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State Income Tax ALERT

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INSIDE

BONUS INSERT

Many states require withholding for nonresident members and partners of flow-through entities. *State Income Tax Alert* has included with this issue a bonus insert that lists each state's rules concerning nonresident member/partner withholding.

COMING IN FUTURE ISSUES

- Update on pass-through entity developments
- New York budget bill enacted
- West Virginia mandates combined reporting

■ MORE RETROACTIVE LEGISLATION

Kentucky passes legislation barring refunds resulting from *Johnson Controls* decision

Kentucky is once again trying to avoid paying refunds that should result from a decision by one of its courts.

Recent legislation (HB316) bars refund payments to taxpayers that filed amended returns for reimbursement of taxes they overpaid during the period that the Kentucky Revenue Cabinet's policy did not allow them to file unitary returns. The Kentucky Court of Appeals ruled last year in *Johnson Controls* that 2000 legislation which allowed the state to retroactively disallow those amended returns was invalid because the period of retroactivity was excessive and, thus, violated the Kentucky Constitution by depriving a group of corporations of due process. The state has appealed to the Kentucky Supreme Court, which has not yet decided whether to hear the case.

Richard Pomp, a professor at the **University of Connecticut Law School**, considers HB316 to be "an outrageous attempt by a state to steal refunds that a taxpayer was entitled to …

"The business community should be up in arms and the national media should crucify the Kentucky Legislature," he continues. "This is an affront to fairness and due process."

Legislative history

In 1988, the Kentucky Revenue Cabinet issued a policy statement that "effectively halted the filing of combined [unitary] returns," which had been allowed since 1972. However, as a result of a 1994 Kentucky Supreme Court decision in *GTE*, unitary businesses were allowed to resume filing unitary tax returns in Kentucky.

In response to the *GTE* decision, Johnson Controls and 25 other businesses involved in the *Johnson Controls* case filed amended tax returns to claim refunds for the years that the cabinet's policy did not allow them to file unitary returns. The cabinet took no immediate action on those claims.

In 1996, at its next regular session following the *GTE* decision, the Kentucky General Assembly enacted HB599, which abolished unitary returns for tax years after Dec. 31, 1995. That legislation had no effect on the *Johnson Controls* appellants' pending claims since they were based on years prior to those affected by HB599. Their claims were *still* pending when the General Assembly convened for its 2000 session.

In 2000, HB541 was enacted to retroactively prohibit the filing of amended returns to change from separate to unitary filing for 1994 and prior years, and provided that a refund claim based on such a change in filing status would have no force and effect. HB541 retroactively extinguished the appellants' pending refund claims. Since the appellants filed for refund of overpayments for the four years preceding the GTE decision, HB541's period of retroactivity was actually about five to nine years. The Kentucky Court of Appeals found that period to be excessive.

The sovereign immunity issue

Last month, Kentucky passed HB316, which bars the payment of any claim for recovery, refund or credit of corporation income tax for any tax year ending before Dec. 31, 1995, made by an amended return or any other method after Dec. 22, 1994, and based on a change from any initially filed separate return or returns to a unitary combined return or to a consolidated return.

In addition, the law revokes and withdraws Kentucky's stated or implied consent to suit in any forum or to any legal, equitable or other relief with respect to any such claim. In effect, the state is, 13 years after *GTE*, legislatively claiming sovereign immunity.

Mark Sommer, chair of the tax practice at **Greenebaum Doll and McDonald PLLC** in Louisville, Ky., believes the legislation is goal-oriented, objective-driven, and incredibly bad tax policy that will be challenged in the courts.

"If you look at the *Johnson Controls* opinion out of the Court of Appeals and look at the state's argument of sovereign immunity, the court all but ignored it and [indicated] the state waived sovereign immunity," Sommer points out. "That was code, via a judicial footnote, to everyone else that you are going to lose that argument if it goes up to the Kentucky Supreme Court. The General Assembly turns right around and tries to 'close the loophole' created by the court opinion and pass this retroactive sovereign immunity defense. They decided they had better take an affirmative, very strong legislative step to demonstrate that 'We believe sovereign immunity is here and we want it here,'" he suggests.

Sommer believes that if the Kentucky Supreme Court decides to hear the *Johnson Controls* appeal, the Revenue Cabinet is likely to vigorously argue sovereign immunity.

"It would point to this very bill that just took effect a week ago and say, 'Look, the General Assembly has said they have not waived sovereign immunity. Therefore, you have to rule in our favor.'"

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More of the same

Sommer points out that the General Assembly has attempted to legislatively overrule tax cases in Kentucky time and time again.

"They are still fighting about giving refunds that were created as a result of the *GTE* decision in 1994," he notes. "This is once again a legislative act designed to thwart refunds that arose as a result of *GTE*. They have tried to bar refunds retroactively. The issue of retroactivity, however, goes right back to the core issue in the *Johnson Controls* case. It has to be a modest period of retroactivity or it violates due process."

Sommer adds that the General Assembly has also barred refunds on a special circumstances basis.

"For example, if a court case came out on Dec. 13 of a year, two months later they may draw up a bill that says this is the law now, and any refund claims filed on or after Dec. 14 of last year are barred. So while not making it retroactive per se, they are trying to cut it short. I just think it is bad tax policy because you don't have certainty in your tax laws in Kentucky."

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Business taxes on the rise

Businesses paid $554 billion in total state and local taxes in fiscal year 2006, an increase of more than 10% since FY 2005, according to a recently released study prepared by Ernst & Young LLP in conjunction with the Council On State Taxation. Businesses paid 44.9% of total taxes collected by all state and local governments.

The increase in business taxes since FY 2002 has accounted for nearly half of the increase in total state and local taxes, with property taxes and sales tax on business inputs accounting for most of the increase in business taxes. Property taxes on business property accounted for 37% of total state and local taxes on businesses in FY 2006, while sales and use taxes on business inputs, including capital equipment, represented almost 23% of business taxes during the same period. Corporate income taxes represented 9% of business taxes nationally, while individual income taxes paid by owners of pass-through entities represented 4% of total state and local business taxes in FY 2006. ◆

State tax reporting of IRS adjustments

The following article is an excerpt from a column contributed by Brian Ertmer and Ruth Kallio-Mielke with Deloitte Tax LLP for the March-April 2007 issue of the JOURNAL OF STATE TAXATION.

The final determination of an IRS audit resulting in a change to a taxpayer's federal taxable income generally brings with it the obligation to amend state filings consistent with the federal changes. Other events impacting federal taxable income that may create an obligation for a taxpayer to amend state returns include a partial agreement to federal adjustments and the filing of amended federal income tax returns.

Final determination date

The finalization of an IRS audit will generally trigger a taxpayer obligation to notify, within a specified time period, those states where the taxpayer had filed returns during the period(s) covered by the IRS audit. Although the various states may have specific notice format requirements, generally speaking there are some common characteristics. Typically, if federal changes have no impact on state income tax filings, notice may be satisfied with a letter and copies of final IRS documents. If state filings are impacted, then a taxpayer may have to file amended state tax returns.

Determination of the federal audit "finalization" date can often be confusing. Generally, once a corporation agrees to all IRS audit adjustments included in the Revenue Agent's Report (RAR) for all tax years under any audit cycle, it will have an authorized officer sign IRS Form 870. In some states, the date indicated on Form 870 becomes the date that an IRS final determination occurs for state notification purposes. If the Form 870 indicates a net overassessment (refund) of $2 million or more, the IRS audit recommendation of the refund will be sent to the U.S. Congress Joint Committee on Taxation for approval. In this situation, a final determination will generally not occur until the Joint Committee on Taxation's approval is obtained.

How a state interprets the concept of an IRS final determination date is further complicated in states that either do not define the term at all or provide definitions that can be vague or convoluted. For example, Texas is specific and requires a corporation whose federal income tax return is adjusted as a result of an IRS examination or other competent authority to file an amended report no later than 120 days after "the date the revenue agent's report or other adjustment is final. For purposes of this subsection, a revenue agent's report or other adjustment is final on the date on which all administrative appeals with the Internal Revenue Service or other competent authority have been exhausted or waived."

Similarly, Colorado generally defines a final determination as the first of the following to occur:

- a taxpayer's execution of a waiver with and acceptance by the IRS of restrictions and collection of deficiency in federal tax or acceptance of overassessment of tax,
- the acceptance by the IRS of an offer of waiver of restrictions on assessment and collection of deficiency in tax or acceptance of overassessment,
- the payment of any additional tax by the taxpayer, or
- any judgment becoming final in any judicial proceeding affecting change in reported federal taxable income.

Several other states offer explanations of a final determination (or similar such term) including California, New Hampshire, Pennsylvania and Wisconsin.

Conversely, almost half the states imposing an income tax include the words final determination (or similar term) in their reporting statutes without clearly defining the term. In these states, determining when to report the IRS adjustments can be difficult. For guidance, it may be reasonable for taxpayers to look to the IRC and other federal authority to understand when an IRS audit is considered final.

Partially agreed adjustments

Instead of agreeing to the RAR's proposed adjustments in their entirety, a taxpayer may agree to a portion of the adjustments. A few states have determined that a taxpayer has an obligation to report the partially agreed-to adjustments within the same time limits specified when an entire audit is agreed to by the taxpayer. For instance, Florida regulations provide that taxpayers that have agreed to some adjustments on a federal audit, but are protesting other items, must file amended Florida returns within 60 days to report the agreed-to adjustments. Depending on the outcome of the protest, another amended return may be required to be filed within 60 days of the date the assessment becomes final. New Jersey requires reporting within 90 days of acceptance of any portion of a deficiency. Taxpayers may be able to negotiate with the states in certain circumstances to allow the taxpayer to file one amended return instead of two.

Amended federal tax return

If a taxpayer files an amended federal tax return, states may require the taxpayer to file an amended state tax return to report the changes in federal taxable income. However, many of these states will not accept the state amended return until the amended federal return is accepted by the IRS. Sometimes, the IRS will include an amended federal return in a current IRS examination, which delays the technical "acceptance" of such return. In these situations, the state generally will require the amended state return to be filed once the IRS exam is considered final. Since most amended federal tax returns are filed to report a decrease in taxable income, it is understandable why states choose not to accept a state amended return resulting in a taxpayer refund until the amended federal return is agreed to by the IRS.

Timing

Once an IRS final determination has been reached, most state and local taxing jurisdictions require that state/local income tax returns be amended to reflect the changes made to a corporation's federal taxable income. Each state/local taxing jurisdiction has its own requirements for reporting RAR adjustments. As a result, taxpayers should review each state's statues and regulations to determine the state due date and the format required to report RAR adjustments, especially if the taxpayer is expecting to file a refund claim. A number of states require notification or amended returns to be filed as soon as 30 days after the IRS audit is final (e.g., Arkansas, Colorado, Kentucky, Mississippi, Pennsylvania and Vermont) while over half of the states require notification within 90 days of the IRS audit finalization date. Other states, such as California, Georgia, Kansas, Minnesota, New Hampshire and South Carolina, require notification within six months. The effective date of recent state statutory changes may also impact a taxpayer's reporting due date. For example, in North Carolina, if the IRS audit was considered final before July 1, 2006, the taxpayer has two years to file an amended state return. If the IRS audit is considered final after that date, the taxpayer has only six months to file an amended return. Virginia is another state that recently changed the due date from 90 days to one year.

Filing format

Once the due date of state notification is determined, a taxpayer must then comply with reporting requirements to notify states of the IRS adjustments. Taxpayers must notify the states using state accepted formats, which may include a typical amended return form, a special amended return form, or a "spreadsheet" form of filing. Attachment of additional information, including IRS documentation, an explanation for the amended state return, and previous filings, is often required.

Certain states have special forms on which to report federal RAR changes. For example, Pennsylvania requires Form RCT-128C, Report of Change in Corporate Net Income Tax, and Rhode Island requires Form T-70C, Supplemental Business Corporation Tax Return, when reporting federal taxable income changes resulting from an IRS final determination. Other states have allowed a taxpayer to use the tax form from the original tax year with "AMENDED RETURN" written at the top of the form, or to mark the appropriate box on the face of the return, such as Georgia, Idaho, Louisiana, Montana, New Jersey, New Mexico, North Carolina, Ohio, Texas, Utah and Wisconsin. Over half of the states require an amended return form (an X form) including Alaska, Florida, Hawaii, Illinois, Indiana, Iowa, Kansas, Michigan, Minnesota, North Dakota and certain other states. Other states offer taxpayers options. For example, Iowa will accept a copy of the RAR and notification of the final federal adjustments in lieu of an amended return. The District of Columbia, Mississippi and Nebraska will allow a spreadsheet to be filed instead of using a state tax return form.

Filing the appropriate forms may be a determinative factor regarding whether a state considers an RAR adjustment properly reported, especially when dealing with decreases in federal taxable income that result in state tax refunds. Idaho, for instance, will not consider a refund claim if it is not submitted on a "properly signed" amended tax return. Other states that allow a spreadsheet for the reporting of federal adjustments may not consider a spreadsheet an acceptable format if there is a refund claim.

Note: This article does not constitute tax, legal or other advice from Deloitte Tax LLP, which assumes no responsibility with respect to assessing or advising the reader as to tax, legal or other consequences arising from the reader's particular situation. ◆

Maryland attempts to close REIT 'loophole'

In a recent news release, Maryland Comptroller Peter Franchot announced that payments to captive Real Estate Investment Trusts may no longer be deducted from Maryland corporate income tax returns. Maryland will begin auditing companies using this deduction and collect the taxes owed. Other states that consider these deductions to be a loophole are also challenging this practice and/or enacting legislation to end it.

The REIT 'loophole'

A REIT is a corporation or trust whose activity is limited to real estate operations. REITs are required to pay all income to shareholders who then pay the appropriate tax, allowing a REIT to be generally tax exempt at the federal and state level.

"Captive" REITs have been formed by multistate companies to lower taxes they pay in states where they do business. For example,

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ARKANSAS

Taxpayers now have 60 days (previously, 30) after service of notice of a proposed tax assessment or denial of a claim for refund to file a written protest setting forth the taxpayer's reasons for opposing the proposed assessment or the denial of a claim for refund. Furthermore, if the proposed assessment or denial of a claim for refund is sustained, in whole or part, the taxpayer or legal counsel for the director must request in writing, within 20 days of the mailing of the decision, that the director revise the decision of the hearing officer. (*HB1498 [Act 212, Laws 2007], effective 90 days after adjournment of the 2007 Legislature*)

Arkansas has updated the incorporation date of the IRC provisions for Subchapter S in effect on Jan. 1, 2007 (previously, 2005), regarding small business corporations. When an S corporation files an Arkansas tax return, the taxpayer must attach a complete copy of the federal S corporation tax return. The director of the Dept. of Finance and Administration will prescribe forms for filing an S corporation election and shareholder consents. (*HB2218 [Act 380, Laws 2007], effective 90 days after adjournment of the 2007 Legislature*)

CALIFORNIA

The Franchise Tax Board has released a brochure that provides answers to questions that taxpayers should be asking about the franchise and income tax consequences of incorporating or registering a corporation in a non-income or non-franchise taxing state, such as Delaware or Nevada. The brochure attempts to dispel some of the myths about avoiding California taxes by incorporating or registering out-of-state. If a corporation has any business activity in California, it may owe California tax regardless of where it incorporates or registers. Also, if a California resident individual receives wages from an out-of-state corporation, the individual will be taxed on those wages, even if the corporation does business entirely outside of California. The FTB warns taxpayers that some tax planning advisors and promoters may charge fees for setting up an out-of-state corporation or other business entity that may offset any potential reduction in tax and can possibly even exceed the amount of California tax that is rightfully owed. Also, the FTB may disregard business entities when it determines that the entities have been created solely for tax avoidance purposes. (*FTB 689*)

COLORADO

The Dept. of Revenue has amended its guidelines regarding C corporations to expand the wages that may be subtracted from federal taxable income in computing Colorado corporate income tax. Colorado allows a subtraction for wages that are not deducted on the federal return under IRC §280C because a federal wage credit is claimed. In addition to the Indian employment credit (IRC §45A), the orphan drug credit (IRC §45C), the work opportunity credit (IRC §51), the empowerment zone employment credit (IRC §1396), the welfare-to-work credit (IRC §51A), and the employee retention credit (IRC §1400R), Colorado also now allows a subtraction for amounts not deducted on the federal return because the research expense credit (IRC §41(A)), or the mine rescue team training credit (IRC §45N) is claimed. (*FYI Income 58*)

FLORIDA

The Dept. of Revenue has amended its rule regarding the application process for the corporate income tax credit for capital investments for a new qualifying project located in an enterprise zone and brownfield area. If the credit is used in whole or in part by a member of the qualifying business's affiliated group or by a related cooperative, the application must include a schedule reconciling the amount of capital investment credit claimed by each entity. The schedule must contain the name, identification number, and amount of credit claimed by each entity. (*Rule 12C-1.0191, effective April 5, 2007*)

IDAHO

The provision that previously exempted non-Idaho banks and financial institutions from corporate income tax payable by Idaho banks and financial institutions has been repealed. Accordingly, both Idaho and non-Idaho banks and financial institutions are subject to this tax. (*HB141 [Chap. 59, Laws 2007], effective for tax years beginning after 2007*)

INDIANA

A parent corporation was required to include its sales office subsidiary in its Indiana adjusted gross income tax consolidated return because the sales office engaged in the business of selling products in Indiana. The sales office subsidiary did not have property or payroll in Indiana and maintained it had insufficient contact with the state to be subject to tax. However, the company's products were manufactured in Indiana by a sister subsidiary that transferred title to the goods to the sales office following manufacturing. The sales office subsequently transferred title to the purchasers. Thus, the sales office had Indiana inventory during the time it held title to the goods. In addition, the sales office Web site allowed customers to place orders through either the sales office or manufacturing division, which meant that the manufacturing division acted on behalf of the sales office by receiving and filling customers' orders. The manufacturing division's activities in Indiana on behalf of the sales office exceeded the solicitation

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standard that otherwise might have protected the sales office's Indiana activities from Indiana taxation. (*Letter of Findings No. 03-0487, Dept. of Revenue*)

MISSISSIPPI

The statute of limitations for income tax purposes is not applicable if a taxpayer's taxable income was decreased by a net casualty loss deduction carryback or a net operating loss deduction carryback. The suspension of the statute of limitations is limited to the extent that the income tax liability was affected by the carryback. Net casualty losses may be carried back three years or as otherwise provided in the IRC. (*HB1563 [Laws 2007], effective Jan. 1, 2007*)

MONTANA

Procedures related to the filing of corporation, partnership and limited liability company documents with the secretary of state are revised to allow a corporation or an LLC annual report to be executed by the entity's authorized agent. For these purposes, an "authorized agent" means any individual granted permission by an entity to execute a document on behalf of the entity. The entity is responsible for maintaining a record of the permission granted to an authorized agent. In addition, the secretary of state is authorized to correct errors caused by the filing officer of a corporation, partnership or association. (*HB158 [Chap. 33, Laws 2007], effective Oct 1, 2007*)

OHIO

The Dept. of Taxation has revised its proposed commercial activity tax regulation that explains the taxability of pre-income tax trusts. The revision addresses pre-income tax trusts with less than $4,500 in taxable gross receipts where the trust is considered a common owner of either a combined taxpayer group or a consolidated elected taxpayer group. (*CAT Information Release 2007-02*)

SOUTH CAROLINA

The Dept. of Revenue has issued Revenue Ruling 07-2 that explains requirements for the annual job credit, the annual small business job credit, and the monthly alternative small business job credit, which may be claimed against income, insurance premium or bank taxes. Generally, the credits are available to qualifying types of new or expanding businesses creating a minimum monthly average number of new, full-time jobs in the state. The ruling discusses qualifying taxpayers and new jobs, determination of the monthly average, county rankings, the 120% gross wages rules, and *per capita* income requirements.

TEXAS

Texas rules of practice and procedure are currently being amended to reflect the transfer of administrative law judges who conduct tax hearings from the Office of the Comptroller of Public Accounts to the State Office of Administrative Hearings. Comptroller Susan Combs directed that the move be made as part of an overall effort to improve the tax appeal process. The proposed updates have been published in the *Texas Register*, and amendments are being made to reflect suggestions received during the comment period. For example, one suggestion involved the availability of mediation as an alternative to a formal hearing. Specific mention is being made of the availability of this new procedure. When the final rules are ready, they will be published in the *Register*. (*News Release, Comptroller of Public Accounts, March 21, 2007*)

UTAH

Enacted legislation has created a new exemption to the tax penalty on nonfiled tax returns. Specifically, the new exemption excludes tax returns from the penalty where no tax is due. Previously, an exemption was only available to amended returns. For penalties incurred due to an intentional disregard of law or rule, intentional tax evasion, fraud or a combination thereof, the State Tax Commission will issue a penalty assessment via certified mail. Previously, the commission would issue such assessments via registered mail. (*SB5 [Laws 2007], effective April 30, 2007*)

VERMONT

The Dept. of Taxes has issued a technical bulletin to provide guidelines for filing a corporate income tax unitary combined return, which is required for tax years beginning after 2005. The bulletin explains how transactions between members of a unitary combined group are treated when determining the taxable business income of the group and how transactions between members of a unitary combined group are treated when determining the Vermont apportionment percentage of the group. (*Technical Bulletin TB-36*)

VIRGINIA

The Dept. of Taxation may assess tax within six years after an income tax return was filed if the taxpayer knowingly failed to disclose an abusive tax avoidance transaction. Furthermore, if the tax return is false or fraudulent, the assessment may be made at any time, even if the falsity or fraud was not related to the abusive tax avoidance transaction. (*HB2920 [Chap. 524, Laws 2007], effective July 1, 2007*)

Maryland *(Continued from page 5)*

a company with stores in Maryland may have created a REIT and had all of its stores pay rent to the REIT. The parent company may then have created another subsidiary to be the shareholders of the REIT and received all the dividends from the rent payments. Another tax rule allows companies to receive dividends from their subsidiaries tax-free. In this example, the company essentially would have been paying rent to itself, getting the money through a tax-free REIT, and then deducting the rent payments from its Maryland corporate income tax.

Addback authority?

The comptroller's office is taking the position that captive REITs fall under the state's addback law as they are transactions among related entities and have no purpose other than state tax avoidance.

The provisions of the addback statute (§10-306.1) allow the state to add back intangible expenses and costs paid to related entities for a tax avoidance purpose. Under the law, the comptroller also has the authority to reallocate deductions, expenses and transactions among related entities to clearly reflect income.

The comptroller's office noted that the typical investment REIT, corporate REIT and trust REIT will not be impacted by the disallowance of the deduction, as the accounting practices targeted by the comptroller are used solely by captive REITs for the purpose of tax avoidance.

But **Karen Syrylo**, a practitioner and consultant for the **Maryland Chamber of Commerce** in Baltimore, believes there will likely be litigation challenging the comptroller's position that the 2004 addback law and IRC §482 powers can be used against captive REITs.

"For example, is the real estate rent expense truly an 'intangible expense' that needs to be added back under 10-306.1?" she asks. "If the rent expense is at arm's-length terms, can the comptroller's 482-type powers really disallow the expense?"

Section 482 allows the state to modify income in the case of two or more businesses owned by the same interest.

States react

The Feb. 1, 2007 edition of the *Wall Street Journal* included an article entitled "Wal-Mart cuts taxes by paying rent to itself." In the article, the *WSJ* points out that Wal-Mart used a REIT strategy like that described above, and North Carolina tax authorities are challenging that strategy, saying it was intended "to distort [the company's] true net income." According to the WSJ, regulators in at least six states are going after companies that have reduced their taxes by using similar arrangements.

Some states are using legislation as a means of closing the captive REIT loophole. For tax years beginning after 2006, SB210 amends New York law to require a controlled REIT or Regulated Investment Company to file a combined report under the corporate franchise tax with its controlling corporation. In addition, the law is amended to disallow the exclusion of certain dividends and gains from a REIT or RIC subsidiary under the bank franchise and insurance franchise taxes.

Maryland has also proposed legislation that would put an end to that state's REIT loophole.

"Current proposed legislation in HB1257 and SB945 would disallow the captive REITs' dividends-paid deduction, thereby creating Maryland taxable income for the captive REIT that owns the Maryland real estate on which the rent expense was paid from [a related] operating company," Syrylo explains.

The Maryland bills are expected to pass in the current legislative session. As of press time, SB945 was in the final stages of passage.

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