

Multistate Taxation

By Philip Tatarowicz and Rebecca Bertothy

Developments in Multistate Taxation

Arizona

When a multistate corporation invests its working capital in short-term instruments, only net gain from these short-term investments is included in the sales factor of the apportionment formula. Inclusion of short-term investment principal inherently distorts the sales factor as the same principal investment may be included numerous times. [Ariz. Dept. of Rev., CTR 07-1 (April 3, 2007).]

Idaho

New law (H.B. 141) amends Id. Code §63-3023 by deleting a provision that exempts non-Idaho banks and financial institutions from Idaho income tax. Provisions of H.B. 141 also amend the definition of transacting business to provide that an out-of-state bank or financial institution is transacting business in Idaho if it owns or leases, whether as lessor or lessee, any real or personal property in Idaho, or engages/transacts any activity in Idaho for the purpose of or resulting in economic or pecuniary gain or profit. These provisions apply to tax years beginning on and after January 1, 2008. [Id. Laws 2007, Ch. 59 (H.B. 141), enacted March 12, 2007.]

Louisiana

An online retailer that has no physical presence in Louisiana does not have substantial nexus with the state based on the activities of a related instate bookstore and, thus, is not required to collect and remit sales or use tax to the parish seeking to tax the online retailer. In reaching this conclusion, a Federal District Court found that the activities of the bookstore on behalf of the online retailer



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(e.g., cross-promotional advertising, selling gift cards that could be used to purchase items online, preferential return policy) were insufficient to attribute the bookstore's physical presence onto the online retailer. [*St. Tammany Parish Tax Collector v. Barnes and Noble.Com, Inc.*, No. 2:05-cv-5695 (E.D. La. March 22, 2007).]

The taxpayer, *barnesandnoble.com*, is an Internet retailer that sells books, movies and music ("online retailer"). The online retailer did not maintain a mailing address or telephone number in the state, nor did it have employees or tangible personal property. Online retailer's only contact with Louisiana was its use of common carriers to deliver goods from out-of-state distribution centers.

During the tax years at issue, a related entity—Barnes & Noble Booksellers—operated bookstores throughout Louisiana, including one in St. Tammany Parish. While the online retailer and the bookstore are related, they did not share business elements such as management, employees, and offices. St. Tammany Parish, however, attributed the bookstore's physical presence to online retailer and sued the online retailer for sales and use taxes it allegedly failed to collect and remit to the Parish. To support this argument, Parish cited the following aspects of the business relationship between the online retailer and the bookstore:

- A membership program offered by both the online retailer and the bookstore
- Bookstore's sale of gift cards that were redeemable on online retailer's Web site
- Commissions received by the online retailer on merchandise ordered at the bookstore but shipped directly to the customer
- Online and bookstore advertised on behalf of the other
- Bookstore's preferential treatment of returns of merchandise purchased from online retailer

In rejecting the Parish's argument that these relationships established a substantial nexus for the online retailer, a federal court ruled that the bookstore's activities on behalf of online retailer were not of the magnitude necessary to establish that bookstore was acting as a marketing presence for online retailer in the Parish. The bookstore never took or solicited orders on behalf of the online retailer and did not provide facilities to place orders with online.

Further, the Parish failed to demonstrate that participation in the membership and gift card programs created the requisite nexus necessary to impose a tax. Neither of these programs produced revenue to the online retailer by virtue of sales made or orders taken by bookstore. In addition, the fact that the online retailer may have derived some benefit from the bookstore's advertising of the programs is insufficient to impute bookstore's nexus onto the online retailer. In regard to the commissions that the online retailer received, the evidence presented during the hearing showed that the online retailer was one of many wholesalers, including competitors, the bookstore used to get merchandise it did not have in stock, to be shipped to the store or directly to the customer.

The final argument put forth by the Parish is that bookstore's physical presence should be attributed to the online retailer based on the preferential treatment the bookstore gave to returns of merchandise purchased from the online retailer. The policy of bookstore affording the online retailer a slightly more generous return policy than the one extended to other retailers is not comparable to the facts involved in *Scripto*¹ and *Tyler Pipe*,² i.e., an independent contractor making sales on behalf of the out-of-state retailer. Moreover, it is not comparable to the level of sales or sales support activity undertaken by in-state agents in other cases in which courts have found nexus.

Lastly, the court explained that even though the two companies shared a common name and brand identity, there was no overlap between the companies' management or directors and they did not hold themselves out as the same entity. Further, the fact that the companies may have shared financial or market data, is not "of independent significance." In finding that attributional nexus did not apply, the court citing *SFA Folio*³ and *Bloomington by Mail*,⁴ held that "[t]he existence of a close corporate relationship between companies and a common corporate name does not mean that the physical presence of one is imputed to the other."

New York

On April 1, 2007, Governor Spitzer signed the budget bill (A. 4310-C/S. 2110-C) for 2007–2008. Provisions of the bill provide business tax rate

reductions and close what Governor Spitzer perceived to be corporate tax “loopholes.” Key provisions reduce business tax rates, effective for tax years beginning on or after January 1, 2007, as follows:

- The Art. 9-A, Art. 32, and Art. 33 rates on entire net income are reduced from 7.5 percent to 7.1 percent.
- The Art. 9-A rate on a manufacturer’s entire net income is computed at the rate of 6.5 percent (note “manufacturer” is narrowly defined as a taxpayer that derives greater than 50 percent of its gross receipts from the sale of goods produced by Investment Tax Credit–eligible activities).
- The Art. 9-A tax rate on the Minimum Taxable Income alternative base is reduced from 2.5 percent to 1.5 percent.
- The Metropolitan Commuter Transportation District surcharge is calculated as if the tax rates in existence for tax years beginning on or after July 1, 1997, and before July 1, 1998 were still in effect.

Provisions of the bill also require related corporations to file a combined report that covers any related corporations if there are substantial inter-corporate transactions among the related corporations, regardless of the transfer price for such inter-corporate transactions. It is not necessary that there be substantial inter-corporate transactions between any one corporation and every other related corporation. Rather, it is necessary that there be substantial inter-corporate transactions between the taxpayer and a related corporation or a group of such related corporations.

In determining whether there are substantial inter-corporate transactions, the tax commissioner will consider and evaluate all activities and transactions of the taxpayer and its related corporations. Such activities and transactions include the following:

- Manufacturing, acquiring goods or property, or performing services, for related corporations
- Selling goods acquired from related corporations
- Financing sales of related corporations
- Performing related customer services using common facilities and employees for related corporations

- Incurring expenses that benefit, directly or indirectly, one or more related corporation
- Transferring assets (such as accounts receivable, patents or trademarks) from one or more related corporations
- Selling policies or contracts of insurance for related corporations (for insurance franchise tax purposes)
- Reinsuring risks for related corporations (for insurance franchise tax purposes)
- Collecting premiums or other consideration for any policy or contract of insurance for related corporations

Except as provided above, a combined report covering any corporation that does not have substantial inter-corporate transactions with the taxpayer or with one or more related corporations will not be permitted or required unless the tax commissioner deems such report necessary in order to properly reflect the taxpayer’s New York corporate franchise tax liability.

Corporations organized under the laws of a country other than the United States are still not allowed be included in the combined report. Other provisions of the bill follow:

- Require a controlled REIT or RIC to file a combined report with such other corporations under the corporate franchise tax
- Reduce the amount of dividend deductions banks and insurance companies can claim to the extent the deduction relates to disallowed investment proceeds from REITs and RICs
- Accelerate the effective date for a 100-percent single-receipts factor business allocation percentage for general corporation tax purposes
- Mandate the New York S corporation election for certain federal S corporations
- Extend for two years until July 1, 2009, New York’s tax shelter registration, disclosure and list maintenance provisions
- Prohibit banks from creating or acquiring 9-A subsidiaries to hold investment assets which would be taxed at a lower rate
- Extend for two years until January 1, 2010, the New York State and City bank taxes and the Gramm-Leach-Bliley Act transitional rules
- Restrict the use of certain partner entities to avoid New York tax

Unless otherwise noted, these provisions are effective for tax years beginning on or after Janu-

ary 1, 2007. [N.Y. Laws 2007, A. 4310-C and S. 2110-C, enacted April 1, 2007.]

New York

In *Talbots, Inc.*, an Administrative Law Judge (ALJ) held that the Department of Taxation and Finance had the authority to require a company and a wholly owned intangible holding company to file a combined report because their inter-company royalty arrangement lacked economic substance and a valid business purpose aside from tax avoidance. The ALJ also found that the transfer pricing agreement was conducted at arm's length, but since the transaction lacked substance, the fact that the transaction was arm's length was moot. [In *the Matter of the Petition of Talbots, Inc.*, No. 820168 (N.Y. Div. of Tax App. March 22, 2007).]

The Talbots, Inc. ("Talbots") is an out-of-state corporation specializing in the retail and catalog sales of women's clothes and apparel. In 1988, Talbots transferred all of its trademarks, tradenames and other intellectual property (collectively "marks") to a wholly owned Dutch subsidiary. According to Talbots, this transfer not only created greater flexibility in making use of the marks in foreign markets, but also created U.S. federal tax savings. State tax savings was not a focus of the transaction.

Prior to an initial public offering of Talbots in 1993, The Classics Chicago, Inc. ("Classics")—a wholly owned subsidiary of Talbots with a principal place of business in Illinois—acquired the marks from the Dutch subsidiary for approximately \$103 million. Classics in acquiring the marks, primarily used funds loaned to it by Talbots. Subsequently, Talbots and Classics entered into a licensing agreement under the terms of a transfer pricing study conducted by an independent third party.

Citing the *Sherwin-Williams*⁵ case, the ALJ noted that "even if the intercompany payments are at arm's length, there must still be a business purpose and economic substance to the intercompany arrangement, for if the intercompany arrangement has no economic substance or business purpose apart from tax avoidance the same will properly be disregarded." Rather than focusing on the reason why Talbots sought to bring ownership of the marks back into the ownership or control of

Talbots, the ALJ focused on why Talbots chose to the structure the transaction in the manner it did. In other words, the ALJ focused not on the business purpose of re-acquiring the marks from the foreign entity (*i.e.*, "to 'best effect' the Talbots' IPO, that is to maximize the value of the Talbots stock to be offered for sale to the public") but rather on the business purpose of placing the marks in Classics rather than placing the marks directly in Talbots.

Relying on various presentation documents and other materials, the ALJ pointed out that state tax savings was one of two reasons for structuring the transaction in this fashion, with the state tax savings being the primary goal. The ALJ reached this conclusion based on the amount of documentation of the potential tax savings, including various memoranda and calculations detailing the tax effects of the transaction. The ALJ noted that there was very little documentation regarding the nontax purposes.

Additionally, the ALJ noted that there was no evidence that "Classics performed any trademark services of consequence, leading to a conclusion that Talbots simply performed the duties of a trademark service provider." Also damaging was the circular flow of money *via* the royalty payments to Classics followed by a payment of principal and interest on the loans and tax free dividends back to Talbots. As a result, the ALJ found that the transaction lacked business purpose and economic substance apart from the tax benefits received in the transactions.

Because the ALJ found that the transaction lacked business purpose and economic substance, it was irrelevant whether the transfer pricing agreement was at arm's length. However, in the interest of providing for a two-tier level of review of the issue, the ALJ concluded that the royalty rates were indeed made at arm's length.

Virginia

In recent letter ruling, the Tax Commissioner advised that the establishment and use of a Virginia distribution center would not create income tax nexus for an out-of-state Internet retailer that has no physical presence in the state. In addition, sales/use tax nexus would not be created because the retailer's activities in Virginia are not sufficient to establish nexus. A retailer is deemed to have sufficient activity in Virginia if:

- it maintains or has within the state, directly or through an agent or subsidiary, an office, warehouse or place of business of any nature; or
- if it solicits business in Virginia by employees, independent contractors, agents or other representatives.

Based on the facts presented, it appears that the distribution center is not acting as an agent for the retailer. While the work done by the distribution center is for the benefit of the retailer, the retailer does not control the work done, or manner in which the work is done, at the distribution center. Note that, while not part of the facts, the letter ruling is based on the presumption that the distribution center is not a subsidiary of the retailer. [Va. Dept. of Taxn., Ruling of Tax Comm'r PD 07-24 (March 27, 2007).]

West Virginia

On April 4, 2007, Governor Manchin signed a bill (W.Va. Laws 2007, S.B. 749) that requires combined reporting for certain taxpayers reduces the rate of the franchise tax, expands the definition of business income, and makes other changes. The new combined reporting provisions, which apply to the state's corporate net income tax, are effective for tax years beginning on and after January 1, 2009, and adopt in substantial part the provisions of the Multistate Tax Commission's Model Statute for Combined Reporting.

Specifically, any taxpayer engaged in a unitary business with one or more other corporations will be required to file a combined report that includes the income of all the corporations that are members of the unitary business, and other information required by the Tax Commissioner. If the tax commissioner determines that the reported

income or loss of a taxpayer engaged in a unitary business with any person not included in the combined report represents an avoidance or evasion of tax by such taxpayer, he/she has the authority to require all or any part of the income and associated apportionment factors of such person be included in the combined report. Alternatively, the tax commissioner may require any person or corporation to make and file a separate return or to make and file a composite, unitary, consolidated or combined return in order to clearly reflect the taxable income of a corporation.

In addition, provisions of S.B. 749 reduce over a five-year period the rate of the franchise tax, which is currently the greater of \$50 or 0.55 percent. The reduction is as follows:

- Tax years beginning on or after January 1, 2009, but before January 1, 2010—greater of \$50 or 0.48 percent
- Tax years beginning on or after January 1, 2010, but before January 1, 2011—greater of \$50 or 0.41 percent
- Tax years beginning on or after January 1, 2011, but before January 1, 2012—greater of \$50 or 0.34 percent
- Tax years beginning on or after January 1, 2012, but before January 1, 2013—greater of \$50 or 0.27 percent
- Tax years beginning on or after January 1, 2013 and thereafter—greater of \$50 or 0.20 percent

Lastly, provisions of S.B. 749 also expand the definition of business income to include all income apportionable under the U.S. Constitution (this provision is effective from passage—March 10, 2007). [W.Va. Laws 2007, S.B. 749, signed by the Governor on April 4, 2007.]

ENDNOTES

¹ *Scripto v. Carson*, 362 US 207 (1960).

² *Tyler Pipe Indus. v. Washington State Dep't of Rev.*, 483 US 232 (1987).

³ *SFA Folio Collections, Inc. v. Bannon*, 217 Conn. 220 (Conn. Sup. Ct. 1991)

and *SFA Folio Collections, Inc. v. Tracy*, 73 Ohio St. 3d 119 (Ohio Sup. Ct. 1995).

⁴ *Bloomington's By Mail, Ltd. v. Pennsylvania*, 130 Pa. Cmwlth. 190 (1989).

⁵ *In re: The Sherwin-Williams Co.*, No. 816712 (N.Y. Tax App. Trib. June 5, 2003), *confirmed*, 12 A.D.3d 112 (N.Y. App. Div. 2004), *appeal denied*, 830 N.E.2d 320 (N.Y. 2005).

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