Income Tax Nexus – 2008 Developments

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http://www.cob.sjsu.edu/nellen_a/TaxReform/21st_century_taxation.htm

Oregon's New Income Tax Nexus Guidance - In May 2008, the Oregon Department of Revenue (DOR) adopted Rule 151-317.010 to clarify that a corporation can have substantial nexus in the state for corporate excise and income tax purposes without physical presence. "Substantial nexus exists where a taxpayer regularly takes advantage of Oregon's economy to produce income for the taxpayer and may be established through the significant economic presence of a taxpayer in the state."

To determine if substantial nexus exists the DOR may look at the regularity of contacts in the state, deliberateness of marketing to Oregon customers, and significant gross receipts from Oregon customers or from the use of intangible property in Oregon. Also relevant is whether the business is protected by Oregon laws, has court access, uses state roads, benefits from Oregon's educated workforce, or receives "police and fire protection for property in Oregon that displays taxpayer's intellectual or intangible property." [http://www.sos.state.or.us/archives/rules/OARS_100/OAR_150/150_317.html]

Florida Economic Nexus Ruling – In Florida Technical Assistance Advisement 07C1-007 (10/17/07), the Florida Dept of Revenue held that a financial services firm providing various services to retailers in Florida had nexus for income tax purposes even though it had no physical presence in the state. T is licensed with the Florida Dept. of Financial Services under Florida law. The license indicates that T has a number of authorized retailers in the state and T paid a fee for each one. The retailers bind T because if a retailer does not pay for any transaction, T is liable to the service provider.

P.L. 86-272 does not apply to T because it is not selling tangible personal property. In analyzing due process, the DOR stated: "the U.S. Supreme Court has said that the "simple but controlling question is whether the state has given anything for which it can ask return." See *Wisconsin v. J. C. Penney Co.*, 311 US 435, 444 (1940). In this case, Florida has provided the Taxpayer with a license, and with an orderly and regulated marketplace. Florida is also providing the Taxpayer with access to its courts. Therefore, Florida meets the requirements of the Due Process Clause."

In analyzing commerce clause concerns using *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977)., the DOR also found no problem with imposing tax. "Florida has provided the Taxpayer with a license, and with an orderly and regulated marketplace. Florida is also providing the Taxpayer with access to its courts and police and fire protection for its authorized agents/representatives. Therefore, Florida's corporate income tax has a fair relation to the services Florida provides."

In analyzing any physical presence requirement, the DOR noted that cases in other states have found that the *Quill* physical presence standard does not apply for income tax purposes. The DOR also noted that the US Supreme Court had declined to hear a state case on this issue. It found these cases to be "persuasive, especially given the fact that the U.S. Supreme Court declined to hear the cases."

While not mentioning the cases, the DOR was likely referring to *MBNA*, 640 SE2d 226 (2006) and *Lanco*, 188 NJ 380 (2006), cert denied 127 S. Ct. 2997 (06/18/2007). In these cases, the courts held that for commerce clause purposes, a "significant economic presence test" was appropriate to determine if a business had a substantial nexus in a state for income tax purposes (*MBNA*).

The DOR found that T had substantial nexus in the state.

Indiana and Economic Presence – In *MBNA America Bank v. Indiana Dept. of Revenue* (Cause No. 49T10-0506-TA-53, 10/08), the Indiana Tax Court held that MBNA was liable for Indiana's financial institutions tax because while it did not have a physical presence in the state, it had an economic presence. MBNA had no employees or facilities in Indiana and only contacted credit card customers and potential customers there by phone or mail. At issue was whether economic presence is sufficient to meet the substantial nexus requirement under the commerce clause of the US Constitution. The court concluded: "The Commerce Clause does not require MBNA to have a physical presence in Indiana to be subject to the FIT – its economic presence is enough." [http://www.in.gov/judiciary/opinions/pdf/10200801tgf.pdf]

Virginia and Third Party Warranty Services – In Ruling 08-184 (10/17/08), the Virginia Department of Taxation ruled that a taxpayer (T) did not have income tax nexus under PL 86-272. T sold products to contractors who installed them for commercial customers. Another product was sold to distributors who then sell the product to retailers and contractors for sale to residential customers. T has no property in Virginia and sales activities were only those permitted under PL 86-272. T requested a ruling to determine if its arrangements for warranty work created income tax nexus. All warranty work was performed by third parties to whom T would ship any needed parts.

The DOT noted first: "Although P.L. 86-272 applies to tangible property, the Department's policy has been to extend the "solicitation test" of P.L. 86-272 to situations involving the sales of services. The Department has a long established policy of narrowly interpreting the provisions of P.L. 86-272." The DOT notes that generally, warranty services are a type not protected by PL 86-272. However, T did not provide the services but instead reimbursed independent third parties for providing them. Public Document 99-278 (10/14/99) provides that warranty services carried on in Virginia are not an activity protected by P.L. 86-272. That ruling further states that the provision of services in Virginia by an independent contractor on behalf of a taxpayer was the purchase by the taxpayer of services from a vendor that were then resold to the taxpayer's customers. Accordingly, such activity would not create nexus for the taxpayer purchasing the services."

The DOT found that T's activities were "substantially similar" to those of a sign manufacturer covered in Public Document 01-136 (9/18/01). In that ruling, T also hired unrelated third parties to provide installation and warranted services. The DOT found that performance of such services was the purchase of services by T that did not exceed the protections of PL 86-272. Thus, the DOT ruled similarly for T.

Virginia DOT rulings can be found at http://www.policylibrary.tax.virginia.gov/OTP/Policy.nsf.

Michigan and MBT Nexus – The Michigan Department of Treasury issued Revenue Administration Bulletin 2008-4 explaining when a business has nexus for purposes of owing the Michigan Business Tax which includes both the Michigan business income tax, gross receipts tax, gross direct premiums tax and the franchise tax. The bulletin states: "two alternative nexus standards under the MBT. First, a person has nexus with the state if that person has *physical presence* in the state for more than one day during the tax year. Alternatively, a person has nexus with the state if the person *actively solicits sales in this state and has Michigan gross receipts of $350,000 or more*." The bulletin also notes that if a business falls under the protections of PL 86-272, it will not be subject to the business income tax although it could be subject to other Michigan taxes not covered by PL 86-272. This lengthy bulletin includes details for how PL 86-272 operates in Michigan and when a business is subject to MBT. It can be found at http://www.michigan.gov/documents/treasury/RAB2008-4_253768_7.pdf.

Colorado Factor Presence Nexus Proposed Regulation – In August 2008, the Colorado Department of Revenue proposed a factor presence nexus standard for companies that are not domiciled in Colorado, but doing business in the state (Regulation (39-) 22-301.1. Doing business in Colorado). Such entities would be considered as having substantial nexus and have income tax filing obligations in any period in which any of the following thresholds are exceeded (unless prohibited from imposing income tax per US Constitution or PL 86-272):

(a) a dollar amount of $50,000 of property; or

(b) a dollar amount of $50,000 of payroll; or

(c) a dollar amount of $500,000 of sales; or

(d) twenty-five percent of total property, total payroll or total sales.

The thresholds would be adjusted for inflation. A hearing is scheduled for 11/3/08. [http://www.revenue.state.co.us/taxstatutesregs/REG3922301.1.html]

Income Tax Nexus Solutions

Business Activity Tax Simplification Act proposals, S 1726 and HR 5267 (110^{th} Congress), would expand PL 86-272 to also apply to services and intangibles. They require a physical presence for a business to be subject to income tax. The bills generally define physical presence as including employees, an exclusive agent or tangible property. Presence of less than 15 days or to conduct limited or transient business activity is ignored.

Congressman Boucher, a co-sponsor, states (Cong. Rec. 2/7/08, E137):

> "The measure we are introducing today will bring certainty to the increasingly chaotic tax environment for businesses by clarifying that the states cannot attempt to tax the income of a company that has no physical presence within the taxing state's borders. Our legislation sets forth clear, specific standards to govern when businesses should be obliged to pay business activity taxes to a state. Generally, a business must use employees or services in a state for 15 days or more in a calendar year before it is liable to pay business activity taxes to that jurisdiction.
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> The Business Activity Tax Simplification Act also modernizes a law which Congress enacted forty-nine years ago that set clear, uniform standards for when states could tax out of- state businesses based upon the solicitation of orders for specified kinds of sales. Reflecting the economy of its time, the scope of Public Law 86–272 was limited to income taxes on the sale of tangible personal property. Our nation's economy has changed dramatically over the past half-century, and the statute must be modernized to apply equally to the sale of intangible property and services, and to other business activity taxes.

> I want to emphasize that the Business Activity Tax Simplification Act does not diminish the ability of states and localities to collect tax revenue. Rather, it rationalizes and makes more predictable the process of doing so."

In February 2008, the House Small Business Committee held a hearing on tax and nexus issues small businesses face that "significantly inhibit their ability to engage in commerce." (http://www.house.gov/smbiz/PressReleases/2008/pr-02-14-08-business-tax.htm)

State governments are generally opposed to the BAT Simplification proposals of the 110th and earlier Congresses (such as HR 1956 and S 2721 in the 109th Congress). The National Governors' Association (NGA) state that the proposed nexus rule is "neither clear nor fair." They are also concerned that it will encourage companies to "shelter" income via increased planning opportunities and that it will hurt smaller and local businesses. They also believe that states will lose over $6 billion annually from the proposal. (9/05 statement on HR 1956)

For more information on cost estimates of BAT simplification legislation – HR 1956 (109th Congress):

- NGA - http://www.nga.org/Files/pdf/0509BAT.PDF
- COST - http://finance.senate.gov/hearings/testimony/2005test/072506dl2test.pdf

HR 1956 defines nexus differently than in S 1726 and HR 5267 (110th Congress).

Subsidiaries Holding Intangibles and Nexus – In *Nordstrom v. Comptroller of the Treasury* (MTC No. 07-IN-OO-0317; 2008), the Maryland Tax Court found that two subsidiaries formed outside of Maryland to own Nordstrom trademarks did not have economic substance. Thus, any activities of the subsidiaries should be treated as activities of the parent corporation, an entity that had income tax nexus in Maryland. Nordstrom paid about $200 million in royalties to one of the subs which then loaned back about two-thirds of that amount to the parent. Nordstrom paid interest, but not much principal. The sub had very little expenses. It did have a full-time paralegal overseeing management of the intangibles. Per the court: "Fundamentally, the subsidiaries did not act independently, although the financial structure creates an illusion of substance." [http://www.txcrt.state.md.us/pubs/PDF/NordstromOct2008.pdf]

New Jersey and "Throwout" and Other Reforms – AB 2722 (5/08) would repeal the "throw-out" treatment where the income apportionment factor excludes from the denominator sales in states where the taxpayer isn't subject to tax. That approach increased the amount of income subject to NJ tax. Governor Corzine also lists repeal of throwout as one of his reforms for the corporate income tax in addition to conforming the NOL carryforward period from 7 years to the federal 20 years. He also directed the State Treasurer to meet with major corporate taxpayers to find a strategy for moving to a single sales factor apportionment approach and unitary combined reporting. [http://www.state.nj.us/governor/home/media_long.html]

In *Pfizer v. NJ Division of Taxation* (2008), the court found the throwout rule to be constitutional. Pfizer has appealed the decision.

UDITPA Rewrite – The National Conference of Commissioners on Uniform State Laws (NCCUSL) drafted the Uniform Division of Income for Tax Purposes Act (UDITPA) in 1957. It was last amended in 1966. UDITPA provides rules on apportionment and allocation of multistate business income among states. In 2007, NCCUSL decided to form a committee to look at changes to update UDITPA. Section 17 of UDITPA which deals with sourcing of sales that are not of tangible property was to be a focal point, but other areas could be looked at as well.

For more information see:

- UDITPA http://www.law.upenn.edu/bll/archives/ulc/fnact99/1920_69/udiftp57.htm
- Committee's work http://www.nccusl.org/Update/CommitteeSearchResults.aspx?committee=302.

The Committee held its first meeting in late May 2008. There were protests by some businesses urging NCCUSL to terminate the project. A coalition of businesses issued a letter noting that state lawmakers were not interested in uniformity of apportionment rules and that uniformity would only be achieved by Congress (http://www.nccusl.org/Update/Docs/UDITPA/UDITPA_Coalition%20in%20Opposition_052808.pdf).

Uniformity among states will not be guaranteed through a UDITPA revision because states are not required to adopt the act, although Congress could provide some incentive for doing so. Federal legislation would provide uniformity, but agreement among legislators, states and businesses on what that uniformity should be remains elusive as indicated by several years of efforts to adopt business activity tax (BAT) nexus rules at the federal level (see http://www.cob.sjsu.edu/nellen_a/TaxReform/PL86-272-50thAnniversary.htm).

A committee meeting is scheduled for December 5 – 7, 2008 in Chicago.