



CT-3

Final return

New York State Department of Taxation and Finance

# General Business Corporation Franchise Tax Return

2003 calendar-year filers check box:

Other filers enter tax period: beginning  ending

March 2005 e-9-A



# State Tax Return

File number  Business telephone number

If you have any subsidiaries incorporated outside NYS, check box

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Volume 12 Number 3

State or country of incorporation  Date received (for Tax Department use only)

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State Tax Return is a Jones Day newsletter reporting on recent developments in state and local tax. Please send changes in address, requests for permission to reproduce this publication, in whole or in part, and comments or suggestions to Christine Rhodes (614/281-3911 or crhodes@jonesday.com) in Jones Day's Columbus Office, P.O. Box 165017, Columbus, Ohio 43216-5017.

## California Appellate Court Holds That The Franchise Tax Board May Exclude Returned Principal From Taxpayers' Gross Receipts

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The California Courts of Appeal ruled on February 28, 2005 that the California Franchise Tax Board may exclude returned principal from gross receipts when the return of principal derives from securities transactions utilized for cash management purposes. *Microsoft Corp. v. Franchise Tax Bd.*, No. A105312, 2005 WL 459697 (Cal. Ct. App. Feb. 28, 2005).

### Marketable Securities Transactions

In 1991, Microsoft Corporation ("Microsoft") invested its cash portfolio in marketable securities as a means of earning a reasonable rate of return while protecting the principal and providing Microsoft with liquidity. Microsoft recognized a gain of \$10.7 million from its disposition of these securities in 1991. The gross proceeds from these transactions, including returned principal, was \$5.7 billion. The inclusion of the \$5.7 billion in the sales factor had the effect of reducing the factor from 15.3412% to 3.067%. The reduction in the sales factor caused the total apportionment factor to drop from 6.859% to 2.9821%. The California Franchise Tax Board ("FTB") asserted that the portion of the gross proceeds from the marketable securities transactions that was a return of principal should not be included in gross receipts because it significantly distorted the representation of Microsoft's business activity in California.

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## What Are “Gross Receipts”

The term sales in the Uniform Division of Income for Tax Purposes Act (“UDITPA”), as adopted in section 25210 of the California Revenue and Taxation Code (the “Code”), is defined to mean “all gross receipts of the taxpayer not allocated under [the nonbusiness income provisions of UDITPA].”<sup>1</sup> Based on this definition, Microsoft asserted that the return of principal must be included in gross receipts. The FTB countered that if the returned principal was included in gross receipts, it should be allowed to apply a different apportionment formula under section 25137 of the Code. Section 25137 provides that where the apportionment provisions do not fairly represent the extent of the taxpayer’s business activity in California, the FTB may apply a different apportionment formula.

### Court’s Holdings

The California Courts of Appeal reached several conclusions favorable to the FTB. First, the court held that the inclusion of returned principal in gross receipts distorted the representation of Microsoft’s worldwide business activity, which necessarily included Microsoft’s business activity in California. The court noted that in 1991, six employees generated a gain of \$10.7 million from securities transactions yielding total proceeds of \$5.7 billion. Microsoft’s other 8,200 employees generated only \$2.1 billion in gross receipts. This comparison, the court asserted, illustrates the extent of the distortion and justified the FTB’s invocation of the relief provisions of section 25137. The court also noted that the FTB’s proposed omission of the returned principal from the gross receipts

element of the sales factor was both reasonable and within the authority of the FTB.

Despite the appellate court’s finding that the FTB was justified in utilizing the powers of section 25137, the court specifically noted that it “need not decide whether Microsoft’s returned principal should be excluded from its ‘gross receipts’ for purposes of the sales factor.”<sup>2</sup> The California Supreme Court, the court noted, would provide the rule to be followed in future cases.<sup>3</sup> The court, however, could not restrain itself from offering, in dicta, that returned principal should be systematically excluded from gross receipts. While the FTB could use the powers of section 25137 on a case-by-case basis to exclude returned principal, this approach would be administratively inefficient and would likely result in at least some companies escaping adjustment. As a result, the systematic exclusion of returned principal from gross receipts “is preferable, for reasons of both equity and administrative efficiency.”<sup>4</sup>

### What The Future Holds

On October 13, 2004, the California Supreme Court granted a petition to review the decision in *General Motors Corporation v. Franchise Tax Board*, 16 Cal. Rptr. 3d 41 (Cal. 2004).<sup>5</sup> The *General Motors* decision specifically addressed the question of whether a corporation’s return of principal from securities transactions is includible in gross receipts. The California Supreme Court’s review of the *General Motors* decision will likely result in a determination of whether returned principal should be systematically excluded from gross receipts. If returned principal is systematically excluded, the FTB will not need to exercise the equitable powers of section 25137 to make adjustments for returned principal. ☐

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<sup>1</sup> See *Microsoft Corp. v. Franchise Tax Bd.*, No. A105312, 2005 WL 459697, at \*1 (Cal. Ct. App. Feb. 28, 2005); Cal. Rev. & Tax. Code § 25120(e).

<sup>2</sup> *Microsoft*, No. A105312, 2005 WL 459697, at \*3.

<sup>3</sup> *Id.* at \*1 n.2 (noting that the issue of whether returned principal should be included in gross receipts is pending before the California Supreme Court).

<sup>4</sup> *Id.* at \*3.

<sup>5</sup> See *Gen. Motors Corp. v. Franchise Tax Bd.*, 19 Cal. Rptr. 3d 823 (Oct. 13, 2004) (granting a petition for review).

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We thought you would be interested in a summary of new nexus developments. This report covers the last two quarters of 2004, during which there were many interesting new cases and nexus interpretations around the country.

### **AFFILIATE NEXUS**

#### **TENNESSEE:**

*Dillard Nat'l Bank, N.A. v. Johnson*, No. 96-545-III (Tenn. Chancery Ct. Jun. 22, 2004)

- i. Dillard Department Stores, Inc. ("Dillard") owned and operated department stores in several states, including Tennessee. It also wholly-owned Dillard National Bank ("DNB"), a limited purpose out-of-state credit card bank that issued a proprietary Dillard-brand credit card. DNB was incorporated in Arizona, with its principal place of business in Arizona. DNB itself had no physical presence in Tennessee, but employees at Dillard's department stores promoted the credit card on behalf of DNB in Tennessee by placing advertisements in newspapers around Dillard stores, soliciting and accepting credit card applications from customers in stores, answering questions in stores for customers regarding their credit card accounts, and accepting credit card payments in stores.
- ii. The Department of Revenue assessed franchise and excise tax on DNB based on its income generated by the credit card activities in Tennessee, and DNB challenged the assessment on nexus grounds. The Chancery Court affirmed the Department's assessment, finding nexus because the activities performed by the employees at Dillard's stores on behalf of DNB "constituted a continuous and targeted solicitation within the State

of Tennessee to establish and maintain a market in Tennessee with Tennessee residents." DNB therefore received a tremendous benefit from the in-store solicitation of Dillard's customers in Tennessee. According to the Court, such benefit was directly parallel to the type of services rendered by the independent contractors in *Scripto* and *Tyler Pipe*, and was sufficient to create substantial nexus with Tennessee. Importantly, the Court also distinguished DNB's activities from the minimal contacts discussed in *J.C. Penny Nat'l Bank v. Johnson*, 1999 Tenn. App. LEXIS 826 (1999), wherein no substantial nexus was found because the retail stores in *J.C. Penny* conducted no activities on behalf of JCPNB in maintaining the credit card business in Tennessee.

- iii. The Court gave little or no weight to several other DNB activities. Although the Court noted that DNB had sent its own employees into Tennessee on three or four occasions to solicit new credit card customers at Dillard's store openings, and also hired a third-party vendor to solicit credit card applications from college on its behalf, it concluded that these two activities only added "extra weight" to finding of a substantial nexus and did not create nexus by themselves. In addition, the Court found that the collection activities of DNB, which consisted of DNB hiring a third-party collection agency in Tennessee to collect and/or file suit on delinquent accounts on its behalf (about 250 judgments were obtained in suits filed in Tennessee), were irrelevant for purposes of nexus activities.

- iv. The case is currently pending in the Court of Appeals Middle Section, Case No. M2004-02102-COA-R3-CV. At present, only the notice of appeal has been filed.

## **INTANGIBLE NEXUS**

### **NORTH CAROLINA:**

*A & F Trademark, Inc. v. Tolson*, 605 S.E.2d 187 (N.C. Ct. App. 2004), *appeal dismissed*, 2005 U.C. LEXIS 226 (N.C. 2005).

- i. The Limited, Inc. (“the Limited”) engaged in retail sales of clothing and accessories through separate retail operating subsidiaries doing business across the United States. Nine of these retail subsidiaries (“retail companies”) operated in North Carolina at over 130 locations. The Limited incorporated retail trademark holding companies (“taxpayers”) in Delaware as trademark holding companies and assigned to each one certain trademarks. After the trademarks were assigned, the taxpayers entered into agreements with the retail companies to license them the trademarks. Under the licensing agreement, the retail company is required to pay the taxpayer, the licensor, a royalty payment of five to six percent of its retail operating gross sales. In addition, the taxpayers entered into agreements loaning any excess operating funds back to the retail companies in the form of notes receivable bearing a market rate of interest.
- ii. The taxpayers had no employees in North Carolina and did not own or lease real property or tangible personal property in the State. The taxpayers did not file corporate franchise and income tax returns in North Carolina. The Secretary of Revenue subsequently gave the taxpayers notice of proposed assessments of corporate franchise and income tax, to which the taxpayers protested. After an administrative hearing, the Secretary issued a final decision sustaining the proposed assessments against the taxpayers without penalties. The Tax

Review Board affirmed the final decision and the Superior Court subsequently upheld the decision of the Tax Review Board. The taxpayers then appealed to the North Carolina Court of Appeals.

- iii. The Court of Appeals affirmed the income and franchise tax assessments against taxpayers, and held that “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.” The Court relied primarily on *Geoffrey, Inc. v. South Carolina Tax Comm’n.*, 437 S.E.2d 13 (S.C. 1993) which held that when an out-of-state taxpayer licenses intangibles to an affiliated operating store for use in the State, there is substantial nexus between the taxpayer and the State.
- iv. Importantly, the court adopted an economic nexus principle as the basis for the imposition of franchise and income taxes, and rejected the taxpayers’ 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.” The Court reasoned that while *Quill* reaffirmed *Bellas Hess*’s bright-line, physical-presence rule for sales and use taxes, it did so equivocally and it was not clear that the U.S. Supreme Court would choose to expand the physical-presence test to other types of tax, and moreover, the Supreme Court noted twice in *Quill* that the *Bellas Hess* rule had not been adopted for other forms of taxation. Accordingly, physical presence is not required for imposition of income and franchise taxes under the Commerce Clause.
- v. The taxpayers further appealed. On March 3, 2005, the Supreme Court of North Carolina denied the taxpayers’ petition for discretionary review filed on January 11, 2005.

## **IN-STATE PERSONNEL**

Independent Contractors, Sales Representatives, and Manufacturing Representatives

### **NEW YORK**

Advisory Opinion, Petition No. C031002A, 2004 N.Y. Tax LEXIS 194 (N.Y. Dept. Tax & Fin. Aug. 31, 2004).

- i. Taxpayer was an Ohio corporation that designed and manufactured currency changing and validation equipment, and had customers located throughout the United States. The taxpayer's solicitation of orders in New York was conducted by telephone from Ohio, and all orders for its products were taken at its Ohio headquarters. One of the taxpayer's directors resided in New York, and had a telephone listing for the taxpayer in her local phone book with her home address listed, without the knowledge of the taxpayer. The listing was subsequently removed when the taxpayer was aware of it. No sales activity was conducted by the taxpayer in New York.
- ii. Taxpayer also trained various independent repair organizations in the repair of its products. All training was conducted at the taxpayer's facility in Ohio, and the taxpayer's employees did not go to New York to train personnel of the service centers. Once trained, the independent organizations were designated as authorized to provide warranty and nonwarranty repairs to the products the taxpayer has sold. These repair organizations were fully independent organizations in New York, with no contractual obligations with the taxpayer.
- iii. The Commissioner held that the taxpayer was not subject to New York franchise tax. First, the taxpayer was not deemed to be maintaining an office in New York because of the telephone listing. The Commissioner reasoned that the director did not conduct taxpayer's business from her home in New York, and neither solicited nor took order for the taxpayer's products in New York.

- iv. Second, the taxpayer was also not deemed to be doing business in New York as a result of the repair activities conducted by the repair organizations. In holding so, the Commissioner relied on *Tower Cleaning Systems, Inc.*, TSB-A-02(6)C (N.Y. Dept. Tax & Fin. May 31, 2002) which held that the hiring of subcontractors as independent contractors in New York to provide services for the taxpayer's customers did not constitute doing business, but that if the subcontractors had an agency relationship with the taxpayer, the taxpayer would then be considered to be doing business in New York. Based on the facts, the Commissioner found the authorized service centers to be independent contractors, and that under *Tower Cleaning*, the activities of the authorized service centers in New York were thus not considered activities conducted by the taxpayer.

Advisory Opinion, Petition No. C040406A (N.Y. Dept. Tax & Fin. Dec. 13, 2004).

- i. Taxpayer was a professional employer organization (PEO) based in Ohio (PEO is an agency that hires staffing for employers). There were two workers for whom it withheld New York State income tax. The two workers were New York residents, but they were drivers for an Ohio trucking company and did not work in New York. Taxpayer did not exercise control over the workers' daily activities but it was authorized by agreement to direct and control the workers. Taxpayer was not doing business, employing capital, owning or leasing property, or maintaining an office in New York.
- ii. The Commissioner held that the taxpayer did not have New York franchise tax nexus by merely withholding personal income tax for the two New York residents, regardless of whether the taxpayer was considered to be the employer of the truck drivers. The Commissioner further concluded that the taxpayer would be subject to franchise tax if it is doing business, employing capital, or owning or leasing property in

New York in a corporate or organized capacity, maintaining an office in New York.

#### **WEST VIRGINIA:**

*MBNA America Bank v. Steager*, West Virginia Office of Tax Appeals, Docket Nos. 03-185 RN, 03-186RFN, 04-074RFN, 04-075RN (Oct. 22, 2004)

- i. The taxpayer, MBNA, was a Delaware bank that issued and serviced VISA and Mastercard credit cards to customers nationwide. It conducted its credit card business exclusively from outside West Virginia. MBNA had no office, place of business, or property located in West Virginia, and had no employees or other representatives who were physically present in the state for the tax period. MBNA promoted its business operations through direct mail and telephone solicitations throughout the country, including solicitation to West Virginia residents, but none of the solicitation activities originated in West Virginia. During the period in issue, MBNA hired attorneys to perform work on three credit card debt collection actions which were brought on MBNA's behalf in the courts of West Virginia. The law firm was located in Kentucky, but the attorneys who performed the work were from the law firm's West Virginia office. The collection actions were subsequently dismissed.
- ii. The Tax Commissioner found nexus from the debt collection actions. The Office of Tax Appeals, however, held that MBNA lacked nexus with West Virginia. The ALJ found that MBNA's only physical presence in West Virginia involved the "extremely isolated and sporadic use of th[e] in-state lawyer's services and courts of the state in the *de minimis* number of credit card debt-collection actions." According to the ALJ, the frequency of the in-state debt collection activities did not rise to a level sufficient to meet *Quill's* test and to create nexus. The ALJ, however, noted that such debt collection activities are relevant for nexus purposes and will create nexus in West Virginia if they occur on a

sufficiently regular basis.

- iii. The ALJ further rejected the nexus presumption contained in the West Virginia statute, which adopts an economic "exploitation of the market" standard for nexus, and emphasized that a finding of a physical presence in West Virginia, not merely an economic exploitation of the market, is required to find a substantial nexus with the State. In addition, the ALJ refused to limit *Quill* to sales/use taxes only, and held that the *Quill* test applies with equal force to any state tax, including the corporate income and business franchise tax at issue.

#### **MICHIGAN SINGLE BUSINESS TAX**

##### **MICHIGAN:**

*Rayovac Corp. v. Dep't of Treasury*, No. 02-000062-MT, 2004 Mich. App. LEXIS 3190 (Mich. Ct. App. Nov. 23, 2004)

- i. Rayovac Corporation ("Rayovac") is a Wisconsin seller of batteries in Michigan, and had three sales persons and one sales manager in Michigan who solicited, but did not accept or approve orders. The trial court determined that this presence was insufficient to establish substantial nexus with Michigan under the limitations imposed by the Commerce Clause and found that Rayovac was not liable for SBT.
- ii. The Court of Appeals agreed with the trial court that Michigan could impose SBT only if Rayovac had substantial nexus with Michigan under the standard established by the U.S. Supreme Court in *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992). The Court, however, reversed the trial court's decision and found that Rayovac had substantial nexus with Michigan based on the presence of its sales force in the state. The Court held that the presence of *any* sales force in Michigan establishes substantial nexus, and refused to consider the size of a taxpayer's sales force in determining nexus. It reasoned that this approach would preserve the *Quill's* "bright line rule"

as interpreted in *MagneTek Controls, Inc. v. Dep't of Treasury*, 562 N.W.2d 219 (Mich. Ct. App. 1997), and to otherwise consider the size of a sales force would “invite chaos from lack of certainty as to what size or character of the sales force would meet the standard.”

- iii. The Court of Appeals concluded that the retroactive application of the Department’s nexus standards for SBT as set forth in RAB 1998-1 did not violate the Commerce Clause. Furthermore, the Court found that Rayovac had no vested right to continued application of a particular taxing standard, and so it could not claim that imposition of the SBT constituted unfair and unjust treatment. Lastly, because Rayovac could not show hardship as a result of the delay, the Department was not precluded from retroactively applying the tax by the doctrine of laches.

### **IN-STATE ADVERTISING/ SOLICITATION**

#### **TENNESSEE:**

- 4 Op. Att’y Gen. 159 (Tenn. Nov. 8, 2004)
  - i. The issue was whether a taxpayer doing business in Tennessee by soliciting orders for tangible personal property which were approved and delivered from locations outside Tennessee was exempt from Tennessee franchise tax liability under P.L. 86-272.
  - ii. The Commissioner first reiterated that a business that systematically solicits orders through a sales force located in Tennessee will be subject to the state’s taxing jurisdiction under established precedents such as *Scripto, Inc., v. Carson*, 362 U.S. 207 (1960) and *J.C. Penny Nat’l Bank v. Johnson*, 1999 Tenn. App. LEXIS 826 (1999). Tennessee may thus assert its taxing jurisdiction unless the entity comes within the protection of P.L. 86-272 which prohibits a state from subjecting a nondomiciliary business to a net income tax where that business’ only activities within the state consist of solicitation

activities or sales of tangible personal property.

- iii. The Commissioner held that the taxpayer was not exempt from Tennessee franchise tax liability under P.L. 86-272. It reasoned that the language of P.L. 86-272 limits the application of the statute to state taxes “measured by net income” and that Tennessee franchise tax is measured by a taxable entity’s net worth and not by “net income.” Accordingly, P.L. 86-272 does not impose any restrictions with respect to the application of the franchise tax.

### **INCIDENTAL OWNERSHIP OF PROPERTY**

#### **KENTUCKY:**

*Annox, Inc. v. Kentucky Revenue Cabinet*, 2003 Ky. Tax LEXIS 246 (Ky. BTA Nov. 18, 2003), *aff’d*. No. 03-CI-1605 (Ky. Franklin County Cir. Ct. Feb. 17, 2005).

- i. Annox is a telecom services reseller with Kentucky customers. It had agreements with local telecom companies to use their physical networks and employees for customer service and connections. Annox relied heavily on Bell South, a local telecom company, in installation of phone service and assignment of new customers’ telephone numbers to Annox’s customers. Annox had no equipment or employees in Kentucky, and solicited customers by direct mail and through an Internet website maintained outside Kentucky. In addition, Annox was a “utility” subject to regulation by the Kentucky Public Service Commission (“PSC”). As a result, Annox must obtain a Certificate of Public Convenience and Necessity from the PSC, and it must pay assessment fees to operate in Kentucky. For 2001, the Revenue Cabinet assessed public service corporation property tax on Annox. Annox appealed to the Board, asserting that it did not have nexus with Kentucky.
- ii. The Board ruled that the physical presence nexus rule set forth in *Quill Corp. v. North Dakota*, 112 S.Ct. 1904 (1992), applies

only to sales and use taxes, and applied the test in *Tyler Pipe Industries Inc. v. Washington Dept. of Revenue*, 483 U.S. 232 (1987) to find nexus for Annox. Even when there is no physical presence, the Board indicated that attributional nexus can be established if “the activities performed in this state on behalf of the taxpayer are significantly associated with the taxpayer’s ability to establish and maintain a market in this state for sales.”

- iii. The Board found that Annox had nexus with Kentucky because its contacts with the state were significantly associated with its ability to establish and maintain a market in Kentucky. Annox had the absolute right to use the physical networks of the local telecom companies. Also, since Annox operated in Kentucky only with the permission of the state Public Service Commission, the state licensing requirement established nexus with Kentucky. The Board also found nexus through Congressional action, since Congress had consented to state nexus over telecom resellers. Moreover, the Board also relied on the fact that Bell South employees acted on behalf of Annox in Kentucky, and that without the actions of Bell South on its behalf, Annox could not have offered its services in Kentucky.
- iv. Annox further appealed on the PSC tax assessment. On appeal, the Court affirmed the Board’s decision, holding that Annox had a substantial nexus with Kentucky. The Court reasoned that Annox’s operating property was physically connected with Kentucky, on the basis that Annox had the right to use Bell South’s telephone lines, equipment, and employees, and that Annox had a franchise in Kentucky. The Court further stated that Bell South, acting as Annox’s independent contractor in Kentucky, was critical to Annox’s Kentucky market, and that Annox was subject to the PSC’s regulatory authority regarding interconnection agreements. Accordingly,

Annox’s tax liability satisfied the Commerce Clause. The Court also held that the tax assessment satisfied the Due Process Clause because Annox purposely directed its commercial activity towards Kentucky residents.

#### **VIRGINIA:**

Ruling of Commissioner, P.D. 04-188 (Dep’t of Tax. Oct 8, 2004).

- i. Taxpayer had included the net operating losses (NOLs) for six of its out-of-state subsidiaries in its consolidated return on the basis that the subsidiaries had nexus with Virginia to which the taxpayer supported by showing that the subsidiaries had property in Virginia during the relevant audit period. One of the subsidiaries was in the television broadcasting business, and the remaining subsidiaries were engaged in the newspaper publishing business. Other than the property stored in Virginia, none of the subsidiaries had any other activities in Virginia. None of the subsidiaries generated sales in Virginia or had employees that entered Virginia. Upon audit, the Department removed the subsidiaries from the taxpayer’s consolidated return on the basis that they lacked nexus with Virginia.
- ii. The Commissioner agreed with the Department, holding that the subsidiaries lacked nexus with Virginia. It determined that the sole reason for placing the property in Virginia was create nexus artificially and to allow the subsidiaries to be included in the taxpayer’s consolidated return, thus using the subsidiaries’ NOLs to lower the taxpayer’s Virginia taxable income. The Commissioner based its determination on the following reasons: (1) the subsidiaries were the only out-of-state subsidiaries that incurred significant NOLs; (2) the tangible personal property was placed in Virginia in the last half of the last month of the taxable year; (3) the property had a relative minimal value; (4) the rental rate was low; and (5) the property was

stored in warehouse space owned by a related party.

## **PUBLIC CONTRACTING NEXUS**

### **GEORGIA:**

Ga. Code Ann. § 50-5-82 (2004).

- i. Effective May 13, 2004, state agencies are prohibited from entering into a contract for goods or services, or both, for amounts exceeding \$100,000.00 with a nongovernmental vendor if the vendor or an affiliate of the vendor is a dealer as defined by Georgia law, but fails or refuses to collect sales or use tax on sales delivered to purchasers in Georgia.
- ii. In addition, the statute provides that “[p]rior to awarding a contract, the Department of Administrative Services and any other state agency to which this article applies shall provide the Department of Revenue the name of the nongovernmental vendor awarded the contract, the name of the vendor’s affiliate, and the certificate of registration number as provided for under Code Section 48-8-59 for the vendor and affiliate of the vendor.” Ga. Code 50-5-82(e).
- iii. A “dealer” is defined under Georgia law to include an out-of-state mail order seller that solicits sales via catalogs. A “dealer” includes a company that “[s]olicits business by representatives or engages in the regular or systematic solicitation of a consumer market in this state by the distribution of catalogs, periodicals, advertising fliers, or other advertising....” Ga. Code 48-8-2(3)(H).

### **NEW YORK:**

N.Y. Tax Law § 5-a (2004).

- i. New York amended its public procurement laws to include a public contracting nexus provision, effective for bids and contracts solicited on or after January 1, 2005. The new law requires certain persons seeking to enter into contracts with state agencies or public authorities to certify that they, their

affiliates, their subcontractors and the affiliates of their subcontractors have a valid certificate of authority to collect New York state and local states and compensating use taxes. Those subject to the law must make this certification before any New York public contract can be approved or renewed. If the contract has a term of more than one year, the certification must be *done* annually.

- ii. The requirement arises if the total amount of such persons’ sales delivered into New York State exceeds \$300,000, and with respect to any affiliates, subcontractors, or affiliates of subcontractors whose sales delivered into New York State exceed \$300,000. This requirement, however, only applies individual contracts or agreements with state agencies or public authorities having a value in excess of \$15,000.
- iii. There are limited exceptions which permit public contracting in situations where it has been determined in writing that the contractor is the only person capable of performing the contract and the contract is necessary to (1) address an emergency; (2) ensure the provision of essential services; and/or (3) ensure the public health, safety and welfare.

### **WISCONSIN:**

Wis. Stat. § 16.75(10m) and § 77.66

- i. Under § 16.75(10m), Wisconsin state agencies and authorities cannot purchase any materials, supplies, equipment, or contractual services from a vendor, if the vendor and its affiliates are not registered, collecting, and remitting Wisconsin sales or use tax on sales of tangible personal property and taxable services in Wisconsin. Under § 77.66, the Secretary of Revenue is required to periodically certify to the Secretary of Administration the names of vendors and their affiliates who are not properly registered and remitting Wisconsin sales or use tax.
- ii. An “affiliate” means a business that controls, is controlled by, or is under common control with another business.

Control means to own, directly or indirectly, more than 10% of the interest in or voting securities of a business. Wis. Stat. § 16.70.

- iii. A vendor and/or its affiliates who qualify to sign an Affidavit of Exempt Sales (a certification that all sales the business makes in Wisconsin are exempt from the Wisconsin sales and use tax) are not required to register for the collection of Wisconsin sales or use tax and are exempt from the § 16.75(10) prohibition. Examples of exempt sales are sales for resale, sales to governmental units, sales to exempt organizations, and sales of non-taxable services. They do not include sales of tangible personal property or taxable services on which a business does not collect tax solely because it does not have nexus with Wisconsin.

### **THE WHISTLEBLOWER CASES**

Nexus issues have also appeared in private *qui tam* or “whistleblower” suits, which are private nexus enforcement actions brought by a law firm hoping to recover a percentage of any tax found to be due and owing by an internet or mail order company with a retail affiliate in the state.

Over the past several years, the law firm of Beeler, Schad & Diamond (“Beeler, Schad”) initiated several hundred private lawsuits in Tennessee, Illinois and Nevada against remote sellers under state false claim acts, seeking to recover uncollected use tax on sales made over the internet and through catalogs. The underlying assumption is that each out-of-state retailer making internet or catalog sales had nexus in the state because each was affiliated with an in-state “bricks and mortar” retail store. According to Beeler, Schad’s theory, the retailers made false claims against the state when they failed to collect tax on their remote sales. The basis of these cases is found in state versions of the Federal False Claims Act, 31 U.S.C. §§ 3729-3733 (“FCA”) under which a fraudulent attempt to reduce the amount owed to the Government constitutes a false claim.

The *Qui Tam* Litigation:

### **TENNESSEE:**

- i. According to the complaint filed by Beeler, Schad, the retailers made “false” statements (on their website, order confirmation forms and invoices, all of which truthfully reflected the fact that no tax was being collected) that were designed to “conceal, avoid, or decrease” the retailers’ obligation to remit tax on internet and catalog sales. Beeler, Schad alleged that the retailers perpetrated false claims when they sold goods to Tennessee residents over the internet and through catalogs but did not collect Tennessee sales and use tax on these sales.
- ii. The Tennessee Attorney General opposed the suit and filed a motion to dismiss the complaint. The Attorney General argued that the Tennessee FCA was not the appropriate procedural vehicle within which to raise such claims and indicated that the activities at issue did not constitute a “false claim” within the meaning of the Tennessee FCA. On December 1, 2003, the Tennessee Chancery Court adopted the Attorney General’s arguments “in their entirety” and dismissed the *qui tam* actions. The court held that Tennessee’s tax enforcement statutes provided the exclusive remedy for determining liability for state taxes, and further noted that the Tennessee FCA conflicted with these tax statutes because it did not contain the important procedural safeguards inherent in the taxing statutes.
- iii. Beeler, Schad did not appeal the decision. The Tennessee FCA was subsequently amended in 2003 to specifically exclude any kind of state tax claim.

### **ILLINOIS:**

Illinois ex rel. Beeler, Schad & Diamond v. Ritz Camera Centers, Inc., No. 02 L 869 (Cir. Ct. Ill. Cook County Jan. 13, 2005).

- i. Between September 2001 and May 2003, Beeler, Schad filed sixty separate lawsuits

under the Whistleblower Act against internet and catalog retailers in Illinois. The complaints alleged that the retailers, through their out-of-state operations, made sales to Illinois residents over the Internet and/or through catalogs, and that the retailers had failed to collect and remit use tax on these sales. In September 2003, the Illinois Attorney General supported these actions, intervened and took over primary responsibilities of the cases as the plaintiff.

- ii. The retailers filed their motion to dismiss based upon six theories of legal deficiency, two of which were directed at establishing that the whistleblower cases deprive them of the rights, procedures and remedies guaranteed by the Illinois tax statutes, and that the Whistleblower Act is not, and was never, intended to apply to tax matters.
- iii. Judge Ronald F. Bartkowicz, however, denied the retailers' motion to dismiss. Although the court recognized that the Whistleblower Act differs from the statutory procedures set forth in Illinois tax statutes, it held that discrepancies between the Whistleblower Act and Illinois tax statutes, standing alone, are insufficient grounds to grant dismissal. The court further ruled that the procedures contained in the two Acts are functionally equivalent, and therefore the procedures set forth in the Whistleblower Act did not deny nor limit the retailers' rights. The court also disagreed with the retailers' argument that the Whistleblower Act was never intended to be applied to use tax matters, reasoning that the Illinois Whistleblower Act, unlike the FCA, failed to disallow tax matters to be included under its guise. The court stated that if the State legislature wanted to exclude use tax matters from inclusion under the

Whistleblower Act, it had the chance to so, and had not done so. Accordingly, the court denied the retailers' motion to dismiss.

#### NEVADA:

- i. Beeler, Schad also filed similar claims. Nevada's Attorney General filed a motion to intervene, consolidate and dismiss on November 24, 2003. No decision has yet been issued.
- ii. Since the motion was filed, a Nevada district court issued an opinion in a non-nexus tax case that had been filed under Nevada's Whistleblower laws. *Nevada ex. rel. McAndrews v. Int'l Game Tech., Inc.*, No. CV03-01329 (Washoe County, 2d. Jud. Dist. 2003), a former employee of a Nevada gaming company filed a *qui tam* action against the company, claiming that it had avoided paying up to \$30 million in sales and use taxes since 1997. The former employee had alleged direct fraud on the grounds that the company knowingly accepted resale certificates from an unregistered company for purchases that the company knew were not for resale.
- iii. Nevada's Attorney General argued that the Nevada False Claims Act was the wrong vehicle for resolving these issues, pointing out that entertaining the suit would usurp the Department of Revenue's authority, erode procedural safeguards designed to protect taxpayers, and undermine the uniform tax collection procedures under Nevada laws. However, on July 1, 2004, the judge denied the motions to dismiss, and ruled that Nevada's False Claims Act can be applied to tax cases.
- iv. Although tax matters are not *per se* barred from whistleblower suits in Nevada, it is unclear whether a court would be willing to entertain affiliate nexus actions of the type filed by Beeler, Schad since arguably the actions do not involve direct allegations of fraud. ☒



## Follow The Four R's: Maine's Guidance On Gift Certificates As Abandoned Property

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In an unpublished opinion, the Maine Attorney General's Office (the "Attorney General") has issued guidance to the Maine State Treasurer regarding the treatment of purchased gift certificates (as opposed to free promotions) under Maine's abandoned property regime. The Attorney General noted that the relevant legal principles have been summarized by the Abandoned Property Division as the four "R's" when it comes to a business' alternatives with respect to gift certificates. They are: (1) R-redeem (to make the customer happy); (2) R-refund (the purchase price paid); (3) R-re-issue (the face value in a new gift certificate); or (4) R-report and remit (to the State).

On its face, the transaction between a business and a purchaser of a gift certificate is a simple contract. The purchaser pays the business a certain sum in exchange for the business' future delivery of either goods or services to a third party "holder" upon presentation of the certificate. If the holder does not timely redeem the gift certificates, the issuer should select and follow one of the four "R's."

### **Maine Law Does Not Prohibit Expiration Dates, But The Attorney General's Opinion States That Expiration Does Not Preclude Property From Being Presumed Abandoned**

The Attorney General specifically noted that there is no law in Maine that prohibits a business from indicating on the face of a gift certificate that it is time limited, or in other words, will expire within a certain period of time. One reason why a business may want to include an expiration date in its gift certificate include the business' desire to insure that the purchase price of the certificate is at least somewhat equivalent to

the value of the goods or services to be redeemed by the owner of the gift certificate.

According to the Attorney General, even though a business and the purchaser of a gift certificate may contract to time limit the use of the certificate, the business may not exploit the failure to use the certificate as a basis for claiming ownership of the monies used to purchase the gift certificate. Because no goods or services have been exchanged for the gift certificate, the business has no ownership right to the monies used to purchase the gift certificate. Rather, the donee of the certificate is entitled to a refund of the purchase price.

Moreover, the Uniform Unclaimed Property Act ("UPA") to which Maine ascribes provides, in M.R.S.A. § 1970(I):

The expiration . . . of a period of limitations on the owner's right to receive or recover property, whether specified by contract, statute or court order, does not preclude the property from being presumed abandoned or affect a duty to file a report or to pay or deliver or transfer property to the administrator as required by [the UPA].

Based upon this statutory provision, the Attorney General opined that, although the time bar may be enforceable against use of the gift certificate, it will not preclude the State from recovering the purchase price from the business as abandoned property. Under M.R.S.A. § 1953(1)(G), a gift certificate is presumed abandoned if it is not claimed by the apparent owner within 3 years after December 31 of the year in which the certificate was sold. The amount, once recovered, is held by the State in perpetuity for the purchaser.

**Maine Permits Dormancy Charges, But The Issuer May Remit Only 60% Of The Price Paid If No Dormancy Charge Or Limitations Period Is Imposed.**

The Maine statutes generally provide that the amount presumed abandoned is the price paid by the purchaser for the gift certificate. If the issuer does not impose a dormancy charge or period of limitations on the donee's right to redeem the certificate, the amount presumed abandoned under M.R.S.A. § 1953(1)(G) is 60% of the certificate's face value.

A dormancy charge is a charge made by the issuer of a certificate against the donee of a certificate which is imposed should the donee attempt to redeem the certificate after its expiration date. The Attorney General concluded that the 60% rule of § 1953(1)(G) was intended by the Maine Legislature as an inducement to issuers of gift certificates to not impose dormancy charges or expiration periods.

**Generally**

A business holding property presumed abandoned in Maine must make an annual report of such property to the Administrator of the Abandoned Property Division of the Office of

State Treasurer. The report must be filed before November 1<sup>st</sup> of each year and must cover the 12 months next preceding July 1<sup>st</sup> of that year. For property valued at \$50 or more and for which the business has an address for the purchaser, notice must be sent by holders of property presumed abandoned not more than 120 days nor less than 60 days before the property is reported to the State. Upon filing the report, the business may also turn over the property identified in the report to the Administrator, who is required to hold the property for the owner.

**Best Practices**

Abandoned property claims are fast becoming a much more prevalent method by which state revenue agencies attempt to generate additional income. Issuers of large amounts of gift certificates should closely check the abandoned property provisions of each state where certificates may be issued or sold. Issues such as whether a certificate may be issued with an expiration date, the effect of a gift certificate's expiration relative to the business' obligations, as well as the state prescribed period after which property may be presumed abandoned, should all be addressed.☒

Frank and Ernest



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## Title Company's Policy Of Transferring Dormant Funds To Income Results In Damage Award In California False Claims Action

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A California title company's blatant disregard of its obligations under California's unclaimed property law through the transfer of dormant funds into income recently resulted in an award of damages to California under the California False Claims Act.<sup>1</sup> Calif. Gov. Code § 12650.

### Facts

Old Republic Title Company ("Old Republic"), a title company licensed by the California Department of Insurance ("DOI"), provided title escrow services for real estate transactions in California. Old Republic received funds from purchasers, sellers, borrowers and lenders and disbursed funds at the close of escrow. Dormant funds accumulated in Old Republic's escrow account either because customers failed to instruct Old Republic to disburse all funds or did not cash checks issued by Old Republic. Instead of filing reports and remitting the dormant funds to the California Controller ("Controller") as required by California unclaimed property law, Old Republic recognized these dormant funds as income and transferred them to its general fund. See Calif. Code Civ. Proc. §§ 1530 and 1532, subd. a.

Old Republic's auditors, Pricewaterhouse Coopers LLP ("PWC"), knew about Old Republic's policy of transferring dormant funds to income and recommended that Old Republic evaluate its escrow accounts to insure compliance with the California unclaimed property law. Despite Old Republic's failure to revamp its practices to comply with unclaimed property law, PWC

issued an unqualified, "clean" audit opinion letter which Old Republic submitted to DOI.

DOI audited Old Republic's business practices and found that since 1980, Old Republic had moved dormant funds from its escrow accounts to its general fund. Further, Old Republic did not file any unclaimed property reports or remit any dormant escrow funds to the Controller until 1992. The unclaimed property reports filed understated the amount of unclaimed funds held by Old Republic. After the City and County of San Francisco ("City") filed a False Claims Act complaint against Old Republic, Old Republic paid additional unclaimed funds plus interest to the Controller.

### False Claims Act Cause Of Action In Trial Court

Old Republic conceded liability for its failure to remit unclaimed dormant funds to the Controller, and the Trial Court awarded damages to the City. Old Republic appealed, asserting that the City lacked standing to bring the False Claims Act ("FCA") action because the City was not a "person" within the FCA. Old Republic also asserted that the allegations upon which the FCA action was based were publicly disclosed prior to the FCA action and barred the City's claims.

### Court Of Appeals Finds City Can Bring FCA Cause Of Action

The Court of Appeals rejected Old Republic's claim that the City could not bring the FCA action, finding that the term "person" in the FCA was

<sup>1</sup> The False Claims Act authorizes lawsuits to recover misappropriated government funds by (1) the Attorney General, with respect to claims involving state funds or both state and local funds; (2) the prosecuting authority of a "political subdivision" for claims involving local funds or both local and state funds; and (3) "a person" for claims involving state or local funds. Calif. Gov. Code § 12652 subd. (a)(1), (b)(2) and (b)(3). This action was brought by the city and county of San Francisco.

not limited to private actors. Further, the Court of Appeals found that public disclosure requires an affirmative act of disclosure and that disclosures made by Old Republic's Chief Financial Officer, Donald Barr, during his criminal proceedings were not public disclosures that precluded the FCA action.

### **Court Of Appeals Affirms Trial Court's Award Of Damages**

In the Trial Court, Old Republic conceded liability based on Mr. Barr's submission of false holder reports to the Controller which concealed Old Republic's failure to deliver unclaimed funds. The City claimed that the measure of the damages should be trebled and include the underreported unclaimed property obligation plus the mandatory 12% interest required under California unclaimed property law. Cal. Code Civ. Proc. § 1577.

Old Republic, however, asserted that because the unclaimed funds did not belong to California but were held for the rightful owners, California sustained no damages. The Trial Court held that California's damages were the loss of use of the underreported unclaimed funds during the time they were wrongfully withheld, plus the 12% statutory interest.

In Affirming The Trial Court's Determination Of Damages, The Court Of Appeals Held That:

Given [California's] continuing obligation to possible claimants and the absence of permanent escheat, plus the statutory purposes of the [unclaimed property law], we conclude that the act of reporting and transmitting less than is required thereunder implicates [California's] interest in the use of funds until reclaimed by their rightful owners, not the remitted funds themselves.<sup>2</sup>

Therefore, the Court of Appeals found that the damage to California was measured by the

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<sup>2</sup> The Court of Appeals noted that the unclaimed property has dual purposes: (1) to protect owners of unclaimed property by locating them and restoring their property to them; and (2) to afford the State, rather than the holder, the benefit of using the property.

<sup>3</sup> The Court of Appeals found that the materiality test requires the Court "to consider whether a statement could, under some set of foreseeable circumstances, significantly affect an action by a governmental department or agency."

loss of use, not the principal amount of the underreported unclaimed funds.

### **Court Of Appeals Finds That The Trial Court's Grant Of Summary Judgment In PWC's Favor On The FCA Cause Of Action Was Error**

The City also brought an action against PWC. Although PWC was aware of Old Republic's policy of clearing dormant funds and escrow accounts and re-routing them to Old Republic's operating income, PWC issued an unqualified "clean" audit opinion letter, which Old Republic submitted to the DOI. Based on this, the City brought an FCA action against PWC for allegedly submitting false audit reports that masked Old Republic's liability for unclaimed funds.

In order to succeed in its FCA action against PWC, the City was required to establish that PWC's omissions from the audit reports were material.<sup>3</sup> The Trial Court found that PWC's omissions from the audit reports were not material because full disclosure of Old Republic's unclaimed property violations by PWC to the DOI would not have influenced the DOI's actions. The Court of Appeals disagreed, finding that earlier discovery by DOI of Old Republic's unclaimed property violations through accurate audit reports would have influenced the DOI's action and resulted in Old Republic's unclaimed property violations being reported to the Controller for investigation. Thus, PWC's submission of false reports was material, and the Court of Appeals found that PWC was not entitled to summary judgment.

### **The Moral Of The Story**

This case is an example of what can befall a company that ignores its obligations under unclaimed property law. The short term gain reaped by Old Republic taking unclaimed funds into income was quickly dissipated by the damages in this case, not to mention the costs of litigation! ☒



## The Streamlined Sales Tax Project - Amnesty Rules

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### Overview

As of January 2005, in connection with the Streamlined Sales Tax Project (the "SSTP"), twenty-one states have enacted all or part of the conforming legislation in compliance with the Streamlined Sales And Use Tax Agreement (the "SSTP Agreement"). As of August 2004, the Implementing States Co-chairs believed the following 18 states have passed amendments to their laws sufficient to be in substantial compliance with the SSTP Agreement: Arkansas, Indiana, Iowa, Kansas, Kentucky, Minnesota, Nebraska, Nevada, North Carolina, North Dakota, Ohio, Oklahoma, South Dakota, Tennessee, Utah, Vermont, West Virginia, and Wyoming.<sup>1</sup>

By its terms, the SSTP Agreement will come into effect after at least 10 states comprising at least 20% of the population of all states imposing a state sales tax have been found to be substantially compliant with the terms of the SSTP Agreement. While the SSTP Agreement has been expected to be effective on October 1, 2005, recent developments in several states have put his timeline at risk: Minnesota moved to have the SSTP Agreement amended to give it until July 1, 2007, to adopt the uniform health care definitions; a bill with strong support in the Ohio Legislature would phase in the destination sourcing rules for small businesses over several years; numerous bills pending in the Tennessee Legislature would delay, to varying extents, Tennessee's conformity date;

and the Utah Governor is expected to sign any day legislation that will delay the state's conformity with the sourcing rules until July 1, 2006, from the current July 1, 2005.<sup>2</sup>

Once the SSTP Agreement becomes effective, qualified sellers will receive complete amnesty for past sales tax collection in every participating state.

### What Is The Streamlined Amnesty?

Section 402 of the SSTP Agreement provides that once a qualified seller registers to pay or to collect sales and use tax in a state, the state must waive the seller's liability for previously uncollected or unpaid sales taxes together with penalty or interest. Further, the streamline amnesty will be provided by any additional state that joins the SSTP Agreement after the seller has registered.

For a seller to qualify for the streamlined amnesty, the following requirements must be satisfied: (i) the seller is not registered in the state in the 12-month period preceding the effective date of the state's participation in the SSTP Agreement, (ii) the seller's registration occurs within 12 months of the effective date of the state's participation in the SSTP Agreement, (iii) the seller has not received any notice of an audit from the state, and (iv) the seller must continue its registration and payment or collection of applicable sales or use taxes for at least 36 months.

<sup>1</sup> See Report On The Streamlined Sales Tax Implementing States And Its Conforming States Committee, September 2004, available at <http://www.ncsl.org>.

<sup>2</sup> See Daniel Schibley, *Logjam Broken at SST Meetings; Two-Tiered Membership Floated*, CCH State Tax Daily (Mar. 11, 2005).

The streamlined amnesty is not available for taxes already collected, paid, or remitted by the seller. The amnesty is applicable only to sales or use taxes due from a seller in its capacity as a seller, not in its capacity as a buyer.<sup>3</sup>

### **When Will The Streamlined Amnesty Be Effective?**

Although some conforming legislation enacted by the states in compliance with the streamlined amnesty rules are already in effect,<sup>4</sup> it is somewhat unclear when the 12-month amnesty period, a key element of the streamlined amnesty, begins. The streamlined amnesty rules cannot be fully effective without a specific date specifying when the 12-month amnesty period will start running. Since section 402 of the SSTP Agreement expressly provides that the 12-month streamlined amnesty period does not start running until “the effective date of the state’s participation in the SSTP Agreement,” most conforming legislation provides that the 12-months amnesty period begins on the effective date of that state’s participation in the SSTP Agreement. However, some state laws provide a specific start date. For instance, Utah’s statutes provide that the 12-month streamlined amnesty period will start running on July 1, 2005.<sup>5</sup> Since no one can guarantee that Utah will become a member of the SSTP Agreement by July 1, 2005, the effect of the fixed date of July 1, 2005 is unclear.

### **Who Should Take Advantage Of The Streamlined Amnesty?**

To answer this question, a seller should list all the states into which its products or services are sold. A state should be crossed off the list if the seller has registered in that state or has received a notice of audit from that state. For the remaining states, where the streamlined

amnesty may be available sometime in the future,<sup>6</sup> the seller may have a tough decision: whether to file a Volunteer Disclosure SSTP Agreement (“VDA”) with the state now, or to wait until the state’s streamlined amnesty rules take effect and then register and take advantage of the streamlined amnesty.

Comparing these two options, the streamlined amnesty has the following advantages and disadvantages. The advantage of the streamlined amnesty is that while VDAs typically include a “look-back” period in which all back taxes must be paid to participate in the VDA, the streamlined amnesty does not have such a “look-back” period. Some states may also have more restrictive qualifications for a VDA.

The disadvantages of the streamlined amnesty include: (i) in exchange for the amnesty, the seller must begin collecting sales tax in each participating state where it makes sales,<sup>7</sup> (ii) it is uncertain whether or when the amnesty will become effective, and during such waiting period, the seller risks being assessed; and (iii) it is uncertain whether the information provided to the member states will be provided to nonmember states under information sharing agreements before those states become members of the SSTP Agreement, thus subjecting the seller to possible audit by those states.

Accordingly, sellers who should take advantage of the streamlined amnesty are those who are willing to take some risk in waiting for the SSTP Agreement to take effect, generally either because they have some strong nexus arguments against a state or because its potential tax liability is not substantial. The streamlined amnesty option will provide more value if the states on the seller’s list will likely become members of the SSTP Agreement soon. ☒

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<sup>3</sup> See the Streamlined Sales And Use Tax Agreement, available at <http://www.streamlinedsalestax.org>.

<sup>4</sup> See, e.g., Iowa Code § 423.54 (effective July 1, 2004); Okla. Stat. tit. 68, § 1354.24 (effective Nov. 1, 2003); W. Va. Code § 11-15B-13 (effective Jan. 1, 2004).

<sup>5</sup> Utah Code Ann. § 59-12-121.

<sup>6</sup> It be noted that some states may not become a member of the SSTP Agreement soon, and some states possibly will never become members of the SSTP Agreement.

<sup>7</sup> See section 401 of the SSTP Agreement, available at <http://www.streamlinedsalestax.org>.



## Georgia Legislative Update: Lawmakers Adopt Single-Factor Apportionment And Take Away Interest And Royalty Deductions

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In H.B. 191, 148<sup>th</sup> Gen. Assem., Reg. Sess. (Ga. 2005); H.B. 488, 148<sup>th</sup> Gen. Assem., Reg. Sess. (Ga. 2005), Georgia lawmakers approved a bill that would phase in single-factor apportionment by 2008 and add back deductions for expenses related to interest and intangible property paid to out-of-state affiliates. The Georgia Senate is also considering a bill adopted by the House that would affect a wide variety of tax provisions.

### **Phase-In Of Single Sales Factor To Apportion Income To Georgia**

H.B. 191's changes to the apportionment formula would benefit most of those companies with relatively large payrolls and asset interests in Georgia relative to sales in the state, which would typically include manufacturers.

The General Assembly adopted H.B. 191, which awaits Gov. Sonny Perdue's signature.

The corporate income tax currently uses a traditional three-factor formula (property, payroll, and gross receipts) that gives gross receipts double the weight of the other two factors. H.B. 191 would shift greater weight onto the gross receipts factor over two years and then move wholly to gross receipts as the single factor in 2008.

For tax years starting in 2006, gross receipts would receive 80 percent of the weight in the apportionment formula, and property and payroll factors would each receive 10 percent. For tax years starting in 2007, gross receipts would receive 90 percent of the weight, leaving 5 percent each for the property and payroll factors.

H.B. 191 would not change the customized apportionment formulas for airlines and credit card data processing companies. Airlines have

a specialized three-factor formula, and credit card data processing companies have a specialized formula with gross receipts as the sole factor.

### **Deductions For Interest And Intangible Property**

At the same time the General Assembly offers a tax break to certain in-state companies, it seeks additional tax revenue from companies that stored debt or intangible property in out-of-state affiliates. H.B. 191 disallows deductions for expenses and costs from interest and the use of intangible property that are paid to affiliates and related persons.

Taxpayers must add back the otherwise deductible interest and intangible property expenses before apportioning their income. Taxpayers that fail to make the add back face a penalty of 10 percent of the amount of the additional tax owed because of the failure.

The bill provides exceptions for certain transactions:

- If the affiliate pays an unrelated party for the same interest- or intangible property-related expense in the same tax year;
- If the affiliate's income from the transaction is apportioned to Georgia or another state imposing an income-type tax; and
- If the affiliate is domiciled in a foreign country that has a comprehensive income tax treaty with the United States.

Every corporation filing a Georgia return and every member of a consolidated group must apply the add back in its separate computation of taxable income. Each taxpayer is only required to add back an interest or intangible property-related expense once.

## **Senate Considers Omnibus Bill**

H.B. 488, titled the State and Local Tax Revision Act of 2005, would enact significant change to Georgia's tax code. Its provisions are so numerous and range so widely that only a portion of them can even be mentioned in a summary.

The House adopted the bill, and the Senate read it for the second time on March 21.

### **I.R.C. Conformity**

The bill is perhaps best known for updating conformity with the Internal Revenue Code, although the bill is much more than a conformity provision. If enacted, the bill would adopt the Internal Revenue Code as it existed on January 1, 2005, including enacted but not then effective provisions of the Code (which would become effective at the same time as under federal law). In addition to other I.R.C. provisions not recognized by Georgia, the bill would prevent recognition of I.R.C. section 199, which deals with the deduction for qualified production activities income.

### **Change In Standard For Imposition Of Georgia Tax**

The legislation would expand the corporate income tax's scope to include companies deriving income from sources within the state. Currently the corporate income tax only applies to companies doing business within the state and companies owning property within the state.

### **Commissioner's Power To Recompute Income**

The legislation would expand the Commissioner's ability to recompute a taxpayer's net income whenever a taxpayer acts to evade taxes, distort directly or indirectly true net income, or distort directly or indirectly the net income attributable to the state. The bill would also expand the situations in which the Commissioner could find evasion or distortion by including transactions with any related person rather than just with parties under "substantially common control."

## **Net Operating Losses For Corporations**

H.B. 488 would require a taxpayer who elected to forgo its federal carryback period for net operating losses to forgo the same for Georgia tax purposes. Also, the legislation would provide that interest would not be paid on refunds due to net loss carrybacks to years prior to the year in which the net operating loss was realized.

### **Government Contracts**

State agencies would no longer be permitted to award contracts for more than \$100,000 to nongovernmental vendors who fail or refuse to collect sales or use taxes on sales delivered to Georgia. County, city and regional governmental authorities would not be so restricted.

### **Add Back Of "Indirect" Interest Expenses**

Current law allows corporations to subtract from taxable income the interest and dividend income from the following sources:

- Federal bonds.
- Income from a domestic international banking facility.
- Income from banking business with parties outside the United States.

Individual taxpayers can also subtract interest and dividend income from federal bonds. However, taxpayers are required to add back any direct expenses attributable to the production of the interest or dividend income.

H.B. 488 would restrict the required add back to only *interest* expenses directly or indirectly attributable to the production of the interest or dividend income.

### **Exclusion Of Nonresident Employees**

The bill would restrict the class of nonresident individuals who can avoid taxation if their income from services performed in Georgia is low enough. Under current law, out-of-state individuals who earn 5 percent or less of their income from services performed in the state during the tax year are exempt from Georgia tax on that income. H.B. 488 would tack on the additional requirement for the exemption that the out-of-state employee could not earn more than \$5,000 for services

performed in Georgia. Also, the bill would clarify that the exempt services must be performed as an *employee* for an employer.

### Interest On Illegal Assessments

Interest will not be paid on erroneously or illegally assessed or collected tax if the taxpayer fails to claim an income tax credit on or before the extended due date for filing the applicable income tax return.

### EFT Payments

The bill would require the following parties with tax collection obligations to pay by electronic funds transfer:

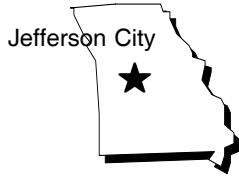
Parties required to collect use taxes if more than \$10,000 is owed.

Third-party payroll providers preparing or remitting withholding tax for more than 250 employers.☒



### Quitman Stephens, Spelling Bee Chief Judge

Spell-checker Quitman Stephens, former two-time regional champion and current-year Chief Judge for the 47th Annual Dallas Morning News Regional Spelling Bee, is pictured with the 2005 Spelling Bee champ, Nikhil Koganti from Collin County, Texas. Nikhil bested spellers from thirty-two counties in North and East Texas. Before spelling “glissade,” Nikhil correctly spelled “icosahedron,” which was misspelled by the runner-up. (Quitman’s 1984 and 1985 winning words were “pergelisol” and “banal.”) We wish Nikhil the best of luck in the 78th Annual National Spelling Bee, which will take place in Washington, D.C., June 1-2, 2005!



## Can Being Passive Be A Good Thing? Missouri Supreme Court Rules That Interest On Funds Invested By Out Of State Parent Is Nonapportionable Income

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In *Medicine Shoppes International, Inc. v. Missouri Director of Revenue*, Case No. SC85781, (Missouri 2005), 2005 Mo. LEXIS 10, the Missouri Supreme Court was asked to determine whether interest income earned by a Missouri based taxpayer pursuant to an investment agreement with its Ohio based parent corporation was includable in net income subject to Missouri apportionment.

Taxpayers in Missouri can elect one of two methods to compute their Missouri taxable income liability. The first method apportions income based upon the ratio that the taxpayer's sales within Missouri bears to the taxpayer's total sales. Under this single factor apportionment scheme, Missouri income is defined as all income from the transaction of business within Missouri, including that from the transaction of business partly done in Missouri and partly done in another state or states. These items of income are referred to as income from Missouri sources. This measure of the tax excludes income which is not at least partially from Missouri sources.

The second method by which Missouri taxpayers may elect to compute their Missouri source income is by utilization of the three factor formula found under UDITPA. Under this method, taxpayers calculate their apportionment percentage based on the ratio that the taxpayer's property, payroll and sales within Missouri bears to the taxpayer's property, payroll and sales everywhere. This apportionment percentage is then applied to the taxpayer's business income to arrive at Missouri source income.

Under UDITPA, all nonbusiness income is allocated under a different analysis. As a result, the inquiry of whether an item of income is "Missouri source income" is only relevant for taxpayers electing single factor apportionment.

Medicine Shoppes International, Inc. ("Medicine Shoppes") is a Delaware corporation with its headquarters in St. Louis, Missouri. Medicine Shoppes is a franchisor of retail pharmacies throughout the United States. It provides system and support services that enable its franchisees to run their retail pharmacy operations. In 1995, Medicine Shoppes became a wholly owned subsidiary of Cardinal Health ("Cardinal"), an Ohio corporation with its headquarters in Dublin, Ohio.

During 1997, Medicine Shoppes entered into an investment management agreement with Cardinal whereby any funds in Medicine Shoppes' bank accounts at the end of each day in excess of those funds needed for operating expenses were transferred to a Cardinal account designated as a corporate concentration account. Cardinal invested these funds on Medicine Shoppes' behalf. The invested funds remained the property of Medicine Shoppes, but Cardinal controlled the funds while in the corporate concentration account and made all investment decisions with regard to the funds. Pursuant to the investment agreement, Cardinal agreed to pay Medicine Shoppes interest on the funds.

In filing its 1998, 1999 and 2000 Missouri corporate income tax returns, Medicine Shoppes elected to calculate its Missouri taxable income utilizing the single factor apportionment formula authorized by the Missouri tax statutes. In filing these returns, Medicine Shoppes classified and reported the interest paid under the investment management agreement as non-Missouri source income that was not subject to Missouri taxation.

In refusing to accept Medicine Shoppes' Missouri returns filed on this basis, the Missouri Director of Revenue asserted that taxpayers that elected to apportion their income to Missouri by

use of the single factor apportionment formula are precluded from allocating any income prior to apportionment and that the Missouri Legislature intended to levy and apportion tax upon the electing taxpayer's entire net income. In deciding the case, the Missouri Supreme Court framed the issue as whether a corporation may exclude so called "passive" investment income earned on non-operating excess funds invested by the corporation's parent company in another state before applying the Missouri apportionment formula.

Under the Director of Revenue's theory, all income from whatever source derived was subject to apportionment under the single factor apportionment method. In contrast, the taxpayer argued that under single factor apportionment, differing types of income should be characterized as either attributable, at least in part, to Missouri sources or as deriving from sources wholly outside of Missouri. Those items of income that can be characterized as deriving from sources wholly outside of Missouri should not be included in the tax base subject to the single factor apportionment method.

In addressing these varying arguments, the Court noted that the language of Section 143.451 of the Revised Statutes of Missouri, which allows use of a single factor apportionment formula, is clear in that only income from sources entirely within or partially within Missouri are subject to Missouri corporate income taxes. Citing the Missouri Supreme Court's earlier decision in *Bass Pro Shops, Inc. v. Director of Revenue*, 746 S.W.2d 97 (Mo. 1988), the Court determined that the source of income has been defined as the place where the income was produced. The Court found further support for this proposition in its earlier decision in *Union Electric Co. v. Coale*, 146 S.W.2d 631 (Mo. 1940). In *Union Electric*, the Court held that dividends from stock on foreign corporations that had no capital or business operations in Missouri were not subject to Missouri income tax because the dividends were not Missouri source income. Central to this determination was the Court's finding, similar to that in *Bass Pro Shops*, that the source of income is the place where it was produced.

Finally, the Court took notice of its decision in *Brown Group, Inc. v. Administrative Hearing Commission*, 649 S.W.2d 874 (Mo. 1983), which applied the logic of the *Union Electric* case to the single factor apportionment formula and directly addressed the question of whether certain non-Missouri source income should be excluded from the net income amount in the formula. At issue in *Brown Group* was certain royalty income that Brown Group received from a Japanese corporation for the use of trade names, shoe designs and shoe patterns developed by a wholly-owned subsidiary of Brown Group. The Court held that the royalties were not subject to Missouri taxation since the royalties were earned wholly outside of Missouri as the trade names and manufacturing processes were used and the income was produced in Japan and other foreign countries.

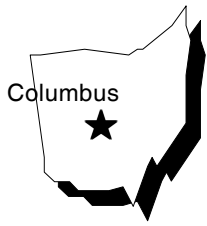
Applying these principles to the case at bar, the Court concluded that the investment income earned from Cardinal was not income from sales or business transacted within Missouri and was excludable from Medicine Shoppes' tax base in computing its Missouri corporate income tax liability. Apart from the Court's analysis of its prior decisions, the Court also found it significant that Medicine Shoppes' only decision relative to the investment funds was whether to terminate the investment agreement. The Court also found it highly persuasive that taxpayers in Missouri had been following the *Brown Group* holding for over 21 years and that the decision had not been overturned by subsequent legislation. Finally, the results of the *Brown Group* decision had been reflected in the Missouri Director of Revenue's corporate income tax forms in that they allow taxpayers to remove certain "non-Missouri source income," such as interest, dividends, royalties and rental income, from their income prior to application of the apportionment fraction. Based upon this tacit acknowledgement of the holding of *Brown Group* by the Missouri Director of Revenue, the Court felt compelled to rule that the investment income could be removed from the tax base before apportionment. Finally, the Court flatly stated that if the decision of *Brown Group* was not indicative of legislative intent, the proper forum for redressing such oversight

was with the Missouri General Assembly.

Taxpayers with operations in Missouri should closely examine each type of income earned during the tax year to determine whether any portion of that income may be classified as income that is not from Missouri sources. To the extent that such income can be attributed to operations outside of Missouri, such income is excludable from the Missouri tax base. In addition, taxpayers should examine all open prior years' returns to determine whether refunds of Missouri income tax may be obtained through classification of

some earnings as income that is not from Missouri sources. However, this method of excluding income only applies to taxpayers who have elected the single factor apportionment method provided in the Missouri Statutes. For those taxpayers who have elected to file based upon the three factor apportionment formula provided for in UDITPA, the inquiry is entirely different and should be based upon the principles of whether the income at issue is either business or nonbusiness income. ☒





## Ohio Department Of Taxation Revises Guidelines Regarding The Issuance Of Responsible Party Assessments For Direct Pay Permit Holders

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The Ohio Department of Taxation (“Department”) recently revised its guidelines regarding the issuance of concurrent responsible party assessments for direct payment permit holders only. A direct payment permit issued under R.C. 5739.031 allows a consumer to pay sales or use tax directly to the Department and waives the collection responsibility of a vendor or seller.

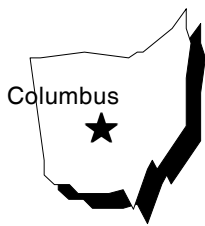
These guidelines are not published but are used by the Department in conducting its audits. In determining whether to issue concurrent responsible party assessments, the Department looks at the following factors:

1. Is a company in bankruptcy or experiencing financial problems?
2. Past return filing history. This takes into consideration the number of late returns and whether there were any bad checks or electronic funds transfer problems.
3. The company’s compliance on audit.
  - If a company’s compliance is 90% or above, no concurrent responsible party assessment will be issued.

- If a company’s compliance is between 80% and 90%, the Department will look at factors 1 and 2 and other facts to determine whether a concurrent responsible party assessment will be issued.
- If a company’s compliance is below 80%, the Department automatically issues a concurrent responsible party assessment and cancels the direct payment permit.

As a result of this change in its guidelines, the Department is requesting that direct pay permit holders complete a Responsible Party Questionnaire. Before disregarding the Department’s request to complete the questionnaire, please consider that R.C. 5739.031(E) allows the Tax Commissioner to cancel a direct pay permit “for cause.” Thus, if the questionnaire is not completed and returned to the Department, the Tax Commissioner may assert that such refusal constitutes “cause” and revoke the direct pay permit. ☒





## Ohio Valuation Of Personal Property In A Lump-Sum Transaction Involving A Complete Business, Division, Or Entire Plant

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The Ohio Department of Taxation has just issued an information release providing the valuation method to use for determining the true value of taxable personal property in the years after the establishment of a revised cost basis due to an arm's-length transaction. Such valuation method, however, only applies to transactions that revise the cost basis of an entire business or a major component thereof, such as a division, a plant, or a separate facility. *Property Tax Information Release PP 2005-01*, January 1, 2005.

### Background

Under R.C. § 5711.18, personal property used in business must be listed at its true value. True value of personal property is generally determined by using the composite *prima facie* annual true value percents prescribed by the Tax Commissioner. The application of the true value percents to historical costs of the property is often referred to as the "true value computation" or "302 Computation." Use of the "302 Computation" has been approved consistently by the Ohio Board of Tax Appeals and the courts for determining true value for personal property tax purposes.

### Effect Of Information Release

The release provides an alternate valuation method for calculating the true value of personal property acquired in a lump-sum transaction involving a complete business, division, or entire plant. Importantly, the release only applies to an arm's-length transaction, which the Department defines as one between unrelated entities where a willing seller (the seller is not compelled to sell) transacts with a willing buyer (the buyer is not compelled to buy). The Department's definition was derived from *Grabler Manufacturing Co. v.*

*Kosydar*, 43 Ohio St. 2d 75 (1975), in which the Ohio Supreme Court held that, "[f]or personal property tax purposes, the best method of determining value is the actual sale price of such property on the open market and at arms length, between one who is willing to sell, but not compelled to do so, and one who is willing to buy, but not compelled to do so." Thus, where an arm's-length transaction results in a revaluation of business or business component, the Department will require the valuation method in the release to apply.

The new valuation approach applies only to transactions occurring on or after January 1, 2004. For transactions occurring prior to that date, the Department will determine on a case-by-case basis the applicability of this valuation method. Also, property valued based on earlier memoranda issued by the Department will maintain such valuation, pending review on audit by the Department as to whether such valuation reflects true value.

Under the new alternate valuation method, the Department will calculate the average remaining composite (useful) life of the assets involved in the acquisition of an entire business or business component using the cost and years of acquisition recorded on the books of the seller of the assets immediately preceding the transaction. The remaining composite life then determines the conversion table to be used to determine the true value of the property acquired in the transaction. Importantly, the release specifically provides that the Department will not allow the true value of personal property, absent special circumstances, to be less than the minimum value as determined by the original prescribed class and original cost to the original

owner for the assets, in conjunction with the Department's "302 Computation."

The release revises the cost basis of only those assets involved in the lump sum transaction. As a result, valuation of assets acquired subsequent to the transaction is to be determined based on the Tax Commissioner's prescribed directive and Ohio Admin. Code §§ 5703-3-10 and 5703-3-11. In addition, the release provides that although other situations can occur that may potentially result in a revised cost basis, the Department will not accept the valuations resulting from these situations as a *prima facie* correct reflection of true value. Such situations include: 1) impairment; 2) "fresh start accounting" if the Department determines that the provisions of *Statement of Position* 90-7 issued by the American Institute Certified Public Accountants have not been strictly followed; 3) an independent appraisal that does not comport with the *Uniform Standard of Professional Appraisal Practice*; 4) an in-house appraisal; and 5) a transaction between related entities. In such situations, the taxpayer bears the burden of proving that the value established does reflect

true value, and is required to provide all necessary supporting documentation that led to the transaction or otherwise supports the taxpayer's opinion of true value. In cases where the Department determines that the true value of assets has been established by the taxpayer, the revised cost basis provisions of this release will be applied.

### **Calculation Of True Value Using The New Valuation Method**

Below is an example of an arm's-length transaction in which property was exchanged in July 2003 to be reported by the buyer in its 2004 tax return. The purchase price for the personal property was \$6,000,000. The seller is engaged in a Class Life V industry. Using the seller's costs and years of acquisitions, the remaining composite life of the assets is computed to be 7.62 years, which falls within Class Life II, according to the composite group table in the release. The true value of personal property for the buyer is then determined using the Class Life V to Class Life II conversion table percentages.

**[See charts on following page]**

**Seller's Diagram: Class V Assets Sold for \$6,000,000**

Year Acquired Column 1	Cost New <sup>1</sup> Column 2	Factor <sup>2</sup> Column 3	Factored Cost <sup>3</sup> Column 4	
2003	\$700,000	15.5	\$10,850,000	
2002	650,000	14.5	9,425,000	
2001	950,000	13.5	12,825,000	
2000	854,000	12.5	10,675,000	
1999	1,789,230	11.5	20,576,145	
1998	258,000	10.5	2,709,000	
1997	489,520	9.5	4,650,440	
1996	487,900	8.5	4,147,150	
1995	1,658,700	7.5	12,440,250	
1994	450,960	6.5	2,931,240	
1993	268,790	5.5	1,478,345	
1992	487,520	4.5	2,193,840	
1991	487,630	3.5	1,706,705	
1990 and Prior	4,685,980	2.5	11,714,950	Average Remaining Composite Life
<b>Total</b>	<b>\$14,218,230</b>		<b>\$108,323,065</b>	<b>7.62</b>
Class V Minimum	16.30%			
Minimum Value <sup>4</sup>	2,317,571			
Cost of Transaction	6,000,000			
Minimum % <sup>5</sup>	<b>38.63%</b>			

<sup>1</sup> Column 2 (cost new) represents the previous booked acquisition costs by year of acquisition.

<sup>2</sup> Column 3 (factor) represents the fixed mid-point of the group class life less the number of years held, considering that the asset was held for ½ year the first year.

<sup>3</sup> Column 4 (factored cost) represents the aggregate dollar-years of remaining useful life.

<sup>4</sup> Minimum Value = Original cost new of the acquired property x Minimum true value percentage for the prima facie correct (prescribed) cost life = \$14,281,230 x 16.30% = \$2,317,571.

<sup>5</sup> Minimum % = Minimum Value / Cost of Transaction = \$2,317,571 / 6,000,000 = 38.63%.

**Buyer's Table: True Value Calculation,  
Class V to Class II Assets**

Year of Tax Return	Cost <sup>6</sup>	Percentage <sup>7</sup>	True Value
2004	\$6,000,000	100%	\$6,000,000
2005	6,000,000	92%	5,520,000
2006	6,000,000	76.30%	4,578,000
2007	6,000,000	60.60%	3,636,000
2008	6,000,000	46.10%	2,766,000
2009 and Subsequent Years	6,000,000	<b>38.63%*</b>	2,317,571

\* True Value can never go below the minimum percentage.

<sup>6</sup> Assume no disposals in the years after the initial acquisition.

<sup>7</sup> The "Class V to Class II" percentages are contained in the conversation tables in the release.

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## “Cost Of Performance” Means All Such Costs, Not Just Costs Of Direct Performance



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In *General Motors Corp. v. Commonwealth of Virginia, Dept. of Taxation*, 602 S.E.2d 123 (Va. 2004), the Virginia Supreme Court recently rejected the Virginia Department of Taxation’s (the “Department”) regulation defining “cost of performance.” The regulation purported to interpret “cost of performance” for purposes of a statutory apportionment formula to include only costs of activities “directly performed” by a taxpayer. The regulation excluded costs of activities performed “on behalf of a taxpayer,” such as by an independent contractor. The Virginia Supreme Court rejected the regulation as inconsistent with the plain meaning of the statute, holding that cost of performance included all such costs, whether from activities directly or indirectly performed.

### Facts And Procedural History

General Motors Corporation (“GM” or the “Taxpayer”) sought corrections of Virginia corporate income tax assessments for tax years 1990 and 1991. GM argued that the Department erroneously disallowed third-party costs that GM had included in calculating the cost of performance ratio under Va. Code Ann. § 58.1-418 for determining the Virginia taxable income of the General Motors Acceptance Corporation (“GMAC”), a GM subsidiary doing business in Virginia. Disallowing the third-party costs increased the percentage of GMAC’s total income subject to Virginia taxation. The trial court agreed with the Department, and GM appealed.

### Practical Difficulties Of Determining Indirectly Performed Costs Unpersuasive To Court

The Court began its analysis by focusing on the statute, Va. Code Ann. § 58.1-418, noting that while the Tax Commissioner has the authority to issue regulations, a regulatory interpretation that is in conflict with the plain and unambiguous language of a statute cannot be sustained. Section 58.1-418 requires the taxable income of a “financial corporation”<sup>1</sup> to be determined by calculating the cost of performance attributable to operations in Virginia, divided by the total cost of performance of operations everywhere.<sup>2</sup> That ratio is then used to determine what portion of income is taxable Virginia income, such that for corporations like GMAC that do business within and outside the State, only income attributable to business conducted in Virginia is taxed by Virginia.

In 23 Va. Admin. Code § 10-120-150, the Department defined cost of performance for purposes of § 58.1-418 to include “the cost of all activities *directly* performed by the taxpayer for the ultimate purpose of obtaining gains or profit.” (Emphasis added.) The regulation excluded, however, the cost of “activities performed on behalf of the taxpayer, such as those performed on its behalf by an independent contractor.”<sup>3</sup>

GM argued that § 10-120-250 improperly narrowed the scope of § 58.1-418 to include only direct costs of performance in the ratio calculation. Had the General Assembly intended to limit the

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<sup>1</sup> § 58.1-418 provides for the apportionment of the Virginia taxable income of “financial corporations.” The parties stipulated that GMAC was to be considered a “financial corporation” for purposes of § 58.1-418.

<sup>2</sup> See Va. Code Ann. § 58.1-418.

<sup>3</sup> See 23 Va. Admin. Code § 10-120-150.

calculation only to such direct costs, it would have done so expressly. Because the term “cost of performance” has a plain and definite meaning, GM argued that the trial court erred in approving the Department’s narrowing of that meaning in § 10-120-250.

The Department countered that its interpretation in § 10-120-250 was both reasonable and consistent with § 58.1-418, claiming that while apportionment of a taxpayer’s direct costs can be “readily ascertained,” it would be difficult to properly apportion the cost of operations of third-party contractors “who could be located anywhere in the world and who may or may not choose to cooperate with the Department.” The exclusion of costs of activities performed on behalf of the taxpayer by third parties in the regulation, the Department claimed, was therefore a “reasonable limitation” on cost of performance consistent with § 58.1-418.

### The Court’s Ruling

The Virginia Supreme Court was not persuaded by the Department’s claims. Noting that the language of § 58.1-418 was clear and unambiguous, the court emphasized that cost of performance under the statute is cast in terms

of “cost of performance in” Virginia over “the cost of performance everywhere.” Nothing in this language, the court observed, limits the costs of performance to *direct* costs or suggests that the Department may properly exclude costs incurred for activities performed on behalf of a taxpayer by a third party.<sup>4</sup> The effect of § 10-120-250 was to exclude all indirect expenses of business operations from both a taxpayer’s cost of performance in Virginia *and* from its total cost of performance everywhere.<sup>5</sup> Such a narrowed definition of cost of performance, the court articulated, was inconsistent with the plain language of the statute. Despite the practical difficulties presented to the Department in determining whether third-party costs are to be ascribed to the taxpayer’s business operations in Virginia or elsewhere, the court held such to be a matter for the General Assembly.

The court overruled the Department’s exclusion from the cost of performance ratio of amounts paid by GMAC to third-parties, reversing the judgment of the trial court. The court then remanded the matter for correction of GM’s assessments for tax years 1990 and 1991.☒

<sup>4</sup> Emphasis added.

<sup>5</sup> Emphasis added.



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**Deloitte & Touche Center For Multistate Taxation At The  
University Of Wisconsin-Milwaukee**

**The Ninth Annual National Tax Conference**

**Milwaukee, Wisconsin  
June 16, 2005**

The Deloitte & Touche Center for Multistate Taxation at the University of Wisconsin-Milwaukee holds its Ninth Annual Multistate Tax Institute on Thursday, June 16, 2005, at the Hyatt Regency Milwaukee, 333 W. Kilbourn Avenue, Milwaukee, Wisconsin.

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For additional information, please call (414) 229-6519 or email [execprograms@uwm.edu](mailto:execprograms@uwm.edu)

*Congratulations to the University of Wisconsin at Milwaukee for making it to the "Sweet Sixteen" in the Men's NCAA basketball tournament this year!*

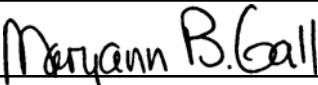


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