Vol. 2, No. 8
September 2011

SUTHERLAND

SALT SHAKER

Shaking things up in state and local tax.

Indiana Jeopardy Assessments (and Taxpayer) Turn Out to be a Dog

While the power to issue a jeopardy assessment has been referred to as part of a state's "power of the purse, not its power of the sword,"[1] state and local taxing authorities have shown a propensity to impose jeopardy assessments. *Indiana Dep't of State Revenue v. Adams,* 762 N.E.2d 728, 732-33 (Ind. 2002). Luckily, state courts increasingly are willing to look behind jeopardy assessments to determine whether the statutory requirements for their issuance have been met. In *Garwood v. Indiana Dep't of State Revenue*, No. 82T10-0906-TA-29 (Ind. Tax Ct. Aug.19, 2011), the Indiana Tax Court invalidated 16 jeopardy assessments issued by the Indiana Department of Revenue as a result of the Department's abuse of its jeopardy assessment authority.

The Garwoods supplemented their dairy farm income by breeding and selling dogs. Prompted by a series of consumer complaints, the Indiana Attorney General investigated the Garwoods. Undercover Attorney General agents purchased dogs and found that the Garwoods had failed to pay Indiana income tax and to collect and remit sales tax. In addition, the Garwoods did not register as retail merchants or file sales tax returns. The Department served jeopardy assessments on the Garwoods at their home and demanded immediate payment of the tax, interest, and penalties alleged to be owed. When the Garwoods informed a Department official that they could not pay immediately, the Department served them with jeopardy tax warrants and, on that same morning, state officials, police, and 60 volunteers from various humane societies raided the farm and seized all 240 of the Garwoods' dogs, including their house pets and farm dogs. Later that day, the seizures were made public in a television press conference and newspaper interview (which the court described as a "media circus"). A day later, state officials sold all of the Garwoods' dogs for a total of $300.

From the outset, the Tax Court noted that a jeopardy assessment is a "powerful tool" to be used in exceptional circumstances because it allows the state to deprive taxpayers of their property without first providing constitutionally guaranteed notice or an opportunity to be heard. As is the case in most states, the Indiana Department may issue a jeopardy assessment if the Department determines that the taxpayer intends to do one of four acts: (1) quickly leave the state; (2) remove property from the state; (3) conceal property in the state; or (4) do any act that would jeopardize collection of those taxes—all four of which the court described as "identifying the line between fair tax administration and oppression." The court found that none of these circumstances had been met: the Garwoods had lived in the community for decades, their property was not easily transported, there was a lack of evidence of intent to conceal their dogs, and a complete absence of any intent to hinder collection of Indiana tax. The court drew an important distinction between *failing* to properly report and pay taxes alleged to have been owed and *intending* not to pay taxes, finding no evidence of the latter.

As states grow desperate for revenue, watch out for more cases where courts narrowly construe taxing authorities' power to issue jeopardy assessments. And, as the home of *Pet of the Month*, the Sutherland SALT Team is always concerned for the dogs.

SUTHERLAND

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Check out Sutherland SALT Online at www.stateandlocaltax.com

Iowa Court Upholds Equal Protection Challenge

Taxpayers frequently challenge tax laws based on equal protection grounds, but states generally prevail on the rather easily met rational basis test. In a noteworthy Iowa decision, Qwest, an incumbent local exchange telecommunications company (ILEC), successfully argued that the application of two property tax exemptions resulted in unconstitutional discrimination against it in favor of competitive long distance companies (CLDCs) and wireless companies. *Qwest Corp. v. Iowa State Bd. of Taxation and Revenue*, Docket No. CV008413 (Iowa Dist. Ct. Aug. 17, 2011).

The first subject of Qwest's challenge was an exemption for personal property acquired by CLDCs after 1995 that was available to "long distance telephone companies," the definition of which specifically excluded ILECs like Qwest. The second aspect of Qwest's challenge involved the state's central assessment property tax scheme. Iowa law exempts all personal property from tax, but for centrally assessed telephone companies like Qwest, the state treats all property as "real property." All "telephone companies" operating a telecommunications line in the state are subject to central assessment. The state did not classify wireless companies as telephone companies, because the wireless companies use radio wave technology and not a network of cable and wires. Therefore, Qwest paid tax on the value of all of its property, while wireless companies did not pay tax on personal property.

With respect to the first exemption, the court first held that Qwest's central office equipment was similarly situated to the property of CLDCs. The court looked to the primary use of the property, noting that the switches and cable used by CLDCs for the long distance part of the call transport was similar—if not identical—in character, function, and use to that employed by Qwest for part of the call transport. The court also found that Qwest and CLDCs compete with one another as both deliver commercial voice communication services to the public.

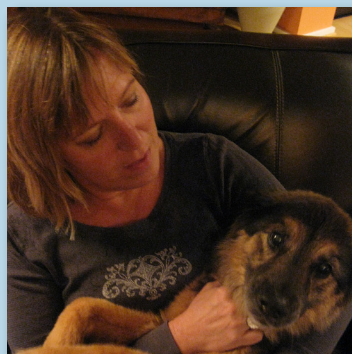
With respect to the second exemption, the court held that Qwest's central office equipment was similarly situated to wireless companies' mobile switching telecommunications offices (MSTOs) because significant parts of each of the relevant networks are very similar in terms of routing calls, such property is intended to accomplish the same purpose or main activity, and primary use of such property is similar or the same.

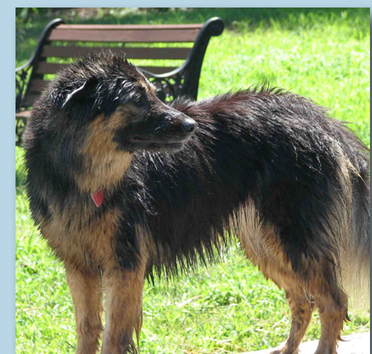
The court found that no rational basis existed for the discrimination against Qwest. The Iowa State Board of Tax Review argued that the differential treatment existed to increase competition in the local exchange market by incentivizing long distance companies to provide service and to encourage the construction of wireless infrastructure in the state, respectively. The court noted that while such rational bases and legitimate governmental purposes may have existed at the time Iowa enacted the statutes, they are now obsolete (Qwest no longer dominated the market and there are more wireless customers than landline customers in Iowa).

SALT PET OF THE MONTH

Mrs. Beasley

Meet Mrs. Beasley ("B" for short)—often called the luckiest dog in the world. Sutherland Chief Client Service Officer Felice Wagner found Mrs. Beasley 15 years ago on U.S. Route 1 in downtown Miami. Since then, Mrs. Beasley has traveled the world, including taking a swim in all of the Great Lakes. Her favorite pastime is chasing critters, although these days her hunting is limited to scaring the birds away with a bark. She currently splits her time between her city apartment and her lake house alongside her younger brother Jack (another great rescue story), who is very jealous that Mrs. Beasley has been chosen as a SALT Pet of the Month.





SALT Pet of the Month: It's Your Turn!!

In response to many requests, the Sutherland SALT practice invites you to submit your pet (or pets) as candidates for SALT Pet of the Month. Please send us a short description of why your pet is worthy of such an honor, along with a picture or two. Submissions should be directed to Andrea Christman at andrea.christman@sutherland.com.

Indiana "Tax-Free" Beer

For the second time, the Indiana Tax Court has ruled that Miller Brewing's sales to Indiana customers from Miller Brewing's Ohio facility were not considered Indiana sales for purposes of inclusion in the sales factor numerator. *Miller Brewing Co. v. Indiana Dep't of State Revenue*, No. 49T10-0607-TA-69, 2011 WL 3630147 (Ind. Tax Ct. Aug. 18, 2011) (*Miller Brewing II*). The Indiana Tax Court previously addressed the identical issue for Miller Brewing's 1994-1996 tax years and held in favor of Miller Brewing. *Miller Brewing Co. v. Ind. Dep't of State Revenue*, 831 N.E.2d 859 (Ind. Tax Ct. 2005) (*Miller Brewing I*).

Miller Brewing's Indiana customers picked up its purchased product at Miller Brewing's facility. The customers' common carriers took possession of the property in Ohio and title transferred in Ohio. For purposes of Indiana's gross income tax and supplemental net income tax for tax years 1997 through 1999, Indiana sourced sales of tangible personal property to the state "if the property is delivered or shipped to a purchaser, other than the United States government within this state, regardless of the f.o.b. point or other conditions of the sale." Ind. Code § 6-3-2-2(b). Additionally, Indiana's regulations provided that "sales are not 'in this state' if the purchaser picks up the goods at an out-of-state location and brings them back into Indiana in his own conveyance." 45 Ind. Admin. Code § 3.1-1-53(7) (the "sourcing regulation").

In *Miller Brewing I*, the Indiana Tax Court held that, pursuant to the sourcing regulation, Miller Brewing's sales to Indiana customers were not included in Miller Brewing's Indiana sales factor numerator. The Department re-strategized after losing *Miller Brewing I* and argued that its statutory sourcing rule for sales of tangible personal property should be interpreted as an ultimate destination rule. The state argued that other states have interpreted similar statutory language as encompassing an *ultimate* destination rule. The court rejected these arguments and found that the Department's sourcing regulation—upon which the court based its holding in *Miller Brewing I*—controlled the outcome of this case.

It seems unlikely that the Department will continue to challenge this issue. However, the Department could take steps to modify the sourcing regulation.

Back to School: Connecticut Supreme Court to Hear Scholastic Book Club Appeal

The Connecticut Supreme Court is set to decide an issue that has been the subject of debate in several states over the last 20 years—whether Scholastic Book Club's (Scholastic) use of teachers to distribute catalogs, collect orders and payments, and distribute books to their students results in a sales and use tax collection obligation. California and Kansas courts found that Scholastic had nexus in the states for sales tax purposes when examining the same facts. *Scholastic Book Clubs, Inc. v. State Board of Equalization,* 207 Cal. App. 3d 734 (1st Dist. 1989); *In the Matter of Scholastic Book Clubs, Inc.,* 920 P.2d 947 (Kan. 1996). However, a Michigan court concluded that Scholastic did not have sales tax nexus. *Scholastic Book Clubs, Inc. v. Michigan,* 567 N.W.2d 692 (Mich. Ct. App. 1997)

Scholastic had no property, employees, or business locations in Connecticut. However, Scholastic offered a program where teachers distributed catalogs to their students, accepted the students' book orders and payments, and submitted them to Scholastic. In exchange for their participation in the program, teachers were rewarded with bonus points, which could be redeemed for prizes for use in the classroom. The Connecticut Department of Revenue Services argued that Scholastic's use of teachers for this purpose created sales tax nexus. On April 9, 2009, the Superior Court held that Scholastic was not engaged in business in Connecticut because the teachers were not "representatives" of Scholastic. *Scholastic Book Clubs, Inc. v. Comm'r of Revenue Services,* 47 Conn. L. Rptr. 698 (Conn. Super. Ct. 2009). The Superior Court concluded that a "representative" is "a person who participates in an in-state 'sales force,' to sell, deliver or take orders to generate revenue." The court relied on the fact that the teachers were acting *in loco parentis*—acting as parents of the students—because the teachers were merely helping the students select and order books, and therefore could not be considered analogous to a sales force.

The Superior Court decision also relied heavily on the fact that the teachers did not receive any compensation for their participation in the program, and their participation was completely voluntary. Although the teachers earned bonus points for the orders placed, those bonus points belonged to the classroom as opposed to the teacher, and could be used to redeem items only for use in the classroom. Therefore, the teachers were not seeking to produce revenue or compensation for themselves as representatives.

The case is now pending before the Connecticut Supreme Court. The state filed its brief on January 29, 2010, and Scholastic filed its brief on April 30, 2010. The court has not yet heard oral arguments. We do wonder about whether the Department of Revenue should have a more pressing audit initiative than seeking to impose sales tax on books sold to students in a school setting.

Allcat "Claims" the Texas Margins Tax is Unconstitutional

On July 29, 2011, Allcat Claims Services, L.P. (Allcat) and one of its individual partners filed a petition with the Supreme Court of Texas seeking a declaratory judgment that the Texas Margins Tax (TMT) is unconstitutional under the Bullock Amendment of the Texas Constitution. *In re Allcat Claims Serv., L.P. and John Weakly*, No. 11-0589. The case is proceeding under a special statutory procedure whereby any challenge to the TMT's constitutionality is filed directly with the Supreme Court of Texas for expedited review.

Under the Bullock Amendment of the Texas Constitution, Texas voters must approve a law that "imposes a tax on the net incomes of natural persons, including a person's share of partnership and

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unincorporated association income" in order for the tax to be valid. Texas voters never approved the TMT, so its constitutionality turns on whether the TMT is an income tax imposed on a natural person's share of partnership income.

The phrase "tax on . . . net incomes" is not a defined term, and Allcat argues that the TMT meets any of three definitions of an income tax: (1) the Multistate Tax Compact's (MTC) definition (adopted by statute in Texas); (2) the *Black's Law Dictionary* definition; and (3) the U.S. Supreme Court's definition.

Allcat further argues that the TMT is imposed on a natural person's share of partnership income because it directly reduces each partner's (1) distributive share of income in proportion to their profit and loss interests in the partnership, and (2) values and liquidation rights in their partnership interests. The Texas Attorney General argues primarily that the TMT "taxes total revenue . . . of 'taxable entities' while that revenue is still maintained in the entity's coffers," and therefore does not violate the Bullock Amendment.

The Supreme Court of Texas must issue its decision by November 28, 2011 under the expedited review process. If the court finds that the Bullock Amendment is violated, it is possible that the court would only invalidate the TMT as applied to individuals (and leave the TMT undisturbed as applied to entities). Even a ruling upholding the tax, however, could have significant implications for corporate taxpayers (e.g., potential application of Public Law 86-272 or the potential impact of an MTC Compact Election). For additional Sutherland analysis of the Allcat challenge, please see our Legal Alert here.

SHOW ME THE MONEY

REMIC—the Remix—Arizona Style

The Arizona Department of Revenue (the Department) issued an Individual Income Tax Ruling describing the treatment of Real Estate Mortgage Investment Conduits (REMICs). Ariz. ITR 11-6 (Aug. 8, 2011). The ruling affirms the Department's longstanding positions regarding the sourcing of income received from REMICs and whether simply holding an interest in an Arizona REMIC creates nexus. Ariz. ITR 91-2 (Apr. 2, 1991).

For federal tax purposes, the IRS treats REMICs as flow-through entities and does not tax the entity itself on its income. Rather, the REMIC's interest holders are taxed on the REMIC's income. Generally, REMICs will have two types of holders: regular interest holders and residual interest holders. Regular interest holders are taxed as if their interests were debt instruments, whereas residual interest holders report the REMIC's taxable income or loss in proportion to their percentage ownership, similar to partners in a partnership.

Expanding on this federal scheme, the Arizona ruling reaffirms several determinations the Department made in 1991. First, the REMIC itself is not subject to Arizona income tax, since it is not engaged in a trade or business. However, if the REMIC is managed or administered in Arizona or owns real property in Arizona (e.g., foreclosure property), it must file annual information returns with Arizona similar to those required for federal purposes. A REMIC that is not managed or administered in Arizona presumably is not required to file the Arizona reports, as the ruling makes clear that a REMIC will not have income from Arizona sources solely by owning mortgages secured by Arizona property or in which the debtors are Arizona residents, or by having interest holders who are Arizona residents.

Holders are subject to Arizona tax on the income they receive from the REMIC if: (1) they are residents of Arizona; (2) the REMIC owns real property in Arizona; or (3) the holder employs the REMIC investment in a business in Arizona. Residents, of course, are subject to Arizona tax on all of their income, regardless of source, including their income from a REMIC. Nonresidents are subject to tax on their REMIC income only if the income has an Arizona source. The ruling clarifies that income received by the residual interest holders in a REMIC will be considered income from Arizona sources only if: (1) the REMIC owns any real property in Arizona at any time during the taxable year, including foreclosure property; or (2) the holder carries on a business, trade, profession, or occupation in Arizona, and the REMIC investment is employed in such business. However, the ruling does not address how much of the nonresident holder's income from such a REMIC would be considered Arizona source income. Presumably, only a portion of the REMIC income could have an Arizona source if the REMIC owned real property in more than one state.

A nonresident holder whose only connection with Arizona is the receipt of income from a REMIC that is managed or administered in Arizona and does not own any real property in Arizona would not be subject to Arizona income tax, as the ruling treats such income as intangible income generally sourced to the individual's state of residence. The ruling states, however, that corporate holders who are otherwise subject to Arizona tax must include their REMIC income as apportionable income. Several states reach similar conclusions regarding nexus in the context of financial institutions as REMIC interest holders, providing that simply holding an interest in a REMIC will not establish nexus with the state, nor be taken into account for purposes of calculating a nexus threshold. *See, e.g.,* Ky. Rev. Stat. Ann. § 136.520(a)91); Tenn. Code Ann. § 67-4-2105(e).

The ruling is a welcome reminder that REMICs may expand their mortgage holdings to Arizona without the risk of incurring an income tax obligation. REMICs take note—Arizona wants you!

NEW YORK, NEW YORK

The Big Apple Goes to the Market for Online Trading Revenue

The New York State Department of Taxation and Finance (the Department) recently released an advisory opinion analyzing the proper characterization and sourcing of various revenue streams derived from the facilitation of online trading activities. Petition No. C080222A, TSB-A-11(8)C (July 12, 2011). Relying on our old friends, *Deloitte & Touche, LLP*, TSB-A-02(3)C (Apr. 18, 2002); *Ins. Servs. Offices, Inc.*, TSB-A-99(16)C (Apr. 7, 1999); and *New York Merchantile Exch.*, TSB-A-00(15)C (Apr. 18, 2002), the opinion represents the Department's growing trend to expand the category of "other business receipts," to source receipts on a market rather than on a cost of performance basis.

In the opinion, the Parent is a Delaware corporation headquartered in New York. It owns and operates an Internet-based platform (Exchange) that serves as a marketplace for over-the-counter (OTC) global futures markets. Although the Parent is not a registered broker-dealer, the Exchange serves as a marketplace for buyers and sellers of certain commodities contracts, financial contracts, and other derivatives contracts in futures and OTCs to meet and execute trades on a real-time basis. All of the Parent's property and equipment associated with the Exchange is located outside of New York, and all of the clearing administration for the OTC is performed outside of New York. In addition to the Parent's activities, its affiliates generate receipts from various transactions, including open outcry trading, digital auction, flat monthly subscriptions, and trades executed with the assistance of interdealer brokers.

New York consistently has determined that receipts received from electronic transmissions, access to Internet databases, products offered through the Internet, and other online fees such as debit card processing fees, are properly characterized as "other business receipts" sourced to the location of the customer. In this opinion, the receipts at issue can generally be put into three categories: (1) fees derived from pure electronic facilitation of trading activities, such as electronic trade confirmation fees and charges to access trading data generated by the Exchange; (2) fees derived from interdealer trading or other trading activities that involve the expertise of individuals, which are fees associated with trading services and advice facilitated by a "live" broker; and (3) brokerage commissions earned by a registered broker-dealer.

Under the first category, the Department determined that all of the receipts generated by the Parent and its affiliates from electronic trading activities, such as fees derived from electronic trade confirmations, commissions earned on trades executed via the Parent's electronic trading platform, and fees generated from the provision of data, were "other business receipts" and should be sourced to the location of the customer (or their mailing address). The Department relied heavily on the principles of *New York Merchantile Exchange* (monthly subscription fees to access market data treated as "other business receipts," sourced to the location of modems and transmission equipment), *Insurance Services Offices, Inc.* (fees received from a subscriber's right to access intangible databases constituted other business receipts, sourced to the location of modems and transmission equipment), and *Deloitte & Touche, LLP* (receipts from online processing of gift certificates and gift cards deemed "other business receipts," sourced based on the location of the customer).

The Affiliate's commissions for open outcry transactions were sourced to the location of the physical trading floor in New York, and the interdealer broker fees and voice brokerage fees were sourced to the location of the representative who facilitated the trades. The Department drew a distinction between the first and second category of receipts because an actual representative, as opposed to an electronic system, facilitated and provided expertise in executing the trades. The Department concluded that these activities constitute services that must be sourced to the location where the transactions took place.

The Department relied on the special apportionment rules available to registered broker-dealers and concluded that revenue generated from the digital auction business, revenue received for the execution of purchase and sale orders, and trading commission receipts were brokerage commissions. Pursuant to N.Y. Tax Law § 210.3(a)(9), brokerage commissions are treated as service receipts that are sourced to the location of the counterparty or customer responsible for paying for the commission.

With the release of this advisory opinion, it is clear that the Department will apply the principles of *New York Merchantile Exchange, Insurance Services Offices, Inc.*, and *Deloitte & Touche LLP* to a broad range of electronic commission receipts. Taxpayers should take note of the Department's revised characterization of electronic trading activities and be aware of the Department's propensity to apply a market approach to receipts from activities that may arguably constitute service receipts.

POLICY WONK

The MTC Wants Your Input! (No, Really)

Not to be confused with the latest TSA controversy, the Multistate Tax Commission (MTC) has opened an "Environmental Scan Forum" to solicit public input in four areas: "Strengths, Weaknesses, Opportunities, and Threats." The "Strengths" and "Weaknesses" categories will give the public an opportunity to compliment and/or constructively criticize the MTC's organizational and internal processes. Per the MTC website description, the "Opportunities" and "Threats" categories will cover "external factors that affect the MTC's ability to achieve its purposes" over the next five to seven years. To submit comments, the public may visit the Forum page on the MTC's website. More detailed comments should be addressed to the MTC's consultant, Elizabeth Harchenko (esharchenko11@gmail.com).

We encourage the MTC to increase involvement by elected officials and taxpayers at MTC meetings. Of course, federal legislation affecting state taxes should also be addressed in the Forum, especially in light of the recently resuscitated discussions surrounding a congressional overturn of *Quill*. For the good of the order—and the MTC—we encourage all readers to submit comments to the Forum.

Mandatory Confusion: Another Turn in the Long and Winding Road of D.C.'s Combined Reporting Law

Mayor Vincent Gray transmitted the District of Columbia's Budget Support Act (BSA) to Congress on August 2, 2011. The BSA, among other things, contains mandatory unitary combined reporting. Per the federal process that governs the District legislation, Congress has 30 days (i.e., 30 days in which both the House and Senate are in session) to review the BSA. If Congress does not disapprove of part or all of the BSA during the 30-day passive review process, the BSA becomes District law.

In the latest twist to a more than two-year process, the City Council estimated the 30-day passive review period would expire on October 21, 2011. However, due to Congress's political maneuvering (and to the surprise of the City Council and observers), the review period actually expired on September 14, 2011. The change makes enactment of the District's combined reporting legislation a third-quarter event rather than the initially anticipated fourth-quarter event. While taxpayer representatives were able to convince the City Council to add a "FAS 109" provision (intended to lessen the financial statement impact of the law change) to the BSA, the shortened 30-day passive review period and the retroactive effective date of January 1, 2011, complicate District taxpayers' compliance efforts.

Shortly after the BSA became effective, the Office of Tax and Revenue (OTR) issued the following guidance: "The District of Columbia combined reporting regime is effective for tax years beginning after December 31, 2010. For taxpayers required to use combined reporting, any estimated payments due before 45 days after September 14, 2011, the effective date of District of Columbia's combined reporting statute, are due the next subsequent installment due date. For example, if a combined group's taxable year begins on January 1, 2011, the first, second and third 'catch up' payments are due on December 15, 2011 together with the fourth quarter payment under combined reporting."

OTR will need to address the many questions surrounding the combined reporting legislation. A regulation drafting effort by OTR is currently underway, and participants predict that the regulation will be modeled after regulations from other states that have adopted the Multistate Tax Commission's combined reporting model statute.

CALIFORNIA SCREAMING

The Sleeping Giant Awakes: The California Supreme Court Accepts Review of *Elk Hills Power v. Board of Equalization*

It has been almost 50 years since the last pronouncement of the California Supreme Court on the issue of whether intangible assets are subject to property tax. This issue is now front and center before the California Supreme Court with its August 24, 2011 grant of review of the petition of Elk Hills Power.

The case involves the assessability of Emission Reduction Credits (ERCs). ERCs are purchased to allow a power producer to offset future emission overloads from its generating facility. The State Board of Equalization (SBOE) added the value of the ERCs to the assessed value of an Elk Hills power plant. Elk Hills protested, arguing that the ERCs are intangible assets that are not assessable for property tax purposes. The California Court of Appeal affirmed the SBOE's assessment.

The California Supreme Court has not addressed the issue of intangibles since 1962, when it ruled that a movie copyright cannot be assessed. This case will have sweeping implications for California businesses that own significant intangible assets.

California's Voluntary Compliance Initiative: Not So Voluntary!

Nordstrom, Inc. (Nordstrom) filed a complaint in Los Angeles Superior Court on August 25, 2011, alleging that California's second Voluntary Compliance Initiative (VCI2) is unconstitutional and violates the state's Administrative Procedures Act (APA). *Nordstrom v. Franchise Tax Bd*., Case No. BS133291 (Cal. Super. Ct. 2011). Specifically, Nordstrom alleges that California's VCI2 law, enacted in March 2011, imposes severe penalties that would coerce the retailer into participating in the VCI2 program, causing the retailer to forego its constitutional rights and concede tax assessments.

California's VCI2 program runs from August 1, 2011 through October 31, 2011, and allows taxpayers to avoid most penalties associated with so-called "abusive tax avoidance transactions" (ATATs) in tax years beginning before January 1, 2011. California defines ATATs to include listed transactions under IRC § 6707A(c)(1) and noneconomic substance (NEST) transactions. As a condition of participation in VCI2, taxpayers must concede disputed tax assessments and waive their rights to appeal. If a taxpayer does not participate in VCI2 and is unsuccessful litigating its tax dispute, the taxpayer will face steep penalties, including a 40% NEST penalty and a 100% interest-based penalty.

This case presents a number of interesting issues, including whether the Due Process Clause and First Amendment can operate to limit the conditions placed on an amnesty program that is supposedly voluntary; whether the FTB's listed transaction notices are excluded from the listed transactions subject to penalty under Section 19777; and whether Proposition 26—the ballot measure that expanded the range of bills subject to the two-thirds legislative vote threshold required for tax increases—can apply to certain tax penalties.

Recently Seen and Heard

September 19-21, 2011
NESTOA Annual Meeting
Hotel Du Pont – Wilmington, DE
Steve Kranz on Federal Legislative Updates
Marc Simonetti on What Keeps a Corporate State Tax Director Up at Night?

September 20, 2011
TEI Dallas Chapter Dinner Meeting
Dallas, TX
Jonathan Feldman and **Maria Eberle** on Tax Litigation and Settlement Strategies: Hot Litigation Issues and How to Best Settle Them

September 21, 2011
Unclaimed Property Professionals Organization Webinar
Marlys Bergstrom on Updates in the Industry

September 21-22, 2011
Wireless Tax Group Meeting
The Edgewater Hotel – Seattle, WA
Steve Kranz and **Beth Freeman** on Digital Goods
Eric Tresh on 911 Fees

September 22, 2011
Wall Street Educational Corp. and Wall Street Tax Association Breakfast Seminar
Credit Suisse – New York, NY
Marc Simonetti on New York False Claims Act

September 22, 2011
COST Pacific Northwest Regional Meeting
eBay Corporate Offices – San Jose, CA
Michele Pielsticker on Current Developments in California and Other Pacific Northwest States and Certain Other Significant States Around the Country
Michele Borens, Jeff Friedman and **Pilar Mata** on Latest and Greatest in State Tax
Michele Borens and **Jeff Friedman** on E-Commerce and Cyberspace State Tax Issues and on Ask the Experts Panel

September 25-28, 2011
IPT Sales & Use Tax Symposium
Renaissance Orlando at SeaWorld – Orlando, FL
Steve Kranz on Taxing Service as Tangible Personal Property: Can the States Do It? And on Nexus and Reporting: Where Have We Been, Where Are We Going?
Eric Tresh on Old Tax Laws Applied to New Technologies

September 26, 2011
TEI Seattle Chapter Meeting
Bellevue Club – Seattle, WA
Michele Borens on Significant State Tax Litigation Around the Country
Michele Borens, Jeff Friedman and **Michele Pielsticker** on California Screamin': A Review of Recent Changes to California Sales and Income Taxes
Marc Simonetti and **Michele Borens** on Reserves – Release or Forever?
Jeff Friedman and **Marc Simonetti** on Top Ten Guidelines for Negotiating a Good State Tax Settlement
Jeff Friedman, Marc Simonetti and Tax Partner **Robb Chase** on State Tax Consequences of Federal Uncertain Tax Positions

September 29, 2011
BNA Webinar
Marlys Bergstrom on Unclaimed Property and Unclaimed Wages

DIGITAL GOODS

Virtual Chaos: Two States Log In to the Online Gaming Arena

Businesses that sell video games and related content online and by remote access have been pondering an essential sales and use taxability question: What is the proper characterization of the goods and services being sold? Although downloaded video games have long been thought to be a form of prewritten computer software, businesses that sell related subscription services, virtual goods, and virtual currencies have enjoyed much less tax certainty. Two states have weighed in on this issue in recent months. Kansas and Missouri issued letter rulings addressing the tax issues that arise in the gaming environment. Although the states' guidance is not entirely consistent, gaming companies may welcome any move toward improved tax clarity in the virtual gaming business.

The facts and issues presented in each ruling were very similar. Each taxpayer requested a ruling on the taxability of a variety of gaming goods and services:

- Remote access software and virtual goods, where the purchaser receives access codes on a printed receipt that allows the customer to access content on a third-party server over the Internet;
- Downloadable digital content where the purchaser receives access codes on a printed receipt that allows download of prewritten software that provides content such as new game levels, virtual equipment, and characters for enhanced gaming experience;
- Subscription cards that provide access to online gaming networks, interaction with other players, and access to digital content by either remote access or download;
- "Points cards" that contain points values that can be used within the online gaming environment for online game play, interaction with other players, and access to digital content by either remote access or download; and
- "Notional dollar value cards" that contain dollar values to be used for the same purpose as the points cards.

Remote Access or Download?

The Kansas Department of Revenue (the Department) reached some interesting conclusions in *Kansas Private Letter Ruling* P-2011-004 (June 16, 2011). In Kansas, downloaded prewritten computer software is subject to tax, but remote access software is not. Thus, the Department found that remote access to the gaming software and virtual goods is not subject to tax, but the same content downloaded should be treated as downloaded prewritten software.

Missouri reached a similar but varied conclusion in *Missouri Private Letter Ruling* No. LR 6866 (August 18, 2011), based on its different treatment of prewritten computer software. In Missouri, only software delivered on tangible media is subject to tax. Thus, the Missouri Department of Revenue, like Kansas, found that the remote access to software and virtual content was not taxable. Unlike Kansas, Missouri approached taxation of downloaded content by looking back at the original gaming software purchase to determine taxability of the downloaded content. Missouri concluded that the determinant in whether the downloaded gaming content is taxable is the method of delivery of the base gaming software. In other words, the vendor must know at the time of the sale of downloaded content whether the original game was purchased on tangible medium or by download. In an industry rapidly moving toward third-party developers and vendors selling virtual content to gamers on a variety of gaming platforms, the need to know the original delivery method will likely prove impossible.

Pick a Card!

The treatment of subscription cards, points or virtual currency cards, and notional dollar cards has prompted a good deal of discussion in the virtual gaming industry. As many gaming platforms move toward their own proprietary virtual currency, the tax treatment of the sale of those currencies has prompted much speculation, but until now, states have offered little guidance.

Kansas takes the position that the sale of cards is subject to tax at the card's point of sale because the card *may* be used for downloaded content, which is taxable in Kansas. At the same time, the Kansas Department determined that the notional dollar value cards are not taxable at point of sale, but rather should be treated as a "gift certificate" and taxed at the point of redemption as a cash equivalent.

Missouri, however, found no difference in treatment among subscription cards, points cards, and notional value cards. In all cases, Missouri imposes tax when the cards are redeemed, not when sold.

Businesses operating in the virtual gaming industry are currently operating without sufficient state guidance to determine their tax obligations.

FLAVOR OF THE SOUTH

Alabama Gets Physical: Upholding the *Quill* Standard in Local Sales Tax Nexus

Alabama ALJ Bill Thompson voided a local sales tax assessment asserted against an electronics retailer because the retailer did not have a physical presence in the taxing jurisdictions. Although the retailer sent repairmen into the local taxing jurisdictions, the retailer did not have a physical store or sales representatives in the localities, and therefore lacked a sufficient nexus. *Cohen Elec. and Appliances, Inc. v. Alabama Dep't of Revenue*, Dkt. No. S10-989 (Admin. Law Div. July 12, 2011).

The ALJ applied the law established by *Yelverton's, Inc. v. Jefferson Cnty*, 742 So.2d 1216 (1997). The court in *Yelverton's* held that local taxing jurisdictions are subject only to constitutional

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due process restraints on intrastate sales, rather than Commerce Clause restraints, because interstate commerce is not implicated. The *Yelverton* court, however, interpreted a Department of Revenue regulation, Ala. Admin. Code r. 810-6-3-.51(2), as requiring a retailer without a physical store to collect tax only if it has a salesforce soliciting sales in the local jurisdiction. The taxpayer in *Cohen Electronics* sent repairmen, but not salespeople, into the taxing jurisdictions, and therefore was not required to collect tax.

Judge Thompson suggested that the Department could amend its regulation to conform to current due process standards and even suggested adopting a factor presence standard as an option. Notwithstanding the Judge's comments, taxpayers with intrastate sales in Alabama should be aware of this unusual regulation.

Come See Us

October 5, 2011
Sutherland SALT Financial Services Roundtable
Sutherland's Office – New York, NY
Jeff Friedman, Marc Simonetti, Scott Wright, Michele Pielsticker, Maria Eberle and guest speaker **Professor Walter Hellerstein** will present

October 6, 2011
IPT Seattle Meeting
The Columbia Tower Club – Seattle, WA
Michele Borens and **Jeff Friedman** on A Day in "Court": Navigating the State and Local Appeal Process

October 19-21, 2011
COST 42nd Annual Meeting
Ritz Carlton – New Orleans, LA
Steve Kranz on Enough Already: Inappropriate Use of Transfer Pricing and Third Party Auditors by States
Eric Tresh on Navigating Recent and Pending Corporate Income/Business Activity State Tax Legislative Changes
Marc Simonetti on Navigating Recent and Pending Corporate Income/Business Activity State Tax Legislative Changes

October 23-26, 2011
Broadband Tax Institute
The Phoenician – Scottsdale, AZ
Steve Kranz on How the BTI Membership is Working Together to Impact the Policy World.
Eric Tresh on Significant Decisions Impacting Our Industry
Maria Todorova on Transaction Tax Update – New and Emerging Issues

October 23-28, 2011
New York University 70th Institute on Federal Taxation
The Grand Hyatt – New York, NY
Diann Smith on State/Local Withholding and Information Reporting Obligations for the Mobile Workforce
Charlie Kearns on an Executive Compensation Panel

October 23-28, 2011
New York University Institute on Federal Taxation
The Grand Hyatt – New York, NY
Diann Smith on State/Local Withholding

October 24, 2011
IPT Luncheon
1130 The Restaurant – Phoenix, AZ
Steve Kranz on Taxation on Digital Goods and Taxing Cloud Computing

October 25-27, 2011
Paul J. Hartman State and Local Tax Forum
Loews Vanderbilt Hotel – Nashville, TN
Steve Kranz on Transfer Pricing – Audits/ Assessments
Diann Smith on The Economic Substance and Business Purpose Doctrines in State and Local Tax

October 26-28, 2011
Tulane 60th Annual Tax Institute
Winsor Court – New Orleans, LA
Jeff Friedman on State and Local Taxation – Recent Developments

October 27, 2011
Chicago Tax Club Annual Fall Seminar
Stephens Center – Rosemount, IL
Diann Smith and **Beth Freeman** on Federal Limits on State Taxation

October 30-November 2, 2011
TEI Annual Conference
Marriott Marquis – San Francisco, CA
Michele Borens and **Marc Simonetti** on Top 10 Practical Tips for Successfully Settling State Audits

November 3-5, 2011
2011 Annual Meeting of the California Tax Bar and California Tax Policy Conference
The Fairmont - San Jose, CA
Pilar Mata on A Detailed Examination of the California Sales Factor
Michele Pielsticker on The Framework that Shapes and Constrains California's Tax System

November 7-11, 2011
Maryland State Bar Association 2011 Advanced Tax Institute
Martin's West – Woodlawn, MD
Jeff Friedman on National Developments – Point-Counterpoint Discussion

November 8, 2011
TEI Arizona Chapter SALT Full Day CPE
APS Corporate Office – Phoenix, AZ
Michele Borens, Pilar Mata, Michele Pielsticker and **Maria Todorova** will present

November 9-11, 2011
IPT Credits and Incentives Symposium
Hyatt Regency – Monterey, CA
Pilar Mata on Gunfight at the C&I Corral: Audit Defense and Controversy

November 11, 2011
William & Mary Tax Conference
Kingsmill Resort – Williamsburg, VA
Jeff Friedman on Going Big: Update on States Seeking to Expand Tax Jurisdiction, Tax Base and Enforcement

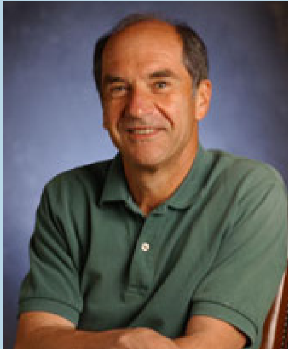
November 15, 2011
COST Minneapolis Regional Seminar
Best Buy Offices – Minneapolis, MN
Steve Kranz will present

November 15-17, 2011
National Premium Tax Annual Conference
Eldorado Hotel Casino – Reno, NV
Maria Eberle on Impact of Federal Legislation and Other Uniformity Efforts on State Taxation

November 18, 2011
New York University 70th Institute on Federal Taxation
The Fairmont Hotel –San Francisco, CA
Diann Smith on State/Local Withholding and Information Reporting Obligations for the Mobile Workforce
Charlie Kearns on an Executive Compensation Panel

November 30, 2011
TEI Rochester Chapter SALT Half-Day Seminar
Rochester, NY
Marc Simonetti will present

Professor Hellerstein's Office Hours: Taxation of Foreign Corporation As Member of Partnership Doing Business in State



In this edition of the *Shaker*, we welcome a new column: *Professor Hellerstein's Office Hours*. In this column, which we hope will become a *Shaker* mainstay, Professor Walter Hellerstein of the University of Georgia School of Law will share his views of a recent case, decision, or other current development. In writing this column, Professor Hellerstein draws freely from his treatise, Jerome R. Hellerstein, Walter Hellerstein, and John Swain, *State Taxation* ¶ 6.12 (3rd ed. 2011 rev.). The views expressed in *Office Hours* are those of Professor Hellerstein only. We may not always agree with him, but we always want to know what he has to say! Professor Hellerstein can be reached at wallyh@uga.edu.

In most states, a corporate partner in a partnership doing business in the state is subject to the state's corporate income or franchise tax on its distributive share of the partnership income, even if the corporate partner has no other ties to the state. The tax is based on the aggregate—as distinguished from the entity—theory of partnerships, under which each general partner is deemed to be conducting the partnership business directly and as owning a share of its assets; or on the alternative theory that the partners who actually conduct the business act as agents for the out-of-state partners. The states generally apply this rule to limited corporate partners as well as to general partners. Thus tribunals in Illinois,[1] Kentucky,[2] Massachusetts,[3] New York City,[4] North Carolina,[5] and Oregon[6] have so ruled.

Tribunals in some jurisdictions, however, have reached a different conclusion, although typically on the ground that they were not "doing business" in the state under the state statute rather than on the ground that they were not constitutionally subject to tax, an issue these decisions do not address. Decisions from Alabama,[7] California,[8] Louisiana,[9] and Tennessee[10] fall within this description.

The decisions of two New Jersey courts, however, may be read as suggesting that a taxpayer, whose only connection to New Jersey was its investment in a limited partnership doing business there, could not *constitutionally* be taxed by the state.[11] The taxpayer was a limited partner owning a 99% interest in a partnership that provided outsourcing technology services for its clients. The taxpayer's sole connection to New Jersey was its limited partnership interest. The New Jersey statutes assert jurisdiction over every corporation "exercising its corporate franchise in the State,"[12] and further provide that:

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[1] *See Borden Chems. & Plastics, L.P. v. Zehnder,* 312 Ill. App. 3d 35, 726 NE2d 73 (2000) (nonresident limited partner subject to tax on distributive share of partnership income based on partnership's in state activities).

[2] *Revenue Cabinet v. Asworth Corp.,* Nos. 2007-CA-002549-MR, 2008-CA-000023-MR (Ky. Ct. App. Nov. 20, 2009, *as modified*, Feb. 5, 2010) (unpublished) (corporation whose only connection with Kentucky was ownership of limited partnership interest in partnership doing business in Kentucky is taxable as a partner doing business in Kentucky), cert. denied, 131 S. Ct. 1046 (2011). (Unpublished opinions may be cited in Kentucky only if there is no published opinion that would adequately address the issues before the court (Ky. St. RCP Rule 76.28(4)).)

[3] *See Utelcom, Inc. v. Comm'r of Revenue,* No. C262339, 2005 WL 244820 (Mass. App. Tax. Bd. Jan. 31, 2005) (nonresident corporate limited partner taxable if "doing business" in the state based on activities of partnership within the state and is taxable on its distributive share of partnership income earned in the state); *SAHI USA, Inc. v. Comm'r of Revenue*, No. C262668, 2006 WL 3068116 (Mass. App. Tax Bd. Oct. 27, 2006) (same).

[4] *In re Petition of Mazie Corp.,* TAT(H) 92 353 (GC), 2000 WL 1162056 (N.Y.C. Tax App. Trib. July 21, 2000) (foreign corporation whose only contact with New York City was ownership of limited partnership that owned real property in the city has nexus with the city).

[5] N.C. Tax Review Bd., Admin. Dec. No. 351 (Jan. 28, 1999) (corporation with no connection to state other than interest in limited partnership that owned and operated restaurants in the state is doing business in North Carolina); N.C. Secretary of Revenue, Decision 97 548 (Apr. 24, 1998) (corporate limited partner in partnership doing business in North Carolina, but with no other connection to the state, is "doing business" in North Carolina and is subject to tax on an apportioned share of its distributive share of partnership income); *cf.* N.C. Secretary of Revenue, Decision No. 2007-28 (Sept. 14, 2007) (corporation with no connection to state other than investment in limited liability company (LLC), which elected to be treated as a partnership for federal tax purposes, is taxable on pro rata share of LLC's apportionable business income from its North Carolina activities).

[6] *CRIV Inv., Inc. v. Dep't of Revenue*, 140 Or. Tax 181, 184 (Ore. Tax Ct. 1997) ("When the income is distributable partnership income, it is immaterial that taxpayer is a limited rather than a general partner").

[7] The Alabama Department of Revenue ruled that holding a limited partnership interest in an Alabama real estate business does not constitute "doing business" in the state for Alabama franchise tax purposes. Rev. Rul. 98 002, 1998 WL 34077673 (Ala. Dep't of Revenue June 16, 1998).

[8] The California State Board of Equalization held that foreign corporations with interests in limited partnerships that acquired, managed, rented, and sold California real property were not subject to California franchise tax, because the corporations were inactive participants in the partnerships. *Appeals of Amman & Schmid Finanz AG*, 96-SBE-008, 1996 WL 281551 (Cal. State Bd. of Equalization Apr. 11, 1996). Unlike general partners, the corporations were not entitled to possess specific partnership property or to participate in partnership management. Their only contact with the state was the receipt of their distributive share of the partnerships' California source income. Accordingly, the corporations were not doing business in California.

[9] *Utelcom, Inc. and Ucom, Inc. v. Bridges*, No. 2010 CA 0654 (La. Ct. App. Sept. 12, 2011) (franchise tax measured by capital stock).

[10] The Tennessee Department of Revenue ruled that a foreign corporation owning a limited partnership interest in a partnership engaged in the real estate construction business in Tennessee is not "doing business" in that state under Tennessee's franchise and excise taxes as long as this activity constitutes the limited partner's only business endeavor in Tennessee and the limited partner exercises no power, management, or control over the partnership. Tennessee Dep't of Revenue, Letter Ruling No. 97 49 (Dec. 2, 1997).

[11] *BIS LP, Inc. v. Director, Div. of Taxation, 25 NJ Tax 88 (2009), aff'd, 2011 WL 3667622 (N.J. Super. App. Div. Aug. 23, 2011).*

[12] N.J. Stat. Ann. § 54:10A-2 (West 2011).

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> A taxpayer's exercise of its franchise in this State is subject to taxation in this State if the taxpayer's business activity in this State is sufficient to give this State jurisdiction to impose the tax under the Constitution and statutes of the United States.[13]

The New Jersey Tax Court approached the jurisdictional question as if it turned entirely on one of the bases set forth in the regulations for asserting jurisdiction over a foreign corporate limited partner, namely, whether "the business of the partnership is integrally related to the business of the foreign corporation."[14] Using this criterion, and relying heavily on the U.S. Supreme Court's unitary business decisions, the court concluded there was no jurisdiction because the taxpayer and the partnership "were not integrally related."[15] Specifically, the court noted that the taxpayer was a "passive investor," it had "no control or potential for control in the limited partnership," and it "was . . . not in the same line of business."[16] It further observed that the corporate partner's interest was "more akin to an example in the regulations, which illustrates that a foreign corporation that simply holds a limited partnership interest in a foreign New Jersey partnership and is not part of the unitary business of the partnership is not subject to the [Corporation Business Tax]."[17]

In affirming the New Jersey Tax Court's opinion "substantially for the reasons stated by Judge Bianco [the Tax Court Judge],"[18] the Appellate Division added little to Judge Bianco's analysis, but it strongly reinforced the impression that both courts' decisions rested on constitutional grounds. Thus, in response to the state's assertion that an amendment to the New Jersey statute reflected an intent to apply the tax broadly to "all circumstances permitted by the federal and state constitutions,"[19] the Appellate Division responded that "such an intent, like the statutory provisions themselves, cannot override constitutional limitations on a state's taxing power."[20] In characterizing Judge Bianco's opinion, the Appellate Division declared that "[h]e found that [the taxpayer] . . . did not have sufficient business activity to give New Jersey jurisdiction to impose tax under the Constitution."[21] Finally, in concluding, the Appellate Division observed that "the Director has not shown that Judge Bianco erred in finding no constitutional basis for imposing the [tax] at issue."[22]

The New Jersey courts' decisions would have been unexceptional if the question had been simply whether a state can constitutionally assert jurisdiction over a holding company with no contact with a state other than its investment in a nonunitary corporation. Indeed, we believe that even the existence of a unitary relationship between an in-state and an out-of-state corporation does not, by itself, establish nexus over the out-of-state affiliate.[23] The problem, however, is that we are dealing with partnerships, not corporations. In this context, the New Jersey decision cannot be reconciled, at least as a matter of constitutional law, with the overwhelming weight of authority (described above) that even a limited partner is deemed to be doing business (and is subject to tax) wherever the partnership is doing business. Those decisions that have held limited partners nontaxable in the states in which the partnerships have carried on business have relied on state statutory rather than federal constitutional grounds.

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[13] *Id.* The implementing regulations reiterate the constitutional nexus standard for exercising a franchise. N.J. Admin. Code §§ 18:7-1.6(b), 18:7-7.6(b) (West 2011).
[14] N.J. Admin. Code § 18:7-7.6(c) (West 2011).
[15] *BIS*, 25 NJ Tax 88, 105 (2009).
[16] *Id.*
[17] *Id.* The example in the regulation provides:
> Corporation LMN holds a limited partnership interest in the same limited partnership. The corporation and the partnership are not part of a unitary business, and the limited partnership does not have liabilities to third parties. LMN is not subject to corporation business tax in New Jersey since it is a true limited partner . . . .

N.J. Admin. Code § 18:7-7.6 (Example IV) (West 2011).
[18] *BIS*, 2011 WL 3667622.
[19] *Id.*
[20] *Id.*
[21] *Id.*
[22] *Id.*
[23] *See* Jerome R. Hellerstein, Walter Hellerstein, and John Swain, *State Taxation* ¶¶ 6.13[2], 8.07[1]; *Barclays Bank PLC v. Franchise Tax Bd.*, 512 U.S. 298, 311-312 n.10, 114 S. Ct. 2268 (1994).

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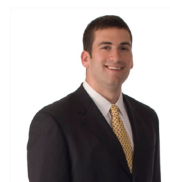

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