Labhart Miles Consulting Group, Inc.

States of Affair

Volume 2, Issue 3 Summer 2004

CA FTB: No Dividend Received Deductions

In *Farmer Bros. vs. Franchise Tax Board*, decided in May 2003, the CA Ct. of Appeals determined that California's method for calculating the DRD (by limiting the deduction to amounts previously taxed by CA) violated the Commerce Clause of the US Constitution.

In response to the California and U.S. Supreme Courts' refusal to deny cert to the FTB in the *Farmer's Brothers* case, the FTB has issued a memorandum to its audit staff on treatment of the DRD. The FTB position is that the *Farmer Brothers* decision invalidated **CRTC §24402**, leaving no statutory authority for any general DRD on California returns. The FTB has also modified Form 100, Schedule H on its website to remove the section to calculate the DRD. FTB relies on **CRTC §19393** which states in pertinent part that if a deduction is held to be unconstitutional, the tax should be recomputed without the deduction.

It is important to note that the FTB's memorandum represents only the position of staff and has not been reviewed by the Legislature or the courts. There is still a question as to whether the entire statute was invalidated, or just a portion, and further, whether the FTB can rely on §19393 for general application.

…See related story "Ceridian" on page 5

Inside this issue:

Credits & Incentives	2
Special Technology Feature	3
Focus on Arizona	4
California Corner	5
Speaking Out	6

Amnesty Programs - Quarterly Update

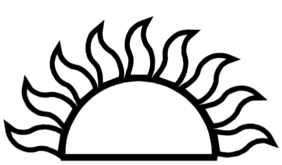
In continued efforts to bring companies into compliance, more states are offering limited amnesty periods. Following are the current programs:

Arkansas: July 1 **-** Dec. 31, 2004 **-** A taxpayer must apply and submit all applicable forms from July 1, 2004 through September 30, 2004, as well as pay all taxes due within three months from the filing date of the amnesty forms, no later than 12/31/04.

Mississippi: Sept. 1 **-** Dec. 31, 2004 **-** Covers all types of taxes from 1999 forward. All civil and criminal penalties are waived during amnesty period. However, harsh penalties apply for eligible taxpayers that do not come forward during the amnesty period.

Nebraska: Aug. 1 **-** Oct. 31, 2004 **-** Application must first be submitted and approved with no recourse regarding the imposition of taxes determined by the Department of Revenue.

West Virginia: Sept. 1 **-** Oct. 31, 2004 **-** Allows for a 50% reduction on accrued interest and waiver of penalties. Additional 10% penalty for eligible taxpayers who do not participate and are identified later.



Even **California** is considering an amnesty program for early 2005! Please contact Labhart Miles for questions or assistance in utilizing these amnesty programs or in reviewing your company's nexus determinations.

New Feature:

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.

In addition to updates on amnesty and credits and incentives, note our special guest editorial section on page 3, discussing technology issues.

We welcome your comments. If you know of someone who could benefit from this publication, please let us know. For more information, please contact us at

408-266-2259 or www.labhartmiles.com

Bill Labhart & Monika Miles

Credits & Incentives Updates

Market Watch…There is Still Good Incentive News!

<u>APN Terminals North America Inc.</u> received $20 million in state road work, enterprise zone jobs-creation tax credits and grants, state rail improvements and a state training grant from **Virginia**. The company will invest $450 million and create 210 new jobs.

<u>Citgo Petroleum Corp.</u>, is moving its corporate headquarters from Tulsa, OK to Houston, TX, also relocating about 700 employees. Some of the benefits received include one of the first Texas Enterprise Fund discretionary grants and a low-interest $15 million loan from the Texas Industrial Loan Program. The costs for this loan will ultimately be shouldered by Houston and Corpus Christi **Texas**.

<u>Verizon Wireless</u>, is creating a 150,000 sq. ft. call center in **North Carolina** and spending a maximum of $29 million with potentially 1,211 jobs. The company received a 10 year state job development investment grant equal to 60% of personal state withholding taxes on new jobs at a benefit of $7.2 million.

State Tidbits

Arizona: Private Letter Ruling LR04-002 – The state provides an EZ Hiring Credit for increases in qualified employment at a business location in the EZ. Query – can separate income tax credit carryovers from a pre-merger subsidiary be allowed against the post-merger liability of the merged corporations? Holding - pre-merger Arizona credits could be applied to post-merger liabilities to the extent the liability was attributable to business activities of the same business unit that earned the credits.

Colorado: Senate Bill 04-003, signed by governor 4/8/04 – As a follow-up to our credits feature, "Focus On – Colorado", the state auditor is now required to report to the governor and the general assembly, no less than every five years, evaluating the implementation of the state's enterprise zone program and its effect on, among other things, employment, unemployment rates, investment and overall growth rate.

Georgia: House Bill 984, signed by governor 5/17/04 – The amount of state jobs credit which can be used to offset a company's liability is raised from 50% to 100%. Also, the requirement for 30% of new jobs to be held by residents of less-developed areas is dropped and the definition of under-developed for purposes of the EZ property tax exemptions are liberalized.

Mississippi: House Bill 829, signed by governor 5/12/04 – Effective January 1, 2004, companies may claim a tax credit for up to 50% of receiving, handling or wharfage charges involved in importing and exporting products through Mississippi seaports and airports, up to a maximum cumulative credit of $1 million to $4 million, depending upon the number of employees at the taxpayer's Mississippi headquarters.

Tennessee: House Bill 3480, signed by governor, effective 5/3/04 - Franchise/excise tax jobs tax credit for each new employee job created in an "economically distressed county" is increased from $3,000 per job to $4,500. Qualifying counties include those where per capita income is less than average, or the average number of dislocated workers exceeds the state average.

Virginia: House Bill 615, signed by governor 4/20/04 – Applicable to only the tax years of 2004 and 2005, and limited to $100,000 per recipient, the jobs-creation threshold for the major business facility tax credit is lowered from 100 employees to 25 employees in severely economically distressed areas suffering unemployment at twice the statewide rate.

<u>Federal R&D Credit Set to Expire Again</u>

As has happened 10 times since its enactment, the R&D credit is likely to be temporarily extended after the June 30, 2004 expiration. There is a bipartisan interest in keeping the credit and S. 1637 and H.R. 4520 would extend the credit through 2005. Stay tuned!

Special Feature - Enhancing Competitiveness through Technology

In this issue we feature an article contributed by Ed Correia, President of Sagacent Technologies, Inc., addressing current technology issues that businesses are facing in today's competitive environment and the effects on their bottom line.

Economic necessities have forced companies to do more with less. Businesses of all sizes face difficult decisions daily to stay competitive. And in order to stay competitive, they must add value while still reducing costs. Interestingly enough, now that the economy is starting to accelerate, we see businesses addressing this challenge in very different ways.

The **larger businesses** we work with, typically over 100 employees, have historically been huge consumers of technology, particularly those investments they can use to improve their competitiveness. They are always looking for solutions which will give them superior access to their data, better management of resources and more precise delivery of efforts. But what has changed is the *expectation* of technology. Implementing something that *might* improve productivity or is *merely popular* with some employees is not going to be pursued. Instead, bigger businesses are looking for ROI within the first 6 to 12 months. The goal is still increasing productivity, efficiency and security, but now only solutions with ultra-fast paybacks are being considered.

Smaller businesses on the other hand, those from 1 to 99 employees, generally don't begin by allocating resources to technology. As a whole, they often provide exceptional value and work very hard at customer service, but may not make investments in infrastructure or better ways to leverage technology. Instead, their focus is often on developing marketing materials and/or hiring more sales and operations people.

Sadly for them, this can only work in the short run. As we see larger businesses becoming increasingly efficient at delivering everything, the pressures on the smaller businesses to compete is giving them the option of continuing to lose more margin and work for less or simply go out of business.

The real fear is that when the economy is running at full throttle again, too many small businesses are going to be overly dependent on expensive personnel and having to work harder. Besides, we all know that when things are hopping we rarely have time to be reflective – we are just too busy being reactive and fulfilling orders. Worse yet, the information systems most small businesses use haven't seen a major upgrade – *let alone a technology audit* – since 1999! Thus, we suggest you ask the following questions now in order to determine if you can find some new ideas for your business before you get too busy.

The questions all businesses should be asking themselves include:

- *Is there something that we can implement that will give me a strategic benefit over my competition?*
- *Can we find ways to better manage our activities and forecast likely and possible outcomes?*
- *Are there systems that would put required information and available resources into the hands of our people more quickly and in a timely fashion?*
- *What can we do to increase the effectiveness of our forces (i.e.; in sales efforts and customer interactions)?*
- *How can we ensure that everything is monitored in real-time and that someone is responding proactively wherever possible and otherwise is consistently reacting quickly?*
- *How can we ensure that our private information is kept safe and in the event of a disaster that no data is lost?*
- *How can we use technology to make our business more efficient (i.e.; save time), more effective (i.e.; save money) and more competitive against our competition tomorrow and into the future*?

Because the **ultimate goal is getting more money to the bottom-line and competing**, businesses should be doing what they can *now* to improve their enabling infrastructures. What can they invest in today that will be a major boost or business enabler tomorrow and into the future? What might better protect the business should the unthinkable happen?

Of course, the answers to these questions are different for every business. And, as cookie-cutter technology solutions are rarely a good idea, the chosen solutions will need to be tailored to the businesses' specific needs and environment.

Should you need assistance with the matters addressed in this article, please contact Ed Correia at (408) 391-7141 or ecorreia@sagacent.com.

Mr. Correia is President of Sagacent Technologies, Inc., a professional technology solutions firm of 21 employees located in San Jose, California.

Focus On: Arizona –The Grand Canyon State

Business Climate:

With a population of 5.5 million, Arizona's primary industries are high-technology manufacturing (semiconductor and aerospace), agriculture and tourism. Expanding industries include the bio-industry, environmental technology, plastics, software and information industries and transportation and distribution.

Taxes

Net income is taxed at a rate of 6.968 percent, with a $50 minimum tax. The income tax begins with Federal Taxable Income before NOL and makes specific state adjustments. Net operating losses and capital losses may be carried forward for up to five years.

Transaction privilege tax (similar to most states' sales tax) is 5.6 percent of gross income for most industries, but mining is taxed at 3.125 percent. Commercial lease tax at the state level was phased out in 1997. A 5.6 percent use tax is levied on use, consumption, or storage of tangible property that has been purchased at retail and upon which a transaction privilege tax has not been levied. Machinery or equipment used directly in manufacturing or processing is exempt from sales and use tax.

Credits & Incentives:

Arizona has enacted legislation that requires a joint legislative committee to review corporate income tax credits according to a prescribed schedule, beginning in 2002 and continuing through 2006. Its purpose is to determine the original purpose, evaluate its success or failure and whether it should be amended or repealed.

Arizona's most notable tax credit is associated with the state's **enterprise zone ("EZ")** program.

- **EZ Employee Hiring Credit**: The credit is allowed for increases in qualified employment of residents of Arizona by a business located in an enterprise zone. Beginning in 2002, the credit is limited to the first 200 jobs created by a taxpayer in a given year. All qualifying employees must live in Arizona, 35% of the EZ employees for the first year of employment must reside in an enterprise zone that is located in the same county in which the business is located. During the three year qualifying period the credit amounts to $3,000 per qualifying employee and is back loaded; $500, $1,000 and $1,500 respectively. The carry-forward period is 5 years.
- **Training**: There are two training programs for new (75% of allowable costs) and existing employees (50% of allowable costs) to meet unique industry standards. There is also a technology training program for 20 employees per year. Both programs have a per employee limitation and the latter has a program limitation.
- **R&D:** A tax credit of 20 percent for up to $2.5 million over the base year expenses and 11 percent for any amount that exceeds the $2.5 million.
- **Pollution Control:** A corporate income tax credit, equal to 10 percent of the purchase of real or personal property used to control or prevent pollution, is available. Maximum amount is $500,000 in a taxable year.

Additionally, Arizona provides credits for such activities as coal consumed in generating electrical power, military reuse zone employment, underground storage tank and others.

From the Grand Canyon to tranquil deserts to majestic mountain ranges to cool pine forests, Arizona is spectacular. Arizona's flag was designed by Colonel Charles Harris - the red and yellow rays represent rays of sunshine and the thirteen original colonies. The copper star represents copper mining, the major natural Arizona resource.

Don't Save Daylight

Arizona observes Mountain time all year with no change to daylight savings time.

Arizona Quotables

"A government that is big enough to give you all you want is big enough to take it all away." Barry Goldwater, 5 term US Senator from Arizona

"There is no such thing as defeat in non-violence." Cesar Chavez, activist from Yuma

"The thing you have to be prepared for is that other people don't always dream your dream." Linda Ronstadt, singer from Tucson

Compromise Bill to Remedy *Ceridian* Claims?

A.B. 263, a bill to provide a potential remedy to taxpayers affected by the December 2000, court ruling in *Ceridian v. FTB (85 Cal. App. 4th 875) (249 DTR K-8, 12/28/00)*, would allow taxpayers to take a partial deduction for insurance subsidiary dividends in exchange for reforms that prevent companies from sheltering assets in insurance subsidiaries to avoid taxation. It also potentially ends seven years of litigation and uncertainty surrounding the dividends received deduction (DRD).

According to Assemblywoman Jenny Oropeza (D), "This bill is a historic settlement between the state and insurance industry. First, it allows us to close the books on overdue taxes from 1997 to 2003. More importantly, it prevents future abuses of the state's tax system."

If enacted, the bill would settle a fundamental dispute between affected taxpayers and the FTB over how to account for DRD for both past and future years, because of the *Ceridian* decision. In *Ceridian*, the state appellate court ruled that the insurance subsidiary DRD under Revenue and Taxation Code section 24410 violated the Commerce Clause by discriminating against companies not located in California. The deduction was available only to California corporations. A.B. 263 would allow a partial deduction but would close loopholes in the state law allowing companies to use insurance subsidiaries to shelter assets and investments from taxation. The bill must still be passed by the full legislature and signed by the governor. It would also take effect immediately.

The bill is expected to pass because of its contentious subject and to settle FTB past claims that are estimated at $180 million, which the FTB would lose. The bill would also cost the state about $30 million in revenue each subsequent year.

"This bill is a historic settlement between the state and insurance industry."

New MIC?

AB 2484 (Ridley-Thomas) encourages a new 6% tax credit for purchase of machinery and equipment, to replace the MIC, which sunset as of 12/31/03. While the bill has been held over, observers are hopeful of its revival in the fall.

Some specifics of the bill include: replacement of the statutory SIC codes with new NAICs codes (will allow some new taxpayers to qualify and also cause some to drop out); inclusion of only those industries whose primary business is manufacturing (to eliminate any *Save Mart* issues); an annual jobs requirement; a recapture provision for companies failing to use the equipment for 5 years; and new reporting requirements to companies about manufacturing jobs created and maintained.

Enterprise Zones

Several bills were considered during the legislative session in spring, including the following:

SB 1876 (Alpert) - As initially written, the bill essentially eliminated the EZ Hiring Credit. The bill was changed many times, and ultimately became a non-EZ related bill.

SB 1179 (Ducheny) - Allows EZs designated after 1990 to apply for a 5 year extension. Held, not passed.

SB 1354 (Escutia) - Credits carried over from previous tax years limited to reduce franchise tax by only 50%. The bill is pending on the Senate floor but is expected to die by August 31, 2004, the end of the legislative session.

VCI Results

As a result of the Voluntary Compliance Initiative, ending on April 15, 2004, California taxpayers (including over 750 individuals and 370 businesses) reported over **$1.3 billion** in taxes owed. California had sent letters to thousands of taxpayers to encourage them to file amended returns to undo any "potentially abusive tax avoidance transactions." (See Winter 2003/2004 *States of Affair* for a detailed discussion of the program.)

Water's Edge

In May, FTB issued **FTB Notice 2004-2** explaining 2003 legislation which removed language requiring a multi-state corporation to enter into a contract with the FTB in order to make the election. The election to file water's edge may now be made on the tax return.

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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:

Labhart Miles has been invited to speak at the ASWA/AWSCPA Joint National Conference in Chicago, IL on Nov.10, 2004.

Topic: "State Tax Basics in Light of Sarbanes-Oxley"

National Role:

Monika Miles was elected to the **American Society of Women Accountants** National Board of Directors for 2004-2005.

In Print:

Bill Labhart is an editor for the ***Journal of Multistate Taxation and Incentives***. If you have an article that you would like to submit for publication, please contact us.

In Our Community:

Labhart Miles will once again sponsor a team for ***Making Strides Against Breast Cancer*** to be held October 23, 2004.

In May, Labhart Miles supported Silicon Valley's ***Loaves and Fishes*** annual Silent Auction, helping to raise funds to feed the hungry.

Monika Miles is a new member of the National Association of Women Business Owners ("NAWBO"), Silicon Valley Chapter.

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