What’s Left of State Tax Planning?

ABA State and Local Tax Committee
May Tax Meeting
May 10, 2019

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Agenda

• *South Dakota v. Wayfair, Inc.*
• What’s left of State Tax Planning?
  • Income Taxes
  • Sales and Use Taxes

• On June 21, 2018, the United States Supreme Court decided one of the most consequential cases in the modern state and local tax jurisprudence, South Dakota v. Wayfair, Inc.

• The 5-4 decision struck down the physical presence nexus standard for sales and use tax collection obligations.

• Dicta from the Wayfair majority opinion has ramifications for tax planning efforts.
  • The Court characterized the physical presence rule as a “judicially created tax shelter” that provided unfair advantages to remote vendors and distortive economic effects for taxpayers and states.
  • “Reliance interests are a legitimate consideration when the Court weighs adherence to an earlier but flawed precedent... Importantly, stare decisis accommodates only ‘legitimate reliance interest[s].’ Here, the tax distortion created by Quill exists in large part because consumers regularly fail to comply with lawful use taxes. Some remote retailers go so far as to advertise sales as tax free. A business ‘is in no position to found a constitutional right on the practical opportunities for tax avoidance.’” (emphasis added).

- Addressing the distortions the physical presence rule had created, the Court’s majority opinion observed that:
  - “[The physical presence] rule produces an incentive to avoid physical presence in multiple States. Distortions caused by the desire of businesses to avoid tax collection mean that the market may currently lack storefronts, distribution points, and employment centers that otherwise would be efficient or desirable. The Commerce Clause must not prefer interstate commerce only to the point where a merchant physically crosses state borders. Rejecting the physical presence rule is necessary to ensure that artificial competitive advantages are not created by this Court’s precedents. This Court should not prevent States from collecting lawful taxes through a physical presence rule that can be satisfied only if there is an employee or a building in the State.”

• The Court majority opinion also grappled with the equity concerns that the physical presence rule had created:
  • “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.”
Income Tax Planning – *Wayfair* impact

- Does the Due Process Clause require a state to notify taxpayers in some way of the extent to which it imposes its taxing statute?

**Economic Nexus for Income Tax - 2015**

- **No tax**
- **No specific authority (incl. AK, DC, HI, RI) or unofficial administrative guidance (AZ, IN, ME)**
- **Intangible licensing or general E/N authority**
- **Financial institution E/N authority (IN, KY, MA, MN, NY, PA, TN, WI, WV)**
- **Factor presence E/N authority (CA, CO, CT, MI, OH, WA)**

Source: KPMG LLP 2015
## Sourcing Based Nexus Statutes - 2019

### A. Income Tax (10 States)

<table>
<thead>
<tr>
<th>State</th>
<th>State</th>
<th>State</th>
<th>State</th>
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<th>State</th>
</tr>
</thead>
<tbody>
<tr>
<td>Alabama</td>
<td>California</td>
<td>Colorado</td>
<td>Connecticut</td>
<td>Michigan</td>
<td>New York</td>
</tr>
<tr>
<td>Ohio (CAT)</td>
<td>Tennessee</td>
<td>Virginia</td>
<td>Washington (B&amp;O)</td>
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</tr>
</tbody>
</table>

### B. Sales and Use Tax (11 States in June 2018; 36 States in January 2019)

<table>
<thead>
<tr>
<th>Prior to January 2016</th>
<th>As of June 2018</th>
<th>As of 2/26/2019</th>
</tr>
</thead>
<tbody>
<tr>
<td>No States had economic nexus statutes</td>
<td>Alabama, Connecticut, Indiana, Maine, Mississippi, New York, North Dakota, South Dakota, Tennessee, Vermont, Wyoming</td>
<td>Arizona, California, Colorado, District of Columbia, Hawaii, Illinois, Iowa, Kentucky, Louisiana, Maryland, Massachusetts, Michigan, Minnesota, Nebraska, Nevada, New Jersey, North Carolina, Ohio, Pennsylvania, South Carolina, Texas, Utah, Washington, West Virginia, Wisconsin</td>
</tr>
</tbody>
</table>
Income Tax Planning Constraints

- Separate Reporting States
- Combined Reporting States
- Sourcing services and intangibles
- Public Law 86-272
Income Tax Planning – Separate Reporting States

• Is an add-back statute relevant anymore?

• Transfer Pricing
  • Will state claim jurisdiction over the procurement company or intangible holding company making sales or licensing directly to an entity in the state?
  • What about 3-tiered, vertically integrated affiliates (e.g. Scioto, OK; ConAgra Brands, WV)?
  • 4-tiered?
Income Tax Planning – Combined Reporting States

• Is *Finnigan* obsolete?
• Outside the water’s edge - nexus, but filing separately?

![Map of Combined Reporting States](image)

- **No Corporate Income Tax**
- **Separate Return States**
- **Mandatory Unitary Combined Reporting (AK, HI, DC)**
- **Combined reporting for certain retailers until 2020, when combined or consolidated reporting is required**
# Income Tax Planning – Sourcing Services

<table>
<thead>
<tr>
<th>Benefit Received</th>
<th>Service Delivered</th>
<th>Service Performed</th>
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</thead>
<tbody>
<tr>
<td>Arizona (elective)*</td>
<td>Alabama</td>
<td>New Jersey</td>
</tr>
<tr>
<td>California*</td>
<td>District of Columbia*</td>
<td>South Carolina</td>
</tr>
<tr>
<td>Iowa*</td>
<td>Kentucky* (beg. 2018)</td>
<td>Texas</td>
</tr>
<tr>
<td>Michigan*</td>
<td>Louisiana*</td>
<td></td>
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<tr>
<td>Missouri* (SSF beg. 2020)</td>
<td>Massachusetts</td>
<td></td>
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<tr>
<td>New York*</td>
<td>Oregon (beg. 2018)*</td>
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<tr>
<td>Ohio (CAT)</td>
<td>Pennsylvania*</td>
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<tr>
<td>Rhode Island*</td>
<td>Tennessee</td>
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<tr>
<td>Utah* (SSF phase in)</td>
<td>Colorado (beg. 2019)*</td>
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<tr>
<td>Washington (B&amp;O)</td>
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<tr>
<td>Wisconsin*</td>
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* Single Sales Factor Apportionment

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## Income Tax Planning – Sourcing Intangibles

<table>
<thead>
<tr>
<th>Market / Use</th>
<th>Cost of Performance</th>
<th>Other</th>
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<tbody>
<tr>
<td>• Alabama</td>
<td>• Alaska</td>
<td><strong>Commercial Domicile</strong></td>
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<td>• Arizona</td>
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<td>• Connecticut</td>
<td>• Arkansas</td>
<td>• Oklahoma</td>
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<td>• District of Colombia</td>
<td>• Delaware</td>
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<td>• Georgia</td>
<td>• Florida</td>
<td><strong>Other</strong></td>
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<td>• Hawaii</td>
<td>• Colorado (as TPP)</td>
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<td>• Iowa</td>
<td>• Idaho</td>
<td>• Maryland (no guidance)</td>
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<tr>
<td>• Louisiana</td>
<td>• Indiana</td>
<td>• Vermont (receipts earned)</td>
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<tr>
<td>• Maine</td>
<td>• Kansas</td>
<td>• Wisconsin (use, commercial domicile, or billing)</td>
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<td>• Massachusetts</td>
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<td>• Utah</td>
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“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...”
Sales Tax Planning Issues

• Entity Isolation
• Attributional Nexus
• Flash Title and Drop Shipments
• Sales Taxes versus Use Taxes
Sales and Use Tax Planning

• Entity Isolation
  • Under entity isolation strategies, taxpayers separate their businesses into multiple legal entities to avoid having the entity making the sales acquire nexus with a state, and establish a tax collection obligation in that state.
  • These strategies took advantage of the bright-line physical presence rule.
  • Now that Wayfair has eliminated the physical presence rule, states have expanded tax jurisdiction and may be less concerned about violating the substantial nexus prong of the Commerce Clause when reaching for out-of-state taxpayers.
    • Even so, Wayfair did not remove the substantial nexus requirement altogether, and implied that a substantial level of economic contacts would be necessary to meet the requirement.
    • Savvy taxpayers might still employ entity isolation strategies to avoid those levels of economic contacts.
Sales and Use Tax Planning

• Attributional Nexus
  • States have come to address entity isolation strategies through attributional nexus approaches enshrined in affiliate nexus and click-through nexus statutes.
    • *Scripto* and *Tyler Pipe*: “the crucial factor governing nexus is whether the activities performed in this state on behalf of the taxpayer are significantly associated with the taxpayer’s ability to establish and maintain a market in this state for the sales.”
    • Affiliate nexus statutes generally look to see whether there is an affiliate or subsidiary in the taxing state that has a relationship with the out-of-state retailer, like common ownership, using the same name and intellectual property, and inter-company exchanges.
    • Click-through nexus statutes target out-of-state vendors who use in-state residents to generate sales by referring customers to the vendor through internet links; these in-state residents are usually compensated on a commission basis.
Sales and Use Tax Planning

• Attributional Nexus
  • Affiliate nexus and click-through nexus statutes mostly rely on presumptions that the attributional nexus standard is met, which may cast doubt on the constitutionality of the statutes.
    • *Wayfair* should put those concerns to rest.
    • However, a number of states are moving away from affiliate nexus and click-through nexus as they enact South Dakota-style economic nexus statutes for sales tax collection obligations.
Sales and Use Tax Planning

• Attributional Nexus
  • States are also targeting online marketplaces for tax collection obligations.
    • These laws typically require entities like Amazon.com, eBay, and Etsy to collect the use tax when vendors using their platforms collectively pass the economic nexus thresholds.
  • These marketplace facilitator statutes provide states with the ability to reach more vendors than just the South Dakota statute alone, which may allow the states to reach sales by taxpayers engaged in an entity isolation strategy.
    • This might indirectly remove the advantage of the entity isolation strategy.
    • But, marketplaces need to be availing themselves of the state market; is facilitating others’ sales enough?
Sales and Use Tax Planning

• Sales Taxes vs. Use Taxes
  • The South Dakota statute at issue in *Wayfair* explicitly required remote sellers to collect the state’s sales tax.
    • In *Wayfair*, the only question was whether the state had nexus with the remote seller.
    • The sellers had conceded that the state had nexus with, and thus could tax, their sales. “It has long been settled” that the sale of goods or services “has a sufficient nexus to the State in which the sale is consummated to be treated as a local transaction taxable by that State.” (*Wayfair*, quoting *Jefferson Lines*, 514 U.S. 175, 184 (1995)).
  • But some states do not impose a sales tax (vendor states) or a sales tax collection responsibility (vendee states), on the seller.
  • Instead, they impose a use tax collection responsibility only.
  • The state where the sales transaction is sourced – *i.e.*, the state with nexus over the seller – may not be the same state where the property is delivered and/or where the use occurs.
  • If that’s the case, there may be situations where there is not a use tax imposed in the state where the seller has nexus, and the seller may not have nexus in the state where the use tax is imposed.
Flash Title and Drop Shipments

• Is flash title still a nexus issue?
• Are drop shipments still an issue?
Questions?

Thank you!
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