Multi-State Taxation: What Your Clients (and You!) Need to Know in the Internet Age

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Chris Sullivan

Stacey Sprinkle

Jon Eggleston

Henry Bubel

Section I

Introduction, Goals, and Background

Introduction and Goals for Today

- Who are we?
  - Chris—Tax Lawyer (SCG-NH)
  - Stacey—Accountant (CO)—Verizon Federal Tax Policy
  - Jon—Tax Lawyer (SCG-VT)
  - Henry—Tax Lawyer (SCG-NY)
- Goals for Today
  - Understand key concepts of multi-state taxation
  - Understand current developments across U.S.
  - Increase ability to understand, plan, and avoid gotcha's for clients

Revenue by Source

OECD Revenue Report 2016	Supra-National	Central	State or Regional	Local	Social Security
Federal countries					
Australia	..	80.0%	16.5%	3.5%	0.0%
Austria	0.3%	66.5%	1.6%	3.2%	28.5%
Belgium	0.7%	57.4%	5.3%	4.6%	31.9%
Canada	..	41.4%	39.1%	10.3%	9.2%
Germany	0.4%	31.2%	22.0%	8.2%	38.1%
Mexico	..	73.3%	4.4%	1.6%	20.6%
Switzerland	..	35.2%	24.7%	15.3%	24.9%
United States	..	42.1%	19.7%	14.1%	24.1%

Revenue by Source

OECD Revenue Report 2016	**Supra-National**	**Central**	**State or Regional**	**Local**	**Social Security**
Regional country					
Spain	0.4%	42.3%	13.6%	10.0%	33.6%
Unitary countries					
Chile	..	86.7%	..	7.6%	5.8%
Czech Republic	0.5%	54.5%	..	1.2%	43.8%
Denmark	0.3%	74.6%	..	25.0%	0.1%
Estonia	0.5%	82.0%	..	1.1%	16.5%
Finland	0.2%	47.4%	..	23.5%	28.9%
France	0.2%	33.1%	..	13.0%	53.7%

Revenue by Source

OECD Revenue Report 2016	**Supra-National**	**Central**	**State or Regional**	**Local**	**Social Security**
Unitary countries					
Greece	0.2%	68.6%	..	3.0%	28.2%
Hungary	0.3%	60.8%	..	5.7%	33.2%
Iceland	..	75.5%	..	24.5%	0.0%
Ireland	0.5%	82.4%	..	2.8%	14.3%
Israel	..	75.6%	..	8.0%	16.4%
Italy	0.3%	53.4%	..	16.5%	29.8%
Japan	..	36.9%	..	23.5%	39.7%
Korea	..	56.2%	..	16.9%	26.9%

Revenue by Source

OECD Revenue Report 2016	Supra-National	Central	State or Regional	Local	Social Security
Unitary countries					
Latvia	0.5%	50.8%	..	19.5%	29.1%
Luxembourg	0.1%	68.8%	..	3.3%	27.8%
Netherlands	1.0%	55.6%	..	3.8%	39.6%
New Zealand	..	93.3%	..	6.7%	0.0%
Norway	..	86.1%	..	13.9%	0.0%
Poland	0.3%	48.2%	..	13.4%	38.1%
Portugal	0.3%	67.8%	..	7.2%	24.7%
Slovak Republic	0.5%	54.6%	..	2.7%	42.1%

Revenue by Source

OECD Revenue Report 2016	**Supra-National**	**Central**	**State or Regional**	**Local**	**Social Security**
Unitary countries					
Slovenia	0.4%	50.0%	..	10.6%	39.0%
Sweden	0.3%	50.0%	..	36.9%	12.7%
Turkey	..	62.0%	..	9.4%	28.5%
United Kingdom	0.6%	75.8%	..	5.0%	18.7%

Why Understanding Multi-State Taxation is Important in Protecting Your Clients

- Increasing number of businesses operating in multiple countries and U.S. states
- Shift from manufacturing economy to services economy
- Technology—How are goods and services delivered and where is income earned?
- New Standards of “Nexus” means more border crossings
- Deficit Budgets and No New Taxes Pledges by Politicians—States Aggressively Searching for Revenues

Section II

Jurisdiction to Tax

"Nexus" and Personal Jurisdiction

- A state's taxing power over a taxpayer or the taxpayer's activities must satisfy Due Process and Commerce Clauses. <u>Quill Corp. v. North Dakota</u>, 504 U.S. 298 (1992).
- Jurisdiction over the taxpayer requires at least a <u>minimal connection</u> between the taxing state and a transaction, property, or party. <u>Mobil Oil v. Commissioner</u>, 445 U.S. 425 (1982).

Overview - Tax Nexus Limits and Issues

- The “nexus” requirement is an element in 2 separate constitutional inquiries
  - Due Process Clause—14th Amendment
  - (Dormant) Commerce Clause –Art. I, Sec. 8
- Although there is a distinction between these 2 constitutional inquiries, courts, taxpayers, and tax authorities often collapse the inquiries.

Non-Tax
Due Process Nexus

- Personal jurisdiction in civil litigation is about the power of a court to adjudicate a dispute over a defendant.
- A state court's assertion of jurisdiction exposes defendants to the State's coercive power, and is therefore subject to review for compatibility with the Due Process Clause.
- Throughout its cases, the Court has adjusted personal jurisdiction based on changes in the economy.

Non-Tax Due Process Nexus—The History

- Pennoyer v. Neff, 95 U.S. 714 (1877). Physical presence in a state is always a basis for personal jurisdiction.
- International Shoe v. Washington, 326 U.S. 310 (1945). “Minimum contacts” such that traditional notions of fair play and substantial justice are not offended.
- World Wide Volkswagen, 444 U.S. 286 (1980). To be subject to suit, defendants must have “purposefully availed” themselves of the forum state.
- Asahi Metal Indus. Co. v. Superior Court, 480 U.S. 102 (1987). “Mere awareness” that a product will make its way to the forum state is not sufficient to satisfy minimum contacts.

EU--Compare

- Regulation 44/2001
  - Domicile--Jurisdiction is generally based on the defendant’s domicile “save in a few well-defined situations in which the subject-matter of the litigation or the autonomy of the parties warrants a different linking factor.”
  - Place of Performance of Contract
  - Consumer Protection (Broader Choices)
  - Agreement of the Parties
  - Situs of the Harm

Commerce Clause Overview—
Article 1, Section 8 of Constitution

- Congress has the power to regulate commerce with foreign Nations and among the several states.
- Designed to Prevent States from interfering with national commerce by being parochial.
- This affirmative grant of power does not expressly limit state action, but the U.S. Supreme Court has interpreted that the “dormant” Commerce Clause limits state authority to tax.

Commerce Clause Overview—Article 1, Section 8 of Constitution

- Framework--Complete Auto Transit, Inc. v. Brady, 430 U.S. 274 (1977)—Prong #1 of four part test to sustain tax against Commerce Clause challenge is "substantial nexus".
- "Substantial nexus" standard –In 1992, the Quill Court limited its re-affirmation of the Bellas Hess "bright-line" physical presence test for substantial nexus to sales/use tax and the mail-order industry. National Bellas Hess, 368 U.S. 753 (1967); Quill Corp. v. North Dakota, 504 U.S. 298 (1992).

Commerce Clause Overview—
Article 1, Section 8 of Constitution

- An issue of the national economy and burdens imposed upon interstate commerce by state tax collection. Quill Corp. v. North Dakota, 504 U.S. 298, 312 (1992)
- Importance of Stare Decisis in 1992
- Are potential burdens to national economy still present?
- Quill is a sales and use tax case—what about income tax?

Post Quill Fallout

- Following Quill, immediate assault on income tax. Instead of "physical presence,"
  - Economic Nexus
  - Attributional Nexus
  - Agency Nexus
- Lack of Judicial Intervention and lack of Congressional Action has emboldened states
- New Developments (and risks to your clients)

Recent Cases & Issues
Factor Presence (Income or Sales Tax)

- Quill is under assault
- Factor Presence Nexus
- Taxpayer is subject to jurisdiction if Taxpayer exceeds certain monetary thresholds are met (sales, transactions, etc.)
- Does a bright-line “factor presence” test conflict with Due Process Clause or Commerce clause limitations?
- What if factor presence nexus relies solely on sales factor presence?

Section III

Corporate Income Tax Considerations

Corporate Income Tax: “Nexus”

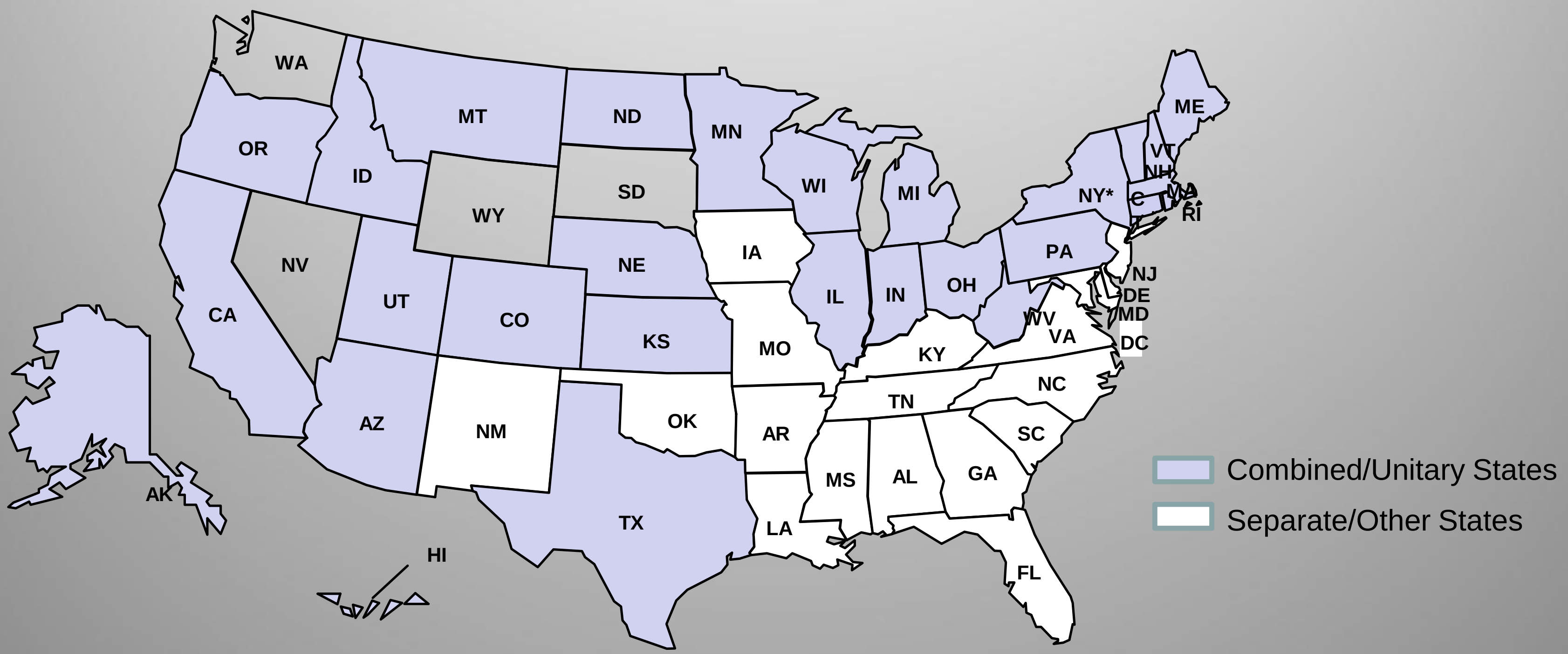
- Each state has right to tax any business “doing business in” its jurisdiction
- States becoming very aggressive in expanding jurisdiction to tax
  - No “permanent establishment” concept
  - “Economic nexus” – IP licensing example
  - “Affiliate nexus”
  - “Attributional nexus”
- Nexus audits very comprehensive and expensive

Nexus Has Been Expanding

- For many years, nexus concepts were based on "physical presence"
- For corporate income tax, there has been a big debate over whether physical presence is required
- States have expanded to "economic nexus," which focuses on location of customers rather than just the activities of the company.
- e.g. New Hampshire in 2007
  - "business activity means a substantial economic presence evidenced by a purposeful direction of business toward the state examined in light of the frequency, quantity, and systematic nature of a business organization's economic contacts with the state. . ." RSA 77-A:1, XII

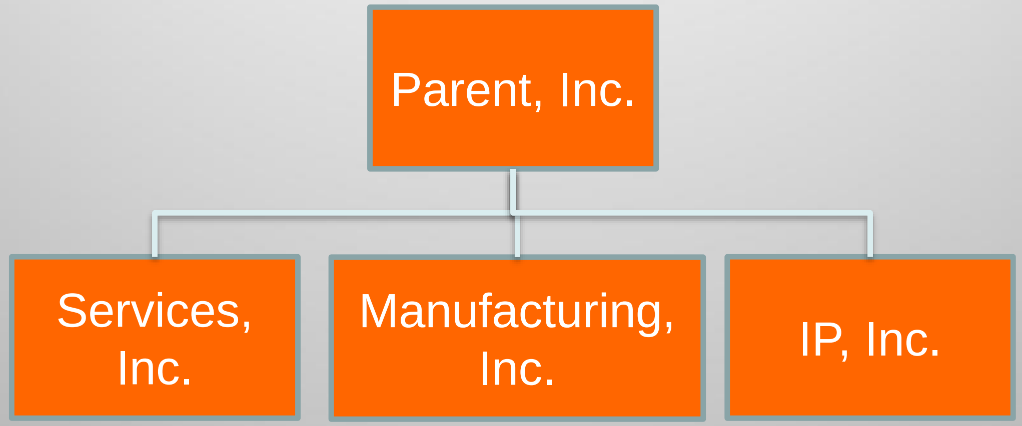
Corporate Income Tax: "Combined or Separate Reporting"

- Some states determine tax by reference to a combined or consolidated group of entities



More: “Separate Reporting”

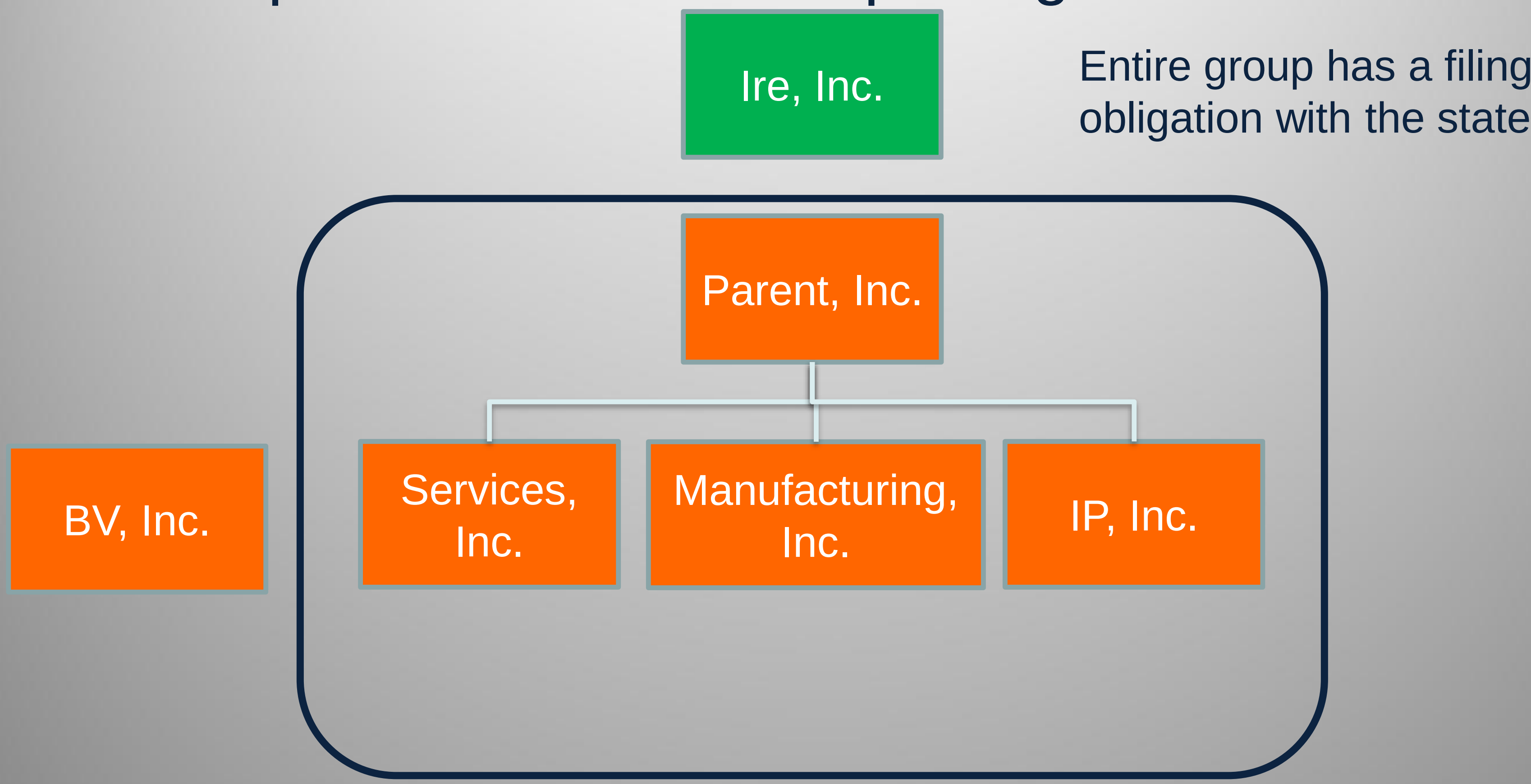
- Example of Separate Reporting



Any company that has nexus with a state has a filing obligation with the state

More: "Combined Reporting"

- Example of Combined Reporting



Combined Reporting

- What companies are combined?
- U.S. Companies Only?
- Worldwide Combination does not violate U.S. Constitution
  - Container Corp., 463 U.S. 159 (1983) and Barclays, 512 U.S. 298 (1994).
  - But causes backlash from U.S. Trading partners
- Result—Rollback to “Water’s Edge”
- Due to rise in world commerce, water’s edge is under attack
  - Deferral (Charge of Tax Avoidance)
  - Inversions (Charge of Lack of Patriotism)
  - Jobs, Jobs, Jobs

Corporate Income Tax: “Apportionment”

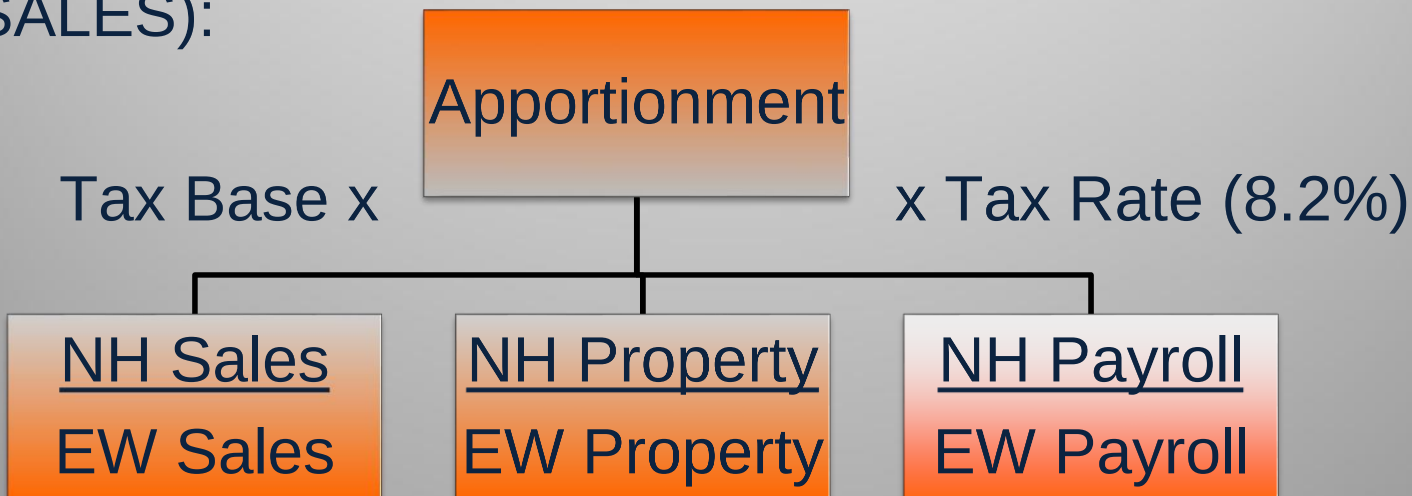
- Each state can only tax its “share” of corporate income
  - U.S. states use “formulary apportionment”
  - Do not use “separate accounting” or “transfer pricing”
  - BEPS Recommendations
- Very disparate set of rules across states
  - Some use 3 factors (property, payroll & sales)
  - Others use just 1 factor (sales)
  - Different rules create risks for double taxation and opportunities for “double non-taxation”

The Algebra of Multistate Taxation

Tax Base x Apportionment x Tax Rate=BPT

($1000) x (10.0000%) x (8.2%) = $8.20

Apportionment is the splitting up of the total state income tax base. For example, in New Hampshire (DW SALES):



EW="Everywhere Sales"
DW="Double Weighted"

Apportionment--Production v. Market

- Traditionally, a state’s apportionment formula balances production factors and market factors
  - Payroll—A production factor—where are the employees located that are producing a company’s products?
  - Property—A production factor—where is the property/machinery that is producing a company’s products?
  - Sales—A market factor—where are the company’s customers and where is the market for the company’s products?
  - In an equally weighted formula, more focus on production factors than on market factors.

Significant Trends to Watch

- Greater Weight on Sales Instead of Property and Payroll
  - Single Sales Factor
- Shifts in Policy Regarding Performance of Services and Intangibles
  - Tangible Personal Property
    - Example—A Car Tire
    - Sourcing Rule—Destination
  - Services
    - Example—Installing a car tire
    - Sourcing Rule—Cost of Performance
    - Emerging Sourcing Rule—Market-Based Sourcing
  - Intangibles
    - Example--The name of the car tire brand
    - Sourcing Rule—"Use"

Complex Products--Highlighting the Changes in Technology

- Sale of DVD
  - TPP and Destination Rule
- Purchase of Movie Downloaded to DVR
  - Sale of Service and Cost of Performance Rule
- Professor Richard Pomp
  - “No theoretical reason exists why the receipts for the delivery of a DVD through the mail of a movie should be assigned to a state differently from the on-line streaming of that movie.”

Section IV

Sales and Use Tax Considerations

Retail Sales and Use Tax

- Over 7,000 state and local governments impose separate uncoordinated sales and use taxes
  - Not European-style VAT (invoice credit)
  - Generally imposed “at retail” – no payment credits
  - Generally imposed on tangible property, not services
  - BUT businesses pay “use tax” on inputs they “consume”
  - Rates between 3% and 7%
  - Returns due monthly or quarterly

Sales & Use Tax: Collection Issues

- Tax is generally imposed on customer per transaction, but the retailer must collect the tax
  - If retailer has no presence in state, then consumer must pay “use” tax
- Digital commerce growth has undermined tax because retailers do not collect, and consumers do not file and pay use tax
- Technology is eroding tax base of states and localities
  - Things that were tangible personal property are no longer
  - CD’s to Apple Music
  - DVD’s to OnDemand and Netflix
  - Discs to Downloaded Software

Sales & Use Tax: Collection Issues

- States are pressing aggressive theories to require retailers to collect tax
  - New Direct Assaults on <u>Quill</u>
  - New “Amazon” laws
  - Attributional and affiliate nexus
- Companies are put in increasingly difficult positions
  - Collect, and be subject to class action suit that over-collected.
  - Don’t collect, and be subject to audit, assessment, tax (that is not yours but becomes yours!), interest and penalties

Increasing *Quill* Challenges

- Attempts to Challenge *Quill* (both legislative and regulatory)
  - Indiana, North Dakota, South Dakota (oral argument held in SD Supreme Court), Wyoming, Alabama, Tennessee, Massachusetts
- "Amazon Laws" and "Click-Through" Nexus
  - New York was the first to enact Amazon legislation in 2008. Numerous states have piggy-backed NY, with varying presumptions and provisions. Numerous states have enacted legislation and/or are considering legislation.
- Notice and Reporting Requirements
  - Direct Marketing Association v. Brohl, 814 F.3d 1129 (10th Cir. 2016), cert. denied, 137 S.Ct. 591 (2016).
    - Notify customers of obligation to self-report
    - Provide an annual purchase summary to each customer
    - Provide DOR with annual customer information report

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How is it all working?

- "It has been found that the present system of State taxation as it affects interstate commerce works badly for both business and the States."

- Although "[e]ach of the state laws contains its own inner logic, the aggregate of these laws – comprising the system confronting the interstate taxpayer – defies reason."

  – Willis Commission (1964-65!)

Section V

Federal Intervention?

Congressional Intervention in State Tax

- In our federal system, actions by Congress are the supreme law of the land
- Lack of uniform rules in the states have led to appeals for Congress to create overriding laws
- But. . .Congress has not been a source of productive achievements in recent years
- Sup. Ct. and Congress has shown propensity to let issues play out in states
- Nevertheless, tax reform at federal and international level may provide opportunities for state tax reform

Some Possible Congressional Action

- Marketplace Fairness Act
  - About sales and use tax collection for “remote sellers”
  - Some estimates are that $23 billion in state and local tax revenue is lost without MFA enactment
  - 45 States have a general retail sales tax
    - New Hampshire, Oregon, Montana, Alaska, Delaware (NOMAD)
- Digital Goods and Services Fairness Act
  - Would eliminate sourcing issues
  - Ohio resident downloads movie on a California server while in a Texas airport. What result under current law?

Some Possible Congressional Action

- Business Activity Simplification Act
  - Would codify “physical presence” for income and other business activity taxes

- Mobile Workforce Act
  - Would prevent non-resident taxation if not physically present for more than 30 days in a jurisdiction

Section VI

Practical Advice and Concluding Thoughts

What can you do?

- Be Aware of Issues and Increasing Risk of Audits
- Advise Clients of Risk and Document
- Design Pro-Active Strategies
- Consider Voluntary Disclosure Agreements and Be Aware of Amnesty Provisions
- Be careful about assertions that statute permits broad assertions
- Does contesting jurisdiction subject you to jurisdiction?
- Advocate for Change

Questions and Discussion

- Thank You!