State tax controversies 2017: A new year, new challenges

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Agenda

Recent developments going into 2017

1. Sales/Use Tax
   • States’ efforts to collect tax and to challenge *Quill*
   • Application of antiquated laws to emerging business models
   • Continued opportunities for reverse audits

2. Income Tax
   • Economic nexus
   • Market-based sourcing

3. Other items to keep on the radar
   • Court challenges to retroactive tax laws and regulations
   • Sharing of information among states, and between states and IRS
   • Election / IRS “campaign” program
Sales and se Tax
Polling question 1

Is *Quill* dead?

A. No, because the Supreme Court’s decision is still the law of the land.

B. Yes, because most states have passed laws and regulations that, one way or another, require collection of tax by out-of-state sellers.

C. Both A and B are true.

D. Don’t know/not applicable
Gradual erosion of *Quill*: expanding physical presence nexus

States have been passing laws that push the boundaries of the concept of “physical presence.”

- Independent contractor/agency nexus
- Affiliate nexus (approximately twenty-five states currently)
- “Click-through nexus” (approximately twenty-one states currently)
  - New York law upheld.
  - Original Illinois law struck down as violating the Internet Tax Freedom Act. Following that decision, Illinois passed a law that did not raise the same concerns.
Click through and affiliate nexus

- Click-through nexus states, 21 in total

- Affiliate nexus states, 25 in total
  AL, AR, CA, CO, FL, GA, IL, IA, KS, LA, ME, MI, MO, NV, NY, OH, OK, PA, RI, SD, TX, UT, VA, WI, WV
“Click-through” nexus – rebutting the presumption

New York published guidance on rebutting the presumption in TSB-M-08(3.1)S (Jun. 30, 2008).

To rebut the presumption, the contract must prohibit:

“engaging in any solicitation activities...that refer potential customers to the seller including, but not limited to: distributing flyers, coupons, newsletters and other printed promotional materials, or electronic equivalents; verbal solicitation (e.g., in-person referrals); initiating telephone calls; and sending e-mails. In addition, if the resident representative is an organization such as a club or a non-profit group, the contract or agreement must provide that the organization will maintain on its Web site information alerting its members to the prohibition against each of the solicitation activities described above; and”

In addition, the resident must submit a signed certification stating that the resident representative has not engaged in any prohibited solicitation activities.

California has a similar rule in Reg. 1684.

These rules require sellers to carefully review contracts, which means the tax team needs to be communicating with the business and marketing teams.
Challenges to Quill

- Information reporting requirements (Direct Mktg. Ass’n)
  - Burden taxpayers until they collect
  - Colorado; Oklahoma; South Dakota; Vermont; Louisiana;
- Direct challenges
  - Sales tax economic nexus
  - South Dakota, Alabama, Tennessee
- Other
  - Federal legislation
Information reporting – “use” tax approaches

• Colorado
  – 2012 statute requires “non-collecting” retailers to inform customers and state that they may have a use tax obligation for taxable purchases
  – Ultimately upheld as being constitutional when the U.S. Supreme Court denied certiorari in DMA challenge this December 2016
  – Any out-of-state retailer that has gross revenues in excess of $100,000 in the state, and does not collect the sales tax on taxable purchases must
    ◦ send a transactional notice to the customer that they may be subject to the state’s use tax
    ◦ send a detailed annual purchase summary to customers that purchase more than $500 of goods during the year, reminding them of potential use tax obligations
    ◦ file the annual customer information report with the DOR

• Other state activity
  – Vermont
  – Louisiana and Oklahoma
Kennedy concurrence – Direct Marketing Ass’n v. Brohl

• In Direct Marketing Assoc’n v. Brohl, 135 S. Ct. 1124, 1131 (2015), Justice Kennedy made statements in his concurrence indicating Quill is ripe for reconsideration and could possibly be overturned

  “Given…changes in technology and consumer sophistication, it is unwise to delay any longer a reconsideration of the Court’s holding in Quill. A case questionable even when decided, Quill now harms States to a degree far greater than could have been anticipated earlier.”

  “The instant case does not raise this issue in a manner appropriate for the Court to address it. It does provide, however, the means to note the importance of reconsidering doubtful authority. The legal system should find an appropriate case for this court to reexamine Quill and Bellas Hess.”

Recent Alabama administrative rule promulgation and South Dakota legislation establishing sales-based nexus threshold for sales tax collection may be a response to Justice Kennedy’s remarks
South Dakota nexus law

− On March 22, 2016, Senate Bill (S.B. 106) was signed with an effective date of May 1, 2016

− Sales tax collection requirement if either criteria is met in the previous or current calendar year:
  ◦ Seller’s gross revenue from sales into South Dakota exceeds $100,000; or
  ◦ Sales of 200 or more separate transactions into South Dakota.

− On April 28, 2016, the state filed a declaratory judgment in Circuit Court against several large online retailers. In response, a group representing online and catalog retailers filed a declaratory judgment in Circuit Court against the state

− In accordance with the state statute, an injunction is currently in place that prevents the state from enforcing the law while the constitutionality is challenged
Alabama sales tax nexus rule

Alabama Sales and Use Tax Rule Number 810-6-2.90.03

– Applies to all transactions occurring on or after January 1, 2016

– Out-of-state sellers who lack a physical presence but who make sales of tangible personal property into the state have substantial economic presence in Alabama and must collect and remit tax when sales exceed $250,000/year (and engage in an activity listed in 40-23-68)
Tennessee sales tax nexus rule

Administrative Rule No. 1320-05-01-.129. Imparts “substantial nexus” for state sales and use tax upon out of state dealers that

− Engage in the regular or systematic solicitation of consumers in Tennessee “through any means,”

− Make sales that exceed $500,000 to consumers in Tennessee during any calendar year

All businesses meeting the economic nexus threshold must register with the Tennessee Department of Revenue by January 1, 2017 and must report and pay all applicable sales and use tax on tangible personal property and other taxable items delivered to Tennessee consumers by July 1, 2017
Polling question 2

If we assume that Quill’s physical presence requirement is overturned and you were given the following options by the states, which would you choose?

a. To collect and remit tax on sales made to customers in each state, and file returns;

b. To report the names of customers to each state annually, along with the dollar amount of purchases made by each customer;

c. Neither option is great for business and what is most important is that every state pick either “A” or “B” to ease compliance issues going forward.

d. Don’t know/not applicable
Emerging business models: online marketplaces

− New business model where the marketplace provider allows a virtual space that brings buyer and seller together in order to facilitate a sale
− The states have generally not provided significant guidance
− Taxpayers must determine the following
  ◦ Who is the marketplace’s customer?
  ◦ Who is the seller of the product or service sold on the marketplace required to collect tax?
  ◦ Is the product or service listed on the marketplace subject to sales and use tax?
  ◦ Is the service fee received from the buyer or seller subject to sales and use tax?
  ◦ Do the agreements, invoicing, or other reporting documentation properly describe the arrangement?
  ◦ Are there any system considerations that limit collection of tax?
Online marketplace – the shared economy

− Often a version of an online marketplace that lets an individual temporarily use or rent its assets (e.g., home, car, storage space) for a fee

− In addition to general considerations, taxpayers in shared economy should consider the following

  ◦ Will “shared economy” seller’s assets create nexus in the seller’s home state?

  ◦ Is the Online Marketplace holding itself out as a provider of services?

  ◦ Level of sophistication of the seller to comply with its tax obligations without assistance?
Online marketplace guidance

Arizona Transaction Privilege Tax Ruling 16-3, September 20, 2016

• ISSUE

Is a business with Arizona nexus for Arizona transaction privilege tax (TPT) purposes that operates an online marketplace through which third-party merchants sell tangible personal property at retail (hereinafter "online marketplace") a "retailer" making "sales" on behalf of third-party merchants, and therefore, responsible for the retail TPT on sales to Arizona customers?

• RULING

A business that operates an online marketplace and makes online sales on behalf of third-party merchants as evidenced by the marketplace providing a primary contact point for customer service, processing payments on behalf of the merchant and providing or controlling the fulfillment process, is a retailer conducting taxable sales. The gross receipts of that marketplace business derived from the sales of tangible personal property to Arizona purchasers are subject to retail TPT, provided that the business already has nexus for Arizona TPT purposes.
Payment of sales tax by marketplace provider relieves the jointly responsible retailers of sales tax obligations

- The Colorado Department of Revenue (Department) released a non-binding general information letter, concluding that a marketplace provider’s payment of sales tax on transactions involving “jointly responsible” third-party retailers discharges the obligations of the third-party retailers to collect and remit sales tax. By statute, the Department has discretionary authority to treat an agent for a retailer as “jointly responsible” for the collection and remittance of sales tax, and can pursue the retailer’s agent when it is “necessary for the efficient administration” of the sales tax. Colo. Gen. Info. Letter No. GIL-16-020 (Colo. Dep’t Revenue Oct. 4, 2016, released Dec. 7, 2016).
Income Tax
In an effort to prevent erosion of the corporate tax base, states have taken action on multiple fronts:

- Economic nexus and factor presence nexus seek to expand the tax base by lowering the nexus threshold.
- Mandatory unitary combined reporting seeks to mitigate base erosion by limiting profit shifting.
- Market sourcing seeks to, in the aggregate, source additional income to a state (typically coupled with factor presence nexus).

Mandatory unitary combined reporting coupled with a single receipts apportionment factor based on market sourcing rules and economic nexus/factor presence nexus may be, from the state perspective, the optimal economic and political approach.

In the new economy, figuring out “where” the sale takes place is critical for economic nexus and market-based sourcing.
Income tax: economic nexus appears here to stay

• 1993 South Carolina Supreme Court (Geoffrey case)
  – Income tax nexus created when licensed intellectual property is used in a state.
• 2006 New Jersey Supreme Court
  – Licensing intangibles creates nexus for New Jersey Corporate Business Tax purposes
  – Quill only applies to sales tax
• 2006 West Virginia Supreme Court of Appeals
  – Adopted “significant economic presence” test
  – Bank had engaged in continuous direct mail, telephone solicitation, and promotion in state
  – Court ruled that Quill only applies to sales and use taxes, not to state business franchise tax

U.S. Supreme Court denied review in these cases and others
Polling question 3

Your business compiles and sells information (digital content) to purchasers/subscribers. Content can be purchased and accessed on computers, smart TV’s, and mobile devices. Customers buy individual files or a monthly subscription that allows access to various libraries of content. Customers pay with credit cards that have billing addresses associated with them. However, you know that the billing address may not correspond with the place of sale or the place where the customer “uses” the content. In what states is the business taxable?

A. The business only has physical presence in one state, so that is the only state that can subject it to income tax.
B. I only have easy access to the billing address so I comply with the laws of the “billing address” states.
C. I consider the need to reserve amounts in other states in case the business is ever required to produce records showing the location of the customer at the time of any particular sale.
D. B and C.
E. Don’t know/not applicable.
Factor-based nexus standards

Under a bright-line “factor-based” standard, nexus is created with a state when a minimum amount of property, payroll or sales in the state is met.

States adopting “Bright-Line” Nexus Tests

Alabama (2015)
California
Connecticut
Ohio
Washington (B&O Tax)

Colorado
New York State (2015)
Tennessee (2016)

Multistate Tax Commission Model “Factor Nexus” Statute

• Substantial nexus is established if any of the following thresholds are exceeded during the tax period: $50,000 of property; or $50,000 of payroll; or $500,000 of sales; or 25% of total property, total payroll or total sales.
• Is a pure “sales-based” nexus threshold constitutional? Consider Due Process cases involving goods put into stream of commerce.
• Factor based nexus statutes must yield to PL 86-272
• Impact of factor based presence on “throwback statutes”
Ohio CAT—Economic nexus

Who is subject to CAT?

• Taxpayers that have nexus in the state
• Taxpayers have nexus in Ohio when they have bright line presence in Ohio, among other factors.
• A person has bright line presence under O.R.C. § 5751.01(I) if the person has within Ohio:
  1. $50,000 in property;
  2. $50,000 in payroll;
  3. $500,000 in taxable gross receipts;
  4. at least 25% of the person’s total property, total payroll, or total gross receipts are within the state; or
  5. the person is domiciled in the state.
Ohio CAT – economic nexus upheld

On November 17, 2016, the Supreme Court of Ohio (the “Court”), in a 5-2 opinion, affirmed decisions of the Ohio Board of Tax Appeals (the “BTA”), consolidated as Crutchfield Corp. v. Testa, Slip Opinion No. 2016-Ohio-7760

In upholding the BTA decisions, the Court ruled that Ohio’s bright-line economic nexus standard is constitutional because

1) The U.S. Supreme Court holding in Quill Corp. v. North Dakota, requiring a physical presence in the taxing jurisdiction in order to impose a sales and use tax obligation, does not extend to a business-privilege tax such as the CAT

2) The $500,000 taxable gross receipts threshold of the CAT’s economic nexus standard complies with the substantial-nexus requirement of the U.S. Supreme Court’s ruling in Complete Auto v. Brady, is not clearly excessive in relation to Ohio’s legitimate interest in imposing the tax, and as a result satisfies the dormant Commerce Clause

Two member dissent would have held that CAT is not dissimilar from a transactional-based sales/tax (thus Quill physical presence standard continues to apply.) Dissent also took issue with majority’s holding that $500,000 in Ohio sales is a constitutionally sufficient measure of “substantial nexus”

Cert petition pending.
Approximately two dozen states have currently adopted market-based sourcing rules for sales other than of tangible personal property. States that have recently transitioned to market-based rules include:

- California (elective in 2011 and 2012, mandatory in 2013)
- Connecticut (2016)
- Louisiana (2016)
- Massachusetts (2014)
- Missouri (effective August 28, 2015)
- Nebraska (2014)
- New York City (2015)
- New York State (2015)
- Pennsylvania (2014)
- Rhode Island (2015)
- Tennessee (July 1, 2016)
What is market-based sourcing

States’ approaches to interpreting the “market” can vary

“Market” for Services
- Customer location
- Where the benefit of the service is received by customer
- Where the service is received
- Where the service is delivered

“Market” for Intangibles
- Where the intangible is used
- Where the intangible has a business situs
- Where the intangible is domiciled

Look-through approach
- Based on location of the customer’s customer
Sales factor sourcing—What is market?

One common approach to “market” sourcing has been to source receipts of services to where the customer receives the benefit of the services performed.

- California Reg. 25136-2 provides detailed, cascading rules to best determine where the benefit is received or property is used.
  - Services to a business customer are sourced to:
    ◦ Where the contract indicates the benefit is received;
    ◦ If the contract does not provide the location, then it may be “reasonably approximated”;
    ◦ If neither of the above provide the location, the receipts are sourced to the state from where the customer placed the order;
    ◦ If none of the above provide the location, the receipts are sourced to the state of the customer’s billing address.

- Maryland sources receipts from services to the state if they are derived from “customers in the state”, which includes:
  - Individuals domiciled in MD;
  - Businesses domiciled in MD where the office or place of business that provides the principal impetus for the sales is in MD, or, if not otherwise identified, where the headquarters or principal place of business management is located in MD.

- Michigan sources receipts from services to the state if the benefit is fully received in MI. However, if the benefit is only partially received in MI, the receipts are sourced to MI to the extent the benefit is received there.
California vs. Massachusetts
Are these market sourcing rules equal?

**California**
- Market sourcing elective 1/1/2011, mandatory 1/1/2013
  - Sales of services—to the extent the purchaser of the service receives the benefit in California
  - Sales of intangibles—to the extent the property is used in California
  - Industry Rules
  - Cascading Rules
  - Worldwide

**Massachusetts**
- Market sourcing effective 1/1/14
  - Sales other than sales of tangible personal property are in Massachusetts if the corporation’s market for sales is in Massachusetts
  - Detailed regulations defining market
  - Industry specific rules
  - Throwout rule
Market-based sourcing—Practical issues

**Reality is that market sourcing can be difficult to apply regardless of whether based on location of delivery, client benefit or something else**

- Based on terms of contract?
- Location from where request for service is made/ordered?
- Based on a look through to the client's customer’s location?
- Location from which customer is billed and/or domiciled?
- What level of analysis and data collection is required by a seller?

**Consider complex services that appear to benefit an entire organization—Where is the “benefit received” if the customer is a multistate (or multinational) company?**

- Cloud computing services
- Accounting and legal services

**Look-through approach**

- Sourcing receipts based on the location of the customer’s customer
  - States have adopted this approach either through regulation or enforcement efforts
    - California applies such an approach to mutual fund service providers (Cal. Code Regs. tit. 18, § 25137-14)
  - Such an approach may lead to a large compliance burden for taxpayers because they may not control the data necessary to accurately source the receipts
Practical issues continued

- Other considerations in determining which state is the “market” state where a state has not provided specific guidance:
  - The customer’s billing address may not represent the domicile or headquarters of the customer or where a license is used by the customer.
  - In determining where a license of intangible property is used, states differ on whether the license is used where the licensor’s customer is located or where the licensee’s customer is located.
Market-Based Sourcing - Litigation


Polling question 4

Tax Research, Inc. is located in Chicago, IL. It has no offices outside of Illinois and its employees do not perform any services outside of IL. It licenses the use of tax research software throughout the U.S. Tax Research has two primary customers, solo accounting practitioners throughout the U.S. and large national accounting firms. All information is stored on servers in IL. When customers conduct research, they are accessing the information on those servers. Tax Research charges a per-user license fee. Where does Tax Research source its receipts?

A. Illinois, since the benefit of the service is received in Illinois where the information is stored?
B. The customer’s state, as indicated on the contract?
C. The customer’s state, as indicated on the contract, and in the case of national accounting firms, a further breakdown of the use by their employees is necessary?
D. B and C.
E. Don’t know/not applicable.
Compliance considerations

**Service Revenue**
- Where is the service performed?
- Is the service performed in multiple locations?
- Is the customer a national account serviced in multiple locations?
- Where is the contract negotiated?
- Where is the customer domiciled?
- Where is the office of the customer which ordered the sale?
- What type of service revenue is being sold?
- Is the service part of a bundled transaction?

**License of an Intangible**
- Where is the license utilized?
- Does the customer have the right to sublicense?
- Does the contract give the customer rights to a specific marketing area/zone?

**Tangible Personal Property**
- How is the product shipped?
- Do customers pick up at the seller’s warehouse?
- Is product being sold to a retailer’s warehouse or through a distribution company?

**What is the revenue stream?**

Records are key, so plan ahead !!!
Other considerations
Retroactive tax legislation

Two sets of cases are pending at SCOTUS on the constitutionality of retroactive tax legislation:

- *DOT Foods* – Retroactive Washington B&O tax change
- *IBM/Gillette* – Michigan’s retroactive elimination of MTC apportionment election

In *U.S. v. Carlton*, the U.S. Supreme Court established a two-part test to determine if retroactive tax legislation violates the Due Process Clause of the U.S Constitution.

- First, the Court looked to whether the legislation was enacted for a “legitimate legislative purpose furthered by rational means.”
- Second, the Court looked to whether Congress “acted promptly and established only a modest period of retroactivity.”

It is difficult to run a business if states can pass *ex post facto* tax laws at will.
Information sharing
Between IRS and states

The IRS routinely shares information with all states:
• Authorized by IRC §6103(d)
• States identify certain data extracts for periodic receipt
  – Audit Results
    ◦ Individual
    ◦ Business – all forms
  – Federal individual and business return information
  – Employment tax information
• Data security is of paramount importance to the IRS
  – Regular field audits are performed to verify security of FTI
• This information is a significant revenue source for states
Information sharing
Among the states and MTC

• FTA facilitated the Uniform Exchange of Information Agreement in 1993
  – 48 States (not NM, NV), DC, NYC and MTC
• States authorized by statutes either by adopting similar rules or conforming to IRC § 6103 (d)
  – To other agencies of the state
  – To other states or localities
  – Comply with a court order
  – To the IRS
• With the exception of other agencies of the state, this is not frequent
  – Tax purposes only
• MTC – SITAS
  – Participation Commitment and Exchange of Information Agreement
Question and answer
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