



State & Local Tax Update – 2011

presented by

*William Mueldener, Tax Principal
& Jason Kennell, Supervising Consultant*



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Agenda

- *Introduction*
 - Current Environment – Local vs. National
 - Examples, issues and taxpayers – how do they mix?
- *State Tax Energy Update*
 - Income Tax
 - Transactional taxes
 - Severance Tax
 - Sales Tax
 - Property Tax

State Update 2011

- *National State and Local Tax Scene*



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State Update 2011

- *National State and Local Tax Scene*

- 44 states face budget shortfalls

- Legislative consequences

- Increased taxes (raise rates and abolish exemptions)
 - Eliminate perceived loopholes
 - Address “new economy”
 - Amnesty Programs

- Administrative consequences

- Increased number of audits
 - More aggressive positions on audits
 - » Reanalyze prior positions
 - » Develop new positions
 - » Use of jeopardy assessments
 - Create administrative hurdles for taxpayers seeking refunds
 - Reduction in interest paid on refunds

State Update 2011

- *State Fiscal Issues: Driving legislation and tax policy* –
 - State Projected FY 2012 deficit (in millions) Deficit as percent of 2011 spending Rank by percent

<u>State</u>	<u>Est. Deficit</u>	<u>% of 2011</u>	<u>Rank</u>
Nevada	\$1,500	45.20	1
New Jersey	\$10,500	37.40	2
Texas	\$13,400	31.50	3
California	\$25,400	29.30	4
Oregon	\$1,800	25.00	5
Minnesota	\$3,800	23.60	6
Louisiana	\$1,600	20.70	7
New York	\$10,000	18.70	8
Connecticut	\$3,200	18.00	9
South Carolina	\$877	17.40	10

<u>State</u>	<u>Est. Deficit</u>	<u>% of 2011</u>	<u>Rank</u>
Pennsylvania	\$4,200	16.40	11
Vermont	\$176	16.30	12
Washington	\$2,500	16.20	13
Maine	\$436	16.10	14
Florida	\$3,600	14.90	15
Illinois	\$4,900	14.60	16
Mississippi	\$634	14.10	17
Alabama	\$979	13.90	18
Colorado	\$988	13.80	19

- *Information provided by The PEW Center on the States*

State Tax Update

- *2011 Activity – Colorado activity*

- Driven by 2010 Action
- 2010 Colorado Legislature passes the “Dirty Dozen”
 - Main Tax Items included:
 - “Amazon Tax” (Rules and Requirements)
 - Software Tax
 - Energy Used in Manufacturing
 - Credit Limitations
 - Net Operating Loss Limitation
 - Other items to which tax was added – “to-go” cups and straws, bull semen and pesticides...

Colorado State Tax Update

- *2011 Legislation*

- SB73: Repeal of the “Dirty Dozen” – failed
- HB1293: Reversal of the software tax – passed
- HB1005: Restore exemption for Ag. compounds, pesticides & bull semen – passed
- HB1318: Revision/Repeal of “Amazon” Tax – failed
- SB223: Vendor Fee reinstated – passed
- HB1265: Clarification of the Statute of Limitations for Refunds - passed
- HB1091: Expansion of the exemption for certain medical equipment – passed
- SB184: Amnesty program (including severance, gas, cigarette taxes) - passed

Colorado State Tax Update

- *Which bills impact the oil and gas industry?*
 - HB1293 – Software tax
 - The legislation passed in 2010 created major confusion for businesses headquartered and operating in Colorado
 - New law returns to the simpler method of determining when tax applies to software – must be associated with Tangible Personal Property.
 - HB1265 – Refund Statute of Limitations
 - Verified that the period of refund for taxpayers was 3 years and not 60 days.
 - Many oil/gas companies historically told by the DOR to file refund claims when vendors could not handle tax correctly.
 - Potentially...
 - SB228 – Vendor Fee
 - SB184 - Amnesty

National Issues and Considerations

- *Key areas of focus*
 - Nexus
 - Combined reporting
 - Eroding conformity
 - Gross receipts
 - Severance Tax
 - Sales/Use Tax
 - Employee wage withholding
 - Unclaimed property

Budget Shortfall

Administrative Actions

- *Brain Drain/Strain at the DOR*
 - More auditors = Increased audit activity
 - Increased burden of proof for taxpayers
 - Broader scope – targeting M&A activity, assets sales, other cash initiatives
- *Use of Third-party contractors*
 - Started with unclaimed property, but is branching out.
 - Contingent Fees = Aggressive Auditors

Trends in Nexus

- *Nexus*

- Income tax

- Economic not physical presence test
 - *West Virginia v. MBNA America Bank*, 640 SE2d 226, (WV 2006)
 - Similar decisions in IN, MA, MN and TN
 - Multistate Tax Commission Proposal (CO, CT, MI, potentially CA)
 - » \$50,000 payroll
 - » \$50,000 in property
 - » \$500,000 in sales
 - Does this really impact the oil and gas industry?
 - Not really...mainly an issue for oil/gas service companies

Budget Shortfall

Tax Trends and Overhauls

- *2008-2010 trend:*
 - Gross Receipts Tax – Growing Popularity
 - MI (MBT), OH (CAT), TX (Margin), WA (B&O)
 - Stabilize Revenues, applies to all businesses
 - Limits Tax Planning
 - 2011 – Still a consideration in the mix but states are reevaluating
 - MI rescinded the MBT in favor of a more traditional income tax

States with Gross Receipts Taxes

Current States:

Delaware

Hawaii

Kentucky

Michigan

New Mexico

Ohio

Oklahoma

Texas

Washington

Proposed States:

California

Illinois

Oklahoma-2013 ?

State Update 2011

- *Oklahoma Business Activity Tax (BAT)*
 - Temporarily replaces franchise tax and ad valorem tax on intangible personal property of a person doing business in the state
 - “Person” is defined to include any natural person, firm, partnership, joint venture, association, LLC, corporation, banking association, estate, trust, joint-stock company and any other group doing business as a unit
 - Effective for tax years 2010 through 2012 and currently set to expire before July 1, 2013

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- *Oklahoma Business Activity Tax (BAT)*
 - Imposed at a per annum rate of \$25 plus 1% of net revenue
 - For tax years 2010-2012 the 1% rate will not apply
 - Previous franchise tax filers will pay the \$25 plus an amount equal to their actual franchise tax liability for the period ending prior to 12/31/10
 - Taxpayers not previously subject to the franchise tax are eligible for a general exemption from the 1% rate

State Update 2011

- *Oklahoma Business Activity Tax (BAT)*
 - Taxpayers are required to report data regarding net revenue and apportionment to enable the state to estimate the BAT with the addition of the 1% rate
 - Without further legislation, the BAT will not be applicable and the prior franchise tax will resume for tax years beginning after January 1, 2013
 - **The initial BAT return is due JULY 1, 2011!**

Budget Shortfall

Tax Trends and Overhauls

- *Unitary Combined Reporting*
 - 23 of 45 income tax states have adopted combined reporting
 - Seven states since 2004; none in the prior 20 years
 - Goal is to raise revenue and close loopholes
 - Ranging from 3% in MD (2007) study to 20% in NM study (2008)
- *Market-based Sourcing*
 - Economic Presence vs. Physical Presence
 - Shifts more tax burden to out-of-state sellers

Examples

- *Chevron USA – New Mexico Letter #L2023525760, Dec. 16, 2010*
 - Apportionment dispute:
 - NM uses 3 factor apportionment to determine taxable income in the state (sales, property, and payroll).
 - Dispute centered on the computation of the property factor.
 - Should royalties paid to third parties as part of the “mineral lease agreement” be treated as rent.
 - NMRS Sec. 7-4-12 explains the state’s property factor to require:
“Property owned by the taxpayer is valued at its original cost. **Property rented by the taxpayer is valued at eight times the net annual rental rate.** Net annual rate is the annual rental paid by the taxpayer less any annual rental rate received by the taxpayer from subrentals.”

Examples – Chevron con't

- NM had adopted the 1950's UDITPA model in 1978.
- Amended state regulation to include a portion of the 1988 amended Multistate Tax Commissions model regulations (specifically did not amend to include the provision on oil and gas royalties).
- DOR argued "Ownership in Place" theory – land law adopted by NM, MA, TX, PA, ND, and AL.
- Chevron based position on State Reg. 3.5.12(c) which defined annual rent:
"Annual rent' is the actual sum of money or other consideration payable, directly or indirectly, by the taxpayer or for its benefit for the use of the property and included...*any* amount payable for the use of real or tangible personal property..."
- Ruling goes in favor of Chevron

Examples

- *Tesoro Corp. v. Alaska Dept. of Rev. (4/28/11)*
 - Unitary combined return dispute:
 - Method by which a group of related entities must file a tax return
 - By separate legal entity or as a combined group (elimination of intercompany)
 - Tesoro had various business units (different legal entities)
 - E&P – none of which was in Alaska
 - Refining and Marketing (R&M) – based in Alaska
 - Other units: Corporate, Finance and Marine Services
 - Ramifications of filing combined:
 - For the years in question Tesoro had significant income from two unique events.
 - » Litigation with Tennessee Gas over a take-or-pay contract
 - » Sale of an overvalued gas field

Examples – Tesoro con't

- Ramifications of filing combined (con't):
 - The R&M business had a high volume of transactions but low realization.
 - The E&P Business (plus additional associated unique income) had lower volume and high realization.
 - Combining the two entities shifted significant income to Alaska in comparison to filing the entities on a separate basis which produced a minor tax liability.
- Court examined the following tests to make the unitary determination:
 - Centralized Management
 - Functional integration
 - Economies of Scale
- Findings:
 - Companies were unitary and Tesoro did not meet the high burden necessary to show the application of apportionment (vs. separate accounting) was unconstitutional.

Examples

- *Alexandre v. Commissioner of Rev. (CT, 4/19/11)*
 - Sales tax and “jeopardy assessment” dispute:
 - CT audited taxpayer for years 1999-2002.
 - Primary issue related to record retention and CT’s method for estimating tax due.
 - July 2005 – CT still not finished with audit, taxpayer refused to sign an additional waiver.
 - CT audit manager threatens to impose a jeopardy assessment and place a lien on the taxpayer’s property and serve a tax warrant.
 - Court Found:
 - The state “improperly imposed a jeopardy assessment...that resulted in unnecessary expense incurred by the taxpayer...”

State Update 2011

- *Income/Franchise Tax*

- Texas: Letter No. 201012993L (12/1/10, released March 2011) – Passive entities must file an annual report vs. the one-time report previously required.
- Texas: Letter No. 201012994L (11/1/10) – Verifies depletion is allowed as a COGS. Pass-through entities may also claim depletion as a COGS (may not be passed through to owners of the pass-through).
- North Dakota: Mobile Workforce Bill Passes State Senate/House (SB2170, 3/10/2011)

State Update 2011

- *Sales Tax*

- **Wyoming:** HB60 2/15/2011 – updates “Special K” (W.S. Sec. 39-15-103(a)(i)(K)). Clarifies statute addressing taxability of well site services to verify that materials in addition to services are taxable.
- **North Dakota:** SB2202 6/30/2011 – Allows contractors to claim the exemption for materials used in the construction of an oil refinery and materials used in a compressing, processing, gathering, or refining gas facility.

State Update 2011

- *Severance Tax Updates*

- **California:** A.B. 1326 would impose a 12.5% severance tax on producers for the privilege of severing oil and gas in the state. The bill was re-referred to the Committee on Revenue and Taxation on 5/3/2011
- **Colorado:** The state has begun accepting cash values reported on the DR 0021W (Oil and Gas Withholding Statement) when accrual values are not provided by the producer

State Update 2011

- *Severance Tax Updates*
 - **Oklahoma:** Expiration of the additional excise tax imposed when the Oklahoma Corporation Commission's emergency well plugging fund drops below \$5MM has been extended from 7/1/2011 to 7/1/2016
 - **Pennsylvania:** H.B. 33 that would have taxed Marcellus Shale natural gas production was blocked in the state House on 5/25/2011

State Update 2011

- *Ad Valorem - Agricultural Classification*
 - Currently an area of controversy in Colorado
 - Counties offer tax benefit for land classified as agricultural
 - Current requirement in Colorado is to merely attempt to make a profit through agriculture
 - H.B. 1146 to be signed by the governor

State Update 2011

- *Federal Legislative Activity Impacting States*
 - HR 1864: Mobile Workforce State Income Tax Simplification Act of 2011
 - This bill seeks to limit the authority of states to tax certain income of employees for duties performed in other states.
 - Offers a “bright-line” test
 - Employee must be in a “non-resident” state for 30 days before the state may force a business to withhold or force the individual to file as a non-resident.
 - If passes – would go into effect 1/1/2013