Another Brick in the Wall

by Jessica Kerner, Stephen P. Kranz, and Charles C. Kearns

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In most states the 2010 legislative sessions were unusually quiet because of midterm elections and the antitax political environment. Even California, which under normal circumstances would have had a busy year for tax legislation, was relatively slow given its dire fiscal circumstance. Short of a federal bailout of state and local governments, mounting budget demands will put incredible political and economic pressure on state policymakers as the 2011 budget discussions take shape. The backdrop of record-breaking budget deficits[1] — set in an antitax environment — is sure to create political gridlock in some states, while others fight over whether to dramatically raise taxes or cut spending. Either way, 2011 is shaping up to be a state tax policy donnybrook and many are asking, "How can you have any pudding if you don't eat yer meat?"[2] In this column, we examine how the confluence of the budget crises and Republicans' political gains may affect state tax policy. In particular, we will address how various substantive state tax areas may be affected by the current political and economic realties.

At the risk of sounding like a broken record, many of the issues discussed in our 2010 legislative outlook Pinch of SALT[3] will continue to be on the front burner in 2011. Of particular note, we expect to see significant sales and use tax nexus legislation (such as click-through nexus, adoption of Colorado-type reporting regimes, and streamlined sales tax conformity legislation); sales and use tax base expansion (particularly attempts to tax digital goods and services); a possibly short-term love affair with combined reporting; and a possible trend toward changing the Uniform Division of Income for Tax Purposes Act's income tax sourcing and apportionment rules.

2010 Midterm Elections: The GOP Strikes

The GOP made widespread gains in the 2010 state elections.[4] Republicans won 23 of the 37 gubernatorial elections. All six Republican incumbents who were up for reelection won their races, and two more Republicans defeated Democratic incumbents. In addition to gubernatorial wins, Republicans made significant gains in state legislative chambers, winning control of both sides in 25 states and splitting control in seven more.[5] For example, Republicans gained control in both chambers of state legislatures in Alabama, Maine, Minnesota, New Hampshire, North Carolina, and Wisconsin. The GOP gained control of the state house of representatives in Colorado, Indiana, Michigan, Montana, Ohio, and Pennsylvania.[6] As a result of these gains by the GOP, there is both a Republican governor and Republican control of the legislature in the following 20 states: Alabama, Arizona, Florida, Georgia, Idaho, Indiana, Kansas, Maine, Michigan, North Dakota, Ohio, Oklahoma, Pennsylvania, South Carolina, South Dakota, Tennessee, Texas, Utah, Wisconsin, and Wyoming.[7]

So how will the election results affect the state tax policy world? Although Republicans historically

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[1]*See, e.g.*, "State Budget Update: November 2010," National Conference of State Legislatures (Dec. 7, 2010), and "The Latest on State Budgets," Center on Budget and Policy Priorities (Dec. 9, 2010).

[2]Pink Floyd, "Another Brick in the Wall, Part 2" (*The Wall*, Columbia 1979).

[3]Stephen Kranz and Charles Kearns, "A Pinch of SALT: Send Lawyers, Guns, and Money," *State Tax Notes*, Oct. 5, 2009, p. 45, *Doc 2009-21177*, or *2009 STT 190-4*.

[4]*See, generally*, http://www.ncsl.org/tabid/21253/default.aspx.

[5]*Id.*

[6]*Id.*

[7]*Id.*

have been viewed as pro-business and antitax, they and other policymakers will face stark budget realities in nearly all states, straining traditional views of how the right and left conduct budget negotiations. The choice between cutting government services and increasing taxes will put incredible political pressure on both sides of the aisle and, if not handled correctly, could further harm fragile state economies. Whether the possibility of a worsening economic picture will lead policymakers to find some middle ground remains to be seen. With no easy solution available, it is clear that most budget battles will be hard fought.

2011 is shaping up to be a state tax policy donnybrook.

In the meantime, as new governors take office, states will see turnover at the top of many departments of revenue. Those appointments can mean as much to a state's tax policy as events in the legislative arena. In many states, we could see revenue departments being asked to help close the budget gap by aggressively enforcing existing laws or adopting new policy interpretations on audit. A number of new commissioners have already been named to head state tax agencies in Georgia, Ohio, Rhode Island, Tennessee, and Virginia, to name a few. Given political aversion to legislating tax increases, it is likely that there will be significant pressure on new tax commissioners to help close the tax gap by whatever means necessary.

Although enforcement of existing laws may generate some additional revenue, the budget situation around the country is much too dire to be solved by reinterpreting old laws. The pressure is inevitably going to be felt by elected officials caught between a spending rock and a tax increasing hard place. In states where outright tax increases are not politically salable, it is likely that we will see tax increases in disguise — whether through expanding nexus provisions, closing technical tax loopholes, or enacting miscellaneous "fees" that flow into a state's general fund. Those creative legislative solutions are not likely to escape the watchful eye of conservative policy groups and, though harder to explain to the public, will be painted as tax increases by those opposed to the legislation.

Sales and Use Tax Nexus: Click-Through, Reporting, and Streamlined . . . Oh, My!

One way for states to increase tax revenue without enacting politically unfavorable tax increases is to expand the obligation to collect sales tax to companies that are protected by the *Quill*[8] physical presence rule. While states and businesses have been working through the 10-year effort to overturn *Quill* embodied in the Streamlined Sales and Use Tax Agreement, that effort has not yet achieved the goal. Advocates for expanded sales and use tax nexus rules — primarily state tax administrators and bricks-and-mortar stores — have grown frustrated with the progress of SSUTA[9] and its related federal legislation. Beliefs that the Main Street Fairness Act (H.R. 5660), which would have given SSTP states authority to require online retailers with no physical presence to collect sales and use tax, would pass in 2010 are fading fast, and the measure will likely face a less friendly Congress in 2011. Concern over the lack of congressional support for H.R. 5660 has led some to support alternative attacks on *Quill* and will likely lead numerous states down the same path in 2011. What does that mean for the 2011 budget debates? We predict that numerous states will consider New York-style click-through nexus legislation, Colorado-style reporting requirements, and legislation to adopt Oklahoma-style commonly controlled nexus presumptions.[10] Unfortunately, those approaches do nothing to address the underlying reason for the *Quill* decision: that sales tax is incredibly complicated, and under the commerce clause of the U.S. Constitution, states cannot burden a company engaged in interstate commerce with tax collection responsibility unless the company has a physical presence in the state.

Because those alternative attempts to change the nexus standard could increase tax collections without the enactment of a new tax or a rate increase, they will likely be seen as more politically palatable. Unfortunately for the states that pass those statutes, which will rely on promised new revenue to balance their budgets, these attempts to change the

[8]504 U.S. 298 (1992).

[9]*See* John Buhl, "Governing Board Studying Option of Overturning Quill in Court," *State Tax Notes*, Nov. 8, 2010, p. 386, *Doc 2010-23498*, or *2010 STT 210-1*.

[10]N.Y. Tax Law section 1101(b)(8)(vi), N.C. Gen. Stat. section 105-164.8(3), R.I. Gen. Law. section 44-18-15(a); Okla. Stat. tit. 68, section 1401(9)(d); Colo. Rev. Stat. section 39-21-112, Colo. Rev. Stat. section 39-21-112(3.5)(d)(II)(A). For an overview of those statutes, see Stephen Kranz, Lisbeth A. Freeman, and Mark Yopp, "Is *Quill* Dead? At Least One State Has Written the Obituary," *State Tax Notes*, Aug. 2, 2010, p. 307, *Doc 2010-16154,* or *2010 STT 147-1*. The problems argued to exist with click-through nexus laws were addressed by Michele Borens and Mark W. Yopp, "Overextending Attributional Nexus: States' Latest Attempts to Tax Internet Sales," *State Tax Notes*, Mar. 2, 2009, p. 697, *Doc 2009-39-47*, or *2009 STT 39-3*.

nexus standard have not produced the type of revenue anticipated and have been the subject of challenges on constitutional grounds.[11] In Colorado, the new Republican House majority is already discussing the possibility of repealing the state's onerous reporting requirements because of the negative effect the provisions have had on the in-state affiliate community.

Despite the likelihood of a judicial challenge and the potential repeal of Colorado's statute, the Multistate Tax Commission has drafted and circulated a model Draft Reporting Act (Draft Act).[12] The model is similar to Colorado's reporting law and will undoubtedly appear in numerous budget proposals as legislative sessions begin. What is not clear is whether those proposals will make it into law. Republican-controlled legislatures may be less likely to pass such nexus proposals for fear of being perceived as anti-business. Republican governors may veto those proposals in a similar manner to when Govs. Arnold Schwarzenegger of California and Linda Lingle of Hawaii vetoed click-through legislation passed in their states in 2009. That said, California is one of the few states where gubernatorial control has shifted from Republican to Democrat, making the state a likely battleground for the nexus issue early in 2011. The State Board of Equalization recently issued an updated "Revenue Estimate from Electronic Commerce and Mail Order Sales" report that annual revenue losses from out-of-state vendors reached $1.145 billion in calendar-year 2010.[13] Given the statistic in this report, it is no surprise then that many are advocating a change in the state's nexus rules to help close the state's looming budget deficit.

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Even though federal SSUTA legislation did not move in 2010, several states appear likely to consider adopting SSUTA conformity legislation in 2011. In 2010, the SSUTA gained Georgia as a new member. Building on that momentum, advocates for the effort are likely to push conforming legislation in California, Florida, Illinois, Missouri, Pennsylvania, South Carolina, and Texas. We note that one of the reasons why California, Texas, Illinois, and Missouri did not previously participate in the effort (a former requirement that each state had to adopt destination-based sourcing) is no longer a firm requirement of participation. Thus, there is at least a possibility that those states could become members of SSUTA in 2011.

Sales Tax Base Expansion

Broad-based, low-rate consumption taxes — for example, sales taxes, "fair taxes," value added taxes, and the like — have long been popular among right-leaning tax policy organizations. Will the right's support for broad-based transaction taxes lead to the expansion of state sales tax bases? Invariably, sales tax base expansion will be proposed to apply to traditional service providers like landscapers, barbershops, and tanning salons. However, those services are local in nature and will engender local opposition. Of greater concern to the multistate business community is whether proposals to expand the sales tax base will lead to taxation of digital goods and services such as electronically provided music, and video and cloud-computing business models. These proposals are more difficult to defeat in part because they are often more difficult to understand. These concerns about tax pyramiding, sourcing, and taxation of business inputs, which are harder to explain to policymakers and may not carry the day as states struggle to balance budgets.

Although 2010 saw far less activity on the imposition of taxes on digital goods and services than did the previous two years, it is anticipated that legislative activity in that area will increase in 2011. Discussions are already under way regarding expanding the tax base to include digital goods and services in California, Minnesota, New York, and South Carolina. For example, the South Carolina Tax Realignment Commission recommends lowering the general sales tax rate from 6 percent to 5 percent and expanding the South Carolina tax base to include digital goods and print newspapers, as well as groceries, some prescription drugs, residential electricity and natural gas, and water sold by utilities at a reduced rate.[14]

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[11]*Amazon.com LLC et al. v. New York State Dept. of Tax'n and Fin., et al.* and *Overstock.com, Inc. v. New York State Dept. of Tax'n and Fin., et al.*, 2010 NY Slip Opinion 07823 (1st Dept. App. Nov. 4, 2010); *Direct Marketing Ass'n v. Huber,* No. 10-CV-01546-REB-CBS (D. Colo. June 30, 2010).

[12]Draft Model Sales and Use Tax Notice and Reporting Act, Multistate Tax Commission, Sales & Use Tax Uniformity Subcommittee (Sept. 20, 2010).

[13]"Revenue Estimate, Electronic Commerce and Mail Order Sales," State of California, Board of Equalization (Dec. 6, 2010).

[14]Final Report of the South Carolina Tax Realignment Commission (Dec. 2010), *available at* http://www.scstatehouse.gov/citizensinterestpage/TRAC/TRAC.html.

Mandatory Unitary Combined Reporting — Dead or Not?

Mandatory unitary combined reporting was the hot state corporate income tax legislative issue in 2009, yet largely flew under the radar in 2010. In 2011 it is likely to be somewhere in between. Conversations about combined reporting are already taking place in New Jersey and the District of Columbia. Efforts to adopt combined reporting seem to have stalled in Maryland and Virginia, though proponents in Maryland appear to be pushing for resuscitation. Word on the street is that support for combined reporting has likely stumbled or completely fallen off in Alabama, Florida, Louisiana, North Carolina, Pennsylvania, and Tennessee. The policy debate over whether to adopt combined reporting will continue to revolve around whether the change will increase state tax revenue or subject the tax base to uncertainty and administrative complexity. Proponents and opponents disagree.

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To shed light on the combined reporting policy debate, the National Conference of State Legislatures' Task Force on State and Local Taxation of Communications and Interstate Commerce commissioned Bill Fox and LeAnn Luna, economists with the University of Tennessee, to study the economic realties and implications of mandatory unitary combined reporting.[15] The Fox report seeks "to explain the features of combined reporting and to analyze the key issues that states should consider when determining corporate tax structures, and specifically the relative merits of separate and combined reporting." The study looks at the consequences of combined reporting for state tax administration, taxpayer compliance costs, the effects on state economic performance, and the effects on state corporate tax revenues.

Of its various findings, the Fox report most notably concluded that combined reporting should not be used as a revenue raiser to close states' budget gaps, concluding "combined reporting has no direct effect on state tax revenues."[16] Rather, if a state's goal is an immediate increase in corporate income tax revenue, adoption or expansion of the use of intercompany expense addback statutes is a much more effective means of achieving this goal than adoption of combined reporting. The Fox report concluded that "addback requirements have a very strong positive influence on tax revenues."[17] Those conclusions should be of particular interest in states with both combined reporting and expense disallowance provisions (for example, Wisconsin) or states with expense disallowance provisions that may consider combined reporting in the future (for example, Alabama and Connecticut). It follows from the Fox report that those states risk negating revenue gains from expense disallowance provisions by having adopted or adopting combined reporting, which hits particularly hard in tough economic times when losses are allowed to offset gains. The Fox report further advises that "lawmakers considering a move to combined reporting should consider the immense complexity the reporting regime will introduce" and that "complexity comes with a great amount of uncertainty."[18] Indeed, that advice is generally echoed by the multistate tax community and supported by similar recommendations made by the Maryland Business Tax Reform Commission and Virginia's Joint Legislative Audit and Review Commission to their state legislatures.[19]

Income Tax Sourcing and Apportionment

State legislatures may look to corporate income tax sourcing and apportionment provisions to score points with in-state businesses and attempt to raise revenue from companies located outside the state. Changes to the traditional UDITPA three-factor apportionment formula and its cost-of-performance sourcing method for receipts derived from sales of services and intangibles (receipts from "other than sales of tangible personal property") are expected to get attention as in-state businesses argue for economic development at the expense of out-of-state companies. Some say that single-sales-factor apportionment is necessary for in-state businesses to compete with out-of-state businesses but it is opposed by others as a "costly giveaway."[20] It is not

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[15]William F. Fox and LeAnn Luna, "Combined Reporting With the Corporate Income Tax: Issues of State Legislatures," National Conference of State Legislatures (Nov. 17, 2010) (hereinafter "Fox report").

[16]*Id.* at 40.

[17]*Id.*

[18]*Id.* at vi.

[19]Report of the Maryland Business Tax Reform Commission, Dec. 15, 2010, p. 4, *available at* http://btrc.maryland.gov/pdf/MBTRC_Report.pdf; Review of Virginia's Corporate Income Tax System (Commission Draft — Not Approved), Joint Legislative Audit and Review Commission Report to the Governor and General Assembly of Virginia, Nov. 8, 2010, p. 128, *available at* http://jlarc.virginia.gov/meetings/November10/Corporate%20Income%20Tax.pdf.

[20]The Center for Budget and Policy Priorities (CBPP), and its fiscal senior fellow, Michael Mazerov, have long been vocal critics of single-sales-factor legislation, arguing, "The fact

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clear whether the desire to draw in and maintain business investment will be outweighed by the loss of revenue in an already difficult budget environment. To pay for adoption of single-sales-factor legislation that many expect to see, some are promoting market-based sourcing of income from services and intangibles.[21] Although we are not yet able to call it a trend, market-based sourcing for income from services and intangibles has recently grown in popularity.[22] For example, California's recent apportionment changes couple a single-sales-factor election with market sourcing, but retain cost-of-performance sourcing for businesses using the state's traditional three-factor, double-weighted sales formula.[23] In other cases, the adoption of single sales factor may be considered as stand-alone legislation. For example, as this article goes to press, New Jersey is expected to phase in single-sales-factor apportionment.[24]

Conclusion

At the risk of the authors crying wolf, 2011 should be an active year in the state tax legislative arena. States and localities continue to struggle to raise funds and several of the newly elected legislators advocated for reform during the recent elections. Although new taxes appear to be off the table in many states, policymakers will look to shore up existing tax compliance through tough administrative policies, or will look to export their state's tax burden to out-of-state businesses through attacks on sales tax nexus or changes to corporate income tax apportionment regimes. The recent political and philosophical shift in the country coupled with the perceived shakiness of the economy may also make state tax policymakers hesitant to upset the apple cart by adopting significant or unproven state tax legislation or changes in state tax policy . . . that is, unless a state really has its back against the wall.✰

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Sutherland's SALT Practice is composed of more than 20 attorneys who focus on planning and controversy associated with income, franchise, sales and use, and property tax matters as well as unclaimed property matters. Sutherland's SALT Practice also monitors and comments on state legislative and political efforts.

that corporations can reap tax savings by exploiting inconsistencies between state tax rules suggests, however, that state officials would be wise to adopt a skeptical stance toward arguments that a unilateral change in their state's corporate tax apportionment policy will lead to more equitable tax treatment of multistate corporations." Mazerov, "Ford, Kraft, AT&T and the Sales-only Formula: What Goes Around Comes Around" and "The 'Single Sales Factor' Formula for State Corporate Taxes: A Boon to Economic Development or a Costly Giveaway?" (May 2001).

[21]For example, in Pennsylvania, tax policy analysts with the Pennsylvania Department of Revenue published articles and gave presentations suggesting that if single sales factor were to be enacted, market sourcing — that is, sourcing of the sales based on customer's location rather than sourcing based on where a majority of the costs related to the service are performed — should also be implemented. *See* Daniel Hassell and Shane Sanders, "The Revenue Effects of a Single-Sales-Factor Apportionment Formula on the Pennsylvania Corporate Net Income Tax," *State Tax Notes,* Jan. 31, 2005, p. 311, *Doc 2004-23656,* or *2005 STT 19-32*.

[22]*See* Pilar Mata and Melissa Smith, "A Pinch of SALT: The Implementation of 'Market' Sourcing Rules: Practical Concerns," *State Tax Notes*, Sept. 6, 2010, p. 649, *Doc 2010-18847*, or *2010 STT 172-1*.

[23]For a detailed explanation of California's new (and yet old) apportionment regime, see Borens, Mata, and Smith, "A Pinch of SALT: Understanding California's New Apportionment Regime," *State Tax Notes*, Dec. 6, 2010, p. 703, Doc 2010-25052, or 2010 STT 233-1.

(Footnote continued in next column.)

[24]N.J. S 1646, 2010-2011 Legislative Session.