A Washington National Tax Services (WNTS) Publication

MyStateTaxOffice Quarterly

State and local tax services

MyStateTaxOffice Quarterly is prepared by PwC – Washington National Tax Services SALT Team. Our objective is to provide a quick reference to our recently issued key developments.

January - March 2011

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SALT Perspective

State tax on majority-owned pass-through entities and LLCs despite insurance industry concerns

by Michael Palm and Michelle Zahler

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In 2008, the Multistate Tax Commission (MTC) initiated a project to analyze the perceived tax discrepancy between pass-through entities owned by insurance companies and those owned by non-insurance businesses. A drafting group was formed by the Income and Franchise Tax Subcommittee to gather and provide educational information, identify policy issues and draft a model statute in an attempt to address the perceived disparity in tax treatment.

In October 2010, a proposed draft statute was adopted by the subcommittee that would impose the corporate income tax on a pass-through entity in those cases where the pass-through entity or LLC is at least 50% owned by a business entity that is not subject to state corporate income tax, such as an insurance company. While the original project only targeted pass-through entities owned by insurance companies, the model statute has since been expanded to include pass-through entities owned by any entities exempt from corporate income tax. The MTC has not provided any additional examples of other entities not subject to the corporate income tax to date, although the

committee notes did identify that the provision will not apply to pass-through entities owned by non-profit entities.

The MTC Executive Committee voted on March 10, 2011, to advance the proposal to public hearings, which is the next step in finalizing the draft statute that states could then adopt via the legislative process. The MTC must give thirty days notice before any public hearing(s). If the proposal is deemed worthy to proceed through the hearing process, a recommendation of action will be drafted and circulated to the member states by the Executive Director to determine in an additional thirty day window, whether or not the members will consider adoption. If the majority of members agree to consider adoption, consideration of the item will be directed at the next regular meeting of the MTC. If a majority of the affected members do not agree based on the survey, the recommendation will be referred back to the Executive Committee for further consideration.

In the majority of states, insurance companies are generally only subject to the insurance premium tax, a flat rate gross receipts tax. This tax methodology is utilized for all revenue streams of an insurance company, to include both their underwriting and investment operations. It is a common industry practice to hold certain investments and underwriting activities in subsidiary business entities structured as flow-through entities for purposes of limiting liability and the administrative ease of accounting separation. Examples of this type of business structure and revenue streams include: 1) ownership of a hotel for investment purposes which is held by a partnership and 2) an insurance agency formed as a LLC which is used to conduct the sales activity for the insurance company. As a result of the state tax structure on insurance companies and the predominant use of flow-through entities by the industry, income received from a pass-through entity is not subjected to state income tax on that revenue in most states.

The MTC's process and proposal itself has been met with much scrutiny from the insurance industry which believes that the MTC proposal has not been subject to sufficient outside input and is based on questionable and unproven assumptions. Among the industry's concerns are 1) the industry is already taxed at a higher burden than most other industries, 2) impact on retaliatory computation for purposes of determining premium tax due, 3) new tax inequalities the draft statute would create on insurance companies, and 4) the lack of evidence that satisfactory research has been performed to address the inherent issues with the draft statute. The insurance industry is urging the MTC Executive Committee to terminate the project or at a minimum, to forgo advancement of the proposal to a public hearing but instead refer it back to the Uniformity Committee for further research and consideration.

PwC observes

The draft model statute represents a significant change in the tax methodology for pass-through entities. If this statute passes and is adopted by states, impacted taxpayers will need to evaluate the additional burden the new tax will create and the effect it will have on market competitiveness and organizational structure.

For further information, please feel free to contact Michael Palm at (312) 298-2483, or Michelle Zahler at (312) 298-4288.

CALIFORNIA and ILLINOIS

Increased estimated tax payment reminders

States are altering estimated tax payment requirements in order to accelerate revenue and attempt to balance their budgets. For example, in 2009, California enacted budget legislation accelerating corporate and individual estimated tax payments, beginning in January 2010. Like other states undertaking such actions, California did not place a sunset on this estimated tax payment acceleration, as doing so would "give back" money from the state's current fiscal year.

Illinois, earlier this year, enacted an increased estimated tax payment requirement. In this case, rather than accelerate income into the current fiscal year, the change is intended to mirror the increase in Illinois corporate and individual tax rates that were effective January 1, 2011. Taxpayers should be aware of the rules for California and Illinois to ensure their estimated taxes are properly paid.

California

For tax years beginning on or after January 1, 2010, taxpayers required to make quarterly estimated payments must pay the following percentages of their estimated tax liability: 30 percent on the 15th day of the fourth month; 40 percent on the 15th day of sixth month; zero

percent on the 15th day of the ninth month; and 30 percent on the 15th day of the 12th month. [A.B. X4 17, enacted 7/28/09]

There is no sunset date for this provision in the legislation, and therefore the accelerated percentages apply for 2011. Along with the first estimated payment, California franchise taxpayers are required to remit the $800 minimum tax. Failure to pay this minimum tax may impact the automatic filing extension and the ability to claim or use reasonable cause exceptions for penalties. Individual income taxpayers should keep in mind that, unless extended, the "supplemental tax rate" of .25% expired on December 31, 2010, and therefore does not apply to 2011 estimated taxes. Individuals should also be aware of a recent announcement by the Franchise Tax Board that, effective January 1, 2011, it will begin assessing a penalty equal to 1 percent of amounts paid by other than electronic means for tax payments subject to the "mandatory e-pay law" (click here for more).

Illinois

Illinois on January 13, 2011 enacted legislation that increased corporate and individual income tax rates, and in tandem increased estimated tax payment requirements. (S.B. 2505, enacted 1/13/11) (Click here for an analysis of the legislation.)

For installments of estimated tax due before February 1, 2011, the law requires taxpayers to timely pay the lesser of 100 percent of the prior year's tax liability or 90 percent of the current year's tax liability in order to avoid an underpayment of estimated tax late payment penalty. However, for payments due on or after February 1, 2011, and before February 1, 2012, an underpayment of estimated tax late payment penalty can be avoided by timely paying the lesser of *150 percent* of the prior year's tax liability or 90 percent of the current year's tax liability. More information on these changes is available in Illinois Information Bulletin FY-2011-09 (click here).

Estimated tax installment payments are equal to 25 percent of the required annual payment, unless the taxpayer is using the annualized payment method. The failure to pay estimated tax penalties do not apply if the taxpayer was not required to file an Illinois income tax return for the preceding taxable year or, for individuals, if the taxpayer had no tax liability for the preceding taxable year and such year was a taxable year of 12 months.

COLORADO

U.S. District Court enjoins enforcement of Colorado sales and use tax "notice and reporting" requirements

A U.S. District Court on January 26, 2011 granted a preliminary injunction barring Colorado, at least temporarily, from enforcing its sales and use tax "notice and reporting" requirements for out-of-state sellers. [*The Direct Marketing Assoc. v. Huber,* U.S. Dist. Ct., Dist. Co., No. 10-cv-01546-REB-CBS, *order granting motion for preliminary injunction,* 1/26/2011]

Under the Colorado notice and reporting regime, enacted on February 24, 2010, out-of-state retailers not collecting Colorado sales tax are required to notify Colorado customers of their sales and use tax obligations at the time of the purchase and provide end-of-year reports containing sales information to both the customers and the Colorado Department of Revenue. The first such reports are due to customers on January 31, 2011, and to the Department on March 1, 2011, each covering the prior calendar year. (Click here for more detail on these requirements.)

The Direct Marketing Association (DMA) filed suit challenging these notice and reporting requirements, and sought to enjoin the state from enforcing them. On January 26, the U.S. District Court for the District of Colorado issued an order grating DMA's motion for a preliminary injunction. The injunction bars the Department from enforcing the statutes and regulations requiring transactional notices to customers, annual reports to customers, and annual reports to the Department, against out-of-state retailers whose only connection with the state is by common carrier or the U.S. mail. (Out-of-state retailers with other connections to the state are not protected by this injunction, and must still comply with the law.) The injunction will remain in effect until modified or rescinded by further order of the court.

Substantial likelihood of success on the merits

In granting the injunction, the court found that DMA established "a substantial likelihood that it is likely to prevail on the merits of the substantive claims that are the basis for its motion." While DMA advanced other claims in support of its

lawsuit, it asserted two claims under the Commerce Clause as reason for the court to grant its injunction.

The first claim was that the Colorado notice and reporting requirements discriminate against out-of-state retailers who do not collect Colorado sales tax, because the law (the enacting "Act" and "Regulations") imposes on those retailers notice and reporting obligations that are not imposed on Colorado retailers. Citing *Oregon Waste Systems, Inc. v. Department of Environmental Quality,* 511 U.S. 93 (1994), the court noted that a law discriminates against interstate commerce in violation of the Commerce Clause if it imposes a "differential treatment of in-state and out-of-state economic interests that benefits the former and burdens the latter." The court also noted that the degree of a differential burden on interstate commerce "is of no relevance to the determination whether a State has discriminated against interstate commerce." In the instant case, the court found, the Colorado requirements impose a notice and reporting burden on out-of-state retailers, and that burden is not imposed on in-state retailers (except for the "very few in-state retailers who defy their statutory sales tax obligations" by not collecting the tax). The court concluded, under these circumstances, "that the plaintiff has shown a substantial likelihood that it will succeed in showing that the Act and Regulations are discriminatory because, in practical effect, they impose a burden on interstate commerce that is not imposed on in-state commerce."

The court noted that the state may justify a discriminatory tax by demonstrating the local benefits flowing from the challenged law and the unavailability of non-discriminatory alternatives adequate to preserve the local interests at stake. However, the court found that DMA showed the availability of non-discriminatory alternatives to the Colorado notice and reporting requirements. For example, like other states, Colorado might collect use tax from Colorado taxpayers via the Colorado income tax form, the court noted.

The second claim was that the Colorado requirements constitute an improper and burdensome regulation of interstate commerce. After discussing *Quill v. Heitkamp,* 504 U.S. 298 (1992), the court noted that the Colorado notice and reporting requirements do not require out-of-state retailers without substantial nexus to collect sales and use taxes, which would run afoul of *Quill.* "However, they do require out-of-state retailers to gather, maintain, and report information, and to provide notices to their Colorado customers and to the defendant about their Colorado customers." The court further noted that the sole purpose of these requirements is to enhance the state's collection of use taxes. The court therefore concluded that "these requirements likely impose on out-of-state retailers use tax-related responsibilities that trigger the safe-harbor provisions of *Quill.*" While the notice and reporting requirements are "somewhat different that the burden of collecting and remitting sales and use taxes," the court found that these requirements "are inextricably related in kind and purpose to the burdens condemned in *Quill.*"

Note: The Colorado Department of Revenue has posted the following to its website: "Pursuant to the order for a preliminary injunction of the Federal District Court for the District of Colorado (Judge Blackburn), enforcement of the reporting requirements for non-collecting retailers that you are attempting to access has been preliminarily enjoined. Until further action by the court in this matter, you are not required to comply with these reporting requirements." All templates and instructions on the website for non-collecting retailers have been replaced by this posting.

State Tax Practitioner Tip

Your local PwC state tax specialists may assist you with participation in these on-going or up-coming state tax amnesties:

- Michigan
- Washington

Enacted legislation and issued court decisions and administrative guidance

Note: The parenthetical date is the MySTO published date for the development

Income/Franchise Tax

Arizona
Arizona legislation phases-in single sales factor apportionment election, decreases corporate income tax rate (March 7, 2011)

California
California Franchise Tax Board announces decision to enforce I.R.C. conformity (January 14, 2011)

California FTB: Owners of disregarded entities with California activity may have nexus (January 14, 2011)

California trial court addresses income sourcing of software license receipts, inclusion of intangible property (February 18, 2011)

California's "doing business" standard may create new franchise tax filers (March 7, 2011)

Illinois
Illinois enacts massive corporate and individual income tax rate increase, suspends NOL deductions (January 13, 2011)

Iowa
Iowa Supreme Court: Franchisor with no in-state physical presence subject to income tax (January 7, 2011)

Massachusetts
Massachusetts: Limited time allowance for withdrawal of combined report election (January 13, 2011)

Massachusetts DOR: Interplay of U.S. income tax treaties and combined reporting requirements (March 18, 2011)

New Jersey
New Jersey could not require addback of extraterritorial income - refund opportunities may exist (January 28, 2011)

Pennsylvania
Pennsylvania conforms to federal 100 percent bonus depreciation deduction (February 25, 2011)

Tennessee
Tennessee Supreme Court finds gain from stock redemption apportionable; applies functional, unitary tests (January 28, 2011)

Sales & Use Tax

Alabama
U.S. Supreme Court holds Alabama's sales and use tax may be challenged under the Federal Railroad Revitalization and Regulatory Reform Act (February 25, 2011)

California
California Appellate Court rules license for software used to operate switch hardware exempt from sales tax as a technology transfer agreement (January 28, 2011)

Illinois
Illinois Appellate Court voids 2009 tax legislation for violation of single subject rule, high court issues stay (February 4, 2011)

Illinois enacts nexus expansion (March 11, 2011)

Other
SEC issues cease and desist order, and imposes a penalty for failure to adequately reflect sales tax liabilities on books and records (January 28, 2011)

U.S. House Judiciary Subcommittee holds hearing on "Wireless Tax Fairness Act of 2011" (March 18, 2011)

Other

California
California FTB issues new notice of listed transaction: "abusive sales factor manipulation" (January 7, 2011)

California enacts "VCI Two," piggybacks federal economic substance codification (March 25, 2011)

New Jersey
U.S. Circuit Court bars New Jersey from requiring "stored value card" customer information (February 4, 2011)

New York
New York: Parent corporation may claim subsidiary's investment tax credit carryover (March 11, 2011)

Washington
Washington Supreme Court holds physical presence not required to establish B&O tax nexus (January 28, 2011)

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