

# **Southeastern Association of Tax Administrators**

## **Southeastern States Update**

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# **CUNO Developments**

## **Southeastern States Update**

## **Alabama**

### VFJ Ventures, Inc. v. Commissioner

The taxpayer is challenging the “add-back” statute that disallows the deduction for certain intangible expenses paid to a related member.

Plaintiff’s objections to the assessment:

1. Royalty expenses are not subject to the add-back under the plain meaning of §40-18-35(b)(1)
  - Reported and included in another state’s taxable income versus the apportioned and allocated approach taken by the Department
2. Royalty expenses are not subject to the add-back under the plain meaning of §40-18-35(b)(2)
  - Add-back applies unless the taxpayer establishes that the adjustments are unreasonable. Taxpayer contends the adjustment is unreasonable because it would ignore the economic substance and valid business purposes of the intangibles management companies.
3. The add-back statute is unconstitutional under the Commerce Clause of the U.S. Constitution.
  - Plaintiff contends that the statute penalizes taxpayers for locating in tax favored or combined or consolidated income tax reporting states.
4. Plaintiff alleges the add-back is unconstitutional under the Due Process Clauses of the U.S. Constitution and the Alabama Constitution and Equal Protection Clause of the U.S. Constitution.

Trial is expected in the Fall of 2005.

## **Arkansas**

### S.B. 509

Signed into law as Act 1982 on April 11, 2005,

**Withholding Provisions.** Requires pass-through entities with Arkansas-sourced income to withhold income taxes for all nonresident owners (members). The Act requires S corporations, partnerships, limited liability companies, trusts, and any other entities that are not taxed as

corporations for federal income tax purposes to withhold Arkansas income tax at the highest individual income tax rate on a nonresident member's distributive share of income attributable to Arkansas. The Act defines "member" as a shareholder of an S corporation, partner in a general partnership, partner in a limited partnership, partner in a limited liability partnership, member of a limited liability company, or a beneficiary of a trust. A corporation is not included in the definition of a "member." A "nonresident member" includes an individual that is not a resident of Arkansas during any part of the tax year; a business entity that does not have its commercial domicile in Arkansas during any part of the tax year; or a trust that is not organized under Arkansas law. These new withholding provisions are effective for tax years beginning on or after January 1, 2006.

## **Florida**

### Crescent Miami Center, LLC v. Florida Dept. of Rev., 30 Fla. L. Weekly S 366 (2005)

Florida Supreme Court held that the transfer of property between a grantor and its wholly owned grantee, absent any exchange of value, is without consideration or a purchaser and thus not subject to the documentary stamp tax in section 201.02(1). While CMC, the grantee, received the property, it gave nothing to Crescent Equities, the grantor, in exchange for that property except for the continuing interest in the same property that Crescent Equities owned before the transaction occurred. This transaction was merely a change in the form of ownership by the entities who had owned and continued to own the property. The argument that the increase in the value of Crescent Equities' interest in CMC constituted consideration was found unpersuasive, as the increased interest resulted from the transfer and was not the consideration for making the transfer.

### Senate Bill 1300

Corporate income tax refund claims - for purposes of corporate income tax refund claims, estimated taxes shall be deemed paid when the return is required to be filed, determined "with" regard to extensions. The legislation applies retroactively to tax years beginning on or after January 1, 2001.

### Senate Bill 2070

This bill effectively repeals the substitute communications systems tax by deleting provisions regarding the manner in which the tax on gross receipts for communications services is applied to substitute communications system. The repeal is retroactive to October 1, 2001, although the retroactive operation is "remedial in nature and shall not be construed to create a right to a refund or to require a refund by any governmental entity of any tax, penalty, or interest remitted to the Department of Revenue on substitute communications systems prior to the effective date of this act."

The legislation also creates a Communications Service Tax Task Force; redefines the term "communications services"; provides that definition of sales price for purposes of

communication services tax does not include specified charges for Internet access services, etc. redefines the term "communications services"; defines the term "service address" when the location of the equipment is unknown or under other circumstances; amends law prescribing methods of record keeping relating to bundled sales; provides that the definition of sales price for purposes of sales tax does not include specified charges for Internet access services; provides for emergency rulemaking by the Department of Revenue; and provides intent that all sellers of communications services must comply with ch. 202, F.S.

### Senate Bill 2348

Intangibles Tax Rate. Beginning January 1, 2006, the intangibles tax rate is reduced from 1 mill to .5 mill.

## **Georgia**

### H.B. 191 - Intangible expense add-back provisions

New O.C.G.A. §48-7-28.3 is enacted and provides that a taxpayer must add back to apportionable income otherwise deductible "interest expenses and costs" and "intangible expenses and costs" directly or indirectly paid, accrued or incurred in connection with one or more direct or indirect transactions with one or more related members.

*"Interest expenses and costs"* includes amounts directly or indirectly allowed as deductions under IRC §163 to the extent such expenses are directly or indirectly for, related to, or in connection with the acquisition, use, maintenance, management, ownership, sale, exchange, or disposition of intangible property.

*"Intangible expenses and costs"* means expenses, losses, and costs directly or indirectly for, related to, or in connection with the acquisition, use, maintenance, management, ownership, sale, exchange, or disposition of intangible property and specifically includes royalties, patents, technical fees, and copyright fees. Intangible property includes patents, patent applications, trade names, trademarks, copyrights, mask words, trade secrets, and similar types of intangible property.

Exceptions:

- (1) The "addback" adjustment shall be reduced, but not below zero, to the extent the corresponding expenses or costs: (a) are received as income in an arm's length transaction by the related member, and (b) such income is allocated or apportioned to and taxed by Georgia or another separate return state that imposes a tax on or measured by the income of the related member.
- (2) The "addback" adjustment shall be reduced, but not below zero, if and to the extent : (a) the corresponding expenses or costs are paid, accrued or incurred to a related member domiciled in a foreign nation which has in force a comprehensive income tax treaty with

the U.S., (b) the transaction giving rise to the expenses and costs has a valid business purpose, and (c) the amounts of such expenses and costs were determined at arm's length rates.

- (3) The addback adjustment shall not apply to the portion of expenses and costs that the taxpayer establishes by a preponderance of the evidence meets both of the following: (a) the related member during the same taxable year paid, accrued or incurred such portion to a person that is not a related member, and (b) the transaction giving rise to the expenses has a valid business purpose.

"Valid business purpose," required under exceptions (2) and (3) above, means "one or more business purposes, other than the avoidance or reduction of taxation, which alone or in combination constitute the primary motivation for some business activity or transaction, which activity or transaction changes in a meaningful way, apart from tax effects, the economic position of the taxpayer. The economic position of the taxpayer includes an increase in the market share of the taxpayer, or entry by the taxpayer into new business markets.

Commissioner has authority to reverse required adjustments when the taxpayer and commissioner agree in writing to the application of alternative method of apportionment.

An additional 10% penalty is imposed for failure to make the required adjustments on the return.

#### H.B. 191 - Single Factor Gross Receipts Apportionment

H.B. 191 provides for the amendment of O.C.G.A. 48-7-31 relating to Georgia's corporate income tax apportionment formula. Currently, Georgia has a three factor formula with a double-weighted (50%) gross receipts factor. Under HB 191, Georgia will move to a single factor gross receipts formula. The gross receipts factor will be weighted 80% for tax years beginning on or after January 1, 2006, 90% for tax years beginning on or after January 1, 2007, and 100% for tax years beginning on or after January 1, 2008.

#### H.B. 488

H.B.488 updates meaning of "Internal Revenue Code" to mean the provisions of the Internal Revenue Code provided for in federal law enacted on or before January 1, 2005. Georgia "decouples" from IRC §199 relating to income attributable to domestic production activities.

O.C.G.A. §48-2-35 is amended to "clarify" that no interest will be paid on refunds attributable to credits under Article 2 of Chapter 7 which a taxpayer fails to claim on or before the due date for filing the applicable income tax return.

O.C.G.A. §48-7-21 is amended to disallow *interest* expenses directly or indirectly attributable to the production of non-taxable interest and dividend income on federal obligations. Prior law disallowed "expenses directly attributable to" the production of such income. H.B. 488 also amends § 48-7-21 to provide that the direct and indirect interest expense shall be determined by the ratio of the taxpayer's average adjusted bases of such federal obligations to the average

adjusted bases for all assets of the taxpayer. (Similar amendment to O.C.G.A. § 48-7-27 relating to taxable net income of an individual).

O.C.G.A. §§48-7-31 is amended to impose the corporate income tax upon every corporation owning property within this state, doing business within this state, or *deriving income from sources within this state to the extent permitted by the United States Constitution*. Prior law imposed the tax upon corporations "owning property or doing business within this state."

The provisions of O.C.G.A. §§ 48-7-21(b)(5) and 48-7-27(b)(6) relating to Georgia treatment of like-kind exchanges were deleted, effectively allowing for federal conformity without regard to the location of the replacement property. Prior law required recognition of gain when property located in Georgia was replaced with property located outside of the state.

## **Kentucky**

### House Bill 272

Signed into law on March 18, 2005; most income tax provisions retroactive to tax years beginning on or after January 1, 2005; License tax repealed for tax years ending on or after December 31, 2005; Intangible property tax repealed effective January 1, 2006.

Highlights of corporate tax provisions:

- Phases in a reduction in top corporate income tax rate from 8.25% to 6%. The top rate will be 7% for 2005 and 2006. For tax years beginning on or after January 1, 2007, the top rate will be 6%.
- Expands the definition of "corporation" to include all limited partnerships, limited liability companies, S Corporations and other entities with limited liability for their members, regardless of federal entity classification. There is no pass-through of income, loss or credit to non-individual owners of pass-through entities subject to corporation income tax. Individual partners, members or shareholders of pass-through entities subject to corporation income tax will receive credit for tax paid at the entity level. General partnerships and certain publicly-traded partnerships are excluded from the new definition of corporation.
- Effective for tax years beginning on or after January 1, 2005, "corporations" will now pay the greater of tax on net income, the alternative minimum calculation, or \$175.
- Alternative minimum calculation – annual election to calculate based on 2 methods: (1) \$0.095 per \$100 of Kentucky gross receipts, or (2) \$0.75 per \$100 of Kentucky gross profits.
- Requires the filing of a nexus consolidated tax return for income tax and alternative minimum calculation purposes for members of an affiliated group (80% ownership test) with nexus in Kentucky; this includes the expanded definition of corporation, with limited liability entities included in the affiliated group.
- Existing consolidated return elections will be honored until they expire.
- Current year loss limitation (50%) rules in nexus consolidated return.

- Nexus standard in Kentucky changed from physical presence to “doing business” standard, which includes, but is not limited to:
  - Being organized under the laws of this state;
  - Having a commercial domicile in this state;
  - Owning or leasing property in this state;
  - Having one (1) or more individuals performing services in this state;
  - Maintaining an interest in a general partnership doing business in this state;
  - Deriving income from or attributable to sources within this state, including deriving income directly or indirectly from a trust doing business in this state; or
  - Directing activities at Kentucky customers for the purpose of selling them goods or services.
  
- Certain deductions related to transactions with one or more related members of the affiliated group, including management fees and intangible interest expense, now require disclosure and possible addback; addback not required if certain criteria are met.
- Net operating loss carrybacks are eliminated.
- Requires three factor apportionment with double-weighted sales for all business entities.
- Adopts the Internal Revenue Code in effect on December 31, 2004 except the bonus depreciation provisions
- License tax repealed for tax years ending on or after December 31, 2005.
- Consolidated license tax filing methodology (KRS 136.071) retroactively reinstated to *Illinois Tool Works* decision
- Intangible property tax repealed effective January 1, 2006

## **Louisiana**

### Bridges v. AutoZone Props., Inc.

In *Bridges v. AutoZone Props., Inc.*, 2005 La. LEXIS 688 (La. March 24, 2005), the Louisiana Supreme Court reversed a lower court opinion and held that a Nevada company that received dividend income from a corporate real estate investment trust (REIT) engaging in business activities in Louisiana has personal jurisdiction for purposes of income tax under the Due Process Clause. Louisiana has the authority, under *International Harvester Co. v. Wisconsin Dept. of Taxation*, 322 U.S. 435 (1944) and its long-arm statute to exercise jurisdiction to "tax a nonresident shareholder's investment income based on its investment in a separate corporation engaging in business activities in the taxing state, when the state has provided benefits, opportunities, and protections which contributed to the profitability of the in-state activities."

AutoZone's petition for a rehearing was denied by the Louisiana Supreme Court on May 13, 2005.

## Recently Enacted Legislation

On June 29, June 30, and July 1 Governor Kathleen Blanco signed bills establishing or extending business tax breaks. While not all inclusive, a few of the bills signed include:

### House Bill 679

The Louisiana Headquarters and Growth Act is the single-sales-factor apportionment bill; it is intended to encourage businesses to relocate their headquarters in Louisiana and retain those already in the state. The bill also allows dividends and interest to be deducted from corporate income and allows the apportionment of income from capital gains.

### House Bill 627

Establishes the angel investor tax credit, which offers tax breaks for investment in high-growth start-up companies.

### House Bill 795

Makes businesses considering moving out of state eligible for five-year contracts of exemption from local taxes.

### House Bill 888

Eliminates the corporate tax deduction for dividends paid to owners of real estate investment trusts when 50 percent or more of the trust ownership is held by another REIT or by a single company.

## **Mississippi**

### S.B. 3009

Gain Recognition; Liquidation of Certain Assets. New law amends the income tax code to remove a provision that provides no gain shall be recognized from the liquidation of certain assets of domestic corporations, effective immediately. Specifically, the deleted provision, Miss. Code §27-7-9(f)(10)(B), provided that no gain shall be recognized from the sale of all or at least 90% of the assets in domestic corporations except those assets that represent the ownership interest of another entity provided: (1) the assets of the corporation have been held for more than one year; (2) the corporation is totally liquidated and dissolved within one calendar year from the date of the sale of all or at least 90% of the assets of the corporation; and (3) the depreciation and/or amortization that has been taken on the assets of the corporation shall be recaptured and taxed as ordinary income in the same manner as provided for in IRC §1245. Miss. Laws 2005, S.B. 3009, effective March 29, 2005.

### House Bill 3

On June 3 the Mississippi House and Senate approved HB 3 which now goes to the governor, who is expected to sign it. HB 3 would offer:

- an income tax credit for investments by manufacturers of at least \$1 million in buildings or equipment;
- the addition of data information processing companies and "technology intensive enterprises" to the list of industries that can be granted local sales tax exemptions;
- the addition of technology-intensive enterprises to the list of industries paying the industrial-rate sales tax of 1.5 percent on electricity and fuels; and
- A change to the job creation tax credit from a set dollar amount per job to a percentage of the employer's payroll.

HB 3 also includes a tax credit of \$1,000 per year for 20 years for each new job created by an alternative-fuels manufacturer if at least 50 percent of the product is derived from Mississippi resources or products. A business does not become eligible for the credits until it has 25 full-time employees, and it cannot claim the credit in any year of the 20 years in which the number of employees falls below 25. The credits are not refundable but can be carried forward for five consecutive years.

## North Carolina

### A&F Trademark Inc. v. Tolson

On December 7, 2004, the North Carolina Court of Appeals affirmed a lower court ruling that Delaware intangible holding companies were doing business in the state and, therefore, were subject to corporate income and franchise taxes. Further, the court rejected the taxpayers' argument that the Commerce Clause of the U.S. Constitution forbids the state from imposing the taxes at issue and upheld the requirement that the companies apportion their income using a single sales-factor formula. *A&F Trademark Inc. v. Tolson*, No. COA03-1203 (N.C. Ct. App. Dec. 7, 2004), reviewed denied, NOC0A03-1203 (N.C. Sup. Ct March 3, 2005).

Specifically, the court held that administrative Rule 17 NCAC 5C.0102 provides that the term "doing business" means the operation of any business in the state for economic gain, including owning or renting income producing property such as trademarks and trade names in the state. The holding companies argued that Rule 17 NCAC 5C.0102 "is of no consequence" because year 2001 amendments to the income tax statutes indicate "that the agency's rule [improperly] expanded the income tax statute" instead of interpreting it, and that the only possible purpose for the 2001 amendments was to "cover the receipt of royalty income from the in-state use of licensed trademarks." In rejecting this argument, the court found that the 2001 amendments endorsed rather than changed the scope of the income tax statute, stating that "the [2001] bill clearly denotes that its function was to enhance compliance 'with the State tax on income generated from using trademarks in [manufacturing and retailing] activities' ... [and] the stated purpose was merely to add a reporting option to the income tax statute, not to modify or change what constituted taxable income."

The court also held that the imposition of franchise taxes by the revenue department does not exceed the department's statutory authority. The state's franchise tax is imposed on every corporation doing business in the state for the opportunity and privilege of transacting business in the state. The court held the "[i]t is beyond dispute that North Carolina has provided privileges and benefits that fostered and promoted the related retail companies. By affording these benefits to the related retail companies, additional benefits have inured to the [holding companies]." Further, the court agreed with the broad rationale accepted by the South Carolina Supreme Court in *Geoffrey, Inc. v. South Carolina Tax Commission*, 437 S.E.2d 13 (1993), that by providing an orderly society in which the related retail companies conduct business, North Carolina has made it possible for the taxpayers to earn income pursuant to the licensing agreements.

The court also disagreed with the holding companies' argument that the presence of their intangible property in North Carolina is irrelevant in light of the lack of physical presence of offices, facilities, employees, and real or tangible property, and that *National Bellas Hess, Inc. v. Department of Revenue*, 386 U.S. 753 (1967) and *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992) mandate that the court find the imposition of tax violates the Commerce Clause. In rejecting the holding companies contention, the court refused to expand the scope of the physical presence test of *Quill* beyond sales and use taxes, stating that "there are important distinctions between sales and use taxes and income and franchise taxes 'that makes the physical presence test of the vendor use tax collection cases inappropriate as a nexus test.'" Ultimately, the court rejected the contention that physical presence is the sine qua non of a state's jurisdiction to tax under the Commerce Clause for purposes of income and franchise taxes. Rather, the court held that "under facts such as these where a wholly owned subsidiary licenses trademarks to a related retail company operating stores located within North Carolina, there exists a substantial nexus with the State sufficient to satisfy the Commerce Clause."

Lastly, the court upheld the use of a single sales factor apportionment formula, finding that the holding companies were properly found to be excluded corporations (i.e., a corporation that receives more than 50% of its income from investments in or dealing in intangible property).

#### DOR Directive - Investment Partnerships

The Department of Revenue issued a directive to clarify when a partnership is an "investment partnership" for North Carolina tax purposes. An "investment partnership" is a partnership in which all income or loss is derived from changes in the value of its investments in intangible assets or from intangible income derived from the assets in which the partnership invests and such income is solely for the benefit of the partnership's owners. A partnership will not qualify as an "investment partnership" for North Carolina income tax purposes if any of the partnership's income is from other activities, either within or outside North Carolina or either received directly or flowing through from other pass-through entities. "Other activities" include providing services or products to customers and holding real property for appreciation and income. N.C. Dept. of Rev., PD-04-2 (Nov. 4, 2004), this directive supplements and clarifies Directive PD-02-1 (Nov. 6, 2002).

## S.B. 51

New law requires a corporation or an affiliated group of corporations that own 70% or more of the capital interests in a limited liability company (LLC) to include in its three tax bases pursuant to N.C.G.S. § 105-122 the same percentage of: (i) the LLC's capital stock, surplus, and undivided profits; (ii) 55% of the LLC's appraised ad valorem tax value of property; and (iii) the LLC's actual investment in tangible property in the State. Ownership of the capital interest in a LLC is determined by reference to the constructive ownership rules for partnerships, estates and trusts with some modifications. If a corporation is required to include a percentage of an LLC's assets in its tax bases, its investment in the LLC is not included in its computation of capital stock base under N.C. G.S. §105-122(b). If the owner is an affiliated group of corporations, the percentage to be included by each group member that is doing business in North Carolina is determined by multiplying the capital interests in the LLC owned by the affiliated group by a fraction. The numerator of the fraction is the capital interest in the LLC owned by the group member, and the denominator of the fraction is the capital interest in the LLC owned by all group members that are doing business in the state. This section does not apply to assets owned by an LLC if the total book value of the LLC's assets never exceeded \$150,000 during its taxable year. These provisions are retroactively effective to January 1, 2003 and apply to taxes due on or after that date. Effective January 1, 2005, the ownership percentage is reduced from 70% or more to 50% or more. N.C. Laws 2004, Ch. SL 2004-74 (S.B. 51), enacted July 8, 2004.

## **Tax Incentives and Credits**

### Computer Manufacturing Credit

On November 5, 2004, Governor Mike Easley approved Senate Bill 2 ("S.B.2") which provides a tax credit for certain major computer manufacturing facilities and enhances certain existing tax incentives for those facilities. S.B. 2 creates a new credit for large computer manufacturers that can be taken against the corporate income or franchise tax. In order to be eligible for the credit, the Secretary of Commerce must determine that the taxpayer will increase its employment level by at least 1,200 new, full-time jobs within five years of when the property is first used as a computer manufacturing and distribution facility. It also must be determined that the taxpayer, directly or indirectly through "strategic partners" and related entities, has or will invest at least \$100 million in private funds to construct a computer manufacturing and distribution facility in North Carolina over a five year period. In order to qualify for the credit, the taxpayer, as well as its strategic partners and related entities, must pay at least 50% of the health insurance premiums for its full-time employees, must have no outstanding OSHA citations at the new facility, and must have no overdue tax debts. In addition, S.B. 2 modifies the existing sales tax refund provision to amend the definition of computer manufacturer for purposes of a sales tax refund on construction to include such a company's related entities and strategic partners. It also adds printers to the items that can be manufactured at a facility to qualify as a computer manufacturer and be eligible for the refund. N.C. Laws 2004, Ch. SL 2004-204 (S.B. 2), enacted Nov. 5, 2004.

## Challenges to Tax Incentives

The developer of a North Carolina shopping center that features a Wal-Wart has filed a suit challenging certain tax incentives and alleging that the City and County of Wilson violated a number of constitutional and statutory provisions. *Westwood Village Ltd. Partnership v. City of Wilson*, No. 5:05-CV-100-BO(1) (E.D.N.C. filed Feb. 10, 2005). The suit arose when the city and county of Wilson gave a rival shopping center developer a \$2 million incentive package to build a shopping center that features a Target.

In addition, former North Carolina Supreme Court Justice Robert Orr has filed a lawsuit challenging the recent state incentive package enacted to encourage Dell Computer to build a manufacturing and distribution facility in the state.

### S.B. 622 (Proposed - Conference Committees Appointed)

Includes IRC Conformity as of 1/1/05 (excluding Section 199 Manufacturing Deduction), sales throw-out provision, property factor throw-out of outer-jurisdictional property, and a reduction of the corporate income tax rate. The Senate's budget legislation, S.B. 622 (Part XXXVIII), was passed on May 5. The legislation includes several positive changes for business, including a reduction in the corporate income tax rate and conformity to certain changes to the IRC. Senate Bill 622 also introduces a "throw-out rule." S.B. 622 defines "outer-jurisdictional property" and removes it from both the numerator and the denominator (Sec. 38.2.(a) and (b)). The legislation also removes from the denominator sales to a state in which the taxpayer is not taxable (Sec. 38.2.(c)). Sales to the United States government would remain in the denominator regardless of the taxpayers' tax status in another state. The Legislature subsequently acknowledged that its original estimate for throw-out (\$10 million) was extremely low, and one Senator indicated that the issue would have been more closely scrutinized if Senators had known it was a bigger issue (the new est. is \$45 million). The House, which passed its version of S.B. 622 on June 16, removed the throw-out provisions. The bill will now go to conference.

## **South Carolina**

### H. 3007,R. 44; Act #41

Reduces tax rate for individuals and other entities (other than C corporations) over a four year period from 7% to 5% for active trade or business income (including income from partnerships, etc). Such income does not include passive investment income, capital gains and losses and for personal services.

<u>Taxable Year Beginning in</u>	<u>Rate of Tax</u>
2006	6.5 percent
2007	6 percent
2008	5.5 percent
after 2008	5 percent

#### H. 3767, R. 188

This Act is one of the two annual Department of Revenue bills.

**Interest Addback.** Section 22 of H.B. 3767 disallows a deduction for the accrual of an expense or interest if the payee is a related person and the payment is not made in the taxable year of accrual or before the payer's income tax return is due, without regard to extensions, for the taxable year of accrual. The disallowed deduction is allowed when the payment is made. The holder must include the payment in income in the year the debtor is entitled to take the deduction. The exception, unless the revenue director is satisfied that tax avoidance is not a significant purpose of the transaction, an interest deduction is not allowed for the accrual or payment of interest on obligations issued as a dividend or paid instead of paying a dividend. This interest must be treated as a dividend to the debtor's shareholders when it is paid, and if the holder of the obligation is not a shareholder at the time, a payment from the shareholders to the holder at that time. Further, this section does not apply to payments deemed to be made by the application of the state's adoption of IRC §482, 7872, a similar provision of the IRC or state law. These provisions apply to taxable years beginning after 2005. S.C. Laws 2005, Rat. 188 (H.B. 3767), became law without the governor's signature on June 9, 2005.

#### H. 3768, R. 150

This Act is the second of the two annual Department of Revenue bills.

**IRC Conformity; Dividends; Allocation.** Provisions of H.B. 3768 adopts the IRC as amended through December 31, 2004, but specifically decouples from a number of IRC provisions, including sections 199 and 965. In addition, H.B. 3768 changes how dividends are allocated. Applicable to taxable years beginning after 2004, dividends received from corporate stocks not connected with the taxpayer's business, less all related expenses, are allocated to the state of the corporation's principal place of business or the domicile of an individual taxpayer. Under prior law, all dividends were allocable regardless of their relationship to the taxpayer's business. S.C. Laws 2005, Rat. 150 (H.B. 3768), enacted on June 7, 2005.

#### H. 3006, R. 207 (Act 157), enacted June 10, 2005

##### *Distribution Facility Incentive*

For income tax and corporate license fee purposes, new code section 12-6-60 is added to provide that whether or not a person has nexus with South Carolina is determined without regard to whether the person: (1) owns or utilizes a distribution facility within the state; (2) owns or leases property at a distribution facility within the state that is used at, or distributed from, that facility; or (3) sells property shipped or distributed from a distribution facility within the state. The distribution facility is not considered to be a fixed place of business in South Carolina for the purpose of nexus.

For sales and use tax purposes, new code section 12-36-2690 is added to provide that “owning or utilizing a distribution facility within South Carolina is not considered in determining whether the person has physical presence in South Carolina sufficient to establish nexus with South Carolina for sales and use tax purposes.”

Pursuant to S.C. Code §12-6-3360, a distribution facility is defined as "an establishment where shipments of tangible personal property are processed for delivery to customers. The term does not include an establishment where retail sales of tangible personal property are made to retail customers on more than twelve days a year except for a facility which processes customer sales orders by mail, telephone, or electronic means, if the facility also processes shipments of tangible personal property to customers and if at least seventy-five percent of the dollar amount of goods sold through the facility are sold to customers outside of South Carolina." This provision applies to tax years beginning January 1, 2006.

### *Jobs Tax Credit*

For jobs tax credit available to taxpayers that employ 99 or fewer employees, the required increase in full time jobs is reduced from 10 to 2. Applicable for tax years beginning January 1, 2006.

### *Capital Access Program*

Creates a program to provide loan loss reserves from a state fund to assist participating financial institutions making loans to small businesses located in South Carolina that otherwise find it difficult to obtain regular bank financing.

Act 157 provides a five year sunset from the date of enactment for each incentive enacted by the act, unless a different time frame is otherwise provided.

## **Tennessee**

### Tennessee Legislation

#### *Overview of 2005 Enactments*

- IRC Sec 199 Decoupling-
  - Decouples TN excise tax from the federal income tax deduction for income attributable to domestic production activities.
  - Public Chapter 499, Sec. 64. (effective June 22, 2005)
  
- Excise Tax Deduction for Certain Charitable Donations
  - Excise tax deduction for 75% of the value of charitable donations made to certain IRC 501(c) organizations;
  - Only applies to monetary donations;
  - Nonprofit entity must certify that donation has been spent to purchase goods and services on which TN sales and use taxes were actually paid;

- Public Chapter 98 (effective July 1, 2005, applicable to tax years beginning on or after July 1, 2005.)
- Annual Franchise Tax Capped for Manufacturers
  - Manufacturers will be subject to franchise tax only on the first \$2 billion of apportioned net worth or tangible personal property in Tennessee (i.e., caps liability at \$5 million)
  - Public Chapter 499, Sec. 61. (Effective for tax periods ending after December 31, 2005)
- Franchise Tax Proration Codification
  - Entities triggering nexus mid-year will be allowed to prorate franchise tax.
  - Entities that have a change in their accounting period covered by the federal return will be allowed to prorate.
  - Public Chapter 499, Sec. 82 (effective June 22, 2005).
- Sales and Use Tax
  - Streamlined Sales and Use tax Agreement (SSUTA) was delayed until July 1, 2007 per Public Chapter 311.
  - Sales tax liability threshold for electronic funds transfer paying requirement is reduced from \$10,000 to \$5,000 (Public Chapter 131, effective May 4, 2005)

#### *2004 Legislative Enactments*

- Royalty Expense Identification
  - Applies to intangible expenses that are paid, accrued, or incurred in connection with a transaction with an affiliated entity;
  - An entity making such a payment is required to add back the intangible expense to its federal taxable income starting point, and disclose the specifics surrounding the payment on a new schedule to be attached to the TN tax return;
  - If added back and properly disclosed as set forth above, the intangible expense may then be subtracted;
  - For taxpayers that do meet the disclosure requirements, the Commissioner is required to make the adjustment for them;
  - The Commissioner has the authority to impose penalties of up to 50% for negligence and/or failure to disclose;
  - Tennessee Laws 2004, Ch. 924 (effective for tax years beginning on or after January 1, 2004).
- Elimination of Deduction for Investment in other TN Taxpayers
  - Tennessee Laws 2004, Ch. 932 eliminated the deduction from the net worth franchise tax base for a taxpayer's investment in other Tennessee taxpayers, applicable to all tax years beginning on or after January 1, 2004.

- Elective Consolidated Franchise Tax filing Methodologies
  - Tennessee Laws 2004, Ch. 932 enacted an elective consolidated franchise tax filing methodology.
  - Effective for tax years beginning on and after January 1, 2004, a taxpayer that is a member of an affiliated group or a financial institution affiliated group may elect to file a consolidated franchise tax return provided that upon such election, each member of the group computes its net worth on a consolidated basis.
  - An affiliated group includes the Tennessee taxpayer and all other “domestic” persons: (1) in which the taxpayer, directly or indirectly, has more than 50% ownership, or (2) which, directly or indirectly, have more than 50% ownership of the taxpayer and includes all other domestic person in which such person has more than 50% ownership interest, regardless of whether such persons do business in Tennessee. (An entity is “domestic” if it has more than 20% of the average of its property, payroll and receipts factors in the U.S.).
  - **2005 Update:** The law was amended in 2005 to state that the election will **not be allowed unless each member of the affiliated group closes its taxable year on the same date** (There is a limited exception: When an entity leaves the group due to a change in ownership, merger or liquidation, the exiting member is excluded from the group and is required to compute its net worth on a separate company basis.) (Public Chapter 499, Sec. 80)

#### Recent Judicial Authority

- *Pfizer v. Ruth Johnson*, Davidson County Chancery No. 01-2385-II (December 10, 2003)
  - All counties and most municipalities in Tennessee levy the business tax, which is a locally-imposed gross receipts tax on the sale of certain goods and services.
  - At issue in Pfizer was whether the tax is imposed on a sale by one wholesaler to another, or whether the tax is imposed only on the last wholesale sale (i.e., the sale to the retailer);
  - The Davidson County Chancery Court ruled that the tax was applicable to a wholesaler-to-wholesaler sale;
  - The taxpayer appealed the decision to the Tennessee Court of Appeals, where it was argued May 4, 2005. No decision has been issued yet.
- *Sodexo Management, Inc. v. Ruth Johnson*, 2004 Tenn. App. LEXIS 729 (May 7, 2004).
  - The Tennessee Court of Appeals ruled that the taxpayer was liable for contractors use tax on the equipment it used to provide food services for a university cafeteria;
  - The Court determined that the taxpayer was an independent contractor rather than an agent of the university and thus liable for the tax. The case was fact specific. The taxpayer’s request for permission to appeal to the Tennessee Supreme Court was denied on May 2, 2005.

- *Dillard National Bank v. Ruth Johnson*, Davidson County Chancery No. 96-545-III (June 23, 2004).
  - Similar to the ultimate issues in the *JC Penny National Bank* and *America Online* cases, the issue in Dillard's was whether the taxpayer had sufficient physical presence in Tennessee to create substantial nexus for franchise, excise tax purposes;
  - The Chancery Court ruled that taxpayer had substantial nexus based on the activities of its own employees, third party contractors, and other agents acting on its behalf;
  - Although the taxpayer had appealed the decision to the Tennessee Court of Appeals, the appeal was voluntarily dismissed on May 9, 2005.

## **Virginia**

### General Motors Corporation v. Commonwealth

In *General Motors Corporation vs. Commonwealth of Virginia*, 268 Va. 289 (2004), the court held that a Virginia Department of Taxation regulation, 23 VAC §10-120-250, was inconsistent with Va. Code § 58.1-418 when it limited the costs of performance used to apportion income of a financial corporation to direct costs, excluding costs of independent contractors. The Department stipulated to the amount of such costs that were included in the return filed by General Motors, and the issue of the proper criteria for assigning costs of independent contractors was not before the Court.