

# Multistate Tax Analyst

*A monthly briefing for the professional involved in  
multistate corporate income, sales and use, and property taxation*

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## North Carolina

### Taxable Income

#### Department of Revenue may combine corporate taxpayer with captive REIT to deny deduction for rent payments

*The Department of Revenue properly exercised its statutory mandate to find the "true net income" of a corporation by combining the incomes of the corporation and its captive REIT, effectively denying the corporation a deduction for its rent payments to the REIT. In attempting to reduce its North Carolina taxable income, the corporation sought to take advantage of three aspects of North Carolina's tax law: a deduction for rent paid (including rent paid to a related entity); a REIT deduction for dividends paid; and a dividends-received deduction. There is no evidence that the leases have economic substance apart from the reduction of the corporation's North Carolina tax liability.*

*Wal-Mart Stores East, Inc. v. Hinton, Secretary of Revenue; Sam's East, Inc. v. Hinton, Secretary of Revenue*  
North Carolina General Court of Justice,  
Superior Court Division, Wake County, December 31, 2007

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States are targeting "captive" REITs in an attempt to stop what they perceive to be the creation of artificial tax-deductible rent expenses incurred as part of a corporate restructuring strategy solely designed to trim corporate income tax liability in separate-filing states. A variety of methods are employed by the states in challenging the savings sought by enterprising taxpayers: requiring the filing of combined or consolidated returns; special statutory provisions eliminating deductions for rent paid to related entities and for dividends received from REITs; elimination of the deduction for dividends paid by affiliated REITs; exercise of statutory discretion to prevent the distortion of income. A recent North Carolina case illustrates that existing statutory mandates and authority may be sufficient to allow a state to prevent the loss of corporate income tax revenue.

**Wal-Mart restructuring strategy:** A large accounting firm had ideas about how to significantly reduce

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the state tax burden for Wal-Mart. The strategy, subsequently adopted by Wal-Mart, called for restructuring Wal-Mart into two operations — essentially, one for the eastern states (Wal-Mart East), another for the western states (Wal-Mart West). The accounting firm indicated to Wal-Mart that the eastern states generally do not allow or require the filing of combined returns, although some — including North Carolina — allow the state to require combined reporting in certain circumstances. That is the key element of the strategy.

Wal-Mart East's stores were transferred to a REIT that was 99-percent owned by Wal-Mart Property Company, a Delaware corporation. Wal-Mart East agreed to pay rent on a monthly basis equal to 2.5 percent of sales. The rental payment was made via an automated journal entry. In turn, the REIT paid its income on a quarterly basis to Wal-Mart Property Company. Wal-Mart (the parent company) wired the necessary funds to the REIT to cover the dividend payment to Wal-Mart Property Company. Immediately following this transfer of funds, Wal-Mart Property Company wired the dividend to Wal-Mart East.

The net effect of the transactions is that Wal-Mart East, a North Carolina taxpayer, creates a deduction for rent payments, thereby reducing its federal taxable income and, due to piggybacking, its North Carolina taxable income. The rent received by the REIT is not taxed because the REIT pays out all of its income to Wal-Mart Property Company. Since Wal-Mart Property Company is domiciled in Delaware and has no significant activity there or elsewhere, it pays no state taxes on the dividends it receives from the REIT. Wal-Mart East receives the rent it paid back in the form of dividends from Wal-Mart Property Company, but pays no tax on those dividends as a result of a dividends-received deduction allowed by North Carolina.

The restructuring had no impact on the management or operations of Wal-Mart nor did it change its federal tax liability. Further, Wal-Mart East, the REIT, and Wal-Mart Property Company had separate bank accounts which were used exclusively for the payment of dividends; daily deposits were swept into Wal-Mart's bank accounts.

**Combined report ordered:** Following an audit, the North Carolina Department of Revenue required the incomes of Wal-Mart East, Wal-Mart Property Company and the REIT to be combined, effectively denying the rental expense as a deduction by eliminating intercompany transactions. This resulted in an assessment for a four-year period of about \$30 million (including \$5 million in interest and penalties).

Wal-Mart East counters that North Carolina's tax statutes allow the group to take advantage of three benefits afforded taxpayers: a deduction for rent paid (including rent paid to a related entity); a REIT

### New York: Nontaxpayer's Sales in Numerator of Combined Receipts Factor

The New York Court of Appeals has ruled that receipts from New York sales made by a nontaxpayer subsidiary which was included in a combined report with its parent must be reflected in the numerator of the combined group's receipts factor in calculating the group's business allocation percentage. The court further finds that inclusion of the nontaxpayer's New York sales in the numerator of the business allocation formula does not amount to an unlawful tax on the income of the no-nexus subsidiary. Moreover, the court holds that the inclusion of these sales in the combined group's numerator does not violate Public Law 86-272, which bars a state from imposing an income tax on a company whose activity in the state does not exceed the solicitation of orders for tangible personal property that are approved and shipped or delivered from outside the state.

Indeed, the court goes so far as to conclude that the tax immunity afforded by Public Law 86-272 is not available to the no-nexus subsidiary since the activities of the unitary group of which it was a member exceed the mere solicitation of orders, *i.e.*, the "person" that might have immunity from tax under Public Law 86-272 is the unitary group and not each member standing alone. (*Matter of Disney Enterprises, Inc. et al. v. Tax Appeals Tribunal*, March 25, 2008)

deduction for dividends paid; and a dividends-received deduction.

**"True net income" standard:** The Department points to several statutory provisions that it says authorize its assessment. G.S. 105-130.6 gives the Department authority to require a consolidated return to be filed by a taxpayer and its affiliates to allow the Department to calculate the taxpayer's "true net income." The court explains that the Department correctly relies on this provision, since the only requirement for implementing its authority is "that a report by [the] corporation does not disclose the true earnings of the corporation on its business carried on" in North Carolina.

In addition, the specific action taken in this case — combination — is authorized by G.S. 105-130.16, says the court. In particular, this section provides as follows:

*When the Secretary [of Revenue] has reason to believe that any corporation so conducts its trade or business in such manner as to either directly or indirectly distort its true net income and the net income properly attributable to the State, whether by the arbitrary shifting of income, through price fixing, charges for service, or otherwise, whereby the net income is arbitrarily as-*

### Louisiana: No Physical Presence Requirement for Income Tax Nexus

A Louisiana appeals court recently considered one of the most pressing state tax questions: Does the physical presence requirement of *Quill* apply in determining nexus for corporate income or franchise tax purposes? After reviewing decisions in other states, a few of which extend the physical presence requirement to those taxes, the Louisiana court concludes that the physical presence requirement applies only to sales and use taxes. (*Cynthia Bridges, Secretary of the Department of Revenue v. Geoffrey, Inc.*, Louisiana Court of Appeal, First Circuit, February 8, 2008)

Bear in mind that while this decision involves a trademark holding company which receives royalty payments from a related corporation, the fact that the entities are related is not significant to the court's conclusion. By licensing intangibles for use in Louisiana and deriving income from their use in that state — or any other state that rejects the physical presence requirement — any licensor of intangibles may be exposed to corporate income and franchise tax liability.

*signed to one or another unit in a group of taxpayers carrying on business under a substantially common control, the Secretary may require any facts the Secretary considers necessary for the proper computation of the entire net income and the net income properly attributable to the State....*

According to the court, this provision allows the Department to use combined reporting or a consolidated return when it finds that the taxpayer is not reporting its "true net income."

Final statutory authority for the Department's assessment is found in G.S. 105-130.4, which allows the Department to determine and properly allocate to North Carolina a portion of the income of a multistate corporation. In other words, declares the court, the Department "may utilize combined reporting."

Ultimately, the court rejects Wal-Mart East's assertion that North Carolina is compelled to accept the separate corporate existence of its REIT and Wal-Mart Property Company. Wal-Mart East argues unsuccessfully that the Department "has disregarded their separate existence apart from [Wal-Mart East] merely because [the Department] dislikes the tax strategy adopted...." While the court would likely approve a deduction for rent paid by a taxpayer to an affiliated entity, it does not view this approval as applying to the circumstances of the present controversy:

*[T]here is no evidence that the rent transaction [in this case], taken as a whole, has any real economic sub-*

*stance apart from its beneficial effect on [the taxpayer's] North Carolina tax liability. It is particularly difficult for the court to conclude that rents were actually "paid," when they are subsequently returned to the payor corporation.*

### ●●● MTA Observations:

The tide has turned against aggressive tax planning using the mechanism of a "captive" REIT. Whether by specific legislation to combat this strategy, general powers to allocate income among related entities, or authority to require combined or consolidated returns, states are putting an end to this tax maneuver. Recognizing that taxpayers and their advisers are very motivated and creative in their tax planning, we are likely to see more states adopt combined reporting in an effort to preempt a revenue drain.

## Taxable Income

### Alabama

#### Addback of royalties paid to trademark management affiliates required

*A manufacturer and marketer of apparel is required to add back royalties it pays to two Delaware affiliates for the use of trademarks and logos owned by the affiliates which relate to the apparel company's manufacturing and marketing activities. An "unreasonableness exception" to the addback statute applies only if the taxpayer proves that the addback results in a tax that is out of proportion with the taxpayer's activities in Alabama. It is not relevant that there was a business purpose for the formation of the trademark management affiliates or that these affiliates have economic substance. Further, a "subject-to-tax exception" to the addback of royalties excludes from the addback only income the trademark management affiliates apportion to other states, i.e., this exception applies on a post-apportionment basis and not on a pre-apportionment basis, as urged by the taxpayer.*

*Surtees, Commissioner, and the Alabama Department of Revenue v. VFJ Ventures, Inc., f/k/a VF Jeanswear, Inc.*  
Alabama Court of Civil Appeals, February 8, 2008

To resist what they perceive to be overly aggressive tax avoidance, about a dozen separate-return states have enacted "addback statutes" requiring corporate taxpayers to add back to federal taxable income interest and royalties paid to affiliated entities. One primary target is the so-called intangible holding company, particularly those incorporated in states such as Delaware or Nevada that do not tax the royalty or interest income the holding company receives.

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One of the states that has adopted an addback statute is Alabama. At issue in a recent Alabama appeals court case is the application of two exceptions to a statutory royalty-expense addback when (a) disallowance of a deduction would be “unreasonable” (the “unreasonableness exception”) or (b) the royalty income was subject to a tax based on or measured by the intangible holding company’s net income in Alabama or any other state (the “subject-to-tax exception”).

**Brand-name jeans:** VFJ Ventures, Inc. manufactures and sells jeans under the brand-names Lee and Wrangler. VFJ has two distribution facilities and a manufacturing facility in Alabama that employ about 600 people. VFJ is a subsidiary of VF Corporation, which is headquartered in North Carolina. Among VF’s subsidiaries are several intangible management companies that own and manage trademarks, including two intangible management companies that own and manage the Lee and Wrangler brand names. These intangible management companies (IMCs) are incorporated in Delaware, a state that does not tax royalty income.

Both the Lee and Wrangler IMCs license their trademarks and logos to VFJ and to other VF subsidiaries, as well as to third parties. However, the overwhelming majority of the royalties received by the IMCs are derived from licensing agreements with related companies. For the tax year at issue, VFJ paid the Lee IMC \$32.2 million in royalty fees and paid the Wrangler IMC \$66.4 million. VFJ deducted these royalty payments as ordinary and necessary business expenses, which would also reduce VFJ’s Alabama taxable income if those expenses are allowed.

**Alabama addback:** Alabama’s addback statute requires a corporation to add back to its taxable income expenses and costs related to intangibles (e.g., trademarks) that are paid to related entities. The Alabama Department of Revenue insists that the addback applies to VFJ’s payments to the Lee and Wrangler IMCs.

VFJ does not dispute that the royalty payments it made to the IMCs are the type of intangible expenses disallowed by Alabama’s addback statute. However, the manufacturer maintains that two exceptions to the addback requirement apply: the “unreasonableness exception” and the “subject-to-tax exception.”

**“Unreasonableness exception”:** According to VFJ, in determining whether it would be “unreasonable” to require a corporation to apply the addback statute to its royalty payments to an affiliate, the focus should be on “whether there is a legitimate business purpose or economic substance to the royalty-payment transactions.” In this regard, the facts generally point to a conclusion that the IMCs were formed for legitimate business purposes (other than the reduction of state taxes) and that the IMCs have economic substance.

In contrast, the Department of Revenue urges that the unreasonableness exception applies “to those situations in which a corporation’s tax as a result of the application of the add-back statute would be ‘out of proportion with what could reasonably be said to be attributed to the State.’” Under the Department’s position, no consideration is given to whether transactions with the IMCs had a legitimate business purpose or economic substance. The Department indicates that the addback statute had not been enacted to address the problem of deductions based on “sham transactions,” *i.e.*, those transactions lacking a legitimate business purpose or economic substance. Its rationale is that the Department could disallow deductions involving sham transactions even before the addback statute was enacted.

The appeals court sides with the Department, emphasizing that “[i]n enacting the add-back statute, the Alabama Legislature elected not to extend its ‘grace’ to deductions for transactions between related entities involving royalty payments for intangible assets.” Since VFJ presented no evidence to demonstrate distortion of its income if the addback statute is applied to disallow its deduction for royalty payments to its affiliated IMCs, there is no basis for finding that the unreasonableness exception should block the disallowance.

**“Subject-to-tax” exception:** Under the addback statute, otherwise deductible royalty payments to a related entity are disallowed unless it is shown that the corresponding item of income was subject to a tax based on or measured by the related entity’s net income in Alabama or any other state. The addback statute defines “subject to tax” as meaning that the royalty payment is “reported and included in income for purposes of a tax on net income, and not offset or eliminated in a combined or consolidated return which includes the payor.” VFJ and the Department differ in their interpretation of the subject-to-tax exception.

Both the Lee and Wrangler IMCs filed corporate income tax returns in North Carolina. (These returns, filed “under protest” based on lack of nexus, may have been filed to benefit VFJ and other VF subsidiaries. Under North Carolina’s addback statute, VFJ and the other subsidiaries with activity in North Carolina would not have to add back royalty payments made to the IMCs because the IMCs filed income tax returns in North Carolina.) In filing their North Carolina returns, the IMCs listed their federal taxable incomes and then applied their apportionment factors to determine the amount of income apportionable to North Carolina, *i.e.*, neither IMC paid North Carolina tax on the entire amount of its federal taxable income. The Lee IMC’s apportionment percentage was 2.87 percent, while the apportionment percentage for the Wrangler IMC was 3.94 percent.

VFJ contends that the subject-to-tax exception means that the entire amount of federal taxable income the IMCs reported on their North Carolina income tax returns was subject to tax, "even if only a small part of that was actually apportioned to North Carolina and taxed in that state." If this interpretation is accepted, all of the IMCs's income would be considered to be subject to tax and the exception to the addback would preclude Alabama from adding back *any* of the royalty payments VFJ made to the IMCs. In sum, VFJ's view is that the subject-to-tax exception to the royalty addback requirement should be applied on a "pre-apportionment" basis.

The Department counters that the subject-to-tax exception excludes from the royalty addback only the income the IMCs apportioned to North Carolina. (Apparently, North Carolina was the only state that taxed the royalty income of the IMCs.) In the Department's view, accepted by the appeals court, the remainder of the royalty income of the IMCs is added back to VFJ's federal taxable income. In sum, the court finds that the subject-to-tax exception is applied on a "post-apportionment" basis.

The court indicates its reason for reaching this conclusion:

*... Under a pre-apportionment interpretation, a corporation could easily avoid the application of an add-back statute that contains a subject-to-tax exception by paying corporate income tax in a state in which its apportionment factor is relatively insignificant. This case is an example of that possibility. Although each IMCO reported significant federal taxable income, Lee had a state-tax burden in North Carolina of approximately .0019% of its federal taxable income, and Wrangler paid state tax on approximately .0027% of its federal taxable income. Based on its argument that that modest level of taxation met the requirement of the [subject-to-tax] exception to Alabama's add-back statute, VFJ sought to avoid the application of that statute. [Footnote omitted.]*

**Constitutional argument:** Having lost on its statutory arguments, VFJ contends that the addback of its royalty payments is unconstitutional. The taxpayer's first assertion is that "the add-back statute is effectively an attempt" to tax the income of the IMCs and that Alabama lacks a sufficient nexus with those entities to justify the tax. The court finds no merit to this characterization of the royalty-expense disallowance:

*... Alabama's add-back statute does not expressly impose a tax on [the IMCs], nor has the Department sought to impose a tax directly on those [IMCs]. VFJ contends, however, that the add-back statute does effectively impose a tax on the [IMCs]. We conclude that the add-back statute does not implicitly (or "effectively") impose a tax on the [IMCs]. Rather, the add-back statute disallows a deduction sought by the taxpayer, VFJ, which does have activities in Alabama sufficient to justify its paying corporate income tax in this state.... [D]eductions*

#### Indiana: Deduction for Royalties Paid to Sister Corporation Allowed

The Indiana Department of State Revenue's corporate income tax audit of an Indiana company engaged in the business of preparing and printing financial and business documents concludes that the company's deductions for royalty payments to an affiliate should be disallowed. The auditors reasoned that the claimed expenses "significantly reduce[d] the amount of income subject to tax in Indiana" and, accordingly, warranted invoking the Department's statutory authority to allocate income derived from Indiana sources among commonly owned entities in order to "fairly reflect" Indiana income. The taxpayer's protest of the disallowance resulted in a reversal of the audit's disallowance. (*Indiana Department of State Revenue Letter of Findings: 06-0511*, January 30, 2008)

The Indiana taxpayer pays royalty fees to a related entity in California in exchange for the right to use certain trademarks and logos. This intellectual property had been transferred by the taxpayer's parent to the California entity in 1997 in exchange for the assumption of liabilities associated with the property. The taxpayer itself never owned the trademarks or logos.

Indiana allows businesses freedom to adopt the corporate form they deem appropriate, and will recognize related corporations as separate taxable entities provided the corporate form is not a sham. For this purpose, the state applies a "business purpose" doctrine, *i.e.*, as long as a corporation's existence is "the equivalent of business activity or is followed by the carrying on of business by the corporation, the corporation remains a separate taxable entity." In this instance, the taxpayer proved that the California affiliate is an "operating company" that actively promotes and preserves the trademarks and logos in question. The California affiliate makes sales to third parties and has a payroll of about \$25 million. The royalty payments the affiliate receives from the taxpayer are used as working capital and are not returned to the taxpayer in the form of loans or dividends. In sum, while the audit correctly notes that the royalty expenses significantly reduced the taxpayer's income subject to Indiana tax, there is no indication that these payments are part of "an abusive tax avoidance scheme" so that disallowance of a deduction would be required to fairly reflect the taxpayer's Indiana source income.

*are a matter of legislative grace.... We do not agree with VFJ that disallowing a deduction for an expense it pays*

### Florida: Regulation Limiting Affiliated Group's NOL Deduction on Consolidated Return Invalid

Federal income tax regulations allow an affiliated group filing a consolidated return to deduct from its gross income net operating losses that one or more of the group's members sustained during a year in which those members filed separate tax returns, provided those members were part of the affiliated group for every day of the "separate return limitation year" during which the losses arose. (See Treasury Reg. sections 1.1502-1 and 1.1502-21(c).) In contrast, Florida's "separate return limitation year rule" provides that a federal affiliated group may *not* deduct a net operating loss carryover sustained in "a prior taxable year for which a Florida consolidated return was not filed and Florida corporate income tax returns were not filed for all members" of the group. (See Fla. Admin. Code R. 12C-1.013(14)(j).)

Recently, a Florida appeals court ruled the state's separate return limitation year rule invalid because it conflicts with the statute, which "piggybacks" on the federal tax law. In particular, Florida's corporate income tax statute specifies that consolidated taxable income of an affiliated group is to be computed "in the same manner and under the same procedures... as are required for consolidating the incomes of affiliated corporations... for federal income tax purposes...." (See Sec. 220.131(4), Fla. Stat.) Further, Florida's corporate income tax statute provides that "[t]he net operating loss deduction allowable for federal income tax purposes under s. 172 of the Internal Revenue Code for the taxable year" is "subtracted from ... taxable income." (See Sec. 220.13(1)(b), Fla. Stat.)

The court explains that Florida's separate return limitation year rule prevents an affiliated group from computing its Florida consolidated taxable income in conformity with federal procedures, and also prevents net operating loss carryovers from being treated in the manner set forth in Internal Revenue Code section 172. Accordingly, Florida's rule "enlarges, modifies, or contravenes the specific provisions" of the state's tax statute and, therefore, "is an invalid exercise of delegated legislative authority." (*Golden West Financial Corporation et al. v. Florida Dep't of Rev.*, Florida District Court of Appeal, First District, February 19, 2008)

*constitutes a tax on the entities to whom it paid that expense....*

VFJ also asserts that the addback statute violates the "fair apportionment" requirement of *Complete*

*Auto*. The argument is that the addback statute lacks external consistency, *i.e.*, it taxes activity beyond that fairly attributable to VFJ's activity in Alabama. The court rejects this assertion, emphasizing that VFJ offered no evidence to demonstrate that the addback of the royalty payments results in taxation that is out of proportion to the manufacturer's activities in Alabama.

#### ● ● ● MTA Observations:

The appeals court decision — which reverses a trial court judgment — is sure to disappoint many taxpayers that had sought to avoid Alabama's addback of royalty payments by arguing that the "unreasonableness exception" applies where a related trademark holding company has economic substance or a business purpose. The Alabama Supreme Court has announced that it will review this decision.

The court's decision is also of interest to taxpayers in about 18 other separate-reporting states that have addback statutes of their own. The statutory question in each state is whether the addback statute is simply the legislative implementation of a "sham transaction" standard or reaches beyond to transactions that have a valid business purpose and economic substance. Further, many of the addback states provide exceptions that are similar to Alabama's "unreasonableness" and "subject-to-tax" exceptions.

## Sales and Use Tax/Nexus

### New Jersey

#### Company operating website in Washington State is a "vendor" required to collect New Jersey tax

*A corporation that operates a website from Washington State through which customers purchase items typically sold in a local drugstore is required to collect sales tax from New Jersey customers. The website, which concedes it has nexus (physical presence) in New Jersey, fails to establish that a subsidiary with no presence in the state is the actual vendor and that the website itself is not involved in the sale of merchandise.*

*Drugstore.com, Inc. v. Director, Division of Taxation*  
New Jersey Tax Court, Docket No. 000637-2003,  
February 11, 2008

A corporation operating a website through which customers can purchase items typically sold in drugstores (*drugstore.com*) failed to convince the New Jersey Tax Court that it is not a "vendor" which may be required to collect sales and use tax. The corporation's strategy of positioning a no-nexus subsidiary as the nominal vendor between itself and customers simply does not ring true to the Tax

Court. (The corporation concedes that it has nexus – a substantial physical presence – with New Jersey; it has both leased equipment and employees who work in a warehouse operated by a wholly owned subsidiary.)

**“Shopping mall” analogy:** Customers access an internet website owned and operated by Drugstore.com, Inc. Testimony on behalf of the corporation by an officer describes the corporation’s website as being “analogous to the services of a shopping mall operator who provides a single location where various retailers offer their merchandise and where customers are able to purchase different items from different vendors in a single place.”

The testimony of the officer of the Washington State-based corporation also indicates that the retailer selling merchandise (other than prescription drugs) at this electronic mall is DSNP Sales, a wholly owned subsidiary of Drugstore.com, Inc. In substance, Drugstore.com, Inc. has granted DSNP Sales a license to use the trademark “drugstore.com” and agrees to provide web-hosting services to DSNP Sales under the domain name “drugstore.com.” Indeed, the name used by DSNP Sales on the website is the name “drugstore.com” licensed to it by Drugstore.com, Inc.

Testimony was offered that when an order for a non-prescription item is placed through the website, DSNP Sales transmits the order electronically to another subsidiary, DS Distribution, *i.e.*, the claim is that DSNP Sales purchases merchandise from DS Distribution for resale to DSNP Sales’s customers. (The unpaid tax the Division of Taxation seeks from Drugstore.com, Inc. involves transaction in which merchandise is distributed from DS Distribution’s New Jersey warehouse to customers located in New Jersey.)

**Testimony interpreted:** Considering the testimony of the officer and documentary evidence, it is clear that DSNP Sales has no physical presence anywhere. The putative vendor has no employees and contracts all of its administrative and purchasing functions to its parent, Drugstore.com, Inc. For example, DSNP Sales is obligated under the web-hosting agreement with Drugstore.com, Inc. to supply the content for its area on the website. Despite this agreement, Drugstore.com, Inc. itself supplies the content. Similarly, DSNP Sales’s obligation to transmit orders to DS Distribution is actually performed by Drugstore.com, Inc.

Based on its interpretation of the evidence, the Tax Court finds that rather than being analogous to a shopping mall operator where a directory identifies various retailers, the website “was more akin to the directory of a single store, namely ‘drugstore.com,’ which guided a customer to the aisle within the store where a particular category of merchandise was located.”

**Who’s the vendor?:** Drugstore.com, Inc.’s contention is that it does not make sales and therefore is not a vendor for New Jersey sales and use tax purposes. It asserts that DSNP Sales is the real seller and, since it has no nexus with New Jersey, DSNP Sales is not required to collect New Jersey sales tax.

The Tax Court disagrees with this assertion, finding “[m]ost significantly” that there is “no actual sale of merchandise by DS Distribution to DSNP Sales.” DS Distribution does not invoice DSNP Sales for the goods Drugstore.com, Inc. says DSNP Sales purchases, *i.e.*, no money changes hands. Further, the distribution agreement between DSNP Sales and DS Distribution provides that title to the products claimed to be purchased by DSNP Sales remains with DS Distribution until shipment is made to the customer. Accordingly, two elements of a “sale” are missing: consideration and transfer of title or possession.

Further, the Tax Court finds no justification for the creation of DSNP Sales other than the avoidance of tax collection responsibilities:

*... I can only conclude that the reason for the formation of DSNP Sales was to bolster the claim that [Drugstore.com, Inc.] was merely the operator of a website and was not involved in the sale of merchandise.*

Based on this analysis, the Tax Court concludes that the Division of Taxation properly regards Drugstore.com, Inc. as a vendor required to collect tax. Essentially, despite the positioning of DSNP Sales between Drugstore.com, Inc. and DS Distribution as the retail seller, Drugstore.com, Inc. is the actual seller. Since Drugstore.com, Inc. has physical presence in New Jersey, it is liable for the collection of tax from its New Jersey customers.

### ●●● MTA Observations:

The strategy of interposing a no-nexus subsidiary in this case fails primarily because the subsidiary has no substance and engages in no activities. As the Tax Court explains, “[t]his is not a case of disregarding corporate entity.” Instead, the court disregards the sales transactions Drugstore.com, Inc. claims were made by the distribution subsidiary to the interposed subsidiary. At a minimum, the interposed subsidiary should have had employees who actually transfer orders to the website’s distribution subsidiary. Some form of bookkeeping entry should have acknowledged “payment” by the interposed subsidiary to the distribution subsidiary.

## Kentucky Combined Reporting Refunds: The Saga Continues

Either administratively or through court decisions, Kentucky has changed its stance on combined reporting several times over the past 30 years. Between 1972 and 1988, the Revenue Cabinet (now the Department of Revenue) consistently took the position that if a multicorporate business was unitary, a combined return was either required or permitted. A major shift occurred with the adoption of *Revised Revenue Policy 41P225*, effective September 27, 1988. That policy, which expressly applied retroactively to all open years, prohibited the filing of combined returns.

**GTE decision:** In a challenge to *Revised Revenue Policy 41P225*, the Kentucky Supreme Court held that a group of corporations engaged in a single unitary business was permitted to file a combined return. The Revenue Cabinet's retroactive policy rejecting combined returns was ruled unenforceable. In its 1994 decision, the court essentially reasoned that the Revenue Cabinet's longstanding interpretation (requiring or permitting combination) was "reasonable under all the circumstances and should have been adhered to by the Cabinet." (See *GTE v. Revenue Cabinet*, 889 S.W.2d 788.)

In reaction to the *GTE* decision, the Revenue Cabinet initially permitted eligible corporations that originally filed separate returns to file amended combined returns for open tax years. The Cabinet adopted settlement guidelines for these taxpayers and even settled several refund claims, some for very substantial amounts.

Tracking actual and potential claims by unitary businesses, the Cabinet estimated that outstanding refund claims could amount to over \$200 million (including interest).

**Legislative action:** Because of the potentially costly consequences of the *GTE* decision, in 2000 the Kentucky legislature enacted a measure designed to limit the blow to the state's treasury. H.B. 541 retroactively precluded taxpayers from claiming Kentucky income tax refunds based on a change of filing status from separate to combined returns for tax periods ending on or before December 31, 1994.

A group of 26 businesses precluded from taking advantage of combined filing by this legislation filed suit challenging the prohibition. Their claims for refund had "languished" in the Kentucky Revenue Cabinet after they filed amended tax returns seeking refunds for open periods (a four-year statute of limitations applies) during which the Revenue Cabinet's policy had prevented them from filing combined returns. In 2006, the Kentucky Court of Appeals concluded that "H.B. 541's retroactive effect deprives [the challengers] of due process... because of the excessive retroactivity contained in that law." (The Kentucky Supreme Court has agreed to consider Kentucky's appeal of this decision.)

**Another legislative hurdle:** In 2007, the legislature enacted H.B. 316, a measure that revokes Kentucky's waiver of sovereign immunity regarding tax refunds relating to the filing of amended combined returns. The new law also restricts the state's ability to pay tax refunds relating to the filing of amended combined returns. Taxpayers reacted by filing an action in *federal court* seeking to have the legislation declared unconstitutional under the Due Process and Equal Protection Clauses of the U.S. Constitution.

Recently, the federal district court ruled that neither sovereign immunity, the federal Tax Injunction Act, nor principles of comity between federal courts and the states preclude the court from considering the taxpayers' contention that the legislative bar to tax refunds is unconstitutional. (*Johnson Controls, Inc., et al. v. Commonwealth of Kentucky, Finance and Administration Cabinet, et al.*, United State District Court, Eastern District of Kentucky, Central Division at Frankfort, February 28, 2008)

Now that the federal court has determined that it has jurisdiction to rule on the constitutionality of Kentucky's legislation, the taxpayers are one step closer to obtaining refunds. If the federal court strikes down the statute, Kentucky courts will have to consider the merits of the taxpayers' refunds claims.

## Business vs. Nonbusiness Income

### Illinois

#### State may not tax capital gain realized on sale of non-unitary business division

*Once a determination is made that a division is not part of a corporate taxpayer's unitary business, gain realized on the sale of that division is not included in the taxpayer's apportionable income on the basis that the division served an "operational function" in the taxpayer's business. The concept of operational function recognizes that an asset can be part of a taxpayer's unitary business even if a unitary relationship does not exist. However, when the asset in question is an entire business, that business does not serve an operational function unless it is part of the taxpayer's unitary business.*

*MeadWestvaco Corp. v. Illinois Department of Revenue et al.*  
United States Supreme Court, No. 06-1413, April 15, 2008

In *Allied-Signal, Inc. v. Director, Division of Taxation*, 504 U.S. 768 (1992), the U.S. Supreme Court reaffirmed the unitary business principal as the constitutional requisite for apportioning capital gains. In rejecting New Jersey's "sweeping theory" that "all income of a corporation doing any business in a State is, by virtue of common ownership, part of the corporation's unitary business and apportionable," the Court explained that the "relevant unitary inquiry" is whether the underlying assets served an "investment function" (non-apportionable) or an "operational function" (apportionable). According to the Court, this is an inquiry "which focuses on the objective characteristics of the asset's use and its relation to the taxpayer and its activities within the taxing State." In establishing the operational function test, the Court stressed that the taxpayer and the entity whose stock it held "need not be engaged in the same unitary business as a prerequisite to apportionment in all cases."

Unfortunately, the Court did not define "operational function" in *Allied-Signal*, thereby leaving this concept open to much discussion, interpretation and controversy. In its recent decision involving MeadWestvaco's substantial gain on the sale of Lexis/Nexis, a unanimous Court does much to clarify its intentions regarding the operational function test for apportionment.

**Background:** Mead Corporation (now known as MeadWestvaco), an Ohio paper and packaging manufacturer, purchased Data Corporation in 1968 for \$6 million, primarily because of its inkjet printing technology. At that time, Data was also developing a computerized, full-text information retrieval system that, by 1973, evolved into Lexis/

Nexis. During its ownership, Mead treated Lexis/Nexis as a corporate division at times and as a subsidiary at other times. Mead approved major capital expenditures for Lexis/Nexis, including a 1984 expansion of Lexis/Nexis's computer center and a capital expenditure of nearly \$13 million in 1993 to improve its search system.

Mead and Lexis/Nexis had separate day-to-day operations, did not share personnel, or make joint purchases. Further, there were no favorable intercompany transactions, although Mead made a nightly cash sweep of Lexis/Nexis's bank accounts and decided how to invest Lexis/Nexis's money.

To settle disputes with the Illinois Department of Revenue, from 1988 through 1994, Mead included Lexis/Nexis in its unitary business group.

In December 1994, Mead sold the assets of Lexis/Nexis to Reed Elsevier for \$1.5 billion. Mead used \$350 million of the gain to buy back stock; it used the balance of the proceeds to reduce its debt. Mead reported approximately \$1 billion in gain from the sale of its Lexis/Nexis division as *nonbusiness* income. The Illinois Department of Taxation took issue with Mead's classification of that gain, arguing that the gain was apportionable as "business income" under the state's statute which followed UDITPA.

**Lower court decisions:** An Illinois circuit court concluded that Lexis and Mead were not unitary because they were not functionally integrated or centrally managed and enjoyed no economies of scale. Nevertheless, the circuit court concluded that the gain was apportionable because Lexis had served an "operational purpose" in Mead's business. ("Lexis/Nexis/ was considered in the strategic planning of Mead, particularly in the allocation of resources.")

The Illinois appellate court agreed, citing several factors as evidence that Lexis served an operational function in Mead's business, *i.e.*, Lexis was wholly owned by Mead; Mead had exercised control over Lexis in changing its corporate form, approving capital expenditures, retaining tax benefits, and controlling its cash; and Mead described itself in annual reports and filings as engaged in electronic publishing. The appellate court did not consider whether Mead and Lexis were unitary. The Illinois Supreme Court decided not to review the appellate court's decision.

**A "fundamental error":** Mead asserts that the circuit court correctly found that Lexis and Mead were not unitary, but that the appellate court wrongly concluded Lexis served an operational function in Mead's business. The U.S. Supreme Court declares that there is a "more fundamental error in the state courts' reasoning":

*In our view, the state courts erred in considering whether Lexis served an "operational purpose" in*

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## 10 Multistate Tax Analyst

*Mead's business after determining that Lexis and Mead were not unitary.*

The Court notes that in *Allied-Signal* it said "that situations could occur in which apportionment might be constitutional even though 'the payee and the payor [were] not... engaged in the same unitary business.'" In this regard, the Court elaborates on this concept:

*It was in that context that we observed that an asset could form part of a taxpayer's unitary business if it served an "operational rather than an investment function" in that business. [Emphasis added.]*

References to "operational function," explains the Court, "were not intended to modify the unitary business principle by adding a new ground for apportionment." The Court points to an example where the operational function test has been applied, *e.g.*, in *Allied-Signal* itself the taxpayer was not unitary with a bank that paid it interest, but its deposits of working capital "were clearly unitary with the taxpayer's business." Therefore, the interest income was apportionable despite the lack of a unitary relationship between the payor and the payee.

In this case, the "asset" in question is Mead's ownership of Lexis, an entire business. The Court clearly indicates that when dealing with the sale of an entire business, that business must have been unitary with the taxpayer as a condition for apportioning gain.

**A remand:** Because the appellate court had relied on the operational function test in ruling that gain on the sale of Lexis was apportionable – and had made no determination whether Mead and Lexis were engaged in a unitary business – the Court remands this matter to the appellate court for consideration of the unitary business issue.

### ● ● ● MTA Observations:

The U.S. Supreme Court effectively reiterates the adage that "the linchpin of apportionability in the field of state income taxation is the unitary-business principle." (See *Mobil Oil Corp. v. Commissioner of Taxes*, 445 U.S. 425, 439 (1980).) Accordingly, gains from the sale of stock of related entities are not apportionable unless the entity is engaged in a unitary business with the taxpayer. The Court's operational function concept is not a distinct basis for supporting apportionment, but merely permits apportionment when a particular asset is part of the taxpayer's own unitary business.

The Illinois Department of Revenue argued in the alternative before the U.S. Supreme Court that Lexis's own substantial business activities in Illinois were sufficient to justify the apportionment of Mead's capital gain. The Court, however, declined to consider "a new ground for the constitutional apportionment of intangibles based on the taxing State's contacts with the capital asset rather than the taxpayer" since this basis for apportioning Mead's gain had not been raised before the Illinois courts. The Court notes that whether this alternative support for apportionment exists is of consequence in New York (State and City) and Ohio, which have adopted this rationale for apportionment. See *Matter of Allied-Signal Inc. v. Commissioner of Fin.*, 79 NY2d 73 (1991), where the New York Court of Appeals held that New York City could constitutionally tax Allied-Signal's income (both dividends and capital gains) from its investment in the stock of ASARCO despite the lack of a unitary relationship between Allied-Signal and ASARCO. The New York high court found that the City afforded privileges and opportunities to ASARCO which had contributed to ASARCO's capital appreciation, thereby providing Allied-Signal "something 'for which [the City] can ask [in] return.'"