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Tax Base

In Part I of 'Through the Crystal Ball,' David Fruchtman guided taxpayers through the turbulent waters of operating a business across state lines. In this article, Part II, he discusses corporate income tax issues and sales and use taxes for remote vendors.

24 Months Through the Crystal Ball: Emerging Trends in State and Local Taxation (Part II)

By David A. Fruchtman

Introduction

This is the second of two articles guiding taxpayers through the next 24 months of state taxation's turbulent waters. In this article, we address three additional significant trends.

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Corporate Income Taxation: Heat and Noise Disproportionate To Actual Tax Collections

Over the next 24 months, corporate income tax issues will continue to be a state tax flashpoint. Indeed, with the exception of the continuing dispute over the nature of the tax presence required of remote vendors for sales and use tax purposes, the most hotly contested issues in state taxation will arise within the states' corporate income taxes.[1] These corporate income tax issues will involve proposed legislation and litigation ad-

[1] The hottest new sales and use tax issue will involve the taxation of services. Over the last several months, the topic has been raised in California, Pennsylvania and Illinois. It is clear that all such proposals will involve extensive battles at all levels of government, as the potential revenue and economic impact are enormous and the difficulties of categorizing and sourcing taxable services almost as great.

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dressing unity/combined reporting,[2] tax haven designations,[3] denial of deductions for interest, royalty and other payments to related corporations, transfer pricing issues[4] and apportionment of income from other than tangible personal property.[5]

These issues are high on anyone's list of the most complex state tax topics. Moreover, as applied to individual businesses, each of these corporate tax concepts requires the application of laws and regulations that, despite their detail and great length, invite differing interpretations. In audits, these corporate income tax issues present a greater likelihood of expensive, complex and, ultimately, uncertain defense of reporting positions than do sales or use taxes.

Sales Taxes Generate Nine Times More Revenue for the States Than Do Corporate Income Taxes. The complexity of corporate income tax reporting, audits and litigation is not matched by the amount of taxes collected. In 2014, for example, the 50 states as a whole collected nine times more tax revenue from sales and use taxes than from corporate income taxes.[6] Notwithstanding the headline-grabbing criticism of businesses' state income tax planning and the responses of legislatures and revenue department policy personnel,[7] there is no reason to believe that over the next 24 months the gap between corporate income tax collections and sales/use tax collections will be meaningfully narrowed.

Legislators and Revenue Departments Will Continue to Identify and Attack Corporate Tax "Loopholes" for Political Purposes. Nevertheless, the political need to tax corporations and hunt for corporate tax loopholes is undeniable. That need applies even when those "loopholes" arise from straightforward applications of a state's law and even when taxpayers did not attempt to minimize that state's income taxes. The need is greater still when businesses receive refunds from the use of such "loopholes." As such, there is no realistic possibility that the states will reduce the amount of attention they devote to corporate income taxes. In Wisconsin, for example, Governor Walker's Executive Budget submitted in February, 2015 includes funds earmarked for the hiring of 102 additional auditors to enhance corporate tax collections, sales tax collections and nexus identification activities.[8]

The current litigation regarding the Multistate Tax Compact ("Compact") provides an unfortunate demonstration of the effects of politics on state taxation. By entering into the Compact, a group of states agreed that they would permit taxpayers to apportion income using a uniform three-factor formula of property, payroll and sales.[9] Under the sales factor, sales of other than tangible personal property are to be apportioned to a state if "a greater proportion of the income-producing activity is performed in this State than in any other State, based on costs of performance."

The Compact was designed to provide a stable, uniform environment for apportioning income. However, over time the states revised their apportionment formulae as they attempted to shift the burden of their income taxes to out-of-state businesses. So, to be clear, *it was the states (rather than taxpayers) that were "tax planning."* One result of the states' tax planning/burden shifting was that multistate uniformity deteriorated into a patchwork of double-weighted sales factors, single-factor apportionment formulae and apportionment formulae using a market basis to source income from other than tangible personal property (whether drafted as such or on a case-by-case basis through the use of a revenue department's discretionary authority).

However, in enacting/adopting new apportionment formulae the states were incautious and failed to revoke their use of the Compact's apportionment election or withdraw from the Compact.[10] The Compact's apportionment provisions are anything but loopholes, and taxpayers claiming refunds based on the application of those provisions are doing no more than applying the law in the way it was enacted and intended to be applied. Moreover, in the cases being litigated in Michi-

[2] New York State and New York City are the newest jurisdictions to adopt full unitary combined reporting, effective in both jurisdictions on Jan. 1, 2015.

[3] *See below* for more on this.

[4] The Multistate Tax Commission (MTC) continues to develop a multistate transfer pricing program. According to an April 30, 2015 MTC internal memorandum, Alabama, Iowa, Kentucky, New Jersey, North Carolina, and Pennsylvania have indicated a desire to be charter members of the program.

[5] *See* e.g., *Vodafone Americas Holdings Inc. v. Roberts*, Ct. App. Tenn., Docket No. M2013-00947-COA-R3-CV (June 23, 2014). On June 2, 2015, the Tennessee Supreme Court heard oral arguments in the case.

[6] "State Government Tax Collections Summary Report: 2014," U.S. Department of Commerce (April 16, 2015).

[7] The South Carolina Supreme Court recently took that state's revenue department to task for its attempt to cast tax planning as being improper or distortive:

"In its order, the [Administrative Law Court] relied on testimony from an auditor that the business structure of CarMax West and CBS is often 'linked with tax minimization strategies.' Furthermore, the ALC relied on evidence regarding the sourcing of income, and the fact that CarMax West's apportionment ratio yielded a significantly lower tax than that of CarMax East, to support its determination that CarMax West's income was diluted. This was the extent of the evidence offered by the Department to prove the contention that the statutory formula did not fairly represent CarMax West's business activity in South Carolina, other than bald assertions by its witnesses that it satisfied this threshold question.

Even if these findings accurately characterize CarMax West's motives, they do not provide a sound evidentiary basis to support the conclusion that the statutory formula did not fairly represent CarMax West's business in South Carolina. *See St. Johnsbury Trucking Co.*, 385 A.2d at 217 ('Merely because the use of an alternative form of computation produces a higher business activity attributable to New Hampshire, is not in and of itself a sufficient reason for deviating from the legislatively mandated formula.' (citations omitted))."

Carmax Auto Superstores West Coast, Inc. v. South Carolina Department of Revenue, Opinion No. 27,474 (S.C. S.Ct. Dec. 23, 2014).

[8] Wisconsin Executive Budget (Feb. 3, 2015) at 15.

[9] The development of the Compact is described concisely in *Gillette Company v. Franchise Tax Board*, 147 Ca. Rptr. 3d 603 (Cal. Ct. App. 2012).

[10] The Compact provides the states with a mechanism for making such changes, stating that "Any party State may withdraw from this compact by enacting a statute repealing the same. No withdrawal shall affect any liability already incurred by or chargeable to a party State prior to the time of such withdrawal." Compact at article X(2). The states at issue here failed to follow that procedure before receiving refund claims from taxpayers asserting an ability to rely on the Compact.

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gan, Texas, California, Oregon and Minnesota, there has been no serious accusation that the corporate taxpayers or their transactions lacked business purpose or economic substance. Nor has there been any serious question of income shifting, form over substance or abuse of ''tax havens.'' Nevertheless, in litigating this issue the states have repeatedly emphasized that the businesses are based out-of-state and that the overall amount to be refunded would be very large.[11]

Some States Are Willing to Change Rules or Make Irrelevant Arguments to Avoid Paying Income Tax Refunds. On July 14, 2014, Michigan's Supreme Court was the first high court of any state to address the Compact issue, and it held in the taxpayer's favor.[12] Thereafter, the court refused to reconsider its decision, despite the state's claim in its Motion For Rehearing that ''The Court's ruling. . .results in the State potentially owing a budget-busting aggregated tax refund in the hundreds of millions of dollars (not including interest) to mostly out-of-state corporations.''[13] But the state of Michigan has no intention of paying those refunds. Instead, in 2014 Michigan changed its tax law retroactive to January 1, 2008 purporting to deny taxpayers the ability to claim refunds.[14] Taxpayers and the state are now litigating the legality of that retroactive change.

This is merely the most recent example of states imposing barriers to taxpayers claiming refunds or credits. There are others, and the political pressure on the states to increase their corporation income tax collections is unrelenting. Realistically, the next 24 months will bring increased efforts to collect income taxes from corporations. Corporations—and all businesses—will be wise to plan carefully and to implement their tax planning well. They can do so with the knowledge that proper planning to reduce taxes is legitimate, and that state supreme courts in Michigan, South Carolina and elsewhere have not been rubber stamps for state tax commissioners.

Taxation of Foreign Businesses Lacking a Permanent Establishment in the U.S.

The unmistakable trend in matters of tax presence is the functional erasing of jurisdictional lines. For example, earlier this year Justice Kennedy asserted that the stare decisis no longer justified requiring in-state physical presence before vendors are required to collect a state's use taxes. He has signaled clearly that he is prepared to reverse the physical presence requirement as set forth in *Quill* and *National Bellas Hess*, and it is certain that the states are reviewing their active cases to find the cases providing the best vehicle for reversal.[15]

Moreover, the trend of erasing jurisdictional barriers to taxation is not limited to sales and use taxes. The dangers from this trend are greatest for foreign companies lacking a permanent establishment (''PE'') in the U.S., as anecdotal evidence suggests that many such companies are not complying with state tax requirements. The reasons for their lack of compliance seem to be two fold: first, a lack of understanding and, second, a belief that they are ''flying below the radar'' and will not be caught.

Regarding a lack of understanding, it seems that state tax practitioners must increase their efforts to educate foreign accountants of the demands of American subnational taxes. (In this regard, I am not aware of efforts by states to educate foreign accountants of the requirements of American subnational taxes. The states, being the parties with the greatest interest in state tax compliance, clearly should undertake organized educational efforts directed at foreign tax professionals.) It is possible that foreign accountants do not understand the significance of subnational taxation in the U.S., or incorrectly believe that the PE concept applies to all types of taxes within the U.S.

Much more troubling are the companies that operate in the U.S. without complying with state tax laws because they believe that they are not going to get caught. The states have been unwitting accomplices to this strategy through their non-pursuit of businesses that, due to treaty protections, do not report federal taxable income.

But this may change over the next 24 months with the advancement of the ''Base Erosion and Profits Shifting'' (''BEPS'') project of the Organization for Economic Cooperation and Development. One aspect of the BEPS project is to attack a perceived abuse of the PE concept to avoid tax presence.[16]

While a discussion of the BEPS initiative is beyond the scope of this article, the initiative is significant here because U.S. companies may be treated as having tax presence in foreign countries by conducting commerce through the Internet. Likewise, the U.S. government might treat foreign companies as having U.S. tax obligations under comparable circumstances. When that happens, states that look to federal filings to identify potential taxpayers are going to have a new list of candidates. Significantly, these will include foreign businesses without PEs but whose employees and representatives have been creating nexus aplenty with the states for years.

In short, over the next 24 months, there is a significantly increased likelihood that foreign businesses are going to receive nexus questionnaires from the states.[17]

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[11] These arguments are, obviously, substantively irrelevant and intended merely to appeal to the judges' presumed emotional attachment to the ''home team'' as represented by the state's revenue department.

[12] *Int'l Business Machines Corp. v. Dep't of Treasury*, 496 Mich. 642.

[13] *Int'l Business Machines Corp. v. Dep't of Treasury*, Motion for Rehearing of Appellee Department of Treasury of the State of Michigan (Aug. 4, 2014).

[14] 2014 PA 282, repealing MCL 205.581 and purporting to make the repeal retroactive to Jan. 1, 2008.

[15] For more on this, *see* ''24 Months Through the Crystal Ball: Emerging Trends in State and Local Taxation (Part I),'' *Bloomberg BNA Tax Management Multistate Tax Report* (March 19, 2015).

[16] BEPS Action Step 7 (''Preventing the Artificial Avoidance of PE Status''), published on Oct. 31, 2014.

[17] Undoubtedly, many foreign businesses' first reaction will be to disregard these questionnaires. That is a mistake. If nothing else, receipt of a questionnaire from only one state alerts these businesses to a substantially increased likelihood of inquiries from other states. This is the time when these businesses should take seriously their ability to reduce their past and future liabilities for state taxes. Nevertheless, it is gener-

Before that happens, foreign businesses whose state "tax planning" has involved non-compliance should consult a state tax professional about methods of initiating filing tax returns with the states.[18]

At the Intersection of Trends I and II: Tax Havens

During the 1980s, the states imposed their income taxes on foreign entities through the application of worldwide combined reporting. See *Container Corp. of America v Franchise Tax Bd.*, 463 U.S. 159 (1984)[19] and *Barclays Bank PLC v. Franchise Tax Board* and *Colgate-Palmolive Company v. Franchise Tax Board*, 512 U.S. 298 (1994).[20] That battle spread to foreign capitals and ricocheted back to Washington D.C. where the U.S. federal government threatened legislation to put a stop to state interference with international relations. The states retreated by permitting water's edge treatment—thereby allowing the exclusion from combined returns of certain unitary affiliates active abroad.

The states are back. Their renewed effort at attaching the income of businesses active abroad takes the form of enacting "tax haven" legislation, by which water's edge reporting states require the income and apportionment factors of entities active in certain foreign countries to be included in a combined group's income and factors. In enacting such legislation, the states claim an ability to determine which countries rig their tax laws to permit the reduction of other countries' primary and subnational taxes.

To date, tax haven laws have been enacted by six states,[21] with such legislation pending in another six states.[22] Some 40 countries have been labeled as tax havens. Over the next 24 months, two occurrences are all but certain: 1) additional states are going to flirt with or enact tax haven legislation, and 2) taxpayers are going to challenge this legislation as implicating foreign policy decisions that must be left to the federal government. In this regard, the most important case might not be *Container Corp.* or *Barclays Bank*. Rather, it is likely to be *Direct Marketing Association v. Brohl*, 135 S. Ct. 1124 (March 3, 2015), in which the Supreme Court held that the Tax Injunction Act does not prevent interested parties from raising state tax challenges in federal court when such challenges do not involve the assessment, levy or collection of taxes. Even though, as mentioned above, state high courts have made recent taxpayer-favorable decisions, where possible many tax lawyers prefer to challenge state tax issues in federal court. (This is the obverse effect of the reasoning used by states when they emphasize that a decision for the taxpayer will result in allegedly enormous amounts of refunds being paid to out-of-state businesses.)

In short, over the next 24 months, taxpayers should expect more states to enact tax haven laws. In addition, taxpayers should expect to see court challenges to those laws, potentially in federal court.

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ally unwise for a business simply to begin filing returns with a state, as doing so naturally raises the questions of "Where were you last year? And the years before?"

[18] The imposition of derivative liability is one of the states' most important tools for enforcing tax compliance. Most relevant here is imposition of liability for a business' non-compliance on that business's responsible persons. These can include officers, financial personnel, sales managers (*see e.g.*, *Matter of the Petition of Jamie Franklin* (NYS Tax Appeals Tribunal 5/14/15) and accountants (*see e.g.*, *Arizona Department of Revenue v. Action Marine, Inc.* et al., 181 P3d 188, 04/09/2008 (S.Ct. AZ 2008)).

[19] Holding that the unitary business principle and worldwide combined reporting can be applied to domestic-based multinational businesses.

[20] Holding that the unitary business principle and worldwide combined reporting can be applied to foreign-based multinational businesses.

[21] Montana, Oregon, Alaska, Rhode Island, West Virginia and including the District of Columbia as a state for these purposes.

[22] Alabama (H.B. 142), Florida (H.B. 1221), Kentucky (H.B. 374), Maine (L.D. 341), Massachusetts (House Docket 1234) and New Hampshire (H.B. 551)).

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