

## MULTI-STATE TAXATION AND SALES TAX NEXUS OF BUSINESSES (MSTB)

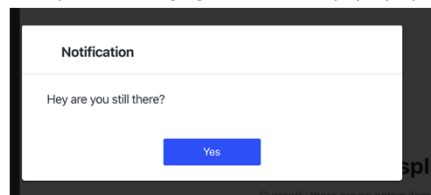
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## OVERVIEW

- Importance of Multi-State Taxation
- Personal Income Tax Considerations
- Sales Tax/Use Tax Nexus Developments
- Sales Tax Issues and Other Controversies
- Income Tax Nexus
- Determining State-Taxable Income
- Apportionment and Allocation of Income
- Taxing Pass-Through Entities
- Considering Tax Planning Opportunities

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## UNIT 1 IMPORTANCE OF MULTI-STATE TAXATION

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## LEARNING OBJECTIVES

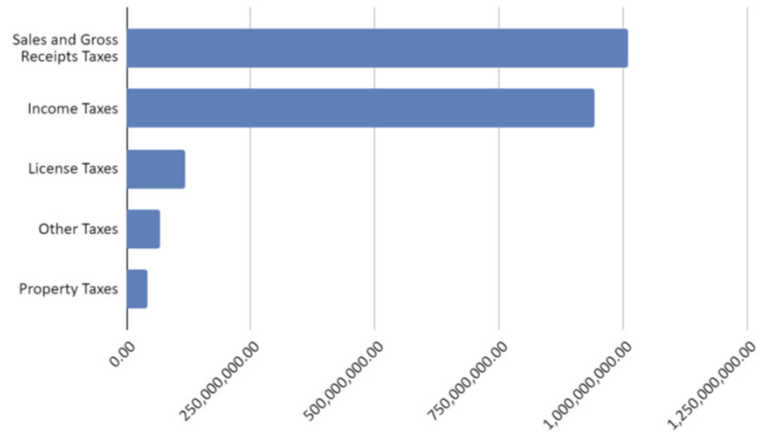
- Recognize the importance of state and local taxation in tax planning and compliance for multi-state business enterprises.
- Identify various types of taxes levied by state and local governments.

## WHAT IS SALT?

- SALT = state and local taxes
- SALT refers to the various income, franchise, sales & use, property, excise, and other types of taxes imposed by each state and their local jurisdictions.
- Significant issues arise when determining how to tax businesses in the various jurisdictions where they produce or sell products and services.
- When engaging in commerce, state and local jurisdictions tax businesses based on their “nexus” or legal connection. Nexus issues are discussed later in this course.
- When businesses are deemed to operate in more than one jurisdiction, the determination of Nexus is sometimes unclear—and with recent court decisions, this uncertainty is far more likely to continue.
- More than 8,000 jurisdictions impose taxes on businesses in the United States.

## BREAKDOWN OF SALT REVENUE

State and Local Taxes by Category



2019 U.S. Census Bureau Annual Survey of State Government Tax Collections

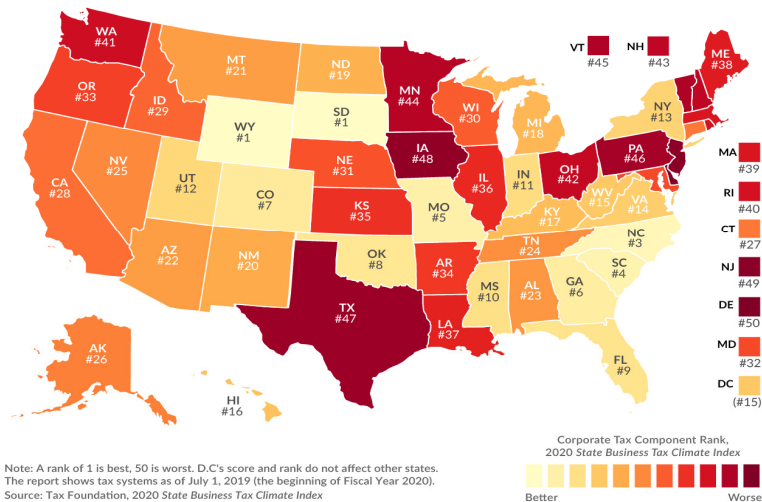
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## How Does Your State Rank on Corporate Taxes?

Corporate Tax Component Rankings, 2020 State Business Tax Climate Index



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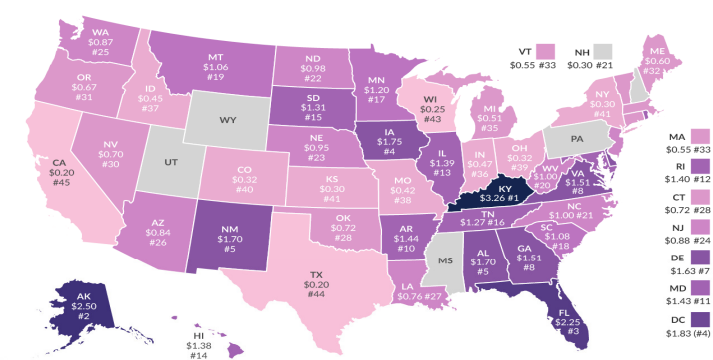
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How High are Wine Taxes in Your State?

State Wine Excise Tax Rates (Dollars per Gallon), as of January 2019



Note: Rates are those applicable to off-premise sales of 11% alcohol by volume (a.b.v.) non-carbonated wine in 750ml containers. Federal rates vary by alcohol content and type of wine, ranging up to \$3.15 for 21-24 percent alcohol and \$3.40 for sparkling wine. D.C.'s rank does not affect states' ranks, but the figure in parentheses indicates where it would rank if included.

AL, AZ, CA, CT, FL, GA, HI, ID, IL, IN, IA, KS, LA, ME, MA, MI, MS, MT, NE, NV, NH, NM, NC, ND, OH, OK, OR, RI, SC, SD, TX, VT, VA, WA, WV, WI, DC: Different rates also applicable to alcohol content, place of production, size of container, place purchased (on- or off-premise or on board airlines) or type of wine (carbonated, vermouth, etc.)

MS, NH, PA, UT, WY: Control states, where the government controls all sales. Products can be subject to ad valorem mark-up as well as excise taxes.

KY: Rates include wholesale tax rate of 10.25%, converted to a gallonage excise tax rate.

AR, MN, TN: Rates include case fees and/or bottle fees which may vary with size of container.

AR, MD, MN, SD, DC: Rates include sales taxes specific to alcoholic beverages.

Source: Distilled Spirits Council of the United States

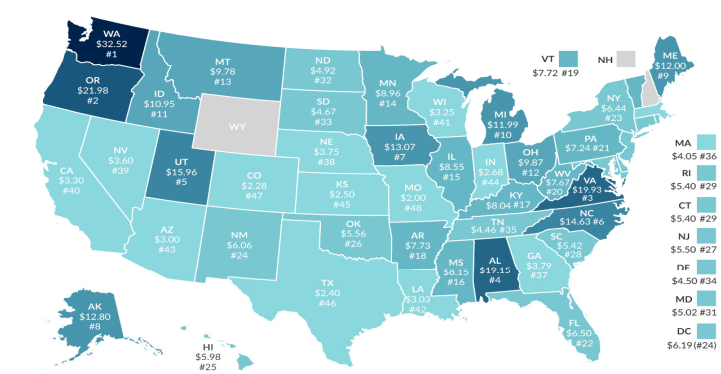
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How High are Distilled Spirits Taxes in Your State?

State Distilled Spirits Excise Tax Rates (Dollars per Gallon), as of January 2019



Note: Rates are those applicable to off-premise sales of 40% alcohol by volume (a.b.v.) distilled spirits in 750ml containers. At the federal level, spirits are subject to a tiered tax system. For 2019-2020, federal rates are: \$2.70 per proof gallon on the first 100,000 gallons per calendar year; \$13.34/proof gallon for more than 100,000 gallons but less than 22,250,000 and \$13.50/proof gallon for more than 22,250,000 gallons. D.C.'s rank does not affect states' ranks, but the figure in parentheses indicates where it would rank if included.

AK, CA, CT, DE, FL, GA, IL, IN, IA, MD, MA, NV, NY, RI, SD, TX: Different rates also applicable to alcohol content, place of production, size of container, or place purchased (on- or off-premise or on board airlines).

AL, ID, IA, ME, MI, MS, MT, NH, NC, OH, OR, PA, UT, VT, VA, WV, WY: Control states, where the government controls all sales. Products can be subject to ad valorem mark-up as well as excise taxes.

KY: Rates include the wholesale tax rate of 11%, converted to a gallonage excise tax rate.

AR, MN, TN: Rates include case fees and/or bottle fees which may vary with size of container.

AR, MD, MN, ND, SD, WA, DC: Rates include sales taxes specific to alcoholic beverages.

Source: Distilled Spirits Council of the United States

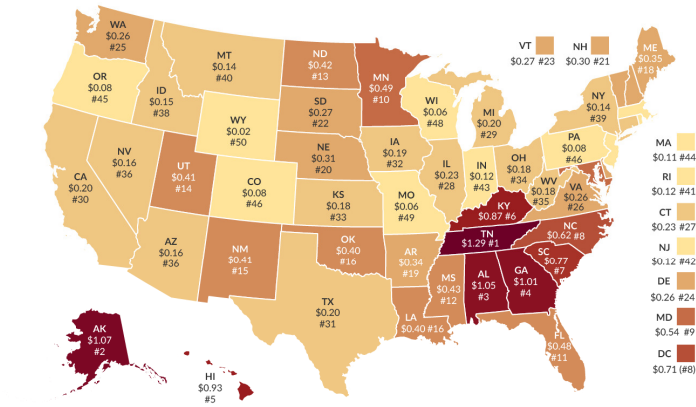
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## How High are Beer Taxes in Your State?

State Beer Excise Tax Rates (Dollars per Gallon), as of January 2019



Note: Rates are those applicable to off-premise sales of 4.7% a.b.v. beer in 12-ounce containers. At the federal level, beer is subject to differing tax rates. Small domestic brewers are taxed between \$0.11/gallon and \$0.516/gallon. All other brewers are taxed at rates between \$0.516/gallon and \$0.58/gallon. D.C.'s rank does not affect states' ranks, but the figure in parentheses indicates where it would rank if included. Different rates are also applicable in FL, GA, HI, ID, IA, KS, MN, NC, ND, OH, OK, TX, UT, VA, WA, and WI according to alcohol content, place of production, size of container, or place purchased (on- or off-premise or onboard airlines). Rates include the statewide local rates in AL (\$0.52) and GA (\$0.53) and sales taxes specific to alcoholic beverages in AR, MD, MN, and D.C. Rates in AR and RI include case fees and/or bottle fees which may vary with the size of container. Rates include the wholesale rate in Kentucky (10%) and Tennessee (17%), converted into a gallonage excise tax rate.

Source: Distilled Spirits Council of the United States, Tax Foundation

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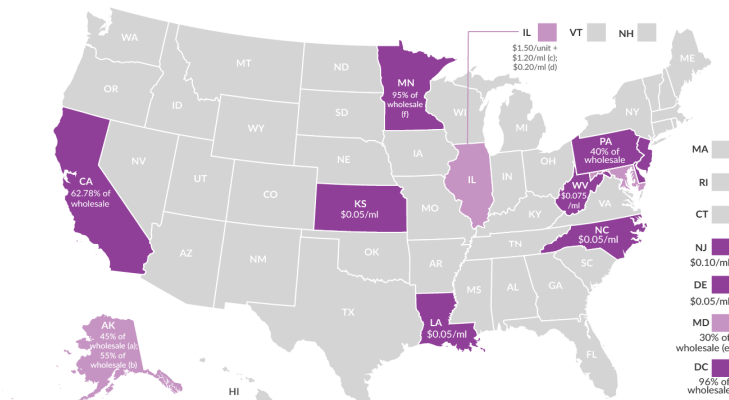
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## How High are Vapor Taxes in Your State?

State & Local Vapor Excise Tax Rates, as of January 2019



Note: (a) Tax is only applicable in Juneau, NW Arctic Borough, and Petersburg; (b) Tax is only applicable in Mat-Su Valley; (c) Tax is only applicable in the city of Chicago; (d) Tax is only applicable in Cook County; (e) Tax is only applicable in Montgomery County; (f) Tax is on the wholesale cost of any product containing or derived from tobacco. The tax on an e-cigarette starter kit is calculated on the total cost unless the nicotine cartridges are sold separately and then the tax is levied only on the value of the nicotine cartridge.

Source: State Statutes; Bloomberg Tax; Vapor Products Tax.

Statewide Vapor Excise Tax

Municipal Vapor Excise Tax

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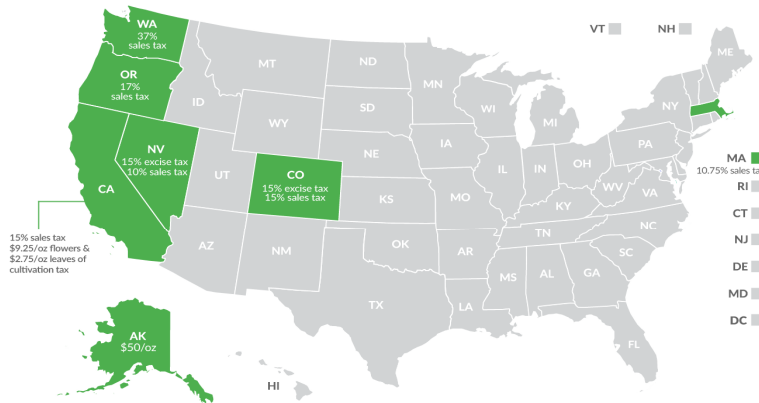
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## How High Are Recreational Marijuana Taxes in Your State?

State Recreational Marijuana Excise Tax Rates, January 2019



Note: Michigan legalized recreational marijuana in 2018 by ballot initiative, but has until Dec. 6, 2019, to implement a legal market. Maine legalized recreational marijuana in November 2016 by ballot initiative, but the state is still working to create a legal market. District of Columbia voters approved legalization and purchase of marijuana in 2014, but federal law prohibits any action to implement it. In 2018, the New Hampshire legislature voted to legalize the possession and growing of marijuana, but did not permit sales. Alabama, Georgia, Idaho, Indiana, Iowa, Kansas, Kentucky, Louisiana, Minnesota, Nebraska, Oklahoma, Rhode Island, Tennessee, and Wisconsin impose a controlled substance tax on the purchase of illegal products.

Source: Bloomberg Tax; state statutes

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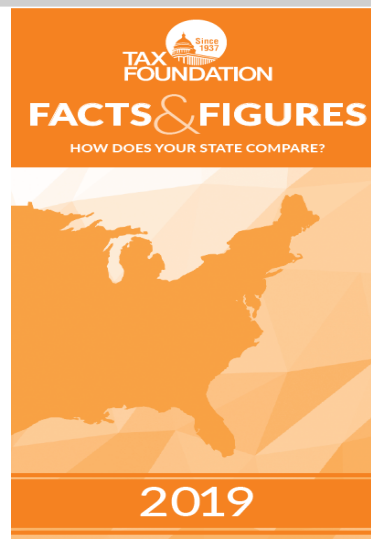
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## TAXES AND ISSUES TO ADDRESS

- Net income taxes, corporate, personal, flow-through (based on nexus)
- Income tax residency and withholding issues (which jurisdictions withhold)
- Apportionment of business income (especially the growth of market-based sourcing)
- Non-net income taxes shouldn't be ignored (often overlooked and potentially significant)
- Gross income taxes such as Delaware, Ohio, Texas, Nevada, and Washington (little or no offset allowed to gross receipts)
- Franchise (capital stock) taxes (becoming less common but can be significant in some instances)
- Sales and use taxes (also based on nexus and a hot topic since the Wayfair Supreme Court decision in June 2018)

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## TAXES AND ISSUES TO ADDRESS

- Credits and incentives (numerous and not at all consistent)
- Unclaimed (escheat) property (often forgotten and neglected)
- Property taxes – Real and personal property (jurisdictional rules vary greatly)
  - Assessed values
  - Ghost property on personal property schedules
- Payroll taxes and withholding
  - When is an employee subject to tax in more than one state? (potential for double taxation)
  - When are you liable for withholding taxes?
  - Convenience of the employer states (Connecticut, New York, Delaware, New Jersey, Nebraska, or Pennsylvania)

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## OTHER TAX-RELATED ISSUES TO ADDRESS

- Tax research on state and local tax issues (often a blind spot)
- Compliance reviews (often undertaken when a buyer shows up and can lead to expensive fixes before the sale can go through)
- Accounting issues
  - ASC 740 for income taxes
  - ASC 450 for contingent liability for non-income taxes
  - Both pronouncements relating to financial statement accounting for state taxes

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## SALT'S CHALLENGING ISSUES

- Income tax (state acceptance of federal conformity)
  - Static conformity (fixed reference to IRC at a point in time) (19)
  - Rolling conformity (congressional changes immediately affect state law) (18 and District of Columbia)
  - Selective conformity (take only specific parts) (New Jersey, Pennsylvania, Arkansas, Mississippi, and Alabama)
- State laws and views change – Have to review nexus issues regularly
- Vast majority of businesses have websites, meaning they are marketing to customers across state lines—and thus have potential exposure to tax filings and tax liability

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## SALT'S CHALLENGING ISSUES

- Fiscal health of states impacts aggressiveness in pursuing tax collections.
- States are currently experiencing devastating losses of revenue due to the COVID-19 crisis in 2020.
- COVID-19 also presents potential nexus issues as more employees work from home and their employer is in another state.
- Some states have announced they won't assert nexus based on employees working from home due to COVID-19 orders—but the vast majority have remained silent.

## EFFECTS OF FEDERAL TAX REFORM

- Due to linkage of most states' income taxes to federal IRC, federal tax reform has impacts on states
- Tax Cuts and Jobs Act (most provisions effective 1/1/2018)
  - Bonus depreciation expansion (100%)
  - Business interest expense limitation (§ 163(j))
- COVID-19 legislation
  - CARES Act – Net operating loss carrybacks, QIP, etc. – March 2020
  - Consolidated Appropriations Act – December 2020

## UNIT 2

### PERSONAL INCOME TAX CONSIDERATIONS

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### LEARNING OBJECTIVES

- 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

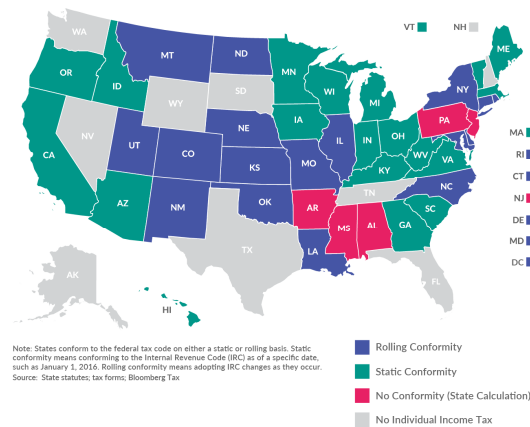
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## TAXATION OF INDIVIDUALS—STATE TAX CONFORMITY

Individual Income Tax Conformity



Source: Tax Foundation

<https://taxfoundation.org/state-conformity-federal-tax-reform/>

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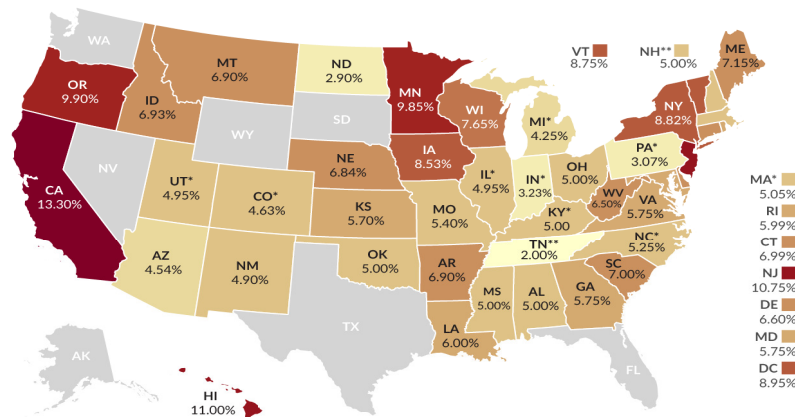
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## How High Are Income Tax Rates in Your State?

Top State Marginal Individual Income Tax Rates, 2019



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## WHEN TO WITHHOLD (IT'S COMPLICATED...)

### Which states are the most friendly to mobile workers and their employers?

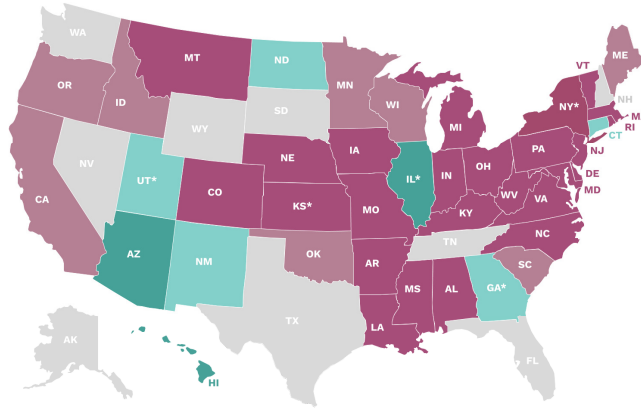
**Very Friendly.** State allows employees to work within the state for 30 or more days before employer is subject to withholding (AZ, HI, IL).

**Moderately Friendly.** State allows employees to work in the state between 15 and 29 days before employer is subject to withholding (CT, GA\*, NM, ND), or has other accommodating provisions (UT\*).

**Unfriendly.** State only allows employees to work in the state between 2 and 14 days before employer is subject to withholding (ME), or has a wage-based threshold (CA, ID, MN, OK, OR, WI).

**Very Unfriendly.** State requires employer withholding on first day an employee works within the state (24 states), or requires an individual to file on first day even if employer isn't required to withhold on first day (NY).

Not applicable. No state income tax.



Notes: In Georgia, employer must withhold if the employee is in the state for more than 23 days in a calendar year, or if \$5,000 or more or 6% or more of total income is attributable to Georgia. In Illinois, the 30-day threshold applies for tax years beginning after December 31, 2020 (this is the result of legislation enacted in 2019). In Utah, employer must withhold if the employer (not the employee) does business in the state for more than 60 days in a calendar year. \*Kansas considered 30-day legislation in 2020.

Source: <https://www.mobileworkforcecoalition.org/problem> (May 2020)

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## VIRTUAL OFFICE, VERY REAL TAX ISSUES

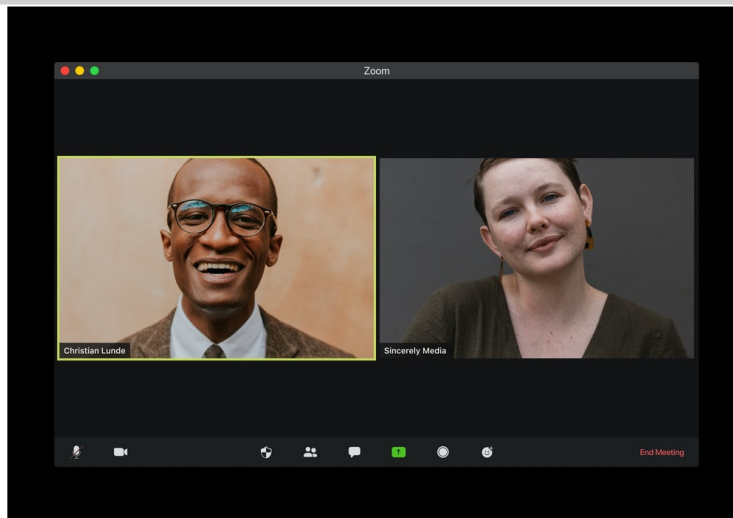


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## HOW DOES A STATE DETERMINE WHEN TO WITHHOLD?

- Most states use the location where an employee performs services for the employer (even if the state otherwise uses a market-based sourcing concept for apportionment of business income):
  - Thus, if an employee works in Arizona for a California employer, Arizona will require withholding and California will not (unless the employee lives in California).
  - Note that COVID-19 orders may cause a shift for employees who live in one state but commute to another.
- Connecticut, New York, Delaware, New Jersey, Nebraska, and Pennsylvania have a “convenience of the employer” rule, imposing tax based on location of the employer.
- Is the employee working at home due to an employer requirement?
  - An employee works from home in Tennessee for a New York employer and comes to the New York office for quarterly meetings.

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## HOW DOES A STATE DETERMINE WHEN TO WITHHOLD?

- It is possible two states could require withholding and demand employees to pay tax?
  - State where employee performs services see these as wages sourced to itself
  - State where employer’s office is sees these wages as sourced to itself
  - Neither will give a credit since there are no “out of state” wages

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## HOW DOES A STATE DETERMINE WHEN TO WITHHOLD?

- The stay-at-home orders brought about by the COVID-19 pandemic raise risks here for double taxation, especially in the Northeast and the six states with the convenience of employer rule:
  - Massachusetts has promulgated relief (TIR 20-5: Massachusetts Tax Implications of an Employee Working Remotely due to the COVID-19 Pandemic).
  - Most other states have *not* addressed these telecommuting issues.
  - Note – This will also potentially create other issues (nexus).
  - Massachusetts-specific relief is on the next slide (and gives a hint at problems that will exist in other states where no relief has been issued).

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## HOW DOES A STATE DETERMINE WHEN TO WITHHOLD?

### From Massachusetts TIR 20-5

A resident employee suddenly working in Massachusetts due to a state's COVID-19 state of emergency who continues to incur an income tax liability in that other state because of that state's sourcing rule will be eligible for a credit for taxes paid to that other state under G.L. c. 62, § 6(a). In addition, the employer of such employee is not obligated to withhold Massachusetts income tax for the employee to the extent that the employer remains required to withhold income tax with respect to the employee in such other state.

However, note that under the same rule, Massachusetts instituted a rule under 830 CMR 62.5A.3, similar to the convenience rule, applicable to telecommuters.

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## VISITING EMPLOYEES AND WITHHOLDING

- Could have exposure in any state an employee ends up in physically (or perhaps even an office of the employer they take on a project for)
- Employer should understand requirements for each state an employee does work in, no matter how minimal
- Illinois – Control and importance of services performed
- Colorado – If the employee works there, pay tax there

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## VISITING EMPLOYEES AND WITHHOLDING

- Working from home – Trap for the unwary
- Increasing number of businesses are hiring out-of-state service workers
- COVID-19 experiences likely to lead to an increase in this hiring – Large number of organizations now have experience with this type of operation
- Employee can run into problems with convenience-of-the-employer states
- Employer can find they have payroll reporting requirements in state where their remote worker lives

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## DEFERRED COMPENSATION

- Congress stepped in to solve a battle between the states in P.L. 104-95:
  - Employees worked in California, earning deferred compensation.
  - At retirement, they relocated to Washington or Nevada and then took deferred compensation.
- The state in which deferred compensation was originally earned *cannot tax it* if paid from a plan that
  - solely provides benefits in excess of § 415 limits *or*
  - provides payments in substantially equal installments
    - for not less than 10 years or
    - the life expectancy of the recipient and/or beneficiary.

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## DEFERRED AND EQUITY COMPENSATION

- Conversely, if the plan does not meet those requirements regarding deferred compensation arrangements, expect the other state to come calling:
  - Stock option plans, NQSO, ISO, and RSU plans, etc. are fair game for any state where employee earned some or all of the right to that compensation
  - Employer and employee should be aware of exposures
  - Also should consider these issues when designing a compensation program
  - Deferred bonus

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## STATE'S RIGHT TO TAX NONRESIDENTS

- States can tax income generated in their state (*Shaffer v. Carter*, 252 U.S. 37 (1920)), although Congress can limit that right (such as in PL 104-95).
- However, tax cannot discriminate against nonresidents.
- There is no absolute right to a credit against taxes paid to another state for the individual.
- Rather, the Supreme Court will apply tests to see if the system would avoid double taxation if *all states* used the same test.

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## LIMIT ON STATE'S RIGHT TO TAX RETIREMENT BENEFITS

- Key state loss years ago in *Davis v. Michigan*, 489 U.S. 803 (1989) when attempted to provide special benefit to state retirees not available to federal retirees
- In 1996 a general rule added in 4 U.S. Code Section 114 by H.R. 4019 to protect retirees in general – States barred from taxing retirement income of nonresidents

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## WHO IS A RESIDENT?

- In most states, the concept of *domicile* is used to determine who is a resident:
  - Common law concept of a person's "true home"
  - Even if absent for a long time, intend to return
  - Key issue – A domicile can only be abandoned when a new domicile is established
- Some states (New York, for example) also have a mechanical test where someone who spends more than a set number of days *will be a resident* for income tax purpose (used in *addition* to the domicile test).
- Note – Other states (California) only treat such a mechanical test as establishing a rebuttable presumption.

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## SOURCING FOR NONRESIDENTS

- In most cases, where the employee performs the service is what counts.
- But watch out for convenience-of-the-employer states or rules of similar effect—even if geographically remote from those locations (telework into a New York office could create issues for an employee in Hawaii).

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## CORPORATE PLANNING AND DOCUMENTATION

- Keep accurate records of where employees are working and mobility tracking, employee relocation, visiting employees, etc.
- Advise clients and management of any particular employment tax issues or incentives involved with relocation of a facility or purchase of a new business.
- Ensure accurate compliance filing records are kept for current and former employees, as well as past records properly maintained for potential state tax audits.

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## UNIT 3 SALES TAX/USE TAX NEXUS DEVELOPMENTS

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## LEARNING OBJECTIVES

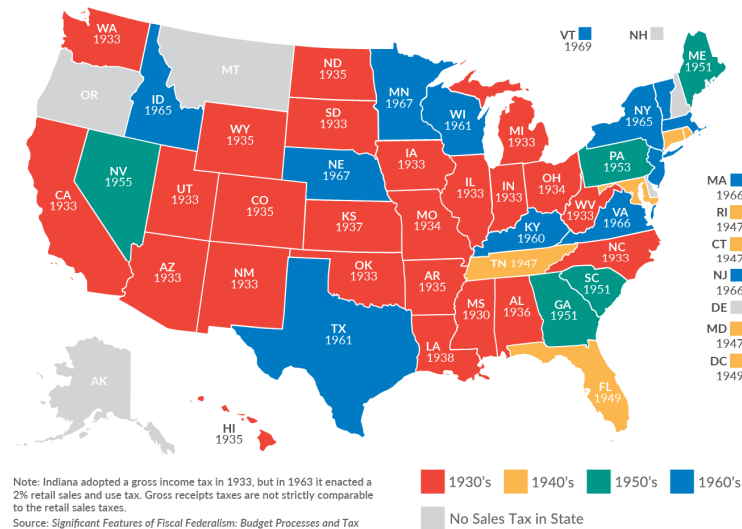
- Identify current sales and use tax nexus issues affecting business enterprises and the evolution of related court opinions.
- Apply standards articulated by state courts to situations where there is no statute.
- Apply principles developing in-state statutes and state courts to sales and use tax planning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

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### When Was a Sales Tax Adopted in Your State?



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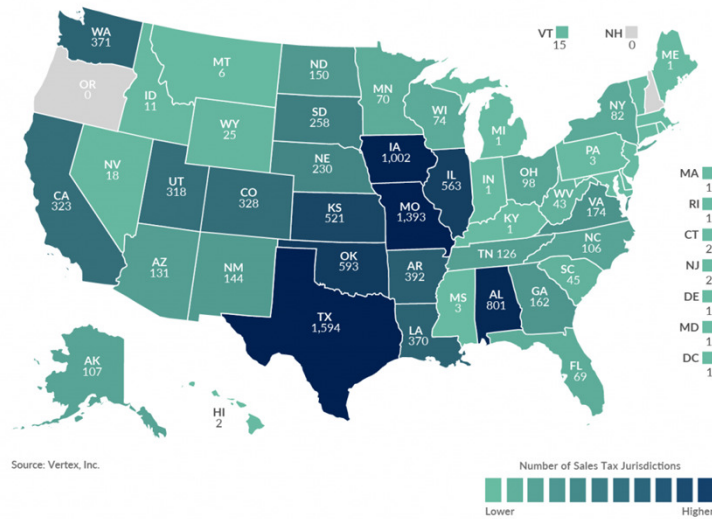
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## How Many Sales Tax Jurisdictions Does Your State Have?

Total Sales Tax Jurisdictions by State, 2018



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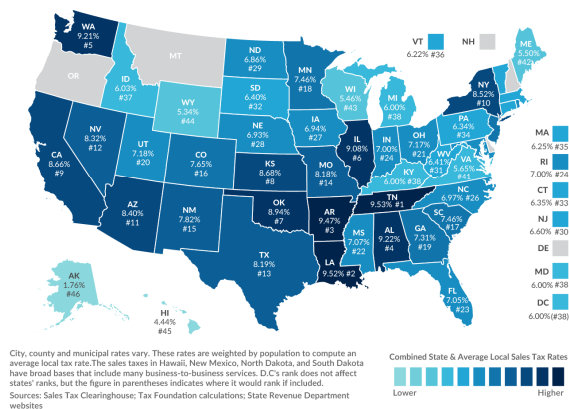
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## SALES/USE TAX RATES

### How High are Sales Taxes in Your State?

Combined State & Average Local Sales Tax Rates, January 1 2020



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Source: Janelle Cammenga, "State and Local Sales Tax Rates, 2020." *Tax Foundation*. January 15, 2020. <https://taxfoundation.org/2020-sales-taxes/>

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## SALES/USE TAXES

- From the same source (Janelle Cammenga, “State and Local Sales Tax Rates, 2020.” *Tax Foundation*. January 15, 2020)
  - 45 states and the District of Columbia collect state-wide sales taxes.
  - Local taxes are collected in 38 states:
    - In some cases, equal or exceed state taxes
    - May also have “home rule” issues (Colorado, for instance)

## SALES/USE TAXES

- From the same source (Janelle Cammenga, “State and Local Sales Tax Rates, 2020.” *Tax Foundation*. January 15, 2020)
  - Five states with the highest combined average state/local sales tax rates:
    - Tennessee (9.53%)
    - Louisiana (9.52%)
    - Arkansas (9.47%)
    - Washington (9.21%)
    - Alabama (9.22%)
  - But note that sales tax bases vary quite a bit

## SALES/USE TAXES

- From the same source (Janelle Cammenga, “State and Local Sales Tax Rates, 2020.” *Tax Foundation*. January 15, 2020)
  - States with no state or local sales taxes are
    - Delaware,
    - New Hampshire, and
    - Oregon.
  - Montana has no state sales tax but does have special taxes in resort areas.
  - Alaska has no state sales tax but does allow localities to charge sales tax.

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## WHO HAS SALES/USE TAX NEXUS?

- Issue
  - Whether a company's selling method or business operations within a state are sufficient to require it to collect sales/use taxes
- Risk
  - Failure to collect the tax can result in significant tax liability for the company, with little or no hope of obtaining reimbursement from the seller's in-state customers.

**Note – Sellers collect sales taxes from purchasers on behalf of the state; they are therefore “trust fund taxes.”**

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## THE NATIONAL BELLAS HESS CATALOG



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## WHO HAS SALES/USE TAX NEXUS?

- *National Bellas Hess v. Department of Revenue*, 386 U.S. 753 (1967)
  - [Mail-order business](#)
  - “. . . The resulting impediments upon the free conduct of its interstate business would be neither imaginary nor remote.”
- U.S. Constitution, Article I, Section 8, Clause 3
  - “The Congress shall have power . . . to regulate commerce with foreign nations, and among the several states, and with the Indian tribes.”

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## WHO HAS SALES/USE TAX NEXUS?

- *National Bellas Hess* created a physical presence test that lasted up to *Wayfair*:
  - Any physical presence in a state – Had to collect the sales/use tax from buyers
  - No physical presence in the state – No duty to collect sales/use tax from buyers
- Note – While *Wayfair* got rid of the “no physical presence” defense against collecting sales tax, most states still believe any physical presence, no matter how minor, will create nexus for sales tax purposes
- It was a *dormant commerce clause* decision, sustained later in *Quill*, finally reversed in *Wayfair*.

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## COMMERCE CLAUSE AND DORMANT COMMERCE CLAUSE

- Article I, Section 8, Clause 3 of U.S. Constitution states: “Congress shall have the power . . . to regulate commerce with foreign nations, and among the several states, and with the Indian tribes.”
- The *Dormant* commerce clause refers to a judicial doctrine developed by the U.S. Supreme Court, first truly asserted in *Reading Railroad v. Pennsylvania*, 82 U.S. (15 Wall.) 232 (1873):
  - Used when an interstate commerce issue arises that Congress has not spoken to
  - Applied until such time as Congress acts on the issue
- In tax, it looks at the relative burden to the out-of-state actor vs. benefits provided.

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## COMMERCE CLAUSE

- *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1974)
  - “. . . For the privilege of engaging or continuing in business or doing business”
  - The tax must satisfy a four-pronged test:
    - Activity with a **substantial nexus** to taxing state
    - Fairly **apportioned**
    - **Not discriminatory** against interstate commerce
    - **Fairly related** to the services provided by the state

## COMMERCE CLAUSE

- *Oklahoma Tax Commission v. Jefferson Lines, Inc.*, 514 U.S. 175 (1995)
  - Is apportionment needed?
  - “The taxable event comprises agreement, payment, and delivery of some of the services in the taxing State. No other State can claim to be the site of the same combination.”
- Congress reacted by passing Section 14505, Interstate Commerce Commission Termination Act (P.L. 104-88, 12/29/1995) to override *Jefferson Lines*.

## COMMERCE CLAUSE

- *Goldberg v. Sweet*, 488 U.S. 252 (1989) clarified *Complete Auto Transit*:
  - 2nd prong – Apportionment; internally consistent
    - This is to “ensure that each State taxes only its fair share of an interstate transaction.”
  - 3rd prong – Nondiscriminatory; externally consistent
    - “It is not a purpose of the Commerce Clause to protect state residents from their own state taxes.”
  - 4th prong – Fairly related
    - This “focuses on the wide range of benefits provided to the taxpayer, not just the precise activity connected to the interstate activity at issue.”

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## COMMERCE CLAUSE—*QUILL V. NORTH DAKOTA*

- Most participants have practiced primarily under the *Quill* decision.
- It was an attempt by North Dakota to get SCOTUS to reverse *National Bellas Hess*.
- It failed to get the desired reversal, but the decision shows the beginning of the cracks:
  - Agreed that concepts used were at odds with other commerce clause decisions
  - Also effectively said it would have decided *National Bellas Hess* differently
  - But due to existence of that case, *stare decisis* leads to continuing it, for now

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## COMMERCE CLAUSE—*QUILL V. NORTH DAKOTA*

- SCOTUS invited Congress to address the issue.
- Congress never took the court up on this:
  - States with heavy reliance on sales tax were in favor of congressional action.
  - Senators/representatives from elsewhere saw little upside in taking this issue on.
- But certain states (especially in the Midwest) took up SCOTUS's invitation to get a simplified system – The Streamlined Sales Tax Agreement established:
  - simplified statewide rates,
  - centralized registration, and
  - “free” software.

## AND THEN THERE WAS *QUILL*

- *Quill Corporation v. North Dakota*, 504 U.S. 298 (1992), May 26, 1992
  - North Dakota Supreme Court
    - *Quill* in effect asks us to accept the notion that the United States Supreme Court will abandon its common sense and experience at the courthouse door and ignore the tremendous social, economic, commercial, and legal innovations since 1967, and blindly apply an obsolescent precedent.
    - The economic, social, and commercial landscape upon which *Bellas Hess* was premised no longer exists, save perhaps in the fertile imaginations of attorneys representing mail-order interests.

## AND THEN THERE WAS *QUILL*

- Due process
  - Minimum contact; fairness
  - Subject itself to the state's jurisdiction
    - In “modern commercial life,” it matters little that such solicitation is accomplished by a deluge of catalogs rather than a phalanx of drummers: “The requirements of due process are met irrespective of a corporation's lack of physical presence in the taxing State.”
- Commerce clause
  - Need substantial nexus
  - A means for limiting state burdens on interstate commerce

## EXPANSIVE VIEWS OF PHYSICAL PRESENCE

- States got creative within this set of rules.
- The ultimate expression was “cookie nexus” from Massachusetts (Ohio took a similar position):
  - Storing a cookie (web token) on buyer's machine in Massachusetts established a physical presence (use of equipment in Massachusetts)
  - Same impact if an application was installed on buyer's phone
  - Hiring company to physically deliver product in Massachusetts also established nexus

## EXPANSIVE VIEWS OF PHYSICAL PRESENCE

- Trade show appearances pre-*Wayfair*
  - 34 states decided making or taking orders at a trade show established physical presence.
  - 36 states find physical presence if a business makes sales in the state, even if just for 3 (or even fewer) days.
- Digital software
  - Selling remote access to canned software is a nexus activity in some states (ultimate defense would have been a cookie nexus type theory).
  - The sale of music and other data.

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## EXPANSIVE VIEWS OF PHYSICAL PRESENCE

- Registration with the state
  - “Voluntary” trigger of nexus
  - May need registration to be able to sue and defend against suits (remember that other commerce clause decisions were not as restrictive as *Quill*)
- Remember – States generally take the position all of these establish nexus independent of fitting under *Wayfair*’s minimum sales type tests.

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## END RUNS AROUND *QUILL*

- Another approach was to concentrate on the idea that *Quill* was an outlier decision that existed only due to *stare decisis*.
- So they tried an approach where they did not require collection but made compliance so burdensome otherwise that vendors would simply volunteer to register.
- “Tattletale” provisions came out of this and were gaining traction in the year before *Wayfair*.
- Even if *Wayfair* had been decided in favor of *Wayfair*, it’s very possible these rules would have caused the same effective result as more states adopted them.

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## COLORADO TATTLETALE PROVISION

- Colorado required out-of-state sellers to
  - inform out-of-state buyers they owe use tax,
  - provide the state with a list of such buyers who bought more than a *de minimis* amount, and
  - send reports to buyers telling them how much they bought and that they had been reported to the state.
- It was challenged in *Direct Marketing Association v. Brohl*, CA10, Case No. 12-1175.
- CA10 ruled that *Quill* didn’t apply—they weren’t being asked to collect the tax.

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## COLORADO TATTLETALE PROVISION

- Rejected idea this discriminated against interstate commerce
  - Rather, DMA was asking the court to require Colorado to discriminate against businesses located in Colorado
  - Commerce clause doesn't mandate giving out-of-state sellers a better deal than what is available to in-state sellers
- Key concurrence authored by Judge Gorsuch (by the time of *Wayfair*, Justice Gorsuch)
  - No requirement to burden in-state businesses
  - Stated that adoption of these provisions would be a backdoor reversal of *Quill*—but that's fine...

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## COLORADO TATTLETALE PROVISION

- Another indication that *Quill* was in trouble occurred when this case got before SCOTUS on a procedural issue.
- Justice Kennedy in a concurrence indicated that this was not the vehicle to revisit *Quill* but that perhaps it was time to do so.
- The comment was interesting because Justice Kennedy was part of the *Quill* majority.
- This gave states looking for a reversal of *Quill* belief that they had two sure votes to repeal when Justice Gorsuch was confirmed (they were right).
- But remember that Colorado still has this tool even if a business believes they are exempt under *Wayfair*.

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## COLORADO TATTLETALE PROVISION

- In practice, the law did not lead to the results Colorado expected.
- However, *Wayfair* changed what the states were paying attention to.
- As well, Colorado's penalties weren't that large for a smaller business—but another state would solve that problem.

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## WASHINGTON TATTLETALE—LOW MINIMUM/HIGH PENALTIES

- Similar tattle tale concept as Colorado but applies to any seller that sells more than \$10,000 per year into Washington (Colorado's limit was \$100,000)
- Actions to take
  - Post notice on website about use tax liabilities
  - Remind buyers on sales form/web page of use tax liability
  - Give notices to buyers
  - Send copies to state

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## WASHINGTON TATTLETALE—LOW MINIMUM/HIGH PENALTIES

- Penalties
  - Failure to give pre-sale notice: \$20,000
  - Annual notice not given to customers: \$5,000 minimum penalty
  - Failure to send notices to the state: \$20,000 minimum penalties
- Would be able to get a conditional abatement if agreed to collect the taxes

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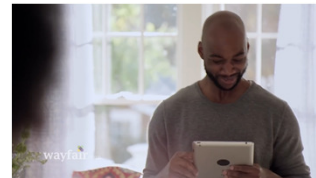
## SOUTH DAKOTA GOES AFTER *QUILL*

- South Dakota decided now was the time to challenge *Quill*.
- They passed a law they knew was contrary to *Quill*, set for any challenge to go straight to the South Dakota Supreme Court:
  - Trial court held it violated *Quill* (expected result)
  - SD Supreme Court ruled it violated *Quill* and they couldn't go against SCOTUS (also expected)
- This set up a SCOTUS appeal.

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## CITATION: *STATE OF SOUTH DAKOTA V. WAYFAIR*, SD SC, CASE NO. 28160, 9/14/17

- Oral arguments heard April 17, 2018
- Quote of the day from Justice Breyer:
  - “When I read your briefs, I thought ‘absolutely right.’ And then I read through the other briefs, and I thought, ‘absolutely right.’ And you cannot both be absolutely right.”
- Decision rendered June 21, 2018



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## SUPREME COURT THROWS OUT *QUILL*

- *South Dakota v. Wayfair, Inc.*, 138 S. Ct. 2080, 6/21/18
  - 5-4 decision
  - Justice Kennedy for the majority, Justice Thomas concurrence, Chief Justice Roberts wrote a dissent
- Death of the physical presence standard
  - Pushes *Complete Auto Transit, Inc. v. Brady*, 430 U. S. 274 (1977) standards
  - Modern internet has changed the world since *Quill*
  - Not clear why physical presence, no matter how minor, should control this

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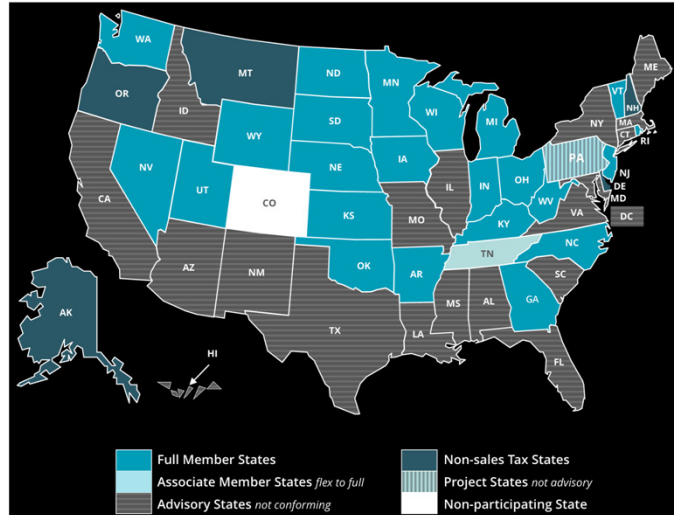
## SUPREME COURT THROWS OUT *QUILL*

- Impact of the internet
  - In 1992, when *Quill* was released, 2% of Americans had internet access.
  - In 1992, mail order was \$180 billion; the internet commerce today is \$453.5 billion.
- Unfair advantage to out-of-state sellers
  - Use taxes are never really paid by buyers.
  - Wayfair actually encourages its buyers to skip paying the taxes as part of its marketing.

## SUPREME COURT THROWS OUT *QUILL*

- Limits on state's ability to require tax collection
  - State still must show their regime does not unreasonably burden interstate commerce
  - Is there too small a level of physical presence? Not really clear
- South Dakota as a template – Did not say it was okay, but...
  - Safe harbor: \$100,000 or 200 transactions
  - No retroactivity
  - Streamlined sales and use tax agreement
  - Access to software paid for by the state that provides audit protection

## SUPREME COURT THROWS OUT *QUILL*



<https://www.streamlinedsalestax.org/>

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## SUPREME COURT THROWS OUT *QUILL*

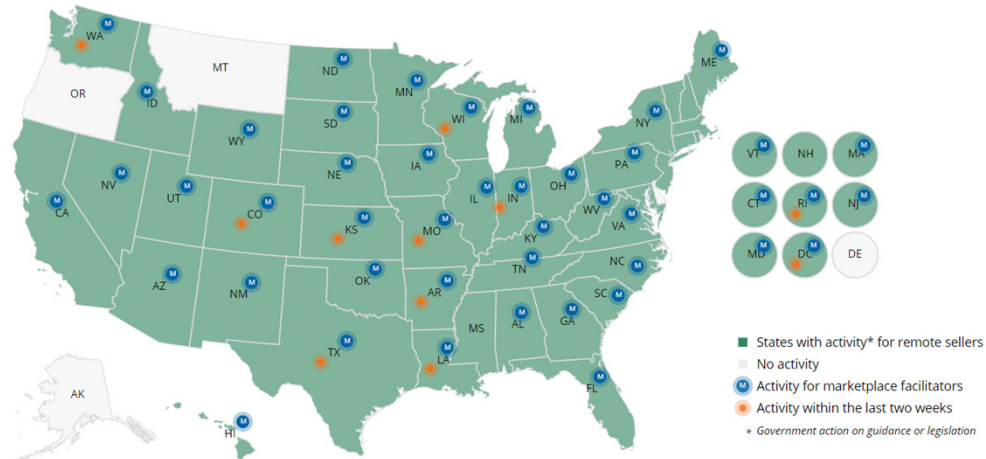
- What will Congress do?
  - There was an initial push for congressional action, but the main interest comes now from states with no sales taxes.
  - There is no pending action at this time, nor is there likely to be any.
- What have the states done?
  - States are “kind of” following South Dakota:
    - Most have followed the minimum sales number.
    - No new state has joined SSUTA.
  - They also have had a series of marketplace acts enacted.

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## STATE ACTIONS POST-WAYFAIR



Source: <https://www.taxnotes.com/nexus-tracker> (subscription required)

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## ACCOUNTING FOR CONTINGENT LIABILITIES

- Accounting for contingent liabilities – ASC 450
- Difference from income tax issues under ASC 740
  - Key definitions
  - Potential liabilities due to unpaid sales taxes
  - Standard for accruing sales tax, interest, and penalty liability
- When a liability should be recorded
- Disclosure issues
- What about claims that now appear possible post-Wayfair
- Evaluating the Wayfair claims of states

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## So, WHAT Do You Do?

- Biggest impact is on midsize organizations
  - Small entities won't have many states due to de minimis rule
  - Very large entities have resources for full departments devoted to the issue
- Significant number of businesses are just ignoring the issue and hoping
- Exposes the CPA, both at the attest and tax level
  - Outside users of the financial statement – Contingency problem
  - CPA firms may face client claims “you should have told us” when a state shows up

## IMPLEMENTATION

- Software vendors, such as Avalara, solve only *part* of the problem.
- Real problems include
  - mapping the inventory to sales tax classes for each taxing jurisdiction and
  - integrating the software system with the business's own internal systems:
    - Sending data to vendor to get proper tax rates
    - Communication of what was actually sold
    - Getting information liability issues back into accounting systems
- So “free” isn't really no cost.



## STEPS TO CONSIDER

- Report on sales by state/locality:
  - By number of transactions
  - By dollar amount
- Highlight states in excess of South Dakota de minimis numbers.
- Pay special attention to **Streamlined Sales and Use Tax** states.
- Research rules for each state.
- Note – An organization may decide that using a marketplace, despite the costs, may be the least expensive option if they want to sell out of state.

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## UNIT 4

### SALES TAX ISSUES AND OTHER CONTROVERSIES

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## LEARNING OBJECTIVES

- 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.

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## KEY ISSUES

- Statistical sampling
- Responsible persons
  - Is an individual truly a responsible person for sales/use tax purposes?
- Corporate reorganizations and transactions
- Third-party drop shipment sales
- Online rules

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## UNCLAIMED PROPERTY AUDITS

- Doesn't fit any unit well, but important to remember
- Impacts lots of property, including the following:
  - Dividends, interest, and security deposits
  - Unpaid wages and uncashed vendor checks
  - Unredeemed coupons and gift certificates
- *New York v. Delaware*, 113 S. Ct. 1550 (1993)
  - First to owner's state, if known
  - If not known, goes to state of incorporation
- Danger is that there are sporadic exams

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## UNIT 5 INCOME TAX NEXUS

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## LEARNING OBJECTIVES

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

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## RECENT NEXUS DEVELOPMENTS

- States prior to *Wayfair* had been more aggressive in pursuing income tax nexus.
- A move toward economic nexus tests as it became clear physical presence wasn't being required by the courts.
- States are likely to expand activity since *Wayfair*.
- *Wayfair*, while related to sales taxes, the court made it clear that the tests established in *Complete Auto Transit* is "the now-accepted framework for state taxation." – Justice Kennedy

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## COMPLETE AUTO TRANSIT TESTS

- 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 occurs within the state.
- Does not discriminate against interstate commerce – It should not favor intrastate commerce over interstate commerce.
- 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.

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## NEXUS

- State of incorporation or formation – Has jurisdiction to tax
- Right to tax business in states where they are not incorporated depends on sufficient connections
  - *Nexus* describes degree of legal connection
  - Sufficient connection determined by amount of activity
    - Legal existence
    - Property location
    - Services performed
    - Revenue derived

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## PUBLIC LAW 86-272

- Limit to states' rights to impose tax on interstate activity in response to *Northwestern States Portland Cement Co. v. Minnesota*, 358 U.S. 450 (1959)
  - SCOTUS allowed Minnesota to tax an Iowa corporation.
  - The Iowa corporation had solicited orders and maintained a leased office in Minnesota.
- Was a “stop-gap” short-term fix that is now over 60 years old and gives evidence how much Congress does *not* want to deal with these issues

## PUBLIC LAW 86-272

- Interstate Income Act of 1959, P.L. 86-272 (better known by its P.L. reference)
  - No income tax can be imposed by a state where the only connection is
    - solicitation of orders for sales of tangible personal property,
    - orders sent outside of the state for approval, or
    - orders filled and shipped from outside the state.

## PUBLIC LAW 86-272

- Mere solicitation of orders is not sufficient
- Applies to “net income” only
- Does not extend to the following:
  - Selling or providing services
  - Leasing or renting personal property
  - Real or intangible property

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## WRIGLEY DECISION

- *Wisconsin DOR v. William Wrigley, Jr., Co.*, 112 S. Ct. 2447 (1992)
  - “Solicitation” of orders includes
    - any explicit verbal request for orders and
    - any speech or conduct that implicitly invites order.
  - Businesses are not subject to net income tax when other activities within a state are either
    - ancillary to requesting orders of tangible property or
    - de minimis.
  - Key issue – If moved outside of these narrow protections, the state is not impacted by PL 86-272.

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## WRIGLEY DECISION

- Found to be ancillary or de minimis:
  - Providing a car and free samples—for solicitation only
  - Recruiting, training, and evaluating sales representatives
  - Using hotels and homes for sales meetings
- Found to be “too much” and allowed taxation:
  - Replacing stale gum in stores
  - Supplying the gum through stock checks
  - Storing gum within state

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## WRIGLEY DECISION

- States are looking for any activity that they see as beyond the protections:
  - Providing repair services via contractors
  - Finding services component of what is being sold
- Remember, once protection is lost, the tangible personal property sales still count.
- Services (which are now a much larger part of the economy) have no protection under P.L. 86-272.

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## EXPANSION OF A STATE'S REACH—EXAMPLES

- Contracts for services inside a state even with no time spent in the state
- California Office of Tax Appeals, *Matter of the Appeal of Blair S. Bindley*, OTA Case No. 18032402, 2019
  - Author did all work from Arizona, spent no time in California
  - Had contracts with 2 LLCs in California
  - Even though below amounts for economic nexus, found still taxable under “doing business” in California view
- California has approached other writers with California clients

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## MULTI-STATE TAX COMMISSION AND UDITPA

- Model law – Relates to the allocation and apportionment of income among states for corporations with multistate operations.
- **UDITPA** – Originally issued in 1957 by the Uniform Law Commission, it provides a model law for allocating and apportioning income among the states. In 1966, a group of state officials drafted the Multistate Tax Compact, which incorporates, to address income tax issues affecting multistate taxpayers. – More on this topic in Unit 7

<http://www.mtc.gov/getattachment/Uniformity/Article-IV/Model-Compact-Article-IV-UDITPA-2015.pdf.aspx>

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## INDEPENDENT CONTRACTORS

- Public Law 86-272
  - Immunity to certain in-state activities conducted by independent contractors
  - Would not be permitted if performed directly by the business
- Third-party repair services create nexus
- Nexus standards for income taxes not the same as—or lower than—sales taxes

## PHYSICAL PRESENCE AND INTANGIBLE ASSETS

- Physical vs. economic presence
- Intangible holding companies
- *Geoffrey v. South Carolina*
  - Physical presence not required in net income tax cases
  - “Minimum connection” and “substantial nexus” satisfy due process clause and commerce clause of U.S. Constitution

## ECONOMIC NEXUS

- Use of subsidiary or affiliate with presence of the following:
  - Intangible asset
  - Account receivable
- Recent cases involving the following:
  - Trademarks
  - Credit cards
  - Software
    - U.S. Supreme Court continues to avoid

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## REACTION TO *WAYFAIR*

- Most experts agree that *Wayfair* will impact net income and other types of taxes.
- Aggressiveness is increasing among the states.
- Wells Fargo booked a \$500 million adjustment to taxes based on expectation of state income tax claims.
- Pennsylvania specifically addresses *Wayfair* in new guidance (Pennsylvania Corporation Tax Bulletin 2019-04):
  - No physical presence test
  - \$500,000 corporate tax trigger
- If a corporation is claiming P.L. 86-272 exemption, it still has to file with PA to claim that exemption.

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## ECONOMIC NEXUS FOR AUTO FINANCE OPERATIONS

- *Capital One Auto Finance, Inc. v. (Oregon) Department of Revenue*, Docket No. SC S064803
  - Provided auto financing marketed via dealers in Oregon
  - Applications were sent out of state and approved there
  - No employees in Oregon
  - Found that they were still doing business in Oregon and owed Oregon state income tax

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## ECONOMIC NEXUS

### State Nexus Standards

Nexus policy based on **physical presence**



Nexus policy based on **economic presence**



Nexus policy based on **factor presence**



NOTE: Some states provided more than one "yes" response. DC and NYC are treated as states for purposes of this chart. NV, SD, WA and WY do not impose a corporate tax based on income. OH, NY and SC did not participate in this portion of the survey. As a result, these 7 states are not included in this chart.

Source: Bloomberg BNA 2017 Survey of State Tax Departments

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## NEXUS QUESTIONNAIRE

- Most states offer guidance on what they believe creates nexus.
  - Example – South Carolina document in the manual

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## UNIT 6 DETERMINING STATE-TAXABLE INCOME

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## LEARNING OBJECTIVES

- 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.

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## THE TAX BASE

- Most states begin corporate income tax with federal taxable income (for individuals, adjusted gross income is used most often).
- But which taxable income?
  - From line 28 – Taxable income before net operating losses (NOL) and special deductions or
  - From line 30 – Taxable income
- Some states adopt their own systems for calculating income.

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## CONFORMITY—ROLLING VS. STATIC

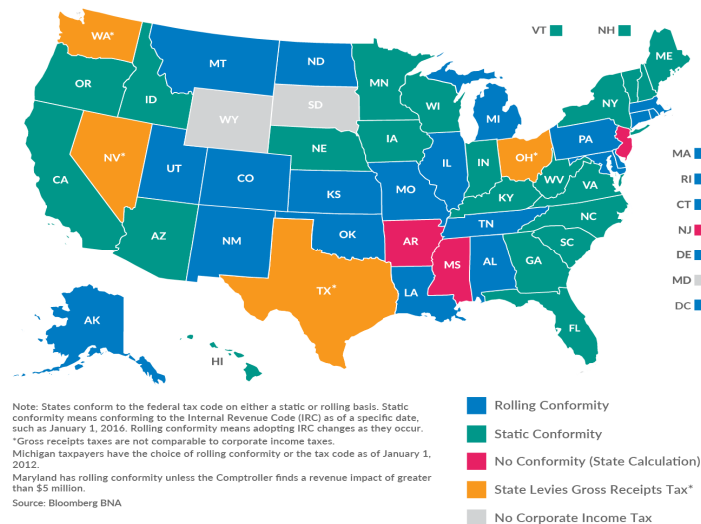
- Rolling conformity – Changes in federal law are immediately reflected in the state tax base unless the legislature steps in and makes adjustments.
- Static conformity – Federal law is adopted as of a fixed date. Law changes are reflected only if the legislature adopts the federal change (normally by moving the date).
- Why not rolling conformity everywhere?

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### Does Your State's Corporate Income Tax Code Conform With the Federal Tax Code?



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## CALCULATING STATE NET INCOME TAX

- 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.
- 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.

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## AREAS OF NONCONFORMITY

- Bonus depreciation issues
- Other federal stimulus provisions
- CARES Act – Likely to see more nonconformity
  - Net operating losses (NOL) carrybacks
  - QIF 15-year life
  - § 163(j) interest rules

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## ALTERNATIVE MINIMUM AND OTHER TAXES

- Most states have a minimum dollar amount for corporate taxes (\$50 to \$800).
- Some states have corporate alternative minimum tax (AMT).

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## COST RECOVERY

- Over time, most states have adopted the § 168 cost recovery system.
- Also, often states have not followed bonus depreciation, which is now up to 100%.
- § 179 has also slowly been accepted by states, though a number still have a lower limit.

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## NET OPERATING LOSSES

- Federal NOLs have been changed twice in recent years:
  - 2-year carryback and 20-year carryforward before 2018
  - TCJA repealed carrybacks entirely, unlimited carryover, and 80% maximum application
  - CARES Act adopts 3-year carryback for years 2018–2020
- States tend to adopt their own rules here, if they allow carrybacks at all

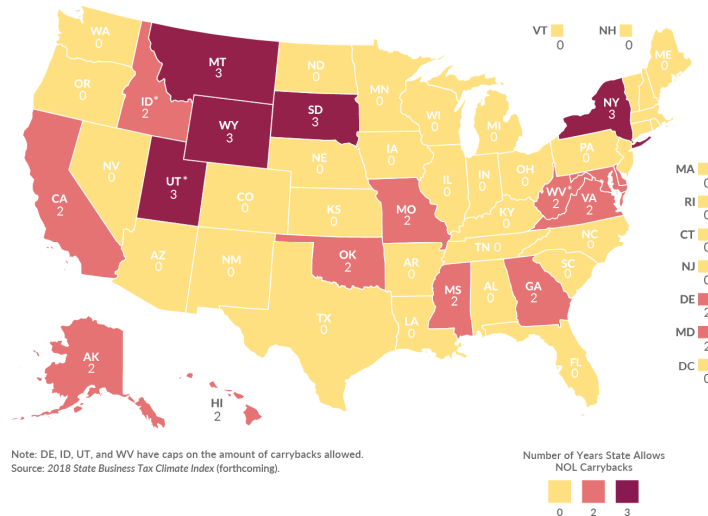
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### Corporate Net Operating Loss Carrybacks

Number of Years Allowed by State as of 2017



**Note – Federal law generally does not currently allow NOL carrybacks for losses arising in tax years beginning after 2017.**

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## STATE INCOME TAX PAYMENTS

- Federal law allows a deduction.
- State and local taxes on a C corporation are *not* limited, unlike individuals.
- Most states do not allow such a deduction.
- A few states allow a deduction for federal income taxes.
- Check to see if non-income taxes are deductible on state returns (sometimes they are).

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## LONG-TERM CAPITAL GAINS AND LOSSES

- Federal computation with special rules for losses (no net loss allowed, limited carryover)
- Most state laws follow federal law

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## NONTAXABLE EXCHANGES

- Certain federal rules allow nontaxable exchanges (§ 1031 on real estate, for instance).
- Most states follow these rules.

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## PASSIVE ACTIVITIES

- Limitations apply to closely held C corporations at the federal level.
- States generally follow federal limitations.

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## CAPITAL STOCK TAXES

- Taxes are imposed on some computations of a business's net worth.
- Businesses pay taxes and does not depend on profitability (aside from long-term profits).
- Only a minority of states impose them, and for some, they are a minimum tax (so pay the higher of regular income tax or capital stock tax).

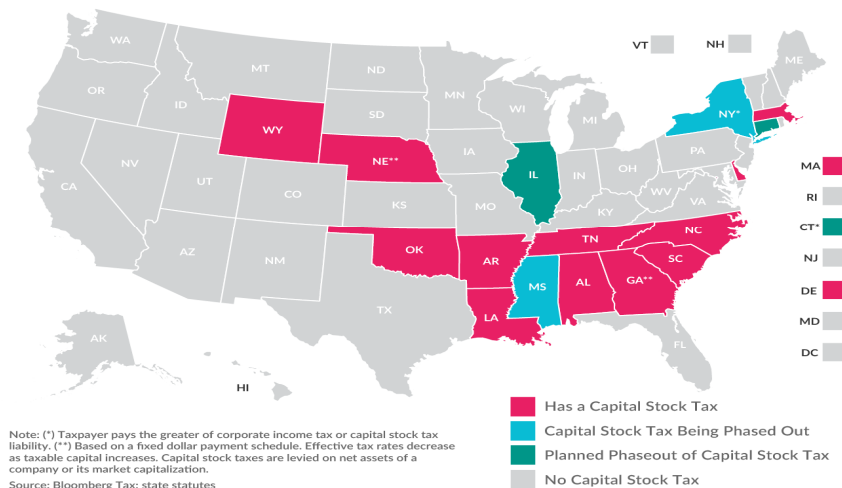
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### Does Your State Have A Capital Stock Tax?

State Capital Stock Taxes as of January 1, 2019



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## NONBUSINESS INCOME

- **Nonbusiness income** – Each state has rules for allocating to particular states. Under the UDITPA model:
  - net rents and royalties from real property are allocated to the state where the property is located;
  - net rents and royalties from tangible personal property are allocated to a state to the extent that the property is utilized in the state;
  - capital gains and losses from sales of real property are allocated to the state where the property is located;
  - capital gains and losses from sales of tangible personal property are allocated to a state if the property was situated in that state at the time of the sale or the business's commercial domicile is in that state, and the business is not taxable in the state where the property is situated;
  - interest and dividends are allocated to the state that is a business's commercial domicile; and
  - patent and copyright royalties are allocated to a state to the extent that the patent or copyright is utilized by the business in that state or, if the business's commercial domicile is in that state, to the extent that the patent or copyright is utilized by the payer in a state in which the business is not taxable.

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## STATES IMPOSING CAPITAL STOCK TAXES AS OF JANUARY 1, 2019

State	Tax Rate	Max Payment
AL	0.175%	\$15,000
AR	0.3%	Unlimited
CT (a)	0.341%	\$1,000,000
DE	0.04%	\$200,000
GA	(b)	\$5,000
IL (c)	0.1%	\$2,000,000
LA (d)	0.3%	Unlimited
MA	0.26%	Unlimited
MS (e)	0.225%	Unlimited
NE	(b)	\$11,995
NY (a,f)	0.05%	\$5,000,000
NC	0.15%	Unlimited
OK	0.125%	\$20,000
SC	0.1%	Unlimited
TN	0.25%	Unlimited
WY	0.02%	Unlimited

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## STATES IMPOSING CAPITAL STOCK TAXES AS OF JANUARY 1, 2019

- (a) The taxpayer pays the greater of corporate income tax or capital stock tax liability.
- (b) It is based on a fixed-dollar payment schedule. Effective tax rates decrease as taxable capital increases.
- (c) The tax rate is 0.15% for the first year and 0.1% for all following years.
- (d) The tax rate is 0.15% for the first \$300,000 of taxable capital.
- (e) The tax will be fully phased out before 2028.
- (f) The tax is being phased out; liability is limited to liability in the tax year ending December 31, 2010.

- Sources: State statutes; Bloomberg Tax.

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## WHAT IS INCOME?

- Business income
  - Transactional – Activities
  - Functional – Assets
- Nonbusiness income (wholly unrelated to the business)

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## CORPORATE STATE INCOME TAX FORMULA FOR MULTI-STATE CORPORATION

- Federal income tax base
- + State adjustments (such as interest on state and local bonds)
- State adjustments (such as interest on federal obligations)
- = Income tax base to be *allocated and apportioned*
- Allocable income (income specifically allocated to particular states) **Note – Including the state for which you are performing the computation**
- = Total income subject to apportionment
- x State apportionment percentage
- = State-apportioned income
- + Income allocated to the state
- = State income tax base
- x State's income tax rate
- = Tentative state income tax
- Tax credits
- = State income tax liability

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## UNIT 7

### APPORTIONMENT AND ALLOCATION OF INCOME

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## LEARNING OBJECTIVES

- 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.

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## KEY DEVELOPMENTS IN RECENT YEARS

- States moving toward a single sales factor apportionment more and more
  - Does not penalize for having employees in state
  - Does not reward for moving out of state if continue to sell in the state
- States also moving to market-based sourcing for determining source of sales of service
  - Again, does not penalize company for having workers in state
  - Old rule looked at where services were principally performed

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## FORMULA AND PERCENTAGES

- UDITPA (**U**niform **D**ivision of **I**ncome for **T**ax **P**urposes **A**ct)
  - Jurisdiction
  - Subject to tax
- Apportionment or allocation
- Business vs. nonbusiness income
- Apportionment formulas
  - Sales
  - Property
  - Payroll

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## BUSINESS INCOME

- **Business income** means income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from property if the acquisition, management, and disposition of the property are integral parts of the regular trade or business.

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## APPORTIONMENT FACTORS

- Standard three-factor formula
- Amounts are generally for the company's annual operating period, with the exception of the property factor that uses average beginning and ending period amounts

Average value of real and tangible personal property

Property factor =  $\frac{\text{Owned or rented and used in the state}}{\text{Average value of total real and tangible personal property owned or rented and used everywhere}}$

Average value of total real and tangible personal property  
owned or rented and used everywhere

Payroll factor =  $\frac{\text{Total amount of compensation paid in the state}}{\text{Total amount of compensation paid everywhere}}$

Total amount of compensation paid everywhere

Sales factor =  $\frac{\text{Total sales in the state}}{\text{Total sales everywhere}}$

Total sales everywhere

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## APPORTIONMENT CHOICES

- 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 the industry.

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## APPORTIONMENT FACTOR TRENDS

- Double-weighted *sales factor*
- Single *sales factor* – As of January 2019, 25 states use sales to apportion income and another 10 states use double-weighted sales factor.
  - Internet commerce and resulting nexus controversies have likely increased state reliance on a single sales factor.
  - Portability of assets and operations has increased through technology making it easier for companies to relocate.
  - It increases tax burdens for out-of-state companies that have minimal property or payroll in the state but a large proportion of their national sales in the state.
  - It arguably does not fairly represent a company's activities in a state.

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## EXAMPLE—STATE INCOME TAX COMPUTATION

State Income Tax Computation Example (State A)	Amount
US -1120 Taxable Income (before FIT)	\$ 1,550,000
<b>Add:</b>	
State Income Tax	\$ 990,000
Federal Depreciation	\$ 340,000
Interest on State Obligations	\$ 10,000
<b>Subtract:</b>	
Interest on US Obligations	\$ (25,000)
State Depreciation	\$ (190,000)
Apportionable or Allocable income or (loss)	\$ 2,675,000
<b>Subtract:</b>	
Nonbusiness income	
Gain on sale of real property in state B	\$ (75,000) *
<b>Business Income Subject to Apportionment</b>	\$ 2,600,000
State A apportionment factor	15.38%
<b>Business Income Apportioned to State A</b>	\$ 399,919
<b>Add:</b>	
Nonbusiness income	
Gain on sale of patent used in State A	\$ 85,000
<b>State Taxable Income</b>	<b>\$ 484,919</b>
State A Tax Rate	5%
State A Tax before Credits	\$ 24,246
State Research & Development Credit	\$ 15,000

\* This amount would be specifically allocable to State B in its state income tax computation.

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## EXAMPLE—COMPUTATION OF APPORTIONMENT

		State A	Everywhere		
<b>Sales</b>		2,473,000	15,000,128	16.49%	
<b>Payroll</b>		379,494	1,978,000	19.19%	
<b>Property</b>	BOY	EOY	AVG		
State A	1,756,987	1,972,145	1,864,566		
Everywhere	17,486,398	18,123,497	17,804,948	10.47%	
			Total	46.14%	
			Average	<b>15.38%</b>	

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## SALES FACTOR

- Calculation
  - Numerator = total sales or gross receipts of corporation within the state during tax period
  - Denominator = gross receipts of corporation everywhere during the tax period
- Only sales or gross receipts that generate business income are in this calculation

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## THROWBACK RULE

- To prevent taxpayers from having “nowhere income” (i.e., income that is not apportionable or allocable to any jurisdiction that will tax the income), many states have a *throwback rule*.
- The rule makes a sale taxable in the state it was made if the state where the goods were delivered does not tax the taxpayer.
- In a drop shipment scenario, if the goods are shipped and delivered to states where the taxpayer does not have nexus, states may invoke a *double* throwback rule.

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## OTHER SALES FACTOR ISSUE

- Lesser-used throw-out rule – Similar in concept to throwback, these are “nowhere” sales removed from the denominator.
- Dock sale rule – A customer in State A may hire a common carrier to pick up purchased items from a vendor also in State A at a warehouse in State B. In this instance, the sale belongs to State B where the warehouse “dock” is located.

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## SERVICES AND SALES ALLOCATION

- Traditional use is cost of performance
- Market-based sourcing (MBS) – Growing number of states using this
  - Look to where the customer resides, not where services are performed
  - One key concern – Contractual customer vs. ultimate consumer
  - Due to inconsistencies, more than one state easily can claim the same sales dollars
- Majority of states now use MBS for at least some apportionment for income taxes and gross receipt taxes

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## SERVICES AND SALES ALLOCATION

- Ratio of time spent method
- Sourcing of director's fees
- Move to 100% sales factor apportionment

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## PROPERTY FACTOR

- Calculation
  - Numerator being the average value of the corporation's real and tangible personal property at the beginning and end of period in the state that is
    - owned,
    - rented, or
    - used
  - Denominator being the average value everywhere
- Trends in property factor

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## PAYROLL FACTOR

- Compensation includes wages and commissions, but it can also include
  - boarding, housing, and lodging;
  - in some states, federally exempt earnings from a cash or deferred compensation plan (401(k)); and
  - other amounts constituting gross income.
- Payroll throwback rule – It's not formally stated as such, but some states have rules with the "throwback" effect.

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## RELATED CORPORATIONS

- Consolidated returns
- Combined returns – Under unitary principles
  - Unitary tests
- Benefits and detriments of consolidated or combined reporting
  - Sale of subsidiary stock
- What income is in the return?

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## UNIT 8 TAXING PASS-THROUGH ENTITIES

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## LEARNING OBJECTIVES

- 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.

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## TAX FOUNDATION FINDINGS

- Pass-through business income is taxed on business owners' tax returns through individual income tax code.
- Pass-through business income faces marginal tax rates that exceed 50% in some state.
- Pass-through businesses face only one layer of tax on profits compared to double taxation faced by C corporations.

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## TAX FOUNDATION FINDINGS

- The number of pass-through businesses has nearly tripled since 1980, while the number of traditional C corporations has declined.
- Pass-through businesses earn more net business income than C corporations.
- Pass-through businesses employed more than 50% of the private sector workforce and accounted for 37% of total private sector payroll in 2011.

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## TAX FOUNDATION FINDINGS

- Although pass-through businesses are smaller than C corporations on average, they are not all small businesses. Many people work for large pass-through companies.
- Most pass-through business income is taxed at top individual tax rates.
- Tax reform aimed at improving the competitiveness of U.S. businesses needs to address the individual income tax code due to the economic importance of pass-through businesses.

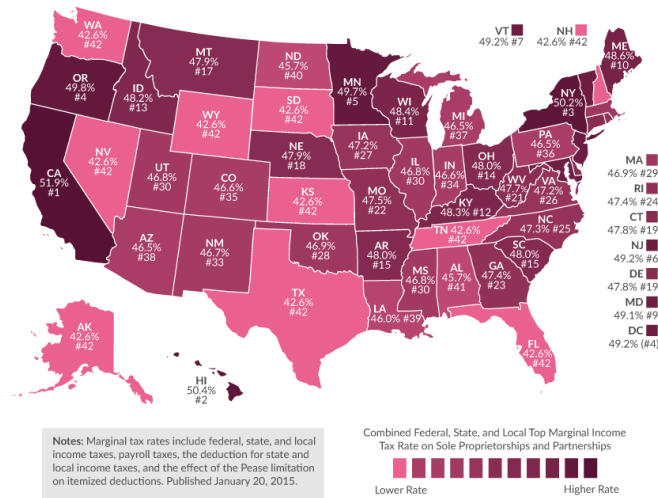
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**Figure 1. Pass-through Businesses Face Marginal Tax Rates Over 50 percent in Some States**

Combined Federal and State Top Marginal Income Tax Rate on Sole Proprietorships and Partnerships, 2014



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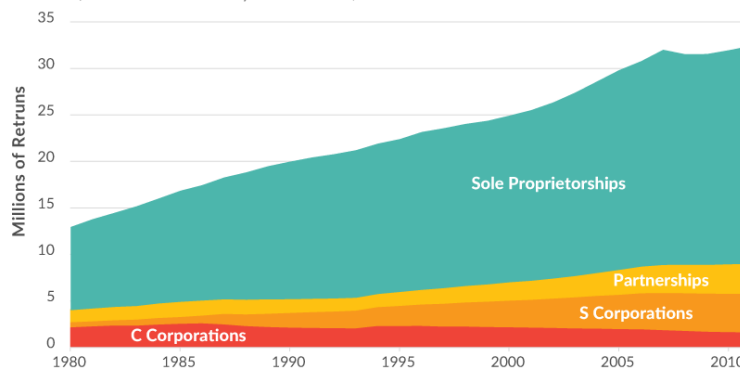
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## TAX FOUNDATION FINDINGS

**Figure 2. The Number of Pass-through Businesses has Nearly Tripled Since 1980**

Number of Business Tax Returns by Business Form, 1980–2011



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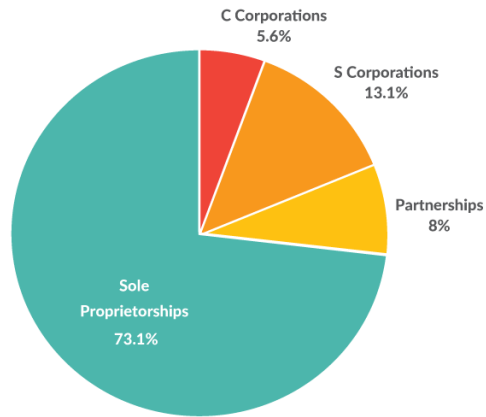
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## TAX FOUNDATION FINDINGS

Figure 3. Sole Proprietorships Are a Majority of All Businesses



Source: Census Bureau.

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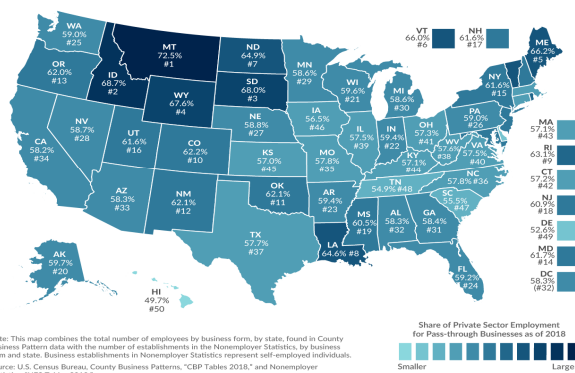
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## TAX FOUNDATION FINDINGS

Pass-Through Businesses Employ Most of the Private Sector

Share of Private Sector Employment for Pass-through Businesses by State, 2018



## PASS-THROUGH ENTITY-LEVEL TAXES

- Workarounds for limits on state income tax deductions – Seven states have as of this writing
- Connecticut started first pass-through tax
  - Nonelective tax – Entity must pay
  - Taxpayer gets a credit for tax paid
- Wisconsin option
  - Entity elects to pay the tax
  - If it elects, flow-through income is removed from Wisconsin income
- Various other states have added similar options and variations
- Key problem is lack of tax credit for out of state partners/shareholders

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## S CORPORATIONS

- Recognize entity, but then what?
  - Disregard status
  - Impose special tax
  - Tax both entity and shareholders
- Nonresident shareholder reporting
- Collection of tax
  - Agreement
  - Withholding
  - Composite

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## S CORPORATIONS

- Determining income
  - Mere shareholder
  - Trade or business connected with state
  - *Harrison* case – Narrow view of S corporation subject to taxation and use of losses

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## PARTNERSHIPS

- Corporate partner
  - General – Include share of income and apportionment factors
  - Limited – Some states treat as nonbusiness income
- Unitary vs. nonunitary treatment
- Composite treatment only for individual partners
- Reaching nonresident income

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## NEXUS FROM PARTNERSHIP

- Owning an interest in an investment partnership or an LLC that has operations in the state is sufficient to create nexus in nearly every state.
- All but four states and the District of Columbia said nexus could arise from owning a nonmanagement interest in an LLC:
  - Connecticut
  - Georgia
  - Tennessee
  - Vermont
- Only the District of Columbia and Vermont said a general partnership interest would not trigger nexus.

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## LIMITED LIABILITY COMPANIES

- In most states, federal elections for tax type respected
- However, some states will tax LLCs – See California tax on LLC on top of regular tax

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## LIMITED LIABILITY COMPANIES

- Every state has its own statute
- Most follow federal treatment
  - May be partnership
  - May be corporation
  - May be taxed as entity
- Single-member LLC
  - Disregarded entity
  - Similar to consolidated or unitary returns

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## PASS-THROUGH ENTITY-LEVEL TAXES

- It was initially proposed by Connecticut to work around the state and local tax deduction limit for individuals and fiduciaries.
- After initially threatening to take action against such structures, the IRS conceded they work in Notice 2020-75. That's true even if
  - the tax is one the entity volunteers to pay (or decides to opt out),
  - the entity holders are given a refundable credit against their individual state income tax, or
  - some other individual tax benefit (such as excluding the income from the entity on the state return) is provided.

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## PASS-THROUGH ENTITY-LEVEL TAXES

- States with such taxes include the following:
  - Connecticut (only one that isn't elective)
  - Louisiana
  - Maryland (effective in 2021)
  - New Jersey
  - Oklahoma
  - Rhode Island
  - Wisconsin
- Expect more states to adopt this unless the cap is repealed.

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## PASS-THROUGH ENTITY-LEVEL TAXES

- Should the entity elect?
  - Generally, it's beneficial for *resident* equity holders.
  - However, it may cause nonresident equity holders to pay more total tax due to loss of resident state credit for tax paid to another state—the *individual* would effectively not have directly paid tax to that other state.
  - Some state do allow the credit—but generally only those states that have adopted the pass-through tax.

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## UNIT 9

### CONSIDERING TAX PLANNING OPPORTUNITIES

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#### LEARNING OBJECTIVES

- Apply what has been learned in Units 1 through 8.
- Discuss available options to legally reduce corporate income tax burden.

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## KEYS TO SUCCESSFUL STATE TAX PLANNING

- Know the business operations.
- Practical business considerations may override tax planning.
- Have a thorough knowledge of the tax structure of states where the entity presently files and other states under consideration.
- Know about special tax incentives related to the workforce, geographic location, or specific activities.

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## SELECTING THE OPTIMAL STATE(S)

- May have limited control over the physical location of company base/headquarters
- Proximity to knowledge base of certain activities such as R&D and key technologies
- Local infrastructure and accessibility to key markets
- Tax incentives – Property taxes and income taxes

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## RESTRUCTURING OF ENTITIES

- Combinations or splits of certain operations to achieve more favorable state or local taxation
- Consolidated or combined filings may benefit if loss entities in the group
- Unitary filings may benefit depending on geographic spread of operations
- Need to be aware of any federal implications to state restructuring

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## QUESTIONS?

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## REMINDERS

- ❑ **Post event evaluation:** Please complete the course evaluation that will be pushed out to you as a pop-up link on your screen. We welcome your feedback!

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