Person of the Year

State Tax Notes is pleased to announce its annual year in review edition, featuring person of the year, given to the individual or organization that had the most influence on state tax policy and practice. The editorial staff has compiled a list of the best in our profession.

Robert Plattner

This year's person and administrator of the year is Robert Plattner for his work on corporate tax reform in New York state. That reform has received accolades for improving the competitiveness of the state's tax code by merging the bank tax into the corporate franchise tax, adopting single-sales-factor apportionment with market-based sourcing, broadening the corporate tax base, and lowering the rate.

But reform didn't happen overnight — it was years in the making. In 2007, after acknowledging that the state needed to modernize the way it taxed businesses, the New York State Department of Taxation and Finance created a small group to identify goals for reform. Plattner had recently joined the department as deputy commissioner of the Office of Tax Policy and Analysis, and given his experience on the State Assembly's Legislative Tax Study Commission and his interest in tax policy, he was the perfect choice to lead the group.

The group spent close to two years brainstorming before presenting the core elements of its reform proposal to the business community and other interested parties. That tack proved beneficial — because there was a document to work with, the discussions were more focused.

After more than two years of extensive discussions with the corporate community and other constituencies, Plattner and his team produced a comprehensive reform proposal, including draft legislation. In December 2012, Gov. Andrew Cuomo (D) created the Tax Reform and Fairness Commission, which was mandated to find ways to make the state's tax code simpler and fairer and enhance the state's business climate. That gave Plattner the chance to share his team's work with the commission. The team's legwork paid off. Because the commission was starting with a nearly complete reform proposal, it was able to present less than a year later a report that largely mirrored the team's draft. Had the commission been starting from scratch, it probably couldn't have issued such a sweeping report so quickly. Cuomo included the proposal as part of the tax reform package in his budget bill for fiscal 2015. The rest is history.

Leah Robinson of Sutherland Asbill & Brennan LLP said Plattner built a great, thoughtful team to work on the reform effort. "He championed tax reform in New York — not just this time but over the past decade," Robinson said.

Jack Trachtenberg of Reed Smith LLP also noted how instrumental Plattner was to the reform effort, saying, "If not for Plattner spearheading the process, reform may not have happened."

Plattner isn't new to making significant changes through legislation. He also took a leading role in developing New York's "Amazon" law, the nation's first "click-through" nexus law. The concept of asserting sales tax nexus against Amazon and other online retailers based on in-state affiliates (for example, in-state organizations that actively solicit sales in the New York market on behalf of an Internet retailer and receive commissions based on completed sales) was novel at the time. Plattner said the legislation was based on a modern interpretation of *Scripto*'s attributional nexus theory. The law caused much debate, culminating in the U.S. Supreme Court's denial of certiorari in two cases challenging its constitutionality.

What's novel about Plattner's tax policy concepts for corporate tax reform and the Amazon law is that they tested constitutional bounds while remaining pragmatic enough to actually be implemented. That he bridged the gap between the theoretical and the practical isn't all that surprising. Those who know him say he's a practical person who thinks about the concepts of good tax policy, he understands that tax reform is only as good as the work put into it, and he knows that major legislation will pass only if the timing and political atmosphere are right.

Arthur Rosen of McDermott Will & Emery LLP called Plattner "a consistent champion of tax reform." Rosen said that although he doesn't always share Plattner's views on tax issues, Plattner deserves much credit for leading the effort that resulted in corporate tax reform in New York state. Plattner "set forth the overall contours of what he believed was good tax policy, gathered support within the relevant government circles, and engaged the business community in meaningful discussions," Rosen said. That coordinated approach allowed Plattner to be "eminently successful where others have failed," Rosen added.

U.S. Supreme Court

With three cases before the U.S. Supreme Court this term, including one that has the potential to significantly alter commerce clause jurisprudence, state and local tax practitioners hope the Court is willing to resolve thorny questions that have lingered for years.

Jeff Friedman of Sutherland said it's difficult to read into the Court's willingness to hear three state tax cases but that he hopes it bodes well for the future. "The number of unanswered constitutional questions is increasing as new business models become more prevalent," he said.

Although the cases are the first on state and local taxes the Court has heard since 2012, this isn't the first time the Court has had multiple SALT cases in one term. During its 1991-1992 session, the Court heard eight state and local tax cases, issuing landmark decisions like *Quill* and *Allied-Signal*.

University of Georgia law professor Walter Hellerstein said the Court didn't decide to focus on state tax cases this term; rather, circuit splits and the individual importance of at least two of the cases drove it to act. While observers can understand why the Court took *CSX* and *Direct Marketing*, it's much harder to understand why it took *Wynne*, he said, adding, "There was no circuit split, there was no disarray — every state in the country, including Maryland, does it this way."

In *Wynne*, the case with the biggest potential impact on state and local tax matters, Maryland residents challenged the state's denial of a credit for income taxes paid in other states. The Maryland Court of Appeals sided with the taxpayers, holding that the state's policy amounted to double taxation in violation of the federal commerce clause. Maryland appealed to the U.S. Supreme Court with the support of the U.S. solicitor general, who argued that states have the authority to tax 100 percent of their residents' income.

Friedman said the Court raised the stakes in *Wynne* when it asked the solicitor general to intervene, calling that request a game changer. The solicitor general argued that Maryland's denial of a full credit doesn't violate the fair apportionment prong of the *Complete Auto* test and that the state's credit scheme doesn't hinder interstate commerce, as the Wynnes argue.

Oral arguments appeared to show a divided Court. Some justices questioned how the Maryland tax scheme doesn't operate as an illegal tariff on interstate commerce. Others appeared persuaded that residents of a state can somehow avoid paying for their fair share of services.

The Court will also issue opinions in *Direct Marketing Association v. Brohl* and *Alabama Dep't of Revenue v. CSX Transportation Inc.* Although neither case has garnered the attention *Wynne* has, both could have interesting effects on state and local tax jurisprudence. A finding for the state in *Direct Marketing* could bar the doors of federal courts for plaintiffs bringing a state-revenue-related challenge. And although the issue in *CSX* is a narrow one based on federal law, what the Court says about different types of potentially discriminatory taxes could have far-reaching applications. (Related coverage: p. 587.)

Lynn Gandhi

Lynn Gandhi of Honigman Miller Schwartz and Cohn LLP has had a busy year. She served as chair of both the State Bar of Michigan Taxation Section and the Michigan Chamber of Commerce Tax Policy Committee, and did so when developments stemming from the Multistate Tax Compact election litigation, which from a national perspective seemed relentless, accounted for only a fraction of the state's tax-related upheaval. (Related coverage: p. 590.)

"It has been an unprecedented period for Michigan taxpayers," Gandhi said. Businesses and practitioners have had to deal with the "tsunami of litigation leading up to, and in response to, the *IBM* decision and Public Act 282," she said — referring, of course, to the Michigan Supreme Court's July ruling (853 N.W.2d 707 (Mich. 2014)) and the state's attempt to legislatively override it by retroactively repealing the compact to avoid paying an estimated $1 billion in tax refunds to out-of-state businesses.

Honigman Miller is involved in the "big three" compact cases in the state, with Gandhi's legal handiwork playing a major role. She has filed an amicus brief on behalf of the Council On State Taxation in support of IBM Corp. at the Michigan Supreme Court, served as local counsel for Lorillard Tobacco Co. at the appellate level, and filed an amicus brief in *Anheuser-Busch*, also at the appellate level. She also represents several taxpayers in compact cases pending before the court of claims.

During her two-year term chairing the chamber's Tax Policy Committee, Gandhi was key in helping the business community secure passage of several bills to increase transparency and improve audit processes at the Michigan Treasury Department. One bill includes measures requiring the department to publish its internal policy directives and provide taxpayers with complete audit workpapers, and another addresses an unclaimed property holder's right to access its audit report.

Tricia Kinley of the chamber said Gandhi has been "a strong and fearless tax leader" for the chamber's members. "She is clearly devoted not only to her profession, but creating a better business tax policy environment for taxpayers of every type and size," Kinley said. "With Lynn's guidance, we've had a hugely successful legislative session in the area of tax reform, providing real solutions to real problems that taxpayers face."

Scott Waller

Equifax Inc. v. Department of Revenue, 125 So.3d 36 (Miss. 2013), sounded the clarion call for Mississippi business and tax practitioners that the state needed to address not just its alternative apportionment methods but also its tax controversy appeals processes.

Scott Waller, executive vice president and chief operating officer of the Mississippi Economic Council (MEC), was indispensable in the passage of a legislative solution (HB 799) to the problems highlighted by *Equifax*.

John Fletcher of Jones Walker LLP said that while Waller isn't a tax guy, he quickly grasped what *Equifax* was really about: fundamental taxpayer fairness.

Waller witnessed the intense negative reaction the decision generated throughout the national business and tax community, Fletcher said. "I think it really bothered him how big an impact that and several other recent cases were having on the state's reputation as a business-friendly environment," Fletcher said. "He really poured himself into fixing the problem."

Fletcher said Waller "talked to a huge number of people not only here in Mississippi but throughout the country to identify and understand the issues and ways other states have responded to similar problems."

Douglas Lindholm, COST executive director, said Waller's greatest asset is the reputation he has built in Mississippi's capitol. "He is well-liked and well-respected at the Statehouse, but more importantly, it was quite apparent that he is trusted implicitly by the state's political players on both sides of the aisle," Lindholm said.

Waller's reputation and experience were invaluable in getting HB 779 passed. He worked with groups such as lawmakers, government officials, the Department of Revenue, Mississippi business leaders, local tax attorneys, and the press, Fletcher said.

Waller's work on HB 779 wasn't his first foray into changing Mississippi's tax law — in 2013 he shepherded a bill (HB 892) establishing statutes of limitations for tax audits — but his leadership in the effort to pass the *Equifax* legislation earned him widespread praise.

"I think it's more than fair to say this bill would not have happened had Scott not taken on this monumental task, and I think we all owe him thanks for all that hard work and what he, the MEC, and Mississippi were able to accomplish," Fletcher said. "What Mississippi produced was a very thorough, balanced, and fair solution that is getting favorable reviews throughout the country."

"Scott really was the tip of the spear in all of this," said Maureen Riehl, COST vice president for government affairs. "When it comes to our partners in the states, I put him at the very top of the list of the people we consider trusted and truly a joy to work with."

Louis Fuller of Brunini, Grantham, Grower & Hewes PLLC said part of what makes Waller so effective is his ability to keep practitioners informed about the process, invite their comments and participation, and welcome their insights.

"I'm not sure that if it had been anybody other than Scott, we would have had the same result," Riehl said. "He was just the right thing at just the right time, and that is because he is who he is."

Anthony Williams

On July 14 the District of Columbia Council approved a budget that included major tax relief, the District's first such package in 15 years. That development was largely a result of the influence of a D.C. mayor — just not the current one.

Instead, it was Anthony Williams, the District's mayor from 1999 to 2007 and its CFO before that, who swayed the council. Williams chaired the D.C. Tax Revision Commission, a blue-ribbon panel appointed by the council and Mayor Vincent Gray (D). The panel's mission? Apportion taxes fairly, broaden the tax base, make the District's tax policy more competitive, encourage business growth and job creation, and modernize and simplify the tax code.

The commission's recommendations, finalized in May, included lowering the business tax rate, switching to single-sales-factor apportionment, conforming individual income tax brackets and the estate tax threshold to federal standards, and expanding the sales tax to various services. The council voted to adopt all the recommendations over Gray's veto.

In an interview, Williams said the fact that Gray wasn't onboard with many of the commission's recommendations made him realize the commission "had some uphill work to do." So Williams went directly to the council.

Council Chair Phil Mendelson (D) agreed with Williams and refashioned the District's budget to include most of the commission's recommendations. "I was delighted," Williams said. "We worked very, very hard toward our conclusions."

Williams said he thought the council took the commission seriously from the start, in part because he was chair. "I think they were influenced by my service as mayor, weighing back in on a subject I thought was important," he said. "I had a track record in the financial world."

But Williams said he mostly reminded council members why the commission was there in the first place. "You created this commission," he told council members. "We worked with you, we consulted with you," to come up with what the council specified: a tax code that was more efficient, fair, and competitive, he said.

Sam Brownback

The tax policies of Kansas Gov. Sam Brownback (R) have not yet amounted to the economic shot of adrenaline Brownback promised, but to the dismay of many pollsters, they didn't prevent the embattled governor's reelection November 4.

Four years ago, Brownback enjoyed a landslide victory over his Democratic opponent. This year, with many in his own party having left him for dead, he merely squeaked by to secure a second term in the governor's mansion. The cause of his near downfall? Massive individual income tax cuts that caused major revenue shortfalls and credit rating downgrades. (Related coverage: p. 597.)

Kansas enacted nearly $800 million in income tax cuts in 2012 and reduced its sales and income taxes in 2013. The three-bracket individual income system, with rates of 3.5 percent, 6.25 percent, and 6.45 percent, became a two-bracket system with rates of 3 percent and 4.9 percent. The state also exempted nearly 200,000 businesses from income taxes altogether.

As a result, the state saw a $701.1 million revenue shortfall in fiscal 2014. According to a November 17 revised forecast, Kansas will see a projected revenue shortfall of $436 million in fiscal 2015 and $100 million in fiscal 2016. The revenue shortfalls are expected to be smaller over time because the forecast assumes that spending will be cut to account for the lower revenues.

Organizations such as the Center on Budget and Policy Priorities have attacked Brownback's policies as a "radical tax-cutting experiment," while others have reserved judgment, saying it's still too early to know the full impact of the tax cuts.

The day after his reelection, Brownback continued to defend his tax policies. He said his administration will work on a new fiscal forecast and has already identified $101 million in budget savings to make up for the shortfall. Despite that, lawmakers in the 2015 session will be forced to address the revenue shortfalls, likely by enacting severe budget cuts.

COST

State Tax Notes recognizes Council On State Taxation as its organization of the year for tirelessly filing amicus curiae briefs both on taxpayers' behalf and in pursuit of its tax policy goals.

Despite its small staff, COST is consistently among the top 20 filers of amicus briefs in the U.S. Supreme Court. Between September 2013 and November 2014, it filed briefs in seven cases, three of which the Court agreed to hear (*Treasury v. Wynne*; *Direct Marketing Association v. Brohl*; and *CSX Transportation Inc. v. Department of Revenue*).

COST also regularly files briefs in state supreme courts, including in *IBM v. Treasury* and *Gillette v. Franchise Tax Board*, both of which address questions regarding the compact election.

Lindholm said COST was formed to support the legislation stemming from *U.S. Steel* and will advocate for taxpayers on compact matters for years to come.

As state tax law has become more complex, so has COST's involvement on taxpayers' behalf. Lindholm said his group used to file about five briefs a year but now files at least 15.

Karl Frieden, COST vice president and general counsel, listed non-compact topics COST has filed briefs on, including corporate apportionment, due process, commerce clause, and discrimination and double taxation. "Our level of filing reflects the level of controversy that exists now in the state tax arena," he said.

Frieden said COST wants to advocate for its members and further its tax policy objectives using its best legal arguments. But he said the group also tries to go a step further by illustrating for the court exactly what it believes to be at stake. For example, in its *Wynne* brief, COST gave the Supreme Court statistics on the amount of business income taxed under the individual income tax to show that a decision for Maryland would equate to saying that income is exempt from the commerce clause protection on double taxation, Frieden said.

Multistate Tax Commission Executive Director Joe Huddleston said he respects COST and reads all its briefs, adding that the groups does "an outstanding job" in giving a legitimate perspective on state tax. Huddleston said that while many people see the MTC and COST as adversaries, he doesn't. "In a fashion, we do the same thing — we are both trying to achieve what we see as the right result on state tax issues," he said. "It's true that COST often has a different perspective than ours, but I don't think that makes us adversaries." ☆

NEWS ANALYSIS

Cases to Watch in 2015

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2015 is shaping up to be a big year in state tax litigation. This year ended with oral arguments in three U.S. Supreme Court cases, and all eyes in the state and local tax arena are focused on the outcome in *Wynne*. There are also several other cases that *State Tax Notes* readers should keep in mind heading into the new year.

Supreme Court

The U.S. Supreme Court pleased the state tax world by agreeing to hear three state and local tax cases in 2014. Opinions should be issued before the Court adjourns at the end of June 2015.

In *Comptroller of the Treasury v. Wynne*, a Maryland couple challenged the denial of a full county income tax credit for taxes paid in other states. The Wynnes argued that the denial of a full credit taxes interstate commerce more heavily than commerce conducted entirely within Maryland, in violation of the U.S. Constitution.

The stakes were raised when the Court asked the U.S. solicitor general to weigh in, and in an amicus brief, the solicitor's office said Maryland is within its rights to tax its residents' income without a full credit. A close decision is expected, although there is disagreement as to which party will prevail. (Prior coverage: *State Tax Notes*, Nov. 17, 2014, p. 369.)

"The Court seemed concerned that the Wynnes might be getting a free ride in Maryland because they have five kids in the public schools," University of Connecticut law professor Richard Pomp said. "But the schools are primarily supported by the property tax (especially in the suburbs), which the Wynnes no doubt pay."

Pomp added that Maryland gives a use tax credit for sales taxes paid in other states. "The Court might just as well have asked why taxpayers who work in other states and do all their shopping during their lunch hours and pay no use tax to Maryland because of that credit aren't also getting a 'free ride,'" he said.

In *CSX Transportation Inc v. Department of Revenue*, the Court will decide whether Alabama's motor fuel sales tax exemption for motor and waterway carriers discriminates against railroads. Railroads pay sales tax on motor fuel, but the motor and water carriers can avoid the tax if they pay the motor fuels excise tax for on-road use.

CSX says the exemptions are discriminatory in violation of the federal Railroad Revitalization and Regulatory Reform Act of 1976, which was passed to ensure fair treatment of the railway industry.

The U.S. solicitor general intervened and said the state's entire tax regime, and not just its sales tax, should be taken into account when determining whether the exemptions are discriminatory. The Court then asked the parties to brief the issue.

"The justices' fixation on water carriers was a bit surprising but seemed to play into the hand of CSX's well-respected attorney, Carter Phillips. But should the Court punish a state via the 4R-Act if the state grants an exemption to a competitor that is required by another federal law or act? Here, I suspect, the railroads would argue for a broad definition of their competitive class," said Bruce Ely of Bradley Arant Boult Cummings LLP.

Ely noted that when Alabama became a state in 1819, Congress — under the Northwest Ordinance — required that businesses and individuals traveling on the state's navigable waters remain free of "any tax, duty, impost or toll therefor, imposed by the said state."

"The Alabama [solicitor general] also gave an example of a narrow sales tax exemption, which might cost the state a few thousand dollars annually, granted to a railroad's competitor, but if also required to be granted to the railroads might cost the state millions of dollars in lost revenue," Ely said. "The justices didn't seem interested in pursuing that line of reasoning, though."

Finally, in *Direct Marketing Association v. Brohl*, the Court will decide whether the federal Tax Injunction Act (TIA) precludes a challenge in federal district court to Colorado's sales and use tax reporting statute. The law requires remote sellers with $100,000 in annual sales to Colorado customers to submit a report to the Department of Revenue listing amounts of purchases made by Colorado residents to increase use tax collection on those sales.

The Direct Marketing Association challenged the reporting requirements in federal court, but the U.S. Court of Appeals for the Tenth Circuit held that the TIA bars federal courts from hearing the case even though the company is not a taxpayer. The association argued that this is not the type of challenge the TIA was designed to prevent because it is not a taxpayer seeking to avoid a tax, and the suit challenges notice and reporting requirements rather than a tax assessment.

"We were quite surprised by the volume and depth of the questioning of Colorado — on what it considered to be the limits of the TIA," said Karl Frieden of the Council On State Taxation. "The justices expressed a concern with an interpretation that was overly broad that would preclude taxpayers from filing in federal court — no matter how tangential the state action was to the assessment and collection of state taxes."

Fred Nicely of COST said he thought the justices would limit federal courts in these types of cases, but was surprised that they understood the concerns taxpayers have with state courts. Justice Antonin Scalia said the odds of a state court case making it to the Supreme Court are "miniscule," Nicely noted.

MTC Developments

The coming year should also see significant developments in the Multistate Tax Compact litigation saga. The leading case from California — *Gillette v. Franchise Tax Board* — is still waiting on oral arguments, which are expected to be held midyear.

Michigan taxpayers will be hoping for a resolution to the jurisprudential dilemma that has resulted from the Legislature's retroactive repeal of the compact following a taxpayer victory in that state's litigation.

In July the Michigan Supreme Court held in *IBM Corp. v. Department of Treasury* that the Legislature did not implicitly repeal the Multistate Tax Compact with the repeal of the business tax and said IBM could use the three-factor apportionment formula. The Legislature responded in September (SB 156) by repealing the compact retroactively to January 1, 2008, in an effort to sidestep the court's decision and avoid paying over $1 billion in refunds to out-of-state taxpayers.

Michigan Attorney General Bill Schuette (R) asked the state supreme court to reconsider *IBM*, but that request was denied in November. However, lower courts in Michigan had already been proceeding as if the decision would remain the law in cases such as *Lorillard Tobacco Co. v. Department of Treasury*. The court of appeals heard oral arguments in *Lorillard* on September 4, before the repeal legislation was passed. On September 16, after the bill was signed, the court issued an opinion saying that the July *IBM* decision controlled.

Now that the Michigan Supreme Court has decided it won't reconsider *IBM*, the courts will likely need to resolve cases challenging the legality of the retroactive legislation. A complaint filed in the court of claims in November in *Arby's Restaurant Group Inc. v. Department of Treasury* alleges that the repeal violated numerous state and federal constitutional provisions.

Multistate Tax Compact cases challenging the state's rejection of the three-factor apportionment formula are also pending in Texas. Texas joined the compact in 1967 and has never officially repealed it, but in 2006 it enacted the franchise tax, also known as the margin tax, which uses a single-factor apportionment formula. The companies argue that the margin tax meets the definition of an income tax under the compact, triggering its rules and formulas. The companies also reject the state's assertion that the margin tax enactment was an implied repeal of the compact.

The lead case challenging the single-factor apportionment requirement is *Graphic Packaging Inc. v. Combs*, which is pending at the Third District Court of Appeals in Austin. The trial court judge held in favor of the state. The taxpayer filed its brief in September, and the state filed a response brief in November. Oral arguments are expected in 2015. (Prior coverage: *State Tax Notes*, Oct. 6, 2014, p. 7.)

Other companies challenging the state's refusal to allow use of the compact's three-factor formula include H.J. Heinz Co., Michelin Corp., and more than a dozen others. The stakes are high, with companies like Gillette Commercial Operations North America Inc. saying the state owes it more than $42 million.

In Oregon, the tax court heard over four hours of oral argument this summer in *Health Net Inc. v. Department of Revenue* on whether the state's apportionment formula was binding on taxpayers. The taxpayers argued that the compact was never entirely repealed and that its apportionment formula should be an option. But the DOR argued that its 1993 law says that when the state's apportionment formula conflicts with the compact's, the state's controls. The state also argued that the compact is advisory and not binding. (Prior coverage: *State Tax Notes*, July 28, 2014, p. 247.) There is no mandatory time frame for the judge to release his opinion, so it could be issued any time.

California

California's Fresno County Superior Court recently held in the taxpayer's favor in *Swart Enterprises Inc. v. FTB*, and the Franchise Tax Board is expected to appeal in the coming year. (Prior coverage: *State Tax Notes*, Nov. 24, 2014, p. 420.)

In July 2013 Swart, an Iowa company, filed a complaint against the FTB, seeking a refund of $1,100 in taxes assessed against it as a result of its passive investment in a California limited liability company. The $500,000 investment equaled approximately 0.02 percent ownership in the LLC, which leases and disposes of interests in capital equipment.

Swart argued that it does not meet the definition of doing business in California because it was not actively engaging in a transaction. It also alleged violations of the commerce, due process, and equal protection clauses of the California and U.S. constitutions.

Although the amount at stake is relatively insignificant, *Swart* has good facts for taxpayers wanting to resist the nexus standard, which — despite cases such as *Griffith v. ConAgra Brands Inc.* and *Scioto Insurance Co. v. Oklahoma Tax Commission* — has weakened over time. Swart also successfully challenged the FTB's position in Legal Ruling 2014-01 in the trial court.

Another case to watch is *926 North Ardmore Avenue LLC v. County of Los Angeles*, a documentary transfer tax case that could have broad implications in a state where taxes related to property are always controversial.

A California court of appeal in September determined that the L.A. County's documentary transfer tax was owed after the transfer of more than 50 percent of ownership interests in a partnership that owned a single-member LLC that in turn owned the property. While this partnership interest transfer constituted a change in ownership for California property tax purposes and triggered a revaluation of the property, there was a question of whether the change in ownership also triggered the county's separate transfer tax. The court of appeal said it did, but practitioners have criticized the opinion. The taxpayer has filed an appeal with the California Supreme Court.

In *Comcon Production Services I Inc. v. FTB*, the Los Angeles County Superior Court March 6 held that Comcast Corp. and QVC Inc. did not form a unitary business during 1998 and 1999 for California income tax purposes and that a merger termination fee received by Comcast in 1999 was apportionable business income that should have been reported. (Prior coverage: *State Tax Notes*, Mar. 10, 2014, p. 567.)

After a dispute over how to calculate Comcast's refund, the court entered a judgment awarding Comcast a $2.8 million refund for tax year 1998 and stipulating that Comcast is not entitled to any refund for tax year 1999. Since then, there has been continued wrangling over attorney fees, and both parties have filed notices of appeal with the superior court. (Prior coverage: *State Tax Notes*, Sept. 1, 2014, p. 549.)

Texas and Oklahoma

The Texas Supreme Court will hear an important franchise tax case this term. In *Combs v. Titan Transportation LP*, the comptroller is appealing a court of appeals decision holding that Titan was entitled to claim the revenue exclusion for subcontractor payments when calculating its franchise tax. Titan delivers components of concrete to construction sites, but the state argued that wasn't enough for it to qualify for the deduction.

Oklahoma is also on the radar for 2015 with *CDR Systems Corp. v. Oklahoma Tax Commission*. In *CDR Systems*, an out-of-state S corporation challenged an Oklahoma statute that grants a deduction for capital gains from the sale of real property or ownership in a company in three circumstances.

The first, for non-Oklahoma companies, requires that the sold property be located in the state and held for five years. The other two deductions are for Oklahoma companies and are granted for proceeds from sales of property located in the state or from selling an ownership interest in a company. Oklahoma companies must have owned the property or the company for three years to receive the deduction. The statute defines an Oklahoma company as one whose primary headquarters have been in the state for at least three continuous years before the sale.

The state supreme court held that Oklahoma's capital gains deduction did not violate the commerce clause. In May CDR filed a petition for rehearing arguing that the court's opinion included errors of both fact and law. Nicely told Tax Analysts that if the state supreme court declines to reconsider its opinion, this case is a good candidate for review by the U.S. Supreme Court. (Prior coverage: *State Tax Notes*, May 14, 2014, p. 400.)

Tennessee and Michigan

In June the Tennessee Court of Appeals in *Vodafone Americas Holdings Inc. v. Roberts* upheld a trial court's decision finding that the revenue commissioner acted within his statutory discretion when requiring a telecommunications company to source its Tennessee receipts using market-based sourcing rather than the statutorily provided cost-of-performance method.

Practitioners have criticized the opinion, and Vodafone's petition for permission to appeal to the Tennessee Supreme Court was granted in late November. The court will schedule the case for oral arguments after briefing is complete next year. (Prior coverage, *State Tax Notes*, June 30, 2014, p. 747.)

In two cloud computing decisions, Michigan courts have exempted cloud services from the state's sales and use tax.

In *Thomson Reuters Inc. v. Treasury*, the Michigan Court of Appeals considered whether a product that permitted customers — through a Web browser — to search and retrieve multiple up-to-date sources, browse compiled information on specific topics, and go to links between sources was subject to sales tax. The Department of Treasury argued that the product was prewritten computer software, which is considered tangible personal property under state law. Therefore, the sale of access to the online research tool was subject to state use tax, the department said.

The court disagreed, saying that customers buying subscription access to the taxpayer's online research tools primarily purchased a service rather than tangible personal property. The court concluded this service was not subject to sales tax. The Department of Treasury has applied for leave to appeal to the Michigan Supreme Court.

In *Auto-Owners Insurance Co. v. Treasury*, the court of claims held that an insurance company's access to a third party's software via the Internet was not subject to the state's use tax as a use of prewritten computer software. Instead, the court said, the products purchased were software-as-a-service transactions properly characterized as nontaxable services.

The department has appealed to the court of appeals, using a different argument than it did in the court of claims: the state's mixed transaction doctrine does not apply to the products at issue because the software is not a service, but the service the software performs is merely a function of tangible personal property.

Illinois

The Chicago Regional Transportation Authority (RTA) is still involved in significant litigation that will continue into 2015. The RTA, since 2013, has sued municipalities and businesses, alleging that they were engaged in illegal sham operations to shift the sourcing of sales to lower-tax jurisdictions outside the RTA region. (Prior coverage: *State Tax Notes*, Mar. 31, 2014, p. 747.)

The litigation includes suits against American Airlines, United Airlines, the city of Kankakee, and the Illinois towns of Genoa, Savanna, and Morris. It centers on discovery disputes between the RTA and several third-party respondents.

In 2013 the Illinois Supreme Court issued an opinion in *Hartney Fuel Oil Co. v. Hamer* that rejected the bright-line standard argued for by the fuel companies, which would have allowed them to source their sales to jurisdictions outside the RTA region. However, the court also held that the companies were not liable for the taxes at issue because of their reliance on DOR regulations.

The DOR has since issued new regulations addressing the flaws identified in *Hartney*. While practitioners have said the regulations bring clarity, the RTA has filed suit challenging them in *Regional Transportation Authority v. Hamer*. The RTA is seeking a preliminary and permanent injunction barring the enforcement of the regulations and is asking the court to declare them invalid as contravening both state statutory authority and *Hartney*. (Prior coverage: *State Tax Notes*, July 7, 2014, p. 25.)

Former RTA Chief of Staff Jordan Matyas previously told Tax Analysts that the RTA has spent well over $1 million in the lawsuit and is prepared to continue litigating the sales tax sourcing issue for as long as it takes to stop what it believes is abusive taxpayer behavior. "Budget is not an issue for us," Matyas said.

Others

In April Papa John's customers filed class action suits against the restaurant in Florida and Illinois, claiming that it charges customers sales tax on delivery fees in violation of state law.

The cases have since seesawed between state and federal courts. Most recently, U.S. District Court Judge Virginia Hernandez Covington refused to dismiss a claim charging that Papa John's International Inc. unlawfully assessed sales taxes on delivery fees and violated Florida's Deceptive and Unfair Trade Practices Act. (Related coverage, p. 605.) Florida customers also asked a federal judge for class action status in their case alleging that the pizza chain overcharged $5 million in sales taxes on delivery fees. The plaintiffs argue that since Papa John's was served with the initial complaint in April, approximately $750,000 has been charged to Florida customers who are unaware of the tax on delivery fees. The motion asked Papa John's to repay customers who were overcharged in sales tax on pizza delivery fees dating back to March 28, 2010. (Prior coverage: *State Tax Notes*, Oct. 27, 2014, p. 187.)

Mediation in both the Florida and Illinois cases is ongoing, according to the customers' lawyer.

In New York, a former associate counsel with Vanguard Group Inc. turned whistleblower in August, alleging that the investment management company has evaded more than $1 billion in taxes, including a substantial amount of New York taxes.

In a *qui tam* action filed under New York's False Claims Act, *New York ex rel Danon v. Vanguard Group Inc.*, David Danon claims that Vanguard has operated as an illegal tax shelter for nearly 40 years and has avoided $1 billion in federal taxes and at least $20 million in New York taxes over the last 10 years. As an employee of Vanguard Group International, Danon says his allegations come from eyewitness knowledge of the company's illegal actions. The complaint alleges that Danon was discharged because of his efforts to remedy the violations.

While the case is important from both attorney ethics and federal tax perspectives, it also raises, yet again, the question whether the False Claims Act is appropriate for tax claims. As Jack Trachtenberg of Reed Smith LLP told Tax Analysts in August, the complaint raises issues concerning state corporate income tax nexus, transfer pricing section 482 adjustments, and state tax apportionment — all of which the state's Department of Taxation and Finance handles regularly.

Vanguard in October filed a motion to dismiss the case, arguing that Danon violated attorney ethics rules, that his tax shelter claim is unfounded, and that he seeks to usurp the power of the tax authorities. The whistleblower in November responded that Vanguard's violations meet the criteria for challenge under New York's False Claims Act.✰

NEWS ANALYSIS

The Year Michigan Rigged the Game

by Amy Hamilton — amy_hamilton@tax.org

Turnabout is fair play.

That's one way of thinking about Michigan's enactment of legislation this year to avert paying an estimated $1.1 billion in refunds to out-of-state taxpayers taking advantage of a long-forgotten elective provision that many had never relied on before. Michigan's government was just bringing its own firepower to battle against large out-of-state corporations that according to in-state manufacturers, had nothing to lose by taking advantage of a tax maneuver pitched by clever advisers who were supposedly working primarily on a contingency fee basis.

"Home cooking."

That's another phrase that was tossed around behind the scenes this year in discussions of how Michigan's legislative and executive branches worked together — colluded? — in trying to influence how the state supreme court decided and might reconsider *International Business Machines Corp. v. Dep't of Treasury*. In that 3-1-3 decision, the court found that IBM had the ability to elect to apportion its business income to Michigan using the Multistate Tax Compact's evenly weighted three-factor formula rather than under the Michigan business tax's mandatory single-sales-factor formula.

It's not a legislature's job to adjudicate statutory interpretation. That was the refrain heard time and again in talks about separation of powers. But as an expression of legislative intent six years earlier, the 2014 Michigan Legislature introduced and passed, and Gov. Rick Snyder (R) signed, a new law purporting to retroactively repeal the Multistate Tax Compact to January 2008.

The bill went from introduction to enactment in 72 hours. A handful of lawmakers opposed the measure on the grounds that it amounted to a tax increase, but no one in-state really expressed any sympathy for out-of-state corporations, never mind that a taxpayer had successfully challenged the Michigan Treasury's application of the law in the state supreme court.

For its part, the Michigan Supreme Court ultimately wasn't swayed by the political pressure, though the justices did conveniently wait until a week after the November 4 election before declining to rehear *IBM*.

Another subject never publicly debated — or seemingly even acknowledged, for that matter — had to do with the many possible complications and implications of retroactively repealing an interstate compact.

"The fix was simple," wrote Norton Francis of the Tax Policy Center in a blog published in the business section of *The Christian Science Monitor*, even as the compact litigation in Michigan morphed into a three-ring legal circus. Michigan "never intended to give firms a choice in apportionment methods" when it adopted the Michigan business tax, Francis wrote, adding that retroactive repeal of the compact "just closes a loophole, preventing what would be a huge tax windfall for a handful of multistate firms."

Including IBM, corporate taxpayers were claiming the compact election in 135 different lawsuits, according to the Michigan Treasury. Arby's Restaurant Group Inc. is the first known taxpayer to file a complaint directly challenging the validity of the state's retroactive repeal of the compact, though indirect challenges have been raised via the Treasury's attempt to get judges at three different court levels to apply the new law to cases before them.

All this, and the compact law questions arguably aren't even front and center in any of the Michigan litigation.

"It's amazing, but it seems litigation over this issue could take a number of permutations," said Shirley Sicilian of KPMG LLP during an October webcast. Sicilian, the former general counsel to the Multistate Tax Commission, was talking about potential offshoot litigation not just in Michigan but in California, also as a result of questions raised by the way the state repealed the compact. "Every action could be subject to litigation," she said of compact litigation in the states.

One nontax group monitoring the Multistate Tax Compact litigation is the Council of State Governments' National Center for Interstate Compacts. Crady deGolian is director of the National Center for Interstate Compacts through which the Multistate Tax Compact originated.

"From our perspective at the Council of State Governments, we viewed the ruling in Michigan as a victory for compacts broadly," said deGolian, who emphasized that he was looking at the matter through the lens of someone thinking about compacts generally rather than any particular one. He noted that the Michigan Supreme Court upheld the right of taxpayers to use the compact's elective formula. "I think in that sense it was a victory for the contractual nature of interstate compacts," deGolian said.

"It will be fascinating to watch the rulings that will ultimately come down in California and Oregon, and how they play out with the Michigan ruling," deGolian added. He said his guess is that if different state supreme courts do wind up at odds with one another, there's a good chance the U.S. Supreme Court might revisit the status of the Multistate Tax Compact.

The retroactivity question is another possible vehicle for how the compact litigation could wind up in front of the U.S. Supreme Court.

To date it appears that state courts, perhaps entirely appropriately, are looking at the compact litigation in state-specific terms as opposed to considering the bigger picture. But all of the compact litigation can be seen as a symptom of a larger problem: Out-of-state taxpayers wouldn't be electing to use the compact's evenly weighted three-factor formula if there wasn't something about apportionment formulas that businesses no longer view as fair outside their home state.

In meetings throughout the year, practitioners — especially those working on behalf of midsize companies — repeatedly said their clients now really are being taxed on more than 100 percent of their business income.

Exporting Taxes

The trend toward exporting state taxes was so marked in 2014 that by the end of the year, one of the panels at the Paul J. Hartman State & Local Tax Forum in Nashville, Tennessee, was titled "What Hath Moorman Wrought?" The title referred, of course, to the U.S. Supreme Court 1978 case *Moorman Manufacturing Co. v. Bair*, in which the Court accepted as constitutional Iowa's single-sales-factor apportionment formula.

The Hartman panel was billed as one in which participants would explore "the seemingly irreversible trend towards shifting the state tax burden to out of state companies, including trends toward market-based sourcing and single sales factor apportionment, the use of an economic nexus standard, unitary combination." So pervasive is the phenomenon of exporting state taxes that the compact litigation wasn't even mentioned in the panel's description.

That's not to say the Multistate Tax Compact didn't become part of the discussion, along with asides about separation of powers.

First, MTC General Counsel Helen Hecht said she didn't completely agree with the premise of the panel; the MTC in July had adopted model amendments to the Uniform Division of Income for Tax Purposes Act that would make UDITPA a market-based sourcing statute. She said the Supreme Court declined to opine in *Moorman* on whether there was a constitutional requirement for the kind of apportionment formula the states had to use.

But Doug Lindholm of the Council On State Taxation said of *Moorman*, "This is when the Court started to wash their hands of state and local taxation, at least with the concept of uniformity." There's a fundamental problem about a court intervening in an apportionment case, because it's not one state's approach that in itself is problematic —

it's the combination of two different apportionment formulas that makes the burden potentially unconstitutional, he said.

Lindholm noted that *Moorman* wasn't the only major state tax case the U.S. Supreme Court took in 1978. Four months earlier, in *U.S. Steel Corp. v. Multistate Tax Comm'n*, the Court found the Multistate Tax Compact to be valid despite its lack of congressional approval.

U.S. Steel became a landmark case overnight not just in the field of state taxation but in the world of interstate compacts. According to deGolian, the number of compacts without congressional approval now probably slightly outnumbers those that have received Congress's consent.

During one of the Hartman panels, Lindholm asserted that *Moorman* and *U.S. Steel* "were inextricably linked in the justices' minds." He suggested that the Court in *U.S. Steel* might have decided to let the MTC exist under the notion "that maybe the MTC could fix this problem." Then, in *Moorman*, Lindholm said, the justices decided to let the state's single sales factor go as long as there was a rough approximation; otherwise, the Court would wind up evaluating every state's apportionment formula when the justices perhaps didn't want to legislate from the bench.

University of Connecticut law professor Richard Pomp joked that Lindholm was a mind reader and said the notion that states were ever uniform in their apportionment methods is a myth. Pomp said that what the Court did do in *Moorman* was talk about separate accounting, but then it seemed to walk that back a few years later in the 1980 case *Exxon Corp. v. Department of Rev. of Wisconsin*.

"Anyone who thinks you're going to win *Moorman II* because you have very good accounting evidence I think is misreading *Moorman*," Pomp said. He added that he believes Lindholm is correct about *Moorman* in one regard. "I think you're right that the Court realized it was a Pandora's box, and it wasn't going to sit there as a Super Legislature," Pomp said.

Alternative Apportionment

Then there were the aftershocks in 2014 of the Mississippi Supreme Court's holding in *Equifax Inc. v. Dep't of Revenue*, states' use of section 18 discretionary authority, and states' use of their alternative apportionment methods against out-of-state taxpayers as a form of in-state economic development.

Equifax had used Mississippi's statutory UDITPA cost-of-performance method for sourcing the sales of a service business. The Department of Revenue believed that the statutory formula failed to fairly reflect the extent of Equifax's business activity in the state and, using its section 18 discretionary authority, required the out-of-state company to use market-based sourcing instead.

Mary Benton and Clark Calhoun of Alston & Bird LLP, the attorneys who represented Equifax, told Tax Analysts this year that what the current alternative apportionment cases demonstrate is that courts are still "having a hard time understanding alternative apportionment and deciding how to put appropriate limits on such 'discretionary authority,' especially in light of the standard deference that is owed to taxing authorities' interpretations during administrative appeals."

Calhoun said that when a state chooses one standard apportionment formula, that choice has foreseeable and intended consequences for both in-state and out-of-state businesses. "It simply cannot be the case that alternative apportionment was designed to allow states to assess taxes against those out-of-state businesses that owe little to no tax as a natural and intended consequence of the state's chosen apportionment formula," he said. "But right now, courts are not quite seeing the forest for the trees."

The U.S. Supreme Court this year declined to hear the case, while the Mississippi Legislature this year passed legislation intended to address aspects of the litigation.

Pomp, who had testified on behalf of Equifax, recommended in 2013 that the MTC revise aspects of section 18 as part of its proposed rewrite of UDITPA. The MTC Uniformity Committee this year initially struck down all of Pomp's section 18 proposals. The MTC Executive Committee later revived most of them, but by then there wasn't enough time for those proposals to clear all the steps in the adoption process before a final vote in July.

Hecht said the MTC is considering calling a special session of the compact states for a final vote on adopting the section 18 changes based on Pomp's recommendations. The MTC has received word that at least a couple of states would like to consider the MTC's proposed market-based sourcing revisions in their 2015 sessions, Hecht said, and the MTC would like state lawmakers to be able to consider an entire final package of MTC model revisions to UDITPA. ✰

A Long-Awaited Turnaround On Incentives?

by Brian Bardwell — brian_bardwell@tax.org

It was hardly the year when states stopped slashing taxes for every new employer to come knocking, but 2014 might have been the year when incentives jumped the shark.

If watching Fonzie water-ski over a shark in 1977 signaled to America that the brains behind *Happy Days* were out of ideas and just waiting for someone to pull the plug, then perhaps the last year of incentive awards has been the sign that lawmakers need some outside help to end the interstate bidding wars.

There are signs that those outside forces are beginning to align, even though it would be easy enough to miss them amid all the major incentive packages handed out this year. From Boeing Co.'s announcement in January that yes, it would accept $8 billion in incentives, to Nevada's offer of $1.3 billion to Tesla Motors Inc., there has been no shortage of states using tax breaks to hawk themselves as the most eager to create jobs.

In the second half of the year, however, there were signs of a sea change.

Accountability and Transparency

First, two governors were put in the spotlight within their own states, as government watchdogs reported major problems in economic development offices in Utah and Texas.

In Utah the state auditor accused the Governor's Office of Economic Development of misleading the public, manipulating its job creation numbers, and making false claims about job wages it said it had secured, prompting a legislative review of the findings. (Prior coverage: *State Tax Notes*, Oct. 20, 2014, p. 133.)

That audit came just weeks after similar findings were reported by the Texas state auditor, who said that under Gov. Rick Perry (R), the Texas Enterprise Fund had been awarding money to companies that never applied for incentives and never committed to creating jobs. (Prior coverage: *State Tax Notes*, Oct. 6, 2014, p. 21.)

While those chief executives were answering questions about whether they were willing to give away too much for too little in return, New York City Mayor Bill de Blasio (D) stood out for his refusal to accommodate a $1 billion incentive request from JPMorgan Chase & Co., which is planning to build a new corporate headquarters. (Prior coverage: *State Tax Notes*, Oct. 27, 2014, p. 192.)

As governors spent the year undercutting each other on taxes, de Blasio bet that New York was the only place JPMorgan wanted to be and said there was no point giving it a tax break to stay put.

It doesn't seem likely that de Blasio is starting a trend, but there are indications of growing pressure on states to at least get a handle on the scope of their incentives and to provide accountability. For instance, a National Conference of State Legislatures task force approved a basic list of best practices for states to adopt as they try to account for the quantity and quality of tax expenditures — part of a measure to bring some level of uniformity to reports that experts say vary wildly in usefulness from state to state. (Prior coverage: *State Tax Notes*, Aug. 25, 2014, p. 497.)

That proposal is purely advisory, but the push for apples-to-apples comparisons of state tax incentives took a huge step forward when the Governmental Accounting Standards Board started moving on a proposal to make the inclusion of similar data part of the generally accepted accounting principles for state and local governments. (Prior coverage: *State Tax Notes*, Nov. 10, 2014, p. 315.)

That proposal, currently in a public comment period, would not take effect for another year, meaning the public may not see any such reporting until 2017. The wait would be long, but incentive watchdogs believe that the information it would provide would cause a "tectonic" shift in the debate over the usefulness of incentives.

The Incentives Keep Coming

There seemed to be a steady drumbeat of new incentive deals and programs approved throughout the year.

Many proposals were modest. Often taking the form of new tax abatements, angel investor credits, or sales tax holidays, they were frequently designed to encourage growth in specific sectors or geographic areas.

But it sometimes seemed as though there was no industry or company so secure that it didn't merit its own tax break:

- Despite the taint of an FBI corruption investigation and the indictment of a state senator, the California State Legislature with little effort pushed through expanded incentives to encourage the filming of motion pictures in Hollywood.
- A Wisconsin company that wanted the flexibility to lay off as many as half of its employees in the state landed $6 million in incentives.
- Even Graceland — an unlikely candidate for relocation — managed to extract millions of dollars in incentives from Memphis, Tennessee, despite acknowledging that it could undertake an expansion without help from the government.

In all, states and local governments awarded businesses more than $7.5 billion in aid in 2014, according to Good Jobs First's Subsidy Tracker.

Big Money for Aerospace

Most of the aid comes from so-called megadeals, subsidy packages worth at least $60 million, including awards worth hundreds of millions of dollars each for Northrop Grumman Corp., Lockheed Martin Corp., and United Technologies Corp.

The largest deal by far was Boeing's acceptance in January of terms laid out in a legislative package approved two months earlier. That deal cut the company's taxes by nearly $9 billion in exchange for its agreement to produce the 777X jetliner in Washington, but the company spent the rest of the year announcing layoffs of employees working on other projects around the state. (Prior coverage: *State Tax Notes*, Oct. 6, 2014, p. 9.)

After Boeing's acceptance of the terms approved in SB 5952, the deals kept coming. Weeks later, for instance, Washington lawmakers sought to expand those incentives to helicopters.

California lawmakers were shooting even higher, and they soon started working on incentives for space shuttles, approving AB 777. Soon after, other states were on board as well, with Colorado approving sales tax exemptions for space flight property (HB 1178) and Texas offering $2.3 million in cash to secure a commercial rocket launch facility.

After Boeing, the next largest deal was an offer from Hillsboro County, Oregon, for a $2 billion tax incentive to encourage new investments and expansion at Intel Corp.'s corporate headquarters there. (Prior coverage: *State Tax Notes*, Aug. 25, 2014, p. 504.)

Tesla

But for marketing savvy and media hype, neither Boeing's nor Intel's deal could compete with Tesla's carefully orchestrated announcement of the site for its new battery factory. Earlier in the year, CEO Elon Musk told investors that he was looking for a state to provide up to $500 million in incentives to help defray the $5 billion cost of a facility to mass-produce batteries for the company's vehicles.

But over the next several months, Musk and his negotiators worked with officials in California, Nevada, New Mexico, and Texas on competing incentive packages, and he timed the announcement of the site — and the 6,500 jobs projected to accompany it — to come just eight weeks before the governors in most of those states would stand for reelection.

In the end, Musk's request for $500 million was met with Nevada's plan to provide well over $1 billion in incentives, a package that Musk told reporters was not the most generous offered.

The Legislature hastily convened for a special session that began before legislative language could even be written — and as the governor refused to release economic impact assessments of his proposal. But none of that was enough to stop the deal's momentum, which was soon approved without a single dissenting vote.

Incentives in 2015

The forces behind incentives — political expediency, ego, and venality — are hard to reverse, and the strongest forces working to bring transparency and accountability to incentives are working slowly, with NCSL guidelines subject to the approval of individual states and the GASB recommendations needing years to produce results.

So, it's probably a safe bet that states will continue doling out subsidies next year, even if they're unlikely to top the nearly $9 billion in incentives Washington offered to Boeing.

Countless proposals have already been offered by the lawmakers and governors elected in November, and many of them are likely to come to fruition.

Nonetheless, budget watchdogs are keeping their focus on the long-term picture and the potential for change that could result from increased transparency, especially from the GASB changes.

"Good Jobs First believes that when states and localities start issuing new data under this Standard in 2017, it will enable massive new bodies of analysis and reform policymaking," Good Jobs First said. "Organizations and scholars concerned with state and local finances, tax policy, government transparency, economic development, regionalism and sprawl, public education finance, campaign finance, and contracting and privatization will all gain access to significant information heretofore unavailable." ✰

Unclaimed Property 2014: Holders Make Progress but Have Far to Go

by Jennifer Carr — jcarr@tax.org

The importance of unclaimed property in the state and local tax arena has increased as cash-strapped states have become more aggressive in auditing and related practices. Not surprisingly, holders and practitioners have criticized states and their auditors, especially in Delaware, where unclaimed property is a significant revenue source.

In the past year, those complaints caught the ear of lawmakers and other state officials. Although 2014 did not see much change to unclaimed property laws or administration, holders saw progress in their push against allegedly abusive audit and administrative practices. Harold Kim of the U.S. Chamber of Commerce described 2014 as a time to launch a national dialogue on unclaimed property regarding enforcement issues.

The Uniform Law Commission (ULC) revision of the Uniform Unclaimed Property Act (UUPA) and the Delaware Unclaimed Property Task Force are among the first steps in two processes that could ultimately result in significant changes to unclaimed property audits and administration.

Uniform Law Commission Revision

In 2014 the ULC began its revision of the UUPA, which was last revised in 1995. According to the ULC, the most recent version of the UUPA has been adopted by 16 states, and approximately 40 states have enacted a prior version — often with significant modifications. Throughout the year, interested parties have submitted comments to the revision committee, which is co-chaired by Rex Blackburn of IdaCorp Inc. and Michael Houghton of Morris, Nichols, Arsht & Tunnell LLP.

The derivative rights doctrine is probably the most important issue before the revision committee. Under the doctrine, the state's right to receive property is derived from and cannot exceed the owner's rights. Although arguably a fundamental unclaimed property concept, neither of the last two uniform acts addresses the doctrine. Describing it as a "basis for much of the conceptual framework of the limits of unclaimed property laws," a memo on issues for consideration urges the committee to take up the subject. Doing so could have a significant effect on the ultimate draft, especially in areas such as anti-limitations provisions.

Kendall Houghton of Alston & Bird LLP said she believes that "it's critical that the ULC recognize and specifically articulate this doctrine."

Likewise, Debbie L. Zumoff, speaking as the president of the Unclaimed Property Professionals Organization, described the doctrine's potential inclusion in the revision as significant and suggested that a debate on the subject would "likely be lively."

Some of the discussion Zumoff anticipates is already occurring. In a May 9 letter to the revision committee, the

National Association of Unclaimed Property Administrators wrote that the holders' conception of the doctrine would "permit a holder to unilaterally impose conditions, restrictions, time limitations, or any other scheme to terminate its obligations to pay or deliver property," and that except for "their transparent dislike for unclaimed property laws and their clients' inability to keep the property of others, the advocates have presented no rationale that justifies overturning the established understanding of the State's derivative rights."

The derivatives rights doctrine is hardly the only big issue on the revision commission's plate, however. The ULC must also decide whether to exclude business-to-business transactions in the new UUPA — a position highly favored by holders. Also, there are myriad other items to consider, including various definitions, a de minimis exemption, and changes to the abandonment periods.

Because they do not fall directly under the unclaimed property statutes and relate more to enforcement, more contentious issues such as the use of contingency fee auditors could be beyond the UUPA revision's scope, said Ferdinand Hogroian of the Council On State Taxation. But Kim said that even if this area is not addressed in the revision, it has been a significant focal point for interested parties.

The UUPA will have many issues to wade through, and a final draft is not due until July 2016. The materials submitted to the commission show a lot of passionate advocacy on both sides of these issues. And of course, no matter what the ULC decides, it will still be up to states to adopt the new model statute. Although 2014 was clearly a big first step on this subject, things are far from over.

Delaware

The biggest unclaimed property state for 2014 (and most years in recent memory) was unquestionably Delaware, which had several major — though preliminary — developments. Long the object of ire, holders and practitioners appear to have made progress this year in pushing back against what they would describe as some of the state's more egregious unclaimed property practices.

Unclaimed Property Task Force

On June 11 the Senate passed Concurrent Resolution 59, which established a task force to study the state's unclaimed property enforcement processes. After noting that many property holders are not in compliance with the state's unclaimed property laws, the resolution notes that Delaware "has an interest in identifying additional ways to improve compliance that will promote the stability and predictability of this revenue source" and that "efforts to improve compliance, as well as the unclaimed property program more generally, should be fair, efficient and predictable for holders of unclaimed property." The resolution mandates that the task force release a report making recommendations by November 1, 2014. However, according to a task force spokesperson, that date has been pushed back indefinitely.

According to Hogroian, the task force meetings have generated substantive discussions, and the last two have gone an hour over their scheduled time allotment. COST has been heavily involved in the process, submitting to the task force on October 1 a survey of its members on Delaware unclaimed property enforcement. A key survey finding was that over a third of respondents said that completed unclaimed property audits took seven to eight years. Half said the lookback period for the audit was 1986 or earlier despite having a regular Delaware filing history. (Prior coverage: *State Tax Notes*, Oct. 13, 2014, p. 66.)

Like the ULC revision, the task force will only make recommendations to the legislature — not implement changes itself. However, Kendall Houghton said that it is good to at least foster dialogue around the issues. "Communication of the debate is important," she said.

Legislation

On June 30, Gov. Jack Markell (D) signed SB 228, which made three slight changes to Delaware's unclaimed property process. First, the new law made it illegal for any state employee to disclose confidential information obtained as a result of an unclaimed property investigation, filing, or settlement. The bill also reduced the penalty for the nonfiling of unclaimed property reports from 5 percent per month to the lesser of 5 percent per month or $100 per day. Finally, the law extended the filing period for the secretary of state-operated voluntary disclosure agreement (VDA) from June 30, 2014, to September 30, 2014, and the payment period from June 30, 2015, to June 30, 2016.

SB 215, introduced on May 8 by Sen. Gregory Lavelle (R) and pending before the Senate Banking Committee, would prevent the state escheator from paying auditors on a commission or contingency fee basis, a practice often criticized by holders who argue that it creates an incentive for auditors to inflate their unclaimed property liability.

The legislation also reiterates that state employees are barred for two years from being employed by a private enterprise in any state matter "if the person gave an opinion, conducted an investigation or otherwise was directly and materially responsible for such matter in the course of official duties as a state employee, officer or official." This provision appears to be a response to the departure of then-state escheator Mark Udinski, who left the state in 2013 for a job with the state's outside auditor, Kelmar Associates LLC. (Prior coverage: *State Tax Notes*, May 26, 2014, p. 455.)

Voluntary Disclosure Agreement Program

Another notable 2014 event was the conclusion of the Voluntary Disclosure Agreement (VDA) program operated by the Delaware Office of the Secretary of State, as opposed to the Department of Finance, which typically oversees the unclaimed property process. The VDA was viewed as a success by both the state and holders. As of July, 535 companies had entered into VDAs with the state, which was generally pleased with participation.

Holders and practitioners were glad to have an additional venue to resolve their unclaimed property issues aside from the state escheator's office, which is seen as somewhat tainted by many involved in the process. Practitioners described the secretary of state VDA as "a more transparent environment of understanding and compliance" compared with other Delaware options.[1] Michael Wynne of Reed Smith LLP said that like other Delaware unclaimed property developments, the VDA is part of the trend showing that Delaware's unclaimed property operations are in need of an overhaul.[2] The relative satisfaction with the program contrasts significantly with enforcement actions through the state escheator's office.

Temple-Inland

Holders with Delaware unclaimed property disputes have also taken to the courts. One highly anticipated case, *Select Medical v. Cook* (No. 1:13-CV-00694-LPS, D. Del.), was settled in January and failed to provide holders with what they had hoped would be a ruling condemning the state's audit and estimation processes. Holders are now pinning their hopes on *Temple-Inland Inc. v. Cook* (No. 1:14-CV-00654-SLR, D. Del.), which was filed in May.

In its complaint, Temple-Inland, a Delaware packaging manufacturer with its principal place of business in Tennessee, alleges that Kelmar could identify only $147.30 in unreported unclaimed property but demanded $1.39 million in unclaimed property because of its improper sampling technique and excessive lookback period. Temple-Inland asserts that the audit method violates federal common law priority rules, the full faith and credit clause, the commerce clause, and the takings clause, and is "arbitrary, capricious, and is not supported by substantial evidence."

Although the litigation is far from over, Hogroian said he is heartened by what he heard at oral arguments during which U.S. District Court Judge Sue Robinson described the audit process — particularly its lengthy lookback period — as "astounding, if not shocking." The judge's comments "expressing shock over the methodology suggested that she saw on its face a potential due process violation," Hogroian said, adding that the comments suggest that "before an independent arbiter, the [audit] method won't withstand scrutiny."

Good for Holders

Missouri — HB 1075

Missouri enacted the biggest holder-friendly reform this year with HB 1075, which Gov. Jay Nixon (D) signed in July. The bill eliminated business-to-business transfers from the unclaimed property process so long as they are part of an ordinary and ongoing business relationship. HB 1075 also established a three-year lookback period for audits. Kendall Houghton described the bill as a "very significant and positive change" for unclaimed property in Missouri. It will also likely result in a significant improvement for the state on COST's unclaimed property scorecard, on which it received a D for 2013.

Texas — *Highland Homes*

A Texas Supreme Court opinion could significantly disrupt the state's unclaimed property system. In *Highland Homes Ltd. v. Texas*, (No. 12-0604 (Tex. 2014) *rev'g* No. 08-10-00215-CV (Tex. Ct. App. 2012), the court held that the state's anti-limitation provision, which is designed to prevent private contractual agreements from interfering with the unclaimed property process, did not apply to uncashed class action settlement checks. Instead, the court concluded there was no unclaimed property because all the settlement funds had been claimed by class representatives even through some class members never actually collected them. Although the opinion applies only to class action settlements, it is a blow to the state's anti-limitation provision and could make unclaimed property operations in the state much more friendly for holders. (Prior coverage: *State Tax Notes*, Oct. 20, 2014, p. 119.)

Bad for Holders — Pennsylvania HB 278

Pennsylvania's revenue bill (HB 278), signed by Gov. Tom Corbett (R) on July 10, included amendments to the state's unclaimed property act. Hogroian said that the fact that the amendments were in the budget bill shows that "some of the impetus" behind unclaimed property is raising revenue. The legislation's primary unclaimed property provision generally reduced the holding period for property from five to three years. It also increased the state treasurer's authority to examine unclaimed property accounts. According to the bill's fiscal note, the holding period reduction was expected to generate $150 million in accelerated revenue for the fiscal 2015 general fund.

Life Insurance — More Than Just Talk

One unclaimed property area that saw considerable development in 2014 was regarding requirements that life insurance companies use the Social Security Administration Death Master File (DMF) to affirmatively check for deceased policyholders. Several states considered or enacted legislation addressing this issue.

Tennessee enacted the Unclaimed Life Insurance Benefits Act (HB 2427, SB 2516), which created an affirmative requirement for life insurers to check the DMF semiannually. Should an insured person be on the DMF, the insurance company is required under the new law to make a good-faith effort to locate the beneficiaries. The new law also clarifies that insurers may require death certificates and implement their own internal policies before paying a claim. The new law will become effective on July 1, 2015.

Georgia enacted a similar law (HB 920) that is effective for policies issued or renewed on or after January 1, 2015.

[1] Nina Renda and Marc Grossman, "Delaware: New, Limited Opportunity for Unclaimed Property Holders," *State Tax Notes*, June 3, 2013, p. 779.

[2] Jennifer DePaul, "State Extends Unclaimed Property Disclosure Program," *State Tax Notes*, July 7, 2014, p. 23.

Rhode Island's law (HB 7031) will take effect January 1, 2016, and Indiana's law (SB 220) took effect July 1, 2014.

On the judicial side, the Florida District Court of Appeal for the First District rejected a Department of Financial Services decision regarding when life insurance proceeds become due and payable (*Thrivent Financial for Lutherans v. Florida*, No. 1D13-5299 (1st Dist. App. 2014)). The department had asserted that a statute stating that life insurance proceeds are escheatable if "unclaimed for more than 5 years after the funds became due and payable as established from the records of the insurance company" meant that the dormancy period began upon the death of the insured. The department also asserted that the statute created an affirmative duty to check the DMF for the insured.

The court held that the plain language of the statute did not support the department's interpretation because the proceeds become payable based on insurance company records. This does not occur, the court wrote, until the insurer receives proof of death and surrender of the policy. The court also rejected the department's assertion that insurers had an affirmative duty to regularly check the DMF for policyholders. The court found no such requirement in the statute.

Prediction for 2015 and Beyond

It's impossible to say what the future holds for 2015, but it is likely to be an active year for unclaimed property. Most significantly, stakeholders should get a first draft of the UUPA revision, which will "make 2015 very interesting," said Kendall Houghton. As issues move from the theoretical to actual concrete language, it's likely to lead to an increased urgency among interested parties. Zumoff said she hopes the UUPA revision will result in increased clarity for holders and more uniform unclaimed property laws nationwide.

Hogroian said that although Delaware will continue to be the focal point, holders are also looking to enact changes in other states, such as Missouri. However, he said that such changes take a lot of time to lay the groundwork. Houghton also anticipated that there will be "new theories of liability introduced by auditors" and states, and that holders will show their increasing willingness to push back on some more contentious issues through litigation. ✰

Kansas Voters Appear Willing To Wait and See on Tax Cuts

by Doug Sheppard — doug_sheppard@tax.org

The initial results of the Kansas tax cuts implemented in 2012 and 2013 were manifested in 2014, and they weren't good.

Fiscal 2014 tax revenues were down $701.1 million from fiscal 2013. Moody's and Standard & Poor's downgraded the state's credit rating. Spending for education and other services was reduced, the state tapped its reserves to avoid budget reductions, and economists warned that with further cuts imminent, the future would be even worse. Supporters, however, contend that it's still too early to write off the tax cuts.

So dramatic were the results that Kansas made national headlines, with debates on cable news and throughout the blogosphere speculating on not only what would happen to the state's budget, but also what dire consequences Gov. Sam Brownback (R), who pushed and then signed the cuts, would face in his reelection bid. On November 4 the answer was provided: none. Brownback won 50 percent to 46 percent over his opponent, House Minority Leader Paul Davis (D), in what some saw as a referendum on supply-side economics.

In 2012 Brownback signed the first tax cut bill (HB 2117), which eliminated numerous tax breaks for individuals, exempted passthrough business income from taxation, and reduced and reconfigured the personal income tax. Under the legislation, the 6.45 percent top bracket on income over $30,000 for single filers was repealed, the 6.25 percent middle bracket for income between $15,000 and $30,000 for single filers was reduced to 4.9 percent, and the 3.5 percent bottom bracket for income below $15,000 for single filers was cut to 3 percent.

The personal income tax was cut further in 2013. Another bill signed by Brownback (HB 2059) phases in additional reductions, culminating in rates of 2.3 percent and 3.9 percent in 2018. After that, relief may also be triggered under a formula if specified general fund revenue grows by more than 2 percent from the previous year. To address revenue shortfalls, HB 2059 set the sales tax rate, which had been scheduled to fall to 5.7 percent, at 6.15 percent, effective July 1, 2013.

"Our new pro-growth tax policy will be like a shot of adrenaline into the heart of the Kansas economy," Brownback wrote in a *Wichita Eagle* op-ed in 2012.

But in October comedian Bill Maher called it "an unfortunate metaphor borrowed from *Pulp Fiction*," in which the hit man played by John Travolta successfully revives Uma Thurman's overdosing character with a syringe full of adrenaline stabbed into her heart. "The only difference being, in the movie, the junkie lived," Maher added.

And so did Brownback politically, surviving even moderate Republican defectors from his own party who backed his opponent. Despite the immediacy implied by his "shot of adrenaline" comment, the governor contended that his cuts were an experiment that would take time to develop — as did one of his advisers in these pages in October.

"The Kansas story is still incomplete, and we will see over the next few years whether growth is revived in a state that people have been fleeing for the past decade," Stephen Moore of the Heritage Foundation said in a *State Tax Notes* debate. "Tax revenues are down, but they are down in most states because of reductions in capital gains receipts from 2013." (For the debate, see *State Tax Notes*, Oct. 13, 2014, p. 89.)

Brownback also argued that some of the public sector job cuts had improved the state's efficiency and that the state share of education spending had increased, albeit not overall education spending.

But the other debate participant, Michael Leachman of the Center on Budget and Policy Priorities, didn't buy it. "Kansas's finances are in shambles, its economy is ho-hum, and its future looks worse — not better," Leachman said. "Other states that follow this path can expect a similar result."

Regardless of whether Kansas ultimately sees the growth promised by Brownback, the election results suggest that Kansas voters are willing to give it more time. ✰

Marijuana Taxes

by Jennifer DePaul — jdepaul@tax.org

It isn't surprising that five years after the official end of the recession, cash-strapped states finally regaining financial footing continue to seek new and alternative revenue options, including taxing marijuana.

The November 4 midterm elections made it abundantly clear that states' legalizing and taxing marijuana is an issue unlikely to go away anytime soon. Oregon and Alaska approved initiatives to regulate and tax recreational marijuana, while District of Columbia voters decriminalized possession of small amounts. That means five jurisdictions, including Colorado and Washington, now have moved to allow the recreational use of marijuana.

"We saw a lot of support for marijuana legalization," said Kim Rueben of the Urban Institute. "Like [with] gay marriage, we will see more states go forward, and the majority of that will happen in 2016."

The Marijuana Policy Project, an advocacy group working to reform marijuana policies around the nation, estimated that serious efforts to legalize and tax the recreational use of marijuana are already underway in other states, including Arizona, California, Massachusetts, and Nevada.

"This year's election was a large step forward, but the 2016 election will be a huge leap toward ending marijuana prohibition in this country once and for all," Rob Kampia of the Marijuana Policy Project said in a statement.

In Oregon, Measure 91 will legalize, regulate, and tax recreational marijuana. It establishes a state tax on marijuana sales but bars cities and counties from imposing a tax or fee on recreational marijuana. Alaska will legalize marijuana for recreational use and will impose a $50-per-ounce excise tax on its sale or transfer. And the District approved Initiative 71 to allow residents age 21 and older to possess up to two ounces of marijuana and grow up to six plants in their homes. The D.C. Council is already working on B20-0466, the Marijuana Legalization and Regulation Act of 2013.

What once was considered the "devil's weed" has gained wider social acceptance, especially since states are not eager to raise taxes. As a result, legalizing and taxing marijuana is turning into a nationwide movement, which began in 1996 when California first approved medical marijuana.

Scott Pattison of the National Association of State Budget Officers said in September that he expects more western states will consider marijuana taxes to help pay for increased mandatory expenditures. "I just think the politics against any general sales or income tax increase is really, really tight," Pattison said. "I'm not expecting a significant change on that."

Revenue estimates vary by state, but the numbers are in the hundreds of millions. The consumer financial website NerdWallet Inc. said in September that the United States could see a $3 billion windfall from state and local tax revenue.

To be sure, not everyone believes taxing marijuana will be a panacea for state budgets and produce a steady revenue stream.

Meg Wiehe of the Institute on Taxation and Economic Policy said that while the trend seems to be to legalize marijuana, states need to discuss best practices about how to tax it because it is still unclear whether Colorado and Washington are the best models. "We shouldn't think about taxing it because it will bring in hundreds of millions of dollars," Wiehe said. "There is so much uncertainty as how much that would be."

During an October D.C. Council hearing on marijuana, Joseph Henchman of the Tax Foundation warned the council against imposing too high a tax on marijuana, pointing to Colorado and Washington state as examples of what could go wrong.

Legal sales of retail marijuana began in Colorado on January 1, 2014, and in Washington on June 1.

Colorado imposes an approximately 29 percent tax on retail marijuana, while Washington imposes an approximately 44 percent tax. Both states have seen revenue collections underperform significantly, compared with estimates before the beginning of legal sales, Henchman said.

If more states consider legalizing and taxing recreational marijuana, officials should review all the other state marijuana taxing systems before placing an initiative on a ballot, in order to gain a comprehensive picture of revenue estimates, Wiehe said. ✰