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User Conference 2015

Fundamentals of State Income Tax Nexus & Apportionment

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- Nexus 101
- State-Specific Nexus
- Trend Towards Economic Nexus
- Allocation vs. Apportionment
- Apportionment 101: 3-Factor Methods
- Trend Towards Market-Based Sourcing
- Other Apportionment Stuff

Section 1a

Overview of Concepts

Income



Gross Receipts



Franchise



Others



What does
it **mean**?



Why is it
important?



Constitutional Nexus

The Commerce Clause

- *Quill v. North Dakota* (1992)
- Let's get physical



Section 1b

Federal Restrictions on Nexus Rules



v.



*Northwestern States
Portland Cement*

Minnesota

“No State, or political subdivision thereof, shall have power to impose, for any taxable year ending after September 14, 1959, a net income tax on the income derived within such State by any person from interstate commerce if the only business activities within such State by or on behalf of such person during such taxable year [is] ... the solicitation of orders by such person, or his representative, in such State for sales of tangible personal property, which orders are sent outside the State for approval or rejection, and, if approved, are filled by shipment or delivery from a point outside the State”

- Tax on “net income”
 - So certain states aren’t covered
 - OH, WA, NJ to name a few
 - NJ *Home Impressions* Case
- Solicitation of Orders
 - Lots of meat; we’ll get there

- For Sales of Tangible Personal Property
 - Really? Just TPP?
 - CA Example: *Personal Selling Power* Case
- Orders sent outside state for approval
- Orders shipped from out-of-state



Not **THAT**
solicitation

Wisconsin v. Wrigley (1992):
Setting the Standard

- Solicitation = “Request for Purchases”
- *De Minimis* = A “Non-Trivial Additional Connection”

Section 2

State-Specific Nexus Issues

De Minimis Rule

Is There Such a Thing?

- Constitutional Basis
- NY's *Orvis* Case
 - Michigan and Illinois Follow Suit



One Day
isn't enough



4 Days!



One Day
isn't enough



A couple days/year
not enough

- The Basic Principle
- *Scripto v. Carson* Rule
- *Tyler Pipe* – Following *Scripto's* Lead

- Nexus Bulletin 95-1
 - In-State Warranty Repair = Nexus
 - Even if Performed by Agent
- Connecticut – *Dell Catalog Sales v. Comm’r*
- Louisiana – *Louisiana v. Dell*
- New Mexico – *Dell Catalog v. New Mexico*

- What's the Difference with Agency Nexus?
- Brother-Sister, Etc.
- The “Dot.com” Affiliate

- Ohio – ***SFA Folio v. Tracy***
- California – Borders and Barnes & Noble Fight It Out
– Reader’s Digest Too
- New Mexico – Barnes & Noble Wins Again
- Tennessee – ***JC Penney v. Johnson***

- In Most Cases, Yes
- But Look Out For a *De Minimis* Argument (MD) or P.L. 86-272 (MA and VA)
- MTC Says It's OK

Section 3

Other Nexus Issues

- Economic Nexus
 - The Next Big Thing?
 - What about *Quill*?
- Geoffrey and South Carolina – It All Starts With The Giraffe
- Opening The Flood Gates: Other States Jump On The Bandwagon



- *KFC v. Iowa*: Kentucky-Fried Nexus
- *A&F Trademark v. Tolson*
- *Geoffrey v. Tax Commission*
(Can't We Leave the Giraffe Alone?)
- *Kmart v. Dept.*
- *SYL v. Comptroller*
- *Dept. of Revenue v. Gap*



- *Lanco v. Division*
- *Tax Commissioner v. MBNA*
- *Capital One v. Comm’r*
(The State Is In Your Wallet!)
- *Acme and Gore*
- *Couchot*
- *Borden Chemicals*



- *General Motors and Lamtec*
- *A&F Trademark*
- *MBNA and Letter Rulings*
- *Lanzi*
- *Capital One v. Comm'r*
(The State Is In Your Wallet!)



- *Cerro Copper v. Dept.*



- *Bandag v. Rylander*



- *Acme Royalty v. MO*



- *MBNA v. Indiana*



- *JC Penney and AOL*



- *Wascana Energy*

- Special Rules for Banks
- Denying Royalty Deductions
- 2015 Economic Nexus Test:
“Dr. Evil Rule”



- California
 - \$50,000 of property; \$50,000 of payroll; \$500,000 of sales
- Colorado
 - \$50,000 of property; \$50,000 of payroll; \$500,000 of sales
- Ohio
 - \$50,000 of property; \$50,000 of payroll; \$500,000 of sales
- Washington
 - \$50,000 of property; \$50,000 of payroll; \$250,000 of sales

- Ownership of Partnership Interests?
 - General vs. Limited Partners
- Ownership of Leased Property?
 - Mobile vs. Immobile Property
- Qualify to do Business = Nexus?
- Presence of Telecommunications?
 - Home Office Employees Create Nexus

Section 4

Allocation vs. Apportionment Basics

- Separate Accounting
 - Separate geographical accounting
- Formula Apportionment
 - States frequently use the 3-Factor Formula contained in the **Uniform Division of Income for Tax Purpose Act (“UDITPA”)**, or a derivative, such as super weighted sales factor or single sales factor
- Specific Allocation
 - Income is traced to its source

- UDITPA divides income into “business income” and “nonbusiness income.”
- “Nonbusiness income” means all income other than business income.

General Rule – Allocate Nonbusiness
Income To a Specific State

- Net Rents and Royalties from Real Property – State Where Property is Located
- Capital Gains and Losses – State Where Property is Located
- Interest and Dividends – Domiciliary State
- Patent and Copyright Royalties – State Where Property is Located

“Business income” means income arising from transactions and activity in the regular course of the taxpayer’s trade or business **and includes** income from tangible and intangible property if the acquisition, management and disposition of the property constitute integral parts of the taxpayer’s regular trade or business operations. (emphasis added).

Rule – Business Income is apportioned among all the states in which the taxpayer does business using the 3-Factor Formula.

Not all states use 3-Factor Formula; trend actually elsewhere, to single-factor

Business income: One Test or Two?

1. Transactional Test: did the transaction giving rise to the gain occur in the regular course of the taxpayer's trade or business?
[Phrase 1 in definition]

2. *Functional Test*: was income-producing property integrated into, or used in, business operations? [Phrase 2 in definition]
- “Liquidation Exception” recognized by many courts when a business is liquidated or goes out of business.
 - Is the Functional Test a separate test? Or is it a sub-part of the Transactional Test (see underlining in definition – “and includes”)? In other words are there two tests or one.

Transactional Test vs. Functional Test

Transactional Test: Did the transaction giving rise to the gain occur in the regular course of the taxpayer's trade or business?

Functional Test: Was income-producing property integrated into, or used in, business operations?

In re Kimberly Clark Corp. v. Alabama Dep't of Revenue, 69 So. 3d 144 (Ala. 2010).

- Lower court found business income existed under the **Transactional Test** when a paper company sold a paper mill and related timberland in Alabama because the company had bought and sold businesses in the past, making the sale a normal part of its ordinary business.
- The Alabama Supreme Court **reversed**, holding that the **sale did not satisfy the Transactional Test** even though it had acquired and sold other businesses during the audit period because the **sale was extraordinary** in nature. The court applied a **Transactional Test only**.
- One test or two?

Texaco-Cities Serv. Pipeline Co. v. McGaw, 695 N.E.2d 481 (Ill. 1998)

- The court notes there were **two tests** under Illinois law for determining whether income from the sale of capital assets constituted business income: the Transactional Test *and* the Functional Test.
- The court applied the **Functional Test** and determined that the gain from the sale of a pipeline in Illinois constituted business income.

- Many courts recognize a “**liquidation exception**” to the Functional Test when a business is liquidated or goes out of business. *See, e.g., Lenox, Inc. v. Tolson*, 548 S.E.2d 513 (N.C. 2001).
 - Liquidations may fall into a separate category from other business transactions: the transaction is a means of **ceasing business operations** rather than furthering them.
- Other states have **rejected** the liquidation exception. *See, e.g., Jim Beam Brands v. Cal. Fran. Tax Bd.*, 34 Cal. Rptr. 3d 874 (Cal. App. 2005).
 - Court distinguished its ruling from other cases by stating that in California, the focus of the Functional Test is on the nature of the income producing *property*, while other cases focused on the nature of the income producing *transaction*.

- Most courts treat 338(h)(10) deemed asset sales as falling under the liquidation exception to the Functional Test.
- *See, e.g., Am. States Ins. Co. v. Hamer*, 816 N.E.2d 659 (Ill. App. Ct. 2004).
 - Gain from a stock sale, deemed to be an asset sale under § 338(h)(10), generated non-business income because the Functional Test was not satisfied in cases involving a liquidation and cessation of business.

Section 5

Apportionment Formula Review

- Traditionally states used the UDITPA Formula which was an equally weighted three-factor formula including sales, property and payroll
- Many states have modified the traditional formula by adding weight to the sales factor
- Payroll and Sales factors are the most troublesome, especially in the services context

$$\frac{\frac{\text{In-State Property}}{\text{Total Property}} + \frac{\text{In-State Payroll}}{\text{Total Payroll}} + \frac{\text{In-State Sales}}{\text{Total Sales}}}{3}$$

x

Apportionable
(Business)
Income

=

Income
taxable by the
State

- The property factor is generally a fraction with the numerator being value of real and tangible property in-state and denominator being of property everywhere

Instate Property
Everywhere Property

- What about “property” like computer servers?

- The payroll factor is a fraction the numerator of which is the corporation's compensation in a particular state divided by the denominator which is the taxpayer's total compensation everywhere

Instate Payroll
Everywhere Payroll

- Compensation usually includes wages, salaries, commissions; generally anything showing up on an employee's W-2 or in the company's state unemployment reports

- If an employee works in more than one state
 - Allocate the compensation to the state in which most of the services are performed
 - If no one state has a majority assign the compensation to the
 - Employee's base of operations
 - Location from which duties are directed or controlled
 - Employee's state of residency

- Who is included in payroll?
 - State auditors use Federal Form 940 to tie payroll figures since payroll generally follows unemployment compensation rules
 - Review common-law employees versus book employees
 - Common law employee: Performs services for a company who controls what will be done and how it will be done
 - Exclusions
 - Payroll attributable to non-business income
 - Independent contractors
 - Non-jurisdictional payroll

- The sales factor is a fraction the numerator of which is the corporation's sales in a state divided by the denominator which is its total sales everywhere

$$\frac{\text{Instate Sales}}{\text{Everywhere Sales}}$$

- Sales are usually sourced by destination for sales of goods, but it's tougher for services

- Cost of performance
 - Source where income producing activities takes place
 - Direct costs determined in a manner consistent with GAAP
 - Income Producing Activity (IPA) is determined from each transaction that goes into making a profit
 - Many states pick up activities performed on behalf of taxpayer by independent contractor in determining direct cost
 - This is the MTC rule

- Most states use cost of performance, but trend towards market-based sourcing
- States which use market-based sourcing
 - Alabama, Arizona, California, Georgia, Illinois, Iowa, Maine, Maryland, Michigan, Minnesota, Nebraska, New York, Ohio, Oklahoma, Utah and Wisconsin

- Market-Based Sourcing: UDITPA Rule
 - Looks to “if and to what extent” the service is delivered to a location in a state
 - If delivery cannot be determined sourcing location should be “reasonably approximated”
 - Includes a “throw-out” provision when taxpayer is not taxable in state to which sale is assigned (or if state of assignment cannot be determined)
- Practical Application?
 - How does a professional service firm allocate based on market sourcing?

Section 6

Special Apportionment Issues & Situations

- Under UDITPA, sales of tangible personal property (TPP) are included in the numerator of the sales factor if either:
 - The property is delivered or shipped to a purchaser (other than the U.S. government) within the state, or
 - The property is shipped from a location in the state and (1) the purchaser is the U.S. government, or (2) the taxpayer is not taxable in the state of the purchaser.
- The second clause is known as the “throwback rule.” Sales that would otherwise be included in the numerator of another state’s sales factor are “thrown back” to the state of origination, if the taxpayer is not taxable in the state of the purchaser.
- Has the effect of increasing the numerator of the state’s sales factor, with no effect on the denominator—causing the sales factor (and thus, the apportionment factor) to increase.

Gillette Co. v. Franchise Tax Bd., 207 Cal. App. 4th 1369 (1st Dist. 2012), *on rehearing*, 209 Cal. App. 4th 938, *petition for review granted* 291 P.3d 327 (2013).

- Prior to 1993, California used a three-factor apportionment formula.
- In 1993, California modified its apportionment formula to double-weight the sales factor.
- **ISSUE:** Can Gillette elect to use the MTC formula, or did the 1993 amendment repeal and supersede the three-factor formula?
- **APPELLATE DISTRICT COURT HOLDING:** California is bound by the MTC's apportionment election provision.
 - The MTC takes precedent over subsequent conflicting legislation.
 - Federal and state Constitutions forbid enactment of state laws that impair contractual obligations.

CALIFORNIA'S RESPONSE:

- California withdrew from the MTC.
- The FTB appealed the case to the California Supreme Court, which granted review; oral arguments set for October 6, 2015.
- Other states, including Minnesota, Oregon, South Dakota, Utah, and the District of Columbia also withdrew from the MTC.
- What will *Gillette* mean for the future of the MTC and the future of interstate compacts in general?

MICHIGAN:

- In July 2014, the Michigan Supreme Court held that IBM was entitled to use the MTC's elective three-factor apportionment formula to calculate its 2008 Michigan Business Tax Liability. *IBM Corp. v. Department of Treasury*, 852 N.W.2d 865 (Mich. 2014).
- The court found that the Legislature did not implicitly repeal the MTC when the state replaced the Michigan Business Tax (MBT) with the Corporate Income Tax (CIT).
- The Legislature responded to the court's ruling by expressly repealing the MTC retroactively to January 1, 2008.
- In April 2015, the Michigan Court of Claims ruled that the state's retroactive repeal prevents IBM from making the three-factor election. *IBM Corp. v. Department of Treasury*, Mich. Ct. Claims, No. 11-000033-MT (4/28/15).

TEXAS:

- Texas joined the MTC in 1967 and has never officially repealed the Compact.
- But in 2006, the state enacted the Texas Franchise Tax, which uses a single-factor apportionment formula.
- In *Graphic Packaging*, taxpayers argued that the franchise tax meets the definition of an income tax under the MTC, triggering its rules and formulas. The taxpayers also rejected the state's assertion that the enactment of the franchise tax implicitly repealed the Compact.
- In July 2015, the Texas Court of Appeals, Third District, determined that the Texas Franchise Tax is not a tax imposed on net income for MTC purposes and therefore the Compact's three-factor apportionment formula provisions are not available to taxpayers. *Graphic Packaging Corp. v. Hegar*, 2015 Tex. App. LEXIS 7717 (Tex. App. Austin, 7/28/15).

MINNESOTA:

- *Kimberly-Clark Corp. v. Commissioner of Revenue*, 2015 Minn. Tax LEXIS 33 (Minn. T.C., 6/19/15).
- In June 2015, the Minnesota Tax Court ruled on summary judgment that the state's repeal of Articles III and IV of the MTC does not violate the U.S. or Minnesota Contract Clause constitutional provisions.
- The case can be appealed directly to the Minnesota Supreme Court.

- The standard alternative apportionment provision is found in UDITPA § 18
 - “If the allocation and apportionment provisions of this Act do not fairly represent the extent of the taxpayer’s business activity in this state, the taxpayer may petition for or the [tax administrator] may require” alternative apportionment.
 - Alternative apportionment may include:
 - Separate accounting
 - The exclusion of one or more factors
 - The inclusion of one or more factors that represents the taxpayers activities in the state
 - Or the employment of any other method to reach equitable apportionment
 - Read literally the taxpayer may only **ask**; while the tax department may **require** alternative apportionment.

- Sidney Frank Importing Company v. Michigan, July 31, 2014
 - Taxpayer seeks to exclude \$2B gain on sale of Grey Goose from sales factor
 - Procedural issues abound; at Court of Appeals for 3rd time
 - Argument: including in tax base and EXCLUDING from sales factor distorts MI income
 - Argument #2: do we include in tax base at all?

- Considerations Related to Special Industry Apportionment
 - Financial Institutions – Receipts sourced to location of borrower & property includes intangible assets like loans and receivables
 - Construction – Include construction in progress
 - Professional Sports – Source by duty-days, i.e. proportion based on games played
 - Motion Pictures – Source by audience data
 - Transportation – Source by in-state mileage, passenger mileage, etc.
 - Insurance – Source by premium dollars written
 - Airlines – Airplane and flight crew payroll may be apportioned based on number of departures from the state
 - Communications – Source by cable-miles, circulation, satellite uplink and downlink stations, or location of the customer

- Nonresident Owners
 - Partners, S corp shareholders, LLC members
- Tax Computation Methodologies
 - Three-factor apportionment
 - Direct accounting
 - Entity v. Aggregate Approach
 - Mixing and Matching in NY
 - Difference between LLCs and S Corp factor-based apportionment



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