David Fruchtman Responds to Bucks's Article on Corporate Income Shifting

INSIGHT  David A. Fruchtman · April 03, 2014

In a letter to the editor published in State Tax Notes on March 31, 2014, David Fruchtman of Rimon P.C. responds to an article written by the former executive Director of the Multistate Tax Commission and former Montana Director of Revenue, who attacked tax planning generally and income shifting in particular. Mr. Fruchtman cautions that tax administrators should avoid a war-like relationship with taxpayers.

To the Editor:

In 2011 I wrote an article **"Nonlitigated Resolutions of Multistate Tax Disputes: Three Case Studies Show How Taxpayers, States Can Find Common Ground" (BNA Daily Tax Reports, Mar. 3, 2011)**. The thrust of the article is that there is too much tax litigation, and that in some cases unnecessary litigation arises from a lack of respect for the party sitting across the table. I counseled that:

> Both in-house tax professionals and outside tax advisers are paid to be advocates and are expected always to have the business's best interest in mind. But that best interest might require abandoning attempts to reach the lowest "dollars and cents" resolution on the discrete issue at

> hand and instead working with state personnel to find the best solution for both sides. This requires the attorney to consider the state's interest as well as his client's interest. The good news here is that many senior personnel within the state revenue departments are prepared to take the same approach to building bridges.

Unfortunately, that bridge building approach is not as widely held as it should be, as demonstrated by Dan Bucks's article **"Corporate Income Shifting: State Tax Evasion or Worse?" (State Tax Notes, Mar. 24, 2014, p. 701)** in which tax planners "sputter" and corporations that structure their affairs "evade" income taxes, commit "theft" of services, stuff money "inside (their) pantyhose" (huh?), and behave immorally.

As Bucks's first paragraph makes clear, his piece targets some state tax administrators -- specifically, those officials who do not treat corporate tax planning as tax evasion. In that regard, the disrespectful tone and language in Bucks's article serves no one's purpose. Nor will anyone be benefited by the disproportionately adversarial posture Bucks recommends.

Thus, the target for my response is broader than was Bucks's. Every state government should encourage its tax administrators to avoid a war-like relationship with taxpayers. Businesses rightfully structure their affairs to reduce their state tax liabilities, and state tax administrators rightfully challenge some of those tax planning arrangements. Sometimes we disagree. But when tax administrators view tax structuring through a prism of immorality, they are certain to distort their vision and their judgement.

As Judge Learned Hand wrote almost 70 years ago: "Over and over again courts have said that there is nothing sinister in so arranging one's affairs as to keep taxes as low as possible. Everybody does, rich or poor; and all do right, for nobody owes any public duty to pay more than law demands: taxes are enforced exactions, not voluntary contributions. To demand more in the name of morals is mere cant." Dissenting in *Commissioner v. Newman*, 159 F2d 848 (1947).

TAGS

tax, **tax law**, **state and local tax**

Constitutional and Other Jurisdictional Constraints On State and Local Taxation

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New York University
July 2011

<u>Constitutional and Other Jurisdictional Constraints On State and Local Taxation</u>

New York University
School of Continuing and Professional Studies
2011 Summer Institute in Taxation
Introduction to State and Local Taxation

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New York University
School of Continuing and Professional Studies
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Introduction to State and Local Taxation

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The United States' system of government is a federalism with federal, state and local governments sharing certain responsibilities and authorities and allocation others. Powers not delegated to the federal government under the U.S. Constitution are reserved for the states. Laws enacted by the various levels of government are not of equal weight. The U.S. Constitution prevails over both federal laws and treaties, as well as other state and local laws; and federal laws prevail over state and local laws. To the extent state tax laws do not conflict with the federal constitution and laws, the taxing rules of the state are supreme within the boundaries of the state's taxing jurisdiction. A state's constitution may impose restrictions on the state government's taxing power. This outline address the state and federal limitations on state taxation.

Part I: Federal Constitutional Limitations

"The powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people." U.S. Const. amend. X.

I. Due Process Clause

"[Nor] shall any state deprive any person of life, liberty, or property, without due process of law …." U.S. Const., amend. XIV, §1.

A. Fundamental Principles

1. Exxon Corp. v. Wisconsin Dep't of Rev., 447 U.S. 207, 219-220 (1980). According to the U.S. Supreme Court's decision in Exxon Corp. v. Wisconsin Dep't of Rev., 447 U.S. 207, 219-220 (1980):

> "The Due Process Clause of the Fourteenth Amendment imposes two requirements for such state taxation: a 'minimal connection' or

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'nexus' between the interstate activities and the taxing State, and 'a rational relationship between the income attributed to the State and the intrastate values of the enterprise.'" (Citing Mobil Oil Corp. v. Commissioner of Taxes of Vermont, 445 U.S. 425 (1980)).

2. Wisconsin v. J.C. Penney Co., 311 U.S. 435, 444 (1940). In Wisconsin v. J.C. Penney Co., 311 U.S. 435, 444 (1940), the U.S. Supreme Court stated:

> "That test is whether property was taken without due process of law, or, if paraphrase we must, whether the taxing power exerted by the state bears fiscal relation to protection, opportunities and benefits given by the state. The simple but controlling question is whether the state has given anything for which it can ask return."

B. Nexus Standards

1. Transactional Nexus

a. Allied-Signal Inc. v. Director, Div. of Taxn., 504 U.S. 768 (1992). Petitioner corporation disputed liability of a gain realized on the sale of its stock interest to a New Jersey corporation. The two corporations were unrelated business enterprises, and petitioner's investment was passive rather than an integral operational one. The Supreme Court reversed the inclusion of the gain in petitioner's tax base, finding that in the case of a tax on an activity, there must be a connection to the activity itself, rather than a connection only to the actor the State seeks to tax.

b. Connecticut General Life Insurance Co. v. Johnson, Treasurer of California, 303 U.S. 77 (1938). Appellant insurer claimed that a tax on its receipt in its home state, Connecticut, of reinsurance premiums from insurance companies operating in California on policies reinsuring them against loss on policies they issued in California to California residents violated the due process clause. Apart from the fact that appellant was privileged to do business in California, and that risks reinsured were originally insured against in that state by companies also authorized to do business there, California had no relationship to appellant or the contracts. The Supreme Court reversed the dismissal of appellant insurer's actions to recover state taxes paid under protest, finding a due process violation and that California had no relationship to appellant or to reinsurance contracts.

2. Presence Nexus

a. Bridges v. Autozone, 900 So.2d 784 (March 24, 2005), reh'g denied (May 13, 2005). The Louisiana Supreme Court provided an unusual twist to Due Process case law in Bridges v. Autozone, 900 So.2d 784 (March 24, 2005), reh'g denied (May 13, 2005). In Autozone, all seven of the court's justices held that due process protections did not prevent the state from taxing an out of state entity that owned intangible property arguably used in the state (an interest in an affiliated real estate investment trust). The taxpayer filed a petition for rehearing, which the court declined to hear due to procedural issues. However, the court's Chief Justice filed a concurring opinion arguing strenuously that in the Autozone decision the court misunderstood the issue. He argued that the due process personal jurisdiction issue involved principles distinct from the question of a state's ability to impose an income tax on an out of state business. In his Autozone concurrence, the Chief Justice was not joined by any of his colleagues. However, less than two months later, he was joined by two other justices in voting to accept a case that might have overturned Autozone. That is, three of the state's seven justices apparently are willing to reconsider Autozone's due process holding.

b. Quill Corp. v. North Dakota, 504 U.S. 298 (1992).

(i) The Due Process Clause requires only that a corporation have "minimum contacts" with the taxing state. The intent of the Due Process Clause is to ensure fairness and notice to the corporation that its contacts with the State cause it to be subject to tax.

(ii) The presence in a state necessary to satisfy the Due Process Clause is comparable to that needed to support a state court's jurisdiction over a defendant in a civil matter. As articulated in cases such as Burger King Corp. v. Rudzewicz, 471 U.S. 462 (1985), that standard is met if the entity purposefully directs its activity into a jurisdiction. The Due Process Clause does not require physical presence in the taxing state.

c. Burger King Corp. v. Rudzewicz, 471 U.S. 462 (1985). The civil *in personam* standard is met if the entity purposefully directs its activity into a jurisdiction.

d. World-Wide Volkswagen Corp. v. Woodson, 444 U.S. 286, 298 (1980). A corporation can be sued in a state, under the Due Process Clause, when the corporation "delivers its products into the stream of commerce with the expectation that they will be purchased by consumers in the forum state," because the defendant's conduct and connection with the forum state are such that it should "reasonably anticipate being hauled into court there."

e. Asahi Metal Industry Co. v. Superior Court of California, 480 U.S. 102, 112 (1987). "The placement of a product into the stream of commerce, without more, is not an act of the defendant purposefully directed toward the forum State .... [A] defendant's awareness that the stream of commerce may or will sweep the product into the forum State does not convert the mere act of placing the product into the stream into an act purposefully directed toward the forum State."

f. International Harvester Co. v. Department of Treasury, 322 U.S. 435 (1944). "We think that Wisconsin may constitutionally tax the Wisconsin earnings distributed as dividends to the stockholders. It has afforded protection and benefits to appellants' corporate activities and transactions within the state. These activities have given rise to the dividend income of appellants' stockholders and this income fairly measures the benefits they have derived from these Wisconsin activities."

g. Geoffrey, Inc. v. South Carolina Tax Commission, 313 S.C. 15, 437 S.E.2d 13 (S.C. Sup. Ct. 1993), cert. denied, 510 U.S. 992 (1993). Delaware holding company that licensed its trademarks and trade names for use by its parent corporation, Toys 'R Us, in South Carolina was determined to have sufficient nexus under the Due Process Clause to subject it to the state's corporate income tax and corporate license fee.

h. Associated Electric & Gas Insurance Services, Ltd. v. Clark, 676 A.2d 1357 (R.I. Sup. Ct. 1996).

(i) The taxpayer collected premiums from four natural gas companies located in Rhode Island. The taxpayer had no physical presence in the state and received all insurance contracts directly from the insured by mail. The taxpayer was assessed Rhode Island's gross insurance premiums tax. The taxpayer argued that subjecting it to the tax violated the Due Process Clause of the U.S. Constitution.

(ii) The Rhode Island Supreme Court upheld imposition of the tax. Based on Quill, the court determined that the taxpayer had "purposefully availed" itself of the benefits of an economic market in Rhode Island and, thus, was subject to tax in Rhode Island.

(iii) Town Crier, Inc. v. Dep't of Revenue, 315 Ill. App. 3d 286, 733 N.E. 2d 780 (Ill. App. Ct., 1st Dist. June 30, 2000). An out-of-state retailer, whose only physical contact with Illinois during a 26 month audit period were 30 deliveries into the state using its own vehicles, and installation of window dressings on five occasions, was determined to have nexus. Taxpayer argued it did not "purposefully avail" itself of the Illinois market because it did not actively solicit customers from Illinois and that all contacts with the state were at the request of customers in the state. The Court found that although the taxpayer's contacts did not rise to the level of contacts in the Illinois Supreme Court's decision in Brown's Furniture, Inc. v. Wagner, 171 Ill. 2d 410, 665 N.E. 2d 795 (Ill. Sup. Ct. 1996), the number of deliveries would have satisfied the statutes cited in that decision and the frequency of the taxpayer's presence in Illinois was approximately equal to that of the taxpayer in the New York Court of Appeal's decision in Orvis Co., Inc. v. Tax Appeals Tribunal, 86 N.Y. 2d 165, 654 N.E. 2d 954, 630 N.Y.S. 2d 680 (N.Y. Ct. App. 1995), cert. denied, 516 U.S. 989 (1995).

II. Interstate Commerce Clause

"The Congress shall have the power ... to regulate commerce ... among the several States . . . ." U.S. Const., Art. I, § 8, cl. 2.

A. Fundamental Principles

1. The U.S. Supreme Court has held that the Commerce Clause not only gives the authority to Congress to regulate interstate commerce, but also prohibits the states from enacting laws that discriminate against or interfere with interstate commerce. Gibbons v. Ogden, 9 Wheat. 1 (1894).

2. Complete Auto Transit, Inc. v. Brady, 430 U.S. 274 (1977).

a. The Supreme Court rejected the rule that a state tax on the "privilege of doing business" is *per se* unconstitutional when it is applied to interstate commerce and overruled its earlier decision in Spector Motor Service, Inc. v. O'Connor, 340 U.S. 602 (1951), which had stood for that rule.

b. The Supreme Court articulated a four-part test that must be satisfied for a tax not to violate the interstate Commerce Clause.

(i) The tax must be applied to an activity with a substantial nexus with the taxing state;

(ii) The tax must be fairly apportioned;

(iii) The tax must not discriminate against interstate commerce; and

(iv) The tax must be fairly related to the services provided by the state.

(a) The states frequently argue, and courts have accepted, that the "fairly related" prong is satisfied by a showing that a business benefited from general state services such as police and fire protection, public roads and schooling. However, in a 2004 case a court held that the imposition of a state use tax violated this prong. See American River Transportation Company v. Glen Bower, 813 N.E.2d 1090, 351 Ill. App. 3d 208 (Ill. App. Ct., 2nd Dist. July 21, 2004), in which the Illinois Appellate Court ruled that the imposition of Illinois use tax on a company that operated tugboats on the Mississippi, Illinois and Ohio rivers was unconstitutional. Although the company's boats were on Illinois waters more than 50% of their time, the court concluded that "Illinois provided no services to those tugboats. The waters are all navigable waters of the United States and are maintained by the United States, not Illinois." The court analogized its decision to the treatment of an aircraft flying over Illinois.

B. Presence Nexus

1. Background

a. U.S. Supreme Court

(i) According to the Supreme Court's decision in Quill Corp. v. North Dakota, 504 U.S. 298 (1992):

(a) The Interstate Commerce Clause requires that a corporate taxpayer (or tax collector, in the case of use taxes) have "substantial nexus" with the taxing state;

(b) A corporation "may have the 'minimum contacts' with a taxing State as required by the Due Process Clause, and yet lack the 'substantial nexus' with that State as required by the Commerce Clause";

(c) In the area of use tax collection, a corporation must be physically present in a state for that state constitutionally to impose collection responsibilities upon the corporation. The degree of presence in a state necessary to satisfy the Commerce Clause is uncertain with respect to the imposition of gross receipts, income, and franchise taxes. (See National Geographic Society v. California Board of Equalization, 430 U.S. 551 (1977) and Felt & Tarrant Manufacturing Co. v. Gallagher, 306 U.S. 62 (1939) regarding support for the argument that a greater nexus standard is appropriate when a tax is being imposed, rather than merely a tax collection responsibility.)

(ii) National Geographic Society v. California Board of Equalization, 430 U.S. 551 (1977).

(a) The taxpayer was held to have use tax collection responsibility on its interstate mail order sales of maps because of the physical presence of its advertising sales offices for its magazine division in the taxing state.

(b) The Court held it to be irrelevant that the mail order sales activity being taxed did not have a physical presence in-state where taxpayer had otherwise established physical presence in the state through its magazine publication activity.

(c) The Court noted that an activity only of the "slightest presence" in the state would not be sufficient to establish taxable nexus in the state.

b. The test is substantial nexus, not substantial physical presence.

(i) Orvis Company, Inc. v. Tax Appeals Tribunal, 86 N.Y. 2d 165, 654 N.E. 2d 954, 630 N.Y.S. 2d 680 (N.Y. Ct. App. 1995), cert. denied, 516 U.S. 989 (1995).

(a) "We do not read Quill Corp. v. North Dakota to make a substantial physical presence of an out-of-state vendor in New York a prerequisite to imposing the duty upon the vendor to collect the use tax from its New York clientele." Orvis, 86 N.Y. 2d at 70, 654 N.E. 2d at 956 (1995) (emphasis added).

(ii) "[A]cceptance of the thesis urged by Orvis ... that Quill made the substantial nexus prong of the Complete Auto test an in-State substantial physical presence requirement - would destroy the bright-line rule the Supreme Court in Quill thought it was preserving in declining completely to overrule Bellas Hess.[3] Inevitably, a substantial physical presence test would require a 'case-by-case, evaluation of the actual burden imposed' on the individual vendor involving a weighing of factors such as number of local visits, size of local sales offices, intensity of direct solicitations, etc., rather than the clear-cut line of demarcation the Supreme Court sought to keep intact by its decision in Quill." Orvis, 86 N.Y. 2d at 177, 654 N.E. 2d at 960, 630 N.Y.S. 2d at (emphasis added, citation omitted).

(iii) Department of Revenue v. Share International Inc., 676 So. 2d 1362 (Fla. Sup. Ct. 1996), cert. denied, 519 U.S. 1056 (1997).

(a) The taxpayer manufactured and distributed chiropractic supplies and sold its product through direct mail. For three days every year, the taxpayer's president and vice president were speakers and coordinators at a national seminar in Florida. During the seminar, the taxpayer's products were displayed and sold. The taxpayer collected and remitted sales tax on these sales. The Department of Revenue determined that the taxpayer should be collecting sales tax on all sales, including mail order sales, to Florida.

(b) The Florida Supreme Court determined that the taxpayer did not have substantial nexus with Florida for other sales and, thus, could not be compelled to collect and remit use tax on mail order sales to Florida residents.

(c) Share provides guidance on the issue of the duration of tax presence. In Share, the court did not require the company to collect tax on sales occurring after it quit the state. In contrast, sales tax rule 3.286(b)(2) of the Texas Comptroller of Public Accounts, requires "out-of- state seller who has been engaged in business in Texas continues to be responsible for collection of Texas use tax on sales made into Texas for 12 months after the seller ceases to be engaged in business in Texas."

[3] National Bellas Hess v. Department of Revenue, 356 U.S. 753 (1967).

(iv) General Motors Corp. v. City of Seattle, 25 P.3d 1022 (Wash. Ct. App. 2001). The appellate court determined that two manufacturers and dealers of automobiles, GMC and Chrysler, with independent dealers in Seattle, but no offices there, had nexus for purposes of the city's business and occupation (B & O) tax. The court based its decision on the facts that both GMC and Chrysler directed national advertising to Seattle; sent sales, service, and parts managers there on a regular basis; and employed Seattle dealers to market warranties that serve an important marketing function. The companies' in-city advertising, marketing, sales, service calls, and service of warranties significantly impacted their ability to maintain a market in Seattle, and thereby justified a conclusion of nexus.

(v) In the Matter of Intercard, Inc., 270 Kan. 346, 14 P.3d 1111 (Kan. Sup. Ct. 2000). Eleven installations of card readers did not create nexus because such contacts were isolated and sporadic.

c. State Registration and Substantial Nexus

(i) Arco Building Systems, Inc. v. Chumley, M2004-01872-COA-R3-CV (Court of Appeals of Tennessee June 12, 2006). The taxpayer did not have property or employees in Tennessee but registered with the state so as to be able to issue resale certificates to its Tennessee vendors. Despite issuing resale certificates, the taxpayer argued that it did not have Tennessee tax presence and was not required to collect sales tax. The court rejected the argument, stating that "Whatever the merits of this argument, it is irrelevant here, for Arco did not simply register as a Tennessee dealer and file annual sales tax returns reporting no tax liability. Arco relied on its Tennessee registration to issue blanket certificates of resale" to prevent its vendors from charging Tennessee sales or use taxes.

(ii) Buehner Block Company, Inc. v. Wyoming Department of Revenue, 139 P.3d 1150, 2006 WY 90 (Wyoming Supreme Court July 27, 2006). The taxpayer was a manufacturer in Utah. It made sales to Wyoming customers, with delivery via common carrier. It had no physical presence in Wyoming but held a Wyoming sales and use tax vendor's license. The state Supreme Court held that the taxpayer's voluntary sales tax registration in combination with its delivery of goods by common carrier created substantial nexus for sales and use tax purposes.

(iii) Rylander v. Bandag Licensing Corp., 18 S.W. 3d 296 (Tex. App. Ct. 3d Dist. 2000). Appellee corporation held a certificate of authority to do business in Texas. Appellee licensed intangible property to its parent corporation, and the Comptroller argued that the licensing activity was taxable due to appellee's possession of a certificate of authority to do business. The court held that the mere possession of a license to do business did not create a substantial nexus, and further held that the holding of a passive interest in intangible property was not an "activity" within the meaning of the tax.

(iv) And see In the Matter of New Milford Tractor Co., Inc., New York State Tax Appeals Tribunal (September 1, 1994). Holding that a taxpayer's voluntary registration for sales and use taxes, allowing it to issue resale certificates on goods purchased in New York, did not create substantial nexus.

2. Specific Issues In Defining "Substantial Nexus"

a. Intangible Assets

(i) Geoffrey, Inc. v. South Carolina Tax Commission, 313 S.C. 15, 437 S.E.2d 13 (S.C. Sup. Ct.), cert. denied, 510 U.S. 992 (1993). Delaware holding company that licenses its trademarks and trade names for use by its parent corporation, Toys 'R Us, in South Carolina has sufficient nexus under the Commerce Clause to subject it to the state's corporate income tax and corporate license fee.

(ii) Rylander v. Bandag Licensing Corp., 18 S.W. 3d 296 (Tex. App. Ct., 3rd Dist., 2000). The Texas Court of Appeals rejected the Comptroller" Geoffrey type approach to nexus by holding that the possession of a certificate of authority and receipt of royalties without any physical presence, does not give rise to substantial nexus.

(iii) K-Mart Properties, Inc. v. Tax'n and Revenue Dept., 139 N.M. 172, 131 P.3d 172 (December 29, 2005). The New Mexico Supreme Court let stand a New Mexico Appellate Court decision allowing New Mexico to impose gross receipts tax and corporate income tax on Kmart Properties, Incorporated (KPI), a Michigan affiliate holding trademarks developed by the Kmart Corporation. KPI received royalty income calculated at 1.1 % of gross sales from all Kmart stores, including twenty-two in

New Mexico. For Due Process purposes, the appellate court said that allowing the marks to be used in New Mexico was purposeful availment of the economic market in the state. In its Commerce Clause analysis, the appellate court determined that the Quill physical presence requirement does not apply to the state income tax. In any event, the appellate court determined that a trademark has a "physical presence" where it is put to tangible use, i.e., where the stores are located, and that Kmart employees in New Mexico were essentially representing KPI's interests.

(iv) Acme Royalty Co. v. Director of Revenue, (consolidated with) Gore Enterprise Holdings, Inc. v. Director of Revenue, Nos. SC84225 and SC84226 (Mo. Sup. Ct. Nov. 26, 2002). In a 4-3 decision, the Missouri Supreme Court reversed two Administrative Hearing Commission (AHC) rulings that had adopted the nexus conclusions espoused in Geoffrey, and held that two intangible holding companies, while related to corporations that had nexus with the state, were separate legal entities that did not have property, payroll or sales in Missouri and thus were not subject to the state's corporate income tax. In order for a taxpayer to be liable for Missouri corporate income taxes, the taxpayer must have had some activity in the state. "The basic requirement for there to be Missouri source income is that there is some activity by the *taxpayer* in Missouri that justifies imposing tax. Although corporate activities can be immeasurably diverse, for multi-state income purposes they fall into three succinct categories: property, payroll and sales."

(v) Lanco, Inc. v. Dir., Div. of Taxation, 980 A.2d 176 (N.J. 2006), aff'g, 2005 N.J. Super. LEXIS 268 (N.J. Super. Ct. App. Div., Aug. 24, 2005), rev'g, N.J. Tax Ct., No. 005329-97 (Oct. 23, 2003), cert. denied, 127 S. Ct. 2974 (June 18, 2007).

Lanco is a Delaware corporation that owns and licenses intangible property (trademarks, trade names, and service marks) to its affiliate, Lane Bryant Inc. for use in its New Jersey retail business. Lanco had no officers, employees, or real or tangible personal property in New Jersey.

The New Jersey Tax Court held that New Jersey's corporation business tax ("CBT") does not apply to an out-of-state corporation that does not have a physical presence in the New Jersey but that has New Jersey-source income from a licensing agreement with a New Jersey retail business.

The New Jersey Tax Court determined that the Commerce Clause requires substantial nexus, which is not satisfied unless the business has a physical presence in the state. Citing *Quill Corp. v. North Dakota* (1992) and reviewing cases in other states that addressed the issue, the court determined that the difference between use tax liabilities and income tax liabilities are not significant enough to justify a different rule for physical presence and that U.S. Supreme Court decisions decided before *Quill* strongly suggested that physical presence was a necessary element of nexus for taxing income.

Reversing the decision of the New Jersey Tax Court, the Appellate Division of the Superior Court held that that *Quill's* physical presence nexus requirement is not applicable to income tax and that the New Jersey Corporation Business Tax may be constitutionally applied to income derived by plaintiff from licensing fees attributable to New Jersey.

On appeal, the Director of Taxation argued that the Commerce Clause does not require a corporation's physical presence to justify state taxation, provided that the state can establish that the corporation derives significant benefits from continued and deliberate in-state economic activity.

The Director also argued that, unlike the vendors in *Quill* (whose only connection with customers was by common carrier or the U.S. mail), Lanco had a long-term contractual relationship with a related corporation that operated outlets throughout New Jersey and Lanco and Lane Bryant enjoyed numerous benefits provided by New Jersey, including judicial protection, highway maintenance, and police and fire protection.

Reversing the decision of the New Jersey Tax Court, the Appellate Division of the Superior Court held that that *Quill's* physical presence nexus requirement is not applicable to income tax and that the New Jersey Corporation Business Tax may be constitutionally applied to income derived by plaintiff from licensing fees attributable to New Jersey

In reversing the Tax Court, the Appellate Division looked to recent state cases adopting the holding of the South Carolina Supreme Court in *Geoffrey*, namely North Carolina in its *A&F Trademark* decision and Louisiana in its *Gap (Apparel)* decision) (see below). After examining these cases, Appellate Division was "satisfied" that the physical presence requirement applicable to sales and use taxes is not applicable to income tax. As a result, it concluded that New Jersey corporation business tax may be constitutionally applied to income derived by Lanco from licensing fees attributable to New Jersey.

The New Jersey Supreme Court upheld the Appellate Division's decision and referred readers to that decision for a substantive analysis of the issue instead of issuing its own detailed analysis. The Court briefly analyzed the *Quill* decision and ruled that *Quill's* nexus application was limited to sales tax.

C. Decision making occurring in jurisdiction

(i) <u>In re Goldome Capital Investments, Inc.</u>, 1991 N.Y. Tax LEXIS 360 (N.Y.S. Div. Tax App. June 27, 1991).

(a) Taxpayer was a Delaware passive investment holding company. The majority of its income was interest from intercompany loans to its New York parent.

(b) The taxpayer maintained a statutory office in Delaware and had no office or address in New York. It generally had no activities anywhere.

(c) All of the taxpayer's officers were in New York; most of the taxpayer's income was from interest on loans to its New York parent; and all of its books and records were located in New York.

(d) The N.Y.S. Division of Tax Appeals determined that the taxpayer was "doing business" in New York state and thus subject to tax in the state.

(ii) Fla. Admin. Code R. 12C-1.011.

(a) The Florida Department of Revenue has issued a regulation which provides that a corporation will be considered to be conducting business in Florida if it has "corporate officers who have permanent or extended temporary residency (3 months in the aggregate of a 12 month period) within the state who make management decisions while residing in the state. If the only officer of the corporation or a key officer of the corporation is residing within the state, management of the corporation is presumed to be occurring within the state.

(b) In interpreting this regulation, the Department issued Technical Assistance Advisement No. 96(C)1-001 (Fla. Dep't of Revenue, May 1, 1996), in which the Department found that a corporation had nexus to Florida because eight of the company's fifteen officers resided in Florida, including its president, chief operating officer, controller, vice president of human resources, vice president of international affairs and another general vice president. In this ruling, the Department advised that the mere presence of a corporate officer in Florida is not sufficient to create nexus for Florida corporate income tax purposes. Instead, nexus is created when the corporation is deemed to be conducting business by having corporate officers in Florida who are involved in conducting the corporation's business. Furthermore, while the mere presence of a corporate officer is not sufficient to create nexus, the mere presence of a key officer creates a presumption that business is being conducted.

b. Customers in the states: "Economic Nexus"

(i) <u>Tax Comm'r of West Virginia v. MBNA America Bank, N.A.</u>, 2006 W. Va. LEXIS 132 (2006), aff'g, No. 04-AA-157 (W. Va. Cir. Ct. June 27, 2005), rev'g, W.V. Office of Tax App. File No. 510331454001 (Oct. 22, 2004), No. 06-1228, *cert. denied* June 18, 2007. Please see subsection (d) below for an in-depth discussion.

(ii) Multistate Tax Commission's factor based nexus proposal. Under the MTC draft proposal, a company would be subject to a state's income or franchise tax if it (aggregated with its affiliates) had more than $50,000 in property in a state, or $50,000 in payroll in a state, or $500,000 in sales in a state, or 25% of total property, total payroll or total sales. *See* MTC Policy Statement 02-02, amended Oct. 17, 2002.

(iii) Oregon Nexus Statute, S.B. 177, 74th Or. Leg. Assem., Reg. Sess, (2007) generally follows the MTC approach. This bill specifies that nonresident individuals and business entities will have substantial nexus with Oregon if certain levels of payroll, property, or sales are exceeded in state. These levels are as follows:

(a) $50,000 in payroll

(b) $50,000 in real and tangible personal property owned or rented in state.

(c) $500,000 in gross sales in state.

Alternatively, if persons or entities have more than 25% of payroll, property, or sales in the state, that person or entity has substantial nexus with Oregon even though its total figures do not exceed those listed above.

This statute also provides for an aggregation approach for commonly owned enterprises. This aggregation approach calls for the aggregation of all commonly-held enterprises whose payroll, property, <u>and</u> sales exceed $5,000 in Oregon. Enterprises that independently meet the nexus tests are included in this aggregate determination.

(iv) <u>A&F Trademark Inc. v. Secretary of Revenue</u>, No. COA03-1203 (N.C. Ct. App. Dec. 7, 2004), *reviewed denied*, NOC0A03-1203 (N.C. Sup. Ct March 3, 2005). The North Carolina Court of Appeals held that Delaware intangible holding companies were doing business in the state and, therefore, were subject to corporate income and franchise taxes. Further, the Commerce Clause of the U.S. Constitution does not forbid the state from imposing the taxes at issue. Specifically, the court held that administrative Rule 17 NCAC 5C.0102 provides that the term “doing business” means the operation of any business in the state for economic gain, including owning or renting income producing property such as trademarks and trade names in the state. The holding companies argued that Rule 17 NCAC 5C.0102 “is of no consequence” because year 2001 amendments to the income tax statutes[4] indicate “that the agency’s rule [improperly] expanded the income tax statute” instead of interpreting it, and that the only possible purpose for the 2001 amendments was to “cover the receipt of royalty income from the in-state use of

[4] N.C. Gen. Stat. §105-130.7A, as amended by 2001 N.C. Sess. Laws 327.

licensed trademarks." In rejecting this argument, the court found that the 2001 amendments endorsed rather than changed the scope of the income tax statute, stating that "the [2001] bill clearly denotes that its function was to enhance compliance 'with the State tax on income generated from using trademarks in [manufacturing and retailing] activities'… [and] the stated purpose was merely to add a reporting option to the income tax statute, not to modify or change what constituted taxable income."

The court also held that the imposition of franchise taxes by the revenue department does not exceed the department's statutory authority. The state's franchise tax is imposed on every corporation doing business in the state for the opportunity and privilege of transacting business in the state. The court held the "[i]t is beyond dispute that North Carolina has provided privileges and benefits that fostered and promoted the related retail companies. By affording these benefits to the related retail companies, additional benefits have inured to the [holding companies]." Further, the court agreed with the broad rationale accepted by the South Carolina Supreme Court in Geoffrey, Inc. v. South Carolina Tax Commission, 437 S.E.2d 13 (1993), that by providing an orderly society in which the related retail companies conduct business, North Carolina has made it possible for the taxpayers to earn income pursuant to the licensing agreements.

The court also disagreed with the holding companies' argument that the presence of their intangible property in North Carolina is irrelevant in light of the lack of physical presence of offices, facilities, employees, and real or tangible property, and that National Bellas Hess, Inc. v. Department of Revenue, 386 U.S. 753 (1967) and Quill Corp. v. North Dakota, 504 U.S. 298 (1992)[5] mandate that the court find the imposition of tax violates the Commerce Clause. In rejecting the holding companies contention, the court refused to expand the scope of the physical presence test of Quill beyond sales and use taxes, stating that "there are important distinctions between sales and use taxes and income and franchise taxes 'that makes the physical presence test of the vendor use tax collection cases inappropriate as a nexus test.'" Ultimately, the court rejected the contention that physical presence is the *sine qua non* of a state's jurisdiction to tax under the Commerce Clause for purposes of income and franchise taxes. Rather, the court held that "under facts such as these where a wholly owned subsidiary licenses trademarks to a related retail company operating stores located within North Carolina, there exists a substantial nexus with the State sufficient to satisfy the Commerce Clause."

c. Tax Comm'r of West Virginia v. MBNA America Bank, N.A., 2006 W. Va. LEXIS 132 (2006), *aff'g*, No. 04-AA-157 (W. Va. Cir. Ct. June 27, 2005), *rev'g*, W.V. Office of Tax App. File No. 510331454001 (Oct. 22, 2004), No. 06-1228, *cert. denied* June 18, 2007.

[5] Both Bellas Hess and Quill involved attempts by a state to require out-of-state mail-order vendors to collect and pay use taxes on goods purchased within the state despite the fact that the vendors had no outlets or sales representatives in the state.

(i) West Virginia's statute imposes tax on financial institutions based on the amount of the financial institutions' economic activity with respect to West Virginia customers.

(ii) The Administrative Law Judge for the West Virginia Office of Tax Appeals determined that to meet the "substantial nexus" requirement of the Commerce Clause, there must be "a finding of a physical presence in the taxing state, not merely an economic exploitation of the market."

(iii) The ALJ then ruled that MBNA's use of the services of in-state lawyers and West Virginia courts for a *de minimis* number of credit card debt collection actions (three actions over a two year period) was insufficient to create nexus in West Virginia because it was merely the "slightest presence" and was not significantly associated with MBNA's ability to establish and maintain a market in West Virginia.

(iv) The Circuit Court reversed the decision of the Office of Tax of Appeals and held that the corporate net income and business franchise taxes had been properly imposed on MBNA.

(a) The Court found that MBNA's gross receipts attributable to a West Virginia source far exceeded the statutory threshold for nexus and concluded that MBNA had substantial nexus with the state for the years in question such that imposition of the corporate income and business franchise taxes was proper.

(b) The Court rejected the "bright-line physical presence test" established in Bellas Hess and adhered to in Quill because the taxes at issue in this case were not sales and use taxes. Specifically, the Court found as a matter of law that physical presence was not required to establish substantial nexus to satisfy the Commerce Clause when imposing corporate net income and business franchise taxes.

(c) In reaching its decision, the Court focused on the many benefits MBNA was deemed to receive from the state, such as the banking and consumer credit laws and access to the state's courts, all of which enabled MBNA to generate income from West

Virginia customers. The Court noted in particular that because MBNA extends substantial unsecured credit to citizens of West Virginia, the fact that MBNA had access to West Virginia courts was essential to its business operations.

(d) The West Virginia Supreme Court affirmed the circuit court decision and introduced a "significant economic presence test" to hold MBNA liable for business franchise and corporate income taxes.

(1) The court began its analysis by determining that Quill applies only to sales and use taxes. It based this conclusion on four grounds. First, the Quill decision was primarily based on *stare decisis* and the need for a continuing bright-line standard for sales tax imposition. The court pointed to language in Quill stating that "contemporary Commerce Clause jurisprudence might not dictate the same result were the issue to arise for the first time today." Second, the West Virginia court read Quill so as to limit its decision to sales and use taxes. Third, the court cited Quill's foundation that without the Quill rule, compliance with the myriad of state and local sales tax rules and rates would be unduly difficult and burdensome on business. The court felt that because income taxes are remitted less frequently and to fewer jurisdictions, the compliance burden for income taxes was not as significant. Finally, the court cited changes in communication technology and electronic commerce leading to the declining viability of Quill's physical presence test in today's world.

(2) After refusing to apply Quill to income taxes, the court introduced a "significant economic presence test" as an indicator of whether businesses have nexus for Commerce Clause purposes. The court described the test as one that incorporates the due process requirements of purposeful direction towards a state while at the same time examining the degree of those directed

contacts. That degree is measured by "the frequency, quantity, and systematic nature of a taxpayer's economic contacts with a state." In applying this standard to MBNA, the court pointed to the systematic and continuous nature of the direct mail and telephone solicitation performed in West Virginia. Furthermore, MBNA's gross receipts of over $8,000,000 and $10,000,000 in 1998 and 1999 respectively were sizable and "attributable" to West Virginia, thus satisfying the significant economic presence test.

(3) In his dissenting opinion, Justice Benjamin argued that the majority opinion missed the mark by analyzing what type of tax this was rather than the effects imposition of the tax would have on interstate commerce. "Absent precedential support for differentiating 'substantial nexus' standards based upon tax types, this Court should resist the State's invitation for us to speculate based on semantics and, instead, focus on the effect which the state tax has on interstate commerce - here, attempting to levy an income tax on an out-of-state corporation with no property, tangible or intangible, in West Virginia where the income in question was generated from credit accounts held outside of this state." Justice Benjamin contended that policy considerations such as undue burden on companies and the need for a bright-line standard are equally as valid for income taxes as for sales taxes. Under this framework, he concluded that for the same reasons that sale tax imposition requires physical presence, imposition of an income tax also should require physical presence.

d. Capital One Bank v. Massachusetts Comm'r of Rev., 899 N.E.2d 76 (Mass. 2009).

(i) The highest court in Massachusetts affirmed the Appellate Tax Board's conclusion that credit card issuer Capital One

Bank had substantial nexus with Massachusetts and that imposition of the Massachusetts financial institution excise tax ("FIET") on Capital One was not unconstitutional.

(ii) The FIET presumed that financial institutions are engaged in business in Massachusetts, and hence are subject to the FIET, if there are transactions involving intangible property with "one hundred or more residents of the commonwealth during any taxable year or if the taxpayer has ten million dollars or more of assets attributable to sources within the commonwealth."

(iii) In its decision, the Massachusetts Supreme Judicial Court wrote that "[i]n addition to their consumer lending activities, the Capital banks were soliciting and conducting significant credit card business in the Commonwealth with hundreds of thousands of Massachusetts residents, generating millions of dollars in income for the Capital banks. In essence, the Capital banks were providing valuable financial services to Massachusetts consumers, for which the Capital banks were compensated in the form of interest payments, interchange fees, and finance charges."

e. Attributional Nexus

The states have generally been unsuccessful in their attempts to use an "attributional nexus" theory to establish sales/use tax nexus over taxpayers, but Matter of Borders Online Inc., No. A105488 (Cal. Ct. App., 1st App. Dist., May 31, 2005) (see below) and Matter of Barnes & Noble.com, No. 89872 (Cal. St. Bd. Equal. Sept. 12, 2002) cases are recent exceptions.

(i) Scripto Inc. v. Carson, 362 U.S. 207 (1960).

(a) The United States Supreme Court decision sustaining the power of a state to require an out-of state seller that made sales through independent contractors to collect the State's use tax on sales.

(b) Georgia company used independent contractors to solicit orders in Florida. The independent contractors forwarded any resulting orders to the home office for shipment of the ordered goods. The Supreme Court held that the company's relationship with a fleet of sales persons continually soliciting on its behalf within the state, taking orders and receiving commissions based on their sales, acted as the functional equivalent of a local sales force. The use of the salesmen to solicit orders for the sale of goods was to be attributed to the principal for purposes of determining the obligation to collect use tax.

(ii) SFA Folio Collections Inc. v. Commissioner, 73 Ohio St. 3d 119, 652 N.E. 2d 693 (Oh. Sup. Ct. 1995).

(a) The taxpayer sold clothes to Ohio customers through catalogs. An affiliate of the taxpayer, Saks Fifth Avenue of Ohio ("Saks-Ohio") operated stores in Ohio. Saks-Ohio stores received copies of the taxpayer's mail order catalogs and made copies available for store customers to review. Saks-Ohio stores also accepted returns of the taxpayer's mail order merchandise.

(b) The Ohio Tax Commissioner assessed the taxpayer use tax on its Ohio sales claiming that the taxpayer had substantial nexus with Ohio through its unitary relationship with Saks-Ohio.

(c) The Ohio Supreme Court determined that under Quill, the vendor itself must have physical presence in Ohio. Inasmuch as the taxpayer and Saks-Ohio were different legal entities and the retail stores did not conduct activities in Ohio on behalf of the taxpayer, the stores' physical presence in Ohio did not establish nexus. For the taxpayer.

(iii) In re Scholastic Book Clubs Inc., 260 Kan. 529, 920 P. 2d 947 (1996).

(a) The taxpayer was a mail-order seller of children's books. The taxpayer sent catalogs to schoolteachers who distributed the catalogs to their students and collected and submitted the orders to the taxpayer. Teachers received bonus merchandise in proportion to student purchases. Kansas asserted that the taxpayer was subject to use tax liability in Kansas because the teachers were acting as sales agents of the taxpayer and, thus, created physical presence for the taxpayer in the state.

(b) The Kansas Supreme Court determined that the teachers were the taxpayer's implied agents because the teachers acted under the taxpayer's authority once they chose to sell the books. The court determined that the taxpayer's use of the teachers created substantial nexus with Kansas and, thus, the taxpayer was required to collect sales tax on the book orders.

(c) This Kansas case is the latest in a series of state decisions addressing the same issue with a similar fact pattern. The state courts that have addressed the issue have come to widely divergent results. Cf. Scholastic Book Clubs, Inc. v. State Bd. of Equalization, 207 Cal. App. 3d 734, 255 Cal. Rptr. 77 (Cal. Ct. App. 1989) (once publisher accepted an order from a teacher, publisher ratified teacher's authority to act on its behalf, thus creating an agency relationship); Pledger v. Troll Book Clubs, Inc., 316 Ark. 195, 871 S.W.2d 389 (Ark. Sup. Ct. 1994) (no agency relationship existed because of lack of requisite control, thus, no nexus); Troll Book Clubs v. Tracy, Case No. 92-Z-590, 1994 Ohio Tax LEXIS 1374 (Ohio Bd. Tax App. Aug. 19, 1994) (Ohio teachers not controlled by publishing company, thus, no nexus).

(iv) Bloomingdale's By Mail, Ltd. v. Pennsylvania Dep't of Rev., 130 Pa. Commw. 190 at 198, 567 A.2d 773 at 778 (Pa. Commw. Ct. 1989) aff'd, 527 Pa. 347, 591 A. 2d 1047 (Pa. Sup. Ct. 1991).

(a) A corporation whose only connection with Pennsylvania was the solicitation of sales through catalogs mailed into Pennsylvania from outside of the state and the shipment of goods into Pennsylvania from outside of the state did not have an obligation to collect use tax on shipments of goods into Pennsylvania. Substantial nexus was not established through the presence of an affiliate's retail stores in Pennsylvania because the stores "do not solicit orders on [the catalog company's] behalf nor act as its agents in any fashion and [the catalog company] does not solicit orders for [the instate stores]."

(b) The only connections between the catalog company and the stores were two documented instances where a catalog item was returned to a store in Pennsylvania - even though the catalog specified that items should be returned only by mail - and the fact that the catalogs and the stores used the same advertising themes.

(v) Current, Inc. v. California State Board of Equalization, 24 Cal. App. 4th 382, (Cal. Ct. App. 1994). A corporation did not have sufficient nexus with California such that it was forced to collect California's use tax on sales of goods shipped into California merely because a corporation that did have nexus with California acquired it.

(vi) Commissioner of Revenue v. Jafra Cosmetics, 433 Mass. 255, 742 NE2d 54 (Mass. Sup. Jud. Ct. Jan. 25, 2001). Company with in-state consultants demonstrating and selling its cosmetics line had representatives in the state and, thus, had substantial nexus for sales and use tax purposes. Taxpayer had argued that consultants were representing their own, independent business, and were not acting on behalf of the out-of-state company. Cf. Shaklee Corp. v. Commissioner of Revenue, Nos. F245496, F24597 (Mass. App. Tax Bd. Feb. 7, 2000). A manufacturer of household products was not subject to Massachusetts excise tax or sales and use tax collection based on the sales activities of local independent contractors or a single sales convention in the state. The board found the local sales representatives operated independent businesses, and thus did not create nexus subjection Shaklee to sales/use tax collection obligations in the state.

(vii) State of Louisiana v. Quantex Microsystems, Inc., 809 So. 2d 246 (La. Ct. of App. July 3, 2001). The First Circuit Court of Appeal reversed and remanded a nexus case involving sales & use taxes. The trial court, citing Quill, had granted summary judgment in favor of the taxpayer, a foreign corporation that sells computer products into Louisiana by mail, telephone, and the Internet. The appellate court stated that Quantex's discovery responses gave inconsistent answers regarding whether Quantex itself provided onsite warranty service to customers in Louisiana or whether it was provided by the manufacturer. The court indicated that additional discovery was necessary to determine whether (or how much) on-site service performed by independent contractors would create nexus for Quantex. One judge dissented, finding no inconsistency and supporting the physical presence standard of Quill. Gateway, Inc. had filed an amicus curiae brief in the case.

(viii) Matter of Borders Online Inc., No. A105488 (Cal. Ct. App., 1st App. Dist., May 31, 2005). The California Court of Appeal, First Appellate District, held that an out-of-state online retailer has nexus with California through the activities of its "authorized representative," a brick-and-mortar affiliate that sells products similar to those sold by the online retailer, and therefore, is liable for use tax collection on goods purchased by customers in California. In reaching this decision, the California Court of Appeal concluded that the in-state retailer's activities on behalf of the online retailer were "for the purpose of selling" the online retailer's goods.

(ix) St. Tammany Parish v. Barnesandnoble.com, No. 05-5695 (United States District Court Eastern District of Louisiana 2007). A federal case involving facts similar to *Borders Online*. An Internet seller was alleged to have sales and use tax presence in Louisiana due to its affiliation with an entity owning bookstores in the state. The companies had separate management, employees and offices. However, they participated in gift card and membership programs operated by their parent, and benefited by advertising of the programs as well as certain other cross promotional activities. The brick and mortar stores also accepted returns of merchandise sold by the Internet seller, but also accepted returns of unrelated sellers' products. The Internet site listed store locations.

The federal court refused to attribute tax presence from brick and mortar stores to the Internet seller. The court stated that the contacts were not "of the order of magnitude necessary to establish that" the brick and mortar stores marketed the Internet company's sales in Louisiana. The sharing of a common name, brand identity and the joint marketing described did not establish nexus. This case has been appealed.

(x) Barnesandnoble.com v. State Bd. of Equalization, No. CGC-06-456465, (Superior Court, San Francisco County, Sept. 7, 2007). An out-of-state corporation that sells books, music, and movies in the state via the Internet does not engage in business in the state, for *use tax* collection purposes, even though limited marketing was done through brick-and-mortar stores in the state. The California Rev. & Tax. Cd. §6203 definition of a retailer engaged in business in the state includes a retailer having an agent within the state. The Superior Court ruled that Barnes & Noble, which owned brick-and-mortar stores in California, was not the agent of Barnesandnoble.com when the brick-and-mortar stores inserted the online retailer's coupons into its shopping bags and printed the name of the online retailer on one side of its shopping bags. The Superior Court distinguished the present case from that in the previous Borders case in that Barnesandnoble.com was not fully controlled by Barnes & Noble. Also, Barnes & Noble had no authority to bind Barnesandnoble.com, and Barnes & Noble owned only 40% of Barnesandnoble.com, whereas in Borders, the subsidiary was wholly owned by the parent.

D. Transactional Nexus

1. Complete Auto Transit, Inc. v. Brady, 430 U.S. 274 (1977). Appellant corporation challenged back taxes for the sales of transportation services. Appellant engaged in business of transporting motor vehicles from Jackson, Mississippi to dealers within the state of Mississippi. The Supreme Court in affirming the decision of the Mississippi Supreme Court, fashioned a four prong test to determine the constitutionality of state taxes on an out of state business. The first prong is whether the tax is applied to an activity with a substantial nexus with the taxing state.

2. Goldberg v. Sweet, 488 U.S. 252 (1989). Appellant individuals and corporation challenged the constitutionality of an Illinois telecommunications Tax Act. Appellant individuals are residents of Illinois who are subject and have paid the tax through their retailers, long distance telephone carriers. Appellant corporation is a long distance telephone carrier that does business in Illinois. Appellants conceded before the Supreme Court that interstate communications reached by the Tax Act constitute a sufficient nexus with Illinois.

3. Connecticut General Life Insurance Co. v. Johnson, Treasurer of California, 303 U.S. 77 (1938). Appellant insurer claimed that a tax on its receipt in its home state, Connecticut, of reinsurance premiums from insurance companies operating in California on policies reinsuring them against loss on policies they issued in California to California residents violated the due process clause. Apart from the fact that appellant was privileged to do business in California, and that risks reinsured were originally insured against in that state by companies also authorized to do business there, California had no relationship to appellant or the contracts. The Supreme Court reversed the dismissal of appellant insurer's actions to

recover state taxes paid under protest, finding a due process violation and that California had no relationship to appellant or to reinsurance contracts.

E. The Direct Aspect of the Commerce Clause. The Commerce Clause explicitly provides that Congress has the power to directly regulate commerce among the several states. Although Public Law 86-272 (discussed below) is the broadest and most general federal legislation restricting state taxation of interstate commerce, there are other federal statutes that either broaden or narrow state taxing powers affecting multistate businesses.

1. The Internet Tax Freedom Act (ITFA), P.L. 105-277, signed into law on October 21, 1998, imposed a three-year moratorium on state taxes on Internet access and multiple or discriminatory taxes on electronic commerce. An exception to the moratorium was provided for Internet access charges that were generally imposed and actually enforced by any state prior to October 1, 1998. On November 28, 2001, President Bush signed H.R.1552 into law and thereby extended the Internet Tax Freedom Act, as originally enacted, for two more years. The moratorium expired on November 28, 2003, but was extended in 2004 and again in 2007.

2. Telecommunications Act of 1996**,** Public Law 104-104 (S. 652), signed February 8, 1996, which substantially rewrote the 1935 Communications Act, exempts providers of direct-to-home satellite services from the collection and/or remittance of any tax or fee imposed by any local, but not state, taxing jurisdiction on direct-to-home satellite services, also known as direct broadcast satellite (DBS) services.

3. Public Law 104-95 (H.R. 394) (1996) (codified at 4 U.S.C. § 114) limits the states' ability to subject retirement income received by a former resident after 1995 to income taxation. The law specifically provides that states may not tax several types of retirement income of non-residents and non-domiciliaries, including income from IRC §403 annuities, §408(k) plans and §7701(a)(37) individual retirement plans. The new law is effective for payments received after December 31, 1995. H.R. 4019 amends Pub. L. 104-95, which prohibits states from taxing the retirement income of nonresidents, to clarify that retirement income of all retirees, regardless of whether they were employees, partners or self-employed prior to retirement, is treated the same for state tax purposes. This amendment applies to amounts received after December 31, 1995. Pub. L. No. 109-264 (H.R. 4019), enacted August 3, 2006.

4. Federal Aviation Administration Authorization Act of 1994, Public Law 103-305, 108 Stat. 1569, broadened the preemption of state authority to tax nonresident wages of airline employees to include in the definition of "compensation" those wages earned while performing union duties.

5. Aviation Safety and Capacity Expansion Act of 1990, Public Law 101-508, 104 Stat. 1388 (codified at 49 U.S.C. §1513(f)), prohibits states and their political subdivisions from imposing "any tax on or with respect to any flight of a commercial aircraft or any activity or service on board such aircraft unless such aircraft takes off or lands in such state or political subdivision as part of such flight. This legislation reversed the results of Republic Airlines, Inc. v. Wisconsin Department of Revenue, No. 89CV2916 (Wis. Cir. Ct. Dane County February 12, 1990) and, apparently, the Oregon Supreme Court's decision in Alaska Airlines, Inc. v. Department of Revenue, 769 P.2d 193 (Ore. 1989), cert. denied, No. 89-346 (U.S. Jan. 8, 1990) (use of overflight miles upheld in apportioning the system value of an airline for property tax purposes). See also Ruling of Virginia Commissioner, P.D. 91-41, March 19, 1991 (inclusion of overflight miles in a corporate income tax apportionment formula preempted by federal law).

6. Airline passenger tickets may not be taxed. 49 U.S.C. 1513(a) prohibits a state from taxing people traveling in air commerce or the sale of air transportation or on the gross receipts from air transportation.

    a. Any activity or service provided during airline overflights may not be taxed unless the aircraft takes off or lands in the taxing state or subdivision as part of such flight. 49 U.S.C. §1513(f)

7. Federal Interstate Commerce Commission (ICC) Termination Act of 1995, Public Law 104-88, 109 Stat. 803 (codified at 49 U.S.C. 14505), prohibits a state or its political subdivisions from collecting or levying a tax, fee, head charge, or other charge on (1) a passenger traveling in interstate commerce by motor carrier; (2) the transportation of a passenger traveling in interstate commerce by motor carrier; (3) the sale of passenger transportation in interstate commerce by motor carrier; or (4) the gross receipts derived from such transportation. The law, which became effective January 1, 1996, was apparently in response to the U.S. Supreme Court's decision in Jefferson Lines, Inc., 115 S. Ct. 1331 (1995) that Oklahoma's unapportioned tax on the purchase price of interstate bus tickets bought in state did not violate the Commerce Clause.

8. Railroad property may not be taxed more heavily than other commercial and industrial properties. Railroad Revitalization and Regulatory Reform Act of 1976 (4-R Act), P.L. 94-210, 49 U.S.C. §1503 (1978).

    a. Interstate railroad employees may not be subject to state and local taxes, except in their resident state. 49 U.S.C. §11504

9. Generation or transmission of electricity may not be taxed in a manner that discriminates against out-of-state manufacturers, producers, wholesalers, retailers, or consumers of that electricity. 15 U.S.C. § 391.

10. Employee Retirement Income Security Act of 1974 (ERISA), §514(a) provides that the provisions of ERISA "shall supersede any and all State laws insofar as they may now or hereafter relate to any employee benefit plan." 29 U.S.C. §1144(a)

   a. New York real property transfer gains tax imposed on gains derived by a qualified employee benefit plan from the sale of property was preempted by ERISA. Morgan Guaranty Trust Co. v. Tax Appeals Tribunal of Dep't of Taxation & Finance, 599 N.E.2d 656 (N.Y. 1992).

11. McCarran-Ferguson Act, 15 U.S.C. §§1011--1015 (1982), removed all Commerce Clause limitations on the authority of the States to regulate and tax the business of insurance. The purpose of the McCarran-Ferguson Act is to allow the States to regulate, directly or indirectly, interstate commerce between insurance companies of one state and the customers of another state. See S.E.C. v. National Securities, Inc., 393 U.S. 453 (1969), Feldman v. State, 615 P.2d 238 (Nev. 1980).

III. *Federal Statutory Limitation: P.L. 86-272*

A. General: P.L. 86-272, Title 1, §101, 73 Stat. 555 (codified as amended at 15 U.S.C. § 381 *et seq.* (1959)).

“No State, or political subdivision thereof, shall have power to impose, for any taxable year . . ., a net income tax on the income derived from within such State by any person from interstate commerce if the only business activities within such State by or on behalf of such person during such taxable year are either, or both, of the following:

1. the solicitation of orders by such person, or his representative, in such State for sales of tangible personal property, which orders are sent outside the State for approval or rejection, and, if approved, are filled by shipment or delivery from a point outside the State; and

2. the solicitation of orders by such person, or his representative, in such State in the name of or for the benefit of a prospective customer of such person, if orders by such customer to such person to enable such customer to fill orders resulting from such solicitation are orders described in paragraph (1).”

B. Limited Applicability of P.L. 86-272.

   1. Applies only to interstate commerce.

   2. Applies only to net income taxes.

3. Only permissible business activity in the state is solicitation of orders.

- But see discussion of *Wrigley* below, which announces a *de minimis* exception.

4. Applies only to sales of tangible personal property.

5. Approval or rejection of orders must occur outside state.

6. Orders must be shipped or delivered from outside state.

7. Independent contractors are distinguished from employees.

C. Interpretation of the Scope of P.L. 86-272.

1. Definition of "solicitation": Until Wisconsin Dep't of Revenue v. William Wrigley, Jr., Co., 505 U.S. 214 (1992) (see below), the question of what is "solicitation" had been subject to state controversy and differing opinions among state tax administrators. State court cases addressing the meaning of the term "solicitation" prior to the *Wrigley* decision were confusing and contradictory. The facts and presentation of the facts have always been critical in any case concerning the meaning of "solicitation".

2. Wisconsin Dep't of Revenue v. William Wrigley, Jr., Co., 505 U.S. 214, 228-229 (1992). In Wrigley, the United States Supreme Court resolved many of these arguments by setting forth the standard to be utilized in determining what activities of a taxpayer will be considered protected "solicitation."

1. Wrigley, a gum manufacturer based in Illinois, sold its products in Wisconsin through a sales force consisting of a regional manager and various field representatives. The manager and representatives' activities included: replacement of stale gum, supplying of gum through "agency stock checks," storage of gum, training and evaluation of sales representatives, use of hotels for sales-related meetings, and intervention in credit disputes between customers and the company.

2. The Wisconsin Department of Revenue concluded that Wrigley's Wisconsin activities created sufficient nexus with the state to support imposition of a franchise tax. Wrigley claimed immunity under P.L. 86-272 and the Wisconsin Supreme Court agreed with Wrigley.

3. Wisconsin appealed and argued before the Court for a narrow interpretation of the term "solicitation," claiming that an out-of-state company forfeits immunity under P.L. 86-272 if it engages in activities other than requesting a customer to purchase merchandise. By contrast, Wrigley argued for a broad interpretation of the term "solicitation" based on the business practices of the particular industry being examined.

According to Wrigley, the term embraced activities that are "ordinary and necessary business activities accompanying the solicitation process" or are "routinely associated with deploying a sales force to conduct the solicitation" for the particular industry. Under Wrigley's argument, the standard of solicitation activity would vary depending on the type of merchandise being sold. Wrigley also argued that even if its activities were not "solicitation" within the meaning of P.L. 86-272, it was still not subject to Wisconsin's taxing jurisdiction since its in-state activities were de minimis.

4. The Court adopted neither the broad "industry" interpretation advanced by Wrigley nor the narrow interpretation of the federal statute offered by the state. Instead, the Court devised its own two-part test to determine what activities fit within the protected activities of "solicitation."

    (i) First, the demarcation between protected solicitation and other activities is the "clear line…between those activities that are *entirely ancillary* to requests for purchases - those that serve no independent business function apart from their connection to the soliciting of orders – and those activities that the company would have reason to engage in anyway but chooses to allocate to its in-state sales force."

    (ii) Second, an activity that is deemed to be more than solicitation can still be insufficient to create nexus with a state if that activity is de minimis when considered in the aggregate with all other non-ancillary actives conducted by the out-of-state vendor in the state. A de minimis activity is one that establishes only a trivial additional connection with the taxing state.

5. Applying this two-part test, the Court determined that the following activities conducted by Wrigley representatives in Wisconsin were not ancillary to the solicitation of orders and were not de minimis: replacing stale gum, supplying gum through agency stock checks and storing gum in the state. As a result of these activities, Wrigley was subject to Wisconsin income tax.

3. MTC Regulations.

1. The Uniformity Committee of the MTC has issued a resolution which recommends that states adopt its "Statement of Information Concerning Practices of Multistate Tax Commission States Under Public Law 86-272" as revised to reflect <u>Wrigley</u>.

2. The statement contains a list of activities, which are considered to be part of solicitation and, thus, exempt from taxation, and others deemed in excess of solicitation:

(i) Soliciting orders for sales by any type of advertising.

(ii) Carrying samples only for display or for distribution without charge or other consideration.

(iii) Owning or furnishing autos to sales personnel.

(iv) Passing inquiries and complaints on to the home office

(v) Missionary sales activities.

(vi) Checking of customers' inventories without a charge therefor.

(vii) Maintaining a sample or display room for two weeks or less at any one location during the tax year.

(viii) Soliciting of orders for sales by an in-state resident employee of the company; provided the employee maintains no in-state sales office or place of business that is attributable to the company or to the company's agents in their agency capacity.

(ix) Recruitment, training or evaluation of sales personnel, including occasional use of homes, hotels or similar places for meetings with sales personnel.

(x) Maintaining, by any sales employee, an in-home office that is not paid for directly or indirectly by the company and which is not attributable to the company or to the company's agents in their agency capacity.

(xi) Mediating direct customer complaints when the purpose thereof is solely for ingratiating the sales personnel with the customer and facilitating requests for orders.

D. State Decisions Applying P.L. 86-272

1. <u>Disney Enterprises, Inc. v. Tax Appeals Tribunal</u>, ___ NY (March 25, 2008). Disney Enterprises, Inc. was the parent of hundreds of subsidiaries and affiliates, including Buena Vista Home Video (Video). Disney included Video in its New York State combined report. As Video's New York activities were limited to sales solicitation for its tangible personal property, it claimed the protection of P.L. 86-272. The Court of Appeals

disagreed and held that the term "person" as used in P.L. 86-272 referred to the entire unitary group. Therefore, because other members of the Disney unitary group engaged in New York in activities not protected by P.L. 86-272, the court held that the entire Disney unitary group was unprotected by P.L. 86-272.

2. Muro Pharmaceutical v. Crystal, No. 524693 (Conn. Super. Ct., Tax Sess. 1994). An out-of-state pharmaceutical manufacturer's income from sales made toConnecticut companies was exempt from tax under the federal statute. The company's primary activity in the state, other than sales, consisted of in-person presentations to doctors in which a company representative provided free samples and product information. These presentations were intended to persuade doctors to prescribe these products. The court held that the representatives' activities were indirect solicitations within the meaning of the federal statute.

3. Nat'l Private Truck Council v. Comm'r, 426 Mass. 324 (1997). Members of the trade association solicited orders in the state that were sent outside the state to be approved and filled. The members also operated truck fleets to deliver products in the state. The association sought a declaratory judgment that they were not subject to state taxation. The court held that P.L. 86-272 precluded taxation of the members reasoning that the federal statute does not require that the transfer occur outside the state.

4. Amgen, Inc. v. Commissioner of Revenue, 427 Mass. 357 (1998). Pharmaceutical company's activities exceeded those permitted under P.L. 86-272. Its clinical support specialists made presentations regarding the company's products to nurses at hospitals and other health care facilities. Sometimes the specialists were asked to review patient charts or answer questions about proper dosage. The company had a reason to engage in these last two activities apart from assisting in the solicitation of sales. Namely, reducing the number of calls to its "hotline" that was staffed by physicians.

5. Schering-Plough Healthcare Prods. Sales Corp. v. Commonwealth, 861 A.2d 259 (Pa. 2004), *aff'g*, 805 A.2d 1284 (Pa. Commw. Ct. 2002). The Pennsylvania Supreme Court affirmed the decision of the Commonwealth Court ruling that P.L. 86-272 protected a corporation soliciting sales in Pennsylvania from liability for corporate net income tax. The sales company was not the owner of the goods for which it was soliciting sales. It was soliciting sales of the products of an affiliated corporation. Still, the Commonwealth Court rejected the Department of Revenue's argument that P.L. 86-272 only protects a corporation if it has title to the good for which it is soliciting sales, and found that the federal law need not be strictly construed against taxpayers.

6. <u>In the Matter of the Protest of Dart Indus., Inc.</u>, Dkt. No. 02-152241-00-3 (New Mexico Taxation and Revenue Department, February 26, 2004). The Department determined that Dart, an out-of-state corporation, was not protected from New Mexico corporate income tax under P.L. 86-272 because (1) Dart's franchised distributor was acting on behalf of Dart in establishing, maintaining and protecting Dart's New Mexico market and because (2) these activities of the distributor which were attributed to Dart exceeded the scope of protected activities under P.L. 86-272.

1. Activities exceeding the scope of P.L. 86-272 ("mere solicitation of orders of tangible property") included:

   (i) The corporation's licensing of its trademark and confidential franchising system,

   (ii) The corporation's establishment of services for the New Mexico franchised distributorship,

   (iii) The distributor's maintenance of an in-state office,

   (iv) The distributor's promotion and protection of the corporation's trademarks and related goodwill, and

   (v) The distributor's handling of customer complaints and warranty services.

7. <u>New York State United Teachers Benefit Trust (Advisory Opinion)</u>, TSB-A-05(3)(C), N.Y.S. Comm'r of Tax'n and Fin. (Mar. 10, 2005). The New York Department of Taxation and Finance found that a Pennsylvania based company whose sole activities in New York State consisted of having a telephone listing in a New York telephone directory and delivering concrete produced at its Pennsylvania facility was engaged in activity protected by P.L. 86-272 and therefore, was not subject to taxation. However, the department made a distinction between concrete that was "central mixed" (mixed entirely at the facilities before being transported and delivered to a customer's location in New York State) and concrete that was "transit mixed" (mixed during transportation in New York or at a delivery site in New York). The department specifically noted that if the company had been engaged in delivering transit mixed concrete, it would not have been protected from taxation under P.L. 86-272.

8. <u>Upromise Invs., Inc. (Advisory Opinion)</u>, TSB-A-05(7)(C), N.Y.S. Comm'r of Tax'n and Fin. (Apr. 4, 2005). The New York Department of Taxation and Finance found that a company whose only activities within the boundaries of New York State were those conducted by one employee, a sales representative responsible for the solicitation of sales from within and without the state was protected from taxation under P.L. 86-272.

Specifically, it was determined that the company did not maintain an office in New York State at the sales representative's residence and that the activities of the sales representative were limited to mere solicitation.

9. Wausau Tile, Inc., TSB-A-05(17)(C), N.Y.S. Comm'r of Tax'n and Fin. (Dec. 12, 2005). The New York Department of Taxation and Finance found that a Wisconsin company whose New York State activities consisted of performing repairs to its products, being a defendant in a product liability case, and maintaining a licensee agreement with a university located in New York are activities that go beyond the mere solicitation of orders as contemplated by P.L. 86-272. However, the company was not subject to New York's franchise tax due to a *de minimis* activity exception for the repairs and the fact that the litigation and licensee did not constitute doing business within New York State.

10. Oklahoma Tax Commission Decision No. 2005-05-10-22 (May 10, 2005). The Oklahoma State Tax Commission ruled that an out-of-state partnership that delivers merchandise to Oklahoma customers using company owned or leased vehicles is protected by P.L. 86-272 and therefore not liable for Oklahoma income tax. Holding that P.L. 86-272's protection is not limited to "shipment or delivery by common carrier," the commission rejected the Audit Division's argument that delivery of products by company-owned trucks is an unprotected activity.

11. Chester A. Asher, Inc. v. Dir., Div. of Taxation, 004061-2003, 2006 N.J. Tax Lexis 1 (Jan. 5, 2006) The New Jersey Tax Court held that the activities of Chester A. Asher, Inc. (Asher) exceeded the protections of P.L. 86-272 and were not *de minimus*, thereby subjecting Asher to income taxation in New Jersey. Asher, a manufacturer of candy and confections, had its primary place of business in California. In each of the tax years between 1999 and 2001, Asher did business in New Jersey resulting in gross sales of over $2,500,000 each year. The court examined Asher's operations in New Jersey and held them beyond the protection of P.L. 86-272 because Asher's delivery drivers acted as more than mere delivery agents by collecting payment from some customers regularly and others less regularly, accepting returned candies, picking up baking supplies in New Jersey, and participating in Asher's "Chocolate Shop Program" (a program designed to help customers set up their own candy shops). Further, the court held that the cumulative effect of these actions was substantial and could not be considered *de minimus*.

12. Virginia Tax Commissioner Ruling, Public Document, 07-51 (04/26/2007) The Virginia tax commissioner ruled selling tangible personal property on behalf of third party clients constitutes a business services, not mere solicitation of sales, and is not protected by P.L. 86-272.

E. State Enforcement of P.L. 86-272 Limitation

1. <u>Nexus Questionnaire</u>. States produce detailed nexus questionnaires that are sent to businesses not currently filing income tax returns to obtain information concerning the out-of-state vendor's business activities.

2. <u>Follow-up</u>. Once the taxpayer's response is received, the state may follow-up with further examination, including discussions with customers and authorized service representatives.

3. <u>Assessments</u>. When a state has targeted a particular taxpayer as a non-complier, the state may issue an assessment. The assessment may be based on the taxpayer's figures or may be estimated by the state. The assessment will generally cover the period of time commencing with the date on which the taxpayer started doing business in the state.

4. Voluntary Disclosure Agreements.

1. A taxpayer that believes it owes an annual tax liability of which a state is unaware should consider entering into a voluntary disclosure agreement with the state. Under this agreement, the taxpayer agrees to pay back taxes and related interest, typically for the two or three most recent years, and further agrees to make timely filings and payments on a going forward basis. In return, the state agrees to abate in full penalties and related interest that would otherwise apply to those two or three years, and to abate in full taxes, penalties and interest for all earlier years. The agreement does not affect the taxpayer's liability for other types of taxes owed to the state.

    (i) A taxpayer seeking a voluntary disclosure agreement should do so anonymously through an attorney. The identity of the taxpayer should not be revealed until all other aspects of the voluntary disclosure arrangement have been agreed to in a signed writing.

    (ii) While most states will enter into such agreements, some will not. Massachusetts, for example, will not enter into a voluntary disclosure agreement. And Florida requires taxpayer identification before signing of the agreement, a condition that makes such an agreement impractical.

5. Dealing With State Enforcement Activities.

    a. Alternative to Questionnaire: Narrative responses in a letter can describe the taxpayer's activities and may also permit certain information, e.g. major customers, to be withheld until there has been an appropriate determination that the taxpayer is doing business in the state.

b. Other Problems: Questionnaires are frequently signed under penalties of perjury. Fraud claims cannot be discounted if the taxpayer's responses are not fair and accurate.

F. Planning to Come Within P.L. 86-272

1. Employee Manual. Consider detailed employee job descriptions placed in the company's employee manual specifically limiting sales representatives' activities to those permitted under P.L. 86-272.

2. Reorganization. If sales and service activities are in a single corporation, consider placing the service activities in a separate corporation.

3. Reduce Sales Factor. Decrease total state tax liabilities by selectively subjecting operations to tax in states that impose no tax or a low tax rate. Benefit is to avoid throwback of sales to high-tax jurisdictions.

G. Application of P.L. 86-272 to Gross Receipts Taxes and Other Non-Income Based Taxes

1. States with Multiple Tax Bases. Certain states, e.g., Pennsylvania and, through 2007, Texas, impose a combined franchise tax with several alternative bases (income, capital, minimum) and require the taxpayer to pay the higher of the taxes. Other states, *e.g.*, New Jersey, Michigan and Ohio, have enacted business taxes imposed on gross receipts instead of net income.

2. Limited Reach of P.L. 86-272. Some of the states with multiple bases have taken the position that P.L. 86-272 protects the taxpayer from net income taxes only; the taxpayer is still required to file the franchise return and pay the tax on capital (or other non-income-based alternatives) if the taxpayer has substantial nexus with the state (e.g., salespeople soliciting orders).

1. For example, the Texas Franchise Tax (under prior law) and Washington Business and Occupation Tax utilize a different nexus standard than that used by P.L. 86-272.

2. Texas. INOVA Diagnostics, Inc. v. Strayhorn, No. 03-04-00503-CV (Tex. Ct. App. May 26, 2005). A California corporation that employed one salesperson in Texas was required to pay the state franchise tax based on the activities of that salesperson. The Court based its decision on the bright line rule set forth in *Quill* requiring physical presence in a state to establish a sufficient nexus to allow taxation under the Commerce Clause. The Court held that INOVA had a permanent sales presence in Texas in the form of one sales representative who spent seven to ten days per month soliciting orders in the state. This was sufficient to establish nexus – while P.L. 86-272 exempts INOVA's earned surplus from

taxation, the taxpayer remained subject to the net taxable capital portion of the tax.

3. Note, however, that the California Franchise Tax uses the P.L. 86-272 standard in determining taxable nexus.

3. New Jersey. The New Jersey Corporation Business Tax was amended effective in 2002 to impose a gross profits/gross receipts tax. After June 2006, these "gross" taxes will apply only to businesses protected by Public Law 86-272.

4. MTC Factor Presence Nexus. Multistate Tax Commission Resolutions Committee Draft Policy Statement 2002-02, "Ensuring the Equity, Integrity and Viability of State Income Tax Systems," as amended October 17, 2002. In addition to its factor presence nexus standard, the MTC has also supported the repeal of P.L. 86-272 in states that enact the factor-based nexus standard (P.L. 86-272 currently protects certain business that merely have customers or certain payroll in a state).

   a. Ohio. Ohio enacted a new "Commercial Activity Tax" that, effective July 1, 2005, replaced its current income/franchise tax. The CAT is based on gross receipts and, thus, the protections of P.L. 86-272 are no longer be available to out-of-state businesses performing solicitation activities in Ohio.

   b. Illinois. Over a period of years, the Illinois Department of Revenue issued rulings asserting that an entity that had sales sitused to Illinois necessarily had tax presence in the state. The approach might have been a realistic rule of thumb when business largely consisted of the manufacturing and sale of merchandise. However, with growth of the service industry the rule of thumb drew objections. As a direct result, the Department amended its regulations to recognize that tax presence principles are different from the principles used to allocate and apportion income: See Ill. Reg. 100.9720(a). "However, the fact that Article 3 of the IITA requires a non-resident taxpayer to allocate or apportion income to this State does not create a presumption that the taxpayer has nexus."

   c. Ohio. Under Ohio's Commercial Activities Tax, a business having at least $500,000 of taxable gross receipts shall be treated as having tax presence n the state. Taxable gross receipts is defined as gross receipts sitused to this state under the tax law's sourcing provisions.

5. BATSA Business Activity Tax Simplification Act ("BATSA") legislation

a. Supporters of federal BAT nexus legislation are asking Congress to enact Business Activity Tax Simplification Act ("BATSA") legislation.

b. A hearing on the version of the bill before the 109th Congress ("H.R. 1956") was held before the U.S. House of Representatives Committee on the Judiciary Subcommittee on Commercial and Administrative Law on September 27, 2005.

c. A mark-up of H.R. 1956 was held by the U.S. House of Representatives Committee on the Judiciary Subcommittee on Commercial and Administrative Law on December 13, 2005 at which the Subcommittee approved by voice vote a substitute amendment.

d. H.R. 1956 was not voted on by the House, but it is anticipated that a new BATSA bill will be introduced in the 110th Congress and that the bill will contain substantially similar language. (See also S. 2721 Introduced May 4, 2006)

e. What does BATSA, H.R. 1956, do?

(i) Modernizes P.L. 86-272.

(a) Deletes "tangible personal property" language and adds the term "transactions." This ensures that the protection for solicitation activities extends to all sales, which recognizes the increased focus in the American economy on intangibles and services.

(b) Adds the concept of "fulfillment" to acknowledge that not all sales or transactions are "shipped or delivered"

(c) Adds "business activity taxes" in addition to "net income taxes." This ensures that protections of P.L. 86-272 extend to all business activity taxes, which recognizes the proliferation on business activity taxes not based on income (gross receipts taxes, capital taxes, etc.).

(d) Implements a physical presence standard for all business activity taxes.

(1) Provides qualitative and quantitative *de minimis* standards.

i) <u>Quantitative</u>: Employees in a state for less than 21 days.

ii) <u>Qualitative</u>: Acting as a customer in the state, *e.g.*, visiting vendors, attending conferences, media events, etc.

(e) Clarifies that certain situations subject a person to tax.

(1) Entertainers and athletes.

(2) Off-the-truck/over-the-counter sales; itinerate handymen

(3) Maintaining an office and storing inventory (this is property in a state).

(f) Addresses those situations when attribution of nexus to other persons is appropriate.

f. Why is Congress Being Asked to Act?

(i) Problems that the Federal Legislation seeks to Address

(a) Uncertainty

(1) There is no clear standard governing when a state or locality may impose its business activity taxes on an out-of-state business.

(2) The Supreme Court has declined to rule on the nexus standard as applied to business activity taxes, apparently preferring to leave the matter for resolution by Congress.

(3) The existing federal statute addresses only a subset of the issue.

(b) Controversy

(1) The lack of a clear standard has engendered contentious tension between the state taxing authorities and businesses.

(2) Many states and localities are trying to impose tax on businesses that merely have

customers in the taxing jurisdiction ("economic nexus").

(3) Businesses want to pay their fair share of tax where they receive the benefits and protections of the state government ("physical presence nexus").

(c) Wasted resources

(1) Compliance with increasingly complex and divergent state and local tax laws and rules places a large burden on interstate commerce.

(2) Litigation absorbs resources (management attention and expenses) that could be used to strengthen the economy.

(d) Chilling effect on interstate commerce

(1) Businesses are hesitant to expand their activities that may cross an invisible "threshold" and make them taxable in other states.

(2) Businesses are forced to construct inefficient business structures.

(e) International ramifications

(1) There is a dramatic, antithetical "disconnect" between the permanent establishment concept used by the U.S. in international tax treaties and the economic nexus standard favored by some state and local tax jurisdictions

(2) If economic nexus becomes an acceptable standard for state and local taxation:

i) U.S. businesses would be competitively disadvantaged because they will be subject to a greater tax burden than foreign businesses.

ii) The strength of the U.S. in treaty negotiations with countries that favor eliminating the permanent establishment standard would be significantly weakened.

(ii) How the Proposed Legislation Addresses the Problems

(a) Benefits and Protections.

(1) A physical presence nexus standard ensures that businesses are taxed only where they receive protections and benefits (fire, police, etc.) of the state.

(2) The argument that states "contribute to nation as a whole" is not a justification for taxing businesses that do not have a physical presence in a state.

(b) Bright-line Standard. A physical presence nexus standard is fair and administrable.

(1) Eases compliance burdens created by current complex and divergent state and local tax laws.

(2) Minimizes litigation, thereby freeing resources (management attention and expenses) that can otherwise be used to strengthen the economy.

(c) International Harmony.

(1) Ensures consistency with the permanent establishment concept used by the U.S. in international tax treaties.

i) Protects the strength of the U.S. in treaty negotiations with countries that favor eliminating the permanent establishment standard would be significantly weakened.

(2) Creates a level playing field for U.S. and foreign businesses.

(iii) Other Considerations

(a) No Effect on Federalism or Infringement on States' Rights

(1) U.S. Constitution grants Congress the authority to regulate interstate commerce.

(2) This is an issue of *when* a state can tax, not *what or how* a state can tax. State legislatures remain free to, among other things:

i) Decide the type of tax(es) imposed, *e.g.*, an income tax, a gross receipts tax, a value added tax, or a capital stock tax.

ii) Determine how to apportion the income that is taxed in the state, be it a single- or three-factor formula based on property, payroll and/or sales.

iii) Set the rate at which the tax chosen will be imposed.

iv) Determine whether to follow federal taxable income, *e.g.*, to choose whether to decouple from federal bonus depreciation.

v) To provide credits or deductions for certain types of expenses.

(b) No Material Effect on Revenue

(1) Businesses that have a facility and/or inventory in the state remain subject to tax

(2) Consensus is that few businesses that do not have a facility are actually paying tax

(3) Result is that businesses will continue to pay their fair share because they will be paying tax where income is earned.

(c) Not a Vehicle For Promoting Tax Shelters.

(1) Opponents of a physical presence nexus standard argue that economic nexus is required to combat "abusive" tax shelters, such as passive investment companies. *Lanco, Inc. v. Dir., Div. of Taxation*, 980 A.2d 176 (N.J. 2006), *aff'g*, 2005 N.J. Super. LEXIS 268 (N.J. Super. Ct. App. Div., Aug. 24, 2005), *rev'g*, N.J. Tax Ct., No. 005329-97 (Oct. 23, 2003); *A & F Trademark, Inc. v. Tolson*, 605 S.E.2d 187 (N.C. Ct. App. 2004), *cert. denied*, 2005 US LEXIS 6033 (2005); *Geoffrey, Inc. v. South Carolina Tax Comm'n*, 437 S.E.2d 13 (S.C. 1993), *cert. denied*, 510 U.S. 992 (1993).

(2) States have many other methods of attacking such perceived tax shelters.

i) Combined reporting. *See, e.g., Matter of Sherwin-Williams Co.*, N.Y.S. Div. of Tax App., Tax. App. Trib., DTA No. 816712 (June 5, 2003); Va. Dep't of Tax'n, Ruling of Comm'r, P.D. 05-139 (Aug. 23, 2005).

ii) Statutory addbacks, deduction denial. *See, e.g.*, Ala. Code § 40-18-35(b); Ark. Code Ann. § 26-51-423(g)(1); Conn. Gen. Stat. § 12-218c; Ga. Code Ann. § 48-7-28.3; Ky. Rev. Stat. Ann. § 141.205; Md. Code Ann., Tax § 10-306.1; Mass Gen. Laws ch. 63, §§ 31I, 31J, 31K; Miss. Code Ann. § 27-7-17(2); N.J. Stat. Ann. § 54:10A-4.4; N.Y. Tax Law § 208(9)(o); N.C. Gen. Stat. § 105-130.7A; Ohio Rev. Code Ann. § 5733.042; and Va. Code Ann. § 58.1-402B. *See also* Multistate Tax Commission Proposed Model Statute Requiring the Add-back of Certain Intangible and Interests Expenses, Multistate Tax Commission (Feb. 17, 2005 Draft).

iii) Common law principles, such as economic substance, sham transaction, lack of valid non-tax business purpose, and alter ego. *Syms Corp. v. Commissioner of Revenue*, 765 N.E.2d 758 (Mass. 2002); *Comptroller of the Treasury v. SYL, Inc.; Crown Cork & Seal Co. (Del.), Inc.*, 825 A.2d 399 (Md. 2003), *cert. denied*, 540 U.S. 9 and 540 U.S. 1090 (2003).

iv) I.R.C. § 482-type authority to make adjustments to properly reflect income.

(iv) Who are the Stakeholders?

(a) For. Many American businesses, some state government officials (mostly from the legislative branch), and economists believe that states should not be able to impose tax on an out-of-state business unless that business has a physical presence in the taxing state.

(1) American Legislative Exchange Council:

i) ALEC has adopted a resolution supporting enactment of federal legislation implementing a physical presence standard.

ii) ALEC has crafted model legislation enacting a physical presence standard, similar to the proposed federal legislation.

(b) Against. Some state government officials take the opposite position and assert that a state may impose tax on any business that has customers in the state. Opponents of such legislation argue that federal BAT nexus legislation is an infringement on state sovereignty, would reduce state tax revenue, and would facilitate “tax shelters.”

(1) Multistate Tax Commission “factor-presence” nexus standard:

i) The MTC states that it objects to codification of the physical presence nexus standard for business activity taxes. Multistate Tax Commission Resolutions Committee Draft Policy Statement 2002-02, "Ensuring the Equity, Integrity and Viability of State Income Tax Systems," as amended October 17, 2002.

(2) The Federation of Tax Administrators approved a resolution to oppose federal efforts to establish nexus standards for state business activity taxes, such as H.R. 1956, at its annual business meeting on June 15, 2005.

i) At the meeting, FTA Executive Director Harley Duncan specifically noted that one major concern that states had with such legislation was that it would create significant opportunities to engage in a variety of tax planning activities.

ii) Also, the Executive Director criticized the bill for being internally inconsistent. "If a clear definition of physical presence is good, then there should be no need to carve out all sorts of activities that don't constitute physical presence. But the bill does just that."

(3) Montana resolution (S.J. 32) supported by the Commissioner of Revenue, Dan Bucks, opposed introduction of federal legislation implementing a physical presence standard for business activity taxes. The measure died in the House committee.

OPERATION AS A PARTNERSHIP OR LIMITED LIABILITY COMPANY – STATE INCOME TAX CONSEQUENCES TO THE ENTITY, ITS PARTNERS AND ITS MEMBERS

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OPERATION AS A PARTNERSHIP OR LIMITED LIABILITY COMPANY - STATE INCOME TAX CONSEQUENCES TO THE ENTITY, ITS PARTNERS AND ITS MEMBERS[1]

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PARTNERSHIPS

I. Classification as a "Partnership"

A. General Income Tax Classification.

For state income tax purposes, classification as a partnership generally is made by reference to the Internal Revenue Code and associated regulations.

B. Specific Jurisdictions.

1. California. Effective for taxable years beginning after 1996, California follows the federal "check-the-box" regulations for purposes of determining whether an entity is classified as a partnership or an association taxable as a corporation. Cal. Rev. & Tax Code section 23038; Cal. Code Regs. tit. 18 ("Franchise Tax Regulation"), section 23038(b)-1 - (b)-3.

2. Illinois. For income tax purposes, Illinois law provides that, "Any entity… shall be treated as a partnership if it is so classified for federal income tax purposes." Ill. Law section 35 ILCS 5/1501(a)(16).

3. New York State. For Business Corporation Franchise Tax purposes, New York State classifies as partnerships those entities classified as partnerships under Internal Revenue Code Section 761(a). N.Y. Comp. Codes R. & Regs. tit. 20 ("Business Corporation Franchise Tax Regulation"), section 1-2.6.

4. New York City. For Unincorporated Business Tax purposes and General Corporation Tax purposes, New York City follows the federal classification scheme (See N.Y.C. Adm. Code sections 11-126, 11-602.1).

5. Pennsylvania. Effective for periods beginning on or after January 1, 2001, for both corporate income and franchise tax purposes Pennsylvania treats as corporations all entities, including partnerships, which are treated as corporations for federal income tax purposes. Act of June 22, 2001, No. 23, amending Pennsylvania law sections 7401 and 7601.

II. Taxation of Partnerships.

A. Income Tax Nexus.

To be subject to state income tax, partnerships must have a tax presence in the state. Federal Public Law 86-272 applies to partnerships to the same extent that it applies to other forms of business organizations; therefore, partnerships having activities in a jurisdiction not exceeding those permitted under Public Law 86-272 are not liable for the jurisdiction's net income tax.

A partnership protected under Public Law 86-272 will not lose that protection by its partners' unrelated contacts or activities.

In addition, some states provide special rules providing that partnerships are not treated as doing business or having tax presence in a state. For example, in a 2003 bulletin the North Carolina Department of Revenue explained that a partnership will not be treated as doing business in the state, and would not be required to file an income tax return, if it is an "investment partnership." Directive PD-02-1 (November 6, 2002). The Directive defines an investment partnership as "a partnership that is not a dealer in securities, as defined in section 475(c)(1) of the Internal Revenue Code, and that derives income exclusively from buying, holding, and selling securities for its own account." (The Directive changed the Department's policy and is effective retroactive to tax year 2001. In 2004, the North Carolina Department of Revenue clarified the Directive as stating that a partnership will not be treated as an investment partnership if any of its income is from another type of activity. Directive P. D.-04-2 (November 4, 2004).)

B. General Income Taxation.

With the exception of the jurisdictions discussed below, the states do not impose net income taxes on partnerships. Nevertheless, most jurisdictions require partnerships having a tax presence to file information returns reporting the partnership's income and factors in the state, identifying the partners, and disclosing the extent of the partners' interests in the partnership.

C. Specific Jurisdictions' Income Taxation.

Illinois, New York City, the District of Columbia, Tennessee, Kentucky and Ohio impose net income taxes on partnerships.

1. Illinois. Illinois imposes its Personal Property Tax Replacement Income Tax ("Replacement Tax") on partnership net income. Ill. Law section 35 ILCS 5/201(c) and (d). The tax is imposed at a rate of 1.5 percent of the partnership's Illinois net income for the taxable year.

To alleviate the possible cascading of the tax, partnerships receive a deduction for distributions to partners that are subject to Replacement Tax and that provide to the partnership a completed Form IL-2569 certifying that they are subject to the tax. 35 ILCS 5/203(d)(2)(I). Such partners include corporations (including S corporations), other partnerships, and trusts. 35 ILCS 5/201(c). In addition, a deduction is permitted for distributions to entities exempt from federal income tax under Internal Revenue Code Section 501(a).

2. New York City. New York City imposes its Unincorporated Business Tax on partnerships. N.Y.C. Admin. Code section 11-502, et. seq. The tax is imposed at a rate of 4 percent of the partnership's total income apportioned to New York City. (In general, computation of a partnership's total income begins with the ordinary income or loss as shown on the partnership's federal Form 1065, with specified additions (including payments made to partners) and subtractions. Total income is classified as either business or investment income, with separate apportionment formulae for each.)

3. District of Columbia. The District of Columbia imposes its Unincorporated Business Franchise Tax on partnerships carrying on or engaging in a trade or business in the District. D.C. Code Ann. section 47-1810.1, et. seq. The tax is imposed on the partnership's total taxable income apportioned to the District. In March, 2006 a District of Columbia court held the tax to be invalid to the extent that it is imposed on nonresident partners. *Bender et al. v. District of Columbia*, Docket No. 8524-05, District of Columbia Superior Court, Tax Division (March 8, 2006). The Office of Tax and Revenue has appealed the decision to the District of Columbia Court of Appeals.

4. Tennessee. Effective for tax years beginning on or after July 1, 1999, Tennessee amended its franchise, excise tax law to tax limited partnerships, limited liability companies, and limited liability partnerships doing business in Tennessee. <u>See</u> Tennessee Law Section 67-4-2004 (16) (definition of "person" or "taxpayer").

5. Kentucky. Effective for tax years beginning on or after January 1, 2005, Kentucky includes limited partnerships within the definition of "corporation", and subjects such partnerships to the state's corporate income tax. KRS 141.010(24)(F) and (G).

6. Ohio. Effective July 1, 2005, Ohio imposes its Commercial Activity Tax (a gross receipts tax) on “persons” including partnerships and limited liability companies. This includes single member limited liability companies. Ohio Rev. Code Chapter 5751.

D. Other Direct Taxes on Partnership Business Earnings.

Alabama, Hawaii, Michigan, New Hampshire, Ohio, Tennessee, Washington, West Virginia and Wisconsin impose various types of business earnings taxes directly on partnerships.

1. Alabama. For tax years beginning after December 31, 1999, Alabama imposes its Business Privilege Tax on "limited liability entities", including limited partnerships. Ala. Stat. Secs. 40-14A-22 and 40-14A-1(k). The tax is based upon net worth and is imposed on a graduated scale ranging from $.25 to $1.75 for each $1,000 of net worth, up to a maximum tax of $15,250 ($15,000 for years after 2000).

2. Hawaii. Hawaii imposes its General Excise Tax on partnerships. Haw. Rev. Stat. section 237-1. The rate of tax varies according to the partnership's business activities.

3. Michigan. Michigan imposes its Single Business Tax on partnerships. Mich. Comp. Laws section 208.6(1). For periods beginning on or after January 1, 2005, the tax is imposed at a rate of 1.9 percent of the partnership's taxable income apportioned to Michigan. (The tax is scheduled to be eliminated for tax years beginning after December 31, 2009.)

4. New Hampshire. New Hampshire imposes its Business Profits Tax on partnerships. N.H. Rev. Stat. Ann. section 77-A:6, I. The tax is imposed at a rate of 8.5 percent of the partnership's net income apportioned to New Hampshire.

5. Ohio. Ohio generally imposes an entity level tax on partnerships to the extent of the distributive share of Ohio income of corporate partners not subject to Ohio's corporate income tax. Ohio Rev. Code sections 5733.40 -.41. The tax is imposed at an 8.5 percent rate. Law Section 5733.41 describes the purpose for the tax as being to "to complement and to reinforce" the corporate income tax.

6. Tennessee. Tennessee imposes its Stock and Bonds Income Tax on partnerships. Tenn. Code Ann. section 67-2-102. In general, the tax is imposed at a rate of 6 percent on dividend income from stocks and on interest income from bonds received by Tennessee partnerships.

7. Washington. Washington imposes its Business and Occupation Tax on partnerships. Wash. Rev. Code section 82.04.030. The rate of tax varies according to the partnership's business activities. The Business and Occupation Tax taxes the privilege of doing business in Washington and generally is based on gross income, gross proceeds of sale, or value of products, depending on the tax classification of the activity (e.g., gross proceeds of sale is applied to retail businesses).

8. West Virginia. West Virginia imposes its Business Franchise Tax on partnerships. W. Va. Code section 11-23-6. The tax is imposed at a rate of .7 percent of the value of the taxpayer's capital employed in the state.

9. Wisconsin. Wisconsin imposes a Recycling Surcharge on partnerships having at least $4 million in gross receipts for the taxable year. Wis. Stat. section 77.93(3) and 77.94(1)(b). The surcharge is imposed at a rate of .2 percent of net business income allocated or apportioned to Wisconsin, with a maximum surcharge of $9,800. Wis. Stat. section 77.94(1)(b).

10. California Tax on Limited Partnerships. Limited partnerships doing business in California are subject to an annual $800 tax. Cal. Rev. & Tax. Code sections 17935(a) and 23153. Other states also impose minimum taxes/fees on limited partnerships.

III. Taxation of Corporate Partners.

A. General Partners.

1. Income Tax. General. In general, jurisdictions in which a partnership has a tax presence treat general partners as having a tax presence and as being subject to income tax. The jurisdictions' treatment is justified under an application of the "aggregate" and "agency" theories of partnerships, which hold that partnerships are mere groupings of their partners, acting as agents for each other for purposes of partnership business, but that the partnership itself is not a distinct entity. Examples of such jurisdictions include the following:

a. New York State. N.Y. State Reg. section 1-3.2(a)(5) (In general, "If a partnership is doing business, employing capital, owning or leasing property or maintaining an office in New York State, then all of its corporate general partners are subject to the [Business Corporation Franchise Tax]").

b. New York City. N.Y.C. Gen. Corp. Tax Rule section 11-03(a)(5) ("If a partnership is doing business, employing capital, owning or leasing property or maintaining an office in New York City, then all of its corporate general partners are subject to the general corporation tax").

c. New Jersey. N.J. Reg. section 18:7-7.6(a) ("A foreign corporation that is a general partner of a general or limited partnership doing business in New Jersey is subject to filing a corporation business tax return in New Jersey and paying the applicable tax under the terms of the corporation business tax to New Jersey. Such a corporation is also deemed to be employing or owning capital or property in New Jersey, or maintaining an office in New Jersey, if the partnership does so").

The tax consequences may be greater for partners deriving other income (i.e., non-partnership income) from the state but otherwise lacking a tax presence in the state — such as a partner with in-state activities (exclusive of the partnership's activities) limited to those permitted under federal Public Law 86-272. By virtue of their partnership interest, such partners may be treated as having a presence exceeding the protection of that law, with the result that all of the partners' in-state income may be subject to taxation. In general, such partners will use their entire in-state and out of state apportionment factors to compute their income apportioned to the state. As an alternative, such partners may seek to separately account for their partnership and non-partnership income.

2. Apportionable/Allocable Character of Income Passed-Through.

a. General. Identification of a "general" rule is difficult, due to the variation in the states' treatments of corporate partners' shares of partnership income and factors. Instead, six states' treatments are discussed below. As is indicated below, the states differ in both the substance of their required treatments and the formality of their methods for prescribing those treatments.

b. California. California franchise tax treatment differs based on whether the partner and partnership are engaged in a unitary business. If the partner and partnership are engaged in a unitary business (disregarding ownership requirements), the partner includes its distributive share of the partnership's income and proportionate share of the partnership's factors with its own income and factors. Cal. Franchise Tax Reg. section 25137-1(f).

If the activities of the partner and partnership do not constitute a unitary business, the partner's share of the partnership's trade or business income is treated as a separate trade or business. Apportionment occurs at the partnership level (i.e., according to the partnership's factors), with the partner treating its distributive share of the partnership's business income as California business income. That income, when added to the partner's other California income, is the taxpayer's measure of tax. Cal. Franchise Tax Reg. section 25137-1(g)(1).

c. Illinois. In general, where a corporate partner and its partnership are unitary (disregarding ownership requirements), the partner determines its net income by including its share of the partnership's income and factors with its own business income and apportionment factors. Ill. Reg. section 100.3380(d). (Such inclusion is prohibited where 80 percent or more of the partnership's business activity is conducted outside of the United States, where the partner and partnership use different apportionment methods or where the partnership is not in the same general line of business or a step in a vertically structured enterprise with the corporate partner. Id.)

Where the partner and partnership are not engaged in a unitary business, the pass-through of income and factors is not permitted. Instead, the partner's distributive share of the partnership's business income is apportioned by the partnership's factors, and the partner's distributive share of the partnership's nonbusiness income is allocated as if such items had been paid, incurred or accrued directly to the partner in its separate capacity. Ill. Law section 35 ILCS 5/305.

d. Kentucky. Through tax years ending December 31, 2004, the Kentucky Revenue Cabinet directed corporate partners to include their distributive share of partnership income in their apportionable income. The Revenue Cabinet classified income from a partnership as being from intangible property and does not include the partner's proportionate share of the partnership's factors with the partner's own factors. Instead, partners included in their receipts factor denominator the net income (not gross receipts) allocated to them by the partnership and include their Kentucky distributive share of the net income from the partnership in their receipts factor numerator. Ken. Rev. Policy 41P200 (June 1, 1983) & Schedule A to Form 720 (Apportionment and Allocation).

Under a law change effective January 1, 2005, partnership factors now generally flow through to the partners.

e. Mississippi. Mississippi income tax law does not contain any special rules regarding allocation and apportionment of income to corporate partners. However, Miss. Tax Regulation section 806.II.B. ("Exceptions") provides that, at least for partnership's earning income in a single state, "Partnership income is allocated directly to the state where the partnership gross income or loss occurred." Moreover, the Mississippi Tax Commission informally advises corporate partners of partnerships earning income in more than one state to take into account their share of the partnership's Mississippi income — that is, with apportionment occurring at the partnership level. The partners do not include their share of the partnership's factors with their factors.

f. New Jersey. Under N.J. Reg. section 18:7-7.6(g), if a corporate partner and a partnership are engaged in a unitary business, the corporate partner includes its distributive share of the partnership's operational income and proportionate share of the partnership's apportionment factors with its entire net income and factors. If the corporate partner and the partnership are not engaged in a unitary business, the partner's distributive share of the partnership's income is apportioned to New Jersey using the partnership's apportionment factors.

g. Tennessee. Under Tennessee law, a corporate partner generally includes its share of the partnership's income and factors with its income and factors. Tenn. Code Ann. section 67-4-2012(k).

h. Arizona. In Central Newspapers, Inc. & Subsidiaries v. Arizona Department of Revenue (Docket No. 1936-05-I November 22, 2005) the Arizona Board of Tax Appeals held that where a partner with Arizona tax presence is not unitary with its partnership, there is "no theory under which Arizona can tax [] -- a Washington partnership with no nexus to Arizona – on its sales into Arizona." The Board of Tax Appeals therefore held that the partnership's Arizona sales were not includable in the sales factor numerator of Arizona consolidated report filed by the partnership's Arizona corporate partners.

3. Other Issues.

a. Allied Signal. In Allied Signal, Inc. v. Director, Division of Taxation, 504 U.S. 768 (1992), the United States Supreme Court held that for income to be treated as apportionable, the income must arise either from a unitary business activity or from a use of capital that serves an operational purpose as opposed to an investment purpose. The rule of Allied Signal does not present an issue in the typical situation where a partnership earns income in the course of its business activities and either the partner's use of capital by participating in the partnership is in furtherance of an operational purpose or the partner and the partnership are engaged in a unitary business. Moreover, in determining whether a unitary relationship exists, states disregard the percentage of ownership threshold required when determining whether two corporations are unitary. See, e.g., Cal. Franchise Tax Reg. section 25137-1(f) & Ill. Reg. section 100.3380(d).

If a partner is not unitary with the partnership and if the partner's interest in the partnership serves an investment (i.e., non-operational) purpose, the treatment of income passed-through from the partnership is less clear. As a matter of federal Constitutional law, the better treatment seems to be for that income to be classified as nonapportionable and instead allocated under the states' rules for investments in intangibles.

However, as is indicated above, not all states follow this approach for nonunitary partnership interests. For example, California treats income as apportionable by reference to the character of the income in the hands of the partnership. See Cal. Franchise Tax Reg. section 25137-1. Under that regulation, where the partner and the partnership are not engaged in a unitary relationship, the partner's interest is deemed to be a separate trade or business, with apportionment of the partnership's income occurring at the partnership level.

b. Withholding of Tax. Certain jurisdictions require partnerships to withhold state income taxes from amounts paid or distributable to nonresident partners, including business entities not having a tax presence in the state. For example:

(i) Indiana. Ind. Code section 6-3-4-12 generally requires partnerships to withhold income tax on distributions made to nonresident partners. Withholding is not required on amounts paid to partners qualified to do business in Indiana. 45 IAC section 3.1-1-107.

(ii) Georgia. Ga. Code Ann. section 48-7-129(a) generally requires a 4 percent withholding from distributions to nonresident partners, to the extent those distributions are attributable to property owned or business done in Georgia. Ga. Reg. section 560-7-8-.34. (But see the exception discussed below for certain corporate limited partners.)

(iii) New Mexico. New Mexico requires pass-through entities to deduct and withhold tax on a nonresident owner's share of net income. NMSA 7-3-2 and 7-3-5, and adding a new section to the Withholding Tax Act). For purposes of this law, "pass-through entity" is defined to include partnerships and limited liability companies, unless they are taxed as corporations for federal income tax purposes. The provision is intended to apply to corporate partners as well as natural persons. Withholding is not required if the nonresident owner executes an agreement with the Department of Revenue to report and pay the tax on its own return. See also 3 NMAC 3.2.10 (effective December 31, 1999).

c. Sales and Use Tax Presence. Under the aggregation theory, the states may treat a partnership's presence in the state as creating a presence for the partners for purposes of other taxes, most notably sales and use taxes. Under that approach, a partner not otherwise required to collect and remit states sales and use taxes (because it otherwise lacks substantial nexus) may be required to do so because its partnership has such a presence in the jurisdiction.

B. Limited Partners.

1. General. Taxing jurisdictions do not follow a uniform rule for determining the income tax presence of limited partners. Three approaches indicative of the range of possible treatments are described below. The discussion below applies to limited partners that are not also general partners in the same partnership and that do not participate in the limited partnership's business; limited partners that are also such general partners or that participate in the partnership's business may be treated as doing business where the partnership is doing business.

2. Jurisdictions Not Distinguishing Between General and Limited Partners. Certain jurisdictions treat limited partners as having tax presence to the same extent as general partners. For example:

a. New York City. N.Y.C. Gen. Corp. Tax Rule section 11-06(a) ("Corporations as Limited Partners") provides that "...a corporation shall be deemed doing business in the City if it owns a limited partnership interest in a partnership that is doing business, employing capital, owning or leasing property, or maintaining an office in the City." (New York City provides limited exceptions for partners in publicly-traded partnerships and partners in portfolio investment partnerships. Rule section 11-06(b) and (c).) A New York City Administrative Law judge determined that the same result occurs even if the corporation does not hold the limited partnership directly, but instead holds an interest in a general partnership which holds the interest in the limited partnership. Matter of Ellsworth Co., Inc., (NYC ALJ) (July 21, 2000) (stating that "The fact that an intermediate general partnership interest exists between Petitioner and the City limited partnership is of no legal consequence.").

b. New York Sate. In general, for Business Corporation Franchise Tax purposes, New York State does not distinguish between general and limited partners. (Regulation section 1-3.2(a)(6) provides certain narrow circumstances in which a foreign corporate limited partner will not be treated as having a tax presence despite the contacts and activities of the limited partnership. Limited partners not meeting those conditions are treated as having a presence for purposes of the tax.)

c. North Carolina. In Final Decision 97-548 (April 24, 1998), the North Carolina Secretary of Revenue ruled that the "doing business" rule (N.C. Admin. Code Rule Sec. 17:05c.0102(b) for determining liability for the State's corporate franchise and income tax does not distinguish between general and limited partners. Thus, the Department held that all partners (general and limited) in a partnership that is doing business in North Carolina are likewise doing business in North Carolina. That interpretation was confirmed in an administrative decision. Perkins Restaurants, Inc., Tax Review Board Administrative Decision 351, January 28, 1999. In Perkins, the taxpayer was a limited partner in a partnership that owned and operated restaurants in North Carolina. The Board rejected the taxpayer's argument that it was not doing business in North Carolina and was not subject to the State's corporate franchise and excise tax was rejected. The Tax Review Board held that "the 'doing business' rule is applicable for all tiers of the partnership structure and does not distinguish between general and limited partners of a partnership. Therefore, a limited or general partner in a partnership, which is a partner in a partnership that is 'doing business' in North Carolina, is likewise 'doing business' North Carolina."

d. Illinois. In Borden Chemicals and Plastics, L.P. v. Zehnder, 726 N.E. 2d 73 (App. Ct. 1st Dist. 2000), leave to appeal denied (May 31, 2000), the Illinois Appellate Court held that a corporate limited partner should be treated in the same manner as a corporate general partner for purposes of determining income tax presence, and that all such partners are treated as doing business in Illinois and being taxable on their distributive share of partnership income. ("Certainly, the physical presence in the taxing state of the partnership that generates the income suffices as a physical presence of the nonresident partner in the state....Plaintiff's characterizations of itself as a separate entity to whom the 'substantial nexus' between the partnership's activities and Illinois did not apply, for taxation purposes, meritless. Plaintiff has failed to cite any case that has applied the Complete Auto test to bar a state from taxing the distributable income of a nonresident limited partner of a partnership that is physically present in Illinois, operates in Illinois, and whose activities undisputedly have a substantial nexus to the taxing state. We decline to extend Quill to the state tax imposed on partnership income. We hold that the tax here is valid under the commerce clause.") Id. at 81-82.

e. Alabama. While no Alabama law or court decision expressly states that a limited partner has an Alabama tax presence merely because of its interest in a limited partnership doing business in Alabama, Regulation

810-3-24.01 ("Taxation of Partnership Income") defines "partnership" as including limited partnerships as well as general partnerships. Consistent with that definition, the regulation describes the Alabama gross incomes of partners without distinguishing between general and limited partners. In addition, in Alabama v. Lanzi, No. CV-2003-2705 (Ala. Cir. Ct. November 11, 2004) an Alabama Circuit Court overruled an Alabama administrative law judge and held that a nonresident individual limited partner had tax presence in Alabama by virtue of its ownership interest in a limited partnership formed under Alabama law. See also Danov Corporation v. State of Alabama, Alabama Department of Revenue, Administrative Law Division, No. 97-283 (December 22, 2000), an administrative law judge treated a limited partner as having a tax presence in the state merely by virtue of its partnership interest, stating, "The taxpayer clearly had nexus with Alabama through its investment in (the partnership) in Alabama."

f. Florida. Florida Rule 12C-1.002 does not distinguish between general and limited corporate partners in providing that, "The partnership's conduct of business, derivation of income or existence within Florida shall be deemed attributable to the partners, rather than to the partnership itself."

g. Georgia (individual partners). Georgia law provides that individual partners are taxable on their share of the partnership's net profits, without distinguishing between general and limited partners. Georgia Stat. section 48-7-24(a). Georgia's Court of Appeals held that nonresident individual limited partners are subject to Georgia income tax on their share of the partnership's net profits. Department of Revenue v. Sledge, 528 S.E.2d 260 (Ct. App. 3d Div. 2000), pet. for cert. denied (May 26, 2000).

h. Wisconsin. Effective for periods beginning on or after January 1, 2001, limited partners and members of LLCs, treated as partnerships for federal income tax purposes, are treated as doing business in Wisconsin and as having a Wisconsin presence for corporate income tax purposes if their partnership/LLC is doing business in Wisconsin. 2001 Wisconsin Act 16, amending Wisconsin Stat. Section 71.22(lr).

i. New Jersey. Effective for periods beginning on or after January 1, 2001, New Jersey law generally provides for corporate limited partners to consent to New Jersey Corporation Business Tax jurisdiction on their distributive income from the partnership. The consent is to be provided to and retained by the partnership. In the absence of such a consent, the partnership is required to remit a payment of tax to the state equal to the tax (at the maximum rate) on the non-consenting partner's share of the partnership's income apportioned to New Jersey. New Jersey Stat. sections 54:10A-5 and -7.

j. Massachusetts. In Utelcom, Inc. v. Massachusetts Commissioner of Revenue, Mass. App. Tax Board No. C262339 (January 31, 2005) the Massachusetts Appellate Tax Board held that a corporate partner has tax presence for Utility Corporation Tax purposes by virtue of its ownership of a limited partnership interest in a partnership conducting business in the state. In reaching that conclusion, the Board adopted in principle a personal income tax decision finding tax presence consequences for personal income tax purposes from the holding a limited partnership interests.

3. Jurisdictions Recognizing Some Differences Between General and Limited Partners.

Some jurisdictions/taxes may treat limited partners as having a tax presence only to the extent of the partner's distributive share of the partnership's income apportioned to the state, or only for income (but not franchise) tax purposes. For example, in Appeal of Amman & Schmid Finanz AG, No. 96-SBE-008 (April 11, 1996) the California State Board of Equalization ("SBE") held that a limited partner does not have a franchise tax presence (i.e., is not doing business in California) merely by reason of its status as a limited partner in a partnership doing business and holding real property in California. The SBE observed that under California's Revised Limited Partnership Act, limited partners are not bound by the obligations of the partnership, have no interest in specific limited partnership property, and are not in an agency relationship with the partnership's general partners. However, California imposes a corporation income tax on corporations not subject to the corporation franchise tax, i.e., corporations not doing business in California, Cal. Franchise Tax Reg. section 23501. The tax is imposed on net income derived from sources within California. Cal. Rev. & Tax. Code section 23501, et. seq. Foreign limited partners have been treated as being subject to the corporation income tax on the California source income of their distributive share of their partnership's California source income. See Appeal of Amman & Schmid Finanz AG, supra.

4. Jurisdictions Not Treating Corporate Limited Partners as Having a Tax Presence. Certain jurisdictions, including Texas, New Jersey and Georgia do not treat corporations as having an income tax presence despite their status as limited partners in partnerships having a presence in the jurisdiction.

a. Texas. The Texas Comptroller's Office has ruled that a foreign corporation limited partner does not have a franchise tax presence merely by reason of its status as a limited partner in a partnership doing business in Texas). See, e.g., Ruling, April 5, 1995. As of the May 17, 2006 date of submission of this outline, the Texas legislature has approved legislation taxing most partnerships. H.B. No. 3 (79^{th} Legislature, 2006). The Governor’s approval of the legislation is expected.

b. Georgia (non-individual partners). Georgia law provides for tax presence of all nonresident "individual" partners, and defines "individual" as "a natural person." Georgia Stat. section 48-7-24(a) and 48-1-2(12). No comparable provision exists for non-individual partners. The difference in the treatments of individual and non-individual partners under Georgia law was acknowledged by a Georgia Assistant Attorney General in a 1982 memorandum to the Director of the

Georgia Department of Revenue's Income Tax Division. The memorandum further stated that "Because income or loss from a corporation's limited partnership interest is treated as income or loss from intangible personal property rather than as from the activities of the partnership itself, a corporation whose only contact with Georgia is by virtue of its limited partnership interest in a partnership operating in Georgia should not be considered to be owning property or doing business within the State." Memorandum from Warren R. Calvert to John G. Carter (October 13, 1982).

Note, however, that effective for tax years beginning on or after January 1, 2002 the Georgia Department of Revenue amended its regulations to provide that "A corporation will be considered to be owning property or doing business in Georgia whenever the corporation is a partner, whether limited or general, in a partnership which owns property or does business in Georgia." Ga. Reg. section 560-7-7-03e

c. Kentucky. Under a law effective January 1, 2005, Kentucky treats the "maintaining of an interest in a general partnership" as subjecting a partner to the state's income tax. The provision does not apply to interests in limited partnerships.

5. Pass-through of Income and Factors. The states do not have a uniform treatment of partnership income received by a limited partner. Illinois has ruled that, in general, a limited partner and its limited partnership may not be treated as being in a unitary relationship. See, e.g., Ill. Ltr. Rul. Nos. IT-88-0258 (September 21, 1988), IT-88-0323 (December 12, 1988). In that case, characterization of income as being business or nonbusiness first occurs at the partnership level, with apportionment of partnership business income also occurring at the partnership level. The partners report as Illinois income their distributive share of the partnership's Illinois income. Ill. Law section 35 ILCS 5/305(a). The partnership's nonbusiness income is taken into account by the partners as if the items were paid directly to the partners. Ill. Law section 35 ILCS 5/305(b).

6. Withholding of Tax and Composite Reporting.

The states increasingly are becoming concerned that limited partnerships and LLCs are being used both to avoid entity level tax and to help nonresident limited partners and nonresident LLC members avoid state taxation. In response, many states are requiring withholding of tax from distributions to nonresident partners that do not agree to be subject to the state's tax.

In their desire to collect tax on amounts distributable to such nonresident partners, the states sometimes attempt to make the partnership liable if a nonresident partner does not pay state income tax. However, the mechanisms used to collect the partner's tax from the partnership may be flawed. For example, on December 28, 2001, Alabama enacted law sections 40-18-22.1 which holds the entity liable for a partner's nonpayment of tax, even if the partner has provided the entity with a consent to Alabama tax jurisdiction (which consent the entity has filed with the state). The attempt to impose liability on the partnership in such circumstances appears to be unfair, as once the partnership receives the partner's consent it cannot control the payment of the partner's tax. Moreover, the Department of Revenue's demand that the partnership pay the partner's liability may be issued after the partner has ceased to be affiliated with the partnership, in which case the partnership will be unable to obtain reimbursement by withholding from future distributions to the partner.

The states may permit or require the filing of a single, "composite", report by partnerships on behalf of certain of their partners. Typically, composite reporting is used where a partnership has noncorporate members having no income from the state except for income earned through the partnership. See e.g., Connecticut Information Publication 2005(13) describing Connecticut's composite return requirements.

C. Multi-Tiered Partnerships.

1. General. When partnerships are themselves partners in other partnerships, complex issues may arise regarding the character and sourcing of income received by the ultimate partners. As the states do not follow a uniform approach to the pass-through of income and factors from partnerships to first-tier partners, neither do they follow a uniform approach to the treatment of multi-tiered partnerships. New Jersey and Illinois practices reflect the range of possible approaches.

2. Specific Jurisdictions.

a. New Jersey. New Jersey looks through the tiers of partnerships to the ultimate corporate partner. As described in N.J. Reg. section 18:7-7.6(i), "A 'tiered partnership,' for the purposes of this section, is a partnership whose partners are partnerships. A corporation that is a partner in a partnership that in turn is a partner in yet another partnership is not immune from New Jersey taxation simply because of the tiered partnership. The ultimate tax burden and loss benefit falls on the corporate partner. The corporation shall file a New Jersey corporation business tax return taking account of its ultimate distributive share of the tiered partnership's income or loss from New Jersey activities."

b. Illinois. The Illinois Department of Revenue generally has interpreted the pass-through provision of regulation Section 100.3380(d) as applying to first-tier corporate partners only. Therefore, where the partner is another partnership, pass-through of income and factors to a corporate partner in an upper-tier partnership generally has not been permitted even where the corporate partner is engaged in a unitary business with the lower-tier partnership. (The Illinois Department of Revenue may require such pass-through.)

Notwithstanding the Illinois Department of Revenue's general interpretation, it occasionally permits a corporate partner in an upper-tier partnership to include its share of the factors of a lower-tier partnership in the computation of its apportionment percentage. For example, the Department of Revenue agreed with a taxpayer that a failure to include such factors would be inherently distortive of Illinois taxable income. Priv. Ltr. Rul. IT-97-0015 (June 26, 1997). See also Priv. Ltr. Rul. IT-96-0159 (December 17, 1996).

IV. Planning With Partnerships.

A. General. In appropriate circumstances, use of a partnership structure can provide significant state tax advantages. Those advantages may include favorable methods for determining amounts subject to tax and protection from nexus for purposes of income and other taxes. However, use of partnership structures may have the effect of spreading the partnership's tax presence to its partners or may result in a flow-through of apportionment factors, both of which can produce unexpected results. Planning with partnerships — particularly where the partners have multi-state business activities — therefore requires caution and frequently requires analyses of tax consequences in jurisdictions and under taxes other than those for which a partnership structure is being considered.

B. Example.

a. Texas Franchise Tax. As is discussed above, the Texas Comptroller has ruled that foreign limited partners, otherwise lacking a Texas tax presence, generally will not become subject to the state's franchise tax by reason of their holding of the limited partnership interest. See, e.g., Rulings 9911323L (November 2, 1999) and 9606338L (June, 1996, "Methods of Tax Avoidance; Prepared at the Request of the Ways and Means Committee"). Therefore, foreign corporations conducting business in Texas should be able to reduce their liability for that tax by operating in a limited partnership form instead of as a general partnership or C corporation. (Of course, the limited partner must be a passive investor in the partnership, as participation in the partnership's management or activities could cause that partner to be subject to the tax.) Note, however, that as of the May 17, 2006 date of submission of this outline, the Texas legislature has approved legislation taxing most partnerships. H.B. No. 3 (79^{th} Legislature, 2006). The Governor’s approval of the legislation is expected.

LIMITED LIABILITY COMPANIES

I. Multiple-Member LLCs - Classification as Corporations or Partnerships.

A. General Income Tax Classification.

For income tax purposes, almost every state classifies and taxes multiple-member LLCs in accordance with the LLC's federal classification. See, e.g., Ill. Law sections 35 ILCS 5/1501(a)(4) ("Any entity ...shall be treated as a corporation if it is so classified for federal income tax purposes"), 1501(a)(16) ("Any entity ...shall be treated as a partnership if it is so classified for federal income tax purposes"); N.Y. State (see, e.g., TSB-A-97(7)I (August 6, 1997) ("It has been established that the classification of an LLC for New York State tax purposes will follow the classification accorded the LLC for federal income tax purposes."); N.Y. City Admin. Code section 11-126; Tenn. Code Ann. section 48-211-101; Cal. Tax Law section 23038.

B. State Income Taxation of LLCs Taxed as Corporations for Federal Income Tax Purposes.

For state income tax purposes, LLCs classified as corporations for federal income tax purposes are taxed as corporations for state income tax purposes. In general, the state income tax treatment of such LLCs is the same as the LLCs would have received if incorporated.

C. State Income Taxation of LLCs Classified as Partnerships for Federal Income Tax Purposes.

With limited exceptions, LLCs taxed as partnerships for federal income tax purposes are taxed as partnerships for state income tax purposes. As a result, LLCs treated as partnerships are subject to the partnership income and other business earnings taxes discussed above with regard to partnerships.

For corporate income/franchise tax purposes, Texas and Kentucky (and formerly Florida) treat all LLCs as corporations without regard to the LLCs' federal classification.

1. Texas. Under Tex. Tax Code Ann. sections 171.001(a)(2) and (b)(3)(A), LLCs are classified as corporations for Texas franchise tax purposes. Texas franchise tax is composed of a tax on the entity's taxable capital and, to the extent it produces a greater tax than the tax on taxable capital, a tax on net taxable earned surplus. Tex. Tax Code Ann. section 171.002. Apportionment is by a single factor (receipts) apportionment formula. The tax on net taxable earned surplus is imposed at a 4.5 percent rate.

2. Kentucky. Under a law effective January 1, 2005, Kentucky treats limited liability companies as corporations for income tax purposes. KRS 141.010(24)(C)(D) and (E).

3. Florida. Florida no longer imposes its corporate income tax on LLCs treated as partnerships for federal income tax purposes. See Fla. Stat. Ann. section 220.02.

Through the effective date of the amendments to Florida law (discussed below), LLCs were classified as corporations for Florida corporate income tax purposes. See Fla. Stat. Ann. sections 220.02(1) and 220.03(1)(e). For the relevant periods, the computation of Florida income tax began with the entity's federal taxable income which, for LLCs, was defined to be equal to the amount of taxable income determined as if the LLC was a corporation under the Internal Revenue Code. Fla. Stat. Ann. section 220.13(2)(j) & Reg. section 12C-1.013(e). After specified additions and subtractions, the corporate income tax was imposed at 5.5 percent of the LLC's net income allocated and apportioned to Florida. (Apportionment was by a three factor formula (property, payroll and receipts), with receipts being double-weighted.)

The Florida Department of Revenue interprets the change in the state's treatment of LLCs as being effective July 1, 1998. See, e.g., Fla. Dept. of Revenue, TIP #98(C)1-05 (July 1, 1998). However, taxpayers should be aware that the amendments to Section 220.02 are subject to a special effective date provision which makes them effective retroactive to January 1, 1997. While the Florida Department of Revenue interprets that special effective date as applying only to a different subsection of the amendments to Section 220.02, the effective date provision actually states — twice — that it applies to all of the amendments to Section 220.02.

D. Other State Fees And Taxes On LLCs. Many states impose modest annual taxes/fees on domestic LLCs and foreign LLCs registered to do business in the state. See, e.g., Delaware ($200). Del. Limited Liability Act. section 18-1107(b).

Other states impose annual fees on LLCs with those fees being determined by the number of members of the LLC. For example:

- New York State imposes an annual fee on LLCs classified as partnerships for federal tax purposes and having income derived from New York sources. That annual fee is $50 per member (determined on the last day of the taxable year), to a maximum of $10,000 per year, and is payable to the Department of Taxation and Finance. N.Y.S. Tax Law section 658(c)(3). For 2003 and 2004, the fee amounts were $100 and $25,000, respectively, but were scheduled to decrease to the prior rates beginning January 1, 2005. However, the scheduled decrease has been postponed until at least 2007. Ch. 61 (S.B. 3671) Laws 2005.

- Tennessee imposes an annual fee on LLCs doing business in Tennessee. The fee is $50 per member to a maximum of $3,000, and is payable to the Secretary of State. Unlike New York State, Tennessee imposes its fee on all LLCs, without excluding those LLCs classified as corporations for state Franchise and Excise Tax purposes. Tenn. Code Ann. section 48-247-103(d).

California imposes an $800 annual tax on LLCs doing business in the state. Cal. Rev. & Tax. Code sections 17941 and 23153. In addition, California imposes on LLCs an annual gross receipts fee. For periods ending prior to January 1, 2001, California annually adjusted the amount of this fee. However, effective for taxable years beginning on or after January 1, 2001, the fee structure no longer will be revised annually. Instead, the fee amounts are now fixed, with the maximum fee set at $11,790 annually. Cal. Rev. & Tax Code Sections 17942 and 17943. The characterization of the gross receipts fee as being a fee and not a tax permits the deduction of that amount in determining the LLC's California income. Cal. Rev. & Tax Code Section 17220(b). However, the "fee" was held to be an unconstitutional unapportioned tax in Northwest Energetic Services LLC v. California Franchise Tax Board (CGC-05-4377211 (SF Sup. Ct. March 3, 2006). The Franchise Tax Board has indicated that it will appeal the case.

II. State Income Tax Treatment of Members of LLCs Treated as Partnerships for State Income Tax Purposes.

A. Pass-Through of Income and Factors.

1. General. In general, state income taxation of members of an LLC classified as a partnership for state income tax purposes is the same as the states' treatment of similarly situated partners of partnerships. Therefore, while many states have not expressly addressed this issue, the income and factors should pass-through to the member for state tax purposes in the same manner that those items pass-through to partners.

2. Specific States.

a. California. An LLC that elects to be treated as a partnership for federal purposes will be treated as a partnership for California income and franchise tax purposes, Cal. Rev. and Tax. Code section 23038, and the LLC's members will be taxed under the California income tax provisions applicable to partnerships. Cal. Rev. & Tax. Code section 17087.6. As a result, corporate members of LLCs should be taxed on their distributive shares of the LLC's income (and include the LLC's apportionment factors with their own factors) in the manner described above with reference to partnerships.

b. New York State. The New York State Department of Taxation and Finance has advised that where a corporation is a member of an LLC treated as a partnership for federal income tax purposes (and therefore treated as a partnership for New York State tax purposes), the corporation is required to include its proportionate part of the LLC's income and apportionment factors with its own income and factors. TSB-A-97(13)(C) (June 26, 1997). The inclusion of those items is made in the same manner as for corporate partners under N.Y. St. Business Corp. Franchise Tax Reg. section 4-6.5.

B. Classification of LLC Members.

1. General. Many states have not expressly addressed the issue of how LLC members are to be classified. As noted above with regard to partnerships, classification as a general or limited partner may affect significantly the partner's liability for state taxes, with general partners being treated as having tax presence where the partnership has tax presence, but with limited partners potentially being

treated as not having such tax presence. However, because LLC statutes generally do not provide formal distinctions comparable to the general partner/limited partner distinction contained in the states' limited partnership laws, tax planning based upon a passive member's lack of a taxable presence in a particular state is difficult.

Theoretical arguments for why members of LLCs treated as partnerships for income tax purposes should not be presumed to have tax presence in a jurisdiction merely by virtue of the LLC's tax presence in the jurisdiction include the following:

- An LLC is a distinct entity formed under state law. Therefore,

  (i) there is no basis for applying the aggregate or agency theories, under which a partnership is treated as a mere aggregation of its partners rather than as a distinct entity and which, by that treatment, provides a substantial justification for treating all partners of a general partnership as having tax presence in jurisdictions where the partnership has a tax presence.

  (ii) while LLCs may be <u>treated</u> as partnerships for purposes of computing their and their members' state tax liabilities, they are not, in fact, partnerships. Moreover, the distinction between computational issues and entity lines is not new to state taxes, and in fact has received substantial attention in the <u>Joyce/Finnigan</u> debate. Arguments against presumptive nexus for members may draw support in <u>Joyce</u> jurisdictions from the reasoning applied by the jurisdiction in adopting the <u>Joyce</u> approach, or, if such reasoning is not available, from the very fact that the jurisdiction has adopted the <u>Joyce</u> approach.

- In general, LLCs are similar to limited partnerships in certain fundamental respects, including: (i) members generally have limited liability for the LLC's indebtedness and other liabilities, (ii) members do not have an interest in specific LLC property, and (iii) membership interests in LLCs generally are treated as intangible personal property. <u>See generally</u> Ill. Law sections 805 ILCS 180/10-10, 180/25-15, 180/30-1. <u>See also</u> the SBE's statement in <u>Appeal of Amman & Schmid Finanz AG</u> ("A general partner simply does not have agency rights over the obligations or the property of the limited partners"), which was made in concluding that limited partners are not doing business in California merely because their partnership is doing business in the state. That statement should have equal application to the relationship between members of LLCs.

Theoretical arguments for why members of LLCs treated as partnerships for income tax purposes should be treated as having a tax presence in those jurisdictions in which the LLC has a tax presence include the following:

- The arguments against finding such presence assume an ability to distinguish between active and inactive partners. Such a distinction is fact intensive, with results that are more likely shades of gray than black and white. The states cannot efficiently administer their taxes if they must routinely contend with such fundamental factual questions.

- The arguments against finding such presence prove too much, as they apply equally to active and passive members of LLCs. Those arguments, if followed, could be interpreted to mean that an LLC's tax presence could not be attributed to even its most active member. Such a result provides greater protection than that received by limited partners — whose protection from tax presence is more clearly derived from the entity's enabling statute.

2. Specific Jurisdictions. In certain circumstances, specific jurisdictions may treat LLC members as being equivalent to limited partners. For example,

a. Ala. Rev. Rul. 96-005. (September 11, 1996) classifying LLC members not directly participating in the management of the LLC as equivalent to limited partners; and

b. N.Y.C. Finance Dr. Rul. 95-4567. (October 31, 1995), stating that "Because of the similarity in the structure and tax treatment of a limited partnership and a limited liability company, in our opinion, the criteria set forth in Rule section 11-06 for whether limited partners are deemed to be doing business in New York under the GCT should be applicable to members of a limited liability company." (Note, however, that except in the limited circumstances discussed above (relating to publicly-traded partnerships and portfolio investment partnerships), limited partners (and therefore members of LLCs) are treated as having a General Corporation Tax presence in the City if the partnership (or LLC) has a tax presence in the City. See Rule section 11-06.)

C. Withholding Requirements. Several states, including California, Georgia, Maryland, Minnesota and South Carolina, require LLCs to withhold tax on distributions made to their nonresident members. (California does not require such withholding for members consenting to California's tax jurisdiction. Cal. Rev. & Tax. Code section 18633.5(e).) In addition, the Ohio tax on pass-through entities (including LLCs not classified as corporations for federal income tax purposes) seems fairly characterized as a withholding-type tax. New Jersey generally imposes its Corporation Business Tax on LLCs classified as partnerships for federal income tax purposes to the extent that the LLC's corporate members do not consent to be subject to the tax. New Jersey Stat. sections 54:10A-15.7.

(See the discussion of limited partner withholding for analysis of possible state overreaching in attempting to hold limited liability entities liable for their members' nonpayment of income taxes.)

III. State Income Taxation of Single-Member LLCs.

A. General. The federal income tax treatment of single-member LLCs is provided for in the "check-the-box" regulations. For federal income tax purposes, such entities are treated as either corporations or divisions of their single-member, at the election of the single-member

LLC. Internal Revenue Regulation Sections 301.7701-1(a)(4), 301.7701-3(b)(1). If no election is made, the LLC is disregarded as an entity separate from its member. Internal Revenue Regulation Section 301.7701-3(b)(1).

B. Explicit Check-The-Box Conformity. For income tax purposes, many states have indicated an intention to follow the federal treatment of single-member LLCs as provided for in the check-the-box regulations. Such conformity may occur

- by statute (see e.g., Ariz. Rev. Stat. section 29-857; Georgia Code section 14-11-1104; Ind. Code section 6-3-1-11; Mo. Rev. Stat. section 347.187; Wis. Stat. section 71.22(1));

- by regulation (see, e.g., Del. Reg. section 1.1900.2);

- or, frequently, by administrative pronouncement or letter ruling (see, e.g., Ala. Rev. Procedure 98-001 (March 16, 1998); Ariz. Corp. Tax Rul. 97-2 (August 8, 1997) (interpreting Ariz. Law section 29-857); Haw. Tax Information Release 97-4 (August 4, 1997); Illinois General Information Letters IT-98-0038 (April 13, 1998) and IT-00-0094 (December 6, 2000); Iowa Ltr. Rul. (March 20, 1997); Mass. Technical Information Release 97-8 (June 16, 1997) and Letter Ruling 99-17 (November 30, 1999); Mich. Revenue Administrative Bulletin 1999-9 (January 21, 2000); Minn. Rev. Notice 98-08 (May 26, 1998) (see also 97-03 (March 17, 1997)); N.Y.C. Finance Memorandum 99-1 (October 21, 1999). N.Y.S. Advisory Opinion TSB-A-96(19)C (July 24, 1996); N.C. Technical Advice Memorandum 97-3 (January 27, 1997)); S.C. Information Letter 96-25 (December 19, 1996) and Ruling 98-11 (May, 1998); Va. Public Document 97-343 (August 28, 1997).

Prior to the adoption of the check-the-box regulations, the California Franchise Tax Board strenuously objected to the "tax nothing" treatment of single-member LLCs. California has since conformed to the federal treatment. See Cal. Rev. & Tax. Code section 23038(b)(2)(B)(iii). However, California imposes its LLC tax and LLC fee without providing an exception for LLCs that have had their income included in their members' determination of its California income. Id. and Cal. Rev. & Tax. Code sections 17941, 17942.

C. Implicit Check-The Box Conformity. Other states, while not expressly conforming to the federal classification of single-member LLCs, nevertheless will follow that classification for income tax purposes. This issue may arise because state tax definitions conform to the definitions provided by the Internal Revenue Code (as opposed to the definitions provided by the Internal Revenue Code and associated regulations), and may be resolved by reference to the state's tax definitions of "corporation", "partnership", and "taxable income".

For example, even before the Illinois Department of Revenue issued General Information Letter IT-98-0038 (April 13, 1998) (stating that Illinois income tax classification of single-member LLCs conforms to the federal income tax classification) taxpayers were aware that the state implicitly conformed to the federal income tax treatment of single-member LLCs under applications of the following Illinois law sections:

- 35 ILCS 5/102 (generally conforming the definitions of terms used in the Illinois Income Tax Act to the meaning of those terms in the IRC but without reference to the regulations (therefore presenting the implicit conformity issue));

- 35 ILCS 5/1501(4) (treating LLCs as corporations when they are so classified for federal income tax purposes). Under this section, a single-member LLC that is disregarded for federal income tax purposes is not a corporation for Illinois income tax purposes.

- 35 ILCS 5/1501(16) (treating LLCs as partnerships when they are so classified for federal income tax purposes). Under this section, a single-member LLC that is disregarded for federal income tax purposes is not a partnership for Illinois income tax purposes.

- 35 ILCS 5/203(b) and (e) (beginning the computation of taxable income with the entity's federal taxable income). Under this section, disregarded single-member LLCs do not have a taxable income for purposes of beginning the computation of their Illinois income. Also under this section, because the member's federal taxable income includes the disregarded single-member LLC's income, the member's Illinois income also includes the single-member LLC's income.

D. Nexus Issues. The Illinois Department of Revenue has expressed a concern that taxpayers will structure their operations so that the only contact with the state is through a disregarded single-member LLC, with the LLC's member taking care to avoid any state contact that might exceed the protection of Public Law 86-272. The Department of Revenue is concerned that the member might argue that it is protected from the state's income tax by that federal law, and therefore that it is not required to file an income tax return with the state. The issue is particularly significant in states using federal taxable income as the starting point for determining state taxable income. In such states (e.g., Illinois), a disregarded single-member LLC may argue that it lacks a federal taxable income, so that its only income in the state is from any required additional modifications to its (nonexistent) federal taxable income.

Various states have attempted to anticipate the issue by providing in their laws, regulations, or rulings that a member of a disregarded LLC is deemed to have a tax presence in the state by virtue of the LLC's tax presence in the state and is required to file an income (or comparable) tax return with the state. See, e.g., Wis. Stat. section 71.22(1r); Del. Reg. section 1.502.1(d)(2)(B); Haw. Tax Information Release 97-4 (August 4, 1997); N.Y.C. Finance Memorandum 99-1 (October 21, 1999); Mich. Revenue Administrative Bulletin 1999-9 (January 21, 2000).

California requires the member to consent to California tax jurisdiction. Cal. Rev. & Tax. Code section 18633.5(i)(1). If the member does not provide that consent, the LLC is required to make a withholding payment on behalf of the member. Cal. Rev. & Tax. Code section 18633.5(i)(2).

E. Other check-the box issues. Taxpayers should be aware that a state's conformity with federal check-the-box treatments may be limited to identified types of entities. See e.g.

Alabama Revenue Ruling 00-005 (June 28, 2001) (stating that the Department's pronouncement concerning the federal check-the-box regulations addresses the tax treatment of LLCs only and does not extend to business trusts) and Massachusetts Department of Revenue Directive 01-8 (November 13, 2001) (explaining that Massachusetts follows the federal tax classification of a non-U.S. business entity if the entity is a foreign LLC and listing particular types of non-U.S. entities which will be classified as foreign LLCs. In the Directive, the Department of Revenue advises taxpayers concerned about the Massachusetts classification of other types of non-U.S. business entities to request a letter ruling.)

IV. State Treatment of Single-Member LLCs For Non-Income Tax Purposes.

The states do not necessarily disregard single-member LLCs for taxes other than income taxes. For example, under a 2002 amendment, Florida treats single-member LLCs as separate entities for non-income tax purposes. Fl. Stat. Title 36, Section 608.471(3). Also, under New Jersey law, single-member LLCs are disregarded for purposes of taxation on income only. New Jersey Stat. section 42:2B-69. The Minnesota Department of Revenue took the same position in a 2002 administrative pronouncement. Revenue Notice 02-10 (July 8, 2002). In addition, the Hawaii and Michigan Departments of Revenue have stated that all single-member LLCs, including those that are disregarded for federal and state income tax purposes, are taxable business entities for General Excise (sales) Tax and sales and use tax purposes, respectively, and must be separately licensed and registered with the states for those taxes. Haw. Tax Information Release 97-4 (August 4, 1997); Michigan Revenue Administrative Bulletin 1999-9 (January 21, 2000). And the Illinois Department of Revenue has advised that single-member LLCs making taxable sales must be registered for and pay the state's Retailer's Occupation (sales) Tax. Ill. PLR No. ST-97-0483-GIL (September 29, 1997). While not discussed in any of the rulings, one consequence of the rulings seems to be that the sales tax presence of a single-member LLC in those states should not create a sales tax presence in those states for its members. <u>See also</u> New York State Advisory Opinion, TSB-A-99(7)S (January 28, 1999) ruling that a single-member LLC is an entity distinct from its members. Interestingly, New York sales and use tax law has not been amended for the use of single-member LLCs. As a result, the Department of Taxation and Finance has ruled that a single-member LLC is a <u>partnership</u> for sales and use tax purposes (TSB-A-98(2)S (January 30, 1998)) (applying the definitions contained in Tax Law Section 2(6) (" 'Partnership' and 'partner,' unless the context requires otherwise, shall include, but shall not be limited to, a limited liability company and a member thereof, respectively") to permit an exemption for transfers of property on formation of a partnership to apply to the formation of a single-member LLC).

As further examples, since Texas does not disregard SMLLCs even for franchise tax purposes, it is no surprise that The Texas Comptroller of Public Accounts ruled that SMLLCs are distinct taxpayers for sales tax purposes. Position Letter 200001993L (January 21, 2000). Of greater interest is the Comptroller's position that a federally disregarded entity that is recognized as an integral part of an exempt activity of its sole member does not qualify for an exemption from Texas sales or franchise taxes. To so qualify, the disregard entity itself must be exempt from federal income tax Position Letter 200106899L (June 21, 2001). Also, the Louisiana Department of Revenue ruled that a non-corporate entity that elects to be treated as a corporation for federal income tax purposes is not necessarily treated as a corporation for Louisiana franchise tax purposes. Check-the-box elections have no significance for Louisiana franchise tax purposes. Louisiana Department of Revenue, Revenue Ruling 01-013 (October 1, 2001). And, the Utah Tax Commission has ruled that a SMLLC is a distinct person "required to collect and remit sales and use tax on taxable transactions, including transactions with affiliated entities." Utah Tax Commission Advisory Opinion 01-009 (May 18, 2001).

In contrast, Missouri requires conformity with federal income tax classifications for sales and use tax purposes. Missouri Law section 347.187(2). Also, Wisconsin has amended its laws so that the member of a disregarded single-member LLC is liable for withholding, sales/use, and recycling surcharge, and is responsible for obtaining a business tax registration certificate. Wis. Stat. sections 71.63(3)(c), 77.51(10), 77.935, 73.03(50)(d), respectively. (But see Wisconsin Private Letter Ruling W9812004 (December 22, 1997) narrowly interpreting those amendments in certain circumstances applicable to qualified subchapter S subsidiaries — and apparently indicating an intention to apply that same interpretation to single-member LLCs.) The Alabama, South Carolina, and Tennessee Departments of Revenue also have ruled that where a single-member limited liability company is treated as a division of its corporate member for federal and state income tax purposes, the LLC will be treated as a division of the corporate member for purposes of the states' sales and use taxes. Alabama Revenue Ruling 98-005 (June 18, 1998), South Carolina Private Revenue Opinion 00-4 (July 10, 2000), Tennessee Letter Ruling 00-47 (November 29, 2000).

V. Property Transfers Involving LLCs.

Even where a property transfer between an LLC and another entity or a person does not result in a federal or state income tax liability, the transfer may be subject to other state taxes. For example, the states may treat a transfer of property to or from an LLC as being subject to various transfer taxes even though there is no change in the ultimate ownership of the property. In this regard, the Wisconsin Tax Appeals Commission recently held that a transfer of real property from a partnership to an LLC was subject to Wisconsin's real estate transfer fee. See e.g. Sunset Meadows v. Wisconsin Dept. of Rev., Dkt. No. 98-T-129 (WTAC Mar. 5, 1999). In Sunset Meadows, the Tax Appeals Commission held that a transfer of real property from a partnership to an LLC, where a husband and wife held the same interests in each entity, was subject to the state's real estate transfer fee. The partnership argued that the transfer should not be subject to the fee because that transfer would have been exempt if it had been effected in two steps. (Wisconsin law exempts transfers between partnerships and their partners (and LLCs and their members) from this fee if all of the partners (members) are related to one another. Thus, if the partnership in Sunset Meadows had transferred the property to its partners, who in turn transferred the property to their LLC, both transfers would have been exempt from the fee). The Commission rejected this argument, noting that none of the exemptions from the fee apply to transfers between entities. See also, J&R Hotel Partnership v. Wisconsin Dept. of Rev., Dkt. No. 96-T-633 (WTAC Mar. 14, 1997). Compare Selle v. Wisconsin Dept. of Rev. Dkt. No. 98-T175 (WTAC Mar. 15, 1999) and Blado v. Wisconsin Dept. of Rev., Dkt. No. 98-T-166 (WTAC Mar. 19, 1999) (holding that transfers of real property from a trust by husband and wife trustees to the trustees' LLC were exempt from real estate transfer fee by the provision exempting transfers between LLCs and their members).

VI. Planning With LLCs.

A. General. Planning with LLCs typically involves either the use of LLCs treated as partnerships or, very recently, the use of disregarded single-member LLCs. The cautions provided above regarding planning with partnerships apply here as well, with the additional caution that few states have ruled that inactive members may be treated as equivalent to limited partners.

In many cases, tax planning with disregarded single-member LLCs will be driven by federal tax consequences or tax consequences in a particular state. However, even when use of a single-member LLC generates tax benefits that are predictable federally or for a tax in a particular state, the consequences for other taxes in that state, and the income and other tax consequences in other states, may be significantly less certain.

B. Examples. Use of an LLC instead of a partnership in each of the structures discussed above in the partnership planning section should have the income tax consequences described below. Also discussed below is a possible state tax planning use for single-member LLCs.

1. Texas Franchise Tax. LLCs are subject to Texas franchise tax. Therefore, use of an LLC instead of a limited partnership in the structure discussed above generally will result in a greater Texas franchise tax liability than would occur by use of a limited partnership.

2. Single-Member LLCs. Businesses may find that a need to separately incorporate their lines of business (for example, to isolate the risks of a particular activity) affects their state income tax liability in non-combination states. If such separate incorporation would create a greater income tax liability to that state than would occur with a single corporation, the use of a disregarded single-member LLC may permit the accomplishment of the business objectives without increasing the amount of income apportioned to the state.

AIRCRAFT ACQUISITIONS, EXCHANGES, LEASES AND REFINANCINGS -- MULTISTATE SALES AND USE TAX CONSIDERATIONS

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Mr. Lindquist is a frequent lecturer, as well as a writer on state and local tax issues. His most recent article, "Illinois Taxpayer Refuses to Settle -- and Wins Important FSC Case," appeared recently in *Interstate Tax Insights*. It addressed his recent successful representation of a multinational pharmaceutical company before the Illinois Department of Revenue in which an Administrative Law Judge ruled in his client's favor and excluded a Foreign Sales Corporation subsidiary from the client's Illinois corporate income tax unitary business group.

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I. Background.

A. Types of taxes addressed.

1. Sales and use taxes.

a. State sales and use taxes are imposed on retail sales or other transfers of ownership to "tangible personal property," unless specifically exempted from tax. Because airplanes are tangible personal property, their transfer generally is subject to such sales and use taxes.

b. In some instances general sales and use taxes are imposed at special rates or at maximum rates on aircraft transfers. See e.g. Mississippi Code Sec. 27-65-17; Mississippi Tax Rule 46 (normal sales tax rate is 7% -- special sales tax rate of 3% applies to sales of aircraft).

2. Aircraft transfer/excise taxes.

a. North Dakota. North Dakota excludes aircraft transfers from its general sales and use taxes, and instead imposes a separate excise tax on aircraft transfers. ND Code Section 57-39.2-04(37) (sales/use tax exclusion); ND Code Section 57-40.5-02 (imposing 5% aircraft excise tax).

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[1] This outline cites statutes, cases, regulations and administrative pronouncements from jurisdictions throughout the United States. The citations are for illustrative purposes and are not intended to be exhaustive.

b. Oklahoma. Oklahoma imposes a 3.25% aircraft excise tax on aircraft transfers, in lieu of its sales/use tax. O. S., Tit. 68, Sec. 6001 et. seq.

c. Virginia. Virginia excludes aircraft transfers from its general sales and use taxes, and instead imposes a separate excise tax on aircraft transfers. Va. Code Sections 58.1-609.1(5) (Sales/use tax exclusion) and 58.1-1502 (imposing 2% aircraft excise tax).

3. Other taxes.

In addition to taxes on the transfer of aircraft, some states impose taxes on the privilege of owning or leasing aircraft. Examples of these taxes include the following:

a. Indiana. In addition to sales and use taxes on aircraft transfers, Indiana subjects aircraft to an annual license excise tax in lieu of a personal property tax, which is equivalent to an average property tax rate of $3.00 on each $100 of taxable value. IC 6-6-6.5-12 and IC 6-6-6.5-22.

b. New York. A special sales tax of 5% is imposed by New York on the lease of noncommercial aircraft in lieu of the general sales tax. NY Tax Law Section 1111(i). The special lease tax is due at the inception of the lease on the total amount of the lease payments for the entire term of the lease. Id.

B. Types of aircraft transferred.

1. What is an aircraft?

a. Statutory definition. Some states have statutorily defined aircraft to include self-propelled vehicles for navigation or flight in the air or airspace. See e.g. Okla. Stat. Tit. 68, Section 6001(1) (special aircraft excise tax statutory definition); Conn. Gen. Stat. Sections 15-34 and 12-412(99)(aircraft sales/use tax exemption references general statutory definition of aircraft); and Tn. Code Section 67-6-102(1) incorporating definition in Tn. Code Section 42-1-101 (sales/use tax provision incorporates state regulatory definition of aircraft).

b. Administrative definition. Where lawmakers have failed to adopt a specific definition of aircraft, state revenue departments have turned to generally accepted definitions of this term for purposes of administering their taxing statutes. Massachusetts Tax Information Release 02-2 (January 24, 2002) (Department of Revenue adopts dictionary definition of "aircraft" for purposes of applying sales and use tax exemption).

2. Commercial and non-commercial.

The determination of whether an aircraft is a commercial or non-commercial aircraft is made from the purchaser's perspective, focusing on the purchaser's intended use of the aircraft. The distinction is important because commercial aircraft may be entitled to certain exemptions to which non-commercial aircraft are not entitled.

a. Certified or licensed carrier -- Some states limit aircraft treated as commercial aircraft to those acquired by common carriers certificated or licensed by the FAA. See Arizona Law Sections 42-5061(B)(7) and 42-5159(B)(7) (limits exemption for aircraft used to transport passengers or freight in interstate commerce to aircraft acquired or used by certificated or licensed carriers; Arizona PLR 01-03 (January 10, 2001) (extends exemption to shares of aircraft); see also 86 Ill. Admin. Code § 130.340 (Illinois regulation requires interstate carrier's FAA registration number as documentation for rolling stock exemption).

b. Non-certificated carriers -- Other states define commercial aircraft to include those used by carriers that are not licensed by the FAA, as long as the preponderant use of the aircraft is to provide transportation services. NYS Tax Law Section 1115(a)(21); Pasquale & Bowers, TSB-A-96(49)S (August 1, 1996).

II. Which states must be analyzed?

More than one state may claim the right to tax aircraft acquisitions, exchanges, leases and refinancings, directly or through a tax on the use of the aircraft. All potential taxing jurisdictions should be considered in evaluating such aircraft transactions. In particular, it is important to analyze the tax treatment in the state where the aircraft is located at the time of the transaction, the state in which the aircraft is hangared, the state(s) where the aircraft is stored temporarily and the state where upgrades are installed or maintenance performed.

A. Location at time of purchase.

First and foremost, it is necessary to analyze the sales and use tax treatment in the jurisdiction in which the aircraft is located at the time of purchase. Such states always have a right to tax the transaction.

B. Location where hangared.

The jurisdiction in which an aircraft is hangared may impose a use tax on the aircraft's owner. Moreover, there is no requirement that the tax be apportioned, although credits should be provided for sales tax paid to other jurisdictions.

1. Connecticut. Aircraft lease payments for 1994 through October, 1997 were ruled taxable where the aircraft was housed and serviced in Connecticut. Air Tiger, Inc. v. Commissioner of Revenue Services, Connecticut Superior Court, No. CV99-0496956S, 2002 Conn. Lexis 976 (March 27, 2002). (Note that effective October 1, 1997, Connecticut law exempts the sale, storage use or other consumption of aircraft having a maximum certificated takeoff weight of 6,000 pounds or more. Connecticut General Statutes Section 12-412(99).)

2. Oklahoma. In general, an aircraft is considered to be used in Oklahoma and therefore subject to the Oklahoma aircraft excise tax when it is operated or based in an airport in the state for a period of 30 days or more. O.S. 6002 and 6001(4), Tit. 68.

3. Pennsylvania. Aircraft was purchased outside of Pennsylvania and used almost exclusively in interstate travel to transport corporate employees. Nevertheless, the Commonwealth Court found that there was sufficient Pennsylvania nexus to impose use tax on the aircraft because it was hangared and underwent maintenance in Pittsburgh, near the corporate offices of its owner. H.K. Porter Company, Inc. v. Commonwealth of Pennsylvania, 534 A.2d 169 (1987).

C. States where temporarily stored or temporarily present.

Use taxes may be imposed by the states in which an aircraft has a mere temporary presence.

1. Alabama. Aircraft delivered in Alabama are not taxed if they are not permanently domiciled in Alabama and are removed from the state within three days of delivery. Section 40-23-4(a)(37).

2. Missouri. Director of Revenue v. Superior Aircraft Leasing Co., Inc., 734 S.W. 2d 504 (MO. 1987) involved a corporate aircraft that was owned by a Missouri corporation and leased to an Ohio-based charter service. The aircraft was hangared and repaired in Ohio, but was present in Missouri 7-17% of its total flight hours. The Missouri Supreme Court held that the aircraft was subject to Missouri use tax.

3. Washington. Tax was owed on a corporate aircraft purchase outside of Washington and hangared outside of Washington. In addition, all flights were from or to locations outside of Washington and the aircraft never remained in Washington overnight. Nevertheless, the aircraft was subject to Washington use tax because it made stops in Washington to pick-up and drop-off its Washington-based owner's employees. Under the Department of Revenue's interpretation, the aircraft's transportation ended in Washington the first time the aircraft landed in Washington. The period of time in Washington is irrelevant. Washington's "transportation finally ended" principle is not applicable to sales to Washington residents. Administrative Petition for Correction Assessment, No. 98-029, 1998 Wash. Tax Lexis 1030 (February 27, 1998).

D. Possible liability from occasional landings in state.

1. Illinois. In PLR 92-0463 (September 1, 1992), 1992 Ill. PLR Lexis 1401, the Illinois Department of Revenue ruled that use tax was not due on aircraft leased by Bermuda corporation to its European affiliate that twice a month ferried that affiliate's executives to meetings in Illinois. The Department found "under the U.S. Supreme Court's decision of Complete Auto Transit, as well as the case law developed under the Foreign Commerce Clause of the U.S. Constitution, that Illinois would be barred by federal supremacy from asserting tax on the facts you have outlined". Interestingly, the Department made that statement after noting that no temporary use exemption applied and also after noting that under the case of Philco Corporation v. Department of Revenue, 40 Ill. 2d 312 (1968), presence of an asset in Illinois in the possession of a lessee is sufficient to hold the owner liable for Illinois use tax.

2. Michigan. The Michigan Court of Appeals held that the state's use tax was not owed by the owner/lessor of two aircraft occasionally landed in Michigan by the lessee, Southwest Airlines. Each aircraft landed in the state more than 40 times during the year at issue. However, Southwest Airlines controlled each aircraft's flight schedule. The court held that the lessor exercised no control over the aircraft and could not have used the aircraft in Michigan. Furthermore, the lessor's use of a Michigan address on its FAA registration did not constitute a use of the aircraft in Michigan. WPGP1 Inc. v. Treasury, 220 Mich. App. 414 (Ct. Appeals April 4, 2000).

3. Missouri. Director of Revenue v. Superior Aircraft Leasing Co., Inc., 734 S.W. 2d 504 (MO. 1987) involved a corporate aircraft that was owned by a Missouri corporation and leased to an Ohio-based charter service. The aircraft was hangared and repaired in Ohio, but was present in Missouri 7-17% of its total flight hours. The Missouri Supreme Court held that the aircraft was subject to Missouri use tax.

4. New York. Ross Lipman, New York Division of Tax Appeals, ALJ Unit, DTA 816710 (February 17, 2000). A New York State resident purchased an aircraft in Mississippi, and took delivery and hangared the aircraft in New Jersey. The aircraft was never permanently stored or hangared in New York, but did occasionally take off or land in New York. The Administrative Law Judge held that a taxable use occurred on the first occasion when the aircraft had a wholly-intrastate flight, both taking off from and landing in New York State. The ALJ distinguished Xerox Corporation v. State Tax Commission, 422 N.Y.S. 2d 493 (1979). In that earlier case, the court refused to impose a local tax on the use of the aircraft, as the aircraft was hangared in a different county. The ALJ stated that this case was based on an administrative rule that local taxes are imposed based upon where the aircraft is hangared. However, the ALJ concluded that this local tax rule did not apply to the state.

E. States where upgrades are installed or repairs/maintenance performed.

States may tax aircraft present for upgrading or servicing. However, the states typically do not do so because of the negative effect such taxation would have on in-state businesses performing such services.

1. Arizona. The Arizona Department of Revenue has ruled that no use occurs and the transaction privilege and use taxes are not due on the in-state transfer of an aircraft to a nonresident "when the aircraft is retained in this state, at the direction of the seller, for the sole purpose of completing the manufacturing process." Private Letter Ruling LR 01-003 (January 10, 2001).

2. Arkansas. State provides a use tax exemption for aircraft that are brought into the state solely for refurbishing, conversion or modification, are not used or intended to be used in the state, and are removed from the state within 60 days of the completion of the refurbishing, conversion, modification, etc. Law Sections 26-53-106(e), 26-53-115, 26-53-130; Reg. UT-9.

3. Wisconsin. Canadian manufacturer's sale of "green" aircraft to purchaser was subject to Wisconsin use tax when the aircraft was transferred by the manufacturer to the "completer" who completed the aircraft's exterior and interior (including installing instruments, seating and other equipment) in Wisconsin on behalf of the purchaser, and when the purchaser had property in Wisconsin in addition to the aircraft. Completer's sale of completion services and tangible personal property installed in the plane was not subject to Wisconsin sales and use taxes because possession of completed aircraft was transferred by completer to the purchaser outside of Wisconsin. Wisconsin Private Letter Ruling W9314001 (January 1, 2002).

4. Michigan (aircraft parts). Under Michigan case law, items brought into Michigan within 90 days of their purchase are presumed to be subject to the use tax. Here, aircraft parts were used when the taxpayer received the parts in Michigan. The court held that no interstate activity was involved, as the tax was imposed on parts delivered and installed or stored in Michigan. The Court rejected the taxpayer's argument that tax was unconstitutional because it was imposed on parts installed on aircraft used in interstate commerce. Zantop International Airlines, Inc. v. Michigan Department of Treasury. Michigan Court of Appeals, 2001 Mich. App. Lexis 830 (unpublished opinion), April 24, 2001, leave to appeal denied, 465 Mich. 912 (November 30, 2001), cert. denied, 122 S. Ct. 1912 (May 13, 2002).

5. Oklahoma (aircraft parts). Effective July 1, 2002, Oklahoma's sales and use tax exemption for aircraft engine and frame repairs, modifications, replacement parts and services applies to repairs or modifications made at an aircraft repair facility (which includes an aircraft manufacturer's authorized service facility) on aircraft weighing more than 9,000 pounds gross take-off weight and less than 300,000 pounds gross take-off weight and provided that the aircraft are brought into Oklahoma exclusively for such repairs or modifications. Oklahoma Statute 1357(26) as amended by ch. 163 (S.B. 1282) Laws 2002.

III. Acquisition of new or used aircraft.

A. States not imposing sales and use taxes.

Alaska, Delaware, Montana, New Hampshire, and Oregon do not impose state-wide sales and use taxes. However, other taxes may apply. For example, sales and use taxes in Alaska are imposed, collected and administered locally.

B. States not taxing aircraft sales.

For policy reasons, some states otherwise imposing sales and use taxes provide exemptions for aircraft transfers.

1. Connecticut. Connecticut General Statute Section 12-412(99), exempts "sales of and the storage, use or consumption of aircraft having a maximum certificated takeoff weight of six thousand pounds or more."

2. Massachusetts. Effective March 1, 2002, the Commonwealth of Massachusetts adopted a broad exemption from sales and use taxes for the sale or storage of aircraft and aircraft repair or replacement parts. Mass. Chapter 64H Sections 6(vv) and 6(uu) (sales tax) and 64I Sections 7(e) and (d) (use tax). "Aircraft" is not defined by the statutory exemption.

However, the Massachusetts Department of Revenue has issued an information release stating the term will be defined using its natural meaning according to ordinary and approved usage of language and adopting American Heritage Dictionary definition that includes "a machine or device such as an airplane, helicopter, glider . . . that is capable of atmospheric flight." Mass. Tax Information. Release 02-2 (January 24, 2002). Note: In the same information release, the Department of Revenue advised that no documentation is necessary to receive the benefit of this exemption.

3. Michigan. Michigan Statute Sections 205.54x(1) and 205.94(x) exempts from sales and use taxes the sale of an aircraft that "has a maximum certificated takeoff weight of at least 6,000 pounds for use solely in the transport of air cargo, passengers, or a combination of air cargo and passengers."

C. States with maximum taxes or reduced tax rates.

Some states provide tax relief by adopting a maximum tax or reduced tax rate on aircraft transfers. For example,

1. North Carolina. Sales and use taxes on aircraft sales are limited to a 3% state tax with a maximum tax of $1,500 imposed on the sale of any single aircraft, including all attached accessories. N.C. G.S. 105-164.4(a)(1b), N.C. Adm. Code 17:07B:4602. Aircraft sales are exempt from local sales and use taxes. N.C.G.S. 105-467(a)(1).

2. South Carolina. General state sales and use taxes imposed at a 5% rate are capped at a maximum tax of $300 for each aircraft sale made after June 30, 1984 or lease executed after August 31, 1985. SC Stat. Sections 12-36-910, 12-36-1310 and 12-36-2110(A)(1) (maximum tax includes unassembled aircraft, but not items to be added to unassembled aircraft). Aircraft sales are exempt from local sales/use taxes. SC Stat. Section 4-10-20.

3. Tennessee (former). Prior to July 1, 2001 sales of aircraft were subject to a reduced tax rate of 3% on that portion of the purchase price over $100,000, however, this reduced tax rate has been repealed. Tn. Code Section 67-6-225 (repealed by Ch. 976, Laws 1998, effective July 1, 2001). Aircraft are currently subject to the general Tennessee sales and use taxes rate of 7%. Tn. Code Sections 67-6-202.

D. Possible exceptions and other non-taxable treatments.

1. Purchase for resale exemption.

a. Exemption of purchase for resale.

Generally, a sales tax is levied on the retail sale of an aircraft to the consumer, and as a result sales of aircraft for purposes of resale by the purchaser are exempt from tax. See e.g. Minnesota Statute Section 297A.61(4)(a) ("'retail sale means any sale, lease, or rental for any purpose other than resale, sublease, or subrent.").

b. Documentation.

A purchaser typically must present its seller with a resale certificate documenting that the purchase is a tax-exempt purchase for resale. The resale certificate, must contain the purchaser's state tax registration number as evidence that the purchaser is a registered vendor of aircraft. Failure to register as a vendor with the state revenue department or present other evidence that the purchaser is an aircraft dealer can result in disallowance of the exemption for the purchase.

In Falcon Helicopter, Inc. v. Department of Revenue, Ill. Circuit Court 01 CH 3578 (March 26, 2002), an Illinois Cook County Circuit Court stated that when an aircraft is purchased "without the benefit of a registration or resale number from the Department, the taxpayer better come 'armed for bear' to the hearing." The court ruled that unsubstantiated testimony of the purchaser that the aircraft was purchased for resale was not sufficient evidence to secure the resale exemption.

c. Use of aircraft prior to sale.

As a general rule, if aircraft are withdrawn from sales inventory, the resale exemption no longer applies and a use tax is due based on the purchase price of the aircraft. See e.g. Neb. Reg. 1-067.067.06. Some states have adopted exceptions to this general rule for use of aircraft for a limited period of time prior to sale.

i. Arkansas. Aircraft inventory may be rented by aircraft dealers for a period of one year or less from their date of purchase without the dealer losing its purchase for resale exemption on the aircraft. Ark. Stat. Section 26-52-409; Ark Reg. GR-14; Neb. If the one-year holding period expires without a sale of the aircraft, tax accrues and is due on the dealer's use of the aircraft based on purchase price.

Weiss v. Central Flying Service, Inc., 326 Ark. 685, 934 SW 2d. 211 (Ark. Sup. Ct. 1996).

ii. Idaho. A use tax is imposed on any taxable use of an aircraft placed in sales inventory. However, this tax is limited to lease payments, or if there are no lease payments the tax is based on an imputed "reasonable rental value for the time the aircraft is used." Idaho Reg. 35.01.02.037.10.

iii. Iowa. Effective July 1, 1999, aircraft sold to aircraft dealers who rent or lease the aircraft is exempt from Iowa use tax if the: i) aircraft continues to be recorded as inventory by the dealer; and ii) the dealer reserves the right to take back possession of the leased aircraft if it finds a purchaser. IA Code Section 422.45(38C) and Rule 701-32.13(422,423), IAC.

iv. Louisiana. New aircraft withdrawn from inventory for use as demonstrators are not subject to use tax [Note: this exemption is currently suspended. La. R.S. Section 47:305(D)(1)(i).]

v. Minnesota. Sale to licensed aircraft dealer is exempt provided the aircraft has been issued a commercial use permit and is resold while the permit is still in effect. The permit is good for one year. The permit allows an aircraft dealer to use the aircraft without generating a use tax on the purchase price during this one year period. Purposes for which the aircraft can be used include charter, instruction, crop spraying or similar activities. The permit expires one year from the date the aircraft is purchased, at which time tax becomes due on the aircraft if it has not been resold. Minn. Stat. 297A.82(4)(c); Minn. Tax Rule 8130.6500.

vi. Mississippi. Aircraft used by dealers as demonstrators remain exempt from tax under the sale for resale exemption where aircraft remains in dealer's inventory. Ms. Reg. Rule 46.

vii. Nebraska. If an aircraft is purchased exempt from tax as a purchase for resale (e.g. by a retailer), but subsequently is used by a purchaser/retailer, the retailer would normally be required to pay a use tax on the purchase price of the aircraft. Neb. Reg. 1-067.067.06. However, in these instances, the purchaser can elect to pay use tax measured against the total “gross receipts” realized from the use of such aircraft. "Gross receipts" are defined to include, but are not be limited to, charges for flying lessons, banner towing, crop dusting, patrols, air ambulance, etc. N.R.S. 77-2706.01; Neb. Reg. 1-067.067.07 and Neb. Reg. 1-067.067.04.

2. Purchase for lease.

a. Purchase for lease exemption.

A purchase of an aircraft for purposes of lease or rental generally is exempt from tax. See Sales and Use Tax Alert, Vol XI, No. 2 (February 1, 2002) (multistate analysis of incidence of sales/use taxes on lease transactions). This is because most states broadly define "sale" to include not only the transfer of ownership, but also the transfer of possession of an aircraft by lease or rental. Consequently, a purchase for rental or lease is treated as a non-taxable purchase for resale. See e.g. Mn Stat. Section 297A.61(4)(a) ("'retail sale means any sale', lease, or rental for any purpose other than resale, sublease, or subrent.").

i. Florida. The lease of an aircraft is taxable. A purchase for use exclusively for leasing is nontaxable if the purchaser provides a resale certificate to the seller. Rule 12A-1.007(14).

ii. Indiana. Acquisition of aircraft by a limited liability company for purposes of rental is exempt from sales/use tax if the LLC provides proper exemption certificate to seller. Indiana Department of Revenue Ruling No. 2002-05ST (March 14, 2002).

iii. South Carolina. Purchase for resale is not taxable, and a lease is treated as a taxable resale. Edisto Fleets, Inc. v. South Carolina Tax Commission, 256 S.C. 350 (1971). See also Reg. Section 117-174.254. However, if an aircraft is used for both leasing and chartering purposes, tax must be paid on either the purchase price of the aircraft or, at the taxpayer's election, on 50% of the chartering fees. Id. See also SC PLR 89-18 (September 27, 1989).

iv. Wisconsin. Wisconsin provides a purchase for lease exemption, but the exemption applies only if the purchase is "solely for lease or rental." Wisconsin Administrative Code Section 11.29. The exemption is lost -- and use tax on an aircraft's purchase price is owed -- if the owner makes more than *de minimis* use of the aircraft. A

Wisconsin Circuit Court held that an owner "uses" an aircraft in a disqualifying manner if its lease terms are preferential to those offered to other lessees. G&G Trucking, Inc. v. Wisconsin Department of Revenue, Docket No. 01 CV 2962, CCH Wisconsin State Tax Reporter, ¶400-621 (July 9, 2002). In addition, the court held that owner's use of the aircraft for between 10 and 20 percent of the total annual charter hours during each of the periods at issue exceeded *de minimis* usage. It therefore held that the taxpayer owed Wisconsin use tax on its acquisition of the aircraft.

b. Election by lessor to treat purchase as exempt purchase for resale.

In some states the purchaser has the option to elect to treat its purchase for lease as taxable or as an exempt purchase for resale.

i. California. General rule is that sale of aircraft to lessor is a taxable retail sale and purchase for resale exemption does not apply to purchase for lease. Ca. Rev. & Tax Code Sections 6094(d) and 6244(d); Ca. Reg. 1661(b)(1). However, lessor may elect to treat its purchase as a tax exempt purchase for resale and instead pay use tax on the fair rental value of the aircraft. Id. An electing lessor pays use tax on the rental value in all periods in which the property is leased, whether inside or outside California. Id.

ii. Colorado. Purchase for lease of at least three years is a purchase for resale and lessor must charge sales tax on lease payments. Colo. Rev. Stat. Section 39-26-114(1)(a)(XII). Where the purchase is for purposes of lease of three years or less lessor can elect to either pay tax on purchase price or to purchase exempt from tax and collect sales tax from its lessee on lease payments. Id. See also FYI -- For Your Information-- Sales 56, Colorado Department of Revenue, November 2000; Western Electric Company v. Weed, 524 P.2d 1369 (Colo. 1974).

c. Purchase for resale exemption does not apply to purchase if subsequent use is not a lease.

A purchase for lease is not exempt under the purchase for resale exemption if the subsequent lease does not transfer possession and control of the aircraft to the lessee.

i. Florida. The acquisition of a plane for use in providing flight instruction does not qualify for the sale for resale exemption. This use is not a true rental of the aircraft because it does not transfer possession and control of the aircraft to the student. TAA No. 02A-007 (January 30, 2002).

ii. Ohio. Purchase of aircraft for use in "charter service" is taxable because it is not a purchase for resale. A.M. & J.B., Inc., Ohio Board of Tax Appeals, No. 99 -T-1387 (December 14, 2001); Laurel Transportation, Inc. 92 Ohio St. 3d 220; 749 N.E. 2d 296 (Ohio 2001). In Laurel Transportation Ohio Supreme Court ruled that the purchase of an airplane was not exempt under the purchase for resale exemption because the purchaser did not resell the airplane. The statutory definition of "sale" includes transfer of "title or possession, or both." Ohio R.C. 5739.01(B)(1). In this instance, in exchange for an hourly charter fee, the purchaser furnished an airplane to its customers, complete with a pilot selected by the purchaser. The court ruled that the purchaser was not transferring title or possession of the aircraft to its customers, but instead was providing a transportation service to them. Accordingly, the court ruled that the purchaser's acquisition of the plane was not an exempt purchase for resale, but instead was a taxable retail purchase.

iii. Virginia. Aircraft tax does not apply to purchases made for qualifying "lease or rental." 23 Va. Code Ann. 58.1-1501. For this purpose, Regulation (23 VAC 10-220-5) defines qualifying "lease or rental" to constitute a period of "time substantially equal to the remaining life (80%) of the aircraft" as determined at the beginning of the lease or rental term.

iv. Wisconsin. Purchaser/owner (G&G Trucking) of aircraft did not qualify for purchase for lease exemption. Court ruled that purchase of aircraft was taxable. Aircraft was not purchased exclusively for lease or rental because purchaser had preferential use of the aircraft it leased to a Charter company (*i.e* charter company could not deny G&G the right to use the plane to transport purchaser's own corporate employees). G&G Trucking, Inc. v. Wisconsin Department of Revenue, Docket No. 01 CV 2962, CCH Wisconsin State Tax Reporter, ¶400-621 (July 9, 2002).

d. Exemption of lease for re-lease.

In states in which a purchase for lease is exempt, the lease of an aircraft for purposes of re-lease is also exempt. However, the re-lease of the plane must be equivalent to the original lease of the plane in order for this exemption to apply to the re-lease.

Connecticut. Purchase for resale exemption did not apply to lease payments because Court found that lessee and lessor did not sell same services. The lessor leased the aircraft to the lessee, but the lessee sold time on the aircraft to its customers and, therefore, the lease was not a sale for resale. Air Tiger, Inc. v. Commissioner of Revenue Services, Connecticut Superior Court, No. CV99-0496956S (March 27, 2002).

e. Purchase for lease may be a taxable retail sale.

Some states do not define taxable retail sale as including lease or rental. Consequently, these states do not extend the sale for resale exemption to the sale of an aircraft for purposes of lease.

i. Illinois. A lessor is considered the end user of an aircraft purchased for lease, and consequently a purchase for lease is taxable, while the lease receipts are not. 86 Ill. Admin. 130.220(a).

ii. Oklahoma. Sale of aircraft for purposes of lease is subject to Oklahoma Aircraft Excise Tax. Under this tax, transfer of legal ownership, not lease, triggers taxation, measured by purchase price. Lease payments are not subject to Aircraft Excise Tax. Oklahoma Tax Commission Order No. 97-05-08-011 (May 8, 1997). While the lease of tangible personal property generally *is* subject to sales tax, effective July 1, 2000, the lease of an aircraft on which the owner has paid Aircraft Excise Tax is exempt from sales tax. O.S. Sec. 1355(9), Tit. 68.

3. Isolated/occasional sale of aircraft by non-retailer.

General Rule. While states frequently treat sales of tangible personal property by non-retailers as non-taxable "occasional" or "casual" sales, casual or occasional sales of aircraft frequently are excluded from this exemption (i.e., are taxable).

a. States taxing isolated or occasional sales of aircraft.

i. Florida. Florida isolated/occasional sale exemption does not apply to aircraft sales. Law Sections 212.02(2) and (20), and 212.05(1)(a), and Rule 12A-1.007(1)(a).

ii. Maine. Casual sales of aircraft are specifically taxable. Tit. 36 M.R.S.A. Sec.1764.

iii. Oklahoma. Definition of event triggering Oklahoma Aircraft Excise Tax includes *any* transfer of legal ownership (i.e. taxable event *not* limited to *retailer's* transfer of legal ownership) to an aircraft registered with the FAA. Consequently, the Oklahoma Aircraft Excise Tax does not have an occasional sales exemption. See e.g. Oklahoma Tax Commission Order No. 97-05-08-011 (May 8, 1997) (refinancing by owner of aircraft was subject to tax because the Commission found that legal ownership was transferred to the refinancing institution; no argument that transfer by owner was exempt under occasional sales exemption).

iv. Rhode Island. Casual sales of aircraft are subject to use tax. RI. Stat. Sections 44-18-20(b) and 44-18-21(a).

v. South Carolina. Casual sales of aircraft are subject to a Casual Sales Excise Tax of 5%, however, like the general sales tax this casual sales tax is capped at a maximum tax of $300. SC Stat. Sections 12-36-1710 and 12-36-2110.

vi. Vermont. Definition of exempt casual sale excludes sale of aircraft. Tit. 32 V.S.A., Sec. 9701(12)(B).

b. States exempting isolated/occasional sale of aircraft.

i. Illinois. 35 ILCS 120/1, 105/2, 86 IAC 130.110 and 130.2005(a)(4)(B); Department v. Preferential Flight, Inc., UT 01-6 2001 STT 220-10 (November 14, 2001). An occasional or isolated sale of tangible personal property by persons who are not engaged in the business of selling such tangible personal property is not subject to Illinois sales or use taxes. 86 Illinois Administrative Code, Section 130.110. The regulation has been interpreted to apply to the sale of several aircraft where the seller used the aircraft in its chartering service. Department of Revenue v. Preferential Flight, Inc., UT 01-6 (May 31, 2001). While not analyzed in the administrative law judge's decision, the regulation also provides that even routine sales of tangible personal property used by the seller, and which the seller does not otherwise sell, are nontaxable occasional sales. Under this provision, qualifying aircraft lessors or charterers of aircraft services should be able to make routine aircraft sales without having to collect Illinois sales tax and without aircraft purchasers having to pay Illinois use tax. (A different regulation provides that a lessor whose only sales are sales of items coming off lease that no longer are needed for rental inventory incurs no Illinois sales tax on the sale. 86 Ill. Adm. Code Sections 130.2013(e)(1) and (h)(1)(A). In addition, a lessor who incurs sales tax on the sale of an item can take a credit against that liability for any Illinois use tax paid to a supplier when he purchased the item. The credit is available to "all" lessors who are required to pay sales tax when selling an item after having used it for rental purposes 86 Ill. Adm. Code Section 130.2013(h)(2) and (4). While the provision does not separately identify aircraft lessors, its application to "all" lessors should make the credit available on their sale of their used aircraft.)

ii. Kansas. Isolated or occasional sale of an aircraft is exempt from sales tax if the requirements of K.S.A 79-3602(j) and K.A.R. 92-19-14(a) are met. See also K.S.A. 79-3606(l).

iii. Virginia. Aircraft tax has an occasional sale exemption. 23 Va. Code Ann. 58.1-1501. See also P.D. 88-103 (May 12, 1988). However, exemption applies only to licensed aircraft upon which Virginia Aircraft Tax has been paid upon acquisition or use by the transferor. Va. Admin. Code Section 10-220-5.

4. Financing transactions.

Financing transactions take a variety of forms including sale-leasebacks and synthetic leases (transactions treated as leases for financial accounting purposes but as loans for income tax purposes). The transactions have in common the transfer of title to a financing company (held as akin to a security interest) while possession and use of the aircraft remain with its true owner. If the transaction is analyzed component-by-component, a sales and use tax liability may be created inadvertently. For example, this may occur in states treating a lease as a taxable transaction because, while the financing company's acquisition of the aircraft title will be nontaxable as a purchase for resale, the leaseback from the financing company will be taxable unless the lessee is an exempt entity or is putting the aircraft to an exempt use. Alternatively, in states not treating a lease as a taxable event, the financing company's acquisition of the aircraft may be taxable. While conceivably the parties may be able to change the location of the aircraft to qualify for tax-exempt treatment, doing so almost always is inconsistent with the true owner's desired use of the aircraft.

Examples of treatments of financing transactions include the following:

a. Massachusetts (compare to Oklahoma ruling below). Through March 1, 2002, Massachusetts looked to the intent of the parties in determining whether a transaction is a nontaxable financing arrangement. See e.g., Letter Ruling 01-8 (September 11, 2001). (Effective March 1, 2002, Massachusetts exempts all aircraft sales.) In the ruling, the Department concluded that no sale occurred even though aircraft title transferred to the lender. Important facts demonstrating that the transaction was a financing arrangement included the continual possession of the aircraft by the lessee, the net lease arrangement under which the lessee was responsible for all registration, outfitting, maintenance, insurance and personal property taxes on the aircraft, the retention of risk of loss by the lessee, and the federal income tax treatment of the arrangement as a loan.

b. New York. A company financing the acquisition of an aircraft may hold title to the aircraft and "lease" it to the true owner, without imposition of New York sales or use tax on the lease payments. TSB-A-02(47)S, (September 18, 2002).

c. Oklahoma (compare to the Massachusetts ruling above). The Oklahoma Tax Commission has ruled that aircraft excise tax was owed on a transfer of an aircraft to a bank, which then was leased to same user that already was in possession of and using the aircraft. Order Number 97-05-08-011 (May 8, 1997). (Aircraft excise tax is imposed in lieu of Oklahoma sales and use taxes. 68 O.S. 1991, Section 6002.)

   In the facts addressed by that Order, a subsidiary (ABC) providing flight services to its parent corporation purchased an aircraft which it hangared in Oklahoma. ABC paid aircraft excise tax on the purchase. The purchase was financed through a leasing company, and the aircraft was registered in the name of the leasing company. Nevertheless, ABC had exclusive possession and use of the aircraft. Approximately 3 years later, ABC negotiated with a bank to refinance the aircraft. Under the terms of the refinancing, ABC made periodic payments to the bank, which were treated as payments of interest and principal for income tax purposes. The aircraft was reregistered with the Federal Aviation Administration in the bank's name, but ABC's possession and use of the aircraft was uninterrupted, ABC continued to be responsible for all costs and expenses of operating, maintaining and insuring the aircraft, ABC was responsible for all taxes on the ownership, use and operation of the aircraft, and ABC was considered the sole owner of the aircraft for federal, state, local and foreign tax purposes.

The Tax Commission first observed that under Oklahoma law excise tax is owed if these has been a transfer of "legal ownership" of the aircraft, but that the law does not define "legal ownership". The Commission then focused on the cost of ABC's purchase option, as compared to the maximum cost to ABC if it walked away from the aircraft. The Commission determined that, as a matter of absolute dollars, the cost of the purchase option was substantially greater than the walk-away price. It therefore concluded that the option price was not nominal and concluded that ABC was not under significant economic compulsion to exercise the option. As a result, the bank was treated as acting as more than a financier, and that aircraft tax was due on the bank's registration of the aircraft.

d. Texas. Texas does not impose sales and use tax on financing arrangements if at termination of the lease, for little or no additional consideration, the lessee will become the owner of the leased assets. "Little consideration" means that the projected value of the property at termination of the lease must be determined at the inception of the lease, and the purchase option amount must be less than 10 percent of the estimated value of the property at the time that the purchase option is exercised. Texas Administrative Code 3.294 (a)(1)(ii). If the lessee does not have such an option but instead is required to pay consideration under the terms of the contract, the transaction will be viewed as a financing arrangement even if the amount of the required payment is greater than 10 percent of the estimated value. Texas Administrative Code 3.294(a)(1)(i). See also Texas Private Letter Ruling 9904335L (April 23, 1999).

5. Nonresident's relocation of aircraft acquired within the state to outside the state.

A number of states have adopted an exemption for the sale of airplanes delivered to nonresidents in the state for subsequent transportation and use outside the state. However, these exemptions are varied and require a purchaser to examine carefully the exemption in a particular state in which it plans to receive delivery. Limitations can include: the time period the plane can remain in the state prior to removal; the use to which the plane can be put while in the state; and purchase price and size of the plane to which the exemption applies.

a. Alabama. Aircraft is exempt if delivered to a purchaser not permanently domiciled in Alabama that removes it from the state within three days of delivery. Section 40-23-4(a)(37).

b. Arizona. Aircraft is exempt if delivered to a nonresident who will not "use" the aircraft in Arizona. Nonresident defined to include corporations not incorporated in Arizona if their principal corporate office is located outside the state. AZ Law Section 42-5061(B)(7) and 42-5159(B)(7). The Arizona Department of Revenue has interpreted this exemption to extend to the sale of aircraft that will remain in Arizona after title has passed from the manufacturer to the purchaser for purposes of permitting the aircraft manufacturer to complete the manufacture of the aircraft by customizing the interior to the specifications of the purchaser. In this regard, the Department found that under its definition of "use," which was to "put into action or service ; employ," the purchaser was not using the aircraft in Arizona simply by permitting the manufacturer to complete the manufacturing process. Therefore, the Department ruled that the aircraft qualified for the exemption. See Arizona Private Letter Ruling LR 01-003 (January 10, 2001).

c. Arkansas. While aircraft sales generally are taxable (Law 26-52-505(a), Reg. GR-14(A)), the sale of new aircraft manufactured or substantially completed in Arkansas to a purchaser for use exclusively outside the state is exempt from tax if possession is taken in Arkansas for the sole purpose of removing it from the state under its own power. Law Section 26-52-505(c), Reg. GR-14(G).

d. California. Sales or leases of aircraft to nonresidents for use outside California are exempt. Rev. & Tax Code Sections 6366, 6366.1 and Reg. 1593.

e. Connecticut. Sales of aircraft to nonresidents who will not use such aircraft in Connecticut other than in the removal of the aircraft from Connecticut are exempt from sales tax. Conn. Stat. Section 12-412(20).

f. Florida. Sales tax does not apply to aircraft sold through a registered dealer to a purchaser who, at the time of taking delivery, is: i) a Florida nonresident that does not make his or her permanent place of abode in Florida, and is not engaged in carrying on in Florida any employment, trade, business or profession in which the aircraft will be used in the state; ii) a corporation, none of the officers or directors of which is a resident or maintains a permanent place of abode in Florida; or iii) a non-corporate entity that has no individual vested with authority to participate in the management, direction, or control of the entity's affairs who is a resident of Florida. Fla. Law Section 212.05(1)(a)(2). The purchaser must remove the aircraft from Florida within 10 days after the date of purchase, or, if the aircraft is altered, within 20 days after completion of the alterations, as well as meet certain documentation requirements regarding removal and registration of the aircraft in another state. Id. Use tax will be imposed on the purchase price of the plane if it is brought back into Florida within six months of purchase, except if it is returned to Florida for repairs within this six month period. Id.

g. Idaho. Aircraft is exempt if delivered to a nonresident for use outside of Idaho. The aircraft must be taken outside of Idaho and registered immediately in another state and not used in Idaho for more than 90 days in any 12-month period. IC § 63-3622GG.

h. Kansas. Aircraft is exempt if delivered to a nonresident and the aircraft does not remain in Kansas more than 10 days after the sale. K.S.A. 79-3606(k). See also Kansas PLRs P-1999-145 (June 24, 1999) (addressing delivery to purchaser that will resell it to nonresident) and P-2000-007 (February 28, 2000) (extending exemption to a nonresident that purchases aircraft for immediate resale to another nonresident).

i. Louisiana. Effective August 21, 1992, the sale of a passenger aircraft that is manufactured or assembled in Louisiana and that has a capacity in excess of 50 persons is exempt if the aircraft is ultimately received by the purchaser outside of Louisiana after all transportation, including transportation by the purchaser, has been completed. (Sec. 47:301(10)(m), La R.S.)

j. Minnesota. A nonresident can take possession of the aircraft in Minnesota and keep it in the state for 10 days without subjecting the sale to tax provided: i) the aircraft is removed from the state and subsequently registered in another state or country, and ii) the aircraft is used exclusively for training purposes during the 10-day period. Minn. Stat. 297A.82(4)(e).

k. Nebraska. Nonresident's purchase of aircraft is exempt from sales and use taxes if the aircraft is removed from Nebraska within 10 days of its purchase. N.R.S. 77-2704.26.

l. Oklahoma. Nonresident's purchase of aircraft with selling price in excess of $2.5 million is not taxable if the aircraft is immediately transferred outside of Oklahoma. O.S. 6003(16), Tit. 68.

m. Texas. Sale for use or registration in another state is nontaxable if aircraft is not used in Texas for any purpose other than flight training and transportation outside the state. Tx. Code § 151.328(a). Aircraft hangared outside of Texas and used more than 50% of time outside the state are exempt from use tax. 34 TAC 3.297(c)(3).

n. Utah. Sale for delivery and use outside of Utah is nontaxable even if title passes in Utah. Utah Code Ann. Sec. 59-12-104(33).

6. Relocation of aircraft acquired outside the state to inside the state.

Some states provide exemptions for aircraft purchased and used outside of the state for a set period of time before being brought into the state. (In some cases, the exemption may be thought of as a conclusive presumption that the aircraft was not purchased for use in the state.)

a. California provides such an exemption/conclusive presumption. Under Regulation Section 1620(B)(4), no California sales or use tax will be owed on an aircraft purchased outside of the state if (a) the aircraft is first functionally used" outside of California and (b) it is not brought into California within 90 days after its purchase (exclusive of the time of shipment to California or storage for shipment to California). "Functional use" means the use for which the aircraft is designed or intended. <u>See e.g.</u> SBE Annual Taxpayers' Bill of Rights Hearing, 1998 Cal. Tax Lexis 300 (September, 1998). Aircraft purchased and used for commercial purposes are not "functionally used" until they are used for the commercial purpose for which they are designed. SBE Annotation No. 325.0013.200 (August 10, 1992).

Even if an aircraft that is purchased outside of California and first functionally used outside California enters California within that 90 day period, it still may be exempt from use tax if it is used, stored, or both used and stored outside of California "one-half or more of the time during the six-month period immediately following its entry into the state." Also, California use tax will not be owed on an aircraft purchased outside California and first functionally used outside of the state if more than half of its flight time during the six-months immediately following its entry into California is commercial flight time traveled in interstate commerce.

b. Illinois. Aircraft relocated to Illinois by nonresident *individuals* who acquired the aircraft outside the state and used it outside the state for at least 3 months after purchase are exempt from Illinois use tax. 35 ILCS 105/3-70. Aircraft similarly acquired and used outside of Illinois by *businesses* are excluded from this exemption (i.e., are taxable). Id.

c. New Jersey. Aircraft "purchase" by a corporation while a "nonresident" of New Jersey is exempt from tax. N.J.S.A. 54:32B-11(2). The New Jersey Tax Court has interpreted this exemption to extend to a corporation that acquired title to an aircraft while a nonresident, but did not acquire possession of the aircraft until after it became a New Jersey resident. Diamondhead Corporation v. Director, Division of Taxation, 4 NJ Tax 255 (1983). The court based this ruling on its finding that the statutory definition of "purchase" included the transfer of "title or possession," and its determination that the purchaser had clearly acquired title to the aircraft while it was still a nonresident of New Jersey. See First National City Bank v. Taxation Division Director, 5 N.J. Tax 310 (1983) (the term "nonresident" as used in exemption interpreted to exclude corporation that is "actively engaged in business" in the state).

d. Wisconsin. Statutory exemption for aircraft relocated from another state to Wisconsin applies if the following conditions are met: i) aircraft purchased in another state; ii) aircraft owner paid all sales/use taxes imposed by state in which purchased; iii) purchaser and affiliates do not have real or tangible property in Wisconsin other than property connected with aircraft and hangar; and iv) purchaser not formed to qualify for this exemption. Wis. Stats. 77.53(17r).

7. Transfer to grantor trust.

In general, state sales and use tax statutes do not specifically address the taxability or non-taxability of transfers of aircraft to grantor trusts, a method frequently used to hold ownership to an aircraft. The taxability of these transfers is typically a matter of state administrative interpretation as to whether consideration was received in exchange for the transfer to the trust and whether an ownership change has taken place that triggers a tax.

a. No consideration/No change in ownership.

California. The sale of an aircraft to a revocable trust is non-taxable if the sale: i) does not change the beneficial ownership of the property; ii) the trust provides that upon revocation the property reverts to the transferor; and iii) the only consideration for the sale is the assumption by the trust of an existing loan for which the transferred property is the sole collateral. Rev. & Tax Code Section 6285. See also Annotation 495.0483 (December 1, 1971) ("Since the only assets are transferred to the trustee with no measurable consideration, such as cash, notes, or assumption of liabilities flowing to the trustee, no sale occurs") and Annotations 585.0275 (March 25, 1992) and 495.0490 (March 25, 1992) ("If a donation of the aircraft to the trust is for no consideration, the transaction would not be subject to use tax.") These latter rulings stated that consideration was received if the trust assumes a liability for an outstanding loan; however, California law has since been amended to allow for such assumption of indebtedness if the property being transferred is sole collateral for the assumed loan. Cal. Rev. & Tax Code Section 6285 (b) (4).

b. Change in ownership

Illinois. The Illinois Department of Revenue has treated trusts as entities distinct from their owners and therefore a transfer to a grantor trust might constitute a change in ownership sufficient to trigger a sales/use tax. See e.g. IL Dept. of Rev. PLR 00-005 (March 20, 2000). However, Illinois has a broad occasional sales exemption that may apply to exempt an otherwise taxable transfer of ownership to a grantor trust.

c. Special aircraft tax exemption for transfer to grantor trust.

Oklahoma. The special Aircraft Excise Tax adopted by the State of Oklahoma contains an exemption for aircraft transferred without consideration by an individual to a trust that the individual has a right to revoke. O.S. Section 6003(17), Tit. 68.

8. Contributions/transfers to Newco. Many states do not impose sales and use taxes on transfers of aircraft to subsidiaries, partnerships and limited liability companies in exchange for an ownership interest in the transferee. Other states, however, have interpreted their sales and use tax statutes to deem a sufficient transfer of "ownership" or "title" to have taken place to trigger a tax.

a. States exempting contributions/transfers to Newco.

i. California. Contributions to commencing corporations, LLC, partnerships or joint ventures are exempt from California sales and use taxes. Rev. & Tax Code Section 1595(b)(4). The exemption will be lost to the extent that the transferor receives any consideration as part of the transfer, including an assumption of indebtedness by the transferee. Beatrice Company v. State Board of Equalization, 6 C4th 767 (1993).

ii. Colorado. Transfers of assets from a parent corporation to a subsidiary owned 80% or more by the parent, in exchange solely for stock or securities of the subsidiary, are exempt from Colorado sales and use taxes. Co. Stat. Sections 39-26-102(10)(e).

iii. New York. Transfers of stock to a corporation upon its organization in consideration for the issuance of its stock, and transfers of property to a partnership in consideration for a partnership interest are exempt from New York sales and use taxes. Tax Law Section 1101(b)(4)(iv). Note that the New York State Department of Taxation and Finance has ruled that, for sales and use tax purposes, contributions of property to a limited liability company (including a single member limited liability company) on its formation must be treated as a contribution to a partnership. TSB-A-98(2)S (January 30, 1998).

iv. Minnesota. Transfer of an aircraft in exchange for stock or a partnership interest, as defined under IRC Sections 351 or 721, is exempt from tax. Minn. Stat. Section 297A.82(4)(b).

v. Oklahoma. Transfer of aircraft to corporation for purposes of organizing corporation is exempt from Oklahoma Aircraft Excise Tax if the former owners of the aircraft are in control of the corporation in proportion to their ownership interest in the aircraft. O.S. Section 6003(7), Tit. 68.

b. States not exempting contributions/transfers to Newco.

i. Florida. Florida Department of Revenue ruled that transfer of airplane title by corporation to its wholly owned limited liability company was a taxable transfer of "ownership" for "consideration." The Department went on to advise that transfer of title to the limited liability company by way of statutory merger would be exempt. TAA No. 02A-007 (January 30, 2002).

ii. Iowa. In the Matter of Legislake Ltd., No. 88-30-6-0439 (October 18, 1988) the Iowa Department of Revenue ruled that transfer of airplane to Newco by individual joint owners in exchange for Newco stock was subject to Iowa use tax. The Department based this ruling on its determination that there had been a change in ownership because the individuals transferring title to the corporation were "different entities" from their corporation for a variety of legal purposes (tort liability, income tax law, etc.). The Department stated that "So long as the law considers them to be two differing persons in other areas the director will refrain from stating that they are the 'same person' for the purposes of sales and use tax law."

9. Commercial carrier/rolling stock exemption.

a. Many states adopt what are generically referred to as "rolling stock" exemptions for the acquisition and use of an aircraft in transporting passengers or freight in interstate commerce.

i. California. Gross receipts from sale of aircraft to common carriers, or to persons who will lease to common carriers, are exempt from tax. Ca. Code Sections 6366 and 6366.1(a); Ca. Reg. 1593(c) provides qualification requirements.

ii. Colorado. Sales, storage, use or consumption of aircraft used or purchased for use in interstate commerce by a commercial airline are exempt from sales and use taxes. Colo. Rev. Stat. Sec. 39-26-114(1)(a)(XXII) and 39-26-203(1)(aa). Commercial airline is an airline carrying freight or passengers for a fee on regularly scheduled flights. Reg. 26-114.1(a)(XXII).

iii. Florida. The sale or lease of an aircraft weighing more than 15,000 pounds maximum certified takeoff weight for use by a common carrier is exempt from sales and use tax. Fla. Law Section 212.08(7)(uu). See also Fla. Law Section 212.08(7)(tt), extending the exemption to sales of replacement engines, parts and equipment used in the repair and maintenance of such aircraft.

iv. Hawaii. Effective July 1, 2001, amounts received for lease of aircraft used for interstate or inter-island transportation of passengers or goods are exempt from general excise (sales) tax. Hawaii Rev. Stat. Section 237-24.3(12). This statutory exemption extends the previously existing statutory exemption that had exempted aircraft purchased by common carrier for use in the commercial transportation of passengers and/or goods. Department of Taxation Announcement No. 2001-12.

v. Idaho. Sale or lease of aircraft primarily used to transport passengers or freight for hire is exempt from sales and use taxes. Effective July 1, 2001 the exemption includes repair and replacement materials and parts installed in or affixed to such aircraft, but not tools and equipment used in such repair. IC Sec. 63-3622GG; Rule 35.01.02.037.03.

vi. Illinois. Purchase or use of aircraft by interstate carrier for hire as rolling stock moving in interstate commerce or by lessors under a lease of one year or longer executed and in effect at the time of purchase is exempt from tax. 35 ILCS 105/3-55(b); 35 ILCS 2-5(12). Purchaser must include interstate carrier's FAA registration number on exemption certificate (RUT-7) by which it claims the rolling stock exemption.

(1) Administrative Decision UT 01-7, 2001 STT 135-16 (May 18, 2001). Rolling stock exemption not applicable to aircraft acquired by corporation, Fahrquar, that leased it primarily to affiliated lessee, Rocketboy, which had FAA certification to operate as an air carrier. Rolling stock exemption not applicable because lease to Rocketboy was not for statutorily required one-year or longer period -- Rocketboy did not have exclusive possession of aircraft, its possession was dependent upon the lessor's use in that Rocketboy paid hourly rate and could only use aircraft when Fahrquar did not have it prescheduled for its own use.

(2) Administrative Decision UT 99-1. Rolling stock exemption not applicable to purchase of aircraft because: purchaser's lease of aircraft to charter service was not entered until *after* purchase; lease was not for a year or longer duration, but instead was a *month-to month* lease; and purchaser introduced no evidence that lessee was interstate carrier for hire. [Note: this administrative decision was affirmed by the First District Illinois Appellate Court in its unpublished decision, Midwest Fastener Corporation v. Department of Revenue, No. 1-00-1677 (June 29, 2001)].

(3) Department General Information Letter ST 01-0081-GIL (April 27, 2001). Rolling stock exemption extends to airplanes purchased for: i) one- year lease to aviation management companies that are FAA Part 135 charter service certified; and ii) where approximately 75% of the airplanes' total use was by the management company for travel in interstate commerce for hire.

(4) Department General Information Letter 97-0281-GIL. Rolling stock exemption extends to replacement parts on aircraft used by interstate carriers, but not fuel, although there is a separate exemption for fuel certified by a carrier for use on an international flight. 35 ILCS 505/2-5(22).

(5) Amendment to Rolling Stock Regulation (86 Ill. Admin. Code § 130.340). Department recently amended its rolling stock exemption regulation to reflect Illinois Appellate Court's unpublished decision, AJF Warehouse Distributors, Inv. v. Illinois Department of Revenue, Dckt. No. 1-92-2126 (November 2, 1994) This decision extended rolling stock exemption to lessors that lease rolling stock for periods of less than a year to an interstate carrier. See 26 Ill. Reg. 8423, effective May 24, 2002.

vii. Kansas. Aircraft used in interstate or foreign commerce are exempt from sales tax, including remanufactured and modified aircraft, aircraft repair, and modification and replacement parts and services. KSA Code Section 79-3606.

viii. Maine. Aircraft used as instrumentalities of interstate or foreign commerce are exempt from tax. 36 M.R.S.A. Sections 1752(21), 1760(41).

Aircraft purchased out-of-state was not exempt under rolling stock exemption because it was brought into Maine and placed in interstate commerce by purchaser's aircraft management company, not the purchaser. J&E Air Inc. retained the management firm, Telford Aviation, to operate the plane for it. The state revenue department agreed that the plane was used in interstate commerce, but disallowed the statutory interstate commerce exemption because Telford, not the purchaser, as required by the statutory exemption, brought the aircraft into Maine and placed it in interstate commerce. The court rejected the purchaser's arguments that Telford was acting as J&E's agent (court found that Telford was not subject to J&E's (the purchaser's) control). J&E Air Inc. v. Tax Assessor, Maine Supreme Judicial Court, No. 2001 ME 95, June 22, 2001.

ix. Maryland. The sale of an aircraft that is used principally to cross state lines in interstate or foreign commerce is not taxable. Md. Sec. 11-208(c).

x. Michigan. Aircraft used by interstate carriers are subject to Michigan sales/use tax if taxation meets the four-part test used to determine the constitutionality of taxation under the United States Constitution's Commerce Clause set forth in Complete Auto Transit, Inc. v. Brady, 430 U.S. 274 (1977). Rev. Admin. Bull. 1993-8 (April 15, 1993).

Michigan Court of Appeals ruled that use taxation of aircraft parts delivered and installed on aircraft in Michigan did not violate Commerce Clause of United States Constitution, despite subsequent use of the parts almost exclusively outside Michigan. Court found that use taxation met four-part Complete Auto Transit test for taxation, specifically that taxation: i) had substantial nexus with Michigan -- parts received and installed on aircraft in Michigan); ii) was fairly apportioned -- no other state would impose tax on parts since they were delivered and installed on the aircraft in Michigan and if such a tax was imposed Michigan adopted a credit to offset this tax; iii) did not discriminate against interstate commerce -- undisputed by taxpayer; and iv) was fairly related to services provided by Michigan -- tax commensurate with services provided to taxpayer's Michigan aircraft repair facility. Zantop International Airlines, Inc. v. Michigan Department of Treasury. Michigan Court of Appeals, No. 217513 (unpublished opinion), April 24, 2001), petition for cert. denied U.S. Sup. Ct. Dckt. No. 01-1284 (May 13, 2002).

xi. New York. Air carrier exemption extends to commercial aircraft primarily engaged in intrastate, interstate or foreign commerce as well as machinery or equipment to be installed on such aircraft and property used by or purchased for the use of such aircraft for maintenance and repairs and flight simulators purchased by commercial airlines. Tax Law Section 1115(a)(21).

(1) Exemption is broad enough to permit corporations to use it to exempt from tax their purchase of corporate aircraft. This is done by setting up a separate subsidiary to acquire the aircraft, which then uses the aircraft to provide air transportation services (i.e. provide aircraft and flight crew) to affiliate/parent corporation in exchange for compensation reflecting costs of the subsidiary's operation of the aircraft. To meet the requirements of the statutory exemption, over 50% of aircraft's use must be for transportation services. Pasquale & Bowers, TSB-A-96(49)S (August 1, 1996), (purchase of aircraft exempt from tax under Tax Law Section 1115(a)(21) where used by owner (TAD) primarily (greater than 50%) to provide transportation services to two corporations owned by same shareholders; exemption applied even though TAD not required to hold FAA 135 air commercial; however, in order for exemption to apply TAD had to be respected as a separate legal entity (i.e. not be an alter ego) separate from the entities to which it provided transportation services).

(2) The fact that aircraft is used exclusively to transport one customer is immaterial for purposes of sustaining the exemption. John J. Bischoff, TSB-A-99(20)S (April 8, 1999), (Aircraft leased by owner, Company A, to Company B acting as Company C's agent. Company C held Part 135 FAA Air Carrier Operating Certificate. Company C entered into agreement under which aircraft was to be used exclusively to provide air transportation services to Company D for three years. Lease of aircraft from A to B qualified for air carrier exemption under Tax Law Section 1115(a)(21). Department stated "It is immaterial that the aircraft is for the exclusive use of one customer.") See also TSB-A-00(6)S (February 1, 2000) (similar facts to Bischoff -- aircraft used to provide air transportation services to Ernst & Young, which owned a "large part" of the entity that owned the plane); Citiflight, Inc., TSB-A-00(30)S (August 3, 2000) (purchase of aircraft exempt from tax where used to provide transportation services for compensation to related companies even though owner did not hold FAA Part 135 air operator operating certificate); Phillip

Morris Management Corp., TSB-A-00(38)S (October 11, 2000) (aircraft exempt under similar facts to Citiflight -- compensation paid transportation service provider based on IRS prescribed Standard Industry Fare Level rates; aircraft exempt even though an insubstantial portion of the aircraft's use was for apparently non-exempt purposes (use by former employees and elected officials)).

xii. South Dakota. Aircraft used in regularly scheduled flying in interstate commerce exempt are from sales/use tax. 50-11-19 SDCL.

xiii. Texas. Sale of aircraft to or use of aircraft by a certificated or licensed air carrier. Tx. Code Sections 151.328(a)(1), 151.328(b).

Texas Comptroller's Decision No. 39,831 (July 6, 2001) -- Comptroller ruled that because purchaser was not a licensed/certificated common carrier under part 135 of FAA regulations, purchase of aircraft did not qualify for rolling stock exemption.

xiv. Tennessee. Aircraft, parts, accessories, materials and supplies purchased or leased by interstate or international air carriers are exempt. Tn. Code Sections 67-6-302 and 67-6-217.

xv. Utah. Sale of aircraft, as well as parts and equipment sold for installation thereon, to common carrier is exempt. Utah Code Section 59-12-104(5); Rule R865-19S-97.

xvi. Vermont. Sale of aircraft and equipment to common carrier is exempt. Section 9741(a)(29), Tit. 32 V.S.A.

xvii. Washington. Use of aircraft primarily in transporting property or persons for hire within interstate commerce is exempt from tax. Tit. 82, Ch. 82.12 Wa. Code Section 82.12.0254.

However, the Washington Department of Revenue held that aircraft used to transport corporate executives did not qualify for exemption as instrument of interstate commerce. The aircraft was not available for hire. Petition for Correction Assessment, No. 98-029, 1998 Wash. Tax Lexis 1030 (February 27, 1998).

xviii. Virginia. Sale of aircraft, as well as replacement and maintenance parts for such aircraft, to common carrier is exempt from aircraft transfer tax. Va. Code Section 58.1-1505.

xix. Wyoming. Aircraft purchased by interstate air carriers that hold valid U.S. Civil Aeronautics Board permits are exempt. W.S. 39-15-105(a)(ii)(B); W.S. 39-16-105(a)(ii)(A).

10. Tax credits.

a. Credit for taxes paid to other states.

In order to limit the risk of cumulative tax burdens on interstate transactions, states typically adopt a tax credit that permits taxpayers to offset, against the use tax due on their aircraft, sales/use taxes they previously paid on the aircraft to other states.

Vermont. Vermont adopts a tax credit against use taxes due on aircraft brought into Vermont for sales/uses taxes previously paid on the aircraft to other states. § 9744(a)(2), Tit. 32 V.S.A. The Vermont Supreme Court held that this tax credit was the mechanism chosen by the Vermont legislature to avoid the risk of unconstitutional multiple taxation of interstate commerce and ruled that a Vermont taxpayer was required to pay use tax on 100% of its acquisition price of an airplane where the taxpayer failed to document that had previously paid any sales or use taxes on the plane to other states. Whitcomb v. Commissioner, 144 Vt. 466, 479 A.2d 164 (Vt. Sup. Ct. 1984). The court overturned the trial court's ruling that had allowed the taxpayer to pay tax on an apportioned tax base equal to 17% of the plane's purchase price based upon the taxpayer's determination that only about 17% of the plane's use was attributable to Vermont. The court held that the United States Constitution's "Commerce Clause does not require apportionment in addition to a tax credit" in order to "ameliorate the risk of cumulative tax burdens upon interstate commerce."

b. Other credits

States also adopt tax credits as incentives encouraging capital investment in the state.

Oklahoma. Effective July 1, 2001, Oklahoma allows a credit against the Oklahoma Aircraft Excise Tax on aircraft with a selling price in excess of $2.5 million for expenditures by those persons owing the tax for the benefit of airports in Oklahoma. Expenditures in excess of aircraft excise tax due may be carried forward 10 years as a credit against future aircraft excise taxes. O.S. Section 6003.1., Tit. 68.

11. Other.

a. Trade-in offset against purchase price.

States permit taxpayers to reduce the retail purchase price of new planes on which the taxpayers pay sales/use tax by the fair value of the old aircraft traded-in for the new aircraft.

i. Illinois. PLR ST-01-0126-GIL (2001 Ill. PLR Lexis 81). Department ruled that Advance Trade-In Regulation, 86 Ill. Admin. Code 130.425, applies to aircraft as well as the motor vehicles specifically referenced in the regulation. In this instance, two Falcon aircraft were traded in by a taxpayer for two Lear Jets. The taxpayer was not certain that at time it traded in second aircraft whether it would have identified aircraft it wanted to purchase. It wanted to know whether it would still qualify for reduction in taxable purchase price of new aircraft based upon trade-in value of old aircraft as long as it entered a contract to purchase a new aircraft at the time it traded in the old aircraft (advance trade-in). The Department ruled that the taxpayer would qualify for advance trade-in reduction of purchase price if requirements of regulation met (trade-in and purchase must be recorded as one transaction on books of retailer).

ii. Maine. A trade-in credit is available for aircraft. Section 1765, Tit. 36 M.R.S.A.

b. Miscellaneous exemptions.

States provide a variety of miscellaneous exemptions for aircraft that include exemptions for vintage aircraft, aircraft used in mineral exploration, kits acquired to construct aircraft, and aircraft sold to family members.

i. California. Sales to certain family members where the seller is a parent, grandparent, child (but not stepchild), grandchild, or spouse of seller are exempt from sales and use taxes. Sales and Use Tax Counsel Annotation 585.0020; Ca. Rev. & Tax Code Section 6285 and Ca. Reg. 1610(b)(2). Seller must not be in the business of selling the property for which exemption is claimed. Reg. 1610(b)(2).

ii. Connecticut. No sales or use tax is due when an aircraft is sold to the seller's spouse, mother, father, sibling or child. Conn. Stat. Section 12-431.

iii. Louisiana. Sales of airplanes more than 25 years old, maintained by private collectors, and not used in commerce are exempt. La. R.S. Section 47:6001(A), (B). [Note: this exemption has been suspended.] Also, helicopters used for mineral production or exploration and acquired through a lease transaction that might be considered a conditional sale are exempt. La R.S. Section 47:302.1

iv. Missouri. Sales to a qualified purchaser of a new light aircraft, light aircraft kits, parts or components manufactured or substantially completed within the state are exempt from sales and use taxes. Mo. Code Section 144.043. A light aircraft is defined as an airplane that seats no more than 4 person with a gross weight of 3,000 pounds or less that is primarily used for recreational flying or flight training. Id.

E. Documentation.

1. Arkansas. Record keeping requirements are provided in Law Sections 26-52-514 and 505; Reg. GR-114.

2. Connecticut. In general, sales or use tax must be prepaid to the Commissioner of Transportation on sales of aircraft. Conn. Gen. Stat. Section 12-430(3). Documentation is described in Conn. Reg. section 12-426-16a.

3. Illinois. At time of application for Illinois registration with the Department of Transportation for aircraft purchased or leased (as lessee if lessee assumes this responsibility), must submit either payment of tax or proof of exemption. Exemption for aircraft used outside of Illinois for more than three months applies only to individuals moving into Illinois.

Use of broker/agent may change a nontaxable sale to a taxable sale if broker/agent takes title.

See also Falcon Helicopter , Inc. v. Department of Revenue, Ill. Circuit Court 01 CH 3578 (March 26, 2002). Administrative review rejecting the taxpayer's argument that purchase was for resale. The Court stated that

> "When trying to prove entitlement to an exemption from use tax when a large purchase is made from an out-of-state retailer and is made without the benefit of a registration or resale number from the Department, the taxpayer better come 'armed for bear' to the hearing. In this case, the only ammunition that the taxpayer brought to the administrative hearing was the testimony of its owner, Andy Kolasa, that he thought he could buy the helicopter and resell it for a profit. The court believes that the Department did not err in failing to accept this testimony for a number of reasons, including the following: 1) The purchase of the helicopter was from a registered aircraft dealer/retailer in Florida and there is nothing in the record to support the underlying assumption in taxpayer's position that the purchase price of nearly $370,000 was below market-value; 2) Prior to such a large purchase, the taxpayer failed to take the rudimentary step of securing a registration or resale number from the Department of Revenue, though Mr. Kolasa was a successful businessman; 3) Mr. Kolasa was neither a helicopter pilot nor a helicopter mechanic; and, 4) While the helicopter was purchased in May of 1996, it appears from the flight log of the craft that flights for demonstration or repair purposes did not begin until late November of that year. In the court's view, these considerations make it understandable why the Department rejected the taxpayer's position that the helicopter was purchased with the intent to resell it for a profit. Accordingly, the Department's determination that the taxpayer is not entitled to the so-called demonstration exemption is not clearly erroneous. See, 35 ILCS 105/2."

IV. Like-kind exchanges and other transactions in which title passes through intermediary to purchaser.

As discussed in Section III. above, many states adopt a casual or occasional sales exemption for airplanes acquired by a purchaser from a non-retailer. However, the seller or purchaser may choose to pass title to the purchaser through an intermediary-retailer. There are a variety of reasons for using an intermediary that include: i) satisfying Internal Revenue Code ("IRC") Section 1031 like-kind exchange requirements for deferring federal income tax gain on the purchaser's/seller's disposition of its old aircraft;

ii) using a broker to assist in the acquisition or disposition of a plane; and iii) facilitating the financing of the aircraft acquisition. Discussed below are judicial and administrative decisions interpreting the tax effect of passage of title to a purchaser through an intermediary-retailer, and where applicable its impact on any casual sales exemption to which the purchaser may otherwise be entitled.

A. Title passes through IRC Section 1031 like-kind exchange "Qualified Intermediary".

1. Like-kind exchange is a taxable sale.

a. Illinois Appellate Court. The Illinois Appellate Court ruled that a use tax was due on the acquisition by a purchaser, Weber-Stephen, of a Hawker aircraft where title passed from Chase Manhattan, the original owner of the Hawker, to Weber-Stephen through an intermediary-retailer. In this transaction Weber-Stephen deferred federal income taxes on its disposition of its old aircraft, a Westwind, under IRC Section 1031, by exchanging the Westwind plus cash with the intermediary for the Hawker. Weber-Stephen argued that its purchase was non-taxable under the occasional sales exemption. It argued that this transaction must be taxed based on its substance, which it characterized as a purchase by it of the Hawker directly from Chase Manhattan, a non-retailer. The court's opinion in this case has been the subject of conflicting interpretations by the Illinois Department of Revenue and taxpayers. The Department has read this opinion to hold that while the government has the right to assert taxation of a transaction based on its substance, taxpayers are bound to the form they choose. Under this reading, the form of this purchase, a bare transfer of legal title by a retailer to Weber-Stephen, generated a use tax. Taxpayers have read the opinion to hold that use taxes are due based on the transfer of substantive ownership, but not on mere formal ownership. Under this reading, use tax was due; because the court determined that the intermediary-retailer had transferred substantive ownership, as well as legal title to the aircraft, to Weber-Stephen. Weber-Stephen Products, Inc. v. Department of Revenue No. 1-99-2578, 324 Ill. App. 3d 893, 756 N.E.2d 321 (1st Dist. 2001).

2. Like-kind exchange is *not* a taxable sale.

a. Illinois Appellate Court. Subsequently, the Illinois Appellate Court clarified its decision in Weber-Stephen. It ruled in JI Aviation v. Department of Revenue, (1st Dist.) No. 1-01-2123 (September 26, 2002) that the sale of a plane by a non-retailer, Richland, to JI Aviation was a non-taxable occasional sale even though title passed to JI Aviation through an intermediary-retailer in order to accommodate Richland's IRC Section 1031 like-kind exchange. The court held that not just the government, but taxpayers too have the right to assert taxation based on the substance and economic realities of a transaction rather than its form. The court explained that its decision in Weber-Stephen was based on its determination that the intermediary-retailer had transferred substantive ownership of the aircraft to Weber-Stephen. By contrast, the court ruled that the intermediary-retailer in this case transferred only bare legal title, not substantive ownership, to JI Aviation, and therefore that JI Aviation's aircraft purchase from Richland was a non-taxable occasional sale. The court's determination that the intermediary-retailer did not transfer substantive ownership to JI Aviation was based on the following six factors: i) the written agreement between the parties defined the limited role of the intermediary; ii) the intermediary immediately re-conveyed title to JI Aviation; iii) the intermediary assumed no liability for good title; iv) the intermediary re-conveyed the purchase price to Richland; v) the intermediary retained no portion of the purchase price; and vi) the intermediary did not pay any closing costs.

b. Illinois Circuit Court. The Cook County Circuit Court ruled that passage of title to a purchaser through an intermediary-retailer did not generate a use tax. Gulfstream et. al. v. Illinois Department of Revenue, Cook County Cir. Ct. Dckt. No. 00L51052 (August 15, 2002), *appeal docketed*, No. 02-2833 (1st Dist. Ill. App. Ct.) . In this case the purchaser, Ameritech, acquired title to two aircraft through an intermediary, KC Aviation, an affiliate of Gulfstream Aerospace Inc. Ameritech had contracted to acquire the two aircraft from the manufacturer, Bombadier. As is a common business practice in the aircraft industry, Ameritech acquired "green" aircraft requiring substantial additional outfitting work, including interior furnishings and avionics, to meet Ameritech's specific needs. In order to accommodate Ameritech's deferral of federal income taxes under IRC Section 1031 on the gain it would otherwise recognize from the disposition of its old planes, the airplane outfitter retained by Ameritech to complete work on the new aircraft, KC Aviation, agreed to accept title to the new aircraft from Bombadier, and re-convey title to Ameritech. Ameritech paid Bombadier for the new aircraft and self-assessed Illinois use tax based on its purchase price of the aircraft. The Department assessed a second use tax against Ameritech based on KC Aviation's transfer of legal title to Ameritech. Ameritech argued that no tax was due because KC Aviation did not transfer substantive ownership of the planes to Ameritech. The

Department argued that transfer of bare legal title generated a use tax. In a one page order, the Circuit Court found, without explanation, that no use tax was due on Ameritech's acquisition of title from KC Aviation.

c. Illinois Administrative Decision. In a Department of Revenue administrative decision, Ill. Dept. of Rev. Admin. Decision UT 01-3 (February 20, 2001), a Department administrative law judge ("ALJ") ruled as taxable a taxpayer's acquisition of title to a plane from a seller through a qualified intermediary-retailer in an IRC Section 1031 like-kind exchange that deferred gain on the purchaser's disposition of its old plane. The ALJ ruled that the purchaser as a matter of law was not entitled to argue substance over form because the taxpayer's characterization of this transaction as a purchase directly from the owner was inconsistent with its characterization of this transaction for federal income tax purposes as an exchange with the intermediary-retailer of its old aircraft for a new aircraft. Furthermore, the ALJ ruled that even if the purchaser could successfully argue substance over form it had not proven that the seller was a non-retailer, and that the occasional sales exemption would therefore apply to its purchase. [Note: this decision was affirmed by the Cook County Circuit Court in <u>JM Aviation v. Illinois Department of Revenue</u>, Dckt. No. 01L 50537 (January 10, 2002) and is on appeal to the Illinois Appellate Court docketed as Case No. 02-0379).]

B. Title passes through aircraft broker.

Sale taxable because broker acquired and transferred substantive ownership to the purchaser.

Texas. A Texas administrative law judge ruled that the occasional sales exemption did not apply to the purchaser's acquisition of an airplane from an aircraft broker who had in turn acquired the aircraft from a non-dealer. This ruling was based on the ALJ's determination that the broker, a retailer, had acquired from the non-dealer, and re-conveyed substantive ownership of the airplane to the purchaser. Administrative Hearing Decision No. 36,323 (December 19, 1997).

C. Passage of title through financing intermediary.

1. Sale taxable because parent of intermediary acquired and transferred substantive ownership to the purchaser.

   Illinois. The United States Court of Appeals, Seventh Circuit, ruled under substance over form doctrine that casual sales exemption did not apply to purchase of an aircraft by a taxpayer, Chandler, from a parent corporation retailer, JPA, and its non-retailer financing affiliate, PLI. Court found that transaction was taxable based on its substance which it determined to be a purchase of the aircraft from JPA, a retailer, in which title flowed to Chandler from JPA through PLI, a non-retailer. In Re Stoecker, 179 F.3d 546 (1999).

2. Sale nontaxable because intermediary did not acquire and transfer substantive ownership to the purchaser.

   Arizona. Arizona Board of Tax Appeals ruled that passage of title from seller to purchaser through intermediary finance company at *seller's* request did not make unavailable the casual sale exemption. The Board of Tax Appeals determined that the substance of this transaction was that the seller conveyed substantive ownership of the aircraft to the purchaser notwithstanding passage of title through the financing intermediary. Marley Cattle Company v. Arizona Department of Revenue, Arizona Board of Tax Appeals Docket No. 386-85-U (Sept. 18, 1986) (1986 Ariz. Tax Lexis 13).

D. Other transactions in which purchase price or title passes through intermediary.

1. Sales taxable.

   a. Illinois. Administrative law judge ruled that casual sale exemption did not apply to Illinois taxpayer's purchase of an aircraft. Taxpayer entered purchase contract with non-retailer, Aeronautics, but unbeknownst to purchaser actual title to aircraft was held by and transferred to taxpayer by retailer, ZZ. Administrative law judge ruled in Department's favor that this was not a casual sales exemption because he found that all of the evidence regarding the sale of the aircraft demonstrated that the taxpayer had acquired ownership of the plane from ZZ. Illinois Department of Revenue Administrative Decision UT-00-2.

b. Illinois. ALJ ruled that under substance over form doctrine passage of title through intermediary titleholder, a non-retailer, must be ignored because this was an attempt by the purchaser to turn a taxable purchase from the original owner, a retailer, into a non-taxable occasional sale by the intermediary, a non-retailer. Illinois Department of Revenue Administrative Hearing Decision UT 95-7 (January 1, 1995).

2. Sale nontaxable.

New York. Department of Taxation ruled that qualified intermediary was not a retailer where its activities were limited to receipt and conveyance of funds, but not conveyance of title (title passed directly from seller to purchaser), in order to further purchaser's like-kind exchange of old leasing inventory for new leasing inventory. Ford Motor Credit Co., TSB-A-02(20)S, June 26, 2002.

V. Leases.

States follow a variety of approaches to taxing aircraft leases. Tax treatments can be affected by the duration of the lease, the size of the aircraft, the use of the aircraft, and numerous other factors. Examples of possible treatments are identified below:

A. Colorado. Leases of three years or more are treated as a continuing retail sale to the lessee and sales and use taxes must be based on lease payments made by the lessee. Co. Stat. Section 39-26-102(23). Purchases made for retail sale are exempt from tax. Co. Stat. Section 39-26-102(18) and (19); Colorado regulation 26-102.19.

B. Connecticut. Taxpayer purchased an aircraft which it leased to its corporate affiliate, which then chartered the aircraft (i.e., sold flight time) to both related and unrelated parties. The Connecticut Superior Court rejected the taxpayer's arguments for sale for resale treatment and held that lease payment were taxable. Air Tiger, Inc. v. Commissioner of Revenue Services, Connecticut Superior Court, No. CV99-0496956S 2002 Conn. Lexis 976 (March 27, 2002). Note that Connecticut law was changed in 1997 so that leases of aircraft having a maximum certificated takeoff weight of 6,000 pounds or more are exempt from sales tax. Conn. Gen. Stat. 12-412(99).

C. Hawaii. Amounts received as rent for the rental or leasing of aircraft or aircraft engines used by the lessees or renters for interstate air transportation of passengers and goods are exempt from Hawaii General Excise Tax. The exemption applies to both operating leases and finance leases. Hawaii Law Section 237-24.3(12). See also Hawaii Announcement No. 2001-12 (June 8, 2001).

D. Indiana. Purchase of aircraft for lease is exempt. IC 6-2.5-5-8 and Revenue Ruling No. 2002-05ST (March 14, 2002).

E. Kentucky. The Kentucky Court of Appeals addressed the tax consequences of change in Kentucky tax law from (a) the imposition of tax on the purchase of tangible personal property for lease, to (b) the imposition of tax on the lease transaction. Kentucky v. Ashland Oil, Inc., Kentucky Court of Appeals, no. 92-CA-3033-MR (July 29, 1994). The statutory change at issue was effective on August 1, 1985. Here, prior to August 1, 1985, the taxpayer's affiliate purchased an aircraft for lease to the taxpayer. (In an earlier case, the affiliate unsuccessfully contested the imposition of Kentucky use tax on that purchase. Therefore, the affiliate paid use tax on its purchase of the aircraft.) The lease agreement provided the Taxpayer, as lessee, with an option to extend the lease term. The Taxpayer exercised the option after the effective date of the new law. The Kentucky Court of Appeals concluded that sales tax was due on lease payments due under the option period. It determined that there was no double taxation, as the first tax was on the lessor's purchase, and the second tax was on the lessee's payment for use of the aircraft. On this last point, compare to the Illinois Supreme Court's analysis in Philco Corporation v. Department of Revenue, 40 Ill.2d 312 (1968).

F. Michigan. The sale of aircraft is exempt from Michigan sales and uses taxes if it is sold to a person for subsequent lease to a domestic air carrier operating under a certificate issued by FAA for use in regularly scheduled transportation of passengers. Michigan law Sections 205.54x(2) and 205.94(y) (Acts 39 (S.B. 491) and 40 (S.B. 492), Laws 2001, effective July 11, 2001).

G. Minnesota. The sale of aircraft and repair parts by an incorporated nonprofit flying club or association to be used solely for leasing to its shareholders is tax exempt as property purchased for resale. However, the leasing of the aircraft to the shareholders is taxable. Minn. Stat. 297A.82(6).

H. Missouri. A Missouri purchaser that buys tangible personal property (including aircraft) for the purpose of leasing the property has two options: The purchaser may pay sales tax on its purchase of the property, but not on subsequent lease receipts. Or, the purchaser may purchase for resale and then must collect sales tax on the lease gross receipts. Missouri law Sections 144.010.1(8) and 144.020.1(8). See also Letter Ruling LR 8651 (January 24, 1996).

I. Mississippi. The purchase of an aircraft for rental by a licensed retailer is exempt from tax, and the subsequent rental of the aircraft is subject to the same reduced rate of tax, 3%, that would be imposed on a taxable purchase of the aircraft. Mississippi Tax Rule 46.

J. New York. A special sales tax of 5 percent is imposed on the lease, for one year or more, of noncommercial aircraft in lieu of the general sales tax. NY Tax Law Section 1111(i). The lease tax is due at the inception of the lease on the total amount of the lease payments for the entire term of the lease. Id.

K. Ohio. Effective February 1, 2002, Amended House Substitute Bill 405 amended Ohio sales and use tax law sections 5739.01(H)(4) and 5741.01(G)(4), and added section 5739.01(VV), to require the imposition of the taxes at the inception of a lease. At inception, the taxes must be calculated and paid based on total payments due over the lease term.

L. Virginia. Virginia's structure for taxing sales and leases of aircraft is complex and involves two types of taxes: the general retail sales and use tax and a special aircraft sales and use tax. (Where the aircraft sales and use tax applies, the Commonwealth's general retail sales and use tax does not apply. VA. Code Ann. Section 58.1-609.1(5); 23 VAC Section 10-210-70.) The only leases treated as sales are those for a period of time substantially equal (80% or more) to the remaining life of the aircraft or in which the aggregate lease payments substantially equal (80% or more) to the value of the aircraft. VAC 10-220-5. For such leases, the lessee is taxable on the aggregate of the lease payments. If, instead, the lease is not treated as a sale, a lessor who is a registered dealer in aircraft is liable for tax on all charges for the use of the aircraft except separately stated charges for pilots. Other lessors pay tax on their purchase of the aircraft. Determining whether tax is imposed on the lessor or lessee is important, as certain exemptions may be available to the lessee which are not available to the lessor.

The Virginia Department of Taxation ruled that an aircraft lease was not subject to Virginia sales and use taxes because the lessee leased the aircraft outside the Commonwealth and the value of the lease did not exceed 80% of the value of the aircraft. P.D. 01-107 (August 17, 2001).

VI. Other and local taxes.

A. California. California Emergency Rule 138 clarifies that certified aircraft owned by air carriers that are temporarily out of service and stored and maintained in California are eligible for the property tax exemption provided by Rev. & Tax. Code Section 220. 2001 STT 235-3 (December 6, 2001). This Rule was issued in response to the numerous aircraft remaining idle following the terrorist attacks.

B. Iowa. Effective July 1, 1999, Iowa subjects transfers of aircraft to its use tax rather than its sales tax. Sec. 423.2, Code of Iowa; Iowa Rule 701 --31.6(423). Local Iowa taxes are limited to sales, not use, taxes. Sec. 422B.8, Code of Iowa. Consequently, the sale of aircraft in Iowa is subject strictly to the 5% state use tax. Iowa Rule 701--31.6 (423).

C. Texas. For property tax purposes, tax assessor must allocate fair market value based on actual use of business aircraft in Texas -- (number of departures from Texas/total departures). Section 21.055 of Texas Property Tax Code.

VII. Foreign sellers, purchasers and users.

A. Arizona. Sales of aircraft are deducted from the retail classification tax base and are exempt from the use tax, Law Section 42-5061(B)(7) and 42-5159(B)(7), when sold to persons holding certain federal certificates or any foreign government for use outside the state or any nonresident who will not use the property in Arizona, including corporations not incorporated in Arizona if the principal corporate office is located outside the state.

B. California. Sales or leases of aircraft to foreign governments or nonresidents for use outside California are exempt. Rev. & Tax Code Sections 6366, 6366.1 and Reg. 1593.

C. Illinois. PLR 92-0463 (September 1, 1992), 1992 Ill. PLR Lexis 1401 -- Illinois Department of Revenue ruled that use tax did not apply to aircraft leased by Bermuda corporation to European affiliate that twice a month ferried that affiliate's executives to meetings in Illinois at common parent's worldwide headquarters. Department found that "under the U.S. Supreme Court's decision of Complete Auto Transit, as well as the case law developed under the Foreign Commerce Clause of the U.S. Constitution, that Illinois would be barred by federal supremacy from asserting tax" based on these facts.

D. Kansas. Aircraft sold to foreign governments for use outside the United States are exempt tax, including parts and services to remanufacture, modify, and repair the aircraft. KSA Section 79-3606(g).

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NEW YORK STATE AND NEW YORK CITY: A COMPARISON OF THEIR CORPORATE INCOME TAXES AND THE ATTRIBUTION OF EXPENSES TO SUBSIDIARY CAPITAL

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I. New York State Business Corporation Franchise Tax And New York City General Corporation Tax Similarities And Differences.

A. Similarities.

1. Background/Fundamental Statutory Similarity. New York New York State's Business Corporation Franchise Tax ("BCFT") (New York State Tax Law ("Tax Law") Article 9-A) and New York City's General Corporation Tax ("GCT") (New York City Administrative Code ("Administrative Code") Title 11, Chapter 6, Subchapter 2) share fundamental similarities. Those similarities are attributable to (i) New York State Constitution, Article XVI, §1 and Article IX, §2(c)(8), by which local authority to impose taxes is derived from the State of New York and which requires that local taxes be consistent with laws enacted by the State legislature, and (ii) New York State's enabling legislation permitting the imposition of a local general corporation tax.

The enabling legislation, Chapter 722 of the laws of New York of 1966, permits cities having populations of one million or more "to raise tax revenue by authorizing the imposition of taxes on [general corporations]..." Section 1 of that Chapter limits local authority to adopt a general corporation tax by providing that "The terms of such local law or local laws shall be, substantially, as follows [in the Model Local Law (General Corporation Tax)]..." The provisions of the Model Local Law were patterned after those of the BCFT.

In addition, Chapter 699 of the laws of New York of 1967 permits amendment of the local laws for the purpose of conforming with similar provisions of the BCFT as then in effect or as amended. However, that Chapter merely allows for absolute conformity between the GCT and the BCFT; such conformity is not required. Nor, in practice, has the GCT been amended to be identical to the BCFT. Rather, the GCT in its current form contains some provisions substantially similar to the Model General Corporation Tax and other provisions conforming with the BCFT as amended.

Provisions of the GCT have been held unconstitutional and invalid where the provision fails to follow substantially the Model General Corporation Tax and, at the same time, fails conform to the BCFT as amended. See e.g., Castle Oil Corp. v. City of New York, 89 N.Y.2d 334; 675 N.E.2d 840 (1996). In Castle Oil, the Court of Appeals (New York's highest court) held that determination of substantial similarity between the GCT and BCFT requires comparison of the particular provision as contained in both the GCT and Model Local Law (rather than a comparison of the entire GCT and entire Model Local Law). In addition, the court in Castle Oil held that conformity to the BCFT as amended required more than conformity at a particular moment in time, but instead required continued conformity such that a GCT provision must be amended to match amendments to the corresponding provision of the BCFT. Therefore, the provisions of the GCT must at all times conform to either the Model Local Law or the BCFT.

2. City Tribunal Bound By State Tribunal Decisions. New York City Charter, Section 170(d), states that "The [New York City Tax Appeals Tribunal] shall follow as precedent the prior precedential decisions of the [New York City Tax Appeals Tribunal], the New York State Tax Appeals Tribunal or of any federal or New York State court or the U.S. Supreme Court insofar as those decisions pertain to any substantive legal issues currently before the [New York City Tax Appeals Tribunal]."

That Charter provision was interpreted by the New York City Tax Appeals Tribunal in U.S. Trust Corporation and Subsidiaries 1997 N.Y. Tax Lexis 52 (1997). At issue in U.S. Trust was whether the City Tribunal (and, of course, its administrative law judges) was bound by the State Tribunal's decision on a legal issue, where the State Tribunal's decision was based on facts that were not materially different from those before the City Tribunal. The City Tribunal concluded that it was so bound where there were no material differences in the facts presented to it as compared to the facts presented to the State.

B. Differences Between The BCFT And GCT. While there are substantial similarities between the BCFT and GCT, there are also important structural and other legal differences between the two taxes. In addition, many taxpayers perceive important differences between the audit style of the New York State Department of Taxation and Finance on the one hand, and that of the New York City Department of Finance on the other.

1. Structural And Legal Differences Between The BCFT And GCT. Following are some of the significant differences between the BCFT and GCT:

a. S Corporations. Federal S corporations are subject to both the BCFT and GCT, although the taxing schemes differ greatly. The GCT does not provide an exemption for S corporations, and such corporations are subject to the GCT without regard to their federal income tax treatment. See e.g. Instructions to Form NYC-4S ("An S corporation is subject to the General Corporation Tax...").

In contrast, for New York State tax purposes a separate S corporation election must be made. Under the New York State election, federal S corporations electing treatment as a New York S corporation for BCFT purposes generally are subject to BCFT on the difference between the BCFT tax rate (or fixed dollar minimum) and the "Article 22 tax equivalent". Tax Law Section 210(1)(g). (Article 22 contains New York State's personal income tax.) Using the generally applicable BCFT tax rate of 9% and the established Article 22 tax equivalent of 7.875% (set at that rate for tax years beginning before July 1, 1999 (see Tax Law Section 210(1)(g)(2)), New York S corporations generally are subject to BCFT at a rate of 1.125%. The Subchapter S differential rate will drop to .975% for tax years beginning on or after July 1, 1999. The New York S corporation election may be made by any corporation subject to BCFT which has in effect a federal S corporation federal election.

Federal S corporations not electing such treatment for BCFT purposes are subject to the BCFT at the regular BCFT rate, although they may qualify for the reduced rates applicable to small business taxpayers.

Note that for personal income taxes, the City and State have absolute conformity. Therefore, where an S election has been made for New York State purposes, the income from that S corporation will be included in a New York City resident's taxable income for both State and City personal income tax purposes. For a New York City resident, it is possible that the City will tax the same income twice -- once at the entity level under the GCT and again at the owner's level under the City's personal income tax. <u>See</u> <u>Gael De Brousse</u>, 1998 N.Y. Tax Lexis 245 (NYS ALJ 1998) ("Chapters 17 and 19 of Title 11 of the Administrative Code of the City of New York, which impose the City of New York personal income tax on residents and nonresidents, respectively, do not provide for the exclusion or deduction of distributions of income from Subchapter S corporations which are also subject to New York City general corporation tax. Thus, the same income may be subject to both the general corporation tax at the corporate level and the New York City personal income tax on an individual level").

b. <u>Qualified Subchapter S Subsidiaries ("QSSS")</u>. For GCT purposes, New York City treats a QSSS as a corporation separate from its S corporation parent. Both the QSSS and its parent may be subject to the GCT. <u>See</u> 1997 Form NYC 3L, Instructions. The S corporation and the QSSS may be required or permitted to file a combined report.

For BCFT purposes, New York State generally follows the federal treatment of a

QSSS where the parent is a New York State S corporation. See Tax Law Section 208(1-B) and (9)(k). If the parent is a New York C corporation, New York State nevertheless will follow the federal QSSS treatment (i.e., ignoring corporate lines and including on the parent's BCFT return the QSSS's assets, liabilities, income and deductions) if either the QSSS is a New York taxpayer or, if the QSSS is not a New York taxpayer, the parent makes a "QSSS inclusion election" on its return and attaches to that return Form CT-60-QSSS. If the parent is not a New York State taxpayer, New York State nevertheless will follow the federal QSSS treatment if the parent elects to be taxed as a New York S corporation by filing Form CT-6; if the parent does not elect to be a New York S corporation, the QSSS must file as a New York C corporation. In those cases where New York follows the federal QSSS treatment, a QSSS will not be treated as a subsidiary of the parent corporation. 1997 Form CT-3, Instructions.

c. Deductibility Of GCT; Nondeductibility Of BCFT. For BCFT purposes, Tax Law Sections 208(9)(b)(3)-(4) require the computation of BCFT entire net income without allowing for the deduction of various profit or income-based taxes, including those "paid or accrued to any other state of the United States or any political subdivision thereof..." Tax Law Section 208(9)(b)(3-a). While the law also expressly requires the addback of the BCFT, see Tax Law Section 208(9)(b)(4), it does not require the addback of profit or income-based taxes paid or accrued to a political subdivision of the State of New York. Under the implication of Tax Law, GCT paid or accrued is deductible in computing BCFT entire net income. To that effect, the instructions to the General Business Corporation Franchise Tax Return (Form CT-3) expressly exclude the GCT from taxes added back to federal taxable income in computing entire net income ("However, do not include New York City taxes").

Neither the BCFT nor GCT may be deducted for GCT purposes. Administrative Code Section 11-602(8)(b)(3) and (4).

d. Apportionment Formulae. For BCFT purposes, business income is apportioned to New York State using a four factor (property, payroll, receipts, receipts) apportionment formula. Tax Law Section 210(3)(a)(1)-(4).

In general, for GCT purposes business income is apportioned by a three factor (property, payroll, receipts) apportionment formula. Administrative Code Section 11-604(3). However, for taxable years beginning on or after July 1, 1996, manufacturing corporations may elect to use a four factor (property, payroll, receipts, receipts) apportionment formula. Administrative Code Sections 11-604(3)(a)(4) and (8). A "manufacturing corporation" is a corporation which, during a given tax year, is primarily engaged in (i.e., more than 50% of its gross receipts are attributable to) the manufacturing and sale thereof of tangible personal property. Administrative Code Section 11-604(3)(a)(8)(c). Manufacturing includes assembly, and is defined to include processes "(i) of working raw materials into wares suitable for use or (ii) which gives new shapes, new qualities or new combinations to matter which already has gone through some artificial process, by the use of machinery, tools, appliances and other equipment." Id.

For corporations filing on a combined basis, the election is permitted only if the entire combined group would be a manufacturing corporation if it was a single corporation. The determination is made after eliminating intercorporate transactions. Administrative Code Section 11-604(3)(a)(8)(d).

The election to use the four factor apportionment formula for GCT purposes must be made on a timely filed original return for the year, without regard to any extensions, and is irrevocable for that tax year. The election must be made separately each tax year. The Commissioner may permit a manufacturing corporation to make or revoke a manufacturing election "where the Commissioner determines that such permission should be granted in the interests of fairness and equity due to a change in circumstances resulting from an audit adjustment." Administrative Code Section 11-604(8)(b).

e. Rates. The BCFT generally is imposed on allocated net income at a rate of 9%. (The general BCFT rate on allocated net income will drop to 8.5% for tax years beginning on or after July 1, 1999, and will continue to drop to 7.5% for tax years beginning on or after July 1, 2001.) The GCT is imposed on allocated net income at a rate of 8.85%.

f. Alternative Tax Bases. For both the BCFT and GCT, the entire net income basis is only one of four possible bases on which the taxes may be imposed. For both the BCFT and GCT, a corporation's applicable basis for the year is that which produces the greatest amount of tax, and both the BCFT and GCT are supplemented by a tax on subsidiary capital. However, the BCFT's alternative bases are different from the GCT's alternative bases. In addition, the BCFT's rate of tax on subsidiary capital is different from the GCT's rate of tax on subsidiary capital.

For the BCFT, the remaining bases are (i) 1.78 mills (.00178) on each dollar of allocated business and investment capital, to a maximum of $350,000; (ii) 3.5% of the corporation's minimum taxable base (entire net income with the addition of certain adjustments and tax preference items); or (iii) a fixed dollar minimum based on gross payroll and currently ranging from $325 to $1,500 (corporations with payrolls of $250,000 or less are eligible for a reduced fixed dollar minimum tax for tax years beginning on or after July 1, 1998). Tax Law Sections 210(1)(b) - (d). The additional tax on subsidiary capital is .9 mills (.0009) for each dollar of allocated subsidiary capital. Tax Law Section 210(1)(e).

For the GCT, the remaining bases are (i) 1.5 mills (.0015) on each dollar of allocated business and investment capital; (ii) 8.85 percent of the corporation's income and salaries [determined as: ((the corporation's allocated income) plus (salaries and other compensation paid to officers (but see below) and shareholders owning in excess of 5% the corporation's issued capital stock) less $30,000)]; or, (iv) $300. Administrative Code Section 11-604(1)(E)(a). The additional tax on subsidiary capital is .75 mills (.00075) for each dollar of allocated subsidiary capital. Administrative Code Section 11-604(1)(E)(b).

The addback of officers' salaries and other compensation currently required under the income and salaries base is being phased out. Currently, only 75% of such amounts are added back. The phase out will be complete for tax years beginning on or after July 1, 1999. The phaseout notwithstanding, the full amount of salaries and other compensation paid to an officer shall be added back if at any time in the tax year the officer was a stockholder owning more than 5% of the corporation's issued capital stock. Administrative Code Section 11-604(1)(H)(a). The $30,000 threshold under the income and compensation tax base also is in transition, and will be $40,000 for tax years beginning on or after July 1, 1998. Administrative Code Section 11-604(1)(H)(b).

g. Advisory Opinions/Letter Rulings. The New York State Department of Taxation and Finance will issue Advisory Opinions ("TSB-As") applying New York State tax law to a particular set of facts. Advisory Opinions may be issued on a taxpayer-disclosed or taxpayer-anonymous basis, although only the former are binding on the Department and even then only with regard to the requesting taxpayer. There is no fee for requesting an Advisory Opinion. A taxpayer may withdraw its request for an Advisory Opinion any time before the opinion is issued. For additional information regarding the requesting of Advisory Opinions, see 20 NYCRR Sections 2375.5 and 2376.1 through 2376.5.

The New York City Department of Finance Office of Legal Affairs issues Finance Letter Rulings ("FLRs") applying New York City tax law to a particular set of facts. In practice, Finance Letter Rulings are issued only on a taxpayer-disclosed basis. They are binding only with regard to the requesting taxpayer. There is a $250 fee for requesting a Finance Letter Ruling. A taxpayer may withdraw its request for a Finance Letter Ruling only within 30 days after the Department of Finance acknowledges receipt of the request. For additional information regarding the obtaining of Finance Letter Rulings, see 19 RCNY 16-01 through 16-06.

h. Reporting Of Federal And New York State Changes To The Department of Finance (Form 3360). New York City Administrative Code Section 11-605(3) requires GCT taxpayers to report changes made to federal or New York State tax returns by the Commissioner of Internal Revenue or New York State Tax Commissioner within 90 days after the final determination of such change "and shall concede the accuracy of such determination or state wherein it is erroneous." See also 19 RCNY 11-83. The language of the Administrative Code is comparable to that contained in Tax Law Section 211(3), except that the State law relates to federal changes only.

Where such changes are not reported, there is no applicable statute of limitations and any additional tax resulting from the changes may be assessed at any time. Administrative Code 11-674(3)(a)(3); Tax Law Section 1083(c)(1)(C). Potential penalties for failure to report the changes include a penalty of up to 25% of the unreported tax. Administrative Code Section 11-676(1); Tax Law Section 1085(a)(1).

Changes to the filed New York City GCT return are shown on Form 3360. Changes to the filed BCFT return are shown on a Form CT-3360.

Where the taxpayer disagrees with the federal or State final determination, the document filed to report the change should clearly indicate the existence of the disagreement and should state the reason for the disagreement. A taxpayer who does not clearly disclose the reason for disagreeing with a federal or state change, even though the existence of the change is disclosed, risks a challenge that the law's disclosure requirements have not been satisfied. See e.g. Barry Yampol 1997 N.Y. Tax Lexis 375 (NYS TAT August 26, 1997) (interpreting a similar reporting requirement under the personal income tax and, in that case, holding that adequate disclosure was made).

Completion of New York City's Form 3360 following a New York State change may be problematic where the taxpayer and the State have compromised one or more issues. In that case, unless the taxpayer is willing to accept the same compromise for GCT purposes, it is important that the taxpayer complete the Form 3360 in a manner that does not permit a conclusion that tax is being self-assessed.

Where a taxpayer fails to make a timely filing of Form 3360 but is the subject of a Department of Finance audit addressing the same issues addressed by the State, the taxpayer will want to discuss with the auditor the appropriate means of completing and submitting the Form. Failure to do so leaves open the possibility that, after the audit is closed, another section of the Department of Finance later will attempt to adjust the audited GCT results to include the State changes.

i. Taxpayers Bill Of Rights. Both New York State and New York City have Taxpayers Bills of Rights. However, while New York State's Taxpayer Bill of Rights is statutory and has been praised by practitioners for providing taxpayers with meaningful rights and remedies, New York City's Taxpayer Bill of Rights is contained in an informal pronouncement of ten general statements which does not provide specific remedies for aggrieved taxpayers.

1. New York State. New York State's Taxpayer Bill of Rights Act (L. 1997 Ch. 577) was signed into law on September 10, 1997 and adds substantial taxpayer rights and remedies to those already existing in Article 41 of the Tax Law. (See TSB-M-97(10)C for a summary of the Taxpayer Bill of Rights.) The provisions in the 1997 Act had various

effective dates. The last of those provisions became effective July 1, 1998. As revised, significant rights for BCFT taxpayers include the following:

a. <u>Partial Recovery of Attorneys Fees And Other Costs For Certain Taxpayers</u>. The Taxpayer Bill of Rights provides the potential for reimbursement of expenses incurred in the course of an administrative or judicial proceeding. Tax Law Section 3030. Such expenses may include court and administrative fees, expert witness fees, expenses for necessary studies, reports and analyses, and, to a lesser extent, fees of attorneys or other advisors authorized to practice before the Division of Tax Appeals. To qualify for the recovery of such expenses, the taxpayer must substantially prevail with respect to the amount in controversy or most significant issues presented.

To overcome a reimbursement of fees and expenses, the Commissioner bears the burden of proving that his position was substantially justified. It is presumed that the Commissioner's position is not substantially justified if the Department of Taxation and Finance did not follow its applicable published guidance (regulations, declaratory rulings, technical services bureau memorandum, announcements and information notices, or advisory opinions or opinions of counsel issued to the taxpayer).

However, there are significant limitations on the reimbursement of such fees and expenses. In particular,

- fees for an attorney (or other advisor authorized to practice before the Division of Tax Appeals) generally are limited to $75 per hour, and

- qualifying corporations are those which, at the initiation of the proceeding, had a net worth not exceeding $7 million and no more than 500 employees.

b. Interest And Penalty Abatement. The Commissioner is authorized to abate part or all of any assessed interest when the interest results from unreasonable errors or delays by an employee of the Department of Taxation and Finance, whether the employee had managerial or ministerial responsibilities. Tax Law Section 3008(a)(1).

Unreasonable errors or delays "shall be taken into account only if no significant aspect of such error or delay can be attributed to the taxpayer involved." Tax Law Section 3008(a)(2).

Penalties shall be abated where attributable to erroneous written advice provided by an employee of the Department of Taxation and Finance, unless the taxpayer failed to provide adequate or accurate information. Tax Law Section 3008(b).

c. Statement Of Basis For Proposed Assessment. Effective July 1, 1998, any first letter of proposed deficiency or determination (i.e., a "thirty day letter") issued by the Commissioner, and any notice and demand, notice of deficiency or notice of determination which is issued by the Commissioner, which is manually initiated and which is the first such letter or notice issued to the taxpayer with respect to the subject matter of the notice must describe the amount of and basis for the tax due (e.g., law or regulation section, or judicial or tax appeals tribunal decision). Tax Law Section 3003. This provision does not provide a taxpayer remedy for lack of compliance.

d. Other Rights With Potentially Significant Remedies. Other rights with potentially significant remedies include:

- The right to bring suit against the state for damages (and costs of the action) if any state employee negligently or knowingly makes an unauthorized disclosure of any return or report, or of any particulars set forth in any return or report. Punitive damages may be awarded where there the disclosure was willful or the result of gross negligence. Tax Law Section 3038; and

- The right to bring suit against the state for actual damages (and costs of the action) if, in connection with the collection of a tax an officer or employee of the Department of Taxation and Finance intentionally or recklessly disregards any provision of the tax or regulation promulgated under the tax. Tax Law Section 3034.

2. New York City. New York City's Taxpayer Bill of Rights may be found, among other locations, on the Department of Finance's internet site. The rights described include various general principles which might reasonably be described as the goal of any good government (fair and consistent application of the law, courteous and

professional treatment by the Department of Finance employees, etc.), and a right to have penalties abated when an understatement of tax is due to erroneous written advice from the Department in response a written inquiry providing complete and accurate information.

2. Public Law 86-272. Under the New York City Department of Finance's interpretation, the applicability of the protection of federal Public Law 86-272 (15 U.S.C. Sections 381-384) for GCT purposes is determined according to the corporation's contacts with or incorporation in New York State. Therefore, a foreign corporation having a New York State presence limited to the solicitation of sales of tangible personal property will be protected from being subject to the BCFT and also will be protected from being subject to the GCT. See 20 NYCRR 1-3.2(a)(3) and 19 RCNY 11-03(a)(3).

However, under the Department of Taxation and Finance's interpretation, once a corporation's New York State contacts exceed the mere solicitation of the sale of tangible personal property, the protection of P.L. 86-272 is forfeited for both BCFT and GCT purposes. This is true for GCT purposes even if the corporation's New York City presence is limited to the solicitation of the sale of tangible personal property. See 19 RCNY 11-04(b)(11)(i) ("The applicability of Public Law 86-272 to taxes imposed by New York City is determined by the nature of the corporation's activities in the entire State...if in addition to sales solicitation activities in New York City, a foreign corporation carries on other activities in New York State sufficient to take it outside the scope of Public Law 86-272 for purposes of taxes imposed by New York State, Public Law 86-272 will not exempt the corporation from the general corporation tax.") See also 19 RCNY 11-03(f)(10) ("A foreign manufacturing corporation has its factory outside New York State but maintains a stock of merchandise in Buffalo, New York. Its only activity in New York City is the solicitation of orders through traveling salesmen, or independent sales representatives, which orders are filled from its Buffalo warehouse. The corporation is subject to [the GCT]." According to the City's Rules, this result does not change even if the Buffalo warehouse is not used to fill New York City orders. See 19 RCNY 11-03(f)(11).)

Of course, the Department of Taxation and Finance and Department of Finance can and do reach independent conclusions on the application of laws to a particular set of facts, and the Departments may differ in their application of P.L. 86-272 to a taxpayer's New York activities. As a result, it is possible that a corporation will be determined to be subject to the BCFT or GCT even though the corporation is treated as being protected by P.L. 86-272 from the other tax.

In addition, the New York City Tax Appeals Tribunal's recent decision in Just Born, Inc., 1998 N.Y. City Tax Lexis 10 (March 30, 1998) (in which the protection of P.L. 86-272 was determined to apply to a corporation's confectionery division even though another non-unitary division of the same corporation (investing in a real estate partnership) had a New York tax presence), appears to extend the boundaries of P.L. 86-272 protection; it is not clear that the State Tribunal would follow suit if faced with the same scenario.

3. Audit And Administrative Differences. "It is not a novel proposition that the City and State have differing agendas, priorities and mandates regarding the collection of various taxes, and have been known to follow different policies regarding various tax administration issues." U.S. Trust Corporation and Subsidiaries, 1997 N.Y. City Tax Lexis 52 (NYC TAT 1997).

A. Procedural Differences.

B. Relationship With Taxpayers.

MENTION 3 TYPES OF CAPITAL

II. Attribution Of Expenses To Subsidiary Capital.

A. Background: One of the most significant items taxpayers are required to add to federal taxable income in determining New York State and New York City entire net income is the amount of their expenses directly or indirectly attributable to subsidiary capital. Tax Law Section 208.9(b)(6) and Administrative Code Section 11-602(b)(6) ("Entire net income shall be determined without the exclusion, deduction or credit of...In the discretion of the [tax commission/commissioner of finance], any amount of interest directly or indirectly and any other amount directly or indirectly attributable as a carrying charge or otherwise to subsidiary capital or to income, gains or losses from subsidiary capital.") Note that while under the law and Administrative Code the adjustments are discretionary, as administered the adjustments are made unless in a particular instance the Tax Commissioner or Commissioner of Finance determines that no adjustment is required. See e.g. 20 NYCRR 3-2.3(a)(7).

The addback has been justified, in part, on the exclusions from BCFT and GCT entire net income of income, gains and losses from subsidiary capital. Tax Law Section 208.9(a)(1) and Administrative Code Section 11-602(8)(a)(1); See also F.W. Woolworth Co. v. State Tax Commission, 126 A.D.2d 876, 877; 510 N.Y.S.2d 926 (3d Dept. 1987), aff'd 71 N.Y.2d 907; 523 N.E.2d 824 (1988) and Unimax Corporation v. Tax Appeals Tribunal, 79 N.Y.2d 139; 589 N.E.2d 358 (1992) (stating that the purpose of the attribution rule (applicable to interest expense only during the periods at issue in the decisions) is "To prevent a parent corporation from obtaining a double tax benefit by taking a deduction for interest payments on loans incurred for directly or indirectly financing investments in subsidiaries while at the same time the parent's income derived from such investment is tax free.")

Application of the procedures for determining the proper addback of indirect expenses can be complex, particularly for periods beginning prior to January 1, 1995 because of differences between in the administration of the BCFT and GCT's attribution provisions. (Of course, for many taxpayers those are the periods currently under audit.)

For years beginning on or after January 1, 1995, the State and City have agreed on a joint approach for attributing non-interest expenses. The joint approach was undertaken with an expressed purpose of reducing the complexity of this area.

B. Periods Beginning Before January 1, 1995.

1. Definition Of "Subsidiary". The first step to attributing expenses to subsidiary capital is identifying the entities qualifying as subsidiaries. "Subsidiary" is defined for both GCT and BCFT purposes as being "a corporation of which over 50 percent of the number of shares of stock entitling the holders thereof to vote for the election of directors or trustees is owned by the taxpayer." Tax Law Section 208(3); Administrative Code Section 11-602(2).

Through January, 1994, the BCFT regulations provided, without further clarification, that "The test of ownership is actual beneficial ownership, rather than mere record title...," 20 NYCRR 3-6.2(a). In 1993, the regulation was interpreted by the State Tax Appeals Tribunal as permitting subsidiary treatment of second and lower-tier entities. Racal Corporation and Decca Electronics, 1993 N.Y. Tax Lexis 208 (NYS TAT 1993). Under Racal, a taxpayer desiring an expansive definition of "subsidiary" could maintain that it had actual beneficial control of lower-tier entities. (While an expansive definition of "subsidiary" has the effect of increasing total subsidiary capital and, in most cases, expenses attributable to subsidiary capital, taxpayers having large amounts of income or gain from lower-tier entities might obtain a net benefit from having those entities classified as subsidiaries.) In 1994 the BCFT regulations' definition of subsidiary was amended to provide that "Actual beneficial ownership of stock does not mean indirect ownership or control of a corporation through a corporate structure consisting of several tiers and/or chains." However, even for years prior to the amendment of the regulation, the Department of Taxation and Finance has resisted the classification of lower-tier entities as being subsidiaries.

Through August 27, 1997, GCT Rule Section 11-46(2) also defined "subsidiary" without regard to whether stock ownership was direct or indirect. Racal therefore applies to the GCT as well as the BCFT. On that date, the GCT Rule was amended to require direct ownership or control by the taxpayer. The Department of Finance, like the Department of Taxation and Finance, has resisted the classification of lower-tier entities as being subsidiaries. See e.g. Notice of Rulemaking (August 27, 1997) stating that "The amendments [to Rule Section 11-46(2)]...clarify the Department's position that only a first-tier subsidiary qualifies as a subsidiary for purposes of the General Corporation Tax and to conform these rules to the comparable regulations of the New York State Department of Taxation and Finance relating to the New York Franchise tax on Business Corporations."

2. Definition Of Subsidiary Capital. Tax Law Section 208(4)(a) defines "subsidiary capital" as "Investments in the stock of a subsidiary and any indebtedness from subsidiaries...whether or not evidenced by written indebtedness, on which interest is not claimed and deducted by the subsidiary for purposes of taxation under [the BCFT]." See also Administrative Code Section 11-602(3)(a).

- Effect Of Subsidiary Interest Deduction. Under Tax Law Section 208(4)(a), the amount of a taxpayer's subsidiary capital -- and the amount of its income from subsidiary capital and expenses attributable to subsidiary capital -- may be altered by directing its subsidiary to deduct (or refrain from deducting) the amount of interest paid by the subsidiary to the taxpayer. If the subsidiary does not claim the deduction, the indebtedness is included in subsidiary capital and the interest payment is income from subsidiary capital (and therefore excluded from the parent's entire net income). However, because the amount of subsidiary capital is increased, the amount of the parent's disallowed expenses indirectly attributable to subsidiary capital also should be increased. The preferred treatment of subsidiary interest payments will differ depending on the taxpayer's and its subsidiary's circumstances, and therefore requires the preparation of comparative computations. The taxpayer's treatment of the interest and indebtedness may differ by year. See 20 NYCRR 3-6.3(d) (Example).

MENTION 3 TYPES OF CAPITAL

3. Directly Attributable Expenses. The next step to attributing expenses to subsidiary capital is identifying expenses that are directly attributable to a particular class of capital -- business, investment or subsidiary. See Technical Services Bureau Memorandum (TSB-M) 88(5)C (applicable to BCFT for both interest and non-interest expenses), General Corporation Tax Policy Bulletin 2-84 (April 2, 1984) (applicable to GCT for interest expenses only) and Statement of Audit Procedure (SAP) 93-1-GCT (March 1, 1993) (applicable to GCT for non-interest expenses only). Where an expense is directly attributable to more than one type of capital, a reasonable method of apportionment should be used to determine the portion of the expense attributable to each type of capital. Examples of reasonable methods of apportionment include relative floor space, relative computer time, and employee hours spent servicing the class of capital.

As no deduction is permitted for expenses directly attributable to subsidiary capital, such expenses must be added back in the computation of entire net income to the extent they were deducted in determining federal taxable income (the starting point for computing entire net income). Examples of such expenses include interest incurred to purchase subsidiary capital, salaries of officers and employees engaged in the management of subsidiary capital, and legal expenses relating to subsidiary capital.

4. Indirectly Attributable Expenses. After completion of the direct attribution of expenses, remaining expenses must be apportioned indirectly among the three classes of capital. However, for years beginning before January 1, 1995, New York State and New York City followed different approaches to indirectly attributing expenses to subsidiary capital.

a. New York State. Interest and non-interest expenses not directly attributed to one of the three classes of capital are subject to indirect attribution. Under TSB-M-88(5)C, indirect attribution of interest and non-interest expenses to subsidiary capital is made according to a ratio comparing

(a) the average value of assets included in subsidiary capital, to

(b) the average value of all of the taxpayer's assets.

For purposes of determining the ratio, real property and marketable securities are valued at fair market value, with other property included at book value under generally accepted accounting principles.

b. New York City. Under Policy Bulletin 2-84, attribution of interest expenses not directly attributable to a class of capital is made according to a ratio comparing

(a) the average cost of investments in the stock of subsidiaries, including contributions to capital, plus the average of any loans and advances (exclusive of accounts receivable acquired in the ordinary course of business and an amount equal to the average of the liabilities to which interest expense is directly traced), to

(b) the taxpayer's total assets (generally defined as the average net book value of all assets after depreciation, amortization and other charges to capital), exclusive of an amount equal to the average of the liabilities to which interest expense is directly traced.

For the same periods, New York City indirectly attributed non-interest expenses according to the general statement contained in SAP 93-1-GCT that a "reasonable general formula" be used. The SAP does not provide an example of such a formula; however, one approach used is to attribute expenses to assets using the indirect attribution approach applied to interest expenses.

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The amount of the loans and advances included in the numerator of New York State and City indirect attribution formulae is net of loans and advances from that particular subsidiary to its parent. The loans and advances from a subsidiary may not reduce the loans and advances from the parent below zero, and also may not be offset against loans and advances from the parent to any other subsidiary. The prohibition against such netting has been upheld by the Court of Appeals. Unimax Corporation v. Tax Appeals Tribunal, 79 N.Y.2d 139; 589 N.E.2d 358 (1992).

C. Periods Beginning On Or After January 1, 1995. For periods beginning on or after January 1, 1995, the New York State Department of Taxation and Finance and the New York City Department of Finance, in cooperation with each other and with the participation of taxpayer groups and private practitioners, adopted lengthy statements describing revised procedures for the attribution of non-interest expenses to subsidiary capital. The State adopted the proposal as TSB-M-95(2)C (January 8, 1996), and the City adopted the proposal as SAP 96-1-GCT (January 29, 1996). The TSB-M and SAP do not apply to interest expenses, which continue to be attributed under the approaches described above.

The proposals are significant both for their descriptions of how non-interest expenses should be attributed and for the Departments' statements of their intention to consult with each other on simultaneous audits and, where possible, to follow each other's determinations.

As before, expenses are directly attributed to the classes of capital and, to the extent such direct attribution is not possible, are indirectly attributed by formula among the classes of capital. (As stated in both the TSB-M and SAP, "Where possible, the taxpayer must directly attribute to the appropriate class of capital or income those non-interest deductions for expenses that proximately, and not incidentally, benefit that class of capital or income.")

(1) Directly Attributable Non-Interest Expenses. The TSB-M and SAP divide directly attributable non-interest expenses into two broad categories: (a) Expenses which, at the taxpayer's election, are irrefutably presumed to be directly attributable to business capital, and (b) expenses that may be directly attributable to business capital if they "proximately, and not incidentally" benefit business, subsidiary or investment capital. For both the State and City the "residual non-interest deductions" are indirectly attributed to the

classes of capital under one of two formulae, as elected by the taxpayer.

(a) Expenses Which, At The Taxpayer's Election, Are Irrebutably Presumed To Be Directly Attributable To Business Capital. Taxpayers are not required to establish separately the basis for direct attribution of these expenses, although substantiation of their amounts may be required. The TSB-M and SAP list 22 types of such expenses including the cost of goods sold; property, excise and sales and use taxes; real estate rents, depreciation and repairs; utilities, including telecommunications costs; research and development expenses; advertising; marketing expenses; and compensation packages of the chief executive officer, chief financial officer and chief operating officer.

(b) Expenses That May Be Directly Attributable To Business Capital If They Proximately, And Not Incidentally, Benefit Business, Subsidiary Or Investment Capital. Except to the extent included in category (a) above, expenses that may be directly attributable to business capital include costs of shipping goods to customers; compensation and other benefits of officers and employees engaged in manufacturing, sales, services, or other activities directly producing business capital or income; and reimbursed non-interest expenses.

Expenses from this category that may be directly attributable to subsidiary capital include computer, legal and compensation expenses relating to the management of subsidiary capital.

Expenses from this category that may be directly attributable to investment capital include safe deposit rentals; subscriptions to financial publications exclusively for employees engaged in the acquisition, management or disposition of investment capital or the income therefrom; custodian fees; and other expenses incurred to preserve investment capital.

As before, expenses that proximately benefit more than one class of capital should be attributed between or among those classes using a method that is reasonable for that particular deduction (e.g., employee time, floor space, etc.).

(2) Indirectly Attributable Expenses. Expenses that cannot be directly attributed to any one or more classes of capital ("residual non-interest deductions") must be indirectly attributed among all of the classes of capital. In particular, residual non-interest deductions are attributed using a combined asset and income apportionment formula or, if elected by the taxpayer, an apportionment formula based solely on assets.

(a) Combined Income And Asset Method. Under the combined income and asset method, a taxpayer must attribute to subsidiary capital a percentage of residual non-interest expenses equal to ((two times its subsidiary capital income factor plus its subsidiary capital asset factor) divided by three). That is,

$$\frac{(2 \times (\text{subsidiary capital income factor}) + (\text{subsidiary capital asset factor}))}{3}$$

The income factor with respect to subsidiary capital is the taxpayer's gross income from subsidiary capital (i.e., dividends, interest, and gains (but not losses) from subsidiary capital) divided by its total gross income (in general, gross income as defined in Internal Revenue Code section 61).

The asset factor with respect to subsidiary capital is the average value of subsidiary capital (without reduction for liabilities) by the total value of all of the taxpayer's assets (without reduction for liabilities). As before, real property and marketable securities are valued at fair market value, and personal property other than marketable securities are valued at the amount shown on the taxpayer's books and records in accordance with GAAP.

(b) Asset Factor Election. The taxpayer may elect to use the asset factor only to attribute its residual non-interest deductions. The election is made annually on a return (or on an amended return, provided that at the time the amended return is filed, no audit has been commenced with respect to the year covered by the return) and is irrevocable for each year unless the filing status of the taxpayer as combined or separate is changed as a result of an audit or a change in the composition of a combined group is made on audit. The taxpayer may not use the alternative asset method for any year in which the value of the taxpayer's total assets is not greater than zero. In the absence of a timely election, the taxpayer must use the combined income and asset method discussed above.

D. Methods Of Reducing The Amount Of Expenses Attributable To Subsidiary Capital. The attribution of expenses to subsidiary capital may significantly increase a taxpayer's BCFT or GCT liability. Three methods for reducing the amount of expenses so attributed include: (1) Marshalling facts that support the attribution of expenses to business capital; (2) Arranging loans to be directly between subsidiaries rather than using the parent as an intermediary; and (3) Reporting on a combined basis. These approaches are discussed below.

(1) Marshalling Facts That Support The Attribution Of Expenses To Business Capital. At least twice in the last two years, reported decisions (discussed below) determined that BCFT taxpayers incurred certain disputed interest and non-interest expenses for business reasons unrelated to subsidiary capital. The taxpayers in those cases have been permitted to deduct those expenses in the computation of entire net income.

In Grumman Corporation, 1996 N.Y. Tax Lexis 335 (July 11, 1996), a New York State ALJ concluded that Grumman's payment of $40 million to settle a lawsuit arising out of its subsidiaries' activities and in which it and its subsidiary were co-defendants was not attributable to subsidiary capital. The ALJ's determination was based on what were characterized as objective facts supporting Grumman's contention that the payment accomplished its business objective (preserving its business reputation and future earning potential) and was not made to enhance or protect its investment in its subsidiary (which was not a viable business). In addition, the ALJ concluded that under the circumstances presented, the Commissioner was required to exercise his discretion to permit the business deduction, as Grumman would not receive a double tax benefit from the deduction (the subsidiary had not generated taxable income for a decade and did not have assets to protect).

In Suburban Carting Corporation, 1998 N.Y. Tax Lexis 144 (May 7, 1998), the New York State Tax Appeals Tribunal concluded that for 1989, a parent corporation's interest expenses incurred for the purpose of redeeming the stock of one of the parent's shareholders could not be indirectly attributed to subsidiary capital. In reaching that conclusion, the Tribunal observed that there was no increase in the parent's "investment in subsidiaries" or "advances to subsidiaries" account in the month that the loan was received. Nor had the Department of Taxation and Finance offered any evidence to show that in 1989 there was a change in subsidiary capital. (In contrast for 1990 the Department determined that the parent's investments in and advances to its subsidiaries had increased significantly. As the taxpayer did not produce any evidence to the contrary, the Department's inference that the loan proceeds were indirectly attributable to subsidiary capital was sustained.)

(It is interesting to contrast Suburban Carting Corporation with F.W. Woolworth v. State Tax Comm'n, 126 A.D.2d 876; 510 N.Y.S.2D 926 (3d Dept 1987), aff'd 71 N.Y.2d 907; 523 N.E.2d 824 (1988) in which the Court of Appeals held that a parent's indebtedness and interest expenses served a dual purpose and therefore could properly be indirectly attributed to subsidiary capital. In Woolworth, the appellate court stated that

> "...it is not alone sufficient to defeat disallowance of the interest deduction that the incurrance of the indebtedness can be directly attributed to a separate business purpose. Tax Law Section 209(b)(6) speaks also of indirect attribution and, thus, envisages situations where the parent corporation may have had a dual purpose in borrowing and where the requisite connection

between the debt and the investment in subsidiaries is only inferable from other facts and circumstances surrounding the pertinent transactions."

In Woolworth, those facts and circumstances were the accumulation of undistributed earnings in the subsidiaries which could have been, but were not, paid as dividends to the parent. According to the court, if such dividends had been paid, the parent's borrowing would have been largely unnecessary. For that reason, the court concluded that the indebtedness served Woolworth's purpose of increasing its investments in its subsidiaries.)

(2) Arranging Loans To Be Directly Between Subsidiaries Rather Than Using The Parent As An Intermediary. The prohibition against applying one subsidiary's net lender status against another subsidiary's net borrower status puts a premium on tax planning. That is because in such circumstances the subsidiaries may be able to directly lend to and borrow from each other, rather than using the parent as an intermediary. When the subsidiaries have direct involvement with each other, the total amount of the parent's investments in subsidiaries is not increased by the lending and borrowing activities. In that case, the amount of expenses indirectly attributable to subsidiary capital will be no greater than would occur by using the parent as an intermediary, and in most cases will result in a reduced attribution of expenses. The parent may continue to coordinate the lending and borrowing activities.

(3) Combined Reporting. If a parent and its subsidiaries file on a combined basis, intercorporate debt and transactions between the parent and the subsidiaries are eliminated. See Tax Law Section 211.4; Administrative Code Section 11-605(4). In addition, intercorporate stockholdings are eliminated from combined subsidiary capital. Id. Therefore, the filing of a combined report can substantially reduce, and potentially eliminate, the need for and consequences of an attribution of expenses to subsidiary capital.

Note, however, that a corporation properly included on a combined report must continue to file on a combined basis until there is a material change in the facts supporting the unitary relationship or existence of distortion which permitted combined reporting. 20 NYCRR Section 6-2.4(c); 19 RCNY 11-91(g))(3).

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Current and Quotable

Proposed Statutory Language on Reporting Options for Nonresident Members of Passthrough Entities

The Multistate Tax Commission has proposed new statutory language on reporting options for nonresident passthrough entities. Several members of the American Bar Association's Section on Taxation have written comments in response to the proposed change.

Section 1. Definitions

A. **Pass-through** entity means a corporation that for the applicable tax year is treated as an S Corporation under [IRC section 1362(a), or State Tax Code section], and a general partnership, limited partnership, limited liability partnership, or limited liability company that for the applicable tax year is not taxed as a corporation [for federal tax purposes] [under the state's check-the-box regulation];

B. **Member** means [optional additional language: an individual who is] a shareholder of an S corporation, a partner in a general partnership, a limited partnership, or a limited liability partnership, or a member of a limited liability company.

Section 2. Composite Return Authorized

A pass-through entity may file a composite income tax return on behalf of electing nonresident members reporting and paying income tax at the highest marginal rate provided in [state tax rate provision] on the member's pro rata or distributive share of income of the pass-through entity from doing business in, or deriving income from sources within, this State.

A non-resident member of a pass-through entity whose only source of income within a state is from pass-through entities may elect to have the pass-through entities on composite returns filed pursuant to this section report and pay income tax due on the member's pro rata or distributive share of income passed through to the member by each entity from doing business in, or deriving income from sources within, this State.

C. The [tax agency] may establish procedures or promulgate rules and regulations necessary to carry out the provisions of this section.

D. A nonresident member that has been included in a composite return may subsequently file an individual income tax return and shall receive credit for tax paid on the member's behalf by the pass-through entity with the composite return.

Section 3. Member Agreements; Mandatory Payments

A. With respect to each of its non-resident members, a pass-through entity shall for each tax year (1) timely file with the [State taxing authority] an agreement as provided in subsection B, and (2) make a payment to the State as required in subsection C. A pass-through entity that timely files an agreement as provided in subsection B with respect to a non-resident member for a tax year shall be considered to have timely filed such an agreement for each subsequent tax year.

B. The agreement referred to in subsection A is an agreement of the non-resident member

- to be subject to the jurisdiction of the State for purposes of the collection of income taxes owed on the member's pro rata or distributive share of income from the pass-through entity from doing business in, or deriving income from sources within, this State; and either
- to be included on a composite return that is filed by the pass- through entity accompanied by payment of tax due on the member's income from the pass-through entity, or
- to file a return in accordance with the provisions of [individual income tax return filing requirement] and to make timely payments of all taxes imposed on the member by this State with respect to the member's pro rata or distributive share of income from the pass-through entity from doing business in, or deriving income from sources within, this State.

C. If no agreement is filed in which the non-resident member consents to be included in a composite return that the pass through entity does, in fact, file for any tax year and if the non-resident member fails to file a [state] individual income tax return reporting the member's pro rata or distributive share of the income of the pass-through entity from doing business in, or deriving income from sources within, this State or fails to pay any tax due thereon, the pass through entity shall be liable for tax on such income at the highest marginal rate applicable to individuals. The pass-through entity shall be entitled to recover the payment made pursuant to the previous sentence from the non-resident member on whose behalf it paid tax.

March 28, 2002

Frank D. Katz
Multistate Tax Commission 444 North Capitol Street Suite 425
Washington, DC 20001

Re: Multistate Tax Commission's Proposed Statutory Language on Reporting Options for Non-Resident Members of Pass-Through Entities

Dear Mr. Katz:

I am enclosing comments on the proposed model statute referred to above, as prepared by members of the State and Local Tax Committee's Subcommittee on Income and Franchise Taxes. Substantive contributions to these comments were made by David A. Fruchtman, Winston & Strawn, Chicago, Illinois, Robert Joe Hull, Bracewell & Patterson, Houston, Texas, and Steven Soles, Dechert, Philadelphia, Pennsylvania. These comments were reviewed by a member of our Committee on Government Submissions. These comments represent the individual views of the members who prepared them and do not represent the position of the American Bar Association or the Section of Taxation.

Sincerely,
Richard M. Lipton
Chair, Section of Taxation

Enclosure

The following comments are the individual views of the members of the Section of Taxation who prepared them and do not represent the position of the American Bar Association, the Section of Taxation, or the individuals' law firms.

These comments were prepared by members of the Committee on State and Local Taxation's Subcommittee on Income and Franchise Taxes. Principal responsibility was exercised by David Fruchtman. Substantive contributions were made by Robert Joe Hull and Steven Soles. The Comments were reviewed by Arthur Rosen of the Section of Taxation's Committee on Government Submissions.

Although members of the Section of Taxation who participated in preparing these Comments may have clients who would be affected by the tax principles addressed by these Comments or may have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

Contact Person:
David Fruchtman
312/558-7522 dfruchtman@winston.com
March 28, 2002

Comments on Multistate Tax Commission's Proposed Statutory Language on Reporting Options For Nonresident Members of Passthrough Entities

I. Introduction

We appreciate this opportunity to comment on the Multistate Tax Commission's ("MTC") "Proposed Statutory Language on Reporting Options for Non-Resident Members of Pass-Through Entities" (the "Model Statute") (copy attached). Our review of the Model Statute is intended to assist the MTC by providing a perspective of attorneys whose practices focus on state and local tax issues; however, our comments should not be construed as endorsing a suggestion that partners, LLC members or S corporation shareholders are or, as a matter of policy, should be subject to income taxation in states in which they neither reside nor have physical presence.

We note that the Model Statute does not distinguish between general and limited partners (or between active participants and passive investors, or between board managed and member managed LLCs). Whether such distinctions are appropriate (or required) has been addressed with conflicting results by state courts[1] and administrative tribunals.[2] Under those circumstances, our only observation is that the need for such distinctions must be determined on a state-by-state basis.

With that preface, we offer the following comments.

II. Comments

A. The Model Statute should not impose derivative liability on pass-through entities without providing the entities with the authority to withhold taxes from cash distributions. We do not believe that the imposition of derivative liability on an entity is justified unless the entity has the ability to avoid that liability by withholding income taxes from its members' distributive income. However, the Model Statute allows for derivative liability to be imposed in such circumstances.

The Model Statute, in Section 3.C., imposes liability on a pass-through entity if a non-resident member chooses not to participate in a composite return but then fails to pay income

[1] *See e.g. Appeal of Amman & Schmid Finanz AG*, California State Board of Equalization, No. 96-SBE-008 (April 11, 1996) and *Secretary of Revenue of North Carolina v. Perkins Restaurant Inc.*, North Carolina Tax Review Board, Administrative Decision 351 (January 28, 1999). (For the full text of the California Board of Equalization's decision in *Amman and Schmid*, see *Doc 96-16081 (8 pages)* or *96 STN 130-3*. For the full text of the North Carolina Tax Review Board's decision in *Perkins Restaurant*, see *Doc 1999-19249 (4 original pages)* or *1999 STT 107-23*.)

(Footnote 1 continued in next column.)

[2] *See e.g. Borden Chemicals and Plastics, L.P. v. Zehnder*, 726 N.E. 2d 73 (App. Ct. 1st Dist. 2000). (For the full text of the Illinois Appellate Court, 1st District's decision in *Borden Chemicals and Plastics*, see *Doc 2000-5242 (12 original pages)* or *2000 STT 38-18*.)

taxes on his distributive share of the entity's income earned in the state. Of course, the entity has no ability to force a member to pay state income taxes. Nor, under the Model Statute, does the entity have the authority to withhold taxes from distributions to members. The imposition of derivative liability on the entity in such circumstances is unfair because the entity lacks the ability to control the payment of tax. For the same reason, no derivative liability should attach where a member has a distributive share of the entity's income but does not receive an actual cash distribution. Here again, the entity has no mechanism to avoid such derivative liability.

As additional practical considerations, many pass-through entities operate in several states and have hundreds if not thousands of members. The monitoring required by the statute imposes an unreasonable burden on such entities. Moreover, an entity may not learn of a member's alleged failure to pay income tax until years after the member has left the entity, at which time it may be difficult or impossible for the entity to obtain information or reimbursement from the member.

We suggest the following revisions: (1) We recommend the addition of a subsection authorizing entities to withhold state income taxes from a non-resident member's cash distributions unless the member provides a statement agreeing to be subject to the state's income tax jurisdiction. We also recommend that the subsection provide that the receipt of such a statement will excuse the entity from all liability for the member's taxes owed to the state. (2) We recommend the addition of a subsection stating that an entity's derivative liability is limited to the income tax imposed on the amount of cash distributed to the non-resident member whose taxes are at issue. Alternatively, the subsection could provide that the entity's liability is limited to the amount of cash distributed to the particular member.[3]

B. The Model Statute should apply only to non-entity members. We recommend that the Model Statute state that it applies to individuals only, rather than leaving to the states' discretion whether to include entities within its reach. The statute seems to have been drafted with non-entity members in mind. For example, under the derivative liability provision, the pass-through entity may be liable for its members' unpaid taxes determined at "the highest marginal rate applicable to individuals." However, no consideration seems to have been given to the different amount of derivative liability that might arise from distributions to members that are entities. There does not appear to be any justification for a mismatch that causes the amount of a pass-through entity's derivative liability to be different from the amount of the member's primary liability. As a second example, it is not clear what the Model Statute intends for pass-through entities that are members of another pass-through entity. What is the effect of such a member-entity agreeing to be "subject to the jurisdiction of the State for purposes of collecting income taxes owed on" its share of distributive income?

These may not be the only areas in which the Model Statute raises questions as to its application to entities. We therefore recommend further analysis before the reach of the statute is extended beyond individuals.

C. The Model Statute should include a provision crediting members with all taxes paid to the state. The Model Statute holds a member liable for income tax on his share of the pass-through entity's income earned in the state, holds the entity liable for the member's unpaid taxes, and grants to the entity the ability to require reimbursement from members whose income taxes were paid by the entity. However, the Model Statute does not provide a dollar-for-dollar credit to members whose taxes were paid by the entity. To protect members from having to pay the same tax twice, we recommend that the Model Statute include a subsection stating that income taxes paid to a state in satisfaction of a member's liability shall be fully credited to the member. The availability of this credit should not be affected by whether the member or the entity made the payment to the state. Nor should the availability of the credit be dependent on the member reimbursing the entity for taxes the entity paid to the state on the member's behalf.

Further, in recognition of the fact that the member may no longer have access to the entity's tax information, the member should have the ability to require a state to provide a statement of the amount of taxes paid to the state in full or partial satisfaction of the member's income tax liability.

D. The Model Statute should be split into two Model Statutes. The Model Statute actually addresses two issues: (1) Imposition of direct and derivative liability for income taxes, and (2) Tax reporting options. There is no apparent advantage to the joining of these issues into a single statute. In addition, the provision imposing liability is much more likely to be controversial than is the reporting provision. Therefore, we recommend separating the statute into two proposals. In addition, consistent with the MTC's desire for simplified tax reporting (a desire with which we agree), we recommend the inclusion of a statement with the Model Statutes clearly stating the MTC's belief that the composite reporting Model Statute should be enacted if the tax liability Model Statute is enacted.

E. The caption to the Model Statute should be revised to describe more accurately its contents and effect. The current caption of the Model Statute, "Multistate Tax Commission's Proposed Statutory Language on Reporting Options for Non-Resident Members of Pass-Through Entities," indicates that the proposal addresses taxpayer reporting options. However, the proposal is far more significant for its imposition of tax liabilities on non-resident members and pass-through entities. State legislators, revenue departments and taxpayers who are being asked to consider the Model Statute should be provided with a caption that is descriptive of its most important aspects. If the Model Statute is not split into two Model Statutes, we recommend the revision of its caption to be: "Proposed Statutory Language Imposing Income Tax Payment Obligations on Non-Resident Members of Pass-Through Entities and Income Tax Collection/Derivative Liability on Pass-Through Entities."

III. Summary

The Model Statute raises a number of important legal and policy issues. The core issue is, of course, whether income earned by non-resident partners should be subject to income taxation in the states in which the partnership earns the income. We believe that issue must be addressed on a state-by-state basis. We believe that incorporation of the recommended revisions will focus discussion at the state level by avoiding issues that the Model Statute does not appear to have been intended to raise. ✰

[3] *See e.g.* Maryland Administrative Release No. 6 (Rev. 8/31/01).

BUSINESS ENTITIES

MAY/JUNE 2001

STATE TAX MAY/JUNE 2001

State Apportionment Factor Consequences of the Section 338(h)(10) Election

By David A. Fruchtman

BRUCE P. ELY
SCOTT D. SMITH

State Apportionment Factor of the Section 338(h)(10)

DAVID A. FRUCHTMAN

Taxpayers making an (h)(10) election should not assume that the election will be followed in determining the selling and target corporations' state apportionment factors

Under Section 338(h)(10) of the Code, a seller of at least 80% of the stock of a corporation that is a subsidiary in a consolidated group, an affiliated but unconsolidated subsidiary corporation, or an S corporation may, when requested by the purchaser, elect to have the transaction deemed a sale of the target corporation's assets for federal income tax purposes.

Following the election, the seller will not recognize gain on the sale of the stock, but the target will recognize gain on the deemed sale of its assets. The effect of the election on the amount of gain recognized on the sale depends upon the seller's and target's particular circumstances. In addition, for S corporation shareholders the character of the gain to the selling shareholders could be affected. In all cases, however, the election makes the gain recognizable on the target's return for the short period ending with the date of the sale, instead of to the seller on its return for the full year in which the sale occurred.

In general, purchasers will desire an (h)(10) election when the purchased assets' fair market value exceeds their combined adjusted bases. The purchaser will obtain a step-up in the assets' basis, which it uses to determine its future depreciation and amortization deductions.


Consequences
Election

Possible Apportionment Factor Treatments

The states' published rulings in this area have tended to focus on whether the states follow the federal election for purposes of determining apportionable income. However, even when it is known that a state follows the federal treatment in determining apportionable income, important issues remain in the determination of the state taxable income(s) of the selling taxpayers. One such issue is the apportionment factor treatment of the election. Where the deemed asset sale is treated as producing business income,[1] there are four possible apportionment factor treatments:

Approach 1: *A state can recognize the election and include the deemed asset sale in the target's factors.*

Approach 2: *A state can recognize the election but exclude the deemed asset sale from the target's factors.*

Approach 3: *A state can disregard the election and include the stock sale in the parent's factors.*

Approach 4: *A state can disregard the election but exclude the stock sale from the parent's factors.*

Only the first approach results in a consistent state tax treatment of the transaction. Under this approach, the target is treated as selling its assets on the last day of its tax year and the resulting gain is included in its apportionable income for that year. Where the election is respected for apportionment factor purposes, the asset sale is included in the target's sales factor in the same manner as any other asset sale. Thus, in general, receipts from the sale of real and tangible personal property are included in the target's sales factor numerators for the states in which the property is located, and receipts from the sale of other than tangible personal property are included in the target's sales factor numerator for the state in which the relevant income producing activity occurs. For property factor purposes, the assets should be excluded from the target's property factor for the end of the period at issue. Alternatively, if using only beginning and end of period values distorts the target's property holdings for the period, a

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David Fruchtman is a partner in the Chicago office of Winston & Strawn. This article is based on a January 12, 2001, presentation Mr. Fruchtman made to the American Bar Association Section of Taxation's State and Local Taxes Committee.

taxpayer may request or a state may require that the target's property factor be determined on a more frequent (e.g., monthly) basis. The more frequent determination of the property factor can greatly reduce any distortive effects of the (h)(10) election. Likely because of this ability to smooth the effects of fluctuations in the property factor, states that have considered this issue have focused on the sales factor treatment.

The second approach—recognition of the election but exclusion of the deemed sale from the target's factors—is obviously inconsistent within the target's return but apparently will be defended as producing a more equitable result than is achieved through factor representation. This approach may be proposed by tax administrators as part of a general policy relating to Section 338(h)(10) elections or by administrators or taxpayers, on a case-by-case basis, under application of a state's regulation comparable to Multistate Tax Commission Regs. IV. 18(a)(4) or IV. 18(c)(1). MTC Reg. IV. 18(a)(4) provides that if the general apportionment provisions do not fairly represent the extent of the taxpayer's business activity in the state, the taxpayer may request or the state tax administrator may require "the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income." MTC Reg. IV. 18(c)(1) provides that "Where substantial amounts of gross receipts arise from an incidental or occasional sale of a fixed asset used in the regular course of a taxpayer's trade or business, those gross receipts shall be excluded from the sales factor. For example, gross receipts from the sale of a factory or plant will be excluded."

It seems difficult to justify a special policy for (h)(10) elections that does not also apply to other types of sales of business assets. For that reason, the more reasonable justification for recognition-but-exclusion treatment will be under a state's regulations comparable to the MTC regulations identified above. While such an apportionment factor treatment is inconsistent with asset sale treatment followed in determining apportionable income, it at least cannot be challenged for distinguishing among types of asset sales. Nevertheless, taxpayers who are required by state tax administrators to exclude deemed asset sales from their apportionment factors often will be skeptical that a refusal to provide for factor representation produces a more equitable result than would have been achieved without the extraordinary treatment. For that reason, a required use of the second approach is likely to be criticized for producing an inequitable result analogous to the result that it was applied to avoid.

Four Apportionment Factor Treaments

Approach 1 **A state can recognize the election and include the deemed asset sale in the target's factors.**

Approach 2 **A state can recognize the election but exclude the deemed asset sale from the target's factors.**

Approach 3 **A state can disregard the election and include the stock sale in the parent's factors.**

Approach 4 **A state can disregard the election but exclude the stock sale from the parent's factors.**

The third approach-disregarding the (h)(10) election for apportionment factor purposes and including the stock sale in the parent's apportionment factors-presents even greater problems than the second approach. In particular,

1. If the parent and target file a return for the period of the sale that fully combines their income and factors, this approach treats the transaction inconsistently within the combined return and fails to provide for true factor representation; or,
2. If the parent and target file returns for the period of the sale that do not fully combine their incomes and factors, this approach creates inconsistency within both the parent's and target's returns and again fails to provide for true factor representation in either return.

If the parent and target file a fully combined return, an apportionment factor treatment that disregards the election (that is, an approach that treats the transaction as a stock sale) fails to produce a consistent result even when it includes the stock sale in the group's apportionment factors. This is because the transaction is treated as a sale of the target's assets in determining apportionable income, but as a sale of the parent's stock for the purpose of apportioning that income. The inconsistency misapportions the gain on the deemed asset sale to the state where the income producing activity occurred (likely, the state of the parent's commercial domicile) and away from the states where the target's assets are located.

In states where the parent and subsidiary do not file a return fully combining their income and factors, the inconsistency between the treatments for income determination and income apportionment purposes is greater still. When the third approach is applied in determining the apportionment factors for such states, neither the parent nor the target has a match between the determination of its apportionable income and its apportionment factors. On the target's return, the transaction is treated as an asset sale for income determination purposes, but is not recognized in the target's factors. The factor representation and other problems discussed above with respect to the second approach (recognition of the election but exclusion of the deemed sale from the factors) are present here as well.

On the parent's return the opposite result occurs. That is, the parent does not recognize income from the transaction in determining its apportionable base (because the election providing for asset sale treatment is respected for income determination purposes), but for apportionment factor purposes the transaction is treated as a sale of stock by the parent.

In short, where the parent and subsidiary do not file fully combined returns, a failure to give effect to the (h)(10) election in the apportionment factors produces two incorrect returns.

The fourth apportionment factor treatment is for a state to disregard the election and to exclude the stock sale from the parent's factors. This result will occur in states that do not recognize the election for apportionment factor purposes and that also do not include stock sales in the determination of the sales factor. Massachusetts, for example, does not include sales of securities in determining the sales factor. Under this approach, the sales factor results will be the same as those discussed above for the second approach (the approach in which the election is recognized but the deemed asset sale is nonetheless excluded from the factors). However, the overall results from following the fourth approach will differ from those of the second approach because the property factor results will be different. Under the fourth approach, because the target is not treated (for apportionment factor purposes) as having sold its assets at the close of the period, its property factor should continue to include those assets.

Specific States' Treatments

The treatment of the election for apportionment factor purposes was analyzed in a recent Massachusetts Appellate Tax Board decision and has also been addressed in rulings by Florida, Texas, and Virginia, all of which are discussed below.

Combustion Engineering. The proper apportionment factor treatment of the election was the subject of a recent administrative controversy in Massachusetts, which followed the fourth approach discussed above. (*Combustion Engineering, Inc. v. Commissioner of Revenue*, Appellate Tax Board Docket No. F228740 (3/29/00).) In *Combustion Engineering,* the taxpayer (CEI) and a subsidiary (Target) filed a Massachusetts combined corporate excise tax return. In 1988, CEI sold Target's stock and, with the purchaser, made an (h)(10) election to treat the transaction as a sale of the subsidiary's assets. Accordingly, for purposes of determining taxable income for corporate excise tax purposes, Target recognized gain on the deemed sale of its assets and CEI did not recognize gain on the stock sale.

At issue was the proper treatment of the sale in Target's Massachusetts sales factor. The Massachusetts Department of Revenue ("the DOR") argued that Target was required to include the asset sale in its sales factor computation. In making that argument, the DOR observed that the election to have the transaction treated as a sale of assets for federal income tax purposes also caused the transaction to be treated as a sale of assets in determining Target's and CEI's apportionable income. The DOR argued that the same deemed asset sale treatment was required for apportionment factor purposes. It also argued that the case was controlled by a regulation it adopted in 1995, which would require inclusion of the deemed asset sale in Target's sales factor.[2]

The Appellate Tax Board ("the Board") rejected the DOR's argument. The Board noted that the Massachusetts statute providing for the sales factor defines "sales" as the "gross receipts of the corporation . . . except gross receipts from the . . . disposition of securities." On its face, the definition is neither tied to the Internal Revenue Code nor does it require conformity with federal tax treatments. The Board noted that "The apportionment formula contained in G.L. c. 63, Section 38(f) makes no reference to the Code" and therefore held that "Whatever the transaction may be 'deemed' to be for federal purpose, it is, in actuality, a sale of stock the proceeds of which are specifically excluded from the sales factor." Under the Board's decision, the deemed asset sale was not represented in Target's apportionment factors even though Target was required to include the gain from the deemed sale in its apportionable income.

In addition, the Board refused to apply the DOR's 1995 regulation to this 1988 transaction, holding that the regulation was neither promulgated contemporaneously with the statute providing for the apportionment of income nor consistent with the plain wording of the apportionment factor statute. That aspect of the Board's decision is especially significant because the regulation is still in effect. Therefore, Massachusetts taxpayers reporting a transaction involving an (h)(10) election may have a choice for transactions engaged in after 1995. If a taxpayer prefers the apportionment factor approach provided for in the regulation, it may use that treatment in determining its apportionment factors. If, instead, the taxpayer does not want to use the approach provided for in the regulation, it may look to the language in *Combustion Engineering* as support for its refusal to apply the regulation.

Combustion Engineering is not under appeal, and the decision is now final.

Other States' Treatments. Other states have taken different approaches. Treatments in Florida, Texas, and Virginia are described below.

Florida. The Florida Department of Revenue has issued two Technical Assistance Advisements addressing this issue. In the earlier of the two TAAs, the Florida DOR granted a taxpayer's request to follow the second approach discussed above. In the more recent TAA, the DOR responded to a taxpayer's inquiry regarding the apportionment factor treatment of an (h)(10) election by following the first approach described above and by refusing to allow the taxpayer to follow the second approach under the facts presented.

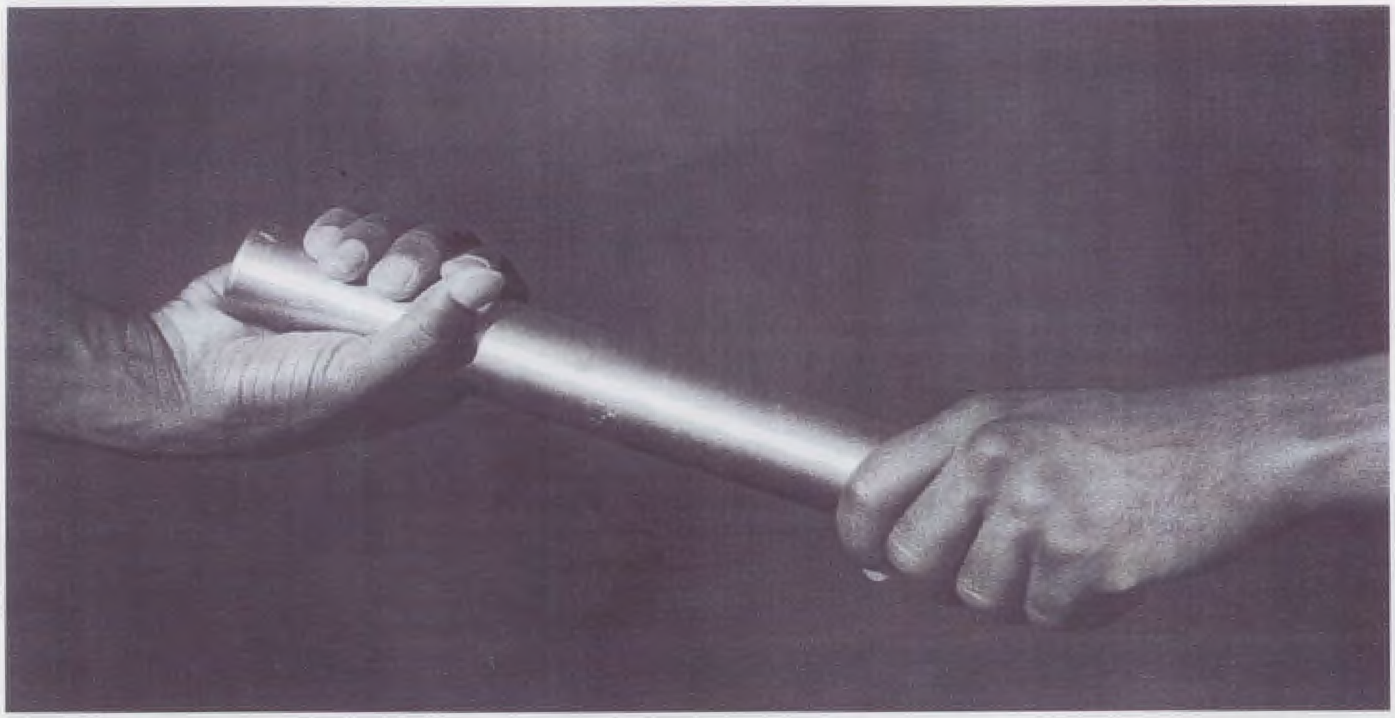
In the earlier Advisement, TAA 97(C)1-007 (11/7/97), the taxpayer sought to exclude from its consolidated sales factor the proceeds from certain sales of business assets, including assets deemed sold under an (h)(10) election. In making the exclusion request, the taxpayer asserted that the sales tripled its sales factor numerator and doubled the factor's denominator, causing a distortion in the amount of income apportioned to the state. The DOR agreed, and ruled that the sales were to be excluded from the taxpayer's sales factor. In reaching that conclusion, the DOR accepted without discussion that the (h)(10) election applied for apportionment factor purposes.

In the more recent Advisement, TAA 00(C)1-012 (11/8/00), a taxpayer made

1 It should be emphasized that this article focuses on the apportionment factor treatment of (h)(10) elections that produce business income. If the election is treated as producing nonbusiness income, the gain on the asset sales will not be apportioned but instead will allocated in accordance with the laws of the states in which the property is located.

2 830 CMR 38.1(9)(b)7 provides that "Gross receipts from the disposition of fixed assets shall include (but are not limited to) deemed receipts from transactions that are treated under the Code as sales of a taxpayer's assets and that results in the taxpayer's recognition of income for Massachusetts purposes. For example, deemed sales of assets (other than securities) by a target corporation under Code Section 338 are included in the target's sales factor at the fair market value of the assets deemed to be sold if the transaction results in the target's recognition of taxable net income."

3 Note, however, that the earned surplus analysis does not apply to the taxable capital component of the franchise tax. Because the taxable capital component is not based on income, its apportionment factor treatments are not necessarily tied to federal tax elections.



the (h)(10) election and requested permission to exclude the asset sale from its Florida sales factor. The DOR rejected the taxpayer's request, finding that inclusion of the deemed sale in the sales factor produced insufficient distortion to grant the taxpayer's request for special treatment. As in the earlier ruling, the DOR recognized the (h)(10) election for apportionment factor purposes without discussing whether such recognition is appropriate.

Texas. For earned surplus purposes, Texas follows the first approach described above. Texas franchise tax rules expressly describe the state's gross receipts apportionment factor treatment of (h) (10) elections. Rule Section 3.557 ("Earned Surplus: Apportionment") contains subsections (d) (4) and (e)(10), which provide:

> (d)(4). In computing gross receipts for apportionment, a corporation is deemed to have made an election to use the same methods used in filing its federal income tax return.....
>
> (e)(10). Deemed sales of assets under Internal Revenue Code Section 338. Amounts deemed received by the target corporation are treated as sales of assets by the target corporation and are apportioned according to rules otherwise applicable to sales of such assets under the Tax Code, Section 171, or this section. For purposes of this section, a purchaser of the target's stock will be considered the purchaser of the assets.

In Ruling 9909262L (9/21/99), the Texas Comptroller's Office addressed the effects of an (h)(10) election on the purchase of an S corporation's stock. The Comptroller's Office ruled that, as provided for in their Administrative Rules, asset sale treatment must be followed in determining the target's apportionment factor. It also ruled, with respect to the apportionment factor treatment to the seller, that "For earned surplus, there would be no gross receipts to Seller as long as it did not have any reportable revenue on its federal tax return from the sale of the [S corporation's] stock. Section 171.1121(a), Texas Tax Code."[3]

Virginia. Virginia has followed the first approach. In a ruling in which the purchaser and seller were part of a combined income tax return, the Virginia Department of Taxation ruled that the selling group's consolidated sales factor included the gross proceeds arising from the deemed sale of the target's assets. Therefore, the sales factor numerator included the deemed sales of real and tangible personal property located in Virginia on the day of the transaction and intangible property if the target is headquartered in Virginia. Ruling P.D. 91-317 (12/30/91). The ruling did not provide analysis or cite any Virginia authority as support for its sales factor treatment. The Virginia ruling also addressed the consequences of the (h)(10) election on the property factor and concluded that the election must be respected for property factor purposes. However, because the sale caused a substantial fluctuation in value of the seller's property, the Commissioner required the use of monthly property values instead of the beginning and end of period values generally used.

Conclusion

Taxpayers making a Section 338(h)(10) election for federal income tax purposes should not assume that the election will be followed in determining the selling and target corporations' state apportionment factors. While it is clearly desirable that there be consistency between the treatment of the election for income determination and apportionment factor purposes, state apportionment factor statutes and regulations may fail to provide for such consistency. In those states, taxpayers or state tax administrators may argue that deemed sale treatment should not be followed for apportionment factor purposes. ■