Working With New York’s New Combined Reporting Rules

New York Corporate Tax Reform: An Investment Fund Perspective

Ohio’s Business Income Deduction: Boon or Boondoggle?

How Mississippi ‘Invented’ the Sales Tax

If I Were a Rich Man

Evolutionary Nexus
Celebrity Doppelgängers

Tax wonks are all celebrities in our eyes, but some of our favorite tax practitioners happen to bear a striking resemblance to other people in the public eye.

Timothy P. Noonan
Hodgson Russ

Tom Cruise
Mission Impossible

Kay Miller Hobart
Parker Poe

Robin Wright
House of Cards

Kathleen K. Wright
Golden Gate University

Jane Seymour
Dr. Quinn

Matthew Hedstrom
Alston & Bird

Jimmy Fallon
The Tonight Show

James Busby
The Cavanagh Law Firm

Robert Patrick
Terminator 2

David Brunori
Tax Analysts

Harrison Ford
Star Wars

Jack Trachtenberg
Reed Smith

John F. Kennedy Jr.
Publisher, George

Lynn Gandhi
Honigman

Courtney Cox
Friends

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The Wonder Years

by Jéanne Rauch-Zender

Decades of research have demonstrated what happens to children during the critically important early years impacts not only their future success, but also the future economic strength and well-being of our communities and our state.

— Samuel J. Meisels, Buffett Early Childhood Institute, University of Nebraska

Nebraskans are shedding light on an issue that is critical to every state — investment in early childhood care and education. The state ranked the issue second among its educational priorities, just behind public schools, in a statewide survey conducted by Gallup and the University of Nebraska’s Buffett Early Childhood Institute. While the survey didn’t specifically address taxes, it addressed funding, finding that nearly all the residents surveyed want more taxes, private funding, and business support to improve early childhood care and education in the state.

The institute studies the first eight years of children’s lives, with a focus on children living in poverty or with developmental challenges, in an effort to prepare them for school. Although experts argue that the most formative years of life — when we acquire language skills, form relationships for the first time, build character, and develop cognitive skills — are from birth to age 8, most Nebraska residents think the state is not doing enough to ensure that early childhood care and education are available and affordable to every family in the state. Experts argue that without that preparation, children will continue to miss out on the opportunities and experiences afforded to their financially secure and socially stable classmates.

According to the institute, 42 percent of children in Nebraska grow up in poverty. Its goal is to be a voice for them. Statewide partnerships between universities, schools, governments, businesses, and citizens are needed to assist in eliminating this gap among children in Nebraska.

Commentary Highlights

On p. 33, Peter Faber of McDermott Will & Emery examines New York’s new combined reporting rules as presented in statutes, frequently asked questions from the Department of Taxation and Finance, and draft regulations.

Mark Engel of Bricker & Eckler LLP discusses the effect of Ohio’s myriad income tax changes over the past decade on business taxpayers, focusing on the small business deduction and its effect on the private sector (p. 47).

On p. 57, Deputy Publisher David Brunori discusses taxing the rich, as well as recent developments concerning tax incentives.

Roxanne Bland addresses the advancement of nexus, as states continue to explore every possible way to raise the revenue needed to provide services to their residents (p. 59).
FEATURED NEWS

Unclaimed Property Statute Not a Ponzi Scheme, Oklahoma Supreme Court Holds

by Stephanie Cumings — stephanie.cumings@taxanalysts.org

The Oklahoma Uniform Unclaimed Property Act (UUPA) doesn’t violate the Oklahoma or U.S. Constitution, nor is it a Ponzi scheme, the Oklahoma Supreme Court held March 29.

In Dani v. Miller, the court held that the UUPA doesn’t violate due process or effectuate a taking in violation of the U.S. Constitution. The court also rejected the argument that the state treasurer violates trust obligations to unclaimed property owners by transferring money into the state’s general revenue fund. There is “longstanding state and federal precedent upholding the constitutionality of state unclaimed property statutes,” the court said.

The outcome in this case is consistent with similar lawsuits brought by property owners in which courts have held that a state is not obligated to pay the owners the interest that accrued while the property was in state custody, Kendall Houghton of Alston & Bird LLP told Tax Analysts.

Diann Smith of McDermott Will & Emery agreed that the result wasn’t “terribly surprising given that the plaintiff received his property and there was not a change in the value of his property between when it was deemed abandoned and its return to him.”

Smith told Tax Analysts it was notable that the court didn’t reference a recent concurrence in a denial of certiorari in which two U.S. Supreme Court justices implied the Court might welcome challenges to state unclaimed property laws.

She also pointed out the Oklahoma Supreme Court’s finding that “the State has not legally pledged its full faith and credit to pay owners of abandoned property.”

“This is certainly a surprise to owners whose property is taken into ‘custody’ by the state — and makes the state statute seem less like a true custody statute,” Smith said.

In Dani, an unclaimed property owner filed a claim and received a check for $169 from the unclaimed property fund. He then filed a lawsuit seeking damages and other relief, which the trial court dismissed.

On appeal, the state supreme court upheld the dismissal. The court said that even if the UUPA creates a trust under Oklahoma law, the act would be the trust instrument that determines the treasurer’s obligations. The UUPA requires the treasurer to determine how money should be reserved in the unclaimed property fund and transfer the excess to the general revenue fund. The court found that because the treasurer was abiding by his obligations under the UUPA, he couldn’t have violated any trust obligations.

The court also rejected the contention that the UUPA is a Ponzi scheme because the unclaimed property fund isn’t sufficient to pay all potential claims and allows the treasurer to use new abandoned property to pay established claims. The court ruled that the UUPA wasn’t a “fraudulent investment scheme being perpetrated against the citizens of Oklahoma” and that the state wasn’t “deceiving new investors in order to pay valid claims.”

The UUPA “operates in such a manner that even if they must wait, owners of abandoned property with valid claims will always be able to eventually recover their previously presumed-abandoned property,” the court said.

Regarding the constitutional arguments, the court said the U.S. Supreme Court has “conclusively rejected the notion that legal termination of ownership rights in abandoned property constitutes a taking entitled to just compensation.” Similarly, the court said, presuming property to be abandoned because of the owner’s inaction or inattention isn’t an unconstitutional taking. The court said the same reasoning applies to the claims for interest.

“The State is not required to compensate a claimant for the consequences of their own neglect, and this includes interest their property might generate while temporarily in the custody of the State,” the court said, noting that other states have reached similar conclusions.

The court also said the due process requirements of notice and an opportunity to be heard don’t apply when a property right is terminated by operation of statute because of the owner’s failure to fulfill specific conditions. “It follows by extension that due process is not offended by the automatic transfer of abandoned property into the custody of the State Treasurer,” the state supreme court said.

The court said the procedural mechanisms to retrieve unclaimed property under the UUPA comport with due process requirements because the UUPA “provides ample notice to potential claimants of abandoned property,” including mailed notice, publication, and posting on the Internet. Further, the treasurer must consider claims filed within 90 days and may even hold hearings on a claim’s validity, the court said.

The state supreme court also said the UUPA doesn’t create a debt in violation of the state constitution because it doesn’t “bind future legislatures to appropriate money or otherwise raise funds to pay established claims under the UUPA.”

State Tax Notes, April 4, 2016

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NEWS ANALYSIS

Quill Continues to Shape Field Of State Taxation

by Amy Hamilton — amy.hamilton@taxanalysts.org

The extent to which Quill Corp. v. North Dakota still reverberates in the state tax world is astonishing, with an impact so pervasive that interesting asides and connections often go without comment.

Here are a few quick examples compiled during the news gathering process in March alone.

Quill Court Trio

Only three members of the Quill Court were still on the bench in 2015 when the U.S. Supreme Court handed down its opinion in Direct Marketing Ass’n v. Brohl (DMA): Justices Antonin Scalia, Anthony Kennedy, and Clarence Thomas.

“I wonder if these three justices who originally participated in Quill were ready to overrule it, and I wonder if the loss of Scalia is now going to affect that,” said Multistate Tax Commission Counsel Lila Disque during the MTC’s winter committee meetings on March 2-3.

The bullet points that led up to Disque’s comment were:

• Scalia — joined by Kennedy and Thomas — filed an opinion in Quill concurring in part and concurring in the judgment. Scalia agreed that the due process holding of National Bellas Hess should be overruled and that the commerce clause holding of Bellas Hess should not be overruled. However, Scalia said his adherence to the commerce clause holding of Bellas Hess would be based on stare decisis.

• Thomas wrote the majority opinion for the Supreme Court in DMA v. Brohl. Disque is among those who have interpreted the decision as narrowing Quill because, in determining that the Tax Injunction Act did not apply and that the Tenth Circuit had jurisdiction, the Court said Colorado’s notice and reporting requirements did not constitute a form of tax collection — Quill, of course, was about tax collection — but were activities that preceded tax collection.

• Kennedy wrote his now-notorious concurrence in DMA. “The legal system should find an appropriate case for this Court to reexamine Quill and Bellas Hess,” he wrote.

“We are now left with Kennedy and Thomas, and I am very, very curious about which way a Quill decision would go today,” Disque said, adding that it might be risky for states to bring a challenge when the result is unclear.

Disque also said he doubted that the DMA case would be the vehicle for challenging Quill, for several reasons — including the fact that Kennedy in his concurrence flat-out said that it is not the case to challenge Quill.

Negotiators

In the 1990s, the Direct Marketing Association and a contingent of state tax officials spent a few years trying to negotiate a solution to what at the time was called the ‘mail order’ issue. Despite being on opposing sides, two of those involved in the negotiations not only developed a close working relationship but are huge figures in the state tax world today: George Isaacson of Brann & Isaacson and Florida Revenue Director Marshall Stranburg.

Isaacson is the attorney who argued for the DMA at the Supreme Court, while Stranburg, who on April 1 will join the MTC as its new deputy executive director, worked with state tax officials to develop a solution.

“I remember that all fell through surprisingly and suddenly,” said Stranburg, adding that several state tax administrators had been en route to announce an agreement at a Madison, Wisconsin, press conference arranged by then-Gov. Tommy Thompson when they learned the effort was dead in the water.

Isaacson said that while the process did not ultimately result in an agreement, it was an opportunity to work closely with Stranburg, who he believes “possesses the very best qualities of a public servant.”

“Marshall has always been focused on achieving tangible results, and doing so in a manner that is fair and efficient for all parties involved,” Isaacson said.

Isaacson said state tax controversies have the potential of being contentious, “and there are many actors in this field, on both the private and government side, that can, at times, be obdurate and inflexible.”

“Marshall, on the other hand, has consistently searched for ways to avoid unnecessary impasses and advance the interests of the state through more reasonable, and considerably more successful, channels,” Isaacson said. “He has a broad and deep perspective on state tax issues, and has acquired an outstanding reputation among peers and professionals for his leadership and integrity.”

Quill Commissioner

While this next piece of information isn’t exactly a secret, the connection also isn’t common knowledge: U.S. Sen. Heidi Heitkamp, D-N.D. — a cosponsor of the Marketplace Fairness Act of 2015 (MFA, S. 698) — was North Dakota’s tax commissioner at the time of the Quill litigation.

That’s correct: Heitkamp as tax commissioner filed the action that became the Quill case, the Supreme Court in Quill said Congress has the ultimate power to resolve the issue, and now Heitkamp is in Congress cosponsoring such a resolution.

“The time to level the playing field for our local businesses is long overdue,” Heitkamp said in a prepared statement upon the 2015 reintroduction of the MFA. “There is no reason out-of-state sellers should have a leg up over our in-state businesses just because those transactions occur remotely.”
Heitkamp will be a featured speaker at the Federation of Tax Administrators’ 2016 annual meeting, which will be held June 12-15 in Annapolis, Maryland.

“From Quill to Today” is the working title of her presentation.

**Expedited Challenge?**

Emboldened by Kennedy’s concurrence in *DMA*, states are quickly drafting laws and regulations that could serve as potential vehicles for challenging *Quill*. The most recent example — South Dakota SB 106, enacted March 22 — is notable for two reasons: Its sponsor is state Sen. Deb Peters (R), a former president of the Streamlined Sales Tax Governing Board, and its provisions allow for expedited court consideration of its potential challenge to *Quill*.

Regardless of whether the state initiates an audit or other tax collection procedure, the new law allows the state to bring a declaratory judgment action in any circuit court against any seller it believes meets the criteria under state and federal law establishing an obligation to remit sales tax.

“The circuit court shall act on this declaratory judgment action as expeditiously as possible and this action shall proceed with priority over any other action presenting the same question in any other venue,” SB 106 says.

The state’s filing of the declaratory judgment action under the new law will operate as an injunction during the pendency of the action, prohibiting South Dakota’s enforcement of an obligation against any taxpayer who does not affirmatively consent or otherwise voluntarily remit the sales tax.

Any appeal from the decision regarding the cause of action established by the new law may only be made to the South Dakota Supreme Court. “The appeal shall be heard as expeditiously as possible,” the bill says.

Accompanying SB 106’s text are several additional paragraphs of legislative findings, which discuss why expeditious review is necessary and appropriate and say that the Legislature recognizes that enactment of the new law “places remote sellers in a complicated position, precisely because existing constitutional doctrine calls this law into question.”

“Accordingly, the Legislature intends to clarify that the obligations created by this law would be appropriately stayed by the courts until the constitutionality of this law has been clearly established by a binding judgment, including, for example, a decision from the Supreme Court of the United States abrogating its existing doctrine, or a final judgment applicable to a particular taxpayer.

“It is the intent of the Legislature to apply South Dakota’s sales and use tax obligations to the limit of federal and state constitutional doctrines, and to thereby clarify that South Dakota law permits the state to immediately argue in any litigation that such constitutional doctrine should be changed to permit the collection obligations of this Act,” according to SB 106.

**IN THE WORKS**

**Tax reform in Kansas: Myth vs. fact (State Tax Notes)**

Jonathan Williams and Joseph Horvath argue that while the Kansas tax cuts enacted in 2012 have been the target of widespread criticism and blamed for the state’s recent budget woes, spending is more to blame, and there’s evidence that the reforms are beginning to turn Kansas’s economy around.

**IBM — The prequel: The MTC election and the single business tax (State Tax Notes)**

Lynn Gandhi examines the Michigan Court of Appeals’ recent finding that the state’s Single Business Tax Act did not implicitly repeal the election of the Multistate Tax Compact by taxpayers and that the state’s Public Act 282 of 2014 did not bar taxpayers from refund claims.

**Taxpayer rights: Coping with globalization and uncertainty (Tax Notes International)**

Duncan Bentley redefines the terminology of taxpayer rights, explores the concept of pragmatic foundations of soft law, and shows that when the principles and legal rules that form the basis for protecting taxpayer rights are reinforced by a strong rule of law, rights expand through taxpayer engagement.

**A catalog of confusion — VAT repayments (Tax Notes International)**

Trevor Johnson discusses a long-running and complex appeal, involving four companies and a number of different VAT repayments, heard by the U.K. Supreme Court.

**A brief review of corporate tax articles of 2014-2015 (Tax Notes)**

Jordan M. Barry and Karen C. Burke review notable corporate tax law literature from 2014 and 2015, including an article on whether corporations should have to publicly disclose their returns in light of recent aggressive international corporate tax minimization strategies and the theory that public shaming could affect corporate behavior.

**Significant issue rulings leave lots to the imagination (Tax Notes)**

Jasper L. “Jack” Cummings, Jr., analyzes two letter rulings on spinoffs and is critical of one that involves the continuity of business enterprise requirement.
ALASKA

Governor Pushes Legislators To Move Forward With Tax Bills

by Paul Jones — paul.jones@taxanalysts.org

Gov. Bill Walker (I) has asked lawmakers to pursue his tax and revenue reform proposals during the remaining weeks of the legislative session.

“There are three things that must happen in 2016 to achieve the goal of a truly sustainable balanced budget,” Walker said in a letter to lawmakers. They are:

- reduced state spending;
- revenue reform that sends annual oil tax revenues to the state’s permanent fund and uses fund earnings for annual spending; and
- new revenues, including some form of a broad-based tax.

“I consider all these requirements written in pen; how they all come together, however, is still very much in pencil,” Walker said in the letter.

Falling oil prices have created major shortfalls in Alaska’s revenue. The state’s projected deficit for fiscal 2017 has grown from $3.5 billion to nearly $4 billion. Walker has proposed an ambitious reform to the state’s revenue model, broad reductions to tax incentives for oil companies, and a half-dozen tax increases, including reinstating an individual income tax equal to 6 percent of taxpayers’ federal liability.

But sources say lawmakers in the majority Republican state aren’t pursuing Walker’s initiatives with enthusiasm. Despite initial hearings, tax legislation hasn’t advanced, and a House committee more or less gutted Walker’s oil incentives bill (HB 247) on March 22. (Prior coverage: State Tax Notes, Mar. 28, 2016, p. 924.)

Walker has indicated to lawmakers that he could call a special legislative session if progress remains slow.

Walker’s revenue reform efforts have received some positive attention, however, and several lawmakers have proposed variations on the overall effort. In his letter, Walker suggested that he’s open to compromise on the specifics, and he included a list of criteria that a successful plan would have to meet, including that it be rules-based to avoid ad hoc use of state earnings, that it be sustainable, and that it shield the state from the volatility of the state’s oil tax revenues.

The Walker administration argues that waiting until next year to reform the state’s revenue model will have long-term repercussions for the state’s finances. “Without fiscal reform this year, we will continue to spend from our savings to fill the fiscal gap,” reducing the amount the state can produce through earnings in the long-term future, according to the administration.

While Walker’s push for reform faces challenges from Republican lawmakers, at least some of the independent governor’s efforts have support from Democrats. Revisions by Republican lawmakers to Walker’s oil industry tax incen-
CALIFORNIA

Administering Marijuana Taxes Could Be Unduly Burdensome, BOE Says

by Paul Jones — paul.jones@taxanalysts.org

As state lawmakers eye new medical marijuana taxes, the State Board of Equalization last week warned that administering those taxes could seriously burden the agency because of the industry’s lack of general access to banking services.

Following last year’s approval of a new, statewide regulatory regime, state lawmakers have proposed special taxes on medical marijuana, which is currently subject only to state sales tax and potentially to local taxes authorized last year by state lawmakers. (Prior coverage: State Tax Notes, Oct. 19, 2015, p. 196.)

SB 987, introduced by Sen. Mike McGuire (D), would create a medical marijuana excise tax equal to 15 percent of the sales price. AB 2243, authored by Assembly member Jim Wood (D), would impose a tax of $9.25 per ounce on cannabis flowers, $2.75 per ounce on leaves, and $1.25 per immature plant to be collected from cultivators by distributors.

BOE members raised several concerns about the bills without taking a position.

Board member George Runner (R) told Jason Liles, McGuire’s chief of staff, that receiving taxes collected at the point of sale as proposed in SB 987 would force the agency to deal with thousands of sellers and create an influx of cash. “Any given day . . . we’ve seen things like $400,000, $500,000 come in [to BOE offices] in duffle bags,” Runner said. Despite the BOE offices’ limited ability to handle such a volume of cash and the risk of attracting criminals, the proposed legislation could crank up that volume significantly, he added.

Although the federal government has released guidance in recent years that offers some protection for banks doing business with marijuana growers and sellers, stringent rules make banks wary of the industry. In effect, medical marijuana businesses remain a pariah and generally can’t use banking services, making them cash-only businesses. (Prior coverage: State Tax Notes, Aug. 10, 2015, p. 524.)

According to Liles, SB 987 could raise as much as $251 million a year if all businesses comply and would provide additional funding to the BOE of $5.4 million for fiscal 2017. However, board member Jerome Horton (D) contended that the state wouldn’t see full compliance and that the heavy presence of black market sellers would require substantial resources be allocated for tax enforcement.

Horton said sources estimate that the industry’s non-compliance would be at 60 to 70 percent. He urged the board to establish an enforcement task force and to allocate part of SB 987’s revenue to hire the necessary BOE staff, as well as beef up the resources of the attorney general’s office and other entities.

The BOE already struggles to collect state sales tax from medical marijuana dispensaries, in part because of businesses’ lack of banking and general compliance with tax rules, and because many operate illegally. (Prior coverage: State Tax Notes, Apr. 27, 2015, p. 262.)

Notably, Liles told the board, McGuire’s bill contains a provision that would make the bill’s excise tax void if a proposed ballot initiative to legalize and tax recreational marijuana qualifies for the ballot and passes in November. (Prior coverage: State Tax Notes, Dec. 21, 2015, p. 872.)

Lucent

Last week the board also heard from staff and the California Taxpayers Association (CTA) regarding the implementation of the court of appeal’s decision in Lucent Technologies Inc. v. State Board of Equalization, which determined that sales of software stored on physical media as part of larger technology transfer agreements are not subject to the state’s sales tax. The decision effectively overturned how the board has sought to tax the sale of physically stored software through such transactions. (Prior coverage: State Tax Notes, Oct. 19, 2015, p. 194.)

Robert Tucker, assistant chief counsel with the BOE, said the board should make changes to existing sales and use tax regulations regarding sales of software via physical storage media to reflect the decision. However, BOE staff argued that the decision isn’t broad enough to exempt most off-the-shelf retail sales of software, when the vendor is selling the storage media but doesn’t control the license.

Therese Twomey of the CTA urged the board to pursue modified regulations that aren’t too narrow in applying the ruling’s logic. For example, new rules shouldn’t “exclude things such as embedded software” like that which is loaded into a device prior to sale, she said. “Such an interpretation could lead to further litigation.”

Twomey argued that the board should make tax refund claims linked to the decision’s outcome simple and centralized. According to BOE staff, there are about 900 refund claims related to the board’s pre-Lucent approach to taxing the transfer of software via physical storage media but it is unclear how many can be addressed quickly by the BOE because they closely match the facts in Lucent, or would potentially have to be addressed in subsequent rulemaking.

The board voted to move forward with the process of implementing the Lucent decision based on staff recommendations and issue a notice to gain involvement from interested parties.
Ruling Could Exempt Tax Ballot Initiatives From Two-Thirds Rule

by Paul Jones — paul.jones@taxanalysts.org

Local grassroots ballot initiatives to raise taxes could be exempt from the California Constitution’s two-thirds majority rule for passing local special taxes in light of a recent appeals court ruling.

In a March 18 decision in California Cannabis Coalition v. City of Upland, the California Court of Appeal, Fourth Appellate District, held that some state constitutional rules for tax-related ballot measures — including a section of the constitution that requires a two-thirds majority to pass special taxes — didn’t apply to a measure in Upland because it was a citizen initiative.

Whether the Upland measure created a tax was disputed, but the court ruled that the restrictions cited by the city to justify barring it from a special election ballot apply only to government-sponsored measures. “Taxation imposed by initiative is not taxation imposed by local government,” according to the ruling. The court found that Article 13C, Section 2 of the state’s constitution — which includes requirements for local special taxes to be approved by a two-thirds majority — “does not apply because Article 13C is limited to taxes imposed by government, not by initiative.”

According to San Diego City Attorney Jan Goldsmith, that could mean other citizen-generated tax measures statewide, including two possible ballot initiatives to fund a stadium/convention center in San Diego, could pass with just a simple majority vote.

Goldsmith said the court was clear that the constitutional rules at issue don’t apply to citizen-backed initiatives, adding that although the ruling is “not necessarily the final decision . . . it certainly is persuasive coming from the court of appeal.”

The case involved a dispute over a ballot measure to allow medical marijuana dispensaries in the city of Upland. Under the measure, dispensaries would be subject to a $75,000 “annual licensing and inspection fee.” Backers wanted to put the initiative before voters in a special election, but the city decided the fee was actually a general tax that under California constitutional rules could be proposed in a ballot initiative only in a general election.

However, in deciding against Upland, the appeals court found that the constitutional requirements cited by the city apply only to tax measures put on the ballot by governments.

Goldsmith said the appellate court opinion could pose a legal question for San Diego, which he said is in the Fourth District. If one or both of the initiatives to fund a stadium and convention center by increasing the city’s hotel tax are placed on the ballot, San Diego may be the first city to implement the appellate court decision, Goldsmith said.

“We’re going to be faced with the question, ‘Is that a majority vote or a two-thirds vote [to pass]?”

Goldsmith said that if the opinion is challenged, the city would “be in the position of being unclear” on the law and would likely urge the appeals court or the California Supreme Court to expedite review of the opinion to clarify matters. “If there’s no petition to the supreme court . . . or [if] the court decides not to hear the case, we’re going to rely on this decision,” he added.

The two-thirds requirement for local tax increases has long been a source of frustration for cities. In July 2015, state lawmakers unsuccessfully pushed to reduce the threshold for transportation taxes. (Prior coverage: State Tax Notes, July 20, 2015, p. 224.)

David Kline, spokesman for the California Taxpayers Association, was critical of the appellate court’s decision, saying in an emailed statement that it “weakens taxpayer protections in the state constitution.”

“Money comes out of the taxpayers’ family budgets the same way regardless of whether the tax was proposed by a local government or through a local initiative,” Kline said.

‘Money comes out of the taxpayers’ family budgets the same way regardless of whether the tax was proposed by a local government or through a local initiative,’ Kline said.

Jon Coupal, president of the conservative Howard Jarvis Taxpayers Association, voiced skepticism that the court’s opinion would broadly affect the threshold requirement for special tax measures proposed by citizens. He said the issues in the case specifically addressed whether the cannabis dispensary charge was a tax or a fee and whether it should be voted on in a special or general election, not the overall two-thirds majority rule. The decision mentions provisions of the state constitution only as they concern the issues in the case, he said.

“It’s a well-known maxim of jurisprudence that cases [don’t have authority] for matters not considered,” Coupal said, arguing that the interpretation by Goldsmith and others is unwarranted. “The two-thirds requirement isn’t even mentioned.”

Also, according to Coupal, the public’s power to legislate through initiatives is coextensive with the legislature’s authority. A corollary to that is “if legislature can’t do it, then neither can the people,” he said.

“I think where the court may have made an error is in saying that the people’s initiative power can do something that the legislature cannot,” he said.

Goldsmith, however, argued that the court’s decision is in line with previous legal reasoning, citing as an example the state supreme court’s 1991 decision in Kennedy Wholesale Inc. v. State Board of Equalization. That opinion included reasoning by the court that the two-thirds majority
requirement for legislative tax increases didn’t apply to state
tax measures initiated by citizens.

However, Coupal said he expects the city will either
petition for an en banc rehearing or appeal to the state
supreme court. Although skeptical of Goldsmith’s interpr-
etation of the decision’s effects, Coupal acknowledged that
“some of the language is troubling” to tax increase oppo-
nents.

“We would also petition the [Fourth District] if they’re
not inclined to change their ruling, to decertify the opinion
for publication” so it couldn’t be cited — for example, by
San Diego — as precedent, Coupal said.

Coupal argued that in the event the opinion was upheld,
it could spur efforts by local government officials to pass
taxes through citizen-led ballot campaigns. “You’d immedi-
ately see collusion between local governments forming front
groups” to get initiatives on the ballot to take advantage of
the lower margin for passage, he said.

CONNECTICUT

Sales Tax Exemptions Cost State Billions
In Revenue, Group Says

by Stephanie Cumings —
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Eliminating sales tax exemptions, with the exception of
those for food purchases, could bring in an additional $2.5
billion a year in revenue for Connecticut, according to a
state policy group.

Despite significant tax increases in recent years, Con-
ecticut is still struggling with deficits, largely because of an
outdated and inefficient tax structure, the Connecticut As-
sociation for Human Services (CAHS) said on their website
last week.

The CAHS said the sales tax is a perfect example of those
outdated policies because it is focused on “raising money
from tangible products in an economy that is more and
more focused on services and ideas.”

“Connecticut’s tax code has a monumental amount of
carve outs, exemptions, loopholes, and special provisions
that leave a huge and increasing percentage of our economy
untaxed,” the CAHS said. “This means that a [person
buying a] diaper, sofa, or cell phone has to pay sales tax,
while things like repairing a boat, hiring an interior decor-
at, or going to the gym are untaxed.”

The sales tax accounts for about a quarter of the state’s
revenue, or slightly more than $4 billion, the CAHS said,
citing statistics from the Connecticut General Assembly’s
Office of Fiscal Analysis.

But many of the sales tax bills introduced during the
current legislative session would create more sales tax ex-
emptions, rather than eliminate them.

For example, HB 5494 would expand the sales and use
tax exemption on services rendered between parent compa-
nies and subsidiaries to include subsidiaries that are certain
stock corporations, partnerships, and limited liability com-
panies when the controlling interest in the subsidiary is
more than 50 percent. HB 5494 was approved last month
by the Joint Finance, Revenue and Bonding Committee and
sent to the Legislative Commissioners’ Office on March 29.

Other bills introduced during this session would exempt
water companies from the sales and use tax; eliminate the
sales tax on some parking fees, car wash services, and tem-
porary employment services; and exempt diapers and fem-
nine hygiene products.

Connecticut is dealing with major budget shortfalls.
Gov. Dan Malloy (D) last week signed bipartisan legislation
(SB 474) to close a $220 million budget shortfall for fiscal
2016, but an estimated $900 million deficit looms for the
next fiscal year.

Roger Senserrich, CAHS policy director, told Tax Ana-
lysts that SB 474 did not include any new revenue and said
he doesn’t expect much in the way of tax reform or legislation to increase tax revenue this session. However, he said, the legislature may not be able to avoid it next year with an even bigger deficit on the horizon, adding that he expects to see proposals to reduce the sales tax rate and broaden its application.

Lawmakers from both parties praised SB 474, which according to a news release “preserves core government services and protects funding for many vital social services,” despite budget cuts.

“This bipartisan package will preserve funding for the most vulnerable in the state, protect our towns from painful cuts, restore funding to our hospitals to care for the sick and elderly, and make the appropriate level of cuts to balance the budget and initiate savings for future years,” Senate Minority Leader Len Fasano (R) said in a statement.

FLORIDA

**Governor Courts Yale University To Relocate**

*by Jennifer DePaul — jennifer.depaul@taxanalysts.org*

Florida Gov. Rick Scott (R), like thousands of others this spring, has been turned down by Yale University.

The governor called on the Ivy League school March 29 to consider relocating its operations to Florida, promising the state wouldn’t tax the university’s $25.6 billion endowment as some lawmakers in Connecticut have proposed.

“With news that the Connecticut Legislature wants to unfairly tax one of the nation’s most renowned universities to deal with the state’s budget shortfall, it is clear that all businesses in Connecticut, including Yale, should look to move to Florida,” Scott said in a statement. “We would welcome a world-renowned university like Yale to our state and I can commit that we will not raise taxes on their endowment. This would add yet another great university to our state.”

But Yale was not impressed with Scott’s pitch.

“It’s wonderful to be recognized as an outstanding asset, but Yale, New Haven, and Connecticut have been on common ground to great mutual benefit for 300 years,” Tom Conroy, the university’s press secretary, said in a statement. “We’re looking forward to reaching even greater heights in education, research and civic engagement over the next three centuries and more.”

At issue are two Connecticut bills (SB 413 and SB 414) that would impose, respectively, the state’s unrelated business income tax on part of the endowment funds of independent institutions of higher education and eliminate a tax exemption for university real estate and equipment valued at more than $2 billion in the aggregate if they generate more than $6,000 in annual income. (Prior coverage: *State Tax Notes*, Mar. 28, 2016, p. 928.)

Lawmakers have proposed the bills to help close the $266 million budget deficit in the current fiscal year and the estimated $900 million deficit for the next fiscal year.

Yale University makes a voluntary payment of more than $8.2 million to the city of New Haven annually and has paid $96 million to New Haven voluntarily since 1991, according to Richard Jacob, associate vice president for federal and state relations for Yale.

And while the institution’s grounds themselves are exempt from property taxes, Yale pays property tax on its non-academic properties, totaling $4.5 million in 2014, according to Jacob.

The tax proposals come at a difficult time for Connecticut lawmakers, who are still reeling from the announcement this year that General Electric Co. is relocating its corporate headquarters to Massachusetts. (Prior coverage: *State Tax Notes*, Jan. 18, 2016, p. 182.)
While some called Scott’s courtship a crazy idea, Dominic Calabro of Florida TaxWatch told Tax Analysts that competition among the states is what the original founders intended, to help allow the United States to remain relevant, strong, and vital.

“If one state is too high in its taxes, other states can take up the slack and in effect force them to deal with solutions in a real-time manner and improve the conditions of all Americans,” he said.

While Scott’s courtship was a long shot, Floridians are thrilled because it shows that their state is truly open for business, Calabro said.

“We want to bring institutions that have assets and income, because the Sunshine State has better days ahead of us, not behind us,” he added.

GEORGIA

Lawmakers Fail to Agree on Income Tax Cuts Before Session Ends

by Eric Yauch — eric.yauch@taxanalysts.org

Georgia lawmakers failed to agree on proposed changes to the state’s corporate and individual income taxes before the March 25 end of the 2016 legislative session.

“The top-line takeaway from this session is more about what they didn’t do as opposed to what they did, because choosing not to pass the two income tax measures, HB 238 and SR 756, really were the most momentous decisions that the General Assembly made,” Wesley Tharpe of the Georgia Budget and Policy Institute (GBPI) said.

HB 238, approved by the Senate on a 35-17 vote, would have replaced the state’s progressive individual income tax rates with a 5.4 percent flat tax, eliminated the corporate net worth tax, and raised the allowable income tax exemption for filers. (Prior coverage: State Tax Notes, Mar. 21, 2016, p. 838.)

According to the GBPI, the individual income tax cuts under HB 238 would have favored higher earners. A fact sheet released by the group found that 80 percent of the state’s households with annual incomes below $100,000 would see only $90 or less in tax cuts but that households with incomes of over $100,000 a year would receive bigger cuts. The GBPI also said that the top 1 percent of earners — those making over $500,000 a year — would receive tax savings of up to $2,850.

SR 756 also died in the House. The measure would have let voters decide whether to amend the state constitution to allow for individual income tax rate reductions based on annual budget surpluses. The Senate approved the resolution in February by a vote of 39 to 17.

However, both chambers of the General Assembly approved HB 951, which would exempt admission tickets to sporting events from the state’s 4 percent sales and use tax. The exemption would apply if the commissioners of economic development and revenue determined that the event could generate at least $50 million in revenue from admissions, meals, lodgings, and vehicle rentals.

Atlanta is in the running to host the 2019 or 2020 Super Bowl, and lawmakers hope the exemption will tip the scales in Georgia’s favor.

The legislature also approved SB 258, which Tharpe said would provide $180 million in income tax credits over three years for donations made to eligible rural hospitals. The bill would also allow local governments hearing challenges to property tax assessments to lower assessed amounts based on the evidence but would preclude the deciding local body from increasing assessments issued by a county board of tax assessors.

HB 951 and SB 258 now head to Gov. Nathan Deal (R) for his signature.
INDIANA

Governor Approves Bill Calling for Study Of Combined Reporting

by Brian Bardwell —

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Gov. Mike Pence (R) has signed a bill directing the Legislative Services Agency to study and report on the feasibility of adopting combined reporting.

SB 323, sponsored by Senate Majority Leader Brandt Hershman (R), who chairs the Senate Tax and Fiscal Policy Committee, was approved 44 to 0 in the Senate and 92 to 0 in the House before being signed on March 24. The bill directs the agency to evaluate the administrative costs of implementing combined reporting, estimate its fiscal impact, consider the approaches taken by other states, review other studies and reports, and review issues related to transfer pricing.

To inform its study, the agency will have access to records from the Department of Revenue, which is obligated to cooperate with requests for necessary information, though the DOR’s confidentiality rules would still apply to any information the agency received.

The agency must hold at least one public hearing to present the findings of its research before it finalizes its study, which is due to the Legislative Council on October 1, 2016.

The decision to pursue only a study of combined reporting likely comes as a relief to many taxpayers, who saw the bill introduced as a proposal to actually require unitary businesses to file their income taxes based on the group’s combined income.

Still, the lack of opposition to even the scaled-back proposal surprised some observers in Indiana, where recent legislative changes have pushed the state up in various comparisons of state tax systems.

Mark Richards of Ice Miller LLP surveyed the history of Indiana’s attitudes toward combined reporting in a client advisory, saying the state was decidedly cool to the idea when the U.S. Supreme Court gave its blessing to mandatory worldwide combined reporting in 1983.

Soon after, he wrote, then-Gov. Robert Orr published a letter to investors swearing off combined reporting and saying that the state would rather maintain a “favorable business climate” than broaden its tax base. Despite the strong statement, Richards said, the state’s conviction on this point has “significantly eroded,” with the DOR demanding combined returns with increasing frequency to “fairly reflect” income sourced to the state, relying on the state’s adoption of the Uniform Division of Income for Tax Purposes Act.

Perhaps in response to unfavorable Indiana Tax Court rulings last year in Rent-A-Center East Inc. v. Department of State Revenue and Columbia Sportswear USA Corp. v. Department of State Revenue — both cases in which the DOR’s combination requirements were rejected — the state now seems interested in stronger authority for those endeavors.

But Richards said that it might come at too high a price to the state, “This fundamental change in long-standing tax policy could have a severe and adverse impact on Indiana’s business development efforts and the perception of Indiana as a state with an attractive tax policy climate, which could actually lead to a reduction in tax revenue for the state in the long run, among the other detrimental effects of a reduction in business investment in the state,” he said.

Separately, the bill also calls on the Legislative Council to direct its Interim Study Committee on Fiscal Policy to look into the local effects of taxes related to riverboat gambling, including taxes on admissions and wagering.
Iowa

State’s Reduced Job Creation Credits Would Offset Biochemical Credits

by Brian Bardwell — brian.bardwell@taxanalysts.org

The Iowa General Assembly has approved new incentives for businesses that produce biochemicals — renewable chemicals manufactured using biomass feedstock.

SF 2300 was approved by the House on March 28 on a 95-1 vote after being approved by the Senate on March 16 on a vote of 46 to 3. The bill has been sent to Gov. Terry Branstad (R), who called for the incentives in his State of the State address earlier in the year. (Prior coverage: State Tax Notes, Mar. 28, 2016, p. 930.)

If signed, it would give the Iowa Economic Development Authority the responsibility for administering the credits, which could be applied to individual or corporate income tax liabilities. The refundable credit would be equal to 5 cents per pound of renewable chemicals produced using renewable organic material. Businesses less than 5 years old would be able to claim credits of up to $1 million annually, but the credit would be capped at $500,000 annually for most taxpayers.

‘Iowa will stand alone both nationally and internationally in offering this biochemical production incentive,’ the association said.

The overall program would be capped at $10 million annually, to be distributed on a first-come, first-served basis to taxpayers that submit applications and agree to report on their performance. Taxpayers would be subject to clawback provisions that could reduce, terminate, or rescind their credits, which could then be subject to payback if they failed to comply with the terms of their agreements.

The General Assembly estimates that the credit would cost the state a little more than $90 million over the life of the program, which would allow credits for chemicals produced between January 1, 2017, and December 31, 2026.

But the bill is projected to be revenue neutral because it also includes provisions to reduce available credits under the high-quality jobs tax credit program, which provides a variety of tax preferences to businesses that make major investments leading to the creation or retention of jobs in the state.

The program includes credits for sales and use taxes paid, property tax exemptions, a credit for research activities, and other credits against corporate and insurance premium taxes.

The credits are not refundable, and the program has been underused, according to the Legislative Services Agency, which said only about half the available credits are taken in the average year. SF 2300 would therefore reduce the available job credits by about $185 million over the life of the biochemical credit. Assuming the credits are claimed at the same rate as in years past, that would save the state approximately the same amount as the new program is expected to cost.

The Iowa Biotechnology Association said the bill would help the state stand out as budding biochemical businesses scout for locations. “Iowa is showing significant commitment to attract the next frontier of bioprocessing,” the group said. “Iowa will stand alone both nationally and internationally in offering this biochemical production incentive.”

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Legislature Leaves New Revenue Out of Latest School Funding Bill

by Brian Bardwell — brian.bardwell@taxanalysts.org

State lawmakers have approved a new school funding bill without destroying the state’s delicate budget, but their unwillingness to raise new money through taxes to better fund poor districts may not satisfy the mandate from the state supreme court.

HB 2655 was approved 32 to 5 in the Senate and 93 to 31 in the House.

The bill came in response to the Kansas Supreme Court’s latest ruling in Gannon v. Kansas II, which held that the state’s school funding scheme’s heavy reliance on local property taxes violates the state constitution’s requirement that public schools be equitably funded. (Prior coverage: State Tax Notes, Feb. 22, 2016, p. 529.)

The court stayed enforcement of a lower court’s order that would have forced the state back into a previous funding formula that had already been ruled constitutional, but made clear that students would not begin their next school year in a system that is not equalized.

Lawmakers expressed resentment that the court was “holding students hostage,” but they quickly began work on plans to address the court’s order.

The final product was HB 2655, which would raise no new revenue and instead recalculates the aid that individual districts may receive by calculating their local option funding and multiplying it by an “equalization factor” based on its distance from the state median.

To address objections from districts that would lose funding under the formula, the Legislature also included a “hold harmless” provision that would ensure those districts still get the money they budgeted for.

The debate on the bill was at times intense, with the presiding member of the House chiding Minority Leader Tom Burroughs (D), who in turn began berating Rep. John Whitmer (R) — whom he referred to as his “former good friend from Wichita” — for accusing the Democrats of trying to block the bill without proposing an alternative.

Burroughs noted that Democrats have spent the last several years calling for the repeal of the state’s preferential treatment of income from passthrough entities, blaming the tax break for the state’s fiscal problems.

While Democrats want to support students and teachers, Burroughs said, Whitmer is merely “an ideologist, a politician,” and something else that was drowned out in the commotion that quickly began in response to the ad hominem attacks.

As unpleasant as the debate was, HB 2655 may have only postponed the real pain, as a resolution to the equalization question will trigger the court’s separate consideration of whether the schools are adequately funded.

A lower court found that they were not and ordered $54 million in additional funding. The state supreme court upheld the finding of inadequacy but postponed consideration of the remedy while waiting for the state to equalize funding.

Producing an additional $54 million would likely not be an enormous burden in most states, but Kansas’s budget is already much tighter than most. Since the state eliminated income taxes for passthrough entities, revenue has plummeted, with collections consistently below projections for several months, forcing the governor to make additional program cuts.

The budget for fiscal 2017 — approved hours after the court handed down its ruling — left the state with a balance of only $6 million, meaning the state would likely be forced to make even deeper cuts or acquiesce to Democrats’ calls to roll back passthrough incentives.

Assuming that Gov. Sam Brownback (R) signs HB 2655, it is not yet clear how the court will go about evaluating it.

A spokesman for Attorney General Derek Schmidt (R) did not respond to a request for comment on the bill, but the plaintiffs’ attorney, Alan Rupe of Lewis Brisbois Bisgaard & Smith LLP, said he expects the court to follow up soon with a show cause order asking the state to “demonstrate how the adopted bill complies with the court’s previous orders and the constitution.”

The court will have to weigh in for itself, but the Legislature’s approach — equalizing the districts and then giving more money to the wealthy ones — seems unlikely to pass constitutional muster, Rupe told Tax Analysts.

“The property-poor districts will receive the same amount of money they were already going to receive, and the wealthier districts will have an opportunity to raise additional local money,” Rupe said. “Once again, the state is disrupting equity by allowing the wealthier districts to retain more resources simply because of their wealth.”

That can’t be the approach the court is looking for, Rupe said. “It does nothing to actually equalize the purchasing power between districts,” he said. “This is the exact opposite of equalization.”
KENTUCKY

Senate Committee Considers Local Option Sales Tax Bill

by Eric Yauch — eric.yauch@taxanalysts.org

The Kentucky Senate Standing Committee on Appropriations and Revenue is considering a bill that would amend the state constitution to allow local governments to impose an additional 1 percent sales tax.

HB 2 was introduced by House Speaker Greg Stumbo (D) in February. Because the bill would amend the state constitution, the General Assembly first would have to pass the measure by a three-fifths majority in both chambers before it could be placed on the ballot for voter approval.

The House passed the bill in March on a 60-31 vote after removing a provision that would have required any tax approved by the voters to apply in any area subsequently annexed by a city and county imposing the tax. (Prior coverage: State Tax Notes, Mar. 14, 2016, p. 773.)

The Senate added three amendments to HB 2 before sending it to the Appropriations and Revenue Committee.

Two of the Senate amendments came from Sen. Chris Girdler (R), who added language changing the title of the bill and another change that would add a new section to the state constitution saying, “Except as otherwise provided in this Constitution, the General Assembly shall have the authority to regulate the commercial activities of cities, counties, merged city and county governments, districts, or other units of local government.”

Another amendment, added by Senate Majority Floor Leader Damon Thayer (R), would require 25 percent of the revenue from the additional local sales and use tax to be spent on the local government’s employee retirement system.

Thayer’s amendment would also require the levy of any additional local government tax to be neutral and to identify other taxes that would be reduced in order to offset revenues generated by the additional tax.

In the 2015 session, a similar bill passed the House (HB 1) but ultimately died in the Senate.

LOUISIANA

State Businesses and DOR Scramble To Comply With Sales Tax Changes

by Eric Yauch — eric.yauch@taxanalysts.org

Louisiana businesses and the Department of Revenue are grappling with new sales tax laws from the recent special session that took effect April 1.

Remote dealers with click-through nexus are now required to collect and remit sales and use tax if they have more than $50,000 of sales in the state, or if they employ an affiliate to solicit and maintain a market in the state for the sale of tangible personal property.

Other sales typically exempt in Louisiana will also be taxed, like manufacturing machinery and equipment, casual and isolated sales, purchases for first use outside the state, sales for the purposes of leasing the property afterward, and business utilities purchases.

Matthew Mantle of Jones Walker LLP said that if someone sold a bike to another person, that transaction could now theoretically be subject to sales tax under the casual and isolated sales exclusion disappearing on April 1.

Highlighting just how rapidly the changes have come about, William Backstrom Jr., also of Jones Walker, noted that the DOR posted a chart of the applicable rates under the laws taking effect April 1, but then on March 29 replaced it with a revised version.

Jaye Calhoun of McGlinchey Stafford told Tax Analysts last week that in the DOR’s original chart, property and services for use in fulfilling lump sum construction contracts that existed when the new provisions were enacted were shown as taxable under one of the new bills, but under the other bill, the applicable rate space was left blank.

However, under the revised chart, those properties and services are not subject to any sales tax under either act.

The revised chart lists eight changes from the original chart posted online and shows the updated effective rates applicable on April 1 under each act.

For example, from April 1 to June 30, purchases of tangible personal property consumed in manufacturing processes will be taxed at 4 percent under Act 25 and an additional 1 percent under Act 26. But from July 1 to June 30, 2018, that same property will be taxable at 2 percent under Act 25 and 1 percent under Act 26.

Calhoun said that the burden of figuring out the changes from the special legislative session doesn’t lie with just the private sector, saying the DOR has had to learn rapidly how to deal with the changes, which have been law since only mid-March.

“They’ve done an amazing job of analyzing a lot of information very quickly,” Calhoun said. “I don’t fault them for that; I’m glad they’re thinking this through.”
Calhoun added that while she does not agree with everything it has done so far, the DOR under Kimberly Robinson, the new revenue secretary, has taken a very practical approach to administering the new laws.

Both Calhoun and Backstrom said that the new sales tax changes could also affect some nonprofit organizations. Calhoun said, for example, that nonprofits with clubhouses or facilities now have to start collecting tax on their dues, according to the DOR’s guidance. But, Calhoun said, a lot of questions remained unanswered one day before the law went into effect.

The sudden sales tax changes are the result of laws passed in the special legislative session called by Gov. John Bel Edwards (D) to address the state’s budget shortfall.

Lawmakers approved a new 1-cent sales tax and scaled back exemptions and exclusions to the state’s existing 4 percent sales tax. However, the state still faces a $70 million budget shortfall for this fiscal year and nearly $750 million for the next fiscal year. (Prior coverage: State Tax Notes, Mar. 28, 2016, p. 931.)

MAINE

**Taxwriters Reject Repeal of Exemption For Conservation Lands**

*by Douglas Rooks*

The Maine Joint Taxation Committee has rejected Republican Gov. Paul LePage’s proposal to remove the property tax exemption for conservation lands.

LD 1667 got an ought-not-to-pass vote after a public hearing and committee work session.

LePage’s senior policy adviser, Avery Day, provided testimony for proponents of the bill, saying the measure would “clarify” state policy in the wake of the state supreme court’s decision in *Francis Small Heritage Trust Inc. v. Town of Limington*. In the case, the court held that a land trust qualified for a property tax exemption under the state’s definition of charitable entities.

Republican Reps. Joel Stetkis and Jonathan Kinney supported the bill, with Kinney saying conservation land exemptions were causing “crushing property taxes” for his constituents.

However, Tom Abello, spokesman for the Nature Conservancy’s Maine office, testified that a lot of conservation lands remain taxable through easements and that the Conservancy pays $400,000 in property taxes and provides another $20,000 in lieu of taxes. He said the public also benefits from the lands through having open space, having access to recreation, and avoiding the costs of unplanned development. Abello said the Conservancy is now the 12th largest landowner in Maine.

Five local land trusts, including the Maine Coast Heritage Trust and Bangor Land Trust, also testified in opposition, as did the Maine Association of Nonprofits.

In testimony that was neither for nor against the bill, Kate Dufour of the Maine Municipal Association said the group’s Legislative Policy Committee is “concerned that LD 1667 as drafted could hamper efforts to protect valuable Maine resources and access to public lands.” She added, however, that the association supports narrowing current charitable exemptions to ensure that for-profit activities by nonprofits be better defined and limited under the law’s “exclusivity” standard, that municipalities be allowed to require annual reviews of eligibility, and that standards for public access to conserved land be spelled out.

During work session discussion, several committee members said the limited time remaining in this year’s session precluded detailed consideration of LD 1667. The committee accepted an ought-not-to-pass motion unanimously.
MARYLAND

Manufacturing Tax Credit Bills Stall In Committee

by Stephanie Cumings — stephanie.cumings@taxanalysts.org

Two Maryland bills to provide tax incentives for manufacturers appear to have stalled in the Senate Budget and Taxation Committee, even though one of the bills has 43 cosponsors.

SB 181, sponsored by Sen. Roger Manno (D), would establish the Manufacturing Development Zone Program to be administered by the Department of Commerce. Counties and municipalities could apply to be designated as development zones and receive 10-year property and income tax credits.

A similar bill, SB 386, which was introduced at the request of Gov. Larry Hogan (R), would target low-income areas to receive tax credits under the Manufacturing Empowerment Zone Program.

Despite broad support, neither bill has made it out of committee. Both bills were cross-filed with identical bills in the House, and neither of those bills has advanced out of the House Ways and Means Committee.

The crossover deadline for sending bills to the opposite chamber was March 21. Bills not sent to the opposite chamber by then are referred to the Rules Committee, creating an additional obstacle to passage. Maryland’s legislative session ends April 11.

“We’ve lost a lot of manufacturing jobs in the last 10 years,” Manno said at a February hearing on SB 181 before the Senate tax committee. “We’ve lost 2 million jobs in this country. In the state of Maryland during that period we’ve lost 25,000 heavy manufacturing jobs. . . . It doesn’t have to be that way.”

Manno said his bill has broad support from both parties, including the 43 cosponsors. He said he’d spoken with several companies that said the bill would make Maryland a more attractive candidate to their businesses. He also said he is open to amendments that would make more companies eligible for benefits under the bill.

Manno also supports an amendment that would clarify and augment tax credits to employees of manufacturing companies, which he said was a matter of “fairness.”

The same bill was also introduced last year, Manno said, and was sent to be studied by the Maryland Economic Development and Business Climate Commission. The commission released a report in January that offered several recommendations to strengthen Maryland’s business climate, but it made no specific recommendations on manufacturing tax credits. (Prior coverage: State Tax Notes, Feb. 1, 2016, p. 337.)

Benjamin Wu, deputy secretary at the Department of Commerce, testified in favor of SB 386, calling it a “more inclusive approach that targets incentives to a broader set of manufacturers.”

The administration’s proposal also “uses zones that target areas of the state with the most need as defined by measures of economic distress as well as locations proximate to transit-oriented developments or military installations,” Wu said.

A fiscal note on SB 181 said numerous federal and state incentives are already available to manufacturing businesses but have produced mixed results. The note also said state revenue would decrease as a result of the proposed credits. The amount of revenue loss would depend on the number and size of the development zones, but the note said losses could be “significant.” The bill would also increase general fund expenditures due to implementation costs at the comptroller’s office.

Gene Burner of the Manufacturers’ Alliance of Maryland (MAM) told Tax Analysts on March 25 that MAM was disappointed the bills don’t appear to have moved. However, he said that important, complicated bills like SB 181 and SB 386 often take two or three years to pass and that he expects a similar bill might reappear next year.

Burner said SB 386 has some differences but is basically the same concept as SB 181.

The Maryland Chamber of Commerce supports SB 181, arguing it would spur manufacturing and create high-wage jobs that would bolster the state’s economy.

“Manufacturing has been declining across the State, and this legislation would provide real and tangible benefits to those companies looking to relocate or expand,” the chamber said in a position statement.

“It’s important to keep in mind that manufacturers already receive preferential treatment in Maryland’s tax code, but that has not led to any growth in the industry,” said Benjamin Orr of the Maryland Center on Economic Policy. “Maryland uses a single-sales-factor formula just for manufacturing companies that allows them to pay no tax on income earned from selling their products out of state.”

Orr said that exempting certain categories of businesses from property or income tax sets a bad precedent and creates an uneven playing field. He also said that the bill is based on a program in New York that had “disastrous results.”

“New York spent roughly $53 million promoting its program and created just 76 jobs in the first year — a cost of nearly $700,000 per job. This is clearly not a good model for boosting Maryland’s economy,” Orr said.

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MASSACHUSETTS

State Appoints New DOR Commissioner

by Jennifer DePaul — jennifer.depaul@taxanalysts.org

Mike Heffernan has been tapped to be the new Massachusetts Department of Revenue Commissioner, Administration and Finance Secretary Kristen Lepore announced March 29.

Heffernan, a former Citigroup Inc. executive and former Republican candidate for state treasurer, will assume his new role on May 2, according to Lepore.

“Mike’s extensive finance experience and entrepreneurial background will be critical to leading an agency with crucial responsibilities to the Commonwealth and the customers who pay taxes here,” Lepore said in a statement.

Heffernan’s appointment came two weeks after Gov. Charlie Baker (R) announced that current DOR Commissioner Mark Nunnelly is stepping down from his post to head MassIT, the state’s information technology office.

“DOR serves a critical role in the Commonwealth by leading compliance with our tax, child support and municipal finance laws, and I look forward to working with the staff, taxpayer community and other key stakeholders to deliver the agency’s mission in a consumer-friendly manner,” Heffernan said in a statement.

Former DOR Commissioner Amy Pitter, now CEO of the Massachusetts Society of Certified Public Accountants (MSCPA), told Tax Analysts that while she hasn’t met Heffernan yet, she is looking forward to continuing the great partnership her group has had with the DOR under Nunnelly.

“The CPA profession is uniquely positioned to guide the department on the practical impacts of their policies and practices, and through our members, the MSCPA is able to deliver important tax information and updates to Massachusetts’s businesses and individual taxpayers,” Pitter said. “Personally, I look forward to working with the new commissioner to increase access, understanding, and the efficiency of tax processes for the citizens of the commonwealth.”

David Nagle of Sullivan & Worcester LLP said he hopes Heffernan builds on his predecessors’ efforts to make Massachusetts tax administration even more transparent.

Nagle said he would like to see “fuller disclosure of DOR’s audit manuals, briefs, and communications with the legislature.” This transparency would further strengthen public trust, encourage voluntary compliance, and encourage consistent treatment of similarly situated taxpayers, he said. Nagle cited the DOR’s Field Audit Manual as an example: After nearly three years since the manual was published online, its corporate excise and financial institution excise chapters are still under revision.

State Releases Final Reg On Fantasy Sports Websites

by Neil Downing

Massachusetts Attorney General Maura Healey (D) has filed a final regulation spelling out the tax obligations of daily fantasy sports websites such as DraftKings Inc. and FanDuel Inc.

The reg, which websites must implement by July 1, is designed to protect Massachusetts consumers who play daily fantasy sports contests “from unfair and deceptive acts and practices that may arise in the gaming process,” according to its statement of purpose. The regulation prohibits game play by those under 21 years old and also forbids contests that include amateur, college, high school, or student sporting events.

The final regulation — like the proposed version posted in November — would require daily fantasy sports sites to:

• comply with laws and regulations on tax withholding and on disclosing information on winnings and withholdings to taxing authorities and consumers; and

• disclose potential tax liabilities to consumers when they sign up and when awarding any prize in excess of $600. The disclosures must include a statement letting consumers know that the obligation to pay applicable taxes on winnings is the consumer’s responsibility and that failure to pay tax may result in civil penalties or criminal liability.

However, the reg does not deal with a broader issue: whether the websites should be regulated and taxed similarly to casinos.

‘Massachusetts will likely be the first with a tax structure. But frankly, the difference between tax and registration is semantics: They both cost companies money,’ Fox said.

The income measure of the Massachusetts corporate income tax, known as the corporate excise tax, is 8 percent, whereas state-licensed casinos in the state are subject to a 25 percent tax rate.

Healey’s regulation deals chiefly with the consumer protection aspect of daily fantasy sports sites.

In early March, Virginia became the first state to regulate daily fantasy sports websites when Gov. Terry McAuliffe (D) signed into law SB 646, the Fantasy Contests Act.

Russell Fox of Clayton Financial and Tax in Las Vegas told Tax Analysts that the Virginia legislation legalized the websites and provided “a registration regime.” The operators that register and are approved by the state “will owe income tax on their Virginia-source income,” said Fox, whose tax practice focuses in part on gambling. The initial registration fee is $50,000, he said.
“Massachusetts will likely be the first with a tax structure. But frankly, the difference between tax and registration is semantics: They both cost companies money,” Fox said.

Healey proposed the regulation last November. Daily fantasy sports site operators had said at the January 12 public hearing that the proposed reg would be costly to implement and could force some businesses to close. (Prior coverage: State Tax Notes, Jan. 18, 2016, p. 183.)

In a statement, DraftKings said it would fully comply with the regulation. It said it has already voluntarily implemented many of the consumer protections contained in the reg, including prohibiting its employees from playing in public contests for money and allowing players to put self-imposed deposit limits on their individual accounts.

“The regulations put forth today by Attorney General Healey are tough, but we will comply. We will continue to work with policymakers across the country to ensure that fantasy contests are fun and fair for the tens of millions of sports fans who enjoy playing them,” DraftKings CFO Tim Dent said in the statement.

Gov. Phil Bryant (R) has tapped the chair of the House Appropriations Committee to be the state’s next commissioner of revenue.

Rep. Herb Frierson (R) will assume the post on July 1, taking over for Ed Morgan, who has held it for more than seven years. Morgan told The Clarion-Ledger that his departure was the governor’s decision, but he also told the newspaper that at age 68, he felt he had accomplished a lot at the Department of Revenue and was prepared to move on. One term for a DOR chief in Mississippi is typically six years.

Notably, Morgan was head of the DOR during the entire case of Equifax Inc. v. Department of Revenue, which began on June 1, 2009, when the taxpayer appealed its assessment to the Hinds County Chancery Court. It ended on June 20, 2013, when the Mississippi Supreme Court reversed the Court of Appeals and reaffirmed the ruling of the trial court in a decision that it was proper for the DOR to use an alternative apportionment method in determining the taxpayers’ Mississippi income. The supreme court also held that the burden of proof for determining that the use of alternative apportionment was arbitrary and capricious rested with the taxpayer.

The Mississippi Legislature and the governor responded by enacting legislation (HB 799) effective January 1, 2015, that clarified the use of alternative apportionment and placed the burden of proof on the party seeking to use an alternate method.

Frierson, 56, joined the House of Representatives in 1992, the same year that Bryant did. In a statement, he said he would miss the House, but he said the DOR job is “the perfect opportunity” to continue with public service.

In a statement Bryant referenced Frierson’s work on the appropriations committee, a post that has given him considerable sway over state finances. “As appropriations chairman, Rep. Frierson has been a big part of shaping a responsible budget that meets current needs and adequately prepares for the future,” Bryant said. “I can think of no one better prepared to oversee the state’s revenue collections.”

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MISSOURI

Kansas City Pushes for Revival Of Missouri Film Incentives

by Maria Koklanaris — maria.koklanaris@taxanalysts.org

Missouri’s film tax incentive program expired in 2013, but there are signs that film tax credits are coming back to life in the Show Me State.

Most notably, for the first time, Missouri’s largest city has enacted its own film tax incentive program. On February 25 the Kansas City Council created the program on a rebate basis — companies with projects that meet the program’s requirements can get up to 7.5 percent of their costs back from the city.

Stephane Scupham, the city’s film commissioner, said in a statement that the move is “a positive step for Kansas City” and a call to the state for help. She said the city was sending a message that it is willing to come to the table. “Now we ask the state to participate in the form of Missouri state film incentives,” she added.

At the urging of the city and of the Missouri Motion Media Association (MOMMA), Rep. Kathryn Swan (R) has filed HB 1645, which would reinstate the film tax incentive program in Missouri. Under the bill, companies could get a credit of 20 percent for qualifying expenses, both in and out of the state. They would be able to get an additional 5 percent credit if at least 50 percent of the project were filmed in Missouri.

This is Swan’s second attempt to get the film tax incentive program revived. She sponsored a similar bill in 2015 after the success of the movie Gone Girl, which was made before the film tax incentive program expired and was filmed in Swan’s district. A statement from MOMMA said the bill made it out of committee last year; the group hopes it can do so again and then go on to be successful. MOMMA testified on behalf of the bill and brought 25 letters of support from Kansas City and other municipalities, companies, and industry groups.

MULTISTATE & FEDERAL

Minnesota Joins Trend of States Proposing Tax Haven Legislation

by Maria Koklanaris — maria.koklanaris@taxanalysts.org

Minnesota is the latest state to consider tax haven legislation to address the taxation of foreign-source income and will do so with a bill listing tax haven countries that companies must account for when filing combined reports.

State Sen. John Marty (DFL) on March 29 introduced SF 3318, which lists the U.S. Virgin Islands and 45 foreign countries as tax havens. The bill would apply to any U.S. corporation that “is incorporated in a tax haven; that reports 20 percent or more of its gross income derived from sources in one or more tax havens; or that has the average of its property, payroll, and sales factors…within the 50 states of the United States and the District of Columbia of 20 percent or more.”

The bill also provides that a country would no longer be on the tax haven list after the first tax year when it either enters into a tax treaty with the United States or imposes a tax rate of at least 10 percent on a tax base equal to at least 90 percent of the tax base that applies to corporations under the Internal Revenue Code.

With SF 3318, Minnesota’s first tax haven bill since 2013, the state becomes part of a trend of states not only introducing tax haven bills but increasingly doing so in the most controversial way — by specifying what opponents call a “blacklist” of tax haven countries.

“This is definitely an issue that a lot of states are taking a hard look at,” Ryan Maness of MultiState Associates Inc. said. “As states are looking for increased revenue, they’re saying, ‘Oh, these huge corporations, they’re shifting their money overseas; we need to get some of that.’”

Maness said states are either adopting the tax haven list approach or drafting bills that give a state official or agency the authority to decide what constitutes a tax haven.

Practitioners have discussed the issue at great length, particularly in the past year. Tax haven legislation was the subject of the first report from the State Tax Research Institute (STRI), the research foundation of the Council On State Taxation. On March 1 the STRI published “State Tax Haven Legislation: A Misguided Approach to a Global Issue,” which said that tax haven legislation is a wrong — and possibly unconstitutional — direction for states to go in. (Prior coverage: State Tax Notes, Mar. 7, 2016, p. 704.)

During the October 2015 Paul J. Hartman State and Local Tax Forum in Nashville, Tennessee, a panel of practitioners said the OECD’s base erosion and profit-shifting project had spurred a great deal of interest among states in addressing foreign-source income, especially tax haven legislation.
“This has exploded overnight,” Todd Senkiewicz of Deloitte Tax LLP, Atlanta, said at the time. “Foreign-source income is an area the states are really focused on.” (Prior coverage: State Tax Notes, Nov. 2, 2015, p. 344.)

Still, Ferdinand Hogroian of COST noted that there is a wide gap between states proposing and actually enacting legislation. For example, he said, previous tax haven bills were proposed when Minnesota was experiencing significant budget deficits. Today, the state has a surplus of about $900 million. He said that if tax haven legislation did not pass then, it is less likely to pass now.

“There is not the monetary pressure,” Hogroian said.

Beth Kadoun of the Minnesota Chamber of Commerce agreed. However, she said the chamber would oppose SF 3318 as it opposed others.

“This undermines Minnesota’s competitiveness,” she said. “And the state should not be in the situation of listing tax havens.”

In other states, a tax haven bill that had passed the Colorado House of Representatives on March 9 by a 34-30 vote died March 28 in the Senate Committee on State, Veterans, and Military Affairs. The vote was 3 to 2 against the bill.

“This has exploded overnight,” Senkiewicz said.

The bill, HB 1275, would have required corporate income tax payers to report any income from affiliates incorporated in a tax haven. It differed from other states’ tax haven bill language in ways that appeared to target the most common complaints from opponents of these proposals.

Foreign nations considered to be tax havens have complained, for instance, about being labeled as such in other bills. But HB 1275 never used that term and instead focused on the conduct of the taxpayer, imposing its restrictions on corporations with affiliates “incorporated in a foreign jurisdiction for the purpose of tax avoidance.”

HB 1275’s sponsor, Rep. Mike Foote (D), told Tax Analysts he will continue to press the issue.

“It is fundamentally unfair that a few hundred multinational corporations take advantage of a blatant tax loophole to the detriment of the hundreds of thousands of businesses in Colorado that pay their taxes,” Foote said. “All small businesses want is a level playing field so they can compete. Right now that doesn’t exist, and we’ll continue to push for that to change.”

Maine also has a tax haven bill, LD 1634, that has made it through the House. Approved March 9, the bill would require corporations to report and pay tax on income sheltered in specific countries listed as tax havens. It would redefine net income — currently defined as the taxpayer’s federal income adjusted for net operating losses and various other factors — to also include any income or loss attributable to any member of a unitary group incorporated in any of the jurisdictions listed in the bill. (Prior coverage: State Tax Notes, Mar. 14, 2016, p. 774.)

However, on March 10 the Maine Senate offered an amendment that would remove all tax haven language from the bill. The status is pending. Maine Gov. Paul LePage (R) vetoed similar tax haven legislation in 2014.

Kentucky and Kansas also have tax haven bills that list specific countries.

In Kentucky, HB 342 was introduced February 5. Mark Sommer of Frost Brown Todd LLC in Louisville told Tax Analysts that the bill is similar to others introduced every year. He said he does not expect it to get out of committee.

In Kansas, HB 2680 was introduced February 10. It has a provision requiring the Department of Revenue to report each year to legislative committees the list of countries designated as tax havens and to make recommendations for adding to or deleting from the list. The bill is with the Committee on Taxation; the House is in recess and does not return until April 27.

Eric Yauch contributed to this report.
Refund Interest Rate Bill
Sent to Governor

by Eric Yauch — eric.yauch@taxanalysts.org

The Georgia legislature recently approved a bill that would adjust the interest rates that state and local governments pay on taxpayer refunds and move cases delayed at the Department of Revenue to the state’s tax tribunal.

The Senate passed the final version of HB 960 hours before the legislative session ended on March 24. The bill would raise the interest rates on taxpayer refunds to 3 percent, plus the federal prime rate set by the Federal Reserve Board. The bill would also automatically transfer to the Georgia Tax Tribunal cases that have been pending before the DOR for more than two years.

If the tribunal determines that the DOR caused the delay, the department would have to pay all interest due to the taxpayer on the refund claim, including the interest due on the local sales and use tax deemed to have been erroneously collected. However, if the taxpayer is at fault for the delay, the order would prohibit the accrual of any interest due to the taxpayer in case of a refund.

Under the bill, the tribunal would have the discretion to determine if a delay was justified.

“HB 960 arose from the work of a special subcommittee formed by the Georgia House Ways and Means Committee to study the impact on the state and localities of large sales and use tax refunds,” according to Jonathan Feldman of Sutherland Asbill & Brennan LLP. “Georgia has long had one of the highest statutory interest rates in the country for tax assessments and refunds, and it was time for the legislature to adjust the rate to one more closely aligned with today’s time value of money.”

Feldman added that the DOR is still considering a proposed regulation that would require participants in the sales and use tax direct pay program to waive interest for refunds beginning on January 1, 2017. (Prior coverage: State Tax Notes, Feb. 8, 2016, p. 394.)

Under Georgia’s direct pay reporting system, manufacturers and other bulk purchasers can remit sales and use taxes directly to the DOR — rather than the vendor — for purchases of tangible personal property, digital property, and some services.

“The business community believes that because the legislature has addressed the amount of refund interest that taxpayers receive on sales and use tax refund claims (by cutting the interest rate by almost half), it would be inappropriate and unnecessary for the department to continue with this portion of its regulatory proposal,” Feldman told Tax Analysts.

Maryland Refund Interest Legislation Pending

The Maryland Senate Budget and Taxation Committee held a hearing March 29 on a bill (HB 422) that would gradually reduce interest rates on assessments and refunds to 9 percent by 2020. The House approved the bill March 19 on a 133-0 vote.

Another bill, SB 844, would have reduced the interest rate on assessments and refunds from 13 percent to 11 percent for 2017 and to 8 percent for 2018, and would have required the rate to reflect the average prime rate of interest for each year after 2018. (Prior coverage: State Tax Notes, Feb. 15, 2016, p. 465.)

However, the committee amended the bill to gradually reduce the interest rate to 10 percent by 2022. The bill passed the Senate on March 22 on a 46-0 vote.
States Largely Ignored in Federal Tax Reform Plans, Panel Says

by Jonathan Curry — jonathan.curry@taxanalysts.org

Given the challenges of accomplishing any sort of tax reform at the federal level, policymakers often give little thought to the effects that their tax reform proposals will have at the state and local level, according to panelists speaking March 31.

“Tax reform doesn’t happen in a vacuum,” moderator Liz Farmer of Governing magazine said at a forum hosted by the Urban Institute State and Local Finance Initiative and the Urban-Brookings Tax Policy Center (TPC). Panelists agreed that the ripple effects of federal tax policies are not felt uniformly across the many state tax codes.

A carbon tax, for example, would have a significantly greater effect on states that mine and produce carbon products, said Frank Sammartino of the TPC. Likewise, proposals to eliminate the federal deduction for state and local taxes would recoup nearly $500 billion in federal revenue over the next five years, but ending the deduction would have a disproportionately stronger effect on states that have high income taxes, particularly in Northeastern states like New York. “It’s a blue state, red state thing,” he added.

According to Sammartino, states will respond to an increase or decrease in their revenues, and places like California have responded to the state and local tax deduction, which he called a “subsidy to state and local governments,” by raising taxes on their high-income taxpayers, knowing that the majority of state and local tax deductions are claimed by taxpayers with incomes over $100,000. The state tax increase would be largely offset by the federal tax deduction, he said. A March 31 report by the TPC examines the effect that eliminating the state and local tax deduction would have on the revenue and spending of state and local governments.

State and Federal Taxes Linked

Jeffrey Friedman of Sutherland Asbill & Brennan LLP said that states often “hitch their wagons” to federal tax policy, which benefits the states by simplifying the administration of their own tax codes and saves them from having to design rules. State constituents tend to prefer conformity between federal and state tax codes because it makes filing tax returns simpler, he said.

He added, however, that the federal government does not have to balance its budget and can use deficit spending to enact expensive tax policies, while state budgets are more limited and may require balancing under a constitutional mandate.

The bottom line for senior elected officials is how a federal tax proposal will increase or decrease revenue, said Scott Pattison, executive director and CEO of the National Governors Association.

Pattison stressed the importance of tax-exempt municipal bonds for states, adding that proposals to modify tax-exempt bonds are seen less as a tax reform debate and more as an infrastructure debate. If Congress does not raise gas taxes, municipal bonds will continue to be a “critical component of infrastructure funding.”

Elizabeth McNichol, senior fellow at the Center on Budget and Policy Priorities, said that while it seems states are often ignored in the federal tax reform debate, there are some reasons to be optimistic, citing cooperation between state and federal agencies on issues like the earned income tax credit.

Proposals

The panelists weighed in on various tax proposals ranging from those of the presidential candidates to more specific policies.

Friedman said a VAT would probably be an improvement over the current system, adding that the sales tax used by many states is inefficient because it taxes sales between businesses. He also said he didn’t think a VAT-style tax, like the one proposed by Republican presidential candidate Sen. Ted Cruz of Texas, would be enacted at the federal level.

McNichol cautioned that sweeping tax reform proposals, such as replacing the income tax with a VAT, would interfere with the ability of states with sales and use taxes to continue collecting those taxes. On average 30 percent of state budgets are funded with federal revenue, and any efforts for revenue-neutral tax reform and deficit reduction would likely shrink state budgets, she said.

Sammartino warned against plans like the one offered by Democratic presidential candidate Sen. Bernie Sanders, I-Vt., to raise the tax rate on capital gains to around 64 percent. “Raising tax rates squeezes the states,” he said, adding that significant tax increases could result in the federal government engaging in “tax cannibalism,” when it begins to eat into its own tax base.

Pattison and Friedman agreed that states are looking for Congress to vote on the Marketplace Fairness Act. Friedman said states and large businesses like Amazon.com Inc. largely support the act, and that even opponents who talk of “fixing” it acknowledge some type of legislation is needed.
NEVADA

State Approves $9 Million in Tax Breaks For Hyperloop Project

by Paul Jones — paul.jones@taxanalysts.org

Nevada has approved $9.2 million in tax abatements for Hyperloop Technologies Inc., a company developing an experimental rapid, land-based transportation system.

Jennifer Cooper, communications director at the Nevada Governor’s Office of Economic Development (GOED), confirmed that the office approved sales tax, modified business tax, and personal property tax abatements for the company on March 25.

Los Angeles-based Hyperloop Technologies is developing a proof-of-concept project to demonstrate the technical and economic feasibility of a hyperloop system, a method of transportation using pods powered by air turbines traveling through sealed tunnels at speeds of approximately 680 mph.

Hyperloop would make $121 million in capital investments in the state and create 89 jobs in the first two years, according to its application. The total number of jobs to be supported by the project over 10 years is estimated to be 214, including 22 in construction. GOED staff projects the company’s activity in the state would produce total tax revenues of $11.7 million and a total economic output of $288 million over the 10-year period.

In application documents, William Mulholland of Hyperloop said Nevada’s performance-based incentives were a key factor in the company’s decision to expand its operations and locate its test track in the state. The company’s decision was lauded by Gov. Brian Sandoval (R), who has also successfully pushed for tax breaks to bring other high-tech companies to the state, including a $1.3 billion incentives deal to draw Tesla Motors Inc.’s “gigafactory” and a $215 million incentives deal to anchor electric car manufacturer Faraday Future.

GOED Director Steve Hill said in December 2015 that Hyperloop’s investment in Nevada would bolster its profile as a high-tech business center.

“It certainly is thrilling to see how Nevada is becoming a place to research, develop, test, and implement advanced technologies driven by innovation,” Hill said.

Nevada’s tax incentives for Tesla and Faraday have drawn criticism from observers such as free-market think tank Nevada Policy Research Institute, which argued that the incentives put tax dollars at risk and create an uneven playing field favoring high-profile companies. The abatements approved for Hyperloop, which include an additional $750,000 from the state’s Catalyst Fund, represent a significantly smaller investment by the state.

Along with Hyperloop’s incentives, the GOED board also approved incentives for several other companies, although none were as large as the Hyperloop package.

NEW YORK

New York City’s First Taxpayer Advocate Stepping Down

by Jennifer DePaul — jennifer.depaul@taxanalysts.org

After less than a year on the job, New York City Taxpayer Advocate Diana Leyden will step down to be a special trial judge with the U.S. Tax Court.

Leyden, a former law professor, started as the city’s first independent taxpayer advocate in July 2015 and assembled a seven-person team to assist her. The Office of the Taxpayer Advocate (OTA) officially opened to the public October 19, 2015, and has been handling taxpayer complaints for all tax categories except personal income tax and sales tax, which are administered by the state.

“In the short time I have been here, I have created a firm foundation for an independent OTA,” Leyden told Tax Analysts in an email. “Starting with nothing in July, I was able to create an office that has easy-to-access procedures for people with business and property tax problems, spreading the word to City Council Members and practitioners that there is a voice within [the Department of Finance (DOF)] for their constituents.”

Sonia Alleyne, press officer with the city’s finance department, said the DOF has not yet posted Leyden’s job and is not yet considering candidates. The DOF is working on what the transition will look like and hopes to hire someone who will be able to pick up where Leyden left off, she said.

The independent taxpayer advocate office was the brainstorm of New York City Finance Commissioner Jacques Jihia. It was established to ensure that taxpayers are treated fairly, that they understand their rights, and that they have an advocate for cases in dispute, Alleyne said.

Taxpayers and practitioners are encouraged to contact the office if a reasonable attempt has been made to solve an inquiry or complaint with the DOF; if the inquiry or complaint was not settled or the taxpayer has not received a timely response; or if a taxpayer can demonstrate that the DOF is applying the tax laws, regulations, or policies unfairly or incorrectly, or has injured or will injure taxpayer rights, among other reasons.

In the past five months since the office opened, Leyden and her team issued a Taxpayer Bill of Rights. They have handled 164 inquiries, opened 95 cases, and closed 54 cases. The OTA has generated over $132,000 in refunds and over $1.7 million in tax abatements, according to Alleyne.

The most challenging aspect in creating this position was setting up the office because the DOF didn’t know what it would look like, Alleyne said.

“Diana has been phenomenal in that she helped put our playbook together and hired people,” Alleyne said.

Leyden will officially take the oath of office and assume her duties in June.
**OREGON**

### Initiative Would Privatize Liquor Distribution, Cut State Revenues

by Paul Jones — paul.jones@taxanalysts.org

A ballot initiative to end Oregon’s monopoly over distribution of distilled spirits would eliminate state revenue collection from its markup of sales of hard liquor, potentially hurting state and local governments’ bottom lines. Proponents argue that lawmakers would simply come up with a replacement tax.

As in a number of other states, Oregon tightly regulates the sale of distilled spirits and has a monopoly on the purchase of liquor from suppliers and its distribution to retailers in the state. The Northwest Grocery Association wants to open up the state’s liquor market and is close to being approved to collect signatures for a November 2016 ballot initiative to that end.

If approved by voters, Initiative 71 would end the state’s control of distribution of hard liquor and shift to a more open market approach that would allow grocery stores already selling wine and beer to sell spirits alongside existing liquor stores.

The group’s well-funded effort follows a canceled initiative in 2014 that would have ended the state’s distribution monopoly and replaced its revenue collection from its price markups with a tax. However, Initiative 71 would simply end the current system and leave it up to lawmakers to come up with a replacement tax by mid-2017.

Pat McCormick, campaign spokesman for the proponents, said the choice not to include a replacement tax proposal was influenced by lawmakers’ decision in 2015 to ditch an excise tax on marijuana approved by voters after they approved legalizing recreational pot in 2014. Instead, lawmakers created a sales tax on marijuana. (Prior coverage: *State Tax Notes*, July 27, 2015, p. 343.)

“The legislature looked and said, ‘No thanks, we’ll do our own version,’ ” McCormick said, arguing that this recent history showed proponents it would make more sense for lawmakers to determine how they want to collect revenue from liquor sales.

“The legislature ultimately has the responsibility for these taxes,” McCormick said.

But critics of the measure, including the Oregon branch of the American Federation of State, County and Municipal Employees (AFSCME), argue that the state’s three-fifths majority requirement for passage of taxes means there might not be a replacement tax.

“We’re mostly afraid that Costco and Wal-Mart and grocers are going to make a ton of money, [while] the state will lose a ton of money,” said Joe Baessler, political director for Oregon AFSCME Council 75.

According to the Oregon Liquor Control Commission, the state pulled in $1.1 billion from alcohol sales in the fiscal 2014-15 biennium, making it roughly the third-largest state revenue source. The vast majority of that amount came from distilled spirits. About $187 million of the alcohol revenue went to local governments and services to treat alcohol-related disorders. If not replaced at the state level, “that funding will have to be made up somewhere,” Baessler said.

Paul Romain, a lobbyist for the Oregon Beer and Wine Distributors Association, said that even if lawmakers can muster the necessary votes, there’d be a minimum three-month delay between when the state would cease controlling liquor distribution and when a new tax could take effect. He said voters could also collect signatures to put a legislatively approved tax up for a vote, creating a delay of more than a year even if it’s upheld.

Baessler said a replacement tax was not included to improve the initiative’s chances, not out of deference to lawmakers.

“‘Their plan was to have no mention of a tax, hoping that they wouldn’t get the word tax in their ballot title,’ Baessler said. “The problem is there’s very little anticipation that [lawmakers will] be able to get that amount of money through the legislative process.”

The initiative has garnered substantial attention. Earlier this year, LC 196 was proposed to eliminate the Liquor Control Commission’s role distributing liquor for sale and to create a privilege tax on liquor should the initiative pass. The bill was a contingency effort to guard state revenue, but the legislature didn’t pass it before lawmakers adjourned in mid-March, Baessler said.

McCormick said that opponents’ concerns are misplaced and that the sizable revenue brought in by the current tax regime would make replacement imperative. He said Initiative 71 is written to ensure the law doesn’t go into effect until mid-2017, “allowing the legislature time to determine for itself the best alternative” for taxing spirits. While the state could face a 90-day implementation delay in tax collections, it would be able to require back tax payments to compensate, he said.

McCormick also dismissed the idea that voters would try to block a new liquor tax passed by lawmakers. “There is no anti-liquor-tax movement I’m aware of,” he said. “It’s overblown.”

In their broader arguments, proponents claim the state’s control of liquor sales is archaic and encumbers small businesses by barring direct wholesaling to retailers. McCormick gave an example of a distiller in the state that wants to sell its product to a nearby restaurant. In Oregon, the distiller must first sell the liquor to the state, which then distributes the product to retail stores where the restaurant owner could buy the spirits.

But opponents say Initiative 71 would mainly benefit large liquor companies and retailers. In criticisms of the initiative mentioned in a dispute over its draft ballot title, Romain said the measure is unfair to some small retailers because it blocks liquor sales at most gas stations that...
currently sell wine and beer. Romain warned that privatization of liquor distribution would also let large liquor companies quash smaller competitors by ending the state’s more egalitarian control over the promotion of distilled spirits.

Critics also say the initiative would undermine state regulation of liquor sales. The current system is highly efficient and ensures strict oversight over purchases of alcohol, Baessler said.

“It’s a lot harder to walk off with a bottle of booze in a liquor store where it’s controlled than [in] a regular shopping store,” Baessler said.

Proponents argue that the initiative would open up a freer, more competitive market and protect against abuses of the new system. Protections include helping retailers combat the risk of liquor theft, mandating training for employees to prevent sales to minors, doubling fines for underage sales, and sending the extra revenue from fines — along with savings the state would realize from ceasing control over distribution — toward public safety programs. The ballot initiative write-up also notes that the state would still be allowed to promote Oregon distilleries.

WASHINGTON

DOR Can’t Ignore Its Own Rules, COST Argues

by Stephanie Cumings — stephanie.cumings@taxanalysts.org

The Washington Department of Revenue shouldn’t be allowed to ignore its own published rules, the Council On State Taxation argued in an amicus brief filed with the state supreme court March 28.

COST also asserted that the Arizona-based taxpayer in Avnet Inc. v. Department of Revenue was erroneously forced to pay Washington’s business and occupation (B&O) tax on sales in which no activity took place in the state.

In the case, Avnet Inc., a distributor of electronic components and computer parts, was assessed $556,330 in B&O back taxes on sales of goods shipped to non-Washington-based customers’ locations in the state and sales drop-shipped to non-Washington-based customers’ buyers located in the state.

The court of appeals found that both kinds of sales should be subject to the B&O tax because the company’s in-state activities were sufficient to establish nexus for the taxation of all its Washington-bound sales. The court also held that a regulation the taxpayer sought to rely on — Rule 193 — was merely an “interpretive” rule and the court was not bound by it. (Prior coverage: State Tax Notes, May 11, 2015, p. 404.)

Avnet appealed to the Washington Supreme Court, arguing that the state can impose B&O tax only on sales that involved activities with substantial nexus with the state. (Prior coverage: State Tax Notes, Oct. 12, 2015, p. 107.)

In its brief, COST argued that the court of appeals erred in finding that the DOR could ignore its own rule because it was merely interpretive. Allowing the DOR to do so would lead to confusion and costly litigation, COST said. COST also contended that gross receipts that are dissociated from any activity within the state aren’t subject to the B&O tax under the dormant commerce clause.

COST said the court of appeals improperly relied on Association of Washington Business v. Department of Revenue to find that the DOR could ignore Rule 193. According to COST, the version of Rule 193 at issue in the case allowed a company to dissociate out-of-state transactions from transactions that involved some in-state activity. The rule was later amended.

In Association of Washington Business, the state supreme court found that interpretive rules aren’t binding on the courts or the public. COST said that Association of Washington Business “neither relieves the DOR from its duty to follow its own rules nor does it authorize the courts to allow the DOR to retroactively reverse its position on a published rule upon which a taxpayer relied.” To find otherwise would
mean that taxpayers would “no longer be able to rely on such rules, and taxpayers’ confidence in Washington’s tax system will erode,” COST said.

“It is critical for taxpayers to be able to rely on the interpretations of the DOR, the agency charged with administering the B&O tax, so they can voluntarily comply with the law and avoid costly controversy and litigation,” the brief said. The uncertainty of being unable to rely on the DOR’s interpretations would also cause problems for the department because it would be “confronted with increased numbers of taxpayers . . . interpreting tax statutes in many different ways, leading to intensified and protracted audit controversies and litigation,” COST added.

COST also asserted that the lower court was wrong to imply that the U.S. Supreme Court’s decision in Norton Co. v. Department of Revenue is no longer good law. The Norton Court held that sales dissociated from a taxpayer’s in-state activity weren’t subject to gross receipts tax. COST said Norton is still good law and, therefore, states like Washington that impose gross receipts taxes on interstate businesses must “allow an out-of-state business to exclude certain interstate sales: those sales that are dissociated from a business’s in[-]state activities in the taxing state.”

The relevant test in Avnet under the dormant commerce clause is whether the activity, not the taxpayer, had substantial nexus with the state, COST said. What constitutes substantial nexus depends on the type of tax being imposed.

COST said states have greater latitude to impose sales and use taxes, while “the U.S. Supreme Court has affirmed that states are more restricted in their ability to tax the income (including gross income subject to the B&O tax) of a multijurisdictional corporation.”

“Other than the unique sales and use tax context, the U.S. Supreme Court has never veered from the Norton dissociation rule for any other tax type,” COST said. 

WEST VIRGINIA

Higher Taxes Could Ease State’s Budget Shortfall, Report Says

by Stephanie Cumings — stephanie.cumings@taxanalysts.org

West Virginia should consider a broad array of tax increases, not just budget cuts, to address its looming $239 million budget shortfall, according to a new report.

The report from the West Virginia Center on Budget and Policy found that the budget shortfall is attributable not just to falling energy prices but also to past state tax cuts, including the elimination of the business franchise tax and the reduction of the corporate net income tax rate from 9 percent to 6.5 percent.

The West Virginia Department of Revenue issued updated fiscal 2017 estimates to the State Legislature in February.

“New estimates were lowered by about $240 million, which reflects $148 million in proposed tax increases that were not passed by the Legislature during the regular legislative session,” Gov. Earl Ray Tomblin (D) said in a statement. “It also reflects an additional $92.4 million reduction in estimates to account for the continued downturn in global energy markets, which is affecting West Virginia and several other energy-producing states.”

The regular legislative session ended March 12, but lawmakers will reconvene this spring for a special session to address the budget shortfall.

The report said increasing taxes would make sense because “tax responsibilities in West Virginia are already the lowest they have been in years.” Further, the state made budget cuts in fiscal 2016, including “$41.5 million to Health and Human Services, $16.5 million to public education, and $13.8 million to both higher education and public safety,” according to the report.

The report’s recommendation to increase taxes on specific tobacco products would bring in the most revenue.

“Governor Tomblin’s proposal of a modest tax increase on various tobacco products won’t be enough to provide long-term funding for services such as Medicaid, nor will it help reduce health care costs and save lives associated with tobacco use,” the report said. “Increasing the cigarette tax to $1.55 per pack from 55 cents, the wholesale tax on other tobacco products to 50 percent from 7 percent, and instituting a 7.5-cent-per-milliliter tax on electronic cigarettes would provide an additional $61 million beyond Governor Tomblin’s tobacco tax proposal, bringing the total to $139 million.”

In February the Senate approved a bill that would have increased the tax on cigarettes to $1.55 per pack, increased the tax rate on other tobacco products from 7 percent to 12 percent, and imposed a tax of 7.5 cents per milliliter on electronic cigarette liquid. The bill was sent to the House of
Delegates but failed to make it out of the House Finance Committee. (Prior coverage: State Tax Notes, Feb. 29, 2016, p. 629.)

The report also called for raising the severance tax on natural gas and natural gas liquids, which has been a controversial subject in the state.

"Research shows that severance taxes have little impact on natural gas extraction and that the tax falls primarily on out-of-state energy companies and customers," the report said. "If West Virginia increased its severance tax on natural gas liquids to 10 from 5 percent, it would increase revenue by an estimated $18 million in the next fiscal year. If the severance tax on all natural gas were increased to 6 percent from 5 percent, it would increase revenue by an estimated $18.5 million in the next fiscal year."

The state, however, reduced natural gas and coal severance taxes earlier this year. The coal industry in particular has been arguing for lower severance taxes as it struggles to stay afloat. The state saw an unprecedented drop in severance tax collections last year because of declining coal production and significantly lower natural gas prices. (Prior coverage: State Tax Notes, Mar. 7, 2016, p. 714.)

West Virginia isn’t the only state heavily reliant on energy income that is suffering from shortsighted tax cuts. Oklahoma and Louisiana made tax cuts in recent years that, combined with falling energy prices, have led to budget problems, according to a blog post from the Center on Budget and Policy Priorities in February.

An increase in West Virginia’s soda tax could bring in $50.5 million in the next fiscal year, the report said. SB 604, which was introduced in February but never advanced out of the Senate Finance Committee, would have increased excise taxes on soda products fivefold.

The report also recommended updating the sales tax to cover specific goods and services sold and delivered on the Internet, which could generate $10 million annually. It said that applying the sales tax to telecommunications services would raise approximately $60 million a year. It also said the sales tax should be applied more widely to personal services — like salons, massage and tattoo parlors, and private fitness centers — that are exempt for "no discernible reason."

The report called for scaling back personal income tax exemptions for wealthier individuals and modernizing the personal income tax rates and brackets. It also proposed enacting an earned income tax credit to help offset some of the tax increases.

"A state EITC at 15 percent of the federal credit would cost approximately $47 million and could be paired with a tobacco tax increase or a sales tax increase to help offset the impact of other taxes that hit hardest at low income levels," the report said.
Working With New York’s New Combined Reporting Rules

by Peter L. Faber

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In this edition of In the Trenches, Faber discusses New York’s new combined reporting rules as presented in the statutes, Department of Taxation and Finance frequently asked questions, and draft regulations. Although Faber asserts that the new combined reporting regime is complicated, he commends the department for its willingness to issue draft regulations and to work with interested parties in developing effective final regulations.

The combined reporting rules in New York state have been completely overhauled by corporate tax reform legislation enacted in 2014 and 2015. The new rules present challenges to taxpayers and the Department of Taxation and Finance frequently asked questions, and draft regulations. Although the rules are effective for tax years beginning on or after January 1, 2015, so they will have to be taken into account on income tax returns during the current filing season.

The department released draft regulations addressing the combined reporting rules on January 22, 2016. Although those regulations have not been formally proposed, they represent the department’s thinking and should be taken into account in filing returns and in planning. They will be discussed below.

The combined return rules have been a continuing source of controversy over the years. In some cases, the department has tried to compel related corporations to file combined returns. In other cases, the department has resisted taxpayer attempts to file combined returns.

Under prior law, corporations were allowed to combine, and could be required to combine, if they were linked by more than 80 percent common stock ownership, they were engaged in a unitary business, and separate filing would distort their New York incomes. The existence of substantial intercompany transactions was sufficient to meet the distortion requirement. The distortion requirement gave rise to a considerable amount of controversy. Tax appeals tribunal and court decisions established the general principle that the existence of distortion should be determined by analyzing transactions among related corporations under principles established by the U.S. Treasury’s regulations under IRC section 482, which generally gives the IRS the discretion to reallocate tax items among related corporations if they do not deal with each other at arm’s length. Proving the existence or absence of distortion was an expensive proposition, and cases could drag on for years. Expert witnesses were required to testify as to arm’s-length standards for particular types of transactions, and this strained the department’s budget. Finally, the department went to the Legislature and persuaded it to eliminate the distortion requirement. Under the new law, the only standard for requiring or permitting combination, other than common stock ownership, is whether the corporations are engaged in a unitary business.

Another change in the landscape resulted from the combination of the bank tax and the general corporation tax. Under prior law, general business corporations were taxed under article 9-A of the tax law, and banks were taxed under Tax Law article 32. Corporations taxed under different articles of the tax law could not file combined returns together because the tax regimes were different. Under the new law, the article 32 tax on banks has been eliminated, and banks are now subject to the general corporate income tax under article 9-A. As a result, banks and general business corporations are now permitted, or may be required, to file combined returns together. That has changed the combined return group composition for many families of companies that include both banks and general business corporations.

The New Statutory Framework

The new rules for eligibility to file combined returns are set forth in Tax Law section 210-C. In general, corporations must be linked by more than 50 percent stock ownership. Under prior law, the stock ownership requirement was 80 percent (the federal level). As a result, many corporations will be filing combined returns with partially owned subsidiaries that previously filed separately. As under prior law, there is no requirement that there be a corporate parent at the top of the chain. The only requirement is that the corporations in the combined return be controlled by the same interests. This means that two corporations each of which is wholly owned by an individual can file a combined return, even though the individual obviously cannot be included in the return. Those corporations would not be
allowed to file consolidated federal income tax returns because federal law requires there to be a corporation at the top of the chain.¹

The corporations must be engaged in a unitary business, with one important exception. A group of corporations that meets the stock ownership test can elect to file combined returns, even though one or more of those corporations are not engaged in a unitary business with other members of the group. The election is irrevocable for seven tax years and is automatically renewed for another seven tax years unless it is revoked. If the election is revoked, a new election cannot be made for any of the three immediately following tax years.

The universe of corporations that can be included in a combined return has been expanded to cover some alien (that is, non-U.S.) corporations and some captive insurance companies. Utilities and insurance companies can still not be included in a combined report with general business corporations nor can real estate investment trusts, regulated investment companies that are not captives, New York S corporations, and alien corporations that are not treated as domestic corporations under the IRC and that have no effectively connected income for the tax year. The statute does not address whether two corporations whose unitary business connection is provided by a noncombining corporation, such as an insurance company, can be viewed as being engaged in a unitary business with each other.

**Detailed Analysis of the Statute**

Tax Law section 210.C.2(a) provides that corporations can be permitted or required to file combined returns if more than 50 percent of the voting power of the stock of each corporation is owned or controlled, directly or indirectly, “by the same interests.” The statute does not define voting power or indicate when the 50 percent ownership requirement must be met.

Voting power can mean many things. It is generally viewed as the ability to elect members of the corporation’s board of directors. That is apparently the department’s view, as reflected in the draft regulations. Presumably, a class of voting stock that was entitled to elect only three members of a seven-member board of directors would not meet this requirement. It is likely that a class of stock that can vote only on some extraordinary transactions such as the sale of substantially all of the corporation’s assets would not be viewed as voting stock with voting power for purposes of this requirement. The treatment of stock that has the right to approve or disapprove of more common transactions is unclear. How would the law treat a class of stock that had the right to approve or disapprove officer compensation or contracts involving amounts in excess of a stated level or extending for more than a stated period? Presumably, stock with voting rights contingent on the occurrence of certain events would not be viewed as holding voting power until those events occurred, but the statute is unclear.

The statute does not indicate when the 50 percent requirement must be met. If a corporation acquires more than 50 percent of another corporation’s stock two weeks before the end of the tax year, can they file combined returns for the entire tax year? The answer undoubtedly is no, but one cannot derive that from the statute. The question of “instant unity” when a corporation’s stock is acquired by another corporation will be discussed below.

The corporations that cannot participate in a combined return are listed in the summary above. One type of corporation deserves special mention. New York law has long provided that corporations organized under the laws of a foreign country, described as alien corporations, could not join a combined return. The status of corporations that were formed under the law of a foreign country but that were treated as U.S. corporations for federal income tax purposes was never clear, and they could not be included in a combined return even though they were taxed as U.S. corporations. That included corporations the stock of which could not be transferred without a transfer of stock of a related U.S. corporation (so-called stapled stock under IRC section 269B). Under Tax Law section 210-C.2(b), an alien corporation can be included in a combined return if it is treated as a domestic corporation under any IRC provision, so stapled corporations will qualify. That change can be viewed as a clarification of prior law. In an extension of prior law, the new rules provide that an alien corporation that is treated as a foreign corporation for federal income tax purposes can be included in a combined return if it has “effectively connected income” for the tax year under Tax Law section 208.9(iv). Income is effectively connected within the meaning of this provision if it is so treated under IRC section 882, which generally applies to income from the active conduct of a trade or business in the United States. Interestingly, the New York statute does not require that the ECI have any connection with the state. Thus, a corporation could include in a combined return income of a subsidiary that had ECI derived entirely from non-New York sources, thus diluting its apportionment factor.

Section 210-C.2(c) lists numerous corporations that cannot be included in a combined return, including some utilities and insurance companies, REITs, RICs that are not “captives,” New York S corporations, and alien corporations other than those described above. The provision further indicates that a corporation cannot be required or permitted to file a combined return if it is taxable under article 9-A solely as a result of owning a limited partnership interest in a limited partnership that is doing business in, or otherwise has nexus with, New York and none of its related corporations are taxable under article 9-A. That is apparently true even if the corporation has not elected to be taxed solely on its income from the limited partnership’s activities.

Tax Law section 210-C.3 provides for the election under which a commonly owned group of corporations can agree

¹IRC sections 1501 and 1504 (a).
to be included in a combined return even if one or more of its members is not conducting a unitary business with other members. The election must be made on an original timely filed return of the combined group, determined by taking into account any extension for filing. The election apparently cannot be made on an amended return, even if the amended return is filed before the normal filing deadline.

The election is irrevocable and applies for the tax year for which it is made and for the next six tax years. Any corporation joining the group during the election’s term is included in the group and must join in the combined return. The election is automatically renewed for seven additional tax years unless it is affirmatively revoked. The revocation must be made on an original timely filed return for the first tax year after the end of the initial seven-year election period. The statute does not indicate whether the election is automatically renewed for a third seven-year period. If an election is revoked, a new election may not be made in any of the three immediately following tax years. Short tax years are not counted in applying the seven-year and three-year rules.

The group election procedure was included in the legislation to spare corporations the need to make difficult determinations as to what constitutes a unitary business. It was also intended to spare department auditors the need to make those difficult determinations in audits. I am working with several clients that are considering making the election. The choice will not always be obvious. It is not that hard to determine whether the election will be advantageous for the next year or so. It is much harder to predict the future. An election that provides tax benefits now may be disadvantageous five years from now, and the irrevocability of the election requires companies to anticipate what their tax profiles will be well into the future. It may be hard to predict what companies will have net operating losses that can be applied against the income of related companies or what the apportionment profiles of the different companies will be. A subsidiary that has a low New York State apportionment percentage now may change its operations and have a high New York apportionment percentage in the future. Despite the difficulty of estimating the desirability of future combined returns, many companies are deciding to make the election now for reasons of administrative convenience.

If a corporation is unsure about the desirability of making the election, one possibility is to not make the election but to structure relationships among the affiliated corporations so as to create a unitary relationship among those corporations that one desires to include in a combined return but to exclude other affiliates from the unitary relationship. This is easier said than done because business considerations will often dictate the nature of relationships among related corporations. Functional integration, centralized management, and economies of scale are not tax terms — they reflect business relationships that typically are determined outside a corporation’s tax department.

Section 210-C.4 addresses the computation of tax within a combined return, but the statutory language is sparse. The statute indicates that the combined group “shall generally be treated as a single corporation, except as otherwise provided, and subject to any regulations or guidance issued by the commissioner or by the department.” The reference to “guidance” is unclear and arguably could involve any communication, formal or otherwise.

Practitioners have wondered for some time about the extent to which the detailed U.S. Treasury regulations involving consolidated returns are part of New York law. The Department of Taxation and Finance has never published clear rules about this. Practitioners have generally assumed that those principles apply for New York state and New York City purposes, and the department’s general approach has been to apply them as long as the taxpayer applied them in a consistent manner.

Tax law section 210-C.4(b)(i) provides that “all intercorporate dividends shall be eliminated, and all other intercorporate transactions shall be deferred in a manner similar to the U.S. Treasury regulations relating to intercompany transactions” under IRC section 1502. This language is inartful: The gain or loss and other tax consequences of intercorporate transactions may be deferred under the Treasury regulations, but the transactions themselves are not. Nevertheless, we know what this language means, and it mirrors language in prior department regulations. In effect, gain or loss on intercorporate transactions is deferred until one party to the transaction leaves the combined return group.

Subsection (c) provides that eligibility for credits is computed on a separate company basis. Each member of the group must compute its own credits based on its own activities and applying statutory limits. The credits can then be applied against the combined tax of the group. In computing combined capital, intercorporate stock holdings and debts are ignored.

Subsection (d) provides for a combined NOL deduction. The deduction is computed as if the group members were a single corporation and is subject to the same limitations that apply to NOLs under federal law as if the corporations had filed a consolidated federal income tax return, regardless of whether one or more of the corporations had in fact filed separate federal returns. Presumably, federal principles will also apply regarding allocating an NOL when a corporation leaves the combined return group.

Section 210-C.5 provides that transactions among members of a combined reporting group are ignored in determining the group’s apportionment factor.

**Department Guidance: FAQs**

Faced with massive corporate tax changes (and the combined return provisions are but a small part of the new legislation), the department has started issuing guidance in the form of questions and answers (referred to on the
The FAQs are updated periodically, the most recent set being distributed on March 7. Several of them involve combined return issues, and they will be discussed here.

One question involves the “instant unity” issue that has been a problem in New York and in other states. If a corporation buys all of the stock of a previously unrelated corporation, when are they considered in a unitary business so that they can begin (or can be compelled to begin) filing combined returns? If the corporations had no prior business relationship, at what point can it be said that their operations are sufficiently integrated to justify a finding that they are engaged in a unitary business? This is not an issue that is unique to the tax reform legislation. It has been around for a long time because being engaged in a unitary business was always a prerequisite to filing combined returns. The FAQ is not terribly helpful, indicating that this “is a facts and circumstances determination upon acquisition.” My understanding, based on informal conversations with the department’s field audit management personnel, is that the department has generally found unity from the date of acquisition if the corporations had a sufficient preexisting business relationship that continued after the acquisition. This has been confirmed in the draft regulations, discussed below. When there was no such relationship, the facts would be examined on a case-by-case basis to see when the operations of the two corporations became integrated.

Another question addresses whether fiscal-year and calendar-year corporations can join in a combined return. The answer is that they can. The year of the corporation that is designated as the group’s agent for filing tax returns is the controlling year, and the income and activities of the other corporations for their years that end within the agent’s tax year are the income and activities that are included in the combined return for the agent’s tax year. However, the FAQs provide that a corporation with a tax year that begins in 2014 and ends in 2015 cannot be included in another corporation’s combined return for the other corporation’s tax year ending in 2015. It can join the combined return only for its first tax year beginning on or after January 1, 2015.

Members of a group that are not taxpayers are not subject to the fixed-dollar minimum tax, but if they are included in a combined return, their income may be taxable and their apportionment factors will be taken into account in computing the group’s apportionment factor.

The FAQs indicate that a unitary corporation’s activities are included in a group’s combined return only for that part of the year in which the stock ownership requirements are met.

The FAQs also provide, what seems obvious, that the capital of a captive REIT, captive RIC, or a combinable captive insurance company is included in the computation of a combined group’s capital base when the tax is based on capital and not on net income.

Other FAQs address the application of New York’s new economic nexus rules to combined return groups. Some of the positions taken by the department in those FAQs are controversial.

Under the corporate tax reform legislation, corporations with receipts from New York sources of $1 million or more in a tax year are treated as having taxable nexus with New York. Before the legislation was enacted, New York statutes did not directly address economic nexus, and the department did not assert economic nexus principles in applying the statutory rule that a corporation had nexus if it was doing business in New York. The tax reform legislation codifies economic nexus under the New York state corporate income tax. Interestingly, although the New York City Administrative Code was amended to incorporate substantially all of the state corporate tax reform provisions, an exception was made for economic nexus, so the city still requires a physical presence for a corporation to be taxed.2

The FAQs indicate that the $1 million receipts threshold is applied to the entire group but takes into account only group members with New York receipts of at least $10,000 during the year and excludes corporations that cannot be included in a combined return under section 210-C.2(c), such as insurance corporations. The FAQ specifically refers to receipts from corporations conducting a unitary business. If the language is read literally, it would mean that receipts of corporations that are not conducting a unitary business, but that are brought into a combined return group because of the seven-year election referred to above, are not counted. While presumably the election would not be made unless the group had nexus to begin with, it is possible that a group might make an election to include all related corporations, not just those engaged in a unitary business, in a year in which one or more group members clearly had nexus with the state but that in a later year (that is, one of the years covered by the seven-year term of the election) the group might not have nexus but for the economic nexus provision. In that kind of case, this issue would become relevant. It is not clear whether the department was deliberately taking the position in the FAQ that in applying the economic nexus threshold, one considers only receipts of corporations engaged in a unitary business and not of corporations that were included in the group because of the election. The department simply may not have thought about the issue.

2I understand that this was a result of lobbying by New York state lawmakers from districts outside the city who did not want their constituents to be taxable by the city on sales made to city customers.
Department Guidance: Draft Regulations

The department released draft regulations relating to the new combined return rules on January 22, 2016. Under New York law, regulations must be proposed and published and subjected to public comment before being finalized. They can be adopted only after a comment period has ended, and the department typically publishes a discussion of comments received and the department’s reactions to them when regulations are finalized.

The department, recognizing that the corporate tax reform provisions are complicated and introduce new concepts, has adopted the practice of publicly releasing draft regulations before they are formally proposed to elicit comments from interested taxpayers and practitioners. Draft regulations have previously been released involving sourcing receipts from services for apportionment purposes and nexus.

The draft regulations on combined returns are just that — drafts — but they indicate the department’s thinking and address many significant issues.® Among other things, they contain for the first time a detailed explanation of the department’s position on the unitary business concept. The existence of a unitary business has always been a prerequisite for filing combined returns in New York state, but the department has not previously detailed its views as to what constitutes a unitary business.

The regulations made clear what has always been implicit: the “same interests” that must control more than 50 percent of the voting power of each of the members of the combined return group need not themselves be eligible to join in the combined return. The regulations indicate specifically that the same interests could include an alien corporation, a partnership, or an individual.

The statute provides that the stock ownership test relates to stock that is “owned or controlled” by the same interests. The regulations expand on the “control” concept, indicating that control is present when “one corporation directly or indirectly possesses the power to dictate or influence the management and policies of another corporation through the direct or indirect ownership of more than fifty percent of the voting power of the capital stock of that corporation.” It is unclear why this provision is needed because the ownership of stock possessing more than 50 percent of a corporation’s voting power is by itself sufficient to meet the common ownership requirement.

The regulations confirm that voting power means the power to elect the corporation’s board of directors. Agreements restricting the power of some stock to vote will be taken into account. The regulations indicate that, if there is an agreement “whether expressed or implied” that a stockholder will not vote its stock in a board of directors election, the rights possessed by that stock will be disregarded in determining whether the stock ownership requirement is met. Moreover, if a stockholder agrees to vote its stock as directed by another stockholder, the other stockholder will be treated as possessing the voting rights of the first stockholder. Voting proxies are taken into account in determining voting power.

The regulations provide that different weighting of voting rights will be taken into account. An example indicates that the number of shares of voting stock is not controlling if different classes of stock have different numbers of votes per share.

The regulations contain a sensible rule relating to different tiers of corporations. An example provides that if corporation A owns 51 percent of the voting power of corporation B and corporation B owns 51 percent of the voting power of corporation C, corporation A controls more than 50 percent of the voting power of corporation C because, by virtue of its control of corporation B, it can compel corporation C to do what it wants. Corporation A’s voting power of corporation C is not determined by taking 51 percent of 51 percent. The latter computation might reflect the value of corporation A’s holdings in Corporation C, but it does not reflect corporation A’s ability to control corporation C’s activities. The same principle applies regarding ownership through tiers of controlled partnerships.

The regulations do not address some of the other issues discussed in the first part of this article regarding voting power, including the treatment of contingent voting rights and the treatment of rights to vote on only limited corporate activities. In my view, the treatment of contingent voting rights should be easy: The stock should be deemed to possess voting power only when the contingency occurs and the rights become exercisable. The treatment of rights limited to the ability to vote on some issues is harder to address in regulations and perhaps should be left to determination on a case-by-case basis, but it would be helpful if the final regulations at least addressed the issue and pointed out the problem. In my view, the right to vote only on major transactions like the sale of substantially all of the corporation’s assets should not be viewed as a voting right for this purpose. That right is often conferred by state statute, and it obviously does not affect a corporation’s day-to-day operations. On the other hand, the right to approve or disapprove routine business transactions that the corporation can be expected to engage in often would involve a right to affect a corporation’s management and, in my view, should be treated as voting power. I have seen arrangements in which a group of shareholders had the right to veto leases of property extending more than a specified number of years or purchases that exceeded a specified number of dollars. The practical consequence of those arrangements was that the holders of those rights had the power to be involved in the corporation’s day-to-day operations. Those rights should be considered in applying the voting power standard.

®For convenience, the draft regulations will be referred to as “regulations” in the following discussion, but readers should remember that they are not yet in force.
In the Trenches

The regulations do not address the treatment of options to buy stock. Ordinarily, an option holder would not possess the right to vote stock, and the normal rule should be that options should be disregarded. On the other hand, one can imagine situations in which the ownership of an option to buy stock for a nominal price could give the owner effective control over that stock. This will be an unusual situation, and it is an issue that is probably best addressed by the courts applying common sense and practical judgments and not by regulations.

The regulations go into considerable detail on the unitary business requirement. As indicated above, the department has not previously stated its position on unitary business issues in detail. Although the unitary business requirement has been part of New York’s legal landscape for decades, most of the combined return litigation has involved disputes about whether separate filing would distort the New York incomes of the corporations, and comparatively little attention has been focused on the unitary business requirement. This is likely to change now that the unitary business test is the only game in town, and the department is to be commended for providing guidance not only to taxpayers but also to its own auditors.

The regulations begin with a general statement that “the term unitary business shall be construed to the broadest extent permitted under the U.S. Constitution as interpreted by the U.S. Supreme Court, the courts of the State and the New York State Tax Appeals Tribunal.” The intention is clear: the term “unitary business” is to be given an expansive reading.

Reciting standards that have been established by the courts, the regulations indicate that a unitary business “is characterized by a flow of value as evidenced by functional integration, centralized management and economies of scale.”

Functional integration “is characterized by transfers between, or pooling among, business activities that sufficiently affect the operation of the business activities.” The regulations indicate that this can apply to a business’s “products or services, technical information, marketing information, distribution systems, purchasing and intangibles.” The concept is an integration of functions. The regulations point out properly that functional integration is a product of common activities and not pricing and that it can be present even if companies charge each other arm’s-length prices.

Centralized management is deemed to exist when employees and directors “jointly participate in the management decisions that affect the respective business activities and that may also operate to the benefit of the entire economic enterprise.” Centralized management may exist even if day-to-day management responsibility is decentralized “so long as the management has an operational role with respect to the business activities, such as participation in overall operational strategy for the business.” The reference to “the business” seems to be to the overall business and not to the activities of any one corporation.

Economies of scale are deemed to exist when there is a “significant decrease in the average per unit cost of operational or administrative functions due to the increase in operational size.”

The regulations indicate that the concepts of functional integration, centralized management, and economies of scale should be analyzed together “for their cumulative effect.” They are not to be viewed as separate and independent requirements but, rather, as components of an overall analysis.

In an interesting approach, the regulations provide a series of presumptions. A unitary business will be presumed to exist in some specified scenarios. The taxpayer or the department may overcome the presumption by presenting “clear and convincing evidence.” The presumptions are illustrated by examples. These presumptions are discussed below.

In an illustration of horizontal integration, corporations will be presumed to be engaged in a unitary business “when all of their activities are in the same general line of business.” This is a very broad concept, and the scope of “general line of business” is not at all clear. What if one corporation owns and operates a children’s toy store and a related corporation owns and operates an automobile dealership? The corporations are both retailers and are engaged in the business of selling tangible personal property. Is that enough to put them in the same general line of business? What if one corporation owns a children’s clothing store and another corporation owns a toy store? They both are retailers and they are both aimed at the same market. There, the connection is closer than in my first example. What if one corporation sells computers and a related corporation services them? In this case, one corporation is selling tangible personal property and the other corporation is selling services, but they are arguably in the same general line of business.

An example sheds some light on this issue. A corporation sells natural and organic foods at retail stores located throughout the United States, and a related corporation sells the same types of foods at retail stores in Canada. The corporations are presumed to be engaged in a unitary business because of horizontal integration. This may give rise to a negative inference that retailers that sell different types of products do not come within the horizontal integration presumption.

The second presumption, labeled “vertical integration,” indicates that corporations are presumed to be engaged in a unitary business when they are “engaged in different steps in a vertically structured enterprise.” This presumption may be easier to administer. It should pick up corporations that are engaged in a chain of operations that end up producing a product or service. It would not only include wholesalers and retailers but also real estate companies that own the premises on which related companies conduct their business.

In an illustration of vertical integration, one example postulates that corporation A explores for oil, corporation B
extracts the oil found by corporation A, corporation C processes the oil extracted by corporation B, and corporation D sells the oil processed by corporation C. In what seems to be a no-brainer, all four corporations are presumed to be engaged in a unitary business by reason of vertical integration.

The third presumption is labeled “strong centralized management.” It is present “where there is strong central management coupled with the existence of centralized departments or affiliates for such functions as financing, advertising, research and development, or purchasing.” The meaning of the word “strong” is not immediately apparent. This presumption is present only if the strong central management is coupled with centralized departments or affiliates. One would think that the presence of centralized departments or affiliates would be enough. The word ‘strong’ mean that the top-tier management people impose their will on lower-tier people? Presumably, top-tier people will always do this to some extent, at least with regard to major policy decisions. Would this apply only if the top-tier people imposed their will on day-to-day operations?

Two examples relate to centralized management. In one example, two corporations are engaged in totally different lines of business (one sells children’s clothing and the other operates restaurants). A third corporation provides centralized purchasing, advertising, and finance services to both corporations, and its executive officers are “actively engaged in the operations” of the other corporations. The group of corporations is presumed to be engaged in a unitary business, even though the product lines of the two customer-facing corporations are markedly different.

In another example, corporations are presumed to be engaged in a unitary business because one corporation provides centralized cash management services to others through a cash sweep mechanism. The cash corporation is not otherwise engaged in the operations of the other corporations, but they all borrow funds from the cash corporation without interest. That represents a change in department policy, because the department has occasionally resisted combination in cases in which the taxpayer has asserted that combination was justified by centralized cash management under a sweep arrangement.

A newly formed corporation is presumed to be in a unitary business with the corporation or corporations that form it from the date on which the capital stock requirement is met. That presumption may be too broad. If a corporation forms a new subsidiary and transfers a preexisting business to it as a contribution to capital, this presumption makes sense. If a corporation forms a new subsidiary for the purpose of acquiring a business from an unrelated company, the presumption seems inappropriate.

The newly formed corporation presumption is illustrated by an example in which a corporation contributes all of its intellectual property to a new corporation in exchange for all of the new corporation’s stock. The corporations are presumed to be engaged in a unitary business.

The final presumption is for newly acquired corporations. The regulations indicate that a newly acquired corporation is presumed to be engaged in a unitary business with the acquiring corporation in the first tax year in which they satisfy the common stock requirement if they have horizontal integration, vertical integration, or strong centralized management. This seems generally consistent with the informal position that the department has taken regarding the instant unity question and that discussed above.

That is illustrated by an example in which a corporation acquires 51 percent of another corporation’s stock and the acquired company distributes the products manufactured by the acquiring company so that they are part of a vertically structured business. They are presumed to be engaged in a unitary business immediately.

In another reversal of position, the regulations indicate that a passive holding company shall be deemed to be engaged in a unitary business with operating companies that it controls. In the past, the department has resisted taxpayer arguments that passive holding companies should be viewed as unitary with controlled operating companies. The change makes business sense as well as common sense and is commendable.

The regulations provide specific rules relating to captive REITs and captive RICs. Captive REITs and captive RICs must be included in a combined report under Tax Law article 9-A if they are not required to be included in a combined report under article 33, dealing with insurance companies.

A captive REIT or captive RIC must be included in an article 33 combined return if the corporation that directly owns or controls more than 50 percent of its voting power is a life insurance corporation subject to tax or is required to be included in a combined return under article 33 or if its closest controlling stockholder is that kind of life insurance corporation. The term “closest controlling stockholder” means the corporation that indirectly owns or controls more than 50 percent of the captive’s voting power and is “the fewest tiers of corporations away in the ownership structure from the captive REIT or RIC.”

The regulations describe the commonly owned group election. They make clear that the election applies to all commonly owned corporations regardless of whether they are included in one or more federal consolidated income tax returns and regardless of whether they are engaged in one or more unitary businesses.

The regulations indicate that when the commonly owned group election is made, all group members are deemed to be engaged in a single unitary business for all purposes under the tax law, including for purposes of calculating business and investment capital, business and investment income, and the apportionment factor. Because numerous provisions of the tax law are based on the existence of a unitary business, this means that making the election can have implications that go beyond merely obtaining the right to file combined returns. For example, the regulations
indicate that if one of the members of the group sells all of the stock of another group member with which it is not engaged in a unitary business under the normal definition of unitary, the gain will be treated as gain from the sale of a unitary subsidiary and will be properly reported as business income on the group’s combined return, even though the corporations were not in fact engaged in a unitary business. This regulation is arguably contrary to the statutory language, which says only that the corporations elect to be included in combined returns and not that they elect to be treated as if they are unitary.

The regulations discuss the election procedure. They make clear that the election must indicate “in the manner required by the Commissioner” that each corporation that is a member of the group has acknowledged that it is bound by the election.

The regulations provide that the disposition of one or more group members outside the group will not sever the election as to the remaining group members. However, they indicate that the reverse acquisition rules provided in U.S. Treasury reg. section 1.1502-75(d)(3) will apply in determining whether a group remains in existence. This means, for example, that if a parent corporation of an electing group merges into an unrelated corporation and the shareholders of the merged corporation end up controlling the acquiring corporation, the merged corporation’s group will be deemed to continue to exist, and its election will remain in effect. There are many variations on this theme, and the continued existence of an election when there are changes in the ownership of the top-tier corporation may vary depending on the circumstances.

The regulations indicate that a revocation must be accompanied by a statement that every corporation that is a member of the commonly owned group acknowledges that it is bound by the revocation. The regulations do not indicate when a group is deemed to terminate so that the election would terminate. For example, what happens if a top-tier parent corporation’s stock is purchased by an unrelated buyer three months after a group election is made? Assume that the buyer has not made a group election regarding its subsidiaries. One would think that the election would terminate because the buyer should not be required to have a continuing election for some members of its controlled group. It would help if the regulations were more detailed about the effect of acquisitions of this type.

In what is certain to be a controversial provision, the regulations state that the department may disregard the tax effects of an election “where it appears, from facts available at the time of the election, that the election will not have meaningful continuing application.” For example, the regulations state that “the Commissioner would disregard the tax effects of a commonly owned group election made in anticipation of the sale of substantially all of the business conducted in New York where a material part of the anticipated gain from the disposition would be apportioned to New York in the absence of the election and where the sale results in the winding up of the seller’s business in New York, such that the continued application of the commonly owned group election would be anticipated to have no meaningful continuing impact in New York.” One can appreciate the department’s concern about a situation in which a corporation that is about to sell a business at a substantial gain makes the election so as to bring within its combined return a non-unitary subsidiary with substantial NOLs, but it is not clear that the department has the statutory authority to disregard an election. Presumably, taxpayers will make the election only when they feel that it is to their advantage from a tax standpoint. The Legislature has not given the department the power to disregard the election when the election will reduce tax revenue, and the department should not attempt to acquire that power through regulations.

Conclusion

The rules for combined reporting in New York have changed dramatically. As might be expected in any complex area of the law, many interpretative problems remain, and taxpayers, and for that matter department auditors, will have to proceed in an uncertain world, although the uncertainties may be different from those that they encountered a few years ago. The department’s willingness to share its tentative thinking through the mechanism of draft regulations is commendable and will improve the usefulness of the final regulations.
New York Corporate Tax Reform: An Investment Fund Perspective

by Dale Y. Kim

Dale Y. Kim is a senior manager in KPMG LLP’s state and local tax practice in New York. In this viewpoint, Kim discusses New York’s corporate tax reform and how it has affected investment capital and receipts apportionment. He encourages investment funds with corporate partners to consider how these changes and their complex rules will apply to their businesses.

The information herein is of a general nature and based on authorities that are subject to change. Applicability of the information to specific situations should be determined through consultation with your tax adviser. This article represents the views of the author only and does not necessarily represent the views or professional advice of KPMG.

Everyone knows New York state tax reform was targeted to corporate taxpayers, right? But did you know that a flow-through entity, such as an investment fund, may be subject to the very same corporate tax reform rules when it comes to information gathering and reporting?1 The tax reform law changes made to the state and city corporate tax systems were effective for the 2015 tax year and had a dramatic impact on businesses in the financial services industry. The changes included many legislative measures other states have used to modernize their corporate income tax systems, including economic nexus, unitary combined reporting, and market-based sourcing. Other changes that were unique to New York include the treatment of income from investment capital and sourcing of receipts from some financial instruments.

While much attention has been paid to it from a corporate taxpayer perspective, the effect those corporate tax law changes have on passthrough entities has been neglected. This article will spotlight the corporate tax reform legislation’s effect on passthrough entities, particularly those in the investment fund community. The following discussion summarizes some of the key aspects of the New York corporate tax reform legislation that will affect investment funds, including hedge funds, private equity funds, fund of funds, and others.2

**Net Income From Investment Capital**

One of the unique aspects of the former New York general corporate tax regime was the treatment of net income from investment capital (that is, investment income). Investment capital was defined under the former law to include some stocks, bonds, and other qualifying securities.3 Under the prior regime, investment income was effectively apportioned to New York based on a weighted average of the underlying issuers of the investment capital stocks, bonds, or other securities.4 This weighted average was referred to as the “investment allocation percentage” and was calculated based on the “issuer’s allocation percentage” (IAP), as published annually by the New York State Department of Taxation and Finance and New York City Department of Finance.5 The IAP regime often resulted in a favorable, low-apportionment tax.

1New York has historically required passthrough entities filing in the state to report distributive shares of partnership items to partners using Form IT-204-IP “New York Partner’s Schedule K-1,” or Form IT-204-CP, “New York Corporate Partner’s Schedule K-1.” As of the date of this writing, the New York state tax authorities have not published the 2015 Form IT-204-CP, which will presumably reflect many of the corporate tax reform changes discussed in this article. Note that New York City has never published a Schedule K-1 form and that it appears unlikely the city will start doing so, despite the similarities in state and city corporate-partner-level taxation, both pre- and post-tax reform. Nonetheless, providing corporate partners their distributive share of New York City partnership items via a K-1 equivalent or substitute form (with similar information as provided in the state IT-204-CP) continues to be prudent practice.

2For purposes of this article, all citations to New York (or New York state) tax authorities should be understood as having parallel citations and applicability to New York City authorities unless specifically noted to the contrary.

3N.Y. Tax Law (former) section 208.5 (2014).

4N.Y. Tax Law (former) section 210.3(b) (2014).

5Id.
Consider, for example, a corporate taxpayer with a 100 percent business allocation percentage (BAP) apportionment to New York that has investment capital solely in the form of corporate bonds, whose issuer has only 1 percent apportionment to New York. Under the prior tax regime, the corporate taxpayer would favorably apportion any interest income and net gains from corporate bonds by 1 percent (that is, the investment allocation percentage), rather than 100 percent (that is, its BAP apportionment).

Under the corporate tax reform legislation, investment income is no longer separately apportioned using the investment allocation percentage method. Rather, net investment income is fully excluded from a corporation’s taxable business income base.7 In other words, investment income is no longer subject to tax. The definition of investment capital, however, is significantly narrowed to include only non-unitary stocks that:

- are capital assets under IRC section 1221;
- are held for investment for more than one year;
- if disposed of, generate, or would generate, long-term capital gains or losses;
- if acquired on or after January 1, 2015, have never been held for sale to customers in the regular course of business; and
- were clearly identified in the taxpayer’s records as stock held for investment in the same manner as required of broker-dealers under IRC section 1236(a)(1) before the close of the day on which the stock (or option) was acquired.8

Further, the amount of a corporation’s investment income is limited to 8 percent of entire net income; the excess is transformed into taxable business income.9

Let’s consider the impact of those changes to an investment fund that typically operates as a partnership for tax purposes. First, only partnerships with corporate partners, either direct or indirect, will be affected by those changes.10 Consistent with the historical approach, New York will generally require a corporate partner to compute tax based on the aggregate method (aka the look-through method), as provided by regulation.11 Under the aggregate method, a corporate partner is deemed to have an undivided interest in the assets, liabilities, receipts, income, gains, losses, and deductions of the partnership.12 A corporate partner is, therefore, required to flow through and report its share of

208.6(b). However, the “40 percent haircut” is applied after investment income has already been limited to 8 percent of entire net income, further diminishing the benefit of earning investment income. The limitation of investment income to 8 percent of entire net income and the 40 percent haircut election are applied at the corporate partner level, rather than at the partnership’s informational reporting level. A partnership with corporate partners will be expected to give them the information they need to compute their taxable investment income, such as how much interest expense at the partnership level is directly or indirectly attributable to the ownership of investment capital.

Note that partnerships with solely individual, estate, or trust partners are unaffected by the corporate tax reform legislation. While the 2014-2015 law reforms made significant changes to the general corporate franchise tax under New York state article 9-A and New York City’s general corporation tax, no changes were made to the New York state article 22 personal income tax laws or city equivalent personal income tax (or the city unincorporated business tax). To the extent that a partnership has both corporate partners and individual, estate, or trust partners, however, the partnership must contend with the tax rules under both the corporate tax reform laws and the historical personal income tax laws, the differences between which are more pronounced now than ever before.

Corporate taxpayers are required to use the aggregate method if they have access to necessary information under current regulation. A taxpayer is presumed to have access to the information if it: (1) conducts a unitary business with the partnership; (2) is a general partner in the partnership or a managing member of a limited liability company treated as a partnership for federal income tax purposes; (3) has a 5 percent or more interest in the partnership’s items of income, gain or loss, deductions, or credits under IRC section 704; (4) has reported information from the partnership on the aggregate method in a prior tax year; (5) has a partnership interest that constitutes more than 50 percent of the partner’s total assets; (6) has a basis in its partnership interest as determined under IRC section 705 on the last day of the tax year of more than $5 million; or (7) has a member of its affiliated group that has information necessary for applying the aggregate method. 20 NYCRR section 3-13.2(a).

While the city does not have a parallel regulation matching this state regulation, it recently published frequently asked questions stating that the city “will conform closely to the New York state regulations for corporate partners.” N.Y.C. Dep’t of Fin., “Answers to the Most Frequently Asked Questions About Corp. Tax Reform,” at 3 (Sept. 14, 2015).

1220 NYCRR section 3-13.3(a).
the partnership’s items, including investment capital, investment income, and apportionment factors. As a result, a partnership is required to report to corporate partners its share of these items, which has historically been reported on Form IT-204-CP, “New York Corporate Partner’s Schedule K-1,” for New York state purposes.\(^1\)

Regarding investment fund partnerships that have corporate partners using the aggregate method, the changes to the investment capital/income regime described above will create new investment capital reporting issues. Consider that only non-unitary stocks that are capital assets under IRC section 1221 and are held by the taxpayer for more than one year will qualify as investment capital. That definition will require the partnership to identify a much more limited category of financial assets that qualify as investment capital, excluding non-equity investments and short-term equity investments. It will require additional due diligence on options, whose underlying asset could be stocks, bonds, exchange-traded funds, or other products, since only some stocks could qualify as investment capital. Further, only the non-unitary stocks that have been clearly identified in the taxpayer’s records as stock held for investment in the same manner as required under IRC section 1236(a)(1) will qualify as investment capital.

One of the key elements of the identification requirement is that to qualify as investment capital, stock acquired on or after October 1, 2015, must be identified as held for investment in the taxpayer’s records before the close of the day on which the stock was acquired.\(^2\) Therefore, investment capital must now be properly identified in the taxpayer’s records daily. Stock that would qualify as investment capital acquired before October 1, 2015, was required to be so identified by September 30, 2015.\(^3\)

As explained in a recent technical memorandum published by the state Department of Taxation and Finance,\(^4\) a partnership must follow specific identification procedures for the stock to qualify as investment capital to a corporate partner. If the partnership is a dealer for purposes of IRC section 1236, stock acquired before and after October 1, 2015, must be clearly identified by the partnership as held for investment under section 1236(a)(1) in order to satisfy the investment capital identification requirement. For partnerships that are not dealers subject to IRC section 1236, stock acquired before October 1, 2015, that otherwise meets the requirements to be investment capital satisfies the investment capital identification requirement if the partnership made the identification before October 1, 2015, in accordance with the procedures described in the memorandum.\(^5\)

Intimidated yet? The detailed analysis discussed above to segregate what may ultimately be a small portion of an investment fund’s assets into investment capital stocks, and to properly identify it as a non-dealer on an ongoing basis, could be a daunting task for the investment fund — all that for a corporate partner’s potential deduction for investment income that may ultimately be capped at 8 percent of its entire net income, anyway.\(^6\)

Now let’s consider what the tax reform changes mean for an investment fund’s assets that do not qualify as investment capital (that is, financial instruments other than long-term equities). Specifically, we will explore business capital/income and receipts factor apportionment rules under the new reform law (concepts that may have been completely foreign to investment funds in the past). Warning: The following discussion on the treatment of non-investment capital qualifying assets may be even uglier.

**Residual Business Income and Receipts Factor Apportionment Implications**

Under the corporate tax reform, the term “business capital” generally means all assets, other than investment capital, less liabilities not deducted from investment capital.\(^7\) As a result, any asset that does not qualify as investment capital falls into the residual category of business capital. Likewise, the term “business income” generally means entire net income minus investment income and some other exempt income.\(^8\) Considering that investment capital is now restricted to non-unitary stocks that are long-term capital assets and that are clearly identified in the taxpayer’s records as held for investment, any other investment assets that previously qualified as investment capital are now business capital producing business income. In other words, assets such as corporate bonds; federal, state, and municipal debt; exchange-traded funds, or other products, since only some stocks could qualify as investment capital. Further, only the non-unitary stocks that have been clearly identified in the taxpayer’s records as stock held for investment in the same manner as required under IRC section 1236(a)(1) will qualify as investment capital.

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\(^1\) Indeed, Form CT-204-CP includes a section for stock, bonds, other securities, apportionment, and other issues. A significantly revised 2015 Form IT-204-CP is expected but has not yet been published by the state’s Department of Taxation and Finance as of the date of this writing.

\(^2\) N.Y. Tax Law section 208.5(a).

\(^3\) Id.


\(^5\) N.Y. Tax Law section 208.8.

\(^6\) N.Y. Tax Law section 208.7(a).

\(^7\) Based on the statutory requirement to identify investment capital stocks before October 1, 2015, it appears that stocks not timely identified will default to business capital classification and produce apportionable business income. It is unknown at this point how the state and city tax authorities will determine timely identification compliance or how strictly the October 1, 2015, deadline will be enforced.

\(^8\) Note that a corporate taxpayer’s investment capital, however, is not limited to 8 percent of total capital. Therefore, a corporate taxpayer is entitled to exclude 100 percent of investment capital for purposes of the alternative tax on business capital. N.Y. Tax Law sections 208.5(a) and 208.7(a).

\(^9\) N.Y. Tax Law section 208.7(a).

\(^10\) N.Y. Tax Law section 208.8.
and other non-equity investments now generate business income (not investment income) under the new law. Unlike investment income, business income is taxable and apportioned by the BAP.21

Under the new tax regime, the BAP for New York state purposes consists of a single receipts fraction, whose numerator is the amount of receipts sourced to the state under the new sourcing rules and whose denominator is the amount of total receipts everywhere.22 The reform law implements what is generally referred to as market-based, or customer-based, sourcing. The customer-based sourcing rules prescribe specific sourcing methods for various categories of receipts from financial instruments.23 Those sourcing methods include (i) a customer-based sourcing method looking to the location of the purchaser, payer, or issuer; (ii) a default 8 percent sourcing method (for example, net gains from other financial instruments if the purchaser or payer is a registered securities broker or dealer or the transaction is done through a licensed exchange); and (iii) a default zero numerator or denominator method. Consider, for example, the following sample of the myriad receipts categories and sourcing methods required thereunder:

- receipts constituting interest from loans secured by real property located in New York are sourced to the state for the numerator of the receipts fraction;24
- receipts constituting interest from loans not secured by real property are sourced to New York for numerator purposes of the receipts fraction if the borrower is located in the state;25
- receipts constituting interest and net gains from the sale of debt instruments issued by the United States, any state, or a political subdivision of a state are not in the numerator of the receipts fraction at all;26
- 8 percent of the interest income from asset-backed securities or other securities issued by government agencies is in the numerator of the receipts fraction;27
- receipts constituting interest from corporate bonds are in the numerator of the receipts fraction if the commercial domicile of the issuing corporation is in New York;28
- 8 percent of net gains and other income from “other financial instruments” are in the numerator of the receipts fraction if the purchaser or payer is a registered securities broker or dealer or the transaction is made through a licensed exchange;29 and
- marked-to-market net gains are in the numerator based on the respective sourcing rule applicable to the underlying instrument being marked to market.30

To illustrate those significant changes, consider a corporate taxpayer that previously had investment capital under the old law in the form of corporate bonds. Assume that the bonds had only one issuer that had 1 percent IAP to New York and there was no other investment capital. The corporate taxpayer would have favorably paid tax on only 1 percent of the amount of interest income from the corporate bonds under the old rules.

Under the tax reform law, however, corporate bonds do not qualify as investment capital. The corporate taxpayer would be left with residual business capital assets producing business income regarding corporate bonds. The interest income from the corporate bonds, therefore, would be apportionable business income subject to apportionment by the business apportionment factor. The BAP calculation would require application of the receipts sourcing rules under the new law to compute the receipts fraction. For interest income on corporate bonds, these receipts are in the numerator of the receipts fraction if the commercial domicile of the issuing corporation is in the state.31 The corporate taxpayer must then apply a hierarchy to determine the commercial domicile location of an issuer, starting with the seat of management and control of the business entity and then the billing address of the business entity in the taxpayer’s records.32

A corporate taxpayer in this example may unfavorably have 100 percent of interest income on the corporate bonds sourced to New York for numerator purposes of the receipts fraction (assuming the commercial domicile of the issuer is in New York) or favorably have 0 percent (assuming the commercial domicile of the issuer is outside New York). Many taxpayers, of course, have numerous types of corporate bonds with various issuers with commercial domiciles located everywhere. Consequently, the commercial domicile of the issuer would need to be determined for each specific corporate bond. Regardless of where the receipts fraction numerator regarding receipts from corporate bonds

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21Note that New York City still refers to its corporate tax apportionment factor percentage as a “business allocation percentage,” or BAP, consistent with the term used in the previous corporate tax regime. However, New York state refers to its apportionment factor as a “business apportionment factor” under the new law. N.Y. Tax Law section 210-A.1. For purposes of this article, all references to the term “BAP” apply to state and city corporate tax apportionment methods.
22Id. Note that New York City, unlike the state with its single-receipts-factor formula, will continue to use a three-factor apportionment formula consisting of receipts, property, and payroll (weighted 80 percent-10 percent-10 percent, respectively, for the 2015 tax year) that will phase out in favor of a single-receipts apportionment formula for tax years beginning after 2017. NYC Admin. Code section 11-654.3(a)(10).
32N.Y. Tax Law section 210-A.5(c).
is sourced, the corporation will ultimately be taxed on its net income from corporate bonds as apportioned by its overall BAP, which will include the effects of applying the customer-based sourcing rules to all of its various receipts (not just its receipts from corporate bonds).

To complicate — or simplify — the matter further, the corporate tax reform legislation also provides an elective-fixed percentage method of sourcing receipts from some qualified financial instruments (QFIs). In determining the inclusion of receipts and net gains from QFIs for receipts fraction purposes, taxpayers may elect to source 8 percent of all net income from QFIs for numerator purposes of the receipts fraction. All net income from QFIs is in the denominator of the receipts fraction. QFIs include (i) any financial instrument that is of a type described in the receipts fraction sourcing categories (that is, loans that are not secured by real property; federal, state, and municipal debt; asset-backed securities and other government agency debt; corporate bonds; non-investment capital, stocks, or partnership interests; other financial instruments; and physical commodities) and that has been marked to market in the tax year under IRC section 475 or 1256; and (ii) any other financial instrument that has not been marked to market but is the same type of financial instrument as one that has actually been marked to market.

Thus, for example, having just one corporate bond marked to market under IRC section 475 results in all other corporate bonds being deemed to be likewise marked to market, and then all the corporate bonds are considered QFIs so that all interest income and net gains from the corporate bonds can electively be 8 percent numerator sourced. However, the fact that corporate bonds are QFIs does not render other financial instrument types — such as asset-backed securities — QFIs.

So how do those business income and receipts apportionment-factor rules affect investment funds? Regarding partnerships that have corporate partners using the aggregate method, the tax reform limitations on the types of assets that qualify as investment capital will likely produce considerable residual business capital assets and thus business income. Apportioning that business income requires applying the labyrinth of receipts-factor apportionment rules.

As demonstrated in the example above, assets that no longer qualify as investment capital under the new law (for example, corporate bonds) are business capital and thus produce business income. Investment fund partnerships with these assets likely reported them as investment capital in pre-reform tax years, with associated investment income and respective IAPs, in terms of informational reporting to corporate partners.

Now it appears that investment funds must contend with the challenge of many types of investments being apportionable business capital that produces business income in the hands of a corporate partner. Accordingly, funds must deal with the receipts apportionment fraction sourcing complexities regarding various financial instrument receipts. Indeed, the historical Form IT-204-CP always required a partnership to report the proportionate share of receipts apportionment information (sourced to the Metropolitan Commuter Transportation District, New York state, and everywhere else) to corporate partners, and that is not expected to change.

Consider the many types of debt instruments typically held by an investment fund (for example, collateralized mortgage obligations, mortgage-backed securities, collateralized debt obligations, inflation-linked securities, U.S. Treasuries, municipal obligations, and non-U.S. government bonds) that will now constitute business-income-producing assets under the new law and require application of the customer-based receipts-factor sourcing rules at the investment fund level. Consider the many types of options, forwards, futures, swaps, commodities, currencies, and other non-equities that will similarly produce business income and require customer-based sourcing analysis at the investment fund level.

With the vast quantities and many types of complex financial instruments typically held by an investment fund, the application of the customer-based sourcing rules under the new reform law will surely cause pain and consternation among the investment fund community. How can an investment fund practically determine the commercial domicile of hundreds or thousands of corporate bond issuers? How can an investment fund practically determine the locations of payers or purchasers of hundreds or thousands of “other financial instrument” receipts that were not facilitated through a broker-dealer or licensed exchange?

The 8 percent QFI sourcing election, which can greatly alleviate the data-mining burden required under the customer-based sourcing rules, is a corporate-partner-level election. By that election, one corporate partner might decide to make the 8 percent QFI sourcing election, while another corporate partner might opt for the default customer-based sourcing. A partnership generally would not know how a corporate partner will elect. Thus, the partnership must bear the burden of gathering all the customer-based sourcing data for its corporate partners to then decide what to do.

A partnership cannot make the 8 percent QFI election, which would lessen much of that compliance headache. To a large extent, the existence of a partnership as the direct earner of receipts from financial instruments renders the compliance-easing impetus for the 8 percent QFI election applicable.

34Id.
35Id.
37See, e.g., 2014 Form IT-204-CP.
an unattainable moot point. What’s more, a corporate partner making the 8 percent QFI election will need to know which of its shares of partnership receipts are actually marked to market or, if they are not, which are of the same type as financial instruments of the corporation that are actually marked to market.

**Conclusion**

The significant law changes regarding investment capital and receipts apportionment sourcing outlined above are just a few of the many changes in the corporate tax reform legislation that will affect partnerships with corporate partners. While many in the investment fund community may cringe at the thought of dealing with such complex rules, it seems unlikely that they will go away anytime soon. With the 2015 tax return season in full swing, and Schedules K-1 to corporate partners underway, it would be prudent for investment funds with corporate partners to consider expeditiously those changes and determine the appropriate application of those complex rules.
Ohio’s Business Income Deduction: Boon or Boondoggle?

by Mark A. Engel

Ohio, like many states, is bent on driving down, if not eliminating, its personal income tax rates. In 2013 it became one of the first states to provide a deduction for business income in computing income subject to tax. Since then, Ohio has increased the deduction, eliminated the need to apportion the deduction, and tinkered with the rates at which business income exceeding the deduction is taxed. Thus, there are numerous details an individual taxpayer needs to consider in preparing his Ohio individual income tax returns for 2015 and beyond.

Before 2005, Ohio’s personal income tax consisted of nine brackets that ranged from a marginal rate of 0.743 percent on the first $5,000 of Ohio adjusted gross income to a high of 7.5 percent on income exceeding $200,000. Beginning with the enactment of broad tax reform in 2005, Ohio ratcheted down its tax rates. By 2009 rates were reduced 21 percent, ranging from 0.587 percent to 5.925 percent. In 2012 rates were further reduced, and in 2013, not only were rates reduced again, but a new deduction for a portion of a taxpayer’s “Ohio small business investor income” was enacted.

The Small Business Deduction

Conceived as a tool to improve small business formation and investment in the state, the small business deduction equaled half of a taxpayer’s Ohio small business investor income. The latter was defined as the portion of a taxpayer’s AGI that is business income, reduced by deductions from business income and apportioned or allocated to Ohio, to the extent not otherwise deducted or excluded in computing federal or Ohio AGI. The amount of the deduction was capped at $62,500 for each spouse if the spouses filed separately and at $125,000 for individuals and for spouses filing jointly. Stated another way, taxpayers could deduct half of the first $250,000 in Ohio small business investor income allocated or apportioned to Ohio. The limitation was calculated on a per-taxpayer basis and not on a per-entity basis. As a result, the owners of some fairly substantial enterprises were able to take advantage of the deduction. Amounts exceeding the deduction were subject to taxation at the regular bracketed rates, resulting in additional tax savings.

A key limitation was that the deduction had to be apportioned and allocated within and without Ohio for all taxpayers. An apportionment schedule was required for all taxpayers, even those doing business only in Ohio. Leaving that information blank — or just reporting factors of 1 — could be construed as an incomplete or false return.

In 2014 income tax rates were cut yet again, and the small business deduction was increased to 75 percent of the first $250,000 of that income. Spouses filing separately could each deduct up to $93,750, while individuals and spouses filing jointly could deduct up to $187,500. Business income exceeding the deduction remained subject to taxation at the graduated rates. The deduction still had to be allocated or apportioned to Ohio.

The Business Income Deduction

In 2015 the deduction was changed dramatically. Under that new scheme, all business income is deducted in computing Ohio AGI and is taxed separately. Taxable business income is defined as business income reduced by either of two amounts. For tax years beginning in 2015, the reduction is capped at $187,500 for single taxpayers and married taxpayers filing jointly, and $93,750 for married taxpayers filing separately. For tax years beginning after 2015, the amount is $250,000. Also, the deduction no longer needed to be allocated and apportioned to Ohio for taxpayers domiciled in the state. An individual could take advantage...
of the entire deduction, even though only a portion of the taxpayer’s business income was allocated or apportioned to Ohio. However, for purposes of the nonresident credit, the deduction still has to be allocated and apportioned by taxpayers who were not domiciled in Ohio. Finally, all taxable business income—that is, business income exceeding the deductible amount—was taxed at a flat rate of 3 percent.4

However, that feature presented a problem for some taxpayers for 2015. Recall that the deduction only extended to 75 percent of the first $250,000 of business income for 2015, and that taxable business income exceeding the deduction amount would be taxed at 3 percent. However, under Ohio’s graduated rate schedule, the 3 percent tax rate would not normally kick in until a taxpayer reported Ohio AGI exceeding $41,700. Thus, taxpayers with taxable business income (that is, business income exceeding the deduction cap of $187,500) had to compute and pay tax on the excess taxable business income at the flat 3 percent rate. As a result, some taxpayers could experience a (dreaded) tax increase for 2015. To remedy the situation, additional legislation was enacted5 to provide that for 2015 only, business income exceeding the deduction would be taxed under a separate rate schedule that mirrored the regular rate schedule until it reached a level of 3 percent, at which point the tax rate was capped.6

For tax years beginning in 2016, the first $250,000 in business income is deducted and all taxable business income in excess of $250,000 is taxed at a flat rate of 3 percent.

The Devil in the Details

Even though the deduction results in an overall tax decrease, computing the tax liability may become more complicated. For tax years beginning in 2015, taxpayers will only be able to deduct 75 percent of the first $250,000 in business income. Business income in excess of that amount will be subject to tax at graduated rates on a separate set of brackets paralleling the normal graduated rates until it reaches $41,700. At that point, all business income exceeding $41,700 will be taxed at a flat rate of 3 percent. Other nonbusiness income remains subject to the existing graduated rates. Thus, taxpayers may have income taxed in three different buckets. For tax years beginning after 2015, the first $250,000 of business income is not taxed at all; business income exceeding that amount is subject to tax at 3 percent; and all other income remains subject to tax at the graduated rates then in effect.

Like many states, Ohio permits a passthrough entity to file a composite return for its nonresident owners.7 That return, Form IT 4708, satisfies any reporting requirement for the nonresident owners of the entity. However, the small business deduction may not be claimed on the composite return. In order for a taxpayer to claim the deduction, it must file an individual income tax return, Form IT 1040.

Commencing with tax years beginning in 2015, the deduction no longer needs to be allocated or apportioned to Ohio. Rather, a taxpayer first allocates and apportions income to Ohio, then may claim the entire deduction amount against its Ohio AGI. And the deduction is applied first against the business income allocated and apportioned to Ohio. For example, for 2016 and subsequent years, a taxpayer receiving $400,000 in business income, half of which is apportioned to Ohio and half of which is not, may claim a deduction of $200,000 against its Ohio AGI. Similarly, if that same taxpayer apportions $300,000 in business income to Ohio and $100,000 outside Ohio, the taxpayer may claim the entire deduction against that portion of the income apportioned to Ohio, reducing its Ohio taxable business income from $300,000 to $50,000.

For a person who owns 20 percent or more of a passthrough entity, Ohio recharacterizes amounts paid as W-2 wages to that owner as distributions of business income. When enacted many years ago, that provision was a mechanism to prevent passthrough entity owners from stripping income from Ohio.8 However, in light of the exclusion for the first $250,000 in business income from taxation, that recharacterization may actually increase the amount of income sheltered from Ohio income tax and reduce the taxpayer’s personal income tax liability.

Because business income is deducted from Ohio AGI and treated separately while other types of income remain subject to the standard rate table, taxpayers with business income must carefully consider their estimated payments for 2016. That exercise is made more difficult by Ohio’s relentless effort to tinker with the income tax over the past several years, creating additional uncertainty for those attempting to bring order to their Ohio tax situation.

Finally, there remains a nuisance associated with the deduction. The withholding tax imposed on passthroughs for amounts distributed to owners maintaining a domicile outside Ohio has not been reduced to reflect the reduction in income tax rates and the impact of the business income deduction.9 The question whether a state may tax the business income of a passthrough entity owner domiciled in another state remains hotly contested. During the 1990s, Ohio was one of several states that addressed the issue by imposing on passthrough entities a withholding tax on all distributions of income to owners who were not domiciled in the state. The amount of the tax is 5 percent of the amount distributed, and withholding is required of any

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4R.C. 5747.02(A)(4).
5See SB 208.
6R.C. 5747.02(A)(4). Other Ohio income remained subject to the graduated rates as high as 4.993 percent.
7R.C. 5747.08(D) (Baldwin 2007).
8That provision also precluded those recharacterized amounts from being included in the wage factor for apportionment purposes.
9See R.C. 5747.41-5747.45.
entity making total distributions to owners domiciled outside Ohio in excess of $1,000. In addition to an annual return, those entities are required to file returns and make estimated tax payments on a quarterly basis.

The amount of the withholding tax has not been reduced as tax rates have been cut and the business deduction put in place. Thus, distributions to owners domiciled outside Ohio continue to be taxed at 5 percent. The owner domiciled outside Ohio is entitled to a credit for the tax paid regarding distributions paid to that owner. However, the generous exclusion for business income and the favorable tax rate for taxable business income mean that the individual is likely to have tax overwithheld. While that amount can be refunded to the individual when the taxpayer files his return, having the tax withheld creates a cash-flow issue for the taxpayer, as well as dealing with the Form 1099-G that will be issued in the following year.

Ohio has tried mightily to eliminate its personal income tax over the past 10 years. It has slashed the rates by about 35 percent, rendered some deductions subject to income caps, and provided generous protection from taxation for business income. Further changes are possible, as the idea of shifting to a flat tax of an undetermined rate has been floated. As a result of that constant tinkering, taxpayers with business income have received significant income tax relief. Whether that relief translates into greater investment in Ohio remains unclear.
Where state legislators discover their best tax ideas.

“The question is not whether states will raise the necessary money. Rather, it’s which groups they will tax.”

— David Brunori,
Deputy Publisher
Only in the publications of Tax Analysts
How Mississippi ‘Invented’ the Sales Tax

by Billy Hamilton

Billy Hamilton is the executive vice chancellor and CFO of the Texas A&M University System. In 2015 Hamilton led Texas Republican Gov. Greg Abbott’s Strike Force on the Health and Human Services Commission to complete a management analysis of the agency. Before that, Hamilton was the deputy comptroller for the Texas Office of the Comptroller of Public Accounts from 1990 until he retired in 2006. He is also a private consultant, advising on numerous state tax matters.

In this edition of State Tax Merry-Go-Round, Hamilton writes about Mississippi’s early success with the sales tax — and all the drama that went into its enactment. Hamilton applauds 1930s-era Gov. Martin “Mike” Conner for sticking to his guns in the face of political opposition to get Mississippi’s fiscal house in order, and cautions contemporary lawmakers against confusing their desire to chase jobs with their responsibility to ensure sound government.

In a recent column, I wrote about the desire of Mississippi’s governor and legislative leaders to enact some new tax breaks, either in the form of income tax credits for moderate-income families or business tax cuts designed to stimulate the economy, which is, it appears, understimulated at the moment.

The Senate favors business tax cuts, and on March 10, it voted overwhelmingly for a plan to phase out the corporate franchise tax, reduce the individual and corporate income taxes, and provide tax cuts for self-employed taxpayers. At the same time, the House was working on a smaller plan to provide individual income tax credits to families with children and incomes of $52,000 or less, in line with Republican Gov. Phil Bryant’s goal of “blue collar” tax cuts.

States do what they do, but it appears to be dawning on some Mississippians that tax cuts, while nice to consider, probably aren’t a good idea right now. State revenues are falling because of sluggish economic growth, and in January, Bryant mandated a 1.5 percent midyear budget cut for most state agencies, a sure sign of trouble. Tax cuts are fun, but sometimes you have to balance the books the old-fashioned way, without stepping off a fiscal cliff based on the belief that you’ll sprout wings on the way down.

In any case, I provide this background only because I wanted to recall another moment in Mississippi’s history, one that was more challenging than the present but that proved exceptionally important to the state — and to state tax policy generally. I’m talking about the year Mississippi “invented” the sales tax.

I admit that people are normally interested in the here and now, but sales tax history needs to be understood because the sales tax has become the revenue choice du jour for many states looking to reduce income or property taxes. A lot of faith is being invested in one tax, especially one that depends on consumer spending. But when the tax was originally created, it had no such lofty goals, and when I recently wrote a summary of state tax history, I discovered a couple of interesting things about the tax. First, it’s relatively new, dating only to the 1930s in its current form. And second, it originated in Mississippi of all places. Creating new taxes seems like a task more suited to California or Massachusetts, but not in this case. Its adoption, I thought, must be quite a story.

I spent some time trying to find out how Mississippi, a rural state with a population of 2 million in 1930, managed to create one of the two most important state taxes — one that spread rapidly across the country after Mississippi showed the way. That’s quite an accomplishment, though probably not one commemorated by a statehouse monument. As a Texas legislator once said: Nobody builds statues for fellas that pass tax bills.

One thing is clear, though: Mississippi didn’t invent the sales tax any more than Thomas Edison invented the light bulb. What it did, like Edison, was invent the first working model of the modern sales tax. How that came about did turn out to be an interesting story, full of determination, drama, and donkeys.

1The quote is attributed to Rep. “Jumbo” Ben Atwell (D), first elected to the Texas House of Representatives in 1951. He served for 12 years as chair of the Revenue and Taxation Committee — and sponsored, reluctantly, a tax (increase) bill. Before his death in 1998, he had erected in the Texas State Cemetery in Austin a Texas-shaped granite monument inscribed: “Ben Atwell Lawyer-Legislator-Author of Tax Bill.” It is still the only monument in Austin dedicated to a person who sponsored a tax bill.
Long before Mississippi’s experiment, transaction taxes had a long history in the world of taxation. In a 2002 paper on sales tax history, Bill Fox sketched out just how old they are: “The imposition of transactions taxes can be found through much of modern civilization. Tomb paintings depict tax collectors in Egypt at least as early as 2000 BC, and sales taxes on individual commodities, such as cooking oil, can be traced to that time. Egypt, Athens, and Rome were all known to have general sales taxes.” The tax was used in various forms through the centuries, including a federal tax on some commodities levied during the Civil War.

At the state level, Fox noted that the idea can be traced “back at least to the Pennsylvania mercantile license tax that was initially introduced in 1821, though this and other early taxes were not broad-based.” It was, as its name implies, a license tax, and it was initially imposed only on “dealers in foreign wares and merchandise,” meaning goods brought in from out of state. It was expanded to a license tax for all merchandise dealers in 1841. The tax initially had a rate of $2 per year, and the law goes to some length to make it clear that a “dealer is not one who buys to keep or makes to sell but one who buys to sell again.” When the tax was extended to in-state dealers, businesses like mechanics who bought goods to use in their own “shop or manufactory” weren’t taxed, nor were “feme sole” businesses, which were businesses run by married women apart from their husbands.

**Mississippi didn’t invent the sales tax any more than Thomas Edison invented the light bulb.**

The other candidate for the distinction of inventing the sales tax is West Virginia. For example, a calendar note from *Politico* from May 3, 2012, informs us, “On this day in 1921, West Virginia became the first state to enact a sales tax,” a point it mentions as part of a longer discussion of state sales taxes.

It’s an easy mistake to make because the tax was often referred to as a sales tax, but it was actually a gross receipts tax. The Tax Foundation made that point in a 2006 study of gross receipts taxes after it noted “a growing trend toward replacing corporate income taxes with Depression-era gross receipts taxes.” The report noted that European countries had experimented with gross receipts or “turnover taxes” as early as the 14th century, but they didn’t appear in the United States “until West Virginia lawmakers enacted a ‘business and occupations privilege’ tax on gross business sales in 1921.”

The West Virginia tax didn’t turn out to be very successful, but it did merit a discussion by the National Tax Association during its 1921 annual meeting. William Hallanan, West Virginia’s tax commissioner, told the audience that his state “had been going forward progressively in recent years in the solution of new problems in taxation that have arisen as our scope of governmental activities has broadened.” He claimed that West Virginia could now claim to be the “first state in the whole sisterhood of states to put into effect the principle of sales tax as applied to all business and professional activities in the state.”

What Hallanan described wasn’t a sales tax as we know it, and he also refers to it as “the business-profession tax.” It was a multi-rate tax on the privilege of doing business in the state. Manufacturers and retailers paid a tax rate of one-fifth of 1 percent on gross sales, wholesalers paid one-third of 1 percent, mining businesses paid two-thirds of 1 percent, and so on. The tax base was, essentially, gross revenue minus the cost of goods sold. “The sale is not taxed, but the business or professional activity [is],” Hallanan specified.

Whatever the case, the West Virginia tax wasn’t what we would think of as a sales tax, and it also wasn’t an important revenue source. There also wasn’t a rush to enact gross receipts taxes. No other states adopted a similar tax until Washington did in 1933, which apparently kicked off a short-lived period of state experimentation with gross receipts taxes. The cause of the renewed interest in gross receipts taxes in the 1930s was the same one that propelled the sales tax debate in Mississippi: the Great Depression.

The Depression was a stunning blow for most states, but in Mississippi, the consequences were worse than dire. By January 1932, 70 banks had closed and property values and incomes had plummeted statewide. The state faced a budget deficit of $8 million and had a total debt of more than $50 million, up from $15 million four years earlier. The state treasury reportedly had just $1,326 on hand when 1932 began, and teachers in many school districts hadn’t been paid in a year. Compounding the state’s problems, outgoing Gov. Theodore Bilbo’s four years in office had been turbulent:


> "If you believe Hallanan, who should have known, the 1 percent rate I reported in my earlier column was wrong. I took the rate from another source, and I regret the error. I’m confident Mr. Hallanan isn’t too worried about my slip-up."
Scandals rocked the State Tax Commission and other departments of government; impeachment proceedings were directed at some of Bilbo’s closest political associates; massive dismissals of university presidents and professors had cost the accreditation of the state’s only university and most of its colleges; the budget was badly out of balance; and to make matters almost desperate was the fact that the entire country had plunged into its most disastrous depression.8

When the Legislature convened in January 1932, it had to authorize the State Tax Commission to borrow $750 to pay for postage to mail income tax notices.

Into this morass came Martin “Mike” Conner, the newly elected governor. In his inaugural address, Conner cried havoc and let slip flights of rhetoric like you never hear today: “The state’s credit is like a woman’s virtue. It is the ‘immediate jewel of her soul,’ and those to whose keeping it is entrusted should hold the duty of safe-guarding it as a sacred obligation, the full discharge of which is the highest form of public service,” he said. “There is but one means whereby the state’s credit may be properly protected and its obligations to its citizens properly discharged. That is through the legislative provision of sufficient revenue to meet legislative appropriations and standing commitments of whatever character. The short phrase for this operation is ‘balancing the budget.’”9

Balancing the budget would be tough. Revenues from the income tax, enacted in 1924, were coming in less than a quarter of what they had been in 1928. By the spring of 1932, only 64 percent of the previous year’s property taxes had been paid, and 45,000 farms had been sold for taxes. Conner’s conclusion was that taxes had to be increased. But, he said, the money couldn’t come from property taxes. Other states were providing relief from “excessive” property taxes, and Mississippi would suffer if it raised those taxes. Something else was needed. He quoted the chairman of the Iowa State Tax Commission to the effect that states were beginning to move away from the property tax and raise more revenue “from taxation of incomes, levies upon intangibles, such as securities and investments, or from selective or general sales taxes.” The sales taxes he mentioned presumably were the taxes on gasoline and other “luxuries” that states had begun to adopt in the 1920s. He also talked about reorganizing state government to make it more efficient and less subject to politics.

What the governor didn’t do was spell out a tax plan. He merely signaled the need for one, and after the speech, Mississippi’s Senate Finance and House Ways and Means committees set about developing a revenue program. Conner met several times with both committees, and it was reported the following week that a package involving a retail sales tax plus an increased income tax was in the works. Mississippi already had both taxes. It had adopted a rudimentary version of the sales tax in 1930, along with Kentucky, but both taxes were minor revenue sources. In 1929 Georgia adopted a temporary sales tax, but it was ineffective and was repealed in 1931.

As they worked on designing a tax plan, the two committees clashed. On February 5, 1932, the Jackson Clarion-Ledger reported that the Senate was leaning toward a 3 percent sales tax, and that Conner wanted it that high to pay for a property tax cut. The following day, the newspaper reported that a 2 percent tax was the probable compromise. It also noted that there was growing opposition to the tax, particularly from retail merchants but also from among some lawmakers. The Natchez Chamber of Commerce called a statewide meeting at the Edwards Hotel in Jackson to oppose any new taxes until spending was cut. Full-page advertisements opposing the sales tax began popping up in papers statewide.

Conner fought back. He requested permission to address a joint session of the Legislature and asked to talk to the opposition in their statewide meeting. On the day Conner ventured into the lion’s den of tax protesters, the crowd was so large that it wouldn’t fit into the hotel. The meeting was instead moved to the city auditorium. The governor didn’t mince words: “A protest never solved any problem. You have adopted resolutions. Instead of giving us your resolutions, give us your plan.”

Later in the day, he addressed the Legislature, again not offering a specific tax proposal, but reminding lawmakers of the state’s financial crisis and the need to balance the budget. Amazingly, it worked. The Senate Finance Committee voted out a 2 percent sales tax bill along with an income tax increase, while the Ways and Means Committee produced a bill with a 1 percent sales tax. In early March, the Senate convinced itself to reduce the tax rate to 1 percent, and then voted down the bill after Conner threatened to veto it as insufficient.

Two days later the House passed a 3 percent tax but added an amendment giving 1 percent to counties, annoying Conner. He again addressed a joint session, reminding lawmakers that the state was broke and that property taxes were too high. He called for a 3 percent sales tax for the state’s use and property tax relief. His words failed to work magic. Later that evening, the House defeated the tax bill on a vote that fell just short of the three-fifths majority constitutionally required to pass revenue measures. A motion to reconsider was also defeated. There were calls for the governor to compromise.

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9Much of this story follows a wonderful historical account written by William Winter in 1979 and recalled by Mann in his blog, Something Like the Truth, which mainly deals with Louisiana politics. William Winter, “Governor Mike Conner and the Sales Tax, 1932,” The Journal of Mississippi History, Aug. 1979 and reprinted in Mann by permission.
He didn’t. Instead, he spent the day (and night) after the second vote twisting arms and cajoling. The next day, the House reconsidered its vote on the tax bill once again. The bill got the same number of affirmative votes, but six of the original opponents apparently agreed to miss the session, and that allowed supporters to get the needed three-fifths majority of those present.

Opponents, though, didn’t give up. Plans were announced for another statewide protest meeting, and the rhetoric ratcheted up several notches. The Mississippi Merchants Association sponsored a newspaper ad that said in part:

Augustus Caesar who ruled the Roman Empire, feudal lords in the Middle Ages, Louise [sic] the Eleventh of France, and Isabella of Spain all levied a sales tax in their time and all with the same result. In each case they were forced to abandon it because of the almost open rebellion of the people.

At the statewide meeting, a Jackson merchant named R.E. Kennington said, “The governor evidently thought that his inauguration was a coronation. He acts as though he was crowned king of Mississippi.” T.M. Hederman, editor of the Clarion-Ledger, predicted disaster if the tax was enacted, saying, “If a sales tax is passed, it will be the darkest day Mississippi has ever known. Sherman’s invasion was not more disastrous.” The meeting adjourned to march on the capitol in a procession led by a fife, a drum corps, and a little donkey wearing a blanket with a sign reading “This is what the sales tax will make of Mississippi.”

One sales tax opponent said, ‘The governor evidently thought that his inauguration was a coronation.’

The crowd was halted by capitol security and things got dicey. As one state representative later recalled:

One red-faced man thrust himself forward, pulled a pistol from his belt and pointed it through the door. “Stand back,” the gunman yelled. “I’m coming in.” Then Dr. E.T. Brock, a physician of McComb, was lunging between us to strike the man’s arm upward.

The crowd opened, swallowed the gunman, then closed again.

Apparantly stunned by the unexpected violence, the protesters slowly dispersed. Later that night when the legislator left the capitol, he said all that remained of the mob was the “little jackass” without his blanket, “nibbling spring grass on the Capitol lawn.” You couldn’t make this sort of thing up.

The legislative follies continued. This time the Senate considered a version of the sales tax bill with a 3 percent rate. It was amended down to 1 percent. Conner again threatened a veto, and the bill went down on a close vote. A second try also failed. Senate leaders then met with the governor to offer a compromise — a 2 percent tax. Conner agreed, and the Senate passed the bill.

But that wasn’t the end. The House, having borne the political brunt of passing a 3 percent tax, refused to compromise, and the two versions of the bill went to conference committee. The first conference was hopelessly deadlocked and gave up after three days. New conference were appointed and voted out a 2 percent tax, with Conner agreeing to go along. The Senate adopted the conference report on April 5.

The House followed but voted down the bill by two votes. More arm-twisting ensued, and a motion to reconsider was adopted. However, the House, presumably sick of the whole mess, agreed that only one motion for reconsideration would be allowed. So the next vote was all or nothing.

On April 10 the House again convened to consider the tax bill with everything on the line. It was, according to press accounts, a raucous evening. A fight broke out. Another was narrowly averted. In the end, 82 votes were needed to pass the bill, and after the vote, the final tally showed 81 in favor, the bill apparently falling one vote short and therefore dead. Suddenly Rep. Oscar Wolfe rose and changed his vote from nay to aye. He later explained that after voting against the tax, he had a vision of financial chaos for the state and hopeless legislative deadlock if the tax issue wasn’t resolved.

Conner signed the bill a few days later, and it took effect May 1, 1932. He refused what must have been an enormous temptation to gloat. Instead, he simply said, “It has been a long, hard fight. I hope everyone will forget about the scrap.”

Nothing makes people forget scraps like success. The tax didn’t end in disaster for Mississippi. In his 1934 discussion of the tax, Alfred Garner wrote that “the tax has produced, even during the depression, revenue even beyond the estimate of its advocates” and had increased state revenue by 25 percent, allowing the budget to be balanced and debt payments made. The treasury, he said, now had about $2 million on hand.10

Garner also had an answer for those who criticized the tax as a burden on the poor. “The salvaging of the state government as such has been achieved and it seems unlikely anyone has been hurt by the burden of this new tax, for in 1932 the per capita monthly payment was only 9.7 cents. The load is too small to be noticed,” he said. He also made a point that would be heard again and again over the years — that the tax was actually fairer because it made the 85 percent of the state’s population that paid no property tax — because they had no property — “bear their share of the tax burden” — this at a time when statewide per capita income was $131 a

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year. He said the tax was “forcing every buyer to contribute something to the support of the government.”

Whatever the case, the results speak for themselves. The tax bill passed in 1932 contained an automatic repealer that would take effect after June 30, 1934. But the tax proved so valuable in stabilizing the state’s finances that in 1934 the Legislature reenacted it as a permanent part of the tax system. One month after Conner’s term as governor ended, the Mississippi Supreme Court held the tax constitutional.

The tax was not without problems, though. In a letter to the editor of The Rotarian, the editor of The Meridian Star reported in August 1933 that the tax was a “cash” success but had some administrative problems. He noted that the state now had to deal with “sales tax racketeers,” and that tobacco and gasoline bootleggers were working to “thwart” the tax. “Even now, an army of auditors and inquisitors are busily engaged throughout our state in checking up on tax collections. Even ‘ferrets’ must be paid.”

Still, the editor was right in the end when he predicted, “Our Mississippi sales tax levy will remain.” It did, and of course other states, seeing the results, soon followed, with 11 states adopting the tax in 1933 alone. In the meantime, Conner served out his four years as governor, leaving office with a surplus in the state treasury. He may be best known today for his later job, serving as the first commissioner of the Southeastern Conference from 1940 to 1946. He died in 1950.

So Mississippi did not, as my title implies, “invent” the sales tax. What it did was take a tax that had been tried, mostly unsuccessfully, and make it work. In so doing, it paved the way for the sales tax to become an important part of the state and local tax mix, and before long, it was one leg of what was known as the three-legged stool of state and local taxation — the mix of income, sales, and property taxes that provides a reasonably stable system for raising revenue without overreliance on any single source.

What I like about the Mississippi story, though (beyond the drama and the donkey, anyway) is that Conner saw what the state needed — to put its finances in order — and he stuck to his guns in the face of intense political opposition from powerful state interests. Of course, the story is better because things worked out, but he had the strength of his convictions. And what convictions! “And if in this hour we shall set the public welfare as the only goal of our ambition, if we shall make it the supreme object of our effort and dedicate to its achievement the best endowment of our lives, we need not fear for the results of our labors nor for the future of the state,” he said in his inaugural speech. Let’s hope that Mississippi’s current leaders are smart enough not to confuse their desire to chase jobs with their responsibility to ensure a sound government.


Crossword Puzzle Solution

For more State Tax Notes content, please visit www.taxnotes.com.
Who knew taxes could be so very entertaining?

Billy did.

“Fine: a tax for doing something wrong, or at least for being unwise enough to get caught.”

— Billy Hamilton, Contributing Editor

*Only in the publications of Tax Analysts*
If I Were a Rich Man
by David Brunori

Recently, 50 really rich folks wrote a letter to New York Gov. Andrew Cuomo (D), asking him to not only raise their taxes but to raise the taxes of all rich people. Well, maybe they don’t want to tax all rich people — just the top 1 percent of earners in the state. It’s always fun to see rich people throw other rich people under the bus.

The letter called for implementation of the “1 percent Plan for New York Tax Fairness.” The plan would establish new marginal rates, ranging from 7.65 percent on income over $665,000 to 9.9 percent for those earning $100 million or more a year. Yes, you read that right, $100 million a year. I doubt even Art Rosen makes a $100 million a year.

I come from a long line of Brunoris who have neither suffered abject poverty nor enjoyed the thrill of lying in a bathtub full of Ben Franklins. I work for a nonprofit and live in Virginia. So why do I care about millionaires wanting to subject themselves to New York tax? Because I find it amusing when people believe that simply being wealthy gives one the right to dictate policy. Many self-flagellants inherited vast sums of money. Steven Clark Rockefeller is on the list. He’s the son of Nelson, great-grandson of John D., a graduate of Deerfield Academy and Princeton University. Abigail Disney (yes, from the Disneys who gave you Mickey and Minnie) is also on the list. Agnes Gund (from the Gunds of Cleveland) is a signatory. Obviously, there are a lot of other rich people on the list.

Perhaps these folks are trying to assuage their guilt. Unlike the rest of us, they have no money problems, since they were lucky enough to have rich relatives. And even those who did not inherit fortunes were lucky to have skill, talent, work ethic, and all of those attributes that can lead to wealth. Personally, I wouldn’t feel guilty if my old man left me bushels of money, my number came in, or I got rich from my hard work.

That said, my question is this: Why are they trying to get other rich people to pay for their guilt? Will it make them feel better about living on the Upper East Side? Having a second home in the Hamptons? Eating at Masa? (For the hoi polloi, Masa is the most expensive restaurant in the city.) Indeed, many of the signatories are well-known philanthropists. If I were really rich in New York, I would not want these folks trying to salve my guilt by raising my taxes. Honestly, if I were really rich, I might give my fortune away to the poor and dispossessed, but I would be giving my money away — not someone else’s.

Maybe I am being too cynical. These 50 may genuinely care about providing good public services in New York. I suspect that they, like the rest of us, value schools, public safety, and roads without potholes. Conceivably, they believe we need more money for such services and are merely writing the governor to let him know they are willing to do their part. Fair enough. The problem is that there is never as much money going after the really rich as proponents think. We have seen this many times before. Numerous attempts to impose millionaire taxes end up imposing taxes on those making a lot less than a million dollars. The rich tend to have an army of lawyers and accountants — you, dear readers — who have the skill to minimize tax burdens for even the richest people on earth. After all, as Warren Buffett and Mitt Romney have taught us, it’s all about effective rates. The $2.2 billion additional revenue the signers say they will raise assumes that the rich will take the rate hike lying down. They won’t.

But if You Really Want to Tax the Rich . . .

Instead of trying to raise statutory rates, policymakers in New York and other places should tax carried interest as ordinary income. Advocates for the poor in Connecticut are pushing for such taxation right now. As everyone knows, carried interest is taxed as capital gains. I’ve always thought this was silly, since most people who earn carried interest are managing other people’s money. The New Haven Legal Assistance Association recently testified for taxing carried interest as ordinary income in the state.

Many of the same millionaires in New York who support higher rates support taxing carried interest as ordinary income. This is actually a good thing. Taxing carried interest as ordinary income is a way to effectively broaden the base. Also, a good thing. And it will raise revenue. I think it’s a much better way to go than raising rates.
Good Incentive News
An Idaho company recently filed a lawsuit against the state for awarding a $6.5 million tax incentive to a competitor company from Illinois. Paylocity Corp., the Illinois firm, received a tax break for setting up operations in Boise. Nothing unusual about that. However, the Idaho firm, Employers Resource, is a competitor and did not like the state giving away public money to its rival. Now that is unusual — and welcome — news. The owner of Employers Resource stated that he wanted to strike a blow against Idaho’s Tax Reimbursement Incentive law — that is also welcome news.
The Idaho law doles out up to 30 percent of income, sales, and payroll taxes for up to 15 years. Recipients must create jobs and pay a certain amount to get the gift. Although Paylocity was meeting the requirements, the government payout to a company going toe-to-toe in the marketplace did not sit well with Employers Resource. So it sued.

As readers know, I’m about as anti-incentive as you can get. One of my issues is: What do you tell companies already in the state that have made the investment and hired workers? Every politician I ask shrugs. But Employers Resource is not shrugging. To its credit, it didn’t go hat in hand to the Legislature and ask for its own tax break. Rather, it took the issue to court. The suit, from what I understand, alleges that the incentives are granted by the Department of Commerce. Under the constitution, only the Legislature can determine who gets tax dollars. Sounds like a technicality, but I’ll take it.

LOST in Kentucky
As I write, cities in Kentucky are trying really hard to get a local option sales tax proposal through the state senate. It doesn’t look good. The proposed constitutional amendment would allow local governments to raise the sales tax by 1 percent with voter approval. Louisville and other cities in the commonwealth love the idea. Here is the problem with local option sales taxes: They tend to be good for cities, which can export tax burdens to citizens of suburbs and rural areas. However, legislators from suburban and rural areas are always less enthusiastic than their city-dwelling counterparts. Folks outside the city will pay taxes that benefit folks inside the city — there’s nothing good or fair about that.

There are other problems with the tax. Most important is that it adds to the regressivity of the overall revenue system. But the exporting problem is the key. Politicians like exporting tax burdens, just not to their citizens.

We Are What We Buy
I learned this from Forbes. In America, more legal pot ($3.4 billion) is consumed than Oreo cookies ($711 million), Dasani water ($1.02 billion), Pringles ($514 million), and Twizzlers ($203 million). These numbers are from 2015. Note that pot is sold legally only in Alaska, Colorado, Oregon, Washington, and the District of Columbia, but you can buy Oreos everywhere.

Worth Reading
Like most excise taxes, those on electronic cigarettes are devoid of policy rationale. They are money grabs, pure and simple. By the way, if you are interested in grabbing money, you probably don’t mind them much. If you are interested in learning more, my friends at the Tax Foundation released a report on taxation of electronic cigarettes. It is available on their website. The report noted that four states, the District, and three local jurisdictions tax e-cigs. The report talks about externalities (not many), comparisons with real cigarettes, and some health policy findings. Well worth reading.

Hats Off!
Kudos to Connecticut Senate President Pro Tem Martin Looney (D) for spearheading a bill that would levy a tax on a portion of the Yale University endowment. The law is aimed at endowments of more than $10 billion — and only Yale qualifies. Yale’s endowment is about $25.5 billion. The bill (SB 413) would tax the earnings of the endowment that were not used for education purposes. I’m not exactly sure what “education purposes” means, and Yale will probably argue everything it does is for education, but this is a good idea. There is no reason to exempt Yale’s earnings from income tax. There is no reason to exempt anyone’s earnings from income tax. Broad base, low rates is the mantra. This bill broadens the base. Nonprofits, in this case universities, enjoy public services. They should pay for them. So hats off to Looney and his allies.
Evolutionary Nexus

by Roxanne Bland

Roxanne Bland is State Tax Notes’ contributing editor. Before joining Tax Analysts, Bland spent 17 years with the Multistate Tax Commission, where she worked with state revenue agency representatives to draft model legislation pertaining to sales and use taxation and corporate income; analyzed and reported on proposed federal legislative initiatives affecting state taxation; worked with legislative consultants and representatives from other state organizations on international issues affecting states; and assisted member state representatives in federal lobbying efforts. Before that, she was an attorney with the Federation of Tax Administrators for over seven years.

In this article, Bland discusses the advancement of nexus, as states continue to explore every means to raise the revenue needed to provide services to their residents.

Ever since the U.S. Supreme Court ruled in Quill v. North Dakota that the commerce clause requires physical presence in order for a state to impose sales and use tax collection obligations on a seller, states have tested various theories that might cause a remote seller to have such presence. In the past decade or so, those theories, some rather novel, have been applied to electronic commerce. Much of the litigation, centering on the so-called attributional nexus theory, has been successful. But states have been taking other routes, too, such as employing the extensive use of technology to ease the burden of collecting and remitting tax on remote sellers, employing use tax notice and reporting requirements, and, finally, throwing down the gauntlet and inviting litigation to overturn Quill. A discussion of the advancement of nexus follows.

Attributional Nexus

Affiliate Nexus

New Mexico Taxation and Revenue Department v. Barnes andnoble.com LLC involved sister corporations, one a bricks-and-mortar bookseller and the other an online retailer. During the audit period, Bookseller was 100 percent owned by its parent company, Barnes & Noble Inc., and its ownership of Online varied from 40 percent to 100 percent. Bookseller had three stores in the state, while Online had no property or employees. The department assessed gross receipts tax against Online for its sales to New Mexico residents under the affiliate nexus theory. Online protested, arguing that because it did not have property or employees in the state, it did not have substantial nexus as required by the commerce clause.

The New Mexico Supreme Court found in favor of the state. It noted that the U.S. Supreme Court has “consistently taken a functional approach to the substantial nexus analysis, and it has been willing to find a substantial nexus even where the business in question had neither property nor regular employees in the taxing state.” For instance, in Scripto v. Carson, the Court found that independent contractors soliciting on behalf of a Florida corporation conferred substantial nexus on the corporation such that the state could impose an obligation to collect sales tax. The Court held that the label placed on the independent contractors was “without constitutional significance.” Rather, it was the “nature and extent” of the taxpayer’s business in the state that mattered.

The Court then turned to Tyler Pipe Industries Inc. v. Washington Department of Revenue, in which an out-of-state manufacturer challenged the state’s imposition of its gross receipts tax on the basis that the manufacturer had no employees, no property, and no offices in the state. However, it had hired sales representatives who called on customers, solicited orders, and “maintain[ed] and improve[d] the [manufacturer’s] name recognition, market share, goodwill, and individual customer relations in Washington.” The Supreme Court held that sales representatives’ activities were sufficient to create nexus for the out-of-state manufacturer, stating that “the crucial factor governing nexus is whether the activities performed in this state on behalf of the

2 303 P.3d 824 (N. M. 2013).
3 Opinion, para. 7.
6 Opinion, para. 8 (quoting Tyler Pipe Indus. Inc. v. State Dep’t of Revenue, 715 P.2d 123, 127 (Wash. 1986)).
BancTec was compensated based on how many on-site calls to perform them. Dell set the price for the services, and parts were supplied by Dell. BancTec's technicians, trained to the customer's premises. All computer repair services to various computer manufacturers. Tennessee via common carrier or the U.S. mail. are taken in Texas, and merchandise is shipped from there or the Internet, the U.S. mail, and the media. Customer orders or property in Louisiana. All of its sales are solicited through the Internet. It has no stores, offices, employees, bank accounts, or property in Louisiana. All of its sales are solicited through the Internet, the U.S. mail, and the media. Customer orders are taken in Texas, and merchandise is shipped from there or Tennessee via common carrier or the U.S. mail.

BancTec is a nationwide company that provides computer repair services to various computer manufacturers. BancTec and Dell entered into a contract under which the former would provide on-site repair services to Dell's customers. Upon purchasing a computer from Dell or at any time thereafter, the customer, at his discretion, could also purchase a warranty contract. To obtain service, the customer contacted Dell directly by telephone. If the problem could not be solved in that manner, Dell dispatched a BancTec technician to the customer's premises. All computer parts were supplied by Dell. BancTec's technicians, trained by Dell, were directed on what services to provide and how to perform them. Dell set the price for the services, and BancTec was compensated based on how many on-site calls it made. Although the service contract was between BancTec and the customer, Dell had the right to terminate the contract and hire another repair service if BancTec did not perform to Dell's standards.

The court found that this case was governed by *Scripto* and *Tyler Pipe*. It rejected Dell's argument that it had no obligation to the customer regarding the on-site service contracts and that the contract was between BancTec and the customer. The argument, the court said, belies the facts. Dell also used the on-site repair service extensively in its advertising, with guarantees to its customers. The court further noted that during the audit period, BancTec made 30,000 calls to Louisiana customers. Under *Scripto*, no matter how Dell chose to contractually identify BancTec employees, they were obviously acting on Dell's behalf. Moreover, it was equally obvious that the repair service, carried out by BancTec employees, helped Dell establish and maintain a market in Louisiana. Therefore, sufficient nexus existed between Dell and the state to support Dell's obligation to collect use tax on its sales to Louisiana customers.

**Click-Through Nexus**

In general, click-through nexus requires online retailers with in-state affiliates to collect the state tax if the in-state affiliate refers, directly or indirectly, customers to its website and earns a commission or other consideration when the customer clicks on a link to the retailer on the affiliate's website and makes a purchase. Tax must be collected if the total of such purchases is a sum certain annually (usually $10,000, though some states differ). Most of these laws have a rebuttable presumption allowing a retailer to escape the obligation if it can show that the in-state affiliates did nothing to encourage these sales other than placing links on their websites. New York was the first to enact a click-through nexus law in 2008 (the “Amazon” law). Amazon.com Inc. and Overstock.com Inc. sued, alleging that the New York statute was unconstitutional under the commerce clause, the due process clause, and the equal protection clause on its face and as applied. The New York Court of Appeals held in favor of the state. Amazon filed a petition for certiorari to the U.S. Supreme Court, which was denied. To date, 17 states have enacted click-through nexus laws.

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7 *Tyler Pipe*, at 250.
8 See also *Borders Online LLC v. State Board of Equalization*, 29 Cal.Rptr.3d 176. (Cal. Ct. App. 2005). On substantially similar facts, the California Court of Appeals held that California could tax sales by Borders Online because of its affiliation with bricks-and-mortar Borders stores in the state.
9 222 So.2d 1257 (2006).
Other Approaches

Streamlined Sales and Use Tax Agreement

The Streamlined Sales and Use Tax Agreement came into force in 2002. Rather than try to assert nexus over a remote seller, it seeks to minimize the undue burden on interstate commerce at the prospect of a remote seller having to collect and remit tax as well as file returns with thousands of taxing jurisdictions. Some of SSUTA’s more notable features are one-stop registration for remote sellers, uniform product definitions and sourcing rules, one tax rate per state administered at the state level, uniform tax returns, a single audit per state per year, and the use of certified service providers to collect and remit tax on behalf of the remote seller. At present, there are 23 full members and one associate member of SSUTA. According to SSUTA, 1,400 remote vendors are now registered with the program.14

Use Tax Notice and Reporting

Pioneered by Colorado in 2010, use tax notice and reporting require sellers without physical presence selling to Colorado residents (non-collecting retailers) to (1) provide notice to each purchaser on each transaction that the seller does not collect Colorado sales tax and that the purchaser may be liable for the state’s use tax on non-exempt purchases; (2) provide anyone who buys more than $500 worth of goods in a year a second notice that his purchases may be subject to Colorado use tax, along with a detailed summary of their transactions; and (3) file annually with the Department of Revenue a customer information report. Retailers who make less than $100,000 in gross sales to Colorado purchasers are exempt. Seven states now have use tax notice and reporting requirements.15

The Direct Marketing Association (DMA) sued in federal district court, alleging that the law violated the commerce clause’s physical presence requirement as set forth in Quill. The court partially granted DMA’s motion for summary judgment. The state appealed. The Tenth Circuit reversed the district court on grounds that the Tax Injunction Act barred the suit. DMA sought certiorari in the U.S. Supreme Court. The Court reversed the Tenth Circuit, concluding that the Tax Injunction Act did not bar the suit because the suit was not one to “enjoin, suspend or restrain the assessment, levy or collection” of Colorado’s sales and use taxes.16 Justice Anthony M. Kennedy’s concurrence is of special note here. He said that though this case was not the appropriate vehicle, it was time for the Court to revisit Quill and reconsider its doubtful authority in light of the reality of the marketplace today.

On February 22 the Tenth Circuit construed Quill narrowly and held it inapplicable because it involved a collection issue rather than a reporting requirement. It also held that Colorado’s law does not discriminate or unduly burden interstate commerce. On March 22 the DMA filed a petition for certiorari with the Court.

Economic Presence Nexus

A few states, through proposed legislation and by regulation, are taking Kennedy at his word and are mounting direct challenges to Quill’s physical presence nexus requirement. Connecticut’s proposed HB 448 adds a new subsection to its definition of retailer to include “every person who has a substantial economic presence within this state, evidenced by a purposeful direction of business toward this state, examined in light of the frequency, quantity and systematic nature of the retailer’s economic contacts with this state, without regard to physical presence.”17 South Dakota’s proposed legislation, SB 106, requires remote sellers with sales of $100,000 or more in the state to collect and remit tax. The proposed legislation even anticipates court action, providing that if the law is challenged, enforcement will be stayed until a resolution on the merits is obtained. On March 22 Gov. Dennis Daugaard (R) signed the measure into law. Alabama Regulation 810-6-2-.90.03, which took effect on January 1, 2016, provides that remote sellers who lack physical presence but who make retail sales of tangible personal property into the state have a substantial economic presence if the seller’s retail sales of tangible personal property sold into the state exceed $250,000 per year. Concerning two of these approaches, one is in active litigation, and the other is sure to engender same. Only time will tell if they are successful.

In sum, states are exploring every means to raise the revenue needed to provide services to their citizens.

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15Colorado, Kentucky, Oklahoma, South Carolina, South Dakota, Tennessee, and Vermont. Jensen, p. 20.
1628 U.S.C. section 1341.
17Id.
18No dollar threshold is provided.
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A Property Tax Book Worth Reading

by David Brunori

I have long been a fan of the property tax. I think it’s the best way to fund local government services. It promotes local government autonomy. It is intrinsically entwined with property values and the most salient services that citizens receive from government. There are no viable local own-source revenue options.

My views on the tax are not original. Most of the greatest scholars in the field of public finance — Wallace E. Oates, Gary C. Cornia, Steven M. Sheffrin, Roy W. Bahl, Robert M. Schwab, Joan Younman — strongly favor the property tax.

Younman, a senior fellow at the Lincoln Institute of Land Policy, recently published *A Good Tax: Legal and Policy Issues for the Property Tax in the United States*. If you really want to understand the property tax, read this book. Because Younman is arguably the leading thinker on the property tax, when she discusses it, as she has done in *State Tax Notes* several times over the years, policymakers listen.

The book, not surprisingly, begins by explaining why the property tax is a good tax. Younman concentrates on local autonomy but closely examines many issues. For example, she spends time explaining (in a manner even a state legislator can understand) the issues regarding the incidence of the tax. For those unfamiliar with that, there has been a long debate over whether the tax is regressive, progressive, or simply a benefits tax. Younman rejects the blanket characterization of the tax as regressive, a key argument by opponents of the tax.

When it comes to property taxation, the largest practical issue is valuation. Younman examines the various issues concerning valuation (there are many) and does a good job explaining the basics while putting them in a larger context. It’s a solid, practical approach.

But the real strength of the book is its chapter on the property tax and school finance. As readers know, the role of the property tax in financing schools continues to be controversial, both legally and politically. This issue is important for education policy as well as public finance policy. Although entire books have been written on the subject, Younman provides a surprisingly in-depth view in a relatively short chapter. Readers will understand the equalization issue and the problems of centralized funding. Youngman also offers insight into the connection between antitax activists and the movement toward centralization. Starting with *Serrano*, this became a critical issue. Youngman does an excellent job clarifying the debate.

Other chapters explain exemptions (and payments in lieu of), sprawl, classification, and, of course, rate and assessment limits in relation to the property tax. I was surprised that Youngman devoted a whole chapter to the valuation of federally subsidized low income-housing. In the grand scheme of things, that seems unworthy of its own chapter, but that’s a nitpick.

I confess that I am biased. I like the book in part because I like the property tax. I also like it because Youngman is widely recognized as an expert. But the book is very good, and it will give its readers a much better understanding of the property tax.
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State Tax Auditors Descend on Corporations
With Novel Conclusions

by Arthur R. Rosen

A large number of corporate tax professionals and their advisers have recently been inundated by auditors asserting that the discretionary authority of the commissioner (or director) should be applied to implement alternative apportionment or that the combined group as filed should be changed.

Time after time, these auditors have said that the corporation should not have used the standard statutory apportionment formula since doing so does not accurately reflect the taxpayer’s business activities in the state (the usual statutory phrase). The auditors have reviewed the business operations and believe that applying the standard statutory rate results in too much income being attributed to the state and thus, because of the application of alternative apportionment, the taxpayer is due a refund.

Similarly, many auditors have reviewed the composition of combined groups and have determined that some members, often those with either large in-state apportionment or large amounts of income, are not really unitary with the balance of the group and therefore that the balance of the group should be only the corporations in the combined return. Accordingly, these auditors have concluded that the corporations are due refunds.

Corporate tax departments are being overwhelmed with the huge number of refund checks they have been receiving. Accounting for these funds, explaining to senior management the reason for the refunds, and planning for the future are just too much of a burden to be placed on these corporations; one would hope that senior management in state revenue departments would take pity on them.

Healthcare Professionals, Look Out!

It finally happened! I — and, I assume, other tax professionals who take airline flights regularly — have been waiting for years to get a little more public respect.

About once a year, I have been on a flight during which there has been an announcement indicating that a passenger is in need of medical assistance and requesting any healthcare professional aboard to notify a flight attendant of his or her presence and willingness to help a fellow passenger. On a recent flight, we finally heard a variation on this. “We have a passenger on board who is in need of urgent tax assistance — there is an immediate need for emergency apportionment relief or non-unitary help.” I volunteered and immediately administered alternative apportionment. I even provided factual support to demonstrate that there was, indeed, no centralized management.

I am not sure how the situation ultimately concluded since upon arrival at our destination — the passenger was met on the tarmac by department of revenue officials in a Brink’s armored car and quickly whisked away.

Trump and Sanders Agree to Eliminate All Corporate Taxation

While some political and economics pundits were shocked by two presidential candidates’ concurrence on a major, fundamental issue, they shouldn’t have been.

Republican Donald Trump recently announced that if elected, he would seek a repeal of all corporate tax provisions in the Internal Revenue Code, as well as legislation (under commerce clause authority) prohibiting all state taxation of corporations. Trump has made clear that human beings ultimately bear the burden of all taxation. He argues that imposing tax both on a corporation’s income and on dividends when received is improper double taxation and accordingly is extremely damaging to our country’s ability to compete in the international economy.

Bernie Sanders, an independent running as a Democrat, recently announced that if elected, he will seek immediate nationalization of all property located in the United States, whether owned by corporations or individuals. Each individual will be expected to contribute to society according to
his means and will receive, from or through the government, according to his needs. Consequently, there will be no taxation, which will make America great again.

**David Brunori Arrested for Destroying Fantasies**

Poor young David. Formerly a young naïf — now a complete cynic. David Brunori’s first brush with reality was his recognition that the tooth fairy was just a myth. Next he had to deal with the nonexistence of unicorns and jackalopes. The final blow to his sanguine view of the world came as he realized that state tax policy is rarely based on sound tax or economic principles.

David, unfortunately, did not keep his newly discovered view of state tax reality to himself. Rather, he was offered employment by a fly-by-night organization, Tax Analysts, to announce his discovery to the world. Once he started demonstrating that the state tax emperor had no clothing, the state tax police (a part of the same organization that enforces the prohibition on removing the manufacturer’s tags from mattresses) took him into custody, where he remains.

**Overheard in Senate Cloakroom**

“Well, what do you want to do about the Supreme Court vacancy? On the one hand, I am cognizant of the constitutional process and aware that January 20, 2017, when the presidency changes hands, is a long time away. On the other hand, I believe that the best interests of our nation dictate that the late Justice Antonin Scalia be replaced by a strong individual who understands the fundamental importance of our Constitution as originally conceived.”

“Yeah, I hear you. But remember, whatever you and I decide to do about the Supreme Court vacancy, we have to make it spectacularly entertaining — maybe even bloodily brutal — to keep up our television ratings. Those presidential candidates are getting all the airtime. It’s just not fair! We run for office to get our egos stroked, but it’s tough to get any publicity nowadays.”

“Well, if we do decide to move ahead, what do you think our major concerns should be?”

“I think we all know — actually, I think all Americans know — that the most crucial issue facing our country, if not all of western civilization, is state taxation. After all, issues like nuclear weapon proliferation, immigration, federal recognition of state drug legalization laws, and international trade agreements pale in comparison.”

“Totally!”

“We know that all rational humans agree that nexus should be based on physical presence, that apportionment should follow traditional economic rules, and that federal courts should be open for all multistate tax controversies. But how does that translate into a specific jurist attitude or inclination?”

“I’ve been thinking about that. A believer in the dormant commerce clause would, presumably, be more protective of the country’s economic health. However, those jurists tend to be more liberal and thus anti-business (that is, anti-jobs) and would likely condone the abusive behavior practiced by state tax agencies.”

I know! Why don’t we let the president know that we would welcome his nomination of someone like...oh, you know, this guy who’s been practicing in the state and local tax area for a few decades. I just can’t remember his name. He’s from Biloxi, Mississippi, he moved from New York City to Miami Beach a few years ago, and he sometimes writes for *State Tax Notes*, but that’s all I can recall...
Tax Agency Reminds Taxpayers: ‘Make Up Your Damned Minds’

by Billy Hamilton

The state Department of Revenue issued a public service announcement on April 1 reminding people “to make up their damned minds” about what tax they hate most before this year’s round of Internet polls begins.

Revenue department spokeswoman Phyllis Pennybottom said that every year around the federal income tax return filing date, there’s an upswing in online surveys, completed by “literally dozens” of people, that purport to show which taxes Americans hate the most.

“Since many lawmakers love polls and ‘high tech’ and uniformly oppose taxes, these polls often influence tax legislation,” Pennybottom said. The more divided people are on the crucial question of which tax they hate most, the more tax plans the revenue department has to contend with as legislators scramble to outdo one another to introduce the biggest tax cuts. “It happens every spring,” she said, “like baseball and Easter Peeps.”

“Frankly, it’s exhausting,” Pennybottom said. “We would feel more like dealing with all of these half-baked ideas if we received tax incentives for exerting the effort, but that’ll never happen.”

Last year the most-hated taxes were “hidden taxes,” Pennybottom said. She found that baffling. “I mean, if they’re hidden, how do people know to hate them, and better still, who is spilling the beans?” she wondered. She said the state’s tax system “is literally stuffed with hidden ‘goodies,’ but you don’t hear the DOR talking about them, do you?” Asked what they are, she declined to elaborate.

Also near the top of the most-hated list last year was the property tax, which is a local tax not administered by the DOR. “If people want to hate the property tax and encourage their legislators to totally screw it up, we’re cool with that,” she said. “We don’t much like property taxes, either.”

She said this is a good time to remind taxpayers that when revenue department employees aren’t busy “confusing people, undermining individual initiative, and strangling economic growth,” they also pay taxes, although they generally know more loopholes than most taxpayers. “But still, a nice tax break for every piece of tax cut legislation we analyze wouldn’t kill anyone and might stimulate the service sector of the economy,” she said. “I know it would improve our morale, so that’s something.”

Pennybottom said her suggestion for a tax that taxpayers can all agree to hate is the federal income tax. “I know I hate it, and to be honest, Congress can’t get anything done, so the polls won’t affect actual policy — and we don’t have to implement any new tax cuts here. It’s a win-win situation,” she said.

Or, she said, people could hate British taxes. “After all, it was British taxation without representation that persuaded Americans to hate taxes in the first place,” she said, although she admitted that taxation with representation hadn’t turned out so well either. “Taxpayers should skip the polls and go dump something into Boston Harbor . . . and leave us alone.”

Pennybottom said she wishes that just once someone would do a poll that shows what tax people don’t hate. She speculated that “any tax I don’t pay” would probably win. Or at least that would be her choice unless an oyster tax was on the list. “Oysters give me indigestion, so I feel pretty good about taxing them,” she said. “Also, it would annoy my sister-in-law to no end. That would be quite satisfying.”

Billy Hamilton

Billy Hamilton is the executive vice chancellor and CFO of the Texas A&M University System. In 2015 Hamilton led Texas Republican Gov. Greg Abbott’s Strike Force on the Health and Human Services Commission to complete a management analysis of the agency. Before that, Hamilton was the deputy comptroller for the Texas Office of the Comptroller of Public Accounts from 1990 until he retired in 2006. He is also a private consultant, advising on numerous state tax matters.

In this edition of State Tax Merry-Go-Round, Hamilton recounts the struggles of a beleaguered state Department of Revenue representative dreading the latest release of most-hated taxes from this year’s round of Internet polls.
Kranz Rookie Card Fetches $500 on eBay

by Doug Sheppard

The rookie card of a prominent state tax practitioner has sold for over $500 on eBay — reflecting a new collecting trend in the state and local tax world. The business card of Stephen P. Kranz (now with McDermott Will & Emery) when he was chief counsel with the District of Columbia Office of Tax and Revenue sold for $517.93 to an as-yet-unidentified bidder in Connecticut.

“The price is certainly a surprise,” said Phil T. Rich of SALT Auctions Inc., an online seller of rare business cards. “But the fact that it’s this card is not.”

Rich said that because Kranz’s tenure with the District was relatively short at two years, not many of the cards were printed — and many have been thrown away since Kranz left in 2000.

“It’s also the design of the card,” Rich added. “It’s a simple, elegant card — just red, white, and black — with that distinctive D.C. star pattern in the upper left corner.”

Previously, the highest bid for a vintage state tax business card was for that of then-Kansas Revenue Secretary Harley Duncan, who has gone on to tenures as head of the Federation of Tax Administrators and now as a tax managing director with KPMG LLP. In 2014, Duncan’s 1987 Kansas card sold for $250.

Rich said that another factor that played into the price of the Kranz card was that he’s the brother of Paula Broadwell, the biographer of Gen. David Petraeus. Kranz’s home served as a sanctuary for his sister when the story broke in 2012 — leading to tabloid coverage.

“Oh, no doubt,” Rich responded when asked if Kranz’s outside fame played into the price. “It’s pure speculation at this point, but the bidder might not even be a SALT insider, the typical bidder on something like this.”

While Kranz held a tax position with the U.S. Department of Justice Tax Division for six years before joining the District, the latter is seen as his rookie card because it was where he first came to prominence in the SALT world.

Rare Cards

As Rich alluded to, the market for vintage SALT cards has3 exploded over the past five years — with pieces of cardboard once thought to be worthless now selling for significant sums. Generally, it has to be a card from a past position of a SALT luminary — and variations help, according to Rich.

Joe Crosby’s original COST card, for example, is worth upward of $100 — but be sure to read the fine print. The cards listing the organization under its current name, the Council On State Taxation, are fairly common and sell for around $10. But the ones under the organization’s previous name, the Committee On State Taxation, are collector’s items.

“COST was only the ‘committee’ for about a year into Joe’s time there,” said John R. Turn, head bidder at SALT Auction House Ltd. “So those cards are uncommon.”

Variations also account for the differing prices of seemingly identical cards of Kendall Houghton at the same firm, Alston & Bird LLP.

“You could probably get Kendall’s current card for no more than the price of the postage stamp it would take for her to send it to you,” Turn said. “But the cards from her first time at Alston in the ’90s are ultra-rare and fetch between $75-$125.”

But experts warn collectors not to get too excited about variations — or at least to pay attention to the market. Whether it’s the “committee” or the “council,” cards of longtime COST Executive Director Doug Lindholm are relatively common and don’t sell for much.

“He gave a lot of them out,” Rich said. “What he didn’t realize is that while he probably helped establish relationships and create goodwill for COST, he devalued his card.”

“That said,” Rich added, “collectors do go for Lindholm’s General Electric business card from the 1990s. I’ve seen it on a lot of want lists. And an autographed Lindholm ’committee’ COST card did recently go for $62.”

Another autographed item that recently scored big on eBay was the Federated Department Stores Inc. card of Frank Julian, now with its successor, Macy’s Inc. The card fetched $187.50 to a bidder in Blue Ash, Ohio.

Collecting Trends

Complete sets are another emerging trend. Individual past cards of Jim Eads and Lynn Gandhi generally sell in only the $15-$20 range because, as Turn put it, “they’ve both worked at a fair number of places.”

“But if you have a complete set of cards from all of their positions, you’re talking $400 easily,” he added.
Rich and Turn predicted that the Kranz D.C. card’s time at the top of the auction heap would be short. “The card a lot of people are looking to buy is Arthur Rosen’s 1974 rookie card with Coopers & Lybrand,” Turn said. “He was only there for about a year, and it’s over 40 years old, so it’s like the Honus Wagner card of the SALT world. There’s a rumor that Peter Faber has one, possibly Paul Frankel as well, but I haven’t confirmed it. I bet it would sell for over $1,000 easy, though I’m not sure if tax would be charged if the seller didn’t have physical presence in the winning bidder’s state.”

Even a more recent card — and of one of Tax Analysts’ own, no less — may see an upsurge. “If you have Cara Griffith’s PwC card, hold on to it,” Rich said. “She wasn’t there long, and the more her profile grows in the state and local tax world, the more it will be worth.”

“Bottom line: Whether it’s your own cards or that of someone you met eating cookies during a break at a COST conference, don’t throw away business cards,” Turn concluded.

Experts know they can rely on us for the answers their clients need. In fact, tax professionals at the top 25 international law firms, 96 of the top 100 U.S. law firms, and the majority of the Fortune 100 turn to us for tax news, analysis, and commentary.

To see why we’ve earned their trust, please visit taxanalysts.com.
State Quotes of Note

Along with our mission of fostering an informed debate on taxation, we at State Tax Notes recognize excellence in parallel areas — such as the finest state and local tax prose. After careful consideration, we have selected the following as our quotes of the year.

All honorees received a gold plaque at the annual “State Quotes of Note” ceremony at Hotel de Rien in the District of Columbia on April 1.

This year’s honorees are:

1. Zach Liszka

Liszka commented on a lawsuit against Dunkin’ Donuts for improperly charging sales tax. See what he did there?

“These lawsuits represent a wake-up call to Dunkin’, ” Liszka said. “The lawsuits urge them to stop dunking their customers and provide refunds or discounts to make them whole.” (Prior coverage: State Tax Notes, Feb. 15, 2016, p. 470.)

And speaking of dunking . . .

2. Wisconsin State Sen. Alberta Darling (R)

Commenting on a package of public financing and tax incentives to build a new arena for the NBA’s Milwaukee Bucks, Darling avoided the perimeter shooting of the defending champion Golden State Warriors and took it right into the paint:

“Passing a bipartisan plan that creates good-paying jobs, creates a destination entertainment district where there is nothing, keeps a sports team in our city without new taxes, is a slam dunk,” Darling said. (Prior coverage: State Tax Notes, Aug. 3, 2015, p. 445.)

3. The Florida Department of Revenue

In a brief asking the Florida Supreme Court to reverse a lower court decision regarding sales tax assessments on flowers, gift baskets, and other items sold to out-of-state buyers, the DOR displayed an affinity for floral prose:

“These transactions frequently provide joy to those receiving bouquets, but they can present thorny issues for sales tax purposes,” the state said. (Prior coverage: State Tax Notes, July 13, 2015, p. 139.)

Lifetime Achievement Award

The Golden Goose

The Golden Goose is unquestionably the most famous bird in state tax history, and SALT insiders have long flocked to this metallic fowl when in need of a metaphor. But are they — pardon the mixed metaphor — beating a dead horse? We think not. Hence the Golden Goose is the recipient of our Lifetime Achievement Award, joining another infamous bird — Chicken Little — on the pantheon. ✰
The power of collecting and disbursing money at pleasure is the most dangerous power that can be trusted to man.

— Davy Crockett

April 4-6

2016 Tobacco Central Region Meeting — Oklahoma City, Oklahoma. The Federation of Tax Administrators will hold a conference devoted to general sessions on topics that affect the tobacco industry and tax administrators in the ongoing joint effort to determine practical and efficient methods for collecting tobacco taxes. Registration will take place on Monday, April 4; government and industry sessions will be held Tuesday, April 5; and government-only sessions will be held on Wednesday, April 6. Government and industry session topics will include brand integrity, tobacco mergers, and the future of electronic cigarettes; government-only session topics will include running a canine program, vapor tax, and a look at Michigan’s use of digital stamps. Contact: Cindy Anders-Robb. Telephone: (307) 632-4144. Email: cindy.anders-robb@taxadmin.org.

April 6

How to Create a Nexus Checklist — Webinar. Avalara will offer a complimentary presentation and workshop on how states define presences for sales tax nexus purposes. Judy Vorn-dran will explain which activities create nexus in most states, the difference between origin-based and destination-based sourcing states, when a taxpayer should review its nexus activities, and how to evaluate nexus. Contact: Morgan Coleman. Email: morgan.coleman@avalaramail.com.

April 7

MTC Arm’s-Length Adjustment Services (ALAS) Committee Meeting — Teleconference. The inaugural meeting of the Multistate Tax Commission’s ALAS Committee will include remarks by MTC Executive Director Gregory Matson; the selection of the committee chair; initial public comment; an outline of the committee’s work, review, and discussion of ALAS; and possible early implementation steps such as training, information exchange, and case discussion. The meeting will be held from 2 p.m. to 3:30 p.m. The teleconference dial-in number is (719) 325-2630, conference code 794129. Contact: Gregory Matson. Email: gmatson@mtc.gov. Telephone: (202) 650-0300.

April 11-14

Statistical Sampling for Sales and Use Tax Audits — St. Paul, Minnesota. The Multistate Tax Commission will present an intermediate/advanced course for state and local revenue personnel on understanding and applying statistical sampling techniques. Contact: Sherry Tiggett. Telephone: (202) 650-0296. For more information, go to www.mtc.gov.

April 17-19

2016 FTA Motor Fuel Pacific Region Conference — Austin, Texas. The Federation of Tax Administrators’ Pacific Region Motor Fuel Tax Section will hold its 2016 conference, offering general sessions on topics that affect the petroleum industry and tax administrators in the joint effort to determine practical and efficient methods for collecting fuel taxes. Contact: Cindy Anders-Robb. Telephone: (307) 632-4144. Email: FTA.Meetings@taxadmin.org.

April 19

California Market-Based Sourcing — Webinar. BDO USA LLP’s state and local taxation practice will provide a complimentary webinar on the market-based sourcing rules for California. The seminar will cover how to properly source revenue from services, sales of intangible property, fees from licensing agreements, and interest and dividends; the benefit of service definition; how to determine the location of use for sales of intangible property and licensing fees; how to identify when interest and dividends are included in the sales factor and how to source the income; and how to recognize when a taxpayer is taxable in another state for purposes of the throwback rule. The webinar will begin at 2 p.m. Contact: BDO Knowledge. Email: bdoknowledge@bdo.com.

April 19-21

2016 FTA Tobacco Western Region Conference — Austin, Texas. The Federation of Tax Administrators’ Tobacco Tax Section will hold its 2016 western region conference, offering general sessions on topics that affect the tobacco industry and tax administrators in the joint effort to determine practical and efficient methods for collecting tobacco taxes. Industry and government may attend on Wednesday, April 20, but Thursday, April 21 is open only to government. Contact: Cindy Anders-Robb. Telephone: (307) 632-4144. Email: FTA.Meetings@taxadmin.org.

April 19-22

Spring Audit Session and Income Tax Conference — Asheville, North Carolina. The Council On State Taxation
will offer presentations on current income and franchise tax issues and will share current audit information on all 50 states, Canada, and Puerto Rico among its members. While state income taxes will be the primary focus, state audits of all types and issues will be discussed during extensive participatory audit discussions. In between audit sessions, attendees will hear updates on the latest hot state income and franchise tax topics. Contact: Karen Galdamez. Email: kgaldamez@cost.org.

April 21

Employment Tax in 2016 - Addressing Challenges Related to Multistate and International Payroll — Webcast. PwC’s State and Local Tax and Global Mobility Services will provide a webcast that explores how companies can proactively manage their payroll tax obligations in an environment where employees increasingly work from remote locations, travel between states, and are on assignment in countries other than their own. The panelists will address how to proactively manage complex rules regarding payroll tax compliance and withholding, how to mitigate the outcome of federal and state payroll tax audits, and effective strategies for managing tax obligations related to inbound employees. The webcast will run from 4 p.m. to 5 p.m. Contact: Kristin Kleist. Telephone: (202) 346-5030. E-mail: kristin.a.kleist@us.pwc.com.

Unclaimed Property: Asset Recovery and Unclaimed Property Reporting — Webinar. Deborah Beauchamp and Keith Keeley of Ryan LLC will lead a one-hour webinar on states’ enforcement of escheatment laws. Participants will learn what they can do to avoid penalties and how to recover assets owed to their companies, and will have to opportunity to view uncashed checks, customer credits, or other liabilities to the proper state. The webinar will begin at 2 p.m. Contact: Deborah Koons. Email: deborah.koons@ryan.com.

April 24-27

Restaurant Industry Sales Tax Audit Professionals 2016 Annual Meeting — Houston. The annual meeting will feature discussions on recent legislative developments and rulings, accounting and audit methods, tax technology and analytics, income tax and property tax for sales tax professionals, costs savings and value added initiative, non-traditional restaurant sales, best practices, contractors, audit issues, and ethical considerations. Contact: Chris Smith. Telephone: (864) 597-8489. Email: csmith@dennys.com.

April 25

State Bar of Texas Property Tax Conference — Austin. Topics at the meeting and legal seminar will include a case law panel discussion, delinquent tax issues, tax collections, discovery issues, ethics, and more. For more information, go to http://www.texastaxsection.org/.

April 26

Advanced Texas Franchise Tax Workshop — Fort Worth, Texas. Lacy Leonard of Martens, Todd, Leonard, Taylor & Ahlrich will lead a four-hour seminar on how to apply the latest franchise tax laws and court cases in a variety of complex situations. Participants will sharpen their franchise tax skills by solving problem sets that will address the research exemption and credit, the revenue exclusion and costs of goods sold deduction for real estate activities, combined reporting, the three-factor election, oil and gas producing partnerships, medical exclusion issues, retail tax rate and installation labor, and more. The seminar is offered through LAT Seminars. Contact: Stacy Noack. Telephone: (855) 829-2527. Email: snoack@textaxlaw.com.

April 28

Advanced Texas Franchise Tax Workshop — Midland, Texas. Danielle Ahlrich of Martens, Todd, Leonard, Taylor & Ahlrich will lead a four-hour seminar on how to apply the latest franchise tax laws and court cases in a variety of complex situations. Participants will sharpen their franchise tax skills by solving problem sets that will address the research exemption and credit, the revenue exclusion and costs of goods sold deduction for real estate activities, combined reporting, the three-factor election, oil and gas producing partnerships, medical exclusion issues, retail tax rate and installation labor, and more. The seminar is offered through LAT Seminars. Contact: Stacy Noack. Telephone: (855) 829-2527. Email: snoack@textaxlaw.com.

Southeast Regional State Tax Seminar — Birmingham, Alabama. The Council On State Taxation will present an update on state tax issues for Alabama, Florida, Georgia, Mississippi, North Carolina, South Carolina, and Tennessee. This seminar is open to industry tax professionals from COST member companies and industry tax professionals from non-COST member companies. Contact: Karen Galdamez. Email: kgaldamez@cost.org.

April 29

Michigan One Day Tax Seminar — Ann Arbor, Michigan. The Institute for Professionals in Taxation, in cooperation with the Michigan Department of Treasury, is hosting a one-day tax seminar that is focused solely on the issues important to taxpayers in Michigan and those that conduct business in the state. Officials from Michigan’s Department of Treasury will provide their perspective on emerging issues. For more information go to www.ipt.org.

May 1-6

Sales Tax School II, Theory & Practice for Experienced Sales & Use Tax Professionals — Cincinnati, Ohio. The Institute for Professionals in Taxation will offer an intermediate level five-day school that will guide students through a review and analysis of many different but essential sales and use tax principles and concepts: research, accounting, auditing, and other technical skills. Enrollment is limited to IPT members and employees of companies that have IPT members. Applicants must have successfully completed IPT’s Sales and Use Tax School I or have successfully challenged it in order to attend. For more information, go to www.ipt.org.
May 2-5

Statistical Sampling for Sales and Use Tax Audits — Hoover, Alabama. The Multistate Tax Commission and the Alabama Local Tax Institute of Standards and Training will present a course providing a first step to understanding and applying statistical sampling techniques. This course will provide participants with the skills necessary to conduct a statistical sample and an understanding of basic statistical sampling theory as it relates to sales and use tax audits. Contact: Sherry Tiggett. Telephone: (202) 650-0296. Email: stiggett@mtc.gov.

May 2-6

2016 E-File Symposium — Kansas City, Missouri. The Federation of Tax Administrators’ symposium on electronic filing offers a forum for states and industry to share their best practices and work out new standards for shared electronic filing programs, providing an opportunity for the state, federal, and private sector to work together on this special cooperative program. A special one-day meeting of the FTA and National Association of Computerized Tax Processors working group will be held on Monday and a meeting of the FTA E-Standards group will be held Thursday afternoon and Friday morning. Contact: Verenda Smith. Telephone: (202) 624-8443. Email: verenda.smith@taxadmin.org.

May 5-7

2016 ABA Section of Taxation May Meeting — Washington. The American Bar Association’s Tax Section’s May meeting will bring together the nation’s leading tax practitioners to discuss current issues, topics, and legislation. Attendees, speakers, and guests include high-level government officials, judges, corporate counsel, and private practitioners engaged in all aspects of tax law. A state and local tax luncheon will be held Friday, May 6. For more information, go to www.americanbar.org/groups/taxation.html.

May 9

Mid-West Regional Seminar — Chicago. The Council On State Taxation and the Chicago Tax Club will present an update on significant state tax issues for Illinois, Indiana, Iowa, Kentucky, Michigan, Minnesota, Missouri, Nebraska, North Dakota, Ohio, South Dakota, and Wisconsin. This seminar is open to members of the Chicago Tax Club, members of COST, and other tax professionals from non-member companies. Contact: Karen Galdamez. Email: kga1damez@cost.org.

May 11-12

2016 May Tobacco Uniformity Meeting — Albuquerque, New Mexico. The Federation of Tax Administrators will hold its tobacco uniformity meeting, including breakout sessions and meetings of the committees on communication and legislation, forms, compliance, and technology. The Uniformity Committees chairs will meet on May 10. Contact: Cindy Anders-Robb. Telephone: (307) 632-4144. Email: cindy.anders-robb@taxadmin.org.

May 12

Mid-Atlantic Regional State Tax Seminar — Pittsburgh, Pennsylvania. The Council On State Taxation will present an update on significant state tax issues in Delaware, Maryland, New Jersey, New York, Pennsylvania, Virginia, West Virginia, and the District of Columbia. This seminar is open to tax professionals from COST member companies and industry tax professionals from non-COST member companies. Contact: Karen Galdamez. Email: kga1damez@cost.org.

May 15-19

Intermediate/Advanced State Income Tax School — Atlanta. The Council On State Taxation’s Intermediate/Advanced State Income Tax School offers a complete meeting package and four days of intensive and entertaining instruction in income tax concepts and issues. The ideal attendee should have more than three years of experience. The emphasis of the school is on practical applications of state tax issues in a corporate environment. The courses are taught using the case-study method and are intended to expose students to the theoretical knowledge and strategic insights of outside experts, along with the practical expertise of in-house practitioners. Contact: Karen Galdamez. Email: kga1damez@cost.org.

Intermediate/Advanced Sales and Use Tax School — Atlanta. The Council On State Taxation’s Intermediate/Advanced Sales and Use Tax School offers a complete meeting package and four days of intensive and entertaining instruction in sales tax concepts and issues. The ideal attendee should have more than three years of experience. The emphasis of the school is on practical applications of state tax issues in a corporate environment. The courses are taught using the case-study method and are intended to expose students to the theoretical knowledge and strategic insights of outside experts, along with the practical expertise of in-house practitioners. Contact: Karen Galdamez. Email: kga1damez@cost.org.

May 17-18


Calendar Submissions

Submissions to State Tax Notes’ calendar may be emailed to stn_calendar@taxanalysts.org. If submitting by email, please write calendar submission in the subject field.

Calendar

State Tax Notes, April 4, 2016

For more State Tax Notes content, please visit www.taxnotes.com.
CROSSWORD PUZZLE

April 2016 Tax Crossword Puzzle

by Myles Mellor

Across

1. Senator proposing a bill to end the prescription drug advertising deduction
5. Prominent politician proposing a flat tax
9. C-level member, abbr.
12. Unpaid portions
14. Trial attorney's concern in criminal cases
16. Tokyo coin
17. State that recently passed a cigarette tax hike, abbr.
18. Jupiter's moon
20. Political figure
21. New Hampshire governor who ran a successful tax amnesty program in 2015
24. Get off the fence
27. Brit finance system
28. Punishment for tax related identity theft
29. Gross receipts style tax in force in Texas
30. Secretary of the Treasury, Jack ___
32. You, in old British court parlance
34. Now I understand!
35. Think through
36. It refers to the negative effect of multinational companies' tax avoidance strategies on national tax bases, a subject now under consideration by the IRS
38. Abbreviation for dealer
40. Celebrity
42. It's being phased out by digital
43. Association urging Treasury to update the taxation of cross-border savings in relation to the U.S. and Canada
45. Commissioner of Internal Revenue was created under this president
47. Distinguished
48. Make a wrong move
49. Justice Alito has indicated the Supreme Court may accept a case to review the constitutionality of these laws in the future
50. One who often gets an inheritance

Down

1. State tax organization in California, abbr.
2. Unite
3. Philadelphia mayor proposing a tax on sugary beverages
4. Reason for some grants
6. Pacific ___
7. Greek letters
8. House Ways and Means Committee Chairman, first name
10. Roman eleven
11. Cook, for Apple
13. ___ Lingus (Irish airline)
15. National Tax Payer Advocate, Nina ____
19. Government org. that is featured in The Firm movie
21. California Democrats voted to extend higher income tax brackets for this demographic, 2 words
22. A. Onassis, familiarly
23. Everyone
25. British wage and tax system which records changes in earnings in real time
26. Agreement between nations regarding exchange of tax information
27. Seize
31. Funding this was the original reason income tax was imposed in the U.S.
33. Technicality in tax law
35. Change a property's tax assessment amount
37. Supreme Court Judge recently passed
38. Case lists
39. ___ the ante
41. Kind of button, pressed when under severe stress
44. React to (2 words)
46. After tax amount

See p. 55 for the solution.)