Advanced State and Local Tax

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Agenda

- Multistate Business Taxes
- Sales & Use Taxes on a Multistate Basis
- Other Taxes
- Acquisitions and Sales
- Audits, Assessments and Litigation

Multitate Business Taxes

- **Defining the tax base**
  - Federal taxable income
    - Modifications
- **Filing Methods**
  - Separate
  - Consolidated
- **Combined reporting**
  - Unitary tests
    - Three unities of ownership, use, and operation
    - Contribution/dependency tests
    - Factors of profitability
      - Functional integration
      - Centralization of management
      - Economies of scale

Tax Formula for Multistate Corporate Taxpayers

- Start with federal taxable income (either line 28 or line 30 of the federal form 1120)

  +/- state modifications

  = state tax base

  - allocable nonbusiness income

  = state apportionable income or (loss)

  x state's apportionable percentage

  = state apportioned income or (loss)

  + state's allocable nonbusiness income

  = state's taxable income (loss)

  x state tax rate

  = state tax liability before credits

  - state tax credits

  = net state income tax liability

Where Do I Have to File? Nexus

- Nexus is a term of art in state and local tax that refers to the quantity and quality of links between a taxpayer and a political jurisdiction before that jurisdiction can impose a tax filing obligation on the taxpayer.
- U.S. Constitution
  - Due Process Clause
  - Commerce Clause
- Public Law 86-272

Sales Tax Versus Income Tax Nexus

- Sales tax – Physical presence under *Quill*
  - Generally, no protected activities
- Income tax – Physical presence unresolved by courts
  - P.L. 86-272 protects certain activities
- Conclusion: Taxpayer can be subject to sales tax collection requirement, but not income tax if certain conditions are met.

Physical Presence and Income Tax

- Public Law 86-272 provides a safe harbor from income tax nexus for out-of state taxpayers whose activities are limited to:
  - Representatives engaged in "solicitation of orders"
  - For tangible personal property
  - Sent outside state for approval, and
  - Filled by shipment or delivery from point outside state
- How Much Physical Presence?
  - Sporadic visits and trade shows
  - Printers, fulfillment and distribution centers
  - Servers, websites, and software
  - Employee, Agent, Representative, Independent Contractor
    - Doing business on behalf of out-of-state company
    - To establish or maintain market in the state

P.L. 86-272 Does *Not* Protect Taxpayers

- Income tax nexus if in-state activities involve
  - Leasing of tangible personal property
  - Sales of services
  - Sale or lease of realty
  - Sale or license of intangibles
- Sales and use tax nexus
- Washington business and occupation tax nexus
- Franchise taxes on capital or net worth (for example, PA)
- Ohio Commercial Activity Tax (CAT)
- Texas Margin Tax (TMT)

Filing Status

- Separate filing (each company files its own return)
- Consolidated returns - State consolidated returns generally follow the federal rules for filing a consolidated return. One significant exception, in many states, is that only companies that have nexus with the state may be included in the consolidated return.
- Combined reports - or “unitary” filing
  - The unitary or combined approach ignores legal entities and geographical boundaries and focuses on the economic unit.
  - May be worldwide, but more likely is “Water’s-Edge.”

Apportionment Factors

- Traditionally, equally weighted three-factor formula: sales, property, and payroll.
- Many states have now modified the traditional formula by adding weight to the sales factor.
- Two types of deviations
  - Extra weight placed on sales factor
  - Specialized industry formulas – transportation; financial; broadcasting
- Placing more emphasis on sales factor provides relief to taxpayers with large concentrations of property and payroll in-state.
  - Encourages companies to stay in the state
  - Shifts tax to out-of-state taxpayers

Multistate Business Taxes - Sourcing

- Payroll – location of work
- Property – location
- Sales
  - Cost of Performance
    - Preponderance
    - Pro rata
    - Market State

Sales and Use Taxes in Multiple States

- 46 taxing jurisdictions
- Physical presence required
- Push for economic presence – *South Dakota v Wayfair*
  - *AL, TN, SD, VT*
- Property, office or personnel
- Independent contractor v employee temporary presence
  - Temporary presence more than de minimis
  - Working on behalf of the out-of-state company
  - To establish or maintain market
- Reporting Requirement, irrespective of physical presence nexus

Sales and Use Tax

- Sales Elements:
  - Sale or exchange
  - Tangible Personal Property or Taxable Services
  - Non-Exempt Transaction
  - Sale within the taxing jurisdiction
- Use Tax -- Complements Sales Tax – covers transactions not subject to sales tax
- Elements:
  - Use, storage or consumption in state
  - Tangible Personal Property or Taxable Service
  - Non-Exempt Transaction
  - Sale Outside the Taxing Jurisdiction

Sale of Tangible Property or Service?

- Mixed transaction – sale of two products, one service and one property, in a single transaction. Usually separate price can be determined for each.
- Bundled transaction – sale of property and nontaxable services for a single price where products are so intertwined as to be indivisible.
- True Object Test or Incidental to Services Test to determine nature of transaction.

Sales and Use Taxes in Multiple States

- Example of a Reporting Requirement Statute:
  - Colo. Rev. Stat. § 39-21-112(3.5)(d): "Each retailer that does not collect Colorado sales tax shall send notification to all Colorado purchasers by January 31 of each year showing such information as the Colorado department of revenue shall require by rule and the total amount paid by the purchaser for Colorado purchases made from the retailer in the previous calendar year.
  - Such notification shall include, if available, the dates of purchases, the amounts of each purchase, and the category of the purchase, including, if known by the retailer, whether the purchase is exempt or not exempt from taxation. The notification shall state that the state of Colorado requires a sales or use tax return to be filed and sales or use tax paid on certain Colorado purchases made by the purchaser from the retailer."
- States with reporting or notification requirements include Colorado, Oklahoma, South Dakota and Vermont.

Other Taxes

- Property Tax
- Property Transfer Tax
- Unemployment Tax
- Unclaimed Property - Escheats

Acquisitions and Sales

- **Asset Sales: Issues for Seller**
- Income tax
  - Characterization of gain (business v nonbusiness)
  - Treatment of proceeds in the apportionment factor
  - Basis differences
  - Possible sheltering of gain in unitary states
  - Recapture of Credits
- Sales/Use Taxes
  - Bulk Sales exemptions
  - Resale certificate for any inventory sales
- Property Transfer Taxes

Acquisitions and Sales

- **Asset Sales: Issues for Buyer**
- Income tax
  - Choice of entity to acquire assets
  - Placement of acquisition of debt
  - Credit and incentive opportunities
  - Instant Unity
- Sales/Use Taxes
  - Bulk Sales exemptions
  - Buyer sales tax registration for inventory purchases
- Unemployment tax experience rating transfer

Acquisitions and Sales

- **Stock Sales: Issues for Seller**
- Income tax
  - Characterization of gain (business v nonbusiness)
  - Treatment of proceeds in the apportionment factor
  - Basis differences
  - Possible sheltering of gain in unitary states
  - Recapture of Credits

Acquisitions and Sales

- **Stock Sales: Issues for Buyer**

- Income tax
  - Choice of entity to acquire assets
  - 338(h)(10) election
  - Instant Unity

- Unemployment tax experience rating transfer

State Taxation of Sale of Interest In FTE

- Treatment varies from state to state
- Depends upon what is apportionable business income, or allocable nonbusiness income
  - Difficult issue with evaluating business vs non-business income is that the partnership interest in the “hands” of the partner might be business income to the partner and the partnership operations might also constitute business income, but are the two “buckets” of business income subject to aggregation
- Multistate Tax Commission definition of business income
  - Some state courts hold two tests, a transactional test and a functional test, and satisfaction of either = business income
  - Minority of states hold there is only a transactional test

Michigan Taxation of A Resident Individual's Sale of a Partnership Interest

- Michigan Court of Appeals held that an individual's gain on his sale of a limited partnership interest in a real estate business partnership resulted in apportionable business income for individual income tax purposes (*Aikens v Department of Treasury*, Docket # 310528 (2014))
  - Because the partnership had no property, payroll or sales in Michigan, the relevant Michigan apportionment factor was zero percent
  - The COA reversed a lower court holding by the Court of Claims which had found that the capital gain recognized was nonbusiness income allocable 100% to Michigan based on the Michigan residency of the seller
  - The COA relied upon prior Michigan decisions in *Grunewald* 305 NW2d (1981) and *Chocola* 369 NW2d 843 (1985) which held, respectively, that a loss earned at the partnership level and income earned at the S corp level were apportionable business income

Ohio Taxation of Nonresident Individual's Gain From Sale of An LLC Member Interest

- Ohio Supreme Court held that a nonresident individual taxpayer's gain from sale of his member interest in an LLC doing business in Ohio was not subject to Ohio income tax. *Corrigan v Testa*, Slip Opinion No. 2016-Ohio-2805 (2016).
- Taxpayer, a CT resident, sold a 79% member interest in an LLC that conducted business in Ohio.
- Ohio Rev. Code §5747.212 requires that a taxpayer owning 20% or more of a flow-through entity must apportion gain on sale of an interest using average of the entity's apportionment fractions for current and two preceding tax years.
- Ohio Supreme Court held that as applied to the taxpayer this statute violated the Due Process Clause of 14th Amendment
  - Court reasoned that there must be a connection between Ohio and the person and activity it seeks to tax.

Audit, Assessment and Litigation

- If its not in writing, there was no appeal
- Assessment means time to appeal is running. Put something in writing to memorialize the appeal, no matter how nice the Department person is.
- Get a local attorney to explain the appeal procedures to you.

Voluntary Disclosure Programs

- Most states allow taxpayer pay prior year taxes and interest and waive penalty when:
  - No prior contact from state
  - Not under audit
  - Reasonable basis for failure to file
  - Agree to file and pay for all years open under statute of limitations
  - Sign agreement

Questions?

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