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Articles:
Corporate Income Tax Legislative Update: What Happened in 2016?

In this edition of “Inside Deloitte,” authors Shona Ponda of Deloitte Tax LLP’s Multistate Office of Washington National Tax, and Jennifer Alban-Bond and Kathryn Jeffery of Deloitte’s Multistate Tax practice in McLean, Virginia, provide an overview of state corporate income tax legislative changes enacted during the 2016 state legislative sessions.
URL: https://www2.deloitte.com/us/en/pages/tax/articles/corporate-income-tax-legislative-update-what-happened-in-2016.html?id=us:2em:3na:stm:awa:tax:012017

Articles:
The Texas Enterprise Zone Program

Texas has historically allowed local communities to lead the way in the realm of business attraction and the awarding of business incentives, notably through a statewide economic development program known as the Texas Enterprise Zone Program. This program allows companies that make capital investments and add (or in some cases commit to retain) employees to potentially qualify for valuable economic benefits. This edition of “Credits & Incentives Talk with Deloitte,” a monthly column by Kevin Potter of Deloitte Tax LLP featured in the Journal of Multistate Taxation and Incentives (a Thomson Reuters publication), is co-authored by George Francis and James Graham Keefe of Deloitte Tax LLP and provides an overview of the Texas Enterprise Zone Program, with discussion of the history and the mechanics of the program.
URL: https://www2.deloitte.com/us/en/pages/tax/articles/the-texas-enterprise-zone-program.html?id=us:2em:3na:stm:awa:tax:012017

Income/Franchise:
Court of Appeal Affirms that Non-managing Member of LLC is Not Doing Business in California

A California Court of Appeal has affirmed that an Iowa corporation, whose only connection to California was its passive membership in a manager-managed California limited liability company (LLC), was not “doing business” in California and was therefore not subject to the $800 minimum franchise tax under Cal. Rev. & Tax. Code section 23151. The Court explained that, under the facts in this case, passively holding a 0.2 percent ownership interest, with no right of control over the business affairs of the LLC, does not constitute “doing business” in California within the meaning of Cal. Rev. & Tax. Code section 23151.

Stay tuned for a forthcoming Multistate Tax Alert that further discusses this recent decision, as well as offers some taxpayer considerations.

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Income/Franchise:
Massachusetts: Biotech Company Qualifies as a "Manufacturing Corporation" Subject to Single-Sales Factor Apportionment

The Massachusetts Supreme Judicial Court (Court) affirmed an earlier Massachusetts Appellate Tax Board ruling, holding that a California-based biotechnology company qualified as a "manufacturing corporation" subject to single-sales factor apportionment for the prior tax years at issue under Massachusetts' corporation excise tax. In doing so, the Court examined the taxpayer's facts and agreed that its drug production activities qualified as "manufacturing" under state law given that "clear transformation" occurs where "each genetically modified and replicated cell is different from the original cell in a most fundamental way," so that the taxpayer can extract and purify the "protein of interest" from such cells as the source of each drug that it then markets and sells. The Court also agreed that the taxpayer was substantially engaged in manufacturing activities under the single-sale factor statutory gross receipts threshold (i.e., more than 25%) by limiting the qualifying "gross receipts" in this calculation to the taxpayer's business income, rather than also including its investment income (i.e., its receipts from interest, dividends, and capital gains). Ruling otherwise, the Court reasoned, would be "distortive" of the taxpayer's operations in that it would transform a biotechnology company with substantial revenue derived from sales of its specialty drugs into essentially an investment business. Lastly, the Court affirmed that application of the single-sales factor apportionment formula and the unavailability of Massachusetts' investment tax credit and research and development (R&D) credit for the taxpayer, did *not* violate the dormant Commerce Clause.

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Income/Franchise:
Minnesota: New Law Updates State Conformity to Internal Revenue Code

H.F. 2, signed by gov. 1/13/17. For state corporate income/franchise tax and individual income tax purposes, effective January 14, 2017, new law generally updates Minnesota's definition of the Internal Revenue Code (IRC) to the IRC of 1986, as amended through December 16, 2016. The federal conformity changes are effective retroactively to the time the changes were effective for federal purposes. Note that the updated federal conformity generally does not change Minnesota's statutory modifications such as bonus depreciation and IRC Sec. 199 deductions.
URL: https://www.revisor.mn.gov/laws/?year=2017&type=0&doctype=Chapter&id=1

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Income/Franchise:
New York: ALJ Rules in Favor of Taxpayer; Receipts from Online Services Sourced Out-of-State

DTA Nos. 825971 and 825972, N.Y. Div. of Tax App., ALJ Unit (1/5/17). An administrative law judge recently held that a taxpayer's receipts from its electronic bill payment and presentment transactions constituted receipts from services rather than "other business receipts," and were properly sourced outside New York to the location where the underlying services were performed by the taxpayer for purposes of calculating the receipts factor under the Article 9-A state business corporation franchise tax for the prior tax years at issue. In doing so, the judge rejected the contention of the New York State Department of Taxation and Finance (Department) that there must be human involvement for the receipts to have resulted from services performed, explaining that employing technology in the performance of services "does not, per se, remove the resulting receipts from the realm of receipts derived from the performance of services." The judge also noted that the facts here showed human involvement on the part of the taxpayer throughout its process of generating receipts from the electronic bill payment and presentment transactions (e.g., contract negotiations and programming/operating services). The judge additionally explained that even if such receipts had in fact constituted "other business receipts," they must be sourced outside New York in this case – i.e., to the location where the work that generated the income was performed.
URL: https://www.dta.ny.gov/pdf/determinations/825971.det.pdf

Lastly, the judge explained that legislation enacted subsequent to the tax periods at issue in this case changed the allocation of service receipts to a customer sourcing approach for Article 9-A state business corporation franchise tax purposes, applicable for tax years beginning on and after January 1, 2015. The judge reasoned that such change would have been unnecessary if the allocation of service receipts was interpreted as the Department had asserted.

Note that this case may not be cited as precedent and may be appealed by the Department. Please contact us with any questions.

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Income/Franchise:
A Closer Look at New York's Draft Proposed Regulations under Article 9-A Business Corporation Franchise Tax – Specific to Apportionment of Other Services and Other Business Activities

Draft Proposed New York Business Corporation Franchise Tax Regulations, Subpart 4-2.15, N.Y. Dept. of Tax. and Fin. (10/19/16). On October 19, 2016, the New York Department of Taxation and Finance (Department) released revised Draft Proposed Regulations for Sec. 4-2.15 concerning the sourcing of other services and other business receipts not otherwise addressed under Tax Law Section 210-A, including, but not limited to, commissions, finder's fees, loan servicing fees, and fees for professional services. These revised Draft Proposed Regulations describe how to source the receipts under the hierarchies described in Tax Law Section 210-A(10). Note that these revised Draft Proposed Regulations replace the previously posted draft versions of the same rules, which are all intended to clarify and

interpret the general rules contained in section 210-A of the New York State Tax Law that are used to determine the business apportionment fraction, pursuant to the Department's broader effort "to amend the Article 9-A Business Corporation Franchise Tax Regulations to incorporate the changes made by the corporate tax reform legislation contained in the 2014-2015 and 2015-2016 enacted New York State Budgets." Below, the apportionment hierarchy of the rules for apportioning receipts from other services and other business receipts, as well as the Draft Proposed Regulations addressing such apportionment, are reviewed.
URL: https://www.tax.ny.gov/bus/ct/pending/draft_Services_and_Other_Business_Receipts_10-19-16.pdf

Sourcing Receipts From Other Services and Other Business Activities

A taxpayer generally must source receipts from other services and other business activities according to the following hierarchy:

1. The location where the customer receives the benefit of the services;
2. Where the service is delivered;
3. According to the apportionment fraction for such receipts for the preceding taxable year; or
4. According to the apportionment fraction for those receipts that can be sourced using the hierarchy of sourcing in 1 and 2 above for the current taxable year. (N.Y. Tax Law Sec. 210-A.10(b)).

Before a taxpayer can move to the next step of the hierarchy, it generally would be required to annually exercise due diligence by following several standards set forth in the Draft Proposed Regulations. As a general matter, the Draft Proposed Regulations state that "[a] taxpayer's method of sourcing its receipts, including the use of a method of approximation where applicable, must reflect an attempt to comply with the regulatory standards set forth herein rather than an attempt to minimize the taxpayer's tax liability." The Draft Proposed Regulations provide specific standards for exercising due diligence, all of which apply. For example, the Draft Proposed Regulations state that when exercising due diligence, a taxpayer must rely on all information that is reasonably available to the taxpayer at the time of filing its tax return, including contracts and agreements with customers. In addition to contracts/agreements, taxpayers may, in good faith, rely on information that is provided to them by customers. When sourcing its receipts, a taxpayer must exercise good faith, and consistently source receipts from similar transactions. Finally, a taxpayer must retain records that provide an explanation for the determination and application of the receipts sourcing method applied in completing its return and any underlying assumptions, and must provide such records to the Commissioner upon request.

While Tax Law Sec. 210-A.10 generally requires due diligence in applying the sourcing hierarchy, Draft Proposed Reg. Sec. 4-2.15(a)(2)(iv) would require taxpayers that are unable to apply a level of the hierarchy (after attempting to satisfy the preferred sourcing method, which, for receipts from other services and other business activities, is where the benefit is received) to document the steps taken before abandoning each level of the hierarchy. As part of exercising due diligence, taxpayers would be required to maintain records explaining "the determination and application of its method of sourcing its receipts," and be able to provide this documentation for audit upon request. See Draft Proposed Reg. Sec. 4-2.15(a)(2)(iii).

Moreover, Draft Proposed Reg. Sec. 4-2.15(a)(2)(iv) states that "[w]hen abandoning a level of the hierarchy, the standard of due diligence is not satisfied if a taxpayer merely relies on the fact that its existing systems of recording transactions or the current format of its books and records do not capture the information required." The Department has informally indicated that a taxpayer should examine its existing systems and, if necessary, determine the feasibility of modifying its current system or putting a new system in place. For example, a taxpayer may have to document its determination that it would be too costly to modify its systems to capture the necessary information before satisfying the due diligence requirement and abandoning a level of the hierarchy.

At any point in the hierarchy where there is a presumption, Draft Proposed Reg. Sec. 4-2.15(a)(3) would provide a way for taxpayers and the Department to overcome the presumption. Taxpayers intending to overcome a presumption would be required to show clear and convincing evidence that the method they are proposing to use is a more accurate reflection of the intent of the applicable rule of the hierarchy. Conversely, to overcome a presumption the Department would be required to show, by clear and convincing evidence, that: (1) the method it proposes to use better reflects the intent of the applicable rule of the hierarchy; and (2) the taxpayer had access to, or could have obtained upon reasonable inquiries, information that could have been used to apply the Department's method.

Draft Proposed Reg. Sec. 4-2.15(a)(4) provides that when receipts from a service or other business activity are commingled with receipts from tangible personal property, the entire receipt would be sourced as tangible personal property as dictated in N.Y. Tax Law Sec. 210-A(2)(a). However, when receipts from a service or other business activity are commingled with receipts from digital products, the entire receipt would be sourced as a service or other business activity.

Draft Proposed Reg. Sec. 4-2.15(g) would provide special rules for an "intermediary transaction" which is defined under Draft Proposed Reg. Sec. 4-2.15(b)(8) as "a transaction in which the location where the customer receives the benefit of a service…or the location at which a service…is delivered, is the location of the consumer rather than the location of the customer itself." Specifically, an "intermediary transaction" is one where a contract/agreement stipulates that the service is either "(a) provided by the taxpayer, at the direction of the intermediary, directly to the consumer; or (b) sold by the taxpayer to the intermediary, who then passes on the service or other business activity related to tangible personal property to the consumer." An example of the first intermediary transaction outlined in subparagraph (a) above is a product fulfillment company (the taxpayer) that, pursuant to a contract with a sales company (the intermediary), ships tangible property to the ultimate consumers on a per shipment basis. See Draft Proposed Reg. Sec. 4-2.15(g)(4), Example 15. Under the current Draft Proposed Regulations, no example has yet been provided of the second type of intermediary transaction outlined above in subparagraph (b).

For both types of intermediary transactions, sales are sourced to the ultimate consumer instead of the intermediary. For those scenarios where the taxpayer relies on an intermediary to deliver the service or other business activity related to tangible personal property to consumers, the taxpayer would be required to perform "at least a substantial portion of the service" after the tangible personal property has been delivered to the consumer by the intermediary.

A taxpayer is required to make inquiries to the intermediary, but not to consumers, when necessary to determine where the consumer receives the benefit of the service regardless of the number of business customers the taxpayer has or the percentage of receipts from any one customer (i.e., regardless of whether the taxpayer qualifies for the reasonable inquiry safe harbor rule described below). The intermediary may provide information from its books and records to the taxpayer that demonstrates the location where the consumer receives the benefit of the service or, if that information is unavailable, where the service is delivered to the consumer.

For both types of intermediary transactions, if, after exercising due diligence, a taxpayer is unable to obtain adequate information to source to the ultimate consumer, the Draft Proposed Regulations generally would permit the transactions to be sourced to the intermediary.

Sourcing Where the Benefit is Received

Draft Proposed Reg. Sec. 4-2.15 outlines the sourcing hierarchies that taxpayers would use to apportion receipts from other services and other business activities. As noted above, the first level of this hierarchy requires taxpayers to source receipts from other services and other business activities to the location where the benefit of the services are received. For individual customers this is presumed to be the customer's billing address. However, for business customers, where the benefit is received is presumed to be New York if the "taxpayer's books and records kept in the normal course of business" indicate that the benefit is received in New York, without regard to the billing address of the taxpayer's customer. If it cannot be determined where a business customer receives the benefit of the services based upon the taxpayer's regularly kept books and records, it must exercise due diligence, in the form of reasonable inquiry, before moving to the next level of the sourcing hierarchy. In scenarios where a taxpayer cannot in good faith determine whether a customer is an individual customer or an business customer, the taxpayer must treat the customer in question as a business customer.

Provided that the taxpayer does not have information to determine where the benefit of the service in question was received, the Draft Proposed Regulations provide a reasonable inquiry safe harbor whereby taxpayers that meet the following two criteria would use reasonable approximation to source the receipts in question: (a) more than 250 business customers purchasing substantially similar services/other business activities (that would be sourced as such) and (b) no more than 5% of the receipts from such services/other business activities are from one customer.

When a taxpayer is unable to determine the location where the benefit is received, a taxpayer would be permitted to reasonably approximate the location. To be eligible to reasonably approximate the location, a taxpayer must not be able to determine the location where the benefit is received, or obtaining such location would require undue effort and expense. In addition, the taxpayer must have "sufficient information to reasonably approximate the location or locations where the benefit is received."

In-person services would be sourced according to whether the service is rendered (a) to the body or in the physical presence of an individual, or (b) on the tangible personal property of a customer. When services are rendered to the body or in the presence of an individual in New York, they would be sourced to New York. When the service is performed on tangible personal property, receipts would be presumed to be sourced to the location where the customer receives the property after the service is performed. While professional services like medical and dental services would follow these special rules, other professional services where significant in-person contact is not required to be performed – such as legal, accounting, and consulting services – would follow the regular sourcing rules for other services.

The benefit of services related to real property would be received in New York where the real property is located in New York. Services related to real property is meant to include not only physical work such as landscaping or construction, but also include "architectural services, engineering services, legal services, mortgage servicing, and services related to the sale of real property." Draft Proposed Reg. Sec. 4-2.15(c)(3).

Sourcing Where the Service Was Delivered

Under Draft Proposed Reg. Sec. 4-2.15(d), if the taxpayer cannot determine, or reasonably approximate, the location where the customer receives the benefit of the service after exercising due diligence, it would be able to source according to where the service was delivered to the customer. For individual customers, this determination would be based on the evidence available to the taxpayer, such as sales records. For business customers, this location would be "presumed to be the location at which the contract of sale is managed by the customer." If this location cannot be determined, the delivery destination would be presumed to be the billing address of the customer.

Sourcing According to Apportionment

Under Draft Proposed Reg. Sec. 4-2.15(e), if the taxpayer cannot determine, or reasonably approximate, the location where the benefit of the service was received by the customer or the location where the service was delivered, such service would be sourced based on the receipts from sales of that type of service for the preceding year. This rule would not be applied to a taxpayer's first taxable year beginning on or after January 1, 2015 and before January 1, 2016. Further, new taxpayers would not be permitted to use this method in their first taxable year as no relevant prior-year data would be available. In both cases, taxpayers must bypass this rule and go directly to the last method in the hierarchy.

Under Draft Proposed Reg. Sec. 4-2.15(f), if after exercising due diligence, a taxpayer cannot utilize the methods described in the higher levels of the hierarchy discussed above for sourcing a service, such service would be sourced based on all those receipts that can be sourced using the higher levels of the hierarchy for the current taxable year (i.e., location where benefit was received and delivery destination).

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Income/Franchise:
Tennessee DOR Reminds that Market-Based Sourcing Applies to Receipts from Non-TPP Beginning July 1, 2016

FAQs: Franchise and Excise Tax, Tenn. Dept. of Rev. (1/11/17). The Tennessee Department of Revenue (Department) has issued an explanation reminding that for tax years beginning on and after July 1, 2016, taxpayers with the "right to apportion" must use market-based sourcing for sourcing sales other than sales of tangible personal property (including rental, lease and license receipts and sales of services) for state franchise and excise tax purposes. Generally, these sales are sourced to Tennessee if the taxpayer's market for the sale is in the state (regardless of the location of the taxpayer's property or payroll determined for the property or payroll factors of the apportionment ratio). "For example, the sale of a service is sourced to Tennessee if the service is delivered at a location in Tennessee (the location of the taxpayer's market or customer for the service provided)."
URL: https://revenue.support.tn.gov/hc/en-us/articles/115000277406-Who-must-use-market-based-sourcing-

Note that legislation enacted in 2015 [*H.B. 644*; see previously issued Multistate Tax Alert for more details on this 2015 law] included the adoption of market-based sourcing for sales other than the sale of tangible personal property for state franchise and excise tax purposes for certain taxpayers.
URL: http://www.capitol.tn.gov/Bills/109/Bill/HB0644.pdf
URL: https://www2.deloitte.com/us/en/pages/tax/articles/multistate-tax-alert-tennessee-enacts-broad-changes-to-state-tax-code.html?id=us:2em:3na:stm:awa:tax:012017

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Indirect/Sales/Use:
Tennessee DOR Reminds that New "Economic Presence" Rule Imparts Registration Requirement on Out-of-State Dealers Making Threshold Sales into Tennessee

Hot Topics: Out-of-State Dealer Sales and Use Tax Registration Application Available, Tenn. Dept. of Rev. (1/11/17). The Tennessee Department of Revenue (Department) reminds that pursuant to Administrative Rule 1320-05-01-.129(2), certain out-of-state dealers with no physical presence in Tennessee must register with the Department for sales and use tax purposes. More specifically, the Department explains that Administrative Rule 1320-05-01-.129(2) requires certain out-of-state dealers with no physical presence in Tennessee to register with the Department for state sales and use tax purposes. "This requirement applies to those dealers that have made sales exceeding $500,000 to Tennessee consumers during the previous 12-month period. These dealers are required to register by March 1, 2017. By registering, dealers affirmatively acknowledge that they will collect and remit sales and use taxes to the Department beginning July 1, 2017."
URL: https://www.tn.gov/revenue/news/47912

Note that the text of this administrative rule generally imparts "substantial nexus" for state sales and use tax purposes on out-of-state dealers that:

1. Engage in the regular or systematic solicitation of consumers in Tennessee "through any means," and
2. Make sales that exceed $500,000 to consumers in Tennessee during the previous twelve-month period.

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