

SALT *Review*

October 11, 2007

Legislative Updates

California LLC fee legislation signed into law—On October 10, 2007, Governor Schwarzenegger signed into law A.B. 198. The bill effectively fixes the unconstitutionality of the California LLC fee raised during court cases decided last year. *Northwest Energetic Services LLC v. California Franchise Tax Board*, California Superior Court for San Francisco County, No. CGC-05-437721 (April 13, 2006), and *Ventas Finance I, LLC v. California Franchise Tax Board*, California Superior Court for San Francisco County, No. CGC-05-440001 (November 7, 2006). The California LLC fee (a fee imposed on every LLC subject to tax in California) was determined to be unconstitutional and thus invalid because it applied to all LLCs regardless of whether an LLC has business activity in California and LLCs doing business in other states could not apportion the fee. The bill adds an apportionment mechanism to the existing LLC fee calculation on a prospective basis and requires refunds of the LLC fee for prior years to be computed as if the new apportionment mechanism applies. In other words, the apportionment mechanism is to be applied retroactively and thus may preclude a portion of the currently pending refund claims. Based on the court decisions, LLCs (treated as partnerships or disregarded entities for federal income tax purposes) that filed Form 568, California LLC Return of Income, and paid the LLC fee within the previous four years were advised to file protective refund claims with the Franchise Tax Board (FTB). It is likely that the FTB will continue to hold such claims in abeyance pending the outcome of the cases, which should be heard sometime this winter. As a result of the new legislation, it appears the FTB will attempt to deny refund claims for entities wholly within California and apportion refunds for companies partially within the state. Undoubtedly, the validity of A.B. 198 will be challenged. The LLC fee was enacted in 1994 as part of the California Limited Liability Act. The LLC fee was intended to generate additional tax revenue to compensate for income tax revenue projected to be lost as a result of the enactment of LLCs. The LLC fee ranges from zero to a maximum of \$11,790 for LLCs with total income of \$5M or more.

Illinois changes to franchise and corporate income tax—Governor Blagojevich signed into law S.B. 1544 on August 16, 2007, which made significant changes to franchise tax and corporate income tax laws in Illinois effective for tax years on or after December 31, 2008. The bill was, in large part, a compromise of the Governor's previously backed bill proposing a gross receipts tax (GRT) for Illinois in lieu of its current corporate income tax regime. The GRT received strong opposition and backlash from the business community and ultimately did not pass. There are four notable changes in S.B. 1544. One, the new law establishes a franchise tax amnesty program for delinquent franchise taxes related to any taxable period. The amnesty program runs from February 1, 2008 through March 15, 2008. Under the program, interest and penalties on such taxes will be abated and the look back period will be limited to four years rather than the typical seven years. Two, the current cost of performance sourcing rules for sales other than sales of tangible personal property (TPP) (*i.e.*, services, intangible property, real property, and leases or rentals of TPP) are replaced with market sourcing apportionment rules, or based on where the benefit is received. As part of this provision in the bill, changes also were made to the apportionment rules for transportation companies. Three, Illinois now requires partnerships, S corporations and trusts to withhold income tax from nonresident partners, shareholders, and beneficiaries based on their distributable share of Illinois taxable income, unless a composite return is filed. The nonresident owners may take a credit on their Illinois return for the tax withheld. Four, Illinois' current related party expense disallowance rules are expanded to include interest and intangible expenses and costs paid to a member of a taxpayer's unitary group. Like several other states, this change is intended to disallow payments between related companies related to intercompany borrowing, factoring arrangements, and royalty structures.

Indiana soon to require composite returns, changes to single sales factor—Effective for taxable years beginning after December 31, 2007, an S corporation or partnership is required to file a composite adjusted gross income tax return on behalf of all nonresident shareholders or partners. Currently, filing a composite return is permissible. The individual nonresident shareholders will not need to file an individual return unless they have income from other Indiana sources. A penalty of \$500 will be imposed for failing to file such a return.

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Also new to Indiana is a single sales factor apportionment formula. Indiana Governor Daniels signed into law H.B. 1001, which requires the gradual phase-out of the current double-weighted sales factor formula to a single sales factor beginning with the 2011 tax year. The property and payroll factors will be phased out by 10% each year from 2007 to 2011.

Michigan Business Tax replaces SBT beginning in 2008—The new MBT will take effect on January 1, 2008. The new tax has two components, an income tax and a modified gross receipts tax. Tax liability is not based on the calculation of the greater of the two components; taxpayers that have nexus for both tax components will pay both. The income tax rate is 4.95% and the modified gross receipts rate is significantly lower at 0.8%. Annual returns are due the same time as they are currently due for Michigan SBT. Estimated payments for the MBT are due on the 15th day of April, July, October, and January following the end of the taxpayer's tax year. One of the controversial changes with the MBT is the nexus standard adopted for the modified gross receipts tax—that is, taxpayers will have nexus if they have gross receipts exceeding \$350,000 and business activity of one or more days in Michigan or if they “actively solicit” sales in the state. The Department of Treasury is supposed to issue guidance later this year regarding what it means to actively solicit sales. As expected, taxpayers will receive P.L. 86-272 protection in determining nexus for the income tax component of the MBT. Several changes have been made to the way in which the tax base is calculated for the MBT versus how it was calculated for SBT, including treatment of compensation, depreciation, and royalty and interest payments to related parties. For the 2008 tax year, taxpayers are permitted to deduct 65% of their SBT business loss carryforward generated in tax year 2006 or 2007. Other changes with the MBT include a combined filing requirement for members of a unitary business group, wherein all members would appear to calculate their own apportioned income and MBT liability (sales would be sourced to Michigan for MBT under the *Finnegan* rule), and the MBT introduces several new credits, including a compensation credit, investment tax credit, R&D credit, personal property tax credit. Some credits available against SBT are carried over to the new MBT, such as MEGA, Renaissance zone credit, and Brownfield credit.

Michigan use tax imposed on 23 new services—Michigan Governor Granholm signed into law H.B. 5198, which subjects certain services to the use tax effective December 1, 2007. The services include: business service center services; consulting services, investment advice services; janitorial and landscaping services, warehousing and storage services; packaging and labeling services; document preparation services; and personal services such as concierge and psychic services. Prior to the new legislation, Michigan sales tax did not apply to services and the use tax was imposed only on a discrete number of services, such as lodging, telecommunications services, and the laundering or cleaning of textiles under a sale, rental, or service agreement with a term of at least five days. Little guidance is provided in H.B. 5198 on how the new services subject to tax will be interpreted. Further regulatory guidance is expected from the Department of Treasury.

New York tax changes effective immediately as part of 2007-2008 budget—Several notable changes have been made to New York tax law as part of the 2007-2008 budget package. First, entities that are eligible S corporations for federal tax purposes and that have not made the election to be New York S corporations, are deemed to be New York S corporations if the corporation's investment income for the current taxable year is more than 50% of its federal gross income for the year. Two, the Article 9-A business allocation percentage formula has been changed to a single sales factor starting with tax years beginning on or after January 1, 2007. The current double weighted sales factor formula was to be phased out starting in 2006, and the new legislation accelerates the phase in by one year. An additional change was made to New York's position on combined filing. New York remains a separate filing state. A combined report is required when necessary to properly reflect the taxpayer's activities and liability in state.

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Prior to the change, New York analyzed whether transactions between related corporations occurred at arm's length prices in determining whether a combined report was necessary. The new legislation eliminates this inquiry. Now, New York will look at whether ownership and unitary tests are met and whether there are substantial inter-corporate transactions and will require a combined report with those entities with which the tests are met.

Texas Margin Tax long awaited changes take effect in 2008—On May 18, 2006, Governor Perry signed into law the new Margin Tax. The tax is effective for tax years beginning on or after January 1, 2008 and will be based on 2007 gross receipts. The first margin tax report is due May 15, 2008. The general rate is 1.0%, and retailers and wholesales are subject to the margin tax at the rate of 0.5%. Taxable margin is equal to gross receipts less either a deduction for compensation or cost of goods sold, based on an annual election by the taxpayer. Taxable margin may not exceed 70% of total revenue. Entities with revenue less than \$300,000 or annual tax liability of less than \$1,000 are not required to pay the tax but must file a report. Some of the notable changes with the margin tax include the elimination of the throw back rule (*i.e.*, sales outside of Texas will not be thrown back and treated as Texas sales if the taxpayer is not subject to tax in the destination state), the requirement that members of a unitary business group file a combined margin tax report (the amount of control between affiliated parties has been reduced from 80% to 50%), and the disallowance of current franchise tax NOL carryforwards to be applied against the margin tax (a temporary credit will be allowed). Generally, the temporary credit is equal to 4.5% of a taxpayer's current franchise tax business loss carryforward, which can be applied against the margin tax for the first 10 years at 2.25% and the next 10 years at 7.75%. The most notable change with the margin tax is that partnerships are now subject to tax in Texas. Under the current franchise tax rules, partnerships are not subject tax. The margin tax will apply to some general partnerships, limited partnerships, and limited liability partnerships. Regarding nexus standards for the margin tax, Texas legislation provides that the tax is not an income tax and thus P.L. 86-272 would not apply. Some commentary has indicated, however, that the margin tax may be considered an income tax for purposes of FASB Statement No. 109, *Accounting for Income Taxes*, and FIN 48 reporting requirements. Further regulatory guidance is expected for the margin tax.

West Virginia reduces rates but requires combined reporting—Governor Manchin signed into law S.B. 749 which makes two principal changes to the corporate taxing regime in West Virginia. First, effective for tax years beginning January 1, 2009 affiliated corporations are required to file a combined report rather than separate returns for West Virginia corporation net income tax. An affiliated group of corporations is no longer permitted to file a consolidated return for tax years beginning after 2008. Second, West Virginia's business franchise tax rate will be reduced from 0.0048 for tax years beginning on or after January 1, 2009 to 0.0021 for tax years beginning on or after January 1, 2013. West Virginia imposes a franchise tax based on capital for the privilege of doing business in the state at the rate of \$50 or 0.75% and imposes a corporate net income tax at an annual rate of 8.75%.

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