

Protecting Your Clients in the Current Multi-State Environment

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Goals for Today

- Framework
- Expand your boundaries because boundaries are expanding
- Practical Advice
- Encourage Dialogue (Today and Beyond)

Order of Today

- I. General Overview of Multi-State Taxation
- II. Legal
- III. Sales
- IV. Business
- V. Compliance
- VI. New Hampshire
- VII. Audits and Appeals

Section I

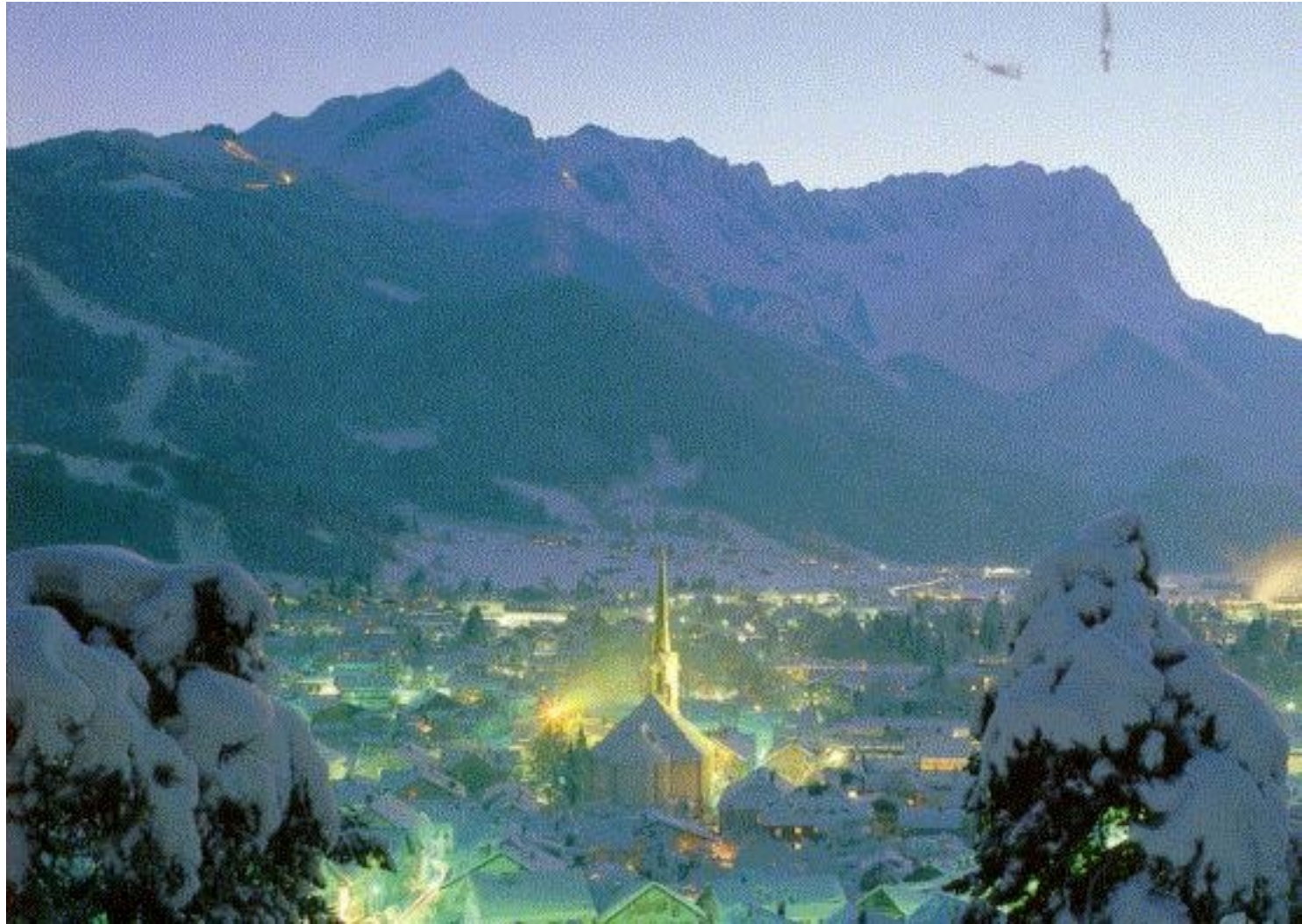
General Overview of Multi-State Taxation

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Why Understanding Multi-State Taxation is Important in Protecting Your Clients

- Increasing number of businesses operating in multiple states and countries
- Shift from manufacturing economy to services economy.
- Intangible Assets—Easier (?) to “isolate” income
- Technology—Where is income earned?
- Deficit Budgets and No New Taxes—States Aggressively Searching for Revenues



Section II

Legal Authority and Limitations on State Taxation

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Overview of Section II

- US Constitutional Authority and Limitations
- Limitations Imposed by Federal Law
- Applying These Concepts-A peek into current “Substantial Nexus” Disputes between States and Taxpayers
- Other Limitations on State Tax Authority-State Constitutions, Laws, and Court Cases

US Constitutional Authority and Limitations on State Taxation

- Overview—A State's power to enact and enforce a taxing rule is subject to Due Process Clause and Commerce Clause.
- Due Process Clause—14th Amendment
- Commerce Clause—Art. I Sect. 8

US Constitutional Authority and Limitations on State Taxation

- Overview—No state may tax income derived beyond its borders (easier said than done).
- Unitary Business Principle helps to implement apportionment of income to accurately assess a corporation's intrastate income while limiting runaway taxation.

Due Process Clause

- Minimal connection between the interstate activities and the taxing state, and a rational relationship between income attributable to the State and the intrastate values of the enterprise—Mobil Oil, 445 U.S. 425 (1982).
- Relevant DP inquiry—Is there “some definite link, some minimum connection between State and person, property or transaction it seeks to tax?”

Due Process Clause

- Relevant DP inquiry— Has the State given anything for which it can ask in return?
- DP not huge bar to jump over but be careful of “distortion.”
- Hans Rees’ Sons—283 U.S. 123 (1931).

Commerce Clause

- The most important line of defense for multi-state taxpayers.
- Congress has power to regulate commerce with foreign Nations and among the several states. This affirmative grant of power does not expressly limit state action, but the U.S. Supreme Court has interpreted that the “dormant” Commerce Clause limits state authority to tax.

Commerce Clause Four-Prong Test

Complete Auto Transit, Inc. v. Brady

430 U.S. 274 (1977)

- Prong #1 - Substantial Nexus
- Prong #2 - Fair Apportionment
- Prong #3 - Discrimination
- Prong #4 - Services provided by State

Complete Auto Prong #1 Substantial Nexus

- Is the tax applied to an activity with a substantial nexus with the taxing state?
- “Physical Presence” to establish nexus, at least for use tax purposes. National Bellas Hess, 386 U.S. 753 (1967).
- Bellas Hess reaffirmed by Quill Corp. v. North Dakota, 504 U.S. 298 (1992).
- New Developments -- 2008

Complete Auto Prong #1 Substantial Nexus

- Quill Corp. v. North Dakota
 - Due Process Clause is concerned with fairness to the individual taxpayer.
 - Commerce Clause is concerned with structural concerns about the effects of state regulation on the national economy.
- Does Quill apply to income tax or just to transactional taxes? A continual battleground.
- We'll take a further peek into substantial nexus disputes later.

Complete Auto Prong #2 Fair Apportionment

- Is the tax fairly apportioned?
- Internal Consistency and External Consistency—Container Corp. v. Franchise Tax Board, 463 U.S. 159 (1983).
 - Internal Consistency—If every jurisdiction applied the formula, it would result in no more than all of the income being taxed.
 - External Consistency—The factors in the formula must actually reflect a reasonable sense of how income is generated.

Complete Auto Prong #3 Discrimination

- Does the tax discriminate against interstate or foreign commerce?
- Probably most important prong and remains the center of litigation challenging a tax law as a violation of the Commerce Clause.
- Discrimination—Differential treatment of in-state and out-of-state economic interest that benefits the former and burdens the latter. Oregon Waste v. Department of Environmental Quality, 511 U.S. 93 (1994).
- Isn't benefiting in-state interests at the expense of out-of-state interests the natural inclination of state legislatures?

Complete Auto Prong #3 Discrimination

- To discourage the natural inclination to enact protectionist laws, the U.S. Supreme Court applies a “virtually per se rule of invalidity” to provisions that patently discriminate against interstate trade. Associated Indus. Of Missouri v. Lohman, 511 U.S. 641 (1994).
- No “de minimis” defense—once discrimination is shown, no inquiry on how unequal tax is. Maryland v. Louisiana, 451 U.S. 725 (1981).
- Most important recent pro-taxpayer Commerce Clause discrimination case authored by Justice Souter—Fulton Corp. v. Faulkner, 516 U.S. 325 (1996).

Complete Auto Prong #3

Discrimination

- Fulton Corp. v. Faulkner, 516 U.S. 325 (1996).
 - N.C. allowed deduction from its intangibles tax base determined solely by amount of business activity that the entity issuing stock conducted within N.C.
 - “There is no doubt that the intangibles tax facially discriminates against interstate commerce. A regime that taxes stock only to the degree that the issuing corporation participates in interstate commerce favors domestic corporations over their foreign competitors in raising capital among North Carolina residents and tends, at least, to discourage domestic corporations from plying their trades in interstate commerce.”
- But see, General Motors v. Tracy, 519 U.S. 278 (1997) (Bundled natural gas products from regulated market exempt from Ohio sales and use tax where unbundled natural gas in unregulated market subject to the tax does not discriminate against interstate commerce). Justice Souter also writes this opinion. No facial discrimination because the products serve different markets. Can Fulton and Tracy be reconciled?

Complete Auto Prong #3 Discrimination

- Recent New Hampshire challenges under the discrimination prong.
 - Interest & Dividends Tax (RSA 77).
 - Dividends Received Deduction of the BPT (RSA 77-A:4, IV).
 - Net Operating Loss Deduction of the BPT (RSA 77-A:4, XIII).
 - New Hampshire's taxation of foreign source royalties and interest.

CA Prong #3--Discrimination Interest & Dividends Tax Challenge (RSA 77)

- New Hampshire law imposed a 5% tax on all interest and dividends received on investments, but expressly exempted interest and dividends received on investments in New Hampshire banks.
 - Repealed—1995 N.H. Laws ch. 188
- Class of Taxpayers challenge--potential refund over \$100 million!!!!!!
- Fulton causes N.H. to concede that the express preference for N.H. banks unconstitutionally discriminates against interstate commerce **with respect to interstate banks**. Smith v. N.H. DRA, 141 N.H. 686 (1997)(“Smith I”).
 - N.H. Bank Dividend versus Bank of America Dividend

CA Prong #3--Discrimination Interest & Dividends Tax Challenge (RSA 77)

- In Smith I, N.H. Supreme Court remands for lower court to determine the scope of discrimination by deciding whether New Hampshire bank interest and dividends competed with other sources of investment income such as stock dividends and bond interest.
 - N.H. bank dividend versus GE dividend
- After remand, court issues opinion relying on GM v. Tracy that, as a threshold matter, the petitioners had to demonstrate that the exemptions caused investment in local bank products that otherwise would have occurred in the non-bank products.
Smith v. N.H. DRA, 813 A.2d 372 (2002).

CA Prong #3--Discrimination Interest & Dividends Tax Challenge (RSA 77)

- The Smith II “causation” standard based on different products undermines “virtually per se invalid” rule and “no de minimis defense” rule.
- Taxpayers challenge by filing certiorari petition to U.S. Supreme Court—cert. denied.
- Refund more like \$3 million than \$100 million.
- A new era of discrimination?
 - Difficulty of showing that discriminatory tax schemes cause an actual effect on economic decisions in the capital markets.

CA Prong #3--Discrimination Dividends Received Deduction Challenge (RSA 77-A:4, IV)

- General Electric, 154 N.H. 457 (Dec. 2006), *cert. denied* 128 S.Ct. 529 (2007).
- New Hampshire provides preferential treatment to dividends based solely on whether or not the paying subsidiary conducts business activity within New Hampshire.
- Based on Fulton, General Electric challenged DRD in N.H.
- A rapidly increasing number of state courts have struck down DRDs in other states (CA, ND, MN).
- NH Supreme Court held that the NH Statute does not violate the U.S. Constitution.
- Aggregate Tax...

CA Prong #3--Discrimination NOL Deduction--(RSA 77-A:4, XIII)

- New Hampshire requires a taxpayer to apportion the NOL deduction twice—once in the year that the loss is incurred and a second time when the loss is applied to offset taxable income.
 - With Double Apportionment:
 - 2002—Company Loses \$500,000.
 - Does 50% business in New Hampshire.
 - \$250,000 is available for N.H. NOL purposes.
 - In 2003, Company earns \$500,000.
 - Due to operation of statute, taxpayer first subtracts \$250,000 of available NOL and then apportions (50%).
 - Leaves \$125,000 of Taxable Business Profits. Company pays \$10,625 in BPT ($\$125,000 \times 8.5\%$).

CA Prong #3--Discrimination

NOL Deduction--(RSA 77-A:4, XIII)

- Without Double Apportionment:
 - 2002—Company Loses \$500,000.
 - Does 50% business in New Hampshire.
 - \$250,000 is available for N.H. NOL purposes.
 - In 2003, Company earns \$500,000.
 - Apportions 50%, leaving \$250,000 of Taxable Business Profits.
 - Uses Available NOL deduction, no BPT is due.
- This “double apportionment” provides a greater benefit to taxpayers as they increase their apportionment fraction in New Hampshire, likely violating the discrimination prong.

CA Prong #3--Discrimination NOL Deduction--(RSA 77-A:4, XIII)

- Legislative efforts in New Hampshire to eliminate double apportionment have been slowed due to revenue impact.
- 2003 legislation eliminated “phantom carryback” (SB 58).
- Litigation challenging double apportionment of NOL Deduction increasingly likely due to gradual increase in NOL cap from \$250,000 to \$1,000,000.

Complete Auto Prong #4 Services Provided By State

- Prong #1—Substantial Nexus
- Prong #2—Fair Apportionment
- Prong #3—Discrimination
- Prong #4—Services Provided by the State
 - Is the tax fairly related to the services provided by the state?
 - Least important prong in recent jurisprudence.
 - Montana imposed a tax where 90 percent of the burden fell on citizens of other states.
 - U.S. Supreme Court upheld tax—measure of the tax must be reasonably related to the extent of the contact with the taxing state. Commonwealth Edison Co. v. Montana, 453 U.S. 609 (1981).

Beyond Complete Auto

- Additional Protections for Foreign Commerce
 - Japan Line, Ltd. v. County of Los Angeles, 441 U.S. 434 (1979).
 - Must avoid enhanced risk of multiple taxation.
 - Not impair federal uniformity in an area where federal uniformity is essential.
- Taxation of Corporate Income on Worldwide Unitary Basis Upheld
 - Container Corp. v. Franchise Tax Bd., 463 U.S. 159 (1983).
 - Barclays Bank PLC v. Franchise Tax Bd., 512 U.S. 198 (1994).

Other U.S. Constitutional Provisions Limiting State Taxation

- Import-Export Clause--Art I. §10
 - Nature of the tax, not the nature of the taxed goods.
- Privileges and Immunities Clause--Art IV. §2
 - Austin v. New Hampshire, 420 U.S. 656 (1975)(strikes down RSA 77-B, “Commuters Income Tax”). RSA 77-B, through imposition and exemption features, taxed only the incomes of non-residents working in New Hampshire.
- Supremacy Clause--Art VI. §2
 - No state taxing statute can directly or indirectly conflict with a federal statute. Aloha Airlines, Inc. v. Director of Taxation of Hawaii, 464 U.S. 7 (1983)(state gross receipts tax explicitly pre-empted by federal law).

Other U.S. Constitutional Provisions Limiting State Taxation

- First Amendment
 - Taxes selectively imposed that infringe on right to free speech or tax exemptions that promote the establishment of religion violate First Amendment.
 - Minneapolis Star&Tribune Co. v. Minnesota, 460 U.S. 575 (1983).
 - Texas Monthly, Inc. v. Bullock, 489 U.S. 1 (1989).
- Equal Protection Clause (14th Amend.)
 - Strict Scrutiny v. Rational Relationship
 - Property tax exemption for Vietnam vets that included residency requirement bears no rational relationship to state's asserted purpose of assisting Vietnam vets. Hooper v. Bernalillo County Assessor, 472 U.S. 612 (1985).

Limitations Imposed by Federal Law

Public Law 86-272

- “No State shall have power to impose . . . a net income tax on the income derived within such State by any person from interstate commerce” if the business activities of such person are limited solely to “solicitation” and certain other narrow actions. 15 U.S.C. §381 (P.L. 86-272).
- Legislative response to Northwestern States Portland Cement Co. v. Minnesota, 358 U.S. 540 (1959).
- Purpose of P.L. 86-272 is to permit companies to conduct certain activities without subjecting them to tax.

Limitations Imposed by Federal Law

Public Law 86-272

- What is Solicitation?
 - Wisconsin Dept. of Rev. v. Wrigley, 505 U.S. 214 (1992).
 - Are activities “incidental” or “ancillary” to solicitation of orders?
 - Stock of free samples of gum—yes
 - Repair and servicing of products--no
 - “De minimis” activities not related to solicitation of orders do not lose P.L. 86-272 immunity.
 - Decisions about nexus remain highly fact intensive, and P.L. 86-272 remains a source of controversy.

Limitations Imposed by Federal Law

Public Law 86-272

- What is “Net Income Tax?”
 - Taxes based on net worth or related measures are not “net income taxes” for purposes of P.L. 86-272.
 - Examples--New Hampshire’s BET (RSA 77-E), Pennsylvania’s capital stock/franchise tax, Michigan’s single business tax.
 - Company selling into N.H. could be exempt from BPT under P.L. 86-272 yet must pay BET.

Limitations Imposed by Federal Law

Public Law 86-272

- The “Real World.”
 - Whipsaw effect on taxpayers (between states and from different taxes within a state).
 - Ex. 1: N.H.-based company sells its products in 20 different states. Files corporate tax returns in 15 states. Sales from the 5 P.L. 86-272 states are “thrownback” to New Hampshire and treated as New Hampshire sales. However, New Hampshire auditors might dispute the taxpayer’s determination that the taxpayer exceeded P.L. 86-272 in some of the 15 states and throwback sales from the disputed states.

Limitations Imposed by Federal Law Public Law 86-272

- The “Real World.”
 - Ex. 2: N.H.-based company determines it is entitled to P.L. 86-272 protection in a remote state (Wyoming). Sales are therefore thrownback to New Hampshire. However, company files sales tax returns in Wyoming (Sales taxes are not “net income taxes” entitled to P.L. 86-272 issues). Wyoming notices that sales tax returns are filed are therefore challenges taxpayer’s determination that it did not exceed P.L. 86-272 in Wyoming.

Other Limitations Imposed by Federal Law

- Internet Tax Freedom Act (47 USC 151)
 - Originally enacted October 1, 1998. The ITFA placed a moratorium on multiple taxes, discriminatory taxes, and taxes on Internet access, although existing access taxes were grandfathered.
 - Is New Hampshire grandfathered or not?
 - Pre-empts the ability to impose new taxes on internet access, but does not keep internet “tax free.”
 - Moratorium extended till 2014, but only after significant political maneuvering.

Applying Newfound Knowledge— A Peek into Current “Substantial Nexus” Disputes Between States and Taxpayers

- Back to Complete Auto Prong #1—
Substantial Nexus
- Dispute in State Courts, Statehouses, and
now Congress about States’ authority to tax
corporate income.
- Economic Nexus, Attributional Nexus, and
Affiliate Nexus.

Current “Substantial Nexus” Disputes--Economic Nexus

- Geoffrey, Inc. v. South Carolina Tax Commission, 437 S.E.2d 13 (1993).
- Geoffrey, Inc. was a wholly-owned subsidiary of Toys R Us, Inc. that licensed intellectual property for 1% royalty.
- Geoffrey, Inc. (a De. Intangibles holding company) had no employees, offices or tangible property in S.C.
- Rejects “physical presence” standard and fashions “economic nexus” standard.
- U.S. Supreme Court denies cert.—states love this case.

Current “Substantial Nexus” Disputes--Economic Nexus

- West Virginia v. MBNA America Bank, 220 W. Va. 163, 640 SE2d 226 (2006) , *cert. denied*, 127 S. Ct. 2997 (2007).
- Business Franchise and Corporate Income Tax Case.
- Court looked at substantial economic presence rather than physical presence standard.
- Substantial economic presence test is satisfied because of Taxpayer’s significant gross receipts in the State.
- Taxpayer systematically and continuously engaged in direct mail and telephone solicitation and promotion in the State.
- Court concluded that the Commerce Clause was not violated.

Current “Substantial Nexus” Disputes--Economic Nexus

- Lanco, Inc. vs. Director, Division of Taxation, 879 A. 2d 1234 (N.J. App. Div. 2005) , *aff'd*, 908 A2d 176 (N.J. 2006) , *cert. denied*, 127 S.Ct. 2974 (2007).
- Corporate Income Tax
- Lanco licensed its intangible personal property to Lane Bryant, Inc. for use in the latter’s retail operations in New Jersey and other states in return for royalty payments.
- Lanco had no physical presence in New Jersey.
- Court held that Lanco has substantial nexus in NJ and that imposition of corporate income tax did not violate Commerce Clause
- The Court concluded that “[t]he recent, and in our view, the more persuasive authority leads us to join the jurisdictions that have followed *Geoffrey* and to uphold the tax” and that the physical presence requirement applicable to sales and use taxes is not applicable to income tax.

Current “Substantial Nexus” Disputes--Economic Nexus

- Capital One Bank v. Commission of Revenue (Mass).
Breaking News
- Corporate Income-based Excise Tax
- Massachusetts statute subjected out-of-state financial institutions to income tax without regard to physical presence in the state if institution exceeded threshold of assets or receipts attributable to in-state borrowers
- Massachusetts Appellate Tax Board sustained application of statute to Capital One credit card bank, which had no presence in MA
- ATB held that Quill's physical presence requirement was not applicable to an income-based excise tax, June 22, 2007.
- ATB adopted a market approach
- Mass Supreme Court Affirms ATB and Rejects Taxpayer Appeal

Economic Nexus and New Hampshire

- During Lanco/ MBNA debate, N.H. wades into economic nexus
- Effective July 1, 2007, definition of “business activity” amended to include “a substantial economic presence evidenced by a purposeful direction of business toward the state.” See RSA 77-A:1
- DRA moves legislation just after Supreme Court denies cert. in Lanco and MBNA

Current “Substantial Nexus” Disputes--Attributional and Agency Nexus

- States attribute the activities of agents or affiliates of the taxpayer to assert taxing jurisdiction.
 - Scripto, Inc. v. Carson, 362 U.S. 207 (1960).
 - Tyler Pipe v. Washington, 483 U.S. 232 (1987).
- P.L. 86-272 vs. “Establish and maintain a market for its sales.”

Current “Substantial Nexus” Disputes – Attribution and Agency Nexus

- Borders Online, LLC v. State Board of Equalization, 129 Cal. App. 4th 1179 (May 31, 2005).
- Sales and Use Tax Case.
- Substantial physical presence through activities of affiliate, Border’s Inc.
- Returns and customer service of online purchases accepted at land store, Border’s Inc.
- Returns of merchandise = “Selling” under CA statute.
- Cross marketing brand activities between Online and affiliate created nexus.
- Activities of Border’s Inc. are significantly associated with Online’s ability to establish and make a market for the sales.
- Returns are much easier with Border’s Online than a typical ecommerce company because the merchandise can be brought back to a physical store.

Current “Substantial Nexus” Disputes—From States and State Courts to Congress

- Court Battles turn to Congressional Battles
- Congress can step in to regulate Commerce under-the Commerce Clause and can amend P.L. 86-272.
- Senator Gregg Example
- BATSA Example
- MTC Factor Presence Example
- MTC Model Statutes Example
- Strong attempt to end the see-saw battle and provide certainty.

Current “Substantial Nexus” Disputes—Senator Gregg’s Federal Legislation

- New Economy Tax Fairness Act (S.664 in 2003-2004 Congress)
 - Would amend 15 U.S.C §381 to codify “substantial physical presence” and prohibit states from imposing income taxes unless substantial physical presence exists.
 - SPP does not exist from (1) the presence or use of intangible personal property (2) use of the Internet or (3) affiliation with a person within such State or use of agents or independent contractors in such State.
- Strong attempt to end the see-saw battle and draw clear lines. Prospects for re-introduction and passage unclear (but unlikely in current climate).

Current “Substantial Nexus” Disputes—Business Activity Tax Simplification Act of 2006

- Business Community favors BATSA, which was introduced in last two Congresses
- BATSA provides a bright line physical presence nexus requirement by amending P.L. 86-272.
- Defines--Physical Presence
- Uniform standard—15 days or more (originally 21).
 - Exceptions for “gathering news,” non-profit activities, non-exclusive agents.
- Expands the applicability of PL 86-272 to Services and Intangibles.
- Passed out of House Judiciary Committee in 2006 but not in 2008.

Current “Substantial Nexus” Disputes— MTC’s Factor Presence Proposal

- Taxpayer is subject to jurisdiction if Taxpayer exceeds certain threshold levels of payroll (\$50,000), property (\$50,000) or sales (\$500,000) in a state.
- Commonly-owned enterprises are aggregated.
- P.L. 86-272 currently pre-empts the factor presence proposal.
- MTC urges Congress to enact a provision that relieves a state of the application of P.L. 86-272 if the state has enacted the factor presence standard with specified thresholds.
- MTC proposal shifts focus from presence of the company to presence of the customer.
- Recent court victories in Lanco and MBNA make MTC’s pursuit of this less necessary

New Hampshire Limitations

- Constitutional Limitations
 - Part I, Article 12—Requires that a given class of property be taxed at a uniform rate.
 - Part II, Article 5—Requires that taxes be proportionate and reasonable, equal in valuation and uniform in rate, and just.
 - Part II, Article 6—Legislature may classify property for purposes of taxation, but may not classify taxpayers for the purpose of taxation.

New Hampshire Limitations

- N.H. Constitutional Limitations:
 - No double taxation—ex., Income taxed under I&D cannot also be taxed under BPT.
 - No graduated rates—unlike many states
 - No minimum tax--\$250 minimum tax on all BPT filers prohibited.
 - No alternate BPT—unlike federal AMT.
 - No cap on employee compensation deduction--\$100,000 cap improperly classifies companies that compensate in excess of \$100,000 and those that do not.
 - No per employee credit--\$2,800 per employee credit would provide disparate number of credits to companies without regard to income or reasonable compensation expenses.

New Hampshire Limitations

- N.H. Statutory Limitations:
 - Generally, for jurisdictional purposes, “doing business” statutes are like jurisdictional “long arm” statutes.
 - It can be assumed that N.H. intends to subject companies to corporate income tax to full extent permitted by U.S. and N.H. Constitutions.
 - Economic Nexus amendments in 2007 make this particularly true.
 - Q.I.C.s and BPT.
- N.H. Case Law Limitations
 - Statutes that are ambiguous must be construed against the taxing authority rather than the taxpayer—In re Denman, 120 N.H. 568 (1980).

Conclusion of Section II

- There are real limits on a state's authority to tax imposed by the United States Constitution, Federal Law (ex. P.L. 86-272), the New Hampshire Constitution, N.H. Statutes, and N.H. Case law.
- Interesting (Con Law), Evolving and Emerging (State v. Federal) Area of the Law.
- New Hampshire has been a center of activity.
 - Smith, DRD, Gregg Bill
- On balance, states here current edge (“Losses” in Lanco/MBNA)



Section III

Sales and Use Taxes

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General Information

- 45 States with a sales tax. New Hampshire, Alaska, Delaware, Montana & Oregon, have no state-level sales tax. Cities and Towns in Alaska have the option of imposing a local sales tax.
- 46.1 Percent of total state revenue comes from sales taxes-(FY 2007)- Survey from FTA.

General Information

- 35 States have a local sales tax rate. Some are “Yes-No” add-on to State rate while others vary at local option. Highest combined rate = 11 percent (Alabama)
- New Hampshire has been very good at imposing selected sales taxes without calling them sales taxes. M&R, CST, ECT

Example 1

- **Jim's Home Entertainment Consulting Services, LLC.** Jim started this firm two years ago when a number of friends and neighbors asked him to help them set up their recently purchased home entertainment systems. Jim, a recently laid off computer programmer and technology buff, enjoyed the challenges of setting up these systems and it was a good way to earn money while seeking new employment. His area of operations is primarily Nashua to Salem, but he has done work for a friend in Massachusetts and his brother in Maine.

Example 2

- **Multi-State Assessing Services, Inc.** A New Hampshire based, specialty service company providing financial service companies a variety of services to protect the financial service company's interests in property. For example, when a company needs services in a state, it sends a request to MSAS detailing what it would like completed. MSAS sends a work order electronically to an Independent Subcontractor in the geographic area. The Independent Subcontractor completes the work and submits a bill to MSAS who then pays the bill.

Example 3

- **Medical Devices Unlimited** Started a number of years ago, operating just in NH. In 1999, a large manufacturer of a specific device approached the owner with an exclusive contract for six southern states. MDU elected to establish a network of independent contractors to sell the new line of products in the franchise states. The independent contractors did maintain a limited amount of product inventory and spare parts.

Examples

- Jim's Home Entertainment
 - Does he or doesn't he
- Multi-State Assessing Services
 - Good arguments against
- Medical Devices Unlimited
 - Could be in trouble

Sales Tax Nexus

Liability (Unaware) Jim's Home Entertainment ?	No Liability (Unaware) Jim's Home Entertainment ?
Liability (Aware) Medical Devices Unlimited	No Liability (Aware) Multi-State Assessing Service

Files

Doesn't
File

Incidence of Taxation

- Should apply at retail level
- Manufacturing inputs are normally exempt
- Use Tax-complimentary tax to sales tax-collected primarily from businesses.
- Some estimates are that 1/3rd of sales tax revenue is from use taxes (generally collected from businesses).

Multistate Transactions

- Remote sellers vs. bricks and mortar sellers
 - Remember Borders Case?
 - Amazon.com v. New York (filed in 2008 / pending)
- Pure competition
- Costs of compliance vs. reimbursement
- Collecting sales tax leads to business tax nexus?

Complexity

- Local Tax Rates
- Exemptions
- Donut rule. “We tax 5 donut holes but not 6 Donuts.”
- Sales tax holidays

Authority

- Scripto-Florida “contractors”
- Bellas-Hess- mail order “physical presence”
- Quill- substantial physical presence
- Congressional authority over Commerce Clause issues.

Streamlined Sales Tax

- Reaction to Quill
 - MTC initiative on affiliate nexus.
 - DMA, FTC, MTC joint effort.
 - Internet Access charges
 - NTA group
 - Moratorium
- Current status of SSTP
 - Sales Tax Simplification Agreement effective October 5, 2005
 - 44+ states, D.C. + local governments
 - www.streamlinedsalestax.org
- Business Activity Tax Legislation
 - BATSA of 2008 (H.R. 5267 and S. 1726)

Practical Application

- Do I have sales tax nexus in any of the States that I make sales into?
- If yes, am I keeping sufficient records?
 - Taxable if not specifically exempt and supported by proper records.
 - FTA web site-Model Record keeping Regulation.

Practical Application

- Actions by management without consulting tax department/tax advisor.
- Help from state tax department-Direct Pay
- Statistical Sampling

Conclusion

“Tax free” New Hampshire is no defense in litigation over your responsibility to collect Sales and Use taxes. Understand your responsibilities and seek legal advice in cases where you are unsure.



Section IV

Business Taxes

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Corporate Income Tax Overview

- 46 States impose corporate income taxes
 - Reporting: Separate vs. Consolidated vs. Combined (Unitary)
 - Combined / Unitary States: 20+
 - Separate Entity Reporting—Larger Planning Opportunities
- New England Snapshot
 - New Hampshire: unitary since 1986
 - Maine: unitary but different application
 - Vermont: unitary beginning in 2006
 - Massachusetts: unitary beginning in 2009
 - Connecticut: studies of unitary reporting proposed in 2008
 - Rhode Island: tax reform panel studying combined reporting for 2010

Business Tax in Multi-State Transactions

- Complexity is barrier
- Keeping up to date to multiple changes
- States continuing efforts to broaden authority to tax.
- Nowhere Income versus Multiple Taxation

Practical Application

- Analyze the factors
- Determine if subject
- Cost/benefit of alternative methods of doing business.
- Establish best practices.

Unitary Taxation

- States Combating Separate Company “Tax Planning”
- Intellectual Property Holding Companies, Financing Companies
- Aggressive Nexus—Attributional, Economic, Affiliate
- Add Back Statutes & Deductibility Denials

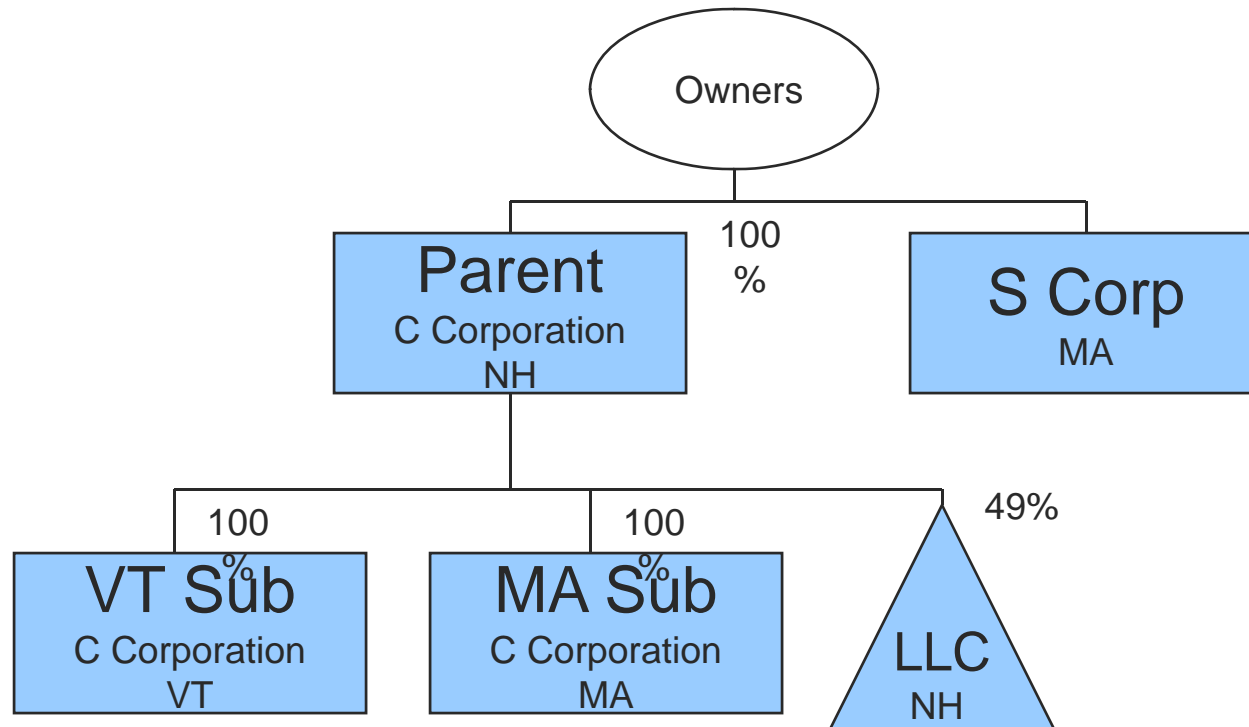
New England Combined Filing Overview

- I. Composition of Group
- II. Composition of Tax Base
- III. Apportionment

I. Composition of Unitary Group: Who's In and Who's Out?

- Unitary Business Definition
- Common Ownership
- Eligible Entities
- Water's Edge Group
- Worldwide Election
- Consolidated Elections
- Same Line of Business
- Intrastate Unitary Twist
- Special Industries

Example: New England Group



Unitary Business Definition

NEW HAMPSHIRE	VERMONT	MASSACHUSETTS
"...one or more related business organizations engaged in business activity both within and without this state among which there exists a unity of ownership, operation and use; or an interdependence in their functions"	"...one or more related business organizations engaged in business activity both within and without this state among which there exists a unity of ownership, operation and use; or an interdependence in their functions"	"...activities of two or more corporations under common ownership that are sufficiently interdependent, integrated or interrelated through their activities so as to provide mutual benefit and produce a significant sharing or exchange of value among them or a significant flow of value between the separate parts"

- VT definition identical to NH definition
- MA adopted MTC definition

Ownership Requirement

NEW HAMPSHIRE	VERMONT	MASSACHUSETTS
<p>No percentage threshold test; "unity of ownership" is defined by regulation to mean the "...activities outside the taxing jurisdiction, together with the in-state activities are owned either directly or indirectly by the same economic entity or group of entities"</p>	<p>"...more than 50 percent of the voting stock of each member corporation is directly or indirectly owned by a common owner or owners, either corporate or noncorporate, or by one or more of the member corporations"; regulations require certain family ownership attribution</p>	<p>"...more than 50 percent of voting control of each member of the group is directly or indirectly owned by a common owner or owners"; common owner can be corporate or non-corporate, and need not be member of the group.</p>

- VT and MA: more than 50% required
- NH: no ownership threshold (NE LLC?)
- "Directly or indirectly"

Eligible Entities Included

NEW HAMPSHIRE	VERMONT	MASSACHUSETTS
Any "business organization" which is defined to include corporate and non-corporate entities (including partnerships, LLCs and federally disregarded entities); no conformity to check-the-box	Any entity taxable as a C corporation for federal purposes; full conformity to check-the-box	Any entity taxable as a C corporation for federal purposes and S corporations; full conformity to check-the-box

- Three potentially different results
- Beware of MA S corporation treatment

“Water’s Edge” Group

NEW HAMPSHIRE	VERMONT	MASSACHUSETTS
<p>Exclusion for "overseas business organizations" ("OBOs"); New Hampshire OBOs are defined to mean "foreign incorporated business organizations" and "business organizations with 80 percent or more of the average of their payroll and property assignable to a location outside" the 50 states and D.C.; 80/20s are excluded only if a certification is made on intercorporate transactions.</p>	<p>Exclusion for "overseas business organizations" ("OBOs"); a Vermont OBO is defined as any "business organization that ordinarily has 80 percent or more of its payroll and property" outside the 50 states and D.C.</p>	<p>Statute as written includes the following members in the water's edge group: (1) all members incorporated domestically; (2) any member (regardless of place of incorporation) if it has 20% or more payroll, property or sales in the U.S.; (3) any intangible property / service company (see endnote) but only to the extent of the related income/factors; the 80/20 test is based upon average of payroll, property and sales within the U.S.; note the intangible property / service company exclusion</p>

- Three different definitions
- NH amended its definition in 2008

Elections Available?

NEW HAMPSHIRE	VERMONT	MASSACHUSETTS
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Worldwide Election

No	No	Yes (on original return, binding for 10 years)
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Consolidated Election

No	Yes, nexus-only, but subject to unitary requirements	Affiliated group election available (on original return, binding for 10 years)
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- VT consolidation subject to unitary rules
- MA has two elections available – 10 years

Same Line of Business

NEW HAMPSHIRE	VERMONT	MASSACHUSETTS
No	Yes by regulation: being in the same line of business is an indicator of interdependence in functions	Presumption by regulation

- VT and MA: unitary presumption
- NH audit initiative

Intrastate Unitary Twist

NEW HAMPSHIRE	VERMONT	MASSACHUSETTS
At least one member of the group must be engaged in business activity "without" New Hampshire in order to file a combined return	At least one member of the group must be engaged in business activity "without" Vermont in order to file a combined return	No such requirement (not by statute or other existing authority)

- MA - normal approach
- VT - unintentional?
- Impact may be good or bad (no offsetting of losses)

Specialized Industries: Who is Included and How Taxed

NEW HAMPSHIRE	VERMONT	MASSACHUSETTS
<p>Included: financial institutions, insurance companies (but credit for insurance taxes paid), REITS (recomputed tax base), public utilities. Excluded/exempt: qualified investment companies</p>	<p>Included but individually exempt from tax: financial institutions, insurance companies, transportation companies, telephone companies, and railroad companies. Excluded/exempt: captive insurance companies and corporations not taxable under the I.R.C.</p>	<p>Included: financial institutions, utilities, insurance companies not taxed as insurance companies for federal income tax purposes (e.g., captive insurance companies), REITs and RICs.</p> <p><u>Excluded/exempt</u> : security corporations and insurance companies</p>
<p>Same as any other business organization</p>	<p>Industries identified as "Included but individually exempt from tax" are required to include their income in the combined group's pre-apportioned tax base</p>	<p>Each "Included" member's income is in the group's combined tax base; special rules apply to groups that are comprised of both financial and non-financials</p>

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Revisit...New England Group

Non-Unitary (Separate) Filings

- NH: Parent and LLC file separate BPT returns
- VT: VT Sub files separate C corporation return
- MA: MA Sub & S Corp file separate returns

Unitary (Combined) Filings

- NH: Parent, VT Sub, MA Sub, S Corp + maybe LLC
- VT: Parent, VT Sub, MA Sub
- MA: Parent, VT Sub, MA Sub, S Corp

II. Composition of Tax Base: What is Included?

- Computation of Unitary Income
- Eliminations
- Dividends
- NOL's
- Business / Non Business
- Specialized Industries

Computation of Unitary Income

NEW HAMPSHIRE	VERMONT	MASSACHUSETTS
"Pure Combined" - tax is imposed on unitary group as a whole	"Separate Combined" - tax is imposed on individual company basis	"Separate Combined" - tax is imposed on individual company basis

- NH: one aggregate tax base and factor
- VT and MA: one aggregate tax base with individual apportionment factors

Net Operating Loss Treatment

NEW HAMPSHIRE	VERMONT	MASSACHUSETTS
Pre-apportioned state-specific NOL computation; NOL is treated as an attribute of each member	Post-apportioned state-specific NOL computation beginning in 2007, with special conversion rules for 2007; NOL is treated as an attribute of each member	Post-apportioned state-specific NOL computation; limitations set forth by regulation

- VT: 2006 federal NOL / 2007 VNOL conversion
- MA: post-apportionment / conversion by year of loss factor / limitations by regulation

Revisit...New England Group

NEW HAMPSHIRE	NH Parent	VT Sub	MA Sub	S Corp	LLC	Combined
Base Income	1,000,000	(500,000)	500,000	10,000	5,000	1,015,000
Apportionment:						
Numerator	1,000,000	0	0	0	10,000	1,010,000
Denominator	1,000,000	500,000	500,000	100,000	10,000	2,110,000
Percentage						48%
Post-Apportioned Income						485,853
Tax Rate						8.50%
State Tax Liability						41,298
VERMONT	NH Parent	VT Sub	MA Sub	S Corp	LLC	Combined
Base Income	1,000,000	(500,000)	500,000	N/A	N/A	1,000,000
Apportionment:						
Numerator	0	500,000	0	N/A	N/A	
Denominator	1,000,000	500,000	500,000	N/A	N/A	2,000,000
Percentage	0%	25%	0%			
Post-Apportioned Income	0	250,000	0			
Tax Rate	8.5%	8.5%	8.5%			
State Tax Liability	0	21,250	0			21,250
MASSACHUSETTS	NH Parent	VT Sub	MA Sub	S Corp	LLC	Combined
Base Income	1,000,000	(500,000)	500,000	10,000	N/A	1,010,000
Apportionment:						
Numerator	0	0	500,000	10,000	N/A	
Denominator	1,000,000	500,000	500,000	100,000	N/A	2,100,000
Percentage	0%	0%	24%	0.5%		
Post-Apportioned Income	0	0	240,476	4,810		
Tax Rate	9.5%	9.5%	9.5%	4.2%		
State Tax Liability	0	0	22,845	202		23,047
<i>*rough approximation of rates</i>						

III. Apportionment: Dividing it Up

- Apportionment Formula
- Sales of Tangible Personal Property
- Throwback Rule: Joyce / Finnegan
- Sales of Other Than TPP
- Special Industries

Apportionment Formula

NEW HAMPSHIRE	VERMONT	MASSACHUSETTS
Three factor, double-weighted sales factor	Three factor, double-weighted sales factor	Three factor, double-weighted sales factor, including in the denominator the separate denominators of all members, including those not subject to the standard apportionment formula

- All three-factor, DW sales factor
- NH / MA: specialized industry factors
- MA: imposition of each entity's formula to determine denominator

Sales of Tangible Personal Property

NEW HAMPSHIRE	VERMONT	MASSACHUSETTS
Destination-based	Destination-based	Destination-based; non-nexus members' Massachusetts sales apportioned to nexus members

Throwback Rules

New Hampshire Department of Revenue Administration applies <i>Joyce</i> rule for throwback (for sales originating in New Hampshire)	<i>Joyce</i> rule for throwback (if property is shipped from an office, store, warehouse, factory or other place in Vermont)	<i>Finnegan</i> rule for throwback (if property was not sold by an agent "chiefly situated at, connected with or sent out from premises" outside Massachusetts)
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- MA non-nexus sales treatment
- *Finnigan* opportunities in MA

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Throwback: *Joyce vs. Finnegan*

Throwback Rule: UDITPA Sec. 16(b)

“Sales of tangible personal property are in this state if... (b) the property is shipped from an office, store, warehouse, factory, or other place of storage in this state and...the taxpayer is not taxable in the state of the purchaser.”

ISSUE: Who is “the taxpayer”?

Joyce Rule

- Cal. SBE, 66-SBE-070 (1966)
- Sales of TPP are included in the numerator if the seller itself is not taxable in the destination state even if other members of the unitary group are taxable there
- Majority Approach (NH / VT)

Finnegan Rule

- Cal. SBE, 88-SBE-022 (1990)
- Sales of TPP are not included in the numerator if any member of the unitary group is taxable in the destination state (even if the seller itself is not)
- Minority Approach (MA)

Joyce / Finnegan Interplay

Outbound: NH to MA Sale - “Double Hit”



NH

- MA sale (destination rule)
- A not taxable in MA (*Joyce* rule)
- A's sales thrown back to NH numerator



MA

- MA sale (destination rule)
- A's non-taxability irrelevant under *Finnegan*
- Sale reported to B's MA numerator

Inbound: MA to NH Sale – “Nowhere Sales”



NH

- NH sale (destination rule)
- B not taxable in NH (*Joyce* rule)
- Sales not included in NH numerator



MA

- NH sale (destination rule)
- A's taxability in NH prevents throwback to MA numerator (*Finnegan* rule)
- Sales not included in B's MA numerator
- *Note:* allocation among numerators rule

Sales of Intangibles / Services

NEW HAMPSHIRE	VERMONT	MASSACHUSETTS
Income-producing activity / cost of performance rule; royalties based upon use; services based upon performance; other income based upon where earned	Income-producing activity / cost of performance rule; royalties based upon use; services based upon performance; other business receipts apportionable	For general corporations income-producing activity / cost of performance rule; specific sourcing rules addressed by regulation

- Cost of performance approaches
- All or Nothing Rule
- More and more of economic product in OTPP
- UDITPA / NCCUSL

Specialized Industries: Method of Apportionment

NEW HAMPSHIRE	VERMONT	MASSACHUSETTS
Special apportionment method for airlines, financial institutions, publishers, railroads, transportation companies, and broadcasting	No special industry apportionment rules; however, industries identifies as "Included but individually exempt from tax" are required to compute a denominator which is included in each taxable member's combined denominator	Special apportionment factor for manufacturing corporations, financial institutions, and mutual fund service corporations; each member determines its own apportionment factor based upon its specific formula (consisting of each member's separate-entity numerator over the combined group's denominator); special rules apply to groups that are comprised of both financial and non-financial organizations.

- VT method potentially distortive
- Beware of MA factor

Unitary Issues To Watch For...

New Hampshire

- Audit initiatives on OBOs and pass-throughs

Vermont

- Clarification of unitary rules
- New forms
- Net operating loss audit issues

Massachusetts

- Draft regulations

Other States

- Rhode Island: combined reporting legislation 2010
- Other states: combined reporting studies / shift

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Section V

Compliance and Coming Forward

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The Compliance Calculation

- Analyze and Quantify risks in each state
- File if Close Call?
- Statute of Limitations Issues
- Nexus Issues and Nexus Questionnaires
- Forward-Looking and Backward-Looking Issues
 - Corporate Income Tax
 - Apportionment
 - Amended Returns
 - Sales Tax
 - Your liability versus your customer

Coming Forward

- MTC Nexus Program
- Third Party Approaches
 - Lawyers and Accountants
- Direct Approaches
- Anonymity Issues and Getting on the Rolls
- Settlement Agreements and Procedural Issues
- Amended Returns for Open Years

Section VI

New Hampshire Specific Business Taxes

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Overview

- Business Profits Tax Enacted 1970
- To Replace “Stock-In-Trade Tax”
- Originally designed to just tax Corporations
- Property tax concept
- Reasonable Compensation Deduction

Reasonable Compensation

- Federal starting point for BPT
- 1970-1980 approximately 10% of net income before compensation taxed
- 1980-1986 more aggressive tax planning
- 1987-Sales of Assets to capture Capital Gains results in 17% of total BPT
- 1988-1992 Two efforts to expand tax to unincorporated.

Business Enterprise Tax

- Direct response to court challenge
- Designed to be revenue neutral
- Implemented 1993 at $\frac{1}{4}$ of 1 percent
- Decreased BPT rate from 8 to 7% over 2 yrs
- Implementation just as recovery took off.

Why the BET?

- 10% of businesses paid approx. 90% of tax
- BPT rate went to 9.56% in early 80s
- Two tries failed court test
- Couldn't be alternative taxes
- Base is a modified Value Added Tax (VAT)
- Inputs from labor and capital
 - Interest for debt
 - Dividends cost of equity
 - Couldn't favor one over the other
- See Article in Supplemental Materials

Filing Requirements

- \$50,000 Gross Receipts for BPT
- \$150,000 Gross Receipts for BET or
- \$75,000 of Enterprise Value Base

Interplay Between BPT & BET

- Administratively easier for taxpayer and department.
- Could have resulted in assessing penalties on one tax for underpayment while paying a refund on the other tax.
- Credit is unique and what makes it work
 - Carry forward for 5 years
 - Unincorporated
- Credit under attack due to current deficit?

Does BET Solve Reasonable Compensation Issue?

- Department aggressively challenging deduction
- Audit Program aggressively making adjustments for many multi-state and in-state businesses
- DRA Reasonable Comp program now challenging wages of C & S Corps in addition to flow-through entities
- 16Z versus RSA 77-A:4, III

Any Questions?



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Section VII

Audits and Appeals

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Audits

- Document Processing
- Multi-State
- In-State
- Nexus Bureau
- Discovery Bureau

Selection

- Not presumed guilty.
- Picked for issues, or when information filed on the return doesn't match with other information available to DRA.
- Increased use of computers has resulted in more hits, particularly with respect to RETT and business tax issues.

Multi-State

- Large firms
- Unitary issues
- Out-of-State-especially outside of NE
- Best trained, best paid
- Train and Assist In-State personal.
- 50-70% travel
- DRA Travel budget restrictions?

In-State

- M&R
- RETT
- Small to Medium businesses, NH Focus
- More office review
- More likely to be generated from Nexus or Discovery
- Big focus on reasonable compensation

Audit Issues

- Tax Base
 - Unitary or non-unitary
 - Foreign Sales Corporations (FSC)
 - Netting of Capital Gains/Losses
 - Compensation Deduction
 - Passive Investment Companies
 - Waters Edge-”80/20 Companies”
 - Add-Backs
 - 1031 issues (Hot!)

Audit Issues (cont.)

- Apportionment
 - Interest Income
 - Throwback sales
 - Valuation of Property
- Other-Interplay between RETT & Business Taxes (Huge Issue!!!)

Nexus

- Aggressive but Knowledgeable
- Many leads from other states
- Review yellow pages, newspaper advertisements and real estate records
- Use of the internet

Discovery

- Power of the computer
- Coupled with imagination
- As many failures as winners
- Pilot groups
- Try not to bother those that are properly complying

Audit Process

- Schedule an appointment
 - 1 day for M&R to 2 weeks for Multi-State.
 - During business hours.
 - Mutually agreeable time.
- Pre-appointment preparation
 - Standard requests.
 - Auditor requests.

Audit Process-Field Work

- Isolate, overwhelm or cooperate
- Provide what is requested if within reason.
- Best opportunity to frame issues and clear up misunderstandings.
- Exit interview is important. Ask for opportunity to review draft report prior to exit interview-share with legal.

Post Field Work

- Provide further documentation where appropriate.
- Statute of Limitations
 - Failure to sign my cause tax notices to be issued.
 - Easier to resolve prior to TNs.
- Informal conferences.

Assessments

- Proposed Assessments and Final Assessments
- Potential Use of Penalties
- Potential Departure from 3 Year Statute of Limitations.
 - Fraud
 - 6 Year “omits from gross income”
 - Omits equals not same result
 - Omits equals failure to report and government at special disadvantage.
 - Colony v. Commissioner, 357 U.S. 28 (1958).

Appeals

- 60 Day Rule—Be Careful
- Do not need attorney at Hearing Officer appeal, but. . . .
- Hearing Officer normally flexible during administrative process
- Adverse Hearing Officer Orders can be appealed to Superior Court or the BTLA.
 - Need Attorney at this level
 - Appeal within 30 days of Hearing Officer Final Order
- “De Novo” Scope of Review

“De Novo” Rules for Superior Court

- The Board of Tax and Land Appeals or the Superior Court, as the case may be, shall hear the appeal “de novo.”
- Each party may introduce whatever evidence it believes necessary, limited only by the evidentiary rules of the forum.
- Legal issues shall be limited to those raised before the commissioner, with the exception that the taxpayer may raise additional legal claims addressing constitutional issues.
- Either party may raise additional legal claims upon a showing of good cause

Recent Horror Stories

- Out of state accountant for 100% New Hampshire Company.
 - Single Member LLC
 - No business filings
 - \$30,000 of BET each year
- Out of state accountant for Multi-State Company
 - Likely missed unitary filing opportunities for related companies due to Massachusetts experiences
 - DRA audit and confusion over proposed assessment versus the official government action that kicks off petition for redetermination timeline
 - Potentially missed date (60 days)
 - 6 Year Statute Issues
 - Likely mismanaged by DRA as well or else full liability
 - Appeal to Superior Court ultimately resolved case, but needless professional fees and potential malpractice issues.

Recent Success Stories

- Stan and Chris
 - Accountant Perspective and Attorney Perspective
 - Government Side and Private Practice
 - National Perspectives
- Increased Coordination by Business Clients
 - Accountants and Lawyers getting best answers
 - Limited Liability Company Agreements
 - Planning for New Operations without conflicting goals
- Successful Advocacy with Revenue Department Officials by Coordinating Expertise of Accountants and Lawyers