administrations Law Judges decision and held that the taxpayer establishes sufficient intercompany transactions to support filing of a combined New York return.

Knowledge Learning Center (KLC) operates pre-k learning center and afterschool care for children six weeks to 12 years. The company operates their center in New York. Kindercare operates child daycare and afterschool programs for children six months to 12 years. Kindercare operated a center in New York. For the 2007 tax year the two companies filed a combined return with other affiliates. On audit, the Department determined the 2007 combined return would not be accepted and required information to support the required intercompany transaction. The company furnished documentation to support they met the 50% substantial intercorporate transaction test.

The Department on audit determined that the intercompany transaction threshold had not been met. The Department also made other adjustments which were unrelated to the combination essence. A Notice of Deficiency was issued.
The Tribunal in reviewing the Administrative Law Judges file concluded that the 2007 statements allowed combined return to be filed even in the absence of substantial intercorporate transactions when the filing is necessary to avoid distortion. However, the matter involves the determination of whether these are sufficient intercorporate transactions. The Tribunal found the taxpayer met its burden and established that there were sufficient intercompany transactions to support the filing of a combined return.

4. *SunGard Capital Corp. and Subsidiaries v. Department of Taxation and Finance* N.Y.S. Tax Appeal Tribunal DTA Nos. 823631, 823632, 8236680, 824167 and 824256, May 19, 2015.

The Tax Appeal Tribunal reversed the Administration Law Judge and found a group of related corporations were conducting a unity business and should be allowed to file combined returns.

SunGard is primarily engaged in providing information service and information technology sales. The Administration Law Judge concluded there were similarities in the business segments but the segments operated independently. Thus, centralized management, a criteria for unity business, was not present. The parent's involvement was not operational. The Tribunal reversed the holding concluding that the various business segments complemented and supported each other. Thus, the entities could be combined based on a unity approach.

In reaching its conclusion, the Tribunal identified evidence of a unitary relationship including the fact that the entities were engaged in similar and related lines of business. The businesses provided complimentary and cross selling opportunities. There was also centralized management through the parent's cash management system. The interest free component of that system created a flow of value between the entities. In addition, flow of value was also established by various non-arm's length transactions. Significantly, services were provided without charge and the affiliates guaranteed the leverage buyout debt. The sole

entities excluded were various holding companies because there was no evidence of their function or role. Thus, there was no showing of flow of value.

Finally, in evaluating the distortion criteria for combination, the Tribunal cited *Matter of Herdilberg Eastern In.,* DTA Nos. 806890 and 807829 (Tax Tribunal May 5, 1994) for the proposition that the same factors indicative of a unity business also give rise to distortion. The Tribunal concluded that SunGard had sufficiently identified the incidence of distortion.

5. *Harley Davidson Inc.* v. *Franchise Tax Board*, California Appeals Court Docket D064241, May 28, 2015.

The California Appellate Court held the Superior Court erred in sustaining the Franchise Tax Board's demurer to Harley Davidson's constitutional challenge to the statutory scheme that allows an intrastate unity group to elect to file a combined return. The Superior Court erred because the statutory scheme forcibly discriminated on the basis of the interstate element in violation of the Commerce Clause. In so doing, the court remanded it back to determine of the tax scheme will withstand the strict scrutiny test.

Harley Davidson basically had two lines of business e.g. a motorcycle business and a financial service business. In filing the California combined return, the company did not report the two lines of business as unitary in nature. On audit, the FTB combined the businesses concluding they were unity. The company argued that the different treatment between intrastate and interstate taxpayers violated the Commerce Clause because an intrastate group received benefits not given to an interstate group. In reaching its conclusion, the Appellate Court applied a three prong and looked at (1) whether the scheme treated interstate and intrastate unitary business differently, (2) does the different treatment burden the interstate business and (3) does the differential discriminatory treatment withstand strict scrutiny. The FTB admitted that the interstate and intrastate businesses were treated differently. The second prong was met as the method discriminated on its face as the sole determination for being a unity combined return was an interstate business; the strict scrutiny prong was remanded.

Finally, the court found that the two financial affiliates had nexus with California and were subject to tax.

6. *SunGard Data Systems, Inc. v. Commissioner of Revenue*, MN. Tax Court Dkt. No. 8461 R, August 11, 2015.

The Minnesota Tax Court held that SunGard and its unitary affiliates were required to file a combined Minnesota return.

SunGard for the tax years 2005 through 2009 filed separate corporate income tax returns. Each of the affiliates doing business in Minnesota also filed returns on a

separate company basis. On audit, SunGard completed a unitary questionnaire indicating there were common officers, common chart of accounts and financial information. In addition, there were common benefit plans and a sharing of administrative services for which a management fee was charged. The company filed on a unity basis in 11 other states. There was also a question raised as whether during the course of the audit the company verbally agreed to the unitary finding. Finally, the Department adjusted the net operating loss for 2005 and 2006 even though the years were closed under the statute.

SunGard argued that the Department in concluding the existence of a unitary relationship relied on the auditor's determination. The company argued the 2005 and 2006 years were adjusted without any factual or legal analysis. Thus, the Commissioner had no authority to adjust the NOLs. In response, the Department argued its conclusion was based on the company's own admission during the audit. The Tax Court citing the fact that the Commissioner's Order is prima facia correct held for the Commissioner because SunGard failed to produce any evidence to refute the company's statement on audit that in fact the group operated as a unitary business during the audit years. There is nothing in the statute that would ban the Commissioner from relying on verbal responses during the audit for purpose of making its determination.

7. *International Business Machines Corporation v. Illinois Department of Revenue,* Illinois Independent Tax Tribunal, No. 14 TT 229, June 30, 2015.

The parent company of a wholly owned subsidiary, which sold the parent's computer hardware, software technology, and other services in foreign countries, was not entitled to summary judgment relating to its petition challenging the assessment of additional Illinois corporate income and replacement tax, penalties, and interest because a factual dispute existed over whether the subsidiary was an "80/20 Company" whose income could be excluded on its parent Illinois combined return. Illinois excludes income of a members of unitary business group that can demonstrate that 80% of their business activities fall outside the United States. The Illinois Department of Revenue disallowed the exclusion for the tax years in question after it was determined the payroll and property figures for the subsidiary should be arrived at by imputing to the subsidiary property and payroll figures that the parent had recorded as its own. The parent company argued that it was entitled to the exclusion and summary judgment because the department did not have authority as a matter of law to impute payroll and property from one company to another company. Whether the parent company was correct in treating the subsidiary as an excluded 80/20 company or whether the department was correct in denying the exemption were factual questions that had to be developed. Therefore, the Summary Judgment was denied.

III. BUSINESS PURPOSE/ECONOMIC SUBSTANCE AND ADDBACK STATUES

1. *Gore Enterprise Holdings, Inc. and Future Value, Inc. v. Comptroller,* Dkt. No. 36, Maryland Court of Appeals, March 24, 2014.

   The Maryland Court of Appeals upheld the Comptroller's assessments against Gore Enterprise Holdings, Inc. ("GEH") and Future Value, Inc. ("FVI"). GEH was founded in 1983 and held and licensed all of the W.L. Gore patents. FVI was formed in 1996 and functioned as a finance company making loans to W.L. Gore. Neither company had any employees or property in Maryland. The Comptroller audited the two entities and determined that both were subject to corporate income tax. Further, for purposes of apportioning the entities income, the Comptroller used the W.L. Gore apportionment ratio. The entities challenged the resulting assessments.

   The Court of Appeals concluded that Maryland under both the Due Process and Commerce Clauses had the authority to tax the income of GEH and FVI. The court's holding was based on the conclusion that neither entity had economic substance or were formed for a valid business purpose. In reaching its conclusion, the court rejected the Court of Special Appeals' conclusion that the unitary relationship with Gore created the nexus with Maryland. Rather, the court held the test to be applied when evaluating intercompany transactions and establishing nexus is whether the entity or entities in question have "real economic substance as separate business entities."

   The court, applying this analysis to the facts at hand, reached the conclusion that GEH and FVI lack economic substance as separate entities. Each entity depended on Gore for its income citing to the circular cash pattern of the structure. In addition, the two entities relied on Gore for their fundamental corporate functions and services. There was little, if any, activity conducted by either entity that would support the conclusion the entitles were separate from Gore. Finally, the court sustained the apportionment method used by the Department.

2. *NIHC, Inc. v. Comptroller of the Treasury*, No. 03-C-10-915, August 18, 2014.

   The Maryland Court of Appeals affirmed the corporate income tax assessment holding that the Comptroller had the authority to assess tax on income reported from a period in which the company was engaged in a tax avoidance strategy.

   Nordstrom created a number of special purpose subsidiaries. The subsidiaries were engaged in licensing intellectual property to the parent corporation. Nordstrom under the terms license agreements paid royalties for the use of the intellectual property. The royalties were deducted as an expense by Nordstrom.

   The court applying the rationale of <u>*SYL*</u> concluded the subsidiaries lacked economic substances separate from the parent corporation Nordstrom. Further, because the lack of economic substance the company had nexus with Maryland.

Through the parents' business activities, thus, the subsidiaries income was subject to tax to the same extent as the parents' income. Therefore the assessments were upheld.

3. *Conagra Brands, Inc. v. Comptroller of the Treasury*, Maryland Tax Court, Dkt. 09-IN-00-01050, February 24, 2015. (Appeal pending).

   The Maryland Tax Court upheld the assessment of tax finding that Conagra Brands had sufficient contact with Maryland and was required to file a return and pay tax on its royalty income. Further the court found that Comptroller's method fairly apportioned the tax to Maryland.

   Conagra Brands was formed in 1996 to manage and market the Conagra brand name and trademarkers. The company had no employees or property in Maryland. The Tax Court rejected Conagra Brands' argument that the company did not have substantial nexus because it was neither physically present nor had it exploited the economic market in Maryland. Rather, the court citing prior decisions concluded that the economic reality of the fact it was the parent's business in Maryland that produced Conagra Brands' income and that was sufficient to create nexus. The real inquiry is whether Conagra Brands had economic substance. The Court found the company lacked economic substance because of the existence of common officers and directors the functional source of the income was from ideas generated by its parent and the circular flow of revenue from the trademarks and trade names. Therefore, the Tax Court held the company did not have economic substance as a separate entity. Thus, the income of the parent produced in Maryland was sufficient to established nexus for Conagra Brands.

   With respect to apportionment, the use of the blended apportionment factor was proper because there was no clear and convincing evidence that it was improper. Finally, the Tax Court found Conagra Brands established reasonable cause so the penalties should be abated.

4. *Staples, Inc.* v. *Comptroller of the Treasury*, Maryland Tax Court No. 09-IN-00-0148 and 09-IN-00-149, May 28, 2015. (Appeal Pending)

   The Maryland Tax Court upheld the assessment and found Staples and Staples Office Superstores ("Superstores") were operated in part to avoid Maryland income tax. Further, the two entities had sufficient contracts with Maryland to require returns and the method to apportion the income was fair.

   In 1998, Staples restructured its business. As a result of this reorganization, Staples provided the managerial and administration services. Superstores provided the franchise system services to two affiliates. Included services were purchasing, inventory control, lease and contract negotiation, advertising and marketing, store site selection and equipment. The Tax Court found the activities

of Staples and Superstores support the Comptroller position that there was enterprise dependency. As a result, the two companies were not separate business entities and part of a unity business enterprise. Thus, there is nexus with Maryland.

Relying on the *Gore* decision, the Tax Court found the apportionment method reflected a reasonable sense of how the income was generated. Finally, the court rejected the argument that the apportionment method resulted in distortion.

5. *PPL Electric Utilities Corporation v. Director, Division of Taxation*, New Jersey Tax Court Dkt. No 000005-2011, October 2, 2014

The Tax Court granted PPL's Motion for Summary Judgment concluding that the Pennsylvania Gross Receipts Tax and the Capital Stock Tax are not required to be added back to income for purpose of computing New Jersey Corporate Business Tax.

The CBT requires that taxable income be adjusted to add-back taxes measured by profits or income, or business presence or business activity that are paid to the United States or a political subdivision of the U.S. or a foreign county. The Tax Court analyzed the gross receipts tax which it paid by distribution companies and electric generation suppliers on the basis of gross receipts from the sale of electric in Pennsylvania. The court concluded such a tax is levied on the suppliers and passed on to the consumer. As such, it became part of the revenue base. The court concluded that the gross receipts tax is not a franchise tax imposed for the purpose of doing business. Rather it is an excise tax and should not be added-back.

With respect to the Capital Stock Tax, the court concluded it was a property tax. The court relied on a number of Pennsylvania decisions that construed the capital stock tax as being the equivalent of a property tax. The court noted that the mere fact income was used in measuring the value of the stock does not require the tax to be added-back.

See also: *Duke Energy Corporation v. Director Division of Taxation, N.J. Tax Court* Dkt. 010448-208, December 2, 2014, holding that electric utilities tax paid to North Carolina and South Carolina are not taxes "on or measured by profits or income, or business presence or business activity" within the meaning of N.J.S.A. 54:10A-4(K)(2)(C). Therefore, the taxes are not required to be added-back.

6. *Morgan Stanley & Co. Incorporated v. Director of Taxation, New Jersey Tax* Court Dkt. No. 007557-2007, October 29, 2014.

The New Jersey Tax Court granted Morgan Stanley & Co.'s ("MS&Co.") Motion for Summary Judgment holding the company was not required to establish that tax had been paid to meet the statutory unreasonable exception.

Morgan Stanley is the parent company domiciled in New York. It entered into a number of financial transactions with subsidiaries and affiliates including a cash subordination agreement, subordinated Involving Credit Agreement and a cash management arrangement. MS&Co. borrowed funds from Morgan Stanley. The loan was funded by third-party debt obtained by Morgan Stanley. The cash management system addressed the daily cash needs. There were also intercompany payable balances. As a result of the transaction and several others with relevant affiliates MS&Co. incurred interest expense.

MS&Co. on its fiscal 2002 Corporate Business Tax return added back the related interest expense and paid tax in the amount of $1,850,764. Subsequently, the company amended its return deducting the interest expense and requesting a refund of $442,126. The Director denied the refund, recalculated the interest add-back and the apportionment percentage resulting in a tax deficiency of $709,162.

The Tax Court in determining that the interest expense fell within one of the statutory exemption analyzed each of the exemptions. To qualify for one of the exemptions the taxpayer must establish by clear and convincing evidence that the exception applies or that the disallowance is unreasonable. Each of the exceptions are independent of each other. With respect to the to the subject to tax exception, Morgan Stanley failed to establish that the interest paid by MS&Co. was included in its New York combined income because due to a substantial loss the tax that was imposed was the minimum franchise tax which is not calculated based on net income. In order to qualify for the exception three prongs must be met: (1) principal purposes not to avoid taxes; (2) the transaction were arm's length and (3) the income was subject to tax. While the transaction met two of the 3 prongs they failed the third prong.

The Tax Court then addressed the unreasonable exception. In its analysis the Tax Court noted that more than a valid non-tax purpose and economic substance needed to be demonstrated to prove the unreasonableness of the interest add-back. Items such as unfair duplicative taxation; a technical failure to qualify under the statutory transaction; an inability or impediment to meet the requirements due to legal or financial constraints; an on unconstitutional result. In denying the unreasonable exception the Director relied on the fact it had not been established that tax had been paid on the interest income. The Tax Court rejected this interpretation concluding it does not have to be established that tax was paid to determine the addback to be unreasonable. Thus, because, the Director used the wrong standard to determine. The unreasonable exception Morgan Stanley's Motion for Summary Judgment was granted. The Tax Court declined to evaluate the merit of the transaction.

7. *Skechers USA, Inc. II v. Wisconsin Department of Revenue*, WI Tax Appeals Commission Dkt. 10-1-73, July 28, 2015.

The Wisconsin Tax Appeal Commission held the Department of Revenue did not have the statutory authority to subject Skechers II to corporate income tax.

Skechers sold footwear in the United States. In 1999, the company formed Skechers II to hold all the domestic intellectual property. Skechers II licensed the property to back Skechers and unrelated third parties. The company was also responsible for designing, developing and marketing Skechers brand footwear. Skechers II had no Wisconsin presence. Skechers made wholesale sales of shoes in Wisconsin which incorporated the domestic intellectual property.

The Department audited Skechers and issued two assessments. It first determined that Skechers II had nexus and was subject to tax on its royalty income. The second assessment was issued against Skechers and disallowed the royalty expense. The Skechers appeal is held in abeyance pending resolution of the Skechers II appeal.

The Tax Commission first addressed whether the Department had the statutory authority to impose a tax. Second, if the authority existed did all of the income producing activity related to the licensing of the intellectual property occur outside Wisconsin so as to result in a zero apportionment. Finally, the Commission was asked to address the computation of the apportionment formula.

The Commission concluded all of the designing, developing and marketing activity took place outside of Wisconsin. Thus, there was no income producing activities in Wisconsin. The key to the analysis is to determine the act or acts directly engaged in by the company for the ultimate purpose of obtaining gain or profits. Skechers II direct activity was the licensing of the intellectual property. It did not sell shoes. While the sale of shoes by Skechers provides the measure of the royalties payable it was not an activity directly engaged in by Skechers II. Therefore, there was no income producing activity in Wisconsin. The sourcing of royalty income based on the license's sales is not supported by the statute. Therefore, the Commission rejected the Department's arguments and reversed the assessment.

8. *Massachusetts Mutual Life Insurance Co. v. Massachusetts Commissioner of Revenue*, Appellate Tax Board, Nos. C305276, C305277, June 12, 2015.

The Appellate Tax Board held combined reporting group was entitled to deduct interest paid on intercompany loans from the parent company to its wholly-owned subsidiary.

Under Massachusetts law, interest paid to a related party is deductible if the taxpayer establishes by clear and convincing evidence that the disallowance of the deduction would be unreasonable. An addback of interest expense is considered unreasonable if it (1) was incurred as a result of a transaction that was primarily entered into for a valid business purpose; (2) was incurred as the result of a

transaction that was supported by economic substance; (3) was incurred because of an underlying bona fide indebtedness; and (4) reflects fair value or consideration.

Documentary evidence and witness testimony established that the promissory notes executed between the parties were bona fide debt primarily entered into for a valid business purpose, were support by economic substance, and reflected fair value or consideration. The notes met the core definition of "debt" for Massachusetts tax purposes, and the conduct of the parties was consistent of that of a debtor-creditor relationship. The loans were evidenced by binding legal agreements with conventional indicia of debt, which contained sufficient terms to enforce repayment. The subsidiary was a creditworthy borrower with sufficient cash and assets to service its debt. It made every payment required under the promissory notes in a timely manner. It had consolidated assets worth billions of dollars during the periods at issue and consistently reported consolidated earnings of five to six times the interest burden on its promissory notes. The facts that the notes were long-term and were non-amortizing, that the subsidiary took on additional debt, and that the notes were convertible to equity were not inconsistent with a debtor-creditor relationship. The debt was primarily motivated by valid business purposes, other than tax avoidance, because the subsidiary needed capital for business expansion and the parent company, a large Massachusetts insurance company, wanted to improve its risk-based capital score (*i.e.,* capital reserve requirements) for insurance regulatory purposes. The notes were supported by economic substance because the proceeds of the notes were used to expand the subsidiary's business. The interest deducted reflected fair value and consideration because the interest rates, which were tied to the applicable federal rate, reflected an arm's-length rate.

9. *Spring Licensing Grp., Inc. v. Dir., Div. of Taxation*, No. 010001-2010 (N.J. Tax Ct. Aug. 14, 2015).

The New Jersey Tax Court held that the Division of Taxation ("Division") properly required a foreign corporation to file corporation business tax ("CBT") returns reporting licensing revenue from its parent attributable to New Jersey, based on New Jersey's economic nexus standard, despite the parent's royalty expense addback in computing its CBT liability. The licensing subsidiary filed CBT returns before New Jersey's enactment of the addback provision; once the parent corporation became obligated to add back the royalty expenses to its income, the licensing subsidiary ceased filing CBT returns, asserting that the parent's royalty expense addback captured the income. In rejecting the subsidiary's position, the court explained that the subsidiary was taxable under New Jersey's CBT under the economic nexus standard. Further, that provision and the royalty addback provision do not operate in the alternative, as neither provision contains a cross-reference to or an exception with respect to the other provision. The court also rejected the argument that requiring the subsidiary to file a return when the parent had already added back the royalty payments it made

to the subsidiary would result in unconstitutional double taxation. The court explained that statutory and regulatory mechanisms existed to eliminate the possibility of double taxation, including the prayor's ability to assert relief under the unreasonableness exception to the addback statute and the Division's "subject to tax" exception, as well as the payee's ability to request discretionary relief from the Division. Failing to take advantage of any of the relief mechanisms made the subsidiary's claim of unconstitutional double taxation "questionable." The court, nevertheless, left open the possibility for Section 8 relief once the subsidiary filed returns and emphasized that the Division must ensure that it taxes such income only once.

IV. BUSINESS INCOME

1. *Fisher Broadcasting Company and Subsidiaries v. Department of Revenue*, Oregon Tax Court TC 5167 (April 29, 2015).

The Oregon Tax Court concluded the gain recognized on the sale of Safeco stock was business income subject to apportionment. Fisher owned and operated radio stations in the states of California, Washington, Oregon, Idaho and Montana. The company is headquartered in Washington. Fisher acquired the Safeco stock in 1923. Safeco was a publicly traded insurance company headquartered in Washington. In 2008 Safeco merged with Liberty Mutual. In 2007 Fisher sold 699,700 shares of Safeco and recognized a gain of $40.6 million. The proceeds were used to acquire two California television stations. Additional shares of Safeco were sold in June and July 2008 with a gain in the amount $127.1 million being recognized.

Fisher in 2002 entered into a financial transaction which collateralized 3 million shares of the Safeco stock. The proceeds were used to construct the Fisher corporate headquarters. In 2004 the company ended the financial transaction and entered into a revolving credit agreement and issued notes. The Safeco stock was not pledged as security for the 2004 financial transaction. However, the notes did place some restrictions on the use of the stock.

The Tax Court in concluding the gains were business income applied both a statutory and constitutional analysis. The court applied both the transactional and functional test. In applying the functional test the court applied the operational tests found in the constitutional analysis. In the opinion of the court the test would not be satisfied if the intangible property was being held as an investment. Applying the rationale of *Allied Signal* the court stated an intangible asset may be used in the business so as to be operational. The Safeco stock was used in two financing transactions the proceeds of which were used in Fisher's business. The first transactions directly lead to the acquisition of additional media assets. With respect to the second transaction, the court recognized that the stock was not affirmatively pledged but the use of the stock was restricted. Thus, it was used as business assets. The relationship of the Safeco stock was operational to Fisher's business activities. Therefore, the gains were apportionable.

Finally, the court found no substantial authority for the position taken on the return and upheld the penalty.

V. APPORTIONMENT ISSUES

1. Receipts Factor

a) *General Mills, Inc. et. al. v. Franchise Tax Board*, 1st District Appellate Court, Dkt. A 131477, August 31, 2012.

General Mills, Inc. is a consumer foods product company based in Minnesota. The company engages in futures trading as a hedging strategy to protect against price fluctuations in the materials that it needs for its business. Between 2000 and 2003, General Mills filed amended income tax returns reporting the full sales price of all of its future sales contracts as gross receipts, which reduced its apportionment percentages. The Franchise Tax Board denied the refund claims and General Mills appealed to the trial court, which found in favor of the FTB. The California Court of Appeal, First Appellate District, held that General Mills may include its commodity futures sales made to hedge against price fluctuations in its sales factor because the contract sales constitute gross receipts. However, the Court of Appeal remanded the case to the trial court to address whether the standard apportionment formula fairly represented General Mills' business activity. On remand, the trial court held that the FTB, under Revenue and Taxation Code section 25137, may use an alternative formula because including the trading proceeds did not fairly represent General Mills' business activity within the state. The trial court noted that the formula should include only net future sales gains in the sales factor.

The Court of Appeal affirmed after finding that General Mills' hedging activity is qualitatively different from the company's other sales that are made of profit. It explained that hedging future sales serves as a risk management function that directly supports its main line of business. Moreover, the court noted that such activity rarely results in actual delivery of and payment for goods. Next, the court held that the company's hedging activity substantially distorts the percentage of its income that is apportioned to California. The court found that although some of the quantitative metrics used to determine if there is substantial distortion were not severe, a key metric profit margin, weighed heavily in favor of a finding of substantial distortion. It explained that hedging for General Mills is not intended to be a profit center because if its strategy is successful, then the profit will be zero. The court concluded that the purpose of General Mills' hedging activity was to achieve the profit margins in its primary business and that using hedging gross receipts to dilute that profit margin, therefore, does not fairly represent California's

market for the company's goods. Finally, the court held that the net gains alternative formula approved by the trial court was reasonable.

b) In re *Buffets Holdings, Inc. v. Franchise Tax Board*, U.S. Bankruptcy Court Dist. Delaware, August 15, 2011.

The U.S. Bankruptcy Court upheld in part the Franchise Tax Board's claim concluding that the FTB used the appropriate apportionment when it excluded treasury receipts from the computation of the sales factor. The court, however, determined the debtor was entitled to additional Manufacturer's Investment Credit because the food preparation activities fell within one of the qualified activities under the SIC categories.

The debtor owned various restaurant chains and in 2008 filed a voluntary petition for bankruptcy. The debtor argued that the additional corporate franchise tax was not owed because the FTB had not used the appropriate apportionment method and had denied the MIC. The FTB excluded the gross treasury receipts from the denominator of the receipts factor based on the fact the inclusion of such receipts did not accurately represent the business conducted in California. The FTB argued as an alternative only the net receipts should be included in the factor computation.

The Bankruptcy Court applying the quantitative and qualitative analysis of *Microsoft Corp. v. Franchise Tax Board*, 39 Cal. 4th 250 (2006) concluded the treasury functions were qualitatively different from the business operation. With respect to the quantitative analysis, the court found the debtors' margin of difference (.08% to 4.25% or 53% greater) fit within the range of quantitative differences which the California courts have found acceptable. Therefore, California established the formula excluding the receipts was reasonable and supported the application of §25127.

c) In *Appeal of Emmis Communications Corporation*, California State Board of Equalization No. 547964. June 11, 2013.

The SBE has ruled that Emmis Communications may include the gross receipts from the sale of its television stations in the computation of the sales factor. Emmis is a diversified media company principally focused on radio broadcasting. It was also engaged in the business of publishing magazines and operating television stations. As part of the plan to discontinue the ownership of the television stations by the end of its 2006 fiscal year, it sold 13 of its 16 television stations, all of which were located outside California. The sale resulted in $931 million of gross receipts, which Emmis included in the denominator of its sales factor.

The FTB on audit excluded all of those receipts from Emmis' sales factor under the regulation that excludes from the sales factor substantial

amounts of gross receipts that arise from an occasional sale of a fixed asset or other property held or used in the regular course of the taxpayer's trade or business. The FTB argued that the sale of television stations was occasional because the taxpayer primarily generated revenue from selling advertising and was not in the business of divesting whole segments of its operations. The FTB claimed that the substantial nature of the gross receipts was evidenced by the 59 percent difference in the sales factor denominator when the gain from the liquidation of that business was included in the denominator.

Emmis argued that the acquisition and disposition of the media properties was a part of its operations and overall corporate strategy to acquire and dispose of operation locations in order to maximize its business. Thus, the sale of the television station was not occasional. The company also argued that it would be distortive to exclude the receipts from the television station sales from the sales factor denominator because these receipts represented the majority of Emmis' gross receipts for 2006 and represented 100 percent of its income. If the receipts were excluded from the sales factor, the gains would be taxed in California without proper representation in the apportionment formula.

The SBE focused on whether the occasional sale rule applied to the taxpayer and the nature of the taxpayer's business in relation to its overall strategy. The SBE granted the taxpayer's petition by a 4-1 vote, finding that the taxpayer properly included the subject receipts in its sales factor denominator.

d) *Idaho Tax Commission*, Dkt. No. 21626, December 19, 2012.

The Idaho Tax Commission has concluded that the receipts from inventory buy/sell arrangements should be included in the sales factor net of the cost of inventory traded.

The taxpayer engaged in transactions whereby it agreed to deliver a certain grade, quality, and quantity of oil at a future date to a party in return for an equivalent grade, quality, and amount of oil at that time or a future date. In the industry, the transactions are referred to as exchanges, the purpose of which is to ensure a steady supply of oil and reduce transportation costs. In computing the sales factor, the taxpayer treated the exchanges as sales and included the full gross receipts from the transactions in the factor.

The Tax Commission in upholding the assessment cited to Rule 325.07, which defines "gross receipts" as the amount realized in a transaction that produces income recognized by the Internal Revenue Code. The transactions are exchanges of inventory where there is no recognition of

gain or loss. Thus, the exchange is not part of the earning process. To the extent there is a differential, it is recorded in costs of goods sold and any gain would then be recognized upon the sale to a third party. Such sales are included in the factor. Although the taxpayer was aware of the rule, it relied on the fact that the gross receipts were used in the IRC §199 computation for the deduction or credit based on Domestic Production Gross Receipts. The Commission rejected the argument concluding that the gross receipts were used to determine the level of domestic production, not total sales or business income. Therefore, the inventory exchanges did not meet the definition of gross receipts for factor purposes.

e) *Tektronix, Inc. & Subsidiaries v. Department of Revenue*, Oregon Supreme Court, SC – S060912, December 12, 2013.

The Oregon Supreme Court held that the gross receipts from the sale of goodwill are excluded from the computation of the sales factor. Tektronix is a manufacturer of measurement and monetary equipment. During the 1999 tax year, the company sold its printer division for $925 million. Approximately $590 million of the gross proceeds were for intangible assets e.g. goodwill. Tektronix did not include the proceeds associated with the sale of intangibles in the computation of the sales factor. The Department, on audit, included the proceeds and issued an assessment in the amount of $3.3 million.

The court, in holding the receipts associated with goodwill were to be excluded, relied on the language of ORS 314.665(6)(a) which specifically excludes from the sales factor gross receipts from the sale of intangible assets unless derived from the taxpayer's primary business. The court concluded that the goodwill was an intangible asset, but Tektronix's primary business was not the sale of divisions. Thus, the receipts were not to be included. In so holding, the court rejected the Tax Court's conclusion that intangible assets were limited to liquid assets and did not include goodwill.

f) *Letter Ruling No. 13-14,* Tennessee Department of Revenue, October 11, 2013.

The Department has determined that the following sourcing methods apply to a taxpayer that manufacturers tangible goods and then sells them to an affiliate.

1) In a drop shipment transaction where the taxpayer receives an order from its affiliate and is directed to ship the goods to a third party located outside Tennessee, the receipt may be excluded from the numerator of the sales factor. The ultimate destination of the sale will control. However, if

the goods are shipped to a customer in Tennessee, the receipts are included in the numerator.

2) In a direct sale transaction where the taxpayer receives an order from its affiliate and ships the goods to the affiliate warehouse outside Tennessee, the receipts are to be excluded from the numerator of the factor.

g) *Hallmark Marketing Co., LLC v. Combs*, TX Court of Appeals, Dkt. No. 13-14-00093-CV, November 13, 2014. (Petition for Leave Pending)

The Appellate Court affirmed the trial court's denial of Hallmark's Motion for Partial Summary Judgment.

Hallmark challenged the Comptroller's calculation of the denominator of the receipts factor. In computing the denominator of the factor the Comptroller subtracted from total gross receipts the losses sustained on the sale of investments and capital assets. The court rejected Hallmark's argument that such losses should not be subtracted based on the statutory language that "only the net gains from the sale" of investments or capital assets are included in the computation of gross receipts. Thus, because there was net loss no adjustment should be made. In reaching its conclusion, the court reviewed the statute and the regulation relied on by the Comptroller. Although the Court found the statute to be ambiguous, it would defer to the Comptroller's reasonable interpretation. Therefore, the phrase "net gain" could reasonably refer to Hallmark's commutations gain or loss, the Court found the Comptroller's interpretation reasonable.

2. Throwout and Throwback Rules

a) State of Illinois Private Letter Ruling, IT-14-0002, April 24, 2014.
The Illinois Department of Revenue had determined that a temporary interruption of a shipment from another state to a foreign country in which the taxpayer is not subject to tax will not cause the sale to be thrownback to Illinois.

The company is a worldwide manufacturer and retailer of audio products for the automotive industry. All the products sold are sold at company facilities located outside of Illinois. A subsidiary operates as a freight forwarder and picks up the products outside the state and temporary stores them in Illinois before shipping the products outside the country.

The issue to be addressed is whether the sale of tangible property to the subsidiary that are destined for export should not be sourced to Illinois.

Illinois looks to the state of destination for purposes of sourcing the sales. The method of pick-up and delivery is not dispositive of where the sale of

the property should be sourced for factor purposes. The Department concluded that the destination of the sales in the foreign county. The property is merely stored in Illinois for short periods in order to consolidate shipments. Thus, the shipment of the property does not terminate in Illinois. Therefore, the sales are not Illinois sales for apportionment purposes

b) *Lorillard Licensing Co., LLC v. Director of Taxation,* New Jersey Tax Court Dkt. No. A-2033-13T (January 14, 2014.) On Appeal.

The Tax Court granted partial Summary Judgment to Lorillard with respect to the nexus standard that is to be used for purposes of the throw out rule.

Lorillard Licensing is a North Carolina limited liability company that had no physical presence in New Jersey. The company licenses its trademarks and trade names to Lorillard Tobacco Company. The Tobacco Company pays royalties for the use of the intellectual property measured by sale in each state. The company did not file New Jersey Corporate Business Tax returns and on audit, the Department determined the company had nexus. In 2009, the company participated in the New Jersey amnesty program conceding nexus. Lorillard Licensing calculated its liability based on its interpretation of the "throw out rule." The Department recomputed the liability take the position that to the extent the company did not file returns and remit tax in a state, the receipts assigned to the state were thrown out for purposes of computing the apportionment formula.

The sole issue addressed on Summary Judgment was what is the proper standard that should be applied in computing the apportionment formula. Lorillard argued that the Director may only throw out receipts from those states which lack jurisdiction to tax the company. Further, the *Lanco* decision established that a trademark holding company with no physical presence in a state is subject to tax in the state by virtue of the receipt of royalties based on sales in the state. Thus, applying the *Lanco* standard, Lorillard is subject to tax in all jurisdictions which impose an income tax. The Tax Court rejected the Department's argument that there is a distinction from being "subject to tax" under *Lanco* and being "subject to tax" under *Whirlpool*. The Tax Court concluded that the relevant analysis is whether the other states have authority under the Constitution to tax the taxpayer because the taxpayer has contact with the states that are sufficient to constitute nexus to be taxed under the Due Process and Commerce Clause. Apply this analysis and the relevant law in New Jersey, Lorillard was subject to tax in all 50 states and the U.S. territories. The Tax Court found it irrelevant to the application of the throw-out rule if the jurisdiction chose to exercise the authority to tax. The actual collection of

tax does not control. Rather, it is the ability to tax which determines if the throw-out rule applies under *Whirlpool*.

c) *Chief Counsel Ruling 2012-03,* California Franchise Tax Board, August 28, 2012.

The FTB has applied both the new economic nexus threshold of $500,000 of sales and the Finnigan Rule in determining when sales of tangible personal property should be thrown back to California for purposes of computing the receipts factor. Effective for tax years beginning on or after January 1, 2011, California has adopted an economic nexus standard. Specifically, a company will be doing business in California if its sales exceed the lesser of $500,000 or 25% of the total sales. In addition, effective January 1, 2011, California once again adopted the Finnigan Rule.

The taxpayer was a unitary group that developed and marketed tangible personal property which it then shipped from California to customers both in the United States and foreign jurisdictions. The sales in a number of jurisdictions exceeded the $500,000 economic nexus threshold. Thus, the question was whether the economic nexus standard would also control the application of the throwback rule. The FTB concluded, consistent with earlier court decisions that PL86-272 does not apply to the foreign sales. Therefore, if the $500,000 threshold has been met, the taxpayer will be considered taxable in the foreign jurisdictions and throwback will not apply.

The second question addressed was regarding the throwback of domestic tangible personal property sales in jurisdictions in which one of the members of the unitary group's sales of other than tangible personal property exceeded $500,000. The FTB recognized by virtue of the adoption of Finnigan and the application of the market-based sourcing rules that a unitary group member was considered subject to tax in those states. Thus, the sales were not required to be thrown back.

d) *Technical Advise Memorandum 2012-11,* California Franchise Tax Board, November 29, 2012.

The FTB issued a Technical Advise Memorandum concluding that for tax years prior to January 1, 2011, substantial economic presence in a state is not sufficient to subject the taxpayer to taxation under constitutional standards. Therefore, for purposes of the throwback rule, a taxpayer must demonstrate physical presence in the state to avoid the application of the throwback rule. The physical presence must be demonstrated either directly or through agents or independent contractors located in the destination state.

3. Cost of Performance

a) *Commissioner of Revenue v. AT&T Corporation*, Dkt. 11-P-1462, Massachusetts Appellate Court, July 13, 2012. Petition for leave denied.

The Appellate Court approved the Massachusetts Appellate Tax Board's decision concluding that AT&T's exclusion of receipts from interstate and international communication services that began in Massachusetts should not be included in the numerator of the sales factor.

The court in affirming the board's decision agreed that based on the facts presented the application of the operational approach was correct. Specifically, under this view, the AT&T income-producing activity consisted of its overall operations. In so holding, the court agreed that AT&T customers were paying for a reliable system of telecommunications and that required the use of the global network in New Jersey. This in fact was the income producing activity of AT&T.

The Board's application of the law was not unreasonable in light of the AT&T facts. Thus, there was no basis to overrule the board's decision.

b) *AT&T Corp. and Subsidiaries v. Department of Revenue*, Oregon Supreme Court Dkt. TC-RD 4814; SC 5060150, September 11, 2015.

The Oregon Supreme Court sustained the Tax Court's denial of AT&T's refunds based upon recomputing the receipts factor using cost of performance. AT&T filed amended returns for 1996 through 1998 tax years, excluding from the receipts factor numerator the gross receipts from interstate and international telecommunication services. The company argued that the greater portion of the income producing activities related to these services was performed in New Jersey, not Oregon. Therefore, based on the Oregon statute, the receipts from interstate and international services should be excluded from the numerator of the factor.

The Oregon Supreme Court held the interstate and international data transmission receipts should be sourced to Oregon based on the Department's cost of performance approach. The Department argued that the cost of performance approach was a transaction based approach. Using a transaction basis the only direct costs are those costs that produced each individual sale. To focus the analysis on the costs of the network is too broad. The use of per minute charges for voice or flat rate monthly subscription is plausible and not inconsistent with the statute. The Court concluded AT&T failed to produce evidence to support its position.

c) *Powerex Corp. v. Oregon Department of Revenue*, Oregon Supreme Court SC S060859 (March 27, 2015).

The Oregon Supreme Court reversed the Tax Court and held electricity to be tangible personal property. In so holding the court remanded the matter back to the Tax Court to determine whether the electricity was delivered or shipped to a purchaser in Oregon. With respect to natural gas both parties agreed it was tangible personal property. The court affirmed the Tax Court's holding that the Department erred when it relied on the fact that title to the gas changed hands when the gas passed through the hub in southern Oregon. The hub represented the contractual point of delivery.

d) *In the Matter of the Appeal of Williams-Sonoma, Inc. & Subsidiaries*, Case No. 519857, State Board of Equalization, June 26, 2012.

The California State Board of Equalization ("SBE") sustained the Franchise Tax Board's ("FTB") denial of Williams Sonoma's refund. In so doing, the SBE agreed that shipping fees on goods sent to California customers from locations outside of California should be included in the numerator of the sales factor.

Williams-Sonoma filed refund claims for the 2002 through 2004 tax years, removing the shipping fees from the numerator of the factor. The company argued that the shipping income was an item of income separate from the sales of tangible person property and should be sourced using cost of performance. Specifically, the shipping fees are separate income producing activity. The cost of shipping is based on the cost of the product and the shipping function is considered a profit center. The costs incurred to provide the service are incurred at the distribution centers located outside of California. Thus, applying the cost of performance methodology, the revenue would not be included in the numerator of the factor.

The FTB argued that Williams-Sonoma is in the business of purchasing and re-selling goods and that the shipping fees must be included in the gross receipts derived from the sale of goods. Thus, the shipping fees would be included in the numerator of the state to which the goods are shipped. Further, the concept of separating shipping fees is a sales tax concept which is not applicable to income tax.

The SBE rejected the Williams-Sonoma argument that the shipping fees were a separate income-producing activity. Rather, the shipping fees were incidental to the purchase of the goods. There are no separate or independent sales of "shipping" to a customer. The shipping services are not separate transactions. Thus, the receipts are included in the gross

receipts derived from the sale of goods. As such, the shipping fees are included in the numerator of the state to which the goods are delivered.

e) *Microsoft Corporation v. Franchise Tax Board*, CA Court of Appeals, 1st Appellate District, Dkt. No. A131964, December 18, 2012.

The Appellate Court reversed the Superior Court and held the licensing of the right to replicate and install software was an intangible property right. Therefore, for purposes of computing the sales factor, the taxpayer correctly used the cost of performance method. The preponderance of the costs associated with the royalty income was incurred in Washington. Thus, the royalties were correctly excluded from the numerator of the California sales factor. The income derived from the sales of the Microsoft keyboard and mouse should be included in the computation of the factor.

Microsoft entered into licensing agreements with OEMs that gave the OEM the right to install the software products on their computer system and then sell the system with the pre-installed software. In addition, back-up disks were bundled with each unit sold by the OEM. Royalties accrued either on a per-system or per-copy basis. Microsoft on a filing basis included the royalties in the denominator of the sales factor but excluded the royalties from the California license from the numerator of the factor applying the cost of performance method. On audit, the FTB included the California royalties in the factor. Microsoft determined that 99.5% of the direct costs to generate the OEM software royalties occurred outside California.

The court concluded that the right to replicate and install software was an intangible property right. In reaching that conclusion, the court relied on previous court decisions interpreting the application of the California sales and use tax statute to technology transfer agreements in which the court found the agreements to be intangible property not subject to sales tax. While recognizing that the sales tax decisions were not controlling, the court found them relevant as there was no justification for treating the license as intangible property for purposes of the sales tax and tangible property in the context of the income tax. Further, the FTB itself advocated a contrary position before the State Board of Equalization in *Appeal of Adobe Systems, Inc.* Finally, the court also relied on the definition of intangible property found in IRC §936(h)(3)(B) as support for its conclusion.

f) *Indiana Department of Revenue*, Letter Finding No. 02-20130238, September 1, 2013.

The Indiana Department of Revenue has held that the income-producing activity of a provider of information services is the sale of that information in Indiana. Thus, the receipts from the sale of the information services should be sourced to Indiana. The taxpayer was effectively required to use a quasi-market-based approach to source income.

The taxpayer is an out-of-state business that provides financial information services to Indiana customers. The company filed amended returns using a cost of performance method to source its electronic service revenues. The Department denied the refunds. The taxpayer identified its direct costs as staffing for its research, analysis and data base managers as well as its information technology system. The identified direct costs were all incurred outside of Indiana. Thus, because preponderance of the direct costs were not incurred in Indiana, the receipts from the sale of the services should not be sourced to Indiana for apportionment purposes.

The Department, in rejecting the taxpayer's arguments, defined the term "income-producing activity" to mean the acts directly related to and for the ultimate purpose of obtaining a profit. In this matter, those activities were conducted in Indiana. The taxpayer earns its revenue because it sells the results of its out-of-state research to Indiana customers. Thus, the Department concluded the Indiana sales transactions constitute Indiana source income.

g) Indiana Letter of Findings No. 02-20130047, January 30, 2014.

The Department has held that a company that earns income from instate franchise license agreements was not entitled to apportion its income using the cost of performance method.

The taxpayer was a multi-state company doing business in Indiana. The company owned licensed trade names, trademarks and other intellectual property to individuals who owned and operated lodging accommodations both within and outside Indiana. The Department audited the books and records of the taxpayer and determined that all license fees earned from Indiana franchises should be attributed to Indiana. The taxpayer argued it had no employees or property in Indiana and that when the cost of performance rules were applied, it had no Indiana corporate tax liability.

The Department rejected the argument citing the statutory section that requires income from intangible property to be sourced to Indiana if attributable to Indiana. (IC§ 6-3-2-2) Since the franchise income was derived from Indiana licenses, it was attributable to Indiana. The value of the intellectual property attached within the stream of Indiana commerce and its association with the Indiana franchisees. Further, even if the cost of performance rules applied, the income-producing activity took place in

Indiana because that is where the taxpayer engaged in the act for the ultimate purpose of obtaining gain or profit.

h) *Cable One Inc. v. Idaho State Tax Commission*, Idaho Supreme Court, Dkt. 41305-2013, October 29, 2014.

Cable One provides cable television and internet service in 19 states including Idaho. For the 2005 tax year the company had 4 sources of income: cable television, internet access service, advertising revenue and cable modem lease revenues. For the Idaho purpose it included all revenue except that revenue associated from providing internet service to Idaho customers. The company took the position this revenue represents Arizona sales. Cable One was headquartered in Arizona. The back office operation that supported the internet service was located in Arizona. Internet access could not be provided without these services. Thus, Cable One agreed that the greater proportion of the income production action associated with the internet server was performed outside Idaho.

The Court, in reviewing the issue, determined pursuant to the regulation one must look to each separate item of income. It is not the activity that produces the income from Cable One's 19 state system but rather the activity that produces the Idaho income. The court concluded that the income producing activities in each state that combined to produce the income must be identified. Further, the cost of performance of the activities that produces the relevant income are only a metric for qualifying the income producing activity in each state. The court applying this approach identified the direct costs incurred by Cable One to provide the internet service including the use of AT&T's and Qwest's Internet backbone in Idaho and determined that 68% of the cost were incurred in performing income – providing activities in Idaho. Thus the sales were properly sourced to Idaho.

i) Colorado Department of Revenue, Private Letter Ruling, DLR-15-006, June 8, 2015.

The Department of Revenue has determined that a company that performs services that it then consumers is a service provides for apportionment purposes. Therefore, it must apportion receipts based on where the cost to perform those services are incurred.

The company is in the business of managing and collecting charge–off commercial and customer accounts purchased from financial leasing companies and other parties who issue credit. The Department in characterizing them as a service provider determined its business activities are akin to a service provider even though it does not generate income by selling the service to a third party. The Department rejected the argument

that the company was a financial institution. The income is generated by the performances of the debtor to pay its obligations. Finally, the Department agreed that the company could use the current costs to determine prior year's apportionment under the cost of performance method.

4. Market-Based Sourcing

a) Illinois Department of Revenue Private Letter Ruling IT-11-0002, September 6, 2011.

The Illinois Department was asked to opine on the application of the market-based sourcing rules that became effective for the 2008 tax year. Specifically, the Department was asked by a for-profit education institution how the tuition receipts should be sourced in two situations. First, what was the appropriate method to source tuition paid for online courses. The Department agreed that pursuant to Act §304(a)(3)(C-5)(iv), such receipts should be sourced to the location of the student's billing address. However, if the educational institution was not subject to tax in the billing address state, the receipts had to be eliminated (thrown out) from the denominator of the sales factor.

The second question posed to the Department was, what is the proper method for sourcing tuition receipts when the student takes both online and classroom courses during the same semester? The Department agreed with the taxpayer that in the situation where the student mixes educational platforms and the taxpayer cannot determine what portions of the tuition is attributable to each platform, the tuition should be sourced to the location where the students are attending class.

b) Illinois Department of Revenue Private Letter Ruling IT-11-0003, November 18, 2011.

The Company is primarily engaged in the business of trading uranium products using a book transfer process. The Company has no officers or employees in Illinois. However, the Company has a notational interest in yellow cake uranium which is held on account in the inventory records of an unrelated federally regulated entity. By federal regulations, the Company can buy, hold, and trade uranium but may not take physical possession of it. Thus, the uranium owned by the trading company must be stored at the facilities of unrelated entities licensed to store such product. The Company's sole Illinois activity is the purchase of yellow cake uranium, holding of that uranium in a book entity for resale and sales of the yellow cake. The Company had previously sourced its sales to Illinois based upon the invoice location.

The Company requested the Department to (1) confirm that it derives income from intangible personal property under Act §304(a)(3)(E-5)(iii); (2) confirm the Company is a dealer in the intangible property; and (3) confirm that the items of income should be sourced based on the location of the customer's commercial domicile, which is presumed to be the billing address. The Department concluded that the Illinois business activities are the sales of intangible property. Further, if the Company qualifies as a dealer within the meaning of IRC §475, then the receipts are assigned to Illinois if the customer is in Illinois. The Department concluded, based on the facts presented, that the Company would be a dealer under IRC §475. Therefore, the receipts would be sourced to Illinois if that was the customer's commercial domicile.

c) Indiana Department of Revenue Letter of Finding No. 02-20120316, November 1, 2012.

The Indiana Department of Revenue denied the taxpayer's protest and concluded that receipts earned by providing audience profile information to Indiana customers constituted Indiana receipts for purposes of the apportionment factor. In reaching its conclusion, the Department adopted a market-based method, despite the statutory cost of performance method.

The taxpayer is an out-of-state media and marketing service business that measures the number and characteristics of audience numbers listening to radio, television, and other types of media. The information is acquired using surveys, the results of which are sold to its customers. The taxpayers applying the statutory cost of performance method excluded the receipts from the numerator of the sales factor because the surveys were not conducted in Indiana.

The Department concluded the receipts should be included in the numerator because the taxpayer performed services and derived income from the state. The income-producing activity was the compilation and analysis of the data received from the survey and sale of that data to Indiana customers. In reaching the conclusion, the Department rejected the taxpayer's argument that it has relied on an example contained in the regulations that used a "time spent" methodology. In rejecting the argument, the Department indicated that it did not regard the regulatory example as having the force of law. The example was also distinguished because the taxpayer was not paid for the out-of-state surveys. Thus, the survey did not produce income. Therefore, the income-producing activity with respect to the surveys took place in Indiana where the data was provided to the customers.

5. Alternative Apportionment

a) *Car Max Auto Superstores West Coast, Inc. South Carolina Department of Revenue*, S.C. S.Ct. Op. No. 27474 December 23, 2014.

The South Carolina Supreme Court affirms the Appellate Court's holding that the party seeking to use an alternative method of apportionment has the burden of proof. Specifically, the party seeking to use the alternative method must satisfy a two prong test. First, the party seeking to use the alternative method must show the statutory formula does not fairly represent the taxpayer's business acting in the state. Second, the formula must be reasonable.

Car Max, Inc. owned two subsidiaries Car Max East and Car Max West which were primarily engaged in the retail sale of automobiles. Car Max East operates superstores on the East Coast and in the Midwest. In addition, the company managed all the financial operations. Car Max West operates the locations in the western part of the county and managed the intangible property. In 2004, the two subsidiaries contributes the financial operations and the management of the intangible to a newly formed limited liability company which operates as a partnership. Both entities paid a management fees to the LLC. In addition, the LLC provides financing for the retail auto sales. The revenue generated by the LLC flowed through to the members e.g. Car Max East and Car Max West.

Car Max West in filing its South Carolina return used the statutory gross receipts method to apportion income. Specifically, it used ratio of South Carolina receipts from financing and licensing of intangibles to total receipts including its retail sales. On audit the Department challenged the use of the statutory method and prepared an alternative method that excluded the retail sales from the denominator of the ratio.

In holding for Car Max, the South Carolina Supreme Court concluded there was a two part test that must be met to support the use of an alternative formula. In analyzing the tests the court agreed with the Department that the alternative formula does not need to be more reasonable than any competing method. Rather it must be reasonable. First, it must be established that the statutory formula does not fairly represent the activities in the state. The court concluded that the Department failed to prove this threshold issue, e.g. the statutory formula was not a fair representation of Car Max West's business. Merely stating what it did rather than citing a justification for the alternative does not support the Department's use of an alternative formula. Thus, the Department fails to meet its burden.

b) *Vodafone Americas Holding Inc. & Subsidiaries v. Roberts*, TN Ct. of Appeals No. M2013-00947-COA-R3-CV June 23, 2014. (Appeal pending)

The Tennessee Appellate Court upheld the lower court holding the Commissioner acted within the scope of his discretion when he issued a variance requiring Vodafone to use an alternative apportionment method.

Vodafone, a provider of cellular communication services, originally apportioned its income to Tennessee using its customers' billing addresses. The company filed amended returns utilizing the statutory cost of performance method. The Department denied the refund request because the statutory formula did not fairly represent Vodafone's business activity in the state. Because the majority of the company's earning producing activities occurred outside of Tennessee using the statutory formula reduced the sales factor by 89%. Vodafone challenged the denial of the refund.

The Commissioner, approximately two years after the matter was filed in court, issued a variance asserting that even if the apportionment method used by Vodafone was statistically correct, the method failed the higher goal of fairly representing the business in Tennessee. The variance required apportionment based on services provided to Tennessee customers based on the customers' address. Vodafone argued that the Commissioner does not have the authority to impose the variance unless there are unusual factual situations which are unique to a specific taxpayer and produce incongruent results that are unintended by the statute. Because no such unusual factual situations exist in this matter as a result of using cost of performance, there is no authority for the variance.

The Appellate Court rejected the Vodafone argument first holding that the Commissioner bears the burden of proof in establishing the variance was proper. The court concluded the Commissioner's variance was within the options provided by the statute. Further, the Commissioner, based on the unusual facts, has exercised reasonable discretion in determining whether the circumstances presented in the matter justify a departure from the statutory formula. Therefore, the variance requiring Vodafone to apportion its income based on the services provided to Tennessee customers was properly issued.

c) *Indiana Department of Revenue v. Rent-A-Center East, Inc.,* Indiana Tax Court Dkt. No. 49T10-0612-TA-00106, September 10, 2015.

Rent-A-Center East (RAC East) operated rent-to-own retail stores which offered home electronics appliances or furniture to customers under a

flexible rental purchase plan. During the 2003 tax year, RAC East owned and operated 1,932 stores in the central and eastern U.S. The company had 106 stores in Indiana. An affiliate owned and licensed the trademark and other intangibles as well as operating 47 stores in the western U.S. A second affiliate employed the executive management and operated 278 stores in Texas. The other affiliates did not operate in Indiana. RAC East filed a separate company Indiana adjusted gross income tax return. The Department on audit took the position the separate return did not adequately reflect the income from Indiana sources and the company should be required to file a combined return.

The Supreme Court in 2012 reversed the Tax Court and remanded the matter back to the Tax Court. The Tax Court on remand granted Rent-A-Center East's ("RAC East"), Motion for Summary Judgment holding the company was not required to file a combined Indiana corporate income tax return.

The Tax Court rejected the Department's argument that a combined return was required because the companies operated as a unitary business. The intercompany transaction distorted Indiana source income and RAC East had earned a substantial amount of income that was not taxed. In so holding the Tax Court concluded the statutory scheme does not require a member of a unitary group to file a combined return solely because there is a unitary relationship. Second, addressing the distortion argument, the Tax Court rejected the argument that the transfer pricing study was irrelevant to the determination of which RAC East's Indiana source income was fairly reflected on a separate return. The arm's length standard under Section 482 is a proper benchmark and the parties stipulated RAC West and RAC Texas were formed for valid business reasons. The Tax Court also rejected the argument that the structure allowed RAC East to shift income. Finally, the Tax Court found RAC East had not engaged in a tax avoidance scheme.

e) *Equifax Inc. and Equifax Credit Information Services Inc. v. Mississippi Department of Revenue,* MS Supreme Court Dkt. No. 2010-CT-10857-S.Ct. (June 20, 2013). Motion for Rehearing denied, November 21, 2013. Petition for Certiorari denied.

The Mississippi Supreme Court reversed the Appellate Court and reinstated and affirmed the Chancery Court decision. The taxpayer bears the burden of showing that the alternative method is not reasonable. Also, the use of an alternative apportionment method was not a promulgation of a rule in violation of the Procedures Act. Finally, there was no abuse of discretion in imposing penalties.

Equifax is a Georgia corporation engaged in the business of consumer credit reporting. The company was registered to do business and did business in Mississippi. The company did not have a Mississippi office but did have three employees in the state. The credit services were provided electronically to Mississippi businesses. Equifax apportioned its income to Mississippi using the standard method for service companies. As a result, it determined that no income was subject to tax in Mississippi. The Department on audit determined that Equifax should have used an alternative market-based sourcing formula. Equifax challenged the Department's use of an alternative apportionment method.

The Appellate Court concluded the Department has the burden to show that the standard formula did not fairly represent the activities of Equifax within Mississippi and that the alternative market-based formula was reasonable.

The Supreme Court in reviewing the Appellate Court concluded the Chancery Court must give great deference to decisions of administrative agencies and a decision of an administrative agency is binding unless the other party proves otherwise. The rebuttable presumption exists in favor of the agency and the burden lies with the challenging party, e.g., Equifax. In reviewing the Order of the Commission, the Chancery Court may only determine if the order was (1) supported by substantial evidence; (2) was arbitrary or capricious; (3) was beyond the power of the administrative agency; or (4) violated some statutory or constitutional right. The court held that the proper standard was applied and the standard applied by the Appellate Court was inconsistent with the statute. Specifically, the court held Equifax had the burden to show the Commission's decision was unsupported by the evidence, arbitrary and capricious, beyond the authority of the Commission, or violated a statute as constitutional right. Further, the use of an alternative apportionment formula did not amount to a rule that was promulgated in violation of the Administrative Procedure Act. The regulatory language clearly allows the Commission to require alternative apportionment when the standard formula does not represent the business activity in the state. Finally, the court concluded that Equifax failed to prove that the Commission did not commit manifest errors by imposing penalties.

f) *Sidney Frank Importing Company v. Department of Treasury,* Michigan Court of Appeals Dkt. Nos. 315610 & 315963, (July 3, 2014).

The Michigan Appellate Court reversed the Tax Tribunal's decision and directed the Tribunal to consider the taxpayer's claim for alternative apportionment.

Sidney Frank sold its interest in Grey Goose vodka. The Tribunal held the transaction was not a sale under the single Business Tax. In addition, the Tribunal held the company waived its right to alternative apportionment. The Appellate Court upheld the ruling on the sale but allowed the company to supplement the record to show it had requested apportionment relief. With respect to the apportionment issue, the court remanded the matter to the Tax Tribunal. Upon remand, the Tribunal concluded because the Department failed to respond to the request for apportionment relief, it was denied and Sidney Frank was not entitled to the relief. The company appealed.

The Appellate Court once again remanded the matter holding the Tribunal failed to comply with its instructions. Further, the court held the Tribunal erred when it determined that the Commissioner's non-response was the equivalent to a denial. Therefore, the court reversed the Tribunal on the ground that a non-response constitutes a denial and directed the Tribunal to address the merits of the company's claim.

g) *Letter of Findings No. 02-20130215,* (Indiana Department of Revenue, October 1, 2013).

The Indiana Department of Revenue concluded that a taxpayer and its two affiliates were not required to report their income using a "separate accounting" method because the Department's auditor failed to prove the standard apportionment formula did not fairly reflect the taxpayer's business activities in Indiana. The taxpayer is a manufacturer of automotive parts. Prior to 2005, the company filed a separate Indiana income tax return. In 2005, it began filing a consolidated income tax return with two affiliated entities. On audit, the Department concluded that the standard method of apportionment did not fairly represent the taxpayer's income from Indiana sources because the taxpayer and one of its affiliated entities had substantial disparities in both the amount of their Indiana activities and their respective amounts of income and loss. As a result, the Department required the taxpayer to file on separate accounting basis for the companies. On appeal, the taxpayer presented evidence that the affiliated entity in question maintained resident and non-resident employees in Indiana who regularly conducted business activities within the state that exceeded the protections under P.L. 86-272 and that such entity had taxable income in years prior to the audit years. The Department reasoned that while sufficient differences in the method of doing business may be justification for separate classification and differential tax treatment, the Department has the burden of establishing that the standard apportionment method does not fairly reflect the taxpayer's Indiana sourced income. Thus, the Department concluded that the taxpayer established that the affiliated entity in question had substantial contacts with the state and that the Department audit staff

failed to demonstrate that a departure from the standard apportionment formula was necessary.

h) Illinois Department of Revenue Private Letter Ruling No. IT-13-0003-PLR, September 18, 2013.

The Illinois Department of Revenue granted a taxpayer's request to use an alternative apportionment method, determining that application of the standard single sales factor formula did not fairly represent the market for the taxpayer's goods, services or other sources of income. The taxpayer's only sale during the year in issue was the sale of a building located in Illinois. Under a mistaken application of Illinois's standard single sales factor apportionment formula, the taxpayer believed 100% of its income from the sale of the building would be apportioned to Illinois. Based on this mistaken application, the taxpayer argued that application of the standard formula produced a "grossly" distortive result and proposed two alternative apportionment methods based on its historical Illinois income apportionment. The Department determined that the single sale of the building located in Illinois must be treated as an incidental or occasional sale and thus be excluded from the taxpayer's sales factor. Because the taxpayer's only income for the year in issue resulted from the sale of the building located in Illinois, exclusion of the proceeds from the sales factor would have resulted in *none* of the taxpayer's income being apportioned to Illinois. The Department determined that application of the standard apportionment formula—which led to 0% apportionment and not 100% apportionment as originally represented by the taxpayer—led to a distortive result. The Department granted the taxpayer's alternative apportionment request and allowed the taxpayer to use an apportionment formula that looked to its historic apportionment average from the prior nine taxable years.

6. The Multistate Tax Compact

a) *Gillette Company & Subsidiaries v. Franchise Tax Board*, California Appellate Court, Dkt. No. A 130803, July 24, 2012. (Decision vacated August 6, 2012.) Petition for Leave granted.

The Appellate Court held that for the years California was a party to the Multistate Tax Compact, it had to allow taxpayer to elect to use the equally weighted three-factor formula found in Article IV of the Compact. California had adopted a double weighted sales factor in the 1990s. In reaching its holding, the court agreed with the taxpayer that California could not unilaterally modify a binding compact.

The court, in reaching its conclusion, found that the statutory modification of the Compact had no effect. A compact is a contract and a state must

either abide by its terms or completely withdraw. In reaching its conclusion, the court relied on (1) California contract law mandated that the state abide by the terms of a binding contract; (2) unilateral modification of the Compact would materially affect taxpayers' rights under the contract, thus violating the Contract Clause; and (3) California's "re-enactment rule" does not allow the state to simply amend the Compact by references to its title in another statute.

> **Note:** Legislation was enacted and signed into law on June 26, 2012, withdrawing California from the Compact. On October 2, 2012, the Appellate Court re-issued virtually the same opinion clearly noting the Compact had been repealed.

The use of the standard three-factor Multistate Tax Compact formula has also been raised and cases are pending in the states of Michigan and Texas.

b) *IBM v. Michigan Department of Treasury*, MI S.CT. Dkt. No. 146440, July 14, 2014. The Michigan Supreme Court held that IBM was entitled to use the three-factor formulas concluding the Michigan Business Tax was an income tax for purposes of the Multistate Tax Compact. The court concluded the MBT legislation did not repeal the Compact. Although the MBT language mandated a formula that was different from the three-factor formula the Compact contemplated conflicting formulas and therefore provided an option. Therefore, the statues may be read in harmony.

> **Note**: The Michigan Legislature enacted Legislation that retroactively repealed the Multistate Tax Compact effective January 1. 2008. SB 156, Public Act 282. The Michigan Court of Claims in *Yaskawa America, Inc. v. Department of Treasury*, Court of Claims No. 11-000077-MT (December 19, 2014) upheld the retroactive application of P.A. 282 to all pending matters.

c) *Lorilland Tobacco Company v. Department of Treasury*, Michigan Court of Appeals Dkt. No. 313256, September 16, 2014. The Appellate Court held the *IBM* decision was dispositive on whether Lorilland could use the three-factor apportionment formula.

d) *Emco Enterprises, Inc. v. Department of Treasury*, Michigan Court of Claims, Case No. 12-000152-MT (April 21, 2015). The Court held the Single Business Tax is an income tax as that term is defined by the Multistate Tax Compact. The court further concluded the legislative change to the apportionment factor superseded the adoption of the

Compact. As such, the Compact election to use a three factor formula is not available.

e) *Graphic Packaging Corporation v. Comptroller of Public Accounts*, Texas Appellate Court, July 28, 2015. The Texas Appellate Court held a taxpayer may not elect to use the three-factor apportionment formula under Articles III and IV of the Compact. The Texas Margin Tax is not an income tax.

f) *Kimberly-Clark Corporation Subsidiaries* v. *Commissioner of Revenue*, Minnesota Tax Court Docket No. 8670-R, June 19, 2015. (On Appeal) The Minnesota Tax Court granted the Commissioner Motion for Summary Judgement concluding taxpayer had no right to elect an equally weighted three factor formula under Article III of the Compact. Minnesota had the right to repeal Article III.

g) *Health Net, Inc. v. Department of Revenue,* OR Tax Court Dkt. TC 5127, September 9, 2015. A Taxpayer may not utilize the Multistate Tax Compact allocation and apportionment provisions. The legislature with the adoption of ORS 314.606 disabled the Compact election.

VI. INTERSTATE COMMERCE/DISCRIMINATION

1. *CDR Systems Corp v. Oklahoma Tax Commission*, 20 L4 OK 31, April 22, 2014. (Case settled.)

The Oklahoma Supreme Court reversed the Appellate Court and held the capital gain deduction statute 68 §2358.D2 does not violate the Commerce Clause by facially discriminating against non-Oklahoma companies or companies that were not headquartered in the state. The statute allows a capital gain deduction but there is a shorter holding period for Oklahoma-headquartered companies. The court also concluded that the statute did not have a discriminating purpose. Further, the court held the deduction had no discriminatory effect on interstate commerce.

CDR Systems was headquartered in Florida and had a manufacturing facility in Oklahoma. The company entered into a stock purchase agreement to sell all of its assets. The parties made an IRC §338(h)(10) election to treat the transaction as an asset sale. CDR had owned the assets for more than three years but less than five years. In filing its amended 2008 return, the company claimed the capital gains deduction on the sale of its assets. On audit, the deduction was denied because the assets had not been owed for at least five years the holding period for a company not headquartered in Oklahoma. The holding period for an Oklahoma company was three years. CDR on appeal argued the longer holding period unconstitutionally discriminates against non-resident taxpayers.

The Supreme Court, in reaching its conclusion, rejected CDR's argument that the deduction facially discriminates against interstate commerce because the taxpayer received the deduction for investing in the Oklahoma economy. The degree to which the entity generating the gain participated in interstate commerce is irrelevant to whether the entity is entitled to the deduction. The deduction at issue is an incentive to invest in the Oklahoma economy. With respect to a discriminatory purpose, the court found CDR had presented no evidence to demonstrate an impermissible motive. Finally, the court concluded there was no discriminatory effect on interstate commerce. There was no evidence that the deduction precluded a tax-neutral decision on the part of CDR to locate in Oklahoma. The court concluded the deduction had legitimate purpose to structure the state's tax system to encourage the growth and development of interstate commerce.

2. *AT&T Corp. v. Mississippi Department of Revenue*, Hind County Chancery Court Case No. G-2004-1393 (March 26, 2015). (Appeal Pending)

The Hind County Chancery Court ha*s* again held unconstitutional the statute that exempts from a parent corporation's Mississippi income dividends received from corporation taxable in Mississippi while not extending the same exemption to dividends received from corporations not subject to Mississippi tax. The court held the statute denies taxpayers a tax benefit based solely on the choice of the taxpayer and subsidiaries not to locate operations in the state. Thus, the exemption is based solely on an interstate element. As such, the statute favors domestic corporations over the foreign corporations and is discriminatory in nature. In addition, the court found the statute led to double taxation for certain corporations. The appropriate remedy was to strike the offensive limitation and extend the benefit of the statute to dividends received from non-nexus companies.

VII. MISCELLANEOUS DECISIONS

A. Amnesty Penalties and Penalties.

1. *United Parcel Service General Service Co., et al. v. Director, Division of Taxation*, New Jersey Supreme Court, Dkt. No. 072421, December 4, 2014.

The New Jersey Supreme Court affirmed the Appellate Court's holding that notes United Parcel Service had established reasonable cause and the late payment and amnesty penalties should be abated.

UPS and its affiliates used a cash management system for intercompany fund transfers. Upon audit the Department determined the transfer to be loans and imputed interest. The Department assessed tax, penalties and interest. The Tax Court and the Appellate Court agreed that the transfers were loans. The Tax Court concluded the Department abused its discretion in denying the waiver of the late payment and amnesty penalties. The Appellate Court agreed. The Department appealed the penalty issue.

In upholding the Tax Court with respect to the penalty issue, the Appellate Court noted the absence of legal accounting or guidance gave rise to a genuine question of law and fact. A taxpayer who interprets a statute based on his knowledge in light of the lack of legal authority has demonstrated reasonable cause.

B. Procedural Issues.

1. *Powery Corp. v. Department of Revenue*, OR Tax Court No. TC 480, August 2011.

The Oregon Tax Court has held that the Department's regulations characterizing the sale of electricity as the sale of tangible personal property are to be applied on a prospective basis.
Powery filed its corporate excise tax returns for its 2003, 2004 and 2005 tax years and did not treat the sale of electricity as the sale of tangible personal property. In 2007, the Department promulgated rules that characterized the sale of electricity as the sale of tangible personal property sourced to the place of delivery. The proposed rules also addressed the treatment of book-out transactions. In December 2010, the Department repealed the rules and adopted the substantive provisions of the proposed rules as temporary rules. The rules were repromulgated in March 2011.

The Department on audit applied the 2007 rules. The Taxpayer argued that a rule promulgated by the Department may only apply retroactively to periods open to examination. The periods in issue, although involved in litigation, are not open to examination. In granting summary judgment for the Taxpayer, the Tax Court rejected the Department's argument that the litigation of a notice of deficiency is the continuing examination of a tax period. Further, due to the Department's repeal of the rule, there was no rule in place for the period at issue. Thus, by the time a valid rule was in place, all of the periods in issue were closed to examination.

2. *Caterpillar, Inc. v. Indiana Department of Revenue, Indiana Tax Court*, Dkt. No. 49T10-0812-TA-70, March 28, 2013.

The Indiana Tax Court concluded that Caterpillar's foreign source dividends were included in federal taxable income and in the Indiana adjusted gross income. Therefore, the company could deduct the foreign dividends in calculating its Indiana net operating losses.

Caterpillar in calculating is Indiana adjusted gross income, started with federal taxable income. The company's federal taxable income included foreign dividends. As a result, Caterpillar in computing taxable income deducted the foreign dividends under §6-3-2-12 and reported net operating losses on a separate company basis for the 2000 through 2002 tax years.

Caterpillar then carried the loss back and requested refunds. The Department on audit concluded the NOL deductions were incurred because of the deduction of the foreign dividends.

The Tax Court in reaching its conclusion addressed two issues: 1) which adjusted gross income is a component of the NOL statute, and (2) if so, was Caterpillar's foreign source dividend included in adjusted gross income. The Tax Court in analyzing the Code found that even though the term "adjusted gross income" is not used in the NOL statute, the components of the NOL calculation established the presence in the statute. Finally, Caterpillar federal taxable income included the foreign source dividends. Therefore, the foreign source dividends were included in the federal NOL, and the adjusted gross income within the Indiana NOL statute. Caterpillar was entitled to deduct the foreign income dividends under calculating its Indiana NOLs.

C. Taxation of Foreign Source Income.

1. *Schlumberger Technology Corp. & Subsidiaries v. State of Alaska Department of Revenue*, Alaska Supreme Court Dkt. No. 5-14729 (July 18, 2014).

Schlumberger Limited ("Limited") is a multinational Netherland Antilles corporation which holds the stock and manages its subsidiaries. The company conducts business in Alaska through its wholly-owned subsidiary, Schlumberger Technology ("Technology"). Technology's primary business is oil field services and it owns and operates all of U.S. affiliates of Limited. Technology filed a federal consolidated return and an Alaska combined return that included all of the domestic subsidiaries engaged in the oil field service business. On audit, the Department concluded that Limited was engaged in a unitary business with Technology and was a water's-edge affiliate included in the Alaska combined return. As a result of the inclusion of Limited, the auditor also included 20% of Limited's dividends received from foreign affiliates.

Limited argued on appeal that the foreign dividends should not be subject to tax because the dividend income was not connected to business conducted in the U.S. and was not earned within the U.S. water's-edge. The Administrative Law Judge rejected the argument concluding that the dividends were related to Limited's regular business operation and apportionable business income. The water's-edge statute does not geographically limit types of income. The Supreme Court affirmed the Administrative Hearing's decision and held that the company failed to preserve the Commerce Clause and Foreign Commerce Clause arguments.

Technology argued that the dividends paid to Limited should not have been included in the tax base because Alaska, by its reference to the Internal Revenue Code, adopts the provisions of IRC §882. Pursuant to

the terms of §882, Alaska may only tax income that is effectively connected with the conduct of a trade or business in the U.S. Further, the federal sourcing provisions exclude dividends received from foreign corporations if less than 25% of the gross income of that foreign corporation was effectively connected with a U.S. trade or business. The court, in rejecting the argument, concluded the federal sourcing provisions are fundamentally inconsistent with the formulary apportionment required under the Multistate Tax Compact. The Alaska statute does not distinguish between foreign and domestic dividends. Rather, there is an 80% exclusion for dividend income. Further, the court held that the Alaska statutes do not incorporate all of the federal sourcing provisions. The statute incorporates the sourcing provisions of the Multistate Tax Compact and these apportionment rules are inconsistent with the federal sourcing rule. Therefore, the Compact apportionment rules control.