"Shaking things up in state and local tax"

SUTHERLAND SALT SHAKER

FORECAST
A front of bad tax proposals will pass to the east, and a merry band of spending cuts will settle in across the country.

VOL. 1, NO. 12 | TUESDAY, DECEMBER 21, 2010 | FREE

Schedule UTP – California Wants to See What's Hidden Under Your Mattress

Ever-dependable California has stepped up to the plate and become the first state to require the submission of a federal Schedule Uncertain Tax Position Statement (Schedule UTP). The Franchise Tax Board (FTB) announced on December 1, 2010 that, for taxable years beginning on or after January 1, 2010, it will require taxpayers that file federal Schedule UTP to attach the same schedule to their Franchise or Corporate Income Tax Return (Form 100/100W). Taxpayers cannot hide from this requirement because they will also be asked to check a box on their California Form 100/100W indicating whether or not they filed a federal Schedule UTP.

For taxable years beginning on or after January 1, 2010, the Internal Revenue Service requires a corporation to file Schedule UTP with its income tax return if: (1) the corporation files Form 1120, U.S. Corporation Income Tax Return; Form 1120-F, U.S. Income Tax Return of a Foreign Corporation; Form 1120-L, U.S. Life Insurance Company Income Tax Return; or Form 1120-PC, U.S. Property and Casualty Insurance Company Income Tax Return; (2) the corporation has assets that equal or exceed $100 million (there is an IRS announced phase-in that reduces the asset threshold to $50 million for 2012 and 2013 tax years and to $10 million for tax years 2014 and after); (3) the corporation or a related party issued audited financial statements reporting all or a portion of the corporation's operations for all or a portion of the corporation's tax year; and (4) the corporation has one or more tax positions that must be reported on Schedule

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Combined Reporting Not a Surefire Revenue Raiser

The National Conference of State Legislatures' Task Force on State and Local Taxation of Communications and Interstate Commerce commissioned Drs. Bill Fox and LeAnn Luna, economists with the University of Tennessee, to study the current economic realties of mandatory unitary combined reporting. The report, entitled Combined Reporting with the Corporate Income Tax: Issues of State Legislatures (Nov. 17, 2010), is intended "to explain the features of combined reporting and to analyze the key issues that states should consider when determining corporate tax structures, and specifically the relative merits of separate and combined reporting."

Of its various findings, the Fox Report most notably concluded that combined reporting should not be used as a revenue raiser to close states' budget holes, stating "[c]ombined reporting has no direct effect on state tax revenues." Rather, if a state's goal is an immediate increase in corporate income tax revenue, adoption or expansion of the use of intercompany expense addback statutes is a much more effective means of achieving this goal than adoption of combined reporting.

The Fox Report further advises, "[l]awmakers considering a move to combined reporting should consider the immense complexity the reporting regime will introduce" and such "complexity comes with a great amount of uncertainty." Indeed, such advice is generally echoed by the multistate tax community and supported by similar recommendations made by the Maryland Business Tax Reform Commission and Virginia's Joint Legislative Audit and Review Commission to their respective state legislatures.

U.S. Supreme Court Asked to Review Partnership Nexus Case

A taxpayer has filed a petition for certiorari, asking the U.S. Supreme Court to rule on whether an out-of-state corporation has nexus with Kentucky by virtue of its ownership interest in a limited partnership that does business in the state. *Asworth LLC (f/k/a Asworth Corp). v. Kentucky Dep't of Revenue*, Docket No. 10-662 (Nov. 16, 2010).

Asworth and its affiliates are out-of-state corporations that manage investments of various legal entities. None of the corporations has any property, employees, or payroll in Kentucky. Asworth owns a limited partnership interest in a partnership that conducts business in Kentucky. The Department of Revenue assessed Asworth for corporate income taxes on its distributive share of partnership income. Asworth challenged the assessment arguing that it was not subject to the corporate income tax because it did not have nexus with the state.

The Kentucky Court of Appeals reversed the decision of the Circuit Court and upheld the Department's finding that Asworth had nexus with the state through its distributive share of partnership income. *Revenue Cabinet v. Asworth Corp.*, 2009 Ky. App. LEXIS 229 (Ky. Ct. App. 2009). Asworth's argument that the assessment violated the dormant Commerce Clause's physical presence nexus requirement was rejected because the corporation owned an interest (up to 99% at various times) in a partnership that conducted business in Kentucky. The court observed that it still remains unclear whether the bright-line physical presence standard articulated in *Quill v. North Dakota*, 504 U.S. 298 (1992), for sales and use taxes applies to income taxes.

The time has come for the Court to accept a nexus case. Time will tell whether *Asworth* is the appropriate vehicle for the Court to provide further nexus guidance.

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Schedule UTP – California Wants to See What's Hidden Under Your Mattress (cont'd)

UTP. Affiliated groups filing federal consolidated returns are required to file federal Schedule UTP for the entire affiliated group.

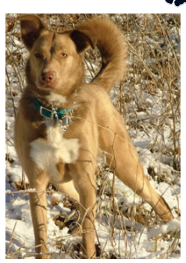
California's announcement raises several concerns. There are serious questions about California's authority to require receipt of confidential information regarding corporations that may not be subject to California's taxing powers, i.e., non-nexus corporations included in a California combined report or corporations that may not be subject to the California franchise or income tax, such as insurance companies. Because California taxpayers come in all shapes and sizes, there is a high likelihood that simply attaching a federal Schedule UTP will transmit information to California regarding corporations over which it has no jurisdiction to tax. Thus, the question arises as to whether a taxpayer will be deemed compliant with this new FTB edict if, rather than submitting the entire federal Schedule UTP, it instead provides a redacted version that deletes information regarding affiliates outside of California's taxing authority or the scope of the franchise or income tax.

For now, California has reserved its discussions on devising its own UTP form and is not requiring disclosure of California-specific tax positions. The FTB plans to include additional details regarding this Schedule UTP attachment requirement in the instructions to Form 100/100W for 2010. Of course, the question remains whether additional states will join in the search under taxpayers' mattresses by requiring the submission of Schedule UTP or adopting their own state-specific UTP schedules.

Washington State's Digital Tree of Knowledge

The Washington Department of Revenue has developed a decision tree that illustrates the analysis necessary to determine how an electronically transferred product is taxed. Excise Tax Advisory 9003.2010 (Nov. 30, 2010) summarizes the process by which taxpayers can determine whether a given item is taxable as a digital product (a digital good or a digitally automated service) or remote access software. The decision tree section is intended to "highlight key considerations in the analysis process."

The decision tree is a five-step process: (1) determine whether the transaction involves the electronic transfer of a product or service according to the definition of digital products found in RCW 82.04.192; (2) determine whether any exclusions from the definition of digital products or remote access software apply (also found in RCW 82.04.192). For instance, payment processing, online educational programs, live presentations, data processing and other products are excluded from the tax imposition statute; (3) apply Washington's sourcing rules to determine whether the transaction is sourced to Washington; (4) determine whether any exemption from retail sales or use tax applies; (5) determine whether any other issues, such as amnesty, nexus, or royalties, are involved. For instance, Washington provides a nexus "safe harbor" for digital products and software on servers in the state (RCW 82.32.532). Then, repeat as necessary.



SALT PET OF THE MONTH

Anna

Meet Anna—the adventurous Husky/ Chesapeake bay retriever mix (a "love child" from a farm in Wisconsin) who is in charge of the home of good Sutherland SALT friend, Victor Ledesma (Kimberly-Clark Corporation) and his lovely wife, Jackie. During Anna's seven years with the Ledesmas, she has earned a variety of nicknames as a result of her antics, including "The Boss," "The Beast," "The Queen," "The Girl," and, of course, "Honey."[1]

Anna loves to hike with her bright red backpack, swim, jump in snow drifts, and chase the local squirrels and rabbits from her yard. After repeating puppy school twice, Anna has mastered a few commands—but "Come!" is unfortunately still not one of them. During one of her walks, Anna took off to chase eight deer for over a half mile, charging through a ravine and out of sight, only to be found an hour and a half later. In another adventure, Anna strutted out onto a (nearly) frozen pond and fell through the ice. Loaded down by the water bottles and dog treats in her backpack, she was unable to climb out herself and had to be rescued by her brave hero—Vic—who bravely pulled her to safety while grasping a hanging tree branch. The two emerged soaked, frozen, and muddy—making it a day they will never forget.

Along with all of her drama, Anna also offers the Ledesmas her unconditional love and companionship. When inside the house, she is by their side constantly—greeting them at the door with genuine excitement and loyally following them from room to room, even if it interrupts her slumber. And despite her energy, she has a true gentleness about her. To quote Vic, she will take celery from your fingertips "softer than a lazy winter snowfall." All of these qualities, found in one striking puppy package, makes us proud to coin Anna's new nickname—Sutherland SALT's Miss December.

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.

1. One nickname has been omitted to protect Anna's reputation.

Update on Multistate Tax Commission Activities – Montana Gets Feisty

The Multistate Tax Commission (MTC) held its Fall Uniformity Committee Meetings in Atlanta, Georgia on December 7-9. With a significant turnover in state tax commissioners expected as a result of the November elections, it will be interesting to see if any of the decisions made by MTC representatives the last few years are revisited at the Winter Committee Meetings to be held in Kansas City, Missouri, March 1-4, 2011.

Income and Franchise Tax Uniformity Subcommittee:

- Amending UDITPA. The two issues discussed at this meeting were: (a) implementation of market sourcing for the license or sale of intangible property and (b) revising the definition of "sales" for purposes of determining what to include in the receipts factor. The Subcommittee directed its drafting group to revise the draft UDITPA amendments to:

  - Adopt a distinction between a marketing intangible and a manufacturing (or non-marketing) intangible similar to what Massachusetts has implemented and California has proposed. The result would be that receipts from a marketing intangible would be included in the numerator of the state in which the ultimate consumer is located, while receipts from a manufacturing intangible would be in the numerator of the state in which taxpayer's customer's production activity occurs.
  - Provide a rule for determining who is the ultimate customer whose activity determines the sourcing of receipts.
  - Include in the sourcing rule a cascade approach so that if the ultimate customer cannot be determined, alternative sourcing rules are provided, including a default rule to sourcing based on some type of population percentage.
  - Draft both a narrow and a broad version of the definition of "sales" for consideration by the Subcommittee at its next meeting. The narrow definition would include in sales only receipts from the sale of inventory.
  - Offer options to the Subcommittee for sourcing of business income from one-time sales of subsidiaries or business assets, particularly if the narrow definition of sales is ultimately adopted. One suggestion is to source such receipts based on the apportionment formula of the subsidiary sold or the location of the asset sold.

- Model Withholding Statute. A surprisingly contentious discussion regarding a previously resolved issue erupted at this meeting. Montana representatives continue to insist that employers must report, though not remit, on all employees entering a state to work, regardless of the days spent in the state. This suggestion was voted down at a previous meeting but was brought up again at this meeting – with the same result. At the MTC's Executive Committee Meeting, Montana Commissioner Dan Buck announced that he had lodged an official complaint that the Subcommittee had not sufficiently considered Montana's proposal. A separate Executive Committee phone call will be scheduled to consider Montana's complaint.

- Amendments to Tax Haven Provision in MTC Model Combined Reporting Statute. The MTC's Model Statute, as well as the statutes of several states, includes a provision that a water's edge reporting group will include non-domestic affiliated entities that are doing business in tax haven countries. The definition of a tax haven country is outdated because it relies on an Organization for Economic Co-operation and Development list that is no longer kept up-to-date. The preference of the group seemed to be to allow states to independently determine what a tax haven country is, based on the existing criteria in the model statute. This could clearly create uniformity issues. One member noted that the United States might be a tax haven country based on the criteria used.

Sales and Use Tax Uniformity Subcommittee

- Model Sales and Use Tax Notice and Reporting Statute. The Subcommittee continued its work on crafting a model statute, a project initially motivated by Colorado's adoption of such a statute. A significant part of the discussion involved the imposition of penalties and how to calculate penalties. Later, during a full Uniformity Committee State Roundtable discussion, a representative from Kentucky said that his state was specifically interested in adopting such a statute.

Massachusetts Shams a Holding Company

In *IDC Research, Inc. v. Comm'r of Revenue*, No. 09-P-1533 (Nov. 30, 2010), the Appeals Court of Massachusetts held that the transfer of International Data Group's (IDG) logo licensing business to a Delaware subsidiary was a sham. The court affirmed the Appellate Tax Board's decision and reallocated the Delaware subsidiary's royalty income from foreign affiliates to IDG.

The court found that IDG never actually transferred ownership of the logo licensing business because it: (1) failed to adhere to multiple corporate formalities; (2) continued to identify itself as the owner of the logo; (3) continued to treat the logo as its own after the transfer; and (4) retained the benefits and burdens of ownership – as evidenced by its withdrawal of millions of dollars from the Delaware subsidiary's account. IDG asserted that the withdrawals were loans; however, there was no loan documentation and minimal repayment to the subsidiary. While IDG claimed that its business purpose for the structure was decentralization, the court held this was inconsistent with IDG's retention of control over the subsidiary and the logo.

In addition to the lack of business purpose, the court found that the Delaware subsidiary lacked economic substance. Its only activities consisted of the receipt of royalty income, the automatic investment of such income, and the leasing of office space in Delaware for $250 a month. Furthermore, all of the Delaware subsidiary's licensing agreements were with affiliated entities. Finally, the court agreed with the Appellate Tax Board's conclusion that the Delaware subsidiary was a "passive vessel" used to divert royalty income from IDG.

Out-of-State Tugboat Operator Washes Ashore in New York State

On November 18, 2010, the New York Division of Tax Appeals held that Dann Ocean Towing (Dann), a Florida corporation with no employees or property in New York State, was liable for New York's petroleum business tax. *In re Dann Ocean Towing, Inc.*, Determination DTA No. 822683 (Nov. 18, 2010). Dann owned 12 tugboats, seven of which were used to perform towing, icebreaking and other operations in New York State on behalf of third-party charter companies. The agreements between Dann and the charter companies were drafted as "service" agreements. However, the tugs were owned by Dann, and Dann's employees operated the tugs and performed services on behalf of the charter companies. The New York Division of Tax Appeals held that the tugboats' operations in New York waters, which included towing and discharging cement and performing ice-breaking operations, constituted substantial nexus with the state. By operating its vessels in New York waters, Dann engaged in business in the state and was liable for the petroleum business tax.

Dann also argued that the charter companies had control over the tugboats, and therefore, they should be responsible for the tax. Dann pointed to the charter agreement provisions requiring the charterers to reimburse Dann for fuel purchased for the tugboat. The Division of Tax Appeals concluded that Dann exercised significant control over the tugboats and, therefore, was liable for the tax.

Recently Seen and Heard

December 3, 2010
COST Southeast Regional State Tax Seminar
Georgia-Pacific LLC – Atlanta, GA
Eric Tresh and **Maria Todorova** on Significant State Tax Litigation Around the Country
Eric Tresh on State Tax Policy Update: 2010 & Beyond – How Will the States Meet Their Revenue Needs?
Jonathan Feldman and **Charlie Kearns** on Evolving Combined Reporting Issues

December 6, 2010
TEI Cincinnati Chapter Tax Seminar
Kings Island Resort & Conference Center – Mason, OH
Pilar Mata and **Mark Yopp** on State and Local Tax Legislation and Litigation Update
Marlys Bergstrom and **Mark Yopp** on Unclaimed Property Developments
Maria Eberle and **Pilar Mata** on Combined Reporting

December 8, 2010
Interstate Tax Planning Conference
Double Tree Hotel – Washington, DC
Michele Borens on The Unitary Concept

December 8, 2010
TEI New York Chapter Meeting
New York, NY
Jeffrey Serether and **Marc Simonetti** on Recent Developments to Non-Income Taxes

December 13-14, 2010
New York University 29th Institute on State and Local Taxation
Grand Hyatt – New York, NY
Jeff Friedman on RAR Adjustments – Are They 'Final'? What Do You File and When Do You File It?
Marc Simonetti on What's Happening Everywhere Today?
Diann Smith on Due Process – Are Pay-to-Play and Internal Hearings the End of the Line? Retained Refunds, Retroactive Laws and Regulations, Harsh Penalties

December 21, 2010
COST Mid-Atlantic Regional Tax Seminar
Tyco Electronics Corporation – Berwyn, PA
Charlie Kearns on State Tax Policy Update: 2010 & Beyond – How Will the States Meet Their Revenue Needs?
Marc Simonetti on Best Practices for Managing Audits & Litigation in Today's Challenging Environment and FIN 48 Disclosures; Discussion of Significant State Tax Litigation Around the Country; and The Economic Substance Doctrine & Reporting of Uncertain Tax Positions, Including Exploring Unintended Impacts on State Taxation

Unclaimed Property: The Year in Review

As the year winds down and we reflect on what has occurred in the world of unclaimed property over the last 12 months, we find it has been an unusually action packed year. Joining the various other countdowns to 2011, here is the 2010 Countdown of the Biggest Unclaimed Property Events of the year.

5. CALIFORNIA FINALLY ENTERS THE 21ST CENTURY: Enactment of Positive Contact Requirement and Allowance of Electronic Communication

California Assembly Bill 1291 (passed in late 2009) was up and running in 2010. The law placed greater owner notification burdens on holders, but permits such notifications to be peformed electronically, with one BIG caveat - an owner must consent to the electronic notice. Another bonus for California holders is that "communications" between holders and owners now includes account statements and statements required under the IRC. This is of special benefit to financial organizations and insurance companies that send monthly account statements to their customers.

California also recognized that not all owners (or even most, or maybe not even more than 10) are aware of the state's unclaimed property laws. AB 1291 also requires holders to include the following specific language in due diligence letters: "THE STATE OF CALIFORNIA REQUIRES US TO NOTIFY YOU THAT YOUR UNCLAIMED PROPERTY MAY BE TRANSFERRED TO THE STATE IF YOU DO NOT CONTACT US." Similarly, a separate section of the legislation, effective January 1, 2011, applies only to banking and financial institutions and requires written notice to a person opening an account that the property in the account may be transferred to the appropriate state if no activity occurs in the account within the time period specified by state law. [If the person opening the account has consented to electronic notice, the above may be provided electronically.] Because everyone reads all of the fine print provided by such institutions, this legislation will surely end any misunderstandings!

On a cheerful note, hopefully the California changes will encourage other states to embrace the technological advances of the last several decades and permit electronic notice to holders, particularly in light of states' "Green Initiatives."

4. MONEY, MONEY, MONEY: Shortened Dormancy Periods

Attempting to minimize the damage of budget deficits, states took to heart the musings of one of the greatest pop bands ever (and a palindrome – can you figure it out?): "Money, Money, Money, Always Sunny , , , All the things I could do, If I had a little money." Several states used their unclaimed property laws to get a "little money" by shortening their dormancy periods. For example, Arizona passed emergency legislation to shorten the dormancy period for most types of property from five years to three years. Michigan permanently shortened its default dormancy period from five years to three years, and New Jersey dramatically shortened the dormancy period for travelers checks from 15 years to three years.

Since we know that states have not miraculously solved their budget problems, we predict that other states will adopt shortened dormancy periods in the coming year. For states that have already shortened their dormancy periods, maybe they will just keep chopping away like a person cutting his/her own bangs – with similar potentially ugly results.

3. GIVE A LITTLE, TAKE A LOT: Delaware Legislation – *McKesson v. Cook*

Bringing joy to holders everywhere, the McKesson Corporation brought suit against Delaware after the state asserted that the company's un-invoiced payables (basically inventory overages) were unclaimed property.Instead of facing almost certain defeat in court, Delaware adopted legislation excluding un-invoiced payables from the definition of unclaimed property. Not stopping there, Delaware also adopted "administrative procedures" which turned this initial joy into a bit of a draw for holders who were hoping that the legislation would also include some type of <u>real</u> and <u>independent</u> administrative review process. The administrative procedures now require/permit that: (1) an audit assessment be paid within 30 days after the close of the audit; (2) any audit dispute be first heard by a Delaware audit manager; (3) the holder may appeal the decision of the Delaware audit manager to the Delaware Secretary of Finance; (4) the matter may be referred to an Independent Reviewer; and (5) the Delaware Secretary of Finance may reject the decision of the Independent Reviewer. We expect that this process will lead to a less than fair result, especially since the "Independent Reviewer" will likely be a current or former employee of the Delaware Bureau of Unclaimed Property.

2. THE STAGES OF GRIEF: Insurance Company Audits

In 2009, life insurance companies began receiving state unclaimed property audit notices. While unclaimed property is nothing new to the industry, the particular focus of these audits was different, focusing almost exclusively upon life and annuity products. One life insurance product under intense scrutiny is retained asset accounts.

1. AND THE STATE OF THE YEAR IS: New Jersey – for its Stored Value Card Legislation, Retroactive Remittance Law, Running Afoul of the United States Supreme Court, Making Delaware Mad and Earning a Preliminary Injunction from a Federal Court

New Jersey wins the prize for most audacious legislation of the year. In addition to dramatically reducing the dormancy period for travelers checks (see number 4), New Jersey (a) revoked its previous judicial exemption for stored value cards; (b) imposed a two-year dormancy period on such cards (which is three years shorter than the federal expiration date law); (c) applied its new law retroactively to all outstanding amounts (which were previously exempt); and (d) took on Delaware and possibly the U.S. Supreme Court by adopting a law providing that the "location of the transaction" trumped the state of incorporation as the state of priority if unclaimed property had no last known address of an owner. 2010 N.J. Laws Chapter 25. The state estimates this law will generate an additional $76 million annually in unredeemed gift cards – if it ever gets out of litigation.

Not surprising, the law was met with great disapproval by retailers, restaurants and organizations, such as the New Jersey Retailers Association. A total of five cases were filed challenging the law and seeking a preliminary injunction. The plaintiffs were successful on the most important merits of the case – the state had unconstitutionally bent the established rules of jurisdiction.

Not one to give up easily (or at all), New Jersey pushed on and issued Treasurer Orders mandating that issuers of stored value cards reconfigure their sales and data retention systems so that by January 3, 2011, they are capable of obtaining and maintaining at a minimum ZIP code information of all stored value card purchasers.

We expect that 2011 will be another very interesting year with respect to New Jersey's stored value card legislation and whether other states will adopt similar statutes. It will not be surprising to see the priority issue in front of the United States Supreme Court.

Companies with Captive Insurance Affiliates – Look Out for a Premiums Tax Increase

On December 10, 2010, the largest bipartisan organization of state representatives – the National Council of State Legislators – voted to support the adoption of a multistate compact that could affect many captive insurance companies.

The compact provides for the centralized collection and allocation of state premium taxes imposed on property and casualty insurance obtained from companies not licensed in the state of the risk. This development is another in a string of legislative and regulatory actions that may fundamentally alter the tax liability of many companies employing a captive insurance entity. Unfortunately, many affected taxpayers are not fully aware, or aware at all, of the possible increase in their tax liability resulting from the adoption of the compact.

Included as part of the 2,319-page federal Wall Street Reform and Consumer Protection bill, known as the Dodd-Frank Act, was a relatively obscure provision known as the Nonadmitted and Reinsurance Reform Act of 2010 (NRRA). Aimed primarily at simplifying the states' taxation and regulation of surplus lines insurance, NRRA provides that no state, except the "Home State" of the insured, may impose a premium tax on nonadmitted insurers. However, the NRRA also provides that states may form a compact and determine by agreement how to allocate among the states in which the risk is located the premium taxes paid to the Home State. Thus, for companies with a captive insurance company in their structure, the issues to watch are: (a) Will their Home State impose a premium tax on 100% of the premiums paid to the captive, regardless of where the risk is located, and if so, at what rate? (b) Will their Home State become a member of the anticipated multistate compact? and (c) What will such a multistate compact ultimately require?

The contents and scope of a multistate compact for the collection and allocation of taxes on premiums paid to nonadmitted insurers is currently being fleshed out by trade organizations in the form of two separate and competing drafts. One alternative is the Nonadmitted Insurance Multi-State Agreement (NIMA), drafted by the National Association of Insurance Commissioners. The other, currently more popular alternative, is the Surplus Lines Insurance Multi-State Compliance Compact – otherwise known as SLIMPACT-Lite (and no, it is not a new diet supplement). SLIMPACT-Lite is supported by numerous groups and associations, including the Council of State Governments and the National Council of Insurance Legislators.

The NRRA was aimed primarily at simplifying the taxation and regulation of surplus lines insurance, and the collateral effect on captive insurance companies will be significant. For companies currently not paying a premium tax on insurance purchased from their captive insurance company, NRRA could significantly increase their liability if their Home State joins the compact or does not join the compact but nevertheless imposes its tax on all risks wherever located. Monitoring the implementation of NRRA is important for those with an existing or contemplated captive insurance company.

South Carolina Off Track with Its Final TRAC Report

The South Carolina Tax Realignment Commission (TRAC) has released its Final Report, which includes proposed draft legislation to achieve its recommendations. As expected, the recommendations include the expansion of the sales tax base to include "data processing, software delivered over the Internet, and digital products." In addition, the recommendations include language to expand sales tax collection obligations with a New York-style click-through nexus provision and an affiliate nexus provision. Although word on the street is that the South Carolina legislature is unlikely to enact the majority of the recommendations contained in this Final Report, current economic conditions require careful monitoring of these and other tax hikes.

The TRAC proposes to achieve the tax base expansion in a curious fashion—by adding data processing, computer software, and digital products to the list of "intangibles" included in the definition of "tangible personal property." Thus, in the topsy-turvy world of state sales tax, intangible property can indeed be taxed as tangible property. The suggested language is as follows:

> "Tangible Personal Property" means personal property which may be seen, weighed, measured, touched, or which is in any manner perceptible to the senses. It also includes services . . . and intangibles, including data processing, computer software, digital products, communications, laundry and related services, furnishing of accommodations and sales of electricity, the sale or use of which is subject to tax under this chapter and does not include stocks, notes, bonds, mortgages or other evidences of debt.

The draft legislation includes a broad definition of "digital products" that includes, but is not limited to, the Streamlined Sales Tax-like definitions of "digital audio-visual works," "digital audio works," and "digital books." Digital products is expansively defined to mean, "electronically transferred goods obtained by the purchaser by means other than tangible storage media."

Likewise, "data processing" is broadly defined in the proposed statute as "the manipulation of information furnished by a customer through all or part of a series of operations involving an interaction of procedures, processes, methods, personnel,

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South Carolina Off Track with Its Final TRAC Report (cont'd)

and computers. It also means the electronic transfer of or access to that information. Examples of the processing include, without limitation, summarizing, computing, extracting, storing, retrieving, sorting, sequencing, and the use of computers."

These proposed definitions are so amorphous that they provide the state with the authority to tax practically any service, data, information, or digital good, so long as it is transferred electronically. This legislation could be interpreted to include information services, cloud computing, and other electronically delivered services far beyond what are specifically enumerated as taxable services in South Carolina statutes. It is precisely this type of unclear and expansive digital imposition that creates uncertainty for businesses and can act as a damper on business development and job creation within the state.

On the nexus front, TRAC recommends a two-pronged attack to compel out-of-state companies to collect sales tax. If adopted, a retailer will be "presumed to be liable for the sales tax . . . if the retailer enters into an agreement with a resident of this State under which the resident, for a commission or other consideration, directly or indirectly refers potential customers, whether by a link on an Internet Web site or otherwise, to the retailer." The recommendations also contain a provision that establishes nexus by expanding the definition of a "retailer maintaining a place of business" in South Carolina to include an out-of-state company if an in-state affiliated entity has a presence in the state and the affiliated entity does any of the following: use "substantially similar name, tradename, trademark, or goodwill, to develop, promote, or maintain sales"; "pay for each other's services in whole or in part"; "share a common business plan or substantially coordinate their business plans"; or the in-state company "provides services to or on behalf of, or that inure to the benefit of, the out-of-state retailer." Adding the TRAC nexus provisions to its long-standing economic income tax nexus regime, the TRAC nexus proposal would make South Carolina one of the most aggressive nexus jurisdictions in the country.

Come See Us

January 11, 2011
DC Bar State and Local Tax Series Lunch
DC Bar Conference Center – Washington, DC
Jeff Friedman and **Pilar Mata** on Top 10 2010 Events and 2011 Trends

January 23-28, 2011
COST SALT Basics School
Georgia Tech Hotel and Conference Center – Atlanta, GA
Charlie Kearns on Streamlined Sales Tax – Changing the Landscape

February 2-4, 2011
Florida Bar Tax Section National Multistate Tax Symposium
Disney's Grand Floridian Resort & Spa – Orlando, FL
Jeff Friedman on Pending State Tax Legislation

February 22-24, 2011
TEI 2011 IRS Audits & Appeals Seminar: Tax Controversies in a Post-Schedule UTP World
Hyatt Regency Orlando International Airport – Orlando, FL
Marc Simonetti and **Pilar Mata** on State Tax Consequences of Federal Tax Controversies

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