

Strafford

presents

Apportioning Service Revenue in Corporate Tax Compliance

Navigating the Latest State Laws and Regulations

A Live 110-Minute Teleconference/Webinar with Interactive Q&A

Today's panel features:

Jon Zefi, Partner, **Eisner**, New York

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Peter Stathopolous, Partner, **Bennett Thrasher**, Atlanta

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The conference begins at:

1 pm Eastern

12 pm Central

11 am Mountain

10 am Pacific

You can access the audio portion of the conference on the telephone or by using your computer's speakers.
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Review Of Recent Key Litigation

Matthew Schaefer, Brann & Isaacson

Recent State Income Tax Litigation

Reported cases in the past year (4/09 – 4/10) have touched on a number of questions relevant to the taxation of service receipts:

- *What income must a business apportion?*
- *What and/or where is the income-producing activity?*
- *What are the costs of performance and/or where are they incurred?*
- *Does the standard reporting methodology fairly represent the business activity in the state?*
- *When do “mixed” transactions generate service receipts?*
- *Are there recent decisions regarding trademark holding companies?*
- *Are there other issues highlighted in recent litigation that may be of interest or concern?*

What Income Must A Business Apportion?

Business vs. non-business income

- *Ex Parte Alabama Department of Revenue*, -- So.3d --, 2010 WL 675606 (Ala. Feb. 26, 2010)
 - Court affirmed the use of the “transactional,” as opposed to the “functional,” test for determining business income.
 - Court found that major sale of property held by taxpayer for more than 30 years was not in the “regular course of the taxpayer’s trade or business,” even though it engaged in many other smaller, similar transactions.

Takeaway: Extraordinary transactions – even sales of assets long held and used in the business – may be “non-business income” not subject to apportionment.

What Income Must A Business Apportion? (Cont.)

Non-unitary Businesses: Holding Company and Operating Entity

- *Blue Bell Creameries, L.P. v. Chumley*, 2009 WL 3126249 (Tenn. Ct. App. 2009), *appeal granted* (2010)
 - Court held neither constitutional test of unitary business met (“hallmarks of a unitary relationship” and “operational function”).
 - Appeal accepted by Tennessee Supreme Court.
- *BIS LP, Inc. v. Director, Division of Taxation*, 25 N.J. Tax 88 (2009)
 - Court held holding company and subsidiary not “integrally related” so as to constitute a unitary business.

Takeaway: A holding company is not automatically unitary with an operating entity; beware aggressive state revenue department seeking to impose state income tax on holding companies.

What Income Must A Business Apportion? (Cont.)

Gross receipts vs. net proceeds – Intangibles and service fees

- *M.D.C. Holdings, Inc. v. State of Arizona*, 216 P.2d 1208 (Ariz. Ct. App. 2009)
 - Net gain/loss on sales of mortgages and mortgage servicing fees included in sales factor denominator, where the use of gross receipts would “artificially distort” the sales factor.
- *General Mills v. Franchise Tax Board*, 172 Cal. App. 4th 1535 (2009)
 - Gross receipts from futures contracts (hedge transactions) included in sales factor denominator, consistent with economic reality of the contracts and UDIPTA plain language .
 - Note: California adopted superseding legislation effective 2011.

Takeaway: Examine gross vs. net receipts in reporting.

What/Where Is The Income-Producing Activity?

Operational vs. transactional approach

- *Interface Group v. Commissioner of Revenue*, 75 Mass. App. Ct. 1116 (Table), 2009 WL 4573450 (Dec. 8, 2009)
 - Court affirmed use of “operational” approach to income-producing activity, as opposed to transactional approach.
 - Court affirmed finding of Appellate Tax Board that taxpayer’s income-producing activity was the broader operation of assembling travel packages, not the thousands of packages sold on a customer-by-customer basis by independent travel agents.

Takeaway: In evaluating whether to source income away from home state, ensure that your own business activities (and state law) permit it.

What/Where Is The Income-Producing Activity? (Cont.)

Income-producing activity in multiple states, not solely in taxing state

- *BellSouth Advertising & Publ. Corp. v. Chumley*, 2009 WL 2632773 (Tenn. Ct. App. Aug. 26, 2009), *appeal denied* (Mar. 1, 2010)
 - Court rejected argument that Tennessee was the sole locus of “earnings producing activity,” although taxpayer’s advertising receipts in question derived solely from directories distributed in Tennessee, because taxpayer “would have no advertising to include in a directory” without its non-Tennessee activities.

Takeaway: Look at full range of business activity that contributes to generating receipts – but remember Sect.18 ...

What/Where Are The Costs Of Performance?

Intangibles (financial instruments) and servicing fees

- *M.D.C. Holdings*, (Ariz. Ct. App. 2009) [see also earlier slide]
 - Court found that cost of performance analysis requires a “customer-based” focus.
 - Income from the sale of mortgages and mortgage servicing fees associated with underlying Arizona real property were properly excluded from the sales factor numerator on an Arizona return, where costs of selling and servicing were incurred in Colorado.

Takeaway: Look to the location of the employees performing the work connected with the sales transactions.

What/Where Are The Costs Of Performance? (Cont.)

Advertising revenue

- *BellSouth Advertising*, (Tenn. Ct. App. 2009) [see also earlier slide]
 - Court noted that, even though taxpayer obtained the relevant receipts solely in connection with advertising distributed in Tennessee, the taxpayer incurred no costs to solicit, design or produce directories in Tennessee.
 - Costs of performance approach dictated excluding advertising revenues from sales factor numerator on Tennessee return – but, Sect. 18 justified a different result [see subsequent slide].

Takeaway: Where costs are incurred is still the driver, under the UDITPA standard methodology for apportioning sales of services.

Does The Standard Methodology Fairly Represent In-State Business Activity?

Alternative apportionment methods under UDITPA Sect. 18

- *BellSouth Advertising*, (Tenn. Ct. App. 2009) [see also earlier slide]
 - Taxpayer had receipts of nearly \$900 million over five years from sale of advertising in directories distributed in Tennessee, and paid less than \$300,000 in excise tax.
 - In approving alternative apportionment method for ad receipts proposed by commissioner, court cited evidence of UDITPA drafter’s intent and discrepancy between receipts and tax paid.

Takeaway: When planning, evaluate the risks – and opportunities – presented by a Sect. 18 “alternative apportionment.” Consider presenting an alternative to avoid a *BellSouth* surprise.

Does The Standard Methodology Fairly Represent In-State Business Activity? (Cont.)

Alternative apportionment methods under UDITPA Sect. 18 (Cont.)

- *M.D.C. Holdings*, (Ariz. Ct. App. 2009) [see also earlier slide]
 - Court did not reach Sect. 18 argument on the issue of net vs. gross receipts (no alternative proposed as to costs of performance).
 - Court’s decision to look to net gain/loss had Sect. 18 “flavor,” under statutory provision that permitted adjustment to sales factor denominator where “the context otherwise requires.”
- *General Mills*, (Cal. Ct. App. 2009) [see also earlier slide]
 - Gross receipts from futures contracts included in sales factor, but:
 - Remanded for consideration of Sect. 18 argument.

Takeaway: Sect. 18 arguments are becoming prevalent.

When Do “Mixed” Transactions Generate Service Receipts?

Bundled sales of tangible personal property and services

- *Midwest Bus Corp. v. Department of Treasury*, 2010 WL 935703 (Mich. Ct. App. Mar. 16, 2010)
 - Six-part “incidental to service” test developed under Michigan sales tax law was applied to determine whether sales were of tangible personal property or services.
 - Despite sale of more than 500 replacement parts with cost more than five times that of the service charges, the court found the transaction was principally for the provision of services.

Takeaway: Nature of transaction revealed through careful examination of contract between the parties; take care in drafting.

Are There Recent Decisions Regarding Trademark Holding Companies?

Economic nexus for trademark holding affiliate

- *Classics Chicago, Inc. v. Comptroller of the Treasury*, 985 A.2d 593 (Md. Ct. Special App. 2010)
 - Taxpayer established that creation of the trademark holding company was **not** motivated by state tax considerations.
 - Nevertheless, the court found “nexus sufficient to justify taxation” of a trademark holding company, based on the “economic reality of the fact that the parent’s business in the taxing state was what produced the income of the subsidiary.”

Takeaway: Holding implies that even “non-sham” trademark licensing affiliates/transactions may be disregarded.

Are There Recent Decisions Regarding Trademark Holding Companies? (Cont.)

No economic substance of royalty payment transactions

- *Hormel Foods Corp. v. Wisconsin Department of Revenue*, (Wis. Tax Appeals Comm. March 29, 2010)
 - Commission upheld disallowance of deductions by parent of royalty payments to affiliated trademark holding company ,because transactions lacked economic substance.
 - Commission recited detailed facts, including internal business presentations, that demonstrated creation of subsidiary was motivated by state tax considerations.

Takeaway: Take care to substantiate valid business reasons for transactions and to not create internal business documents that undermine such reasons.

Are There Recent Decisions Regarding Trademark Holding Companies? (Cont.)

No economic substance of royalty payment transactions (cont.)

- *The Talbots, Inc. v. Commissioner of Revenue*, 2009 WL 3162121 (Mass. App. Tax Bd. Sept. 29, 2009)
 - Board disallowed deductions by parent of royalty payments to affiliated trademark holding company as “sham” transactions that “lacked economic substance beyond creation of tax benefits.”
 - Board recited detailed facts that demonstrated parent retained control over the trademarks and that state tax minimization was the “sole motivation” for the transaction.

Takeaway: As in *Hormel*, ensure that subsidiary is created for non-tax purposes and also has actual substance (employees, control of operations) – transactions with third parties are key.

BRANN & ISAACSON
ATTORNEYS AND COUNSELORS AT LAW

Are There Other Issues Highlighted In Recent Litigation?

Combined group cannot claim 86-272 immunity for single member

- *Arizona Department of Revenue v. Central Newspapers, Inc.*, 218 P.3d 1083 (Ariz. Ct. App. 2009)

State cannot dictate uniform state tax reporting by multi-state taxpayer

- *Oracle Corp. v. Department of Revenue*, 2010 WL 496945 (Ore. Tax Ct. Feb. 11, 2010)

State (Kentucky) can retroactively bar filing of refund claims for prior periods, without violating due process

- *Miller v. Johnson Controls, Inc.*, 296 S.W.3d 392 (Ky. 2009)

Partnership interest in business alone sufficient for income tax nexus

- *Revenue Cabinet v. Answorth Corp.*, -- S.W.3d. --, 2009 WL 3877518 (Ky. Ct. App. 2009)

Are There Other Issues Highlighted In Recent Litigation? (Cont.)

New Jersey Division of Taxation's aggressive nexus campaign continues

- *Praxair Tech., Inc. v. Director, Division of Taxation*, 988 A.2d 92 (N.J. 2009) (ownership of patents licensed to parent for use in New Jersey sufficient for corporate business tax nexus even for periods predating regulatory change)
- *Accuzip, Inc. v. Director, Division of Taxation*, 25 N.J. Tax 158 (2009) (sales of computer programs on tangible CD-ROMs to New Jersey customers insufficient for corporation business tax nexus)
- *BIS LP, Inc.*, (N.J. Tax Ct. 2009) (holding company not “integrally related” to operating entity and not subject to CBT) [see also earlier slide]

Recent State Tax Litigation: Reminders

- The cases discussed in this presentation always concern the tax law of the state in question – the law in other states may (and usually will) differ.
- The “takeaways” presented highlight general principles and planning points that may be gleaned from the cases and decisions, but their applicability will depend on the particular facts and circumstances and the laws of the relevant state(s).
- We are not discussing federal law.
- Consult your counsel and/or tax advisors regarding your particular state tax issues.