State and Local Tax Update

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## Agenda

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The Wayfair Decision


- In a 5-4 Decision, Justice Kennedy (joined by Thomas, Gorsuch, Ginsburg, Alito) held that:
  - *Quill’s* physical presence rule is unsound, is an incorrect interpretation of the Commerce Clause, and restricts the states’ authority to “collect taxes and perform critical public functions”
  - Court adopted an unclear “economic or virtual” presence test
- The majority concluded that the following features of South Dakota’s law minimized the burdens on interstate commerce:
  - Included a transactional safe harbor (200 sales or $100,000 in sales)
  - Did not apply retroactively
  - South Dakota was a full member of the Streamlined Sales and Use Tax Agreement (SSUTA)
- The dissent disagreed, reasoning in part that the regulation of interstate commerce was best left to Congress.
State Responses

- Rapid enactment of dollar and transaction thresholds similar to South Dakota’s
  - CA and TX have a $500,000 threshold; AL and MS use a $250,000 threshold
  - Note: some have eliminated the transaction thresholds
  - By January 1, 2019 – all but 9 of 46 jurisdictions with economic nexus standard in statute, rule, regulation or proposed law.
  - By October 1
  - NH SB 242 – Registration requirements
What’s Next?

— How important is SSUTA membership?
— Responses of states with Home Rule jurisdictions
  • Louisiana, Colorado, Alabama, etc.
— Economic nexus approaches for localities
— Federal legislation?
— Makeup of the court?
Marketplace Facilitator Legislation

— Marketplace Facilitator/Provider Bills Enacted in ~37 States
  • Basic premise is that ‘marketplaces’ are required to collect and remit sales/use tax on sales through the marketplaces.
  • Although many statutes are similar, lots of variation in the language.
  • Issues with industry-specific application
  • Referrer provisions.

— Information reporting issues (*Airbnb/Homeaway v. City of NY*).
— Remainder of states all considering legislation.
— Stakeholder activity
  • COST, NCSL, MTC
Normand v. Walmart.com USA LLC (Court of Appeals, Louisiana December 27, 2018)

— The Fifth Circuit Louisiana Court of Appeals affirmed a trial court judgment holding Walmart.com liable for approximately $1.8 million in unpaid taxes on sales made by third parties on Walmart.com’s online marketplace, finding the trial court correctly determined the legislative intent was clear and statute was unambiguous.

- The trial court found Walmart.com was liable as a “dealer” within the meaning of La. R.S. 47:301(4)(1) because providing the marketplace constituted “regular or systematic solicitation of a consumer market.”
- Walmart.com argued it was not a “dealer” because it never had title or possession of the property being sold.

— In its appeal, Walmart.com argues that the parish imposes a discriminatory tax on electronic commerce that violates ITFA because the Collector does not require operators of similar offline marketplaces to collect local sales taxes.

- For example, the owner of a shopping mall is not required to collect tax when a store that leases space in the mall makes a sale to its customer.
- Nor is a newspaper required to collect tax when a seller advertising in the classified ads section makes a sale to a customer.

— Awaiting oral argument at Louisiana Supreme Court
Amazon Services, LLC v. South Carolina Department of Revenue, State of South Carolina Administrative Law Court, Docket No. 17-ALJ-17-0238-CC (September 10, 2019).

— Relying upon a decision by the South Carolina Supreme Court in Travelscape, a South Carolina Administrative Law Court held that Amazon was required to collect South Carolina sales and use tax on sales made through the Amazon marketplace by third-party sellers.

— The judge relied upon language in the South Carolina statute that referred to a person required to collect sales and use tax as being in the business of selling.

— This is despite the fact that South Carolina had enacted a marketplace collection law after the assessment.

— The Department also conceded that it had not enforced such a requirement on anyone else prior to this case.
Income Tax—Nexus Cases
Post-Wayfair - Factor Presence Nexus for Business Activity Taxes

** Notes states with legislation currently pending, but which has not yet been enacted.

Economic Nexus of Consolidated Group Members

Capital One Auto Fin. Inc., v. Dep't of Revenue, Or., No. SC S064803, 08/09/18

- Capital One Auto Finance Inc. filed a consolidated Oregon corporate tax return in a group that included two affiliated banks, both located in Virginia.

- Neither bank had any property, office, or employees in Oregon nor did either apply for the authority to do business in the state.

- The banks’ activities of offering credit card products and consumer loans were all conducted from their offices outside of Oregon.

- Capital One concluded that because they had no physical presence in Oregon, the affiliated banks were not subject to Oregon tax, thus excluding the banks’ Oregon sales from the numerator of the consolidated group’s sales factor.

- The Oregon Supreme Court relied on the “plain, natural, and ordinary meaning” of “derived from sources within this state” to unanimously rule that the banks did not need a physical presence in Oregon to be included in the consolidated group’s sales factor numerator.

- OR Supreme Court: “If customers located in Oregon are paying money to a taxpayer, then taxpayer would appear to have ‘income derived from sources within this state’.”
Sourcing of Ohio CAT Sales

• *Greenscapes Home & Garden Prods. v. Testa* (Ohio February 7, 2019)
• Ohio Court of Appeals held that a Georgia company had sufficient Due Process nexus with Ohio to be liable for Ohio’s commercial-activity tax (“CAT”) because it knew its customers were bringing its products into Ohio.

• Greenscapes was a Georgia company selling garden products to national retailers with distribution centers in Ohio. Customers provided shipping with pickup from Greenscapes’ loading dock with title transfer in Georgia.

• The Ohio Court of Appeals concluded “a defendant who sells products to a national or regional retailer for the resale to ordinary, individual customers in the forum state has purposefully availed itself of the privilege of doing business in the forum state."

• The Court reasoned because Greenscapes purposefully took advantage of the distribution ability of national retailers and knew its products would be shipped to Ohio, its contacts with Ohio were sufficient to satisfy Due Process.
Income Tax—Tax Base Trends, Cases and Emerging Issues
Mandatory Unitary Combined Reporting 2018/2019 Developments

• Enacted
  ▪ Kentucky H.B. 458 (2019) corrections bill
  ▪ New Jersey A. 4202 (2018)
  ▪ New Mexico H.B. 6 (2019)

• Proposed
  ▪ Florida S.B. 1692 / H.B. 1377
  ▪ Pennsylvania H.B. 1445
  ▪ Oklahoma H.B. 1118, H.B. 1864, H.B. 2182
  ▪ Maryland S.B. 377 / S.B. 76 (limited to retail and food and drink establishments)
Renewed Interest in Worldwide Combined Reporting

- **Hawaii**—S.R. 87 (passed) would convene a task force to study mandatory worldwide reporting.
- **Illinois**—H.B. 2085 (pending) would make worldwide combination the default and S.B. 1115 (pending) would allow a water’s-edge election, but includes tax haven blacklist and cap on DRD of 75%.
- **Massachusetts**—H.B. 3787 and H.B. 3788 (pending) would implement mandatory worldwide reporting.
- **Minnesota**—H.F. 2125 (failed) would require unitary CFCs that create GILTI to be included in combined group and provides a worldwide election (10 years).
- **Montana**—S.B. 141 (died) would have repealed water’s-edge election.
- **Oregon**—H.B. 2149 (pending) and H.B. 2697 (pending) would require foreign affiliates to be included in the unitary group.
COMBINED REPORTING States: Joyce/ Finnegan

1 Combined reporting for a tax based on gross receipts
2 INDIANA: Finnigan rule for unitary group filing on a combined basis. Joyce rule for filing on a consolidated basis
3 New Mexico: Combined reporting starts in 2020

Source for Joyce and Finnigan: RIA Checkpoint, March 2019
MTC Uniformity Projects—Finnigan Work Group

- Formed last year to create an “alternative” Finnigan combined reporting model
- Finnigan model is not intended to replace the MTC’s current Joyce model
- Last fall, the Uniformity Committee instructed the work group to take a “one taxpayer” approach, which would allow for the sharing of tax attributes among the members (similar to Utah)
- On April 25, a draft model was presented to the Uniformity Committee
  - The model takes the one taxpayer approach to general reporting and does allow for NOL sharing for current members of the group.
  - Certain restrictions (similar to the SURLY rules) are imposed on members entering and leaving the group.
  - The model allows for complete sharing of tax credits.
Combined Reporting – Includable Entities

- *Dep’t of Revenue v. Agilent Technologies*, 2019 CO 41 (May 28, 2019) and *Dep’t of Revenue v. Oracle*, 2019 CO 42 (May 28, 2019)
  - The Colorado Supreme Court held the DOR erred in requiring a corporate taxpayer to include in its Colorado combined return an affiliated holding company that has no property or payroll of its own.
  - The affiliated holding companies did not meet the definition of "includable C corporation" having more than 20% of its property and payroll assigned to locations inside the US, and DOR’s regulation supported taxpayer position.
  - State’s general anti-abuse provision cannot be used to circumvent statute where there was no evidence the taxpayers’ structures were abusive or intended to avoid tax

- **Colorado S.B. 233** (signed May 31, 2019):
  - Provides that C corporations with de minimus or no property or payroll are “includable” for purposes of the Colorado combined group, effective Aug. 2, 2019.

- Trial court had held in favor of the FTB and concluded that Abercrombie had not shown that using a separate accounting method in a non-discriminatory way would have reduced its tax liability.
- The appellate court upheld this decision and concluded that the company had not proven that using a separate accounting method would have both lowered its tax liability and that it would not have gained an advantage over in-state businesses.
- The appellate court cited to the 4th District’s Harley-Davidson decision which upheld the constitutionality, though the Abercrombie court did not rule on constitutionality.
- The appellate court also concluded that Abercrombie’s request for a remedy was limited to a refund, and had not asked that the in-state option for separate accounting be struck down.
Dividend Received Deduction Treatment

- **Exxon Mobil Corp. v. Montana Dep’t of Revenue**, No. DDV-2016-1030 (Mont. 1st Jud. Dist. Ct. Aug. 8, 2018)
  - Montana First Judicial District Court upheld the Department of Revenue’s interpretation that dividends actually paid by an 80/20 company that is excluded from the Montana water’s-edge filing group are not subject to a 100% dividends received deduction (DRD)
  - The court found that the state’s general 80% DRD applies

- **Exxon Mobil Corp. v. Montana Dep’t of Revenue**, (Mont. 2019)
  - The Montana SC overruled the lower court & held that Exxon was entitled to fully deduct the dividend payments received from domestic subsidiaries that held most assets internationally.
  - The Court found that the state mirrors the 100% federal deduction for dividends received from 80/20 companies and that the 80% cap applied only to an income exclusion of after-tax net income for 80/20 companies & not to dividends that a water’s edge combined group actually receives from them.
Transfer Pricing

- **See’s Candies, Inc. v. Utah State Tax Comm’n**, 435 P.3d 147 (Utah 2018)
  - See’s Candies transferred its intellectual property to an affiliate, Columbia Insurance Company, and then paid royalties to Columbia to use that IP.
  - The Utah Tax Commission allocated the royalty payments back to See’s taxable income under the state’s transfer pricing statute, which is modeled on, but does not adopt, IRC Section 482.
  - The court held that the Commission abused its discretion in failing to consider interpretive guidance under Sec. 482 and improperly ignored transfer-pricing study and other evidence supporting the intercompany transaction.
  - The court determined that See’s royalty payment deductions were proper, minus a 10% adjustment determined after an MTC audit.

- **Utah H.B. 268** (enacted March 29, 2019) now requires an addback for payments made to a captive insurance company.
Income Tax
Apportionment—National Trends and Recent Cases
The Inexorable Trend to Single Sales Factor

*Note: Arizona expanded single sales factor election to additional taxpayers in 2018. Missouri will use a single sales factor apportionment method beginning January 1, 2020. Maryland approved single sales factor in 2018, and it will be phased in by 2022. Mississippi taxpayers may choose their apportionment method using one or more of the three factors. Minnesota proposed a bill in 2019 to move back to Three-Factor apportionment.

** Notes states with legislation currently pending, but which has not yet been enacted.

Disclaimer: This information should be used for general guidance and not relied upon for compliance.
Receipts from the sale of services are sourced to Texas if the service is performed in Texas. If the service is performed both inside and outside of Texas, the receipts are sourced to Texas on the basis of the fair value of services rendered in the state.

** Notes states with legislation currently pending, but which has not yet been enacted.

Disclaimer: This information should be used for general guidance and not relied upon for compliance.
Sourcing of Subscription Receipts:  
**Sirius XM Radio v. Hegar**, (Texas Dist. Ct, August 14, 2018)

- The Court found that Sirius XM correctly apportioned its subscription receipts using cost of performance method for Texas franchise tax purposes.
  - Sirius XM apportioned its receipts based on the locations where it performed its activities, *i.e.*, the locations of its headquarters, transmission equipment, and production studios.
- The Court rejected the Comptroller’s argument that the “service” customers were paying for was the decryption of scrambled radio signals, a position that would have resulted in the apportionment of Sirius XM’s receipts to Texas based on the percentage of customers that received the satellite transmissions in Texas.
- The Court also held that Sirius XM was entitled to a cost of goods sold deduction for the direct costs of producing, acquiring, and using its live and prerecorded radio programs.
- The Comptroller has appealed the decision.
The Virginia Supreme Court upheld Virginia’s cost-of-performance sourcing methodology as constitutional.

Corporate Executive Board (CEB), an advisory service firm headquartered in Virginia that sold mostly to customers outside of Virginia, sued the state of Virginia assert its cost of performance provisions violated the Due Process and dormant Commerce Clauses.

- Specifically, CEB asserted that since many states have moved from cost-of-performance sourcing of intangibles to marketplace sourcing, these other states also included a portion of CEB’s sales in their sales factor numerators, resulting in the taxation of over 120 percent of CEB’s nationwide income.

The Court acknowledged CEB was subject to double taxation but ultimately concluded that Virginia’s apportionment formula did not create a “grossly distorted” result and, therefore, passed the external consistency test.
Alternative Apportionment & Economic Substance

  - The Maryland Court of Special Appeals determined a corporate group’s subsidiaries operating in Maryland lacked economic substance apart from the rest of the group such that the entire group had nexus with the State.
  - The Court concluded the subsidiaries’ “total financial dependence” and “total administrative and managerial dependence” on the parent companies – demonstrated through intercompany management, administration, and intellectual property licensing arrangements – showed there was a general absence of substantive activity from the subsidiaries that was meaningfully separate from the parent companies.
  - Cert petition is under review. The company filed its reply brief Oct. 8.

  - Maryland Court of Special Appeals determined the State could subject an out-of-state holding company to tax because its parent company conducted business in Maryland and the holding company lacked economic substance apart from the parent and lacked substantive activity apart from the parent.
  - The Court also upheld the imposition of an alternative apportionment method using a blended factor of the entire corporate group’s apportionment factors.
TCJA Conformity

- GILTI
- Interest Expense Limitation (Sec. 163(j))
- Section 118 (contributions to capital)
Sales and Use Tax Case Developments
Sales Taxation of Software

**Ex parte Russell County Community Hospital LLC v. Dep't of Revenue** (Alabama May 2019)

- The Alabama Supreme Court on May 19 determined all software is taxable tangible personal property, regardless of whether it is custom or canned software.
- Denied refund claim for sales tax paid on software purchased and then customized by the seller for a hospital’s specific needs.
- The Court, however, noted, separately stated and invoiced charges for services rendered that “accompany the conveyance of software,” including customization and implementation services, are nontaxable.
- “The pertinent distinction,” the Court said, “is how the transaction is documented and invoiced, and that is left strictly in the hands of the seller and purchaser.”
Citrix Systems, Inc. v. Commissioner of Revenue, ATB Dkt Nos. C321160, C325421 (Massachusetts, Nov. 2, 2018)

• Subscription fee charges for use of remote-desktop access services were held to be sales of software subject to sales/use tax.

• While the Massachusetts statute taxes only “transfers” of standardized software, the ATB followed the Commissioner’s regulation in deeming the remote access of vendor-hosted software to be transfers.

• The ATB concluded that the “true object” of the transaction was to sell the right to use Citrix’s prewritten software, and not to provide a service, notwithstanding the fact that Citrix’s:
  - On-line products could not function without the services of numerous employees, who operate and maintain the systems;
  - Employees view the company as a provider of services and not software; and
  - Sales agreements and marketing materials refer to the online products as “services”.
Sales tax on “Information Services”


• The Appellate Division, reversing the Tax Appeals Tribunal, held that pricing information furnished to a grocery store chain qualified for the exclusion from sales tax for information services that are “personal or individual in nature”

• The Court of Appeals granted the Tax Department’s motion for leave to appeal

• Issues before the Court:
  ▪ Whether the statutory exclusion for “personal or individual” information services should be construed in favor of the taxpayer or the government
  ▪ Whether the Appellate Division correctly concluded that the information services were “personal or individual” in nature
Vendors sought sales tax refunds on behalf of Massachusetts-based customers who purchased software for use in multiple states.

In a 2017 decision, the ATB initially ruled in favor of the Commissioner, who argued that unless the seller obtains a Multiple Points of Use certificate on or before the date the sale is reported for sales tax purposes, no refund is available and sales tax is due on the entire purchase, regardless of where the software is used.

In 2019, the ATB issued an order on its own initiative reversing its earlier decision, and allowing the refund with respect to software used outside Massachusetts. The ATB noted that nothing in the statute or regulation bars taxpayers from establishing multiple points of use at a later date.
Internet Tax Freedom Act:

**Apple Inc., v. The City of Chicago** (Circuit Court of Cook County, Illinois, Docket No. 2018L050514)

- Apple challenged the expansion of Chicago’s amusement tax to music streaming services as a violation of ITFA.
- Apple argues that the tax violates ITFA because it is imposed on charges for electronically delivered music on customers with addresses in Chicago but is not imposed on charges for listening to music on automatic amusement machines — stationary devices owned by businesses and generally operated per use with coins.
- Complaint filed 8/27/2018, currently pending.

- The Illinois Appellate Court held on Sept. 30 in *Labell v. City of Chicago* that the amusement tax did not violate ITFA or the state uniformity clause.
- The Court did conclude that using billing address was not an accurate determination of location of use, but ultimately that would be something the taxpayer would have to rebut.
Qui Tam

People v. Sprint Nextel Corporation (New York)

• Whistleblower suit brought in 2011 under the New York False Claims Act alleged that Sprint violated state tax law by failing to collect sales tax on 100% of charges for flat rate wireless voice plans.

• In 2012, the New York AG filed a superseding complaint, converting the whistleblower suit into a civil enforcement action.

• On October 20, 2015, the New York Court of Appeals ruled that the False Claims Act action may proceed, affirming the lower court’s denial of Sprint’s Motion to Dismiss.

• On December 21, 2018, Sprint agreed to pay $330 million to settle the False Claims Act suit with New York.
Other Corporate Income/Business Activity Tax Issues to Watch
Oregon Gross Receipts Taxes: State Corporate Activity Tax and Portland Retail Gross Receipts Tax

Oregon H.B. 3427, signed May 16, 2019

• Hybrid of the Ohio Commercial Activity Tax and the Texas Margins Tax, incorporating the situsing of Oregon gross receipts (similar to Ohio) with an apportioned 35 percent deduction of either “cost inputs” or “labor costs.”

• Imposed a .57 percent tax on “taxable receipts” above $1 million, but with a filing requirement triggered by a $750,000 economic nexus threshold.

Portland Retail Gross Receipts Tax

• Effective for tax years beginning on or after 1/1/2019, Portland imposes a 1% “surcharge on gross revenues from sales within the City, unless otherwise exempted,” on “Large Retailers.”

• Large Retailer is a “business” that:
  ▪ Is subject to the Portland Business License Tax
  ▪ Had annual gross revenue from retail sales from all locations in the U.S. where the taxpayer conducts business that exceeded $1 billion in prior year
  ▪ Had annual gross revenue from retail sales within Portland of $500,000 or more in the prior tax year
Washington B&O Surcharge

- Surcharge is imposed on receipts in the ‘services and other business activities’ category.
- ‘Tier 1’: imposed on a broad number of services, for companies not subject to the other tiers.
- ‘Tier 2/Tier 3’ imposed on advanced computing businesses. Difference is in the amount of worldwide revenue (Tier 2 is for more than $25 billion but less than $100 billion; Tier 3 is for $100 billion or more).
Other Supreme Court Cases
The Kaestner Decision


— NC Sup. Ct held that the NC DOR unconstitutionally taxed the income of an irrevocable inter vivos out-of-state trust, based solely on the North Carolina residence of the beneficiaries.

  • The court found that the Trust did not have sufficient minimum contacts with the state to satisfy the Due Process Clauses of the federal and state constitutions.

  • The residency in North Carolina of the Trust beneficiary was not sufficient.

— The U.S. Supreme Court granted cert., and in a unanimous decision upheld the NC Sup. Ct., concluding that the trust did not purposefully avail itself of the state.
The *Hyatt* Decision


— In a 5-4 decision, the U.S. Supreme Court held that individuals cannot sue states in the courts of another state, due to sovereign immunity. The taxpayer had attempted to sue the FTB in Nevada state court.

— Related: *Crutchfield v. Commonwealth of Massachusetts.*
Arizona v. California

- FTB assesses minimum tax on entities with passive investments in LLCs that do business in California
- Arizona argues that FTB’s assessments violate Arizona’s sovereignty
- Are there issues with Arizona’s standing?
- Even if SCOTUS doesn’t take the case, draws attention to FTB’s practices
  - Forcing taxpayers to fight small assessments or concede issue
  - Justices could use this as an platform to invite another challenge, like in DMA v. Brohl
- Last status: On June 24, SCOTUS requested the Solicitor General file a brief.
Questions?