National Judicial Update & Discussion of State Tax Issues, Cases and Policy Trends– Including *Wayfair*

COST California and Pacific Southwest Regional State Tax Seminar
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Agenda

- Business Tax Burdens
- Sales Tax Collection after *Wayfair?*
- Corporate Income Tax Issues and Trends

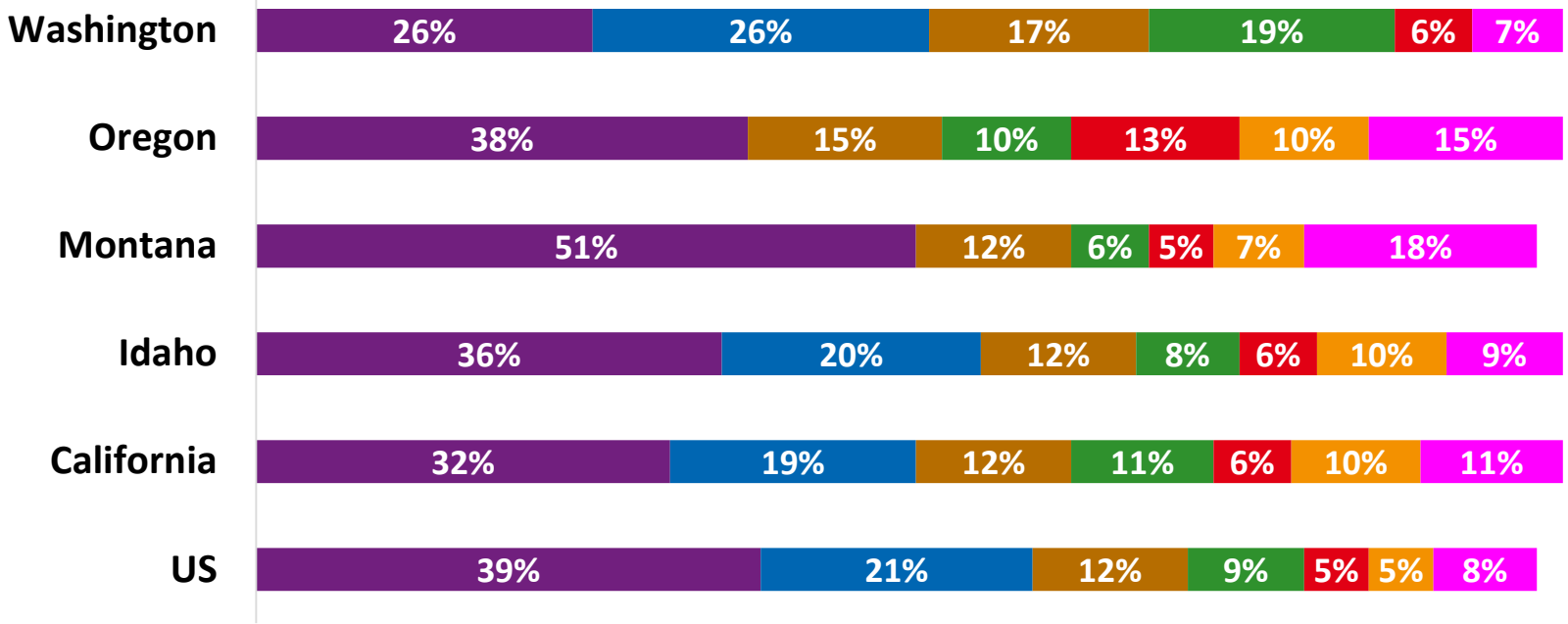
Business Tax Burdens

What Do Businesses Pay?

- Businesses paid more than $738 Billion in U.S. state and local taxes in FY 2017, an increase of **2%** from FY 2016
- How Much Do Businesses Contribute to State and Local Revenues?
  - U.S. Average for FY2017: 43.7% of all tax revenues
- Remarkably, the business share of SALT nationally has been within **2% of 45% since 2000**
- Moreover, C Corporations on average pay about three-fifths more in income tax than pass through businesses

Sources: COST/EY Study, *Total State and Local Business Taxes: State-By-State Estimates for Fiscal Year 2017, November 2018*; COST/PWC Study, Corporate and Pass-Through Business State Income Tax Burdens, October, 2017

Composition of State and Local Business Taxes, By Type, FY2017



How many states have returned to pre-Great Recession levels of revenue?

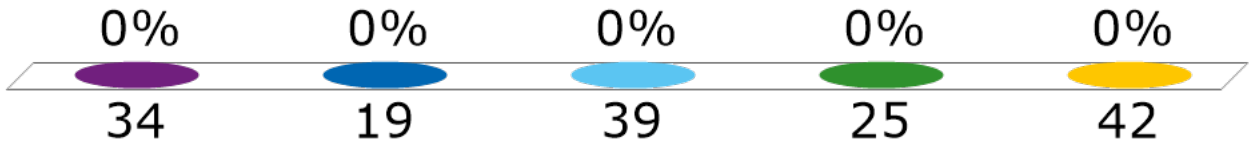
A. 34

B. 19

C. 39

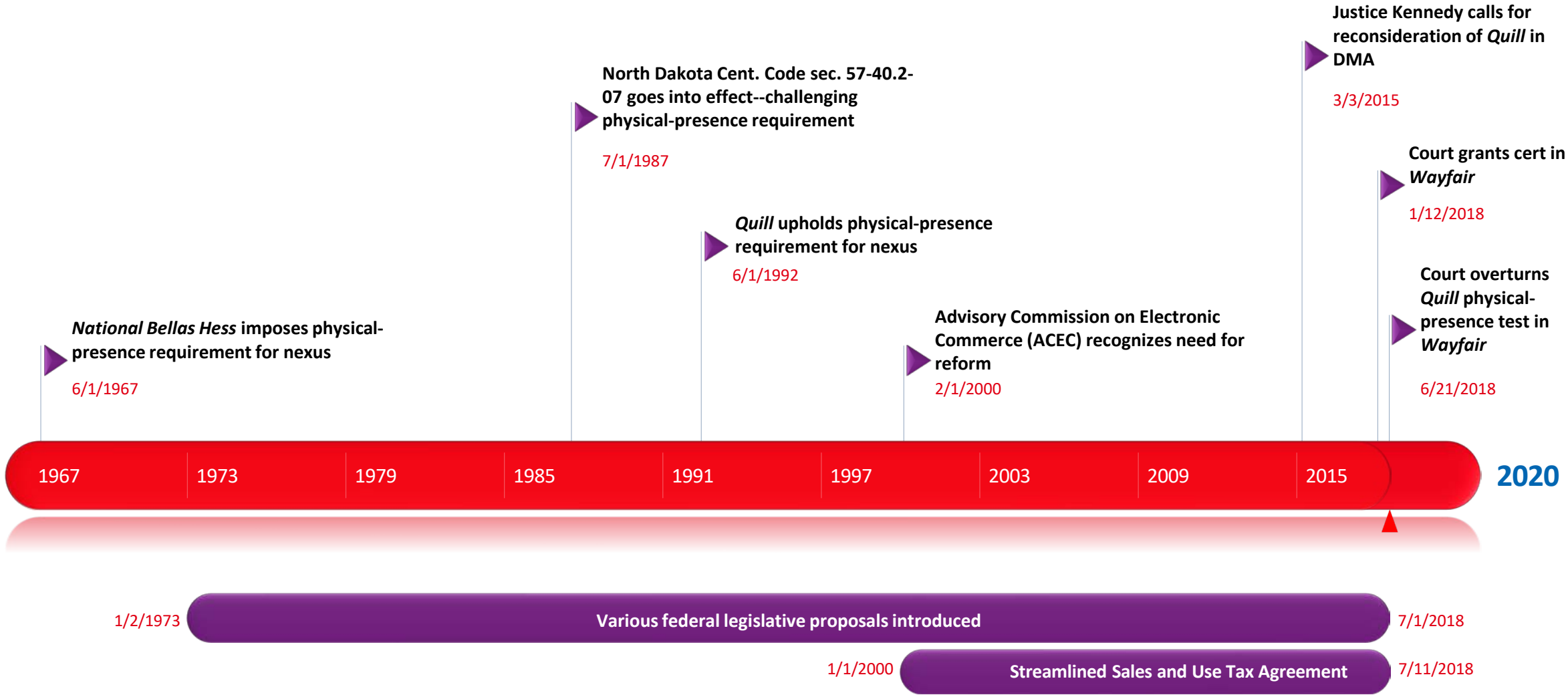
D. 25

E. 42



Sales Tax Collection after *Wayfair*

National Bellas Hess to *Wayfair*



What are US sales-and-use tax nexus creating activities?

- US State sales and use tax nexus is not based upon Permanent Establishment (PE) principles or treaties. Previously nexus can be created in various ways:
  - In–state employees
  - Sporadic employee visits
  - Attending trade shows and seminars
  - In–state deliveries made by one's own truck
  - Physical presence of property even temporality
  - Incidental ownership of property
  - Voluntary registration or incorporation
- States wanted to change 'physical presence standard' and started to pursue remote sellers in various ways:
  - Affiliate or agency nexus; volunteers, agents, independent contractors
  - Click–through nexus (e.g. NY)
  - Internet nexus through "cookie" or electronic nexus presence
  - Notification and reporting statutes for remote sellers with steep penalties for non-compliance (e.g. CO)

Information Reporting—“Use” Tax Approaches

- Colorado model
  - 2012 statute requires “non–collecting” retailers to inform customers and state that they may have a use tax obligation for taxable purchases.
  - The law specified that any out–of–state retailer that does not collect the sales tax on taxable purchases that have gross revenues in excess of $100,000 in the state.
- Penalties
  - Penalties for failing to comply and report vary between states, but are generally high and punitive.
- As of September 30th, there are approximately 13 states with some variation of use tax notification statutes.

Use Tax Notification Requirements & Reporting

(as of September 30, 2018)

State	Effective Date	Threshold
Alabama	7/1/2017	$250,000
Colorado	7/1/2017	$100,000
Connecticut*	7/1/2017	N/A
Georgia	1/1/2019	$250,000 or 200 transactions
Iowa	7/1/2019	$100,000
Kentucky	7/1/2013	$100,000
Louisiana	7/1/2017	$100,000
Oklahoma**	6/9/2010,11/1/2016 & 4/10/2018	$100,000/$10,000
Pennsylvania***	4/1/2018 & 4/1/2019	$10,000
Rhode Island	8/17/2017	None
South Dakota	7/1/2011	$100,000
Vermont	7/1/2017	$100,000
Washington (retail sales)	1/1/2018	$10,000

*The Connecticut Department of Revenue Services began mailing notices to several unregistered online retailers demanding electronic sales records for all individual sales made to customers with Connecticut addresses over the past 3 years. On July 7, 2017, Governor Daniel Malloy signed Public Act No. 17-147 into law, which gives the Commissioner authority to impose a civil penalty of $500 per day for failing to comply with these type of information requests, effective July 1, 2017

**Oklahoma has had three different use tax notification requirement statutes. The first had a $100,000 threshold. The most recent version has a threshold of $10,000.

***Pennsylvania effective date of 4/1/18 applies to sales of products and services other than digital products and services. Effective date of 4/1/2019 applies to sales of digital products and relates services.

The above list of states that have currently enacted use tax notice and/or reporting provisions based on the existence of a certain amount of in-state sales and/or transactions is intended for informational purposes only. Taxpayers should consult with their tax advisors as to each state's effective date and other requirements relative to their specific business activity and potential penalties for non-compliance.

The Wayfair Decision Holding: June 21, 2018

- In a 5-4 Decision, Justice Kennedy (joined by Thomas, Gorsuch, Ginsburg, Alito) held that:
  - *Quill* and *National Bellas Hess* are overruled
  - The physical presence rule is unsound, is an incorrect interpretation of the Commerce Clause, and restricts the states' authority to "collect taxes and perform critical public functions"
- Majority concluded that the following features of South Dakota's law minimized the burdens on interstate commerce:
  - Included a transactional safe harbor
  - Did not apply retroactively
  - South Dakota was a full member of the Streamlined Sales and Use Tax Agreement (SSUTA)

Transactional Safe Harbor

- South Dakota's transaction safe-harbor of an annual threshold of 200 sales or $100,000 in sales was sufficient
  - States argued that the first sale triggered the collection responsibility and Justice Kennedy did not respond
  - Should the threshold be the same for California as South Dakota?
  - Can states require small businesses making few sales to collect in all cases?

Retroactivity

- Not really dealt with, despite emphasis in oral argument
- South Dakota law foreclosed retroactive application
- Although generally speaking a determination by the U.S. Supreme Court about the meaning of the U.S. Constitution can be applied retroactively, consider whether such an application in a particular set of facts (and considering prior positions of the state) could violate Due Process as a retroactive application of a state statute (*See United States v. Carlton*, 512 U.S. 26 (1994))

State Enforcement Dates/Thresholds

Pre-Wayfair	
RI	(8/17/2017)
MA	(10/1/2017)
OH	(1/1/2018)
WA	(1/1/2018)
PA	(3/1/2018)

July 1, 2018	
HI	$100k/200
ME	$100k/200
OK	$10K
VT	$100k/200

September 1, 2018	
MS	$250k

October 1, 2018	
AL	$250k
IL	$100k/200
IN	$100k/200
KY	$100k/200
MI	$100k/200
MN	$100k/100
ND	$100k/200
WA	$100k/200
WI	$100k/200

TX- Proposed Rule Eff 1/1/2019, collections to begin 10/1/2019

November 1, 2018	
NC	$100k/200
SC	$100k
SD	$100k/200

December 1, 2018	
CO	$100k/200
CT	$250k/200

January 1, 2019	
GA	$250/200
IA	$100k/200
LA	$100k/200
NE	$100k/200
UT	$100k/200

State Implementation Details: Thresholds

- Issues surrounding measurement period (prior year sales or current year sales)
- Does tax collection apply to the first $100,000, or only after nexus is established?
- Impact of sales fluctuation on nexus determination
- Application of thresholds to local taxing jurisdictions
- Issues surrounding use of “taxable sales” vs. all sales to determine nexus threshold
  - Wholesale sales
  - Exempt sales (product, use, or entity based)
- Issues surrounding transaction counts
  - By invoice
  - By item

State Implementation Details: Thresholds

- Illinois Emergency Administrative Rule-Section 150.803, 9/11/18
  - For 2018, prior calendar year, quarterly test thereafter
  - Nexus applies on an annual basis, measured each quarter for prior 12 months
  - Have option to de-register if threshold not met, but must test quarterly
  - Resale, titled property and occasional sales not included in threshold
  - All other sales included
- Mississippi Sales and Use Tax Guidance for Online Sellers-8/6/18
  - Specifies that wholesale sales must be included
- States have noted in public forums that zero and low dollar returns are not desired, but are reluctant to set that as policy
- Could see increase in “annual filings”

Will Congress Step in?

- What would Federal Legislation look like?
- July 24 Judiciary Committee Hearing Discussed a moratorium
- S. 976 — *Marketplace Fairness Act*
- H.R. 2193—*Remote Transaction Parity Act*
- *Online Sales Simplification Act (*hybrid origin-based system*)*
- Implications for Income and other Business Activity Taxes? (More urgency for BATSA now that *Quill* is gone)

What's next for the states?

- What happens with SSUTA?
- Will the "big states" join SSUTA?
- Will the MTC get involved?
- New rules for all sellers, not just remote sellers
- Future litigation?
- Marketplace collection requirement?
- How does this impact inbound sales?
- Will *Wayfair* have an impact on the nexus standard for corporate income and other business activity taxes?

Wayfair: Impact on Income Taxes

- Because Quill was a sales tax case, many states had enacted economic (i.e., non-physical) nexus standards for income tax purposes. Conversely, some companies may have interpreted a physical requirement to apply to state income taxes as well.
- After Wayfair, there is no question as to the constitutionality of economic or factor presence nexus standards for both income tax and sales tax purposes.
  - E.g., Wells Fargo earnings statement established a $481 million state income tax reserve specifically due to Wayfair.
- **Further Questions to Consider:**
  - Without a physical presence requirement will the states:
    - Enact factor presence nexus provisions and/or other broad nexus rules?
    - Broaden the definition of doing business without bright-line test?
    - Challenge historic filing positions based on the Court's ruling?

Wayfair: Impact on Income Taxes

- Potential ASC 740 Considerations may include:
  - New separate company filing obligations
  - Combined / unitary filings
    - New filing obligations based on one member having nexus
    - Impact to sales apportionment based on Joyce/Finnigan filing requirement
    - NOL and credit utilization within the group
- P.L. 86-272 is still valid after Wayfair.
  - P.L. 86-272 generally precludes a state from imposing an income tax if the only in-state business activities involve the solicitation of orders for sales of tangible personal property.
  - If virtual connections can create nexus, can virtual connections constitute an “in-state” activity that exceeds solicitation such that the protections of P.L. 86-272 are lost?
  - Note that by its terms P.L. 86-272 protection operates in interstate commerce, not foreign commerce.

Financial Accounting Impact

- **ASC 450-20, Accounting for Loss Contingencies**
  - Sales/use taxes are not based on income and are accounted for as part of pre-tax income
  - ASC 450 accounts for loss contingencies, including sales/use taxes
- **ASC 740-10, Accounting for Uncertain Tax Positions**
  - Since many states have had economic nexus standards for several years, it is possible that the impacts of any non-filing liabilities may be imposed retroactively
  - When considering uncertainties related to nexus, there is no statute of limitations on non-filing positions
  - The recent Wells Fargo second quarter earnings announcement stated that the company has provided for a $481 million discrete item under ASC 740-10 related primarily to state income tax nexus exposures resulting from the Wayfair decision

Marketplace Provider Legislation

Marketplace Facilitator / Provider Bills

- Enacted:
  - Oklahoma (H.B. 1019)
  - Kentucky (H.B. 366 / H.B. 487)
  - Iowa (S.F. 2417)
  - Connecticut (S.B. 417)
  - Alabama (H.B. 470) (permitting participation in Simplified Sellers Use Tax Program by marketplace facilitators)
- Proposed:
  - New Jersey (A.B. 4261 (pending signature) / S.B. 2794 / A.B. 4206)
  - New York (Initially included in Governor's budget proposal)
  - Kansas (H.B. 2756)
  - New Mexico (H.B. 198)

Marketplace Provider Implementation Issues

What is a marketplace facilitator?

- States typically have broad definitions.

> A person that contracts with sellers to facilitate for consideration, regardless of whether deducted as fees from the transaction, the sale of the seller's products through a physical or electronic marketplace operated by the person, and engages:
> (a) Directly or indirectly, through one or more affiliated persons in any of the following:
>
> (i) Transmitting or otherwise communicating the offer or acceptance between the buyer and seller;
> (ii) Owning or operating the infrastructure, electronic or physical, or technology that brings buyers and sellers together;
> (iii) Providing a virtual currency that buyers are allowed or required to use to purchase products from the seller; or
> (iv) Software development or research and development activities related to any of the activities described in (b) of this subsection (3), if such activities are directly related to a physical or electronic marketplace operated by the person or an affiliated person; **and**
>
> (b) In any of the following activities with respect to the seller's products:
>
> (i) Payment processing services;
> (ii) Fulfillment or storage services;
> (iii) Listing products for sale;
> (iv) Setting prices;
> (v) Branding sales as those of the marketplace facilitator;
> (vi) Order taking;
> (vii) Advertising or promotion; or
> (viii) Providing customer service or accepting or assisting with returns or exchanges.

- Leads to significant uncertainty as to whether a company is a marketplace facilitator.

Marketplace Provider Implementation Issues

What does this mean for companies selling on a marketplace?

- Marketplace facilitators are responsible for collecting and remitting on behalf of the marketplace sellers.
- Both parties must reflect the sales on their tax returns in most states.
- **Key Marketplace Seller Considerations**
  - Make sure that agreements set forth when a marketplace facilitator will **and will not** collect and remit sales tax (i.e. sales into non-facilitator states).
  - Understand impact on bad debt statutes and responsibility for refunding sales tax to customers on merchandise returns.
  - Ensure that both parties have a clear understanding of exemption requirements and will have access to appropriate documentation in an audit.

Application of *Wayfair* to Inbound Sellers

- Nothing in *Wayfair* limits the holding to domestic US businesses
- The presence or lack of Permanent Establishment (PE) does not determine whether there is nexus.
- Controlling case may be *Japan Line Ltd. V County of Los Angeles,* 441 US 434 (1979)
  - Court first applied the four part test articulated in *Complete Auto Transit Inc. v Brady* 430 US 274 (1977)
  - Two additional factors must be considered regarding foreign commerce clause:
    - The tax may not create the risk of international multiple taxation
    - The tax must not prevent the US from speaking “with one voice” regarding foreign trade

Corporate Income Tax Issues and Trends

Which U.S. Supreme Court case upheld single sales factor apportionment?

A. ***Moorman Mfg.***

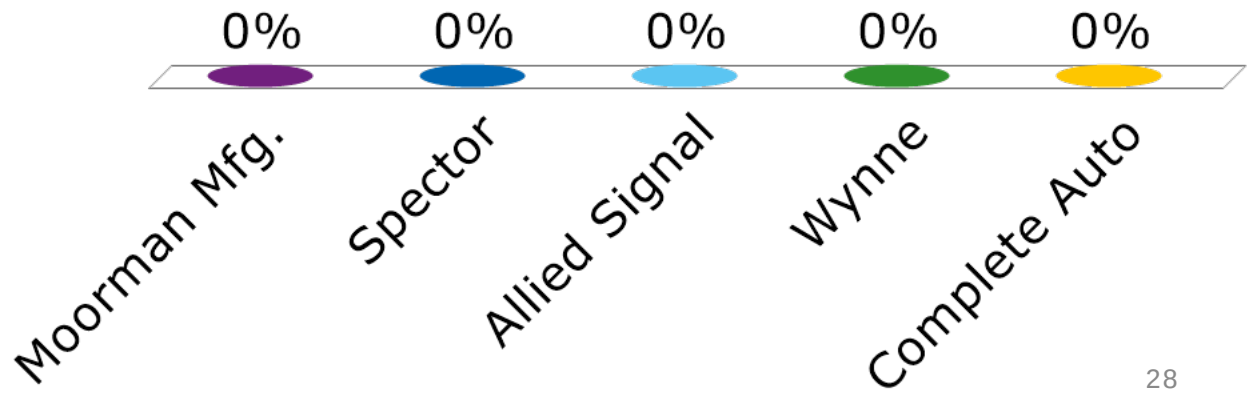
B. ***Spector***

C. ***Allied Signal***

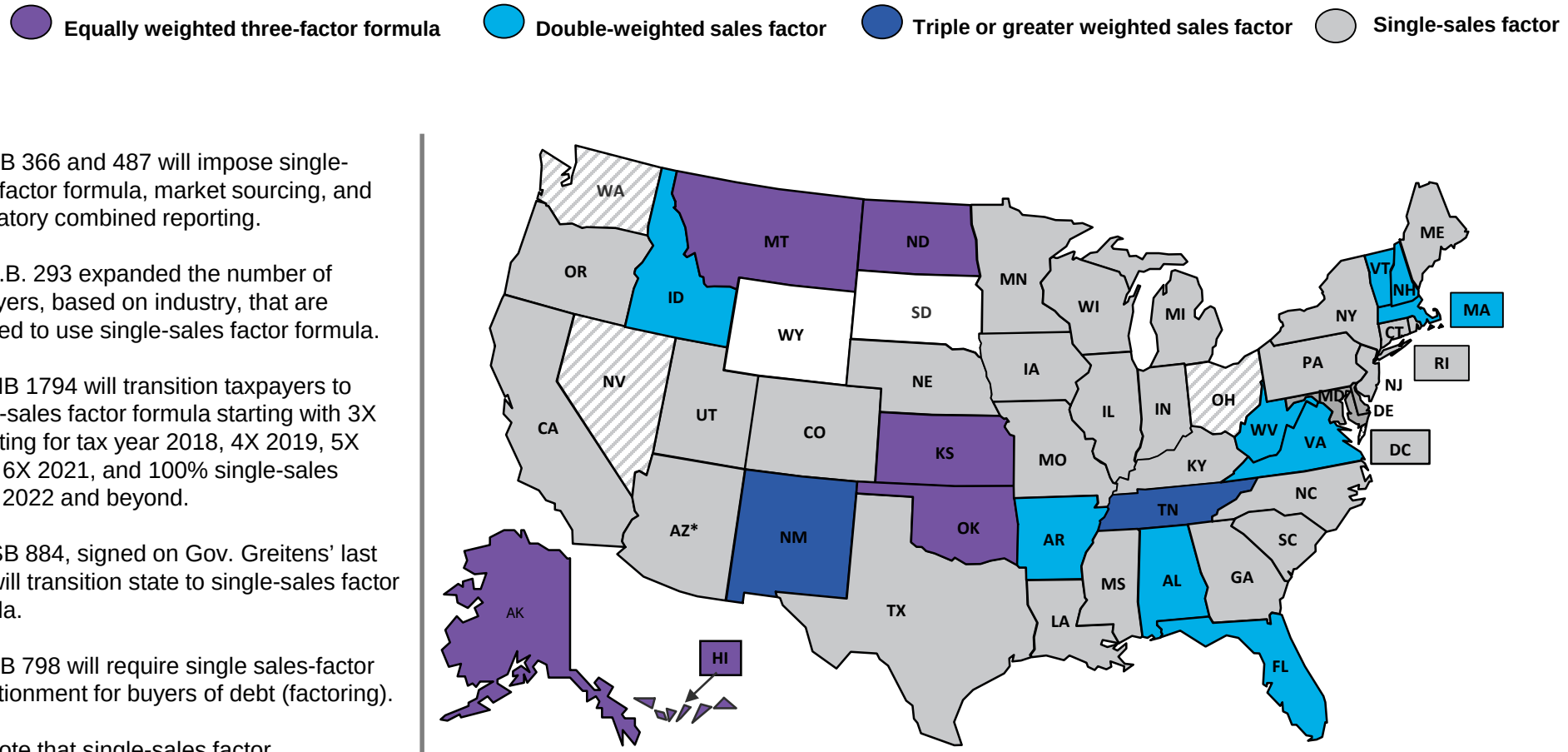
D. ***Wynne***

E. ***Complete Auto***

FACTOR SALES



Apportionment Formulas in 2018 – Some Formulas Effective in Future Years



KY: HB 366 and 487 will impose single-sales factor formula, market sourcing, and mandatory combined reporting.

UT: H.B. 293 expanded the number of taxpayers, based on industry, that are required to use single-sales factor formula.

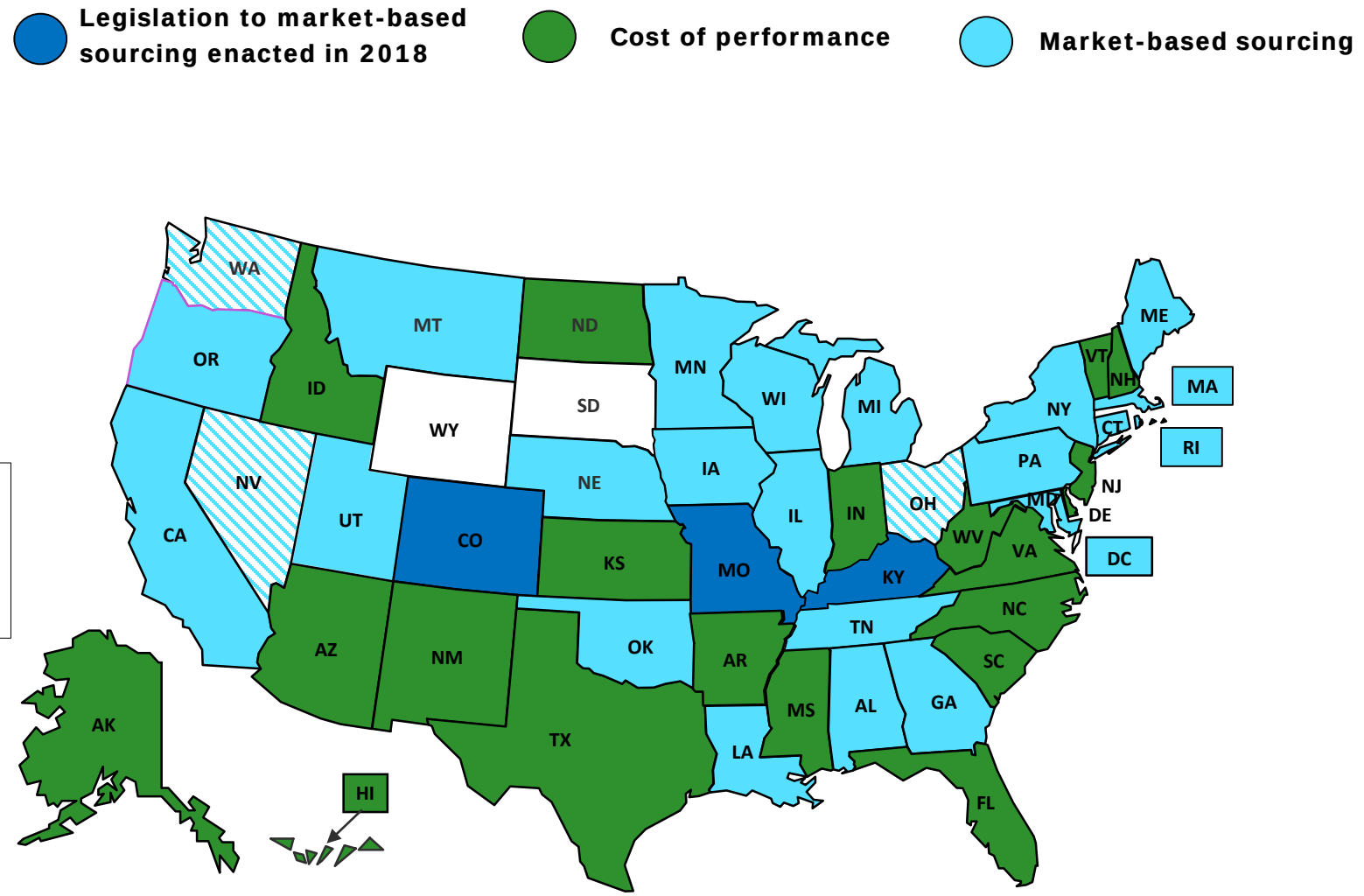
MD: HB 1794 will transition taxpayers to single-sales factor formula starting with 3X weighting for tax year 2018, 4X 2019, 5X 2020, 6X 2021, and 100% single-sales factor 2022 and beyond.

MO: SB 884, signed on Gov. Greitens' last day, will transition state to single-sales factor formula.

VA: HB 798 will require single sales-factor apportionment for buyers of debt (factoring).

AZ: Note that single-sales factor apportionment is elective – otherwise, it is double-weighted sales factor apportionment.

Sourcing of Receipts from Sales of Services



2018 Legislation
CO: HB 1185
KY: HB 366
MO: SB 884

Note: many states have unique rules for sourcing intangibles.

Other Developments in Sourcing of Receipts from Sales of Services

- Associated Bank N.A. v. Comm’r (MN 2018)
- Target Brands Inc. v. Dep’t.(CO 2017)
- Kentucky, Ch. 171 H.B. 366, Laws 2018, eff. 4/13,2018
- Idaho Ruling No. 976-965-632 (ID 2018)

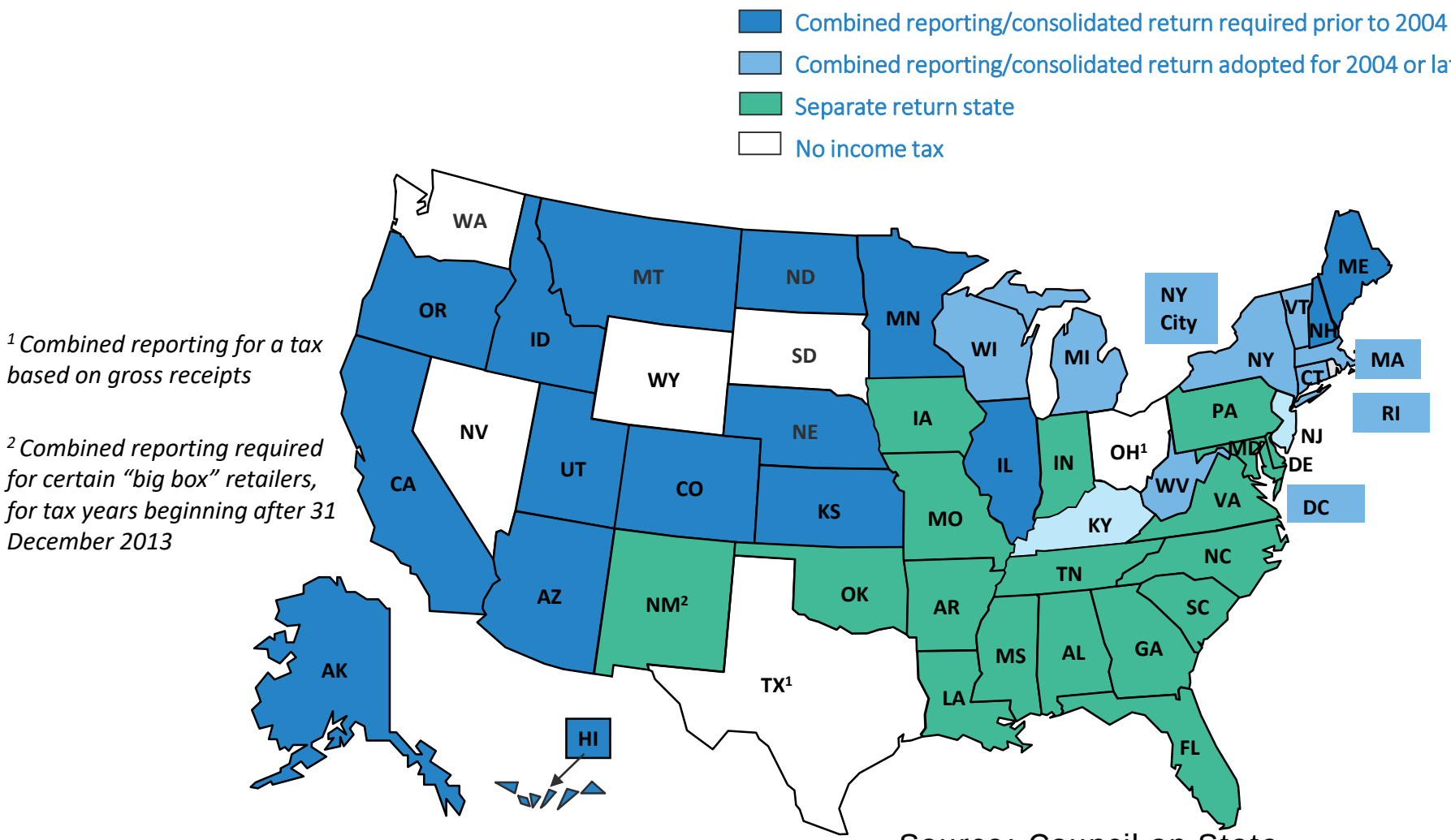
Cost of Performance – Distortion?
Corporate Executive Board v. Dep't of Taxation, No. CL16-1525 (Va. Cir. Ct. Sept. 1, 2017)

- The Virginia Circuit Court upheld the Department's use of the statutory COP method to apportion income from the sales of subscription-based services based on finding that COP method did not lead to inequitable results and was not unconstitutional.

- The court found that under the COP method, most of CEB's sales originated in Virginia and were attributable to the state.

- Taxpayer's request for alternative apportionment using market-based sourcing was characterized as "arbitrary" and CEB failed to show the statutory method lead to a "grossly distorted result."

Combined Reporting vs. Separate Reporting States



[1] Combined reporting for a tax based on gross receipts

[2] Combined reporting required for certain "big box" retailers, for tax years beginning after 31 December 2013

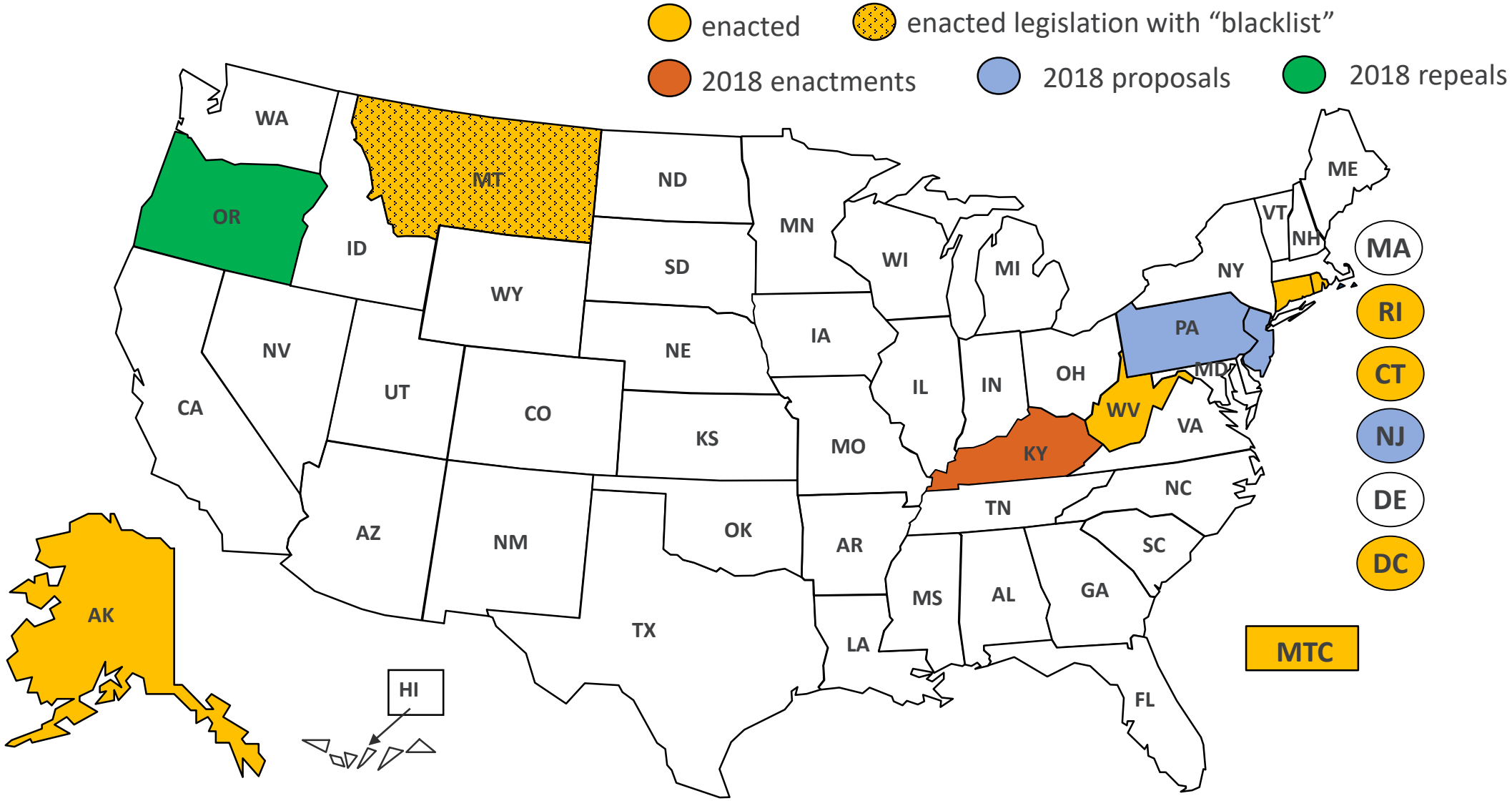
Source: Council on State Taxation

Mandatory Unitary Combined Reporting

- **Enacted:**
  - Kentucky H.B. 366/H.B. 487
  - New Jersey A. 4202

- **Proposed:**
  - Oklahoma H.B. 2532
  - Pennsylvania H.B. 2424
  - Maryland
    - S.B. 195 / H.B. 556
    - S.B. 227 / H.B. 842 – limited to retail and food and drink establishments

‘Tax Haven’ State Enactment Status and 2018 Proposals



Colorado Forced Combination Litigation:
Agilent Techs., Inc. v. Dep't of Revenue, (Colo. App. Nov. 2, 2017); *Oracle Corp. v. Dep't of Revenue*, (Colo. App. Nov. 30, 2017)

- In both cases, the Colorado Court of Appeals held that a subsidiary corporation with no property or payroll could not be included in its corporate parent's Colorado combined report because the subsidiary did not have more than 20% of its property and payroll located in the United States. This was consistent with the Department of Revenue's own regulation that a corporation with no property or payroll cannot be included in a combined report.
- The Colorado Supreme Court has accepted review of both cases.

Alternative Apportionment:
Commissioner of Revenue v. Associated Bank N.A. (Minnesota July 5, 2018)

- The Minnesota Supreme Court reversed a Minnesota Tax Court decision, which had held that the Commissioner improperly invoked her authority to use alternative apportionment.
- The taxpayer calculated its tax liability using the State's statutory apportionment formula, however the Commissioner determined the taxpayer's method did not fairly reflect the bank's income and applied an alternative apportionment formula.
- Reversing the Tax Court's finding that alternative apportionment was improper because the Commissioner used her power to change an unfavorable result for the State, the Supreme Court determined the Commissioner properly considered the method used as improper, not just the result, and was, therefore, entitled to invoke alternative apportionment.

Alternative Apportionment & Economic Substance:
Staples, Inc. v. Comptroller of the Treasury (Maryland August 9, 2018)

- The Maryland Court of Special Appeals determined that a corporate group's subsidiaries operating in Maryland lacked economic substance apart from the rest of the group such that the entire group had nexus with the State.
  - The Court concluded the subsidiaries' "total financial dependence" and "total administrative and managerial dependence" on the parent companies – demonstrated through intercompany management, administration, and intellectual property licensing arrangements – showed there was a general absence of substantive activity from the subsidiaries that was meaningfully separate from the parent companies.
- The Court also determined the companies constituted a unitary group because "substantial mutual interdependence existed at all levels" between the companies in the corporate family, therefore permitting the Comptroller to impose an alternative apportionment formula that used franchise fees and interest payments made by the in-state subsidiaries to the corporate parents to determine the income attributable to Maryland for the parent companies.

Alternative Apportionment:
Comcast Corp. and Subs. v. Dept. of Revenue, Oregon Supreme Court No. S064698

- Case involved the application of Oregon's interstate broadcaster special apportionment formula
- Should it be applied to all members of a consolidated group, even those members which are not interstate broadcasters?
  - For purposes of this appeal, Comcast conceded that it was an interstate broadcaster. Thus, the Court did not opine on what that term encompasses.
- "Gross receipts from broadcasting" is defined as "all gross receipts of an interstate broadcaster from transactions and activities in the regular course of its trade or business, except receipts from sales of real or tangible personal property."
- The Court read this language very literally and concluded that since Comcast conceded it was an interstate broadcaster then all of its receipts should be considered "gross receipts from broadcasting" under the statute.
- While Comcast argued that this created an incongruity—if this interpretation is true then the legislature has defined "gross receipts from broadcasting" as including more than gross receipts from "broadcasting." The Court found that such seeming incongruity was not itself a reason to disregard the legislature's definition of "gross receipts from broadcasting."
- Comcast also argued that the term "gross receipts from broadcasting" should mean only transactions and activities that consist of the business of broadcasting. The Court agreed that Comcast's "narrow construction" of the term "gross receipts from broadcasting" was textually plausible. However, the Court then stated "but several contextual clues persuade us that the legislature did not intend to limit the term to receipts from transactions and activities that consist of 'transmitting a one-way electronic signal' if the taxpayer engages in other activities in the regular course of its trade or business."

Alternative Apportionment:
Philip Morris USA, Inc. (Franchise Tax Board, June 15, 2017)

- On June 15, 2017, the 3-member FTB denied an RTC § 25137 petition by Philip Morris USA, Inc. and its Unitary Affiliates to use an alternative apportionment method consisting of a payroll, sales and double-weighted property factor instead of the standard single sales factor apportionment formula for its 2013 tax year
- Second Interested Parties Meeting scheduled for November 26, 2018 to insider potential amendments to Regulation 25137 pertaining to hearings before the 3-member FTB on RTC § 25137 Petitions
- Requests by taxpayers or FTB staff to use a variance now are reviewed by the FTB's 25137 Committee
- Taxpayers and their representatives are now permitted to make oral presentations before the FTB 25137 Committee in support of petitions for relief and in opposition to staff's request
  - FTB Notices 2017-05 and 2018-02

Apportionment / Sales Factor:
Broker-Dealer Activities

- If a broker-dealer is unitary with a bank should the broker-dealer's gross receipts be included in the sales factor?
- This is a very active and controversial issue
- A number of cases are pending or have been settled
- *UBS AG and Combined Affiliates*, OTA Case No. 18011773 (2018)
- What is the effect of *Merrill Lynch* (1989)?
- What is the effect of *Fuji Bank* (2000)?
- Is a broker-dealer a financial corporation?

Apportionment / Sales Factor:
Broker-Dealer Activities (cont.)

- What is the effect of Regulation 25137(c)(1)(D)?
  - Applicable for tax years beginning on or after January 1, 2007
  - Broker-dealers not considered to be performing a treasury function
  - What is the effect of RTC § 25120(f)(2)?
    - Applicable for tax years beginning on or after January 1, 2011
    - Treasury function does not include trading activities of a registered broker-dealer
  - May a bank which has a broker-dealer subsidiary use a double-weighted sales factor after 1993?

Apportionment / Sales Factor:
Broker-Dealer Activities (cont.)

- May a bank be required to use a single sales factor apportionment formula for 2013?
- RTC § 25128(b) looks to whether a unitary business derives more than 50 percent of its gross receipts from banking and financial activities
  - If the receipts are excluded from the sales factor under RTC § 25137, they are still considered for purposes of RTC § 25128(b)
- FTB has been considering some type of administrative action in this area

Business / Nonbusiness:
ComCon Production Services v. FTB, Court of Appeal No. B259619, 2016 Cal. App. Unpub. LEXIS 9078 (2016)

- Trial court held that a termination fee received in connection with a failed merger was business income
- Trial court also held that Comcast and QVC were not engaged in a unitary business
- Court of Appeal affirmed in unpublished opinion

Business / Nonbusiness:
Fidelity National Information Services v. FTB, No. C081522, 2017 Cal. App. Unpub. LEXIS 5148 (2017)

- Sale of minority stock interest
- Trial court held the gain was business income
- In an unpublished opinion, Court of Appeal reversed and remanded case back to the trial court to determine whether the stock was a business asset when decision was made to sell it
- On remand, trial court again found the gain to be business income
- After appeal filed, case was dismissed in 2018

Business / Nonbusiness:
State Board of Equalization appeals

- *Bank of America Corp.,* SBE Case No. 983272 (2017)
  - On November 14, 2017, the SBE held that dividends received by the Bank from one of its Chinese affiliates was nonbusiness income because of lack of integration and interwoven ties between the affiliates
  - FTB filed petition for rehearing
- *Levi Strauss,* SBE Case No. 54705 (2013)
  - SBE appeal involving issue whether interest and other expenses incurred in connection with a leveraged buy out of a California corporation's stock were nonbusiness expenses wholly allocable to California
  - Case settled prior to the SBE hearing
- *Esprit de Corp.*, SBE Case No. 48986 (2001)
  - SBE held that LBO interest expense was a nonbusiness expense wholly allowable to California

Business/Nonbusiness Income:

- *Leslie's Holdings, Inc.*, SBE Case No. 955278 (2017)
  - On November 15, 2017, the SBE held that 84 percent of interest expense incurred as a result of borrowing to conduct a corporate reorganization was a nonbusiness expense allocated the taxpayer's commercial domicile in Arizona
  - Remaining 16 percent was held to be an apportionable business expense because it was attributable to borrowing to make distributions to employees

Nexus / Doing Business:

- Under RTC § 23101, “doing business” expanded for tax years beginning on or after January 1, 2011
  - Economic nexus
  - Factor-based presence
    - Sales in California exceed lesser of $583,867 or 25% of taxpayer’s total sales
    - Real property and tangible personal property in California exceeds lesser of $58,387 or 25% of taxpayer’s total property
    - Payroll in California exceeds lesser of $58,387 or 25% of taxpayer’s total payroll

Nexus / Doing Business:

Swart Enterprises v. FTB, 7 Cal.App.5th 497 (2017)

- Case involved issue whether a corporate taxpayer is doing business in California and subject to the minimum tax solely through its .2 percent membership interest in a California LLC
- Court of Appeal concluded that the taxpayer was not doing business in California

Legal Ruling 2014-01

- While *Swart* was pending, the FTB issued Legal Ruling 2014-01
- Business entity held to be doing business in California merely by holding a membership interest in an LLC that is doing business in California

Bunzl Distribution v. FTB, 27 Cal.App.5th 986 (2018)

- Case involved issue whether a nonresident corporate member of a single-member LLC, which is a disregarded entity that conducts business in California, is a California taxpayer solely as a result of its membership interest in the LLC
- On September 28, 2018, the Court of Appeal issued a published opinion in favor of the FTB and held that the non-resident corporate member of the LLC had nexus
- The Court rejected the taxpayer's argument that RTC § 18633 and RTC § 23038 barred the use of the UDITPA apportionment formula
- The Court also distinguished *Swart*

Nexus / Doing Business:

Legal Ruling 2018-01

- Modifies Legal Ruling 2014-01
- If an LLC is treated as a partnership for tax purposes, both the LLC and its members are subject to the same legal principles applicable to any partnership
- If the LLC is doing business in California under RTC § 23101, the members themselves are generally considered to be doing business in California
- A narrow exception (*Swart*) may apply in limited circumstances

Harley Davidson v. FTB, 237 Cal.App.4th 193 (2015)

- Case involved issue whether certain special purpose entities (SPEs) formed to securitize loans originated by affiliates were taxable in California
- Case potentially raised issue of applicability of the immunity provisions for foreign lending institutions under Corporations Code § 191(d)
- Court of Appeal held that although the SPEs had no physical presence in California, they had nexus due to the in-state activities conducted by their affiliate, as agent of the SPEs

Nexus / Doing Business:
In the Matter of the Appeal of Satview Broadband, Ltd., OTA Case No. 18010756 (9/25/18)

- The OTA rejected the FTB's extremely narrow interpretation and application of *Swart*.
- The OTA concluded that a foreign corporation which held a 25% passive, non-managing member interest in an LLC which did business in California, was not itself doing business in California simply because it held that 25% interest.
- Shortly after the *Swart* decision was issued, the FTB issued Notice 2017-01, which stated that the FTB "will follow the Court of Appeal decision in *Swart*, in situations with the same facts."
- Satview Broadband challenged the FTB's narrow interpretation of *Swart*.
- Relying on *Swart*, the OTA found the "doing business" status of a pass-through entity is not automatically attributed to its non-managing minority members where the non-managing minority member had no power or authority to participate in the LLC's management or operations.
  - Although Satview's 25% non-managing member interest is significantly greater than Swart's 0.2% interest, both Satview and Swart held a minority interest in the in-state pass-through entity.
  - The OTA concluded that merely holding a non-managing minority interest was not enough and, therefore, Satview was not doing business in California.

Nexus / Doing Business:
Capital One Auto Finance Inc. v. Dept. of Revenue, Oregon Supreme Court No. S064803

- Case involved the issue whether the corporate excise tax may be applied to a business with no physical presence in the state
- The Court's analysis was largely based on statutory construction.
- The Court concluded that the taxpayer in that case was subject to the corporate income tax notwithstanding the fact it had no physical presence in the state.
- The Court applied the "plain English" of the statute and held that income derived from sources in Oregon (under the corporate income tax) does not require physical presence as long as a customer in Oregon is "paying money to a taxpayer, [and thus] the taxpayer would appear to have 'income derived from sources within this state,' within the ordinary sense of those words."
- The Court did not analyze the constitutional issues and specifically did not address taxability under the excise tax.

Virginia – "Subject to Tax" Addback:

Kohl's Dep't Stores, Inc. v. Virginia Dep't of Taxation, No. 160681 (Va. Aug. 31, 2017)

- The Virginia Supreme Court found that only the portion of royalties that is actually taxed by another state falls within its "subject to tax" exception to Virginia's addback statute for corporate income tax purposes, but implied that inclusion in a combined report where the royalty is eliminated meets the "subject to tax" test.
  - The Court acknowledged that the plain language of the statute is ambiguous and that both parties' respective positions could be supported by the statute. The Court deferred to the Department's interpretation.
- The case has been remanded to the Circuit Court to determine the portion of the royalty payments actually taxed by another state.

Addback:
Kraft Foods Global Inc. v. Division of Taxation, NJ Superior Ct., App. Div. No. A-1157-16T1 (May 17, 2018)

- Taxpayer's deduction of interest paid to its parent on intercompany loans was disallowed
- Court concluded that the taxpayer did not meet the unreasonable exception
- Compare with *Beneficial New Jersey v. Director of Taxation*, NJ Tax Docket No. 009886-2007 (2010)
- Compare with *Apple Inc. v. Franchise Tax Board*, 199 Cal.App.4th 1 (2011)

Consolidated return rules applied to separate company returns: *MCI Communication Services, Inc. v. Director, Division of Taxation* (New Jersey, July 15, 2018)

- The Superior Court of New Jersey, Appellate Division, determined federal consolidated return rules applied to a separate company return, upholding a lower court ruling that disallowed a $271 million of depreciation deduction based on the federal consolidated return rules.
- The deduction stemmed from the exclusion of cancellation of indebtedness income from its parent's Chapter 11 bankruptcy proceedings, which subsequently required the taxpayer to reduce its tax attributes for federal income tax purposes.
- The taxpayer asserted the cancellation of indebtedness income was not taxable income and claimed it was entitled to a $271 million depreciation deduction for state income tax purposes because New Jersey is a separate return state, which the State denied.

Meaningful Remedy:
Nextel Commc'ns of the Mid-Atl., Inc. v. Commonwealth of Pennsylvania, (Pa. Oct. 18, 2017)

- The Pennsylvania Supreme Court held that Pennsylvania's flat cap on NOLs violated the Uniformity Clause of the Pennsylvania Constitution. Regarding remedies, the court severed the flat cap from the statute, leaving the percentage cap in place. The taxpayer did not receive a refund because it had computed its NOL deduction using the percentage cap.
- U.S. Supreme Court denied review June 11.
- Petition for Review, and COST as Amicus, argued PA's failure to provide a refund violated the Due Process Clause by failing to provide meaningful relief, and that the PA Supreme Court disregarded the U.S. Supreme Court's precedent established in *McKesson Corp.* (496 U.S. 18 (1990)).

See's Candies, Inc. v. Utah State Tax Comm'n, 2018 UT 57, No. 20160910 (Oct. 5, 2018)

- See's Candies deducted IP royalty payments made to an insurance company also owned by Berkshire-Hathaway.
- The Tax Commission argued that it could adjust See's income for the royalty payments based on the states 482-style adjustment statute without reference to federal rules on related-company adjustments.
- The 4th District Court held that the Commission abused its discretion in failing to consider federal 482 guidance and, therefore failing to look at See's transfer-pricing study and approved the deduction, minus a 10% adjustment determined after an MTC audit.
- The Utah Supreme Court upheld the decision of the 4th District Court.

MTC SITAS Program

- A committee of the Multistate Tax Commission developed a transfer-pricing program that would be available to the states.
  - May, 2015, the MTC Executive Committee approved the program, originally called ALAS (Arm-Length Adjustment Service); now called SITAS (State Intercompany Transactions Advisory Service).
  - SITAS is designed to (1) provide training for state staff to identify distorting intercompany transactions and (2) provide third-party support to combat transfer-pricing studies provided by taxpayers.
  - The program was designed to launch with the support of 10 states, but was scaled back after failing to meet that goal.
- Recent cases have been cited by the MTC as “need” for multistate program.

Qui Tam

- ***State of New York ex. Rel. Hunter v. Starbucks Corp.*** (New York, April 6, 2018) – The New York State Supreme Court granted the taxpayer's motion to dismiss a false claims action. The plaintiffs-relators in this case brought a New York false claims action against Starbucks, alleging that Starbucks fraudulently withheld sales tax on certain food items, mainly pastries, that it sold in its stores. Plaintiffs based their claim on information they collected during an informal survey of approximately 80 Starbucks stores located in the state, claiming Starbucks employees did not charge sales tax on pastries consumed at the store, and instead rang the items up as "to-go" purchases.

  - The Court noted that there were no allegations that supported the claim that Starbucks knowingly concealed or knowingly or improperly avoided or decreased its sales tax obligation, and the allegations only demonstrated negligence or carelessness on the part of some employees.

- ***Phone Recovery Services LLC v. Qwest Corp., et al.*** (Minnesota, April 4, 2018) – The Minnesota Supreme Court heard oral arguments in a case involving Minnesota telecommunications charges to determine whether those charges are fees or taxes and whether a claim to recover underpayments of those charges is allowed under the Minnesota False Claims Act (MFCA). The qui tam plaintiff was unsuccessful at both the trial court and court of appeals, where the courts found that the tax bar of the MFCA barred the suit.

Qui Tam

- ***People v. Sprint Nextel Corporation*** (New York, 2011) – New York lawsuit against telecommunications provider for failure to charge sales tax on 100 percent of charges for flat rate wireless plans
  - NY Court of Appeals - October 20, 2015 false claims act action may proceed against Sprint Nextel Corp.
  - NY First Department, Appellate Division issued a ruling during 2017 regarding discovery, “tax secrecy laws” and discoverable Department and taxpayer opinions.

Captive Insurance

- ***Matter of Stewart Shops Corp.*** (NYS Tax Appeals Trib., July 27, 2017)
  - Payments by a corporation to its captive insurance company did not qualify as deductible insurance premiums
  - Appealed to New York State Court
- ***Anonymous v. Moody's Corporation*** (New York, August 30, 2018)
  - Reverse false claims act matter regarding captive insurance company structure.

City Taxes:

- San Francisco Business Tax
  - Combination of Payroll Expense Tax and a Gross Receipts Tax
  - Worldwide/water's edge unitary tax at local level
  - Proposition C
    - Passed November 6, 2018
      - Would levy an additional gross receipts tax on corporate revenues greater than $50 million to fund homelessness
      - May be subject to challenge since did not obtain 2/3 voter approval

- Head Taxes
  - City of Cupertino proposed an employee "head tax " patterned after the Seattle head tax – aimed at Apple
    - City Council decided on July 31, 2018, to wait until 2020 before putting the tax proposal before voters
  - On November 6, 2018, the voters of the City of Mountain View passed a "head tax" to fund transportation issues – aimed at Google

City Taxes:

Portland Measure 26-201

- Sets up a 1% tax on the revenues of large retailers in the city to fund clean energy programs.
- The tax will apply to retailers that have U.S. revenue over $1 billion and Portland revenue over $500,000, with groceries and medicine exempted.
- Proponents say companies such as Ikea, Wells Fargo, Comcast, Apple and Banana Republic will be impacted by this new tax.
- Proponents say the initiative would raise $30 million, but opponents say it could be as much as $79 million.

Questions?

Thank you!