The Kentucky Court of Appeals ruled last month that the decision of the Kentucky Board of Tax Appeals allowing a Nevada real estate investment trust (REIT) doing business in Kentucky to claim a deduction for dividends paid in computing corporation income tax liability was not arbitrary. For the 1995-1997 tax years that were at issue in the case, Kentucky law defined net income as federal gross income minus all the deductions from gross income allowed by Chapter 1 of the Internal Revenue Code (IRC). Since the dividends paid deduction is a deduction allowed by Chapter 1 of the IRC, AutoZone argued that it was entitled to the deduction.

Kentucky made two arguments in opposition to the deduction. First, Kentucky argued that since the General Assembly changed Kentucky’s statutes in 1998 to expressly allow REITs a dividends paid deduction this meant that the deduction was not available in prior years. Second, the Department argued that under federal law the dividends paid deduction was a deduction for arriving at “real estate investment trust taxable income,” and that this “taxable income” was different than Kentucky’s “net income.” The Court of Appeals held that the statutory definition of “net income” for Kentucky tax purposes was the functional equivalent of the definition of “taxable income” for federal income tax purposes.

As AutoZone attorney, Erica L. Horn of Stites & Harbison, PLLC in Frankfort, Kentucky explained, “this case is significant because it is a case of statutory construction in Kentucky where the court held that even before its 1998 amendment the plain meaning of the statute allowed the dividends paid deduction. The statute said that net income was the difference between gross income and the deductions allowed by Chapter 1 of the IRC. Chapter 1 included the dividends paid deduction.”

Therefore, for the tax years in question in the AutoZone case, 1995-1997, the REIT could take the dividends paid deduction.

**Dividends Paid Deduction**

This issue has emerged in several states where large corporations, such as AutoZone or Wal-Mart, have put their land and buildings in REITs in order to save on federal and state taxes. States
are now going after REITs that are related in some fashion to an operating business that uses the real estate in its business. With the REIT structure, the operating company transfers real estate to the REIT and then leases it back. The REIT receives rental income and the operating company gets to deduct the rent. Pursuant to federal law, in order to maintain its status as a REIT, the REIT must pay a dividend to its shareholders in amount equal to 95% of the gross income of the company. Code Sec. 857 allows this “dividend” to be deducted from gross rental receipts, resulting in little to no federal taxable income. At the same time, the taxable income of the operating company is reduced by the rent expense paid to the REIT.

**State Action**

As Timothy J. Eifler of Stoll Keenon Ogden in Louisville noted, “It’s a great holding and a great taxpayer win, but unfortunately, the legislature changed the statute effective January 1, 2007.” Specifically, for tax years beginning on or after January 1, 2007, taxpayers computing net income for purposes of the corporation or after January 1, 2007. That’s the right answer, and AutoZone means that taxpayers will no longer have to fight about it with Revenue.”

For companies that have a related-REIT structure like AutoZone, Eifler cautions, “that benefit is lost in Kentucky, and if Kentucky is your only state of operation, that structure may not be viable.” In states that have not adopted legislation that prohibits deducting dividends paid by Code Sec. 856 captive real estate investment trusts, this structure is still viable.

**Going Forward**

Eifler notes that a nice thing about the AutoZone decision is that it clarifies deductions under the federal tax code are permitted in Kentucky unless the Kentucky statute expressly modifies the calculation of income subject to tax. “AutoZone says that if it’s a deduction, it’s still allowed for Kentucky purposes. That is significant and will survive post-January 1, 2007. That’s the right answer, and AutoZone means that taxpayers will no longer have to fight about it with Revenue.”
Horn offers another consideration. “Because states are beginning to change their statutes, like Kentucky, you really have to look at what is prohibited or available to REITs. Even if a state has taken away all or part of the advantage of being a REIT, the federal benefit may be significant enough for the company to want to maintain its REIT structure.”

As this issue of State Income Tax Alert goes to press, the state of Kentucky is expected to file a motion for discretionary review with the Kentucky State Supreme Court.

**KEY TAKEAWAY POINTS**

AutoZone lost in a similar action in Louisiana. The Louisiana Supreme Court determined in *Bridges v. AutoZone Properties Inc.*, La. SCt, 900 So2d 784 ; reh’g denied, May 13, 2005, that an out-of-state shareholder was taxable simply because that shareholder received dividends from a company doing business in Louisiana. However, the federal Commerce Clause was not addressed in the case so taxpayers in similar situations should not necessarily acquiesce to Louisiana nexus based on AutoZone.

After the rehearing in Louisiana was denied, the chief justice there stated that he believes the court’s decision was incorrect. This is good news for taxpayers because it may mean that future cases heard before the court on the same issue could have a different outcome.

In Kentucky, the court’s decision is a taxpayer victory, but it’s a limited-time-only engagement since the state legislature enacted a statute that disallows a dividends paid deduction by a captive REIT. Therefore, the case is not beneficial to tax periods beginning on or after January 1, 2007 in Kentucky, but is still viable in other states that have not enacted similar legislation. Additionally, the benefits of using a REIT at the federal level may be enough to still make it an attractive way to manage real estate.

The decision clarifies that in the absence of express statutory language to the contrary adjustments under the federal tax code are permitted in Kentucky. That is significant and will survive post-January 1, 2007.

**BUSINESS INCENTIVES**

**Appellate Court Upholds Dismissal of Challenge to Dell Incentive Package**

The North Carolina Court of Appeals has upheld a superior court’s dismissal of an action that challenged the constitutionality of corporate income, corporate franchise, sales and use, and property tax benefits and other economic incentives and subsidies granted to Dell, Inc., a private-sector computer manufacturing corporation.

“The decision is another blow for legal challenges to the use of tax incentives. While much of the opinion is specific to North Carolina, the discussion of standing may well influence courts in other states. All hope now rests with the North Carolina Supreme Court,” according to Richard Pomp, a professor at the University of Connecticut Law School.

**Constitutional Challenges**

In 2004, the North Carolina General Assembly enacted legislation that allowed the granting of incentives to major computer manufacturers (Law 2004-204, Article G-Tax Incentives for Major Computer Manufacturing Facilities, also known as the “Dell Legislation”). General Statutes §105-129-60(1)-(7) set forth the public policy of the state with regard to stimulating economic activity and creating and maintaining jobs for North Carolina citizens in strategically important industries like computer manufacturing.

Seven North Carolina citizens, suing in their individual capacities as residents and taxpayers of North Carolina, claimed the incentives offered to Dell under the 2004 legislation to encourage the company to locate in North Carolina were unconstitutional on both a federal and state level.

The taxpayers will be filing a notice of appeal on constitutional review and a notice for discretionary review, according to Jeanette Doran, of the North Carolina Institute for Constitutional Law (NCICL). In the North Carolina Supreme Court, constitutional issues are appeals as a matter of right, providing that the court agrees that there is a substantial constitutional issue to resolve. The petition for discretionary review does
not require a constitutional issue, but three of the seven justices must agree to hear the case.

**Public Purpose**

Although the Court of Appeals reversed the trial court’s ruling that the plaintiffs lacked standing to bring their claims under the Public Purpose and Exclusive Emoluments Clauses, it upheld the trial court’s finding that the plaintiffs had failed to state a claim for relief. In *Maready v. City of Winston-Salem*, 342 NC 708, 467 SE2d 615 (1996), the North Carolina Supreme Court held that economic incentives offered by governmental entities to a private business for the purposes of job creation and economic development fulfills a public purpose. In addition, the offering of such incentives does not constitute a prohibited exclusive emolument even though a private company might benefit from the incentives. As the plaintiffs failed to distinguish this case from *Maready*, the holding in *Maready* controls.

The Court of Appeals, Doran stated, ruled that if the government aimed to allocate money for a public purpose, that’s all that’s necessary. The taxpayers argue that the court must examine the government’s actions in order to determine that it had a public purpose in offering incentives. “We think that the judiciary should engage in a real examination of what the government has done and what the purposes really are.”

Jody Joyner of Moore & Allen PLLC in Raleigh, North Carolina said that the plaintiffs were fighting an uphill battle unless the court was going to change the *Maready* case. “The appeals court analyzed the Public Purpose clause and Exclusive Emoluments clause. There was a public purpose.”

Doran thinks that *Maready* can be distinguished from this case. “*Maready* dealt with a facial challenge to a different statute. We don’t see *Maready* at all controlling. Dell received benefits from a statute solely for Dell’s benefit. It was a facial challenge, not an as-applied challenge.”

**Standing**

The Court of Appeals also upheld the trial court’s decision that the plaintiffs lacked standing under the state Uniformity of Taxation Clauses and the federal Dormant Commerce Clause as the plaintiffs failed to demonstrate that they belonged to a class that was prejudiced by the challenged statute.

While the case was in the Court of Appeals, the North Carolina Supreme Court issued an opinion [*Goldston, Jr. v. North Carolina*, NC SCt, 637 SE2d 876 (2006)] that taxpayers have standing for the misuse of taxpayer dollars, Doran explains. Now, the taxpayers are trying to get the Supreme Court to make a decision on the merits, specifically whether the incentives themselves are unconstitutional.

**Incentives**

“The Court of Appeals decision should cause some concern that the government can do what it wants to do with very little judicial review and that’s something we should all be concerned about,” Doran cautions.

The NCICL has filed a similar lawsuit regarding incentives to Google and they have been authorized by their board of directors to file suit against Goodyear. They expect to file in the Goodyear case before the end of the year.


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**ARIZONA TAX COURT**

**State Could Tax Imputed Profit From Out-of-State Partnership**

Arizona was not prohibited by U.S.C. §381 (P.L. 86-272) from imposing state income tax on an Arizona-domiciled corporation’s imputed profit from its investment in a Washington state partnership.

The taxpayer argued that P.L. 86-272 prevented the taxation of its profits at least until there was a distribution. However, P.L. 86-272 only prohibited the state from taxing the out-of-state partnership’s income. The federal law did not prohibit the state from sourcing the partnership’s sales to Arizona and imputing a distribution of profits in order to compute the taxpayer’s taxable income. To the extent that the partnership’s sales were relevant to the calculation of the taxpayer’s gross Arizona income, they were properly included in the nu-
merator of the taxpayer’s apportionment formula sales factor. Here, the taxpayer did not claim that the partnership’s profits were not relevant, but claimed only that P.L. 86-272 prohibited their inclusion, which it did not.

Arizona Department of Revenue v. Central Newspapers Inc., Arizona Tax Court, No. 2006-050001

CERT. DENIED

High Court Will Not Review Treatment of Foreign Subs’ Dividends

The U.S. Supreme Court has denied a taxpayer’s request to decide whether the New Hampshire business profits tax (BPT) regime facially discriminates against foreign commerce in violation of the Commerce Clause by providing a tax deduction for dividends received from foreign subsidiaries only to the extent that the foreign subsidiary conducts income-generating business in the state.

Background. The taxpayer and its domestic unitary affiliates were treated as one water’s edge combined group under New Hampshire law. Dividends paid to the taxpayer by its foreign subsidiaries were separately apportioned to New Hampshire, and the apportioned amount was added to the water’s edge group’s combined income. These foreign subsidiaries did no business in New Hampshire and, therefore, they did not file their own BPT tax returns.

New Hampshire permits a parent corporation to take a deduction for dividends paid by a subsidiary whose profits have already been subject to the BPT. The taxpayer challenged the constitutionality of the state’s tax regime, arguing that a parent of a foreign subsidiary doing business in New Hampshire would be entitled to a dividend-received deduction, limited to the amount of the subsidiary’s income taxed by the state. However, assessing the tax regime as a whole, the court found no improper discriminatory treatment. The dividend-received deduction ensures that the income of a business entity is taxed only once. A foreign subsidiary that is not doing business in New Hampshire is not taxed directly on its income by the state; therefore, there is no need for a deduction for its apportioned dividends because that income is taxed only once.

General Electric Co. v. Comm’r New Hampshire Department of Revenue Administration, SCt, Dkt. 06-1210, cert. denied, October 29, 2007

OREGON TAX COURT

Taxpayer Failed to Prove Existence of Partnership

A taxpayer was disallowed an Oregon personal income tax deduction for partnership losses because he did not sufficiently prove the existence of the partnership. The taxpayer claimed that he entered into a verbal partnership with his father to operate the family farming business. Oregon law, like federal law, looks to the objective intent of the parties in determining the existence of a partnership. Generally, joint control is an essential element of a partnership. The taxpayer had a full-time job that was not related to the farm and he provided no evidence as to his role, if any, in the operation and management of the farm. A single bank account was used for both the farm’s income and expenses and the father’s personal income and expenses and there was no evidence that the taxpayer was a signatory on the account. The father was the sole owner of all the farm’s assets, which he contributed to the partnership. There was no substantiation that the “gifts” made to the taxpayer by his father were the taxpayer’s contribution to the partnership. There was no evidence that the taxpayer and his father joined together for the purpose of carrying on the operations of the farm. Therefore, no partnership existed for which the taxpayer could claim partnership losses.

Etzel v. Department of Revenue, Oregon Tax Court, No. TC-MD 070018D, October 15, 2007
ILLINOIS
An Illinois company was permitted to use, without risk of recapture, a corporate and personal income tax film production credit that it purchased from another company. The taxpayer, a state corporation, purchased a production company’s tax credit at discount in order to apply the credit against its taxes. The companies correctly obtained approval of the Department of Commerce and Economic Opportunity (DCEO) prior to transferring the credit and obtained the necessary certificate of transfer from the DCEO. As a result, the taxpayer was entitled to the full amount of the credit without risk of recapture. (Private Letter Ruling, IT 07-0002-PLR, Illinois Department of Revenue)

INDIANA
Effective January 1, 2008, the threshold amount at which estimated income tax payments are required by a corporation, an entity, or a financial institution is increased from $1,000 to $2,500 for a taxable year. Effective January 1, 2008, estimated corporate income tax payments must be made by electronic funds transfer if the Department of Revenue determines that a corporation’s estimated quarterly tax liability for the current year or average estimated quarterly tax liability for the preceding year exceeds $5,000 (previously, $10,000). Applicable to taxable years beginning after December 15, 2007, a corporation’s estimated corporate income tax payment is calculated on the lesser of 25% of the corporation’s estimated tax liability for the taxable year or the annualized income installment calculated in the manner provided by Code Sec. 6655(e) as applied to the corporation’s liability for corporate income tax. Previously, estimated tax payments were calculated at 25% of the corporation’s estimated tax liability. Applicable to taxable years beginning after 2007, taxpayers are required, when calculating corporate income tax, to add back to federal taxable income an amount equal to any deduction for dividends paid to shareholders of a captive real estate investment trust (REIT). A “captive REIT” is defined as a corporation, trust, or association that is considered a REIT for the taxable year under Code Sec. 856; is not regularly traded on an established securities market; and in which more than 50% of the voting power, beneficial interest, or shares are owned or controlled, directly or constructively, by a single entity that is taxed as a corporation under the Code. (P.L. 211, (S.B. 500), Laws 2007, effective and applicable as noted above)

KENTUCKY
An emergency regulation has been issued that provides guidance on the apportionment of income related to tax increment financing (TIF) projects for purposes of computing the Kentucky corporation income tax, the limited liability entity tax and the personal income tax. Corporations, pass-through entities, including S corpo-
rations, partnerships, and limited liability companies (LLCs), and sole proprietorships that have a physical presence inside and outside the footprint of a TIF area must use an equally weighted three-factor apportionment formula consisting of property, payroll and sales. The property factor is the average value of the real and tangible personal property owned or rented and used by the corporation, passthrough entity or sole proprietorship in the TIF area over the average value of the real and tangible personal property owned or rented and used in Kentucky during the periods before and after commencement of the project. Property that has been certified as a pollution control facility is excluded from the factor. The payroll factor is the total amount paid or payable by the corporation, passthrough entity or sole proprietorship for compensation in the TIF area over the total amount paid or payable for compensation in Kentucky. The sales factor is the total sales of the corporation, passthrough entity or sole proprietorship in the TIF area over the total sales in Kentucky during the periods before and after commencement of the project. Details on the sourcing of sales and property valuation methods are also provided in the emergency regulation. (103 KAR 50:050E, Kentucky Tax Increment Financing Commission)

MARYLAND
A Maryland regulation covering the adjusted gross income (AGI) of nonresident individuals is amended to clarify the treatment of a net operating loss (NOL) for corporate or personal income tax purposes. Now, an NOL generated when an individual is not subject to Maryland income tax law may not be allowed as a deduction to offset the Maryland income from an earlier year when that individual was subject to Maryland income tax law. (Reg. Sec. 03.04.02.06, Maryland Comptroller of the Treasury)

MASSACHUSETTS
A Massachusetts corporation excise tax taxpayer must add back an amount that it seeks to deduct for the amortization of intangible property, using a calculation based on Code Sec. 197, in determining the taxpayer’s Massachusetts net income when the deduction derives from the acquisition of intangible property from a related member, unless the claimed deduction is eligible for one of the statutory exceptions. To be eligible for one of the exceptions to the addback statute, a taxpayer needs to demonstrate by clear and convincing evidence that the transaction that gives rise to the purported cost or expense was primarily entered into for a valid business purpose and is supported by economic substance. (Directive 07-9, Massachusetts Department of Revenue)

MICHIGAN
The items that the Michigan Economic Growth Authority (MEGA) must include in agreements with taxpayers for single business tax and Michigan business tax credits are revised. Specifically, if a business has filed for Chapter 11 bankruptcy, the company’s plan of reorganization must be confirmed by the court within six years (previously, three years) of the agreement’s date. (Act 62 (S.B. 207), Laws 2007)

NORTH CAROLINA
Recently enacted legislation clarifies the repeal date of the William S. Lee credits against North Carolina corporation franchise and income taxes and personal income tax and mandates the inclusion of a clawback provision in all economic incentive agreements, including agreements governing a business’s local property and sales and use taxes, that are entered into between private enterprises and a city or county. A clawback provision requires that economic incentives must be repaid or forfeited if the recipient business does not fulfill its responsibilities under the incentive law, contract, or both. In addition, the legislation revises the definitions of agrarian growth zones and urban progress zones for purposes of the jobs credit and business property investment credit against personal income and corporation franchise and income taxes. (Ch. 515 (H.B. 1595), Laws 2007)

TEXAS
A taxpayer was not permitted to file amended Texas franchise tax reports using an alternative accounting method for computing impairment in the value of its oil and gas producing assets or an alternative Generally Accepted Accounting Principles (GAAP) depreciation method. Texas law allows taxpayers to submit amended reports to correct an accounting error in an original report or in response to a change in agency rule or policy; however, the taxpayer failed to meet either of these threshold requirements for filing amended returns. In addition, the taxpayer’s impairment computations were appropriately disallowed because the taxpayer could not produce sufficient source records or proof of separate income streams. As such, the taxpayer failed to meet the burden of proof to demonstrate that the audit adjustment was erroneous. (Decision, Hearing No. 43,544, Texas Comptroller of Public Accounts)

 VIRGINIA
A taxpayer was not subject to corporate income tax in Virginia because the use of a common carrier to deliver materials did not establish sufficient physical presence in the state to create nexus. Additionally, the use of an independent agent to witness delivery did not create nexus with the state. (Ruling of Commissioner, P.D. 07-163, Virginia Department of Taxation)
ECONOMIC NEXUS

The Silver Lining in the Dark Clouds of Recent Economic Nexus Cases

The following article is an excerpt from a column written by Maryann Gall and Laura Kulwicki for the November–December issue of the Journal of State Taxation.

In Quill Corp. v. North Dakota, the U.S. Supreme Court rejected a state’s bid to retire the physical presence nexus requirement that had been established 25 years before in National Bellas Hess v. Illinois Department of Revenue. Both Quill and Bellas Hess involved mail order companies and sales and use taxes. Since Quill, a number of states have exploited this distinction by limiting Quill’s rule exclusively to sales and use tax cases. In the past 12 months, three more states (West Virginia, New Jersey, and Massachusetts) have joined this trend and announced that they will only respect the physical presence requirement when sales and use taxes are concerned.

Much has been written about the negative implications of these cases for taxpayers—including, among other things, the erosion of clear and long-standing nexus guidelines, the overreaching of state authority to tax and the lack of any meaningful Commerce Clause limitations in this context. Even more noteworthy, perhaps, was the U.S. Supreme Court’s refusal to address this issue by denying certiorari in the Lanco and MBNA cases. Certainly, the application of Quill’s physical presence rule to taxes other than sales and use taxes has been one of the most litigated and significant issues in state taxation since 1992. Over the course of this litigation, a split of authority had developed among the states on this issue. Nowhere was this split more evident than in the differing outcomes—based on nearly identical facts—adopted by the Tennessee Court of Appeals in J.C. Penney Nat’l Bank v. Johnson, and the West Virginia Supreme Court in Tax Commissioner v. MBNA America Bank. Although industry and government share very little in the way of common viewpoints on this subject, both sides appear to agree on the simple fact that the time was ripe for Supreme Court guidance in this area.

Although taxpayers are batting zero for four this year in economic nexus cases, the following discussion emphasizes some of the positive points that tend to get overlooked in these decisions.

The Positives

MBNA (West Virginia). The court noted that the Supreme Court has never upheld a finding of nexus in any case involving a state tax—whether sales tax, income tax, or otherwise—where the putative taxpayer had no in-state presence.

Another helpful point is the Court’s analytical distinction between the prior intangible holding company cases. The Court relied little on prior cases, finding the persuasiveness of such authorities to be limited, because they involved the in-state presence of the taxpayer’s licensed property. This distinction could serve as a useful tool for other taxpayers who do not have the additional connection of licensing intangible property for use at a retail location within the state.

Finally, perhaps taxpayers can take comfort in the very overreaching nature of the court’s analysis. The MBNA decision relies in great extent on the court’s finding that there should be a “fresh application” of Commerce Clause principles in light of modern technological changes. These very arguments were raised by the state in Quill and soundly rejected by the U.S. Supreme Court. It is difficult to imagine that the Court would be any more receptive to the same arguments here.

Capital One Bank and Geoffrey (Massachusetts). In both Capital One and Geoffrey, the Appellate Tax Board acknowledged the basic Commerce Clause limits on state taxation. Indeed, in Capital One, the ATB quoted Quill for its proposition that the Commerce Clause’s “substantial nexus requirement is not, like due process’ minimum contacts requirement, a proxy for notice but rather a means for limiting state burdens on interstate commerce.” It further acknowledged that the nexus requirement seeks to prevent overreaching by States, and limits a State’s ability to tax businesses operating within interstate commerce which lack a sufficient connection to the taxing state. While the principles are correct, the Board’s application of those principles in practice conflicts with the Supreme Court’s longstanding commerce clause analysis.