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Multi-State Taxation and Sales Tax Nexus of Business

(MSTB)

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Edward K. Zollars, CPA
Thomas J. Burger, CPA

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Unit

1

Importance of Multi-State Taxation

LEARNING OBJECTIVES

When you have completed this unit, you will be able to accomplish the following.

- Recognize the importance of state and local taxation in tax planning and compliance for multi-state business enterprises.
- Identify various types of taxes levied by state and local governments.

INTRODUCTION—WHAT IS SALT?

State and local taxes (SALT) are, basically, the other half of the taxing scheme (opposite from federal tax) and refer to the various income, franchise, sales and use, property, excise, and other types of taxes imposed by states and localities.

SALT applies to taxpayers operating in more than one state (typically); to businesses operating in just one state; to every individual, business (any format), nonprofit, and trust; and in every state and local jurisdiction.

It does not matter if the taxpayer is paying federal income taxes, or if the taxpayer is in a loss situation. There are approximately 8,000 taxing jurisdictions (state and local jurisdictions). Each state (or locale) has its own set of statutes, rules, regulations, and court systems separate from the Federal Internal Revenue Code.

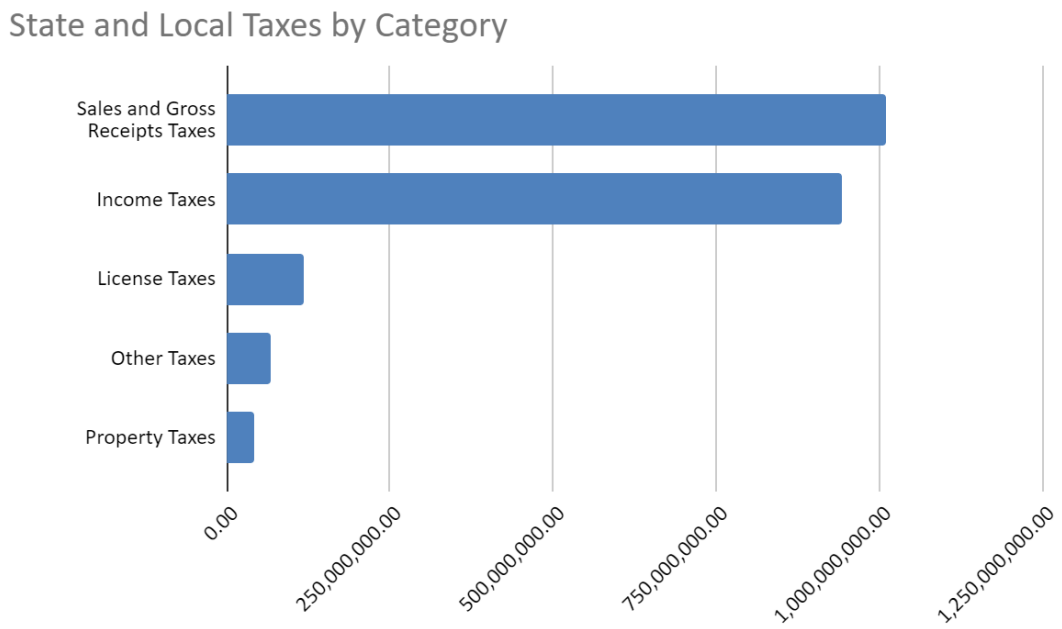
Breakdown of SALT Revenues

State and local taxes come from a variety of sources. States are heavily dependent on property and sales taxes. Individual income taxes also make a large component of the tax base for many states and localities.

States and localities may also take advantage of unique sources of revenue from natural resources that are sold to nonresidents, thereby exporting the economic burden of the taxes to residents of other states. For example, states that have significant oil and gas operations will often see significant revenue from excise taxes imposed on those resources.

Sources of income based on information from the 2019 U.S. Census Bureau Annual Survey of State Government Tax Collections.

Figure 1.1: Total State Government Tax Collections by Category



Basic SALT Taxes and Issues Tax Practitioners Should Address

A tax practitioner should be aware of the following types of taxes and related state issues that will impact clients at the state and local services, and consider the need to offer services with regard to these issues:

- Net income taxes
  - Corporate and individual income taxes
  - Flow-through entities
  - Residency issues for individual taxpayers

- Unitary, apportionment, etc. for taxpayers with what states see as operations in multiple jurisdictions, which in today's post-*Wayfair* age arguably is almost every business except, perhaps, those offering only services that must be performed in person (hair styling, for instance) with the rise of sales made on websites

- Non-net income taxes

  - These are also often imposed by states, either in addition to or in lieu of income taxes. Such taxes include the following:

    - Gross income taxes – While not discussed in further detail in this course, these states take the approach of tax gross receipts, subject to modifications, credits, and varying tax rates. Presently, Washington State and Ohio impose gross receipts taxes.

    - Franchise taxes – While not discussed in further detail in this course, these taxes are based on capital stock values and are imposed for the privilege to do business in the state. Unlike corporate income taxes, which are levied on a business's state adjusted net income, capital stock (franchise) taxes are imposed on a business's net worth. Typically, the calculation starts with a company's stock or net assets and is then subject to certain adjustment. Businesses pay a capital stock tax regardless of current or prior profitability. As of 2019, sixteen states levy capital stock taxes. Capital stock taxes are most prevalent in the southeast; however, a few northeast and Midwest states impose the tax. Many of the states imposing a capital stock tax have realized that taxing a company based on its net worth penalizes the accumulation of wealth, or capital. Consequently, many states have reduced or repealed them altogether.

    - Sales and use taxes – These are now an issue for almost every business following the Supreme Court's *Wayfair* decision, which removed any requirement that a business must have physical presence in a state to be required to collect the tax. Complications in this area include the following:

      - Taxable items – State and/or local sales taxes may vary significantly from jurisdiction to jurisdiction and sometimes even within the same state.

      - Sourcing of the sale – Which sales must the tax be collected, and for which jurisdiction(s) in the state.

      - Exemptions from the sales taxes – Businesses and various interest groups convince state legislatures to add new and varied exemptions (vary wildly from state to state). The exemptions can be based on what the seller is selling, the customer the product is sold to, what the buyer plans to do with the product, or even the day the product is sold ("sales tax holidays").

      - Compliance issues – Each jurisdiction has its own rules for when and how sales taxes are to be paid over and when and how reports are to be filed. Again, there is no consistency here, so businesses must be aware of the requirements for each jurisdiction as to when payments and returns are due.

  - "Home rule" for localities – While many states have a single point of collection and reporting for sales taxes and a standard law that determines what is taxed no matter where sold in the state, that is not true of all states. Some states allow localities to practice "home rule" to a greater or lesser extent on sales taxes. Rather than solely being able to set a rate, the locality may be able to change what is taxed, add or remove exemptions, or even have their own complete independent sales tax law. Advisers must be aware of this issue in states that allow some amount of home rule on sales tax issues.

  - Industry-specific issues – In some cases, industries will face their own unique issues on sales taxes with the various states and localities.

- Credits and incentives
- Escheat or unclaimed property
- Real and personal property tax
- Assessed value issues
- Compliance assistance
- Review for "ghost assets"
- Payroll taxes
- Multi-state withholding
- Unemployment taxes
- Workers' compensation
- Reciprocity agreements
- Tax research
- Compliance reviews
- ASC-740-10 (FIN 48) – Income tax provision detail relating to uncertain tax positions; ASC-450 for sales/use and other taxes
- Audit representations
- Voluntary disclosures and amnesty programs
- Nexus studies
- Reverse sales tax audits
- Compliance matrix

- Sales/use tax procedures
- Client manuals and seminars
- Planning ideas
- Sales tax software implementation
- State tax due diligence in buy/sell transactions
- Outsourcing compliance functions

SALT's Challenging Issues

Because there are so many different and independent state laws, annual changes always occur. Since states tend to make at least some reference to federal income tax laws, federal law changes create state income tax issues. Some states have laws that automatically take into account any federal law change when it occurs (referred to as "rolling conformity"), while others require an act of the state legislature to incorporate any federal law change, if the state decides to do so (referred to as "static conformity"). Some static conformity states have tended to regularly update their conformity date (for example, Arizona), while other states often lag behind in enacting conformity laws (for example, California).

Budget needs impact a state's need for tax dollars, which can cause changes in the underlying law or an increased level of enforcement, especially when looking at businesses based outside the state.

Taxpayers expand their business operations constantly, which also changes their state tax issues. State tax consequences are generally not on their minds versus basing their choices on various other business impacts. For instance, a business who adds an online website ordering option to what had previously been sales solely out of a physical location may not realize that they now may have exposure to every state with a sales and/or income tax, depending on the level of sales or whatever other metric the states use to determine who needs to file and pay.

Many state tax engagements need to be revisited every few years based on these changes. A lack of prior state tax knowledge or education creates filing and compliance issues regarding what to do with past obligations and how to proceed with future compliance. While some options may exist for obtaining some relief under a state's amnesty style programs, clients may recoil from what the state would require and may just want to hope the state never notices the problem—a strategy fraught with risk for the adviser, especially if the CPA firm is also conducting any sort of attest or financial statement engagement for the entity.

Fiscal Condition and Stability of State and Local Governments: The Changing Landscape

The states are facing spiraling costs of providing public services, as we have had a shift of programs and funding responsibilities to states over the past decades. Couple this with economic challenges brought on by 2020's coronavirus crisis, placing many, if not virtually all, state and local governments are in tough financial straits.

States and local jurisdictions will likely be looking at a combination of options to address reduced tax revenues, by reducing spending. This could include laying off/furlough of employees and enacting new taxes and/or surtaxes. In addition, states may add enforcement staff to raise tax compliance and collection levels. In addition, it is likely states may also look to the Federal government for increases in funding.

The Supreme Court decision in *Wayfair*, coupled with the Federal court's reluctance to limit state income taxing authority, suggests that the states may decide to lean more heavily on the compliance enforcement for past taxes the states believe should have been paid to help make up budget deficits.

Recent actions in multi-state taxation of corporations include the redefining of nexus for all types of taxes, including but not limited to sales, income, gross receipts, tobacco, and more.

For income tax apportionment, we've seen a shift towards deeming all income to be business income. As well, a major change, now in place for at least some businesses in a majority of states, is a move towards market-based sourcing for sales of services. While traditionally, sales of services had been sourced to the state where a majority of the services (income producing activities) were performed, states are now rapidly turning towards looking at sourcing a sale to where the service or benefit is received (consumed).

Adding to the impact of market-based sourcing is the similarly rapid move towards only one factor of the historically considered "three-factor formula," looking solely at sales to determine the apportionment of business income.

EFFECTS OF FEDERAL TAX REFORM

Federal tax policy does not generally take state issues into account, even though many states base their income tax on federal law. Congress does not consider the impact of federal tax legislation, even though 41 of 46 states imposing corporate net income tax use federal corporate taxable income as a starting point in computing state taxable income.

Over recent decades, we have had more frequent and comprehensive changes in federal tax law, most recently looking at 2017's Tax Cuts and Jobs Act (TJCA) and 2020's Coronavirus Aid, Relief, and Economic Security Act (CARES Act).

On the one hand, the move towards conformity at the state level has led to greater coordination and consistency of terms, but on the other hand, states continue to increase the use of special rules decoupling a state's tax system from the federal system for one or more items due to continued federal tax laws made by Congress.

Several federal tax bills from recent decades have impacted state income taxation by accelerating certain business tax deductions or allowing preferential tax treatment of certain items. Most notable is the TRA of 1986 that introduced extensive federal tax reform and a rapid cost-recovery system for depreciable assets. Expansions and amendments of the 1986 act followed to present. Of recent note are the 2017 TCJA and two more-recent bills resulting from the COVID-19 pandemic:

- TCJA 2017
  - This temporarily increased bonus depreciation to 100%.
  - The Section 179 deduction limit increased to $1,000,000, with phaseout beginning at $2,500,000.
  - Cash method accounting was allowed for businesses with average annual gross receipts of $25,000,000 or less.
  - Inventory accounting was not required for cash method taxpayers.
  - Interest deductions may be limited for certain businesses.
  - Entertainment expenses are not deductible.
- CARES Act 2020, March 2020
  - This temporarily reversed some of TCJA's provisions that were meant to raise revenue.
  - It added provisions to set qualified improvement property at 15 years (eligible for bonus depreciation).
  - It made various other changes, most of which are temporary, but a few are permanent.
- Consolidated Appropriations Act, December 2020
  - This coronavirus relief bill extends and/or modifies several provisions of the CARES Act.

Conformity with the federal system for states is generally a good thing for business taxpayers, at least in terms of reducing compliance costs. The goals should be similar, and conformity makes the tax system cheaper and easier to administer and cheaper and easier to comply with.

The reality is that while you can have a state sales tax without a federal sales tax without creating significant extra compliance, you cannot (absent a separate state by state accounting) have a state income tax without a federal income tax to which the state will mostly conform.

Unprecedented Recent Issues

At the time this material was written and now updated (January 2021), many of the original stay-at-home measures or impacts of those original measures remain in place to varying degrees. Most private and government employees are still telecommuting whenever possible. As of this writing, there are three FDA approved COVID-19 vaccines that will take considerable time and logistical effort to distribute throughout 2021. Many small businesses in the United States have been particularly hard hit by this crisis, and the economic impact has been devastating to those business owners. This will undoubtedly have a significant impact on the finances of both state and local governments' tax revenues.

Unemployment claims have soared to levels well above any levels seen since the weekly unemployment filing figures have been compiled, resulting in many states quickly depleting their unemployment funds. At the same time, sales tax revenues have dropped dramatically due to the decline in economic activity. States that depend heavily on excise taxes on oil and gas or taxes imposed on tourism are seeing those revenues also drop.

These factors, together with the fact that most states are barred from operating at a budget deficit, mean that states are facing the double problems of increasing expenditures to deal with the crisis (unemployment claims, increased demands on health departments, etc.) and a rapid decline in revenue to pay for those expenditures.

As previously noted, vaccines for COVID-19 have been approved. However, it is not clear as of this writing how quickly state and local governments will ease restrictions or how consumers will respond once that happens. It seems very possible that it will take a long time for consumers to feel comfortable in larger public facilities (e.g., malls, theaters, entertainment venues) or traveling.

Consequently, it remains unclear how states will fill potential revenue voids, although it is likely measures will be taken to both increase revenues and decrease expenses.

Unit

2

Personal Income Tax Considerations

LEARNING OBJECTIVES

When you have completed this unit, you will be able to accomplish the following.

- Recognize multi-state employment tax issues affecting employees who work in more than one jurisdiction.
- Identify employer responsibilities for wage tax withholding and wage reporting to state and local jurisdictions.
- Consider the importance of state and local employment taxes on corporate tax planning, including the following:
  - Location of facilities
  - Assignment of personnel to temporary work locations
  - Necessary documentation for state and local compliance

Personal income taxes of employees may seem a strange topic in a manual devoted to multi-state taxation of businesses. But, in fact, it can't be ignored due to the burden placed on employer to properly report state wages and tax withholdings.

Most of the income taxes paid by employees are paid through the employer's withholding of such taxes. Having taxes withheld at the source greatly increases the chance that the taxpayer will file a return with the state in question, thus states impose withholding responsibilities on employers. When that responsibility is triggered is a key issue for businesses.

There is one item of good news though: while we will talk a lot here today about states looking to impose income taxes even where there is no physical presence in a state, for wage income, the states still look to the physical presence of the employee most often as the key trigger in determining if the employee should be paying income taxes to the state and, consequently, the

employer withholding and turning over such state taxes. With the COVID-19 pandemic, the requirement that many employees work from home has caused significant controversy with regard to which state has the right to tax the employee. See the later discussion on the convenience of the employer rule.

VISITING EMPLOYEES AND NONRESIDENT PAYROLL TAX WITHHOLDING

A key question facing employers who have employees perform some services in more than one state is how long can an employee stay in a state before withholding taxes must be taken out of pay. As should not be surprising, the states have different answers to that question, answers the employer is responsible for knowing and complying with.

Where do you draw the line—what's required versus what is practical? The Supreme Court did make clear in the *Wayfair* case (dealing with sales taxes) that, at a certain point, imposing tax and withholding responsibilities (which should include wage withholding) would not be constitutional where there is only a minor benefit to the state but a large burden on the out-of-state business. But where the line is to be drawn was left by the Court to consider the facts and circumstances of each case.

Employers must also consider how to prevent post-transaction penalties. If State A determines the employer was required to withhold taxes on certain employees and has failed to do so, most often State A would require the employer to pay an amount to retroactively pay the taxes not withheld plus charge significant penalties and interest on that late paid amount.

The reality is that there are no standards in place—each state has a different (and, in some cases, not necessarily practical in the employer's view) trigger for when state taxes must be withheld. But we can look at some examples listed below:

Illinois: De Minimis (Revenue Letter IL-91-185)

In the first case covered in the letter, an out-of-state employee takes two-week training course in the state of Illinois under the facts in the ruling. The wages not paid in Illinois, the two-week training was incidental to services performed, and therefore no Illinois withholding is required.

In the second case, an out-of-state audit manager spends four weeks at acquisition target's office performing due diligence testing. The services were temporary and transitory in Illinois, and this was an isolated transaction that was not part of the normal operation of the organization was not part of "continuing enterprise." The letter concluded that no Illinois withholding was required.

In the third case, a consultant accumulates eight weeks of work at an in-state site over one year. But the employee's base of operations was outside of state, and the place from which the services directed and controlled was not in Illinois. Thus, not Illinois withholding was required.

One key item to note—Illinois is somewhat unique in looking at the location of the direction and control of the employee. Thus, an employee from an Illinois office who goes on a temporary assignment to New York, but is directed from the office in Chicago will still be deemed to be receiving Illinois wages. And that issue goes down to the employee as well.

In the case of *Department of Revenue v. John and Jane Doe, Department of Revenue Office of Administrative Hearings*, IT 16-02 an Illinois resident that worked in New York on assignment for his employer, but was directed out of an Illinois office was denied a credit on his Illinois tax return for taxes paid to New York. The ruling held that such wages, in the view of Illinois, were Illinois, not New York, wages and thus no credit was allowed.

Colorado: "If You Work Here, You Pay Taxes Here."

Colorado has a different take. In Andersen Consulting, 1986-9, the taxpayer's employees were involved in computer software engagements. At various times during the year, 350 employees were temporarily assigned to be on-site in Colorado.

Only Andersen's Seattle office paid withholding tax on nonresident employees, while other Andersen offices did not. The Colorado Department of Revenue (DOR) investigation began in 1990, and the state found that Andersen should have withheld Colorado income tax from all employees.

Andersen Consulting agreed to comply with withholding obligations and paid $700,000 in penalties and interest on unpaid taxes.

The bottom-line for Colorado: if an entire paycheck is earned in Colorado, then withholding applies for that employee, regardless of the fact that the employee may only be in Colorado for a short time period. In fact, that time period may be as short as one week.

Working From Home—Trap for the Unwary

There are serious nexus concerns for telecommuters. The internet and software supporting remote meetings and information access has made it possible for many types of employees to be working from locations far removed from the employer's physical location. But remember that, as was noted earlier, states generally look at where an employee is physically located to determine if the wages are taxable to the state and, by extension, if the employer is required to withhold.

The stay-at-home orders enacted as part of the coronavirus crisis have brought this issue back to the forefront, especially for employers located near a state border. While the state of New Jersey issued guidance that it will not assert nexus based solely on an employee working from home due to a coronavirus stay at home order, most other states have made no such commitment.

An employee working from home in another jurisdiction may trigger new corporate tax liability. While physical presence may no longer be asserted as requirement for corporate nexus by most states, most states will still assert nexus based on any such physical presence.

There may be a number of inadvertent tip-offs that a company has employees working from home in the state that would cause investigation by state authorities, and the risk of such detection would certainly increase for a company with a significant mobile workforce. Employers must be aware of a state's particular rules in these instances to avoid non- compliance with payroll tax withholdings and assertion of income tax nexus.

DEFERRED COMPENSATION

Public Law 104-95 also exempts nonqualified deferred compensation from taxation by a state if part of

- an executive retirement plan, or a nonqualified "mirror" plan, that provides payments after termination of employment solely to furnish benefits in excess of the limits allowed under IRC; or
- a plan, program, or an arrangement [as defined in IRC Section 3121(v)(2)(c)] that provides payments in substantially equal installments for a period of
  - not less than 10 years or
  - the life expectancy of the recipient and/or recipient's beneficiary.

EXAMPLE

A 60-year-old executive in California is entitled to receive $1.2 million over the eight years following retirement or any other termination. Even by relocating to Nevada, the executive would not avoid California income tax on that $1.2 million because the new statute requires a minimum 10-year payout.

Most companies with nonqualified deferred compensation plans, even in states where they are not currently taxing pension payments to nonresidents, have modified their plans to meet the requirements of the previous paragraph.

But a warning is appropriate to keep from losing this protection. There may be an issue of constructive receipt if: an executive is allowed to change payout schedule; or a plan is amended to allow a change of payout period. Note that such a change also runs a significant risk of running afoul of the nonqualified deferred compensation rules of IRC §409A, which has its own Federal level negative tax implications. Compliance with Section 409A regulations should ensure that constructive receipt will not be an issue.

OTHER COMPENSATION ISSUES

A number of other compensation items are still at issue as states issue rulings to cover the following special cases.

Deferred Bonuses

A form of deferred compensation with payment made by employer, rather than by separate plan administrator, can create issues with the state in which the bonus was earned claiming the right to have such a bonus included in income, subject to state income taxation for the employee and income tax withholding by the employer. The state may claim that such a program with the employer as the administrator is simply regular payroll, not a true deferred compensation arrangement.

Stock Options

If you exercise stock options (NQSOs, RSUs, ISOs) received on account of employment in State X, you may be liable for tax on the appreciation related to State X in more than one state. The appreciation is the compensation component that equals the fair market value of the stock related to the exercised option, less the grant price of the option. While beyond the scope of this course, ISOs do have favorable federal tax provisions that may also apply in some states.

The appreciation may be subject to tax in both the state where the option was earned and the state of residence where the option is exercised. Arizona, California, Indiana, Oregon, and Virginia allow a nonresident reverse credit.

Sixteen other states have reciprocal agreements with one or more other states to avoid double taxation. You should check current statutes before giving advice on the taxability of stock options in a state of residence that is not the state where the taxpayer resided when the options were earned.

STATES' RIGHT TO TAX INCOME OF NONRESIDENTS

States have constitutional authority to tax nonresidents on their income from in-state sources. The U.S. Supreme Court ruled on this issue in the case of *Shaffer v. Carter*, 252 U.S. 37 (1920).

In this case, a Chicago businessman was involved in Oklahoma oil business subject to Oklahoma taxation. He attempted to claim that Oklahoma should not have the right to tax him on that income, but the Supreme Court disagreed.

If you can carry on business in the state, you can be subjected to taxation in the state. However, the state's tax regime may not discriminate against nonresidents. For instance, the state could not impose a tax that solely applied to nonresidents who conducted in business in the state.

LIMIT ON STATE'S ABILITY TO TAX RETIREMENT BENEFITS

Retirement benefits are deferred compensation, subject to limits on such. In the case of *Davis v. Michigan*, 489 U.S. 803 (1989) the state wanted to tax retirement benefits of federal government employees, exempting retirement benefits of state government employees. Generally, states cannot tax federal employee compensation on a less favorable basis than that allowed for state employee compensation.

But the court decided that retirement benefits, based on account of retiree's service, are equivalent to compensation, and thus the taxing scheme unconstitutional.

4 U.S. Code Section 114—"Limitation on State income taxation of certain pension income" was added to law in 1996 to prevent states from taxing retirement income of retirees who are not residents. Retirement income of partners is given protection from multi-state taxation by H.R. 4019 signed by President George W. Bush on August 3, 2006.

WHO IS A RESIDENT?

As states can tax all income of residents of the states, advisers would likely prefer a bright-line test for whether a person is a resident. But in most cases, no such bright-line test exists.

Rather, a number of states look to a taxpayer's domicile, which is a very subjective standard. The concept of domicile is based on the common law concept of "home" as place you intend to return to, even if you are away for a period of time—even an extended period.

Once domicile is established, it does not change until the person establishes a new domicile—that is, you can't lose your domicile with a state until you clearly establish another domicile.

Note that some states, in addition to judging residency by domicile, will also treat a taxpayer by a resident if the person resides in the state for a certain number of days (such as over ½ of the year) even if the taxpayer remains domiciled in another state. In such a case, a taxpayer will likely be treated as a resident for income tax purposes by both states (Yes, it is possible to be a full-year resident of more than one state).

Generally, if a taxpayer has a permanent place of residence and spends more than 183 days there, the state would consider them to be a statutory resident. In some states, the number of days is a presumption, while in others (New York, New Jersey), it creates a resident regardless of domicile. Note–it is very possible to be treated as a resident by more than one state (an individual domiciled in California and over 183 days in New York will have the taxpayer treated as a full year resident of both California and New York).

Convenience of the Employer Rule

Some states look to see if the employee is working outside the state, such as from home, as an employer requirement (that is, for the convenience of the employer), or for the employee's convenience. New York taxes income as New York source if work is done outside the state of New York for the employee's convenience and at least some work is done in New York.[1] Note that the U.S. Supreme Court declined to hear a challenge to the Huckaby case, where an individual primarily worked from his home in Tennessee—but the Court found the employer would not have objected had he worked out of its New York office.

With the increasing ability of employees to work from a location other than the employer's offices, the issue of where the employee is subject to tax is a significant issue for convenience of the employer states. Only a minority of states have a convenience of the employer test, and those are primarily located in the Northeast. Elizabeth Pascal, JD and Emma Savino in a 2020 article published by the New York State Society of CPAs identified the states that currently use the "convenience of the employer" test as

- Connecticut,
- New York,
- Delaware,

[1] *Huckaby v. New York State Division of Tax Appeals*, 4 N.Y.3d 427, 796 N.Y.S.2d 312, 829 NE2d 276 (2005), cert. den. U.S. S.Ct., 10/31/05.

- New Jersey,
- Nebraska, and
- Pennsylvania.[2]

The states that use this doctrine look to whether it was possible for the employee to have performed the work at the employer's location they are "assigned' to that is located in their state. If so, the state will conclude that the employee is working out of state for their own convenience as opposed to that of the employer. In the Huckaby case, even though it would have been a very long commute (from Tennessee to New York), the employee could have worked in the organization's New York office and did actually come to that office for some meetings each year. The fact that the employee would have, for all practical purposes, needed to move to New York was not relevant—that was an issue for the employee, not the employer.

Since most other states look solely to where the employee performed the service, an employer may find itself on the hook for withholdings both to the state where the employer is located (under the convenience of the employer rule) and where the employee lives (based on where the services were performed).

Similarly, an employee may find him/herself in the position of owing tax to both states—and potentially not qualifying for a credit for taxes paid to another state. That is, the state where the employee lives may take the position that those earnings are simply not out of state earnings, and thus no credit would be allowed for taxes paid to that other state.

Note that the risk here arises from where the employer is located, since that's what drives the analysis. An employer who wishes to avoid issues in this area needs to consider reasons why the employer prefers to have the employee work from a location other than the employer's offices.

COVID-19 Pandemic and Employee Nexus

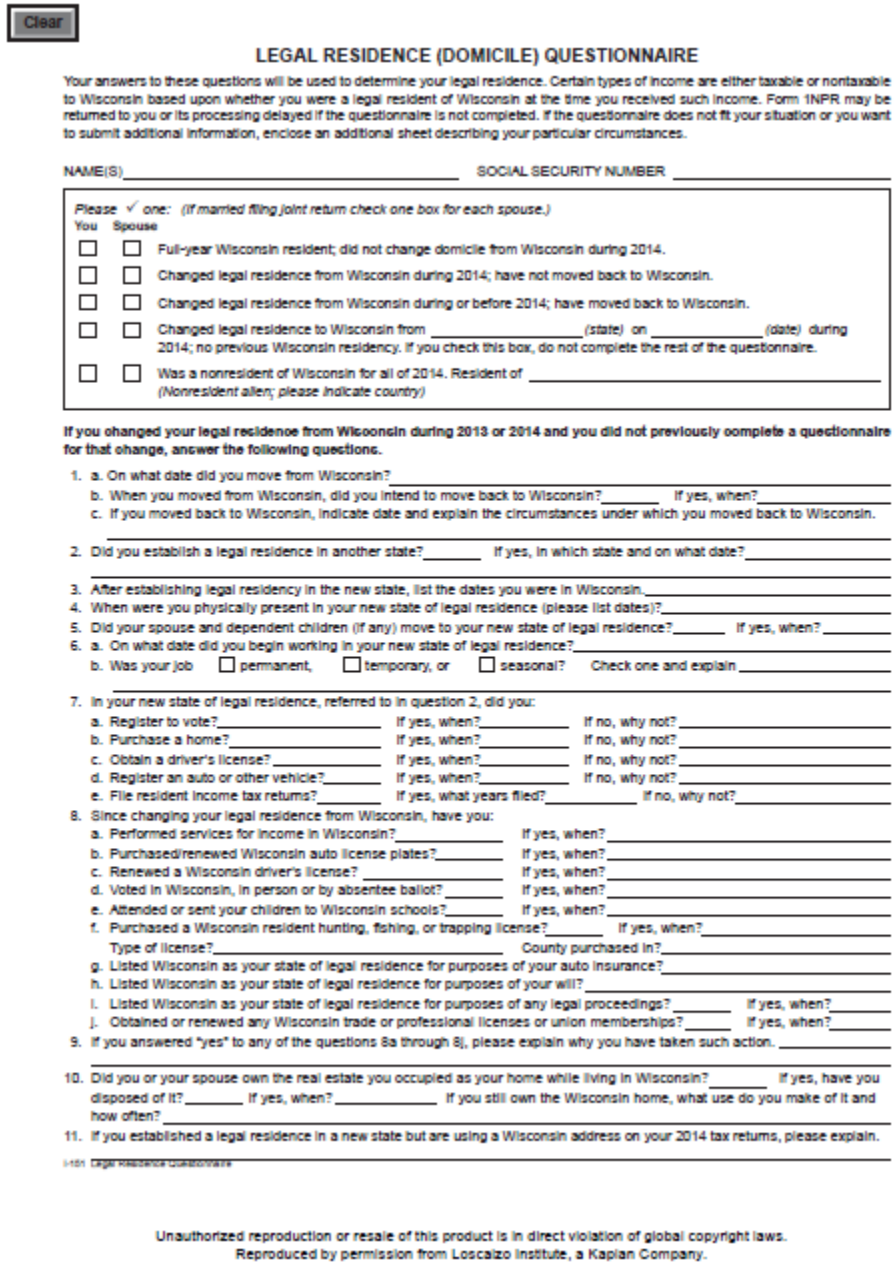
States can tax employees where they live and work, but prior to the COVID-19 pandemic, it was seldom an issue because an employee's state of domicile would allow a credit for taxes paid to another state or have a reciprocity agreement. The *convenience* rules noted previously certainly underscore the risk of paying taxes in two jurisdictions without a credit offset. Massachusetts has instituted a similar rule where

> all compensation received for personal services performed by a non-resident who, immediately prior to the Massachusetts COVID-19 state of emergency, was an employee engaged in performing such services in Massachusetts, and who, during such emergency, is performing such services from a location outside Massachusetts due solely to the Massachusetts COVID-19 state of emergency, will continue to be treated as Massachusetts source income subject to personal income tax under M.G.L. c. 62 and personal income tax withholding.

New Hampshire challenged Massachusetts's rule and filed a petition with the Supreme Court, which the court refused to hear in December 2020.

[2] Elizabeth Pascal, JD and Emma Savino, "Telecommuting During and After COVID-19: What Every Employer Should Know," April 1, 2020, New York State Society of CPAs webpage, http://www.nysscpa.org/most-popular-content/telecommuting-during-and-after-covid-19-what-every-employer-should-know#sthash.O85CkYi0.dpbs (retrieved June 1, 2020)

Figure 2.1: Legal Residence Questionnaire



Clear

LEGAL RESIDENCE (DOMICILE) QUESTIONNAIRE

Your answers to these questions will be used to determine your legal residence. Certain types of income are either taxable or nontaxable to Wisconsin based upon whether you were a legal resident of Wisconsin at the time you received such income. Form 1NPR may be returned to you or its processing delayed if the questionnaire is not completed. If the questionnaire does not fit your situation or you want to submit additional information, enclose an additional sheet describing your particular circumstances.

NAME(S)_____ SOCIAL SECURITY NUMBER _____

Please ✓ one: (If married filing joint return check one box for each spouse.)

You	Spouse	
☐	☐	Full-year Wisconsin resident; did not change domicile from Wisconsin during 2014.
☐	☐	Changed legal residence from Wisconsin during 2014; have not moved back to Wisconsin.
☐	☐	Changed legal residence from Wisconsin during or before 2014; have moved back to Wisconsin.
☐	☐	Changed legal residence to Wisconsin from _____ *(state)* on _____ *(date)* during 2014; no previous Wisconsin residency. If you check this box, do not complete the rest of the questionnaire.
☐	☐	Was a nonresident of Wisconsin for all of 2014. Resident of _____ *(Nonresident alien; please indicate country)*

If you changed your legal residence from Wisconsin during 2013 or 2014 and you did not previously complete a questionnaire for that change, answer the following questions.

1. a. On what date did you move from Wisconsin? _____
   b. When you moved from Wisconsin, did you intend to move back to Wisconsin?_____ If yes, when?_____
   c. If you moved back to Wisconsin, indicate date and explain the circumstances under which you moved back to Wisconsin. _____
2. Did you establish a legal residence in another state?_____ If yes, in which state and on what date?_____
3. After establishing legal residency in the new state, list the dates you were in Wisconsin._____
4. When were you physically present in your new state of legal residence (please list dates)?_____
5. Did your spouse and dependent children (if any) move to your new state of legal residence?_____ If yes, when?_____
6. a. On what date did you begin working in your new state of legal residence?_____
   b. Was your job ☐ permanent, ☐ temporary, or ☐ seasonal? Check one and explain _____
7. In your new state of legal residence, referred to in question 2, did you:
   a. Register to vote?_____ If yes, when?_____ If no, why not?_____
   b. Purchase a home?_____ If yes, when?_____ If no, why not?_____
   c. Obtain a driver's license?_____ If yes, when?_____ If no, why not?_____
   d. Register an auto or other vehicle?_____ If yes, when?_____ If no, why not?_____
   e. File resident income tax returns?_____ If yes, what years filed?_____ If no, why not?_____
8. Since changing your legal residence from Wisconsin, have you:
   a. Performed services for income in Wisconsin?_____ If yes, when?_____
   b. Purchased/renewed Wisconsin auto license plates?_____ If yes, when?_____
   c. Renewed a Wisconsin driver's license?_____ If yes, when?_____
   d. Voted in Wisconsin, in person or by absentee ballot?_____ If yes, when?_____
   e. Attended or sent your children to Wisconsin schools?_____ If yes, when?_____
   f. Purchased a Wisconsin resident hunting, fishing, or trapping license?_____ If yes, when?_____
      Type of license?_____ County purchased in?_____
   g. Listed Wisconsin as your state of legal residence for purposes of your auto insurance?_____
   h. Listed Wisconsin as your state of legal residence for purposes of your will?_____
   i. Listed Wisconsin as your state of legal residence for purposes of any legal proceedings?_____ If yes, when?_____
   j. Obtained or renewed any Wisconsin trade or professional licenses or union memberships?_____ If yes, when?_____
9. If you answered "yes" to any of the questions 8a through 8j, please explain why you have taken such action. _____
10. Did you or your spouse own the real estate you occupied as your home while living in Wisconsin?_____ If yes, have you disposed of it?_____ If yes, when?_____ If you still own the Wisconsin home, what use do you make of it and how often? _____
11. If you established a legal residence in a new state but are using a Wisconsin address on your 2014 tax returns, please explain. _____

I-101 Legal Residence Questionnaire

Unit

3

Sales Tax/Use Tax Nexus Developments

LEARNING OBJECTIVES

When you have completed this unit, you will be able to accomplish the following.

- Identify current sales and use tax nexus issues affecting business enterprises and the evolution of related court opinions.
- Apply standards articulated by state courts to situations where there is no statute.
- Apply principles developing in-state statutes and state courts to sales and use tax planning and compliance.

WHO HAS SALES/USE TAX NEXUS?

The fundamental issue in determining nexus is whether a multi-state business has sufficient local activity within a state to be subject to the state's taxing authority. In the context of sales/use tax, the primary consideration is whether the enterprise's selling method or business operations within a state are sufficient to require it to collect use taxes. The significance of this issue is that failure to collect the tax can result in significant tax liability for the company, with little, or no hope of obtaining reimbursement from customers in states where sales tax has not been collected.

Before the advent of online sales and national franchising, U.S. Supreme Court decisions required that there must be some local activity to bring transactions within a state's taxing power. In *National Bellas Hess v. Department of Revenue*, 386 U.S. 753 (1967), the Supreme Court ruled that a mail-order house, which was located in Missouri and had no outlets or sales representatives in Illinois, could not be required to collect Illinois use tax.

The court reasoned:

> If the power of Illinois to impose use tax burdens upon National were upheld, the resulting impediments upon the free conduct of its interstate business would be neither imaginary nor remote.

The Supreme Court sustained the concept of a requirement for physical nexus when it revisited the issue in the *Quill* case (1992)—but in that decision, the Court noted that the principal wasn't consistent with other decisions the Court had rendered on the Commerce Clause, holding open the possibility the court might eventually revisit the issue unless Congress (which always had the power to decide this issue) took action in the interim.

In 2018, tired of waiting on Congress to resolve the issue, the U.S. Supreme Court did formally abandon the requirement for physical presence when it decided the case of *Wayfair*, causing a much larger number of businesses to become potentially subject to the requirement to collect sales taxes for multiple states.

COMMERCE CLAUSE

In deciding *National Bellas Hess*, the Supreme Court held that the state tax scheme violated the U.S. Constitution's Commerce Clause. More precisely, the Court looked at what is referred to as the concept of the dormant Commerce Clause—how the Supreme Court should look at an issue related to the impact of a state action on interstate commerce when Congress has not issued guidance on the matter. In effect, the "Dormant" Commerce Clause concept means that because Congress has been given power over interstate commerce, states cannot discriminate against interstate commerce nor can they unduly burden interstate commerce, even in the absence of federal legislation regulating an activity.

Congress is clearly granted the right to regulate interstate commerce in the Constitution—but early in the country's life, Chief Justice John Marshall, in a series of decisions, developed the concept. Just because Congress has not spoken on the issue does not mean a state has an unfettered right to do what it wishes.

Complete Auto Transit—The Key Tests

Ten years after *National Bella Hess*, in *Complete Auto Transit v. Brady*, 430 U.S. 274 (1977) the Supreme Court developed a four-part test to determine if state taxes discriminate or unfairly burden interstate commerce. This test would be cited by the U.S. Supreme Court in the *Wayfair* decision, discussed later.

For a tax to be acceptable under the dormant commerce clause, a tax must satisfy all four of the following elements of the test:

- Be applied to an activity with a substantial nexus to taxing state (the definition of substantial nexus has changed significantly in the last 10 years)
- Be fairly apportioned (i.e., tax only the apportionment of activity that transpires within the state)
- Does not discriminate against interstate commerce (i.e., should not favor intrastate commerce over interstate commerce)
- Be fairly related to the services provided by the state

This four-pronged test would be explicitly referenced by the U.S. Supreme Court in the *Wayfair* case. The key test is the last—does the value provided by the state to the business outside the state justify the burden imposed? The Court suggested that the number of sales into the state would eventually justify the imposition of the burden.

Jefferson Lines Case—Fairly Apportioned

An illustration of test outlined in Complete Auto Transit is found in the case of *Oklahoma Tax Commission v. Jefferson Lines, Inc.*, 514 U.S. 175 (1995).

Issue: Can a state (Oklahoma) impose its sales tax on the sale of an interstate bus ticket, measured by 100% of the ticket's cost, even if the service is going to be performed primarily out of state?

The Bankruptcy Court, U.S. District Court, and U.S. Court of Appeals for the Eighth Circuit (15 F.3d 90 (1994)) agreed with the taxpayer: it is a tax on the gross receipts of the bus company and must be apportioned by the miles traveled—Oklahoma could not tax the entire value merely because the ticket was sold in the state. But the Supreme Court said that the tax is fairly apportioned, because it applies to a distinct local event "the sale of the ticket" and no apportionment is necessary.

Finally, Congress enacted Section 14505 of the Federal Interstate Commerce Commission Termination Act [P.L. 104-88] to override the result of the Supreme Court's decision in *Jefferson Lines.*

Goldberg v. Sweet Case

According to *Goldberg v. Sweet*, 488 U.S. 252 (1989), which clarified the *Complete Auto Transit* ruling, a state tax must be

- internally consistent—no multiple taxation would occur if every state adopted the same tax; and
- externally consistent—states tax only that portion of the revenues from interstate activity that reflects the in-state component of that activity.

The Quill Decision

For many years, the key case that outlined when a state could force a seller to collect its sales tax was the 1992 case of *Quill v. North Dakota* (the "Quill" case).

The North Dakota District Court, South Central Jurisdictional District, Burleigh County, No. 41677 ruled in May of 1990 that mail and phone order sales delivered in North Dakota are not taxable. Quill Corporation, an Illinois-based catalog company, does business in North Dakota by U.S. mail, telephone, and common carrier, and has no other physical presence in the state. Accordingly, the limited activities were not sufficient nexus under North Dakota law to require the collection of use taxes.

However, on appeal, the North Dakota Supreme Court, Docket No. 900257, overturned the District Court's decision on May 7, 1991. The court held that the state use tax law does not violate the due process or Commerce Clause, so that constitutionally, Quill Corporation was required to

collect and remit use taxes on its mail-order sales into the state of North Dakota. In this case, the North Dakota Supreme Court found that Quill had sufficient nexus with North Dakota for use tax purposes, based on

- the volume of sales,
- quantity of mailings disposed by local governments, and
- software licensing agreements.

The U.S. Supreme Court reversed the decision that Quill had sufficient connection with North Dakota to justify the use tax on in-state purchases, holding that North Dakota's attempt to impose use tax on goods purchased from an out-of-state mail-order seller without outlets or sales representatives violated the Commerce Clause of the U.S. Constitution. [*Quill Corporation v. North Dakota*, 504 U.S. 298 (1992)]

The Supreme Court held that the Due Process Clause does not bar North Dakota's enforcement of the use tax against the mail-order seller, even though the Commerce Clause does. The taxpayer had sufficient minimum contacts with North Dakota to satisfy Due Process Clause requirements, because the taxpayer had purposefully directed its activities at North Dakota residents and the tax was related to the benefits it received from the state.

Nevertheless, even though the seller had sufficient minimum contacts to validate the state tax under the Due Process Clause, the tax was invalid because the seller lacked the substantial nexus with the state required by the Commerce Clause.

Note: The requirements of these two clauses spring from different constitutional concerns. Due process analysis concerns the fundamental fairness of governmental activity and its touchstone is notice or fair warning. Commerce Clause analysis, in contrast, concerns the effect of state regulation on the national economy. Typically, Congress is better qualified than the courts to resolve an underlying Commerce Clause issue.

Effects of Quill

For the next 26 years, *Quill* set standard for sales tax nexus that was applicable to all states. The case

- clarified a distinction between the Due Process Clause and Commerce Clause,
- established substantial nexus importance,
- failed to define substantial nexus or provide guidance, and
- established de minimis argument.

Massachusetts's Expansive View of Physical Presence for Internet Sellers

The Boston Tea Party is closely associated with the slogan "no taxation without representation" but the Commonwealth of Massachusetts appears to be just fine with requiring collection of taxes from those located outside the state who don't get a vote.

The number of states taking aggressive positions to expand the number of out-of-state entities that must take some action with regard to the state's sales or use taxes continues to expand. Massachusetts has issued regulations effective September 22, 2017, that require Massachusetts internet vendors who have sales exceeding $500,000 and more than 100 transactions resulting in delivery into Massachusetts to collect and remit sales taxes. (Massachusetts Regulation 830 CMR 64H.1.7)

The regulation begins with the department's statements regarding why this rule does not run afoul of the Supreme Court's decision in *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992), especially the physical-presence requirement in that ruling. The department states that virtually every Internet seller makes use of some Massachusetts located property, stating:

Unlike the mail-order vendor at issue in Quill, internet vendors with a large volume of Massachusetts sales invariably have one or more of the following contacts with the state that function to facilitate or enhance such in-state sales and constitute the requisite in-state physical presence:

- Property interests in and/or the use of in-state software (e.g., "apps") and ancillary data (e.g., "cookies"), which are distributed to or stored on the computers or other physical communications devices of a vendor's in-state customers and may enable the vendor's use of such physical devices

- Contracts and/or other relationships with content distribution networks resulting in the use of in-state servers and other computer hardware and/or the receipt of server or hardware-related in-state services

- Contracts and/or other relationships with online marketplace facilitators and/or delivery companies resulting in in-state services, including, but not limited to, payment processing and order fulfillment, order management, return processing, or otherwise assisting with returns and exchanges, the preparation of sales reports or other analytics, and consumer access to customer service [Reg. 830 CMR 64H.1.7(1)(b)]

The regulation notes that this ruling applies only to internet vendors who otherwise would not be subject to any tax. If an internet vendor is subject to collecting the tax due to other factors, then these tests would not apply and collection would be required with the first dollar of sales.

Similarly, if the vendor does not have one of three contacts noted at Reg. 830 CMR 64H.1.7(1)(b) reproduced earlier, the vendor would not be subject to collection of sales and use tax. The following two examples of vendors that would not be subject to collection of Massachusetts sales tax are found in Reg. 830 CMR 64H.1.7(4):

- 830 CMR 64H.1.7(3) does not apply if the vendor's only contacts with Massachusetts are that in-state customers may access a site on the vendor's out-of-state computer server. Furthermore, the mere fact that in-state customers may access such a site, without more, will not be considered a factor in determining a vendor's tax collection obligation. See ITFA Section 1105.

- An internet or online services provider is not deemed to be the agent of a vendor for purposes of determining the application of 830 CMR 64H.1.7(3) to such vendor solely as a result of (1) the display of such vendor's information or content on the provider's out-of-state computer server, or (2) the processing of orders through the provider's out-of-state computer server. See id.

Because many businesses outsource website hosts, they may have trouble determining whether any servers in Massachusetts may house their data. It may be difficult to prove an entity isn't subject to this rule if the entity does any sort of outsourcing, because the machines servicing some or all of the company's website could be located anywhere.

An initial interim period test applies to determine if an organization must begin collection as of October 1, 2017. As the regulation provides at Reg. 830 CMR 64H.1.7(3)(a), the following test will be applied to determine if collection is required through the end of 2017:

- For the period from October 1, 2017, through December 31, 2017, if during the preceding 12 months—October 1, 2016 to September 30, 2017—it had in excess of $500,000 in Massachusetts sales from transactions completed over the internet and made sales resulting in a delivery into Massachusetts in 100 or more transactions

For periods after December 31, 2017, the testing period will be the preceding calendar year.

Vendors subject to this tax must file a report with Massachusetts by the 20th day of each month to report sales for the prior month and pay the tax. Failure to file the return or pay the tax will subject the taxpayer to penalties and interest. [Reg. 830 CMR 64H.1.7(7)]

It is important to note that after *Wayfair*, Massachusetts has continued to insist that it can collect for periods before the *Wayfair* decision based on cookie nexus—it argues it is not contrary to *Quill* and thus did not need to wait for *Wayfair* to remove the physical presence test.

Other Nexus Concepts Developed Under Quill

The states developed a number of theories for physical presence triggering nexus for sales tax based on physical presence, and some states may assert a nexus requirement even if the business does not meet the minimum sales number for the state.

Trade Show Attendance

Wrigley, MTC regulations, and a majority of the states indicate mere attendance at a show will not establish nexus. However, a majority of states said that attending a one-day seminar was sufficient to create nexus.

According to Bloomberg BNA's 2016 Survey of State Tax Departments,

- in 34 states, making a sale or accepting orders at a trade show was enough to create sales tax nexus; and
- in 36 states, making sales while in the state for three or fewer days was enough to create nexus.

Digital Property

Just granting remote access to digital products will not create nexus in a majority of states.

However, in seven states (Arizona, District of Columbia, Hawaii, Massachusetts, New Mexico, North Dakota, and Wyoming), selling remote access to canned software will create nexus.

Only Vermont and Virginia do not impose nexus when a company's representatives visit the user of customized canned software.

Digital magazines and newspapers do not create nexus yet, but the sale of music files and other data will create nexus in 23 states.

Registration

Registering with any department in the states of Iowa, Louisiana, Missouri, Nevada, New Mexico, Pennsylvania, and Vermont will create nexus.

Other states have limited or no nexus depending on the type of registration and whether there is any actual business activity in a state.

"Tattletale" Tax Provisions—The Quill Wall of Protection Was Crumbling Before *Wayfair*

Colorado, now followed by some other states, has taken a different track to deal with Quill. Rather than require sellers to collect and pay sales tax, these laws require out-of-state sellers to file a detailed report of the in-state buyers to the state, inform the buyers they are being turned in and how much they purchased, and post notices advising potential buyers of their responsibilities to report use tax. "Tattletale" laws have sprung up in a number of states following Colorado's victory in federal court for its statute. In the oral arguments presented to the Supreme Court in *South Dakota v. Wayfair* (see the following discussion) it was clear that the Colorado statute was the "alternative" if the court decides to continue to require physical presence for a state to be able to force a vendor to collect sales tax.

Original Colorado 10th Circuit Win

For dealing with sales and use tax compliance, applicability of a constitutional provision (or perhaps lack of a provision, given the issue is the Dormant Commerce Clause) may have a broad impact. The case in question is a challenge to a Colorado provision requiring out-of-state sellers to report to the state customers who are residents of the state to assist in collection of use tax from those individuals. (*Direct Marketing Association v. Brohl*, CA10, Case No. 12-1175)

Specifically, the challenged Colorado law provided for the following:

> To assist the state in collecting use tax from in-state purchasers, most seemingly unaware of their tax responsibility, the Colorado legislature passed a law in 2010 that imposes three obligations on retailers that do not collect sales taxes—"non-collecting retailers": (1) to send a "Transactional Notice" to purchasers informing them that they may be subject to Colorado's use tax, see Colo. Rev. Stat. § 39-21-112(3.5)(c)(I); 1 Colo. Code Regs. § 201-1:39-21-112.3.5(2); (2) to send Colorado purchasers who buy goods from the retailer totaling more than $500 an "annual purchase summary" with the dates, categories, and amounts of purchases, reminding them of their obligation to pay use taxes on those purchases, Colo. Rev. Stat. § 39-21-112(3.5)(d)(I); 1 Colo. Code Regs. § 201-1:39-21-112.3.5(3); and (3) to send the department an annual "customer information report" listing their customers' names, addresses, and total amounts spent, Colo. Rev. Stat. § 39-21-112(3.5)(d)(II); 1 Colo. Code Regs. § 201-1:39-21-112.3.5(4).

The Direct Marketing Association challenged this requirement, claiming that the imposition of this requirement violated the Supreme Court's decision in the case of *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992). Quill dealt with the state of North Dakota's attempt to require a mail-order office supply vendor to collect taxes on its sales to residents of the state despite having no physical presence there.

Specifically, as the opinion notes, "DMA argues the Colorado law unconstitutionally discriminates against and unduly burdens interstate commerce."

However, the 10th Circuit panel did not find this case governed by Quill, nor did it find that the law unconstitutionally discriminates against and burdens interstate commerce. The court noted that the Supreme Court has generally not expanded upon Quill beyond the situation of forced collection of sales and use taxes for businesses not having a physical presence in the state.

The court notes that this provision does not give in-state sellers a competitive advantage over out-of-state sellers, because in-state sellers must actually collect and pay a sales tax. In fact, Judge Gorsuch noted the following in a concurring opinion:

> If anything, by asking us to strike down Colorado's law, out-of-state mail-order, and internet retailers don't seek comparable treatment to their in-state brick-and-mortar rivals, they seek more favorable treatment, a competitive advantage, a sort of judicially sponsored arbitrage opportunity or "tax shelter." *Quill*, 504 U.S. at 329 (White, J., concurring in part, and dissenting in part).

The concurring opinion goes on to note that, assuming this position is adopted by other circuits, many states will move to impose reporting obligations on out-of-state sellers.

> It is a fact—if an analytical oddity—that the Bellas Hess branch of Dormant Commerce Clause jurisprudence guarantees a competitive benefit to certain firms simply because of the organizational form they choose to assume while the mainstream of Dormant Commerce Clause jurisprudence associated with West Lynn Creamery is all about preventing discrimination between firms. And the plaintiffs might well complain that the competitive advantage they enjoy will be diluted by our decision in this case. Indeed, if my colleagues and I are correct that states may impose notice and reporting burdens on mail-order and internet

> retailers comparable to the sales and use tax collection obligations they impose on brick-and-mortar firms, many (all?) states can be expected to follow Colorado's lead and enact statutes like the one now before us.

Taxpayers who make out-of-state sales will need to stay informed of developments in this area. At the very minimum, it would appear that businesses in states subject to the 10th Circuit's jurisdiction will need, at least for now, to respect the Colorado rule (along with Colorado, they include Kansas, New Mexico, Oklahoma, Utah, and Wyoming).

On December 12, 2016, the Supreme Court declined to review the decision of the 10th Circuit in this case.

Colorado Adopts Regulations to Implement the Tattletale Rule

The Colorado DOR has published an emergency rule (Rule 39-21-112(3.5)) to implement Colorado's tattletale use tax reporting requirement for sellers who have more than $100,000 of sales into Colorado and do not collect Colorado sales tax. The law in question is the one that was upheld by the 10th Circuit Court of Appeals in the case of *Direct Marketing Association v. Brohl*, CA10, Case No. 12-1175, 2/22/16, cert denied.

The basic requirements of the provision are outlined in Rule 39-21-112(3.5)(1) which provides the following:

> General Rule. Every non-collecting retailer whose total gross sales into Colorado are $100,000 or more in a calendar year shall:
>
> - Provide a Transactional Notice to all Colorado Purchasers as described in paragraph (4) of this rule;
>
> - Provide an Annual Purchase Summary to all Colorado Purchasers by January 31 of each year as described in paragraph (5) of this rule; and
>
> - Provide an Annual Customer Information Report to the department by March 1 of each year as described in paragraph (6) of this rule.

The Transactional Notice must be provided with every Colorado reportable purchase that is not exempt from Colorado sales and use tax. [Colorado Rule 39-21-112(3.5)(4)] For online purchases, the rule requires the seller to take the following steps in providing this Transactional Notice:

> Online purchases. For all purchases made online, a Transactional Notice shall be prominently located in close proximity to the "tax" or "sales tax" line at checkout, or if no "tax" line is available, in close proximity to the "total price" line shown at checkout.
>
> If it is impractical for the non-collecting retailer to display the Transactional Notice as described above, the non-collecting retailer shall provide a prominent hyperlink in close proximity to the "tax" or "sales tax" line or the "total price" line shown at checkout that reads as follows: "See here for information on the tax you may owe to Colorado" so long as such hyperlink directs the Colorado purchaser to the principal Transactional Notice. [Colorado Rule 39-21-112(3.5)(4)(a)]

The Transactional Notice must contain the following information:

- The retailer does not collect Colorado sales or use tax.
- The purchase is not exempt from Colorado sales or use tax merely because it is being made over the internet or by remote means.
- The state of Colorado requires the purchaser to file a sales or use tax return, reporting all purchases that are taxable in Colorado and on which no tax was collected. [Colorado Rule 39-21-112(3.5)(4)(c)]

For purchases that are not online purchases, the notice must be prominently located on any order form in close proximity to the total price line. [Colorado Rule 39-21-112(3.5)(4)(b)] If that is not practical, the seller must state on the invoice or confirmatory communication near the tax, or total price, line, "See attachment for information on the tax you may owe," and then provide the information in the Transaction Notice in an attachment. [Colorado Rule 39-21-112(3.5)(4)(b)(i)]

If a seller is required to provide a similar notice for other states, a generalized notice may be used so long as it provides the same information as required previously. [Colorado Rule 39-21-112(3.5)(4)(e)]

The seller also must provide an Annual Purchase Summary to all Colorado purchasers by January 31 each year, summarizing each Colorado purchaser's transactions in the prior year. The envelope with the summary must be prominently marked with the statement "Important Tax Document Enclosed" and sent to the purchaser's last known address. The rule provides an optional method for purchases to opt-in to receiving the notice electronically. [Colorado Rule 39-21-112(3.5)(5)]

The Annual Purchase Summary must contain the following:

- The total amount paid by the Colorado purchaser in the prior year (This total must include shipping and handling charges unless the seller is certain that these amounts are not subject to Colorado sales or use tax.)
- A statement that the state of Colorado requires the purchaser to file a sales or use tax return and pay the necessary tax
- A notice that the seller is required to report the total amount sold to each Colorado resident to the state of Colorado each year
- If available,
  - the dates of each reportable purchase,
  - the amount of each reportable purchase,
  - a description of each item purchased, and
  - if the seller knows, whether the purchase is subject to Colorado sales or use tax. [Colorado Rule 39-21-112(3.5)(5)]

The notice does not need to be sent to a purchaser if the total purchases by that purchaser for the prior calendar year were less than $500. [Colorado Rule 39-21-112(3.5)(5)(c)]

Finally, the rule details the filing of the Annual Customer Information Report with the state of Colorado. The report must be filed by any seller who is required to send at least one Annual Purchase Summary to customers. The report will contain the following information:

- The name of each Colorado purchaser
- The billing address, notice address, and shipping address of the purchaser, if known by the seller (If there is more than one of these various addresses, each one is to be provided to the state.)
- The total dollar amount of purchases made by the purchaser [Colorado Rule 39-21-112(3.5)(6)]

As would be expected, there are penalties for sellers who fail to comply with these rules.

The penalty for failing to provide a Transactional Notice is $5 per sale. If a retailer was not aware of the requirement and begins to provide such notices within 60 days of demand by the state, the maximum penalty for the year is capped at $25,000. Some or all the penalty may be waived for reasonable cause. [Colorado Rule 39-21-112(3.5)(4)(f)]

The penalty for failing to provide the Annual Purchase Summary to a purchaser is $10 for each summary not issued. As with the Transaction Notice penalty, this penalty can be capped at $50,000 if the seller was not aware of the requirement and sends out notices within 60 days of demand by the state. Additionally, if the notices are provided to the purchasers within 30 days of the original due date, the penalty is capped at $1,000. Again, the department may waive some or all the penalty for reasonable cause. [Colorado Rule 39-21-112(3.5)(5)(d)]

The penalty for failing to file the Annual Customer Information Report is $10 per customer whose information should have been reported on the report. If the report is filed within 30 days of the due date, the penalty is capped at $1,000. For a seller who reasonably lacked knowledge of the requirement, and then files within 60 days of demand by the department, the penalty is capped at $50,000. As with the other penalties, this penalty can be waived by the department for reasonable cause. [Colorado Rule 39-21-112(3.5)(6)(d)]

Colorado Begins Receiving Reports From Out-of-State Sellers

The state of Colorado's number of reports received from out-of-state sellers under its tattletale use tax law were "disappointing" in the words of Phil Horwitz, director of tax policy analysis for the Colorado DOR. Horwitz's comments to the MTC's Uniformity Committee on April 25, 2018, were reported on by Tax Notes Today in an April 26 story.

The law took effect on July 1, 2017, with the first reports due by March 1, 2018.

Horwitz stated that the state received reports on over 800,000 people or businesses in the state on which the use tax was not collected, with the amounts purchased totaling over $250,000,000. If all those amounts are taxable, then the state of Colorado would be looking at collecting $7.5 million of tax from those buyers.

However, sellers are not required under Colorado law to determine if the items purchased are subject to the use tax and at least some of those buyers may have filed use tax reports, so the actual amount of uncollected revenue that could be obtained from these reports is likely less than that potential maximum amount.

The largest amount of reported purchases not subject to use tax by a single taxpayer was $900,000, with the next highest amount of purchases reported being $300,000. One seller filed 115,000 reports of untaxed sales in the state.

Horwitz noted that the state believes it still has work to do to inform out-of-state sellers of their obligation to file such reports. The article cites MTC General Counsel Helen Hecht's statement that since Colorado passed its law, the states of Vermont, Washington, Pennsylvania, Minnesota, and Rhode Island have passed similar laws.

Washington Adopts Tattletale Bill With Very Low Sales Minimums

The state of Washington has upped the ante regarding the risk to businesses that don't pay attention to individual state laws requiring reporting on sales to residents of a state by a business with no connection with the state. Washington's governor signed into law Washington H.B. 2163, a tattletale use tax bill that is triggered whenever a remote seller has more than $10,000 in gross sales in a year to Washington State residents.

A tattletale bill does not attempt to require remote sellers to collect sales tax for the state on their remote sales. Rather, the bill requires that such sellers take various steps to turn in such buyers to the state and motivate the buyers to comply with their use tax obligations. The law will often require some form of notice to potential buyers of their use tax obligations, along with later reports given at the end of the year to both the buyers (listing items they bought for which use tax would be due) and the state in question.

The state of Colorado enacted the first such bill and, not unexpectedly, it was immediately challenged in court. But the challenge did not turn out well for the remote sellers. In the case of *Direct Marketing Association v. Brohl*, 814 F.3d 1129 (CA10 2016) cert denied (2016), the 10th Circuit Court of Appeals found that Colorado has the power to compel such reporting by out-of-state vendors. The panel found that because Colorado was not requiring the collection of tax, the physical presence test found the U.S. *Supreme Court's Quill Corp. v. North Dakota* case [504 U.S. 298 (1992)] did not bar the state from imposing this obligation on remote sellers. The Supreme Court declined to hear the appeal of the result in this case, although previously they had heard the case on the question allowing the case to proceed.

The state of Washington's new law expands upon the Colorado requirements. An out-of-state entity with more than $10,000 of gross receipts from sales to Washington residents is required to follow these procedures unless the entity voluntarily agrees to collect the Washington sales tax on such sales. [Act Sections 202(1)(a)(i) and 202(2)(a)]

Section 205 of the act imposes several requirements on those sellers who don't "get the hint" and simply collect tax for the state of Washington. First, pursuant to Section 205(2)(a) of the act, the seller must comply with the following pre-sale notice requirements:

- Post a conspicuous notice on its marketplace, platform, website, catalog, or any other similar medium that informs Washington purchasers that
  - sales or use tax is due on certain purchases;
  - Washington requires the purchaser to file a use tax return; and
  - the notice is provided under the requirements of this section.
- Provide a notice to each consumer at the time of each retail sale, which must include
  - a statement that neither sales nor use tax is being collected or remitted upon the sale;
  - a statement that the consumer may be required to remit sales or use tax directly to the Washington State DOR; and
  - instructions for obtaining additional information from the department regarding whether and how to remit the sales or use tax to the department.

The notice to each customer must be "prominently displayed on all invoices and order forms including, where applicable, electronic and catalog invoices and order forms, and upon each sales receipt or similar document provided to the purchaser, whether in paper or electronic form." [Act Section 205(2)(b)]

Also, sellers are barred from stating that no sales or use tax is imposed on the sale unless the notice to sellers listed previously immediately follows it or the sale is one that is exempt from both sales and use tax under Washington law. [Act Section 205(2)(b)]

A referrer is subject to similar disclosure rules. A referrer would be an organization like eBay that lists items for sale but does not actually sell the item. In addition, the referrer must give notice that "if the seller to whom the purchaser is referred does not collect retail sales tax on a subsequent purchase by the purchaser, the seller may be required to provide information to the purchaser and the department about the purchaser's potential sales or use tax liability." [Act Section 205(3)(a)(vi)] This notice arguably is a bit sneaky because, if the seller does not trip the $10,000 sales limit, there won't be any required reporting—but the referrer's notice will likely be read by purchasers to mean that they will be turned in.

Referrers will be required to give a notice to each marketplace seller for which it referred a potential Washington seller. That notice, to be sent by February 28 of the following year, must give the seller information regarding their Washington reporting requirements. [Act Section 205(5)] A list of such notices issued must also be provided to the Washington DOR by the referrer. [Act Section 205(5)(c)]

The act imposes an annual reporting requirement on covered sellers for reports to be sent to their customers. A report must be sent to each Washington customer on or before February 28 of each year. That report must include

- a list, by date, generally indicating the type of product purchased or leased during the preceding calendar year by the consumer from the seller, sourced to Washington, and the price of each product;
- instructions for obtaining additional information from the Washington State DOR regarding whether and how to remit the sales or use tax to the department;
- a statement that the seller is required to submit a report to the Washington State DOR stating the total dollar amount of the consumer's purchases from the seller; and
- any information the Washington State DOR may reasonably require. [Act Section 205(4)]

The notice must be sent to customers

- by first class mail at their billing address if known;
- if no billing address is available, then by first class mail to the shipping address if known; or
- to the customer's last known email address. [Act Section 205(4)(c)]

The seller is also required to file a report with the state of Washington giving information about Washington customers. The report must be filed by February 28 of the following year and must include information about every customer who received an annual customer report from the seller. The report will list the

- customer's name;
- billing address and, if known, the last known mailing address;
- shipping address of each product sold or leased to the customer for delivery in the state of Washington in the prior year; and
- total amount of all such purchases by the customer. [Act Section 205(6)]

Every seller subject to these rules must maintain suitable records for five years. [Act Section 205(8)]

So, what happens if a seller decides to ignore the state of Washington—after all, if the seller is located in Vermont, what can Washington do? Well, assuming that the other circuit courts agree with the 10th Circuit's view that this law does not run into constitutional issues, Washington's penalties should be enforceable against a business in any state. And those penalties are not insignificant.

The law provides a harsh penalty of $20,000 in addition to any other penalties that may apply to any seller or referrer that fails to give the required pre-sale notice to consumers of their Washington State use tax obligations. [Act Section 206(1)]

Also, if the annual notice is not given to consumers (or, for referrers, to sellers) another penalty applies. That penalty amounts to

- $5,000 for a seller with gross receipts sourced to Washington of less than $50,000;
- $10,000 for gross receipts of $50,000 or more but less than $150,000;
- $50,000 for gross receipts of $150,000 or more but less than $300,000; and
- for those with gross receipts of $300,000 or more,
  - $100,000, plus
  - $25,000 for every $50,000 in gross receipts in excess of $300,000. [Act Section 206(2)(a)]

Similar penalties will apply to referrers who fail to give the annual notice to sellers. [Act Section 206(2)(b)]

Finally, the act provides penalties for failing to provide the required reports to the state of Washington. If a seller fails to provide the information to the state of Washington, a penalty will be imposed equal to the greater of

- $20,000 or
- $25 per consumer who should have been included in the report. [Act Section 206(3)]

Having given the department a potentially ruinous penalty with which to threaten out-of-state businesses, the seller is now offered a one-time-only chance to obtain a waiver.

First, the seller may obtain a conditional waiver of penalties and interest under this section if the seller

- enters into a written agreement with the department electing to collect retail sales or use tax or
- fully complies with all applicable notice and reporting requirements of this chapter, beginning by a date acceptable to the department. [Act Section 206(9)(a)(i)]

The department also has the authority to grant a straight waiver of penalties and interest for failure to comply with the notice and reporting requirements for one or more violations. [Act Section 206(9)(a)(ii)]

However, the department is only allowed to grant a single request for a waiver of the penalties and interest. [Act Section 206(9)(a)(iii)]

If a conditional waiver is granted, the entire amount of penalties and interest will be reassessed if the department finds that, after the effective date of an agreement to provide notice, the seller failed to

- provide notice under Section 205(2)(a)(ii) of this act to at least 90% of the consumers entitled to such notice in any given calendar year or portion of the initial calendar year in which the agreement required under this subsection was in effect for less than the entire calendar year;

- timely provide the annual reports required to all consumers who received notice from the seller of this act during any calendar year, unless the department finds that any such failure was due to circumstances beyond the seller's control;

- timely provide the reports required to the Washington State DOR during any calendar year, unless the department finds that any such failure was due to circumstances beyond the seller's control; or

- with respect to referrers, timely provide the notice required under Section 205(3) of this act and the notice and list required under Section 205(5) of this act during any calendar year, unless the department finds that any such failure was due to circumstances beyond the referrer's control. [Act Section 206(9)(a)(iv)]

If the conditional waiver was based on an agreement to collect and pay Washington sales tax, the entire amount of penalties and interest must be reassessed if the seller failed to

- register with the department and

- make a reasonable effort to comply with the requirements of RCW 82.08.050 and 82.12.040. [Act Section 206(9)(a)(v)]

In all cases, the penalty must either be

- originally assessed [Act Section 206(5)] within four years of the close of the calendar year in question or

- reassessed for a conditional waiver [Act Section 206(9)(vi)] within four years of the calendar year in which the department granted the conditional waiver.

The act does provide some penalty relief options:

- Relief must be granted if the department determines the failure to comply was due to circumstances beyond the seller's control. [Act Section 206(9)(b)]

- The department may waive penalties if the failure of the seller to fully comply with the notice or reporting requirements was due to reasonable cause and not willful negligence. The department's determination must be granted great deference by a court or the board of tax appeals unless it is shown by clear and convincing evidence that the department's decision lacked any reasonable basis. In making that determination, the department will consider, among other factors, whether

  - the failure was due to willful or reckless disregard of the seller's notice or reporting obligations;

  - the seller made subsequent efforts to avoid future noncompliance; and

  - the magnitude of the noncompliance was significant in terms of dollars and time when accounting for the seller's size and volume of transactions. [Act Section 206(9)(c)]

These rules take effect for taxable years beginning on or after January 1, 2018, with an exception for certain digital goods and codes when the effective date is delayed until January 1, 2020. [Act Section 205(1)(a)(i) and (ii)]

As a practical matter, except for a seller with a single sale to Washington in excess of $10,000 (or at least very few sales into Washington), it will likely be far more cost effective to simply agree to collect Washington sales tax rather than comply with the disclosure and reporting procedures cited previously. And, that is likely the real reason Washington's (and, previously Colorado's) legislature enacted this provision.

This will probably not be the last tattletale provision to be enacted by a state to encourage remote sellers to collect the sales tax directly. No matter how small a business is, it must be aware that if product is sold to out-of-state buyers, those states may come calling and asking for payment of various taxes.

STATE ATTEMPTS TO GET THE SUPREME COURT TO REVERSE QUILL

The Supreme Court, at best, reluctantly decided to continue the National Bellas Hess physical presence test in Quill, with the opinion suggesting that if the precedent had not existed, the court likely would have arrived at a different decision. But the court noted that at that point (1991), it was not the time to overturn the precedent.

The most public challenge to date to Quill went before the U.S. Supreme Court in 2018, as the South Dakota Supreme Court in the case of *State of South Dakota v. Wayfair*, SD SC, Case No. 28160 ruled South Dakota's tests for when an out-of-state seller must collect and remit sales tax are unconstitutional. On January 12, 2018, the U.S. Supreme Court agreed to hear the appeal by the State of South Dakota and issued an order granting certiorari.

The state of South Dakota was hoping (correctly it turns out) that the Supreme Court believes now is the time to get rid of the physical presence test that was left in place in the Quill case. The Supreme Court's opinion in Quill gave, at best, halfhearted support for keeping the test in place, doing so largely because that's what had been decided before. The opinion suggested that, if there had not been prior case law, the court would not have imposed this test and, as well, left open the door to reconsidering the issue later.

The Issue of Overturning Quill

As we have discussed in other articles, this is one of three broad methods being used by states to attempt to increase collections of sales and use taxes by having out-of-state sellers, especially internet-based ones, collect more sales tax. Other states have attempted to claim a very broad definition of "physical presence" to include the use of affiliated sellers in the state and the like (see Massachusetts) to simply chip away at the impact of Quill, while others have enacted tattletale laws that require sellers not to collect and remit the tax, but rather to report names and addresses of buyers in the state.

The latter two options have, to date, fared reasonably well in the federal courts, most significantly when the 10th Circuit in *Direct Marketing Association v. Brohl* upheld Colorado's tattletale law, a holding the Supreme Court declined to review on appeal. The appellate panel

held that because there was no tax collection required, Quill was not relevant to a determination of whether a state could impose this requirement on out-of-state businesses.

But, South Dakota was looking to render the need to use those two methods unnecessary by getting the Supreme Court to revisit the entire concept of the physical presence test. The South Dakota Legislature enacted a law (S.B. 106) that clearly violated Quill and was meant as a vehicle to get the issue before the Supreme Court again. For that reason, the state is not necessarily upset that it lost at the state level, knowing the goal was to get the Supreme Court to hear the case.

The South Dakota Supreme Court Opinion

The South Dakota Supreme Court opinion described South Dakota's law with the following:

> Senate Bill 106 was introduced during the session as: "An act to provide for the collection of sales taxes from certain remote sellers, to establish certain legislative findings, and to declare an emergency." S.B. 106, 2016 Legis. Assemb., 91st Sess. (S.D. 2016). The act provided that any sellers of "tangible personal property" in South Dakota without a "physical presence in the state... shall remit" sales tax according to the same procedures as sellers with "a physical presence[.]" Id. § 1. However, the act limited this obligation to sellers with "gross revenue" from sales in South Dakota of over $100,000 per calendar year or with 200 or more "separate transactions" in the state within the same time frame. Id. §§ 1-2. The act authorized the state to bring a declaratory judgment action in circuit court against any person believed to meet the act's criteria "to establish that the obligation to remit sales tax is applicable and valid under state and federal law." Id. § 2. The act further authorized a motion to dismiss or a motion for summary judgment in the action. Id. It also provided that the filing of the action "operates as an injunction during the pendency of the" suit prohibiting the state from enforcing the act's obligations. Id. § 3. Other sections of the act prohibited retroactive application of the obligation to remit sales tax and made the obligation prospective only from the date of dissolution or lifting of an injunction provided for by the act. Id. §§ 5-6.

The state filed suit shortly after the bill took effect, triggering the legislative injunction against any enforcement, but allowing the challenge to move forward.

This was one of the reasons the state believed the time was ripe to attempt to get the Supreme Court to hear this case related to the Brohl case mentioned earlier. Initially, the question arose whether the federal courts had the right to hear the challenge to Colorado's law, a question that was finally resolved by the U.S. Supreme Court. The South Dakota Supreme Court opinion describes the matter with the following:

> In 2015, the Supreme Court reviewed a Colorado law that instead of imposing the obligation to collect and remit use tax on sellers with no physical presence in that state, imposed the obligation "to notify... customers of their use tax liability and to report" sales information back to the state. Direct Marketing, __ U.S. at __, 135 S. Ct. at 1127. The issue before the Supreme Court was whether the United States District Court had jurisdiction under the Tax Injunction Act (28 U.S.C. § 1341) over a suit challenging the new law on Commerce Clause grounds. Justice Kennedy, however, took the opportunity to write a concurrence questioning the advisability of continuing to follow Bellas Hess and Quill in light of later Commerce Clause jurisprudence and "in view of the dramatic technological and

> social changes that [have] taken place in our increasingly interconnected economy." Id. at __, 135 S. Ct. at 1135 (Kennedy, J., concurring). Despite noting the "startling revenue shortfall in many states" due to Bellas Hess and Quill, Justice Kennedy observed that Direct Marketing did not raise reconsideration of those decisions "in a manner appropriate for the court to address it." Id. Nevertheless, he concluded that Direct Marketing provided "the means to note the importance of reconsidering doubtful authority." Id. He invited "[t]he legal system [to] find an appropriate case for [the Supreme] Court to reexamine Quill and Bellas Hess." Id.

The state Supreme Court, in deciding for the out-of-state sellers, found that the requirements imposed violated the physical presence test of Quill. Considering the law was designed to challenge Quill, the finding that there was no inherent reason why internet sellers should be treated differently than the mail-order seller that was the subject of the Quill case is likely one in which South Dakota is happy.

The South Dakota Supreme Court concluded simply that the question of whether Quill should be overturned is one that only the U.S. Supreme Court could answer affirmatively. The opinion states the following:

> However persuasive the state's arguments on the merits of revisiting the issue, Quill has not been overruled. Quill remains the controlling precedent on the issue of Commerce Clause limitations on interstate collection of sales and use taxes. We are mindful of the Supreme Court's directive to follow its precedent when it "has direct application in a case" and to leave to that court "the prerogative of overruling its own decisions." *Rodriguez de Quijas v. Shearson/American Exp., Inc.*, 490 U.S. 477, 484, 109 S. Ct. 1917, 1921-22, 104 L. Ed. 2d 526 (1989). Therefore, we affirm.

This opinion set up the challenge to Quill that was eventually heard by the U.S. Supreme Court.

THE SUPREME COURT THROWS OUT THE PHYSICAL PRESENCE TEST—WAYFAIR RULING

In a 5-4 decision, the United States Supreme Court eliminated the physical presence test that determined if a state can force a seller to collect its sales and/or use tax. In the case of *South Dakota v. Wayfair*, USSC Case No. 17-494 all of the Justices agreed that the physical presence test applied previously in the cases of *National Bellas Hess, Inc. v. Department of Revenue of Ill.*, 386 U.S. 753, and *Quill Corp. v. North Dakota*, 504 U.S. 298 was inappropriate. However, the four Justices making up the minority in the dissenting opinion argued that the physical presence rule should have remained in place due to the fact that entities have acted for years in reliance on that standard.

The Court had limited states to imposing sales and use tax collection responsibilities only on sellers that had a physical presence in the state in the National Bella Hess case. Twenty-five years after that case, the Court again agreed that physical presence was necessary in the Quill case. Now, 26 years later, the Court, visiting the issue for the third time has reversed that position—and two of the five Justices in the majority had previously ruled for the opposite result in the Quill case.

The beginnings of this case actually can be traced back to Colorado's tattletale use tax law and the challenge to it. That case resulted in two concurring opinions, one in a U.S. Supreme Court case that held federal courts could rule on the validity of the law and the other in the Tenth Circuit case that decided Colorado's rule did not violate the Quill requirements, that all but stated that Quill used an outdated standard.

The Supreme Court concurring opinion was written by Justice Kennedy, while the Tenth Circuit concurrence was penned by now-Justice Gorsuch. The state of South Dakota read those opinions as an open invitation to pass a law to get the Supreme Court to revisit, and hopefully overturn, the holding in Quill.

Under the South Dakota law, a party that either sells more than $100,000 into South Dakota or has more than 200 sales is required to collect the state's sales tax. The law's specific omission of any need to show physical presence was, as the authors of the law knew, at odds with Quill. The law was meant to draw the scrutiny of the Supreme Court and the Court took up the challenge.

Physical Presence Requirement for Substantial Nexus

Even in the *Quill* decision, the opinion noted that the physical presence test for sales tax collections was at odds with the requirements that the Court had developed generally to determine if a state can tax an activity that was outlined in *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977).

The *Complete Auto* tests, as described in the *Wayfair* majority opinion, are as follows:

> The Court will sustain a tax so long as it (1) applies to an activity with a substantial nexus with the taxing State, (2) is fairly apportioned, (3) does not discriminate against interstate commerce, and (4) is fairly related to the services the State provides.

Outside of the sales tax context, substantial nexus has not required that the entity being taxed meet a physical presence test. But due to the existing precedent, the Court in *Quill* found that such a presence was required to meet the nexus requirement in *Complete Auto*.

The new opinion rejects that view. The *Quill* court worried that subjecting an entity without physical presence to sales tax collection might be an excessive burden on interstate commerce. However, in the *Wayfair* opinion, the Court did not find a reasonable link between a mere physical presence and the burden on interstate commerce.

In the current ruling, the majority states:

> But the administrative costs of compliance, especially in the modern economy with its Internet technology, are largely unrelated to whether a company happens to have a physical presence in a State. For example, a business with one salesperson in each State must collect sales taxes in every jurisdiction in which goods are delivered; but a business with 500 salespersons in one central location and a website accessible in every State need not collect sales taxes on otherwise identical nationwide sales. In other words, under Quill, a small company with diverse physical presence might be equally or more burdened by compliance costs than a large remote seller. The physical presence rule is a poor proxy for the compliance costs faced by companies that do business in multiple States.

The opinion goes on to lay out an example of what the majority sees as the arbitrary nature of the physical presence test, which it finds must be eliminated.

> Consider, for example, two businesses that sell furniture online. The first stocks a few items of inventory in a small warehouse in North Sioux City, South Dakota. The second uses a major warehouse just across the border in South Sioux City, Nebraska, and maintains a sophisticated website with a virtual showroom accessible in every State, including South Dakota. By reason of its physical presence, the first business must collect and remit a tax on all of its sales to customers from South Dakota, even those sales that have nothing to do with the warehouse. See National Geographic, 430 U.S., at 561; Scripto, Inc., 362 U.S., at 211–212. But, under Quill, the second, hypothetical seller cannot be subject to the same tax for the sales of the same items made through a pervasive Internet presence. This distinction simply makes no sense.

The opinion also touches on the lengths to which the concept of "physical presence" can be taken—making a reference to the "cookie nexus" concept that has been adopted by Massachusetts and Ohio.

> For example, a company with a website accessible in South Dakota may be said to have a physical presence in the State via the customers' computers. A website may leave cookies saved to the customers' hard drives, or customers may download the company's app onto their phones. Or a company may lease data storage that is permanently, or even occasionally, located in South Dakota. Cf. *United States v. Microsoft Corp.*, 584 U.S. ___ (2018) (per curiam). What may have seemed like a "clear," "bright-line tes[t]" when Quill was written now threatens to compound the arbitrary consequences that should have been apparent from the outset. 504 U.S., at 315.

The opinion later specifically notes the lengths states have gone to in the search for a *Quill* physical presence, rendering the test far less than the obvious bright line test.

> Attempts to apply the physical presence rule to online retail sales are proving unworkable. States are already confronting the complexities of defining physical presence in the Cyber Age. For example, Massachusetts proposed a regulation that would have defined physical presence to include making apps available to be downloaded by in-state residents and placing cookies on in-state residents' web browsers. See 830 Code Mass. Regs. 64H.1.7 (2017). Ohio recently adopted a similar standard. See *Ohio Rev. Code Ann.* §5741.01(I)(2)(i) (Lexis Supp. 2018). Some States have enacted so-called "click through" nexus statutes, which define nexus to include out-of-state sellers that contract with in-state residents who refer customers for compensation. See e.g., N. Y. Tax Law Ann. §1101(b)(8)(vi) (West 2017); Brief for Tax Foundation as Amicus Curiae 20–22 (listing 21 States with similar statutes).

The majority concludes that this requirement is also no longer even a practical test based on reliance on a flawed, but clear, standard, holding the following:

> Reliance interests are a legitimate consideration when the Court weighs adherence to an earlier but flawed precedent. See *Kimble v. Marvel Entertainment, LLC*, 576 U.S. ___, (2015) (slip op., at 9–10). But even on its own terms, the

> physical presence rule as defined by Quill is no longer a clear or easily applicable standard, so arguments for reliance based on its clarity are misplaced.

Impact of the Internet

The majority also finds that today's marketplace is very different from the one in place when *Quill* was decided in 1992.

> The Quill Court did not have before it the present realities of the interstate marketplace. In 1992, less than 2 percent of Americans had Internet access. See Brief for Retail Litigation Center, Inc., et al. as Amici Curiae 11, and n. 10. Today that number is about 89 percent. Ibid., and n. 11. When it decided Quill, the Court could not have envisioned a world in which the world's largest retailer would be a remote seller, S. Li, Amazon Overtakes Wal-Mart as Biggest Retailer, L. A. Times, July 24, 2015, http://www.latimes.com/business/la-fi-amazon-walmart-20150724story.html (all Internet materials as last visited June 18, 2018).

This new factor in the economy is large as the majority notes:

> The Internet's prevalence and power have changed the dynamics of the national economy. In 1992, mail-order sales in the United States totaled $180 billion. 504 U.S., at 329 (opinion of White, J.). Last year, e-commerce retail sales alone were estimated at $453.5 billion. Dept. of Commerce, U.S. Census Bureau News, Quarterly Retail E-Commerce Sales: 4th Quarter 2017 (CB18–21, Feb. 16, 2018). Combined with traditional remote sellers, the total exceeds half a trillion dollars. Sales Taxes Report, at 9. Since the Department of Commerce first began tracking e-commerce sales, those sales have increased tenfold from 0.8 percent to 8.9 percent of total retail sales in the United States. Compare Dept. of Commerce, U.S. Census Bureau, Retail E-Commerce Sales in Fourth Quarter 2000 (CB01–28, Feb. 16, 2001), https://www.census.gov/mrts/www/data/pdf/00Q4.pdf, with U.S. Census Bureau News, Quarterly Retail E-Commerce Sales: 4th Quarter 2017. And it is likely that this percentage will increase. Last year, e-commerce grew at four times the rate of traditional retail, and it shows no sign of any slower pace. See ibid.

Under this system, states are losing out on large amounts of taxes that are clearly due but are never collected.

> This expansion has also increased the revenue shortfall faced by States seeking to collect their sales and use taxes. In 1992, it was estimated that the States were losing between $694 million and $3 billion per year in sales tax revenues as a result of the physical presence rule. Brief for Law Professors et al. as Amici Curiae 11, n. 7. Now estimates range from $8 to $33 billion. Sales Taxes Report, at 11–12; Brief for Petitioner 34–35. The South Dakota Legislature has declared an emergency, S. B. 106, §9, which again demonstrates urgency of overturning the physical presence rule.

Granting an Unfair Advantage and Encouraging Tax Evasion

The majority also noted that the current system gives a large advantage to businesses that are not required to collect sales taxes. While their customers are almost always supposed to voluntarily remit sales taxes, very little is actually collected based on voluntary payment of use taxes by citizens.

As Justice Gorsuch states in his concurring opinion,

> [o]ur dormant commerce cases usually prevent States from discriminating between in-state and out-of-state firms. *National Bellas Hess, Inc. v. Department of Revenue of Ill.*, 386 U.S. 753 (1967), and *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992), do just the opposite. For years they have enforced a judicially created tax break for out-of-state Internet and mail-order firms at the expense of in-state brick-and-mortar rivals. See ante, at 12–13; *Direct Marketing Assn. v. Brohl*, 814 F. 3d, 1129, 1150 (CA10 2016) (Gorsuch, J. concurring). As Justice White recognized 26 years ago, judges have no authority to construct a discriminatory "tax shelter" like this. *Quill*, supra, at 329 (opinion concurring in part and dissenting in part).

The majority opinion notes one of the defendants in this case effectively encourages its customers to shirk their use tax payment responsibilities, noting the following:

> In essence, respondents ask this Court to retain a rule that allows their customers to escape payment of sales taxes—taxes that are essential to create and secure the active market they supply with goods and services. An example may suffice. *Wayfair* offers to sell a vast selection of furnishings. Its advertising seeks to create an image of beautiful, peaceful homes, but it also says that "'[o]ne of the best things about buying through *Wayfair* is that we do not have to charge sales tax.'" Brief for Petitioner 55. What *Wayfair* ignores in its subtle offer to assist in tax evasion is that creating a dream home assumes solvent state and local governments. State taxes fund the police and fire departments that protect the homes containing their customers' furniture and ensure goods are safely delivered; maintain the public roads and municipal services that allow communication with and access to customers; support the "sound local banking institutions to support credit transactions [and] courts to ensure collection of the purchase price," Quill, 504 U.S., at 328 (opinion of White, J.); and help create the "climate of consumer confidence" that facilitates sales, see ibid. According to respondents, it is unfair to stymie their tax-free solicitation of customers. But there is nothing unfair about requiring companies that avail themselves of the States' benefits to bear an equal share of the burden of tax collection. Fairness dictates quite the opposite result. Helping respondents' customers evade a lawful tax unfairly shifts to those consumers who buy from their competitors with a physical presence that satisfies Quill—even one warehouse or one salesperson—an increased share of the taxes. It is essential to public confidence in the tax system that the Court avoid creating inequitable exceptions. This is also essential to the confidence placed in this Court's Commerce Clause decisions. Yet the physical presence rule undermines that necessary confidence by giving some online retailers an arbitrary advantage over their competitors who collect state sales taxes.

Limits on a State's Ability to Require Tax Collection

The majority notes that states do not have an unfettered ability to impose collection of tax requirements if the physical presence test is removed. While physical presence may have been required under *Bella Hess* and *Quill* for a business to have nexus, physical presence is not the only factor to establish nexus—if the requirements are overly burdensome compared to the benefits received from the state, the state will be barred from imposing the tax.

The majority notes:

> Respondents argue that "the physical presence rule has permitted start-ups and small businesses to use the Internet as a means to grow their companies and access a national market, without exposing them to the daunting complexity and business-development obstacles of nationwide sales tax collection." Brief for Respondents 29. These burdens may pose legitimate concerns in some instances, particularly for small businesses that make a small volume of sales to customers in many States. State taxes differ, not only in the rate imposed but also in the categories of goods that are taxed and, sometimes, the relevant date of purchase. Eventually, software that is available at a reasonable cost may make it easier for small businesses to cope with these problems. Indeed, as the physical presence rule no longer controls, those systems may well become available in a short period of time, either from private providers or from state taxing agencies themselves. And in all events, Congress may legislate to address these problems if it deems it necessary and fit to do so.
>
> …[O]ther aspects of the Court's Commerce Clause doctrine can protect against any undue burden on interstate commerce, taking into consideration the small businesses, startups, or others who engage in commerce across state lines. For example, the United States argues that tax-collection requirements should be analyzed under the balancing framework of Pike v. Bruce Church, Inc., 397 U.S. 137. Others have argued that retroactive liability risks a double tax burden in violation of the Court's apportionment jurisprudence because it would make both the buyer and the seller legally liable for collecting and remitting the tax on a transaction intended to be taxed only once. See Brief for Law Professors et al. as Amici Curiae 7, n. 5. Complex state tax systems could have the effect of discriminating against interstate commerce. Concerns that complex state tax systems could be a burden on small business are answered in part by noting that, as discussed below, there are various plans already in place to simplify collection; and since in-state businesses pay the taxes as well, the risk of discrimination against out-of-state sellers is avoided. And, if some small businesses with only de minimis contacts seek relief from collection systems thought to be a burden, those entities may still do sounder other theories. These issues are not before the Court in the instant case; but their potential to arise in some later case cannot justify retaining this artificial, anachronistic rule that deprives States of vast revenues from major businesses.

The majority even stops short of holding that South Dakota's law does not otherwise violate the Commerce Clause and could still be found invalid. As the opinion notes:

> The question remains whether some other principle in the Court's Commerce Clause doctrine might invalidate the Act. Because the Quill physical presence rule was an obvious barrier to the Act's validity, these issues have not yet been litigated or briefed, and so the Court need not resolve them here.

South Dakota Act as a Template for the States

That said, while the Court may have sent the case back down for a finding of whether other issues may block the tax, the opinion seems to clearly indicate that the majority does not really believe that is true.

The opinion continues:

> That said, South Dakota's tax system includes several features that appear designed to prevent discrimination against or undue burdens upon interstate commerce. First, the Act applies a safe harbor to those who transact only limited business in South Dakota. Second, the Act ensures that no obligation to remit the sales tax may be applied retroactively. S. B. 106, §5. Third, South Dakota is one of more than 20 States that have adopted the Streamlined Sales and Use Tax Agreement. This system standardizes taxes to reduce administrative and compliance costs: It requires a single, state level tax administration, uniform definitions of products and services, simplified tax rate structures, and other uniform rules. It also provides sellers access to sales tax administration software paid for by the State. Sellers who choose to use such software are immune from audit liability. See App. 26–27.

What these comments leave open is the question of whether a state needs to meet all of those requirements to impose collection responsibilities.

A major question that arises is whether a state that has not adopted the Streamlined Sales and Use Tax Agreement may find itself denied the ability to force collection of taxes by out-of-state sellers.

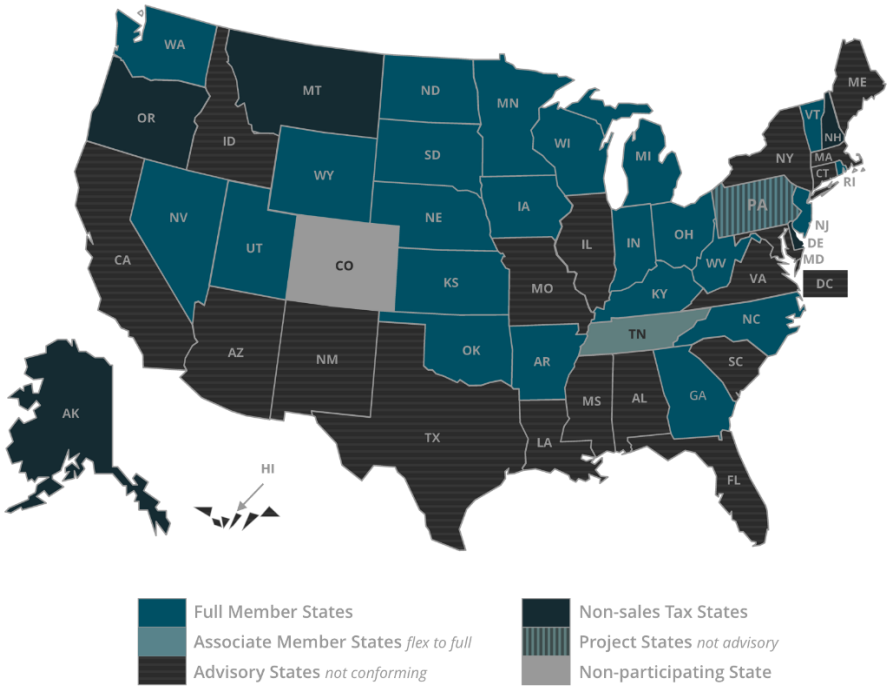
The following states have adopted the Streamlined Sales and Use Tax Agreement:

- Arkansas
- Georgia
- Indiana
- Iowa
- Kansas
- Kentucky
- Michigan

- Minnesota
- Nebraska
- Nevada
- New Jersey
- North Carolina
- North Dakota
- Ohio
- Oklahoma
- Rhode Island
- South Dakota
- Utah
- Vermont
- Washington
- West Virginia
- Wisconsin
- Wyoming[3]

[3] "State Info", Streamlined Sales Tax Governing Board website, http://www.streamlinedsalestax.org/index.php?page=state-info, June 21, 2018

The following map from the Streamlined Sales Tax Governing Board shows the status of each state with regard to the agreement:



Source: https://www.streamlinedsalestax.org/images/default-source/default-album/map_05-21-18.png?sfvrsn=f453233d_2

While the map is dated as of May 21, 2018, no states have changed their status with regard to the agreement from that date through the publication of this manual.

Similar questions arise if the state's *de minimis* exceptions do not rise to $100,000 or 200 transactions, the state seeks to collect taxes retroactively under this decision or provide protection for vendors using approved software.

Some states may move to take the "safe" route and move to model their statutes on the South Dakota law—but others are likely to go for lower limits or keep the lower limits they already have.

Will Congress Act?

While the Court has removed the physical presence test, it was the Court that created that test to begin with. As the opinion notes, Congress can write rules that would limit the abilities of states to impose tax collection requirements that are more restrictive than those that will exist after this ruling if Congress does not act.

The *Quill* opinion invited Congress to solve this problem—but Congress failed to do so in the years since. Now, however, the nature of the pressure on Congress to act will change as small businesses protest that they are being subjected to oppressive requirements.

What Will the States Do?

Regardless of whether Congress acts or not, states will also have to decide their reactions to this ruling and any Congressional action in this area. Some states may be able to expand their collection requirements merely by issuing modified rules, others may require new statutes to be passed into law, while some may argue their current rules already impose this requirement—and they may even attempt to argue that they should have a right to retroactively collect these taxes for prior periods.

The Tax Foundation in March of 2018 published an article noting that 31 of the 45 states with a sales tax already had provisions enacted that expanded to their sales tax to vendors without a physical presence in their state.[4]

States that have such authority on the books are likely to start taking action to enforce those rules, even if they are triggered at a lower level of sales or transactions than the South Dakota case or the state is not a member of the Streamlined Sales Tax Agreement.

For instance, the North Dakota Tax Commissioner Ryan Rauschenberger issued an announcement on the day of the decision that included the following quote from the Commissioner:

> "I was pleased to hear that the Supreme Court overturned Quill vs. North Dakota." Rauschenberger said. "This will go a long way to ensure local businesses are on a level playing field with online retailers. I'm glad the Supreme Court was able to recognize the unfair advantage online retailers have. The North Dakota Legislature passed a law during the 2017 session to address remote seller sales tax. Remote sellers will be required to collect and remit sales tax to North Dakota only if they make a minimum of either 200 sales or $100,000 in sales per year in North Dakota, even if they don't have a physical presence here. Over the next few weeks, our office will be working to implement this new law change."[5]

[4] Joseph Bishop-Henchman, "Should Congress Act Before SCOTUS On Online Sales Taxes?", Tax Foundation Website, March 13, 2018

[5] https://www.nd.gov/tax/news/351/, June 22, 2018

This banner was also put on the NDTax website.

Source: https://www.nd.gov/tax/, June 22, 2018

Note that the North Dakota statute has the same *de minimis* trigger the majority indirectly blessed in the South Dakota law. Although, technically, the South Dakota case needs to go back to court to see if there are other issues with the law, don't be surprised if more states adopt North Dakota's approach of tax now, ask questions later—even some of those who have triggers lower than those found in the South Dakota law and/or lack other of the protections Justice Kennedy cited in his favorable comments on South Dakota's statute.

In fact, it did not take long for the states to follow North Dakota's example and take action in this area. We have been covering these developments on the Current Federal Tax Developments website since the decision and those stories are reproduced below to help provide some information on state level developments of which we are aware.

However, be aware that we will continue to see such developments so you need to take action to determine what steps you will need to take with regard to any particular state or locality.

WAYFAIR AND GAAP—ACCOUNTING FOR CONTINGENT LIABILITIES VS. ACCOUNTING FOR INCOME TAXES

The *Wayfair* decision increases the possibility that businesses will find themselves challenged for the failure to collect and remit sales and use taxes for sales into one of the 45 states that collect a sales or use tax. While ASC 740 deals with uncertain income tax positions, it does not cover issues related to potential liabilities for other taxes.

Liabilities for taxes other than income taxes come under the more general contingent liability guidance found at ASC 450.

Accounting for Contingent Liabilities—ASC 450

The basic accounting for contingent liabilities found in ASC 450 goes back to *Statement of Financial Accounting Standards No. 5, Accounting for Contingencies* that was issued in March 1975 and has not significantly changed in the over 40 years since its first issuance.

While a potential liability arising from a claim that the business had not properly collected and paid over sales taxes is governed by ASC 450, ASC 740 governs similar issues that would relate to income taxes. This means that the conditions under which the tax assessment will be reflected on the balance sheet are different under the two standards.

Difference from Income Tax Claims

Under ASC 740, a tax benefit is not recognized unless it is more likely than not to occur. A benefit includes being found not liable for the tax in question. Thus, unless the taxpayer believes it is more likely than not that it will not be found to have income tax nexus in a state where no return has been filed, the tax due to the state would be recorded under ASC 740.

For other taxes, such as sales and use tax issues, the potential assessment is recorded only if the liability is found to be probable of eventual assessment. While that may seem a minor distinction, in realty there's a major difference between the positive assertion that the entity will not owe the tax and the much more limited assertion that is not yet probable that a liability for the tax will be asserted.

Key Definitions

The actions to be taken regarding a contingent liability depend on the likelihood of the contingency coming to pass. In ASC 450-20-20, the following definitions are found:

- **Remote** – "The chance of the future event or events occurring is slight."
- **Reasonably possible** – "The chance of the future event or events occurring is more than remote but less than likely."
- **Probable** – "The future event or events are likely to occur."

Potential Liabilities Related to Uncollected Sales and Use Taxes

A business that has failed to properly collect and remit sales taxes in most jurisdictions will find itself subject to the following liabilities:

- **Uncollected sales/use tax** – While the vendor may have a right to not charge this tax if the customer provides evidence the use tax was paid, in most cases a vendor will discover the customer has not paid the tax. Similarly, while the vendor may have a right to seek payment from the customer, that will rarely be a practical solution, nor is it likely to help customer relations if aggressively pursued.

- **Failure to file penalty** – Most often if a taxpayer has not been collecting the sales and/or use tax for a jurisdiction, the vendor has also not been filing the tax returns. While a state may choose various methods for determining such penalties, many use a variant of the federal failure to file penalty from income taxes—5% per month for each month or portion of a month the return is filed late, with the penalty capped at 25%.

- **Failure to pay penalty** – This penalty is separate from the failure to file penalty in most jurisdictions. There may or may not be a cap on this penalty.

- **Interest** – The vendor will almost always owe interest at a statutory rate for the time period the tax goes unpaid.

In addition to the above taxes, the business must also determine how many periods the above taxes and penalties could be assessed upon. In virtually all jurisdictions, a statute of limitations on assessing the taxes, penalties and interest will not begin to run until a return is filed. Thus, the *potential* liabilities to be assessed could date back to the inception of the business.

However, most jurisdictions, as a practical matter, will not pursue beyond a set period of years except in extraordinary cases. Often, the state may reduce the time period for which they will look back if a taxpayer comes forth voluntarily.

One method businesses have to give some more certainty to their liability is to enter into a voluntary disclosure program. The Multistate Tax Commission has information on their website regarding the MTC's voluntary disclosure program. That information can be found at http://www.mtc.gov/Nexus-Program/Multistate-Voluntary-Disclosure-Program.

The MTC provides a table showing whether each state participates in the MTC's voluntary national nexus program (NNP) for voluntary disclosure. The current status of the various states, taken from that website, is listed below.[6]

State	NNP Member
Alabama	Yes
Alaska	No
Arizona	Yes
Arkansas	Yes
California (FTB)	No
California (BOE)	No
Colorado	Yes
Connecticut	Yes
Delaware	Yes

[6] http://www.mtc.gov/Nexus-Program/Member-States, June 23, 2018

State	NNP Member
District of Columbia	Yes
Florida	Yes
Georgia	Yes
Hawaii	Yes
Idaho	Yes
Illinois	No
Indiana	No
Iowa	Yes
Kansas	Yes
Kentucky	Yes
Louisiana	Yes
Maine	No
Maryland	Yes
Massachusetts	Yes
Michigan	Yes
Minnesota	Yes
Mississippi	No
Missouri	Yes
Montana	Yes
Nebraska	Yes
Nevada	No
New Hampshire	Yes
New Jersey	Yes
New Mexico[7]	Yes
New York	No
North Carolina	Yes

[7] New Mexico does not have a voluntary disclosure program but accepts applications for its managed audit program through the MTC. Managed audit is substantially different from voluntary disclosure.

State	NNP Member
North Dakota	Yes
Ohio	No
Oklahoma	Yes
Oregon	Yes
Pennsylvania	No
Rhode Island	Yes
South Carolina	Yes
South Dakota	Yes
Tennessee	Yes
Texas	Yes
Utah	Yes
Vermont	Yes
Virginia	No
Washington	Yes
West Virginia	Yes
Wisconsin	Yes
Wyoming	No

Standard for Accruing the Sales Tax, Interest, and Penalty Liability

Under ASC 450-20-25-1 to 2, the following standard is used to determine when the potential liability would be recorded on the financial statements:

> 25-1 When a loss contingency exists, the likelihood that the future event or events will confirm the loss or impairment of an asset or the incurrence of a liability can range from probable to remote. As indicated in the definition of contingency, the term loss is used for convenience to include many charges against income that are commonly referred to as expenses and others that are commonly referred to as losses. The Contingencies Topic uses the terms probable, reasonably possible, and remote to identify three areas within that range.

> 25-2 An estimated loss from a loss contingency shall be accrued by a charge to income if both of the following conditions are met:
>
> a. Information available before the financial statements are issued or are available to be issued (as discussed in Section 855-10-25) indicates that it is probable that an asset had been impaired or a liability had been incurred at the date of the financial statements. Date of the financial statements means the end of the most recent accounting period for which financial statements are being presented. It is implicit in this condition that it must be probable that one or more future events will occur confirming the fact of the loss.
>
> b. The amount of loss can be reasonably estimated.

Thus, the standard requires not only the probability of the loss, but also a method to reasonably estimate the amount of such loss. That estimation will require a study of the underlying state law to determine the tax that should have been collected, the interest and penalties that may be asserted, as well as the likelihood that the state will pursue the year(s) in question and whether the taxpayers could reduce penalties through defenses such as good faith.

ASC 450-20-25-2 provides that if the loss is probable, but the entity is unable to reasonably estimate the amount due, disclosure is preferable to an accrual of a highly uncertain amount.

ASC 450-20-25-3 warns the accountant that the requirement that a loss be probable does not mean that there must be virtual certainty of a loss—the requirement for an accrual is triggered well before absolute certainty of the loss exists.

ASC 450-20-25-4 also cautions against attempting to use the "reasonable estimate" standard to avoid recording a loss. The standard notes that the reasonable estimate condition is to "prevent accrual in the financial statements of amounts so uncertain as to impair the integrity of those statements."

However, if the entity has determined it is probable a liability will be incurred and can estimate a range of potential losses, then it is reasonably clear some loss has been incurred and that a loss should be recorded. That is, clearly at the least the low end of the loss range should be reported on the financial statements, along with proper disclosure.[8]

ASC 450-20-30-1 provides the following guidance on selecting the proper number to be recorded in such a case:

> 30-1 If some amount within a range of loss appears at the time to be a better estimate than any other amount within the range, that amount shall be accrued. When no amount within the range is a better estimate than any other amount, however, the minimum amount in the range shall be accrued. Even though the minimum amount in the range is not necessarily the amount of loss that will be ultimately determined, it is not likely that the ultimate loss will be less than the minimum amount.

[8] ASC 450-20-25-5

EXAMPLE

ABC has determined that it is probable that State Y will successfully assert a liability against the entity for sales taxes that should have been collected from buyers over the past five years. ABC knows that $40,000 of taxes clearly should have been collected on certain products sold into that state. ABC is also aware that is possible the state may assert another $10,000 of tax should have been collected on sales that ABC believes may have been exempted from the collection requirement under an exemption found in state law.

ABC believes the interest to be charged will be between $20,000 and $25,000 depending on the resolution of the issue related to the potentially exempt sales. The total of the failure to pay and failure to file penalties would be 40% of the tax assessed. However, ABC is asserting a reasonable cause for the failure to file or pay based on a reasonable reliance on professional advice. ABC believes there is about a 50% chance they will prevail on the reasonable reliance defense.

Based on this information, ABC is admitted a minimum tax due of $40,000 and minimum interest of $16,000. The remaining tax, interest and penalties are possible (and should be disclosed), but they are part of the upper end of the range for the ultimate liability. The taxpayer believes that the resolution of those items will be a binary result—in each case, either nothing will be found to be due, or the maximum amount is due. The entity's management believes either result is equally possible for both issues.

Based on this information, ABC should record a loss of $56,000 related to this potential tax issue with State Y. While that amount is not necessarily what will be due, it is considered unlikely the amount ultimately found to be due will be less than $56,000.

When a Liability Should Be Recorded

The loss would normally be recorded in the period when the loss becomes probable and can be reasonably estimated. Tax advisers may be used to ending such an analysis for recording a loss once the year ended—under tax year, information that was not available at year-end generally does not impact the tax return for the year.

However, under accounting standards, information that becomes known after the balance sheet date but before the financial statements are issued may require a liability be recorded on the financial statements.

ASC 450-20-25-6 provides the following regarding information that becomes known to the entity after the balance sheet date:

> 25-6 After the date of an entity's financial statements but before those financial statements are issued or are available to be issued (as discussed in Section 855-10-25), information may become available indicating that an asset was impaired or a liability was incurred after the date of the financial statements or that there is at least a reasonable possibility that an asset was impaired or a liability was incurred after that date. The information may relate to a loss contingency that existed at the date of the financial statements, for example, an asset that was not insured at the date of the financial statements. On the other hand, the information may relate to a loss contingency that did not exist at the date of the financial statements, for example, threat of expropriation of assets after the date of the financial statements

> or the filing for bankruptcy by an entity whose debt was guaranteed after the date of the financial statements. In none of the cases cited in this paragraph was an asset impaired or a liability incurred at the date of the financial statements, and the condition for accrual in paragraph 450-20-25-2(a) is, therefore, not met.

If the probable status of a loss is established, but no reasonable estimate of the amount is possible, ASC 450-20-25-7 provides the following guidance on timing for recording the liability and loss:

> 25-7 If a loss cannot be accrued in the period when it is probable that an asset had been impaired or a liability had been incurred because the amount of loss cannot be reasonably estimated, the loss shall be charged to the income of the period in which the loss can be reasonably estimated and shall not be charged retroactively to an earlier period. All estimated losses for loss contingencies shall be charged to income rather than charging some to income and others to retained earnings as prior period adjustments.

Disclosure Issues

If there is at least a reasonable possibility that a contingent liability will come to pass, various information regarding the liability must be disclosed, found at ASC 450-20-50-3 to 6.

That guidance reads:

> 50-3 Disclosure of the contingency shall be made if there is at least a reasonable possibility that a loss or an additional loss may have been incurred and either of the following conditions exists:
>
> a. An accrual is not made for a loss contingency because any of the conditions in paragraph 450-20-25-2 are not met.
>
> b. An exposure to loss exists in excess of the amount accrued pursuant to the provisions of paragraph 450-20-30-1. Examples 1–3 (see paragraphs 450-20-55-18 through 55-37) illustrate the application of these disclosure standards.
>
> 50-4 The disclosure in the preceding paragraph shall include both of the following:
>
> a. The nature of the contingency
>
> b. An estimate of the possible loss or range of loss or a statement that such an estimate cannot be made.
>
> 50-5 Disclosure is preferable to accrual when a reasonable estimate of loss cannot be made. For example, disclosure shall be made of any loss contingency that meets the condition in paragraph 450-20-25-2(a) but that is not accrued because the amount of loss cannot be reasonably estimated (the condition in paragraph 450-20-25-2[b]). Disclosure also shall be made of some loss contingencies that do not meet the condition in paragraph 450-20-25-2(a)—namely, those contingencies

for which there is a reasonable possibility that a loss may have been incurred even though information may not indicate that it is probable that an asset had been impaired or a liability had been incurred at the date of the financial statements.

50-6 Disclosure is not required of a loss contingency involving an unasserted claim or assessment if there has been no manifestation by a potential claimant of an awareness of a possible claim or assessment unless both of the following conditions are met:

a. It is considered probable that a claim will be asserted.

b. There is a reasonable possibility that the outcome will be unfavorable.

The standard goes on to provide disclosure information regarding information that becomes available after the balance sheet date. This guidance is found at ASC 450-20-50-9 and 10.

50-9 Disclosure of a loss, or a loss contingency, arising after the date of an entity's financial statements but before those financial statements are issued, as described in paragraphs 450-20-25-6 through 25-7, may be necessary to keep the financial statements from being misleading if an accrual is not required. If disclosure is deemed necessary, the financial statements shall include both of the following:

a. The nature of the loss or loss contingency

b. An estimate of the amount or range of loss or possible loss or a statement that such an estimate cannot be made.

50-10 Occasionally, in the case of a loss arising after the date of the financial statements if the amount of asset impairment or liability incurrence can be reasonably estimated, disclosure may best be made by supplementing the historical financial statements with pro forma financial data giving effect to the loss as if it had occurred at the date of the financial statements. It may be desirable to present pro forma statements, usually a balance sheet only, in columnar form on the face of the historical financial statements.

What About Claims That Now Appear Possible Post-*Wayfair*?

The *Wayfair* case leaves open the question regarding whether it may be applied retroactively, but only the state of South Dakota technically had a statute that applied if there was truly no physical presence. It does appear reasonable, however, to believe that where there is some minor physical presence (such as Massachusetts's cookie nexus) the *Wayfair* results could significantly change the analysis of whether the taxpayer may prevail—and could transfer a potential liability from the "remote" to the "reasonably possible" or even "probable" category.

How should that situation be reflected in the financial statements? Would the *Wayfair* case be deemed to create a situation not existing at the balance sheet date, or does it represent merely more information about events existing at that date.

ASC 450-20-55-11 provides some guidance that could be read to require recording or disclosure in such a case. That provision reads:

> 55-11 Accrual may be appropriate for litigation, claims, or assessments whose underlying cause is an event occurring on or before the date of an entity's financial statements even if the entity does not become aware of the existence or possibility of the lawsuit, claim, or assessment until after the date of the financial statements. If those financial statements have not been issued or are not yet available to be issued (as discussed in Section 855-10-25), accrual of a loss related to the litigation, claim, or assessment would be required if the probability of loss is such that the condition in paragraph 450-20-25-2(a) is met and the amount of loss can be reasonably estimated.

The fact the case decision might require action on the financial statements with a balance sheet date before June 21, 2018 (the date of the *Wayfair* decision) also appears to be supported by ASC 450-20-55-17.

> 55-17 As a condition for accrual of a loss contingency, the condition in paragraph 450-20-25-2(a) requires that information available before the financial statements are issued or are available to be issued (as discussed in Section 855-10-25) indicate that it is probable that an asset had been impaired or a liability had been incurred at the date of the financial statements. Accordingly, accrual would clearly be inappropriate for litigation, claims, or assessments whose underlying cause is an event or condition occurring after the date of financial statements but before those financial statements are issued or are available to be issued. For example, an entity would not accrue a suit for damages alleged to have been suffered as a result of an accident that occurred after the date of the financial statements. However, disclosure may be required by paragraphs 450-20-50-9 through 50-10.

The actual sales into the state that may now have a claim that is more likely to be successful would have taken place before the balance sheet date. Only the court case that decided what was previously some potential uncertainties regarding the support for the government's case took place after that date.

Evaluating the *Wayfair* Claims of States

The mere fact that a state begins making inquiries about a potential liability for uncollected sales or use taxes does not mean disclosure or recording of a liability is appropriate.[9]

The method to be used to evaluate the probability that a contingent liability related to sales or use taxes will come to fruition is found at ASC 450-20-55-12.

> 55-12 If the underlying cause of the litigation, claim, or assessment is an event occurring before the date of an entity's financial statements, the probability of an outcome unfavorable to the entity must be assessed to determine whether the

[9] ASC 450-20-55-13

condition in paragraph 450-20-25-2(a) is met. Among the factors that should be considered are the following:

a. The nature of the litigation, claim, or assessment

b. The progress of the case (including progress after the date of the financial statements but before those statements are issued or are available to be issued [as discussed in Section 855-10-25])

c. The opinions or views of legal counsel and other advisers, although, the fact that legal counsel is unable to express an opinion that the outcome will be favorable to the entity should not necessarily be interpreted to mean that the condition in paragraph 450-20-25-2(a) is met

d. The experience of the entity in similar cases

e. The experience of other entities

f. Any decision of the entity's management as to how the entity intends to respond to the lawsuit, claim, or assessment (for example, a decision to contest the case vigorously or a decision to seek an out-of-court settlement).

At least initially, most entities will not be facing an assertion of a potential liability. Rather, the adviser will likely make the entity's management aware of the risk that such a claim will be asserted. The fact that no claim has yet been asserted does not let the organization off the hook—rather, the standard analysis of probability is required.[10]

The procedures management is to undertake to evaluate these unasserted claims are found at ASC 450-20-55-14. That provision states:

> 55-14 With respect to unasserted claims and assessments, an entity must determine the degree of probability that a suit may be filed or a claim or assessment may be asserted and the possibility of an unfavorable outcome. If an unfavorable outcome is probable and the amount of loss can be reasonably estimated, accrual of a loss is required by paragraph 450-20-25-2. For example:
>
> a. A catastrophe, accident, or other similar physical occurrence predictably engenders claims for redress, and in such circumstances their assertion may be probable.
>
> b. An investigation of an entity by a governmental agency, if enforcement proceedings have been or are likely to be instituted, is often followed by private claims for redress, and the probability of their assertion and the possibility of loss should be considered in each case.

[10] ASC 450-20-55-14

c. An entity may believe there is a possibility that it has infringed on another entity's patent rights, but the entity owning the patent rights has not indicated an intention to take any action and has not even indicated an awareness of the possible infringement. In that case, a judgment must first be made as to whether the assertion of a claim is probable.

Once these steps are undertaken, ASC 450-20-55-15 provides the following guidance on the steps to take:

> 55-15 If the judgment is that assertion is not probable, no accrual or disclosure would be required. On the other hand, if the judgment is that assertion is probable, then a second judgment must be made as to the degree of probability of an unfavorable outcome. The disclosures described in paragraphs 450-20-50-3 through 50-8 would be required in either of the following circumstances:
>
> a. An unfavorable outcome is probable but the amount of loss cannot be reasonably estimated.
>
> b. An unfavorable outcome is reasonably possible but not probable.

Wayfair—Two Years Later

Since June 2020, a majority of states have taken some action to establish an economic nexus standard and require remote sellers to collect sales taxes. Accordingly, despite the current pandemic, many states saw their sales tax revenues increase.

Reporting for multiple jurisdiction is much easier for large retailers that have the scale-up capability to comply with additional collection and state compliance requirements. Conversely, the additional collection and reporting burden has been more difficult for both small domestic retailers and also foreign sellers.

It remains unclear whether some states will attempt to collect retroactively. This issue continues to have the potential to subject retailers to significant tax liability exposure and should be researched and monitored for each applicable state. With the looming state economic impact of the COVID-19 pandemic, taxpayers should expect states to be more aggressive in expanding their taxable base under *Wayfair*.

Unit

4

Sales Tax Issues and Other Controversies

LEARNING OBJECTIVES

When you have completed this unit, you will be able to accomplish the following.

- Identify other business transactions with potential sales tax implications and responsible parties for compliance with sales tax laws.
- Develop working knowledge of basic state audit strategies.
- Apply state unclaimed property rules.

STATISTICAL SAMPLING

Statistical sampling is used by almost every state for auditing sales/use tax compliance of taxpayers due to the large number of transactions that otherwise would be subject to testing for many entities.

Even if the seller maintains adequate records for sales, the taxing agencies may look for use tax issues by reviewing accounts payable invoices and fixed asset purchases.

In most cases, statistical sampling can be used by a state even without seller's consent—however, the agency generally looks to get the taxpayer to sign a consent form or agreement.

As the taxpayer's adviser, you should make sure the sample selected meets the needs for determining a reasonable verification of the tax and is chosen in a manner to make the selection representative.

The justification for using sampling is reduced expense and time for the examination, with the state's justification is looking at the relative efficiency of using a statistical sample. By using this method, the state hopes to

- determine the integrity of the taxpayer's records and
- provide a supportable basis for an alternative assessment.

Most often a taxpayer must take state to court to throw out the sample's results. However, the taxpayer may be able to negotiate extraordinary circumstances with field auditor. The following cases are relevant in this area:

- *W.T. Grant v. Joseph*, 2 N.Y. 2d 196
- Marine Midland Bank, NYS Tax Appeals Tribunal, May 13, 1993

RESPONSIBLE PERSONS

Many states have become very aggressive in pursuing sales tax liabilities, and many of these states have provisions in their laws similar to the federal responsible party rules for trust fund taxes. Like the taxes withheld from employee's paychecks, these rules view the funds received (or which should have been received) from customers as merely being held for the state—they are the state's property.

A responsible person rule creates a personal liability for parties that were in a position to assure that the taxes were transferred to the state, rather than being used otherwise (such as pay the rent that is due). Those in such a position to assure that the taxes be paid are considered a responsible person.

There have been increased actions against officers and responsible persons—similar to withholding payroll taxes, analogous to trust fund taxes withheld from wages.

The details of responsible party rules are a state-by-state issue, both in terms of the underlying statutes and how those rules are applied against various parties.

Remember, sales taxes are collected by retailer for the state, so the funds in question are, in the view of many states, the state's property received from customers being temporarily held by the business prior to begin sent to the state. If a person with the power to ensure those funds are sent to the state allows those funds to be used for another purpose, a number of states' statutes authorize pursuing collection of those funds personally from that *responsible person*.

Action taken by the state must generally be based on an assessment against business that cannot be collected and a rational basis for pursuing an assessment against an individual. The good news is that usually taxing agencies go after individuals as a last resort—but they will do it when it's clear nothing will come from pursuing the now insolvent company.

There are some states that do not hold individuals liable, such as Hawaii, Nevada, South Carolina, and Wyoming.

If the state does attempt to pursue the penalty, the adviser should first make sure the state met all requirements for mailing of notices and action has been taken within the relevant statute of limitations.

Is the Individual Truly a Responsible Person for Sales/Use Tax Purposes?

The net that can ensnare a person with liability for a responsible person penalty is broader than many parties at risk may realize. Generally, the person does not have to hold a corporate office (such as President, Treasurer, etc.) to face potential liability. The ability a person had to control payments (even if not normally exercised) is most often the key test. Once a person with the power to get the state paid is aware the state is not being paid, they must normally take action if there a responsible person statute to avoid liability—and end up with a continuing obligation to monitor compliance.

A question is did they willfully decide not to pay? Note that once a person has knowledge of the problem, or has clearly made him/herself intentionally ignorant of the status, the lack of action often will be construed as willfulness by the courts.

What are key factors to see if a person has willfully decided not to pay? Key factors are the person's control over payment, the level of supervision exercised by others over the process of selecting bills to be paid, and the person's level of responsibility in the organization.

But, note that a party with the power to determine who gets paid most often will not escape liability just because they claim they were told not to pay the taxes—in such cases, the only option to avoid responsible person status may be to quit on the spot. The defense that "I was told to pay this vendor first" has failed multiple times in such cases.

Usually the state will first concentrate on officers and owners as the responsible party, but under most laws, the liability could fall even on payable clerks or similar individuals who are not officers of the corporation or have any ownership interest in the entity.

Ultimately, the ruling on whether a party is a responsible person is based on facts and circumstances. Anyone who becomes aware of unpaid taxes needs to understand they will be at risk for being seen as a responsible person unless they take all actions they have a right to take to insure the taxes get paid.

CORPORATE REORGANIZATIONS AND TRANSACTIONS

As CPAs training in taxes normally concentrate heavily or entirely on federal taxes, with state and local taxes either ignore entirely or barely mentioned, too often CPAs assume that something that is not a problem. But such assumptions can prove very costly to the taxpayer and the CPA.

Don't assume a transaction that is exempt from federal income tax is also exempt from state sales and use tax laws—there is no real connection between state sales and use tax laws and federal income tax laws. Don't assume sales tax issues are non-existent! Sales tax issues do not equal income tax issues.

Sales tax statutes are broadly crafted in most states. The term "sale" includes every transfer of title or possession, unless specifically exempted by some provisions of state law. So the burden is not on the state to prove the sale is taxable—the burden is on the taxpayer to show what provision of state law exempts this transaction from tax.

For instance, the sales of businesses are exempt only if state legislature thinks of exempting such sales and drafts the provision correctly so all parts of the sale are exempt.

States that have an exemption for sales of businesses often disregard the form of transaction, the nature of consideration received, and other exempt issues. Thus, in many (but not all) cases, the following will be protected from sales and use taxes:

- Sale of stock exempt
- Sale of assets (taxable unless casual or isolated sales exemption)
- Resale certificate for the inventory items
- No sales tax on realty

Most states agree that sale of business should be exempt from sales tax, but also note that sales tax exemptions should not be linked to income tax exemptions.

A sales tax is an excise tax on transfer of property at retail, while an income tax is a tax imposed on gain realized by the seller.

The reorganization provisions of IRC defer tax, not actually avoid it. When the asset is eventually sold, the basis remains at its pre-deferral level, so the gain is not based on the value when the asset was transferred, but when it was originally acquired. When the transaction is ignored for sales and use tax purposes, that treatment truly avoids the tax—it's not sitting waiting to be paid someday.

Some states exempt all transfers that are tax-free under IRC Section 368. For instance, see Maryland, Section 11-209(c)(1)(i) which applies to transfers in exchange for the stock of the buyer's parent as well as to transfers in exchange for the buyer's stock.

Other states exempt a narrowly drawn definition of merger, limiting the applicability of an exemption. For example, see New York, Section 1101(b)(4)(iv)(A) that provides the exemption applies only if a transfer is in exchange for the buyer's stock, not the buyer's parent's stock.

THIRD-PARTY DROP SHIPMENT SALES

Who should collect sales/use tax in the context of third-party drop shipment sales? This has become somewhat less of an issue since *Wayfair* removed the physical presence requirement, but that problem still arises when there are three parties in the transaction.

For example, say a manufacturer of goods, located in State A, has tax nexus with State C. The distributor, located in State B, which has no nexus with State C, orders goods from the manufacturer, with the goods shipping directly to the distributor's customers in State C.

The answer depends on the state in question. In some cases, the manufacturer is not liable (approximately 31 states take this position). They hold that the transfer of possession is not a taxable event. This rule is followed by

- New Jersey—*Steelcase Inc. v. Director*, Div. of Taxation, 13 N.J. Tax 182 (1993);
- Iowa—Department of Finance Rule 701-18.55 (8/28/91); and
- more liberal states that accept almost any valid sale-for-resale documentation (Minnesota and Oklahoma).

Other states have a more restrictive approach that may put the manufacturer at risk of being the party to collect the tax. For instance, while this looks like a sale for resale to the manufacturer, the question becomes if this is going to be recognized by the state as such.

Resale exemptions are key to handling sales tax issues, especially for entities that do not normally sell to the ultimate consumer of their product. Generally, the certificates are valid regardless of which state the seller happens to be located in or have nexus with. But in some cases it is state specific, so you must have a resale certificate in a particular state—see Florida, Maryland, Pennsylvania, and South Dakota.

In the worst case, a state may treat the manufacturer as the seller, bypassing the distributor. Such states include California, Connecticut, Washington, D.C., Florida, Hawaii, Idaho, Kansas, Kentucky, Louisiana, Maryland, Massachusetts, Mississippi, Nevada, Rhode Island, Tennessee, and Wisconsin.

When the manufacturer is liable to collect, the next question becomes what is the sales price on which the tax is to be computed? The tax base may either be retailer's selling price (e.g., California, Connecticut, Florida, Massachusetts, Nevada, and Wisconsin) or the manufacturer's price to distributor. In the former case, the manufacturer needs to know and collect tax on more than the manufacturer receives for selling the product.

Note that *Wayfair* has made it more likely that the distributor has nexus in the state the product is being shipped to. If the distributor has more sales than the state's *de minimis* amount, the drop shipment would often simply be deemed the distributor's sale—with the distributor liable for collecting and paying over the tax.

ONLINE RULES

Prior to *Wayfair*, online sellers often had it relatively easy, at least based on *Quill* protection. But, as was noted earlier, that protection was being chipped away by various mechanisms, including "cookie nexus" (using the web browser cookie stored on the buyer's computer in the state as providing the necessary physical presence) or "tattletale" laws that made it more onerous to report the customers in the state that bought from the buyer to the state.

Although we now have some not terribly clear guidance on the limits on when a state may require collection based on the concepts discussed in *Wayfair*, advisers should note that most states continue to see the *Wayfair* options as an addition to a physical presence trigger and not having any impact on tattletale rules if the seller other falls under the state's *de minimis* rule. Thus, even a business with few sales in the state may find that a state will assert the right to tax if the business stores inventory in the state or has an employee that resides in the state.

The fact that something is sold online doesn't really change the analysis, as the same rules apply regardless of how a product is sold. Prior to *Wayfair*, online sales often meant sales over a wider geographic area so that more sales went to locations where the seller had no physical presence (and thus, ignoring cookie nexus theories, no nexus), giving some advantage to online sales.

Sales tax liability for tangible goods most often goes to the location of the physical delivery of the product. Especially post-*Wayfair*, sellers need to know where their customers are located. Often, software databases have to be licensed and integrated into a company's sales system to deal with these issues since even a zip code may not be sufficiently precise to truly determine all taxes applicable to a seller.

Online sellers have found, since *Wayfair*, that actually integrating a sales tax database system into their sales systems has proven to be one of the most complicated and expensive parts of sales tax compliance. While Streamlined Sales and Use Tax states all provide "free" software to handle sales tax issues, the free status does not include paying for the work to integrate databases into sales systems.

The other big complication for online sellers is mapping their product inventory to the proper sales tax category for each taxing jurisdiction. This is also not part of what is provided with the free software—rather, the business has to understand the sales tax classification for each taxing jurisdiction it must file with and then integrate this information into the systems.

UNCLAIMED PROPERTY AUDITS

This particular topic doesn't fit easily within any chapter and technically isn't a tax, but it is important to consider. What about unclaimed, abandoned, or escheat property? Many businesses end up with such property, such as credit balances on accounts receivable for customers the business no longer has a contact for.

Such items are not, as some business owners may assume, property of the company when the customer fails to take action to be repaid the excess. Rather, such abandoned property becomes an item to be forwarded to the appropriate state to be held until the owner claims the funds.

Laws on disposition and reporting have been enacted by every state. Twenty states have adopted a form of the Uniform Division of Unclaimed Property Act.

The law is applicable to a wide range of property, including the following:

- Dividends, interest, and security deposits
- Unpaid wages and uncashed vendor checks
- Unredeemed coupons and gift certificates

The last category has become an increasingly important issue, since experience shows that a rather predictable percentage of such items will never be used by the holder.

One key problem is that the various states' holding periods vary from one year to as many as ten years or as few as five years (wages are generally required to be turned over after one year). The most common holding period before the property must be turned over to the state is three or five years for bank accounts, checks, gift cards and similar items.

The other key issue is which state is entitled to claim the property when the business is located in one state, but the customer, employee, etc. was last know to be residing in another state. Why would states care? In one unclaimed dividend case, the amount at issue was $360 million. Because only a small percentage of this property is claimed, it's effectively a source of revenue for the state that had the right to receive the property.

Of course, having multiple states claim the right to the same property puts the business holding the property in an awkward position—it can't give the property to both states.

A 1993 U.S. Supreme Court case (*New York v. Delaware*, 113 S. Ct. 1550 (1993)) reaffirmed that generally funds go first to the state of owner's (creditor's) last known address and, if that is not available, then the funds go to the state of holder's (debtor's) incorporation.

There are a number of compliance and enforcement traps for unclaimed property issues. The issue is difficult to track in multi-state environment, as state laws vary on many details (a common refrain in this course). There are differing holding periods for different states as well what may be seen as unusual reporting requirements for some jurisdictions.

Complicating the issue is that there are only sporadic enforcement efforts, so often businesses are lax in compliance. That creates problems when the state eventually does decide to send out examiners to find what the state views as easy money—and the business may find itself stuck with a large liability to pay.

Note that in some cases, the administration of the program may be vested in the state treasurer, not a revenue or tax agency whose reporting and administrative systems the CPA may be more familiar with.

In some cases, states take part in multi-state examinations with audit teams devoted to uncovering the funds for each state. Some states retain third-party, contingent-fee examiners whose pay is, obviously, dependent on how much money they move into the state coffers.

If faced with an exam on unclaimed property, is it worth challenging? Well, maybe. If the business has not been diligent in keeping good records and forwarding such property to the state on schedule, there likely is going to be a significant amount of any proposed liability that simply can't be challenged. And, without good records, it may not be possible to dispute amounts that arguably should be able to be disputed.

But if the business has kept good records and has a history of regularly transferring abandoned property to the state, then it may make sense to challenge an examination, especially one from a contingent fee examiner who has every incentive to push the envelope on what has to be sent to the state.

In some cases, legal counsel may decide a fight against a contingent-fee exam may be possible on the ground of illegality, if there is a reasonable possibility such exams may be held by a state court to be against public policy. (See *Sears v. Parsons*, 260 Ga. 824 (1991).)

NOTES

Unit 5

Income Tax Nexus

LEARNING OBJECTIVES

When you have completed this unit, you will be able to accomplish the following.

- Consider nexus issues in historical context.
- Identify trends in definition of nexus.
- Properly calculate apportionable income for any state.
- Apply different methods of apportionment.

INTRODUCTION

The state in which a business is incorporated has the jurisdiction to tax the corporation, regardless of the amount of business activity that is conducted within the state. As the state is responsible for, effectively, the very existence of the corporation, it has automatic nexus.

Whether a state has the right to tax the income of a business that is incorporated in another state depends on the connection between the state and the corporation. The concept of nexus discussed above also applies to the degree of business activity that must be present before a taxing jurisdiction has the right to impose a tax on a corporation's income.

The amount of activity (or connection that is necessary) to create income tax nexus is defined by each state, subject to any limits under the Constitution. Congress has the power to regulate interstate commerce under the Constitution, but it has generally shied away from doing a lot in the tax arena (aside from PL 86-272 that we will discuss shortly). Where Congress has not acted, the Supreme Court can find there are limits under the dormant commerce clause rules discussed in the sections on sales taxes.

The *Complete Auto Transit* case concepts generally apply to income taxes as well to apply the Supreme Court's view of the limits of a state's ability to impose an income tax. When we discuss apportionment, especially when looking the increasingly popular use of market-based sourcing and 100% sales-based apportionment, we'll see how the Complete Auto tests will often allow an allocation of income to the various states in total that is well in excess of 100% of the entity's income.

For review, under *Complete Auto* for a tax to pass Constitutional muster, the tax must

- be applied to an activity with a substantial nexus to taxing state—now the courts have generally accepted the concept of economic nexus for these purposes;
- be fairly apportioned—tax only the apportionment of activity that transpires within the state;
- not discriminate against interstate commerce—should not favor intrastate commerce over interstate commerce; and
- be fairly related to the services provided by the state—in *Wayfair*, the Court weighed the administrative burden of complying with the state's tax regime vs. the revenue the business gained from being able to sell to residents of the state.

NEXUS FOR INCOME TAX PURPOSES

Nexus is a key concept we've encountered earlier in this manual with other taxes.

Normally, sufficient nexus for income tax purposes is present when a business is incorporated in the state, owns property or performs services in the state, or has a sufficient level of revenue being generated from within the state. The last item is the most recent addition to the list, and is most often referred to as economic nexus. That is, the economic benefit enjoyed by the business from sales into the state provides a sufficient connection to the state to allow the state to impose taxes and compliance rules on the business.

But is there nexus when a business' only activity is the solicitation of orders for the sale of tangible personal property?

PL 86-272—Congress Acts to Limit States Ability to Impose an Income Tax

In 1959, Congress enacted P.L. 86-272 to limit the states' rights to impose an income tax on interstate activities. (codified as 15 USC 381)

This law prohibits a state from taxing a business whose only connection with the state is the solicitation of orders for sales of tangible personal property that are

- sent outside the state for approval or rejection and
- if approved, filled and shipped from outside the state.

The law applies only to a tax based on net income—not based on something other than net income, such as a gross receipts tax (Texas, Washington, etc.) or a sales tax. So even though a company may meet the requirements of PL 86-272 to avoid the income tax, it may still face liability for a series of other taxes imposed by the state—so long as it is not an income tax.

As well, only a very limited set of activities get immunity; specifically this immunity does not extend to

- selling or providing services,
- leasing or renting personal property, or
- any activity in connection with
  - real property or
  - intangibles.

In addition, an activity is immune from taxation if it consists merely of solicitation; because solicitation is not defined by P.L. 86-272, each state felt free to select its own interpretation. The text of the provision is reproduced below.

15 USC §381—Imposition of an Income Tax

> **(a) Minimum standards.** No State, or political subdivision thereof, shall have power to impose, for any taxable year ending after September 14, 1959, a net income tax on the income derived within such State by any person from interstate commerce if the only business activities within such State by or on behalf of such person during such taxable year are either, or both, of the following:
>
> > (1) the solicitation of orders by such person, or his representative, in such State for sales of tangible personal property, which orders are sent outside the State for approval or rejection, and, if approved, are filled by shipment or delivery from a point outside the State; and
> >
> > (2) the solicitation of orders by such person, or his representative, in such State in the name of or for the benefit of a prospective customer of such person, if orders by such customer to such person to enable such customer to fill orders resulting from such solicitation are orders described in paragraph (1).
>
> **(b) Domestic corporations.** Persons domiciled in or residents of a State The provisions of subsection (a) shall not apply to the imposition of a net income tax by any State, or political subdivision thereof, with respect to—
>
> > (1) any corporation which is incorporated under the laws of such State; or
> >
> > (2) any individual who, under the laws of such State, is domiciled in, or a resident of, such State.
>
> **(c) Sales or solicitation of orders for sales by independent contractors.** For purposes of subsection (a), a person shall not be considered to have engaged in business activities within a State during any taxable year merely by reason of sales in such State, or the solicitation of orders for sales in such State, of tangible personal property on behalf of such person by one or more independent contractors, or by reason of the maintenance, of an office in such State by one or

more independent contractors whose activities on behalf of such person in such State consist solely of making sales, or soliciting orders for sales, or tangible personal property.

(d) Definitions. For purposes of this section—

(1) the term "independent contractor" means a commission agent, broker, or other independent contractor who is engaged in selling, or soliciting orders for the sale of, tangible personal property for more than one principal and who holds himself out as such in the regular course of his business activities; and

(2) the term "representative" does not include an independent contractor.

The Wrigley Decision

The term solicitation was finally defined, more than 30 years after the enactment of P.L. 86-272. On June 19, 1992, the U.S. Supreme Court reversed the decision of the Wisconsin Supreme Court in *Wisconsin DOR v. William Wrigley, Jr., Co.*, 112 S. Ct. 2447. According to the court, Wrigley's activities in Wisconsin exceeded the protection of P.L. 86-272, but it gives us guidance on

- what is the scope of the term solicitation of orders and
- does a *de minimis* exception (beyond the solicitation of orders) exist?

The facts of Wrigley were as follows.

Wrigley conducted its worldwide chewing gum business from its Chicago offices and sold its products in Wisconsin through a sales force, consisting of a regional manager and several field representatives who resided in Wisconsin.

As mandated by P.L. 86-272, all orders were sent to Chicago for acceptance or rejection, and were filled by common carrier shipments from outside of Wisconsin. In addition, no property was owned, or leased by Wrigley in Wisconsin and all credit and collection activities—with few exceptions—were handled from Chicago. Furthermore, all Wisconsin advertising was placed from out-of-state locations by a Chicago advertising agency.

The regional manager had no office and spent the majority of his time working with the field representatives and contacting key accounts. The representatives were provided with company cars and were supplied with a stock of gum, company literature, and display racks, which were supposed to be stored at their own homes. Typically, a representative would visit retail accounts and would

- distribute literature,
- provide free samples,
- replace stale gum with fresh gum (at no cost), and
- supply gum to accounts that had insufficient amounts on hand to fill display cases.

Procedurally, the following four steps that ultimately resolved the issue at the U.S. Supreme Court took more than 12 years:

- In 1980, the Wisconsin DOR determined that Wrigley's activities were sufficient to subject the company to its net income-based franchise tax and assessed the company for prior tax years.
- Although Wrigley maintained it was protected from taxation by Wisconsin under P.L. 86-272, the Wisconsin Tax Appeals Commission did not agree. The case began to wind its way through the Wisconsin court system.
- The Wisconsin Supreme Court reversed the Court of Appeals and held that the company's business activities in the state did not exceed the mere solicitation of orders, even though company employees replaced stale products, maintained product displays, conducted regular, and periodic training seminars, maintained offices in their homes, and sold products by use of agency stock checks. (*William Wrigley, Jr., Co. v. Wisconsin DOR*, Wis S Ct, No 88-2265, February 19, 1991)
- Finally, in June of 1992, the U.S. Supreme Court overruled the Wisconsin Supreme Court, and finally added a degree of clarity to a long-congested area of state taxation.

Solicitation of Orders

Per the *Wrigley* decision, the solicitation of orders, the protected activity under the law, includes

- any explicit verbal request for orders and
- any speech or conduct that implicitly invites an order.

The solicitation process is more than what is strictly essential to making requests for purchases, distinguishing between activities that

- are entirely ancillary to requests for purchases (serve no independent business function) and
- the company would have reason to engage in any way but chooses to assign to its sales force.

In Wrigley's case ancillary or immune activities included

- providing a car and free samples—for solicitation only;
- recruiting, training, and evaluating sales representatives; and
- using hotels and homes for sales meetings.

Thus, in the view of the Supreme Court, a state cannot impose an income tax on a business solely based on those activities. But the Court found that the taxpayer conducted other activities that did grant the state a right to impose its income tax.

These non-ancillary or taxable activities included

- replacing stale gum in stores,
- supplying the gum through stock checks, and
- storing gum within the state.

In the view of the Court, these activities fell outside the limited protection provided by the law.

De Minimis Exception

The Supreme Court did find there a de minimis exception. Even though an action may technically be outside the protection of PL 86-272, if it is limited enough, it won't trigger taxation authority to the state. This ruling is based on the established background of legal principles. To be de minimis, the activity must avoid establishing a "nontrivial additional connection with the taxing state."

Expanding the State's Reach for Schedule C (Sole Proprietorship) Businesses

The California Office of Tax Appeals in the *Matter of the Appeal of Blair S. Bindley*, OTA Case No. 18032402[11] ruled that an Arizona individual who had a contract for screenwriting services for two California LLCs had California source income on which he had to pay tax, even though all services were performed in Arizona.

California, like many other states, has moved to pure market-based sourcing for apportioning sales in a business setting. Under California Revenue & Taxation Code (RT&C) §25128.7, apportionment for the vast majority of businesses with California operations is based solely on the sales factor. RT&C §25136(a)(1) assigns a sale to California to the extent that the purchaser of a service received the benefit of the service in California.

In this case, the taxpayer argued that he had performed all of the services in Arizona, so he did not have a sufficient connection with California to trigger a requirement to file a return and report the income to the Franchise Tax Board.[12]

California imposes its tax on any nonresident carrying on a business within the state of California (RTC §18501(a)). The OTA opinion notes that nothing in the statute requires that the taxpayer be physically present in the state of California.[13] The Court found that the taxpayer received income from California LLCs, with he and his sole proprietorship deemed to be conducting business in California, making the proprietorship's income subject to apportionment under California's apportionment rules.[14]

[11] https://ota.ca.gov/wp-content/uploads/sites/54/2019/08/18032402_Bindley_Decision_OTA_053019.pdf, May 30, 2019
[12] Ibid, p. 4
[13] Ibid, pp. 4-5
[14] Ibid, pp. 5-7

So now the question becomes where did the taxpayer's buyer receive the benefit of the services provided, not where the taxpayer performed such services. Reg. §25136-2(c)(2) provides that where a business is the taxpayer's customers, the place where the customer receives the benefit of the services is determined under the following rules:

> (A) The location of the benefit of the service shall be presumed to be received in this state to the extent the contract between the taxpayer [i.e., appellant] and the taxpayer's customer[s] [i.e., Mindbender and Lakeshow] or the taxpayer's books and records kept in the normal course of business, notwithstanding the billing address of the taxpayer's customer, indicate the benefit of the service is in this state. This presumption may be overcome by the taxpayer or [FTB] by showing, based on a preponderance of the evidence, that the location (or locations) indicated by the contract or the taxpayer's books and records was not the actual location where the benefit of the service was received.
>
> (B) If neither the contract nor the taxpayer's books and records provide the location where the benefit of the service is received, or the presumption in subparagraph (A) is overcome, then the location (or locations) where the benefit is received shall be reasonably approximated.
>
> (C) If the location where the benefit of the service is received cannot be determined under subparagraph (A) or reasonably approximated under subparagraph (B), then the location where the benefit of the service is received shall be presumed to be in this state if the location from which the taxpayer's customer placed the order for the service is in this state.
>
> (D) If the location where the benefit of the service is received cannot be determined pursuant to subparagraphs (A), (B), or (C), then the benefit of the service shall be in this state if the taxpayer's customer's billing address is in this state.

The OTA opinion applies these rules, coming to the determination that since the LLCs are registered and located in California, the second test is met, with the benefit received in California.

> Public records from the California Secretary of State provided by FTB show that both Mindbender and Lakeshow are registered and located in California. Moreover, appellant's contracts with Mindbender and Lakeshow both list California addresses. Appellant also concedes that Mindbender and Lakeshow are California LLCs. Based on the evidence in the appeal record, we find that it was both reasonable and rational for FTB to conclude that both LLCs received the benefit of appellant's services within California. Because we have determined that the LLCs received the benefit of appellant's services in California under Regulation section 25136-2(b)(2)(B), there is no need to discuss the remaining cascading rules.[15]

[15] Ibid, p. 9

The opinion summarized the findings as follows:

> In sum, pursuant to the provisions of UDITPA relating to the sale of services and the regulations thereunder, appellant's physical presence does not determine whether he had income derived from California, but rather it is determined by where the benefits of appellant's services were received.[16]

MULTI-STATE TAX COMMISSION AND THE UNIFORM DIVISION OF INCOME FOR TAX PURPOSES ACT

The Uniform Division of Income for Tax Purposes Act (UDITPA) is a model law relating to allocation and apportionment of income among states for corporations with multi-state operations.

Many states have adopted UDITPA by joining the Multistate Tax Commission, (A United States Intergovernmental state tax agency) (MTC) while others have modeled their laws after UDITPA provisions. Under the MTC's model statute, both economic and physical presence determine nexus.

The level of activity is quantified in order to provide a threshold for what constitutes economic nexus. If threshold amounts are exceeded during the tax period, then nexus is triggered:

- $50,000 of property
- $50,000 of payroll
- $500,000 of sales
- 25% of total property, total payroll, or total sales

Only seven states now indicate that they apply a Quill test of substantial nexus with a physical presence requirement that must be more than de minimis. However, only six states indicate that they have adopted the model statute. This leaves a lot of uncertainty as to what standard does apply. (*Bloomberg BNA's 16th annual Survey of State Tax Departments*)

MTC STATEMENT OF INFORMATION CONCERNING PRACTICES UNDER P.L. 86-272 (1986–2001)

The MTC, as might be expected, has ideas about how far *Wrigley* goes in protecting activities. The statement of information expands on Wrigley issues and solicitation activities, adding to and clarifying prohibited and allowed activities:

- Allows sales representatives to be reimbursed for their home offices
- Allows sales representatives to have computers and autos
- Mere registration and qualification "to do business" does not create nexus (however, not the same as Secretary of State registrations)

[16] Ibid

A practical issue is that while the MTC may have ruled "merely" registering does not trigger nexus, it does put the business on the state's radar and the state may decide other activities beyond the mere registration demand the payment of income taxes.

WHERE DO WE STAND NOW?

Based on *Wrigley*, a business will not be subject to net income tax when its activities within a state are either ancillary to requesting orders of tangible property or are de minimis:

- The states that had adopted a narrow definition of solicitation will be required to adjust their nexus standards.
- Review the activities within those states to determine if tax refunds are due or additional filings exist.
- Economic presence standards must now be considered (see Section VII).

CLASS EXERCISE #1

McClary Machine makes and sells a variety of high-quality, low-cost brass candleholders. It has no manufacturing or distribution operations in State "A;" rather, its sales staff forwards orders from that state to the company's main office.

The sales staff consists of 18 full-time representatives, who generate substantial sales for the company and who act as liaisons to the company's in-state customers. These representatives are given company-leased automobiles for their business use, as well as a small supply of promotional materials and sample items.

Besides soliciting orders, McClary's representatives inform their customers of promotional opportunities, replace any defective merchandise, and review displays, and shelving arrangements of the company's products.

Based on these facts and on State "A's" imposition of its corporate taxing system, answer the following questions:

- Should McClary's activities be protected from taxation under the limitations imposed by P.L. 86-272?
- If State "A's" tax is a business privilege tax, not based on net income, should P.L. 86-272 apply?
- Does the tax meet the standard of the federal Due Process Clause? (minimum connection)
- Does the tax meet the standard of the federal Commerce Clause? (substantial nexus)

INDEPENDENT CONTRACTORS: A SPECIAL NOTE

P.L. 86-272 extends immunity to certain in-state activities conducted by independent contractors that would not be permitted if performed directly by the business through its employees or manufacturer's representatives. P.L. 86-272 accepts certain activities of independent contractors.

Typically, an independent contractor may engage in limited activities on behalf of a corporation without creating nexus for the business, such as

- soliciting sales,
- making sales (accepts on behalf of), and
- maintaining a sales office (in public).

The maintenance of inventory by an independent contractor will result in loss of immunity, whether on a consignment basis or other type of arrangement.

For purposes of applying independent contractor provisions, a sales or manufacturer's representative who exclusively works for one corporation is not considered to be an independent contractor. For the special rules to apply, the contractor must: hold himself out to the public as soliciting orders for more than one principal; and actually solicit orders for more than one business.

Companies with common ownership, whether or not they are members of a unitary business/consolidated group, will not count as different businesses.

IMPACT OF MTC NEXUS BULLETIN 95-1

MTC Nexus Bulletin 95-1 advises computer companies and other interstate businesses that providing third-party in-state repairs creates an obligation to: collect and remit sales and use taxes; and file corporate income tax returns.

The bulletin describes the circumstances under which the provision of in-state repair services creates nexus.

> The industry practice of providing in-state warranty repair services through third-party repair service providers creates constitutional nexus for imposition of use tax collection responsibility for all sales made to customers in that state and for income, franchise or comparable tax liability (including, but not limited to, a gross receipts excise tax) in the taxing state where the warranty services are performed. The repair services performed in the taxing state by the third-party representative do not constitute de minimis activities in the taxing state.

Nexus standards for the imposition of income taxes are not necessarily the same as the standards for imposition of sales taxes, or at least they were in the pre-*Wayfair* world.

Based on legislative history of P.L. 86-272, it does not seem that congressional intent favored that nexus be created for purposes of income taxes whenever a company hires a truly independent agent to repair its products under warranty. But, again, Congress claimed they planned to resolve these issues after passing PL 86-272 over 60 years ago as a "temporary" measure and courts have become more apt to allow states wide leeway on these issues.

INTANGIBLE ASSETS—THE GEOFFREY CASE

In a decision that surprised many tax advisors, the U.S. Supreme Court decided not to hear an appeal (that is, declined certiorari) on the issue of physical versus economic presence from the South Carolina Supreme Court. The case predated by decades the *Wayfair* decision and allowed the presence of intangible assets used by a related customer in the state to create nexus.

Geoffrey was the giraffe that was associated with the Toys "R" Us retail chain. The chain established a subsidiary, *Geoffrey, Inc.*, to license the use of that image to stores throughout the country, which had the claimed effect of offsetting in state income with an expense that went to an out of state entity with no physical assets in the state.

But the South Carolina Supreme Court found in *Geoffrey v. South Carolina* (1993) that there existed an economic nexus, giving South Carolina a right to tax the corporation on its income from South Carolina licenses. Following *Geoffrey* most states have adopted a *Geoffrey* statute to tax such intangible income.

Geoffrey v. South Carolina (1993) and *Lanco, Inc. v. New Jersey* (2006) are key cases in the birth of economic presence nexus standard. Honestly, this may be the standard case of bad facts create bad law—these intangible companies pushed the envelope and, it turns out, the envelope burst, risking far more than just the income of the intangible company.

The cases involve intangible holding companies (IHCs) that received royalty income and created deductions by related entities. While the IHC in another state has no physical nexus in the state (and, the taxpayer argued, the state had no right to tax that income based on lack of such presence), the in-state related party takes the royalty deduction, reducing tax due to the state.

The courts in these cases ruled that the IHC is "doing business in the state," and that a physical presence is not required in net income tax cases—gaining an economic benefit from transactions in the state is enough to trigger the state's right to tax the income.

The states countered this strategy by taking various steps, including

- specifically disallowing intercompany royalty deductions,
- requiring a combined unitary filing, and
- asserting the IHC has sufficient net income tax nexus.

In a July 6, 1993, decision, the South Carolina Supreme Court—in the case of *Geoffrey, Inc.*—ruled that a taxpayer may be liable for South Carolina income taxes, even if it had no physical contacts within the state. The court concluded—with minimal analysis—that the U.S. Supreme Court's *Quill* decision does not apply in determining whether a state can impose its income tax on an out-of-state taxpayer. According to the court, "a taxpayer need not have a tangible, physical presence in a state for income to be taxable."

Geoffrey, Inc.,—incorporated, and domiciled in Delaware—is the owner of several trade names and trademarks, including Toys "R" Us and a mascot giraffe known to parents and children throughout the world as Geoffrey the Giraffe. The company licensed these trademarks and trade names, along with its merchandising skills, techniques, and know-how,

to Toys "R" Us stores located in South Carolina. While these stores paid a 1% licensing fee based on their net sales levels to Geoffrey, Inc., the Delaware company maintained no offices, employees, or physical presence in the state of South Carolina.

In considering whether the use of Geoffrey's intangible interests subjected the company to its income tax, the South Carolina court held the following: By licensing intangibles for use in this state and deriving income from their use here, *Geoffrey* has a substantial nexus with South Carolina. In other words, according to the court, *Geoffrey* has both the minimum connection and the substantial nexus with South Carolina that is required to satisfy the Due Process Clause and Commerce Clause of the U.S. Constitution.

By denying the petition for certiorari, many tax experts believe the Supreme Court ducked the issue and will eventually be called upon to resolve conflict between states and multi-state corporations.

In the wake of *Geoffrey*, the Florida DOR proposed a revised corporate nexus rule that includes the provision that the sale or licensing of the use of intangible property in that state automatically established nexus with the state for tax purposes. As for Geoffrey, Inc., itself, it immediately received a nexus questionnaire from the MTC's National Nexus Program to determine in what other states it may be subject to taxation: "We understand that your company is doing business or deriving income within the jurisdiction of various states, many of which impose income tax nexus based on minimal activities."

The impact of this rule is severe enough on companies that own intangible property, whether it is franchising a trade name or it is licensing software and/or copyrighted materials in a state.

But the economic nexus concept triggered by *Geoffrey* has gone on to have impact for companies not engaged in franchise or copyright operations. For example, in recent years, a number of states—such as Indiana, Minnesota, Tennessee, and West Virginia—have imposed their state income taxes on financial services institutions, even though these companies maintain no in-state presence other than joint operating agreements for ATMs or credit card collections. While the validity of these taxing schemes is also being challenged, the Geoffrey decision does lend some credibility to those states' efforts at taxing this income.

Economic Nexus for Income Taxes and *Wayfair*

In the Pennsylvania Corporation Tax Bulletin 2019-04,[17] the state of Pennsylvania treats any corporation with $500,000 of sales into the state as having nexus with the state. The state bases this revised view of nexus on the Supreme Court's rejection of a physical presence requirement for sales tax nexus in the *Wayfair* case.[18]

The Department provides the following analysis for why it has concluded physical presence should also no longer be a requirement for income tax nexus:

> The Court went on to conclude "that the physical presence rule of *Quill* is unsound and incorrect."

[17] Corporation Tax Bulletin 2019-04, Pennsylvania Department of Revenue, September 30, 2019, https://www.revenue.pa.gov/GeneralTaxInformation/TaxLawPoliciesBulletinsNotices/TaxBulletins/CT/Documents/ct_bulletin_2019-04.pdf, retrieved October 2, 2019.

[18] *Wayfair v. South Dakota*, 138 S. Ct. 2080, (2018)

> As a result, the Commerce Clause analysis set forth in *Complete Auto Transit* remains valid, but the physical presence rule, which was previously held in *Quill* to be a necessary part of the substantial nexus prong is incorrect. While taxpayers contested for years whether the physical presence nexus standard in *Quill* was limited to sales taxes or also applied to corporate net income taxes, the decision in "*Wayfair* has made certain that, at least prospectively, no physical presence standard exists for purposes of limiting the ability of a state to impose a net income tax on an out of state taxpayer so long as the constitutional requirements under the Due Process and Commerce Clauses of the United States Constitution are satisfied".[19]

The bulletin notes that under Article IV of the Tax Reform Code (TRC), 72 P.S. §§7401, a corporation is subject for the following actions, which the bulletin concludes have taken place when a corporation exceeds the $500,000 sales trigger:

- Doing business in the Commonwealth of Pennsylvania
- Carrying on business in the Commonwealth of Pennsylvania[20]

The ruling provides:

> For Pennsylvania Corporate Net Income Tax purposes the decision in *Wayfair* has confirmed that out of state corporations are considered to be doing business in this Commonwealth and/or carrying on activities in this Commonwealth to the extent they are taking advantage of the economic marketplace of the Commonwealth regardless of whether they are physically present in Pennsylvania.[21]

The state notes its reasoning for setting the level at which economic nexus is triggered at $500,000.

> While the Court in *Wayfair* did not express a bright line threshold of economic activity which would satisfy the nexus requirements existing under the Due Process and Commerce Clauses, it did approve the approach of South Dakota whereby an out of state taxpayer was subjected to a sales tax collection requirement where it had in excess of either 200 sales or $100,000 worth of sales of goods or services to South Dakota customers during the course of a tax year. While all taxpayers with nexus under the Constitution of the United States should file a Corporate Tax Report with Pennsylvania, the Department will deem there to be a rebuttable presumption that corporations without physical presence in the state, but having $500,000 or more of direct or indirect gross receipts from any combination of the following, sourced to Pennsylvania per year pursuant to the sales factor rules contained in 72 P.S. § 7401, have a filing requirement with the Commonwealth for purposes of the Corporate Net Income Tax:
>
> > (1) Gross receipts from the sale, rental, lease, or licensing of tangible personal property;

[19] Corporation Tax Bulletin 2019-04, p. 2
[20] Corporation Tax Bulletin 2019-04, p. 2
[21] Corporation Tax Bulletin 2019-04, p. 2

> (2) Gross receipts from the sale of services; and/or,
>
> (3) Gross receipts from the sale or licensing of intangibles, including franchise agreements.[22]

Since Congress did impose a set of conditions under which a state cannot impose a state income tax in Public Law 86-272, the state does address that issue in the bulletin. The bulletin provides:

> In interpreting this standard the Department recognizes that taxpayers with or without physical presence in the Commonwealth can still potentially claim exemption from the imposition of the Corporate Net Income Tax under the provisions of P.L. 86-272. To the extent protection under this federal law is claimed, taxpayers should continue to file a Pennsylvania Corporate Tax Report (Form RCT-101) and complete the necessary schedules to claim this exemption from tax.[23]

The bulletin concludes by noting it will apply the revised nexus standard to taxpayers for tax years beginning on or after January 1, 2020.[24]

Economic Nexus for Automobile Financing Operations

While the *Wayfair* decision involved sales tax issues, the fact that the Supreme Court found that there was no need for physical presence for a business to be required to collect sales taxes suggested it was unlikely that such a test would apply for other types of taxes. Shortly after the *Wayfair* decision was announced, Wells Fargo announced it was recording an additional $481 million in state income taxes on its financial statements.[25]

Now the Oregon Supreme Court has ruled that the state's corporate income tax does not require the physical presence of the corporation in the case of *Capital One Auto Finance, Inc. v. Department of Revenue*, Docket No. SC S064803.

The Court noted that the entities in this case did not have an office in Oregon, nor did it have any employees in the state.

> The banks did not have any property, offices, or employees in Oregon, and they did not apply to the Secretary of State under ORS 60.707 for authority to do business here. The parties have stipulated that the banks' "activities in [offering credit card products, consumer loans, accepting deposit products, and engaging in consumer and small-business lending] were all from [their] offices outside of Oregon."

However, they did have revenue that had its source in the state of Oregon.

> The banks did, however, make substantial amounts of money from customers in Oregon. The banks provided "consumer finance products" — credit cards, consumer loans, and similar products — to Oregonians; communicated with

[22] Corporation Tax Bulletin 2019-04, pp. 2-3

[23] Corporation Tax Bulletin 2019-04, p. 3

[24] Corporation Tax Bulletin 2019-04, p. 3

[25] "Wells Fargo's $481 Million Tax Surprise", Wall Street Journal, Online Edition, July 13, 2018, https://www.wsj.com/articles/wells-fargos-481-million-tax-surprise-1531499680

> Oregonians; and collected fees from Oregonians. In 2007 and 2008, the banks sent 24 million solicitations to Oregonians. The banks had 536,000 Oregon customers in 2007, and 495,000 customers in 2008. During those same years, the banks charged Oregonians nearly $150 million in fees each year, including finance charges, late fees, and over-limit fees.

The taxpayer concluded that there was no Oregon tax liability since they had no physical presence in the state.

> Because the banks had no physical presence in Oregon, taxpayer concluded that the banks were not subject to Oregon tax. Accordingly, taxpayer did not use income earned by the banks from Oregonians in the formula to calculate the fraction of its income that could be taxed by Oregon.

The Oregon Department of Revenue did not agree with that position, taking the position that the corporations owed Oregon income tax.[26]

The opinion notes that at the trial court, the

> … taxpayer contended that both the corporate income tax and the corporate excise tax applied only to taxpayers that had a physical presence in the State of Oregon. The corporate excise tax applies only when a taxpayer is "doing business * * * within this state," ORS 317.070, and taxpayer asserted that that phrase required a taxpayer to be physically conducting business activities in Oregon. As to the corporate income tax, taxpayer contended that the banks did not have any "income derived from sources within this state." ORS 318.020(1). That argument, too, was based on the banks not having any property or physically conducting any activities within this state.

The Supreme Court looked at Oregon's statute, found at ORS 318.020(1), for income that is subject to Oregon's income tax.

> (1) There hereby is imposed upon every corporation for each taxable year a tax at the rate provided in ORS 317.061 upon its Oregon taxable income derived from sources within this state, other than income for which the corporation is subject to the tax imposed by ORS chapter 317 according to or measured by its Oregon taxable income.

The taxpayer did not argue that it had no items of income, nor that such income was not from Oregon residents. But the taxpayer argues the examples provided by the legislature in ORS 318.020(2) all involve taxpayers with a physical presence in the state, thus indicating that such a presence is required.

> The legislature provided a list of three examples of what constitutes "income from sources within this state" in ORS 318.020(2): income from property located here, income from property with a situs here, and income from activities here. Taxpayer correctly recognizes that the examples in ORS 318.020(2) are not exclusive,

[26] Note the case will refer both to the Oregon income tax and the Oregon excise tax. The opinion gives the history and relationship between these two taxes (which arrive at the same tax), but the opinion notes that the two taxes should be construed together. For this reason, the article will simply refer to the Oregon corporate income tax.

> because of the connotation of the term "includes," and asserts that our understanding of "income derived from sources within this state" should be informed by what it considers the "common characteristic" of all the examples. Specifically, taxpayer contends that "each [example] involves income derived from the taxpayer's physical presence in the state." (Emphasis in original.) Thus, taxpayer asserts, we should conclude that "income derived from sources within this state" requires a taxpayer to have a physical presence in Oregon.

The Court agrees with the idea that the examples presented are context for understanding what was meant by the phrase "income derived from sources within the state." But the agreement stops there.

> However, we do not find in the examples set out in ORS 318.020(2) the common characteristic that taxpayer asserts. What is common to all the examples — "income from tangible or intangible property located or having a situs in this state and income from any activities carried on in this state" — is that the source of the income — the property or the activities — are in this state. The examples imply only the taxpayer's existence as recipient of the income, and they say nothing about where the taxpayer must be located. The common characteristic that we find thus accords with the ordinary meaning of the text: there must be income from "sources within this state," and the taxpayer must receive that income. Nothing about the statutory text or context suggests that the taxpayer must also have some physical presence here.
>
> …Accordingly, the Tax Court correctly concluded that taxpayer is subject to assessment for income earned by the banks from its Oregon customers.

States had been asserting that there was no need for physical presence to impose an income tax with increasing frequency even before the *Wayfair* decision, as federal courts indicated that Quill was a sales tax only case. But, as Wells Fargo's actions note, many now expect more states to start looking for tax from out of state businesses on their income even when the businesses have no physical presence in the state.

While PL 86-272 does provide some protection for out of state businesses from an income tax imposed by a state, that protection is very limited. In this case it wasn't relevant because the issue was not the sale of a product, but rather the services provided by the banks.

Growth of Economic Nexus Standards

Bloomberg Tax's 2019 Survey of State Tax Departments found that

- 33 states have some form of economic presence standard,
- 9 states are based on physical presence, and
- 14 states conform or partially conform to the model statute Factor Presence Nexus Standard.[27]

[27] *Bloomberg Tax 2019 Survey of State Tax Departments*, Bloomberg Tax, 2019, p. 10, https://data.bloomberglp.com/bna/sites/9/2019/05/TAX_REP_2019_Survey_State_Tax_Exec_Summary.pdf (retrieved May 18, 2020)

EXAMPLE—SOUTH CAROLINA REVENUE RULING #16-11: NEXUS-CREATING ACTIVITIES FOR INCOME TAXES

On July 27, 2016, the South Carolina DOR published its Revenue Ruling #16-11. It contains a checklist of over 100 examples of activities that could create nexus for income tax purposes. This ruling supersedes a 2003 ruling and is a good reflection of the evolution of nexus-creating activities not only in South Carolina but in the country as a whole.

The general trend is the move away from a physical presence test for nexus to an economic activities criterion.

Because South Carolina was one of the leaders in pursuing nexus from the licensing of intangibles (remember Geoffrey), this ruling reflects their continuing aggressive stance, pushing hard against the traditional interpretations of due process.

The ruling groups the various activities as follows:

- General Activities
- Registration with State Agencies/Departments
- Ownership/Leasing of In-State Property
- Ownership Interest of In-State Pass-Through Entities
- Licensing Intangibles
- Employee Activities – Sales Related
- Employee Activities – Non-Sales Related
- Activities of Unrelated Parties
- Distribution and Delivery
- Financial Activities/Transactions
- Transactions with South Carolina Printers
- Cloud Computing or Software as a Service Transactions
- Internet-Based Activities

That assumes that each activity as described stands on its own for the purpose of determining nexus and that unless otherwise specifically stated in the activity text, the activities are assumed to not be de minimis.

The ruling explains how to use the responses in determining nexus.

> A "yes" response indicates the activity or relationship will, by itself, create nexus with South Carolina. A "no" response indicates the activity or relationship will not, by itself, create nexus with South Carolina. However, it is important to note that a combination of several different de minimis activities or relationships, even if each, by itself, does not create nexus, may create nexus with South Carolina.

The entire text of the ruling is included in the next pages. The reason for including the ruling is that although technically it only applies to clients who have contact with South Carolina, the ruling is based on case law from the across the United States and can be used as an indication of potential nexus for any state.

EXAMPLE

STATE OF SOUTH CAROLINA
DEPARTMENT OF REVENUE
300A Outlet Pointe Blvd., Columbia, South Carolina 29210
P.O. Box 12265, Columbia, South Carolina 29211

SC REVENUE RULING #16-11

SUBJECT:	Nexus Creating Activities for Income Taxes (Income Tax)
EFFECTIVE DATE:	Applies to all periods open under the statute, unless otherwise stated in the Introduction.
SUPERSEDES:	SC Revenue Ruling #03-4 and all previous advisory opinions and any oral directives in conflict herewith.
AUTHORITY:	S. C. Code Ann. Section 12-4-320 (2014) S. C. Code Ann. Section 1-23-10(4) (2005) SC Revenue Procedure #09-3
SCOPE:	The purpose of a Revenue Ruling is to provide guidance to the public. It is an advisory opinion issued to apply principles of tax law to a set of facts or a general category of taxpayers. It is the Department's position until superseded or modified by a change in statute, regulation, court decision, or another Department advisory opinion.

Introduction:

Nexus is the minimum connection or contact between a taxpayer and a state sufficient to subject the taxpayer to the taxing jurisdiction of a state. The Due Process and Commerce Clauses of the United States Constitution, 15 U.S.C. §381 (Public Law 86-272) and other federal statutes provide limitations on a state's powers to tax out-of-state businesses.

Over the years, courts have provided limitations and guidelines in determining whether certain activities create nexus with a taxing state. For example, see *Quill Corp. v. North Dakota* 504 U.S. 298 (1992), *Wisconsin Department of Revenue v. William Wrigley, Jr., Co.,* 505 U.S. 214 (1992), *Burger King Corp. v. Rudzewicz*, 471 U.S. 462 (1985), *Helicopteros Nacionales de Columbia, S.A. v. Hall*, 466 U.S. 408 (1984), *Complete Auto Transit, Inc. v. Brady,* 430 U.S. 274 (1977), and *Geoffrey, Inc. v. South Carolina Tax Commission,* 313 S.C. 15, 437 S.E.2d 13 (1993) cert. denied 510 U.S. 992 (1993).

The purpose of this advisory opinion is to update written guidance from the Department concerning nexus creating activities for income tax purposes. For additional information in determining whether Public Law 86-272 protects certain activities from South Carolina taxation see SC Revenue Ruling #97-15.

This document reflects the Department's official position regarding income tax nexus at the time of its issuance. Since developments in this area are constantly taking place, any response is subject to change due to a future statute, regulation, court decision, or advisory opinion.

Any change in South Carolina's position as set forth in this document that is not the result of a court case or change in statute or regulation will be prospective. Any change resulting from a court case will apply to all periods open under the statute unless the court states otherwise, and any change resulting from a change in statute or regulation will be applicable as of the effective date established by the General Assembly.

This document covers the following categories:

A. General Activities
B. Registration with State Agencies/Departments
C. Ownership/Leasing of In-State Property
D. Ownership Interest of In-State Pass-Through Entities
E. Licensing Intangibles
F. Employee Activities – Sales Related
G. Employee Activities – Non-Sales Related
H. Activities of Unrelated Parties
I. Distribution and Delivery
J. Financial Activities/Transactions
K. Transactions with South Carolina Printers
L. Cloud Computing or Software as a Service (SaaS) Transactions
M. Internet-Based Activities

Questions concerning the existence of nexus with South Carolina should be directed to the Department's Nexus/Discovery Section at 803-898-5235 or 803-898-5695.

Qualifications to Responses:

Each response is based upon the specific facts described in the question and the following assumptions:

- Each specific question by itself was the only possible nexus creating activity or relationship a business has in South Carolina[1]; and,

[1]Even though some questions specifically state that the activity represents the business's "sole activity" in South Carolina, all other questions also represent the business's sole activity in South Carolina, whether or not such is specifically stated.

- The activities described are not "*de minimis*" unless the question or answer specifically states otherwise.

A "yes" response indicates the activity or relationship will, by itself, create nexus with South Carolina. A "no" response indicates the activity or relationship will not, by itself, create nexus with South Carolina. However, it is important to note that a combination of several different *de minimus* activities or relationships, even if each, by itself, does not create nexus, may create nexus with South Carolina.

Caution: Since a thorough review of the facts and circumstances of each taxpayer's situation is required in order to make a nexus determination, any variance from the facts stated in a question, any additional facts not stated in a question, or additional facts not considered in answering the questions below may change the answer set forth in this document.

Each response refers only to income tax nexus. Activities that create nexus for income tax purposes differ somewhat from those that create nexus for other tax purposes. Further, the Department did not address the imposition of any license fee, registration or filing requirements, withholding responsibilities, or the consequences of unity and foreign commerce.

References used in preparation of this document include:

1. *Wisconsin Department of Revenue v. William Wrigley, Jr., Co.*, 505 U.S. 214 (1992);

2. SC Revenue Ruling #97-15, an advisory opinion providing guidance for determining whether Public Law 86-272 protects certain activities from South Carolina taxation;

3. SC Revenue Ruling #08-1, an advisory opinion providing examples that show activities or relationships that will not, by themselves, create income tax nexus with South Carolina;

4. SC Private Letter Ruling #94-8, an advisory opinion concluding that a company's leveraged leases of five aircraft to commercial airlines were *de minimis* when it had three landings in South Carolina and 58,722 landings everywhere for the tax year. Therefore, the company did not have nexus in South Carolina;

5. SC Private Letter Ruling #95-2, an advisory opinion addressing the appropriate sourcing of nonresident limited partners' income in a limited partnership organized under Delaware law for the purpose of pooling resources in order to maximize investments in stocks, securities, and other intangible assets (including limited partnerships) for its own account. Based upon the facts, the nonresident partnership was not considered to carry on a business in South Carolina since its income was solely from its purchase and sale of property for its own account.[2] As a result, the income generated by the partnership was not considered South Carolina source income to its nonresident limited partners. Note, the advisory opinion did not address the taxation of the general partner, an S corporation, authorized to do business in South Carolina and maintaining an office in South Carolina;

[2] See SC Code Section 12-6-1720(1)(c).

6. SC Commission Decision #92-58, a decision distinguishable from SC Private Letter Ruling #95-2, wherein it was determined that an S corporation incorporated under South Carolina law for the sole purpose of investing in stocks, bonds, real estate, and partnerships was not merely an investment vehicle deriving income solely by reason of the purchase and sale of property for its own account. The S corporation was a business with significant fee income from financial advising, deal making, and financial contracts. As such, the gains from the disposition of intangible assets and the interest income were derived from property connected with the S corporation's business and were apportionable, and the dividend income was allocated to the shareholders' domicile outside of South Carolina; and

7. Specific South Carolina income tax laws cited in the notes, *e.g.,* SC Code Sections 12-6-555 (persons contracting with a commercial printer) and 12-6-4920 (interstate motor carriers required to file).

A. General Activities

	YES	NO
1. The out-of-state corporation is doing business in South Carolina.	☑	☐
2. The out-of-state corporation makes sales to customers in South Carolina by means of an 800 telephone order number and advertises in South Carolina.	☐	☑
3. The out-of-state corporation is listed in the local telephone books of cities in South Carolina. The phone is not answered in South Carolina.	☐	☑
4. The out-of-state corporation uses local phone numbers in South Carolina, which are forwarded to the corporation's headquarters located in another state.	☐	☑
5. The out-of-state corporation maintains a bank account at a bank located in South Carolina.	☐	☑
6. The out-of-state corporation provides consulting services in South Carolina during the year. The services are not *de minimis*.	☑	☐
7. The out-of-state corporation, through a third party, provides warranty services on goods sold in South Carolina. Note: If not *de minimis* and if the services are conducted on behalf of the out-of-state corporation Generally, services will be considered to be conducted on behalf of the out-of-state company if that company contracts for or controls the services.	☑	☐
8. The out-of-state corporation sends catalogs to residents in South Carolina.	☐	☑
9. Does South Carolina have a *de minimis* standard? Note: South Carolina has a *de minimis* standard and follows the principles defined by case law. See *Wisconsin Department of Revenue v. William Wrigley, Jr., Co*., 505 U.S. 214 (1992), SC Revenue Ruling #97-15, SC Private Letter Ruling #94-8, and SC Code Section 12-6-4920.	☑	☐
10. Does South Carolina conform to the Multistate Tax Commission's Nexus Bulletin 95-1 "Computer Company's Provision of In-State Repair Services Creates Nexus?" Note: South Carolina has not adopted MTC's Nexus Bulletin, but South Carolina generally considers services conducted by a third party to be on behalf of the out-of-state company if that company contracts for or controls the services.	☐	☐

B. Registration with State Agencies/Departments

	YES	NO
1. The out-of-state corporation is registered, authorized, certified or qualified by the Secretary of State, or other similar agency, to transact business in South Carolina as a foreign corporation.	☐	☑
2. The out-of-state corporation holds a general business license issued by South Carolina.	☐	☑
3. The out-of-state corporation holds a specialty license issued by South Carolina.	☐	☑
4. The out-of-state corporation is registered with South Carolina as a government vendor or contractor.	☐	☑

C. Ownership/Leasing of Property in South Carolina

	YES	NO
1. The out-of-state corporation owns raw land.	☑	☐
2. The out-of-state corporation stores inventory or other goods in a public warehouse for fewer than 30 days per year. Note: Except for independent contractors under Public Law 86-272 and persons storing material in connection with a printing contract under SC Code Section 12-6-555.	☑	☐
3. The out-of-state corporation ships in-process inventory to an unrelated party in South Carolina solely for processing. Note: Except for processing in connection with a printing contract under SC Code Section 12-6-555.	☑	☐
4. The out-of-state corporation consigns goods to vendors, independent contractors, or other parties. Note: Except for independent contractors under Public Law 86-272.	☑	☐
5. The out-of-state corporation owns display racks. Note: Furnishing and setting up display racks and advising customers on the display of the company's products without charge or other consideration is a protected activity under SC Revenue Ruling #97-15. The answer assumes that the corporation does not sell or lease the racks and the racks do not operate to prepare the product for use or as vending machines.	☑	☐

	YES	NO
6. The out-of-state corporation owns tooling, molds, dies, etc., located at a manufacturing facility in South Carolina.	☑	☐
7. The out-of-state corporation leases (as lessor) real estate in South Carolina to an unrelated third party.	☑	☐
8. The out-of-state corporation leases (as lessor) rented mobile property such as rail cars, planes, and trailers, which the lessee may use in South Carolina. The use is not *de minimis*. Note: See SC Private Letter Ruling #94-8 where it was concluded that the leasing of airplanes landing in SC three times per year was *de minimis*.	☑	☐
9. The out-of-state corporation owns or leases automobiles provided to salespersons.	☐	☑
10. The out-of-state corporation owns or leases trucks or automobiles used by non-salespersons.	☑	☐
11. The out-of-state corporation owns or leases other machinery or equipment.	☑	☐
12. The out-of-state corporation holds title to property located in South Carolina until the contract price has been paid. Note: Assuming ownership has not passed and that holding title does not serve merely as a security interest.	☑	☐
13. The out-of-state corporation files a security interest on inventory sold until the contract price has been paid.	☐	☑
14. The out-of-state corporation owns or leases a place for company employees, directors, and officers. Note: Assuming ownership or long term rental of real property in South Carolina.	☑	☐

D. Ownership Interest of In-State Pass-Through Entities

	YES	NO
1. The out-of-state corporation owns an interest in an investment partnership or LLC taxed as a partnership that has operations in South Carolina. Note: Although the income may not be taxed in SC. See SC Commission Decision #92-58 and SC Private Letter Ruling #95-2.	☑	☐
2. The out-of-state corporation owns a general interest in a partnership that is doing business in South Carolina.	☑	☐

	YES	NO
3. The out-of-state corporation owns a limited interest in a partnership that is doing business in South Carolina.	☑	☐
4. The out-of-state corporation owns an interest in an LLC that is doing business in South Carolina and is involved in managing the LLC. Note: Assuming the LLC is taxed as a partnership or S Corporation.	☑	☐
5. The out-of-state corporation owns an interest in an LLC that is doing business in South Carolina, but is not the managing member or otherwise involved in managing the LLC. Note: Assuming the LLC is taxed as a partnership or S Corporation.	☑	☐
6. The out-of-state corporation owns an interest in an entity located in South Carolina that is disregarded for federal income tax purposes. Note: Assuming the entity is doing business or owns property in South Carolina.	☑	☐
7. The out-of-state corporation has an ownership interest or a beneficial interest in a flow-through entity, directly or indirectly through one or more other flow-through entities, that has substantial nexus in South Carolina.	☑	☐

E. Licensing Intangibles[3]

	YES	NO
1. The out-of-state corporation licenses trademarks or trade names to related entities with locations in South Carolina.	☑	☐
2. The out-of-state corporation licenses trademarks or trade names to unrelated entities with locations in South Carolina.	☑	☐
3. The out-of-state corporation sells/licenses franchises (such as fast-food franchises) to residents of South Carolina. Note: Assuming this does not mean the sale of an entire business, e.g., not an outright sale of a restaurant and not a sale of all of franchisor's interest in the franchise.	☑	☐
4. The out-of-state corporation licenses canned software to consumers in South Carolina.	☑	☐
5. The out-of-state corporation sells/licenses the right to use a patent or copyright to related entities with locations in South Carolina.	☑	☐

[3] See *Geoffrey, Inc. v. South Carolina Tax Commission*, 437 S.E.2d 13 (S.C. 1993).

	YES	NO
6. The out-of-state corporation sells/licenses the right to use a patent or copyright to unrelated entities with locations in South Carolina.	☑	☐

F. Employee Activities – Sales Related

	YES	NO
1. Employees, while in South Carolina, accept and approve customer orders.	☑	☐
2. Employees, while in South Carolina, negotiate prices, subject to approval outside South Carolina.	☐	☑
3. Employees, while in South Carolina, investigate credit-worthiness of customers.	☑	☐
4. Employees, while in South Carolina, secure or accept deposits on sales.	☑	☐
5. Employees, while in South Carolina, handle credit disputes.	☑	☐
6. Employees, while in South Carolina, attend trade shows or maintain sample/display rooms for one to 14 days per year.	☐	☑
7. Employees, while in South Carolina, maintain a two-month supply of free samples.	☐	☑
8. Employees, while in South Carolina, check customers' inventories for reorder.	☐	☑
9. An employee, while in South Carolina, makes a single sale on his own initiative and without the company's prior knowledge. The sale is not *de minimis*.	☑	☐
10. Employees, while in South Carolina, solicit sales of services in South Carolina. The solicitation activity is not *de minimus*.	☑	☐
11. Employees, while in South Carolina, perform a sales-related function associated with services and are reimbursed for the costs of maintaining a home office.	☑	☐
12. Employees, while in South Carolina, operate mobile stores.	☑	☐

G. Employee Activities – Non-Sales Related

	YES	NO
1. Employees, while in South Carolina, collect delinquent accounts.	☑	☐

	YES	NO
2. Employees, while in South Carolina, repossess property.	☑	☐
3. Employees, while in South Carolina, regularly perform installation, repair, maintenance, or warranty services.	☑	☐
4. Employees, while in South Carolina, perform installation, repair, or warranty services one to four times per year. Note: Unless *de minimis*.	☑	☐
5. Employees, while in South Carolina, set up promotional display of products (e.g., end caps) and inspect inventory. Note: The setting up of promotional displays of products will not create nexus. The inspection of inventory for purposes other than reorder, such as quality control, will create nexus.	☐	☐
6. Employees, while in South Carolina, supervise or inspect installation.	☑	☐
7. Employees, while in South Carolina, conduct training courses, seminars, or lectures two times per year. Note: Unless sales training.	☑	☐
8. Employees, while in South Carolina, provide engineering or design functions related to customized products.	☑	☐
9. Employees, while in South Carolina, handle customer complaints. Note: Facilitating communications between the company and the customer when the purpose of such mediation is to ingratiate the sales personnel with the customer is a protected activity. See SC Revenue Ruling #97-15.	☑	☐
10. Employees, while in South Carolina, pick up defective merchandise.	☑	☐
11. Employees, while in South Carolina, pick up or replace damaged or returned property.	☑	☐
12. Employees, while in South Carolina, provide shipping information and coordinate deliveries.	☐	☑
13. Employees, while in South Carolina, telecommute from their homes located in South Carolina and perform non-solicitation activities.	☑	☐

	YES	NO
14. One employee telecommutes from his home located in South Carolina and performs back-office administrative business functions, such as payroll, as opposed to direct customer service or other activities directly related to the employer's commercial business activities.	☑	☐
15. One employee telecommutes from his home located in South Carolina and performs product development functions such as computer coding.	☑	☐
16. Employees, while in South Carolina, assist the out-of-state corporation in defending a lawsuit (e.g., legal staff and witnesses) while in South Carolina for one to 30 days. Note: See SC Revenue Ruling #08-1 where the Department concluded that the use of the South Carolina court system by an out-of-state company sending various employees to South Carolina to assist its independent legal counsel in defending a lawsuit does not give the out-of-state company nexus with South Carolina. The law firm providing counsel is taxable in South Carolina.	☐	☑
17. Employees fly into South Carolina on a commercial airline for business purposes.	☐	☑
18. Employees, while in South Carolina, purchase raw material and inventory while in South Carolina for 20 or fewer days.	☐	☑
19. Employees, while in South Carolina, attend seminars.	☐	☑
20. Employees, while in South Carolina, attend an annual training seminar, convention, trade show, retreat, or board of directors meeting for up to 14 consecutive days each year. During their stay, employees maintain contact with the out-of-state office, and conduct business over the telephone, computer, etc. in South Carolina.	☐	☑
21. Employees fly into South Carolina on a company plane to attend a seminar.	☐	☑
22. Employees fly into South Carolina on a company plane to attend sports events as spectators.	☐	☑
23. Employees, while in South Carolina, attend seminars or social functions while staying on a company yacht docked in waters in South Carolina for up to 14 days.	☐	☑
24. Employees, while in South Carolina, hold job fairs, hiring events, or other recruiting activities for the out-of-state office. Note: Unless in the recruiting business.	☐	☑
25. Employees, while in South Carolina, hire, supervise, or train other employees. Note: Unless sales training.	☑	☐

I. Activities of Unrelated Parties

	YES	NO
1. Unrelated third parties located in South Carolina provide fulfillment services (*i.e.,* fill product orders from inventory owned by the out-of-state corporation).	☑	☐
2. Unrelated third parties located in South Carolina collect regular or delinquent accounts. Note: If the unrelated third party is performing the activity for more than one company, the answer will depend on additional facts.	☑	☐
3. Unrelated third parties located in South Carolina investigate credit-worthiness of new customers. Note: If the unrelated third party is performing the activity for more than one company, the answer will depend on additional facts.	☑	☐
4. Unrelated third parties located in South Carolina repossess property. The parties Activities are not *de minimis*.	☑	☐
5. Unrelated third parties located in South Carolina repair or provide maintenance, including warranty services that are not *de minimis* and are conducted on behalf of the out-of-state company. Note: Generally, services will be considered to be conducted on behalf of the out-of-state company if that company contracts for or controls the services.	☑	☐
6. Unrelated third parties located in South Carolina assist with the "set-up" or installation of the company's products that are not *de minimis* and are conducted on behalf of the out-of-state company. Note: Generally, services will be considered to be conducted on behalf of the out-of-state company if that company contracts for or controls the services.	☑	☐
7. Unrelated third parties located in South Carolina perform repairs under standard or extended warranty that are not *de minimis* and are conducted on behalf of the out-of-state company. Note: Generally, services will be considered to be conducted on behalf of the out-of-state company if that company contracts for or controls the services.	☑	☐
8. Unrelated third parties located in South Carolina close mortgage loans for an out-of-state financial organization. Note: If the unrelated third party is performing the activity for more than one company, the answer will depend on additional facts.	☑	☐

	YES	NO
9. Unrelated third parties located in South Carolina service mortgage and/or consumer loans for an out-of-state financial organization. Note: If the unrelated third party is performing the activity for more than one company, the answer will depend on additional facts.	☑	☐

I. Distribution and Delivery

	YES	NO
1. The out-of-state corporation ships products into South Carolina in returnable containers. Note: Assuming the corporation asks for their return.	☑	☐
2. The out-of-state corporation delivers goods into South Carolina (from a point outside South Carolina) to customers in the corporation's owned or leased vehicles.	☐	☑
3. The out-of-state corporation picks up defective products or scrap materials in South Carolina in taxpayer-owned vehicles.	☑	☐
4. The out-of-state corporation picks up raw materials in South Carolina in taxpayer-owned vehicles. Note: Assuming the pickup is not a back haul (*i.e.,* the out-of-state corporation picks up shipments at the destination or nearby location in South Carolina for delivery to another point).	☐	☑
5. The out-of-state corporation travels through South Carolina in taxpayer-owned trucks, but does not pick up or deliver goods in South Carolina. Note: SC Code Section 12-6-4920 for the filing requirements for interstate motor carriers.	☐	☑
6. The out-of-state corporation "back hauls" shipments in corporate-owned trucks.	☑	☐
7. The out-of-state corporation holds title to electricity flowing through a transmission wire within South Carolina (the transmission neither originates nor terminates in South Carolina). Note: Assuming the corporation does not own or lease the transmission wire.	☐	☑
8. The out-of-state corporation holds title to natural gas flowing through a pipeline within South Carolina (the natural gas neither originates nor terminates in South Carolina). Note: Assuming the corporation does not own or lease the pipeline.	☐	☑

J. Financial Activities/Transactions

	YES	NO
1. The out-of-state corporation negotiates and obtains bank loans from a bank located in South Carolina. Officers of the corporation visit the bank at least twice a year to discuss business.	☐	☑
2. The out-of-state corporation makes loans secured by real estate located in South Carolina. Note: No response, depends on facts that are not provided.	☐	☐
3. The out-of-state corporation makes loans secured by tangible personal property in South Carolina. Note: No response, depends on facts that are not provided. SC Revenue Ruling #08-1 provides an example where a NC finance company does business in NC and TN. The company makes a personal loan to a NC resident who moves to SC the following year. The finance company does not have nexus with SC. The result would not change if the NC resident who moved to SC had his personal car secured by the NC loan. Further, the finance company does not have nexus with SC if the SC borrower contacts the NC finance company to renew the loan.	☐	☐
4. The out-of-state corporation issues credit cards to residents of South Carolina.	☑	☐
5. The out-of-state corporation purchases, via the secondary market, mortgage loans, secured by real estate located in South Carolina. Note: No response, depends on facts that are not provided. SC Revenue Ruling #08-1 provides an example where a NY finance company is in the business of packaging and selling credit card and mortgage loans to passive investors throughout the US. A few of the debtors and some of the property securing the loans are located in SC. The passive investors do not have nexus with SC. Note, however, if the purchaser "services" the loans in SC, there may be nexus depending on the facts and circumstances.	☐	☐
6. The out-of-state corporation is a passive investor who purchases, via the secondary market, credit account balances of residents of South Carolina. Note: No response, depends on facts that are not provided. SC Revenue Ruling #08-1 provides an example where a NY finance company is in the business of packaging and selling credit card and mortgage loans to passive investors throughout the US. A few of the debtors and some of the property securing the loans are located in SC. The passive investors do not have nexus with SC. Note, however, if the purchaser "services" the loans in SC, there may be nexus depending on the facts and circumstances.	☐	☐
7. The out-of-state corporation makes personal loans to residents of South Carolina who traveled across the state-border to obtain the loans. Note: No response, depends on facts that are not provided.	☐	☐
8. The out-of-state corporation makes personal loans to out-of-state residents who over a number of years subsequently move to South Carolina. Note: See SC Revenue Ruling #08-1 debt examples.	☐	☑

	YES	NO
9. The out-of-state corporation makes automobile loans to out-of-state residents who over a number of years subsequently move to South Carolina. Note: See SC Revenue Ruling #08-1 debt examples.	☐	☑
10. The out-of-state corporation is in the business of packaging and selling credit card and mortgage loans to passive investors throughout the United States. A few of the debtors and some of the property securing the loans are located in South Carolina. Note: See SC Revenue Ruling #08-1 debt examples.	☐	☑
11. The out-of-state corporation forecloses on one parcel of real estate located in South Carolina. Note: No response, depends on facts that are not provided.	☐	☐
12. The out-of-state corporation forecloses on several parcels of real estate located in South Carolina.	☑	☐

K. Transactions with South Carolina Printers[4]

	YES	NO
1. The out-of-state corporation leases tangible personal property located at a printer in South Carolina for use in connection with a printing contract. Once the work is complete, the printer ships the printed material out of South Carolina for addressing and mailing.	☐	☑
2. The out-of-state corporation owns raw materials at a South Carolina printer.	☐	☑
3. The out-of-state corporation visits South Carolina printers for quality control purposes one to six times per year.	☐	☑

L. Computer and Internet Based Transactions

	YES	NO
1. The out-of-state corporation provides access to its software to South Carolina customers and pays independent contractors to perform configuration/set-up services in South Carolina.	☑	☐
2. The out-of-state corporation provides access to its software to South Carolina customers and has employees solicit business in South Carolina.	☑	☐

[4]See SC Code Section 12-6-555.

	YES	NO
3. The out-of-state corporation provides access to its software to South Carolina customers and lacks a physical presence in South Carolina, but has a substantial number of customers with billing addresses in South Carolina.	☑	☐
4. The out-of-state corporation provides access to its software to South Carolina customers and lacks a physical presence in South Carolina, but earns a substantial amount of revenue from customers in South Carolina.	☑	☐
5. The out-of-state corporation owns an internet server located in South Carolina.	☑	☐

SOUTH CAROLINA DEPARTMENT OF REVENUE

s/Rick Reames III
Rick Reames III, Director

July 27, 2016
Columbia, South Carolina

Unit

6

Determining State-Taxable Income

LEARNING OBJECTIVES

When you have completed this unit, you will be able to accomplish the following.

- Discuss the differences in federal and various state laws for determination of taxable income.
- Apply an organized, step-by-step approach to determination of state-taxable income.
- Address special problems created by differences in federal and state income tax systems.

THE TAX BASE

The majority of states with corporate income tax begin the computation of state-taxable income with taxable income as reflected on form 1120, the federal corporate income tax return.

These states typically use taxable income

- from line 28—taxable income before net operating losses (NOL) and special deductions; or
- from line 30—taxable income.

States that adopt their own state-specified definitions of gross and taxable income typically borrow from federal income and deduction provisions.

CONFORMITY—ROLLING VS. STATIC

Adoption of the federal code is either: on a current or ongoing basis (*rolling conformity*) (e.g., Colorado, Michigan, and New York); or as of a specific reference date (*static or fixed-date conformity*) (e.g., Arizona, California, and Indiana). Generally, regardless of their conformity status, most state legislatures review conformity and new law issues annually.

For example, Section 199A provides generally a 20% of business income deduction to noncorporate taxpayers, and some states will provide this new deduction. See "Tax Reform Friday: I.R.C. 199A Roundup – Does Your State Offer a Deduction?" Lindsay Trasko, Salt Talk Blog, bna.com, November 23, 2018; https://www.bna.com/tax-reform-friday-b57982094109/. Effective in 2018, there is generally more entity level focus in IRS audits of partnerships, S corporations and LLCs, which will impact many multi-state businesses. See, e.g., Section 6221.

WHY IS THERE NOT ROLLING CONFORMITY EVERYWHERE?

There is little question that a rolling conformity system is the easiest to comply with—the taxpayer has to deal with the federal changes to do the federal return, and any changes necessary to comply with multiple state rules makes state tax compliance far more complex.

So why do so many states continue to use static conformity. First, some state courts have considered a complete tie-in to be an unconstitutional (under the applicable state constitution) delegation of powers by the state legislature to U.S. Congress.

As well, state legislatures want to review code changes before adopting them for state tax purposes due to budget concerns or simply choosing not to do so for policy reasons. With rolling conformity, action must be taken to break away from a federal change the legislature does not want to adopt—but with static conformity, simple inaction will block all federal changes made in a year.

Additional details will be provided later, but first, following is an overview of why computing a corporation's state income tax liability generally involves the following steps (on a state-by-state basis):

- Begin with Federal taxable income line 28 or 30 as per state rules. Add (or subtract) state adjustment and modification items, the result is the state tax base subject to apportionment.
- Remove all nonbusiness income applicable to the states to arrive at income to be apportioned and taxed.
- Multiply that amount by the state's apportionment percentage; this is the state's apportioned taxable income or loss.
- Add or subtract the income or loss, net of related expenses, which are specifically allocated to the state; this results in the state taxable income/loss.
- Multiply the state taxable income/loss by the state tax rate; this is the income tax liability before tax credits.
- Finally, subtract the state's tax credits from the gross income tax liability for the state to arrive at the net income tax liability for the state.

The trend has been less conforming by the states with federal tax provisions, with major moves that way in 2008 in response to states' budget crises. For instance, we saw

- decoupling from bonus depreciation; cancellation of debt income; and
- decoupling from other federal stimulus provisions of recently passed legislation (Economic Stimulus Act of 2008, American Recovery, and Reinvestment Act of 2009, Small Business Jobs Act of 2010, etc.).

We may see similar moves with states not wishing to adopt federal law changes following the COVID-19 driven CARES Act and its impact on state budgets. While Congress will likely think in terms of tax stimulus, states are looking at a major revenue shortfall and balanced budget requirements.

Also, some states have moved away from a net income tax and towards a gross receipts tax, which necessarily will differ from the federal income tax.

ALTERNATIVE MINIMUM TAX AND MINIMUM TAXES

Currently, approximately one-third of the states impose a corporate minimum tax, based in part on a corporation's taxable income attributable to the state:

- Most states impose a minimum dollar amount (typically $50 or $100, but it can be up to $600 in California) rather than a tax structure.
- Fewer than 10 states currently impose an alternative minimum tax system similar to former federal AMT: Alaska, California, Iowa, Maine, Minnesota, New York, and North Dakota.

COST RECOVERY SYSTEMS

As mentioned in Unit 1, the numerous tax acts that were passed in the past several decades substantially shorted the depreciable lives of fixed assets. Over the years, the vast majority of states have adopted the ACRS, MACRS, and ADS methods of computing depreciation deductions.

Generally, the revenue impact of the Section 179 deduction was not as significant to the states as MACRS. One big reason is that large companies that purchase lots of equipment are not able to take Section 179 expensing due to the applicability limitation. This amount is $1,050,000 in 2021. However, some states do not allow or limit the Section 179 deduction.

A few states that permit MACRS, and ADS do not allow the Section 179 deduction. Other states, like New Jersey, did not adopt the cost recovery method of depreciation, but do allow the Section 179 deduction.

Since many states required that Section 179 be elected on the federal return to use it on the state return, those preparing the federal return may find that even though it seems that the simplest thing to do is to use 100% bonus depreciation, the impact on state returns may continue to make the use of Section 179 expensing preferable on the federal return in many situations.

NET OPERATING LOSSES

The carryback (2 years) and carryforward (20 years) provisions for NOLs—under federal law—alleviates the inequity that can result from taxing the corporation on a strict annual basis. This was the rule prior to the 2017 Tax Cuts and Jobs Act. For NOLs arising in taxable years ending after December 31, 2017, the new general rule is losses carry forward indefinitely but cannot be carried back. In general, such losses are deductible to the extent of 80% of taxable income. This is the new general rule for corporations and individuals. For taxable years beginning after December 31, 2017, non-corporate business losses in excess of $250,000 or $500,000 in a joint return cannot offset current non-business income but rather must be considered net operating loss carryforward. Sec. 461(l).

But then Congress passed the CARES Act in 2020, retroactively allowing NOLs from 2018–2020 to be carried back for federal purposes for 5 years, getting rid of the 80% limit for carrybacks and carryover for those years, and retroactively delaying the excess business loss rule of §461(l) from entering the law until 2021.

While states have also generally adopted provisions for NOLs, they vary substantially, and the current law should be checked for each state in which returns will be filed.

The majority of the states have not adopted provisions that are in strict accordance with the federal rules, often permitting only a carryforward, or providing for shorter periods for NOLs.

A few states provide that an NOL deduction is allowed in the same manner as permitted under IRC Section 172, so long as the corporation files a separate state return for that year.

The starting point, once again, is the computation of federal taxable income, and whether the state uses line 28 (pre-NOL) or line 30 (post-NOL) of Form 1120.

Federal law permits taxpayers to forego the carryback period in favor of the carryforward of the NOL. Most of the states that permit the carryback of NOLs also permit the election to forego the carryback. A majority of these states will permit that election only if the taxpayer also made the election for federal tax purposes.

Although many states conform to the federal rule in terms of time periods, recent actions by the states have restricted the use of NOL deductions:

- Even prior to the change in federal law, five states limited the amount of carrybacks: Delaware, Idaho, New York, Utah, and West Virginia.

- Of states that allow a carryforward of losses, only Pennsylvania and New Hampshire limit carryforwards.

More problematic has been a trend toward state-specific NOL provisions.

In many cases, the amount of NOL available for carryover purposes is restricted to the amount of NOL determined after apportionment; and even if uses federal provisions, NOL—carried forward or back—is limited to NOL apportioned to that state.

Many states have their own version of IRC Section 381, permitting carryover of NOL in tax-free reorganization or in liquidation of a subsidiary. In a classic scenario, Z generates losses and merges into Y, and Z's NOL disappears for state tax purposes unless Z is the surviving entity.

- 30 states – Surviving company can carryover NOL of extinct company, so long as survivor doing business in state before merger
- Montana and New Jersey – NOL deduction is only allowed to company generating loss
- 10 states – NOL carryover is limited to merged company's state-apportioned NOL

DIVIDENDS RECEIVED DEDUCTION

To alleviate the effects of so-called double taxation, domestic corporations are allowed a federal income tax deduction for dividends received from certain other corporations. The majority of states permit a total or partial dividends received deduction (DRD). However, the provisions governing these deductions vary widely. On the federal level, the purpose of the DRD is to relieve the effects of multiple corporate taxation. Effective for taxable years beginning after December 31, 2017, in consideration of reduced corporate tax rates, the dividend-received deduction was reduced. This could have state tax implications.

The state situation is different because the corporation paying the dividend may not be subject to income tax (or it may be subject to tax on only a small fraction of its income) in the state taxing the corporation receiving the dividend.

The majority of states do permit a total or partial DRD. Other than that statement, there are very few generalizations because of the diverse treatment of dividend income. For some states, with line 30 of Form 1120 as the starting point, the corporation is automatically accorded the same DRD treatment for state and federal tax purposes. Other states have formulated their corporate net income tax statutes to conform to the concept of partial exclusion of dividend income.

Several states allow a general deduction for intercorporate dividends from domestic corporations. In addition, a partial deduction for dividends received from either domestic or foreign subsidiaries is available in other states:

- Connecticut, Kentucky, and Michigan – All intercorporate dividends are generally exempt from tax.
- Other states—such as Idaho and Rhode Island—provide a DRD or exclusion only for dividends that are received from a payor corporation that is subject to tax by that state.

A question that arises in computing a DRD for state tax purposes is whether subpart F income and foreign dividends qualify for a particular state's dividends deduction. During 1991, the Illinois Appellate Court held (in a case involving Kraft Foods Group, Inc.) that for years prior to the enactment of a specific provision allowing a subtraction modification for such income, Subpart F income is not considered to be a foreign dividend deductible under Illinois' DRD.

In another case involving Kraft Foods Group, Inc., the Iowa Supreme Court held that the state's corporate income tax treatment accorded dividends received from foreign subsidiaries neither violated equal protection guarantees nor unlawfully discriminated against interstate commerce. In general, Iowa defines corporate net income by reference to federal law. Because federal law does

not allow a deduction for dividends received from foreign subsidiaries, these dividends were included in a corporation's Iowa tax base. The taxpayer, a unitary business with operations in the United States and several foreign countries, had deducted its foreign subsidiary dividends on its Iowa income tax return, notwithstanding the contrary provisions of Iowa law.

According to the U.S. Supreme Court, the statute that allows corporations to take an income tax deduction for dividends received from domestic but not foreign subsidiaries unconstitutionally discriminates against foreign commerce in violation of the Foreign Commerce Clause of the U.S. Constitution. (*Kraft General Foods v. Iowa Dept. of Revenue*, Docket No. 90 1918, June 18, 1992)

> It was indisputable that the statute treats dividends received from foreign subsidiaries less favorably than those received from domestic subsidiaries by including the former, but not the latter, in taxable income.

The 2017 Tax Cuts and Jobs Act as it pertains to foreign operations and dividends from foreign entities is not only complex but dramatic and inclusive of new concepts. We note generally the provisions may entail new requirements of income inclusion, and in some cases a 100% dividend received deduction. The initial analysis by California of the various 2017 federal changes relative to the California tax law was over 450 pages – State of California, Summary of Federal Income Tax Changes 2017, https://www.ftb.ca.gov/law/legis/Federal-Tax-Changes/2017.pdf. A major aspect of its analysis relates to the impact of the 2017 Tax Act. For example, this analysis discusses the new Federal Code Section 245 that may exempt foreign source income by means of a 100% deduction for the foreign portion of dividends received from a 10% owned foreign corporation. The analysis concludes this provision doesn't apply for California purposes – Summary of Federal Income Tax Changes 2017, p. 370. In general, anticipate researching what may be an influx of analysis by state taxation commentators and state taxing authorities pertaining to foreign source income as impacted by the 2017 Tax Act.

STATE INCOME TAX PAYMENTS

A fundamental principle of federal taxation is that all income is taxable, unless there is a specific law that exempts it. Because deductions are created by law, the legislature can change the law at any time. For example, state, and local income taxes can be deducted in arriving at federal taxable income.

There is no economic benefit to state governments in having a deduction of SALT in calculating state taxable income. As a result, most states do not allow deductions for state taxes based on net income, whether imposed by: the taxing state itself (approximately nine states will allow a deduction); or other states (approximately 15 states will allow a deduction).

In addition, many states refuse to allow a deduction for franchise taxes paid to a sister state.

A few states allow corporations a deduction for federal income taxes. See Alabama, Iowa (50%), Missouri, and North Dakota—the tax deduction may be limited to the income attributable to that state.

Even in states in which there is no partial disallowance, the deduction is indirectly reduced as a result of the apportionment formula.

If federal taxable income is the starting point for computing state taxable income, and the deduction for state taxes paid is denied, then an add-back modification is required. State statutes

vary, but it is typically described as a net income tax or a tax measured by net income, which is broad enough to encompass most types of state income and franchise taxes. Several states have changed the definition to include gross receipts and capital stock taxes as well.

Taxpayers should not assume that a state's prohibition on the deduction for income taxes applies to privilege franchise taxes that are not based on or measured by income. Some states allow a deduction for a business and occupation tax even though they do not allow a deduction for states' income taxes. Most states indicate that the deduction for income-based taxes paid to local governments is treated in the same manner as are state taxes based on or measured by income.

LONG-TERM CAPITAL GAINS AND LOSSES

Under IRC Section 1221, the disposition of a capital asset generally results in gain or loss to the holder of the asset.

This gain or loss will be treated differently based on

- whether the owner was a corporation,
- how long the asset was held,
- the adjusted basis of the asset,
- whether depreciation expenses were taken, and
- whether recapture rules apply.

As a result, taxpayers classify the gain or loss as either: long-term (held more than 1 year); or short term.

The computation of net capital gains/losses for state taxation purposes generally follows federal tax rules. Some states indicate that they provide for preferential treatment of capital gains by providing, for example, a reduced tax rate or a current deduction of net capital losses against ordinary income (e.g., Arkansas, Indiana, Louisiana; Massachusetts, Missouri, North Carolina, Rhode Island, Tennessee, Texas; Utah, and West Virginia).

Most states, however, conform to federal treatment by disallowing or limiting a current deduction for net capital losses; that is, they cannot be used to offset ordinary income.

Virtually all of the states have adopted provisions providing a specified holding period for long-term capital gains, which follow the federal rules. More than half the states follow the federal periods for corporate carrybacks (three years) and corporate carryforwards (five years) of net capital losses. The federal rules for individual capital losses generally allow a modest current deduction, no carryback and indefinite carryforward. Sec. 1212.

Some states do not allow any net capital loss carrybacks or carryforwards, and thus, no tax benefit for capital losses (e.g., Arkansas, Massachusetts, Montana, and North Carolina). A few states (e.g., Connecticut, Hawaii, Maryland, and Nebraska) permit net capital loss carryforwards, but not carrybacks.

NONTAXABLE EXCHANGES

For federal tax purposes, certain exchanges of property result in a change in the form—but not in the substance—of the taxpayer's economic position. Because the new property received in the exchange is a continuation of the old investment, the gain is not permanently excluded, but merely deferred. The most popular form of exchange comes when property held for a productive use in a trade or business or for investment is exchanged solely for property "of a like-kind" under IRC Section 1031. Like-kind exchanges are more restricted following the 2017 Tax Cuts and Jobs Act but tax-free exchanges of non-dealer real estate are still possible.

Almost every state follows these federal rules for like-kind exchanges. A few states (e.g., South Carolina) impose additional restrictions. Delaware, Louisiana, and Mississippi require both properties in like-kind exchanges to be located in their state in order to apply the like-kind exchange rules.

PASSIVE ACTIVITIES

Prior to the Tax Reform Act of 1986, investors could deduct for purposes of federal taxes losses from passive activities against other non-passive income. In general, the passive activity loss regulations (IRC Section 469) required taxpayers to segregate the income or loss from different types of income, such as

- active (those that are regular, continuous, and substantial),
- passive (rentals, plus non-active/no material participation), and
- portfolio.

This limitation, like the at-risk rules, applies to closely held C corporations; that is, a corporation in which at any time during the last half of the taxable year more than 50% of the value of the outstanding stock is owned directly or indirectly by five or fewer individuals, and personal service corporations.

Almost all of the states limit passive losses. Most states have automatically adopted the federal rules because they use federal taxable income. Similarly, almost all of the states that limit passive losses impose the limitation on closely held C corporations. In Massachusetts and Minnesota all corporations are subject to the passive loss limitation.

For federal purposes, disallowed, or suspended losses or credits can be carried forward indefinitely. In general, states also allow suspended losses and credits to be carried forward. Naturally, the majority of the states do not have the same credit provisions as the federal rules.

CLASS EXERCISE #2

McClary Machine, Inc., is subject to tax in States A and B. The starting point in computing State A taxable income is federal taxable income. Modifications are then made to reflect, among other things

- the exempt status of interest on State A obligations,
- 100% DRD for dividends received from in-state corporations, and
- the disallowance of deduction for state income tax.

In addition to trade/business activities, McClary receives $300,000 of nonbusiness income from State B activities. State A does distinguish between business and nonbusiness income. McClary has determined that its State A apportionment percentage for the tax year is 75%.

EXAMPLE

McClary generated these income and deduction amounts this year:

Sales	$1,700,000
Interest on federal obligations	200,000
Interest on State B municipal obligations	50,000
Dividends received (from State A corps)	100,000
Nonbusiness income (State B)	300,000
Total income	$2,350,000
Expenses related to federal obligations	7,000
Expenses related to State B municipal obligations	3,000
State income tax expense	250,000
Depreciation allowed for federal tax (state depreciation—$500,000)	350,000
Other allowable deductions	900,000
Total expenses	$1,510,000

McClary's federal taxable income is computed as follows:

Sales	$1,700,000
Interest on federal obligations	200,000
Dividends received from domestic corps	100,000
Nonbusiness income	300,000
Total income	$2,300,000
Expenses related to federal obligations	7,000
State income tax expense	250,000
Depreciation	350,000
Other allowable deductions	900,000
Total deductions	$1,507,000
Taxable income before special deductions	$793,000
Less: Dividends received (80% × $100,000)	(80,000)
Federal taxable income	$713,000

Note: The dividends-received deduction varies with the level of stock ownership. It may be 100% if from a member of an affiliated group but otherwise is 80% or 70% prior to the 2017 Tax Cuts and Jobs Act, or 65% or 50% under the 2017 Tax Act. The example assumes a year prior to the 2017 Tax Act. Section 243.

How would you calculate McClary's State A taxable income?

State A tax computation:	
Starting point is federal taxable income	$713,000
State Adjustments:	
Nonbusiness income – State B	(300,000)
Federal interest income	(200,000)
Federal interest expense on federal obligations	7,000
Disallowed state income taxes	250,000

Additional dividend received deduction (100,000–80,000 in federal return)	(20,000)
Additional state depreciation	(150,000)
Municipal interest – State B	50,000
Municipal expense – State B	(3,000)
Total state apportionable income	347,000
Times apportionment factor	× 75%
State A taxable income	$260,250

Note:

State B tax filing potential:	
Specifically allocated nonbusiness income	$300,000
The remaining 25% of apportionment factor (assuming the exact formula as in State A and same state taxable income adjustments)	86,750
Overall potential state taxable incomes	$647,000

CAPITAL STOCK TAXES

Unlike corporate income taxes, which are levied on a business's state adjusted net income, capital stock (franchise) taxes are imposed on a business's net worth. Typically, the calculation starts with a company's net assets and is then subject to certain adjustment. Businesses pay a capital stock tax regardless of current or prior profitability. As of 2019, sixteen states levy capital stock taxes. Capital Stock taxes are most prevalent in the southeast, however, a few northeast and Midwest states impose the tax.

While the calculation methodologies vary from state to state, capital stock (franchise) taxes are usually levied as a percentage of a company's net assets apportioned to the state. Rates are typically fractions of a percent, and subject to minimums or caps in certain states. In some states, the capital stock tax functions similarly to an alternative minimum tax, and a company pays the higher of the two.

Many of the states imposing a capital stock tax have realized that taxing a company based on its net worth penalizes the accumulation of wealth, or capital. Consequently, many states have reduced or repealed them altogether.

NOTES

Unit

7

Apportionment and Allocation of Income

LEARNING OBJECTIVES

When you have completed this unit, you will be able to accomplish the following.

- Differentiate between income that is allocated (by situs or location) and income that is apportioned.
- Address different methods of apportionment and the reasons for them.
- Discuss the MTC's role in developing model legislation for uniform application of tax law from state to state.
- Understand UDITPA.
- Discuss why states are abandoning UDITPA.
- Apply "Three Unities" and other tests to apportionment of income.
- Identify combined reporting issues.

FORMULA AND PERCENTAGES

A corporation that conducts business activities in more than one state must determine the portion of its net income that is subject to tax by each state. Most states do not permit a corporation to assign part of its net income to another state unless the entity has established sufficient nexus with the other state.

Consequently, a corporation first must determine whether it is entitled to divide its net income among the various states in which it conducts activities. This may not be easy, because the laws that define the amount of activity necessary to create nexus vary. Some states prohibit a corporation from apportioning or allocating its income to another state unless it has an office or is otherwise deemed to do business in that state.

UDITPA was established to provide uniformity among the states with respect to the taxation of multi-state companies. Under UDITPA, a business is considered to be taxable in another state, when:

- the other state has jurisdiction (generally under standards of P.L. 86-272) to impose a net income tax on the corporation, whether or not it actually does so; or
- the corporation is subject to the other state's net income tax, franchise tax measured by net income, franchise tax for the privilege of doing business, or corporate stock tax.

Apportionment is a means by which a corporation's business income is divided among the states in which it conducts business. A corporation determines the allowable income and deductions for the entity as a whole, and then apportions some of its net income to a given state, according to that state's approved formula.

Note—here we hit an issue with the Complete Auto test—a state's formula is tested based on whether a double tax would result if every other state used the same formula, and we do not worry about the fact that other states use a different formula which, in reality, will result in double taxation.

EXAMPLE

Double Taxation of Income

A key issue in apportionment today is the method used to allocate sales from services, as well as the growing use of a single sales factor to apportion sales. A slight majority of states now use market based sourcing to determine if a sale is deemed allocable under the apportionment formula to their state. Most of the remainder use the test that used to be standard, looking at where a service is performed.

Let's take A, Inc., a business offering online services that is based in Arizona. It runs all of its courses in Arizona, which uses the location where the service is performed to determine Arizona sales. Let's say A takes on a big contract to provide these online services to a major customer that is located in Colorado. Colorado uses the market-based sourcing test. Thus, the sales will be *both* a Colorado and Arizona sale when the corporation goes to apportion revenue to compute each state's income tax.

This is not a problem in the view of the U.S. Supreme, since if all states used market-based sourcing, there would be no double tax (so Colorado is in the clear) and, as well, there would be no double tax if all states looked to the location where the service was performed (meaning Arizona is fine as well).

Allocation is a method under which specific components of a corporation's income are directly assigned to a particular state. Allocation differs from apportionment in that allocable income generally is assigned to one state, whereas apportionable income is divided among several states.

Business versus nonbusiness income: The distinction is necessary to determine the state or states in which the corporation's income will be taxed.

Nonbusiness income is

- defined as the corporation's income that is unrelated to its regular business operations and
- assigned to the state where the income-producing asset is located or to the taxpayer's commercial domicile.

Business income is

- net income generated in the ordinary course of business operations and
- taxpayer's income presumed to be business income, unless it is clearly classifiable as nonbusiness income.

Accounting labels are of no use in determining whether income is business or nonbusiness, as legal principals and case law are determinative in this area with, as always, the states not necessarily taking a consistent view in this area.

Per the MTC,

> [i]n general, all transactions and activities of the taxpayer which are dependent upon or contribute to the operations of the taxpayer's economic enterprise as a whole constitute the taxpayer's trade or business and will be transactions and activity arising in the regular course of, and will constitute integral parts of, a trade, or business.

Some states fail to distinguish between business and nonbusiness income, holding that all of the corporation's income is subject to apportionment (e.g., Connecticut, Maryland, Nebraska, and Rhode Island).

EXAMPLE

McClary Machine is subject to income tax in several states. Last year, it earned $2.5 million from the sales of its products and $1 million from the sale of assets that were unrelated to the corporation's regular business operations.

In the states that distinguish between business and nonbusiness income, $2.5 million of McClary's income is apportioned to the state according to the pertinent apportionment formula, and the gain on the sale of nonbusiness assets is allocated to the state in which the assets were located.

In states that subject a corporation's entire income to apportionment, $3.5 million of McClary's income is assigned to the state.

Apportionment percentage is when the corporation's business income is apportioned among the states by determining the appropriate apportionment percentage for each state that has a right to tax the company.

To determine the apportionment percentage for each state, a ratio is established for each of the factors included in the state's formula. Each ratio is calculated by comparing the level of a specific

business activity within the state to the total corporate activity of that type. The ratios are then summed, averaged, and appropriately weighed to determine the corporation's apportionment percentage for each state.

Apportionment formulas vary among jurisdictions. All states use an apportionment factor that consists of one or all of the following factors in differing weights:

- Sales
- Property
- Payroll

Traditionally, states used a three-factor formula, under which the sales factor is assigned more weight than the other two factors. But we have seen a steady movement away from this traditional double-weighted sales three-factor apportionment:

- Only 10 states use the equally weighted three-factor apportionment formula (with some exceptions).
- 19 states weigh the sales factor at 50% or higher.
- 18 states use only the sales factor as the apportionment weight.
- Some states have a different factor depending on industry.

Use of a double-weighted sales factor tends to pull a larger percentage of an out-of-state corporation's income within the taxing jurisdiction of the state because the corporation's main activity within the state, sales of its product, is weighed more heavily than its payroll and property activities.

Double weighing the sales factor also provides tax relief for corporations that are domiciled in the state because those corporations generally own significantly more property and incur more payroll costs within the state than do out-of-state corporations.

A single factor apportionment formula that contains only the sales factor is even more detrimental to an out-of-state corporation than an apportionment factor that double weighs the sales factor.

EXAMPLE

During 2008, McClary Machine realized $1.5 million of taxable income from the sales of its products in States A and B, allocated between the two states.

	State A	State B	Total
Gross Sales	$2,000,000	$2,000,000	$4,000,000
Payroll	1,500,00	0	1,500,000
Property	2,500,000	0	2,500,000
Income tax rate	10%	5%	

If State A uses an equally weighted sales factor in its apportionment formula, $1,249,500 of McClary's taxable income is apportioned to State A.

Gross Sales	50%
Payroll	100%
Property	100%
Sum of apportionment factors	250%
Average	÷3
Apportionment factor for State A	83.3%
Taxable income	$1,500,000
Taxable income apportioned to A	$1,249,500
Tax rate	x10%
Tax rate due to State A	$124,950

However, if State A uses a double weighted sales factor in its apportionment formula, only $1,125,000 of McClary's taxable income is apportioned to State A.

Gross Sales – 50% × 2	100%
Payroll	100%
Property	100%
Sum of apportionment factors	300%
Average	÷ 4
Apportionment factor for State A	75%
Taxable income	$1,500,000
Taxable income apportioned to A	$1,125,500
Tax rate	× 10%
Tax due to State A	$112,500
If single-sales factor:	
50% × $1,500,000	$750,000
$750,000 × 10% (lowest tax rate)	$75,000

Because many states that impose a tax based on net income use a three-factor formula, we will discuss each of the three factors and their planning possibilities. A majority of states allow separate accounting in certain circumstances. A majority of states that allow it, do so when apportionment does not fairly represent the extent of the business activity in the state.

The states are almost unanimous in excluding a factor when the denominator is zero, but including a factor when there is a denominator value even though the state's numerator is zero.

Although rare in practice, some states allow taxpayers to allocate specific items, when apportionment formulas do not fairly allocate the income. States also allow special accounting for potential nonbusiness income, such as

- rents,
- royalties, and
- interest.

Virtually all states apply the same apportionment requirements to domestic corporations as to foreign corporations. For clarity, the terms domestic and foreign in this context refer to a corporation's state of incorporation.

Sales Factor

Sales (or receipts) factor yields the greatest planning opportunities.

The factor is a fraction:

- Numerator = total sales or gross receipts of the corporation within the state during the tax period
- Denominator = gross receipts of the corporation everywhere during the tax period

Only sales that generate business income are includable in the fractional.

Throwback Rule

Out-of-state sales will be pulled back into the origination state, if the state originating the shipment has adopted a "throwback" rule. A throwback rule is a provision that sales do not escape taxation if they are shipped or delivered to a destination state that does not have sufficient nexus to tax corporations.

Sales are considered to be in-state sales for the state of origination, disregarding actual destination of product, whenever

- a corporation is not subject to tax in the destination state or
- the purchaser is the U.S. government.

When the seller is immune from tax in the destination under P.L. 86 272, the sales are considered to be in-state sales of the origination state, if that state has a throwback provision.

To eliminate the possibility that a corporation's drop shipment sales will escape taxation, some states have also adopted a double throwback rule. These sales involve sales by an in-state corporation that are filled by an out-of-state supplier that ships the goods directly to an out-of-state customer from a free onboard point (FOB) outside the state. Under the double throwback rule, drop shipment sales that are not taxable in another state are deemed to be in-state sales.

Throw-out Rule

Instead of adopting the throwback or double throwback rules, a few states have adopted a throw-out rule (West Virginia and New Jersey were eliminated effective June 30, 2010; Maine became effective January 1, 2009). If a taxpayer corporation is not subject to income tax in the state of destination, the receipts from sales into the destination state are not included in the sales figures':

- Numerator
- Denominator

If not taxable in the destination state, then it is removed from the numerator and denominator. This sales factor change can significantly alter the resulting throw-out state's apportionment percentage.

EXAMPLE

McClary Machine's entire operations are located in State A. About 70% of the company's sales are also made in State A, while the remaining 30% are made in State B. McClary's taxable income for the year is $900,000. Both State A and State B impose a 10% corporate income tax, and both include only the sales factor in their apportionment formulas.

Like Wrigley, McClary's sales representatives, besides merely soliciting sales, also replace stale products for its customers. Because each state independently determines the extent of activities necessary to create nexus within the state, the laws of State A and State B must be reviewed to determine the consequences of McClary's sales in State B.

Under the laws of State A, replacing stale products exceeds mere solicitation and establishes nexus within the state. Therefore, McClary's activities in State B are sufficient as determined by State A law to subject McClary to a tax based on its income. Furthermore, McClary is able to apportion its income between State A and State B.

However, State B's interpretation of activities necessary to create nexus is less strict than imposed by State A, because replacing stale products does not subject a corporation's income to tax. If State A is not a throwback state reference the following table.

	Apportionment	Net Income	Rate	Tax
State A	70%	$900,000	10%	$63,000
State B	0%	$900,000	10%	0
Total Tax Liability				$63,000

Effective state income tax rate = $63,000/$900,000 = 7%

But what happens, with the same set of facts, if State A has adopted a throwback rule? In this case, the sales in State B are considered to be in-state sales of State A, yielding an effective 10% tax rate.

	Apportionment	Net Income	Rate	Tax
State A	100%	$900,000	10%	$90,000
State B	0%	$900,000	10%	0
Total Tax Liability				$90,000

Effective state income tax rate = $90,000/$900,000 = 10%

Tax savings if State A has not adopted a throwback provision:

$90,000 – $63,000 = $27,000

As a result, the astute tax planner must examine the statutes of each state in which a company does business in order to

- determine the target amount of sales to minimize tax in various states and
- ascertain whether an overall tax savings will result from
  - altering the means of shipping the products to the purchasers or
  - changing the location from which the products are shipped.

Dock Sale Rules

Dock sales occur when an out-of-state consumer or customer picks up the tangible personal property at the seller's location, then immediately removes that property from the seller's state. It seems logical that those sales would be considered sales apportioned to the seller's state, because that is where delivery occurs. However, if a state has a dock sale rule, those sales are not considered sales to be apportioned to the seller's state. States take a destination approach to apportioning these sales (e.g., Iowa, Wisconsin, Minnesota, Kentucky, Georgia, Ohio, and Tennessee). Contrary positions are California and New York.

Services Rendered

One of the most significant areas of change today is in the sourcing of service-based sales. A move is afoot to go from the cost of performance method of allocating sales to market based sourcing.

The traditional method was the Cost of Performance rule (COP). Generally, service revenues are apportioned to the state where a majority of the costs to perform that service are incurred. There are direct costs in performing contracts, such as wages and travel. Costs incurred in selling contracts generally do not apply. This method is an all-or-nothing apportionment methodology.

Market-based sourcing method (MBS; formerly known as the benefit method) where the customer receives the benefit of the services provided is quickly displacing the Cost of Performance rule. An increasing number of states are moving to market-based sourcing to eliminate the advantages of moving the performance of services out of state.

States have been adopting rules that source services not to where they are performed, but rather where they are consumed. Traditionally apportionment in such cases treated the sale based on where the service was performed.

One key area of disagreement in such laws is whether the "market" is that of the customer or, if different, that of the ultimate consumer of the service

Note that some states (Arizona for example) allow a company under certain conditions to elect market-based sourcing. In that case, it would be elected by a business that performs the services in the state but mainly sells to consumers outside the state. In such a case, this is not a step to counteract planning, but rather a step to attempt to attract the jobs related to providing the service to the state.

Note as well that it is very possible for multiple states to claim the right to tax the same income while we are in the position where some states use a market-based approach to sourcing sales while others are using the traditional test of where the service is performed to source a sale.

Deloitte in a presentation to the 2019 National Multistate Tax Symposium in February noted that the vast majority of states now have mandatory market-based sourcing for income and/or gross receipts taxes.[28]

EXAMPLE

Mary gives a training session from her home in Arizona via a webcasting service to a customer's employees who are located in Colorado. The revenue from that training session would be claimed as Arizona source income (Mary does many things in her business and does not qualify to elect market-based sourcing in Arizona) by Arizona. However, Colorado would claim the same revenue as a Colorado sale since the recipients of the service were located in Colorado.

These changes are being driven by two different motivations. For states that are looking to attract service provider businesses, switching to market-based sourcing gives an incentive to have the service providers work in the state with market-based sourcing. If paired with a single factor system tied to sales, revenue is not subject to tax in the state where the services are performed.

Alternatively, if a state tends to be a net consumer of such services, the use of market-based sourcing is a source of revenue for the state. It also serves to reduce the incentive to move facilities where the services are performed out of the state, since the income will be taxable to the state regardless of where the service is performed.

The same rationale works for single-sales-factor systems—companies are not penalized for locating in the state that has this rule and it works to enable the state where the consumers are located to impose their income tax on the sale, again reducing the incentive to move out of state.

[28] https://www2.deloitte.com/content/dam/Deloitte/us/Documents/Tax/us-tax-sales-factor-deep-dive-defining-todays-market.pdf, p. 12, accessed June 8, 2019

Ratio of Time Spent Method

If personal services are rendered, some states used a modified cost of performance method that requires you to allocate the revenue based on a ratio of time spent in performing those services under the contract. The service performed in each state is deemed a separate income-producing activity. Therefore, the ratio is contract hours spent in one state divided by total contract hours spent for that one engagement everywhere. Contract hours are hours directly incurred in performing the contract. (Hours negotiating the contract would not count.)

Interesting California View on Sourcing Director's Fees

In Chief Counsel Ruling 2019-03[29], the Franchise Tax ruled on the application of California's market-based sourcing rules as applied to an outside director that attended a shareholder or board of directors meeting in California.

Market-based sourcing is increasingly being used by states to determine whether the state has the right to impose an income tax on the amounts paid to an out of state organization or resident for services rendered. Previously, states had generally looked to the location of the sale being tied to where the services were primarily performed.

Under California's market-based sourcing rules, the sale will be sourced to where the service recipient is deemed to receive the benefit of the services.[30] Under California Regulation section 25136-2(b)(1), the benefit is deemed received where the customer has directly or indirectly received the benefit of the service.

In this case, the company had independent directors on its board of directors who made up a majority of the board. This governance rule is a requirement for the company to be listed on New York Stock Exchange. The Company is domiciled outside California.[31]

The ruling seeks to answer the following question:

> Whether compensation paid to an independent director, who is a nonresident of California, is sourced to California if the Company holds a shareholder meeting or board of directors meeting in California which the director attends?[32]

The ruling, looking at the situation in question, gives the following analysis of where the benefit of the service is received:

> Here, the independent director is providing a service to the Company and its shareholders that is unique—to act, with the other directors, to govern the Company. One role of the Board of Directors is to oversee management's assessments of major risk factors facing the Company and review options to

[29] Chief Counsel Ruling 2019-03, California Franchise Tax Board, October 7, 2019, https://www.ftb.ca.gov/tax-pros/law/chief-counsel-rulings/2019-03.pdf, retrieved October 22, 2019

[30] California Revenue and Taxation Code §25136

[31] Chief Counsel Ruling 2019-03, California Franchise Tax Board, October 7, 2019, https://www.ftb.ca.gov/tax-pros/law/chief-counsel-rulings/2019-03.pdf, retrieved October 22, 2019, p. 1

[32] Chief Counsel Ruling 2019-03, California Franchise Tax Board, October 7, 2019, https://www.ftb.ca.gov/tax-pros/law/chief-counsel-rulings/2019-03.pdf, retrieved October 22, 2019, p. 2

> mitigate such risks. Directors also serve on Board committees which require their independence to meet best practices and NYSE requirements with respect to audit policies, compensation practices and other corporate governance requirements.
>
> The benefit of that service is received where the Company received value from the delivery of that service. The value of an independent director's services does not derive from the place from which the Board of Directors confers and makes decisions, but rather from that place the decisions and actions of the Board detailed above are executed. Unlike consulting or similar services, these services do not merely recommend actions that may be taken by management. Independent directors are in a very distinct class of service-providers. The Board of Directors, acting as a body, gives authority to and directs management to take action. Since these services go to the core of the governance of the Company and the implementation of any such decisions are taken by the highest echelons of management, the location of that benefit is the place where the highest-ranking corporate officers carry out these directions.[33]

Thus, the ruling comes to the following formal answer to the question initially posed:

> No. The fees or other compensation received from the Company by the independent director of the Company for services performed in California will be sourced to where the highest-ranking corporate officers carry out the Board's directions.[34]

When advisers consider the reason for states moving to market-based sourcing, the answer makes perfect sense even if the state in this case is passing on being able to tax the fees paid to these directors, assuming the highest ranking officers perform their services outside of California. Market based sourcing is meant to remove the incentive to locate service providing employees outside of a state. If a company wishes to sell services to residents of the state in question, the company is going to have a sale in the state regardless of where the service is performed.

By looking not to where directors' meetings are held but rather to where the headquarters of the organization is, the ruling serves to remove an incentive for organizations to hold such meetings outside California.

But the ruling is not necessarily good news—it suggests that any individual located anywhere performing such governance services for an organization headquartered in California will have California source income.

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[33] Chief Counsel Ruling 2019-03, California Franchise Tax Board, October 7, 2019, https://www.ftb.ca.gov/tax-pros/law/chief-counsel-rulings/2019-03.pdf, retrieved October 22, 2019, p. 3

[34] Chief Counsel Ruling 2019-03, California Franchise Tax Board, October 7, 2019, https://www.ftb.ca.gov/tax-pros/law/chief-counsel-rulings/2019-03.pdf, retrieved October 22, 2019, p. 3

Move to 100% Sales Factor Apportionment

The Deloitte presentation mentioned earlier also stated that, as of February 2019, a majority of states have now moved to a 100% sales-factor-based apportionment for some or all taxpayers.[35]

The reason for this is simple—it both creates an incentive for manufacturers to locate in the state (you don't pay any state income tax on sales that you ship to other states) and it removes the incentive to leave the state, especially if (as seems likely) the U.S. Supreme Court would view the *Complete Auto Test* as applying to income taxes just like sales taxes--so physical presence is not required for the state to impose its taxing authority.

The good news is that such a sourcing is simpler, but the bad news is that if you are located in low tax state but have a lot of customers in a high tax state, your state income taxes are likely heading up.

Property Factor

The property factor reflects the extent of total property usage by the corporation in the state, with the

- numerator being the average value of the corporation's real and tangible personal property at the beginning and end of the period in the state that is
  - owned,
  - rented, or
  - used; and
- denominator being the average value of all of the corporation's real and tangible property, wherever it is located.

For purpose of the factor, real, and tangible property includes land, buildings, machinery, inventory, equipment, and other real, and tangible personal property. Property owned by the corporation is typically valued at its average original or historical cost, plus the cost of additions and improvements, but without adjusting for depreciation. Some states allow property to be included at its net book value or federal adjusted tax basis.

Leased property is usually valued at eight times its annual rental, less any sub-rentals.

You will recall that McClary Machine is subject to tax in State A and State B. Both states require that leased or rented property be included in the property factor at eight times the annual rental costs, and that the average historical cost be used for other assets.

[35] https://www2.deloitte.com/content/dam/Deloitte/us/Documents/Tax/us-tax-sales-factor-deep-dive-defining-todays-market.pdf, p. 15, accessed June 8, 2019

EXAMPLE

Average historical cost:			
Property located in State A	$750,000		
Property located in State B	450,000		
Total property	$1,200,000		
Lease and rental expenses:			
State A			$50,000
State B			150,000
Total expenses			$200,000

State A property factor:

$$\frac{750{,}000 + (8 \times 50{,}000)}{1{,}200{,}000 + (8 \times 200{,}000)} = \frac{1{,}150{,}000}{2{,}800{,}000} = 41.07\%$$

State B property factor:

$$\frac{450{,}000 + (8 \times 150{,}000)}{1{,}200{,}000 + (8 \times 200{,}000)} = \frac{1{,}650{,}000}{2{,}800{,}000} = 58.93\%$$

Only property that is used in the production of apportionable income (business income) is includable in the numerator and denominator of the property factor. Idle property and property that is used for producing non-apportionable (nonbusiness) income generally is excluded. Property that is temporarily idle or unused generally remains in the property factor.

Although the average value of the property is usually determined by averaging the beginning and ending property values, some states allow the average value to be calculated

- monthly or
- quarterly.

For example, many use less than annual average value when a company acquires business assets mid-year.

Because most fixed costs are stationary in nature, the property factor is not easily manipulated. Because most states are switching to a heavier sales factor formula, it may be best to locate operating facilities or other major assets in states that focus less on their property factor. The corporation may also benefit by storing inventory in a low- or no-tax state, because the average property value in the state in which the manufacturing operation is located will be reduced slightly. If the manufacturing operation is located in a high-tax state, the establishment of a distribution center in a low- or no-tax state may reduce the corporation's overall state tax liability.

Trends in the Property Factor

The majority of the states use original cost in valuing property included in the property factor. The states are nearly unanimous in using beginning and year-end balances to compute the average value of property included in the property factor. All but a few states allow the "last in first out" (LIFO) method of inventory valuation in computing the amount for the factor. A majority of states specifically exclude any intangible property or assets used in the production of nonbusiness income. Also excluded may be construction in progress.

Mobile property (e.g., salesperson's autos, construction equipment, etc.) may be apportioned among the states based on either a ratio of days, a ratio of miles, or any other reasonable method of determining total time spent in each state.

MTC regulations provide that property in transit between locations of the taxpayer is considered to be at its destination for purposes of the property factor. In California, the State Board of Tax Equalization has held that inventory is not considered to be in transit if the temporary stoppage was for the taxpayer's own purposes, for example, inspection. (In the Matter of the Appeal of Craig Corporation, 87 SBE 013) Inventory in transit to Maryland, but potentially destined to dealers outside the state, could be included in the Maryland property factor. (*Comptroller of Treasury v. Mercedes Benz of North America*, No. 8834940/CL88967) In a similar case, the Ohio Board of Tax Appeals ruled that the taxpayer should include inventory in transit in the Ohio property factor, because the taxpayer failed to present evidence that inventory was in transit. (*Income International v. Limbach*, No. 84 D 1149)

Payroll Factor

Payroll factor compares compensation paid for services rendered within a state to a corporation's total compensation. Payments made to independent contractors are excluded from the numerator and denominator.

Compensation includes wages, salaries, and commissions, but it also can include

- board, housing, or lodging;
- in some states, federally exempt earnings from a cash or deferred compensation plan (401k); and
- other amounts constituting gross income.

Payroll "Throwback" Rule

Although this is not formally referred to as such, some states may throwback payroll in the following instances.

Compensation is deemed to be paid in the state even though the individual is not residing or performing services in that state, if the

- employee is directed or controlled from an office in the state,
- employee periodically returns to the state for business purposes, and
- state in which the employee resides does not have jurisdiction to impose income or franchise tax on the employer.

Payroll throwback increases the amount of a corporation's income that is apportioned to the state.

Generally, the payroll factor provides limited planning potential, unless corporate employees spend substantial periods of time outside their state of employment, or unless the corporation is willing to relocate highly paid employees to low-tax states. Some states exclude the compensation paid to executive officers from the payroll factor anyway. In at least one state, management fees paid to a related corporation for the performance of personal services are included in the payroll factor. Use of independent contractors who work for more than one principal may reduce payroll factor in a high-tax state.

EXAMPLE

McClary's total payroll costs are $1.4 million. Of this amount, $1 million is attributed to State A, which is a high-tax state. Accordingly, McClary's payroll factor in State A is 71.43% ($1,000,000/$1,400,000).

If McClary paid $200,000 of its State A compensation to sales representatives, and replaced them with independent contractors, McClary's payroll factor in State A is reduced to 66.67% ($1,000,000 $200,000/$1,400,000 $200,000).

FILING METHODS

There are three methods that business entities have to file and pay net income taxes in a state: separate return, consolidated return, or combined (unitary) return. The following discussion outlines those methods and their characteristics. Note that terminology can vary from state to state for returns containing more than one entity; the taxpayer needs to understand the following outlined criteria to identify the type of filing for that particular state.

Separate Returns

Separate return means that only an entity with nexus in a state is required to file a return, regardless of whether the entity is part of an affiliated group or consolidated tax return as defined by IRC Section 1504 and Treasury Regulation 1.1504, respectively. Many states require separate returns for business entities with nexus in the state.

Consolidated Returns

Some states require or permit consolidated tax returns. However, most require the same criteria be applied as IRC Sections 1501–1504 and accompanying regulations. That is, those corporations in the affiliated group that meet the 80% stock ownership requirements will be allowed to be included, the same as for federal income tax purposes. Other states may only permit entities from the consolidated group with nexus in the state to be included in the return. While large corporations will record income and expenses separately for each entity in the group, many types of revenue and expenses are recorded on a consolidated basis or in a single entity within the group. In addition, special purpose entities are often established for numerous business and/or tax reasons and record many intercompany transactions within the group. The state view in allowing a consolidated return is that it will more clearly reflect the taxpayer's income of the entire enterprise.

Combined Returns

Combined filing requires the members of the group to calculate their taxable income on a combined-basis unity ("unitary") theory of a business unit. Combined reporting ignores the legal structure of an affiliated or consolidated group and instead focuses on the underlying economic reality of the businesses or functions within the group. The combined reporting concept asserts that companies with inter-functional dependence are a single economic unit. A combined filing may include foreign corporations or only U.S. entities (referred to as "water's edge").

A combined filing represents one entity—so nexus is not required to be included in the combined report. Intercompany transactions are eliminated and apportionment factors are similarly adjusted to eliminate duplication. The unitary concept includes the following principles.

Unitary Principle Tests—As Determined by State Rules and Numerous Court Cases

Three unities test—most common test—all three must exist

- Unity of ownership (more than 50% ownership)
- Unity of operations (centralized purchasing, advertising, accounting, management, etc.)

- Unity of use (intercompany product flow, know-how, other information)

Contribution/dependency—subjective

- The three unities test is generally implicit with this test as well.
- Integrated business segments are dependent upon each other or contribute to each other's operations (vertical and horizontal).
- The key test is how independent business segments are in reality.

Factors of profitability

- Functional integration – Functions of business are integrated, centralized
- Centralized management – Various business segment decisions made by same management team, concurrent officers, board members, etc.
- Economies of scale – Savings generated by centralized functions, personnel, purchase discounts, bulk purchases, etc.

Flow of value/operational integration tests

- Intercompany loans and guarantees not at arm's length
- Parent's management role played in sub's operations
- Substantial flow-of-goods (manufacturing businesses)

BENEFITS AND DETRIMENTS OF CONSOLIDATED OR COMBINED REPORTING

Benefits include the following:

- Ability to offset losses of members
- Eliminate intercompany dividends
- Defer gains on intercompany transactions
- Use otherwise unavailable credits
- Use another member's NOLs
- Dilute a state's apportionment factor
- Reallocate income by adjusting apportionment factors

Detriments include the following:

- Prevents restructuring planning ideas (e.g., creating legal entities to shift income out-of-state via related entity)
- Convinces certain non-nexus entities into filing where they would not have had to on their own (unitary issues, increases tax)
- Increases state tax compliance costs—more complex

WHAT INCOME IS IN THE RETURN?

Business income is defined in UDITPA and the MTC provisions and is generally defined as

- income arising from transactions and activities conducted in the regular course of the taxpayer's trade or business and
- includes income from property if the acquisition, management, and disposition constitute integral parts of the taxpayer's regular trade business.

Are there two tests? Some states say so, meaning you only need to meet the definition of either, but not both:

- Transactional test is the first section of the definition in 2.(a).
- Functional test is the latter section of the definition in 2.(b).
- In practice, most states deem all income as business income, and it's the taxpayer's burden to prove the income is not business income.

Nonbusiness income is defined to include all other types of income (not from regular or continuous activities). Thus, it could include interest, dividends, rents, etc. (but watch out).

The Implications

In previous cases, the Court has drawn a sharp distinction between capital transactions that serve investment functions and those that serve operational functions. The fact that the transaction in this case was undertaken for a business purpose did not change its character. An otherwise-passive investment is not transformed into an integral operational asset only because it was acquired as part of a long-term corporate strategy of acquisitions and dispositions.

The Supreme Court explicitly rejected New Jersey's contention that the court should overrule ASARCO, which sets the unitary business standard. New Jersey's attempt to tax the income in this case greatly exceeded the latitude that is granted to states to fashion apportionment formulas.

The decision provides some negative assurance as to when it is not necessary for a state to apportion investment income: there doesn't have to be a unitary relationship between the parties. But little guidance was given on how to prove that an item of income was earned outside the course of the unitary business. Even though it was pro-taxpayer, states may be more aggressive in asserting that out-of-state investments serve an operational function with the in-state operations.

The U.S. Supreme Court, on June 20, 1994, upheld the constitutionality of California's worldwide combined reporting (WWCR) method. Under this method, worldwide income is pooled, and a portion of income is allocated to California based on a three-factor apportionment formula.

The federal government, for example, uses the arm's length or separate accounting method, treating subsidiaries and affiliates of parent companies as distinct tax units. An earlier Supreme Court decision in *Container Corp. v Franchise Tax Board*, 463 U.S. 195 (1983) decided that state tax is unconstitutional if it prevents the federal government from speaking with one voice.

On April 15, 2008, the U.S. Supreme Court refused to apply an operational function test to conclude that Meadwestvaco was required to include the gain from a functionally integrated subsidiary in its apportionable income reported to Illinois. (*Meadwestvaco Corp vs. Illinois Dept. of Revenue*; No. 06-1413; October Term 2007, April 15, 2008)

NOTES

Unit

8

Taxing Pass-Through Entities

LEARNING OBJECTIVES

When you have completed this unit, you will be able to accomplish the following.

- Understand general state tax treatment of multi-state tax reporting for pass-through entities and their owners.
- Understand the effect of corporate partners on partnership nexus.
- Understand the effect of partnership nexus on corporate partners.
- Apply composite return concepts where permitted.

State taxing jurisdictions are increasingly aware of: substantial increase in S elections after TRA 1986; and increased number of partnerships converting to LLCs. Almost every state is trying to locate those out-of-state businesses, regardless of their choice of entity, which are liable for

- nexus and filing returns, plus nonresident withholding requirements, and
- subjecting income to apportionment.

S CORPORATIONS

Good news is that most states with an income tax recognize S corporation status. Just about every state has adopted special provisions—somewhat similar to federal law—to govern the taxation of S corporations and their shareholders. "Somewhat similar" usually means special state election, with potential restrictions on who may elect and whether federal election is acceptable.

Non-recognition jurisdictions are now limited to Washington, D.C., Tennessee, and Louisiana.

But S status may also be disregarded for special tax purposes:

- Michigan business tax
- New Hampshire business enterprise tax

- Ohio CAT tax
- Texas margin tax
- Washington business and occupations tax

Price to Be Paid?

There is an increasing trend—S corporations may be subject to state entity-level or minimum tax. Additionally, entity level taxes are also increasing in popularity due to the limits on the deduction of state and local taxes imposed directly on the individual.

The tax may be set by statute or by regulation. It may be a special rate (subtract corporate tax rate from highest individual rate) or may be the same as other corporations:

- California = 1.5%
- Illinois = 1.5%
- Michigan = 4.95%
- New Hampshire = 8.5%
- South Carolina and Utah = 5%
- New Jersey = $375 to $1,500 based on gross receipts

These taxes do not reduce or otherwise affect tax liability of S shareholders.

Other states exempt S corporations from corporate income tax if all of the corporation's shareholders are state residents:

- Delaware
- Vermont

Nonresident individuals who are shareholders of an S corporation are typically required to report—and pay tax on—pro rata share of S corporation income apportioned to that state.

New and modified provisions ensure that those nonresident shareholders pay tax on income that is derived from business conducted within the state:

- Multiplicity of requirements, formula
- Continued focus on compliance

Mechanisms to enforce payments by nonresidents are often included as a requirement of S election. Such rules may include the following:

- All nonresident shareholders must agree to file returns and pay taxes (generally a state-specific statement provided to the S corporation).

- S corporations must withhold income taxes on nonresident shareholders' pro rata share of income allocated to state.

- S corporations can file a composite return.

- Georgia and Missouri both have withholding provisions.

Withhold from dividends or undistributed income that is paid/credited to nonresident shareholder, normally at the highest rate so that if an out of state shareholder doesn't file, the state is going to be as well off in most cases as it would if the return was filed—and most likely in a better position:

- Georgia = 4%

- Missouri = 6%

These withholding provisions have a threshold where there is no withholding if the aggregate annual distribution to shareholders is less than follows:

- Georgia = $1,000

- Missouri = $1,200

Both states' alternatives offer another option to withholding: the S corporation files composite return and makes composite tax payment for nonresident shareholders, or shareholder provides S corporation with state-specific nonresident shareholder agreement (e.g., GA Form 600S-CA).

S corporations and nonresident shareholders are jointly and severally liable for withholding tax:

- IRS – Does not equal distribution for purposes of second class of stock

- Looming issue – Credit for S corporation—level taxes paid to other states

Courts are aware that states overreach and the case of Dupee and Schiff (Mass. App. Tax Board, #170355, 4/29/95) is useful to review:

- It makes a distinction between
  - being a mere shareholder in an S corporation (passive) and
  - income from trade or business properly allocated to the state (active).
- The Boston Celtics' S corporation was liquidated, followed by an asset transfer to Dupee, who receives
  - interest in a new publicly traded partnership and
  - sale of assets to a general partner for $18 million.

- Is it derived from or effectively connected with trade or business?
  - Status as shareholder
  - Gain actually derived from the sale of securities, not in-state assets

Another case offers a trap for the unwary? Although Alabama has enacted a substantial part of the Model S Corporation Income Tax Act, the decision in *Harrison v. State of Alabama DOR* (Admin. L. Div. No. INC. 95-156, 12/14/95) reminds us of the quirks in interpreting the statute.

Harrison—a resident of Birmingham, Alabama—was the sole shareholder of Peerless Electric, Inc., an S corporation organized in Florida, and arguably doing business only in Florida. Peerless suffered losses during the years in question. Losses were claimed by Harrison on his Alabama individual income tax return. According to Ala. Code Section 40-18-160(a), an "Alabama S corporation" must be an electing (federal) S corporation that is a corporation qualified to do business in Alabama or actually doing business in the state (even if it is not qualified to do so).

ALJ focused on whether Peerless was actually doing business in Alabama during the subject years to qualify it as an Alabama S corporation because it was not

- a domestic corporation or
- qualified to do business in the state.

ALJ determined that Peerless was not doing business in Alabama, despite in-state presence of its

- bank accounts,
- corporate records, and
- key officer/director (Harrison).

In other words, the Alabama DOR properly disallowed the pass-through losses claimed by the taxpayer on his Alabama individual tax returns.

One item is notable in this case—the state arguing that the corporation did not have nexus in Alabama. So the good news is there is a potential refund opportunity for any resident who is a shareholder of a profitable multi-state S corporation that does not meet definition of an Alabama S corporation.

PARTNERSHIPS

General apportionment of partnership items involves how the state views the partnership. Federal purposes, treated as a conduit that passes the income or loss through to partners, reported on their individual returns (majority view) Minority view—allocation and apportionment at partnership level, not attributed to each partner.

Apportionment of Partnership Income/Loss Among Corporate Partners

Although the majority of states follow the federal treatment, a few states do impose an income tax at the partnership level. Depending on the circumstances, a state's treatment of a corporation's ownership of a partnership interest could be either beneficial or detrimental to the corporation's overall state tax liability.

The state level taxes are picking up in popularity as a response to the limitations on individuals deducting state income taxes on Schedule A. The IRS's failure to challenge the first such tax in Connecticut has emboldened a number other states (such as Wisconsin and New Jersey) to pass similar entity level taxes.

General Corporate Partners

Usually, general corporate partners (a business is integral and the partners exercise some control) in either limited or general partnerships acquire partnership's nexus. General corporate partners must file corporate returns (income and/or non-net income tax). Generally, the partners must include the ratable share of the partnership's income and apportionment factors (property, payroll, and sales) in the corporate partners' overall state factors.

Limited Corporate Partners

Some states hold if a limited corporate partner lacks sufficient control over partnership operations, the partner does not automatically acquire partnership nexus. Some states treat income from partnerships to limited corporate partners as nonbusiness income, therefore sourced to limited corporate partner's state of domicile. This would not include their ratable share of the partnership's income and apportionment factors (property, payroll, and sales) in corporate partners' overall state factors. The remaining states treat these partnerships no differently than if they were a general partnership.

Corporate Partners in Non-Unitary States

Separate filings are made by partner and partnership (if a filing requirement exists). States usually look to see if a corporate partner is a

- general or active partner—acquired nexus; or
- limited passive partner—generally does not acquire nexus.

Our previous discussions then apply regarding filing requirements, et cetera.

Note: General corporate partners' nexus does not "flow up" to create nexus for the partnership (unless they are performing services for the partnership).

Corporate partners do not create nexus for a partnership, unless business is performed by the corporate partner for the partnership.

Corporate Partners in Unitary States

If unitary states determine that the corporate general or limited partner's and partnership's activities are unitary (depending on their unitary tests),

- combined business income of the unitary group will be apportioned to states based upon the combined apportionment factors,
- they may file one return, or
- they may file separate returns.

Other Partnership Issues

A partnership's nexus activities and state tax credits generally flow through to corporate partners. Composite return options are available only to individual partners with conditions that must be met by the partners. A composite return is an individual return filed by the pass-through entity that reports the state income of all the nonresident owners or, in some cases, the electing members, as one group, and calculates tax that is paid by the pass-through entity on behalf of the nonresident owner.

Holding a partnership interest may be a great state planning tool because it creates nexus for apportionments. However, it may also be a detriment because it creates nexus for filing in the state where P.L. 86-272 protection exists, and brings corporate partnerships into that state.

New York provides that a corporation that

- is a limited partner in one or more limited partnerships,
- is subject to the franchise tax on business corporations solely as a result of its holding of a limited partnership interest, and
- does not file on a combined basis in New York

may elect to compute its tax liability by taking into account only its distributive share of partnership items of each limited partnership that is

- doing business,
- employing capital.
- owning or leasing property. or
- maintaining an office in New York.

This election is not available when there are substantial transactions between the limited partnership and the corporate group or if they are engaged in a unitary business.

Several other states distinguish between general and limited partners, with provisions that are less elaborate than New York's.

A number of states require a corporate limited partner to include its ratable distributive share of partnership income, expenses, gains, and losses as part of its tax base; generally line 28 or 30 of the federal corporate income tax return: form 1120.

While a corporate general partner would include its pro rata share of the partnership's property, payroll, and sales in its own apportionment factors, a limited partner would not.

Several Court Decisions Subject Partnership Income to In-State Taxation

Hickey v. Tax Appeals Tribunal (N.Y. App. Div. 3d, 10/27/94) case looked at a multi-state law firm.

Robert Hickey, resident of Maryland, practices law in Washington, D.C. as partner in Kirlin, Campbell, Meadows & Keating. The bulk of the firm's 35 attorneys practice in New York. This accounts for 80% of the firm's income.

In New York, 80% of Hickey's partnership income is subject to personal income tax:

- Taxpayer – Contribution of profits from Washington, D.C. to New York
- Taxpayer – No agreement to share profits and losses

Form over substance shows:

- Single firmwide management committee
- No signed agreement with New York Department of Taxation and Finance

Domber v. Tax Appeals Tribunal (N.Y. App. Div. 3d, 12/1/94) looked at another New York partnership issue.

Two partners in a New York partnership owned, in equal shares, corporations that developed housing projects in West Virginia and Pennsylvania:

- Taxpayer – Nonresident as well as income from non-New York sources
- Court – Uphold state's argument and tribunal's decision that income is attributable to New York because the business was conducted and managed there, despite the fact that income was earned elsewhere

LIMITED LIABILITY COMPANIES (LLCS)

Generally, under state statutes, LLCs are business entities combining the following:

- Corporate characteristic of limited liability for its owners (referred to as managers)
- Pass-through attributes of partnership taxation

The federal check-the-box regulations provide that an LLC can elect to be

- a corporation;
- a C corporation;
- an S corporation;
- an unincorporated entity, which, depending on the number of owners, is either
  - a partnership or
  - a disregarded entity; or
- a default classification.

An LLC with at least two members is classified as a partnership for federal income tax purposes. An LLC with only one member is treated as an entity that is disregarded as separate from its owner for income tax purposes, unless it elects to be taxed as a corporation (but as a separate entity for purposes of employment tax and certain excise taxes).

Every state has enacted its own LLC statute beginning in 1977 with Wyoming.

Although the driving purpose is federal tax treatment as a partnership (see Revenue Ruling 88-76), states do not tax LLCs uniformly, and inconsistent treatment may become a problem.

Virtually all states follow federal treatment, but state taxation may be different on a state-by-state basis. Some states impose tax on LLCs as if they were corporations—an LLC level income tax is imposed by some states (e.g., Alabama, Kansas, and Michigan net income, New Hampshire, and Tennessee).

Other states impose an LLC level non-net income tax or minimum taxes (e.g., Texas margin tax, Ohio CAT, Washington B&O, and Michigan gross receipts).

Nonresident members can be subject to tax if the entity is treated as other than a C corporation. LLCs use the same apportionment formula as other entity types.

Enforcement/collection issues are generally the same as partnerships and S corporations:

- Georgia – 4% withholding requirement on nonresident members
- Annual per-partner or member license fee (e.g., New York, New Jersey, and Tennessee)

ENTITY-LEVEL PASS-THROUGH TAXES

The passage of the 2017 Tax Cuts and Jobs Act resulted in a $10,000 SALT deduction limitation for individual taxpayers. This limitation also impacted the individual partners and shareholders of partnerships and S corporations by correspondingly limiting the SALT deduction available to those partners and shareholders. In response to this federal legislation, seven states as of this writing have enacted pass-through entity-level taxes as a work-around to this deduction limitation, and it seems very likely more states will follow. Although it was not certain the IRS would permit

these taxes to be deducted without limitation, the IRS released Notice 2020-75,[36] which announced the Treasury's intent to issue proposed regulations to clarify that the state and local income taxes imposed on and paid by a partnership or an S corporation on its income are allowed as a deduction by the partnership or S corporation when computing its non-separately stated taxable income or loss for the taxable year of payment. Discussion of this notice and the SALT impact are discussed below.

The IRS notes the following:

> Certain jurisdictions described in section 164(b)(2) have enacted, or are contemplating the enactment of, tax laws that impose either a mandatory or elective entity-level income tax on partnerships and S corporations that do business in the jurisdiction or have income derived from or connected with sources within the jurisdiction. In certain instances, the jurisdiction's tax law provides a corresponding or offsetting, owner-level tax benefit, such as a full or partial credit, deduction, or exclusion. The Treasury Department and the IRS are aware that there is uncertainty as to whether entity-level payments made under these laws to jurisdictions described in section 164(b)(2) other than U.S. territories must be taken into account in applying the SALT deduction limitation at the owner level.[37]

The IRS begins by announcing that they will be issuing proposed regulations to allow this deduction.

> .01 Purpose and scope. The Treasury Department and the IRS intend to issue proposed regulations to provide certainty to individual owners of partnerships and S corporations in calculating their SALT deduction limitations. Based on the statutory and administrative authorities described in section 2 of this notice, the forthcoming proposed regulations will clarify that Specified Income Tax Payments (as defined in section 3.02(1) of this notice) are deductible by partnerships and S corporations in computing their non-separately stated income or loss.[38]

The notice provides the following with regard to the deduction of such payments:

> (2) Deductibility of Specified Income Tax Payments. If a partnership or an S corporation makes a Specified Income Tax Payment during a taxable year, the partnership or S corporation is allowed a deduction for the Specified Income Tax Payment in computing its taxable income for the taxable year in which the payment is made.[39]

The term *Specified Income Tax Payment* is defined as follows:

> For purposes of section 3.02 of this notice, the term "Specified Income Tax Payment" means any amount paid by a partnership or an S corporation to a State,

[36] Notice 2020-75, November 9, 2020, https://www.irs.gov/pub/irs-drop/n-20-75.pdf (retrieved November 9, 2020)
[37] Notice 2020-75, Section 2.02(3)
[38] Notice 2020-75, Section 3.01
[39] Notice 2020-75, Section 3.02(2)

> a political subdivision of a State, or the District of Columbia (Domestic Jurisdiction) to satisfy its liability for income taxes imposed by the Domestic Jurisdiction on the partnership or the S corporation. This definition does not include income taxes imposed by U.S. territories or their political subdivisions.[40]

One area of concern that some had with regard to the entity-level pass-through taxes imposed by states was that some were imposed at the election of the entity. Would the fact that an entity has elected to pay the tax eliminate the treatment as a tax imposed on the entity? The IRS has decided that is not an issue. Similarly, the fact that a partner ends up with a benefit against his/her tax liability also is not a problem for such taxes.

> For this purpose, a Specified Income Tax Payment includes any amount paid by a partnership or an S corporation to a Domestic Jurisdiction pursuant to a direct imposition of income tax by the Domestic Jurisdiction on the partnership or S corporation, without regard to whether the imposition of and liability for the income tax is the result of an election by the entity or whether the partners or shareholders receive a partial or full deduction, exclusion, credit, or other tax benefit that is based on their share of the amount paid by the partnership or S corporation to satisfy its income tax liability under the Domestic Jurisdiction's tax law and which reduces the partners' or shareholders' own individual income tax liabilities under the Domestic Jurisdiction's tax law.[41]

The tax will *not* be a separately stated item but rather will be part of the non-separately stated income or loss from the partnership or S corporation.

> Any Specified Income Tax Payment made by a partnership or an S corporation during a taxable year does not constitute an item of deduction that a partner or an S corporation shareholder takes into account separately under section 702 or section 1366 in determining the partner's or S corporation shareholder's own Federal income tax liability for the taxable year. Instead, Specified Income Tax Payments will be reflected in a partner's or an S corporation shareholder's distributive or pro-rata share of nonseparately stated income or loss reported on a Schedule K-1 (or similar form).[42]

Additionally, the amounts paid will not be taken into account for the individual SALT limitation.

> Any Specified Income Tax Payment made by a partnership or an S corporation is not taken into account in applying the SALT deduction limitation to any individual who is a partner in the partnership or a shareholder of the S corporation.[43]

The applicability date allows taxpayers to deduct taxes paid on such taxes generally for years ending after December 31, 2017.

> The proposed regulations described in this notice will apply to Specified Income Tax Payments made on or after November 9, 2020. The proposed regulations

[40] Notice 2020-75, Section 3.02(1)
[41] Notice 2020-75, Section 3.02(1)
[42] Notice 2020-75, Section 3.02(3)
[43] Notice 2020-75, Section 3.02(4)

> will also permit taxpayers described in section 3.02 of this notice to apply the rules described in this notice to Specified Income Tax Payments made in a taxable year of the partnership or S corporation ending after December 31, 2017, and made before November 9, 2020, provided that the Specified Income Tax Payment is made to satisfy the liability for income tax imposed on the partnership or S corporation pursuant to a law enacted prior to November 9, 2020. Prior to the issuance of the proposed regulations, taxpayers may rely on the provisions of this notice with respect to Specified Income Tax Payments as described in this section 4.[44]

At the time that Notice 2020-75 was issued, seven states had adopted a form of the pass-through entity tax meant to assist individual equity holders of the business with avoiding the $10,000 state and local income tax deduction caps on their returns. These states were

- Connecticut,
- Louisiana,
- Maryland,
- New Jersey,
- Oklahoma,
- Rhode Island, and
- Wisconsin.[45]

With the exception of Connecticut, the taxes in those states are only imposed at the election of the pass-through entity.[46]

The decision to elect to use the tax is not as simple as it might appear—while it will almost always benefit residents of the state in question who have state and local taxes in excess of the $10,000 cap on such deductions on Schedule A, nonresidents will often find that they will no longer be able to claim a credit for taxes paid to another state when filing their own return, thus increasing the tax they are paying on their resident return and often costing the individual more than the federal tax saving obtained from getting a full deduction for the pass-through tax.

With the IRS now conceding that these laws do create a valid way to work around the limit on deducting state and local taxes for pass-through interest holders, we expect to see more states add these provisions in the future unless the SALT deduction limitation cap is repealed.

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[44] Notice 2020-75, Section 4

[45] "KPMG report: IRS to respect deduction for elective passthrough entity taxes of various states," November 16, 2020, https://home.kpmg/us/en/home/insights/2020/11/tnf-kpmg-report-irs-to-respect-deduction-for-elective-passthrough-entity-taxes-of-various-states.html (retrieved February 8, 2021)

[46] "KPMG report: IRS to respect deduction for elective passthrough entity taxes of various states," November 16, 2020

NOTES

Unit

9

Considering Tax Planning Opportunities

LEARNING OBJECTIVES

When you have completed this unit, you will be able to accomplish the following.

- Apply what has been learned in Units 1 through 8.
- Discuss available options to legally reduce corporate income tax burden.

INTRODUCTION

The usual objectives of state tax planning are to provide the optimal mix of corporate entities and to direct the organization's activities so that the overall state tax liability is minimized.

Effective state tax planning requires a thorough study of the corporation's current state tax liability and the statutes and apportionment formulas of the various states that have preferential tax provisions, or in which the corporation makes sales or otherwise does business.

In addition, all suggested tax planning strategies should be reviewed in light of the practical business considerations and the costs that might be incurred, because the minimization of state taxes may not be prudent from a business perspective.

It should also be noted tax planning strategies may conflict with a company's business needs or requirements in several ways. Key items such as workforce availability, state and local infrastructure, and short- or long-term local incentives need to be considered.

Traditional state tax planning involves a review of a corporation's activities within the various states to identify the activities that can be redirected in a manner that will reduce the organization's overall state tax liability.

These planning techniques generally include legally manipulating the percentage of income that is apportioned among the states by minimizing the apportionment factors in certain states.

Potential tax reductions generated under this approach may not be cost effective for a corporation whose income is widely distributed among a large number of states that impose a tax based on income.

Although the planning techniques available for reducing a corporation's overall state tax burden are practically without limit, let's focus on the four most popular and most successful areas for planning opportunities:

- Selecting the optimal state to be taxed
- Restructuring corporate entities
- Subjecting the organization's income to apportionment
- Using the most beneficial filing methods

SELECTING OPTIMAL STATE

Because the states use different definitions of the amount and type of activity necessary to place a tax situs within the state, a company is allowed—to a certain extent—to select the states with which it desires to have nexus.

When a corporation has only a limited connection with an undesirable (high-tax) state, it may abandon that activity by electing an alternative means of accomplishing the same result.

If nexus is established by:	Company could:
Sales employees call on customers in state	Create an internet marketing campaign or program
Delivering via company-owned trucks	Use common carriers
Conducting training sessions or seminars	Perform training via internet (i.e., webinars)

Although most planning techniques are used to disconnect a corporation's activities from an undesirable state, they can also be used to create nexus in a desirable (low-tax or no-tax) state. Establishing nexus in a given state can be advantageous when that state has a lower tax rate than the state in which the income is presently taxed.

EXAMPLE

McClary Machine, Inc., generates $500,000 of taxable income in one year from selling 40% of its product in State A and 60% in State B. Both states include only the sales factor in their apportionment formulas. State A, where McClary's manufacturing and shipping operations are located, has a tax rate of 10%, so its

income is subject to tax. State B has a rate of 3%, but McClary is currently immune from tax in the jurisdiction. State A is a throwback state.

Current situation (throwback required):

	Apportionment	Net Income	Rate	Tax
State A	100/100	$500,000	10%	$50,000
State B	0/100	$500,000	3%	0
Total tax liability				$50,000

If nexus is created with State B (no throwback required):

	Apportionment	Net Income	Rate	Tax
State A	40/100	$500,000	10%	$20,000
State B	60/100	$500,000	3%	9,000
Total tax liability				$29,000

RESTRUCTURING ENTITIES

The major objective is to design proper mix of entities to protect highly profitable companies in multi-state taxation scheme.

Preferably, you should situate highly profitable entities in low (or no) tax jurisdictions, then limit nexus if possible (though with economic nexus this becoming increasingly difficult).

Less profitable entities can, if necessary, be located in high taxing jurisdiction, or structure so these entities are the ones to create the multi-state nexus. Alternatively, a taxpayer may merge two entities. However, any planning must consider unitary state rules.

EXAMPLE

McClary Machine and its subsidiary, R&D Corp., are located in State A, where all of their sales and payroll is incurred and all of their property is located. During 1992, McClary generated $800,000 of taxable income, resulting in a tax liability to State A of $80,000. R&D Corp. posted a $300,000 loss; in fact, the company has never been profitable, but its research is vital to McClary's strategic goals. If R&D had been

merged into McClary (say, in a tax-favored reorganization), McClary's tax liability would be reduced by $30,000, to $50,000, a 37.5% reduction.

PASSIVE INVESTMENT SUBSIDIARIES

Nonbusiness or passive income generally is allocated to the state in which the income-producing asset is located, rather than apportioned among the states in which a corporation does business.

It is beneficial to have tax situs for nonbusiness assets in a state that

- does not levy an income tax,
- provides favorable tax treatment for passive income, or
- requires a corporate group to file a unitary return.

It is not necessary to be domiciled in state if you form a subsidiary holding company to

- hold the intangible assets and
- handle investment activities.

Delaware, for example, does not impose an income tax on a corporation whose only activities within the state are maintenance and management of intangible investments and collection and distribution of income from such investments or from tangible property physically located in the state.

This means the holding company

- must have an actual office and nexus and
- must not have contact with other states.

It is ideal for transferring patents and stock.

EXAMPLE

You will recall that McClary Machine had $800,000 of taxable income last year; $600,000 was income from operations and $200,000 was earned from passive investments. All of its sales and assets are in State A, which imposes a 10% corporate income tax, resulting in an $80,000 liability.

McClary created a passive investment subsidiary in State B, which does not impose income tax on a corporation within a state that maintains and manages passive investments. Result: assuming State A is non-unitary, State A tax drops from $80,000 to $60,000, a $20,000 savings and a 25% reduction.

SUBJECTING INCOME TO APPORTIONMENT

The purpose of apportionment: divide business income among the states in which the company does business.

If domiciled in a high-tax state, income eliminated from the tax base by apportionment may generate tax savings. Recall that the use of apportionment formulas is neither automatic nor elective in most cases.

Apportionment must be justified by the entity's actions and must have activities in, and contact with, one or more states. Remember: the company is entitled to apportion its income, when activities, or contacts subject it to tax.

Whether actually paying tax may be irrelevant as well as whether other states also tax.

Favorite planning ideas include the following:

- Locate a warehouse in a non-taxing or low-taxing state (sales and property factor).
- Use independent contractors instead of employees where possible (independent contractor payments do not enter payroll factor).
- If able to relocate manufacturing, find a single-sales-factor state that comprises minimal customers.

APPORTIONMENT

Keep abreast of judicial decisions in jurisdictions where you are subject to tax. If all else fails, you can petition for relief based on an inequitable apportionment. But remember that merely being subjected to a double tax isn't necessarily a surefire sign that the state's position will be held to be illegal.

CHANGING FILING METHODS

Consolidated Returns

For federal purposes, a consolidated return can be filed if all members of group consent. At that point, the group must continue to file on consolidated basis so long as the group remains in existence or the IRS grants permission for a separate combined return meaning that only one tax and is permitted by many states. It may be allowed as long as a consolidated return has been—or could have been—made for federal purposes:

- Missouri – An affiliated group that files a federal consolidated return can only elect a state consolidated return if at least 50% of the group's income is derived from Missouri sources.
- Decide on a state-by-state basis whether it is advantageous to file separately or consolidated.

Benefits of changing to consolidated reporting include being able to offset profitable company with loss company.

Detriments of changing to consolidated reporting include compliance costs, higher tax possible if all companies are profitable, and more potential filing states.

BURDEN OF PROOF

The Structure of state taxing schemes provides state with procedural advantages. There is a home-field advantage that states have in litigating tax controversy:

- Illinois and Pennsylvania—If evidence is not provided to auditor within 60 days, can never be used
- Connecticut—No court appeal until formal notice by commissioner

The burden of proof is normally imposed on taxpayers in state tax cases, presuming that

- the taxpayer has better access to information necessary and
- taxing authorities are experts in their duties.

NEW FORUM OF CHOICE—BANKRUPTCY COURT

The burden of proving validity and amount of claim is on the claimant. All claimants, whether private or governmental, must be treated equally. So a state government seeking recovery of taxes is just another claimant.

There is a split in the circuits on the issue of burden in bankruptcy cases for taxing agencies. In four circuits the state or federal government bears burden of proof when tax liability is litigated in bankruptcy court:

- Specifically, 5th, 8th, 9th, and 10th circuits
- See *Placid Oil Co. v. IRS*, 988 F.2d 554 (CA-5, 1993)

In two circuits (CA-3 and CA-4), burden of proof remains on the taxpayer:

- Company with state tax liability on threshold of bankruptcy—Consider filing for bankruptcy in favorable jurisdiction

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