



States of Affair

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CA MIC: The Good, the Bad...and the Paradox

The Good

In early December, the State Board of Equalization (SBE) considered the *Appeal of California Steel Industries (CSI)*.

Issue: Whether amounts paid to third party contractors for capitalized labor were fully eligible for the CA Manufacturers' Investment Credit ("MIC"), or whether those amounts needed to be bifurcated into "direct" and "indirect" costs of labor. **Held: The BOE ruled 3 to 1 in favor of the taxpayer** that indirect labor costs paid to third party contractors are "directly allocable" to qualified property and therefore qualify for the MIC in their entirety.

Since 1994, manufacturers have been able to claim a credit against California franchise tax equal to 6% of the cost of qualified manufacturing and R&D property purchased or leased and placed in service in California. Qualified property includes tangible personal property defined under IRC Section 1245, special purpose building for certain companies, and pre-written computer software. Capitalized labor costs associated with construction or modification of the property also qualify for the credit.

This ruling is likely to affect many companies that place in service equipment that is constructed or installed by third party contractors, and where those costs include overhead and other items (such as contractor profit). As mentioned in our previous newsletter (Autumn 2002), the BOE has heard **three other MIC appeals since February 2002, and all have been decided in favor of the taxpayer.**

The Bad

An often overlooked part of the MIC statute has a termination provision which provides for a sunset of the credit if the manufacturing jobs in California are not increased by and maintained at 100,000 individuals over levels established in 1994. The yearly determination of this calculation is the responsibility of the Employment Development Department. With the recent downturn in the economy, these figures are expected to drop below the required minimum for the first time since the inception of the credit. This means that the MIC would expire on January 1, 2004. Thus, unless the section is amended or repealed, 2003 could well be the final year of the credit.

...and the Paradox

With the pending potential sunset of the MIC, the legislature is faced with eliminating one of the programs it put in place during the last fiscal crisis to create the very jobs which are presently necessary to bail them out of the current fiscal predicament. Any ideas?

YES! Labhart Miles is committed to working with a coalition whose goal is to repeal the sunset of the statute entirely or extend the sunset date so that California businesses can continue to benefit from the credit and likewise create jobs. For more information, please see page 6, under "*Speaking Out*."

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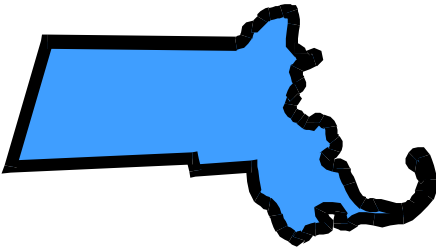
Have a Great and Prosperous 2003!

Labhart Miles Consulting Group, specializing in cost effective state and local tax solutions, is pleased to provide our first newsletter of 2003 as a resource for our clients and contacts.

We welcome your comments. For more information, please contact us at 408-266-2259 or www.labhartmiles.com

Bill Labhart & Monika Miles

MA Supreme Court Paints A Pretty Picture in *Sherwin Williams* Decision



In an event sure to turn the heads of state tax practitioners and clients alike, October brought what could be a landmark case in Massachusetts, and may set a precedent for other

states to follow. At issue was the deductibility of royalties paid from parent company, Sherwin Williams, to its wholly owned subsidiaries created to hold and manage the company's trademarks. The MA Board of Tax Appeals had previously found that the payments and related interest expenses were not allowable as ordinary and necessary business expenses because the formation of these companies was a sham, devised only to avoid state taxes.

The MA Supreme Court ruled that the company had a well-documented business purpose for forming the subsidiaries, and while the outcome may have also benefited the company from a state tax perspective, there was economic substance in the transaction, and it was therefore not a sham.

The formation of intangible holding companies is a commonly used planning tool for companies, often benefiting them from both a business and tax perspective. Many companies prefer to transfer their valuable intangibles into separate legal entities for a variety of legal and accounting reasons. This transfer into a separate legal entity may benefit a company from a state tax perspective.

While this case will not necessarily prove precedent setting, its "great service", as discussed by leading state tax authority Walter Hellerstein, "is to establish the proper analytical framework for addressing these issues - focusing on whether the transaction had economic substance, i.e., whether the transaction had practical economic effects beyond the creation of tax benefits." (RIA - State and Local Taxes Weekly, 11/11/02).

Planning: Companies that have previously implemented this strategy should review the structure to ensure it has sufficient economic substance and the appropriate documentation.



Massachusetts' Industry is Taking the Economic Bull by the Horn

The Associated Industries of Massachusetts (AIM), not wanting to see the state's economic situation wane into oblivion, has proposed to the state legislature several items which would stimulate economic growth within the state. Specifically, the industry group would like to see the **investment tax credit** made permanent at 3% (rather than reverting back to 1% at the end of 2003) and adjust the method of calculation for leased property to permit qualifying taxpayers to use the credit on a prorated basis in the first year. The Massachusetts Investment Credit is a credit against the corporate excise (income) tax for the acquisition or construction of qualified tangible property located and used in the state by companies engaged in manufacturing, R&D, and agriculture or commercial fishing.

Other items on AIM's agenda include providing a 5% **tax credit for employee training**, updating the **research credit** to incorporate the most current federal definitions and terms, and establish a Secretary of Economic Development.

If you are interested in supporting these measures, AIM's website is: www.aimnet.org.

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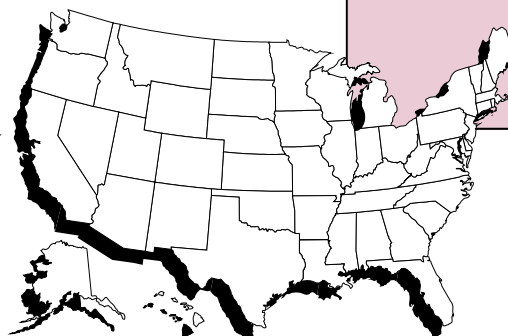
Streamlined Sales Tax Project

The Streamlined Sales Tax Project is an effort created by state governments, with input from local governments and the private sector to simplify and modernize sales and use tax collection and administration. Most of the states are involved either as voting participants or as interested members. In November, representatives of 33 states and the District of Columbia voted to approve a multistate agreement to establish one uniform system to administer and collect sales tax on the nation's nearly \$3.5 trillion in annual retail transactions. The simplified system reduces the number of sales tax rates, brings uniformity to definitions within tax laws, and significantly reduces paperwork burdens on retailers.

With the passage of the agreement, the onus is now on each state to enact legislation to implement the agreement and bring the state into compliance. The agreement does not become binding and take effect until 10 states comprising at least 20 percent of the total population of states that impose a sales tax have approved the agreement.

California is not a member of the project.

For more information about this topic, contact the project's website at www.streamlinedsalestax.org.



39 States and the District of Columbia are members of the Project.

Inconsistency is Gross! Or in Illinois...Net

As occurs occasionally in many states, regulations and statutes are not always consistent. This is the case with gross receipts vs. net income derived from intangibles as it pertains to the sales factor of the apportionment ratio in Illinois. Despite a relevant statute's use of the words "gross receipts," administrative provisions which require taxpayers to calculate apportionment formulas using net income rather than gross receipts from the sales of intangibles are valid, according to the latest ruling by the Circuit Court of Cook County, IL: motion for reconsideration filed by the Dept. of Revenue in *Mead Corp. v. Illinois Department of Revenue*, Cir. Ct., No. 00 CH 7854, Dec. 12, 2002.

Summary: Mead Corp. (Mead) regularly sold short-term instruments and included the gross receipts in the sales factor of its apportionment ratio. During Illinois' audit of Mead's tax returns, the IL DOR recalculated

the sales factor using net income from Mead's short-term financial instruments instead. In the first ruling, the Circuit Court held that gross receipts from the sale of financial instruments, and not net profits, were properly included in the denominator of the taxpayer's receipts factor. The DOR had argued that only the net gain from the sales should be included and that the gross receipts should be excluded from the taxpayer's receipts factor because the investments were merely held by the taxpayer and were not a part of its business. The court, however, rejected this argument and determined that the financial instruments were under the company's "active management." *Mead Corp. v. Illinois Department of Revenue*, Cir. Ct., No. 00 CH 7854, Feb. 5, 2002.

In reversing the previous ruling, the Circuit Court held that to permit Mead to include the gross rather than net proceeds in the factor would invite distortion of the apportionment scheme. The original ruling was overturned.

Planning: There exists a position in several states to include gross rather than net proceeds in the sales factor. Many states are addressing the effect of this position. Subsequent to the years involved in this ruling, Illinois modified its regulation to provide that gross proceeds may be included in the sales factor if more than 50% of the taxpayer's total gross proceeds are comprised of income from intangibles.

Related: Not to be cited as precedent, but of interest, in the *Appeal of Colgate-Palmolive*, California SBE Case No. 152028, Nov. 12, 2002, the SBE held that the proceeds from the "churning" of short-term investments and forward exchange contracts were not to be included in the denominator of the sales factor because the taxpayer had employed independent contractors to perform the investment work, thus, the work performed by the contractors was not the taxpayer's "income producing activity."

Focus on: Texas...The Lone Star State



Business Climate:

Texas has long been regarded as a state that's friendly to business. As the second most populous state in the union and the nation's second leading exporter (according to the Texas Department of Economic Development - "TxED"), Texas has in the past lured companies by being a "right-to-work" state with low unionization, low worker's compensation costs, and lower rental rates for office space than many other states. The state also boasts concentration in an array of industries, including space related research, telecommunications, electronic components, agribusiness, and petroleum.

Taxes

From a tax perspective, the state and local jurisdictions impose sales and property taxes. Texas has a state franchise tax on businesses (C and S corporations), which is levied on the greater of net taxable capital or adjusted taxable income (or "earned surplus"). Apportionment is calculated using a single gross receipts factor. Currently, the

state does not impose the franchise tax upon partnerships and sole proprietors, although this topic has been addressed at recent legislative sessions and is expected to be revisited again when the 78th Legislature convenes in mid-January. Many companies use the limited partnership structure as a planning tool to minimize their Texas Franchise Tax. The state does not have a personal income tax.

Credits & Incentives

Texas utilizes Enterprise Zones and Enterprise Projects to offer benefits to companies investing in economically distressed areas of the state.

Texas' incentives are usually negotiated at the local levels. Local taxing jurisdictions often offer reductions or abatements in property taxes, tax increment financing and other benefits through enterprise zone programs.

Several years ago, the Legislature passed Senate Bill 441 which established franchise tax credits for certain research and development (R&D) expenditures, jobs creation, and capital investments. R&D expenditures can be incurred anywhere in the state to qualify for the credit, while jobs and capital investments must be increased in strategic investment areas ("SIAs") designated by the Comptroller of Public Accounts. Over 85% of

Texas's counties are located at least partially within an SIA.

R&D: Credit is 4% (5% for tax reports due after 1/1/02) of qualified research expenses over a base year, plus basic research payments in Texas, as defined by federal IRC Section 41. Companies receive a bonus for R&D performed in SIAs. The credit is limited to 25% of the tax due on the report before other taxes, but is increased to 50% for reports due after 1/1/02. Unused credit carries forward for 20 years.

Job Creation: Credit equals 25% of wages paid for new qualifying jobs created in SIAs. At least 10 new full-time jobs must be created, and they must pay 110% of the county average weekly wage and include health insurance.

Capital Investment: Credit equals 7.5% of qualified investments (most depreciable property other than real property) made in SIAs. A minimum investment of \$500,000 is required.

For both job creation and capital investment, the credits are claimed in equal installments over a five year period and neither credit may exceed 50% of franchise tax before other taxes. Unused credits carry-forward 5 years.

Focus on Economic Development

Texas recently commissioned national economic expert and Texas, Dr. Ray Perryman to draft a comprehensive economic development plan for the state. In his detailed analysis, "Texas, Our Texas: An Assessment of Economic Development Programs and Prospects in the Lone Star State," Dr. Perryman reports that Texas must, among other things, expand its existing incentives programs, intensify its marketing programs, and work to improve workforce development and training efforts. For additional information visit his site at www.perrymangroup.com or Texas Economic Development at www.tded.state.tx.us.



Planning: For more information on expanding in Texas, or claiming valuable credits and incentives that your company may be missing, please contact us.

CA Enterprise Zones and Updates

California is one of many states offering a credit program to companies investing in people or property in targeted areas, commonly known as enterprise zones ("EZs"). California has 39 EZ locations across the state, and includes such cities as San Jose, San Francisco, Oakland, Los Angeles, Long Beach, Santa Ana, Fresno, and Tulare County.

Some of the more lucrative benefits in California are:

EZ Hiring Credit – Benefit can be up to \$31,000 per qualified employee.

EZ Sales/Use Tax Credit – Credit is allowed for sales tax paid on qualified machinery and equipment.

Lender's Net Interest Deduction – Allows banks and other qualified lenders to claim a deduction for interest received on loans made to qualifying companies in EZs.

Unlimited NOL – 100% carryforward for all net operating losses generated related to EZ activities. (Note, however, that CA has suspended all NOL carryforwards until 2004 - including NOLs generated in EZs.)

Planning Opportunity - Qualifying manufacturers in an EZ may double-up on the MIC and the EZ Sales/Use Tax Credit for a benefit of up to 14%.

Recent legislation authorizes CA's TTCA to designate three additional zones (for a total of 42). Awards will be made to qualifying cities in upcoming years.

Recent updates:

California's Technology, Trade and Commerce Agency (TTCA), which oversees the enterprise zones, has drafted regulations related to policies and procedures in an attempt to standardize the EZ program among the various jurisdictions.

Currently, the 39 enterprise zones in California vary in their treatment of the following major areas:

- Different zone designation dates and related targeted employment areas ("TEAs"), used to qualify certain employees for credit benefits.
- Different standards for vouchering employees for the EZ Hiring Credit. (In order to be eligible to claim the credit, a company must be able to substantiate that an employee meets certain qualifications. Once complete, the EZ coordinator issues a "voucher" to be used as support when claiming the credit on the tax return.)
- Differing standards for retroactive vouchering, which often occurs when a company realizes that it is in an EZ and qualifies for benefits, yet hasn't claimed benefits for open tax years.

Technology, Trade and Commerce has asked for input from both enterprise zone coordinators and consultants. Draft regulations were distributed at the annual CAEZ Conference in Santa Ana in late October and were discussed during a general session. Final regulations are expected to be issued in the first or second quarter of 2003. **Interested taxpayers should also weigh in on the subject before the regulations are finalized!**



Amnesty Programs Prove Successful

In the fall, several states offered amnesty programs to reach out to companies that have been operating in the state but, for whatever reason, have neglected to collect and remit, or report and pay the required taxes. **Connecticut** has recently reported that its program (which ran from September through November 2002) was responsible for generating almost \$100 million.

Current Programs:

New York - through January 31, 2003, includes a waiver of civil penalty, a 2% reduction of the interest rate, and immunity from all administrative, civil and criminal prosecution for tax amnesty granted periods.

Massachusetts - has extended its tax amnesty program to run from January 1, 2003 through February 28, 2003, for tax periods prior to August 31, 2002.



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Cost Effective State Tax Solutions

Our Mission:
To provide our clients with the highest quality, value-added state and local tax consulting services; to make our client, not the fee arrangement, the focus of our every effort.

Speaking Out

Labhart Miles Consulting Group stays involved in current tax events:



Published:

Recently published in Journal of Multistate Taxation and Incentives - November/December 2002 Edition: “*CA Employment Training Panel Changes Funding, Adds New Program*”

Public Speaking:

In **June 2003**, Labhart Miles will speak to the Silicon Valley Chapter of the American Society of Women Accountants.
Topic: State tax issues faced by companies today.
(www.aswa.org)

MIC Advocacy:

Our firm is working with Chris Micheli at Carpenter Snodgrass & Associates in Sacramento to build a consortium of companies interested in amending the MIC statute which is **currently set to sunset in January 2004**. If your company is interested in joining this coalition (and/or contributing financially to these efforts), please contact Monika Miles at 408-266-2259 as soon as possible.

Please visit our website for helpful links and other state tax information! It is updated regularly.

And thanks to all that have linked and written us with your comments and questions.