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Articles:
Direct Marketing v. Brohl – Son of Quill?

In this edition of "Inside Deloitte," authors Dave Vistica and Jeremy Sharp of Deloitte Tax LLP's Multistate Office of Washington National Tax contend that the long road traveled by *Direct Marketing Association v. Brohl* – from the Tenth Circuit to the US Supreme Court and back again – has created two approaches for states seeking to challenge the *Quill/Bellas Hess* sales and use tax physical presence standard: One that seeks to see the standard overturned, and one that seeks to render its applicability moot. Are we witnessing the pending end of *Quill* either way?
URL: http://www2.deloitte.com/us/en/pages/tax/articles/direct-marketing-v-brohl-son-of-quill.html?id=us:2em:3na:stm:awa:tax:102116

Income/Franchise:
Important Underlying State Income Tax Implications of Recently Finalized Treasury Regulations under IRC § 385

TD 9790, Treasury Department and Internal Revenue Service (released 10/13/16; formal publication expected 10/21/16). The Treasury Department and Internal Revenue Service recently released final and temporary regulations under Internal Revenue Code section 385 that i) establish threshold documentation requirements that ordinarily must be satisfied in order for certain related-party interests in a corporation to be treated as indebtedness for US federal income tax purposes; and ii) treat as stock certain related-party interests that otherwise would be treated as indebtedness for US federal income tax purposes.
URL: http://newsletters.usdbriefs.com/2016/Tax/TNV/161014_1suppA.pdf

The section 385 regulations follow the issuance of – and are *significantly narrower in scope* than – the proposed regulations issued on April 4 under section 385 that would have (i) authorized the IRS to treat certain related-party interests as part stock and part debt for federal tax purposes; (ii) established contemporaneous documentation requirements that must be satisfied for certain related-party debt to be respected for federal tax purposes; and (iii) treated certain related-party debt as stock for all purposes of the code when issued in connection with certain distributions and acquisitions.

Nonetheless, important underlying state income tax implications of these section 385 regulations still exist and could include:

- Separate entity application of the rules in states with statutory requirements to compute taxable income beginning with pro forma separate federal taxable income;
- Differing combined group filing thresholds, including 50 percent ownership requirement, worldwide filings, and inclusion or exclusion of entities with a certain percentage of apportionment factors within or outside the US (80/20 companies); and
- Differing earnings and profits and basis, absent application of the consolidated return regulations.

In this respect, these regulations under section 385 may have more of an impact for state income tax than for federal tax purposes. Companies should consult with their Deloitte tax advisors about the potential implications in specific state and/or local tax jurisdictions.

See recently released US tax alert for more details on these section 385 regulations, as well as related taxpayer considerations from a state income tax perspective.
URL: http://newsletters.usdbriefs.com/2016/Tax/TNV/161014_1suppB.pdf

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Income/Franchise:
California FTB Issues Ruling on Tax Treatment of IRC § 338(h)(10) Election When Target is an Insurance Company

Chief Counsel Ruling 2016-05, Cal. FTB (9/16/16). The California Franchise Tax Board (FTB) recently issued guidance on the California tax treatment of an IRC section 338(h)(10) election when the target corporation is an insurance company – holding that, under the provided facts, the IRC section 338(h)(10) election pertaining to the sale of an insurance company target's stock will be respected for California tax purposes. However, pursuant to California Revenue and Taxation Code (CRTC) sections 24465(h)(2)(B) and 24465(h)(3), with respect to the applicability of IRC section 332 as it relates to the transaction, the seller at issue will be treated as receiving a distribution of all of the insurance company target's earnings and profits, which will be treated as a dividend for purposes of the dividend received deduction allowed pursuant to CRTC section 24410.
URL: https://www.ftb.ca.gov/law/ccr/2016/05.pdf

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Income/Franchise:
Indiana: Combined Reporting and Transfer Pricing Studies Released; Are Positive Impacts for States Only Short-Term?

A Study of Practices Relating to and the Potential Impact of Combined Reporting; *Transfer Pricing: A Review of Issues*, Office of Fiscal and Management Analysis Indiana, Legislative Services Agency (10/1/16). Indiana's Legislative Services Agency (LSA) has released two studies that, respectively, address i) the combined reporting approach to apportioning income for income tax purposes; and ii) issues related to transfer pricing under Indiana's adjusted gross income tax law, pursuant to legislation enacted earlier this year [*S.B. 323*] that requires such studies to be submitted to Indiana's Legislative Council before October 1, 2016. The combined reporting study comprises a lengthy 50+ page document that attempts to review the varying impacts for states of switching to a mandatory unitary combined reporting regime, generally finding that while "most researchers agree that the separate-reporting method provides state corporate taxpayers with the opportunity to create favorable business structures and intercompany transactions that shift income from affiliates based in high-tax states to affiliates based in low-tax or no-tax states," econometric results suggest that combined reporting may only have an initial positive impact on generated corporate income tax revenue – but "this impact is not lasting." The report estimates that the initial positive impact for states may be economically significant; however, such impact is estimated to be only short term and "will decline to zero in the long run."
URL: https://iga.in.gov/static-documents/6/b/7/8/6b78b5a3/exhibit_1410.pdf
URL: https://iga.in.gov/static-documents/b/0/3/f/b03f9a34/exhibit_1411.pdf
URL: https://iga.in.gov/legislative/2016/bills/senate/323#document-70429980

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The study also explains that while combined reporting may neutralize several tax planning strategies like the use of intellectual property holding companies, transfer pricing, captive real estate investment trusts, captive insurance subsidiaries, and overseas management affiliates, "it could also create different complexities in the determination of the unitary group, creative manipulation of sales-factor apportionment, and additional administrative burdens during the transition," and that based on experiences from other states, it is not clear whether combined reporting leads to additional long-term state administrative costs related to audit workload and litigation. However, "a transition to combined reporting would require substantial resource commitment during the change." Regarding associated administrative issues, the study notes that based on case studies and a survey of state revenue departments, the most common areas of disagreements between taxpayers and state revenue departments in combined reporting states include:

- Unitary group determination;
- Creative manipulation of sales-factor apportionment;
- Captive insurance companies;
- Corporate inversion issues in water's edge election states, "which means mostly moving income offshore instead to another state;"
- Nexus establishment for affiliates; and
- Taxpayers' lobby for additional changes to state law to minimize increased tax liability due to combined reporting.

The released transfer pricing study comprises a shorter eleven-page document that examines how state governments may scrutinize intercompany transfers to help ensure that "multistate companies are not artificially shifting taxable profits out of their jurisdictions," – noting that transfer pricing examination and analysis can be complex and expensive, and that most states (including Indiana) have adopted statutes requiring addbacks and disallowing tax benefits that occur from related-party transactions to help reduce the number of disputed transactions.

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Income/Franchise:
Massachusetts: Proposed Changes to Alternative Apportionment Regulation Released for Practitioner Comment

Working Draft for Practitioner Comment 830 CMR 63.42.1, Mass. Dept. of Rev. (10/12/16). The Massachusetts Department of Revenue (Department) has issued a working draft of proposed regulatory amendments that involve a taxpayer's application for use of alternative apportionment under M.G.L. c. 63, including various proposed revisions to the underlying procedural and implementation requirements. Under the proposal, a taxpayer's application must contain a statement of the reasons, supported by detailed facts, of why the applicant believes that the allocation and apportionment provisions of M.G.L. c. 63, § 38, or, where applicable, a regulation issued under M.G.L. c. 63, § 38(j), are not reasonably adapted to approximate its net income derived from business carried on within Massachusetts. An applicant must show by clear and cogent evidence that the income attributed to Massachusetts using the standard statutory apportionment method does not fairly represent the extent of the applicant's business activity in Massachusetts, including a detailed description of the applicant's proposed alternative apportionment method and attaching sufficient documentation to support the overall result reached. The proposal also requires that the application be submitted with a duly-filed tax return showing computation of tax using both the standard statutory apportionment and the applicant's proposed alternative apportionment method; however, the amount of tax due with

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the return must be computed using the standard statutory apportionment method. The proposal permits an approved alternative method of apportionment to be effective for up to three tax years, at the Department's discretion, absent any material change in the applicable facts and law.
URL: http://www.mass.gov/dor/businesses/help-and-resources/legal-library/regulations/63-00-taxation-of-corporations/c-users-hankerson-desktop-section-42-redlined-reg.pdf

With respect to a taxpayer corporation that files a Massachusetts corporate excise return as a member of a combined group (i.e., that files a Massachusetts combined report under M.G.L. c. 63, § 32B), the working draft proposal requires that the application for use of an alternative apportionment method be submitted by the principal reporting corporation on behalf of the member that is requesting alternative apportionment. In the review of such an application, the Department will consider the business activities of all members of the combined group and the Massachusetts apportionment percentages of all such taxable members in determining whether the combined group's taxable income attributed to Massachusetts reasonably reflects the business activity of the combined group carried on within Massachusetts. The working draft proposal also states that the alternative apportionment request of the taxable member of the combined group will be granted only if the Department concludes that the combined group's taxable income attributed to Massachusetts under the standard method does not reasonably reflect the business activity of the combined group in Massachusetts.

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Income/Franchise:
New Jersey Tax Court Addresses Apportionment of Credit Card-Related Income

Bank of America, etc., et al. v. State, Division of Taxation, N.J. Tax Ct. (10/11/16). A recent New Jersey Tax Court (Court) ruling involving New Jersey's corporation business tax (CBT) held that interest earned on credit cards issued to New Jersey customers must be sourced to New Jersey for purposes of computing the taxpayer's CBT apportionment formula. In doing so, the Court determined that the intangible (i.e., the credit card receivable) had been integrated into the taxpayer's in-state business. Moreover, the Court found that certain fees (i.e., "interchange fees") constituted interest given the nature of the item and the taxpayer's federal income tax treatment of these charges. Finally, the Court found that certain other charged fees at issue (e.g., late fees, return check fees, and annual fees) were derived from services whose income must be sourced to New Jersey based on where the benefit was received pursuant to the "catch all" statutory provision for all other business receipts; however, under New Jersey's corresponding regulatory interpretation of this provision, only 50% of the income from such fees was deemed sourced to New Jersey.
URL: http://www.judiciary.state.nj.us/taxcourt/tax_published/12945-11opn.pdf

Financial institutions and other taxpayers with similar income streams in New Jersey may wish to consider reviewing their own CBT returns to assess any potential impacts of this decision.

Stay tuned for forthcoming Multistate Tax Alert for more details on this case, as well as related taxpayer considerations.

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Income/Franchise:
New York: Proposed Amendment to Article 9-A Business Corporation Franchise Tax Law Regarding the Use of Fulfillment Services

S. 8170, pending in N.Y. State Senate. Legislation pending in New York's State Senate proposes to amend New York Tax Law Sec. 209.2, adding "fulfillment services" to the list of activities that will not deem a foreign corporation to be doing business, employing capital, owning or leasing property, or maintaining an office in New York State, or deriving receipts from activity in New York State, for purposes of Article 9-A Business Corporation Franchise Tax Law.
URL: https://www.nysenate.gov/legislation/bills/2015/S8170

Fulfillment services under the pending bill are defined as any of the following services performed by an entity on its premises on behalf of a purchaser: (a) the acceptance of orders electronically or by mail, telephone, telefax or internet; (b) responses to consumer correspondence or inquiries electronically or by mail, telephone, telefax or internet; (c) billing and collection activities; or (d) the shipment of orders from an inventory of products offered for sale by the purchaser.

Under this pending bill, fulfillment services must be performed by an unaffiliated person and the taxable nexus exemption applies to the ownership of property stored on the property of the fulfillment services provider in conjunction with such services.

New York Tax Law had previously provided that utilizing fulfillment services as defined in pending bill S. 8170 would *not* create taxable nexus for foreign corporations; however, this provision subsequently was repealed for tax years beginning on or after January 1, 2015.

This pending legislation, however, states that this exemption applies "provided [that] receipts, including receipts pursuant to such services, do not exceed the [bright-line statutory nexus] threshold set by [New York Tax Law Sec. 209.1(b)]." This reference to New York's bright-line statutory nexus threshold may raise the question of whether Public Law 86-272 would apply under these circumstances.

Note that the New York State Department of Taxation and Finance has previously ruled that because the use of fulfillment services is exempt from tax under Article 9-A, it does not disqualify the petitioner from the Public Law 86-272 exemption. See Deloitte & Touche, TSB-A-98(26)C (December 2, 1998), in which a foreign corporation's use of public warehouses in New York State for the purpose of storing goods to be sold to customers in New York and throughout the country was found to be use of a fulfillment service, which allowed the corporation to be eligible for exemption under Public Law 86-272.

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Sales/Use/Indirect:
New York: Advisory Explains Taxation of Internet-Based Products, Including Information Service Exclusion for "Personal or Individual" Data

TSB-A-16(26)S, N.Y. Dept. of Tax. & Fin. (8/31/16). A sales/use tax advisory opinion involving certain Internet-based products provided to the hotel industry explains that while all such products sold by the taxpayer constitute taxable information services under state law, two of them may qualify for the "personal or individual" exclusion. Under the stated facts, the taxpayer is in the business of selling products to hotels and hotel management groups that provide feedback and information to its hotel customers to facilitate the hotels' marketing and sales to prospective customers. The taxpayer generally sells four types of products – i.e., i) online reputation management services, ii) post-stay surveys, iii) on-site surveys, and iv) a "guess suite" that integrates all three of its other provided services. The opinion explains that while these various products have multiple components, including attributes of the sale of prewritten software, the predominant element of the taxpayer's products when viewed as a whole is the creation of a database of information that is pertinent to their customers' businesses. This is accomplished by collecting information from review websites or directly from guests, processing it, and giving customers access to this information in various ways, including access to the raw data collected (i.e., the actual reviews or comments) or through reports and/or analysis of the data (e.g., the described "sentiment analysis" which is the taxpayer's unique way of reviewing the data that it collects, analyzing it, and quantifying it for its customers) – all of which constitute taxable information services under state law.
URL: https://www.tax.ny.gov/pdf/advisory_opinions/sales/a16_26s.pdf

However, the provided post-stay and on-site surveys may qualify for New York's "personal or individual" exclusion from sales tax on information services because the source of the information that they provide is not a common or non-confidential source. Rather, the information that is provided to customers in these two offerings is derived from surveys of the customer's hotel guests. Accordingly, so long as the information collected for such offerings is not provided to other customers or compiled for the taxpayer's later use in providing information to other customers, these two products may be excluded from state sales and use taxation.

Regarding the "guest suite" combination offering, the opinion explains that because this bundled service includes the taxable online reputation management services where the provided information is derived from review websites operated by third parties, the entire offering is considered taxable. However, because the components are available for sale separately, if the charges for each of the three underlying services are separately stated on a customer's statement and are reasonable in relation to the entire charge, the taxpayer may collect sales tax only on the separately-stated charges for online reputation management services.

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Multistate Tax Alerts

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US Supreme Court Denies Petition for Review of *Gillette* California Compact Appeal
On October 11, 2016, the United States Supreme Court denied Taxpayers' petition for writ of certiorari in *The Gillette Company, et. al. v. Franchise Tax Board*, Docket No. 15-1442.

This Multistate Tax Alert summarizes the recent developments in the *Gillette* California case and provides some taxpayer considerations.
[Issue Date: October 14, 2016]
URL: http://www2.deloitte.com/us/en/pages/tax/articles/us-supreme-court-denies-petition-for-review-of-gillette-california-compact-appeal.html?id=us:2em:3na:stm:awa:tax:102116

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