



BDO Seidman, LLP  
Accountants and Consultants

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# State and Local Tax Alert

## Subject: Mid-year Update

BDO Seidman presents a recap below of important recent state and local tax developments.

### **New York Accelerates Adoption of Single Sales Factor**

The New York governor recently adopted New York's 2007-2008 budget (A. 4310-C / S. 2110-C). The recently adopted budget makes a number of changes to the tax law, including a key provision that would implement 100% single sales factor apportionment for business allocation purposes. The adoption of this provision is significant since the sales factor was previously scheduled for implementation on or after January 1, 2008.

### **U.S. Supreme Court Will Review Kentucky Muni-Bond Case**

On May 21, 2007, the U.S. Supreme Court agreed to review an important Kentucky municipal-bond tax decision. In 2006, the Kentucky Court of Appeals held that the state cannot exempt interest on bonds issued within Kentucky and tax interest on non-Kentucky municipal bonds. The court stated that this statutory taxing scheme is facially unconstitutional and is in violation of the U.S. Commerce Clause. The Kentucky Supreme Court denied review of this case in 2006. The U.S. Supreme Court will probably render a decision sometime during 2008. This case has national importance because most states have similar municipal-bond laws. Taxpayers seeking to preserve their right to claim potential refunds for prior tax periods may wish to consider filing "protective-refund claims." Department v. Davis (cert. granted May 21, 2007).

### **U.S. Supreme Court Declined to Review Two Nexus Cases**

On June 18, 2007, the U.S. Supreme Court declined to review two economic nexus cases. The Court's refusal to address these cases is important because the question of whether states can impose a business tax on corporations with no physical presence in the state was left open by the U.S. Supreme Court in Quill Corp., 504 U.S. 298 (1992).

In particular, the U.S. Supreme Court declined to review a West Virginia Supreme Court of Appeals decision holding that a bank engaged in issuing/servicing major credit cards had "substantial nexus" with West Virginia for purposes of the Commerce Clause even though it had no physical presence. FIA Card Services NA (formerly known as MBNA America Bank NA) v. Tax Commissioner of West Virginia, 640 SE 2d 226 (2006), cert. denied, (U.S. June 18, 2007) (No. 06-1228).

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For more information, please contact:

#### **Jon Zefi**

360 Madison Avenue  
New York, NY 10017  
Phone: 212-885-7488  
[jzefi@bdo.com](mailto:jzefi@bdo.com)

#### **Bevin Meade**

360 Madison Ave  
New York, NY 10017  
Phone: 212-885-7487  
[bmeade@bdo.com](mailto:bmeade@bdo.com)

#### **Wallace Truesdale**

360 Madison Ave  
New York, NY 10017  
Phone: 212-885-7227  
[wtruesdale@bdo.com](mailto:wtruesdale@bdo.com)

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In addition, the Court declined the opportunity to review Lanco, Inc. v. Director, Division of Taxation, N.J. S. Ct. (2006) 188 NJ 380, cert. denied, (U.S. June 18, 2007) (No. 06-1236). In Lanco, the New Jersey Supreme court held that New Jersey could subject a foreign corporation with no physical presence in New Jersey to business tax because the corporation derived income through a licensing agreement with a company that conducted retail operations in New Jersey. Lanco, Inc. v. Director, Division of Taxation, N.J. S. Ct. (2006) 188 NJ 380, cert. denied, (U.S. June 18, 2007) (No. 06-1236).

The Supreme Court's inaction in this situation is relevant because the above cases represent taxpayer uncertainty surrounding the ability of a state to impose business taxes on a company with no physical presence will remain until the Supreme Court reviews a case or Congress enacts legislation.

### **New Jersey's Throwout Rule Being Challenged**

New Jersey's tax court will hear summary judgment motions in cases concerning New Jersey's throwout rule, which was enacted in 2002 as part of the state's Business Tax Reform Act. Companies such as Pfizer and General Engines are challenging the constitutionality of the controversial throwout rule by arguing that the rule is facially unconstitutional. Experts believe that these challengers have a high possibility of success, which could result in refund claims and reduced exposure for taxpayers such as holding companies.

### **Texas Transition Rule: Wind Down of Partnership Yields One Time Savings**

Most partnerships are now subject to the new Texas Franchise (Margin) Tax, but a timely liquidation of a partnership can save a taxpayer up to six months of Texas Franchise Taxes.

Texas recently passed a Technical Correction Bill to the new Texas Franchise Tax and included in the bill a clarification of a transition rule. Under the transition rule, certain partnerships will not be subject to the new Texas Franchise Tax if the partnership is merged or liquidated out of existence prior to June 30, 2007. However, post merger or liquidation operations of the partnership will be subject to the Franchise Tax if the partnership is liquidated or merged into a taxable entity.

The one-time savings opportunity applies to both stand alone partnerships and partnerships included in a combined group. Thus, for combined report Taxpayers, if a partnership is liquidated into corporate members of the combined group before June 30, 2007, the combined group can exclude from the 2008 report all pre-liquidation revenue of the partnership.

### **Michigan Can Continue to Apply Its Retroactive Application of the Single Business Tax Nexus Standard**

The Michigan Supreme Court declined to review J.W. Hobbs Corporation v. Department of Treasury, a case challenging the retroactive application of Michigan's SBT nexus standard, which in July 2006 the Court decided to wait to hear the case until the its decision in International Home Foods. In International Home Foods, which was decided on January 5, 2007, the Michigan Supreme Court held that Michigan's Single Business Tax (SBT) nexus standard can be applied retroactively. This case is significant because although the SBT has been repealed, these provisions can still impact taxpayers by retroactive application of its standards. The holding in this case represents current law.

### **Illinois Bill Makes Significant Changes**

The Illinois Senate approved a bill (S.B. 1544) that would have the following impacts on Illinois taxpayers: (1) expand the interest and intangible expense add-back provisions to include payments made to persons that would otherwise be in the same unitary group as the payor but for the "like-apportionment" rule contained in the definition of a unitary business; (2) disallow the dividends paid deduction for captive REITs; (3) disallow certain insurance premiums expenses and costs otherwise allowed as a deduction that were paid, accrued, or incurred, directly or indirectly to a person who would be in the same unitary business but for "like-apportionment" rule in the definition of a unitary business group; (4) change the apportionment sourcing rules for sales other than sales of tangible personal property, financial organizations, and transportation companies; and (5) require nonresident withholding by partnerships and S Corporations. S.B. 1544 was approved by the General Assembly on May 31, 2007 and has to be approved by the Governor before becoming effective.

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### **California – Income Tax: Bill Would Repeal Interest Offset Rule**

The California Assembly has passed a bill that, if enacted, would prospectively repeal the interest offset rule for California corporation franchise and income tax purposes beginning with the 2008 taxable year. If the bill is enacted, the amount of an apportioning California corporation's income subject to taxation would increase because the interest offset deduction would no longer automatically reduce the amount of its nonbusiness income allocable to California. Instead, interest expense would either be deducted from business and/or nonbusiness income to which it can be directly traced or prorated among business income and nonbusiness income in a manner that fairly distributes the deduction. The California Franchise Tax Board estimates that, if passed, the bill would raise less than \$250,000 during the 2007-08 fiscal year, \$1 million during the 2008-09 fiscal year, and \$2 million during the 2009-10 fiscal year.

### **A Trend Toward Mandatory Combined Reporting**

There is a growing trend for states to mandate combined reporting. This trend reflects an effort by states to more accurately measure the income of entities that operate in multiple jurisdictions. The following is a brief list of recent combined reporting legislation:

- **West Virginia:** On March 10, 2007, both the House and Senate approved a bill (S.B. 749) that would mandate taxpayers engaged in a unitary business with one or more other corporations (with a water's-edge election) to file a combined report for corporate income tax purposes. The Tax Commissioner has discretion to require the combined report to include the income and associated apportionment factors of any persons that are not included in the group, but that are members of a unitary business, in order to reflect proper apportionment of income of the entire business.
- **Missouri:** A new law (S.B. 642) would require a corporation doing business in Missouri that is a member of a unitary group, to file a water's-edge combined report. A group of corporations that are not otherwise a unitary group would be allowed to elect to file a water's edge combined report if each member of the group is: (a) doing business in Missouri; (b) part of the same affiliate group; and (c) qualified pursuant to IRC Sec. 1501 to file a consolidated return
- **Vermont:** A tax bulletin issued by the Department of Taxes provides information on how transactions between members of a unitary combined group are treated for purposes of determining: (1) the taxable business income of the unitary combined group, and (2) the Vermont apportionment percentage of the unitary combined group. In general, for purposes of determining the taxable business income of the unitary group, intercompany transactions are deferred in a manner similar to federal law (see Treas. Reg. 1.1502-13). The purpose of this rule is to clearly reflect the taxable income of the combined group as a whole by preventing intercompany transactions from creating, accelerating, avoiding or deferring combined taxable income.
- **Pennsylvania:** Legislation introduced in the Pennsylvania House on May 1, 2007 (H.B. 1186) would mandate unitary combined reporting for corporate net income tax purposes, effective for taxable years beginning on or after January 1, 2009.
- **New York:** The New York Department of Taxation and Finance has issued a corporate memorandum explaining the combined reporting rules applicable to Article 9-A general business corporations, effective for tax years beginning on or after January 1, 2007. The law requires a taxpayer to file on a combined basis with related corporations if there are substantial intercompany transactions among the related corporations.