

Legislative, Judicial and Administrative Developments in State Taxation

Valerie Dickerson
Deloitte Tax LLP

Karl Frieden
Council On State Taxation

Jeff Friedman
Sutherland Asbill & Brennan, LLP



Agenda

“Top 5” Litigation Trends & Cases to Watch

Legislative Trends & Developments

ALAS & Other MTC Developments

“Top 5” Litigation Trends and Cases to Watch

Apportioning the Personal Income Tax

***Md. State Comptroller of the Treasury v. Wynne*, 64 A.3d 453 (Md. 2013), cert. granted, 134 S. Ct. 2660 (2014).**

- Question Presented: Does the U.S. Constitution prohibit a state from taxing all the income of its residents—wherever earned—by mandating a credit for taxes paid on income earned in other states?
 - Can individual residents of a state be taxed on their full income without the state apportioning or providing credit for taxes paid to other states?
 - How far does this apply – sales/use taxes, piggyback and non-piggyback local income taxes, etc.?

The Supreme Court heard oral arguments on November 12.

Scope of the Tax Injunction Act

***Direct Mktg. Ass'n v. Brohl*, 735 F.3d 904 (10th Cir. 2013), cert. granted, 134 S. Ct. 2901 (2014).**

- Question Presented: Does the Tax Injunction Act bar federal court jurisdiction over a suit brought by non-taxpayers to enjoin the informational notice and reporting requirements of a state law that neither imposes a tax, nor requires the collection of a tax, but serves only as a secondary aspect of state tax administration?
- Colorado's State District Court issued a preliminary injunction (2/18/14) based on the statute discriminating against interstate commerce; permanent injunction granted 6/2/2014 based on finding that the statute was discriminatory.

The Supreme Court heard oral arguments on December 8.

Discrimination under the 4-R Act

***CSX Transp., Inc. v. Ala. Dep't of Revenue*, 720 F.3d 863 (11th Cir. 2013), cert. granted, 134 S. Ct. 2900 (2014).**

- Several states impose a sales/use tax if motor fuel is not subject to the state's motor fuel excise tax. (Some states impose both!)
- Questions Presented:
 - Does a state discriminate against a rail carrier in violation of the 4-R Act when the state generally requires businesses to pay a sales/use tax, but grants exemptions from the tax to competitors of the railroads?
 - In resolving a claim of unlawful tax discrimination under 49 U.S.C. § 11501(b)(4), should a court consider other aspects of the State's tax scheme rather than focusing solely on the challenged tax provision?

The Supreme Court heard oral arguments on December 9.

Multistate Tax Compact Litigation

***Gillette Co. v. Franchise Tax Board*, 207 Cal.App.4th 1369 (Cal. Ct. App. July 24, 2012), Cal. S.Ct., No. S206587, petition for review granted 01/16/2013**

- The Court of Appeals upheld taxpayers' use of the Multistate Tax Compact's three-factor apportionment election in lieu of the double-weighted sales factor mandated by California law.

***International Business Machines Corporation v. Department of Treasury*, No. 146440 (Mich. S.Ct. Jul. 14, 2014)**

- Michigan Supreme Court rules in favor of taxpayers on statutory grounds
 - No repeal by implication.
- On 9/12/14, the Michigan Gov. signed legislation (S.B. 156) retroactively repealing the Compact, stipulating that multistate corporations weren't entitled to use the MTC's apportionment formula as of Jan. 1, 2008.

***Taskawa America, Inc. v. Department of Treasury*, (December 19, 2014)**

- Michigan Court of Claims upholds retroactive legislation.

Other cases pending in Texas, Oregon, and Minnesota.

Federal Disconformity

Schlumberger Tech. Corp. v. State, Dep't of Revenue, 331 P.3d (Alaska 2014).

- The Alaska Supreme Court held that Internal Revenue Code § 882(a)(1), which requires a foreign corporation to report only income effectively connected with the conduct of a trade or business within the United States (“ECI”). . . ., has not been adopted by reference because it is inconsistent with the formula provided by the Alaska Net Income Tax Act.

Massachusetts Case – Intercompany financing with foreign entities:

- The Massachusetts Appellate Tax Board upheld assessments denying the taxpayer’s interest deductions for payments under deferred subscription arrangements (“DSAs”) with foreign entities on the basis that the DSAs did not qualify as true debt because they lacked an unconditional obligation to repay.
- Taxpayer request to follow IRS “No Change” was denied.

Maryland

- The Maryland Court of Appeals held that the Comptroller had the authority to assess parent corporation's intellectual property holdco subsidiary, \$1.9 million for unpaid taxes, interest and penalties related to its 2002 and 2003 Maryland tax returns.
- The parent and subsidiary originally filed in Maryland using federal consolidated rules, which the state does not follow, and subsequently tried to amend their returns to comply with Maryland's separate filing requirements.
- The parent corporation argued that deferred gain related to a series of transactions shown on the subsidiary's Maryland tax return in 2002 and 2003 should have been included on its 1999 return when the deferred gain was recognized – outside the statute of limitation for assessment.
- In rejecting the parent corporation's argument, the court relied on the Comptroller's assessment and the use of the originally filed 2002 and 2003 returns.

Unitary Business

- An Oregon Tax Court determined that Taxpayer and its wholly owned franchising subsidiary were not unitary, while it was unitary with its captive insurance subsidiary.
- The court determined that the presence of all three unitary factors (i.e., flows of value evidenced by centralized management, economies of scale, and functional integration) were required to find a unitary business.
- The franchising subsidiary only exhibited centralized management with Taxpayer, but found that the captive insurance subsidiary exhibited all three unitary factors.
 - The court specifically focused on functional integration and found that providing insurance to Taxpayer's unitary relieved the subsidiaries of the burden of finding their own insurance and resulted in a financial benefit to the entire group.

Sales Tax

Sale of informational/research website - Michigan Case

- The Michigan Court of Appeals held that Taxpayer's sale of was the sale of a nontaxable information service and not tangible personal property.
- The Michigan Department of Treasury argued informational/research website was tangible personal property because it constituted the sale of "prewritten computer software subject to tax when plaintiff's Michigan customers used and controlled the computer code that resided on the web browser interface and on the server side."
- Applying Michigan's "incidental to service test," however, the Court of Appeals found website customers sought access to information, not the underlying computer code that constituted less than one percent of the transaction.

Sales of VOD & PPV – Louisiana Case

- Louisiana's Fifth Circuit Court of Appeal held that a cable television provider's video-on-demand (VOD) and pay-per-view (PPV) programming services are not tangible personal property and therefore not subject to sales tax.
- In reaching its conclusions, the court considered that the programming:
 - (i) was a digital data stream that requires the provider's constant involvement and has to be interpreted by software,
 - (ii) was not considered to be software within the cable industry,
 - (iii) was not taxed by other jurisdictions as tangible personal property, and
 - (iv) was included in the local franchise fee base.

Other State Tax Cases to Watch

- **False Claims Act Application to State Taxes: New York Case**
 - Issues relating to treble damages; circumventing normal tax administrative appeals process; longer SOL; confidentiality of tax records.
- **Alternative Apportionment: Tennessee Case**
 - On utilizing alternative apportionment in COP state to impose market sourcing on out-of-state company.
- **Tax Incentives: CDR Systems Corporation v. Oklahoma Tax Commission; 2014 OK 31; Case No. 109886. Rehearing requested at the Oklahoma Supreme Court.**
 - On constitutionality of favorable capital gains treatment for home state companies.

Other State Tax Cases to Watch

- ***Challenge to Estimation Methodology in Unclaimed Property Audits:*** October 1, 2014 U.S. District Court of Delaware hearing on cross motions to dismiss and for summary judgment before U.S. Dist. Ct. Judge Sue Robinson:
“I was astounded that an audit could go back decades and without any historical records come up with an estimate. Quite frankly, I found that astounding, if not shocking...the question is whether this formula and this process has really been run by a body that is interested in due process and fair play.”
- Array of possible next steps include ruling and appeal to U.S. Court of Appeals (3rd Cir.); remand to Chancery Court (U.S. Dist. Ct. could retain jurisdiction); certify question to Delaware Supreme Court

Legislative Trends & Developments

Elections 2014: And the Winner Is...

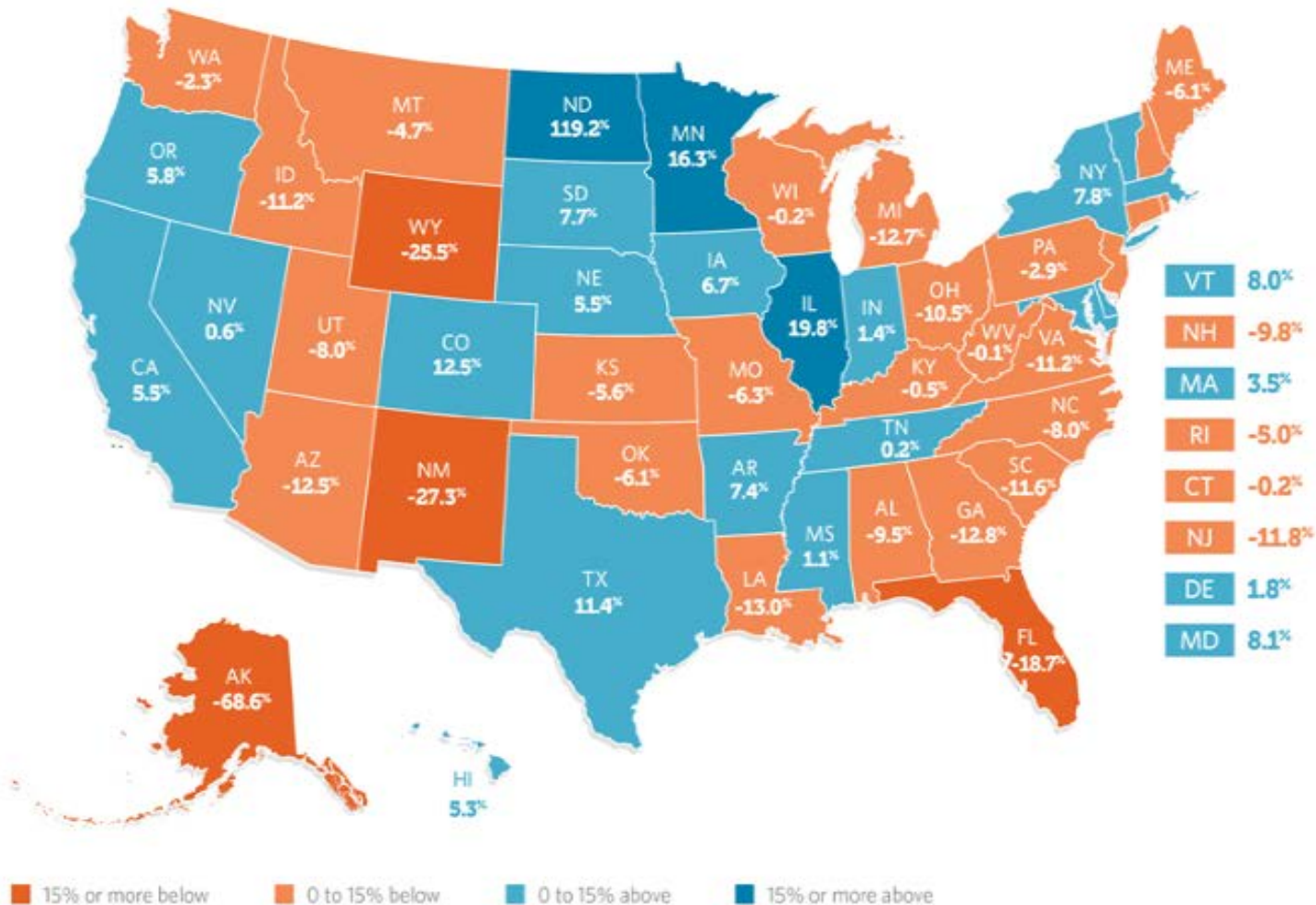
The Final Tally:

- Legislatures: 30 R, 11 D, and 8 split (1 non-partisan)
- Chambers: 68 R, 30 D (Republicans gain of 10)
- Governors: 31 R, 18 D and 1 independent
 - New Republican Governors in Massachusetts, Illinois, and Maryland
- State governments: 23 R, 7 D, 20 divided
- Federal Govt.: Republicans take over control of the U.S. Senate and increase majority in U.S. House.

Source: NCSL , “Republican Wave Capsizes Democrats”, 11/5/14.

Real Tax Revenue Is Still Lower in 29 States Since the Recession

Tax collections in 2Q 2014 compared with each state's peak, adjusted for inflation



The Pew Charitable Trusts. The analysis is based on the U.S. Census Bureau's quarterly tax revenue data, as adjusted by the Rockefeller Institute of Government.

2014 Election Results: Impact on State Taxation?

State tax reform

- More business friendly legislation
 - State tax administrative reforms
- Taxing out of state companies
- Favoring consumption taxes over income taxes

Federal tax reform

- President Obama and Senate Majority Leader Mitch McConnell listed **corporate tax reform** as one possible issue that Congress and the Administration can work on together.
- Lowering the federal income tax rate – little impact on states.
- Broadening the federal income tax base – significant impact on states.

Federal tax legislation on state tax issues

- Marketplace Fairness Act
 - Hybrid origin sourcing
 - Streamlined Sales Tax states
- Mobile Workforce State Income Tax Simplification Act
- Internet Tax Freedom Act

The most significant tax legislation of 2014: New York tax reform

- 8559D/S. 6359D, effective January 1, 2015
 - Economic nexus where corporation derives at least \$1 million of annual receipts
 - Market-based sourcing of receipts & sourcing of income from financial instruments
 - Domestic unitary finding no longer tied to “substantial intercorporate transactions” and taxpayers may make binding election for 7 years
 - Overhauls Article 9A to tax business income on an apportioned basis and eliminate “subsidiary capital” classification so that investment income will no longer be taxable and “investment allocation percentage” disappears
- Investment capital narrowly defined to only investments in stock of non-unitary corporations held for more than six months

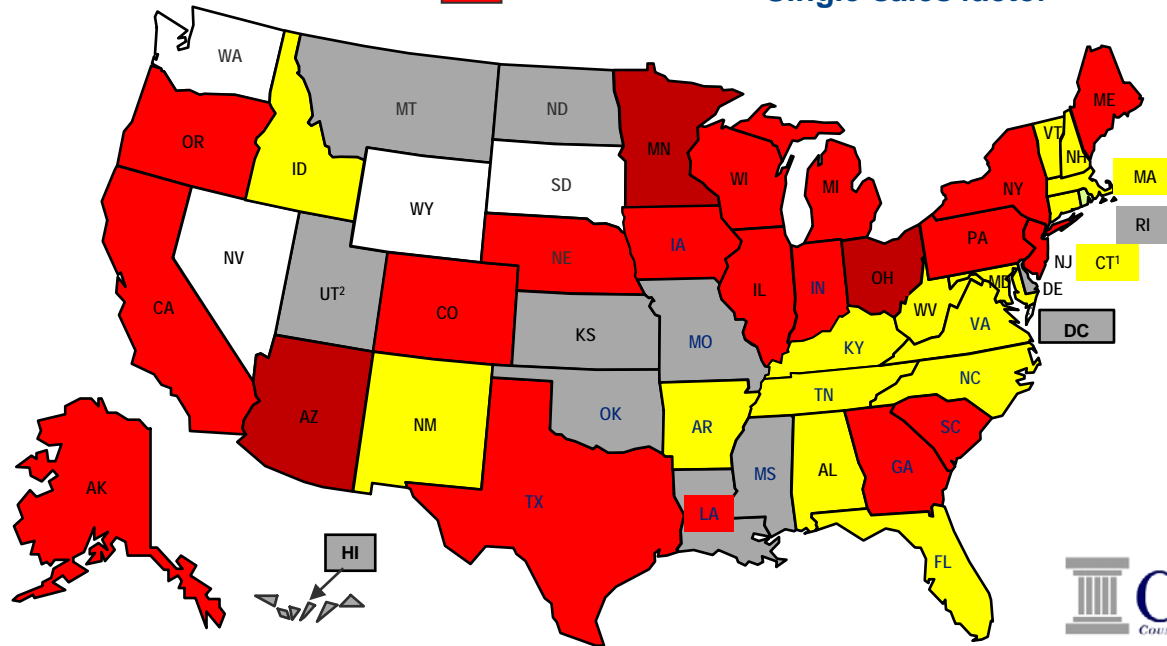
What was hot in 2014: tax policy as an economic development tool

- DC: FY2015 BUDGET SUPPORT ACT/B20-849
 - SSF, corporate rate relief, limited sales tax base expansion
- RI: FY 2015 BUDGET/H.B. 7133 SUB A
 - SSF, coupled with combined reporting, corporate rate reduction
- IN: S.B.1
 - Extended rate relief, county option for business personal property tax relief
- MN: Repeal sales tax on certain B2B (e.g., warehousing/storage, repair/maintenance) (H.F. 1777)
- MA: R&D credit expansion (H.B. 4377)
- CA: Enacts “new markets” credit (A.B. 1399), expands “GO Biz” tax credit (A.B. 1560) and film tax credit (A.B. 1839)
 - Rejects corporate tax surcharge based on CEO comp. (S.B. 1372)

What's Hot: movement to single-sales factor

Key

- Equally weighted three-factor formula
- Double-weighted sales factor
- Triple or greater weighted sales factor
- Single-sales factor



What's Hot: movement to market sourcing receipts from sales of other than tangible personal property

¹ 2014 for certain taxpayers.

² 2013 for most taxpayers.

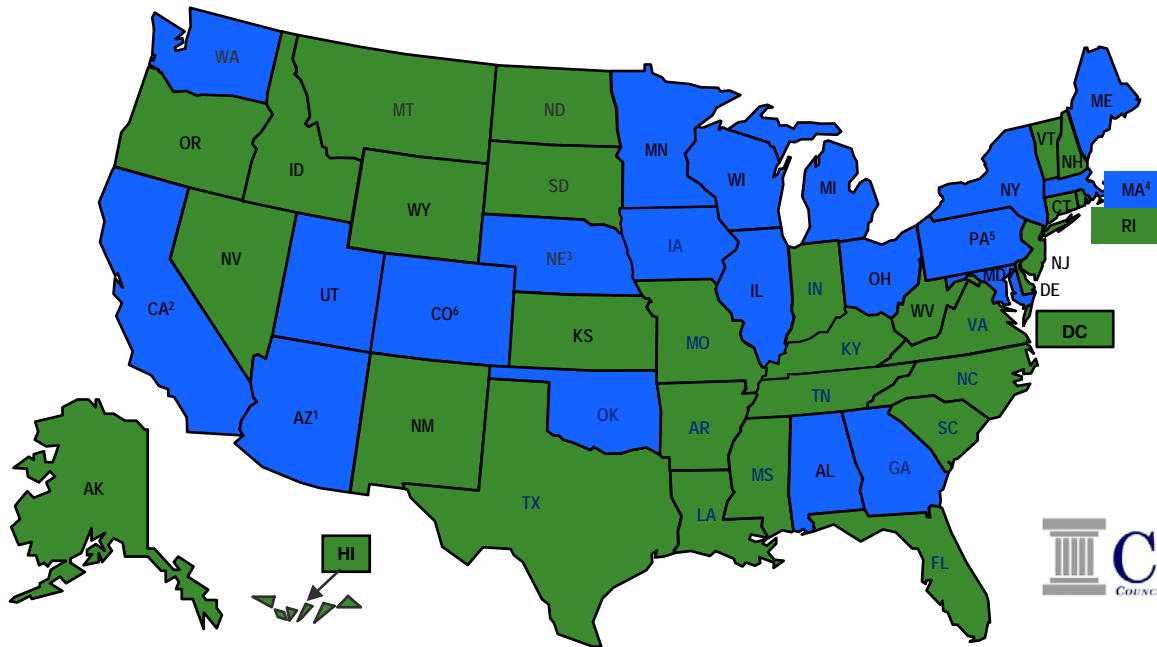
^{3,4} Effective 2014.

⁵ Effective 2014 for service receipts only.

⁶ For receipts from sales of intangible property only.



Key
Cost of Performance – Services and Intangibles
Market Based Sourcing – Services and Intangibles



Issues with Market-based Sourcing

A movement towards uniformity? Not exactly.

- While adopting states uniformly source revenue to a state based on the “market”, inconsistencies lie in defining the market
 - Services → where the customer is located, where the benefit of the service is received by the customer, where the service is received, or where the service is delivered
 - Intangibles → where the intangible is used, has a business situs, or is domiciled

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 taxpayer’s because they may not control the data necessary to accurately source the receipts
 - Regulation may be subject to constitutional challenge and may exceed the scope of the statute

What's hot: economic nexus – physical presence not required

Most states now have statutes or rulings that assert nexus over taxpayers that have an economic presence in the state, even those that lack a physical presence.

States adopting “Bright-Line” Nexus Tests

California

Colorado

Connecticut

New York (2015)

Ohio

Virginia

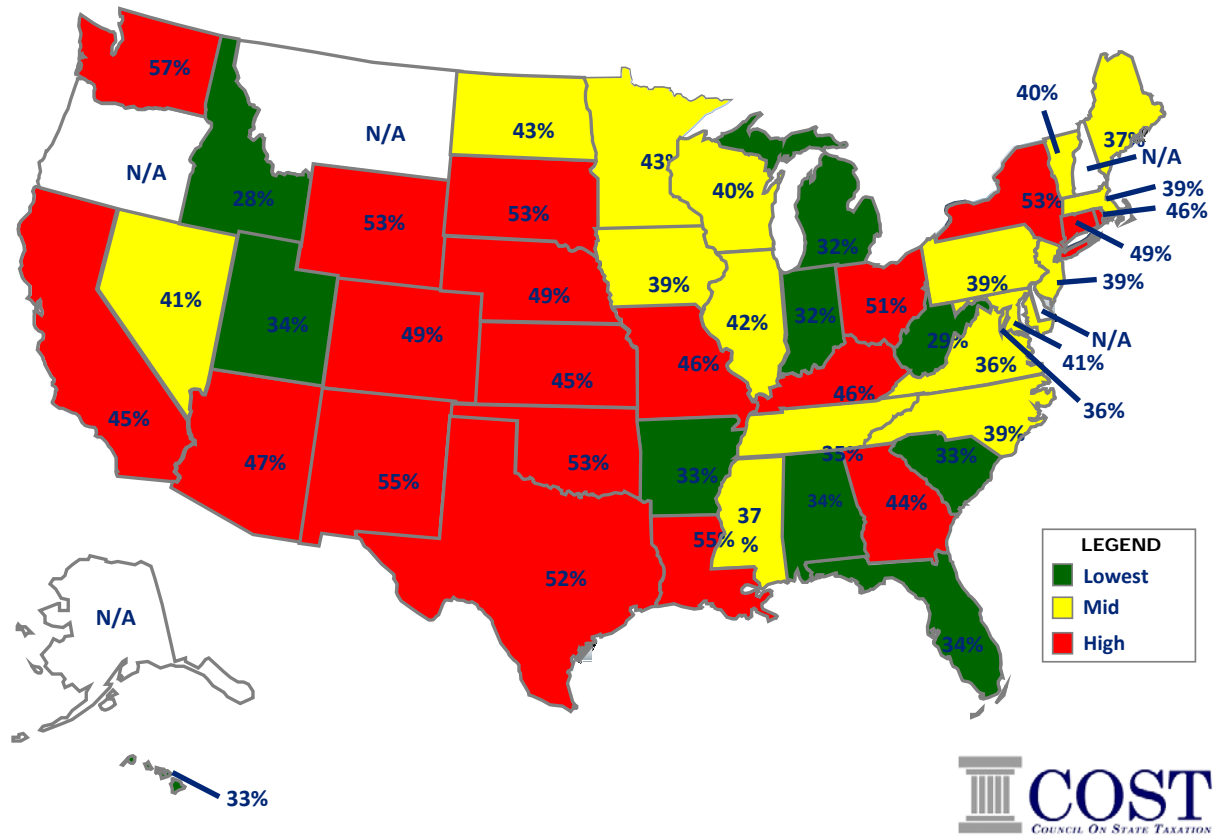
Multistate Tax Commission Model “Factor Nexus” Statute

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.

What's not hot: broadening the sales tax to tax services

- Lessons learned in 2013: Defeat of major sales tax reform legislation in 2013 in Louisiana, Nebraska, Minnesota, and Ohio.
- Few proposals in 2014 – an election year. What will happen in 2015? The narrow sales tax base – about 25 percent of all goods and services purchased by households.
- Continued growth of the largely untaxed “service” sector.
- The problematic design of sales and use taxes: taxing business to business services.
- The one exception: taxation of digital goods and services.

State and Local Sales Taxes Imposed on Business Input Purchases, 2011



E&Y/COST Sales Tax on Business Inputs Study Published 2013



Future attractions: possible state responses to BEPS

- The OECD is currently undertaking a multiyear project to address what the industrialized nations refer to as Base Erosion and Profit Shifting (BEPS). The initial OECD BEPS Recommendations were issued in September 2014. A second set will be issued in September 2015.
- **More tax haven legislation?**
 - Five states (AK, MT, OR, RI, and WV) plus D.C. currently have some form of a tax haven provision that seeks to include certain foreign entities in a state's unitary combined return
 - Rhode Island is the most recent, going into effect for tax years beginning on or after January 1, 2015
 - Montana and Oregon are the only two states to currently employ a statutory "blacklist" approach that identifies specific countries as tax havens
 - Alaska, Rhode Island, West Virginia, and the District of Columbia generally perform a more subjective analysis based on the individual facts and circumstances of each foreign entity and the countries involved
- **Renewed interest in worldwide combined reporting?**
- **Inversions: the next big thing?**

ALAS & Other MTC Developments

Arm's-length adjustment service project

States have attacked perceived income-shifting, with:

- Statutes and regulations similar to IRC § 482 and the regulations thereunder.
- Discretionary adjustments for related party transactions / forced combination.
- Statutory intercompany addback requirements.
- Taxing the related party payee.

The MTC and States are gearing up to hold intercompany transactions to greater scrutiny, through:

- Information/cost sharing
- Additional audit staff
- Transfer pricing challenges (hiring economists)
- Greater information disclosure / penalties
- Standardized transfer pricing IDR's

The Compact amendment effort

On July 30, 2014, the MTC adopted amendments to five provisions of Article IV of the Multistate Tax Compact (“Compact”):
Compact amendments are advisory in nature.

MTC’s Executive Committee approved several other amendments to Section 18 for submission to Compact member states as part of a Bylaw 7 survey.

- Burden of proof exception – Art. IV. 18(c)
- Limitation on civil or criminal Penalties – Art. IV. 18(d)
- Written permission from a state tax agency – Art. IV 18(e)

A special session may be convened to have Compact member states vote on the proposed revisions of Section 18. If a special session is not convened, the vote will take place during the MTC’s annual meeting in July.

Uniformity Committee regulatory drafting efforts:

- Definition of the term “receipts” – Art. IV.1(g)
- Sourcing of services and intangible – Art. IV.17

MTC – possible focus on compliance-oriented uniformity projects

- “One thing I keep hearing from industry is they’d like the MTC to start focusing on uniformity projects that address more compliance-driven issues – such as different filing requirements--as opposed to policy issues. So we might be talking about that in the not-too-distant future.”

MTC Executive Director Joe Huddleston quoted in *State Tax Notes* in December 2014

- Current uniformity project on limiting class action lawsuits and the application of False Claims Acts to state tax issues.
- Possible federal change reporting project.
- Other topics?

Contact Information

Valerie Dickerson, Partner
Deloitte Tax LLP
vdickerson@deloitte.com

Karl Frieden, Vice President and General Counsel
Council On State Taxation
kfrieden@cost.org

Jeff Friedman, Partner
Sutherland Asbill & Brennan, LLP
jeff.friedman@sutherland.com