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National Update
The Year in Review

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I. NEXUS ISSUES

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

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

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

2. *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.

3. *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.

II. UNITARY ANALYSIS

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

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

The first issue addressed by the SBE was whether Comcast was unitary with QVC. Comcast owned a 57.5% interest and Comcast officers sat on the QVC Board and were officers of the Company. QVC was managed by the officers who were in place prior to the Comcast acquisition. Comcast argued the relationship did not meet the three unities test nor did it meet the contribution and depending test. The SBE concluded these were alternative tests and the failure to meet one is not conclusion that a unitary relationship does not exist. The Board members who voted against Comcast relied on the flow of value between the companies, citing the ability to pay the executives with options and overlapping board members. Thus, the view of the majority was the contribution and dependency tests were met. The Superior Court reversed this conclusion.

With respect to the termination fee, the Board adopted the FTB's position that it was apportionable business income. In support of its position, the FTB argued that Comcast has built the business through acquisition and, in fact, the termination fee was nothing more than lost profits from the business. Thus, the transactional test was met. Further the merger agreement was relevant property that was integral to Comcast's business. Therefore, the functional test was met. In reaching this conclusion, the SBE rejected Comcast's argument that the termination fee was a "once-in-a-lifetime" transaction and as such, did not meet the transactional or functional tests. The court agreed with the SBE that the fee was apportionable income.

2. *AIG Insurance Management Services, Inc. v. Vermont Department of Taxes*, Vermont Supreme Court Dkt. No. 2014-312, December 2015.

The Vermont Supreme Court affirmed the superior court holding that AIG, an *insurance* company, did not have unitary operations with its wholly-owned subsidiary a Mount Mansfield, a ski resort.

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

The Supreme Court in analyzing the unitary concept stated that a unitary business must have unity of ownership, operation and use or an interdependence in their functions. Applying these concepts to AIG and Mount Mansfield the Supreme Court concluded the relationship did not exist. The two entities were in different lines of business and thus did not have the opportunity for centralized functions that would provide economies of scale. Second, there was no centralized management despite the fact that AIG appointed the board. Specifically, there were no common operating departments such as purchasing, advertising or marketing. Finally, the Supreme Court concluded there was no functional integration because they operated in entirely different lines of business. Further the funding by AIG only served as an investment and was not an operational function.

3. *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.

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

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

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

In reaching its conclusion, the Tribunal identified evidence of a unitary relationship including the fact that the entities were engaged in similar and related lines of business. The businesses provided complimentary and cross selling opportunities. There was also centralized management through the parent's cash management system. The interest free component of that system created a flow of value between the entities. In addition, flow of value was also established by various non-arm's length transactions. Significantly, services were provided without charge and the affiliates guaranteed the leverage buyout debt. The sole entities excluded were various holding companies because there was no evidence of their function or role. Thus, there was no showing of flow of value.

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

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

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

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

SunGard for the tax years 2005 through 2009 filed separate corporate income tax returns. Each of the affiliates doing business in Minnesota also filed returns on a separate company basis. On audit, SunGard completed a unitary questionnaire indicating there were common officers, common chart of accounts and financial information. In addition, there were common benefit plans and a sharing of administrative services for which a management fee was charged. The company filed on a unity basis in 11 other states. There was also a question raised as whether during the course of the audit the company verbally agreed to the unitary finding. Finally, the Department adjusted the net operating loss for 2005 and 2006 even though the years were closed under the statute.

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

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

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

8. *Labelle Management, Inc. v. Michigan Department of Revenue*, Michigan Court of Appeals No. 324062 (March 31, 2016).

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.

9. *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.

10. *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.

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.

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

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

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

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

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

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

5. *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.

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

   The New Jersey Tax Court held that the Division of Taxation ("Division") properly required a foreign corporation to file corporation business tax ("CBT") returns reporting licensing revenue from its parent attributable to New Jersey, based on New Jersey's economic nexus standard, despite the parent's royalty expense addback in computing its CBT liability. The licensing subsidiary filed CBT returns before New Jersey's enactment of the addback provision; once the parent corporation became obligated to add back the royalty expenses to its income, the licensing subsidiary ceased filing CBT returns, asserting that the parent's royalty expense addback captured the income. In rejecting the subsidiary's position, the court explained that the subsidiary was taxable under New Jersey's CBT under the economic nexus standard. Further, that provision and the royalty addback provision do not operate in the alternative, as neither provision contains a cross-reference to or an exception with respect to the other provision. The court also rejected the argument that requiring the subsidiary to file a return when the parent had already added back the royalty payments it made to the subsidiary would result in unconstitutional double taxation. The court explained that statutory and regulatory mechanisms existed to eliminate the possibility of double taxation, including the payor's ability to assert relief under the unreasonableness exception to the addback statute and the Division's "subject to tax" exception, as well as the payee's ability to request discretionary relief from the Division. Failing to take advantage of any of the relief mechanisms made the subsidiary's claim of unconstitutional double taxation "questionable." The court, nevertheless, left open the possibility for Section 8 relief once the subsidiary filed returns and emphasized that the Division must ensure that it taxes such income only once.

7. *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.

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. 4^{th} 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.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

The court concluded that the right to replicate and install software was an intangible property right. In reaching that conclusion, the court relied on previous court decisions interpreting the application of the California sales and use tax statute to technology transfer agreements in which the court found the agreements to be intangible property not subject to sales tax.

While recognizing that the sales tax decisions were not controlling, the court found them relevant as there was no justification for treating the license as intangible property for purposes of the sales tax and tangible property in the context of the income tax. Further, the FTB itself advocated a contrary position before the State Board of Equalization in *Appeal of Adobe Systems, Inc.* Finally, the court also relied on the definition of intangible property found in IRC §936(h)(3)(B) as support for its conclusion.

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

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

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

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

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

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

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

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

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

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

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

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

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

The company is in the business of managing and collecting charge–off commercial and customer accounts purchased from financial leasing companies and other parties who issue credit. The Department in characterizing them as a service provider determined its business activities are akin to a service provider even though it does not generate income by selling the service to a third party. The Department rejected the argument that the company was a financial institution. The income is generated by the performances of the debtor to pay its obligations. Finally, the Department agreed that the company could use the current costs to determine prior year's apportionment under the cost of performance method.

4. Market-Based Sourcing

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

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

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

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

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

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

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

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

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

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

5. Alternative Apportionment

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

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

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

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

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

b) *Vodafone Americas 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.

c) *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.

d) *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 [ricing 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.

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

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

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

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

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

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

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

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

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

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

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

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

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

6. The Multistate Tax Compact

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

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

> **<u>Note</u>:** 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.

> **<u>Note</u>:** 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)

> **<u>Note</u>**: 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. 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. Statute of Limitations.

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.

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. Texas Margin Tax.

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.

VIII. SALES/USE TAX

1. *Office Depot, Inc. v. Dir. of Revenue*, Mo.S.Ct. No. SC95029 (Mo. April 5, 2016)

Office Depot was headquartered in Florida but operated retail stores in Missouri and promoted and advertised to Missouri by mailing unsolicited product catalogs. Although Office Depot purchased the paper for the catalogs from outside Missouri, they were printed by a third-party present in Illinois and Indiana. Once the catalogs were printed, they were shipped to post offices outside Missouri. As a result, when the materials first entered Missouri to be delivered to Office Depot's customers, they were in the hands of the United States Postal Service.

The Missouri Supreme Court considered whether Office Depot "used" the materials in Missouri and is therefore liable for the use tax. "Use" is defined by

Missouri statute as "the exercise of any right or power over tangible personal property incident to the ownership or control of that property." As a result, the court analyzed whether Office Depot exercised a right or privilege of ownership or control over the catalogs at the time they entered Missouri in the United States mail.

The court previously determined in May Dep't Stores Co. v. Dir. Of Revenue 748 S.W.2d 174, 175 (Mo. banc 1988), that a third-party printer placing catalogs in the mail in another state for delivery to Missouri residents is not "use" of the product in Missouri. The court in May Dep't Stores Co. held that by simply giving directions that are executed outside the state of Missouri, May is not using the catalogs in Missouri. Similarly, Office Depot did not have possession of the catalogs in Missouri as the last time Office Depot exercised control was when the catalogs were printed and delivered to the post offices in Illinois and Indiana. Further, this case contrasts with Southwestern Bell Yellow Pages, Inc. v. Dir. Of Revenue, 94 S.W.3d 388 (Mo. Banc 2002), where Southwestern Bell arranged for the printer to ship the directories to an independent contractor in Missouri who was employed by and under the direction of Southwestern Bell. Unlike Southwestern Bell, the catalogs are never in the possession of Office Depot or its agents in Missouri.

As a result, the Missouri Supreme Court determined that mailing a product from another state into Missouri is not the exercise of right or power or control over the property in Missouri, which the use tax statute requires.

2. *American Catalog Mailers Association and NetChoice v. Gerlach* (6^{th} Circuit, S.D.) (April 29, 2016).

In May 2016, two declaratory judgment suits were filed in the Sixth Judicial Circuit Court of South Dakota regarding the constitutionality of Senate Bill 106. South Dakota Senate Bill 106, signed into law on March 22, 2016, requires that beginning May 1, 2016 any person making more than $100,000 of South Dakota sales or more than 200 separate South Dakota sales transactions collect and remit sales tax. The law was an attempt by the legislature to challenge the physical presence requirement under Quill.

In NetChoice v. Gerlach, an ACMA suit, the complaint seeks an order declaring that Senate Bill 106 is unconstitutional because it violates the Commerce Clause under Quill and the Due Process Clause. The state has also filed a suit arguing that South Dakota has personal jurisdiction over the defendants under the state's long arm statutes. Further, the complaint addresses the Circuit Court's subject matter jurisdiction by stating the State cannot enforce the Act's collection obligation against the defendants unless the State prevails in this suit. However, if the State prevails, the Act will immediately apply to the defendants, requiring them to collect and remit sales tax on a go-forward basis.

Still at issue is when the obligation for sellers to collect the sales tax will kick in. South Dakota argues within its complaint that a seller's obligation to collect will commence as soon as a judgment in this case is handed down.

3. *Scholastic Book Clubs, Inc. v. State of Alabama Department of Revenue*, Dkt. No. 14-374 (Ala. Tax. Trib. Mar. 25, 2016)

The Alabma Department of Revenue imposed the Alabama use tax upon the Taxpayer that is headquartered in Missouri but sells books and other educational materials in Alabama by mailing catalogs, order forms, and coupons to schools and to households in which children are homeschooled. The Alabama Tax Tribunal considered two issues: (1) Was the Taxpayer required to collect, report and remit Alabama use tax? (2) Is the Department bared from assessing the Taxpayer by the Due Process Clause of the Fourteenth Amendment or the Commerce Clause?

Under the first issue, the Taxpayer argued it is not subject to use tax, because it does not engage in any of the activities specified in the nine subparagraphs in Ala. Code § 40-23-68. However, the Tribunal disagreed and held that the catchall paragraph (b)(9) controls, requiring a seller to report and pay Alabama use tax if it "[m]aintains any other contact with this state that would allow this state to require the seller to collect and remit the tax due under the provisions of the Constitution and laws of the United States."

Further, under the second issue the Tribunal determined the presence and activities of the teachers on behalf of or that benefit the Taxpayer thus established a physical presence for the Taxpayer in Alabama sufficient to establish Commerce Clause nexus under existing U.S. Supreme Court guidelines. Pursuant to Quill, the Taxpayer has Due Process nexus because it "purposely directs its activities towards the residents of the state and avails itself of the economic benefits of the state" by making over $17 million in the sales period.

The issue of whether the Taxpayer had Commerce Clause nexus is a much more difficult question, however. Quill held that for Commerce Clause purposes, an out-of-state vendor only has nexus if the vendor has a physical presence in the state. Therefore, the issue is whether the teachers' activities in Alabama relating to the sale of the books established a physical presence to satisfy Quill. Whereas MI, AR, and OH held the teachers' activities on behalf of the out-of-state retailer were not sufficient to create nexus, CT, CA, KS, and KS have found nexus. The Alabama Tribunal held with the CT, CA, KS, KS courts that the Taxpayer's activities were clearly and significantly associated with the Taxpayer's ability to establish and maintain a market in the state. The Tribunal noted that the teachers' motivations are not controlling but rather the effect of their participation in fostering the out-of-state retailers' goal of selling its products. Here, the teachers were implied agents of the Taxpayer, which creates nexus for Commerce Clause purposes. Therefore, the Taxpayer is subject to Alabama use tax.

4. *Rent-A-Center West, Inc. v. Utah State Tax Comm'n*, 2016 UT 1, P6 (Utah 2016)

The Utah State Tax Commission conducted an audit of Rent-A-Center and declared its optional liability waiver fee subject to Utah sales and use tax on the basis that (1) Utah Code section 59-12-103(1)(k) taxes "amounts paid or charged for leases or rentals of tangible personal property," and (2) the liability waiver "fee is part of the total rental 'purchase price' and 'sales price'."

When customers lease property from Rent-A-Center, they receive the option of participating in an optional liability waiver program which includes an extra fee of 7.5 percent of the rental payment each pay period. In return, the customer is not required to reimburse Rent-A-Center for any loss if the product is damaged or destroyed due to several causes, including lightning, fire, smoke, theft, or flood. The Utah Tax Code imposes sales tax on "amounts paid or charged for leases or rentals of tangible personal property if within this state the tangible personal property is: (i) stored; (ii) used; (iii) otherwise consumed. The Commission argued Utah unambiguously requires taxation of Rent-A-Center's liability waiver fee because the fee is charged "in conjunction with the rental of tangible personal property."

The Utah Supreme Court considered whether the liability waiver fee is an amount "paid for" the lease or rental of tangible personal property. The Utah Supreme Court decided it is not, because the liability waiver fee does not affect the possession, use, or operation of the rental property. The Oxford English Dictionary defines "pay for" as giving "money or other equivalent for goods or services." The Commission focused on the fact that the liability waiver fee does not entitle the customer to repairs or replacement items but instead secures Rent-A-Center's promise to waive any claims against the customer if damage occurs. Further, the Commission's implementation of 103(1)(k) impermissibly broadens the scope of the statute. The regulation requires a lessor to "compute sales or use tax on all amounts received or charged in connection with a lease or rental of tangible personal property," whereas the statute requires the collection of sales tax on "amounts paid or charged for leases or rentals of tangible personal property," As a result, the Utah Supreme Court determined Rent-A-Center's waiver liability fee is not subject to Utah sales or use tax because it does not affect the use, possession, or operation of tangible personal property under the statute.

5. *Wis. Dep't of Revenue v. Orbitz, L.L.C.*, 2016 WI App. 22, P1 (Wis. Ct. App. 2016)

The Wisconsin Court of Appeals considered whether Orbitz's facilitation fees are subject to tax under Wisconsin Stat. 77.52(1)(a)1. Orbitz is an online company that contracts with hotels which are not owned, operated or managed by Orbitz, for the right to facilitate reservations for, and in the name of, travelers at net rates that are determined by the hotels. Orbitz does not pay hotels for rooms in advance nor do the hotels set aside certain rooms exclusively for Orbitz. Rather, Orbitz accesses the inventory databases of the hotels, checks availability, and makes a reservation request to the desired hotel in the traveler's name if a room is available for booking. The cost charged to the customer consists of two components: (1) average price per night, which is the "net rate" the hotel will receive plus a markup amount which will be retained by Orbitz; and (2) "taxes and fees" which include a tax recovery charge and any service fees. When the customer checks into the room, the hotel collects payment from Orbitz for the hotel's net rate, the taxes due on the net rate, and any hotel-imposed fees. Orbitz retains the markup amount.

During the period at issue, retail sales tax was not collected from travelers or remitted on the markup amount. The Department asserted Orbitz is an "internet lodging provider" and as such the markup retained is subject to taxation under Wis. Stat. 77.52. The statute provides that tax is imposed on "the furnishing of rooms or lodging to transients by hotelkeepers, motel operators and other persons furnishing accommodations that are available to public." However, the Commission disagreed with the Department based on a few determinations. First, the Commission determined Orbitz did not furnish rooms or lodging within the meaning of the statute or in any "traditional sense of the word". Also, the Commission concluded Orbitz lacks the essential functions and characteristics of a business which provides lodging accommodations, because it does not own hotels, check people in, clean the rooms, or provide access to the rooms. Also, the taxing statute is ambiguous as to whether "furnishing" includes arranging for or facilitating reservations, so the ambiguity must be resolved in favor of the taxpayer. Lastly, the statute does not impose a sales tax on those selling the service of making reservations on behalf of members of the public.

The Wisconsin Court of Appeals confirmed the Commission's conclusions, thereby concluding Orbitz's reservation facilitation services are not subject to sales and use tax under Wis. Stat. 77.52(1)(a)1.