

State & Local Tax **Alert**

Breaking state and local tax developments from Grant Thornton LLP

SALT Top Stories of 2011

A prolonged economic slump, political challenges at the state and federal level and long-term structural budget issues continued to impact states in 2011. Viewing this big picture in a vacuum, it would be easy to harken back to the last couple of years and ask whether anything has changed from 2010, or even 2009. While the big picture seemed to stay about the same, significant changes in many of the states really did come about this year, inspired by governors and legislatures empowered to make some difficult choices, and buttressed by active judiciary systems willing to decide SALT matters of importance. Some states made the difficult choice to raise taxes on a broad swath of citizens. Others tried reforming their tax systems, with winners and losers still to be determined.

It is not surprising that the disparate tax policies tried by the states are outgrowths of their overall budget situations. Some states, like Iowa and Indiana, have been successful at substantially reducing the structural budget gap that grew during the last several years, due in part to stabilization and in some cases, increased growth in revenues. These states have not made major changes to their tax structures in the past several years. In contrast, other states, like California, Illinois and New York, continued to struggle with closing their structural deficits despite modest improvements in revenue levels, in large part because of the effect of large pension obligations and other nonnegotiable costs. These states have tended to make more substantial changes to their tax structures.

According to a Center on Budget Priorities and Policies (CBPP) report published earlier this year, 42 states and the District of Columbia were trying to close \$103 billion in budget gaps in fiscal year 2012, on top of fiscal shortfalls faced by states in the previous three years.¹ Though the aggregate amount of budget gaps is very high, and will remain so for several years, an interesting dichotomy may be developing, between the states that have taken proactive steps to reduce their budget gaps (along with a select number of states that did not go into recession because of a plethora of natural resources that rose in value) and states that did not effectively deal with budget gaps and have been forced to take stern austerity measures. The budget conditions in the more fiscally sound states are likely to dictate tax policies that will be vastly different from the states that have been unable to get a handle on their finances.

¹ See CBPP report written by Elizabeth McNichol, Phil Oliff and Nicholas Johnson, "States Continue to Feel Recession's Impact" (updated June 17, 2011), which can be accessed at <http://www.cbpp.org/cms/?fa=view&id=711>.

Release date

December 22, 2011

States

All

Issue/Topic

All

Contact details

Brian Murphy

Chicago
T 312.602.9017
E brian.murphy@us.gt.com

Giles Sutton

Charlotte
T 704.632.6885
E giles.sutton@us.gt.com

Jamie C. Yesnowitz

Washington, DC
T 202.521.1504
E jamie.yesnowitz@us.gt.com

Dale Busacker

Minneapolis
T 612.677.5185
E dale.busacker@us.gt.com

Chuck Jones

Chicago
T 312.602.8517
E chuck.jones@us.gt.com

Angela McNeany

Chicago
T 312.602.8174
E angela.mcneany@us.gt.com

www.GrantThornton.com/SALT

At the local level, budgetary problems could remain an issue for a longer period of time than at the state level, due to local government reliance on property taxes, which does not always grow in line with other types of taxes. Over the past several years, the fair market value of real property has significantly declined in many geographical markets and those values are only now beginning to stabilize. However, the assessed values on which the property tax base is calculated actually continued to rise well into the heart of the recession, because of limitations on the rates of increases on such values during the real estate market boom. But now, the assessed values are faltering (even as localities may wish to artificially keep such values as high as possible), and as a result, real property collections are likely to continue declining until assessed values or tax rates start to rise. For localities that are already seeing cutbacks from state government funding, the reduction in collections from the property tax base could be disastrous. To date, it may come as somewhat of a surprise that the municipal bond market utilized by these localities has not suffered a serious downturn already. Though the risk of a meltdown in the municipal bond market appear to have temporarily abated at the present time, local governments will need to continue to evaluate how they can derive the most out of their limited revenue streams even in a looming recovery, as it is uncertain as to how robust future property tax growth will be.

The continuing challenges brought on by budgetary constraints will require states to consider how to expand their revenue streams by taxing growing sectors of the economy and new technologies. One way to do this is to broaden the reach of the taxes imposed by the states as much as possible, for example by utilizing factor presence nexus standards in the realm of the corporate income tax. As the barriers preventing companies from remotely selling products on a domestic and international basis have dissipated by reason of new technologies, states have increasingly turned to factor presence nexus statutes and regulations to impose corporate income tax obligations on companies without actual physical presence. This policy will have tremendous implications for domestic companies selling to other regions of the United States, as well as for global trading partners with no physical presence at all in the United States, but discover that they have corporate income tax filing requirements and liability because of factor presence nexus rules that have no federal income tax counterpart. While these policies might temporarily benefit a state's bottom line, they may act to curb economic growth in the long run as companies become reticent to do business in jurisdictions that are quick to impose taxes on these sales, along with consequent tax compliance requirements. Further, there is no guarantee that such policies satisfy constitutional muster.

States will also need to consider how to tax special products derived from the new technologies being created. For example, cloud computing, pursuant to which companies utilize offsite providers for various types of computing services accessed through the Internet, will present a challenge to the states from both a sales tax and income tax perspective. At an elemental level, does the receipt of cloud computing services have nexus implications? For sales tax purposes, are cloud computing services taxable or exempt, and can the answer change depending upon what types of services or products are provided? For income tax purposes, does the character of each distinct cloud

computing item being sold impact the method by which the receipts from such sale are sourced for purposes of apportionment? Most states are still considering how to resolve these and other issues, and it is far from certain that the states will come to uniform conclusions. The choices made by the states will have tremendous budgetary impact in the future as new technologies continue to grow in importance.

If 2011, from a SALT perspective, can be captured in one global comment, it would be the following: covering SALT developments truly progressed from a part-time endeavor requiring some focus, to a full-time activity needing constant attention. Until recently, practitioners and taxpayers spent the late winter and most of spring tracking state legislative activity, with the occasional important case arising from a state supreme court that would require review, as well as guidance from state tax authorities from time to time. As the developments from 2011 show, many of the large state legislatures work twelve months a year, significant decisions are being released from state courts on a regular basis, the regulations authorized by state tax authorities are becoming incredibly complex, and SALT issues are having their day in Congress. The good news is that there is no more “busy season” in tracking SALT issues. The bad news is that each day can bring unpredictable and substantial changes to the SALT landscape, with information overload a real possibility. The end result seems to be that the predictability that taxpayers seek in order to make stable business decisions has been lacking. We hope to provide some perspective (and at least some sort of respite from information overload) in this year’s review of material SALT events.

1. Legislatures gone wild: Amazon rule, sales tax disclosure, and affiliated nexus rules explode

The issue of collection and remittance obligations for remote sellers, along with potential solutions, has captured the interest of the SALT world and beyond, and in the eyes of many, was the dominant SALT issue of importance this year. States considered several different approaches to require remote sellers to comply with sales tax collection and remittance requirements, most notably by way of click-through and affiliate nexus rules, as well as disclosure regimes.

The click-through nexus rules target out-of-state Internet retailers utilizing resident Web site owners to advertise for such retailers, in return for a commission on sales resulting from the followed link, by generally requiring the retailers to collect and remit sales tax even though they have no actual physical presence in the state. In 2011, Arkansas,² Connecticut³ and Illinois adopted these rules.⁴ Interestingly, Amazon.com, the company that inspired much of this legislation, initially fought proposed and final enactments through litigation (ongoing in New York) and the termination of many of its in-state associate programs. In 2011, Amazon shifted its focus to negotiations with several states,

² Act 1001 (S.B. 738), Laws 2011.

³ Act 6 (S.B. 1239), Laws 2011.

⁴ P.A. 96-1544 (H.B. 3659), Laws 2011.

and attempted to procure delays in the implementation of the click-through nexus rules, by promising additional in-state jobs and investment. In California, Amazon was instrumental in persuading the legislature to temporarily and retroactively repeal click-through and affiliate nexus provisions⁵ by dropping a planned referendum challenge to these provisions, and promising to create substantial numbers of jobs and capital investment.⁶ The temporary repeal is tied to the effort to adopt federal remote seller legislation. If the federal legislation is not enacted by July 31, 2012, the click-through and affiliate nexus provisions will again become operative on September 15, 2012. Even if the federal legislation is adopted by July 31, 2012, if California does not implement such federal legislation by September 14, 2012, then the click-through and affiliate nexus provisions will become operative on January 1, 2013.

As for affiliate nexus rules, several states, including Arkansas,⁷ Illinois⁸ and Texas,⁹ adopted these provisions in 2011. These rules are designed to expand the definition of a “retailer” subject to the collection and remittance requirements of a state’s sales tax in a number of ways. For example, an out-of-state retailer that owns an interest in a resident company that sells the same or a similar line of products as the retailer, or uses the same names or trademarks as the retailer may be brought into the state through the related-party relationship.

States also have turned to notification requirements as a method by which an out-of-state retailer that does not register for the sales tax, and does not have click-through or affiliate nexus, can be compelled to notify in-state purchasers that a use tax may be owed on transactions in which the sales tax is not collected or remitted by the retailer. South Dakota¹⁰ and Vermont¹¹ adopted somewhat limited notification requirements applicable to out-of-state retailers in 2011. However, the most controversial of the notification requirements, Colorado’s three-pronged sales and use tax notice and reporting requirements for out-of-state retailers targeting Colorado markets adopted in 2010,¹² was at least temporarily quashed early in 2011. A U.S. District Court judge in Colorado issued a preliminary injunction against the Colorado Department of Revenue, preventing the

⁵ A.B. 28x, Laws 2011.

⁶ A.B. 155, Laws 2011.

⁷ Act 1001 (S.B. 738), Laws 2011.

⁸ P.A. 96-1544 (H.B. 3659), Laws 2011.

⁹ S.B. 1, First Special Session, Laws 2011.

¹⁰ S.B. 147, Laws 2011.

¹¹ Act 45 (H.B. 436), Laws 2011. Note that the Vermont legislation containing notification requirements will convert to a click-through nexus policy when 15 or more states have adopted click-through nexus requirements.

¹² COLO. REV. STAT. § 39-21-112(3.5). The first rule requires the use of specific language on such retailers’ invoices to Colorado-based customers stating that Colorado sales tax is due on all non-exempt purchases (retailers with less than \$100,000 of prior year Colorado sales are exempt from this notice requirement). The second rule requires notification to all Colorado purchasers by January 31 of each year showing amounts paid by the purchaser for Colorado purchases from the retailer in the previous year, along with other information as required by the Department. The third rule requires the filing of an annual statement by March 1 of each year for each purchaser to the Department showing the total amount paid for Colorado purchases of such purchasers during the previous calendar year.

enforcement of the statute.¹³ Though the case has not been resolved and the injunction remains in effect, the Multistate Tax Commission (MTC) is attempting to adopt model legislation mirroring the Colorado disclosure regime.¹⁴ The MTC held a public hearing on the model legislation, and while such legislation did not get sufficient support from the states at the MTC's annual meeting, further action is expected early next year.

2. Congressional activity on remote seller rules

In recognition of the wide-ranging activity in the states on this issue and the U.S. Supreme Court's unwillingness to act, Congressional interest ramped up, with three bills proposed on the subject in 2011: the Main Street Fairness Act,¹⁵ the Marketplace Equity Act,¹⁶ and the Marketplace Fairness Act.¹⁷ Each of the bills is based on the premise that for a state to require remote sellers to register, collect and remit sales tax, such state must adopt certain sales tax simplification reforms. The bills differ in what reforms must take place, and only the Main Street Fairness Act requires that a state become a member of the Streamlined Sales Tax (SST) Agreement to subject remote vendors to collection and remittance requirements. Each of the bills contains a small seller exception from the remote seller requirements, though there is no absolute consensus on how large the exception will be. Further, the bills are not consistent on the issues of requiring vendor compensation for collecting and remitting the sales tax, and requiring one uniform sales and use tax rate.¹⁸

Perhaps as a first step to reconciling these differences, the House Judiciary Committee held a hearing on November 30 addressing the issues raised in three bills, with a total of six witnesses representing businesses and government interests participating.¹⁹ The tenor of the meeting, which lasted nearly three hours, was that agreement on these issues could be obtained in a bipartisan manner, particularly if the law is not construed to result in a tax increase, the level of the small seller exception is resolved and the role of the SST in the legislation is clarified. While it is uncertain at this time as to which bill ultimately will be the vehicle utilized by Congress to address these issues in the next couple of years, for the first time, there appears to be an air of inevitability that some kind of federal intervention in this area will ultimately happen.

¹³ *The Direct Marketing Association v. Roxy Huber*, Civil Case No. 10-cv-01546-REB-CBS, Order Granting Motion for Preliminary Injunction (U.S. Dist. Ct. Colorado, Jan. 26, 2011).

¹⁴ Multistate Tax Commission Sales & Use Tax Uniformity Subcommittee, Draft Model Sales & Use Tax Notice and Reporting Act.

¹⁵ S. 1452, H.R. 2701, introduced July 29, 2011.

¹⁶ H.R. 3179, introduced Oct. 13, 2011.

¹⁷ S. 1832, introduced Nov. 9, 2011.

¹⁸ In addition to the bills, a House resolution has been proposed, stating that: "Congress should not enact any legislation that would grant State governments the authority to impose any new burdensome or unfair tax collecting requirements on small online businesses and entrepreneurs, which would ultimately hurt the economy and consumers in the United States." H. Res. 95, introduced Feb. 16, 2011.

¹⁹ House Judiciary Committee, "Constitutional Limitations on States' Authority to Collect Sales Taxes in E-Commerce," Nov. 30, 2011.

3. Bold tax changes in Connecticut, Illinois and New York

States in fiscal distress took radically different approaches in trying to eliminate their budget problems. Connecticut spread the tax increases broadly in its budget legislation, leaving no person or business unscathed.²⁰ On the sales tax front, Connecticut increased the general sales and use tax rate from 6% to 6.35%,²¹ imposed a higher 7% sales tax rate for “luxury” items,²² eliminated several sales tax exemptions generally taken,²³ added certain items to the list of taxable services,²⁴ and imposing click-through nexus on remote sellers with Connecticut markets.²⁵ Connecticut’s temporary corporation business tax surcharge became a little more permanent and somewhat more material with respect to corporations with at least \$100 million in annual gross revenue with a corporation business tax over \$250, as the corporate surcharge will be increased from 10% to 20% for tax years 2012 and 2013.²⁶ Finally, the personal income tax rate rose in 2011 for “high-income” taxpayers, impacting those with taxable income over \$100,000 for joint filers, \$50,000 for single filers and married people filing separately, and \$80,000 for heads of household, and resulting in more taxpayers subject to a 6.7% or 7% tax rate in contrast to the previous 6.5% maximum tax rate.²⁷

The Illinois legislature approved significant tax changes at the beginning and the end of the year. In January, the state adopted legislation dramatically increasing corporate and personal income tax rates, and restricting the use of net operating loss deductions.²⁸ The corporate income tax rate jumped from 4.8% to 7% for taxable years between January 1, 2011 and December 31, 2014.²⁹ The Illinois personal income tax rate increased from 3% to 5% between January 1, 2011 and December 31, 2014.³⁰ The corporate net operating loss deduction was suspended (except for S corporations) for tax years ending after December 31, 2010 and prior to December 31, 2014 for losses created in any taxable year ending on or after December 31, 2003.³¹ In December, bowing to the reality that several large corporations were considering leaving the state in light of these massive tax increases, several significant incentives were approved by the legislature to keep these

²⁰ S.B. 1239, Laws 2011.

²¹ CONN. GEN. STAT. § 12-408(1)(A).

²² CONN. GEN. STAT. § 12-408(1)(H).

²³ See generally CONN. GEN. STAT. §§ 12-407(a)(37).

²⁴ See CONN. GEN. STAT. §§ 12-407(a)(37)(GG) through (NN).

²⁵ CONN. GEN. STAT. § 12-407(a)(12)(L).

²⁶ CONN. GEN. STAT. § 12-214(b)(7)(A). The exception from the increased surcharge does not apply to corporations who earn less than \$100 million in annual gross revenue for those filing combined or unitary tax returns. CONN. GEN. STAT. § 12-214(b)(6)(B).

²⁷ CONN. GEN. STAT. § 12-700(a)(8)(A). Connecticut also adopted recapture provisions, which are designed to eliminate benefits received by taxpayers from having a portion of their taxable income taxed at a lower marginal rate. CONN. GEN. STAT. § 12-700(a).

²⁸ P.A. 96-1496 (S.B. 2505), Laws 2011.

²⁹ 35 ILL. COMP. STAT. 5/201(b)(9), (10). The rate is scheduled to drop from 7% to 5.25% for taxable years beginning on or after January 1, 2015, with a proposed reversion to the 4.8% rate beginning on or after January 1, 2025. 35 ILL. COMP. STAT. 5/201(b)(11)--(14).

³⁰ 35 ILL. COMP. STAT. 5/201(b)(4), (5). The rate is scheduled to drop from 5% to 3.75% on January 1, 2015, and then from 3.75% to 3.25% on January 1, 2025. 35 ILL. COMP. STAT. 5/201(b)(5.1)--(5.4).

³¹ 35 ILL. COMP. STAT. 5/207(d).

companies in the state.³² In addition, legislation was approved restoring the net operating loss deduction to the extent of up to \$100,000 per year for tax years ending on or after December 31, 2012 and prior to December 31, 2014.³³

As for New York, a fast-tracked change to the state's tax structure occurred in December, as the legislature was called into special session, resulting in a temporary reduction in the state's personal income tax in the 2012-2014 tax years from 6.85% (the rate currently in effect for all joint or surviving spouse filers earning more than \$40,000) to 6.45% (for joint or surviving spouse filers earning between \$40,000 and \$150,000) and to 6.65% (for joint or surviving spouse filers earning between \$150,000 and \$300,000). The tax rate stays at 6.85% for joint or surviving spouse filers earning between \$300,000 and \$2 million, and a new 8.82% tax rate applies for joint or surviving spouse filers earning more than \$2 million.³⁴ On the corporate tax side, the legislation temporarily reduces the regular corporation income tax rate on manufacturers from 6.5% to 3.25%, the alternative minimum tax on manufacturers from 1.5% to 0.75% for the 2012-2014 tax years, and significantly reduces the fixed dollar minimum tax applicable to manufacturers.³⁵ In addition, the legislation provides small businesses and some self-employed individuals relief from the 0.34% payroll tax.³⁶

4. Michigan changes corporate tax regimes . . . again

While Connecticut, Illinois and New York made changes to existing tax systems, Michigan went one step further and revamped its corporate tax regime, for the second time in four years. Michigan adopted a series of bills³⁷ enacting a Michigan corporation income tax (CIT), eliminating the Michigan Business Tax (MBT) except in limited situations, and making significant changes to the individual income tax provisions. The CIT will be imposed at a 6% tax rate on apportioned business income of C corporations and will take effect January 1, 2012. The freeze of the individual income tax rate at 4.35% is effective October 1, 2011, and accordingly, a 0.1% scheduled reduction in the tax rate did not occur on October 1, 2011.

The CIT is a more straightforward tax than its predecessors, the Single Business Tax (SBT) and the MBT. Similar to the MBT, the CIT imposes a filing obligation for

³² P.A. 97-636 (S.B. 397), Laws 2011.

³³ 35 ILL. COMP. STAT. 5/207(d).

³⁴ N.Y. TAX LAW § 601(a)(1). For head of household filers, the 6.45%, 6.65%, 6.85% and 8.82% tax rates apply to income over \$30,000, \$100,000, \$250,000 and \$1,500,000, respectively. N.Y. TAX LAW § 601(b)(1). For married filing separate and single filers, the above tax rates apply to income over \$20,000, \$75,000, \$200,000 and \$1 million, respectively. N.Y. TAX LAW § 601(c)(1).

³⁵ N.Y. TAX LAW § 210.1(a)(vi), (c)(ii), (d)(5).

³⁶ N.Y. TAX LAW §§ 800(b), 801(a).

³⁷ Enrolled House Bills 4361 (2011 PA 38), 4362 (2011 PA 39), 4479 (2011 PA 40), 4480 (2011 PA 41), 4481 (2011 PA 42), 4482 (2011 PA 43), 4483 (2011 PA 44) and 4484 (2011 PA 45) are all components of the new Michigan corporate and individual income tax regime. 2011 PA 38 and PA 39 address the corporate and individual income tax provisions, as well as the optional MBT filing and certificated credits. 2011 PA 40 amends the MTC three-factor apportionment option to specifically exclude the MBT and the CIT from such provision, and 2011 PA 41 through 45 enact legislation that affects public pensions.

businesses with \$350,000 or more of apportioned gross receipts³⁸ sourced to Michigan, unitary return requirements (applying a *Finnigan*³⁹ approach for sourcing), decoupling from federal benefits such as the IRC Sec. 168(k) bonus depreciation deduction and the IRC Sec. 199 domestic production activities deduction,⁴⁰ apportionment via a single sales factor, with carryover MBT sales definitions and sourcing provisions; and practically no credits for the general taxpayer, though there is an elective regime available for taxpayers holding credits under the MBT.⁴¹

The adoption of the CIT will result in the need to master a new type of Michigan corporate tax, while dealing with remaining SBT and MBT audit issues, along with numerous technical corrections that are still being considered in the legislature. Clearly, the benefits from a facially simpler tax will not be realized until administrators, taxpayers and practitioners alike learn the CIT (assuming of course that the CIT remains the corporate tax of choice in Michigan), and the older SBT and MBT regimes run their course. Further, it should be noted that Michigan's abandonment of the MBT, and its modified gross receipts component, may not represent a trend toward the abandonment of broader-based or multiple transactional tax regimes by states, as much as it may reflect Michigan's particular economic predicament.

5. Alabama's switch to market-based sourcing of services, and more states consider regulations

The trend toward market-based sourcing of services (and items other than tangible personal property) for purposes of the sales factor continued to pick up steam, as Alabama became the latest state to move away from the historic cost of performance rules advocated by the Uniform Division of Income for Tax Purposes Act (UDITPA).⁴² Instead, Alabama's new statute looks to the location of the taxpayer's market. Sales of services are sourced to the location where the service is delivered.⁴³ To the extent the sourcing location cannot be determined by this rule, a reasonable approximation methodology is authorized, though a "throwout" rule could be applied in the event the sale is assigned to a state in which the taxpayer is not taxable, or where the state of

³⁸ The definition of gross receipts for the CIT is substantially similar to the definition in the MBT. The CIT definition does not include phased-in provisions for certain receipts.

³⁹ Under the approach followed in *Appeal of Finnigan Corp.*, No. 88-SBE-022-A, Cal. State Bd. of Equalization, Jan. 24, 1990, a member of a unitary group has nexus with a state if any members of the group have nexus with the state. Many states follow the opposite ("*Joyce*") approach, under which a member of a unitary group does not have nexus with a state by reason of other members of the group having nexus with the state. See *Appeal of Huffly Corp.*, No. 99-SBE-005, Cal. State Bd. of Equalization, April 22, 1999.

⁴⁰ 2011 PA 38 §§ 603(2), 607(1).

⁴¹ 2011 PA 39 § 500(1).

⁴² In conjunction with this change in sourcing methodology, Alabama changed its equally weighted apportionment formula (in line with UDITPA) to a property, payroll and double-weighted sales apportionment formula. ALA. CODE § 40-27-1.

⁴³ It should be noted that sales from the rental, lease or license of real or tangible personal property, and sales of real property are sourced to the location of the property. ALA. CODE § 40-27-1.IV.17(a)(1), (2). Further, sales of intangible items are subject to a more complex evaluation, and may be sourced to the location where the intangible is used, or to the location where a consumer purchased a marketed good or service associated with the intangible. ALA. CODE § 40-27-1.IV.17(a)(4), (5).

assignment cannot be determined or reasonably approximated.⁴⁴ Interpretive regulations are in the process of being drafted and should be released for public comment in the next few months.

In California, a market-based sourcing rule for taxpayers electing to use a single sales factor apportionment formula was essentially finalized, more than a year from the beginning of the regulatory project.⁴⁵ While the statute simply requires sourcing to the location where the purchaser of the service received the benefit of the service in California,⁴⁶ the regulation goes into complex, and sometimes excruciating detail into the concept. The regulation defines the term “benefit of a service is received” as the location where the taxpayer’s customer has either directly or indirectly received value from delivery of that service.⁴⁷ In addition, the regulation provides a rebuttable presumption that for a taxpayer’s individual customers, the location of the customer’s billing address is where he or she has received the benefit, and for a taxpayer’s corporate customers, there is a rebuttable presumption that the location designated by a contract or the taxpayer’s books and records is the location of benefit.⁴⁸ Numerous examples are contained in the draft regulation to explain these concepts.⁴⁹

Illinois and New Jersey are also evaluating market-based sourcing concepts in draft regulations. Illinois’ statute requires the sourcing of sales from services to Illinois if the services are received in the state.⁵⁰ A draft regulation interprets this phrase through several examples, and also adds a cascading rule for situations where the location where the services are received cannot be determined.⁵¹ In New Jersey, sales from services are sourced to New Jersey if the service is performed within the state.⁵² The regulation currently in place explains that sourcing should be based on the cost of performance or time spent in the performance of services, or by another reasonable method reflecting trade or business practice and economic realities underlying the generation of the compensation for services.⁵³ In addition, the current regulation requires sourcing of service fees from transactions having contact with New Jersey to be sourced 25% to the state of origination, 50% to the state in which the service is performed, and 25% to the state in which the transaction terminates.⁵⁴ Revisions to the regulation currently being drafted would propose a change from these sourcing rules to using the location of

⁴⁴ ALA. CODE § 40-27-1, Art. IV, 17(b), (c).

⁴⁵ CAL. CODE REGS. tit. 18, § 25136-2. The regulation has been submitted to the California Office of Administrative Law, which is unlikely to make any substantive changes to the regulation prior to officially going final in the near future. Taxpayers who do not elect to use a single factor apportionment formula will continue to use the preponderance cost of performance rule. CAL. REV. & TAX. CODE § 25136(a).

⁴⁶ CAL. REV. & TAX. CODE § 25136(b)(1)-(4).

⁴⁷ CAL. CODE REGS. tit. 18, § 25136-2(b)(1).

⁴⁸ CAL. CODE REGS. tit. 18, § 25136-2(c)(1), (2).

⁴⁹ CAL. CODE REGS. tit. 18, § 25136-2(c)(1)(C), (2)(E).

⁵⁰ 35 ILL. COMP. STAT. 5/304(a)(3)(C-5)(iv).

⁵¹ ILL. ADMIN. CODE tit. 86 § 100.3370 (draft).

⁵² N.J. REV. STAT. § 54:10A-6(B)(4).

⁵³ N.J. ADMIN. CODE tit. 18, § 18:7-8.10(a).

⁵⁴ N.J. ADMIN. CODE tit. 18, § 18:7-8.10(c).

customer benefit rule, followed by several cascading rules in the event the location of customer benefit could not be determined.⁵⁵

Notably, the trend within the trend of moving to market-based sourcing is the lack of conformity between the market-based sourcing states themselves. For example, with respect to sourcing sales of services, the location of customer benefit principle contained in the California statute and regulation differs from the Alabama statute looking to where the service was delivered to the customer, and likewise, there will be important distinctions inherent in the Illinois and New Jersey interpretations of the concept. It should be noted that even more complex rules regarding the market-based sourcing of intangibles are contained in several of the statutes and regulations examined above.

Designed as a method to reduce complexity, the variety of market-based sourcing rules being adopted by the states promises just the opposite result.

6. Revised Texas Franchise Tax litigation (*Allcat / Nestle*) and the Comptroller's restrictive view on COGS

When the Revised Texas Franchise Tax (RTFT) was adopted, a curious provision allowing for direct challenge of constitutional issues to the Texas Supreme Court, with an expedited review and decision required by the Court within 120 days, was inserted into the enacting legislation.⁵⁶ In 2011, the first two challenges to the RTFT were offered up to the Court, and in *Allcat Claims Service*, the Court determined that the RTFT did not facially violate the “Bullock Amendment” of the Texas Constitution because the RTFT does not impose a tax on a natural person’s share of partnership income. The Court also held that it lacked jurisdiction to consider an “as-applied” challenge made by the taxpayers.⁵⁷

The second case, *Nestle*, will be decided by the Court by mid-February 2012.⁵⁸ In *Nestle*, three taxpayers with distinctive fact patterns have joined in the litigation. The first taxpayer (Nestle) is a manufacturer and distributor of food and beverages that only engages in wholesale activities in Texas but is classified as a manufacturer subject to the higher 1% RTFT rate. The second and third taxpayers (Switchplace and NSBMA) are not allowed to deduct significant costs in their businesses as cost of goods sold (COGS), though other companies that are considered by the taxpayers to be similarly situated are allowed the COGS deduction. The taxpayers are arguing that the RTFT violates both the Texas Constitution and the U.S. Constitution on several grounds.

Switchplace and NSBMA’s challenges may be the first of many on the COGS issue that the Texas Comptroller is required to defend, either in administrative hearings, lower courts, or in the case of a constitutional question, potentially the Texas Supreme Court. While the term COGS is required to be determined for federal income tax purposes, it is clear that the amount reported for federal COGS does not equal the amount of the

⁵⁵ N.J. ADMIN. CODE tit. 18, § 18:7-8.10 (draft).

⁵⁶ H.B. 3, Laws 2006, § 24(b).

⁵⁷ *In Re Allcat Claims Service, L.P.*, Texas Supreme Court, No. 11-0589, Nov. 28, 2011.

⁵⁸ *In re Nestle USA, Inc., Switchplace, LLC, and NSBMA, L.P.*, Texas Supreme Court, filed Oct. 19, 2011.

deduction allowed under the RTFT for taxpayers utilizing Texas COGS.⁵⁹ The Texas Comptroller's restrictive regulatory interpretation of what costs are allowed to be deducted, and the material tax impact resulting from the denial of a COGS deduction make it even more likely that some future test cases will relate to COGS.⁶⁰ One recent example of this restrictive view is a recent Comptroller letter concluding that direct labor costs for COGS (which are fully deductible) only include labor of those that physically produce or acquire a good, and as such, supervisory labor does not qualify as a direct cost (rather, it is an indirect cost subject to a much more limited deduction).⁶¹ Many overly aggressive Texas taxpayers may be in for a rude awakening.

7. New Jersey Whirlpool case

In *Whirlpool Properties, Inc. v. Director, Division of Taxation*,⁶² the New Jersey Supreme Court affirmed, with modification, a 2010 decision of the New Jersey Superior Court, Appellate Division⁶³ concluding that New Jersey's "throwout rule" was facially constitutional. The throwout rule was used to compute the denominator of the sales factor of the apportionment formula that was used in determining the portion of a corporation's entire net income subject to New Jersey's Corporation Business Tax. Under the throwout rule, non-jurisdictional or "nowhere sales"⁶⁴ made into foreign jurisdictions where a corporation was not subject to tax were excluded from the denominator of the sales factor.⁶⁵ The throwout rule was repealed in New Jersey for tax years beginning after June 30, 2010.

While the Court generally upheld the constitutionality of the throwout rule, the Court found that untaxed receipts could not constitutionally be thrown out where the taxpayer has nexus with a destination state which has chosen not to impose an income tax. As a result, states that have decided not to impose an income or similar business activity tax (i.e. Nevada, South Dakota and Wyoming) can be excluded from the New Jersey throwout denominator exclusion calculation, and refund claims for open tax years would be appropriate.⁶⁶ ***The questions that remain unresolved as a result of the decision are many, including whether an "as applied" constitutional challenge would be successful, whether the Court's decision can be used to argue that intercompany sales to unitary affiliates should not be thrown out of the sales factor calculation,***

⁵⁹ See TEX. TAX CODE ANN. § 171.1012.

⁶⁰ 34 TEX. ADMIN. CODE § 3.588.

⁶¹ Letter, *Comptroller of Public Accounts*, Aug. 30, 2011, STAR Accession No. 201108182L.

⁶² *Whirlpool Properties, Inc. v. Director, Division of Taxation*, 26 A.3d 446 (N.J. 2011).

⁶³ *Whirlpool Properties, Inc. v. Director, Div. of Taxation*, 25 N.J. Tax 519 (2010).

⁶⁴ Assembly Budget Committee Statement to A. 2501, p.3 (June 27, 2002); Senate Budget and Appropriations Committee Statement to S. 1556, p. 3 (June 27, 2002).

⁶⁵ N.J. REV. STAT. § 54:10A-6(B). The adoption of the throwout rule was one of several substantial statutory changes to the CBT that were enacted in a reform effort to overcome perceived tax avoidance by taxpayers. See Business Tax Reform Act of 2002, c. 40, § 8, (1). Published questions and answers concerning the new statute, along with regulations interpreting the throwout rule were adopted by the Division. Questions and Answers Regarding the Business Tax Reform Act 2002, New Jersey Division of Taxation, Jan. 9, 2003; N.J. ADMIN. CODE tit. 18, § 18:7-8.7(d).

⁶⁶ See Notice, "New Jersey Supreme Court Decision in *Whirlpool Properties Inc. v. Director*," Sep. 7, 2011.

and the role of economic nexus standards in potentially eliminating the effect of throwout.

8. New North Carolina combination provisions

The non-uniform array of potential filing methods in states imposing corporation income taxes contributes to the complexity and time-consuming nature of filing within these states. Some states mandate unitary combined reporting, others require separate reporting, and others allow a taxpayer to elect to use consolidated reporting akin to the federal income tax method, or some other hybrid method. At the same time, many states afford their state tax authorities the right to change the filing group or methodology in certain instances, particularly where income to the state is not clearly reflected by the taxpayer.

North Carolina, historically a separate reporting state, has afforded the Secretary of the North Carolina Department of Revenue wide latitude to require combination. Specifically, the Department was allowed to make adjustments to a corporation's tax return or require a combined return in cases where the corporation had not properly reported its state net income under the statutory separate entity reporting method.⁶⁷ Taxpayers and the Department have engaged in continued disputes over when and how a combined return could be required. Cases such as *Wal-Mart Stores East, Inc. v. Hinton*⁶⁸ and *Delhaize America, Inc. v. Lay*⁶⁹ are examples of contentious disputes that could not be resolved at the administrative level.

Earlier this year, North Carolina enacted legislation, effective for tax years beginning on or after January 1, 2012, that substantially clarifies the procedures the Secretary of the Department of Revenue must follow in order to adjust a corporation's tax return or require corporations to file on a combined basis, and allows the Department to enter into alternative filing methodology agreements with taxpayers in order to accurately reflect North Carolina net income.⁷⁰ The legislation requires that when the Department has reason to believe that any corporation conducts its trade or business in a manner that fails to accurately reflect its net income from business carried on in North Carolina through the use of transactions that lack economic substance or are not at fair market value between members of an affiliated group, the Department may issue a notice to the taxpayer for further information to determine if combination is required.⁷¹ In addition, a corporation may request in writing from the Secretary specific advice regarding whether a redetermination of the corporation's net income or a combined return (for all affiliates in the unitary group) would be required under the new law based on the taxpayer's specific

⁶⁷ N.C. GEN. STAT. § 105-130.6 (subsidiary and affiliated corporations); N.C. GEN. STAT. § 105-130.15(a) (method of accounting for income and deductions); and N.C. GEN. STAT. § 105-130.16(b) and (c) (corrections for distortions and other corrections needed on returns).

⁶⁸ 676 S.E.2d 634 (N.C. Ct. App. 2009).

⁶⁹ N.C. Sup. Ct., Wake County, No. 06 CVS 08416, Jan. 12, 2011.

⁷⁰ H.B. 619, Laws 2011; S.B. 580, Laws 2011.

⁷¹ N.C. GEN. STAT. § 105-130.5A(a).

facts and circumstances.⁷² The Department is statutorily authorized to redetermine the corporation's net income properly attributable to its business carried on in the state through adjustments or by requiring combined reporting, if the corporation's intercompany transactions lack economic substance or are not at fair market value.⁷³

In response, the Department of Revenue later issued a Directive that further explains the Department's authority to redetermine a corporation's net income by adjusting the corporation's intercompany transactions or requiring the corporation to file a combined income tax return.⁷⁴ The Directive describes the Department's powers in this area in significant detail, focusing on: (i) transactions that have economic substance; (ii) a determination of economic substance under the two-prong test; (iii) a determination of fair market value; (iv) adjustments to net income; (v) combined returns; (vi) other authority and limitations; and (vii) voluntary redeterminations.

The legislation, which is an attempt to provide limitations on the Department's power to require combination, still gives the power of combination to the Department, without an equal right for the taxpayer to request combination in cases where such filing method would be beneficial. However, if the Department wishes to combine a taxpayer, the combination must be done in an all-or-nothing manner, and the Department cannot pick and choose specific members of the unitary group to combine. Even with the new guidance contained in the statute and the Directive, it is still likely that the Department's discretionary authority to combine will be subject to protracted legal disputes in certain cases.

9. *Nortel* and Sales Tax Treatment of Technology Transfer Agreements

As corporations continue to upgrade their technology, they commonly purchase large quantities of hardware and software, often in an intricate manner. Typically, a straight sale of hardware and prewritten (canned) software will be subject to sales tax, while the sale of custom software is less likely to be taxable, particularly if delivered in electronic format. A question that recently arose in California was whether the license of prewritten software, including copyrighted software and programs performing processes subject to a patent or copyright interest, could be considered a technology transfer agreement (TTA)⁷⁵ exempt from the California sales tax.

⁷² N.C. GEN. STAT. § 105-130.5A(l).

⁷³ N.C. GEN. STAT. § 105-130.5A(b). The determination of whether intercompany transactions lack economic substance or are not at fair market value will be considered on a year-to-year basis.

⁷⁴ *Directive No. CD-11-01*, North Carolina Department of Revenue, Nov. 16, 2011. Note that the Directive provides that “[t]he interpretation in this Directive is a protection to the taxpayers affected by the interpretation and taxpayers are entitled to rely on this interpretation.”

⁷⁵ An agreement is a TTA if (1) the **holder** of a patent or copyright assigns or licenses to another person “the right to make and sell a product” that is subject to the patent or copyright interest, **or** (2) the **holder** of a patent assigns or licenses a “process” that is subject to the patent. CAL. REV. & TAX. CODE §§ 6011(c)(10)(D), 6012(c)(10)(D) (emphasis added).

In *Nortel Networks, Inc. v. State Board of Equalization*,⁷⁶ the California Court of Appeal held that a California regulation promulgated by the California State Board of Equalization (SBE) excluding prewritten software from the broad statutory definition of TTA was invalid. In doing so, the Court concluded that the seller of the software transferred an interest in intangible property that was subject to patents and copyrights and, as a result, the licensed software was exempt from sales tax under the TTA statute. In reaching its decision, the Court noted that the copyrighted programs were subject to the licensor's patents, the programs were contained on external storage media, not in the hardware when manufactured, and the licenses gave the purchaser the right to reproduce the copyrighted material on its computers. The Court held that the SBE's regulation stating that a TTA "does not mean an agreement for the transfer of prewritten software" conflicted with the statute and as such, the SBE exceeded its authority by promulgating the regulation.⁷⁷

In response, the SBE published a press release claiming that *Nortel* does not affect sales tax imposed on off-the-shelf software.⁷⁸ Following the decision in *Nortel*, the SBE amended its regulations to note that when the holder of copyrights or patents also sells the intellectual property to another in a TTA (including transfer of software), the amount charged for the copyrights or patents is not subject to sales tax. As a result of the decision, refund opportunities may be available with respect to similar types of transactions on which California sales tax was charged. The decision also potentially informs other states as to how sales of TTAs should be treated, to the extent that such issue has not been addressed to date.

10. Interesting and distinctive analyses in online travel company cases

In the past several years, the advent of the online travel company (OTC) has transformed the hotel industry. OTCs book hotel rooms and make other travel arrangements for customers over the Internet. The OTCs enter into contracts with individual hotels in which a discounted rate is negotiated and agreed upon for the hotel room. OTCs then display, offer and facilitate reservations of the rooms to the public at the discounted rate, plus a facilitation fee. The OTCs ultimately charge their customers a single amount which includes the discounted rate plus the facilitation fee, as well as a tax recovery charge (hotel occupancy taxes based on the discounted rate), and an additional amount for the OTCs' travel services (beyond the facilitation fee). After receiving payment from the customers, the OTCs typically pay the discounted rate and the state and local hotel occupancy taxes based on the discounted rate to hotels, which remit the taxes to relevant states and municipalities.

⁷⁶ 119 Cal. Rptr. 3d 905 (Cal. Ct. App. 2011).

⁷⁷ CAL. CODE REGS. tit. 18, § 1507(a)(1).

⁷⁸ "Nortel Case Does Not Affect Sales Tax On Off-The-Shelf Software," California State Board of Equalization, NR 66-11-H (May 27, 2011).

An issue that has resulted in a significant amount of litigation for OTCs is whether the hotel occupancy taxes that they pay should be based on the fully discounted rate, or on the actual amount collected by the OTCs. In 2011, a federal District Court upheld the validity of a 7% local hotel tax imposed by the Village of Rosemont, Illinois, on the full amount of the room rental fees charged by several OTCs.⁷⁹ In doing so, the Court determined that the OTCs were considered to be “owners” subject to the tax, and the OTCs’ service fees charged to ultimate consumers were part of the “room rental rate” comprising the tax base. In addition, the South Carolina Supreme Court held that an OTC was required to pay sales tax on its service and facilitation fees because it was in the business of furnishing accommodations in the state.⁸⁰ However, the Missouri Supreme Court held that OTCs were not subject to local hotel and tourism taxes in Missouri because OTCs did not provide sleeping rooms for transient guests.⁸¹

Given the significant differences in the hotel occupancy tax statutes in place across the country, it is unlikely that pure consensus will be reached on this issue any time soon, requiring OTCs to continue to be vigilant in all jurisdictions in which the hotel rooms they purchase at a discount are located. The OTC cases also bring to the forefront a more global consideration, notably what constitutes the true meaning of agency nexus for purposes of SALT. The cases holding that an OTC without physical presence in a jurisdiction is nevertheless subject to hotel occupancy taxes raise the question of whether such a finding is an impermissible extension of traditional agency nexus principles.⁸²

The information contained herein is general in nature and based on authorities that are subject to change. It is not intended and should not be construed as legal, accounting or tax advice or opinion provided by Grant Thornton LLP to the reader. This material may not be applicable to or suitable for specific circumstances or needs and may require consideration of nontax and other tax factors. Contact Grant Thornton LLP or other tax professionals prior to taking any action based upon this information. Grant Thornton LLP assumes no obligation to inform the reader of any changes in tax laws or other factors that could affect information contained herein. No part of this document may be reproduced, retransmitted or otherwise redistributed in any form or by any means, electronic or mechanical, including by photocopying, facsimile transmission, recording, re-keying or using any information storage and retrieval system without written permission from Grant Thornton LLP.

⁷⁹ *The Village of Rosemont, Illinois v. Priceline.com Inc.*; *TravelWeb LLC*; *Travelocity.com LP*; *Site59.com LLC*; *Expedia, Inc.*; *Hotels.com, LP*; and *Hotwire, Inc.*, United States District Court for the Northern District of Illinois, 09 C 4438 (Oct. 14, 2011).

⁸⁰ *Travelscape, LLC v. Department of Revenue*, 705 S.E.2d 28 (S.C. 2011).

⁸¹ *St. Louis County v. Prestige Travel, Inc.*, 344 S.W.3d 708 (Mo. 2011). Likewise, other courts have concluded that the OTCs are not “operators” subject to hotel occupancy taxes. See *Priceline.com Inc. v. Anaheim*, California Superior Court, Dkt. No. JCCP 4472, Feb. 1, 2010; *In re: Expedia, Inc.*, Philadelphia Tax Review Board, Dkt. No. 36HRMERZZ9933, July 6, 2010.

⁸² In particular, these cases may go beyond the oft-cited agency nexus holding by the U.S. Supreme Court that an out-of-state company’s use of independent contractors within the state resulted in the imposition of sales and use tax nexus for that company. See *Scripto, Inc. v. Carson*, 362 U.S. 207 (1961).

Tax professional standards statement

This document supports the marketing of professional services by Grant Thornton LLP. It is not written tax advice directed at the particular facts and circumstances of any person. Persons interested in the subject of this document should contact Grant Thornton or their tax advisor to discuss the potential application of this subject matter to their particular facts and circumstances. Nothing herein shall be construed as imposing a limitation on any person from disclosing the tax treatment or tax structure of any matter addressed. To the extent this document may be considered written tax advice, in accordance with applicable professional regulations, unless expressly stated otherwise, any written advice contained in, forwarded with, or attached to this document is not intended or written by Grant Thornton LLP to be used, and cannot be used, by any person for the purpose of avoiding any penalties that may be imposed under the Internal Revenue Code.