"Shaking things up in state and local tax"

SUTHERLAND SALT SHAKER

FORECAST
Political winds shifting, leaving the atmosphere unsettled.

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Michigan Gears Up for 2011 Amnesty

In what was beginning to seem like an unlikely event, the Michigan Legislature finally passed a nearly year-old bill that will allow for a limited amnesty period, from May 15, 2011, to June 30, 2011. While the Senate passed the original amnesty bill in 2009, there was no further movement of the bill until September 2010, when the House and Senate finally agreed that the bill could help close Michigan's $484 million budget gap—without raising taxes. Governor Jennifer Granholm approved Senate Bill 884 on October 5. The amnesty program is projected to bring in $61.8 million of additional revenue.

Unlike other recent amnesty programs, Michigan's program is relatively simple. Taxpayers that participate in the program will receive a waiver of all penalties (civil and criminal) for taxes paid through the program. The Bill does not state whether taxpayers will be required to waive their right to seek a refund of liabilities paid under the program. Nor does it indicate whether post-amnesty penalties will apply to taxpayers who do not participate in the program. In order to qualify for Michigan's amnesty program, taxpayers must file a written request for a waiver on a form provided by the Department, and meet the following requirements:

- Have an outstanding Michigan tax liability (except for taxes due after the close of the 2009 calendar year). The Bill does not specify the types of taxes eligible for the amnesty program;

Continued on Page 2

Events in Neighboring Southern States May Foreshadow Changes to Come

Within the last month, Tennessee and North Carolina have replaced the heads of their respective Departments of Revenue. On September 20, Charles Trost was sworn in as the new Tennessee Commissioner of Revenue. Mr. Trost was a partner at a Nashville law firm, and takes over for outgoing Commissioner Reagan Farr. In Tennessee, the Commissioner is appointed by the governor, and there are four months left in the term of the outgoing governor.

Change is also occurring on the other side of the Appalachian mountains, as Ken Lay (no, not that Ken Lay, the other Ken Lay) is stepping down as North Carolina Secretary of Revenue. Governor Beverly Perdue has appointed outgoing State Senator David Hoyle as the replacement. Mr. Hoyle is the former co-chairman of the North Carolina Senate Finance Committee and has been a significant force in rewriting the tax laws of that state. Governor Perdue's term will end in 2013.

These two changes may be the first of many changes for state taxing authorities. In 2010, 37 states will elect governors. New governors may bring new tax policy. Furthermore, in many states, the governor appoints the head of the state's taxing authority, so there may be many new Secretaries, Commissioners, and Directors of Revenue. Taxpayers can expect to see some significant changes not only in state law and policy, but also in enforcement and collection practices.

Throw Out the Throwback: Maine Replaces "Throwback" with "Throwout" and Adopts *Finnigan*

Despite the overwhelming business opposition to "throwout" sales factor apportionment rules and New Jersey's recent repeal of its "throwout" rule, Maine is now bucking the trend and adopting a new "throwout" rule. Effective for 2010 and subsequent years, Maine adopted the *Finnigan* methodology for computing the sales factor for a combined return and to replace its "throwback" rule with the "throwout" rule.

Under the new *Finnigan* methodology of Code Me. R. 810 for determining the numerator of the sales factor in a combined report, "total sales of the taxpayer" in Maine now includes sales of the taxpayer and sales of any other entity included in a combined return, regardless of whether those entities themselves have nexus with Maine. The adoption of *Finnigan* applies to both unitary groups that have elected to file a single combined return and those that file separate returns utilizing combined apportionment. If separate returns are filed, each taxpayer's return will include in the numerator of the sales factor its own Maine sourced sales as well as a portion of the Maine sourced sales of those entities in the unitary group that do not have nexus with Maine.

The new "throwout" rule in Code Me. R. 801 requires taxpayers to exclude from the sales factor denominator those sales of tangible personal property shipped to customers within a state in which the taxpayer is not taxable. Notably, sales are thrown out of the sales factor regardless of whether they are shipped or delivered from Maine. The "throwout" rule applies in the context of a combined return as well but – under the

Continued on Page 2

Continued from Page 1

Michigan Gears Up for 2011 Amnesty cont'd

- File any unfiled or amended returns; and
- Pay all outstanding tax and interest.

Additionally, some taxpayers are ineligible to participate, such as:

- Those eligible to enter into a voluntary disclosure agreement under § 30c for the tax at issue. Under § 205.30c of Act 122 of 1941, a non-filer who either: (1) has a filing responsibility under nexus standards issued by the department after December 31, 1997; or (2) has a reasonable basis to contest liability, as determined by the state treasurer, for a tax or fee, is eligible to enter into a voluntary disclosure agreement.
- Those whose tax is attributable to income derived from a criminal act, if the taxpayer is under criminal investigation or involved in a civil action or criminal prosecution for that tax, or if the taxpayer has been convicted of a felony under this act (Act 198 of 2010) or the Internal Revenue Code of 1986.

The Department of Treasury is expected to provide further details on Michigan's amnesty program as the amnesty period approaches. In addition, the Department is required to provide "reasonable notice" to taxpayers who might be eligible to participate in the program at least 30 days prior to the start of the amnesty period. Thus, as 2011 moves into full swing, taxpayers with outstanding Michigan tax liabilities may be receiving notice of their eligibility to participate in the amnesty program.

Continued from Page 1

Finnigan rule – only if none of the members of the unitary group is taxable in the state of delivery.

Although the differences between a "throwback" and a "throwout" rule may seem subtle, the important distinction is that a "throwback" rule increases the sales factor by including sales in the numerator that have some connection with the state (i.e., sales of tangible personal property shipped from Maine to a state where the taxpayer is not taxable). On the other hand, a "throwout" rule increases the factor by excluding sales from the denominator that arguably have no connection with the state because the exclusion occurs regardless of the location from which the property is shipped.

Maine's adoption of the "throwout" rule is of particular concern given the fact that it apportions income based only on a single sales factor apportionment formula. The exclusion of a large amount of sales from the denominator under the "throwout" rule therefore may cause a significant increase in the overall apportionment percentage. West Virginia is another state that employs "throwout," but West Virginia uses a three-factor formula with double-weighted sales factor. New Jersey previously had a "throwout" rule that was challenged in court. Despite the fact that the court upheld the rule in *Whirlpool Properties, Inc. v. Director, Division of Taxation* and *Pfizer, Inc. v. Director of Taxation*, Dockets A-1180-08T2 and A-1182-08T2 (N.J. Super. Ct. App. Div., July 12, 2010), New Jersey has repealed the "throwout" provision for tax periods beginning on or after July 1, 2010.

SALT PET OF THE MONTH

Chester

Four years ago this month Sutherland SALT Business Manager Andrea Christman, and her husband Andrew, expanded their family with the adoption of Chester – a "talkative" SALT and pepper miniature schnauzer who loves to be the center of attention. Chester spends his days keeping close watch over his Herndon, Virginia neighborhood and, while his bark can be fierce, he attacks only with kisses. Chester's favorite pastimes are reading with Andrew and watching musicals with Andrea, and he is their constant companion – until a football game comes on, at which time he makes a quick exit to avoid the excitement. Chester's favorite treat is ice cubes, and he has developed supersonic doggie radar that enables him to detect the opening of the freezer door from any room in the house.

SALT Pet of the Month: It's Your Turn!!

In response to many requests, the Sutherland SALT practice invites you to submit your pet (or pets) as candidates for SALT Pet of the Month. Please send us a short description of why your pet is worthy of such an honor, along with a picture or two. Submissions should be directed to Andrea Christman at andrea.christman@sutherland.com.

Concern Over New Jersey Software Regulation

The New Jersey Division of Taxation is revisiting a proposed regulation that would provide new rules governing the sale of software and related services. While the draft regulation has not been formally published for public comment, the Division is working with interested parties to accept comments prior to the draft's publication.

The draft would amend existing definitions and add new definitions to N.J. Admin. Code §18:24-25.1, and replace the existing §18:24-25.6, entitled "Treatment of maintenance contracts and software-related services," with new §18:24-25.6, entitled "Treatment of software-related services and software maintenance contracts." These changes are significant because New Jersey taxes the enumerated services of installation and services to tangible personal property; but does not tax downloaded prewritten computer software when sold to a business

Continued on Page 5

Would You Like Tax With That?

West Virginians (and hungry road-trippers passing through the state) may soon face a new tax on their drive-through purchases. The West Virginia Department of Transportation has proposed charging an additional five percent tax on food and beverages purchased at drive-through windows, in addition to the six percent customers already pay.

The proposal is one of many suggestions by the state's transportation department to bring in money for the state road fund. Advocates say the tax is necessary to repair and maintain miles of neglected roads although the connection between drive-through food and road repair is tenuous at best. Other suggestions include levying a one percent surcharge on car insurance premiums. The Department of Highways estimates that the drive-through tax could bring in $50 million a year, and proponents argue that it would encourage healthier eating habits.

There is no indication, however, that the Legislature will support the idea. Customers and business owners are likely to oppose it as well – customers because of the higher prices (and general antipathy toward "sin" taxes), and business owners because of the potential hit to their sales. For instance, customers who would otherwise have made a quick stop for a cup of coffee on the road might be discouraged by the higher price. Moreover, some critics have pointed out that most of the revenue for the state road fund comes from gas taxes – which drive-through customers are already paying.

For his part, West Virginia Governor Joe Manchin is not on board. He released a statement on September 14 saying, "I want to be clear that these are suggestions that I strongly oppose and do not in any way support as a means to generate revenue for the state road fund."

Recently Seen and Heard

September 20-21, 2010
Broadband Tax Institute 2010 Annual Conference
Park Hyatt – Beaver Creek, CO
Michele Borens on State Income Tax: Update – Audit, Reform, COP, Unitary/Combined
Jeff Friedman on Significant Decisions Impacting our Industry
Steve Kranz on Role of Congress in State Taxation; MTC and Nexus: Click-Through Bills and the States' Efforts to Get Around Nexus; State Transaction Tax: Digital Goods Update
Eric Tresh on State Taxes: How to Get Your Fair Day in Court; The Eye of the Storm: Preparing for Next Year and How to Get Reform Without Higher Taxes

September 23, 2010
IPT Wisconsin One-Day Tax Seminar
Monona Terrace – Madison, WI
Jeff Friedman on Multistate Tax Update: Digital and Other Difficult Tax Issues

September 23-25, 2010
ABA Section of Taxation Fall Meeting
Sheraton Centre Toronto Hotel – Toronto, Canada
Steve Kranz on New Breed of Amazon "Taxes" – Colorado's Clever Twist

September 26-28, 2010
Northeastern States Tax Officials Association Annual Conference
Park Plaza Hotel & Towers – Boston, MA
Steve Kranz on Alternative Approaches to Remote Sales Transactions

September 26-29, 2010
IPT Sales and Use Tax Symposium
Renaissance Esmeralda Resort and Spa – Indian Wells, CA
Michele Borens on Join the Penny Pinchers – Learn How to Lower Your Tax Costs Through Proper Contracting Language
Steve Kranz on The Organized Chaos of State Tax Legislation

September 26-29, 2010
The Tax Foundation National Taxpayers Conference
One Washington Circle Hotel – Washington, DC
Charlie Kearns on in-the-news tax issues and on current state fiscal policy developments, pending federal legislation on state tax issues, SSTP developments, and their potential impacts on states and taxpayers

October 5, 2010
TEI Dallas Chapter State Tax Luncheon
City Club – Dallas, TX
Marc Simonetti and **Jonathan Feldman** on Evolving Nexus

October 14, 2010
Wireless Tax Group Meeting
Burlington, VT
Steve Kranz on Spotlight on Digital Goods – Federal and State Legislative Activity; Compliance Issues

Come See Us

October 19-22, 2010
COST 41st Annual Meeting
Sheraton Wild Horse Pass – Phoenix, AZ
Jeff Friedman on Attributional Nexus Developments for State Income, Sales/Use and Gross Receipts Taxes – Reconciling *Bellas Hess* and *Quill* with *Scripto* and *Tyler Pipe*
Steve Kranz on Contingent Fee and Contract Audits: Addressing a Troubling Trend
Diann Smith on Emerging Issues With Abandoned & Unclaimed Property: It's Not a Tax, But You Own the Audit

October 21, 2010
Stafford Webinar
Pilar Mata on 80/20 Companies and Foreign-Source Income: State Treatment

October 24-27, 2010
TEI 65th Annual Conference
Sheraton Chicago Hotel – Chicago, IL
Eric Tresh and **Pilar Mata** on Dangers of Unreliable Intercompany Accounting Issues in State Taxes

October 28, 2010
COST Southwest/West Regional State Tax Seminar
Four Seasons Hotel – Houston, TX
Michele Borens on State Tax Policy Update: 2010 and Beyond – How Will the States Meet Their Revenue Needs
Michele Borens and **Pilar Mata** on Digital Age SALT Issues – Applying Old Rules to New Technology
Marc Simonetti and **Pilar Mata** on Update on Significant State Tax Litigation Around the Country

November 1-5, 2010
MACPA & MSBA 2010 Advanced Tax Institute
Martin's West – Baltimore, MD
Jeff Friedman on National Developments and Trends in State Taxes

November 3, 2010
STARTUP State Tax Roundtable for Utilities and Power
Richmond Falls, VA
Jeff Friedman and **Eric Tresh** on Jurisdiction to Tax

November 4-6, 2010
The State Bar of California 2010 California Tax Policy Conference
Loews Coronado Bay – San Diego, CA
Pilar Mata on State Tax Issues in A Global Economy

November 8-11, 2010
IPT Advanced Sales and Use Tax Academy
Doral Hotel – Miami, FL
Charlie Kearns on SSTA Implementation: Top to Bottom; Digital Goods

November 9, 2010
Paul J. Hartman State and Local Tax Forum
Loews Vanderbilt Hotel – Nashville, TN
Michele Borens on Hot Topics – Virginia
Steve Kranz on Streamlined Sales Tax Project Versus Amazon Laws and Other Techniques Designed to Increase the Reach of State Sales and Use Taxes to Remote Sellers
Pilar Mata on Expense Addbacks and Exceptions

November 9, 2010
Manufacturers Alliance Fall Tax Council Meeting
Westin – Alexandria, VA
Jeff Friedman will present

November 9, 2010
TEI Carolinas Chapter Meeting
Research Triangle Park, NC
Marc Simonetti on State Amnesties and Penalties

November 10, 2010
Michigan Association of Certified Public Accountants Michigan Tax Conference
Rock Financial Showplace – Novi, MI
Diann Smith on Revenue for State Government

November 12, 2010
TEI Connecticut Valley Chapter Meeting
Farmington, CT
Michele Borens and **Marc Simonetti** on SALT Policy

December 8, 2010
ITP Conference
Double Tree Hotel – Washington, DC
Michele Borens on The Unitary Concept

December 8, 2010
TEI New York Chapter Meeting
New York, NY
Marc Simonetti on Recent Developments to Non-Income Taxes

December 13-14, 2010
New York University 29th Institute on State and Local Taxation
Grand Hyatt – New York, NY
Jeff Friedman on RAR Adjustments – Are They 'Final'? What Do You File and When Do You File It?
Marc Simonetti on What's Happening Everywhere Today?
Diann Smith on Due Process – Are Pay-to-Play and Internal Hearings the End of the Line? Retained Refunds, Retroactive Laws and Regulations, Harsh Penalties

Continued from Page 3

Concern Over New Jersey Software Regulation cont'd

user. New Jersey's position is that these services are taxable, even when performed on electronically delivered, prewritten computer software. Although New Jersey amended its definition of tangible personal property to include prewritten computer software on October 1, 2005, to conform to the Streamlined Sales and Use Tax Agreement (SSUTA), businesses presumed that because the State had also adopted a statutory exemption for prewritten computer software when sold to a business user, that all associated services (e.g., installation, configuration, and customization) would continue to be exempt. However, the Division's policy is that because prewritten computer software is expressly included in the definition of tangible personal property, the Division can tax the services performed on the software, regardless of how it was delivered. Taxpayers who receive electronic delivery of software in New Jersey should evaluate the regulation's implications for those purchases.

Networking in New York Gets Pricey

On September 15, 2010, the New York State Tax Commission issued an Advisory Opinion, TSB-A-10(40)S, addressing the taxability of various services offered on a professional networking website. The website enables members to create profiles, search for potential contacts, research business opportunities, and participate in discussion groups, among other things. The Commission held that charges received for premium subscriptions to the website, in-network e-mails, and customer surveys constitute taxable "information service" charges. In contrast, charges collected from employers to post job listings or to participate in online virtual job fairs constitute charges for advertising services that are not subject to sales tax.

Although information services are generally taxable, there is an exception for services that are personal or individual in nature and that may not be substantially incorporated into reports furnished to other persons. The Commission held that the first requirement (personal or individual in nature) was not satisfied because the information came from a source that was not itself confidential. The Commission applied the "common database" test to the second requirement (substantial incorporation) and found that although the data provided to one customer might be slightly different than the data provided to another customer, the information came from the same source and could be used to furnish reports for multiple consumers. Thus, the charges for premium subscriptions, network e-mails, and surveys did not meet the exception.

The Advisory Opinion follows the July 19, 2010, issuance of TSB-M-10(7)S, which provided general guidance regarding services potentially qualifying as information services and the related information services exceptions.

StubHub! Punches Its Ticket to Ride in Federal Court (Briefly)

On September 29, 2010, the U.S. Court of Appeals for the Seventh Circuit certified a state law question to the Illinois Supreme Court for review in a case that the taxpayer had originally removed to federal court. *City of Chicago v. StubHub!, Inc.*, No. 09-3432 (7th Cir. 2010). In *StubHub!*, the City of Chicago filed suit in Cook County Circuit Court for a declaratory judgment that StubHub! was required to collect an amusement tax, and StubHub! successfully removed the action to federal court, invoking federal court jurisdiction on diversity grounds. The ability of a company to challenge a state/city tax in federal court is often preempted by the Tax Injunction Act (TIA). So, why was StubHub! not precluded by the TIA from removing the case to federal court?

Passed by Congress in 1937, the TIA prohibits federal court jurisdiction over suits to "restrain the assessment, levy or collection" of a state tax, provided that a plain, speedy and efficient remedy is available in state court. Underlying the TIA are principles of federalism and comity, and a recognition of the needs of states to manage their own fiscal affairs. The TIA has been interpreted broadly such that it is difficult for taxpayers challenging a state tax to be heard in federal court. The TIA does not, however, bar federal court jurisdiction in cases where taxing authorities are seeking a declaratory judgment against taxpayers to begin enforcing the collection of a tax. Since the City of Chicago brought the action for declaratory judgment to compel the collection of the amusement tax, the TIA did not apply.

Although StubHub! was permitted to remove the declaratory judgment action to federal court because of the unusual origination of the case, its procedural victory was short-lived as the federal court sent the case back to state court to decide the substantive tax issues at the heart of the litigation. According to Rule 20 of the Illinois Supreme Court Rules, the Seventh Circuit can certify questions of state law to the Illinois Supreme Court, where such questions are dispositive and there are no controlling precedents in the Illinois Supreme Court. In deciding to certify the issue of whether municipalities can require electronic intermediaries to collect and remit amusement taxes on resold tickets, the Seventh Circuit noted the abundance of web-auction sites, that the resolution of the tax issue is important for municipalities in Illinois, and that certification was the only way to ensure that a state court would have an opportunity to resolve the issue.

Supreme Court Grants Cert in Two Jurisdiction Cases – Will the Long Arm Get Longer?

On September 28, 2010, the United States Supreme Court granted certiorari in two important Due Process Clause cases dealing with the assertion of personal jurisdiction against foreign corporations. In *Goodyear Luxembourg Tires v. Brown*, the Court will consider "whether a foreign corporation is subject to general personal jurisdiction, on causes of action not arising out of or related to any contacts between it and the forum state, merely because other entities distribute in the forum state products placed in the stream of commerce by the defendant." *In J. McIntyre Machinery Ltd. v. Nicastro*, the Court will consider a related question: whether a state may be permitted to exercise specific jurisdiction over a foreign manufacturer under the stream-of-commerce theory "solely because the manufacturer targets the United States market for the sale of its product and the product is purchased by a forum state consumer." Although there are no direct state tax implications in these two cases, they will raise issues among corporations engaging in electronic commerce and are concerned about being subject to tax in every state. If the Court rules that jurisdiction was properly asserted in either of these cases, businesses, and particularly those engaged in electronic commerce, will be faced with the daunting prospect of being haled into court anywhere in the United States with no connection to the forum state beyond selling items on a third-party website. So much for purposeful availment!

The United States Supreme Court has previously considered the Due Process Clause standard in the state tax context. In *Quill v. North Dakota*, 504 U.S. 298 (1992), the Court applied the Due Process Clause analysis that is applied generally to whether a defendant could be subject to suit in another jurisdiction: "Building on the seminal case of *International Shoe Co. v. Washington*, 326 U.S. 310, 66 S.Ct. 154, 90 L.Ed. 95 (1945), we have framed the relevant inquiry as whether a defendant had minimum contacts with the jurisdiction 'such that the maintenance of the suit does not offend 'traditional notions of fair play and substantial justice.' ' *Id*., at 316, 66 S.Ct., at 158 (quoting *Milliken v. Meyer*, 311 U.S. 457, 463, 61 S.Ct. 339, 343, 85 L.Ed. 278 (1940))." *Id*. at 307. Thus, the Court has made clear that general Due Process Clause analysis applies for purposes of state tax nexus, and in this manner, there is concern that any expansion of Due Process Clause jurisdiction will have a direct effect on state tax nexus principles.

Although both cases deal with a question of personal jurisdiction over a foreign corporation, some key facts make the question presented in each case notably different. That factual difference hinges on the type of personal jurisdiction being asserted; in *Goodyear*, the plaintiff/appellee is attempting to assert *general* jurisdiction over the foreign corporation, while in *McIntyre*, the case deals with specific jurisdiction over the defendant. Where specific jurisdiction is available in suits "arising out of or related to the defendant's contacts with the forum," general jurisdiction, if applicable, allows for a defendant to be haled into court in the state on any claim whatsoever and unrelated to the actual forum contacts. *Helicopteros Nacionales de Colombia*, *S.A. v. Hall*, 466 U.S. 408, 414-15 nn. 8-9 (1984). General jurisdiction may be asserted only when the defendant's contacts and activities in the forum state are "so substantial and of such a nature as to justify suit against it on causes of action arising from dealings entirely distinct from those activities." *Int'l Shoe Co. v. Washington*, 326 U.S. 310, 318 (1945). Indeed, the petitioners in *Goodyear* point out that, similar to the Commerce Clause physical presence standard affirmed in *Quill*, the Court has consistently held that a company is required to have contacts so substantial that it is "constructively present" in a state before general jurisdiction may be asserted by that state.

The assertion of general jurisdiction based upon the mere act of inserting product into the stream of commerce, as challenged in *Goodyear*, is an extreme position that we expect to be decided in favor of the foreign corporation. The stream-of-commerce theory has been only successfully asserted in specific jurisdiction cases. The closer question, and the case that bears watching, is *McIntyre*. According to defendant's petition for certiorary, the New Jersey Supreme Court "contended that traditional notions of fair play and substantial justice . . . should reflect what it termed 'the radical transformation of the international economy.'" In other words, because technology has advanced and international (and interstate) commerce has become so important to the economy, businesses should reasonably expect to be haled into a court in any state where it knows its product may possibly be purchased. No purposeful availment would be necessary. If the lower court ruling is upheld, no longer will a corporation need to purposefully direct its sales activities to the forum state to satisfy Due Process Clause concerns; rather, a product sold on a website that the business knows may be viewed within any state could be sued in that state's court if the business's product happens to end up in that state and causes harm to a person there.

Particularly within the realm of the digital economy, where a company is not shipping goods but merely providing electronically delivered products and services to end users in undisclosed locations, such an expansion of the concepts of personal jurisdiction would be an impediment to the free market concepts that drive the American economy. The Supreme Court should treat the lower court decision premised on the "radical transformation" of the economy with a skeptical eye, because those quaint notions of "fair play and substantial justice" have not changed at all.

New Jersey Appellate Division Says Praxair Should Have Read the Tea Leaves on Tax Liabilities

On September 1, the Superior Court of New Jersey, Appellate Division, issued its opinion in *Praxair Technology, Inc. v. Dir., Div. of Taxation*, Case No. A-6262-06T3 (N.J. Super. Ct. App. Div. 2010), which upheld the Director's imposition of a penalty on Praxair for failing to file a tax return for the 1994, 1995, and 1996 tax years. Praxair took the position that it was not subject to tax under New Jersey tax law because it did not have physical presence in New Jersey. Although the statute remained unchanged, the New Jersey Division of Taxation made a regulatory change in 1996 to add an example that explained that it was the Division's position that Praxair was subject to the corporate business tax. In addition, the Appellate Division upheld a post-amnesty penalty against Praxair because it failed to take advantage of the 2002 tax amnesty, even though the New Jersey Supreme Court, in 2006, held that economic presence was put into effect in 1996 with the regulatory change. *Lanco, Inc. v. Dir., Div. of Taxation*, 908 A.2d 176 (N.J. 2006).

The Appellate Division rejected Praxair's argument that the Director abused its discretion by failing to waive the penalty in light of the legal uncertainty at the time. The ruling is surprising given that the New Jersey Tax Court found the Director's refusal to waive a penalty to be "manifestly unreasonable" in *United Parcel Services General Services Co. v. Div. of Taxation*, 25 N.J. Tax 1 (N.J. Tax Ct. 2009). In *UPS*, the Tax Court found that "genuine questions of . . . law existed." But in *Praxair*, despite recognizing the "unsettled state of the law," the Appellate Division rejected Praxair's position, stating that it did not show enough "respect" for the Director's position and had enough state tax guidance to read the tea leaves on whether it would have tax liabilities.

In addition, the Appellate Division held that the post-amnesty penalty was constitutional despite Praxair's claim that the penalty violated its due process rights. In *UPS*, the Tax Court found that a taxpayer cannot be expected to satisfy a tax liability during an amnesty period when the taxpayer "did not know and, by reasonable inquiry, could not have known that additional taxes were due." The Appellate Division, however, again took the contrary position, holding that Praxair had notice of the amnesty period and the post-amnesty penalty, of which Praxair failed to take advantage. Moreover, Praxair did not suffer a deprivation of property, according to the Appellate Division, because it did not yet pay the penalty and was currently litigating the issue.

Praxair has 45 days to appeal the Appellate Division's determination to the New Jersey Supreme Court. Will the New Jersey Supreme Court recognize that it is unreasonable to impose penalties before published guidance is provided to taxpayers? Stay tuned.

IRS Subject to APA???

The U.S. Court of Appeals for the District of Columbia, sitting en banc on September 29, raised serious questions in a suit seeking refund of telephone excise taxes paid to the Internal Revenue Service (IRS). A decision on the arguments raised could have far-reaching consequences for the IRS, potentially requiring it to conform to the Administrative Procedure Act (APA) when issuing guidance.

The case involves 26 U.S.C. § 4251, a three percent excise tax on long-distance phone calls for which the charges varied based only on transmission time, which five circuit courts declared invalid in 2005 and 2006. In May 2006, the IRS declared that it would no longer impose the tax and would allow taxpayers to claim refunds for excise taxes. The guidelines for claiming the refund, which were outlined in Notice 2006-50, required taxpayers to affirmatively request the refund on their 2006 federal tax return and precluded other administrative remedies.

A number of taxpayers filed suit to overturn the Notice, claiming that it represented final agency action that "arbitrarily, unreasonably, and unlawfully limits restitution of the funds unlawfully exacted." *In re Long-Distance Tel. Serv. Fed. Excise Tax Refund Litig.*, 501 F.Supp.2d 34, 38-39 (D.D.C. 2007). Taxpayers protested the fact that they were not allowed to seek refunds in any other manner than that set forth in the Notice. This, they argued, constituted "final agency action" subject to judicial review under the APA, and that the Notice was laden with mandatory language and created new obligations for taxpayers in violation of the rules of administrative procedure.

The IRS argued in *Cohen v. United States*, No. 08-5088 (D.C. Cir. Aug. 7, 2009), that the decision of whether or not to process refund requests was entirely up to the IRS's discretion and that its methods were unreviewable under the APA. The IRS also insisted that the guidelines set forth in the Notice did not preclude other administrative action. The Court disagreed, noting that the taxpayers had no other remedy at law than to challenge the Notice on the grounds that it violated the APA. In response to the government's contention that the Anti-Injunction Act (AIA) precluded the suit, taxpayers said the statute was inapplicable because the IRS had already collected the tax. The AIA only affects lawsuits while the agency is in the process of assessing or collecting a tax.

Gilbert Rothenberg, acting deputy assistant attorney general to the Justice Department Tax Division, pointed out during the en banc hearing that Congress had established procedures taxpayers must follow to obtain a refund—procedures the taxpayers had ignored in this case—and that the statute of limitations was in fact still open. It would be unprecedented, he said, for a court to find that it had jurisdiction to hear a case challenging compliance with the APA when a taxpayer had not first used the appropriate refund process. But the judges questioned how the IRS could be immune from the APA and criticized the terms of the Notice.

If the court finds that the IRS failed to adequately adhere to the APA in constructing the procedures in the Notice, the consequences could be significant. A ruling for the taxpayers could require the IRS to follow formal notice-and-comment procedures when formulating guidance—such as Revenue Rulings, Revenue Procedures, and Notices—that have the effect or force of law.

Connecticut Issues Guidance on New "Factor Presence" Nexus Standard

The Connecticut Department of Revenue recently issued an Informational Publication (Publication) on September 23, 2010, to provide guidance on its new "economic nexus" standard, effective for tax years beginning on or after January 1, 2010.

Connecticut's new economic nexus standard states that "Any company that derives income from sources within this state, or that 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 a company's economic contacts with this state, without regard to physical presence…shall be liable for the tax…." Conn. Stat. L. 2009 § 90 (emphasis added). The Publication sets forth those activities that will constitute "substantial economic presence" and will result in a corporation being subject to Connecticut corporate income tax. The Publication provides that the substantial economic presence in Connecticut must be attributable to the purposeful direction of business activities toward the state, and those activities are evaluated "based on the frequency, quantity, and systematic nature of the business's economic contacts in Connecticut." The Publication provides a bright-line test for determining when these activities will result in substantial economic presence: when the company has receipts from business activities of $500,000 or more attributable to Connecticut sources during a taxable year. Even if a company has less than $500,000 in receipts, the Commissioner may still assert that a company has a filing and tax payment obligation if it has nexus with the state through some other means.

The Informational Publication also addresses when the use of an intangible in the state will result in a Connecticut tax liability pursuant to the new economic nexus standard:

1. The intangible property generates, or is otherwise a source of, gross receipts within the state for the corporation, including through a license or franchise;

2. The activity through which the corporation obtains such gross receipts from its intangible property is purposeful (e.g., a contract with an in-state company); *and*

3. The corporation's presence within the state, as indicated by its intangible property and its activities with respect to that property, result in it having $500,000 or more of receipts attributable to Connecticut sources during a taxable year.

To determine if a taxpayer has $500,000 or more of receipts from the use or sale of intangibles in the state, Connecticut's existing market-sourcing rules must be used. Under these rules, receipts from intangibles are sourced to Connecticut if the receipts are from: (1) rentals and royalties from properties situated within the state; (2) royalties from the use of patents or copyrights within the state; (3) net gains from the sale or other disposition of intangible assets managed or controlled within the state; and (4) all other receipts earned within the state. The Publication further provides that passive investment income derived from Connecticut is not considered in subjecting a company to economic nexus.

"Factor presence" tests—like Connecticut's—have been growing in popularity since the Multistate Tax Commission approved a model regulation on October 17, 2002, which provides for such a standard. Washington state enacted a similar factor presence test earlier this year with respect to its Business & Occupation Tax, and a similar standard in California for corporate income tax purposes becomes effective January 1, 2011. However, the factor presence nexus standard is not without controversy, and legal challenges to these standards likely are on the horizon.

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