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National Update
The Year in Review

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I.NEXUS ISSUES

1. *Swart Enterprises, Inc. v. Franchise Tax Board*, CA Appellate Court 5th District Dkt. No. F070923, January 12, 2017.

   The Appellate Court affirmed the Superior Court's holding that mere ownership of a .2 percent interest in a California limited liability company was not doing business in the state for purposes of being subject to the California Franchise Tax. Swart operated a small farming operation in Kansas and had no physical presence in California. The company had invested in Cypress LLC ("LLC") which was engaged in the business of acquiring, holding and disposing of capital equipment. Swart was not engaged in the operations of the LLC and had no right or authority to act for the LLC. Rather, it passively held a .2 percent interest in the LLC. For federal tax purposes Cypress elected to be treated as a partnership. The Franchise Tax Board took the position that the ownership resulted in Swart doing business in California and subjected it to the $800 minimum franchise tax.

   The court rejected the doing business argument concluding that the statute required that to be doing business one had to be actively engaged in a transaction for pecuniary gain or profit. Swart did not actively participate in the LLC. In addition, the court rejected the argument that the election to be treated as a partnership for federal income tax purposes meant that Swart was a general partner which under California law would require Swart to be doing business in the state. The court noted there was no legal authority cited for that position and went on to state that a tax election for one purposes does not necessarily control for all tax purposes. Finally, the court pointed out the FTB's argument failed to distinguish between a general partner and a limited partner. A limited partner would not be characterized as doing business. The investment in the LLC in the opinion of the court was similar to a limited partnership interest as Swart had no authority to participate in or manage the LLC. Thus, even under that argument the company was not subject to the tax.

2. *Capital One Auto Finance Inc. v. Department of Revenue* Oregon Tax Court Dkt. No.TC 5197 (December 23, 2016).

   The Oregon Tax Court concluded that two bank subsidiaries of Capital One Financial Corp. had substantial nexus with Oregon due to their extensive economic activities even though neither entity had property or payroll in the state. The Tax Court rejected the argument that the banks must have physical presence in Oregon to be subject to tax.

   In reaching its conclusion the Tax Court pointed to the lending and depositing activities of the bank's clients in the state as support for the fact the banks were doing business in the state as that term is defined for financial institutions. The banks earned income in Oregon through interest and fee charges and under the terms of the statute this was income earned from sources within the state. Specifically, the Tax Court found that the banks earned in excess of $150 million in fees in the 2007 and 2008 tax years. This income originated in Oregon. As such, the banks had economic gain from Oregon.

Applying the Commerce Clause standard of substantial presence the court reasoned that the physical presence standard in the sales and use tax context was twofold: (1) the imposition of sales or use tax on an out of state taxpayer created an un due burden; and (2) there were settled expectations regarding a physical presence standard in the realm of sales or use taxes. However, neither of rationales is applicable to income tax because the collection of income taxes is not onerous and there is no collection requirement from third parties. Finally, the established case law and the Department's substantial nexus guidelines indicate that the applying the tax to the banks would not upset "settled expectations" that concerned the Supreme Court in *Quill*.

3. *Washington Department of Revenue Appeals Division*, Determination No. 15-2251, May 31, 2016.

The Washington Administrative Law Judge denied a German pharmaceutical company's protest finding that the royalty income received from products sold in Washington exceeded the economic nexus threshold.

The company had no physical presence in Washington and argued that the US-German Tax Treaty pre-empted the imposition of the B&O tax on the royalty income. The ALJ determined there was no double taxation because the corporation could exclude the income taxed by Washington from its German income base. Finally, even if the Treaty's non-discrimination provisions applied to state and local taxes there was no discrimination because the tax applied to both U.S. and non-U.S. businesses that derived royalty income in the state.

4. *Irwin Naturals v. Washington Department of Revenue*, Washington Court of Appeals No. 73966-2-1, July 25, 2016 (unpublished).

The Appellate Court held Irwin Naturals has nexus for both Business and Occupation Tax ("B&O") and sales tax on its Washington retail sales. The Commerce Clause did not prohibit the collection of sales tax. The company had sufficient nexus because its Washington activities helped established and maintain a market.

Irwin Naturals is a California based company that develops, markets and sells retail and wholesale nutritional products. The company argued its retail sales were separate and distinct from its wholesale sales because the transactions were wholly interstate in nature and not connected with its Washington activities. The disassociation argument is no longer a viable argument and the Court concluded that for sales tax purposes substantial nexus exists if there is physical presence in the state. Naturals had physical presence in the state through retail stores. For

B&O tax purposes substantial nexus exists if the company is making a market. The mere fact that the orders are received and filled outside of Washington is irrelevant. The activities that create the nexus with the state do not need to be tied to the specific sales but merely have to support the vendor's activity to maintain a market. The Court noted that Naturals have invested resources in its Washington State, had marketing activities in the state and had a frequent presence of senior executives in the state. Taken together this is substantial nexus.

5. *Target Brands, Inc. v. Dep't of Revenue*, District Court City and County of Denver Colorado. No. 2015CVV33831, January 27, 2017.

The Denver District Court adopted an economic nexus position when it held that an out-of-state holding company that licensed the use of its intellectual property to its affiliate on a nationwide basis, including within Colorado, was "doing business" in Colorado for state corporate income tax purposes. The court recognized the company meets the definition of an 80/20 company and thus could not be included in the group but Target Brands was subject to tax on a separate return basis. The court concluded that such taxation was deemed permissible under the Commerce Clause because the holding company had substantial nexus with Colorado through its in-state licensing activities despite its lack of an in-state physical presence.

In reaching its conclusion with respect to apportion the holding company's income to Colorado, the trial court denied the Department of Revenue's utilization of a single-sales factor method based solely on a percentage of its affiliate retailer's in-state sales. The Department argued it had discretionary authority to impose an alternative apportionment method because the standard statutory three-factor apportionment formula in effect during some of the tax years at issue did not fairly represent the extent of the holding company's in-state business activity under the statute's cost of performance sourcing mechanism. The court concluded the alternative apportionment formula must include the holding company's payroll and property. The court explained that in failing to consider the holding company's breadth of business activities, *e.g.*, its substantial brand compliance, training, monitoring, management and protection efforts, including employees and property that helped create, enhance, and preserve the income that the Department seeks to tax, the proposed alternative apportionment formula was *not* "reasonable." In doing so, the court concluded that including the holding company's payroll and property in any alternative apportionment formula was "necessary."

II.UNITARY ANALYSIS

1. *ComCon Production Services, Inc. v. California Franchise Tax Board*, California Appellate Court, Second District (December 14, 2016).

The Appellate Court affirmed the Superior Court holding that Comcast was not engaged in a unitary business with QVC Inc. during the 1998 and 1999 tax years. In reaching its conclusion the court said the various tests used to determine whether businesses are unitary “are not intended to represent a binary choice, but rather articulate related approaches to resolving the question of unity.” The Appeals Court also affirmed the Superior Court's decision that a $1.5 billion termination fee Comcast received in 1999 as a result of a failed merger with MediaOne Group Inc. was taxable business income.

During the tax years at issue, Comcast owned 57 percent of QVC and had exclusive rights regarding its management. Also during the years at issue, Comcast senior executives comprised QVC's entire board of directors. However, day-to-day operations of QVC’s businesses were conducted by QVC management and were independent from Comcast. In 2005, after auditing Comcast's 1998 and 1999 tax returns, the Franchise Tax Board issued a notice of proposed assessment in the amount of $933,142 for tax year 1998 and $11,300,834 for tax year 1999, along with additional tax, interest, and penalties. The State Board of Equalization determined the companies were unitary and upheld the assessments. The matter was appealed to the Superior Court.

The Superior Court held that Comcast and QVC were not unitary because evidence of the three hallmarks of a unitary relationship, centralized management, functional integration, and economies of scale was lacking. The FTB, appealed and argued that the trial court erred by not analyzing the evidence under the dependency or contribution tests. Comcast argued that the Superior Court considered not only the *Mobil Oil* test but also two other tests. Specifically, the three unities and dependency or contribution tests had to be considered and applying these tests the companies were not unitary.

The appellate court agreed pointing out that the U.S. Supreme Court in *MeadWestvaco Corp.* held that “any number of variations on the unitary business theme are logically consistent with the underlying principles motivating the approach.” The appellate court said the trial court's decision was consistent with California cases that focus mainly on centralized management and functional integration, and also considered flows of value and dependency or contribution tests. "In sum, as reflected in its statement of decision, the trial court fully understood the governing federal and state case law that described three closely related approaches for analyzing whether Comcast and QVC were appropriately considered a unitary business for the two tax years at issue.” The appellate court added that “the trial court correctly concluded, properly applying those legal principles, that QVC did not engage in a unitary business with Comcast -- that, although commonly owned, the entities were not integrated in a way that transferred value between them.”

The court also affirmed that a $1.5 billion termination fee, which was the result of a failed merger of Comcast and MediaOne Group Inc. in 1999, was business income for Comcast because it satisfied the transactional test under the Uniform Division of Income for Tax Purposes Act. The transactional test looks to whether the transaction that gave rise to the income arose in the regular course of the taxpayer's business. In so concluding the court rejected Comcast's argument that the massive fee was a once-in-a-corporate-lifetime event. It found that rather than being an extraordinary occurrence, the termination fee was a "bargained-for, direct result of Comcast's agreement to acquire MediaOne through merger" and that "cable acquisition transactions, including the proposed MediaOne merger, as Comcast has effectively conceded, occurred in the regular course of Comcast's business. Thus, it met the transactional test.

The court also held that taxing an apportioned share of the fee didn't violate the due process clause, despite Comcast's claim that California lacked a definite link to the income. Finally, the court held that Comcast had forfeited its claim that a recalculation of its tax liability was required given that the termination fee was found to be business income. "

2. *Agilent Technologies, Inc. v. Department of Revenue*, District Court County of Denver, Dkt. No. 2014 CV 393, January 20, 2016.

The District Court granted Plaintiffs' Motion for Summary Judgment concluding that its subsidiary World Trade does not meet the definition of an includable C corporation.

The Agilent group does business in Colorado and is subject to corporate income tax. World Trade and its foreign subsidiaries are unitary with Agilent's business. Agilent treated World Trade and is four foreign subsidiaries as a single entity in the federal return due to the federal check the box rules. The group was excluded from the Colorado combined return because more than 80% of the property and payroll were outside the U.S. The Department took the position that it was not bound by the federal check the box rule and thus, World Trade should be included in the combined return.

The District Court in reaching its conclusion first stated that the statute did not require the Department to treat the group according to the federal check the box rule because the Colorado statute on the federal rules serve different purposes. Thus, because the federal rules are not required to be followed Agilent cannot demonstrate more than 80% of the property and payroll are outside the U.S. Although World Trade does not meet the definition of an excluded 80/20 company it does not meet the statutory definition of an includables "C" corporation. World Trade as a separate entity has no property or payroll. The regulation states that a company with no property or payroll of its own cannot have 20% or more of the factors assigned to a location in the U.S. Therefore, World Trade is not an includable "C" corporation as defined by statute.

3. *Harley Davidson Inc.* v. *Franchise Tax Board*, California Appeals Court Docket D064241, May 28, 2015. (Leave for Appeal denied). On remand to Superior Court.

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.

4. *Labelle Management, Inc. v. Michigan Department of Revenue*, Michigan Court of Appeals No. 324062 (March 31, 2016). Petition for Leave Denied.

The Michigan Court of Appeals reversed the trial court, finding that indirect ownership in the context of determining a unitary business group means ownership through an intermediary and not constructive ownership.

Labelle is a Michigan corporation that is owned equally by two brokers. The broker also held a 1% general partnership interest and a 49% limited partnership interest in a Michigan limited partnership. Finally, Plaintiff was a subsidiary of Pixie, Inc. the issue was whether the entities were unitary in nature. Specifically, was more than 50% ownership test met.

The court is analyzing the issue concluded the trial court erred in using the federal income tax definition of constructive ownership. The term "indirect ownership" as used in the statute is not defined. Therefore, because the federal rules do not address a comparable context, the ordinary rules of statutory construction should be used to define the term. Apply in those rules the Court concluded that the term "indirect ownership" means ownership through an intermediary. The facts in this case were brother/sister corporations and the court held there was no intermediary. Therefore, there was no unitary relationship.

5. *Ashland Inc. v. Commissioner of Revenue*, MN Tax Court Dkt. No.08819-R, June 6, 2016.

The Tax Court has held that a foreign subsidiary of a domestic corporation that elects to be a disregarded entity for federal tax purposes may be included in the combined return. Ashland acquired Hercules Inc. including its wholly-owned subsidiary Hercules SARL. For federal tax purposes the subsidiary was characterized as a disregarded entity. For federal tax purposes the disregarded entity status treated SARL as having been liquidated and all of its assets and liabilities being distributed to Hercules. Hercules reported all of SARL's income, loss and deductions as its own on the Ashland combined return. The Department on audit excluded SARL from the unitary group based on the argument that for the years at issue Minnesota did not permit the income of foreign entities to be included in the combined return.

The Tax Court in granting Ashland's Summary Judgement Motion concluded because SARL was deemed to have distributed all of its assets and liabilities to its sole shareholder and liquidated before the disregarded entity election had been made SARL was no longer an entity separate from Hercules. Therefore, the income and apportionment factors of SARL are deemed to be part of the income and apportionment facts of Hercules. Thus, there was not violation of the statute.

> It should be noted: The statute was amended in 2013 for tax years beginning after December 31, 2012 to clarify that the income of a foreign entity other than a C corporation that is included in the federal taxable income of a domestic corporation or domestic entity must be included in the net income and apportionment factors of the unitary business.

6. *In the Matter of the Petition of Whole Foods Market Group, Inc.*, New York Division of Tax Appeals, DTA No. 826409, July 14, 2016.

The New York Administration Law Judge held that Whole Foods Market Group should have filed a combined return with its Whole Foods Market IP, LP which held the company's intellectual property.

The question addressed was whether the IP company had to be combined. The ALJ agreed with the Division of Taxation that the royalty payments represented substantial intercorporate transactions. Thus, the requirements for filing a combined return were met. The filing of the combined return is not discretionary but mandated.

Whole Foods paid in excess of $100 million in royalties for each year of the audit period. The company deducted the payments for federal tax purposes but added them back to taxable income for New York purposes. The IP company included the payments in its federal taxable income.

New York amended its statute in 2007 to require combined reports when there were substantial intercorporate transactions among related corporations. Whole Foods argued that despite the statute the addback negated the need for a combined report. The ALJ rejected this argument concluding the intercompany transaction were substantial and the first analysis should have been to determine if a combined return should be filed.

7. *Revenue Ruling No.02-20150653*, Indiana Department of Revenue, September 28, 2016.

The Department of Revenue has ruled for corporate income tax purposes an Indiana taxpayer was not allowed to apportion its partnership income at the individual partnership level because its relationship with its various limited partnerships (LPs) and limited liability companies (LLCs) constituted a unitary business. The taxpayer was a multi-state company that provides communication services including phone, cell phone, cable television, internet access, and other related services. Since 1985, the taxpayer, and its affiliates, had been filing combined returns as an organization conducting a unitary business. For 2009, 2010, and 2011 the taxpayer treated its interest in various LPs and LLCs as non-unitary. On audit, the Department found that the entities were a unitary business sharing attributes of common ownership, common functions and interdependence. Thus, the partners' income and apportionment factors properly flowed through to the corporate partner. The taxpayer protested the assessment, arguing that a limited partner did not have a legal right to exercise control over an underlying partnership and as such, its relationship with the underlying LPs and LLCs did not constitute a unitary business.

The taxpayer also argued that the department erred in adjusting its net operating loss utilization and carryforward for 2007. According to the taxpayer a settlement agreement it entered into with the department allowed a NOL carryforward of approximately $231 million for tax years after 2007. The taxpayer explained that the carryforward amount consisted to two segments and that under IRC § 382 limitations, the amount that could be claimed in a tax year from each segment was limited. According to the taxpayer, the audit applied approximately $220 million of the NOL carryforward to 2008 but only approximately $114 million was available.

The taxpayer raised a reasonable question and the Department ordered a supplemental audit to address the NOL issue. With respect to the unitary issue the Department noted that as set out in the prior audits, the current audit, and previous administrative decisions, the limited partners shared common attributes of management, ownership, and business functions entitling the department to require the limited partners' income and apportionment factors to "flow up" to the corporate partner.

8. California Franchise Tax Board *Notice 2016-02, September 9, 2016.*

The FTB has issued a Notice that discusses how it will treat an otherwise valid water's-edge election when a unitary foreign affiliate of the water's-edge combined group becomes a taxpayer because it is doing business in California due to *Rev.& Tax §23101(b)*, (factor presence standards) which for taxable years beginning on or after January 1, 2011, sets forth additional circumstances that constitute doing business in California. A qualified taxpayer may elect to determine its income from or attributable to sources within California pursuant to a water's-edge election, but such an election will be effective only if every member of the self-assessed combined reporting group that is subject to tax, i.e., all taxpayer members of the group, make the election. Because of the enactment of the factor presence standards a foreign affiliate of a water's-edge combined group that, at the time of the election, was not doing business in California (and thus could not be included in the group) could be doing business in California. Depending on whether a unitary foreign affiliate is a corporation whose income and apportionment factors would have been properly considered in computing the income of the taxpayers making a water's-edge election, the foreign affiliate may have been required to make an election for the election to be effective.

The Notice addresses the treatment the FTB will apply in situations in which a unitary foreign affiliate of a water's-edge combined group could not make an election at the time of a water's-edge election because the affiliate was not subject to tax in California, but after the addition of *Rev. & Tax §23101(b)* would have been required to make a water's-edge election for the election to remain effective. The FTB will treat the existing water's-edge election as follows: (1) When a unitary foreign affiliate has income derived from or attributable to sources within the United States both before and after the beginning of a taxable year in which the affiliate becomes a taxpayer solely due to the addition of *Rev. & Tax. §23101(b)*, the deemed election provisions of *Rev. & Tax. §25113(b)(4)* will apply, i.e., the unitary foreign affiliate will be deemed to have made the election with the other members of the combined reporting group; (2) When a unitary foreign affiliate does not have U. S. income either before or after the beginning of a taxable year in which the unitary foreign affiliate becomes a taxpayer solely due to the addition of *Rev. & Tax.§23101(b)*, the affiliate would never have been includable in the water's-edge combined report despite its status as a taxpayer under *Rev. & Tax § 23101(b)*. However, in order to give effect to the objective intent of the taxpayers' unitary group to maintain an effective water's-edge election, the unitary foreign affiliate will be deemed to have made an election as of the taxable year in which it became a taxpayer. The commencement date of the deemed water's-edge election will be the same as the commencement date of the electing taxpayers of the existing water's-edge combined reporting group. In such circumstances, the foreign affiliate may be included in the group return of the existing water's-edge combined reporting group for administrative convenience; (3) When a unitary foreign affiliate does not have U. S. income before, but has U.S. income after, the beginning of a taxable year in which the affiliate becomes a taxpayer solely as a result of the addition of *Rev. & Tax. § 23101(b)*, the unitary foreign affiliate will be deemed to have made an election as of the taxable year in which it becomes a taxpayer. The commencement date of the deemed water's-edge election will be the same as the commencement date of the electing taxpayers of the existing water's-edge combined reporting group.

The Notice also sets forth four conditions, each of which must apply, for the treatment of elections in described in (1), (2), and (3) to apply; if all of those conditions apply, the FTB will not to seek to terminate the water's-edge election of the water's-edge combined reporting group that is unitary with the foreign affiliate that is now a taxpayer. Also, the deemed election provisions of the Notice will apply only to taxable years beginning within 84 months of September 9, 2016, the date of the Notice

III.BUSINESS PURPOSE/ECONOMIC SUBSTANCE AND ADDBACK STATUES

1. *ConAgra Brands, Inc. v. Comptroller of the Treasury*, Arundel County Circuit Court, October 19, 2015. (Appeal pending).

The Arundel County Circuit Court affirmed the decision of the Tax Court that a holding company established nexus in the state through its parent company and should be assessed corporate income taxes. The Maryland Tax Court upheld the assessment based on the court of appeals' decision in *Gore,* which held that intangible holding companies lacked economic substance on their own and upheld the use of blended apportionment based on the companies' unitary status with its parent.

ConAgra Brands was formed in 1996 to manage and market the Conagra brand name and trademarks. The company had no employees or property in Maryland. On appeal at the Circuit Court Brands argued that it lacked any meaningful connection with the state and that the assessment was unconstitutional. The company also argued that it had no employees, agents, or representatives in Maryland, nor did it conduct business or generate any income in the state. Further, the state's use of a blended apportionment formula was improper because the company didn't have any property, payroll, or sales in the state -- the factors all equaled zero. It also argued that when the comptroller used the parent company's apportionment figures to calculate Brands' liability, it effectively endorsed the unitary model, which isn't authorized under Maryland law.

The circuit court rejected the arguments based on the similarities of the companies at issue in *Gore.* The court noted that both cases involved subsidiaries created to manage patents and trademarks and that in both instances, the parent companies own the majority of the subsidiaries' stock. The court also rejected the taxpayer's due process and commerce clause claims based on the court of appeals' rejection of those claims in *Gore*. As for the Tax Court's waiver of interest, the circuit court said that the court in *Gore* affirmed interest charges on back taxes and said that since the issue was not appealed in *Gore*, it was the law.

2. *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.

3. *Kohl's Department Stores, Inc. v. Virginia Department of Revenue*, Circuit Court of the City of Richmond, Case. No.CL12-1774, February 3, 2016. Petition for Review granted. Argued April 21, 2017.

The Circuit Court denied Kohl's Motion for Summary Judgment and held the royalties paid by Kohl's to a wholly-owned subsidiary did not fall within the safe harbor provisions of the add back statute.

The sole issue before the court is to what extent was Kohl's entitled to the safe harbor exception to the add back statute for royalties paid to Kohl's of Illinois. Specifically, Kohl's argued that if the income was included in the computation of a corporation's taxable income it is subject to tax Thus, because Kohl's of Illinois included the royalty payments it received in its income tax filings in other states the company was subject to tax and falls within the safe harbor. As a result no portion of the royalty payments should be added back.

The court in rejecting the argument concluded within the plain meaning of the statute that not only must the intangible expenses paid to a related member be subject to tax in another state but the tax must be actually imposed by another state. Thus, the income must actually be taxed by another state to fall within the safe harbor provisions. There was no showing that the income was taxed.

4. *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.

5. *Kraft Foods Global Inc. v. Div. of Taxation*, Dkt. No. 017974-2009, (N.J. Tax Ct. April 25, 2016).

The New Jersey Tax Court held that Kraft Foods Global ("Kraft") was not entitled to deduct interest payments it made it its parent during the 2005 and 2006 tax years. The court held the taxpayer failed to establish that the deduction was reasonable.

Kraft Foods Inc. in 2001 began to issue public debt in the form of bonds. Shortly after the issuance of the bonds the proceeds were transferred to Kraft who in turn used the proceeds to pay off debt held by its ultimate parent Philip Morris Holdings. After each transfer of fund to Kraft, the company executed a Promissory Note in favor of Kraft Foods, Inc. in the amount of the transferred funds. The company agreed to pay interest on the Notes equal to the interest that was due on the bonds that had been issued. Kraft argued that in effect the payment of the interest was merely a conduit to the payment of interest to the bondholders. Therefore, it fell within the reasonableness exception to the add back rule. In reviewing the notes the court found: (1) the notes did not contain a guarantee to pay the bondholders; (2) did not contain payment terms or a payment schedule of the principal; (3) did not provide for any recourse against Kraft in case the interest was not paid; (4) Kraft Food's debt obligations were not mentioned in the notes; and (5) the bondholders were not third-party beneficiaries of the Notes and have no recourse in the event payments are not made. Thus, the court found that the Notes represented financial transactions entirely independent from Kraft Food's debt to the bondholders. Although Kraft Foods used the interest received from Kraft to pay the bondholders, it was under no obligation to do so. Therefore, Kraft failed to carry the evidentiary burden that it was ultimately responsible for the interest due the bondholders.

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.

2. *Xylem Dewatering Solutions, Inc. V. Director, Division of Taxation*, New Jersey Tax Court Dkt. Nos. 011704-2015, 000056-2016, 000057-2017, April 10, 2017.

The tax Court addressed the issue of whether a gain from a deemed asset sale under I.R.C. §338(h)(10) recognized by a New Jersey based Subchapter S corporation was non-operational income allocable 100% to New Jersey. The Tax Court applied the precedent developed for C corporations, *McKesson Water Prod. Co. v. Director, Div. of Taxation*, 408 N.J. Super. 213 (2009) and held the deemed asset sale and liquidation resulted in non-business income. Therefore, the gains were allocable to New Jersey. In reaching its conclusion the Tax Court there was no constitutional requirement to apportion the income from a deemed asset sale and complete liquidation.

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, Dkt. No. 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. Glenn Hager*, TX S.Ct., Dkt. No. 14-1075, (April 15, 2016).

The Supreme Court reversed the Appellate 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 trial and Appellate courts had 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. The Supreme Court agreed with Hallmark stating under no reading of the statute does only "net gain" include a net loss. The Court in reaching its conclusion reviewed the statute and gave effect to the legislative intent. Based on that review, the phrase "net gain" could only reasonably refer to Hallmark's net gains and there should be no adjustment for losses.

h) *Duke Energy Corporation v. South Carolina Department of Revenue*, South Carolina Supreme Court, Opinion No. 27606, February 17, 2016

The South Carolina Supreme Court held the principal recovered from the sale of short-term securities should not be included in the computation of the sales factor. Thus, denying Duke's refund. In reaching its conclusion the court looked to decisions rendered in other jurisdictions that held the inclusion of principal recovered from the sale of short-term securities in an apportionment formula leads to an absurd result and distorts the sales factor within the formula. Further, the inclusion would defeat the legislative intent of the apportionment statute.

i) *First Marblehead Corporation & another v. Commissioner of Revenue*, MA Supreme Judicial Court, SJC 11609, August 12, 2016. Petition for Certiorari Denied.

GATE Holdings, Inc. ("Gate") was a wholly-owned subsidiary of First Marblehead Corp. and was an integral part of the student loan securitization process in that it held the beneficial interests in all of trusts that owned the securitized student loans. The company had no offices or employees. The loans had been assigned to Florida for apportionment purposes.

The U.S. Supreme Court vacated the 2015 decision and remanded the case to the Supreme Judicial Court following the decision in *Comptroller of the Treasury v. Wynn* 135 S.Ct. 1787 (2015). On remand the court again addressed the issue of whether the property of a student loan processing company, Gates Holdings Inc. should be apportioned under the state's financial institution excise tax. The computation of the property factor was specifically at issue. In affirming its earlier decision the court determined that the general rule is that loan is properly assigned to a regular place of business with which the loan has a preponderance of substantive contacts. In other words, the loan should be assigned to the state where it has a regular place of business. If in a fact the loan is assigned to a state that is not a regular place of business the statute provides a rebuttable presumption that the loan should be assigned to Massachusetts if at the time the loan was made the taxpayers commercial domicile was in Massachusetts. The court concluded that Gate had no regular place of business so pursuant to the statutory rebuttable presumption the loans would be assigned to Massachusetts and not Florida.

In addressing the internal consistency test the court explained if each state had enacted an identical law the loan would be sourced to Massachusetts the state of corporate domicile because gates had no property or employees anywhere. If every state had a similar law no more than 100 percent of gate's income would be subject to tax and there is no disadvantage to the fact the company operates in interstate commerce. Thus, Gate's interest in securitized student loans that were held in trusts was properly assigned to Massachusetts.

j) *Comcast Corporation & Subsidiaries v. Department of Revenue*, OR Tax Court Dkt No. TC 5265, October 2016.

The issue presented to the Tax Court involves whether Comcast was required to apportion its income using the Broadcast apportionment formula. The company is engaged in the provision of cable television, internet and VOIP services to Oregon subscribers. In addition, the company derives revenues from the sale of advertising time commission and fees related to its cable operations, franchise fees that are collected from subscribers and paid to local governments as well as licensing fees from programing. The company argued that the revenue derived from items other than broadcasting should be apportioned using the methology for sourcing sales other than the sale of tangibles personal property. Thus, the company basically argued each revenue stream should be apportioned using a separate and distinct method.

The Tax Court in regarding the argument analyzed the statutory language and concluded because some of its revenue fall within the definition of broadcast revenue all of the income had to be apportioned using that method. The statutory language does not provide for a carve out of the other revenues. Specifically, the Tax Court found Comcast to be an interstate broadcast for purposes of the Oregon tax statute.

k) *Genentech Inc. v. Commissioner of Revenue*, MA Supreme Judicial Court Dkt. No. SJC-12083, January 12, 2017.

The Massachusetts Supreme Judicial Court (Court) affirmed the Appellate Tax Board holding that a California-based biotechnology company qualified as a "manufacturing corporation" subject to single-sales factor apportionment for the prior tax years at issue under Massachusetts' corporation excise tax.

Genentech is a biotechnology company that develops drugs derived from proteins produced by living cells. Using a four step process the company modifies the genetic codes of living cells to produce proteins that have desired pharmacologic effects. The Court examined the taxpayer's processes and agreed that its drug production activities qualified as "manufacturing" under state law given that "clear transformation" occurs where "each genetically modified and replicated cell is different from the original cell in a most fundamental way," so that the taxpayer can extract and purify the "protein of interest" from such cells as the source of each drug that it then markets and sells. Based on this analysis the court concluded the taxpayer was substantially engaged in manufacturing activities under the single-sale factor statutory gross receipts threshold (i.e., more than 25%). In reaching this conclusion, the court limited the qualifying "gross receipts" in this calculation to the taxpayer's business income, rather than also including its investment income. The Court reasoned, the inclusion of the investment income in the computation would be distort the taxpayer's operations in that it would transform a biotechnology company with substantial revenue derived from sales of its specialty drugs into essentially an investment business. In addition, the Court affirmed the Appellate Tax Board's holding that the application of the single-sales factor apportionment formula and the unavailability of Massachusetts' investment tax credit and research and development credit for the taxpayer did *not* violate the dormant Commerce Clause.

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 Company LLC v. Director, Division of Taxation*, Superior Court of New Jersey Appellate Division Dkt. No.A-2033 –13T1 (December 4, 2015), Petition for Certification denied N.J.S.Ct.

The Appellate Court affirmed the Tax Court and adopted the reasoning of the Tax Court. The court agreed with the Tax Court's interpretation of *Whirlpool*, in that it whether Lorillard actually paid taxes elsewhere was not relevant. Further, *Lanco*, addresses the Commerce Clause the limits placed on New Jersey's ability to tax. The Commerce Clause is not offended when a taxing state applies the New Jersey business tax to an out of state holding company receiving income from New Jersey sources. This is the standard to be applied and in determining throwout it only matters if another state could have constitutionally imposed a tax not whether it actually imposed the tax.

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 by the Tax Court 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) *Elan Pharmaceuticals, Inc. v. Director, Division of Taxation,* N.J. Tax Court Dkt. No. 010589-2010, February 6, 2017.

The New Jersey Tax Court has held that Elan in computing its New Jersey sales factor was not required to throwout sales made to states where the company was protected by P.L. 86-272. In reaching its conclusion, the Tax Court took into consideration the application of the throw-back rule and found that Elan had inventory in 6 states there was no support for the Division's conclusion that sales to states other than the 6 states were nowhere sales due to the application of the throw-back rule.

Elan is a pharmaceutical company headquartered in California which did business in New Jersey. The company filed tax returns in six states including a unitary return in California. In computing its New Jersey sales factor for the 2002 tax years it included the receipts from product sales in states which it was protected by P.L. 86-272. On audit, the Division adjusted the sales factor to include only sales made to six states where returns were filed and allocated a portion of the non-sourced sales using a ration pf products shipped from inventory in New Jersey top products shipped from inventory located outside New Jersey.

The Division argued based on the discussion in *Whirlpool* that sales made to states where P.L. 86-272 protection applied are thrown out because the destination states lacked the ability to tax Elan. In rejecting the argument, the Tax Court stated the "linchpin of the analysis in Whirlpool" is the constitutional ability to tax. In other words, did Elan have the requisite constitutional contacts with the state. The Tax Court pointed out that several of the states had the authority to tax the non-New Jersey sales because those states adopted throw-back provisions. Thus, a shipping state could capture those sales by applying the throw-back rule. Thus, these sales do not constitute nowhere sales to be eliminated from the denominator of the factor. Rather, Elan had property in the destination states and the fact that a state chose not to tax it does not mean that New Jersey or any other state may tax it.

d) *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.

e) 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.

f) California Franchise Tax Board, *Chief Counsel Ruling 2016-03,* July 5, 2016

A recent Chief Counsel's Ruling issued by the California Franchise tax Board illustrates the issues and potential opportunities that arise as a result of adopting a factor presence nexus standard. California, effective January 1, 2011, adopted a factor presence nexus standard for determining if a corporation was doing business in the state. That standard was amended and effective January 1, 2014 a corporation is doing business in California if its sales exceed the lesser of $529,562 or 25 percent of the total sales. The question addressed in the Ruling is how that threshold is computed when a taxpayer is engaged in both the sale of tangible personal property and receives income form intangibles. In this case it was royalty income.

The Taxpayer was engaged in the design and distribution of products that were marketed under various brand names. The products are sold through department stores, specialty retail outlets and online retailers. In addition the Taxpayer licensed its trademarks to unrelated third parties. In turn the Taxpayer received royalty income measured by sales. The FTB in computing the doing business threshold aggregated the revenue from the sales of tangible personal property and royalty income to determine if it had been met. In so doing, the FTB is taking the position that for purposes of determining the doing business threshold the safe harbor protection of P.L. 86-272 is not taken into consideration. The analysis raises an interesting question which has not been vetted as to the interaction between the safe harbor protection for the sale of tangible personal property and a factor presence standard for nexus. It should be noted, that based on this FTB analysis corporations who have argued they are protected by P.L. 86-272 may actually be doing business in California because the company receives income from intangibles used in the state.

The Ruling also addresses the question as to what standard applies for determining if the throwback rule applies. The initial assumption would be that the FTB would merely have applied the factor presence nexus standard in the destination state to determine if the taxpayer is doing business in that state. Rather, than merely applying the statutory factor presence analysis the FTB used a convoluted analysis to reach the conclusion that the taxpayer was subject to tax in the destination state. The FTB acknowledged that the safe harbor protections of P.L. 86-272 applied but the nexus analysis did not stop there. The focus of the analysis was not on the threshold dollars but rather on the nature of the business activity in the destination state. The fact the taxpayer earned royalties in the states went beyond the P.L. 86-272 safe harbor protections. As a result, under the FTB's approach the Taxpayer was subject to tax and the sales were not required to be thrown back. Utilizing the FTB's analysis, if a company earns income from other than the sale of tangible personal property that activity alone is sufficient to establish that the company is subject to tax in that state. Thus, in those situations the company avoids the application of the throwback rule.

g) *In the* Matter *of the Appeal of Craigslist Inc.*, CA State Board of Equalization, Nos. 725838 and 843070 (March 29, 2016).

The SBE held that certain sales were properly excluded from Craigslist's sales factor because the company was not taxable in certain states. The FTB had granted the company permission to use an alternative apportionment formula for the 2007 thorough 2010 tax years. The FTB had stipulated that the company's receipts would be subject to the throwout rule.

Craigslist filed an amended return for the 2007 tax year requesting a refund based on the argument that the sales should be included in the denominator of the factor because the company had met the $500,000 threshold for sales in those states. The FTB determined that the company was not taxable because it lacked physical presence in those states. The company argued the 2010 amendments to the statue to define doing business, e.g. economic presence, should be applied retroactively.

The BOE rejected the argument citing Chief Counsel Ruling 2012-03 and Technical Advice memorandum 2012-01 as support for the statutory change would not be given retroactive application. In addition, the BOE noted that taxpayers, practitioners and the FTB have relied on precedents in planning their affaires and determining whether a taxpayer's activities were subject to tax by California and it is important that the same standard be applied to sales outside of California as in California for the same tax years. Therefore, to ensure consistent application of the law the sales from the states in issue should be thrown out in determining Craigslist's sales factor.

3. Cost of Performance

a) *Quest Diagnostics Clinical Laboratories, Inc. v. Barfield*, LA Court of Appeals, 2015 CA 0926, September 9, 2016.

The Appellate Court held a nonresident medical laboratory's diagnostic testing of Louisiana patient specimens was not attributable to the state for corporate income tax apportionment purposes. Quest sought a refund of corporate income taxes paid to the Louisiana Department of Revenue for tax years 2005 and 2006, claiming it incorrectly apportioned income that did not reflect changes the lab made after Hurricane Katrina. Before the 2005 hurricane, the company operated a regional laboratory in Louisiana where it performed diagnostic testing on in-state specimens and apportioned income from those tests to the state. But Hurricane Katrina destroyed the facility, and when a new facility was constructed in 2006, it was a smaller, rapid-response laboratory that performed only a limited number of tests and shipped the majority of the specimens to a larger, regional lab in Houston. When the company realized its tax overpayment and filed amended returns, it attributed income from tests performed at the new Louisiana lab to the state, but attributed to Louisiana only a portion of the income derived from testing that took place in Houston.

The Department effectively denied the taxpayer's refund claim by not taking any action on the amended returns. The company then appealed to the Louisiana Board of Tax Appeals, which upheld the denial. The Louisiana Court of Appeal, First District, however, reversed and sided with the taxpayer. . The taxpayer argued that it was a service business whose property was not a substantial income-producing factor, so that it was required to apportion its income using the two-factor formula consisting of payroll and revenue, and excluding the property factor altogether. In turn the Department took the position that the taxpayer's high-tech equipment and instruments should be considered property under the statute, and that none of the specific apportionment formulas in the statute were applicable.

The court determined that the Board’s decision was not manifestly erroneous in concluding that the taxpayer's property was a substantial income-producing factor in its testing services, saying the taxpayer's amended returns showed that the property was considerable in amount or value. However, although the company was required to use the three factor formula, the Board erred by requiring it to source the disputed income to Louisiana and not Texas under the apportionment statute. The court concluded the statute "does not clearly and unambiguously express intent to attribute income derived from general services performed in another state to Louisiana."

b) *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.

c) *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.

d) *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.

e) *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.

f) *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.

g) *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.

h) 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.

i) *Bank of America Consumer Card Holdings v. New Jersey Division of Taxation*, N.J. Tax Court No. 012945-2011, 012949-2011,012942-2011,000386-2011 and 000387-2012, October 6, 2016.

The New Jersey Tax Court has held that credit card issuers must source to New Jersey the interest and interchange fee receipts and half of their credit card service fees from New Jersey cardholders.

The taxpayers earned interest and credit card service fees which included late fees,, returned check fees, over the limit fees and annual fees from cardholders located both in and outside of New Jersey. In addition, the taxpayers earned interchange fees from transactions entered into by the cardholders. The issue addressed by the Tax Court was how this income should be sourced. The Tax Court concluded the Department's regulations required the taxpayers to source interest receipts based on the location of the cardholder. In reaching this conclusion the Tax Court rejected the argument that the interest receipts were not so integrated with the New Jersey business operations so as to acquire New Jersey tax situs.

The Tax Court also addressed the regulation that requires sourcing 25% of the receipts to where the service originates, 50% to where the service is performed and 25% to where the service terminates. The court concluded that 50% of the credit card fees from New Jersey cardholders should be sourced to New Jersey because the services were performed where the credit cardholder received the benefit of the service which was New Jersey. Finally, the court rejected the application of the throwout rule because the Tax Division failed to establish that any state did not have jurisdiction to tax the sales if the New Jersey economic nexus standard applied.

j) *In the Matter of the Petitions of Checkfree Services Corp.*, DTA 825971 and 825972 N.Y. Div. of Tax App. January 5, 2017.

Checkfree was headquartered in Georgia and provided electronic bill payment and presentation services to its customers that allowed the customers to pay bill through various methods and receive them electronically. Specifically, a customer could log onto the taxpayer's website and make payments to any vendor. These services were provided using proprietary software and were performed from various locations outside of New York.

The administrative law judge determined that Checkfree's receipts from its electronic bill payment and presentment transactions constituted receipts from services rather than "other business receipts," and were properly sourced outside New York to the location where the underlying services were performed by the taxpayer for purposes of calculating the receipts factor. The judge rejected the contention of the Department that there must be human involvement for the receipts to have resulted from services performed, explaining that employing technology in the performance of services "does not, per se, remove the resulting receipts from the realm of receipts derived from the performance of services." The judge also noted that the facts here showed human involvement on the part of the taxpayer throughout its process of generating receipts from the electronic bill payment and presentment transactions. The judge additionally explained that even if such receipts had in fact constituted "other business receipts," they must be sourced outside New York, i.e., to the location where the work that generated the income was performed.

Finally, the judge explained that legislation enacted subsequent to the tax periods at issue in this case changed the allocation of service receipts to a customer sourcing approach for Article 9-A state business corporation franchise tax purposes, applicable for tax years beginning on and after January 1, 2015. The judge reasoned that such change would have been unnecessary if the allocation of service receipts was interpreted as the Department had asserted.

4. *S&P Global Inc. f/k/a McGraw-Hill Financial, Inc. v. New York City,* Tax Appeals Tribunal, 2017 NY Slip Op. 01448 (1st Dep't, Feb. 23, 2017).

The Appellate Division affirmed the decision of the New York City Tax Appeals Tribunal, which had held that McGraw-Hill's receipts from its credit rating business were receipts arising from the performance of services and sourced to where the services were performed, rather than "other business receipts," sourced to where the receipts were "earned. The Appellate Division also upheld the Tribunal's conclusion that McGraw-Hill did not have a First Amendment right to source its credit ratings receipts for New York City general corporation tax purposes using an "audience-based" methodology similar to that available to publishers and broadcasters.

McGraw-Hill, through its Standard & Poor's division, operated a credit rating agency to provide ratings, risk evaluations and investment research. Debt issuers hired the division to prepare credit ratings. Upon approval by an S&P ratings committee, the ratings were communicated to the issuer, and then usually made public on the S&P website to registered users free of charge. The debt issuers paid S&P for providing the credit ratings and also paid for follow-up monitoring. For the tax years 2003 through 2007, McGraw-Hill filed general corporation tax returns, and included the credit rating fees in McGraw-Hill's receipts factor as receipts derived from the performance of services. These receipts were sourced based on a place-of-performance methodology. In 2009, McGraw-Hill filed amended its returns, requesting refunds for those years based on sourcing the credit rating receipts to "customer" locations based on the theory the receipts were other business receipts. The Department of Finance disallowed the refund claims on the grounds that the credit rating fees were from the performance of services.

The Chief ALJ held that McGraw-Hill was entitled to a discretionary adjustment to source its credit rating receipts using an audience-based allocation methodology on based on freedom of the press and the First Amendment. The City Tribunal reversed the Chief ALJ's decision, holding that the denial of use of an audience method did not violate the First Amendment rights. The City Tribunal also rejected McGraw-Hill's argument that its credit rating receipts constituted "other business receipts". In reaching the conclusion the Tribunal indicated the company was compensated for its work which involved substantial investigation and analysis. Thus, the receipts were receipts from the performance of services which are sourced based on a place-of-performance method.

The Appellate Division affirmed the Tribunal's decision holding the terms of S&P's agreements "make it clear that petitioner is being paid for a service, namely, 'analytic review and issuance of a rating.'" In further support for the conclusion the court noted that, even where a rating was not issued, the issuer compensated S&P based on the time, effort and charges incurred. The Appellate Division also held that the allocation of the receipts in question did not violate the First Amendment. Finally, the Appellate Division also distinguished *McGraw-Hill, Inc. v. State Tax Commission*, 75 N.Y.2d 852 (1990), which held that the State of New York could not source McGraw-Hill's revenues from advertisements in its periodicals based on place of performance, because this represented differential treatment between the print media and the broadcast media, in violation of the First Amendment.

5. 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.

6. *FTB Notice 2017-02*. March 29, 2017

The California Franchise Tax Board (FTB) issued Notice 2017-02, providing relief from late payment penalties imposed as a result of an underpayment of tax due to complying with the new amendments to California Code of Regulations, Title 18, Section 25136-2, that were finalized on September 15, 2016 and came into effect on January 1, 2017. The regulations address the assignment of sales of services and sales of intangible property. These regulations must be applied to taxable years beginning on or after January 1, 2015. The FTB notice explains that because these new regulatory amendments apply to taxable years beginning on or after January 1, 2015, but became final on September 15, 2016 the FTB will presume reasonable cause and not willful neglect in the case of a late payment attributable to the new amendments and waive the associated penalty. The relief under this notice is limited to only late payment penalties under Revenue and Taxation Code Section 19132, imposed with respect to tax liabilities shown on timely filed returns for taxable years beginning on or after January 1, 2015 and before January 1, 2016. The FTB will consider both prepayment requests for relief as well as claims for refund of amounts paid in satisfaction of the penalty. This FTB notice also sets forth the procedure that must be followed in order to request relief from the late payment penalty.

7. 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) *Rent-A-Center West, Inc. v. South Carolina Department of Revenue*, South Carolina S. Ct. of Appeals, No. 5447, October 26, 2016.

The Appellate Court reversed the Administrative law Court's finding that the standard statutory apportionment formula did not fairly represent the business activities of Rent-A-Center West. ("RAC West")

Rent-A-Center is a rent to own business that provides consumer good for rent. Rent-A-Center East (RAC East") owns and operates retail stores in South Carolina RAC West is a RAC East subsidiary that operates retail stores in the western states and owned and licenses the Rent-A-Center tradenames and trademarks. RAC West filed its South Carolina returns using the three factor apportionment formula. On audit the Department of Revenue took the position RAC West's only income was royalty income and applied an alternative formula. The Department took the position the three factor formula did not represent RAC West's South Carolina business activity. RAC West amended its returns to use a single factor formula under the gross receipts method.

In reversing the lower court, the court noted that the apportionment formula must reasonably represent the proportion of the trade or business carried on in the state. A two part analysis is required to determine if there should be a deviation from the statutory formula. The party arguing for an alternative apportionment formula must show the statutory formula did not represent the business activity in South Carolina and the alternative formula is reasonable. The Department failed to present evidence to establish the standard formula did not reasonably reflect RAC West's South Carolina business activity. The court rejected the Department's argument that only royalty income should be included in the computation of the factor finding that RAC West's business activities were unitary in nature. The court did not address whether the alternative method was reasonable because the threshold issues was not met.

c) *Vodafone Americas Holdings, Inc. & Subs. v. Richard Roberts, Commissioner of Revenue*, TN S.Ct. No. M2013-00947-SC-R11-CV, March 23, 2016.

The Supreme Court affirmed the Appellate Court holding that the Commissioner did not abuse his authority by requiring Vodafone to use a market based sourcing methodology to apportion its income.

In reaching its conclusion the court determined that the legislature intended to give the Commissioner the authority to impose a variance when the application of the statutory formula did not accurately reflect the business activity in the state. In support of its conclusion the court indicated that if the statutory formula had been applied "billions" of dollars of revenue earned in from Tennessee customers would not be taxed. It is exactly this type of a situation that supports the conclusion that the statutory formula does not accurately represent Vodafone's business activity in the state and a variance is required. The court recognized that not apportionment method is perfect but the method purposed by the Commissioner in the variance was a reasonable method as it produced a rough approximation of the income reasonably related to Vodafone's Tennessee activities.

The court rejected Vodafone's argument that the regulation interpreting the statute limits the Commissioner's authority to situations when unusual facts or circumstances produce incongruous results which are not present in this case. Rather, the court stated that the regulations are based on a set of model MTC regulations and the court will give deference to the Department's interpretations of its rules taking into consideration the intent of the legislature.

d) *Indiana Department of Revenue v. Rent-A-Center East, Inc.,* Indiana Tax Court Dkt. No. 49T10-0612-TA-00106, September 10, 2015. Petition for Review denied, March 2, 2016.

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) *Columbia Sportswear USA Corporation v. Indiana Department of Revenue*, Indiana Tax Court Dkt. No. 49T10-1104-TA-00032 (December 18, 2015)

The Indiana Tax Court granted Summary Judgement for Columbia Sportswear holding the Department's adjustments to Columbia Sportswear's taxable income were not proper under either the alternative apportionment statute or the statutory section that requires taxpayers to clearly reflect income.

Columbia Sportswear was formed in 2003 to sell the products for its parent Columbia Sportswear Company and its affiliate Mountain Hardware. The company had an independent transfer pricing study to determine the arm's length pricing for the products being sold. The company filed its Indiana returns on a separate company basis. On audit the Department adjusted the company's income arguing the intercompany transactions distorted the income sourced to Indiana. Thus, pursuant to the alternative apportionment section of the statute the income was increased. Cross Motions for Summary Judgments were filed.

The Tax Court rejected the Department's argument that it has the authority to adjust the company's income that would be apportioned to Indiana by utilizing the income and expense figures of the entire consolidated group because the method merely allocated back the sales that Columbia Sportswear had allocated outside of the state. The adjustment was made pursuant to the alternative apportionment section of the Indiana Code. However, the Department in adjusting the income failed to adjust the apportionment factors to be applied against the revised income. The Tax Court pointed out statutory section (6-3-2-2(l)) relied on by the Department deals only with the fairness of the allocation of income not with the determination of the tax base. Accordingly, the allocation and apportionment sections of the Code are distinct from the provisions that determine the Indiana tax base. The use of reasonable apportionment methods does not authorize adjustments to the tax base. Therefore, the Department was entitled to summary judgment on this issue.

The Tax Court also rejected the Department's argument that the adjustments were authorized under section 6-3-2-2(m) which allows the Department to reallocate income between related parties. The evidence presented did not show that the income sourced to Indiana was not fairly related to the business activity in the state. Finally, the adjustments were unreasonable specifically because the adjustments attributed over 99% of the consolidated group's gross income to one entity without any apportionment adjustments.

f) *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.

g) 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.

h) *Cannon Financial Services, Inc. v. Director, Division of Taxation*. N.J. Tax Ct. Dkt. 000404-2014, October 13, 2016.

The Tax Court sent the matter back to the Division of Taxation to determine an appropriate method to apportion the company's lease income. In doing so the Tax Court rejected the use of the standard three factor formula.

Cannon Financial Service is a commercial financial service company that was headquartered in New Jersey. The company provided lease financing to its parent company Cannon U.S.A., under the terms of the lease. The taxpayer owned the equipment but the lessee had the possession of the equipment. In addition, when the company needed funds to run its business it received loans from its parent. In return the company paid interest on the loans. All of the business and lease finance transaction took place in New Jersey. For purposes of the corporate income tax return the company apportioned its income using the standard ethics factor formula and deducted the interest expense. On audit the Direct allocated 100% of the income to New Jersey and denied the interest income.

The Tax Court addressed the use of an alternative apportionment method stating the Director has the discretion to use a formula that will accurately reflect the taxpayers business activity in New Jersey. However, the Tax Court rejected the use of 100% formula with a credit for taxes paid to other states because such a formula resulted in taxes ranging from 221% to 310% of taxes paid under the three factor formula. Thus, this did not result in fair apportionment but the Director has demonstrated that the standard three factor formula did not produce a fair result. Thus, the matter was remanded for further justification of an alternative apportionment method.

8. The Multistate Tax Compact

a) *Gillette Company & Subsidiaries v. Franchise Tax Board*, California, Supreme Court, Dkt. No. 206587, December 31, 2015. Petition for Certiorari Denied.

The California Supreme Court reversed the holding of the Appellate Court concluding the Multistate Tax Compact constitutes a state law and is not a binding reciprocal agreement among its members. The court held that Legislature had the authority to unilaterally eliminate the compact election. It was the legislative intent to supersede the elective apportionment formula when they adopted a mandatory double weighed sale formula

> **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.

> **Note:** The FTB issued Notice 2016-01 to explain how to handle cases involving the compact election prior to the conclusion of the litigation. Specifically, the FTB will take no action on pending matters until the Court either grants or denies certiorari or issues a final opinion.

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. The Michigan Court of Appeals remanded the matter with a directive to pay IBM its refund. The lower Court did not have the authority to ignore the Supreme Court's holding. *International Business Machines v. Department of Treasury*, Ct of Appeals, Dkt No. 32759 (July 21, 2016). Petition for Certiorari Pending.

> **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) *Gillette Commercial Operations North America & Subs., et al. v. Department of Treasurer*, MI Court of Appeals, September 29, 2015. The Court of Appeals upheld the retroactive repeal of the Compact.

d) *Lorilland Tobacco Company v. Department of Treasury*, Michigan Court of Appeals Dkt. No. 313256, November 3, 2015. The Appellate Court originally held the *IBM* decision was dispositive on whether Lorilland could use the three-factor apportionment formula. On remand the court held it was bound by the *Gillette* decision.

e) *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.

f) *Graphic Packaging Corporation v. Comptroller of Public Accounts*, Texas Appellate Court, July 28, 2015. (Appeal pending). 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.

g) *Kimberly Clark Corporation & Subsidiaries v. Commissioner of Revenue*, MN S.Ct. A-15-1322. June 22, 2016 Petition for Certiorari and pending. The Minnesota Supreme Court held the enactment of the MTC Articles III and IV did not create a contractual obligation that the prohibited the repeal of the 3 factor formula. The court found that even if the Compact created a contractual obligation the obligation was invalid because the state is barred from surrendering its authority to amend or repeal tax provisions.

h) *Health Net, Inc. v. Department of Revenue,* OR Tax Court Dkt. TC 5127, September 9, 2015. (Appeal pending). 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. *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 has 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. <u>Statute of Limitations</u>.

1. *In the Matter of Haliburton Energy Services, Inc.*, Alaska Office of Administrative Hearings, OAH 14-1619-Tax, March 16, 2016.

   The Administrative Law Judge granted Haliburton's refunds for the 2000 tax year because there was a properly filed federal form 872 extending the statute. However, the ALJ denied the 2001 refund claim because net operating losses may only be carried back 2 years. Finally, the ALJ held the Department properly compounded the interest due on the deficiencies.

   Haliburton filed two amended returns for the 2000 tax year and amended the 2001 tax return to carry back a net operating loss incurred in 2004. In addition, for various amended returns filed for 2000-2003 Haliburton paid the tax due but did not pay interest on those amounts. The Department concluded the amended returns were barred by the statute of limitations and denied the claims. The ALJ agreed with Haliburton that an extension of the federal statute is an extension of the Alaska statute. Haliburton had timely executed a federal form 872 to extend the statute for the 2000 and 2001 tax years. As a result, the Alaska statute was also extended. Thus, the amended returns were timely and the refunds should be granted unless barred by another statutory provision.

The 2001 refund was a result of the carry back of a 2004 net operating loss. The statute provided for a 2 year carry back period. Haliburton acknowledged that it had carried the loss back in error but argued because of the significant amount of time that had elapsed the Department is estopped from now taking the position that the claim was barred by the statute. The ALJ rejected Haliburton's argument concluding the Department never asserted a position regarding the carry back and the error was Haliburton's alone. Finally, the ALJ concluded compounded interest is proper as it is specifically provided for in the statute.

2. *In the Matter Plasmanet, Inc.* New York City Tax Appeal Tribunal, TAT€12-17 (GC), January 20, 2017.

The New York City Tax Tribunal has held that the same source rule must be applied in computing net operating losses. Thus, the net operating loss deduction for New York City is limited to the losses arising in the same year as the losses claimed on the federal returns. The losses must be same as those reported on the federal returns. In reaching its conclusion, the Tax Tribunal did agree with the taxpayer that New York City should have allowed the use of the charitable contributions to offset its income for the years in issue. In so doing. The Tax Tribunal rejected the City's argument that because the company had failed to claim it on its original returns it was barred by the statute of limitations.

B. 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.

C. <u>Texas Margin Tax</u>.

1. *Glen Hager Comptroller of Public Accounts et.al. v. CGG Veritas Services (US), ING.*, No. 03-14---713-CV, TX App. Ct. (March 9, 2016).

The Texas Appellate Court affirmed the Travis County Circuit Court holding that the seismic data company was entitled to a cost of goods sold deduction on costs related to the repair or construction of oil wells as there was no showing that these services were not integral to the drilling process.

CGG is an integrated seismic company whose clients are companies that explore for and produce oil and gas. The company provides seismic data for its clients and processing that data to generate images of the subsurface of the earth. These images assist in drilling and production both on shore and offshore. CGG in computing its 2008 Margin tax liability took a deduction for costs of goods sold. On audit the Comptroller denied the deduction and characterized the company as a service provider who was not entitled to a COGs deduction. The issue relates to whether CGG furnishes labor and materials for the construction of oil and gas wells or merely provides services to companies engaged in the exploration of oil and gas. The analysis is whether a particular activity is essential to and direct component of the construction. Based on the facts in the record the court concluded the seismic services were essential and a component of the construction projects. Thus the costs could be deducted as COGS.

D. Transfer Pricing.

1. *District of Columbia Office of Tax & Revenue v. ExxonMobil Oil Corporation et.al.*, Court of Appeals Dkt. Nos. 14-AA-1401; 14-AA-1403 and 14-AA-1404, June 30, 2016.

The DC Court of Appeals vacated the Orders of the DC Office of Administrative Hearings (OAH) that granted summary judgment to Exxon Mobil, Shell Oil and Hess Corp. in the transfer pricing litigation. In vacating the Orders, the court concluded that OAH abused its discretion in applying the concept of offensive non-mutual collateral estoppel against the Office of tax & Revenue.

In question was whether the concept of offensive non-mutual collateral estoppel could be applied to the District to keep the Department from re-litigating the use of the Chainbridge transfer pricing methods. OAH had held that the doctrine applied because the Department had previously litigated the use of the method in *Microsoft* and OAH found the method to be arbitrary and unreasonable.

The court in determining that OAH abused its discretion first concluded that estoppel against the government is not favored and should only be invoked in rare and unusual circumstances particularly if the application impacts the public fisc. OAH did not address the questions as to whether this matte involved unusual circumstances. *See:* March 15, 2017 OAH Order entered in this matter conducting that it was not appropriate to apply collateral estoppel.

E. Federal Audit Adjustment.

1. *General Foods Credit Investors #3 Corporation v. Director Division of Taxation,* N.J. Tax Court Dkt. No. 011330-2015 (February 22, 2017)

At issue was whether certain sale-leaseback assets belonged in the taxpayer's property factor for corporation business tax purposes. In reaching its conclusion the Tax Court allowed the taxpayer to adjust its apportionment factor for years that were closed under New Jersey's four-year statute of limitations but were open for purposes of reporting federal adjustments.

New Jersey's statute requires a taxpayer to report any changes in federal taxable income made by the Internal Revenue Service. If the federal change results in a decrease to the taxpayer's New Jersey corporation business tax, the taxpayer has an additional four years from the date of the change to request a refund. Under the Division's policy, this additional limitations period applied only to reporting the New Jersey tax effect of changing the federal tax base. If the federal change occurred more than four years after the taxpayer filed its original return, the Division prohibited a taxpayer from making any reduction to its apportionment factor resulting from the federal change.

The Tax Court adjusted the taxpayer's factors despite the Division's policy. The Division had increased the taxpayer's entire net income based on the results of a federal audit. For federal tax purposes the taxpayer was deemed not to be the owner of certain sale-leaseback assets. The Division had applied the New Jersey apportionment factor that the taxpayer had reported on its original CBT returns to the taxpayer's increased net income. The Tax Court held that this was improper, and ordered the Division to adjust the taxpayer's apportionment factor to reflect the results of the federal audit. In other words, to the extent that General Foods was considered not to be the owner of certain assets for purposes of computing the tax base, the Tax Court ruled that General Foods was not the owner of those assets for apportionment purposes either.