MARY F. BERNARD, CPA, CMI, is a Director in the State Income and Franchise Tax practice in the Providence, Rhode Island office of Ryan, LLC.

MARK L. NACHBAR, Esq., CPA, is a Principal in the State Income and Franchise Tax practice in the Los Angeles, California office of Ryan, LLC.

Current Developments in State and Local Tax

The Supreme Court Overturns Quill *in* Wayfair

By Mary F. Bernard and Mark L. Nachbar

The "tax case of the millennium" was decided in June by the U.S. Supreme Court. In *South Dakota v. Wayfair Inc.*,[1] the Court ruled 5-4 to overturn the decades-old physical presence requirement established in *Quill Corporation v. North Dakota.*[2] Justice Anthony Kennedy wrote for the majority that the "physical presence rule becomes further removed from economic reality" as time passes, which is resulting in significant losses in revenue to states. The dissent led by Chief Justice John Roberts would have preferred to leave this complex decision to Congress, as stated earlier in *Quill*.

Wayfair Inc. challenged the long-standing concept upheld in *Quill* in 1992, which said that a state could not require a seller with no physical presence in the state to collect and remit sales tax. This concept was intentionally challenged in 2016 when South Dakota legislators passed S.B. 106, requiring remote merchants with no physical presence in the state to collect and remit South Dakota's sales tax, upon meeting certain threshold requirements. Under this law, tax collection is imposed if either of the following criteria is met:

1. The remote seller's annual gross revenue of sale of tangible property, any products transferred electronically, or services delivered into South Dakota exceeds $100,000; or
2. The remote seller has 200 or more separate transactions of tangible property, any products transferred electronically, or services delivered into South Dakota per year.

With the removal of the physical presence requirement, e-commerce merchants can expect a significant increase in their sales and use tax reporting and data accumulation responsibilities, despite the state's arguments that sales tax collection is now cheap and easy for merchants due to technological advances. Fortified with this win, additional states may impose similar dollar and transaction thresholds for nexus, with very little uniformity among the states. Furthermore, the recordkeeping necessary to comply with potentially 10,000-plus taxing authorities would be excessive, at best. Merchants will first need to do research and determine if their goods and services are subject to tax in each jurisdiction, then determine if each customer's transaction is exempt from the tax due to a resale or other exemption circumstance. Merchants will likely start charging sales tax and have an extreme bookkeeping challenge when customers subsequently provide exemption certificates.

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Although the Court awarded a win to the state, without any restrictions or guidelines, unresolved issues now include: Will this be applied retroactively? Is one transaction in the state enough to create nexus? What about foreign entities selling into the states, formerly protected by the physical presence requirement? These issues alone could have far-reaching impacts.

As of July 15, 2018, 24 states either have existing economic presence thresholds requiring out-of-state retailers to collect or have enacted or have new laws pending to that effect.

Reactions to the Tax Cuts and Targeted Jobs Act

States Attempt a Workaround to SALT Caps of TCJA

Historically, State and Local Taxes (SALT) have been deductible in full against the federal taxable income of individuals. The Tax Cut and Jobs Act (TCJA) enacted on December 22, 2017, now limits the SALT deduction to $10,000, including all property, income and sales taxes, effective for tax years beginning on or after January 1, 2018. This change has caused many states to attempt to circumvent this limitation through the creation of tax credits or charitable contributions.

Currently, 33 states already have tax credits in place that have been successfully allowed in exchange for charitable contributions, without any Internal Revenue Service (IRS) objections. The IRS, however, has recently stated that it will be issuing guidance to counteract the efforts of states to work around the SALT cap limitation.

The most notable of workaround attempts are in the high state income tax states of Connecticut, New York, and New Jersey. Connecticut is proposing an entity-level tax on net income of passthrough entities, with an offsetting income tax credit for all entity members, as business taxes are not subject to the limitation. New York is exploring two options for workarounds: a charitable contribution in lieu of tax and a voluntary 5% payroll tax that would be deductible as employment tax from federal taxable income. As New Jersey has very high property tax, its workaround would allow municipal and county governments to set up a charitable contribution account for taxpayers to contribute to in exchange for offsetting property tax credits.

Conformity with New Provisions

As of the beginning of July 2018, of the 20 states, including the District of Columbia, that automatically conform to the Internal Revenue Code, one half of those jurisdictions either issued guidance on the new law or decoupled from the new law in some fashion. Seventeen states have enacted legislation to adopt or decouple, in part from the TCJA. The remaining states are still considering and evaluating the changes and their impact on the state's tax laws.

Colorado Implements Market-Based Sourcing Apportionment Methodology

Colorado corporate income taxes will incorporate a new method of sourcing sales of services, following a trend of states abandoning the cost of performance approach. The enactment of HB 18-1185 changes the procedure of sourcing services to a market-based approach, effective for tax years beginning on or after January 1, 2019.

Historically, most states used the cost of performance method to source sales of services to the location where the income-producing activity is performed. The details of this method vary among the states as to the definition of an income-producing activity and, as well, as to what costs should be included, resulting in a lack of uniformity among states. This also results in court cases for the same taxpayer being decided with opposite results based on the different state law distinctions, even with identical facts.

At this point, approximately half of the states have adopted market-based sourcing for sales of services revenue. Many follow the model rules proposed by the Multistate Tax Commission, in whole or in part. This methodology allows a state to tax out-of-state entities that provide services to in-state residents. Gross receipts of a taxpayer, other than from tangible personal property, are sourced to Colorado if the taxpayer's market is in Colorado. The taxpayer's market is in Colorado to the extent that the service is delivered to a location in Colorado. If the state of assignment cannot be determined, the state must be reasonably determined. If a determination cannot be made, the receipts in question must be removed from the denominator of the apportionment factor.

If the allocation and apportionment methods dictated by this new law do not fairly represent the extent of business activity in Colorado, the taxpayer may petition for an alternative allocation and apportionment method that is reasonable for the taxpayer's industry.

The intended purpose of this law change is to conform to the Multistate Tax Commission's model act, which simplifies the collection and administration of income taxes for the state and relieves taxpayers' compliance burden.

The Ongoing Chainbridge Saga

Since 2010, taxpayers have been challenging assessments in the District of Columbia (DC), and elsewhere, based on the transfer pricing calculations of the subcontractor Chainbridge Software LLC. The taxpayers claim that the comparable profits method of calculation used by Chainbridge violates the regulations under the Code Sec. 482 and that the DC Office of Tax and Revenue (OTR) did not review the taxpayer's operations or Chainbridge's analysis. Some of these cases in DC, involving combined assessments of more than $9.2 million for Exxon Mobil Oil Corp., Shell Oil CO., Hess Corp., Eli Lilly and Co., AT&T Services Inc., and Honeywell International Inc., have been quietly settled. The terms of the settlement are private and will not be disclosed by the Office of Administrative Hearings (OAH).

Two additional challenges still pending at OAH involve Pfizer Inc. and Ahold USA Holdings Inc., which may head to court if settlement cannot be reached.

Kentucky Enacts Major Tax Reforms

On April 13, 2018, lawmakers overrode the Governor's veto to HB 366, and on May 1, 2018, the House enacted HB 487, both of which make significant changes to the Kentucky corporate income tax. The new laws contain several provisions that are in reaction to the federal Tax Cuts and Job Creation Act. Also, several changes were made to the current way in which Kentucky taxes corporate income.

The state's apportionment definitions and rules were changed. The term "business income" is replaced with "apportionable income," and the term "sales" is replaced with "receipts." Both changes will result in a broader calculation of the state's sales factor. In addition, the traditional three-factor apportionment formula is replaced with a single receipts factor formula. The state has also chosen to tax the sales of non-tangible personal property based on the market for the sale, rather than under the income-producing activity test. These changes are effective for years beginning on or after January 1, 2018.

Effective January 1, 2019, Kentucky has also chosen to require unitary taxpayers to file a combined report or make an election to file a consolidated return that includes all affiliated group members. The combined returns are to be filed on a water's edge basis. The state has also taken a *Finnegan* approach to the computation of the apportionment factor for the combined return.

Maryland Adopts Single Sales Factor Apportionment

Maryland joined the latest group of states adopting single sales factor apportionment on April 24, 2018, when Governor Larry Hogan signed Senate Bill 1090 and House Bill 1794. These bills revised the existing three-factor apportionment to phase in single sales apportionment over five years, beginning with tax years after December 31, 2017.

Under prior law, all multistate corporate taxpayers, other than manufacturers, were required to use a three-factor apportionment formula consisting of a property factor, a payroll factor, and a double-weighted sales factor to apportion income to Maryland. Under the new law, the single sales factor apportionment formula will be phased in as follows:

- For tax years beginning in 2018, the apportionment formula will be a property factor, a payroll factor, and three times sales factor, with a denominator of five.
- For tax years beginning in 2019, the apportionment formula will be a property factor, a payroll factor, and four times sales factor, with a denominator of six.
- For tax years beginning in 2020, the apportionment formula will be a property factor, a payroll factor,

and five times sales factor, with a denominator of seven.

- For tax years beginning in 2021, the apportionment formula will be a property factor, a payroll factor, and six times sales factor, with a denominator of eight.
- For tax years beginning in 2022 and thereafter, the apportionment formula will be single sales factor.

Under both the new and old tax law, manufacturers are required to use the single sales factor apportionment formula.

An annual election is available to a taxpayer who qualifies as a "Worldwide Headquartered Company" in Maryland to continue to use the prior law method of three-factor apportionment with double-weighted sales. To qualify for this election, the statute defines a "Worldwide Headquartered Company" as a corporation included in a group of corporations, including a parent corporation that:

1. Filed a Form 10-Q with the Securities and Exchange Commission for the quarterly period ended on June 30, 2017;
2. Has its principal executive office in Maryland; and
3. Employs at all times between July 1, 2017 and June 30, 2020, at least 500 full-time employees at its principal executive office.

At this time, no definition of "principal executive office" has been provided by statute or regulation. Guidance may clarify the issue but could raise constitutional issues by favoring in-state headquartered taxpayers over out-of-state companies.

Massachusetts Appellate Tax Board Determines Taxpayer Is a Manufacturer

A footwear company that used overseas contract manufacturers to produce its product was determined to be a manufacturer for purposes of using the Massachusetts single-sales factor formula for manufacturers. In *Deckers Outdoor Corp. v. Commissioner of Revenue,*[3] the taxpayer designed and distributed footwear. It developed and provided design drawings and specifications, which it provided to an international subsidiary that outsourced the manufacturing of the product. Deckers tested and inspected the products during the production process and once the goods were finished.

Under Massachusetts law, "manufacturers" are required to apportion their income under a single sales factor formula. The term "manufacturing" is defined as transforming raw or finished physical products into a new product. The Board relied on several cases[4] in which contract manufacturers produced the product for the taxpayer. These interpretations of the term "manufacturing" were given broad construction in these cases. Based on this far-reaching reading of the term "manufacturing," and Deckers' significant involvement in the design and testing of the product, the Board concluded that Deckers was required to use the single sales factor apportionment formula.

Minnesota Supreme Court Overturns Financial Institution Ruling

The Minnesota Supreme Court has issued its decision in *Associated Bank, N.A. v. Commissioner of Revenue*[5] on July 5, 2018. The Court overturned the tax court's ruling that the commissioner of revenue properly invoked alternative apportionment resulting in a tax on the income of non-corporate entities. The taxpayer had taken advantage of an anomaly in Minnesota law that defined financial institutions as corporations. Associated Bank had changed its ownership structure so that its Minnesota real estate loan assets were held by two new limited liability companies located in Wisconsin. In doing so, under the reading of the statute, the interest income earned by the LLCs would not be included as Minnesota source income in the numerator of the taxpayer's Minnesota apportionment factor.

The commissioner invoked the states alternative apportionment provision to include the interest income of the LLCs in the financial institution's combined report. The Minnesota Supreme Court upheld the determination made by the commissioner. In doing so, the Court distinguished this case from its earlier decision in *HMN Financial v. Commissioner of Revenue,*[6] in which the Court did not allow the commissioner to look through or disregard a taxpayer's corporate structure. The Court found that in the current controversy, the commissioner was not disregarding the taxpayer's structure but was using his authority to rectify the misrepresentation of the tax liability resulting from the structure. The fact that the LLCs were not included in the combined report did not "fairly reflect" the income of the taxable entities in the group. Because there was not a "fair reflection" of income, the commissioner appropriately used his authority to invoke alternative apportionment.

Missouri Makes Changes to Its Corporate Income Tax Laws

Missouri enacted S.B. 884 on June 1, 2018 effective for tax years beginning on or after January 1, 2020. This new law reduces the corporate income tax rate from 6.25% to 4%. In addition, the state will require all income to be apportioned by a single sales factor formula. Market-based sourcing for the sales other than the sale of tangible personal property will be sourced to Missouri if the market for the sale is in Missouri. The market sourcing rules also include a throw out provision if the market for the sale cannot be determined or reasonably approximated. The rules with respect to consolidated returns have also been changed by eliminating the requirement that the affiliated group must derive at least 50% of its income from Missouri sources.

New Jersey Headquarters Company to Pay Self-Procurement Tax on All Assets Insured by Its Captive

In *Johnson & Johnson v. Dir., Div. of Tax'n*,[7] the New Jersey Tax Court ruled that Johnson & Johnson (J&J) was required to pay premiums tax on all U.S. assets insured by its captive insurance company. In its opinion, the Tax Court performed a lengthy analysis of the state taxation of insurance premiums in the U.S. The issue in the case was whether changes made to New Jersey's premium tax statutes, based on a federal insurance reform statute enacted in 2010[8] (NRRA), were intended to allow the state to impose a premiums tax on all of J&J's U.S. self-procured insurance risks insured by its captive insurance company.

The NRRA was passed to streamline and simplify the complexities that developed over many years related to multistate taxation of premiums paid to non-admitted insurers. Non-admitted insurers are those insurance companies that are not regulated by the insurance commission of the state in which the risks are located. The inconsistencies of state laws resulted in different rates and multiple taxation of the premiums assessed against non-admitted insurers. The NRRA provided that "no state other than the home state of the insured may require any premium tax payment for non-admitted insurance." In other words, the home state may tax all non-admitted insurance premiums in the United States.

New Jersey began to regulate non-admitted insurers starting in 1960. From 1960 to 2011, New Jersey only imposed a premium tax, assessed against the insured ("self-procurement tax"), on insured risks within New Jersey. New Jersey amended its self-procurement tax, effective July 2011, to bring its taxing policy into compliance with the broader mandate of the NRRA. However, the amendments did not explicitly include captive insurance companies in the broader taxing statute. The New Jersey Legislature specifically stated that the amendment to its premium tax law was to bring "surplus line" insurance taxation into conformity with the NRRA. "Surplus line" insurance policies are policies for hard to insure liabilities that may not be available through in-state insurance companies. These policies may or may not be written by captive insurance companies.

The Tax Court was not persuaded by J&J's argument that the 2011 changes to the New Jersey law did not apply to captive insurance companies. The Court found that while the language used by the Legislature simply included "surplus lines," the intent was to include captive insurance companies under the new law because both surplus line insurance companies and captive insurance companies were subject to the self-procurement tax under the old law. Taxpayers with captive insurance companies should consider how this decision will affect them in New Jersey and possibly other states that have enacted similar law changes to conform to the NRRA.

New Jersey Superior Court Denies Interest Addback Exception in *Kraft Foods Global Inc.*

The Superior Court of New Jersey held that the Division of Taxation Director ("Director") was correct in denying the application of the unreasonable exception and requiring Kraft Foods Global Inc. ("Global") to add back intercompany interest in *Kraft Foods Global Inc. v. Division of Taxation*.[9]

Kraft Foods Inc. ("Kraft") was an out-of-state corporation with activity in New Jersey, filing corporate business tax returns for the years at issue. The returns did not include an addback of the intercompany interest paid by Global to the parent, Kraft, based on the unreasonable exception to the addback provision provided in N.J. Stat. §54: 10A-4(k)(2)(l). The parent had issued public debt in the form of bonds periodically, followed by a transfer to Global of the proceeds of the issuance to allow Global to pay off its debts. Global then issued a series of notes to Kraft for the amounts lent. These notes provided only for interest payments equivalent to the interest Kraft was to pay bondholders. The notes did not contain a guarantee to Kraft's bondholders, nor did they provide for a repayment of the principal borrowed.

During an audit of the applicable returns (2005–2006), the Division of Taxation denied the deduction of the interest payments related to the intercompany loans because 1) the debt between Global and Kraft was not at arm's length, as Kraft charged the same rate as it was paying to bond holders; and 2) Global was not the legal guarantor of the debt. The Tax Court agreed with the Director's assertions in its decision in 2016.

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The Superior Court only addressed the issue of whether the taxpayer qualified for the unreasonable exception to New Jersey's interest expense addback provision. Although there are five exceptions to the addback, the taxpayer claimed only the unreasonable exception, which requires the taxpayer to establish "by clear and convincing evidence, as determined by the Director, that the disallowance of a deduction is unreasonable."

The Court held that the Director was correct in denying the application of the exception to the addback by relying on the lack of guaranty of the loans and the lack of tax paid by the affiliate receiving the income. While earlier decisions established that the Director could not rely solely on the absence of tax paid on the income to deny the unreasonable exception, in this case, there were other factors—the lack of guaranty and lack of arm's-length terms, notwithstanding that the latter fact was not established.

To prevail on this issue, the taxpayer bears a high burden of proof to produce clear and convincing evidence that the Director's disallowance is unreasonable. The Superior Court's decision illustrates how fact and circumstance dependent exception appeals are the challenge taxpayers face.

New Jersey Makes Corporate Income Tax Changes

On July 2, 2018, New Jersey enacted several changes to its corporate income tax provisions. A-4204 imposes a surtax on New Jersey corporate income that exceeds $1 million at a rate of 2.5% for years January 4, 2018 to December 31, 2019; and at a rate of 1.5% for years January 1, 2020 to December 31, 2021. The new law also decouples from many provisions of the newly enacted federal tax changes.

The legislation also provides for mandatory combined reporting for all unitary taxpayers for periods beginning January 1, 2019. S Corporations can elect out of the combined group. Taxpayers can also elect to report income on a worldwide basis; however, the default group is a water's edge group excluding 80/20 companies. The election to file on a worldwide basis would be for five years. The state has taken the *Joyce* approach for purposes of inclusion of New Jersey sales in the combined apportionment factor. The new law also provides for a deduction if there is a significant increase in the member's net deferred tax liability or a significant decrease in the member's net deferred tax assets. The deduction can be taken five years after the date of enactment, spread over a 10-year period. The legislation also makes changes to the state's existing NOL rules to align them with the new combined reporting regime.

Finally, the new legislation adopts a market approach to apportioning income from the sale of services. Sales of services will be sourced to New Jersey if the benefit of the service is received in New Jersey.

Nextel Pennsylvania Net Loss Carryover Final Denial

The U.S. Supreme Court declined to review the Pennsylvania Supreme Court ruling in *Nextel Communications of the Mid-Atlantic, Inc.*[10] In this decision, the Court ruled that a statutory limitation on the net loss carryover (NLC) deduction violated the state's constitutional uniformity provision.

At the state level, the trial court determined that the $3 million cap on the state's NLC deduction disparately affected companies of different sizes by allowing some taxpayers to reduce their tax liability to zero, while others were limited on the amount of loss that could be used to reduce income. This resulted in creating two classes of taxpayers—those who could completely eliminate their tax liability and those who could not.

The remedy instituted after *Nextel* was to eliminate the $3 million cap, while keeping the percentage limitation in place. This eliminated the violation that caused two classes of taxpayers, as all taxpayers were to be limited by the same percentage of taxable income for the deduction losses.

This win for the taxpayer at the lower court level unfortunately did not result in a refund for the taxpayer. The state Supreme Court overturned the ruling, and the remedy was to sever the $3 million cap to preserve uniformity. Nextel was still subjected to the percentage limitation and therefore was not eligible for a refund. Nextel petitioned the U.S. Supreme Court to review the case, asserting that the state court ruling violated the federal due process clause because Nextel was deprived of property without a proper process to obtain relief.

The denial of review denotes the end of the line for Nextel. The Pennsylvania Department of Revenue issued guidance in May when it announced that the *Nextel* ruling would not apply to tax years before 2017. The Department reinstated the unconstitutional $3 million cap on the NLC for years beginning after December 31, 2006 through December 31, 2016. For years beginning in 2017, only the limitation of 30% of taxable income will continue to apply to the NLC deduction.

Texas Telecommunications Company Provides a Service Not a Product

A Texas Court of Appeals considered whether a telecommunications provider of internet access, landline telephone service, and online video streams was selling "goods" or providing a "service." In *NTS Communications Inc. v. Hegar,*[11] the Court determined that the taxpayer was providing a service and therefore not eligible for the Cost of Goods Sold (COGS) deduction in calculating the taxable margin for purposes of the franchise tax.

NTS Communications Inc. (NTS) argued that its products were goods, not services, and as such it was entitled to deduct the cost of electricity used to generate and transmit its telecommunications products. Although the term "services" is not defined in the franchise tax statutes, the Court looked to common definitions and concluded that supplying internet access, telephone connectivity, and video streams to private consumers through a network of cables and wires constituted providing a service, as the term is commonly used. In addressing the taxpayer's argument that the video stream product met the narrow definition of the statute under subsection 171.1012(a)(3)(A)(ii), which defines tangible personal property to include "films, sound recordings, videotapes, live and prerecorded television and radio programs…," the Court determined that NTS does not sell films or programming through the video product.

Although the Court conceded that the landline product would be considered tangible property, the related deductions were insufficient to warrant any change to the tax calculation, using the COGS deductions available to that revenue stream.

The IRS has hinted that the upcoming guidance will consider substance-over-form principles, while noting that the IRS will continue to monitor state legislative proposals.

ENDNOTES

1 *South Dakota v. Wayfair Inc.*, 138 SCt 2080, 6/21/2018.

2 *Quill Corporation v. North Dakota*, 504 US 298 (1992).

3 *Deckers Outdoor Corp. v. Commissioner of Revenue,* Docket No. C320020; C321955, Massachusetts Appellate Tax Board, 6/21/18.

4 *Commissioner of Revenue v. Houghton Mifflin Company*, 423 Mass 42 (1995); *The First Years, Inc. v. Comm'r of Revenue,* Mass. ATB Findings of Fact and Reports 2007-1004; *Onex Communications Corporation v. Comm'r of Revenue*, 475 Mass. 419 (2010); *Duracell, Inc. v. Comm'r of Revenue,* Mass. ATB Findings of Facts and Reports 2007-903 and *Random House, Inc. v. Comm'r of Revenue,* Mass. ATB Findings of Fact and Reports 2012-973.

5 *Associated Bank, N.A. v. Commissioner of Revenue*, Minn., No. A17-0923, 07/05/18.

6 *HMN Financial Inc. v. Commissioner of Revenue*, Minn., 782 NW2d 558, 5/20/10.

7 *Johnson & Johnson v. Dir., Div. of Tax'n*, N.J. TC, No. 013502-2016, 06/15/18.

8 The Nonadmitted and Reinsurance Reform Act of 2010 (P.L. 111-2013), Title V, Subtitle B, Secs. 521–527; 531–533 and 541–542. 15 USC Secs. 8201–8206. Effective 7/21/11.

9 *Kraft Foods Global Inc. v. Division of Taxation,* 2018 N.J. Super. Unpub. DOCKET NO. A-1157-16T1, May 17, 2018.

10 *Nextel Communications of the Mid-Atlantic, Inc.*, U.S. Supreme Court Order List 584 U.S. Order Number 17-1506, 6/11/2018.

11 *NTS Communications Inc. v. Hegar*, Tex: Court of Appeals, 3rd Dist., 2018.