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STATE INCOME TAX FILING ISSUES – ILLINOIS & WISCONSIN

Because the State tax filing season is here for calendar year corporate taxpayers, we devote this month's newsletter to selected income tax issues that affect corporate taxpayers in Illinois and Wisconsin.

ILLINOIS SINGLE SALES FACTOR ISSUES

Background. In 1998, Illinois adopted the single sales factor for apportionment of business income, phased in over a three year period and fully effective for taxable years ending on or after December 31, 2000. The single sales factor applies to all taxpayers other than financial organizations, insurance companies and transportation companies, each of which apportion business income using a special one factor formula. *See* 35 ILCS 5/304. Illinois' adoption of the single sales factor formula has created incentives for Illinois based corporations to avoid the "throwback rule" and remove sales from the Illinois numerator by creating nexus in other States, and for out-of-State corporations to avoid nexus with Illinois altogether.

What Sales are Included in the Sales Factor? The Illinois Income Tax Act defines "sales" broadly, to include "all gross receipts of the taxpayer" treated as business income, other than compensation. 35 ILCS 5/1501(a)(21). The Income Tax Act specifically excludes from the sales factor denominator subpart F income, the federal Section 78 gross-up and dividends, all or most of which are also excluded from taxable income base. 35 ILCS 5/304(a)(3)(D).

However, the Department of Revenue's regulations go much further than the statute and modify the "all gross receipts" definition of "sales" in various ways, generally to the detriment of corporations headquartered outside of Illinois. For example, under the category of "special rules," the regulations exclude gross receipts from the occasional sale of property (such as a factory), include gross receipts from intangibles (e.g., interest on financial instruments that are "merely held") only where those receipts are readily identifiable with a State, and include only the net gain, rather than the gross receipts, from sale of business intangibles (e.g., sales of stock investments or

continued on next page

UPCOMING EVENT

Advanced Illinois and Wisconsin Tax Issues Seminar

December 10 • Deerfield, IL
December 11 • Waukesha, WI

Foley & Lardner will team with Clifton Gunderson LLP to present two all-day seminars on Advanced Illinois and Wisconsin Tax Issues, targeted to corporate tax professionals at companies with significant tax exposure and planning opportunities in the two States. The seminars will cover current issues and planning strategies in the income tax, sales & use tax and franchise tax areas, plus procedural strategies to optimize your results of disputes with the Illinois and Wisconsin Departments of Revenue. Look for our detailed seminar announcement in the near future, and save the date for this exciting program. For additional information, contact:

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Treasury bills). 86 Ill. Admin. Code 100.3380(c). The regulations also state that gross receipts associated with any income that is not included in the computation of base income may not be included in the sales factor. 86 Ill. Admin. Code 100.3370(a)(2).

The Department's positions seem to conflict with the statute. Recently, the Circuit Court of Cook County reined in one of the Department's changes to the statutory sales factor, holding that a taxpayer could include in its sales factor denominator the gross receipts from sales of financial instruments that were "actively managed" (as distinguished from those that were "merely held"), rather than the net gain from those sales,. *Mead Corporation v. Department of Revenue,* No. 00 CH 07854 (Cir. Ct. Cook County, Feb. 5, 2002). The *Mead Corporation* decision, which has been appealed by the Department, suggests that the courts may be receptive to challenges to the Department's restrictive definition of "sales." Taxpayer should examine their sales factor closely to determine whether the Department's positions unduly apportion income to Illinois.

The Cost of Performance Rule. Sales, other than sales of tangible personal property, are Illinois sales if either the income producing activity is performed wholly within Illinois, or a greater proportion of the income-producing activity is performed within Illinois than without Illinois, based on performance costs. 35 ILCS 5/304(a)(3)(C). Under this test, over 50 percent of the performance costs must be incurred in Illinois for the associated gross receipts to be included in the Illinois numerator. Accordingly, if 49 percent of the costs of performance is incurred in Illinois and the remaining 51 percent of the costs is spread over more than one State, the gross receipts will not be included in the Illinois numerator, even if the Illinois costs are greater than the costs incurred in any other State.

Taxpayers engaged in service businesses (including businesses where the sale of tangible personal property is incidental to the service) should include sales in the Illinois numerator only where more than 50 percent of the costs of performance is incurred in Illinois.

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MORE NEWS

Wisconsin Next Economy Act Tax Permits LLC-Corporate Mergers

Effective October 1, 2002, Wisconsin has made the "cross-species" merger of business entities possible under Wisconsin law. Under the new law, any combination of domestic corporations, non-stock corporations, limited liability companies, and limited partnerships (but not general partnerships) may be parties to a merger.

The Wisconsin income tax treatment of these cross-species mergers will follow federal tax treatment. For a review of the Next Economy Legislation, co-authored by Len Sosnowski of Foley & Lardner, see "*Next Economy Legislation: Allowing Complex Business Reorganizations",* WI Lawyer (Aug. 2002) (http://www.wisbar.org/wislawmag/2002/08/).

Throwback Sales Rule Applied to Unitary Business Groups. Illinois takes the position that sales will be thrown back to Illinois if the seller is not taxable in the destination State, despite the fact that another member of the seller's unitary business group has nexus and is taxable in the destination State. This position was upheld in *Hartmarx Corporation v. Bower,* 309 Ill. App. 3d 959 (1st Dist. 1999) (involving 1986-1991), despite Section 502(e), which then provided that unitary groups filing a combined return may be treated as one taxpayer for purposes of determination of the group's tax liability. The *Hartmarx* decision reached the questionable conclusion that the term "taxpayer" as used in Section 502(e) means something different than the term "person" in the throwback rule. The other four Illinois Appellate Courts have not addressed this issue.

As of 1993, Section 502(e) was amended to provide that the filing of a combined return and the treatment "as one taxpayer for purposes of determination of the group's tax liability" is mandatory for unitary business groups. This amendment may bolster the argument that a unitary group must be considered to be one taxpayer for purposes of the throwback rules, for taxpayers who decide to challenge the *Hartmarx* result.

Treatment of Royalties in the Sales Factor. Gross receipts from the licensing and sale of patents, copyrights and similar intangible property are excluded from the sales factor unless these revenues constitute more than 50 percent of the taxpayer's gross receipts for the year and the two preceding years, determined by considering all gross receipts of a unitary business group. For most taxpayers, this rule eliminates all royalties from the apportionment formula. Royalties and gains from these intangibles, if included in the sales factor, are sourced to Illinois based upon place of utilization rather than place of creation of the intellectual property. 35 ILCS 5/304(a)(3)(B).

ILLINOIS PETITIONS FOR ALTERNATIVE APPORTIONMENT

One likely consequence of the single sales factor regime will be a new emphasis on Section 304(f) petitions for alternative apportionment. Section 304(f) provides that a taxpayer may petition for alternative apportionment if the statutory apportionment formulae do not "fairly represent" the extent of a person's business activity in the State. Despite this apparently flexible statutory standard, the Department of Revenue historically has applied the Constitutional standard and permits an alternative apportionment only where the taxpayer proves its Illinois income to be "out of all proportion to the business transacted in the State", causing a "grossly distorted result". 86 Ill. Admin. Code 100.3390(c). Earlier versions of this regulation explicitly cited the U.S. Supreme Court cases that require a gross distortion of income for the malapportionment to rise to violation of the Due Process Clause and Commerce Clause. *Lakehead Pipe Line Company Inc. v. Department of Revenue,* 192 Ill. App. 3d. 756 (1st Dist. 1989) and *Miami Corp. v. Department of Revenue,* 212 Ill. App. 3d 702 (1st Dist. 1991).

A petition for alternative apportionment may be filed in three circumstances:

(1) 120 days prior to the due date of the tax return, including extensions (which typically is not feasible as a practical matter);

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(2) as an attachment to a timely filed amended return; or

(3) as part of a protest to a notice of deficiency, but only if the petition is made necessary by the audit adjustments, and could not have been filed under (1) or (2) prior to the audit adjustments.

We know that the single sales factor will not "fairly represent" the business activity in Illinois, particularly for many out-of-State taxpayers, but what is not clear is the amount of distortion necessary to support a successful Section 304(f) petition. In *Lakehead Pipeline,* the Appellate Court concluded that a distortion of less than 50 percent was not sufficient to justify deviation from the statutory one factor formula (meaning that the Illinois taxable income using the statutory formula was no more than 150 percent of Illinois taxable income derived under the alternative two-factor and three-factor formulae).

Taxpayers who have suffered significant overtaxation by Illinois due to the single sales factor (or for any other reason) should consider filing Section 304(f) petitions with amended returns for their open years. The regulations imply that separate Section 304(f) petitions must be filed by a taxpayer for each year for which an alternative apportionment method is sought. 86 Ill. Admin. Code 100.3390. Taxpayers considering the filing of a Section 304(f) petition should be prepared to provide a detailed economic analysis of the amount and cause of distortion caused by the single sales factor formula.

BUSINESS/NONBUSINESS INCOME DEVELOPMENTS IN ILLINOIS

Illinois follows the UDITPA regime for business income, which is apportioned by formula, and nonbusiness income, which is specifically allocated to the situs of property (in the case of rents from real and tangible personal property) or to the taxpayer's commercial domicile (in the case of interest, dividends and other income).

The Illinois Department of Revenue has a strong bias toward business income and has published a regulation which creates a presumption that all income is business income unless clearly shown otherwise, a presumption recognized by the Illinois Supreme Court in *Texaco-Cities Service Pipeline Co. v. McGaw,* 182 Ill. 2d 262 (1998). Nevertheless, taxpayers domiciled outside of Illinois have recently prevailed in several cases which hold that investment income, gain from the sale of a subsidiary, and gain recognized in a complete liquidation are nonbusiness income or are not taxable by Illinois under the Due Process and Commerce Clauses of the U.S. Constitution.

Investment Income on Funds in Excess of Working Capital Needs. In a case with potentially broad implications for other taxpayers, a Texas taxpayer succeeded in convincing the Illinois Appellate Court that the portion of its investment income on funds not needed for working capital could not be taxed by Illinois. *Home Interiors and Gifts, Inc. v. Department of Revenue*, 318 Ill. App. 3d 205 (1st Dist. 2000). The taxpayer maintained five short-term investment accounts, only one of which was clearly segregated from its business operations and set aside for long-term investment (the Salomon Brothers account, which the Department conceded generated nonbusiness income). The taxpayer proved that the other four accounts, although available for working capital expenditures, were only

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used in part for working capital needs. The Appellate Court agreed with the taxpayer that only a proportionate share of the investment income could be included in Illinois business income, under the "operational" test articulated in *Allied-Signal, Inc. v. Director, Division of Taxation,* 504 U.S. 768 (1992).

Illinois-based taxpayers concerned with the implications of the *Home Interiors* case lobbied for relief, and the legislature granted them an election to treat all income as business income, for taxable years beginning on or after January 1, 2003. If made, the election will be irrevocable. 35 ILCS 5/1501(a)(1); Public Act 92-0846 (Aug. 23, 2002).

***Asset Sale and Subsidiary Sale Cases**.* Two recent taxpayer victories illustrate the circumstances in which nonbusiness income may result from an asset sale or a sale of a subsidiary or affiliate. In *Blessing/White, Inc. v. Zehnder,* No. 1-01-0733 (1st Dist. App. Ct., March 29, 2002), the Appellate Court found that nonbusiness income resulted when the corporate taxpayer sold all of its assets and distributed all of the proceeds in complete liquidation. In *Hercules Incorporated v. Department of Revenue,* 324 Ill. App. 3d 329 (1st Dist. 2001), the taxpayer sold a 38.7 percent interest in a subsidiary, Himont, which it helped form four years earlier and which it originally owned 50-50 with a joint venture partner. The Appellate Court did not reach the "nonbusiness income" issue, finding instead that the gain could not be taxed by Illinois under Due Process and Commerce Clause principles, since no unitary or operational relationship existed between Hercules and Himont at the time of sale.

The *Home Interiors, Blessing/White* and *Hercules* cases give taxpayers significant support for treating investment income and gains from extraordinary dispositions as nonbusiness income, or as income or gain which is not "operationally" connected to the Illinois business under the *Allied-Signal* standard.

UNITARY BUSINESS GROUP DEVELOPMENTS IN ILLINOIS

***Inclusion of Partnerships – In General**.* Since its enactment in 1969, the Income Tax Act has provided that partnerships must apportion their business income at the partnership level, using the partnership's apportionment factors, and then the income apportioned to Illinois is taken into account by the partners. 35 ILCS 5/305. However, since 1987 the Department of Revenue has taken the position that the apportionment of partnership income must be made at the partner level.

The Department's regulations provide that a corporate partner must include, in its unitary business income and apportionment factors, its proportionate share of the partnership's business income and apportionment factors, to be added to and apportioned with the remainder of the corporation's income and factors (if a unitary business relationship exists between the partnership and corporate partner, disregarding ownership requirements). 86 Ill. Admin Code 100.3380(d). In two cases pending in the Illinois Appellate Court, taxpayers represented by Foley & Lardner have challenged the 1987 regulation. The outcome of this litigation may determine whether partnership income will be apportioned at the partner level or the partnership level. *BP Oil Pipeline Company v. Department of*

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Revenue, No. 01-2364 and *Unocal Pipeline Company v. Department of Revenue,* No. 01-2365.

Second-Tier and Third Tier Partnerships and the 2002 Regulations. Many taxpayers have taken the position that the Department's regulation applies only to a first-tier partnership owned by a corporate partner but not to second-tier or lower-tier partnerships which are in turn owned by upper-tier partnerships. This position was supported by the literal language of 86 Ill. Admin. Code 100.3380(d) prior to its revision in 2002, and by the Department's position that only corporations can be members of unitary business groups, 86 Ill. Admin. Code 100.9900.

Apparently in order to close the two-tier partnership planning "loophole," the Department revised the partnership regulation in 2002 to require the "flow-up" of business income and apportionment factors from second-tier partnerships. However, the regulation does not appear to apply to third-tier partnerships. 86 Ill. Admin. Code 100.3380(d), 26 Ill. Reg. 9864 (July 5, 2002). Although this amendment applies generally to taxable years ending after its promulgation on June 20, 2002, the Department will accept Section 304(f) petitions to apply it to earlier years, and taxpayers that would benefit from this "flow-up" of income and apportionment factors from lower-tier partnerships should consider filing a petition to do so.

Sales Finance Company Developments. Under the Illinois Income Tax Act, a "sales finance company" is a "financial organization" and cannot be included in the same unitary business group as manufacturing or other companies that use the general sales factor apportionment formula. Amendments enacted in 1999 significantly expanded the definition of "sales finance company" to include not only a company that purchases customer receivables (including ordinary accounts receivable which do not carry stated interest) from its affiliates, but also companies engaged in the business of making loans secured by the customer receivables of its affiliates, making loans to affiliates for the purchase of tangible personal property, and finance leasing. 35 ILCS 5/1501(a)(8)(C); Public Law 91-535 (eff. Jan. 1, 2000). As a result, some taxpayers may find that special purpose finance subsidiaries constitute Illinois "sales finance companies", even where the taxpayer did not plan for this treatment.

In addition, the Illinois Department of Revenue recently finalized regulations that would codify the "lockbox rule" and the "wire transfer rule" which the Department previously adopted in private letter rulings. 86 Ill. Admin. Code 100.3400, 26 Ill. Erg 9864 (July 5, 2002). Interest income of a financial organization is included in the numerator of the Illinois apportionment factor only if the interest is "received" in Illinois from Illinois customers, and not if it is "received" outside of Illinois or from customers located outside Illinois. 35 ILCS 5/304(c)(1)(c). The lockbox and wire transfer rules make it easy to "receive" interest from Illinois customers outside of Illinois and to utilize a sales finance company to reduce Illinois taxable income, by shifting income from the taxpayer to a sales finance company with a smaller Illinois apportionment factor.

ILLINOIS PROCEDURAL CONSIDERATIONS AND PENALTY PROTECTION

In preparing Illinois income tax returns, taxpayers should look ahead to the probability of an audit and

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contest of specific issues and should minimize the risk of penalties. The Department of Revenue may be expected to scrutinize nonbusiness income, exclusion of companies from the taxpayer's unitary business group, and the elements of the single sales factor. The Department also should be expected to assert penalties unless the taxpayer shows "reasonable cause" for its position, which has been interpreted to mean the exercise of ordinary business care in preparing the tax return, rather than reasonable grounds for the position taken on the return. The "reasonable cause" test generally is satisfied by reliance on written advice from an independent tax professional.

If a contest with the Department over one of these issues is likely, the taxpayer should consider the three procedural choices for contesting the issue:

(1) *Assert the Filing Position and Contest in Administrative Hearings.* Claim the position on the return and, if the issue is raised in audit, protest the deficiency and request an administrative hearing, without payment until the case is final. To protect against penalties, an opinion of counsel may be desired at the time of filing the return. The Department's decision in an administrative hearing is reviewable in court, based strictly upon the record made in the administrative hearing and subject to unfavorable standards of review.

(2) *Assert the Filing Position and Contest Directly in Circuit Court.* Claim the position on the return and, if the issue is raised in audit, pay the tax under protest and contest the adjustment directly in circuit court. The advantage of this method is choice of forum, choice of venue and avoidance of the administrative hearing. Again, an opinion of counsel may be desirable to protect against penalties.

(3) *File an Amended Return to Claim a Refund.* Do not claim the position on the return, and instead file an amended return shortly after the original filing to claim a refund. The advantage of this method is the avoidance of penalty exposure, but the taxpayer must request an administrative hearing and may not contest a claim denial directly in court.

All three procedural strategies preserve the taxpayer's right to an informal conference with the Department prior to issuance of a final notice of deficiency or final notice of denial of a refund claim. We generally recommend that taxpayers utilize the second procedure (or "Protest Act" procedure) described above, relying upon written advice of an independent tax professional for penalty protection. For many taxpayers, the second procedure not only will avoid the Department's administrative hearing, but also will preserve their right to litigate the issue in court outside of Cook County.

WISCONSIN APPORTIONMENT ISSUES

Corporations doing business only in Wisconsin pay Wisconsin corporate income tax on their entire net income. Corporations engaged in business in and outside of Wisconsin must apportion their business income using the traditional three-factor apportionment formula but with a double-weighted

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sales factor (throwback sales are single weighted). Wisconsin couples a very broad definition of "apportionable income" (particularly with respect to royalty income) with a very narrow definition of nonapportionable nonbusiness income.

Wisconsin Treatment of Royalties. Royalties from intangible assets (i.e., patents, copyrights, trademarks, etc.) are always included in apportionable income for purposes of determining a corporation's Wisconsin tax. However, for purposes of applying Wisconsin's apportionment formula, only royalties from income-producing activities are included in the sales factor; royalties and income produced from passive investments in intangible assets are not included in the sales factor. Royalties from intellectual property used in income-producing activity will be included in the Wisconsin numerator if the "income-producing activity" relating to the royalties, defined to include the sale, licensing or other use of the intangible property, is performed in Wisconsin.

Avoiding Throwback of Sales to Wisconsin. In determining a corporation's sales factor under Wisconsin's apportionment formula, out-of-state sales are "thrown back" to Wisconsin if the corporation cannot establish nexus in the States in which the sales were made. The Wisconsin Department of Revenue has been aggressive in attacking corporations that attempt to allocate sales to other States in an attempt to lower their Wisconsin tax.

One example is a Wisconsin corporation that maintained a traveling service force that made service calls for the corporation throughout the continental United States. The corporation argued that the presence of its service representatives in other States, coupled with its other activities in those States, established nexus (a taxable presence) in those States which prevented Wisconsin from taxing the income derived from those activities. Despite the fact that the corporation filed returns in many of the States in question, and obtained nexus determinations from those States, the Department took the position that the activities of the corporation's service representatives were not substantial enough to establish nexus in those other states, and, therefore, attempted to throwback all the sales to Wisconsin for purposes of determining the corporation's Wisconsin income tax liability.

The Wisconsin Department of Revenue's requirement of strict proof to substantiate throwback sales relief forces corporate taxpayers with exposure to the Wisconsin throwback sales rule to keep detailed records of their contacts with other States. By keeping detailed employee logs, invoices and receipts regarding purchases and other activities conducted in the State, a corporation can lay the framework for substantiating its nexus in that State. Without this detail, a corporation may be unable to rebut a challenge by the Wisconsin Department of Revenue, and may be forced to include throwback sales in the Wisconsin numerator despite taxation in the other States.

Payroll Factor: Leased Employees & Management Companies. Amounts paid for leased employees are not considered "payroll" for purposes of Wisconsin's apportionment formula. Therefore, corporations that lease employees located in Wisconsin will not be considered to be maintain a Wisconsin payroll for purposes of apportioning income. Alternatively, Wisconsin corporations that have operations outside of Wisconsin that utilize leased employees will not be entitled to allocate income to the states in which the employees actually perform services. However,

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amounts paid to an affiliate corporation under a management services agreement generally are included in the payroll factor for Wisconsin.

WISCONSIN SEPARATE RETURN ISSUES

Wisconsin does not allow the filing of combined or consolidated returns by unitary business groups of corporations, and instead requires each corporation to file a separate return. The separate taxpayer status of each entity within a related group must be recognized in structuring transactions, and the tax consequences of ignoring this separation may be significant.

Inadvertent Loans and Imputed Interest. One example of the effect of Wisconsin's "separate return" system arises where a parent corporation sweeps the cash accounts of its wholly-owned subsidiaries on a daily or monthly basis to consolidate cash at the parent. Although the cash transfers will be eliminated when preparing the federal consolidated income tax return, the transfers of cash from the subsidiaries to the parent are classified as loans for purposes of Wisconsin's separate return system. Accordingly, the Department of Revenue imputes interest income to the subsidiary and a deduction to the parent due to the existence of the inter-company loans.

IP Holding Company Planning Technique Under Fire. The Wisconsin Department of Revenue has begun to take an aggressive stance on advanced state tax planning techniques. A recent example of this is the Department's challenge to the intellectual property holding company that was established by Kohl's Department Stores. The intellectual property holding company (or "IP holding company") established by Kohl's was similar to those used by other corporations. The parent company contributes all of its intellectual property (e.g., its trademarks, patents, copyrights, etc.) to a subsidiary or affiliated company, which then agrees to license the intellectual property back to the parent corporation. The parent company takes deductions for the license fees (royalties) paid to the intellectual holding company, thereby reducing its state tax liability.

Because Wisconsin is a separate reporting state, the deductions taken by the parent company are not eliminated. If the intellectual holding company is established in a no-tax state (or a State that does not tax royalties), this structure can result in a significant reduction or elimination of State tax liability for the parent company.

The Wisconsin Department of Revenue has taken the position that royalty payments between affiliated corporations do not qualify as "ordinary and necessary" business expenses, and can therefore not be deducted by the parent corporation. This issue is the focus of the *Kohl's Department Stores* case, which is pending in the Wisconsin Tax Appeals Commission.

WISCONSIN AND ILLINOIS DECOUPLE FROM FEDERAL DEPRECIATION CHANGES

Both Illinois and Wisconsin have declined the adopt the federal change which allows a bonus 30 percent first-year depreciation deduction for qualified property, enacted by the Job Creation and Worker Assistance Act of 2002. Wisconsin now follows the Internal Revenue Code as of December 31, 2000, for purposes of computing amortization or depreciation on property placed in service on or

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after January 1, 2001. The prior law allowed taxpayers the option of computing Wisconsin amortization or depreciation under either the Internal Revenue Code as of December 31, 1999 or as of the date in effect for the taxable year in which the return is filed.

For More Information

To learn more about our Federal and State Tax Controversy services, please call your Foley & Lardner attorney or feel free to contact one of the individuals listed below.

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