



States of Affair

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CA - Voluntary Compliance Initiative

California has become serious about identifying companies (and individuals) that have entered into “potentially abusive tax avoidance transactions.” The FTB is encouraging companies that have entered into such transactions to come forward under its Voluntary Compliance Initiative, or “VCI.” Taxpayers must come forward between **January 1 and April 15, 2004** by filing an amended return, a Voluntary Compliance Participation Agreement Form (Form 621 for businesses, Form 622 for individuals), and by paying tax and interest due. In exchange, the FTB will waive underpayment penalties. A “potentially abusive tax avoidance transaction” is defined by statute (under §19751 to 19755) as any plan or arrangement devised for the principle purpose of avoiding tax and includes listed transactions defined under Federal Regulations, and others specifically identified by CA.

Companies can file for relief in one of

two ways – with appeal rights and without. If they file without appeal rights, the FTB may not bring criminal action against the taxpayer for any transaction covered by the VCI and the taxpayer is precluded from filing claims for refund for amounts related to the abusive tax avoidance transaction. If a taxpayer files with appeal rights, the company has the right to file claims for refund. However, if they do not prevail on the refund claims, they may be subject to accuracy related penalties on the understatements.

As with all new and “short-window-of-opportunity” type programs, there are several questions that remain which are not clearly addressed by the statute or the forms. This may be a good time to review any major state tax planning strategies entered into recently to ensure that they have a valid business purpose and economic substance. Please contact us for help with any of these issues or additional details on the VCI.



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Delaware Franchise Tax



A reminder to those companies incorporated in Delaware:

The annual Franchise tax return is due not later than **March 1, 2004**. The state offers companies two methods of calculation, as follows:

Authorized shares method: A flat rate, based upon the number of shares authorized. The minimum tax under this method is \$35 for companies with 3,000 or less shares, up to a yearly maximum tax of \$165,000 for much larger companies.

Assumed par value method: Requires calculation of total gross assets divided by all issued shares to arrive at “assumed par”, and then applying the appropriate tax rate. While this method requires a little more information to compute, it often results in a more favorable calculation.

Note that the state’s pre-printed notices mailed to DE corporations calculate the tax using the “authorized shares method” which often results in the higher of the two methods. Companies can also file online. Visit Delaware’s site at www.state.de.us, or contact us for questions about the alternative filing methods or amending prior year returns for possible overpayments.

Article Ideas?

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

We cover California and North Carolina extensively this quarter, and welcome guest articles from our strategic partners and clients for future editions. For comments or more information, please contact us at 408-266-2259 or www.labhartmiles.com

Bill Labhart & Monika Miles

Amnesty Programs - Quarterly Update

States of Affair reports quarterly on upcoming amnesty programs. This quarter has been relatively quiet, with many states recently coming off of successful programs. The following states with recent amnesty programs reported large successes:

Kansas - \$23.6 million **Illinois** - \$504 million

Arizona - \$73 million

We recommend that companies continue to monitor their activities in various states to determine if they have a filing requirement.

Please contact Labhart Miles for questions or assistance in utilizing these amnesty programs or in reviewing your company's nexus determinations.



Credits & Incentives - State Tidbits

Despite tough economic times, many governors across the country are encouraging their constituents and legislators to back tax incentives to encourage new businesses to settle in their states, and to encourage existing businesses to stay and expand operations. Following are some of the suggested plans. Stay tuned in the upcoming year to see if the plans are implemented....

Arizona - Gov. Janet Napolitano has taken under advisement recommendations made by high tech industry leaders to encourage increased investment in high tech in the state. Recommendations include creation of a fund to help small high tech companies raise money, and extension of the R&D credit, which is currently set to expire at the end of 2004.

Michigan - Gov. Jennifer Granholm signed a series of bills extending the MEGA credits against the Michigan Single Business tax, encouraging expansion in the state.

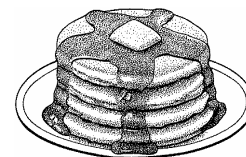
New Jersey - Gov. James McGreevey is pushing for incentives for companies relocating into the state's new "innovation zones" - areas near the state's research universities.

New Mexico - Gov. Bill Richardson is considering targeted tax incentives for businesses, including credits for companies that create jobs paying above average wages.

Washington - Gov. Gary Locke wants to extend credits that will expire in 2004, including a "per employee" B&O tax credit for software development, rural county technology related credits, and sales/use tax deferrals for certain high technology and R&D facilities.

...*On the flip side:*

Missouri - Gov. Bob Holden and legislators are concerned that there may be abuses in the state's tax credit programs and they seek to tighten standards and accountability as a result of alleged abuses in one tax credit program.



...*And in an interesting twist:*

Texas: Boeing is being pursued by Texas and has been offered an incentives package to locate a plant in the state. Gov. Rick Perry had filed a suit seeking to prevent disclosure of the details of the package to maintain competitive advantage. However, in January the suit was dropped.

Streamlined Sales Tax Implementing States Project

Several states have moved forward by introducing or passing legislation which would bring the states' statutes into compliance with the SSTIS Agreement. Approximately 15 states have proposed or adopted conforming legislation. The agreement goes into effect when 10 states with at least 20% of the population come into compliance. However, until either the U.S. Congress or Supreme Court act, the Agreement remains voluntary.

For more information on Streamlined Sales Tax, please see previous editions of *States of Affair* - available on our website .

Alert: IRS & States Sharing Info on Tax

Avoidance The IRS announced in early February that it will begin sharing leads on taxpayers engaged in abusive tax avoidance schemes with tax agencies in 45 states, the District of Columbia and NY City. The IRS, cities, and states will share information on tax adjustments resulting from audits, allowing the agencies to leverage their resources.

The Effect of the Sarbanes-Oxley (“SOX”) Act on CPA Firms

The recent Sarbanes-Oxley (“SOX”) regulations issued by the SEC affect not only public companies’ management and boards of directors, but attorneys, brokerage firms and analysts. However, the group impacted the most is probably CPA firms who also provide tax services to their attest clients. Suddenly, as greater restrictions are placed upon audit firms, a formerly predictable stream of revenue from tax compliance and consulting has dropped dramatically. Because most large CPA firms maintain large tax staffs with myriad layers of administration and management, overhead and billing rates continue to increase. This, along with increased competition, continues to create the need to market many different and new ideas and complex “planning strategies” in addition to tax compliance services. So it is understandable that the most efficient and expeditious sales pipeline has in the past led straight to audit clients. What group would an accounting firm know better than those with which they have intimate knowledge and, presumably, established relationships? This illustrates one of the issues that SOX is attempting to address.

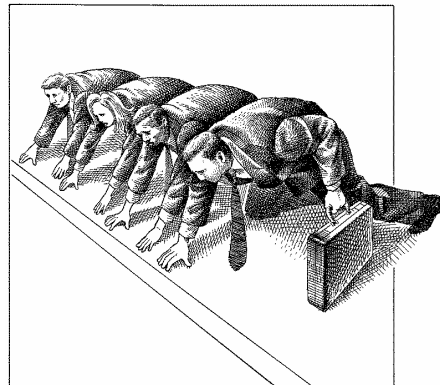
Although one must give the accounting firms the benefit of the doubt regarding integrity and expertise, every action the accounting firm undertakes for its attest client, or any client for that matter, must be guided by the standard that it is not enough to actually act independently of clients - the firm must also appear to be independent. So the higher standard of actual independence is not the level with which accounting firms and their clients must aspire, it is the appearance of independence which must be attained and recognized by the investing public.

Targeting of non-attest clients has increased significantly in light of Sarbanes-Oxley

Where does this leave the corporate business community that depended on their auditors for that familiar relationship? There are several good options. But gone are the days when the sole trusted business and tax advisor comes from a public company’s auditing firm. Again, the rule of the day must be **not only actual independence** but, the **appearance** of independence.

One option is to draw from the resources of another large accounting firm. The breadth of services is likely to exist but

rates will be commensurate as the firm can no longer rely on the reoccurring audit fees to justify reducing the fees on non-attest services. As long as that firm doesn’t perform any attest services for a unit of the parent or an affiliate, the SOX exposure is reduced, and this may be a good option. As companies have surely noticed, the large firms have stepped-up efforts to target non-attest firms, often assigning high profile personnel to lead these efforts. And while a competitive marketplace usually does lead to the best answer in the long run, will companies really want to shop for their business advisor as one does for their phone company?



Another alternative is to tap into the large number of professionals that have left the large firms. The expertise is the same as was delivered when these professionals worked for the large firms, but rates for services are generally lower because of substantially reduced overhead. While the smaller firms will likely not provide a “one-stop shop” for all tax related services, clients can seek out specialized services from subject-matter-experts at fees that won’t leave them gasping as they reach for their corporate pocketbook. And, in many cases, companies will be dealing with the actual principals of the smaller firms.

Whatever the solution, these will be times of challenge for many but also times of opportunity for all. Clients will have the opportunity to work with new service providers and the service providers will be able to forge new business relationships - seemingly a win-win for everyone.

“When angry, count four; when very angry, swear.”
- Mark Twain, “Pudd’n head” - 1894

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Focus On: North Carolina -The Tar Heel State

Business Climate:

North Carolina, one of the 13 original colonies of the United States, is a place of great natural diversity. In 1629, King Charles I of England "erected it into a province." When Carolina was divided in 1710, the southern part was called South Carolina and the northern or older settlement, North Carolina. From this came the nickname the "Old North State."

The population is approximately 8 million. Principle products include: **agriculture** (tobacco, turkeys, sweet potatoes, peanuts, hogs, soybeans, corn, and dairy); **manufacturing** (tobacco products, chemicals, textiles, furniture, food products, machinery, electrical equipment); **mining** and **fishing**.

Taxes

North Carolina has a corporate income and franchise tax with rates of 6.9 % and \$1.50 per \$1,000 of net worth, respectively. The income tax begins with Federal Taxable Income before NOL deduction and makes specific state adjustments.

- NC defines "income producing activities", requiring the filing of a tax return, as owning in state: realty; tangible personal property; trademarks/names, franchise rights, computer programs, copyrights, patents, processes and licenses.
- Income is apportioned using a three factor formula consisting of property, pay-

roll and double weighted sales. The sales factor does not use the throwback rule. There are special formulas for some industries.

- The state does not tax partnerships or the corporate income of S Corps, but does levy the franchise tax against S Corps.
- North Carolina imposes a sales/use tax, estate and gift taxes, property and excise taxes.

Credits & Incentives:

North Carolina's **New Jobs and Machinery and Equipment Investment** credits are based on a 5 tier system – with the "value" to the company depending upon the county in which the activity is located, (with Tier 5 being the wealthiest counties). The Department of Commerce publishes a list of the counties and their respective tier designations each year.

New Jobs: The amount of credit ranges from \$12,500 in Tier 1 to \$4,500 in Tier 5, per person, and is taken in four equal installments beginning in the tax year after the year in which the jobs are created. Unused portions may be carried



forward for 5 years. Taxpayers must provide health insurance for each job at the time the employee commences employ-

ment.

Investment: The credit applies to purchased and/or leased machinery and equipment. Minimum investment thresholds must be met, depending upon the tier in which the establishment is located - \$0 to \$2 million for Tiers 1 through 5; and the credit ranges from 7% to 4% for Tiers 1 through 5, respectively. The credit is taken in 7 equal installments beginning with the tax year following the year in which the M&E is placed in service. Unused portions may be carried forward for 5 years.

R&D: The credit is for research and development credit conducted, and is based upon the federal credit. The business must also be included in one of several qualifying categories of businesses. The eligible general rate is 5%. An alternative method is also available. The credit is not taken in installments, and unused credit may be carried forward 15 years.

Worker Training: Available only in Tier 1 counties: the amount of credit is \$1,000 per each qualified employee, and training must be conducted for 5 or more employees.

NC: Presidential birthplace of James K. Polk (1845-1849) and Andrew Johnson (1865-1869)

William S. Lee Act

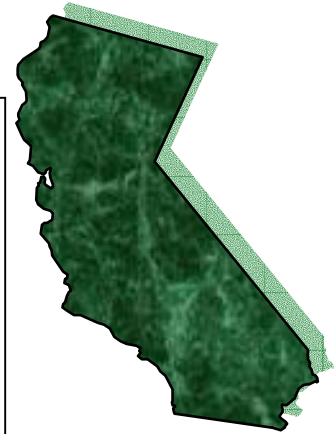
The William S. Lee Act (WSL) enacted in 1996, has been one of the State's chief economic development incentive tools. The Act's goal is to promote economic development by providing tax credits to companies creating new jobs, placing into service equipment and machinery, engaging in R&D, and training workers. The WSL Act includes a five tier system to apportion higher credits to economically distressed counties. Credits can be earned by businesses to offset up to 50% of corporate income tax or franchise tax liabilities.

Every couple of years, an assessment of results relative to the WSL Act credits is performed by the State of NC Department of Commerce. The current study, completed in December 2003, revealed the following results:

- Between 1996 and 2001, businesses at 1,835 NC sites generated credits of \$1.16 billion. Companies generating the credits created an estimated 121,000 new jobs, trained 30,000 workers, installed over \$12 billion in M&E, and conducted over \$2.2 billion in new R&D.
- Actual claims on the generated credits amounted to only \$208.5 million, 18% of the eligible amount. This is a result of many businesses not having sufficient tax liability to offset with credits.
- Credits are generated where business is already predominantly located within the state. Companies in the wealthier tiers (4&5) have earned substantially more credits than in the lower tiers.

For additional information on these benefits, and further analysis of the program, please visit the NC Dept of Commerce's website at www.nccommerce.com.

CA Enterprise Zone Benefits Update:



EZ Net Interest Deduction for Lenders

Banks and other financial institutions making loans to businesses located in enterprise zones can claim a tax deduction for a portion of the interest earned on these loans. California allows a deduction for the **net interest** earned on qualified loans made to businesses located in one of the state's 39 zones. Net interest is defined as *"the full amount of interest received, less any direct expenses incurred in making the loan."* Examples of direct expenses include, but are not limited to commissions paid to a loan representative, costs incurred in funding the loan, and "other costs" of the loan. For a bank located solely in California, the **net tax benefit** from taking this deduction is **over 6%** of the net interest income amount.

The challenge many banks face is that it is difficult to determine which loans are made to

qualified businesses. Labhart Miles uses sophisticated software to quickly determine loans made to businesses in qualifying zones and then apply a sound methodology to review supporting documentation for a sample of identified loans. This ensures that reasonable care has been taken in claiming the deduction and providing support in case of an audit.

EZ Hiring Credit

The much-anticipated regulations formalizing standards for cross-jurisdictional vouchering and allowable supporting documentation among CA's enterprise zones have stalled in Sacramento. With the dissolution of the Technology Trade and Commerce Agency in July, and the governor's moratorium on new regulations in November, the regulations simply did not get passed in time. The California Association of Enterprise Zones (of which Labhart Miles is a member) hopes that regulations standardizing the issues above can be reintroduced soon, and in the meantime are hopeful that zones and consultants alike will act in good faith, following the proposed regulations to maintain consistency in the program. (For additional detail on these proposed regs, please see *States of Affairs*, Spring 2003, available on our website.)

Other MIC News:

As a followup to the MIC in lieu cases decided last fall, the SBE was to hear additional cases in January, which may have set a precedent for other refund claims filed under the "in-lieu" statute. However, the hearings have been postponed at least until Spring.

MIC Terminated; Governor Still Open to Extension

It wouldn't be a true "California Corner" without a welcome to our new Governor, Arnold Schwarzenegger. Those of us working with clients in the manufacturing sector were hoping to welcome the governor throwing his support behind a MIC extension. The MIC has officially become history for investments after 12/31/03. While the governor has said previously that he understands the importance of the MIC, his premiere focus for businesses at this time is to fix worker's compensation. The good news is that his administration still appears open to reinstatement of the credit. Manufacturers are expected to continue lobbying efforts to bring the valuable credit back in 2004. For more information on how to get involved in these efforts, please contact us.



Planning note: Although the MIC has lapsed for property placed in service in 2004, companies should consider beefing up supporting documentation for earlier years, as the FTB is still reviewing the MIC closely as part of its audits.

Individual Returns— Electronic Filing Required

Beginning 1/1/04, tax practitioners preparing more than 100 California individual income tax returns (Form 540) in a calendar year must file all such returns electronically with the FTB. If the preparer is required to file electronically and does not do so, he would be subject to a \$50 penalty per return not e-filed. The preparer can be excepted from the penalty if a client elects not to file electronically (on CA Form 8454).



Attention: Internet & Catalog Purchasers

Welcome to Line 51 of CA Individual Income Tax Form 540! This new line requires CA taxpayers to report the amount of use tax owed to the state. Thus, all of us that ordered on-line for Christmas to "save the sales tax" must now pony up on this line. As with any other line on a personal tax return, if a taxpayer does not have the supporting documentation, a good faith estimate should be used.

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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



Public Speaking:

On **June 9, 2004**, Labhart Miles will be presenting at the SBA Cisco Systems San Jose Entrepreneur Center

Topic: *“CA Sales/Use Tax Issues for Small Companies”*

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Professional Affiliations - Updates:

ASWA - A long time member of the organization, Monika Miles has been nominated to the organization’s National Board of Directors. Installation will be in May 2004.

eWomenNetwork.com - This organization, started in 2000 to connect women and their businesses worldwide, formed the Silicon Valley chapter in April 2003. Monika Miles joined the organization in January 2004.

In print:

Bill Labhart is an editor for *“The Journal of Multistate Taxation and Incentives”* and extends an offer to anyone wishing to write an article regarding an incentive or credit opportunity.

Please visit our website at www.labhartmiles.com for helpful links, current updates on other state tax information, and previous copies of our newsletter!