

LA Department of Revenue Provides List of Top Audit and Litigation Issues for 2009

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The Louisiana Department of Revenue has identified top audit and litigation issues for 2009. A number of issues from prior years remain on the list but there are a few new issues to watch out for (drum roll, please)... and the top concerns are:

Nexus and Pass-Through Entities – The Department remains concerned with nexus issues as they relate to non-resident owners of limited liability companies, partnerships and other pass-through entities. According to the Department, nonresident corporations who hold ownership interests in Louisiana pass-through entities are not filing franchise tax returns. The Department believes that nonresident corporate entities are recognizing that they have nexus for income tax filing purposes but are missing their franchise tax obligations. The Department views a nonresident’s capital in, and distributive shares of income from within, the State as items which properly go into their property and revenue factors for Louisiana franchise tax purposes. To what extent does the receipt of income from intangibles generated by entities with a presence in the state subject you (a nonresident) to tax in the state? The Department says it continues to study the issues.

Combination/Consolidation – Louisiana law requires that corporations file separate returns and does not allow consolidated returns as a general rule. Nevertheless, Louisiana has adopted La. Rev. Stat. §47:287.480(2) which is based on an analogous federal provision (IRC §482) and which provides: “In any case of two or more organizations, trades, or businesses, whether or not incorporated, whether or not organized in the United States, and whether or not affiliated, owned or controlled directly or indirectly by the same interests, the secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any such organizations, trades, or businesses.” The Department anticipates exercising its powers under this statute to a greater degree in 2009.

Sourcing of Gas Sales for CIFT Purposes – According to the Department, this issue has been bouncing around since deregulation. Before deregulation, pipeline companies were considered to be in the business of buying and transporting gas. As the result of deregulation, it is now illegal for a pipeline to own the gas it transports and the pipeline company is restricted to its transportation function. The sale is no longer considered to occur where the gas enters the pipeline but is attributed to the first location in which the customer uses the gas in its business. Unfortunately, according to the Department, many industry members have not changed their

recordkeeping practices to keep up with this aspect of deregulation so they are being audited on this issue. Cases should be in litigation soon.

Next Generation IHCs (or “Son of IHCs”) – State tax departments around the country have been successfully attacking “intangible holding company” structures in litigation and Louisiana has been no exception. In the classic first generation IHC case, a taxpayer doing business in Louisiana transfers its trade names and trademarks to an affiliated intellectual property holding company with operations and commercial domicile in a state like Delaware (okay, almost always Delaware) which has no income tax. The Delaware company then licenses the use of its intangibles to other members of the operating group which then take deductions on their Louisiana tax returns for payments made to the Delaware company. The State alleges that tax is owed by the Delaware company based on those facts and the Delaware company responds by arguing that it lacks nexus with Louisiana. In *Bridges v. Geoffrey, Inc.*, 984 So. 2d 115 (La. App. 1st Cir.), writ denied, 978 So. 2d 370, (La. 2008), the District Court relied on La. Rev. Stat. 47:287.67 and concluded that the sourcing rule for allocation of trademark and trade name income meant Geoffrey’s income should have been allocated to Louisiana and held that Geoffrey was subject to Louisiana tax. A similar result was reached in *Bridges v. Gap Apparel, Inc.*, 866 So.2d 459 (La. App. 1st Cir. 2004). Although it has not yet been conclusively decided by the US Supreme Court, the Louisiana Department of Revenue believes that the physical presence requirement of *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992), does not apply to income taxes in La. Rev. Rul. No. 02-001 (May 13, 2002).

Which brings us to our audit issue: the Department is finding that taxpayers are restructuring to avoid the clear intangible holding company structures and are putting more operations in companies that hold intangibles or otherwise are trying different organizational structures to “avoid” the payment of tax to this State. For example, they are seeing a trend in which a company is split up between east and west divisions, because most western states have combination and unitary taxation and eastern states tend to have separate entity taxation. The landscape is perceived to be changing but the Department believes the bottom line is that taxpayers are still trying to divert income by making payments to out of state entities

Sole Proprietorships Filing Schedule C Take Note: On the top of the list of individual income tax issues is “residency” for income tax purposes. The Department continues to examine claims of nonresidency by individuals with strong ties to the State but who take the position that they are residents of other states which do not impose income taxes. In particularly egregious cases, the Department may consider the taxpayer’s failure to file fraudulent. The Department intends to pursue individuals who maintain a Louisiana residence as well as an out-of-state residence (and claim residency based on the latter) but who continue to have family, friends and business interests as well as club and organization memberships in Louisiana and who spend more time in Louisiana than elsewhere. The Department does not consider “nominal” acts such as changing one’s driver’s license, voting and claiming a homestead exemption in another state to effect a transfer of residency if the taxpayer spends more than six months of the year in Louisiana and continues to maintain the family, business and social ties mentioned above in this State.

Non-Taxable Service v. Lease of TPP – In the sales and use tax area, the issue of whether a contractual agreement between a vendor and a purchaser is primarily a lease of tangible personal property or one for services remains a topic of interest to the Department. The issues arise in situations in which some service is required in connection with the use of tangible personal property. Is the service the primary object (as in the

case of AV equipment operated by the vendor) or is the tangible personal property itself the object (as in the case of AV equipment operated by the consumer)? When the business primarily sells services, or sells both tangible personal property and services, it is very important that taxable and nontaxable services be separately stated on a customer's invoice because failure to separate out nontaxable transactions may result in the entire amount being subject to tax. With respect to leasing activities, the Department has previously issued rules with respect to dumpster rental (mostly not taxable) under La. Rev. Rul. 06-012 (Aug. 23, 2006), scaffolding (mostly taxable) under La. Rev. Rul. 07-005 (Sept. 19, 2007), and port-o-lets (mostly taxable) under La. Rev. Rul. 06-013 (Sept. 19, 2006), see also Louisiana La. Rev. Rul. 06-012 (Aug. 23, 2006). Temporary bank buildings were held to be more temporary than permanent so that the lease of these erstwhile immovables was taxable as the lease of tangible personal property in *Bridges v. National Financial Systems Inc.*, 960 So.2d 202 (La. App. 1st Cir.), writ denied, 966 So.2d 602 (La. 2007).

Origin v. Destination (Where did the Sale Occur) – The Department is planning to issue a rule in the first quarter of 2009 on this issue. Did the seller or the buyer contract with the carrier? If the seller engages the carrier in Louisiana and places the product with the carrier in Louisiana then the sale may be considered to take place in Louisiana.

Bad Debt – There have recently been a couple of cases at the BTA where financial institutions have sought refunds of tax remitted on behalf of individuals and have had their claims denied. In general, only the dealer can get a bad debt refund even if the finance company paid the tax. In *DaimlerChrysler Financial Services of North America, L.L.C. v. Dept. of Revenue*, 976 So.2d 725 (La. App. 1st Cir. 2007), writ denied, 976 So.2d 725 (La. 2008), the taxpayer sought a refund of sales taxes paid under the bad debt statute, La. Rev. Stat. §47:315, for sales tax that it had charged off of its federal income tax returns as a result of purchasing sales contracts from Louisiana dealers on which customers defaulted. The contracts were between the dealers and the consumers but were transferred to the taxpayer after they were finalized and after the dealers had remitted the taxes. In the transfers, the dealers assigned all of their rights under the contracts to the taxpayer including the right to receive payment on the contract from the consumer. When a consumer defaulted, the vehicle was repossessed and the portion of the unpaid balance that represented sales taxes remitted but uncollected was charged off by the taxpayer for accounting and federal income tax purposes. The taxpayer was not allowed to recover the taxes because, as the financing company, the taxpayer did not qualify as the dealer entitled to the refund under La. Rev. Stat. §47:315 and the statute did not permit transfer or assignment of the claim to the refund despite the fact that the taxpayer was the source of the funds remitted. Neither the taxpayer nor the dealers were obligated to pay the tax, only to remit their customers' taxes, and neither were entitled to a refund and an assignee acquires no greater rights than its assignor.

Miscellaneous Issues Mentioned: The Department intends to continue to investigate natural gas franchise tax issues, issues related to the new tobacco discount rules, 305.1(b) exemptions claimed for ships and vessels ostensibly operating in foreign and coastwise commerce and a perceived compliance issue of recreational vehicle registration for out of state purchases. Apparently Department employees have been doing "field inspection work" and have noted that there are quite a few RVs parked outside of Tiger Stadium having tailgate parties during LSU games that are registered in Montana or one of the other 4 no tax states where these vehicles might be titled. Although LSU undoubtedly has the best college football team in the country (!), our suspicious revenue-ers suspect that the local team is not quite as popular among Montanans as the proliferation

of out-of-state license plates at Tiger Stadium would suggest. They are gratified to report that the other no-tax states have been cooperating with the Department to identify Louisiana residents who are registering their RVs in other states to avoid Louisiana tax.