

# Multi-State Tax Update

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## Topics

- Nexus Issues and Developments
- FIN 48 Implications
- Voluntary Disclosure Programs
- Texas' evolving Business Purpose and Economic Substance Doctrines

# Nexus Issues

- Legal Backdrop
- State and Local Taxing Jurisdictions Seek to Tax Commerce Taking Place Within Their Borders
  - Net income tax
  - Non-net income based taxes such as gross receipts and capital taxes
  - Use tax collection by out-of-state vendors
- U.S. Constitution limits States' Power to tax out-of-state businesses
  - Due Process Clause
  - Commerce Clause

# Nexus Issues

Due Process Clause requires essentially that it be fair for a state to tax the out-of-state company in light of contacts by the out-of-state company with the state and protections and services provided by the state.

Commerce Clause reserves to Congress the power to “regulate commerce ... among the several states.. ”

# Commerce Clause Requirements

U.S. Supreme Court created the “dormant” or “negative” Commerce Clause that protects interstate commerce even absent Congressional action-

## Complete Auto Test (1977)

A state tax on interstate commerce will be sustained if it: (1) is applied to an activity with a *substantial nexus* with the taxing state; (2) is fairly apportioned; (3) does not discriminate against interstate commerce; and (4) is fairly related to the services provided by the State.

# Commerce Clause Requirements

Congress has also acted-

Public Law 86-272 adopted in 1959 provides, in part:

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 are...:

(1) 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**

# Net Income Based Taxes

- Even though Constitutional Nexus limits may have been exceeded, P.L. 86-272 may protect Sellers from a net income based tax.
- P.L. 86-272
  - Examples of Protected Activities
    - Solicitation of orders for sales of tangible personal property and activities ancillary to solicitation of orders (ancillary activities have no other business purpose apart from their connection to solicitation of orders).
    - Carrying samples and promotional materials for display without charge.
    - Recruiting, training and evaluating sales personnel.
    - De Minimis non-solicitation activities.
      - For example, Pennsylvania published guidance providing a safe harbor definition of de minimis activities (Corporate Tax Bulletin 2004-01, 5/19/04). Included are certain non-solicitation activities, like repair, maintenance and service activities if conducted no more than 7 days per year and if all non-protected activities together generate less than \$10,000 in Pennsylvania sales per year.)

# Net Income Based Taxes

- Prohibited Activities under P.L. 86-272
  - the list is long, but relevant examples include:
    - Repair or servicing of products.
    - Maintaining an office in the state.
    - Replacing damaged product.
    - Storing inventory.
    - Collection of current delinquent accounts.
    - Credit checks.
    - Training other than solicitation training.
    - Approving or accepting orders.
    - Picking up damaged merchandise or repossessing merchandise.

# Net Income Based Taxes

- P.L. 86-272 of lessening utility
  - All or nothing aspect.
  - Applies only to solicitation of sales of tangible personal property.
  - Sales of services and intangibles not protected.
  - “Solicitation” narrowly defined.
  - Business practicalities may override income tax protection as a company objective.
  - Throw back statutes lessen utility of income tax protection
  - Non-net income based taxes such as (Texas margin tax?) not restricted by PL 86-272.

# Sales and Use Tax Collection by Remote Sellers

- For sales or use tax collection responsibility, remote sellers must have some *physical presence* in the state Quill Corp. v. North Dakota U.S. S. Ct. (1992).
- Presence in state of independent contractors soliciting orders for companies' products provides nexus for states to require sales and use tax collection Scripto, Inc. v. Carson (1960)
- Exemptions such as the sale for resale exemption may be available to protect Sellers from sales and use tax collection responsibility, but requisites of exemption must be observed.
- Sales and use tax collection exposure can become very large; it's a percentage of gross, not net!

# Nexus – Changing Landscape

- Does *Quill* physical presence requirement apply to taxes other than sales and use taxes?
- Whose physical presence will be attributed to remote sellers?
- Will “economic presence” alone support “substantial nexus” required for taxes other than sales and use taxes?
- State courts and legislatures have been expanding their nexus “nets” with little or no reaction from Congress or the U.S. Supreme Court.

# Nexus – Changing Landscape

- Sales and Use Tax
  - ***Drugstore.Com, Inc. v. Director, Division of Taxation*** (NJ Tax Ct 2008). Internet sales company with no physical presence in NJ required to collect NJ use tax based on presence in NJ of affiliated companies (taxpayer's interco transaction documentation was suspect).
  - ***Dell Marketing L.P. v. New Mexico Taxation and Revenue Dept.*** New Mexico courts held "substantial nexus" physical presence required by ***Quill*** satisfied by presence of third-party warranty service providers. Dell contracted with the service provider and then sold the service agreements to Dell's New Mexico customers at time of sale of the computers.
    - U.S. Supreme Court ***denied*** certiorari in March 2009
  - ***Amazon.Com, LLC and Overstock.Com, Inc. v. New York State Dept. of Taxation***. In January of 2009, New York court upholds New York statute requiring out-of-state vendors to collect New York sales and use tax based on presence in New York of "affiliates" providing advertising on their independently maintained websites.
    - Appeal to New York Supreme Court pending
    - Several other states have adopted similar statutes

# Nexus – Changing Landscape

- Sales and Use Tax
  - *Amazon.Com*
- “Half the money I spend on advertising is wasted; the trouble is I don’t know which half.” John Wannamaker, quoted from Wikipedia in Amicus Brief filed 9/2/09 in N.Y. S. Ct. by Performance Marketing Alliance.
- Does advertising paid for regardless of whether it works create no physical presence while advertising paid for only if it works creates physical presence?
- Difficult questions

# Nexus – Changing Landscape

- Other Non-Income Based Taxes
  - ***Capital One Bank (USA), N.A. v. Commissioner of Revenue of Massachusetts***. Massachusetts courts permitted imposition of state’s financial institution excise tax on an out-of-state bank having no property or employees in Massachusetts. Massachusetts Supreme Court held:
    - ***Quill’s*** physical presence test applies only to sales and use taxes.
    - ***Complete Auto*** “substantial nexus” requires greater presence than minimal contacts
    - Capital One’s consumer lending and credit card business with hundreds of thousands of Massachusetts residents provided “substantial nexus”
    - U.S. Supreme Court ***denied*** certiorari in June, 2009

# Nexus – Changing Landscape

- Income Taxes
  - ***Geoffrey, Inc. v. Commissioner of Revenue of Massachusetts*** (1/2009). Intangible Holding Company received \$6 to \$7 million per year in royalties for use of trademarks in Massachusetts. Massachusetts Supreme Court Held:
    - ***Quill*** applies only to sales and use taxes
    - “Substantial nexus” requirement satisfied
    - U.S. Supreme Court ***denied*** certiorari in June, 2009
  - ***FIA Card Services NA (f/k/a MBNA America Bank) v. Tax Commissioner of West Virginia***. In 2007 West Virginia Supreme Court held even though credit card company had no physical presence, ***“the frequency, quantity and systematic nature of taxpayer’s economic contacts with state”*** satisfied required “substantial nexus” for imposition of state’s income tax.
    - U.S. Supreme Court ***denied*** certiorari in June, 2007
  - Wisconsin and Connecticut have adopted statutes applying their income taxes to out-of-state companies deriving income from their states ***regardless of physical presence***.
  - Michigan statute defines nexus for purposes of its new business tax as either (i) physical presence for more than one day during the tax year, or (ii) actively soliciting Michigan sales and having annual Michigan gross receipts of \$350,000 or more.
  - ***Accuzip, Inc. and Quark, Inc. v. NJ Division of Taxation***. NJ Tax Court held in August 2009 that company selling tangible personal property into NJ, having no physical presence in NJ, is **NOT** subject to New Jersey income tax. Court rejects “significant economic presence test.” Compare ***Lanco*** where NJ Supreme Court in 2006 held that an intangible holding company with no physical presence in NJ can be subjected to NJ income tax.

# Current Nexus Standards

Type of Tax

Contact with State	Type of Tax		
	Sales/Use	Net Income	Capital/Excise/ Gross Receipts/Other
Physical presence	Yes, subject to possible <i>de minimis</i> exception	Yes, but P.L. 86-272 may protect taxpayer	Yes, subject to possible <i>de minimis</i> exception
Substantial economic presence, no physical presence	No, but states stretching to end run <b>Quill</b>	Apparently yes, until U.S. S. Ct. or Congress say otherwise, but P.L. 86-272 may protect taxpayer*	Apparently yes, until U.S. S. Ct. or Congress say otherwise*

\*Note, some states apply **Quill** physical presence to all taxes (e.g. Texas, Tennessee). Others apply only to use of intangibles in state (e.g., NJ).

# Implications of FIN 48

- All GAAP financials must comply (including effective for 2009, those of private companies)
- Basic rules.
  - Applies to all material positions taken on any income tax returns filed or that should have been filed
  - Assume position will be examined and tax authority will have full knowledge of all relevant information
  - For each position, first determine whether after litigation and appeals, position will more likely than not be sustained (recognition)
  - If position survives “recognition test”, then apply probability analysis to determine likely settlement result (measurement)
- Implications
  - Applies only to income tax issues, but. . . .
  - Limitations never runs if returns not filed
  - Nexus standards are imprecise and changing
  - States are aware of FIN 48 requirement and work papers supporting financial reporting positions taken
  - Were FAS 5 reserves adequate?
  - How are bank covenants impacted?

# Negotiating Voluntary Disclosure Agreements

- Benefits
  - Limited look-back.
  - Waiver of penalties (and sometimes interest).
- Eligibility for Voluntary Disclosure Agreements
  - No contact for audit or other investigations.
- Consider protective refund claims in states where taxpayer did report under “throw-back” rules.

# Business Purpose and Economic Substance Doctrines in Texas

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- Scenario 1: *Disregard of Corporation* - Individual purchases an aircraft outside of Texas and contributes the aircraft to his wholly-owned corporation before the aircraft enters Texas. The wholly-owned corporation brings the aircraft into and hangars the aircraft in Texas. Operating Agreement between the individual and corporation permits the individual to use the aircraft for no consideration.
  - An aircraft purchased outside of Texas and brought into Texas for use in Texas within one year of its purchase is presumed to have been purchased for use in Texas and is subject to Texas state and local use tax, unless otherwise exempt.
  - An aircraft purchased outside of Texas, transferred to an affiliated entity outside of Texas for no or nominal consideration and brought into Texas for use in Texas within one year of its purchase is presumed to have been purchased for use in Texas and is subject to Texas state and local use tax, unless otherwise exempt.
  - The Comptroller may disregard the corporation under such circumstances and hold the person who purchased the aircraft for use in Texas responsible for the use tax.

# Business Purpose and Economic Substance Doctrines in Texas

- Scenario 2: “Economic Substance Doctrine” – Broker sells aircraft to an individual (“X”). The sale takes place outside of Texas. X, who holds no sales tax permit and has made no other sales of tangible personal property in the previous 12 months, sells the aircraft to a second individual (“Y”) who brings the aircraft into Texas and hangars it in Texas
  - The purchase by Y can be eligible for the occasional sale exemption when Y brings the aircraft into Texas provided the series of transactions between the broker and X and between X and Y have a legitimate business purpose apart from the avoidance of taxes
  - The series of transactions may be disregarded under the economic substance doctrine if the transactions are nothing more than a vehicle for tax avoidance
  - Transactions between related parties that do not affect the economic interest of an independent third party deserve particularly close scrutiny

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