

State and Local Tax Watch

A briefing for tax professionals

Fall 2008

Gross receipts taxes: A growing trend in state taxation

As states try to fill budget deficits and find more stable forms of tax revenue, they are increasingly viewing gross receipts taxes as a viable method to tax corporations. The number of states imposing gross receipts taxes are relatively small, but growing. With the imposition of a new business tax, Michigan (i.e. the Michigan Business Tax (MBT)) joined the growing list of states with gross receipts taxes. The list of gross receipts taxes also includes the Ohio Commercial Activities Tax (CAT), the Texas Franchise Tax on “margin”, and the Washington Business and Occupation (B&O) tax. Furthermore, New Jersey and Kentucky also have gross receipts components to their corporate tax structures.

Background

States watched as corporate income taxes shrank as an overall percentage of state tax collection. Between 1980 and 2004, state corporate income tax revenues fell from a peak of 9.6 percent of total state taxes collected in 1980 to only 5.2 percent of total state taxes collected in 2004.¹ As corporate income taxes shrank as a percentage of total state tax collected, the effective tax rate also declined. By 2004, the effective state corporate income tax rate was less than 4 percent, having fallen from the 1980 peak of 8 percent.² Some state legislators no longer consider the corporate income tax a stable source of funding for state government.

One obvious reason for this volatility is that corporate income tax collections have fluctuated with the national economy, for better or worse. However, states blame four additional factors for the long-term decline in state corporate income taxes:³

- Federal laws limit the state tax base
- Decline in the federal income tax base
- Corporate participation in tax planning
- State legislative actions to reduce tax bases

Federal limits on state taxation

Under the U.S. Constitution, Congress has the authority to regulate commerce among the states. Congress utilized this authority when it passed Public Law 86-272 (P.L. 86-272) to restrict the activities that

create a state income tax filing requirement. P.L. 86-272 was a response to the U.S. Supreme Court’s 1959 decision in *Northwestern States Portland Cemen*.⁴ Congress mandated the allowance of businesses to solicit sales of tangible personal property in a state without incurring a state net income tax filing requirement.

Following P.L. 86-272, Congress passed numerous bills regulating interstate commerce. For example, Public Law 94-210 prohibits a state from taxing railroad property more heavily than other commercial or industrial property. Congress subsequently extended the prohibition to motor carriers⁵ and air carriers.⁶ Among other limitations, Congress also:

- Limited states’ abilities to levy stock transfer taxes⁷
- Superseded all state taxes related to employee benefit plans⁸
- Prohibited localities from taxing providers of direct-to-home satellite services⁹
- Prohibited states from taxing interstate passenger transportation¹⁰
- Prohibited state and local governments from imposing new taxes on Internet access¹¹

Decline in federal tax base

Due to state reliance on federal taxable income as the starting point for corporate income tax allocations, the widely-reported decline in the federal income tax base has resulted in reduced state corporate income taxes. Much of the decline in federal corporate income taxes is a result of Congress’ allowance of pass-through entities for federal income tax purposes. Income once attributed to corporations can be reported as the income of S corporations, partnerships, and limited liability companies. Income of these entities is reported as personal, rather than corporate income.

A common reason to form such entities is to eliminate double-taxation — taxation at both the corporate

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1 U.S. Census Bureau State Government Tax Collections: 2004 (Revised January 2006)

2 Op. Ct.

3 Federalism at Risk, A Report of the Multistate Tax Commission (June 2003)

4 *Northwestern States Portland Cement Co. v. Minnesota*, 358 U.S. 450 (1959)

5 49 U.S.C. §14502

6 49 U.S.C. §40116

7 15 U.S.C. §78bb(d)

8 29 U.S.C. §1144(a)

9 P.L. 104-104 (1996)

10 P.L. 104-88 (1995)

11 Internet Tax Freedom Act (1998)

Income and franchise tax

All states

On Nov. 5, 2007, the United States Supreme Court heard arguments in the appeal of *Davis v. Department of Revenue*. This case challenges Kentucky's exemption of interest earned on its bonds and those of its political subdivisions, but not on bonds issued by other states and their political subdivisions.

In a 2003 class-action lawsuit, two Kentucky residents challenged Kentucky's personal income taxation of out-of-state bond interest. The individuals lost at the trial level, but in 2006 the Kentucky Court of Appeals ruled that Kentucky's bond interest taxation scheme was unconstitutional. Later, the Kentucky Supreme Court declined to review the appeals court ruling. The U.S. Supreme Court in Docket No.06-666, May 19, 2008, upheld the traditional state tax treatment of municipal bond interest, under which a state exempts from its corporate income tax the interest on bonds issued by the state and its own localities, but not the interest on bonds issued by other states and their localities. The court held that Kentucky and the 40 other states with similar taxing regimes don't violate the Commerce Clause by limiting the exemption to the interest on in-state bonds. The exemption permissibly favors a traditional government function and is critical to the functioning of the municipal financial market, according to the majority. Furthermore, it does not represent the sort of protectionism the Commerce Clause was designed to prevent.

California

Franchise Tax Board will not appeal recent appeals court ruling on LLC fees

According to a report published by the Bureau of National Affairs (BNA), the California Franchise Tax Board (FTB) has decided not to appeal Northwest Energetic Services further. The FTB will accept the recent appeals court ruling that California's former limited liability company (LLC) fee is an unconstitutional tax.

According to the BNA report, the FTB will send notices to taxpayers that filed protective claims to determine if a refund is due. It is expected that the FTB will limit LLC fee refunds to only those LLCs that fit the California business activity profile discussed in Northwest Energetic Services. Specifically, California will refund LLC fees only to out-of-state LLCs with no business activity in California.

Until a law change effective Jan. 1, 2007, California required LLCs to pay an annual \$800 minimum tax and an annual fee based on worldwide total income without apportionment. The LLC fee

ranged from \$0 for LLCs with total income of \$250,000 or less to \$11,790 for LLCs with total income of \$5 million or more. For tax years beginning on or after Jan. 1, 2007, the LLC fee is based on apportioned California income.

In Northwest Energetic Services, the appellate court held that California's LLC fee was a tax, not a fee as argued by the FTB. The court held that the fee failed both the internal consistency and external consistency tests of "fair apportionment" established in Complete Auto Transit. It failed the internal consistency test because an identical fee imposed by every other state would place a greater burden on interstate commerce than intrastate commerce. It failed the external consistency test because the fee would tax non-California income not attributable to activities in California.

The court rejected the FTB's arguments that the internal consistency test was inapplicable and that the taxpayer must otherwise demonstrate that the LLC fee burdened interstate commerce. The court also rejected the FTB's argument that Northwest could not bring a Commerce Clause challenge because it voluntarily elected taxation as an LLC.

Two other pending court cases also challenge the California LLC fee: *Ventas Finance I* and *Bakersfield Mall*. In *Ventas Finance I*, the FTB appealed a superior court decision regarding a taxpayer that derived some income from inside California. In *Bakersfield Mall*, the LLC derived all its income in California. This case is in San Francisco Superior Court, and the taxpayer has received class action status to represent LLCs with similar situations. On April 14, the FTB released Notice 2008-2 addressing protective claims regarding the California LLC fee. This Notice was related specifically to a recent court decision on Northwest Energetic Services (NES), LLC v. Franchise Tax Board.

NES was a foreign LLC that registered with the California Secretary of State, but did no business in California. In a recent decision on this case, the California Court of Appeal, First Appellate District, held that assessing an LLC fee to an entity that had no income attributable to business conducted in California was unconstitutional as applied to NES, and the fee should be refunded.

Two additional pending court cases address the constitutionality of the LLC fee:

- *Ventas Finance I, LLC* — a foreign LLC registered in California that earned income inside and outside California.
- *Bakersfield Mall, LLC* — a foreign LLC that claims it earned income only in California. These cases are ongoing and final decisions haven't been issued.

Because the NES decision about the LLC fee is now final, it's possible to take action on claims for refund filed by LLCs that had no income attributable to activities in California.

Maryland

New legislation increases corporate taxes, imposes significant new reporting requirements

Maryland enacted the Tax Reform Act of 2007 (SB 2) and the Transportation and State Investment Act (HB 5), which were passed by the Maryland general assembly during a special session. Among other changes, the legislation imposes higher corporate income tax rates and adds significant new information reporting requirements.

Maryland increased the corporate income tax rate from 7 percent to 8.25 percent for tax years beginning after Dec. 31, 2007. Beginning with tax year 2008, nonresident entities that are members of pass-through entities will have a tax rate of 8.25 percent. Additionally, nonresident individual members of pass-through entities will owe a 6.75 percent personal income tax.

New corporate information reporting requirements

The legislation adds several information reporting requirements for corporations for tax years beginning after Dec. 31, 2005. There are new requirements that apply to corporations required to file Maryland corporate income tax returns that are part of a corporate group, publicly traded corporations that are doing business in Maryland (whether or not they are required to file Maryland income tax returns), and publicly-traded corporations with worldwide receipts for the taxable year of more than \$100 million. The information provided is subject to audit by the state and is to be filed annually in electronic format on or before dates to be specified by the comptroller. The reports are to be filed under oath and signed in the same manner as tax returns. The legislation also indicates that persons who willfully fail to provide information or provide false information may be subject to fines up to \$10,000 or up to five years of incarceration.

Corporations part of a corporate group

Each corporation that is required to file a Maryland income tax return and is a member of a corporate group is required to file statements:

- Identifying each member of the corporate group, and for each member for the tax year:

- Whether the member filed a Maryland income tax return
- The total volume of sales by the member worldwide
- The volume of sales made by the member in Maryland
- Identifying each state other than Maryland in which any member of the corporate group filed an income tax return for the tax year
- Listing the members of the corporate group that are included in the combined or consolidated group in any state that requires combined or consolidated income tax reporting

Publicly traded corporations doing business in Maryland

Publicly traded corporations doing business in Maryland, or corporations that are more than 50 percent owned by publicly traded corporations, have additional information reporting requirements. These requirements apply whether or not the corporation is required to file a Maryland corporate income tax return. Effective for all tax years beginning after Dec. 31, 2005, all publicly traded corporations doing business in Maryland must provide:

- The name of the corporation and the street address of the corporation's principal executive office
- The name of any corporation that owns, directly or indirectly, 50 percent or more of the voting stock of the corporation and the street address of that corporation's principal executive office
- The corporation's six-digit North American Industry Classification System code number
- As specified by the comptroller, information reported on or used in preparing the corporation's Maryland return or the information that would have been reported or used if the corporation were required to file a Maryland return
- A corporation not required to file a return can provide an explanation of why it isn't required to file a Maryland income tax return and a statement as to whether its total Maryland sales falls within certain specified ranges for the taxable year.

Publicly traded corporations with worldwide gross receipts in excess of \$100 million

In addition to the other information required for publicly traded companies, corporations with more than \$100 million in worldwide gross receipts must provide:

- The information required for publicly traded corporations for each member of the corporate group, regardless of whether the member is required to file

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a Maryland corporate income tax return or is doing business in the state

- A list of corporate group members that would be included in the combined group using the “water’s edge” method of combined reporting and the difference in Maryland income tax owed if the corporation were required to use the water’s edge combined reporting method
- A calculation of the difference in Maryland income tax owed if the corporation were required to include throwback sales in the Maryland sales factor numerator
- If a publicly traded company allocated income outside of Maryland, the source of the income and the state to which it was allocated, as well as a calculation of the difference in the tax due had the income been allocated to Maryland
- The full-time equivalent employment of the corporation in Maryland on the last day of the taxable year and the three previous years
- The profits before tax reported on the company’s 10-K filed with the SEC for the taxable year

Maryland House Bill 5 and Senate Bill 2, signed Nov. 19, 2007

Michigan

MBT deferred tax liabilities amended

Effective Jan. 1, 2008, Michigan has a new deduction for increased deferred taxes resulting from the enactment of the Michigan Business Tax (MBT). HB 5104 reduces the future MBT liability and creates a deferred tax asset that would eliminate the potential net decrease in book value.

The MBT has an income tax and a margin tax component, and both are widely considered to be income taxes for FAS 109 purposes. Since not all businesses treated Michigan’s Single Business Tax (SBT) as an income tax, these businesses may realize an increase in their deferred tax liability when accounting for the components of the MBT. The increase in deferred tax liability will reduce the book value of the business. The new deduction is equal to the change in deferred tax liability during the first tax period ending on or after July 12, 2007. Businesses can deduct a percentage of the difference from the income tax component of the MBT according to the following schedule:

- 4 percent during tax years 2015 to 2019
- 6 percent during tax years 2020 to 2024
- 10 percent during tax years 2025 to 2029

The deduction is limited to the increased deferred tax liability resulting from enactment of the MBT and may not exceed the tax base for the Michigan income tax component. Unused portions of any year’s deduction

can be carried forward to future years. There is no current limit on the number of years such a deduction can be carried forward.

The Michigan Department of Treasury may require taxpayers to report the deduction amount on a form to be developed. This form would be due on or after the due date of the first quarterly return and estimated payment.

Michigan House Bill 5104, signed Sept. 30, 2007

Texas

Businesses must notify Texas to preserve margin tax “temporary credit” On or before the due date of their Texas franchise tax reports, eligible businesses must notify the Texas Comptroller of Public Accounts of their intention to preserve the right to claim the “temporary credit” enacted under the Texas franchise tax on margin. Businesses that do not extend their Texas franchise tax report had to notify the Texas comptroller by May 15, 2008. Businesses that extend their Texas franchise tax report must also elect to take the credit on Form 5-164. Texas will not grant extensions to preserve the right to take the temporary credit.

Originally, businesses subject to Texas franchise tax had until March 1, 2007 to notify the comptroller of their intent to preserve their right to claim the temporary credit. In February 2007, the comptroller adopted regulation Section 3.594 that extended the notification due date to Sept. 1, 2007.

When it was enacted in June 2007, Section 23 of the margin tax correction legislation in HB 3928 further extended the notification due date to May 15, 2008. This bill also changed the notification procedure. Businesses must provide their notice of intent to preserve the temporary credit on or before the due date of the 2008 Texas franchise tax report. The Texas comptroller has requested that businesses file this form (Form 05-172) at least two weeks prior to filing the 2008 franchise tax report.

The Texas temporary credit is available for business loss carryforwards created on or after 2003 Texas franchise tax report that have not expired or exhausted on a reports due before Jan.1, 2008. Business loss carryforwards must have been used to offset any positive amount of earned surplus, including for years when no Texas tax was due. Combined groups are allowed to take a credit for eligible members of the group. To apply for the Texas temporary credit, a business must have been subject to the Texas franchise tax on May 1, 2006.

The Texas temporary credit calculation is based on unexhausted business loss carryforwards at Jan. 1, 2008 multiplied by:

- Report years 2008 to 2017: x 2.25 percent x 4.5 percent
- Report years 2018 to 2027: x 7.75 percent x 4.5 percent

Texas House Bill 3928, signed June 17, 2007

Sales and Use Tax

California

Mixed lump-sum transaction ruled partially exempt

Affirming a trial court ruling, the California Court of Appeal recently ruled that optional computer service contracts sold with computers for a lump-sum price were not subject to California sales and use tax. In the ruling, the court stated that the computers and service contracts were distinct consumer items and each was a significant object of the transaction. The court further indicated that the California State Board of Equalization (SBE) cannot decide that separate statement of an optional service contract's value is the only method to support tax exemption absent a statute, regulation or consistent administrative interpretation of the laws mandating separate statement on an invoice.

Dell, the retailer in this case, sold computers and optional service contracts to customers for one price and billed tax on the total amount. Several consumers sued Dell for refunds of California sales tax on the optional service contracts and Dell, in turn, sued California for refund of the disputed taxes. The consumers won at the trial court level where the court found that the service contracts were optional to the customer and constituted sales of intangible property. The appeals court affirmed this decision.

The trial court and the appeals court also considered SBE and Dell's reliance on the so-called separate statement rule, where sales and use tax is charged on a bundled price unless the price of any non-taxable component is separately stated. The trial court found reliance on this rule consistent with common sense and common practices, but inconsistent with the California tax statutes. The appeals court affirmed.

The appeals court determined that Dell's sales of computers and service agreements for one price are not "bundled transactions" involving inextricably intertwined goods and services, but "mixed transactions" involving separately identifiable transfers of goods and services. For bundled transactions,

the appeals court stated, the "true object" test applies and the entire transaction is taxable or exempt. In mixed transactions, however, the separate elements of the transaction are analyzed as separate transactions for tax purposes. The appeals court found that Dell's service contracts sold with computers are clearly mixed transactions and are not taxable, even without separate invoicing.

The SBE presented separate statement as a general principle of sales and use tax administration, but may choose to enact a legal requirement in the future. Other states that don't have separate statement requirements may also consider enacting such rules.

Dell, Inc. v. The Superior Court of the City and County of San Francisco, California Court of Appeal, Jan. 31, 2008

Credits and Incentives

Illinois

Condominium development terminates enterprise zone exemption

An Illinois appellate court ruled that a developer's intent to build, and subsequent construction of, condominiums terminated its enterprise zone exemption from Chicago real estate transfer tax. In its decision, the court stated that the exemption depends on the future use of the property.

The developer purchased a property in an enterprise zone that was used in the manufacture and distribution of paper products. The developer immediately leased the property back to the seller for 11 months. Beginning shortly after purchasing the property, the developer also constructed a sales office on the property, applied for a zoning classification change and applied for demolition permits. Later, the developer built 175 residential condominiums.

The developer argued that it satisfied all conditions for exemption because the property was used primarily for commercial or industrial purposes before the transfer and for 11 months after the transfer. It further argued that neither the ordinance nor a revenue ruling indicated a time frame during which the property must continue to be used for industrial or commercial purposes.

In upholding the tax assessment, the court stated it was the buyer's intended and future use of the property that was relevant. While the property was used for industrial

purposes for a short duration after the sale, the intent was always to convert the property for residential use.

Metro Developers, LLC v. City of Chicago Department of Revenue, IL App. Ct., Oct. 30, 2007

S corporation is separate taxpayer for empire zone benefits

A recent release by the New York Department of Taxation and Finance clarifies treatment of S corporations for empire zone corporate income and personal income tax benefits. Specifically, the release responds to a business organized as an S corporation and wholly owned by a single member limited liability company (SMLLC).

The release states that empire zone and qualified empire zone tax credits are available only to certified entities. It clarifies further that an SMLLC and its owner are treated as one taxpayer and either may be certified for credits to be claimed. Unlike the treatment of an SMLLC, an S corporation is regarded as a separate taxpayer and must obtain separate certification to earn empire zone and qualified empire zone corporate income and personal income tax benefits, which then pass through to the owner if the S corporation made the New York S election.

New York Department of Taxation and Finance Release NYT-G-07(5)C, NYT-G-07(1)I, Nov. 15, 2007

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and shareholder levels. Instead of being taxed at the corporate level, income is passed through to the shareholders, partners, or members. This creates challenges for states trying to administer and collect income taxes from non-resident partners of pass-through entities domiciled outside their respective states.

Federal “bonus” depreciation resulting from the Economic Growth and Tax Relief Reconciliation Act (EGTRAA) also led to a decline in the federal corporate income tax base. Unless states passed legislation to decouple from bonus depreciation, their corporate income tax base decreased. Unfortunately for some states, decoupling occurred only after state revenue was noticeably reduced.

State income tax planning

State lawmakers see significant changes in what corporate taxpayers pay in state income taxes, and some wonder if tax planning might explain a material part of these changes. In response, the states

have passed new laws to limit or eliminate the use of certain planning ideas in their jurisdictions. However, new state tax planning strategies appear regularly and some for instance are never legislated out of existence.

Reduced state tax bases

As part of the competition for jobs, states have established various tax incentives to encourage state and local investment. In deciding where to locate a new plant or whether to expand an existing one, companies consider the overall state and local tax burden, including available tax credits and incentives. The states have implemented various methods to reduce the tax base. For example, some states are changing from traditional three-factor (sales, property and payroll) apportionment formulas to apportion formulas that use sales only. This places greater emphasis on a company’s in state sales and often reduces the overall tax burden for companies with property and payroll in the given state.

Some gross receipts tax concerns

A gross receipts tax methodology in general does not consider whether a taxpayer has derived a profit when taxing a transaction. In addition, a gross receipts tax may be imposed each time a product or service turns over from the time the raw material is extracted until it reaches the final consumer. This “pyramiding” or “cascading” favors integrated firms. A gross receipts tax focuses on transactions and business classification of the transacting entity, not on profit.

Additionally, states with gross receipts taxes need to address complex issues such as sourcing multistate services, requirements for filing returns, instructions for filing consolidated returns, and transition issues, such as the use of net operating losses and credits. States are also likely to grapple with the trend of legislators complicating gross receipts taxes with multiple rates and deductions.

Where from here?

States are closely watching the gross receipts tax experiences of other states to determine if this is a better way to tax corporations. They are weighing the merits of a broad-based tax with low rates that produces a more even revenue flow. They may also appreciate that gross receipts taxes are difficult to reduce through corporate planning and are not currently subject to the federal limitations of P.L. 86-272. Will other states adopt a gross receipts tax to replace or supplement their state income taxes? It’s difficult to say, but if Illinois’ recent inability to pass one is any indication, passing a gross receipts tax may not be an easy task.

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