University of Mississippi

eGrove

Guides, Handbooks and Manuals

American Institute of Certified Public Accountants (AICPA) Historical Collection

2011

Advisor's guide to multistate income taxation : compliance and planning opportunities

Bruce M. Nelson

Follow this and additional works at: https://egrove.olemiss.edu/aicpa_guides

Part of the Accounting Commons, and the Taxation Commons

Bruce M. Nelson, MA, CPA, has over 25 years' experience in state and local tax and is currently employed at Ehrhardt Keefe Steiner Hottman, P.C. (EKS&H) in Colorado. Prior to joining EKS&H, Bruce was with a law firm specializing in state tax audit defense and litigation, was manager of tax policy for the State of Colorado, and was a senior tax manager in a Big Four accounting firm. Bruce earned his BA from the University of Nebraska-Lincoln and an MA from Colorado State University. He is on the adjunct faculty of Regis University and is a frequent seminar speaker. He teaches continuing education classes in state and local tax for the University of Denver's Graduate Tax Program, the Colorado Society of CPAs, and the AICPA. Bruce has published more than 40 tax articles in various publications, is a coauthor of the *Sales and Use Tax Answer Book*, and is a former columnist for the *Journal of State Taxation*. Bruce is a member of the AICPA and the Colorado Society of Certified Public Accountants.

Multistate Income Taxation in an E-Commerce World

With rapid technological changes in e-commerce, more and more businesses find themselves doing business in a multistate environment. The rise of internet sales has affected the age-old nexus issue in unprecedented ways.

If you have clients doing business in the multistate arena, you need to be aware of the issues, liabilities, and opportunities arising from doing business in more than one state. To keep up with your clients' growing businesses—whatever their size—you need to be up to speed on multistate tax issues.

In this guide—and the included CD—you will learn about the tax-saving opportunities and alternatives available to your clients and how to advise your clients in complying with the various federal, state, and local requirements.

Topics covered in this book include the following:

- Nexus
- State modifications
- State filing methods
- Combined reporting
- Apportionment and allocation
- Uniform Division of Income for Tax Purposes Act (UDITPA)
- Business and nonbusiness income
- Intangibles: interest, dividends, and royalties
- Irregular corporate tax structures

The included CD features an informative 124-slide PowerPoint presentation that you can use to educate your clients and potential clients on multistate tax issues. It helps you illustrate situations that raise potential tax issues and reviews the rules and regulations that present tax-saving opportunities.

ISBN 978-1-93735-003-1

PTX1201P

AICPA American Institute of CPAs®

aicpa.org | cpa2biz.com

The Adviser's Guide to Multistate Income Taxation – Compliance and Planning Opportunities –

The Adviser's Guide to Multistate Income Taxation

— Compliance and Planning Opportunities —

AICPA®

Bruce M. Nelson, MA, CPA

11429-359_Advisor's Guide to Multistate Income Taxation_Spread.indd 1 10/6/11 2:39 PM

The Adviser's Guide to

Multistate Income Taxation

Compliance and Planning Opportunities

11429-359

AICPA®

Bruce M. Nelson, MA, CPA

Notice to Readers

The Adviser's Guide to Multistate Income Taxation: Compliance and Planning Opportunities does not represent an official position of the American Institute of Certified Public Accountants, and it is distributed with the understanding that the author and publisher are not rendering, legal, accounting, or other professional services in the publication. This book is intended to be an overview of the topics discussed within, and the author has made every attempt to verify the completeness and accuracy of the information herein. However, neither the author nor publisher can guarantee the applicability of the information found herein. If legal advice or other expert assistance is required, the services of a competent professional should be sought.

Copyright © 2011 by
American Institute of Certified Public Accountants, Inc.
New York, NY 10036-8775

All rights reserved. For information about the procedure for requesting permission to make copies of any part of this work, please email copyright@aicpa.org with your request. Otherwise, requests should be written and mailed to the Permissions Department, AICPA, 220 Leigh Farm Road, Durham, NC 27707-8110.

1 2 3 4 5 6 7 8 9 0 PIP 1 9 8 7 6 5 4 3 2 1

ISBN: 978-1-93735-003-1

Publisher: Amy M. Plent
Senior Managing Editor: Amy Krasnyanskaya
Acquisitions Editor: Martin Censor

About the Author

Bruce M. Nelson, MA, is a CPA with over 25 years' experience in state and local tax, and is employed at Ehrhardt Keefe Steiner Hottman, P.C. (EKS&H). Prior to joining EKS&H, Bruce spent three years with a law firm specializing in state tax audit defense and litigation; two years as the Manager of Tax Policy at the State of Colorado; and before that, he was a Senior Tax Manager for several years in a "Big Four" accounting firm, where he ran the state and local tax desk. Bruce earned a Bachelor of Arts degree from the University of Nebraska-Lincoln and a Master's degree from Colorado State University, and he is a certified public accountant in the state of Colorado. He is also on the adjunct faculty for Regis University where he teaches courses in individual, partnership, and corporate taxation. He is a frequent seminar speaker and teaches continuing education classes in state and local tax for the University of Denver's Graduate Tax Program, the Colorado Society of CPAs, and the AICPA. Bruce has published more than forty tax articles in many publications including the *Journal of Accountancy, Tax Executive, Controller Magazine*, the *Journal of Multistate Taxation, State Tax Notes*, and *Colorado Lawyer*. He is a co-author of the *Sales and Use Tax Answer Book*, co-editor of the *Guidebook to Colorado Taxes*, and a former columnist for the *Journal of State Taxation*. Bruce is a member of the AICPA and the Colorado Society of Certified Public Accountants.

Preface

Why a National Multistate Income Tax Book?

Multistate corporate income tax books are not widely available in colleges or other institutions of higher learning. It is only recently that undergraduate textbooks have begun to include chapters on multistate taxation. In addition, multistate income tax books continue to be difficult to find at the local level. So, many practitioners enter the field ill-equipped to handle multistate issues. As the Internet now allows even small businesses to conduct and transact business more easily in the national—and even international—arena, this information has become more important for most advisers, including advisers to small- and medium-sized businesses.

Although no two states are identical in their treatment of corporations doing business in a multistate tax environment, a general multistate income tax sourcebook seems appropriate for a variety of reasons.

First, states rely on a limited number of concepts in applying their corporate income tax laws. For instance, most states distinguish between business and nonbusiness income and use some variation of the traditional three-factor (sales, property, and payroll) method for apportioning business income.

Second, given the rapid technological changes in e-commerce, more and more small businesses find themselves doing business in a multistate environment. State tax administrators, for example, continue to press for authority to tax any out-of-state business that does only online sales in their state. In some states, simple participation in a trade show by an out-of-state business will create a filing obligation with the state. A simple misstep by even the smallest of mom-and-pop businesses can result in thousands of dollars of tax, penalties, and interest.

After reading this book, you should be alerted to situations when potential multistate income tax saving opportunities exist. In each situation, you will need to review the appropriate rules, regulations, and practices of the particular jurisdiction to see what options and alternatives may be available.

In summary, this book is intended to make you aware of the pertinent issues, potential liabilities, and opportunities in doing business in more than one state.

Who Needs This Information?

This book is intended to be an introduction to the basic concepts of multistate corporate income tax. CPAs, CFOs, attorneys, and other professionals will benefit from this information.

This book addresses issues pertinent to public practitioners as well as accountants in industry or other nonpublic positions. The examples at the end of the chapters illustrate issues and principles that apply to companies in a variety of industries and recur time and again in multistate taxation.

How Will Your Business or Practice Benefit?

In light of the competitive business environment that includes not only public accounting, but virtually all businesses, this book should assist you or your business in reducing costs, generating additional revenues, and creating goodwill with clients or superiors.

As mentioned previously, many businesses unwittingly incur significant state income tax liabilities. This book will help you become familiar with the basic concepts of multistate corporate income so that you can identify potential liabilities and tax savings.

The basic information included in this book can assist you whether you are dealing with a state department of revenue, or even when negotiating a fee with an outside expert. For example, the ability to negotiate a settlement has its obvious benefits. Having a basic knowledge of the multistate income tax will enable you to approach, discuss, and perhaps even negotiate more effectively and with more confidence.

Federal taxes have always been the mainstay for tax advisers. The focus has been so heavy on federal taxes that, until recently, state tax planners have had little competition. This is changing quickly, making the state and local tax arena an exciting and competitive field.

An expertise in multistate tax can offer both employees and practitioners a higher profile in their company or community. Obviously, these taxes can have a drastic effect on a company's bottom line, and the field is rich with planning opportunities.

Contents

Introduction..1
Tax Formula for Multistate Corporate Taxpayers..1
Irregular Corporate Tax Structures.......4
Michigan....................................4
Ohio 7
Texas..8
Washington...............................10
Capital Stock and Franchise Taxes.....................................14

Chapter 1: Interstate Activity and Nexus..15
Introduction 15
Nexus Defined..................................15
Due Process Clause.....................16
Commerce Clause 17
Sales Tax Nexus 20
The Continuing Questions About Sales Tax Nexus...........22
Income Tax Nexus.....................39
Public Law 86-272 39
Statutory Provisions and Where to Go From Here...................................46
Offers in Compromise 47

Chapter 2: Calculation of State Taxable Income: Modifications........49
Introduction 49
Additions 50
Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 50
American Recovery and Reinvestment and Worker, Homeownership, and Business Assistance Acts of 2009 51
American Jobs Creation Act of 2004 52
Depreciation, Depletion, and Amortization...........................52
Related Party Royalty and Interest Payments....................53
State and Municipal Interest Income 54
State Income Taxes.....................55
The Federal NOL.......................55
Subtractions 58
Deduction for Federal Income Tax Paid 58
Deduction for State Income Taxes Paid 58
Expenses Related to Nontaxable State and Municipal Interest Income 59
Interest Income Earned on Federal or U.S. Obligations 59
Refunds of State Income Taxes.....................................60
Deductions Disallowed by Federal Credits........................60
Dividends Received Deduction..............................60
Appendix 1: Multistate Tax Commission Model Statute 65

Chapter 3: Filing Methods for Multistate Taxpayers.....................71
Introduction 71
Separate, Consolidated, or Combined Filing............................71
An Incredibly Simplified Example.................................73
Unitary Tax...............................75
The Landmark Cases..........................77
The Three Unities Tests.............77
The Contribution and Dependency Tests...................82

Factors of Profitability Test 83
Taxpayer Victories 85
Flow of Value Test and Worldwide Combination 87
Should the Unitary Business Principle Be Abandoned? 89
Pulling It All Together 92
Multistate Tax Commission 93

Chapter 4: Apportionment and Allocation 101
Introduction 101
Current Rules 101
Right to Apportion 101
Business Versus Nonbusiness Income 102
Two Tests or Three 103
Attempts to Define Business Versus Nonbusiness Income 105
Problem Areas 105
Gains and Losses From Real or Tangible Personal Property Dispositions 106
Patents, Copyrights, and Trademarks 108
Interest Income 109
Income From Stock Sales 111
Dividend Income 111
Liquidations 112
Other Income 113
Internal Revenue Code Section 338(h)(10) 114
Partnership Interests: Business or Nonbusiness Income? 114
The Hercules Cases 115
Illinois 115
Kansas 116
Maryland 116
Minnesota 116
Utah 116
Wisconsin 116
Having Your Cake and Eating It Too 116
The Supreme Court—Once Again 117

Chapter 5: Apportionment Formulas and Factors 121
Introduction 121
Payroll, Property, and Sales Factors 121
The Payroll Factor 124
The Property Factor 125
Property Included in the Factor 126
Property Value 127
Computational Problems 128
The Sales Factor 129
Definitions 129
Problem Areas 130
Destination Sales 131
Dock Sales 132
Throwback Sales 132
Service Sales 134
To Market, to Market 136
Outsourcing and Independent Contractors 137
Specialized Industries 137
The "Relief Provision" 138
How Much Distortion Is Enough? 139
The Treatment of Factors in Partnerships 139
Appendix 1: Apportionment Formulas and Corporate Tax Rates by State 143
Appendix 2: 25137-1. Apportionment and Allocation of Partnership Income 147

Chapter 6: Basic Ideas of Multistate Income Tax Planning 153
Introduction 153
Identifying Goals and Methodologies 153
General Planning Goal 153

Specific Tactics 154
Unique State Provisions 159

Chapter 7: Audit Defense Strategies 163
Introduction 163
Audit Selection 163
Formulas and Statistics 163
Prior Audits: Data from Outside Sources 164
The Pre-Audit 165
Whom to Contact 165
Type of Tax: Audit Period 165
Required Documentation 165
Time and Place of Audit 165
Initial Meeting and Audit Work 166
Controlling the Flow of Information 166
Avoiding Commitments 167
Limits on Time and Distance 168
Be Professional 168
Closing Conference 168
Conclusion 169

Appendix A: Public Law 86-272 171
Appendix B: Uniform Division of Income for Tax Purposes Act 173
Appendix C: *Wisconsin vs. Wrigley* 187
Appendix D: *Geoffrey, Inc. v. South Carolina Tax Commission* 205
Appendix E: State C Corporation Income Tax Return Checklist 2010 211
Tax Glossary 219

Introduction

Forty-five states and the District of Columbia impose some type of income tax on corporations. (Nevada, Ohio, South Dakota, Washington, and Wyoming do not impose corporate income taxes.) Most of these states "piggyback" off federal taxable income. Unfortunately, while the concepts of dividing a company's taxable income among the states in which it is doing business are few in number, the application and methods of applying those concepts are various and often contradictory.

The state approach to taxing multinational corporations differs from the federal approach. The latter generally uses a "separate accounting" approach that requires that income be allocated to a specific jurisdiction based on complex transfer pricing and sourcing rules. States apportion a multistate or multinational corporation's income based upon a formula intended to reflect the company's presence and income in each state. The formula traditionally has relied on factors such as sales, property, and payroll.

The basic outline of state income tax begins with federal taxable income, adds and subtracts certain state modifications and allocable nonbusiness income, and then multiplies the apportionable income based on some combination of sales, property, and payroll factors. The following tax formula illustrates the basic computation.

Tax Formula for Multistate Corporate Taxpayers

	Federal taxable income (IRS Form 1120, line 28 or 30)	$ ________
Plus or minus	State modifications	$ ________
Equals	State tax base	$ ________
Minus	Allocable nonbusiness income	$ ________
Equals	State apportionable income or (loss)	$ ________
Times	State's apportionment percentage	________ %
Equals	State apportioned income or (loss)	$ ________
Plus	State's allocable nonbusiness income	$ ________
Equals	State taxable income (loss)	$ ________
Times	State tax rate	________ %
Equals	Tax liability before credits	$ ________
Less	State tax credits	$ ________
Equals	Net state income tax liability	$ ________

The following simplified example illustrates the basic multistate calculation.

The Rocky Mountain Corporation does business in two states, North Dakota and Alabama. Its federal taxable income for the year was $1,900,000, which included interest on U.S. obligations of $26,000. During the year the company made estimated tax payments of $50,000 to North Dakota and $20,000 to Alabama. The company's sales, property, and payroll by state were as follows:

	North Dakota	Alabama	Total
Sales	$38,000,000	$12,000,000	$50,000,000
Property	6,000,000	3,000,000	9,000,000
Payroll	1,200,000	800,000	2,000,000

Rocky Mountain's modified state taxable income is $1,874,000 ($1,900,000 − $26,000).

Its North Dakota apportionment factor is 67.56 percent, making its North Dakota taxable income $1,266,074 ($1,874,000 x 0.6756).

$$\frac{(\$38{,}000{,}000/\$50{,}000{,}000 + \$6{,}000{,}000/\$9{,}000{,}000 + \$1{,}200{,}000/\$2{,}000{,}000)}{3}$$

Using the North Dakota figures, our tax formula for North Dakota looks like this:

	Federal taxable income (IRS Form 1120, line 28 or 30)	$1,900,000
Plus or minus	State modifications	26,000
Equals	State tax base	$1,874,000
Minus	Allocable nonbusiness income	-0-
Equals	State apportionable income or (loss)	$1,874,000
Times	State's apportionment percentage	67.56%
Equals	State apportioned income or (loss)	$1,266,074
Plus	State's allocable nonbusiness income	-0-
Equals	State taxable income (loss)	$1,266,074
Times	State tax rate	5.00%
Equals	Tax liability before credits	63,304
Less	State tax credits	(50,000)
Equals	Net state income tax liability	$ 13,304

The company's Alabama apportionment factor is 32.44 percent, making its Alabama taxable income $607,926 ($1,874,000 x 0.3244).

$$\frac{(\$12{,}000{,}000/\$50{,}000{,}000 + \$3{,}000{,}000/\$9{,}000{,}000 + \$800{,}000/\$2{,}000{,}000)}{3}$$

Using our tax formula, the Alabama numbers look like this:

	Federal taxable income (IRS Form 1120, line 28 or 30)	$1,900,000
Plus or minus	State modifications	26,000
Equals	State tax base	$1,874,000
Minus	Allocable nonbusiness income	-0-
Equals	State apportionable income or (loss)	$1,874,000
Times	State's apportionment percentage	32.44%
Equals	State apportioned income or (loss)	$ 607,926
Plus	State's allocable nonbusiness income	-0-
Equals	State taxable income (loss)	$ 607,926
Times	State tax rate	4.00*
Equals	Tax liability before credits	24,317
Less	State tax credits	(20,000)
Equals	Net state income tax liability	$ 4,317

* For purposes of this example, flat rates of 5 and 4 percent, respectively, have been used.

Please note that the apportioned income comes out to exactly 100 percent (67.56 percent for North Dakota and 32.44 percent for Alabama). The chances of this happening in the real world are highly unlikely. For example, let us say that North Dakota decided to adopt single sales factor apportionment. Then, its apportionment factor would be 76 percent (38,000,000/$50,000,000), and Rocky Mountain would be apportioning more than 100 percent of its income—108.44 percent (0.76 + 0.3244). This is not good. However, just the opposite could happen as well. Suppose Alabama, instead of North Dakota, adopted a single sales factor. Alabama's factor would then be 24 percent (12,000,000/50,000,000), and Rocky Mountain would now be apportioning only 91.56 percent of its income (0.24 + 0.6756). The fact is that given the differences among the states in how they define the tax base and the apportionment factors, it would be downright miraculous if a company ever ended apportioning exactly 100 percent of its income.

In this book, we will analyze the elements of this formula in detail. The topics we will cover will include the required and allowable modifications to federal taxable income, what constitutes business and nonbusiness income, and a detailed examination of the factors (property, payroll, and sales) of the apportionment formula and the different weight that is often given to the sales factor.

This book is designed to be a permanent reference tool. Nevertheless, it is no substitute for researching a state's specific tax statutes, regulations, and case law. We hope your reading of this guide enriches your professional learning experience.

Author's Note: On Personal Pronouns

We use the terms he and she alternately throughout the book (except when a particular person is mentioned), because both genders are well represented throughout the profession.

Irregular Corporate Tax Structures

A handful of states have unique tax structures that are beyond the scope of this book. They include the new (soon to be replaced) Michigan Business Tax (MBT), Ohio's commercial activity tax (CAT), the new Texas Margin Tax (TMT), and Washington's business and occupation tax (B&O). The following is a snapshot of those taxes.

Michigan

Michigan's single business tax (SBT) was repealed effective December 31, 2007, and replaced with the MBT. Applicable to almost all business entities including C corporations, S corporations, limited liability companies, partnerships, and sole proprietorships, the new tax is composed of two parts. The first part, the business income tax (BIT), is imposed on "business income" at a rate of 4.95 percent. The second part, the modified gross receipts tax (GRT), is imposed at the rate of 0.8 percent. Most taxpayers will pay both taxes. Certain industries, specifically insurance companies and financial institutions, pay special taxes rather than the MBT. Insurance companies will pay a premiums tax of 1.25 percent on gross direct premiums, and financial institutions will pay a franchise tax on the net capital at a rate of 0.235 percent. Businesses with gross receipts of less than $350,000 are exempt from the MBT, and a credit phase-in is available to businesses with gross receipts between $350,000 and $700,000.

The nexus standards for the two elements of the MBT are different. The BIT applies to any taxpayer whose activity in the state exceeds the safe harbor provisions of Public Law 86-272 (see chapter 1 for a discussion of nexus and Public Law 86-272). The gross GRT applies to any taxpayer that (1) has physical presence in the state for more than one day during a tax year or (2) "actively solicits" sales in Michigan and who has gross receipts sourced to the state of more than $350,000. The state defined "active solicitation" in Revenue Administrative Bulletin (RAB) 2007-6, "Michigan Business Tax—'Actively Solicits' Defined," approved December 28, 2007, to mean solicitation through

1. the use of mail, telephone, and e-mail;
2. advertising, including print, radio, Internet, television, and other media; and
3. maintenance of an Internet site over or through which sales transactions occur with persons in Michigan.

Examples of active solicitation provided by RAB 2007-6 include "sending mail order catalogs; sending credit applications; maintaining an internet site offering online shopping, services, or subscriptions; and soliciting through media advertising, including internet advertisements." It is clear from these examples that the nexus standard for the GRT is really more of an "economic presence" rather than a "physical presence" test.

Unlike Michigan's previous SBT, both taxes will be applied on a unitary basis (see chapter 3 for a discussion of the unitary concept) using a single sales factor (see chapter 5 for a discussion of the sales factor).

A unitary group is defined as

- a group of United States persons, other than a foreign operating entity, one of which owns or controls, directly or indirectly, more than 50 percent of the ownership interest with voting rights of the other U.S. persons and
- whose business activities has a flow of value between or among persons included in the unitary group that are integrated with, are dependent upon, or contribute to each other.[1]

A foreign operating entity is a United States person who has substantial operations outside the United States and has at least 80 percent of its income characterized as active foreign business income as that is defined in Internal Revenue Code (IRC) § 861(c)(1)(b).

The Michigan Department of Revenue recently released guidance on the first part of the unitary definition, the control test, but not the relationship test. See Michigan RAB 2010-1, "Michigan Business Tax Unitary Business Group Control Test," approved February 5, 2010, which provides examples and details of how to apply the control test to parent-subsidiary, brother-sister, and combined controlled entity groups.

Business Income Tax

The business income tax base for the BIT begins with federal taxable income followed by several modifications, including

- Adding back federally exempt interest and dividends from non-Michigan sources, net of any expenses to generate that income.
- Adding back any net income taxes deducted in arriving at federal taxable income.
- Adding back any net operating losses deducted to arrive at federal taxable income.
- To the extent included in federal taxable income, adding back any loss attributable to another entity subject to the BIT.
- Adding back any royalty, interest, or other expenses paid to a related person for the use of an intangible asset, if that person is not included in the unitary group.
- To the extent included in federal taxable income, subtracting interest income from U.S. obligations.
- Subtracting any deduction taken for net earnings from self-employment of the taxpayer, partner, or member of a limited liability company. (This provision will put sole proprietors, for example, on a level playing field with corporations.)
- Subtracting any net operating loss, after allocation and apportionment, incurred after 2007. (Business losses may be carried forward 10 years.)

Please note also that effective January 1, 2008, Michigan decoupled from the federal taxable income by excluding any bonus depreciation (IRC § 168[k]) and the domestic production activities deduction (IRC § 199).

[1] See S.B. 94 § 117(6), 94th Leg., Reg. Sess. (Mich. 2007).

The taxable base, after the preceding modifications, is then apportioned or allocated based on a single sales factor. The sales factor is the percentage derived from dividing total sales in Michigan by total sales everywhere. For a unitary group, Michigan sales will include sales in Michigan by each member of the unitary group regardless of whether that member has nexus with Michigan. (See the discussion of the "*Finnigan* rule" under the sales factor in chapter 5.)

Sales of tangible personal property are based on ultimate destination, while sales of services rely on the market approach. Service sales under the prior SBT were sourced based upon cost of performance coupled with an all-or-nothing approach to services provided in more than one state. Service sales under the new MBT will not only be included in the jurisdiction of the recipient of the services, but will be prorated to the extent the service is provided in more than one state. The MBT also provides extensive guidance for sourcing sales for various industries such as investment, brokerage, oil and gas, and telecommunication companies.

Modified Gross Receipts Tax

The GRT is assessed on the taxpayer's "modified gross receipts tax base," which is defined as "gross receipts less purchases from other firms before apportionment." Gross receipts is defined much like it was under the prior SBT as "the entire amount received by the taxpayer from any activity whether in intrastate, interstate, or foreign commerce carried on for direct or indirect gain, benefit, or advantage to the taxpayer or to others."[2] The rate for the modified GRT is 0.8 percent.

"Purchases from other firms" includes inventory, materials, supplies, assets, and compensation costs paid to staffing firms and construction companies.

Michigan Surcharge

On December 4, 2007, Michigan Governor Jennifer M. Granholm signed Public Act 145 of 2007, amending the MBT. The primary purpose of Public Act 145 was to institute an MBT surcharge of 21.99 percent of the taxpayer's MBT liability after allocation and apportionment, but before any tax credit. The surcharge is capped at $6 million for all taxpayers, except for financial institutions. For a financial institution, the MBT surcharge is 27.7 percent for tax years ending in 2008 and 23.4 percent for tax years ending in 2009 and later. The MBT surcharge will be eliminated on January 1, 2017, assuming Michigan's personal income growth exceeds zero percent in 2014 through 2016. Insurance companies are not subject to the surcharge, nor are taxpayers that qualify for the state's Small Business Alternative Credit. Taxpayers must factor in the surcharge in their calculation of estimated tax credits. Although the surcharge was the key element of Public Act 145, the provision made additional changes that are beyond the scope of this text, but it included such items as reductions and caps on various credits and changes in taxpayer refund opportunities.

As of September 1, 2011, the Michigan Department of Revenue had helpfully issued more than 400 frequently asked questions (FAQs) covering administrative matters and

[2] See S.B. 94 § 111(1), 94th Leg., Reg. Sess. (Mich. 2007).

questions regarding nexus, apportionment, unitary groups, and many other topics. These FAQs can be found at www.michigan.gov/taxes/0,1607,7-238-47449---F,00.html.

Okay, so just as you start getting the proverbial "handle" on the new MBT, Michigan has changed its tax structure once again. Effective January 1, 2012, the MBT is repealed and replaced with a new corporate income tax (CIT) imposed at a 6 percent rate. The new CIT will apply only to regular C corporations; pass-through entities, such as partnerships, S corporations, and limited liability companies taxed as partnerships will not be subject to the tax. Instead, the owners of the pass-through entities will pay tax on their respective shares of income at a 4.35 percent rate. Because the new law becomes effective for all taxpayers January 1, 2011, fiscal year taxpayers will be required to file two short-year returns for 2011.

The nexus standard for the new CIT is the same as that of the MBT: income will continue to be apportioned using a single sales factor, and unitary filing will still be mandatory. The tax treatment of financial institutions and insurance companies will remain largely unchanged.

The CIT decouples from bonus depreciation and the "domestic production activities deduction" (IRC §§ 168(k) and 199), and most tax credits are eliminated. However, taxpayers with "certified credits" earned under the MBT may elect to continue to file under the MBT rules until they have exhausted their credits. Finally, the CIT begins with a taxpayer's federal taxable income and makes certain modifications including adding back state and local taxes, federal net operating losses, interest and dividend income earned from other state obligations, and certain expenses paid to related parties for using intangible assets. Subtractions include foreign royalties and dividend income and interest income from U.S. obligations to the extent it was included in federal taxable income.

While the first returns will not be due until 2013, prudent taxpayers and their advisers should begin planning their Michigan activities accordingly.

Ohio

In June 2005, Ohio enacted a new CAT that is intended to replace the state's corporate income tax as well as personal property tax. The corporate income tax will be phased out over five years.

The CAT is a tax on the privilege of doing business in Ohio and is not measured by net income, but by "taxable gross receipts." As a privilege tax, the tax is on the person receiving the gross receipts, that is, the vendor, not the purchaser. "Person" is widely defined and includes individuals, corporations, partnerships, limited liability companies, trusts, indeed, almost any combination of individuals in any form.

The tax base, gross receipts, includes amounts received from sales, services, and exchanges including "the total amount realized by a person, without deduction for the cost of goods sold or other expenses incurred … the fair market value of any property and services received, and any debt transferred or forgiven as consideration." Excluded items include interest, dividend, and capital gain income; repayment of principal; contributions to exempt organizations; life insurance proceeds; tax refunds; damage awards; gifts; and certain excise taxes.

Nexus for the CAT exists if a taxpayer owns or uses capital in Ohio, holds a certificate of compliance to do business, or has a "bright-line presence" in the state. A bright-line presence is established if a taxpayer meets any of the following tests:

- Has more than $50,000 in property in the state
- Has more than $50,000 in payroll in the state
- Has gross receipts of $500,000 or more in the state
- Has 25 percent or more of its total property, payroll, or sales in the state
- Is domiciled in Ohio for any other business purpose

Under these nexus standards, a taxpayer who has no presence or connection with the state other than online sales will have a filing obligation if the sales into Ohio exceed $500,000. The Ohio legislature specifically stated that the CAT was not an income tax and, thus, the safe harbor provisions of Public Law 86-272 (see chapter 1) do not apply. In addition, the state taxation department does not believe that the physical presence test for sales tax nexus applies to the CAT.

There have already been constitutional challenges to the CAT. The Ohio Court of Appeals ruled that the CAT, when applied to certain food sales, was an unconstitutional excise tax on food. See *Ohio Grocers Ass'n v. Ohio*, 178 Ohio App. 3d, 897 N.E.2d 188 (Ohio 2008). The case was appealed to the Ohio Supreme Court, which reversed the appeals court decision on September 17, 2009.[3] The Ohio Supreme Court held that the CAT was a permissible tax on the privilege of doing business and not a tax triggered by the sale of food. Although the CAT falls upon sellers of food, it is not the case that it necessarily falls upon the sale or purchase of food. Given the state's nexus provisions, there will, no doubt, be other constitutional challenges.

The tax rate for the CAT is 0.26 percent of taxable gross receipts and is being phased in over the next few years. For the period April 1, 2006, through March 31, 2007, 40 percent of the CAT is due, and for the period April 1, 2007, through March 31, 2008, 60 percent of the CAT is due. Beginning after March 31, 2009, the tax will be fully phased in.

The CAT's reporting period is quarterly (annually for taxpayers with gross receipts of less than $1 million).

The Ohio Department of Taxation is regularly releasing new guidance on the CAT. Nonetheless, there are many unanswered questions, and the CAT imposed some difficult problems during the transition period with respect to various issues with net operating losses, consolidated and combined filing, and Financial Accounting Standards Board (FASB) Statement No. 109, *Accounting for Income Taxes*.

Texas

Through 2006, Texas' taxpayers calculated their corporate franchise tax based on "net taxable earned surplus" and "net taxable capital" and paid the greater of the two. Texas' net taxable earned surplus was basically a corporation's federal taxable income plus an add back

[3] *Ohio Grocers Ass'n. v. Levin*, 916 N.E.2d 446 (Ohio 2009).

of compensation paid to officers and directors. Net taxable capital was the corporation's stated capital plus surplus. Surplus was the net assets of the corporation minus its stated capital. S corporations and limited liability companies were also subject to the Texas franchise tax.

Texas has replaced the state's franchise tax with a modified GRT called the Texas Margin Tax (TMT) or the Revised Texas Franchise Tax (RTFT). The margin tax was effective for periods beginning on or after January 1, 2007, and the first returns were due May 15, 2008. The formula for the margin tax is as follows:

Start with:	Total revenue from combined business entity of group
Less:	The greater of: 1. Cost of goods sold 2. Compensation
Equals:	Margin tax base (but not to exceed 70 percent of total revenue)
Times:	Texas apportionment percentage
Equals:	Margin tax base apportioned to Texas
Less:	Other deductions
Equals:	Taxable margin
Times:	Tax rate of 1 percent (or 0.5 percent for wholesalers or retailers)
Equals:	Texas tax liability
Less:	Tax credits
Equals:	Texas tax due

Businesses that must pay the margin tax include partnerships, limited liability companies, business trusts, corporations, banks, savings and loans, joint ventures, and other professional and business associations. General partnerships having only individuals as partners and sole proprietorships are not subject to the margin tax.

Total revenue is taken from an entity's federal tax return. For example, a corporation will start with the amount from line 1c of its IRS Form 1120 and add the amounts from lines 4 through 10. A partnership will start with line 1c of IRS Form 1065 and add the amounts from lines 4 through 7.

Exclusions from revenue include dividends and interest from federal obligations, Schedule C dividends, foreign royalties, and dividends under IRC § 78 and IRC §§ 951–64.

The margin tax also has specific definitions for cost of goods sold and compensation. For example, cost of goods sold has a separate calculation different from the federal calculation for cost of goods sold. Compensation will include wages, tips, health care contributions, retirement benefits, and stock options deductible for federal taxable income but is capped at $300,000 per individual per year. The cap is adjusted for each even-numbered year beginning January 2010, based on the percentage increase or decrease in the consumer price index. This adjustment raises the limit on the compensation deduction for 2010 and 2011 to $320,000.

After the calculation of total revenue, cost of goods sold, and compensation, the tax base is apportioned based on gross receipts. The apportionment calculation is similar to the calculation made previously under the state's franchise tax. There are differences, however. For example, there are no throwback sales under the margin tax.

A taxable entity with total revenue of $10 million or less may elect to pay the franchise tax by multiplying total revenue times its apportionment factor times 0.575 percent (0.00575). Taxable entities with revenue of $300,000 or less do not owe any tax but must still file a return.

One of the biggest changes is that Texas is now a combined reporting state. (See chapter 3.) Taxable entities that are part of an affiliated group engaged in a unitary business must file a combined report. An affiliated group is a group of taxable entities in which a controlling interest is owned by a common owner or by one or more of the member entities. A combined group must include eligible entities even if those entities do not have nexus with the state. And unlike most other combined reporting states, partnerships and other flow-through entities are taxable entities for purposes of combined filing. (Most states use the federal definition of an affiliated group under IRC § 1504(a), generally 80 percent or more common ownership, which excludes noncorporate entities from being part of an affiliated group.) In short, partnerships, limited liability companies taxed as partnerships, S corporations, and disregarded entities are all taxable entities subject to combined filing. Because the state frequently issues new rulings and policies on the application of the tax, filing the margin return is still somewhat like shooting at a moving target.

Since the margin tax was passed in May 2006, the state has issued a series of explanations, clarifications, and rulings. These can be found on the state's website at www.window.state.tx.us/taxes/

Since its inception, there has been controversy regarding whether the TMT was a gross receipts tax or an income tax. Because the Texas constitution prohibits an income tax on natural persons, it is a critical question. Former Texas Comptroller Carole Keeton Strayhorn concluded it was an income tax, but former Comptroller John Sharp concluded that it was not. FASB has ruled that for financial statement purposes, it is an income tax. In addition, several states including California, Kansas, Missouri, South Carolina, and Wisconsin have ruled that it is an income tax for purposes of deduction against state income taxes. Nevertheless, many believe that because the tax must be paid whether a company is profitable or not, it is not an income tax. On July 29, 2011, a partner in the Allcat Claims Services, L.P., filed a petition with the Texas Supreme Court seeking a declaratory judgment on the question, so perhaps we will find out. The court must rule on the issue within 120 days of the petition, which is after this book goes to print. Stay tuned.

Washington

The state of Washington does not have an individual or corporate income tax. Instead, it has a gross receipts tax called the business and occupation (B&O) tax that is levied for the privilege of doing business in the state. Gross receipts include proceeds from the sale of services and goods largely to Washington customers. As a gross receipts tax, generally there are no deductions for wages, materials, or other costs of doing business. Other than returns and allowances, bad debts, advances, and casual sales, there are few exemptions or deductions. The law also provides a few credits against the tax for rural county employment, high technology investment, and small businesses and, most importantly, a multiple activities credit

that mitigates paying the B&O tax twice on the same product or transaction under different categories. Finally, unlike a sales tax, a sale does not have to occur to be subject to the B&O tax. For example, if you manufacture items for your own use, those items are subject to the B&O tax. Like a sales tax, however, returns are filed monthly, quarterly, or annually depending on your annual tax liability.

Washington adopted new rules regarding nexus in 2010, and the state is particularly aggressive in asserting nexus.

A taxpayer is deemed to have nexus if the taxpayer is a nonresident individual or business entity that is organized or commercially domiciled outside Washington and in any calendar year has (*a*) more than $50,000 of payroll or property in Washington, (*b*) more than $250,000 of receipts from Washington, or (*c*) at least 25 percent of its total property, total payroll, or total receipts in Washington. For a recent decision in Washington regarding nexus see *Lamtec Corp. v. Washington*, No. 83579-9 (Wash. Jan. 20, 2011). The B&O tax applies to all types of businesses including corporations, partnerships, limited liability companies, and sole proprietorships. The B&O tax rate varies depending upon the business type. The five primary types and their rates include the following:

B&O Classification	Rate
Retailing	0.00471
Extraction	0.00484
Manufacturing	0.00484
Wholesaling	0.00484
Services	0.015

A business may be subject to tax under more than one classification. For example, selling building materials to a homeowner is a retail sale while the same transaction to a custom builder could be a wholesale sale. Nonretail businesses making less than $28,000 per year are not required to file returns.

The following material is a brief description of the major B&O tax classifications adapted from the state's publication on its B&O tax.

Retailing

Businesses that sell products and specified services to consumers are retailers. Taxable retail services include

- Construction
- Repair
- Certain personal services, including
  - — Turkish and steam baths,
  - — dating and escort services, and
  - — tattooing

- Specialized activities, including
  - — lawn mowing and tree and shrub pruning and trimming,
  - — insect spraying,
  - — guided tours, and
  - — renting equipment with operators

Wholesaling

Wholesalers sell goods and services to persons who will resell them to others. The B&O tax is calculated on the wholesale selling price. If you are a wholesaler, you must keep a resale certificate on file from each buyer to document that the transaction was not a retail sale. Retail sales tax is not collected on wholesale transactions. Blanket resale certificates for frequent wholesale customers must be renewed every four years.

Manufacturing

The manufacturing B&O tax classification is used by firms that produce items in Washington, regardless of where that item is sold. Thus, products sold and delivered out-of-state are still subject to the manufacturing B&O tax. Manufactured products which are used by the manufacturer, but are not sold (or are used prior to sale), are also subject to tax under the manufacturing classification. The manufacturing B&O tax is based on the value of the products. In cases when there is no sale, the value is the selling price of similar products.

Selected Business Services

Businesses that provide these services to customers are required to pay the B&O tax under the selected business services B&O tax classification:

- Secretarial and clerical services
- Computer and data processing services
- Information services (financial or legal research)
- Legal services (including attorneys)
- Accounting, auditing, bookkeeping, and tax preparation
- Engineering and architectural services
- Business and management consulting
- Public relations and advertising services (excluding media advertising—radio, television, newspapers, and magazines)
- Surveying and real estate appraisal

Financial Services

Businesses that provide financial services including banking, securities or investment management, investment advising, and similar activities are subject to the B&O tax under this classification.

Service and Other Activities

Businesses that provide personal and professional services (such as doctors, beauticians, and teachers) are generally subject to B&O tax under this classification. This classification includes services that are not subject to the retailing, selected business services, or financial

services B&O tax classifications. Also, any business which is not described under a particular classification of the B&O tax must report under this "catch-all" category. For example, garbage collection services and janitorial services are taxed under this classification. Commission income is also subject to tax under this classification.

In addition to the major B&O tax classifications, the state provides many specialized classifications. Some of these include rates for insurance agents, printers, publishers, warehousing, radio and television broadcasters, and government contractors (0.00484); manufacturing and selling aircraft (0.002904); extraction and manufacturing of timber (0.002956); travel agents, tour operators, manufacturers of computer chips (0.00275); processors of meat, soybeans, wheat, seafood, fruit, vegetables, and dairy products (0.00138); and gambling contests (0.015 or 0.0163 depending on the amounts).

One of the principal problems with Washington's B&O tax is its application to sellers who are performing more than one activity. In short, the tax rate is dependent upon the nature of the taxpayer's business activities. But what if this is not clear? For example, if a business makes both retail and service sales in a mixed transaction, which is the proper rate to apply—the retail 0.471 percent or the services 1.80 percent rate. The Washington Supreme Court recently addressed this problem in a case that included elements of both a telecommunication and information service.

Qualcomm sold its OmniTRACS system to trucking companies that used it to track and gather "detailed information about its trucks and drivers while they are away from the company's place of business." The system was made up of three components: (1) mobile telecom terminals (hardware) in the trucks used to collect data, (2) a relay system (service) that transmitted the data to Qualcomm's network facility where the data was processed, and (3) software located at the customer's dispatch facility that gathered and used the data provided. Each of the components, hardware, service, and software, were interdependent, but Qualcomm separately invoiced the customer for them for sales tax purposes. Qualcomm paid B&O taxes on its revenue from OmniTRACS at the 1.5 percent rate for services. Upon audit, the Washington Department of Revenue held that the service element was a network telephone service and subject to the 0.471 B&O retailing rate. Thus, the question before the Washington Supreme Court was whether Qualcomm was selling a "network telephone service" or an "information service."

The decision depended in part upon whether the "primary purpose" test used by the court in its determination should be applied to the OmniTRACS system as a whole or to the separate components. The court held that the "primary purpose," the "true object," of the transaction was the system as a whole and that system was provision of a service that was appropriately taxed at 1.5 percent.[4] The decision provides a helpful guide to taxpayers and tax practitioners alike in the application of the state's "primary purpose" test for taxpayers with business operations that cross the state's traditional B&O categories.

Farming, federal credit unions, governments, sales of real estate, and certain nonprofit activities are not subject to the B&O tax. Cities and towns may also have a local B&O tax not to exceed 0.02 percent. However, keep in mind that there is no necessary connection between the state and local B&O taxes.

---

[4] *Qualcomm Inc. v. Washington*, 249 P.3d 167 (Wash. 2011).

Other Gross Receipts Taxes

In addition to the gross receipts taxes of Ohio, Texas, and Washington, several smaller levies are traps for the unwary taxpayer. Watch out for some of the following:

- Hawaii Gross Receipts tax
  - This tax looks like a traditional sales tax except that it is imposed on the gross receipts of the seller, not on the buyer, and is literally assessed on almost all business activity including purchases by governments and nonprofit entities.
- Kentucky Limited Liability Entity tax (LLET)
  - A replacement for the state's former alternative minimum tax calculation, it is imposed at a rate of $0.095 per $100.00 of Kentucky gross receipts, or 0.75 per $100 of Kentucky gross profits, with a minimum tax of $175.00. The tax serves as a "minimum floor" for the state's corporate income tax because taxpayers subject to both taxes can take the LLET as a credit against their corporate income tax.
- New Mexico Gross Receipts and Compensation tax
  - This tax is also very similar to a sales tax except that it is imposed on the seller's gross receipts for the privilege of doing business in New Mexico and is assessed on all gross proceeds.
- Pennsylvania Gross Receipts tax
  - This is a special industry levy imposed on select industries such as telecommunications, transportation, private banking, and electronic companies. The rate ranges from 5 percent to 5.9 percent for most taxpayers.
  - Local business and occupation taxes in both Washington and West Virginia

Capital Stock and Franchise Taxes

Several states have more than one element to their corporate income tax. For example, New York and Pennsylvania each have a capital stock calculation.

New York corporations calculate their tax using four different measures: a tax measured by net income, a tax measured by the company's capital base, a tax measured by the minimum taxable income tax, and a fixed dollar minimum base. (To calculate the tax on capital, a company must divide its capital into several components: investment capital, business capital, and subsidiary capital.) The corporation must pay the highest of the four taxes. In addition, the state imposes a tax on subsidiary capital allocated to New York.

Pennsylvania has a capital stock and franchise tax in addition to its corporate net income tax. The capital stock tax is a property tax imposed on the capital stock value of domestic corporations. The franchise tax is imposed on the capital stock value of foreign corporations doing business in the state. Both taxes are to be phased out by 2010.

Obviously, this brief thumbnail sketch cannot do justice to the exclusions, exemptions, modifications, and other complexities of these unusual or irregular tax structures. This book, instead, will focus on the key themes of nexus, state modifications, allocable and apportionable income, and the makeup of the sales, property, and payroll factors common to the majority of states.

1

Interstate Activity and Nexus

Introduction

Nexus is the beginning issue in any multistate activity. Unless you are doing business in, that is, have nexus with a political jurisdiction, no obligation exists to file a return with that jurisdiction.

The word "nexus" comes from the Latin word "nexum" referring to obligations between contracting parties. More simply, in the state and local tax context it refers to both the *quantity* and *quality* of contacts, links, or connections between a taxpayer and a political jurisdiction sufficient enough to subject the taxpayer to the jurisdiction of the state. Or to put it even more simply, are you doing business in our ________ (fill in the blank: town, county, or state)?

The nexus issue is becoming increasingly volatile and complex in light of the states' attempts to broaden their tax bases and increase their tax collections. States are pressing out-of-state companies, with the most slender of connections to the state, to file returns and pay sales tax and income tax. The rapid growth of e-commerce and the Internet has added to this complexity, making proper tax planning in this area more critical than ever. Even though this is a guide on multistate corporate income tax, in this chapter we discuss both sales tax nexus and income tax nexus. The principles behind nexus for both taxes overlap and, as a consequence, much confusion exists over the distinction between sales tax and income tax nexus. It is critical to understand both and the differences between the two.

Nexus Defined

Nexus is the contact that must be established with a taxing jurisdiction before that jurisdiction can require a business to collect its tax, or otherwise subject it to its taxing authority.

Generally, states extend their taxing authority as far as constitutionally possible. Consequently, it is with the U.S. Constitution that we must begin our discussion of nexus.

Please note, however, that nexus may be different for different taxes. In analyzing income tax issues, be careful not to confuse nexus for sales and use tax purposes with nexus for income tax purposes. For instance, most businesses are concerned with three types of nexus

when doing business in surrounding states or states outside their domicile's taxing jurisdiction. Most common are nexus for sales and use tax purposes, nexus for income and franchise tax purchases (if this tax applies in a state), and nexus for purposes of registering or qualifying to do business in a state. Nexus conditions for all three of these are generally different.

The two clauses of most importance in the U.S. Constitution for defining the taxing jurisdiction of states are the due process and commerce clauses.

> ***Author's Note: On 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.***

Due Process Clause

The Fourteenth Amendment to the Constitution prohibits states from denying any person "life, liberty, or property, without due process of law." Because taxation is regarded as depriving someone of their property, a state cannot exact such tolls without due process of law.

Due process relates essentially to questions of fundamental fairness, to "traditional notions of fair play and substantial justice." "That test is whether property was taken without due process of law, or if we must paraphrase, whether the taxing power exerted by the state bears fiscal relation to protection, opportunities and benefits given by the state. The simple but controlling question is whether the state has given anything for which it can ask return."[1]

The due process clause of the Fourteenth Amendment imposes two hurdles a state must overcome before it can impose a tax.

1. There must be a minimum connection between the taxpayer and the state. There must be "some definite link, some minimum connection, between a state and the person, property, or transaction it seeks to tax."[2]
2. There must be some rational relationship requirement. The "income attributed to the State for tax purposes must be rationally related to 'values connected with the taxing State.' "[3] If property is taken, or responsibilities are imposed on the taxpayer, the government must have sufficient jurisdiction over the taxpayer or due process is not served.[4] (The decision in *National Bellas Hess, Inc. v. Illinois*, 386 U.S. 753 (1967), seemed to combine both the commerce clause and the due process clause analyses.)

---

[1] *Wisconsin v. J.C. Penney Co.*, 311 U.S. 435.

[2] *Quill Corp. v. North Dakota*, 504 U.S. 298, 306 (1992), citing *Miller Bros. v. Maryland*, 347 U.S. 340, 344–45 (1954).

[3] *Quill* at 306, citing *Moorman Mfg. Co. v. Bair*, 437 U.S. 267, 273 (1978).

[4] *Wisconsin v. J.C Penney*, 311 U.S. 435 (1940); *National Bellas Hess v. Illinois Dept. of Revenue*, 386 U.S. 753 (1967).

Some commentators have recently questioned whether or not due process is really a serious hurdle. Why? Because the U.S. Supreme Court has ruled that the due process hurdle is cleared whenever a company "purposefully directs" its business activity or solicitation toward a state's residents. The "minimum connection" for a company need be no more than "purposefully avail[ing] itself of the benefits of an economic market in the forum State," or engaging "in continuous and widespread solicitation of business within a State." In other words, the due process clause does not require physical presence. Thus, a mail-order company, whose only contacts with a state were catalogues and goods sent through the U.S. mail, satisfied the nexus standard for due process.[5]

> ***Author's Note: Due Process Hurdles***
>
> *There must be "a minimal connection" between the activities or taxpayer and the state (*Wisconsin v. J.C. Penney Co.*, 311 U.S. 435 (1940))*
>
> *There must be "a rational relationship between the incomes attributed to the State and the intrastate values of the enterprise" (*Exxon Corp. v. Wisconsin*, 447 U.S. 207 (1980))*

Commerce Clause

The second applicable constitutional provision is the commerce clause which provides for congressional regulation of interstate commerce. The commerce clause of the Constitution provides that "Congress shall have the power to regulate Commerce with foreign Nations, and among the several states, and with the Indian tribes."[6]

The commerce clause has been interpreted as not only conferring power on the national government to regulate commerce but also as limiting the states' power to interfere with commerce even when Congress has not acted. Under this "dormant" commerce clause principle, taxes that have been found to unduly burden interstate commerce have been declared unconstitutional. However, the crux of the commerce clause analysis is not necessarily that states are prohibited from imposing any burden on interstate commerce, but rather whether the tax discriminates against interstate commerce either by providing a direct commercial advantage to local businesses or by creating multiple taxation on interstate commerce. In short, states can tax interstate commerce so long as they meet the four-prong test of *Complete Auto Transit, Inc., v. Brady*, 430 U.S. 274 (1977).

[5] See *Quill*, 504 U.S. 298 (1992).

[6] U.S. Const., art. I, § 8, cl. 3.

The general view is that state taxation may be imposed on interstate commerce, but it is justified only if the tax is designed so that the interstate business bears a fair share of the cost of the government entity whose protection it enjoys.[7]

In *Complete Auto Transit*, the Supreme Court provided a four-prong test for determining whether a state tax on interstate commerce is constitutional. A state tax will be deemed constitutional if

1. The tax is applied to an activity with substantial nexus with the taxing state. For sales and use tax purposes, substantial nexus has been defined as physical presence.[8]
2. The tax is fairly apportioned. The Supreme Court has stated that fair apportionment requires that the tax meet both an internal and external consistency test. "Internal consistency is preserved when the imposition of a tax identical to the one in question by every other State would add no burden to interstate commerce that intrastate commerce would not also bear."[9] In short, if every state adopted the same test as the one before the court and the income tax would be no more than 100 percent, then the internal consistency test is met.

   External consistency is "the economic justification for the State's claim upon the value taxed, to discover whether a State's tax reaches beyond that portion of value that is fairly attributable to economic activity within the taxing State."[10] In short, external consistency requires that the formula or methodology used be a fair or reasonable reflection of how the income is earned in the state.

   Most of the debate over the fair apportionment test has been over the formulas used by states in apportioning and allocating the income of a multistate business.
3. The tax does not discriminate against interstate commerce. A state may not "impose a tax which discriminates against interstate commerce ... by providing a direct commercial advantage to local business."[11]
4. The tax must be fairly related to services provided by the taxing state. This "fourth criterion asks only that the measure of the tax be reasonably related to the taxpayer's presence or activities in the State."[12] Generally, if the sale takes place in the state and is measured by sales price, there will be no violation of this fourth test.

It is important to note that the nexus requirements for the two constitutional hurdles, due process and the commerce clause, are not the same, a point emphasized by the Supreme Court in *Quill v. North Dakota*, 504 U.S. 298 (1992). "[North Dakota] contends that the nexus requirements imposed by the Due Process and Commerce Clauses are equivalent

[7] *Complete Auto Transit, Inc., v. Brady*, 430 U.S. 274 (1977); *Western Livestock v. Bureau of Revenue*, 303 U.S. 250 (1938); *McGoldrick v. Berwind-White Coal Mining Co.*, 309 U.S. 33 (1940); *Northwestern States Portland Cement Co. v. State of Minnesota*, 358 U.S. 450 (1959).

[8] See *Quill*, 504 U.S. 298 (1992).

[9] *Oklahoma Tax Comm'n v. Jefferson Lines*, 514 U.S. 175, 185 (1995).

[10] *Id*.

[11] *Northwestern States Portland Cement*, 358 U.S. 450, 458 (1959).

[12] *Complete Auto Transit*, 430 U.S. 274 (1977).

and that if, as we concluded above, a mail-order house that lacks a physical presence in the taxing State nonetheless satisfies the due process 'minimum contacts' test, then that corporation also meets the Commerce Clause 'substantial nexus' test. We disagree. Despite the similarity in phrasing, the nexus requirements of the Due Process and Commerce Clauses are not identical."[13]

In summary, the due process clause requires only (1) "minimum contacts" (physical presence not necessary) and (2) a rational relationship between the income and the state. The commerce clause requires (1) substantial nexus, (2) nondiscrimination, (3) fair apportionment, and (4) some relation to the services provided.

Let us look at an example to see how the preceding case law and rules work in practice.

For example, Crystal City Computers has one small store in Denver, Colorado, but it sells most of its computers and peripherals over the Internet and through catalogues. It has no employees, sales representatives, or facilities other than the Denver store. A farm girl from Kansas, Dorothy, orders one of the company's computers over the Internet. Crystal City ships the computer to Dorothy by common carrier. Crystal City does not have any obligation to collect sales or use tax from Dorothy on the sale because it does not have any nexus with the state of Kansas. Nor does Crystal City have any obligation to file an income tax return with Kansas.

Would our answer be any different if Crystal City has maintenance agreements with several Kansas computer service repair shops that provide warranty repair in case Dorothy's computer fails? Perhaps. Many states have adopted a rule asserting that warranty repair services provided by third-party independent contractors will create nexus for a remote vendor. The rule continues to be hotly debated.

Suppose Crystal City delivers the computer in its own truck rather than using a common carrier. Would that create nexus? If the deliveries were infrequent and sporadic, the seller would probably not be deemed to have created nexus. However, if the deliveries are significant in number, most states will claim that sales tax, but not income tax, nexus has been created between it and the remote seller.

Suppose Crystal City had one sales person who made only two trips into Kansas during the past 18 months. Would the physical presence of the salesperson create a filing obligation on the part of Crystal City? Probably not. It is not enough physical presence.

The questions about deliveries, the extent of physical presence, and the actions of agents are part of the continuing debate over nexus. But before we look at those issues, let us stop for a moment and distinguish sales tax nexus from income tax nexus. People often confuse the two.

[13] *Quill*, 504 U.S. 298 (1992).

Author's Note: Commerce Clause Hurdles

- *The tax must be applied to an activity with* **substantial nexus.**
- *The tax must be fairly apportioned.*
- *The tax must not discriminate against interstate commerce.*
- *The tax must be fairly related to the services provided by the state.*

(Complete Auto Transit v. Brady, ***430 U.S. 274 (1977)*****)**

Sales Tax Nexus

Two key U.S. Supreme Court cases define the test for sales tax nexus: *National Bellas Hess* and *Quill*. In both instances the Court ruled that "physical presence" is the bright-line test for sales tax nexus.

National Bellas Hess was a landmark decision in the sales and use tax nexus area. In this 1967 case, the seller was a Missouri mail-order house with no presence or activity in Illinois, except for catalogs and fliers that were mailed to its customers twice a year. Any products sold in Illinois were delivered by common carrier. Illinois required that National Bellas Hess register to collect sales and use tax, asserting it had nexus in the State of Illinois. Illinois believed that National Bellas Hess was "doing business" in the state because its "large-scale, systematic, continuous solicitation and exploitation is a sufficient 'nexus' to require Bellas Hess to collect" Illinois use tax. The U.S. Supreme Court held that National Bellas Hess did not have a filing obligation with Illinois. In fact, the Court held that a taxpayer must have physical presence in a state before incurring a sales or use tax filing obligation. The Court was sensitive to the fact that the thousands of sales taxing jurisdictions in the state posed a considerable impediment to interstate commerce.

The Court decided that the activities of National Bellas Hess in Illinois were strictly in interstate commerce. Accordingly, there was not sufficient nexus for National Bellas Hess to be liable to collect the Illinois use tax on sales to Illinois residents. The Court determined that requiring the seller to collect sales and use tax in Illinois would violate the company's rights under both the due process and commerce clauses of the U.S. Constitution. In short, the sales were clearly a matter of interstate commerce; the company did not have any physical presence in the state and, thus, had no obligation to collect the state's tax.

Given the significant changes in technology, including computers, fax machines, cell phones, and the Internet, it was no surprise that states believed the physical presence test to be archaic and wanted to revisit the issue. North Dakota did just that in *Quill* in 1992.

The *Quill* case was similar factually to the *National Bellas Hess* decision. Quill Corporation, a non-North Dakota business, had no physical presence and no employees in North Dakota. Quill sold business equipment and supplies in North Dakota only through catalogs, fliers, and by telephone. The post office or common carrier delivered all sales in North Dakota.

The opinions of the lower courts involved in the *Quill* cases were varied. The North Dakota trial court found *Quill* indistinguishable from *National Bellas Hess* and, accordingly, ruled in favor of Quill. The North Dakota Supreme Court, however, overruled the trial court in favor of the state, citing that changes in the economy and the law, in essence, outdated *National Bellas Hess*. The North Dakota Supreme Court embraced an "economic presence" test versus a "physical presence" test and held that Quill's economic presence in the state was sufficient nexus to require Quill to collect the use tax. After all, reasoned the court and its supporters, with fax machines, cell phones, satellite transmissions, and the beginning of the Internet, a company no longer had to be physically present in a state to do business there.

The U.S. Supreme Court reversed the decision of the North Dakota Supreme Court but agreed with it on some grounds. With respect to the due process analysis, the court held that a physical presence was not required. The court's due process analysis was based on whether a multistate business's contacts with a state made it reasonable to require it to defend a lawsuit in the state. The Supreme Court reasoned that Quill's continuous and widespread activity within North Dakota was sufficient warning that its activities may subject it to the taxing jurisdiction of the state. It is important to note that this finding differed from the Court's position in *National Bellas Hess*. However, the court did not completely overrule *National Bellas Hess*. Nevertheless, one of the Supreme Court justices indicated that in the 25 years between the *National Bellas Hess* ruling and the *Quill* ruling, there were enough changes in law and in technology that the due process analysis of *National Bellas Hess* was no longer applicable.

The U.S. Supreme Court held that while requiring Quill to collect North Dakota's sales or use tax was not a due process violation, it would still place an unconstitutional burden on interstate commerce. The Court found that the physical presence requirement is still a valid requirement under the commerce clause analysis, and, in that regard, it refused to overrule *National Bellas Hess's* reasoning. It also reaffirmed that the *Complete Auto Transit* four-part test was an adequate test under the commerce clause. In essence, the decision maintained the status quo, yet sent a strong message to Congress that Congress is not only better qualified to resolve this issue, but that it also has the ultimate power to do so.

In summary, the *Quill* decision holds that a taxpayer has established nexus for sales and use tax under the due process clause when the taxpayer's activity is limited to purposefully directing its economic activities to the state's residents. Thus, a retailer whose only activity in a state is limited to the mailing of catalogs has probably created nexus for purposes of the due process clause. In other words, a company need not be physically present in a state to create a filing obligation for purposes of the due process clause.

The commerce clause, however, still offers significant protection to remote sellers. First, a state cannot interfere with the regulation of the national economy. Second, a state can only assert jurisdiction over businesses when there is "substantial nexus" with the state. The U.S. Supreme Court disagreed with the North Dakota Supreme Court's assertion that the technological and economic business changes since *National Bellas Hess* would justify totally overruling that decision. The Court made it clear that there still must be some physical

presence in a state before the commerce clause hurdle is met. An economic presence in a state through telephone, advertising via radio, television, fliers, and so on was not deemed sufficient in *Quill* to subject a company to a state's taxing jurisdiction.

In brief, the question of sales tax nexus since *Quill* is whether or not a business has sufficient physical presence in the state to constitute "substantial nexus." If the business has sufficient physical presence, then it has nexus and must start collecting and remitting that state's sales and use tax. If the business does not have any physical presence in the state, it does not have a collection obligation. So, if the only activity your business has in a state is through mail order, either by catalog or over the Internet, you do not have a filing obligation with that state.

The Continuing Questions About Sales Tax Nexus

The U.S. Supreme Court held in *Quill* that physical presence was to be the bright-line test for sales and use tax nexus. If a seller has no physical presence in the state, it cannot be required to collect tax on its sales into the state. But how much physical presence is necessary? In brief, the nexus debate since *Quill* has generally revolved around three questions:

1. How much physical presence is sufficient to create nexus?
2. Can nexus be attributed to the seller through the physical presence of the seller's agent or affiliate?
3. Is there a physical presence test for income tax?

How Much Physical Presence?

The U.S. Supreme Court has stated that physical presence must be more than the "slightest presence" to rise to a "standard of constitutional nexus."[14] For example, in *Quill* the Court held that Quill's ownership of some floppy disks and the licensing of the accompanying software in North Dakota did not create sales and use tax nexus in the state. The disks, while owned by Quill, were software used by its customers to place orders and check current inventories and prices.

It is difficult to say with certainty how much physical presence will create the necessary "substantial nexus" to satisfy the commerce clause. Prior to *Quill*, in *Miller Bros. Co. v. Maryland*, 347 U.S. 340 (1954), the Supreme Court ruled that occasional deliveries, in its own trucks by a Delaware retailer into Maryland, did not create nexus for sales and use tax. After *Quill*, the Court had an opportunity to revisit the delivery issue in *Brown's Furniture, Inc. v. Wagner*, 171 Ill. 2d 410, *cert. denied*, 519 U.S. 866 (1996), but declined. The Illinois Supreme Court held that Brown's Furniture had nexus in Illinois by virtue of its advertising in the state coupled with 942 deliveries in its own trucks over a 10-month period. Such activity created nexus, the court stated, because it was more than incidental, occasional, or sporadic, but instead "regular and frequent." More recently, the Illinois Appellate Court ruled that 30 furniture deliveries over a 26-month period was enough physical presence to be "substantial

[14] *National Geographic Soc'y v. California Bd. of Equalization*, 430 U.S. 551, 556 (1977).

nexus" for sales and use tax.[15] In Maine, a company whose advertising and solicitation were specifically directed toward the state and that made 180 deliveries in its own trucks into Maine had sufficient physical presence to constitute the substantial nexus necessary to create a filing obligation to the state.[16]

State courts have also differed on whether occasional or sporadic visits by employees are sufficient physical presence to constitute "substantial nexus." New York has held that visits by an out-of-state retailer's employees exceeded the state's "slightest presence" test, thereby creating nexus. In one case, the visits were to 19 wholesalers, four times a year, and in another, there were 41 visits over a three-year period. According to the New York court, an out-of-state company's presence "need not be substantial;" it need only be more than the "slightest presence."[17] In a holding to the contrary, the Kansas Supreme Court ruled that 11 visits by an out-of-state seller to install card readers did not create nexus because the visits were isolated and sporadic.[18] The Arizona Court of Appeals held that a company had nexus with the state whose only activity during a three-year period was one visit per year by a salesperson coupled with 21 days of customer training.[19]

The physical presence need not be that of an employee or independent contractor. North Carolina attempted to hold a company responsible for sales, corporate income, and franchise taxes, whose only connection with the state is the selling and renting of VHS videotapes through the mail. Educational Resources, Inc. (ERI), a South Carolina company, sells and rents videotapes about workplace safety. Between 1990 and 1995 it made 219 sales and 906 rentals into North Carolina totaling $201,304 and $99,521, respectively. ERI did not have any employees in North Carolina or any other contacts with the state except for the tapes that it sold and rented to North Carolina customers through the mail. The tapes rented for $150 to $200. Customers would keep rented tapes between five and 30 days before mailing them back to ERI.

The North Carolina Department of Revenue audited ERI and assessed them for sales, income, and franchise taxes. North Carolina argued that the presence of the rented tapes, which were ERI's property, created nexus with the state. The superior court ruled in favor of ERI stating that "the Court finds and concludes that, under the Commerce Clause of the United States Constitution as interpreted in *Quill* ..., and other cases, there is not a "substantial nexus" justifying the state's attempts to collect the use tax, corporate income tax, and franchise tax in these cases."[20] As the reader may recall, the U.S. Supreme Court ruled in *Quill* that the licensing of its software in the state along with the presence of a few floppy disks did not constitute "substantial nexus." Compare North Carolina's actions with a recent decision in Alabama. In Alabama, an administrative law judge has ruled that an

---

[15] *Town Crier, Inc. v. Illinois*, 315 Ill. App. 3d 286, 733 N.E.2d 780 (2000).

[16] *John Swenson Granite v. State Tax Assessor*, 685 A.2d 425 (Me. 1996).

[17] *Orvis Co. v. Tax Appeals Tribunal*, 86 N.Y.2d 165, 654 N.E.2d 954, *cert. denied*, and *Vermont Info. Processing, Inc. v. Tax Appeals Tribunal*, 86 N.Y.2d 165, 654 N.E.2d 954, *cert. denied*, 516 U.S. 989 (1995).

[18] *In re Appeal of Intercard, Inc.*, 270 Kan. 346, 14 P.3d 1111 (2000).

[19] *Care Computer Sys. v. Arizona*, 4 P.3d 469 (Ariz. 2000).

[20] *Educational Resources, Inc. v. Tolson*, Nos. 00CVS14723 and 14724 (N.C. Super. Ct. (Wake County) Feb. 20, 2003).

out-of-state leasing company was not doing business in the state despite the fact that the company's lessee was using the company's property in the state.[21]

Sporadic Visits and Trade Show Nexus

The landmark case with respect to trade shows is *Share International, Inc. v. Florida*, 676 So.2d 1362 (Fla. 1996), *cert. denied*, 117 S. Ct. 685 (1997). Share International was a Texas corporation in the business of manufacturing and distributing chiropractic supplies primarily through direct mail solicitation. It did not have any offices or employees in Florida. However, the company did attend a three-day seminar in Florida every year at which it displayed and sold some of its products. Share International registered with Florida and collected and remitted sales tax on the seminar sales, but not on its mail order sales. Florida argued that the seminar presentation and sales created the sufficient nexus with the state that obligated Share International to collect and remit sales tax on all of its Florida sales, including its mail order sales. The Florida Supreme Court disagreed, holding that Share International's physical presence at the seminars was not sufficient to rise to the standard of substantial nexus.

In light of the *Share International* decision, and coupled with pressure from business and economic development groups, several states have backed away from asserting "trade show nexus." For example, California regulations provide that out-of-state retailers may receive up to $10,000 in sales at up to 15 days of trade shows, seminars, or conventions without incurring any sales or use tax collection responsibilities.[22] Connecticut's trade show legislation is restricted to 14 days per year and trade show activities are limited to displays and promotion. No sales are allowed.[23] Minnesota also provides a similar, but more restrictive, safe harbor of three days over 12 months. Most states, however, do not provide such exemptions or safe harbors and aggressively pursue taxpayers for use tax collection with any physical presence in the state. For example, Alaska, Georgia, Indiana, Iowa, Missouri, and Ohio have indicated that trade show attendance for fewer than even 14 days a year may create a tax filing obligation. Other states, such as Illinois, have provided mixed signals. Some of Illinois' early letter rulings indicated that any participation in a trade show triggered nexus. Illinois retracted that position in the mid-1990s but recently seemed to have reversed themselves.[24] New Mexico held in 1997 that attending a trade show triggers a filing obligation,[25] as did Tennessee in 1996 and Texas in 2000.[26] More recently, the Washington Court of Appeals held that two or three visits per year were sufficient to trigger a filing obligation for the state's business and occupation (B&O) tax. The court added that the physical presence test in *Quill* was irrelevant because that case was limited to a sales tax, and the issue before the

[21] *Union Tank Car Co. v. Alabama Dep't of Revenue*, No. Corp. 04-247 (Ala. Admin. Law Div. Jan. 11, 2005).

[22] Cal. Code Regs. tit. 18 §1684.

[23] See S.B. 1232, Laws (Conn. 2005).

[24] See Sales Tax Ltr. Rul. 94-0126-GIL; Priv. Ltr. Rul. 87-003; Priv. Ltr. Rul. 86-0170; Sales Tax Ltr. Rul. 95-0089-GIL; Sales Tax Ltr. Rul. 00-0089-GIL; and Sales Tax Ltr. Rul. 01-0049-GIL.

[25] Rev. Rul. 480-97-01.

[26] Priv. Ltr. Rul. No. 96-16; Texas Priv. Ltr. Rul. 200006394L.

court was a gross receipts tax.[27] Furthermore, P.L. 86-272 was not applicable because the B&O is not an income tax, but a gross receipts tax.

The harsh result in *Lamtec Corp. v. Washington*, No. 83579-9 (Wash. Jan. 20, 2011), should be compared to a recent Utah private letter ruling that held that an out-of-state entertainment company's annual presence at a 10-day film festival did not trigger an income tax filing obligation with the state.[28]

Arguments continue between tax practitioners, revenue officials, and other commentators over whether or not the "substantial nexus" test for purposes of the commerce clause means substantial *physical* presence.

Printer's Nexus

A company may trigger nexus with a state in which it contracts with a printer, particularly if the company stores printed material at the printer's warehouse or makes frequent or routine visits to the printer to supervise or inspect the printed material. It may be that the visits would be *de minimis*, but the threat is real enough that many states, at the behest of local printers, have passed safe harbor laws exempting such activity from triggering any filing obligations. States that have passed such legislation include Connecticut, Florida, Georgia, Illinois, Indiana, Kentucky, Ohio, Oklahoma, Pennsylvania, South Carolina, Tennessee, Utah, Virginia, and Wisconsin. Some of the state provisions provide a safe harbor for both sales and income tax, but several states limit their provisions to only sales tax or income tax, but not both.

Fulfillment Centers, Public Warehouses, and Distribution Centers

Printers have not been the only industry to successfully lobby for nexus safe harbor provisions. Because engaging a fulfillment center to take orders or engage in telemarketing and storing inventory at a public warehouse may often provide the substantial nexus to trigger a filing obligation, several states have passed protective legislation in these areas as well. Some of the states that exclude contractual arrangements with fulfillment service providers from nexus include Connecticut, New Mexico, New York, Ohio, and South Carolina. Unfortunately, most of these states limit the safe harbor to sales tax nexus, and even among those states the varying qualifications, the activities covered, the time involved, and the specific nuances of each state's statute make generalizations nearly impossible. Nevertheless, like printers nexus legislation, it is important to note that it may be available, and, therefore, specific state research is in order.

Servers and Websites

Advertising via the Internet through a website should be no different than advertising on national television or providing 1-800 numbers. Absent any other activity, it is an interstate communication activity protected by the commerce clause. It should not trigger nexus. Nevertheless, no specific prohibition blocks states from trying to tax a company that maintains a website on a server in the state. The state may argue that the server itself

[27] *Lamtec Corp. v. Washington*, No. 83579-9 (Wash. Jan. 20, 2011).

[28] See Utah Priv. Ltr. Rul. 08-013 (May 4, 2009).

is sufficient property to trigger nexus, or it may argue that the service provider hosting the website is an agent acting on behalf of the out-of-state company. As with printers and fulfillment centers, some states have specifically provided, either through statute or rule, that owning or operating an in-state server will not create nexus. That said, given the ever-evolving technology of the Internet, states have begun to closely study the various types of marketing appearing online, that is eBay, Craigslist, and so on. For example, do website linking arrangements constitute a physical presence, local solicitation, or intangible property in the state? Probably not, without something more. However, the most recent development in this area is the "Amazon tax" passed by New York in spring 2008 that requires online retailers, that pay commissions or other compensation to New York businesses for customer referrals, whether by a link on an Internet website or other manner, and that generate sales into the state over $10,000 for the past four quarters, to register with the state and begin collecting state and local taxes on all the retailer's sales into the state.[29] Rhode Island and North Carolina have passed similar legislation, and it is being considered in several other states. (See the section titled "State Statutory Change" in this chapter for a thorough discussion of the "Amazon Wars.")

Affiliation, Attribution, and Agency

In addition to the continuing debate over physical presence, there is a question about whether the physical presence of a third party will create substantial nexus for an out-of-state taxpayer. The fact that the third party is an independent contractor may be irrelevant. What is at issue is the nature of the contractor's activities. As long ago as 1960, the U.S. Supreme Court held that independent contractors could create sales tax nexus for an out-of-state retailer. "The test," according to the Supreme Court, "is simply the nature and extent of the activities" in the state. When there is "continuous local solicitation" and the independent contractors are performing the same role and function as sales employees by *establishing and maintaining a market* in the state for the remote seller, the out-of-state seller has nexus with the state.[30] Often, the key problem is in defining an agency relationship.

If a third party acts as an agent for an out-of-state seller, that agency relationship may create nexus for the seller. Box 1-1 outlines series of cases involving high school book club sales as an illustration of third-party agency for an out-of-state seller.

Box 1-1: Case Examples of Third Party Agents for Out-of-State Sellers

- *Scholastic Book Clubs, Inc. v. State Board of Equalization*, 207 Cal. App. 2d 734 (1st Dist. 1989) (Out-of-state book club is deemed to have nexus because teachers collected money from the schoolchildren.)

[29] New York Senate Bill 6807, Chapter 57, N.Y. Laws of 2008.

[30] See *Scripto, Inc. v. Carson,* 362 U.S. 207, 208 (1960), and *Tyler Pipe Indus., Inc. v. Washington Dep't. of Revenue*, 483 U.S. 232 (1987).

- *Pledger v. Troll Book Clubs Inc.*, 871 S.W.2d 389 (Ark. 1994) (Teachers are not agents for the out-of-state book seller.)
- *Scholastic Book Clubs, Inc. v. Michigan Department of Treasury*, 567 N.W.2d 692 (Mich. Ct. App. 1997) (Taxpayer does not have nexus, because teachers, lacking the authority to bind Scholastic, are not agents of Scholastic.)
- *In re Scholastic Book Clubs, Inc.*, 920 P.2d 947 (Kan. 1996) (Kansas Supreme Court holds that Scholastic has nexus, because an agency relationship exists with the schoolteachers.)
- *Scholastic Book Clubs, Inc. v. Commissioner*, No. CV 07 4013027S, CV 07 4013028S (Conn. Super. Ct. April 9, 2009) (Superior court holds that while teachers certainly aid the taxpayer, their activities do not rise to the level of a sales force or agent and, thus, the taxpayer does not have a filing obligation with the state.)

In an eminently more reasonable opinion, the Connecticut Superior Court recently ruled that the teachers were simply not "representatives" of the book seller because they were not in the same class as salesmen, canvassers, or solicitors. While their administrative functions were important to Scholastic, those functions did not rise to the level of a sales force.[31] Although the differing conclusions of these cases indicate the importance of a state's specific interpretation of its laws on agency, the cases remain troubling because substantial nexus can be created by a third party in absence of a formal contract or compensation.

A secondary issue related to the use of independent contractors and the law of agency is whether activities unrelated to sales or solicitation will also constitute substantial nexus. For example, will the performance of post-sale services by independent contractors create nexus for an out-of-state seller? The Multistate Tax Commission's (MTC's) Nexus Program Bulletin 95-1, "Computer Company's Provision of In-State Repair Services Creates Nexus," generated considerable discussion when it was issued because it asserted that warranty repair services provided by third-party independent contractors created sales tax nexus for an out-of-state seller (Remember, services are not protected by P.L. 86-272; so, arguably, warranty work triggers income tax nexus as well.). More than 20 states have adopted the bulletin. New York has held that an independent third party engaged by an out-of-state seller to diagnose and repair computers sold in-state by the seller created nexus for the seller.[32]

Dell Computer has litigated the issue of whether sales tax nexus is created by a third-party independent contractor performing warranty repair services in Connecticut, Louisiana, and New Mexico. In all three states, Dell contracts with BancTec, an independent contractor, to perform repairs and warranty work with respect to the company's catalog and Internet computer sales. Dell won its case in Connecticut and at the district court level in Louisiana.[33] However, Louisiana's Court of Appeal has rejected the district court's decision to

[31] *Scholastic Book Clubs, Inc. v. Comm'r of Revenue*, Nos. CV 07 4013027 S and CV 07 4013028 S (Conn. Super. April 9, 2009).

[32] TSB-A-00 (42) S (N.Y. Dep't of Taxation & Fin. Oct. 13, 2000).

[33] *Dell Catalog Sales v. Comm'r*, 834 A.2d 812 (Super. Ct. 2003), and *Louisiana Dep't of Revenue v. Dell Catalog Sales*, LP, No. 456,807 (La. Dist. Ct. May 25, 2004).

grant summary judgment and has instructed the lower court to determine if there existed an agency relationship between Dell and BancTec, and whether the latter helped to establish and maintain a market for Dell's computers in the state.[34] Dell suffered another setback in New Mexico when the state court of appeals ruled that the company had nexus in the state because BancTec helped to "establish and maintain a market" in the state for Dell's computers.[35] In short, BancTec's relationship with Dell was sufficient "substantial nexus" to subject Dell to New Mexico's gross receipts and compensating tax. Because BancTec provides similar services to other computer retailers, such as Toshiba and Compaq, the case is being closely watched.

MTC Nexus Program Bulletin 95-1 is typical of many states' approach to agency. In brief, the states are extending the agency argument from one of true agency to a "but for" argument, that is, but for some unrelated party the taxpayer couldn't do business in the state and, therefore, that relationship by helping the taxpayer to create and maintain a market for its goods in the state is a nexus-creating activity. The use of the "but for" argument is misleading if not clearly a logical fallacy, but nevertheless difficult to contest.

With the growth in e-commerce, states have taken opposing positions on whether locating a server in the state creates more than the "slightest presence" needed to create nexus. States are still sorting out the nexus issues surrounding the presence of servers in managed hosting and co-location service providers. See, for example, Virginia's ruling that nexus was not created when a company's only connection to the state was an Internet link on a website maintained on a server in Virginia by the company's partner.[36]

States have been routinely unsuccessful in arguing that the physical presence of an out-of-state seller's affiliate creates nexus for the out-of-state taxpayer. Generally, the states have tried to argue that the affiliate had an agency relationship with the out-of-state vendor, because the two shared the same business names, trademarks, and logos, engaged in cross advertising, or were in similar lines of business. For example, Bloomingdale's had different affiliated corporate entities conducting sales in Pennsylvania, one through in-state retail stores, the other through mail-order catalog. Pennsylvania argued that the mail-order company had nexus because its corporate affiliate's in-state stores sold many of the same goods, shared advertising campaigns, and, on two occasions, accepted merchandise returns of items purchased by catalog. The Pennsylvania Commonwealth Court found for the taxpayer, rejecting the state's argument that nexus existed because of an agency relationship between the affiliated corporations.[37] The courts in Connecticut and Ohio came to similar conclusions in two cases with Saks Fifth Avenue.[38] The Ohio case is of particular interest because the state attempted to use the income tax "unitary" doctrine to assert substantial nexus for sales tax.

---

[34] *Louisiana v. Dell Int'l Inc.*, No. 2004 CA 1702 (Feb. 15, 2006).

[35] See *Dell Catalog Sales, LP. v. New Mexico*, 189 P.3d 1215 (N.M. Ct. App. 2008).

[36] See VA Pub. Doc. No. 05-128 (8/2/05).

[37] *Bloomingdale's By Mail, Ltd. v. Dep't of Revenue*, 567 A.2d 773 (Pa. Commw. Ct. 1989), *aff'd without opinion*, 591 A.2d 1047 (Pa. 1991)

[38] *SFA Folio Collections, Inc. v. Bannon*, 217 Conn. 220 (1990), 585 A.2d 666 (Conn. 1991); *SFA Folio Collections, Inc. v. Tracy*, 652 N.E.2d 693 (Ohio 1995).

In *Current, Inc. v. State of Board of Equalization*, 29 Cal. Rptr. 2d 407 (Cal. App. 1st Dist. 1994), the court held that an out-of-state mail-order company, with no nexus with California, was not required to collect use tax even though its parent did have nexus with the state. In other words, the nexus of the parent could not be attributed to the subsidiary.

California continues to be one of the state leaders in asserting nexus through agency and affiliation. The California State Board of Equalization (SBE) recently ruled in two separate hearings that an online bookseller with no physical presence in the state must collect the state's use tax.

Borders Online, Inc., operates a website through which it sells primarily books, CDs, and DVDs. It is a separate corporate entity affiliated with the traditional "bricks and mortar" Borders, Inc., bookstores. Borders, Inc., bookstores routinely accepted returns from its patrons regardless of whether the item was purchased at Borders, Inc.; Borders Online, LLC; or one of Borders' competitors. If the item was purchased from a competitor, Borders, Inc., would give the purchaser store credit. If the item was purchased from Borders Online, the store would provide a cash refund.

The SBE determined that the refunding of cash for returned goods made Borders, Inc., the "authorized representative" of Borders Online. In addition, the SBE held that the refunding of cash for returns was a key element of the selling process and, in and of itself, constituted "selling" in California under California Revenue & Taxation Code §6203.[39]

The decision has been roundly criticized by the tax community, which has argued that Borders' return policy was nothing more than good customer service rather than an action taken as a representative on behalf of Borders Online. Furthermore, critics say, the SBE decision did not adequately address the principle articulated in *Scripto, Inc. v. Carson*, 362 U.S. 207 (1960), and *Tyler Pipe Industries, Inc. v. Washington*, 483 U.S. 232 (1987), that an in-state representative creates nexus only through actions *that purposefully establish and maintain a market* in the state for the remote seller.

One year after its ruling in *Borders Online*, the SBE held that the online subsidiary of Barnes & Noble Booksellers, Inc., (B&N) had nexus in California because B&N distributed discount coupons that could be redeemed with its online affiliate Barnes & Noble.Com (B&N.C). As in the *Borders Online* decision, the SBE determined that B&N acted as B&N.C's representative through their joint marketing effort whereby B&N.C paid to have printed coupons inserted into the shopping bags of B&N customers. The SBE rejected the taxpayer's argument that the discount coupons inserted into shopper's bags were simply advertising akin to coupon inserts in magazines and newspapers.[40]

On September 7, 2007, the California Superior Court overruled the SBE holding that B&N.C did not have nexus through its "brick and mortar" sister corporation, B&N. According to the court, B&N did not act as B&N.C's agent or representative. Distributing coupons or bags with advertising logos, the court stated, was akin to somebody on the street corner passing out flyers or coupons. Agency requires much more, and because the state did not provide a useful definition of agency, the court looked to general principles. The essential principle of agency is that the agent must have authority to bind the principal,

[39] *Borders Online, LLC v. State Bd. of Equalization,* No. A105488 (Cal. App. May 31, 2005).

[40] *Barnes & Noble.com*, No. 89872 (Cal. State Bd. Equalization, Sept. 12, 2002).

and B&N did not have that authority. In addition, there was no evidence that there existed common management or control between the two companies. For example, neither company had any common directors or officers.[41] Despite the win at superior court, on May 29, 2008, B&N agreed to a settlement with the SBE, paying $9 million of the original assessment of $17.7 million. The settlement covered all taxes, penalties, and interest through November 1, 2005—the date B&N.C began voluntarily collecting the state's sales and use taxes.

Louisiana also recently argued that B&N.C had nexus in that state as well. Unlike California, however, Louisiana focused its argument on certain key facts, arguing that those facts alone met the substantial nexus hurdle required of states under the commerce clause.[42] The facts included a common membership program, gift card exchange, advertising, preferential treatment on returns, and commissions. The federal district court found the facts either misplaced or insufficient to create substantial nexus. The common advertising was limited, and the commissions, membership program, and gift cards were common to all booksellers including competitors. While the return policy was a bit more generous for B&N.C than others, it was not sufficiently so. In brief, Louisiana's argument was reduced to holding that the close corporate relationship between the companies, similar company names, and brand identity itself was sufficient to establish substantial nexus. The court simply disagreed.

Despite these two recent setbacks, other states continue to follow California and Louisiana's lead, and in April 2005, the MTC proposed a new affiliate nexus standard entitled, "Proposed Model Affiliate Sales Tax Nexus Proposal." The proposed standard provides that an out-of-state business has nexus with an in-state business if they (1) are "related" (members of the same federal "controlled group," or there exists a 50 percent ownership), and (2) they use "an identical or substantially similar name, tradename, trademark or goodwill to develop, promote, or maintain sales," or (3) the in-state business "provides services to, or that inure to the benefit of, the out-of-state business related to developing, promoting, or maintaining the in-state market."

Tennessee's recent attempt to tax the activities of America Online has been stalled by the state's court of appeals, which, pointing out that physical presence for nexus is fact-specific, has remanded the decision for further discovery.[43]

Instead of litigation, other states have simply passed legislation providing that companies are taxable in the state for sales and use tax through affiliation. Effective January 1, 2002, a remote seller affiliated with an Arkansas retailer will have nexus with the state for the purposes of sales and use tax. The out-of-state or remote seller will have to collect and remit Arkansas use tax on sales into the state, if the seller is affiliated with an Arkansas retailer and "the vendor sells the same or substantially similar line of products ... under the same or

[41] See *barnesandnoble.com, LLC. v. SBE,* No. CGC-06-456465 (Calif. Super. Ct. (San Francisco County) Sept. 7, 2007).

[42] See *St. Tammany Parish Tax Collector v. barnesandnoble.com, LLC*, No. 05-5695 (E.D. La. Mar. 22, 2007).

[43] *America Online, Inc. v. Johnson*, No. 97-3786-III (Tenn. (Chancery Ct.) Mar. 13, 2001), *rev'd and remanded, America Online, Inc. v. Johnson*, M2001-00927-COA-R#-CV (Tenn. Ct. App. Jul. 30, 2002).

substantially similar business name, or the facilities or employees of the Arkansas retailer are used to advertise or promote sales by the vendor to Arkansas purchasers."[44]

Like Arkansas, Minnesota has amended its statutes to require that an affiliated remote seller of an in-state retailer must collect the state's use tax. An out-of-state retailer or remote seller is an affiliate of an in-state entity if "the entity uses its facilities or employees in this state to advertise, promote, or facilitate the establishment or maintenance of a market for sales of items by the retailer to purchasers in this state or for the provision of services to the retailer's purchasers in this state, such as accepting returns of purchases for the retailer, providing assistance in resolving customer complaints of the retailer, or providing other services."[45] Other states to enact attributional or affiliate nexus statutes include the following:

- Alabama (Ala. Act. 390 [H.B. 650, effective Aug. 1, 2003])
- Indiana (Ind. P.L. 81-2004 [H.B. 1365, effective July 1, 2004])
- Kansas (Kan. Laws ch. 159 [H.B. 2416, effective July 1, 2003])
- Utah (Utah Laws ch. 255 [H.B. 273, effective July 1, 2004])

Yet another approach states have taken recently to "encourage" remote sellers to charge and collect the state's use tax is to require that any vendors doing business with any state agencies to register and collect the state's sales and use tax. California initiated such a requirement effective January 1, 2004. Other states with similar requirements include Connecticut, Hawaii, Illinois, Missouri, North Carolina, Oklahoma, South Dakota, and Virginia. Critics have charged that the practice is illegal and a violation of the commerce clause. They claim that while states may have the right to establish their purchasing requirements, such requirements violate the Constitution when their participation in the market becomes an attempt to regulate the interstate market.

Federal Legislation

The MTC and state supporters continue each year to introduce the commission's "factor presence" standard nexus proposal, a proposal it first introduced in 2002. In brief, the proposal provides that any company whose activity in a state exceeds (1) owning $50,000 of property, or (2) $50,000 of payroll, or (3) $500,000 of sales has nexus for both income and sales tax. Under the proposal, a remote seller whose only contacts with the state are either through the Internet or catalog sales would have nexus in the state if those sales exceeded $500,000. Thus, the proposal would remove the physical presence standard established in *Quill*. While the MTC's "factor presence" standard has failed to ever garner any support in the United States Congress, several states, including California, Colorado, Connecticut, Michigan, Ohio, Oklahoma, Texas, and Washington, have adopted some version of the standard either through legislation or regulation. This activity by the states does not mean that states have given up on a congressional solution. In July 2011, Senator Dick Durbin (D-Ill.) introduced the Main Street Fairness Act of 2011. The bill provides that any state adopting the Streamline Sales Tax Project and implementing a series of simplifying provisions will be allowed to require remote sellers to collect that state's sales tax. It will come

[44] Ark. Code Ann. § 26-53-124(a)(3)(B).

[45] Minn. Stat. § 297A.66(4).

as no surprise that the proposal is controversial among business groups, and its future is uncertain. Opponents of the MTC proposal continue each year to introduce their own legislation. The most recent is the Business Activity Tax Simplification Act of 2011 (BATSA) (H.R. 1439), introduced April 8, 2011, by Rep. Bob Goodlatte (R-Va.) and others. Essentially, the legislation would prohibit any state from imposing any tax (income or sales) unless the taxpayer had a physical presence in the state for 15 days or more during the year. Representative Boucher has introduced the same bill for the last five years to no effect.

The "Amazon Wars" and "Click-through Nexus"

The most recent development in sales tax nexus was ignited by legislation passed by New York in spring 2008 that requires online retailers, that pay commissions or other compensation to New York businesses for customer referrals, whether by a link on an Internet website or other manner, and that generate sales into the state over $10,000 for the past four quarters to register with the state and begin collecting state and local taxes on all the retailer's sales into the state.[46] On May 8, 2008, the New York Taxpayer Services Division issued TSB-M-08(3)S, "New Presumption Applicable to Definition of Sales Tax Vendor," to explain and illustrate the application of the new statute. (Technical Service Bulletins [TSBs] are issued as informational guidance only.) Exhibit 1-1 outlines the TSB in its entirety.

[46] New York Senate Bill 6807, Chapter 57, N.Y. Laws of 2008.

Exhibit 1-1: TSB-M-08(3)S, Technical Services Bureau, Taxpayer Services Division, New York Department of Taxation and Finance, May 8, 2008

New Presumption Applicable to Definition of Sales Tax Vendor

Recently enacted legislation (Chapter 57 of the Laws of 2008) amended the Tax Law to provide a presumption that certain sellers of taxable tangible personal property or services are sales tax vendors that are required to register for sales tax purposes and collect state and local sales taxes. The new law provides that a seller is presumed to be a vendor if the seller enters into agreements with residents of this state to refer customers to the seller, as described below under ***New rules regarding who is presumed to be a vendor.***

Background

The term *vendor* includes persons who solicit business within the state through employees, independent contractors, agents or other representatives and, by reason thereof, make sales to persons within the state of tangible personal property or services that are subject to sales tax. **Accordingly, if a business located outside New York State solicits sales of taxable tangible personal property or services through employees, salespersons, independent contractors, agents, or other representatives located in New York State, the business must register as a vendor and obtain a *Certificate of Authority* for New York State sales tax purposes.** (See Tax Law Section 1101(b)(8) and Sales and Use Tax Regulations Section 526.10(a)(3).)

For example, an out-of-state business that uses independent manufacturers' representatives in New York State to sell its product in New York State is considered to be soliciting business within this state through the use of independent contractors or representatives. (See Sales and Use Tax Regulations Section 526.10(a)(3).) Therefore, the business must register as a vendor for New York State and local sales tax purposes. Also, an e-commerce retailer that uses persons to act as its representatives in the state to solicit sales or to make and maintain a market in return for commissions, referral fees or other types of compensation is considered to be soliciting business within this state through the use of independent contractors or representatives. Therefore, the e-commerce retailer must register as a vendor for New York State and local sales tax purposes. However, a business is not considered a vendor under section 1101(b)(8) of the Tax Law merely because the business stores advertising on a server or other computer equipment located in New York State, or has advertising disseminated or displayed on the Internet. (See Tax Law Section 12 and TSB-M-97(1.1)S.)

New rules regarding who is presumed to be a vendor

The new legislation provides that a seller that makes taxable sales of tangible personal property or services in New York State is presumed to be a vendor required to be registered for sales tax purposes and

required to collect sales tax on all of its taxable sales in New York State, if **both** of the following conditions are met:

- The seller enters into an agreement or agreements with a New York State resident[1] or residents under which, for a commission or other consideration, the resident representative directly or indirectly refers potential customers to the seller, whether by link on an Internet website or otherwise. A resident representative would be indirectly referring potential customers to the seller where, for example, the resident representative refers potential customers to its own website, or to another party's website which then directs the potential customer to the seller's website.
- The cumulative gross receipts from sales by the seller to customers in New York State as a result of referrals to the seller by all of the seller's resident representatives under the type of contract or agreement described above total more than $10,000 during the preceding four quarterly sales tax periods. (Sales tax quarterly periods end on the last day of February, May, August, and November.)

For purposes of the presumption described above, a seller is also considered to have met the condition of having an agreement with a New York State resident where the seller enters into an agreement with a third party under which the third party, in turn, enters into an agreement with the New York resident to act as the seller's representative.

In addition, an agreement to place an advertisement does not give rise to the presumption described above. For this purpose, placing an advertisement does not include the placement of a link on a website that, directly or indirectly, links to the website of a seller, where the consideration for placing the link on the website is based on the volume of completed sales generated by the link.

Example 1:

CAB Company (CAB) manufactures and sells specialty fitness equipment. CAB is located in Arizona, where it has its manufacturing plant, administrative offices and catalog call center. CAB has no retail outlets in New York State. Other than making sales of its products, as described below, which are delivered in New York State by common carrier trucking companies, CAB has no other connection with New York State.

CAB maintains a market for its products in New York State mainly by entering into agreements with health and fitness clubs (clubs) located throughout the state whereby the clubs refer club members to CAB's fitness equipment products. When a club member purchases a product from CAB, the member's club is identified and paid a commission equal to 5% of the selling price of the product. From March 1, 2007, to February 29, 2008 (i.e., the preceding four quarterly sales tax periods), CAB's gross receipts from sales made through its agreements with the clubs located in New York State totaled $38,628.

Based on the foregoing, CAB is presumed to be making sales in New York State through independent contractors or other representatives and required to be registered as a sales tax vendor, collect New York State and local sales taxes, and file the required sales tax returns.

Example 2:

XYZ Company (XYZ) is an Internet-based retailer of sporting goods specializing in downhill skiing equipment. XYZ is located in Vermont, where it has its administrative offices and its warehouse, which holds its inventory for sale. XYZ makes sales of its merchandise throughout the United States and has

---

[1] A *New York State resident* for sales tax purposes includes, but is not limited to

- Any individual who maintains a permanent place of abode in New York State; and
- Any corporation incorporated under the laws of New York, and any corporation, association, partnership or other entity doing business or maintaining a place of business, or operating a hotel, place of amusement or social or athletic club in New York State. (See Sales and Use Tax Regulations Section 526.15.)

customers in New York State. The merchandise sold by XYZ is delivered by the U.S. Postal Service or by common carrier.

As part of its marketing plan, XYZ has entered into agreements with several ski clubs located in New York State whereby the ski clubs will maintain links to XYZ's retail website on the clubs' own websites. XYZ will pay a commission to the ski clubs based on the sales that XYZ makes that originate from these links.

From March 1, 2007, to February 29, 2008 (i.e., the preceding four quarterly sales tax periods), XYZ has gross receipts from sales of its merchandise based on these agreements with the New York State ski clubs totaling $78,390.

Based on the foregoing, XYZ is presumed to be making taxable sales in New York State by soliciting business in New York State through the use of independent contractors or other representatives and required to be registered as a sales tax vendor, collect New York State and local sales taxes, and file the required sales tax returns.

Example 3:

T sells a variety of small tools nationwide, over the Internet. T's home office is in Arkansas, where its warehouse and administrative offices are located. Other than making sales of its products as described below, which are delivered to its customers in New York State by common carrier, T has no other connection with New York State.

T enters into a contract with S, a service provider. Under the contract, S enters into agreements with New York State residents on behalf of T, whereby the New York State residents agree to refer potential customers to T's website in order to purchase T's products by placing T's product links on their websites. Under the contract, S tracks sales of T's products as a result of the referrals from the New York State residents' websites. S distributes commissions to the New York State resident representatives based on these sales from an account maintained by S on behalf of T for this purpose.

From March 1, 2007, to February 29, 2008 (i.e., the preceding four quarterly sales tax periods), T's gross receipts from sales made under its agreements with S and the New York State residents as described above totaled $68,000. Therefore, T is presumed to be soliciting sales in New York State through the use of independent contractors or other representatives and required to be registered as a sales tax vendor, collect New York State and local sales taxes, and file the required sales tax returns.

Example 4:

G Inc. (G) is an Internet-based retailer of gardening tools and supplies. G's home office is in North Carolina, where its warehouse and administrative offices are located. G makes sales of its products nationwide, including New York State, and its products are delivered to its customers by common carrier. Other than having customers in New York State and the agreements described below, G has no other connection with New York State.

As part of its business plan to market its products in New York State, G enters into agreements with several garden clubs and other local organizations to place online advertisements on their websites, which, when clicked, lead the website user to G's retail website. In exchange for placing G's advertisements on its website, G will pay the organizations a set fee based only on the number of clicks on the link to G's website, whether or not sales are made.

G's agreement with the organizations is merely to place advertising on the organizations' websites. Therefore, G is not presumed to be a vendor making taxable sales in New York State by soliciting business in New York State through the use of independent contractors or other representatives. Therefore, G is not required to register for sales tax purposes.

Presumption that solicitation takes place may be rebutted

A seller may rebut the presumption that it is soliciting sales in New York State through resident representatives. For purposes of administering the new **presumption**, the Tax Department will deem the **presumption** rebutted where the seller is able to establish that the only activity of its resident representatives in New York State on behalf of the seller is a link provided on the representatives' websites to the seller's website and none of the resident representatives engage in any solicitation activity in the state targeted at potential New York State customers on behalf of the seller.

Example 5:

This example assumes the same facts as in Example 2. In addition, at least one of the ski clubs refers potential customers to XYZ by distributing flyers in New York State that promote the links to XYZ on the ski club's website. Therefore, XYZ is unable to rebut the presumption that it is making taxable sales in New York State through New York State resident representatives. XYZ is required to register for sales tax purposes and collect sales tax on all of its taxable sales in New York State.

Example 6:

This example also assumes the same facts as in Example. However, none of the ski clubs refer potential customers to XYZ through the use of flyers, newsletters, telephone calls or e-mails to club members or any other means of solicitation in the state targeted at potential New York State customers on behalf of XYZ. Therefore, XYZ may successfully rebut the presumption that it is making taxable sales in New York State through New York State resident representatives and XYZ is not required to register for sales tax purposes.

Relief for sellers covered by the presumption

For sales tax quarterly periods beginning before June 1, 2008, the Tax Department may not assess sales tax required to be collected, or related penalty and interest, against a business that is covered by the presumption discussed in this memorandum, if the business meets all of the following conditions:

- On April 23, 2008, the business is covered by the presumption such that the business is a vendor by virtue of having a representative soliciting sales on its behalf in the state.
- The business is not required to be registered for sales tax purposes and collect tax for any reason other than having resident representatives soliciting sales in the state as described in this memorandum.
- The business was not registered for sales tax purposes on April 23, 2008, and was not registered for sales tax purposes at any time between July 23, 2007 and April 23, 2008.
- The business was not registered for sales tax purposes at the time it made the sales for which it failed to collect sales tax.
- The business registers for sales tax purposes and begins to collect sales tax from its New York State customers by June 1, 2008.

[See Tax Law Section 1101(b)(8)(vi).]

The New York legislation is particularly significant because it says that a taxpayer need not have physical presence in New York to be subject to the state's sales tax. This is clearly contrary to the U.S. Supreme Court's decisions in both *National Bellas Hess* and *Quill* discussed previously. Thus, it was no surprise that Amazon.com and Overstock.com filed suits immediately after the New York law was passed challenging the legislation as invalid, illegal, and unconstitutional because it violated the commerce, due process, and equal protection clauses of the U.S. and New York constitutions. The case is currently being considered by

the New York courts. (Some have argued that the physical presence test is met through the nexus of the New York associate or affiliate with whom the remote seller has a "click-through" contract.)

North Carolina's "Amazon legislation" has also run into difficulties. The U.S. District Court for the Western District of Washington ruled the North Carolina statute unconstitutional because it violated the First Amendment to the extent that it required the disclosure of customer's names, addresses, and other personal information. The law's defect can be cured by simply requesting only the names, addresses, and general product information of total purchases. Thus, it is probably only a temporary setback for the state.[47]

The importance of New York's legislation and the constitutional challenges it raises cannot be over emphasized. Several other states attempted to follow New York's lead by adopting similar legislation. The legislation failed in Connecticut, Maryland, and Tennessee. However, it passed in California, Hawaii, and Minnesota only to be vetoed by the governors of those states partly in fear that the legislation was unconstitutional. North Carolina and Rhode Island are the only states to have successfully passed an "Amazon tax." As a consequence, both Overstock.com and Amazon.com have revoked their affiliate/associate programs in both states as well as New York. Nevertheless, states are continuing to emulate New York. Illinois just recently enacted an "Amazon bill" similar to that of New York, but it dropped New York's stipulation that such relationships simply created a "presumption" of nexus. There is no "presumption of nexus" in the Illinois law; it just flatly states that such a taxpayer does have nexus—period.[48]

Colorado passed a variation of New York's "Amazon tax" in 2010 that imposes only a reporting requirement, not a collection and payment requirement. Under the Colorado provision, a remote seller with no presence in Colorado must do three things:

1. Notify their customers by January 31 of each year through separate first-class mailings the dates and amounts of their purchases and that sales/use tax may be due on those purchases. The failure to comply is a penalty of $5.00 for each purchaser.
2. In addition, the retailer must file an annual statement by March 1 with the Colorado Department of Revenue showing the total amount purchased by its Colorado customers during the previous year. The failure to comply is a penalty of $10.00 for each purchaser.
3. According to the Department of Revenue, the invoice or notice to Colorado customers must include the following statements:
   a. The retailer is not obligated and does not collect Colorado sales tax;
   b. The purchase is not exempted merely because it was made over the Internet or other remote means;
   c. Colorado requires that the buyer file a use tax return at the end of the year reporting all of the purchases that were not taxed and pay the tax on those purchases;
   d. The retailer did not collect the Colorado sales tax and is obligated to provide purchaser with an end-of-year summary of purchases to assist the purchaser with filing their tax report;

[47] *Amazon.com, LLC v. Kenneth R. Lay*, No. C10-664 (W.D. Wash. Oct. 25, 2010).
[48] See H.B. 3659.

e. Retailers that do not collect Colorado sales tax are required by law to provide the Colorado Department of Revenue with a report of all of a purchaser's purchases at the end of the year.

Oklahoma has enacted a statute similar to Colorado's law, and California is reportedly considering one as well. The Colorado version of New York's "Amazon law" has met with some favor recently by state tax administrators who believe it avoids some of the constitutional issues raised by the New York statute. Others believe, however, that the state tax administrators are entirely mistaken and that the Colorado statute raises just as much of a constitutional issue as does the New York law. They emphasize that it was the imposition and impediment on interstate commerce that was the issue in *National Bellas Hess* and *Quill*, more than the tax itself. They argue that the reporting requirements are as much, if not more, of an imposition on interstate commerce as simply collecting and remitting the tax.

But How Do You Know They Are From Pocatello?

Massachusetts recently added a new twist to the nexus wars by taking the position that a taxpayer with stores both in and outside the state had to collect Massachusetts sales tax on sales in its New Hampshire stores when it appeared that the stores were making sales to Massachusetts residents.[49]

Massachusetts has long had a problem with its residents avoiding the state's sales tax by driving to New Hampshire, which does not have a sales tax, purchasing goods and bringing them back into Massachusetts and, of course, failing to remit use tax to the state. In fact, economists estimate that Massachusetts loses from $130 to $410 million annually due to this practice. The *Town Fair* case was an attempt to put a stop to this "tax evasion."

Town Fair is a Connecticut corporation whose principal business is the sales and installation of automobile tires. The company has stores throughout New England. In 2003, Massachusetts audited Town Fair and determined that its three New Hampshire stores had sold tires to Massachusetts residents. The auditor reached this conclusion based on store invoices listing sales to individuals with Massachusetts addresses, telephone numbers, driver's licenses, and motor vehicle plates. The Massachusetts Department of Revenue (DOR) assessed Town Fair $109,000 in tax on 313 sales identified as sales to Massachusetts residents and that assessment was upheld by the state's tax board.

The Massachusetts Supreme Judicial Court, however, overruled the board, holding that the DOR had to show actual use in Massachusetts, not simply the presumption of use. Despite "compelling circumstantial evidence," the mere intent to use the tires in Massachusetts was insufficient because the statute did not provide for such presumption. In fact, the court pointed to statutes in California, Nevada, and Wisconsin that provided for just such a presumption, indicating that had the Massachusetts's statute had such language, it might have reached a different conclusion.

The court did not address the constitutional implications of the case, specifically whether a state can impose a transaction tax, that is its sales tax, on a transaction occurring outside

[49] *Town Fair Tire Centers, Inc. v. Comm'r of Revenue*, 911 N.E.2d 757 (2009).

its borders or whether such an imposition violates the interstate commerce clause by creating an undue administrative burden on retailers. For example, what kind of record keeping would be required of a vendor and what would be deemed sufficient in reconciling conflicting customer information. Suppose the car had Massachusetts plates but the customer had a New Hampshire driver's license, or vice versa.

Town Fair is just the most recent example of state efforts to extend their taxing authority. Stay tuned.

Income Tax Nexus

While physical presence is the bright-line test for sales tax nexus, it is not determinative for income tax nexus. In fact, a company can have numerous employees in a state creating physical presence aplenty and yet not have an income tax filing obligation. That is because a federal law, P.L. 86-272, creates a safe harbor from income tax nexus even when there is physical presence.

Public Law 86-272

Due process and interstate commerce are the constitutional hurdles. But there is also a bit of federal legislation which adds yet another hurdle to establishing nexus, *but only for income tax nexus*. That legislation is P.L. 86-272

P.L. 86-272 states that "No state ... shall have the power to impose (an) income tax ... if the only business activities within such state (are) the solicitation of orders ... for sales of tangible personal property, which ... are sent outside the State for approval or rejection, and, if approved, are filled by shipment or delivery from outside the State ..." See Appendix A for the complete text of P.L. 86-272.

In brief, P.L. 86-272 provides a safe harbor for certain activities with respect to income tax nexus. Essentially, physical presence alone will create a filing obligation for *sales tax*. So if your company has employees, property, even independent contractors in a state, it is likely that the company will have a sales tax filing obligation to that state. Note, however, that under P.L. 86-272 a company can have employees busy soliciting sales in the state and not create nexus for income tax. In the earlier Crystal City Computers example, the company could hire employees to sell their computers in Kansas (in fact, the employees could live in Kansas) and so long as those employees restricted their activities to the solicitation of sales of tangible personal property, and those sales orders were sent back to Colorado for acceptance and fulfillment, Crystal City would not have to file income tax returns with Kansas. New York recently ruled that the presence of an in-state representative working out of his office-in-the home, and provided with a company laptop, constituted protected activities under P.L. 86-272.[50]

Please pay particular attention to the fact that P.L. 86-272 applies only to net income taxes and the sales of tangible personal property. Some states (for example, Pennsylvania) impose combined franchise taxes upon income and capital, and the taxpayer may have to pay tax upon either both income and capital, or the greater of the two. These states have taken

[50] See TSB-A-05(7)(C) (N.Y. Dep't of Taxation & Fin. Apr. 4, 2005).

the position that P.L. 86-272 only applies to their *income base* not their *capital base*. Thus, a taxpayer who may have only salespeople soliciting in the state would still be required to pay the state's franchise tax based on capital, but not income. The Texas Court of Appeals specifically ruled that the net worth component of the state's old franchise tax did not fall under the safe harbor provision of P.L. 86-272.[51] Texas has since replaced its corporate franchise tax with a modified gross receipts tax, called the Texas Margin Tax, that the Texas legislature specifically stated did not fall under the safe harbor provisions offered by P.L. 86-272. Taxes measured by gross income or receipts are not covered by P.L. 86-272. As a consequence, Washington's business and occupation tax and New Mexico's gross receipts tax have different nexus standards.

Please note also that P.L. 86-272 applies only to the solicitation of sales of tangible personal property. Sales of services, for example, are not protected. Thus, if Crystal City Computers were to offer training seminars or computer classes in Kansas, these activities would not be protected and the company would have to begin filing Kansas income tax returns.

Finally, P.L. 86-272 leaves undefined what constitutes "solicitation." The Supreme Court addressed the term in its decision in *Wisconsin Dep't. of Revenue v. William Wrigley, Jr. Co.*, 112 S. Ct. 2447 (1992). Wrigley's activities within Wisconsin included the in-state recruitment, training and evaluation of sales representatives who solicited sales using company cars and carrying with them a stock of gum for samples, display racks, and promotional literature. The Court ruled these activities were protected under P.L. 86-272. The sales reps also supplied gum for a charge to retailers that installed new display racks and occasionally replaced stale gum. Despite the fact that the replacement of stale gum only represented 0.00007 percent of the company's total sales in Wisconsin, the Court ruled that these activities went beyond solicitation. In brief, since one would have reason to replace stale gum apart from solicitation, it is not the volume, but the company practice itself that exceeds the safe harbor provisions of P.L. 86-272. The Court wrote that the demarcation between protected solicitation and other activities is the "clear line ... between those activities that are entirely ancillary to requests for purchase—those that serve no independent business function apart from their connection to the soliciting of orders—and those activities that the company would have reason to engage in anyway but chooses to allocate to its in-state sales force." (See appendix C for a copy of the *Wrigley* case.)

The one exception to the preceding rule is as follows: "Even if engaged in exclusively to facilitate requests for purchases, the maintenance of an office within the State, by the company or on its behalf, would go beyond the 'solicitation of orders.' " That said, for purposes of P.L. 86-272, the one key difference between an employee and an independent contractor is that the latter can have an office in the state. (See appendix B for a copy of P.L. 86-272.)

The MTC offered its interpretation and an elaboration of the term solicitation in its "Statement of Information Concerning Practices of Multistate Tax Commission and Signatory States under Public Law 86-272" issued in January 1986. The statement has been revised and reissued in January 1993, July 1994, and July 2001. According to the MTC, the term *solicitation* includes (1) speech or conduct that explicitly or implicitly invites an

[51] See *INOVA Diagnostics, Inc. v. Compt'r*, 166 S.W.3d 394 (Tax Ct. of App. 2005).

order and (2) activities that neither explicitly nor implicitly invite an order but are entirely ancillary to requests for an order. " 'Ancillary activities' are those that serve no independent business function for the seller apart from their connection to the solicitation of orders." If the seller would engage in an activity apart from soliciting orders, the activity is not ancillary. Even if the activity is not ancillary, it will still qualify for immunity if it is *de minimis*. "*De minimis* activities are those that, when taken together, establish only a trivial connection with the taxing state." Both the quantitative and qualitative nature of the activity will be considered but not its economic importance. If the activity is conducted on a regular or continuous basis, it will not normally be considered trivial or *de minimis*.

The statement provides examples of minimal activities within a state that could establish nexus for income tax purposes and a list of those examples can be found in box 1-2.

Box 1-2: Minimal Activities That May Trigger Nexus for Income Tax Purposes

- Repairs and maintenance;
- Collections on accounts;
- Credit investigations;
- Installation and supervision of installation;
- "Nonsolicitation" training;
- "Nonsolicitation" technical advice;
- Handling/processing customer complaints (except mediating customer complaints when the sole purpose is to ingratiate sales personnel with the customer);
- Approving/accepting orders;
- Repossessing property;
- Securing deposits on sales;
- Picking up or replacing damaged or returned property;
- Hiring, training, or supervising personnel other than those involved only in solicitation;
- Using agency stock checks or any other instrument by which sales are made in the state by sales personnel;
- Maintaining a sample or display room in excess of 14 days at any one location within the state during the tax year;
- Carrying samples for sale, exchange, or distribution in any manner for value;
- Owning, leasing, using, or maintaining a repair shop; parts department; warehouse; meeting place for directors, officers, or employees; stock of goods (other than samples for sales personnel or that are used entirely ancillary to solicitation); telephone answering service that is publicly attributed to the company or to the employee(s) or agent(s) of the company in their representative status; mobile stores; real property or fixtures of any kind; or any other office (other than a protected in-home office described below);
- Consigning tangible personal property to any person;

- Maintaining by any employee or other representative, an office or place of business of any kind (other than an in-home office located within the residence of the employee or representative that (i) is not publicly attributed to the company or the employee or representative in an employee or representative capacity, and (ii) so long as the use of such office is limited to soliciting and receiving orders from customers; for transmitting orders outside the state for acceptance or rejection; or for such other activities that are protected under P.L. 86-272).
- Any indication through advertising or business literature that the company or its employee or representative can be contacted at a specific address within the state, or a telephone or other public listing within the state for the company or its employee or representative in a representative capacity is normally considered an in-state office or place of business. However, the normal distribution and use of business cards and stationery that identify the employee's or representative's name, address, telephone and fax numbers, and affiliation with the company is not, itself, considered as advertising or otherwise publicly attributing an office to the company or its employee or representative.
- The maintenance of any office or other place of business that does not qualify as an "in-home" office described above will, itself, cause the loss of protection under P.L. 86-272. It is not relevant whether the company pays directly, indirectly, or not at all for the maintenance of such in-home office.
- Entering into/selling franchises/licenses; selling tangible personal property pursuant to such franchise or license agreements to in-state franchisees and licensees; and
- Any other non-protected, non-ancillary activity (even if such activity helps to increase purchases).

Activities that the MTC deems protected include the following:

- Soliciting orders for sales by any type of advertising;
- Carrying samples and promotional materials for display only or for distribution without charge or other consideration;
- Furnishing or setting up display racks and advising customers on display of products without charge or other consideration;
- Providing autos to sales personnel for use in protected activities;
- Passing orders, inquiries, and complaints to the home office;
- Checking customers' inventories without charge (for re-order only);
- Maintaining a sample or display room for 14 days or less at any one location within the state during the tax year;
- Soliciting orders for sales by an in-state resident employee or representative of the company, provided such person does not maintain an in-state sales office or place of business other than a protected in-home office;
- Missionary sales activities (i.e., the solicitation of indirect customers for the company's goods. For example, a manufacturer's solicitation of retailers to buy the manufacturer's goods from the manufacturer's wholesale customers would be protected if such solicitation activities are otherwise immune);
- Recruiting, training, or evaluation of sales personnel, including the occasional use of homes, hotels, or similar places for meetings of sales personnel;

- Mediating direct customer complaints when the purpose is solely for ingratiating the sales personnel with the customer and facilitating requests for orders;
- Coordinating shipment or delivery without payment and providing related information prior to or subsequent to placement of order; and
- Owning, leasing, using, or maintaining personal property for use in an in-home office or car that is used solely for protected activities

Author's Note: Public Law 86-272 Does Not Protect

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
Michigan "business tax" nexus
Washington "business and occupation tax" nexus
Franchise taxes on capital or net worth (for example, Pennsylvania)
Ohio commercial activity tax
Texas Margin Tax

Physical Presence and Income Tax

As the preceding discussion indicates, a taxpayer can have physical presence in a state and still avoid an income tax filing obligation if that presence is protected by P.L. 86-272. However, the current debate over income tax nexus has focused, not so much on P.L. 86-272, as on whether a taxpayer's *economic* presence in a state can create income tax nexus.

Quill made it clear that economic presence was insufficient for sales tax nexus, but the U.S. Supreme Court has never addressed whether there exists a physical presence requirement for *income tax nexus*. In fact, more than one state supreme court has ruled that physical presence is not necessary for income tax nexus. The South Carolina Supreme Court ruled that a Delaware holding company, whose only presence in the state was the licensing of its trademarks, was subject to South Carolina's income tax. In brief, the state's argument was that physical presence is unnecessary for income tax nexus, due process is satisfied by the "purposeful direction" of business activity, and that P.L. 86-272 does not protect the licensing of intangibles, only the solicitation of the sale of tangible personal property. The South

Carolina Supreme Court ruled in favor of the state and the U.S. Supreme Court denied *certiorari*.[52] (See appendix D for a copy of the *Geoffrey* decision.)

In the past few years, there have been a significant number of state court cases involving intangible holding companies. For example, the same Geoffrey, Inc., that lost in South Carolina recently lost similar cases in Oklahoma and Louisiana on the same facts.[53] The retail clothing store the Gap also lost an intangible holding company case in Louisiana.[54] After a lower court victory in New Jersey, when the court argued that it was illogical that there would be a higher nexus standard (physical presence) for an indirect tax (sales) than a direct (income) tax, Lanco, Inc., an intangible holding company for Lane Bryant, lost on appeal to the New Jersey superior court, which did not find it illogical at all.[55] Lanco was also included in a North Carolina court loss with several other taxpayers that the U.S. Supreme Court declined to review.[56] Other taxpayer losses include the following:

- *SYL, Inc. v. Comptroller*
- *Crown, Cork & Seal Co. (Del.) Inc. v. Comptroller*, 825 A.2d 399 (Md. 2003)
- *Kevin Associates, LLC v. Crawford*, No. 03-C-0211 (Jan. 30, 2004)
- *Bridges v. Autozone Properties*, 900 So.2d 784 (La. 2005)
- *Kmart Properties, Inc. v. New Mexico*, 2006-NMCA-026; 21,140 (N.M. App. Ct. Mar. 13, 2006)

Not all the intangible holding company cases have been taxpayer losses. For example, review, *ACME Royalty Co. and Brick Investment Co. v. Director of Revenue*, 96 S.W.3d 72 (Mo. 2002).

The decision in *Lanco, Inc. v. Director, Div. of Taxation*, 879 A.2d 1234 (N.J. Super. Ct. App. Div., 2005), like the *Geoffrey* cases, involved an intangible holding company, a tax planning structure that is considered by some state tax administrators to be little more than a tax scam. That cannot be said, however, of *West Virginia v. MBNA*, 640 S.E.2d 226 (W.Va. 2006).

MBNA America did not have any employees, property, or other physical presence in West Virginia. Nonetheless, the company had $8 to $10 million in gross receipts from the state through the issuance and servicing of credit cards. The only contacts MBNA had with West Virginia were through mail and telephone solicitation. Nevertheless, the West Virginia Supreme Court ruled that the bank's "systematic and continuous business activity in [the State] produced significant gross receipts attributable to its West Virginia customers which indicate a significant economic presence sufficient to meet the substantial nexus prong of

---

[52] *Geoffrey, Inc. v. South Carolina Tax Comm'n*, 437 S.E.2d 13, *cert. denied*, 114 S. Ct. 550 (1993).

[53] See *Geoffrey v. Tax Comm'n*, 132 P.3d 632 (Okla. Ct. Civ. App. 2006), and *Louisiana v. Geoffrey, Inc.*, No. 2007 CA 1063 (La. Cir. Ct. App. Feb. 8, 2008).

[54] *Louisiana Dep't. of Revenue v. Gap (Apparel) Inc.*, 886 So.2d 459 (La. Ct. App. 1st Cir. 2004).

[55] *Lanco, Inc. v. Director, Div. of Taxation*, 879 A.2d 1234 (N.J. Super. Ct. App. Div. 2005). See also *Praxair Technology, Inc. v. Director*, No. A-91-92, (N.J.S. Ct Dec. 15, 2009).

[56] See *A&F Trademark, Inc., et al. v. Tolson*, 605 S.E.2d 187 (N.C. App. 2004), *cert. denied*, No. 04-1625 (U.S. Jun. 6, 2005).

Complete Auto." The court reasoned that the physical presence test provided by *Quill* was inapplicable because that decision was expressly limited to sales and use tax. In addition, an income tax imposition, unlike that of sales and use tax, imposed little burden on interstate commerce. In any case, the technological changes in commerce made "the application of a physical presence standard ... a poor measuring stick of an entity's true nexus with the state." On March 9, 2007, MBNA filed a petition for *certiorari* with the U.S. Supreme Court. It was denied on June 18, 2007.

Not surprisingly, other states have followed West Virginia's lead in targeting financial institutions via economic nexus. The Indiana Tax Court recently followed the reasoning of the West Virginia court in ruling that MBNA had substantial nexus in the state without physical presence.[57] The Massachusetts Supreme Judicial Court came to the same conclusion based on the same reasoning as the West Virginia and Indiana courts.[58] However, the New Jersey Tax Court recently rebuffed the state's attempt to adopt a "significant economic presence test" in determining nexus for the simple reason that it had not been adopted by the state legislature.[59] Nevertheless, several other states, including California, Connecticut, Hawaii, Minnesota, and Tennessee, have indicated that they expect to adopt the "economic nexus" standard articulated in these recent cases. The decisions are unsettling, because given the basis for the courts' holdings in West Virginia, Indiana, and Massachusetts; no reason exists for why such reasoning cannot be extended to any business whose presence in a state is limited to solicitation through the mail or over the Internet. It is no exaggeration to say that the implications of *MBNA* and *Capital One Bank v. Massachusetts*, 899 N.E.2d 76 (Mass. 2009), are enormous.

Financial institutions, however, are not the only industry that has been targeted of late by state tax administrators. Franchising has also become a primary target. On December 30, 2010, the Iowa Supreme Court ruled that Kentucky Fried Chicken's (KFC) licensing of intangibles in the state to its franchisees, was the "functional equivalent of 'physical presence' under *Quill*." Consequently, despite having no employees, property or other presence in the state, KFC had to pay tax on the royalties it received from its franchisees in the state. The court went on to say that even if the intangibles were not the functional equivalence of physical presence, it didn't really matter because *Quill* was limited to sales tax and inapplicable to income tax.[60] It appears that KFC may appeal to the U.S. Supreme Court and, if it does, perhaps we will get an answer to whether the Court intended physical presence to be the bright-line nexus test for all taxes.

---

[57] *MBNA America Bank v. Indiana Dep't of State Revenue*, No. 49T10-0506-TA-53 (Ind. Tax Ct. Oct. 20, 2008).

[58] *Capital One Bank v. Massachusetts*, 899 N.E.2d 76 (Mass. 2009).

[59] See *AccuZIP, Inc. v. Director*, No. 005744-2003 (N.J. Tax Ct. Aug. 13, 2009) (unpublished).

[60] *KFC Corp. v. Iowa*, No. 09-1032 (Iowa Dec. 30, 2010).

Statutory Provisions and Where to Go From Here

After the *Quill* case, which put a significant restriction on the ability of states to collect sales tax from out-of-state companies by confirming a physical presence requirement, many state statutes must be scrutinized before determining whether they must followed. At the time *Quill* was decided, approximately 35 state statutes were most likely unconstitutional because they required companies to register for and collect their sales and use tax if certain activities were conducted in their state even without a physical presence in the state.

Almost 15 years after *Quill*, many states still have not adjusted their statutes accordingly. Thus, many are still unconstitutional. Most states will address what they consider nexus-generating activity by identifying those activities in their statutes. Generally these are found under a state's definitions for being "engaged in business," "doing business," and so on.

Although it may be clear what activities in a state constitute sufficient contacts to create nexus, it is arguable whether the state statutes must be followed.

Each state statute must be analyzed and considered on its merits. Box 1-3 outlines statutes subjecting companies to registration for sales and use tax programs that both would be constitutional and some grey areas.

Box 1-3: Activities Triggering Sales Tax Nexus and Some Gray Areas

Activities sufficient to create sales tax nexus:

- Sales people or other employees frequent the state.
- An office, place of business, inventory, or other physical property is located in the state.
- Property is rented in a state.

Gray areas might include the following:

- Soliciting orders via mail or soliciting orders via continuous, regular, systematic activities, such as through radio or television
- Benefiting from banking, financing, debt collection, or marketing activities located in the state
- Using independent contractors or authorizing a location in the state for installation, servicing, and repair
- Having a related business that is in the same or similar line of business located in the state
- Maintaining a franchisee or licensee in the state

These last bullet points represent areas in which there is continuing litigation, so staking a filing position in one of these areas must be made with caution and a clear understanding of the associated risks. As in most other areas of the tax laws, the state statutes should be reviewed and analyzed. Your specific facts should be compared with the state statute at issue. If the company is performing an activity that allegedly creates nexus under the state statutes, but that is questionable in light of the *Quill* or *Wrigley* cases or other Supreme Court cases,

practitioners should be further analyze the issue before informing the taxpayer that nexus is created by the activities in question. However, a taxpayer should be informed that under the state statute, nexus would be deemed present so they can be prepared for a potential state tax challenge and the costs associated with it. Nonetheless, a state statute that is clearly in violation of *Quill*, or some other Supreme Court decision, will often not be pressed by the state for fear that a taxpayer would not only win on the issue but also be entitled to attorney's fees, and other court costs, which, incidentally, may provoke other taxpayers to sue the state. That said, given the disastrous condition of many state budgets, they are being increasingly aggressive in these areas. It seems clear that the goal of most state tax administrators is to require any company with a customer in their state, to file returns with their state.

Offers in Compromise

Many states provide for a formal offer-in-compromise program. Some companies may have had nexus for quite some time but have refrained from filing because of ignorance or misunderstanding of the law, or have simply postponed fulfilling this obligation because of administrative constraints or even because they "didn't want to bother."

Those companies may be willing to file prospectively but fear that doing so would cause the taxing jurisdiction(s) to look back after receiving the application and then propose a substantial (if not staggering) assessment. Note that, even when activity was rather limited, assessments could still be very significant because the statute of limitations does not start running until a return is filed. Theoretically, states could go back indefinitely, although they usually will not do so. In addition, the assessment would include significant penalties and interest.

These are the ideal circumstances in which an offer-in-compromise or voluntary disclosure agreement (VDA) may be appropriate. There are two primary advantages to a VDA. First, most states will waive penalties and some will even waive part of the interest due. Second, and perhaps more importantly, the state will limit the look-back period, usually to three or four years. Generally, the VDAs are proposed anonymously through the use of a tax professional. For effecting a satisfactory compromise, it may be best to ask an expert tax professional to contact the state(s) and determine whether a lump-sum settlement would be agreeable to bring the taxpayer current or, alternatively, whether the state might be willing to limit its review to just a few years (for example three to five). VDAs are particularly useful in those situations when the nexus determination is ambiguous or in a particularly gray area of the law. For companies facing possible disclosure requirements in their financial statements because of Financial Accounting Standards Board Interpretation No. 48, *Accounting for Uncertainty in Income Taxes—an interpretation of FASB Statement No. 109* a VDA can be very helpful by eliminating the reason and need for disclosure.

Making an offer could also be considered in conjunction with state amnesty programs. However, even if such a program exists, the taxpayer should act very cautiously because the program might specifically limit the amnesty to specified periods or types of taxes.

In addition to specific state programs, the MTC has a formal offer-in-compromise program through which taxpayers and their representatives can approach multiple states through a voluntary disclosure process. For more information see the MTC website at www.mtc.gov.

2

Calculation of State Taxable Income: Modifications

Introduction

The majority of states "piggyback" off the federal corporate income tax base. Most state statutes specifically begin with federal taxable income although some states limit their adoption of the federal Internal Revenue Code (IRC) to a specific date. States that do not automatically follow federal taxable income must annually update their statutory adoption of the IRC. Requiring annual legislative adoption provides the state legislatures in those states an opportunity to review federal changes before adopting them. A few states are prohibited from automatically following changes in the federal tax code because their judiciaries have ruled that such a delegation of legislative authority to the federal government is unconstitutional. Some states' tax bases, such as New York's, do not tie directly to federal taxable income. New York uses a taxpayer's entire net income as the beginning point for calculating state taxable income. As a consequence, foreign source income, which is often excluded in other states, is part of New York's state tax base.[1]

While most states begin with federal taxable income as a starting point (either line 28 or line 30 from the IRS Form 1120), every state has certain additions or subtractions that must be made before arriving at state taxable income before allocation and apportionment. Typical additions include state, local, and foreign income taxes; interest from state obligations; federal net operating losses (NOLs); excess depreciation; and federal NOL, capital loss, and charitable contribution carryovers. Typical subtractions include dividends, interest on U.S. obligations, state income tax refunds, wages upon which the federal jobs credit was taken, subpart F income, and the federal income tax.

[1] See *Reuters, Ltd. v. Tax Appeals Tribunal*, 623 N.E.2d 1145 (N.Y. Oct. 12, 1993), and *Matter of Schlumberger Ltd.*, No. 811620 (N.Y. Div. Tax App. Apr. 13, 2000).

Additions

Some of the more common additions to federal taxable income are discussed in the following sections.

Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010

The Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 (2010 Tax Relief Act) boosted bonus depreciation from 50 percent to 100 percent for qualified purchases made after September 8, 2010. Many states have decoupled from federal bonus depreciation in the past, and that tradition has been upheld with the most recent legislation. The District of Columbia along with the following states decoupled from 100 percent bonus depreciation: Arizona, Arkansas, California, Connecticut, Florida, Georgia, Hawaii, Iowa, Idaho, Kentucky, Massachusetts, Maryland, Maine, Michigan, Minnesota, Mississippi, North Carolina, New Hampshire, New Jersey, New York, Ohio, Oregon, Rhode Island, South Carolina, Tennessee, Virginia, Vermont, and Wisconsin.

Some states, such as Texas and Indiana, conform to the IRC on a certain date. Whether these states will adopt the bonus depreciation when they update their conformity date is difficult to predict. In fact, it is easier to identify the states that have conformed to federal depreciation: Alaska, Alabama, Colorado, Delaware, Illinois, Kansas, Louisiana, Missouri, Montana, North Dakota, Nebraska, New Mexico, Oklahoma, Pennsylvania, Utah, and West Virginia.

Many of the same states that decouple from bonus depreciation have also decoupled from immediate expensing under IRC § 179. There are enough exceptions, however, so that one cannot assume that if a state refuses to adopt one it will also reject the other. The District of Columbia along with the following states have decoupled from IRC § 179 of the Tax Relief Act of 2010: Arkansas, Arizona, California, Florida, Georgia, Hawaii, Indiana, Kentucky, Maryland, Maine, Minnesota, North Carolina, New Hampshire, New Jersey, Ohio, Oregon, Rhode Island, Texas, and Wisconsin. States that conform to the Tax Relief Act of 2010 IRC § 179 provisions include Alaska, Alabama, Colorado, Connecticut, Delaware, Idaho, Illinois, Iowa, Kansas, Louisiana, Massachusetts, Michigan, Missouri, Mississippi, Montana, North Dakota, Nebraska, New Mexico, New York, Oklahoma, Pennsylvania, South Carolina, Tennessee, Utah, Vermont, Virginia, and West Virginia.

Given the current fiscal crisis that many states face, it would not be surprising if some state legislatures that currently conform to the federal tax base decouple during the year. In any event, as the following text illustrates, the inconsistency of state decoupling has been a headache for tax practitioners and tax software companies alike. For example, while Alabama (as yet) has not decoupled from the 2010 Tax Relief Act, it did decouple from the Economic Stimulus Act (ESA) of 2008. It is always best to periodically double check the current status of state conformity with bonus depreciation and immediate expensing.

American Recovery and Reinvestment and Worker, Homeownership, and Business Assistance Acts of 2009

On February 17, 2009, President Barack Obama signed into law the American Recovery and Reinvestment Act (ARRA) of 2009. The ARRA was followed on November 6, 2009, with the Worker, Homeownership, and Business Assistance Act of 2009 (WHBAA). Although these acts, particularly the ARRA, provided significant financial aid to the states, several of the tax provisions undermined the tax base of those states that piggyback off federal taxable income. The most important of these provisions included the

A. Extension of the first year 50 percent bonus depreciation provision of the ESA.
B. Extension of the ESA § 179 increase to $250,000 and the phase-out cap to $800,000.
C. Extension of the NOL carryback for businesses.

Provisions with a smaller but still negative impact on state tax bases included the temporary reduction of the S corporation built-in-gain recognition period to seven years, the election to defer the recognition of cancellation of indebtedness income per IRC § 108(i), and the changes to the IRC § 382 loss limitations. Thirty-three states and the District of Columbia decoupled from the federal taxable income calculation, in full or in part, with respect to the ESA and, later, the ARRA bonus depreciation provisions. Those states with rolling conformity to the IRC may continue to conform to ARRA. However, states with fixed or static conformity dates must update their conformity to be consistent with the federal bonus depreciation changes. States that have decoupled from the 50 percent bonus depreciation, the IRC § 179 immediate expensing provisions, or both, include Alabama, Arkansas, Arizona, California, Connecticut, Florida, Georgia, Hawaii, Iowa, Illinois, Indiana, Kentucky, Massachusetts, Maryland, Maine, Michigan, Minnesota, Mississippi, North Carolina, New Hampshire, New Jersey, New York, Ohio, Oklahoma, Pennsylvania, Rhode Island, South Carolina, Tennessee, Texas, Virginia, Vermont, Wisconsin, and West Virginia.

It should be noted that depreciation adjustments can also affect states that otherwise do not piggyback off federal taxable income. For example, Texas only incorporates the IRC through January 1, 2007. That means that Texas does not incorporate the federal changes that boosted IRC § 179 to $250,000 or the federal bonus depreciation for property placed in service in 2008 and 2009, which means that the limit for IRC § 179 for Texas is $112,000 for 2008 and $115,000 for 2009.

Texas also does not follow the federal amendment that extended the suspension of the percentage depletion limitation for oil and gas produced from marginal properties, nor does it include the extension for the 15-year recovery period for qualified leasehold improvements and restaurant property.

As a consequence, these differences may affect your Texas return if your company takes the cost of goods sold deduction for the Texas Margin Tax (TMT) instead of the compensation or 30 percent deduction.

American Jobs Creation Act of 2004

There were at least two provisions in the American Jobs Creation Act of 2004 that prompted states to decouple from federal taxable income. The first (§ 965) is a temporary 85 percent deduction for dividends received from a controlled foreign corporation (CFC). Although it is expected that this provision will increase tax receipts by stimulating the repatriation of deferred foreign earnings, some state legislators immediately called for decoupling from the federal 85 percent deduction and instead taxing the repatriated dividends in full. The District of Columbia and the following states did not conform to the federal temporary dividends received deduction: Alabama, Alaska, Arkansas, California, Connecticut, Hawaii, Kentucky, Massachusetts, Michigan, Minnesota, Mississippi, Montana, New Hampshire, New Jersey, New York, North Dakota, Ohio, South Carolina, Tennessee, Texas, Utah, and Wisconsin.

The second of the act's provisions (§ 199), replacing the extra-territorial income (ETI) exclusion with a deduction for qualified production activity income (QPAI), prompted one state, Massachusetts, to decouple almost immediately. One of the act's initial purposes was to repeal the ETI exclusion found illegal by the World Trade Organization (WTO) and replace it with something that would pass WTO muster. The act replaced the ETI with a phased-in deduction against net income for "domestic production activities." The deduction began at 3 percent and increased to 9 percent (not to exceed taxable income) by 2009. Although the detail of how the provision works is not important for this discussion, the impact of the deduction on state revenues when fully in place was estimated to be as high as $1.3 billion. Massachusetts calculated that the deduction for QPAI would have cost the state $42 million. As a consequence, Massachusetts passed legislation decoupling from the federal production activity deduction for tax years beginning on or after January 1, 2005.[2] Other states that have decoupled from the § 199 deduction include Arkansas, California, Georgia, Hawaii, Indiana, Maine, Maryland, Minnesota, Mississippi, New Hampshire, New Jersey, North Carolina, North Dakota, Oregon, South Carolina, Tennessee, Texas, and West Virginia.

Depreciation, Depletion, and Amortization

The federal Job Creation and Worker Assistance Act of 2002 (JCWAA) provided an additional 30 percent first-year depreciation deduction for qualifying property purchased after September 10, 2001. The federal Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA) increased the 30 percent allowance to 50 percent for qualifying property purchased after May 5, 2003. Only a dozen states have incorporated both changes to their statutes: Alabama, Alaska, Colorado, Delaware, Kansas, Louisiana, Montana, New Mexico, North Dakota, Oregon, Utah, and West Virginia.

Other states have adopted the federal accelerated depreciation methods only in part. For example, Florida adopted the JCWAA but not the JGTRRA, and Tennessee decoupled from the JCWAA but not the JGTRRA. Other states require that various percentages of the

[2] See L. 2004, c. 466 (H 5156).

additional depreciation be added back. Nebraska requires an 85 percent add-back prorated over five years beginning in 2005. Arizona, Illinois, Maine, Minnesota, Missouri, North Carolina, Ohio, Oklahoma, and Pennsylvania all require add-backs at various percentages and prorations.

As states face increasing budget constraints, more and more of them are decoupling from the federal bonus depreciation rules. One unhappy consequence for the corporate taxpayer is increased complexity with properties having a different tax basis not only for calculating federal and state depreciation, but also for computing gains and losses when those properties are sold or otherwise disposed.

Related Party Royalty and Interest Payments

In an effort to combat the use of intellectual holding companies or passive investment companies such as in the *Geoffrey* cases[3] or in *Lanco, Inc. v. Director, Division of Taxation*, 879 A.2d 1234 (N.J. Super. Ct. App. Div. 2005), many states have passed legislation disallowing a deduction for royalties or interest paid to a "related party." Because the states acknowledge that many valid circumstances may exist in which such deductions are appropriate, the rules with respect to these add-backs are often confusing and vary from state-to-state. There is no substitute for checking each state's specific rules and exceptions. That said, the District of Columbia and the following states have passed such add-back legislation: Alabama, Arkansas, Connecticut, Georgia, Illinois, Indiana, Kentucky, Maryland, Massachusetts, Mississippi, New York, New Jersey, North Carolina, Ohio, Oregon, South Carolina, Tennessee, and Virginia.

The Multistate Tax Commission (MTC) has adopted a model statute addressing related party add-backs for intangible expenses and interest paid to a related member. The statute's language echoes the language used in several of the states that have already enacted add-back legislation.

Intangible expenses include expenses, losses, or costs related to the acquisition, use, maintenance, or management of intangible property. Intangible property is defined to include trade names, patents, copyrights, trademarks, and trade secrets. A related member or entity includes component members defined in IRC § 1563(e), a 50 percent or more stockholder, or a corporation or affiliate that is owned 50 percent or more by the taxpayer.

The intangible and interest expenses will not have to be added back if the related party's income is taxable in another jurisdiction at a rate within a certain percentage of the taxpayer's state rate. Other exceptions exist as well. In any case, it is clear that the model statute is aimed at intangible holding companies such as were found in the *Geoffrey* cases. (See appendix 1 at the end of this chapter for a complete copy of the MTC proposal.) Some states also require add-backs for management fees or rent expense, and some states have enacted enhanced penalties for those taxpayers failing to add back the required expenses. Finally, some states have provided a "subject to" exception to their add-back provisions that allows

[3] *Geoffrey, Inc. v. South Carolina Tax Comm'n*, 437 S.E.2d 13, *cert. denied*, 114 S. Ct. 550 (1993); see *Geoffrey, Inc. v. Tax Comm'n*, 132 P.3d 632 (Okla. Ct. Civ. App. 2006); and *Louisiana v. Geoffrey, Inc.*, No. 2007 CA 1063 (La. Cir. Ct. App. Feb. 8, 2008).

the expense so long as the related party is "subject to" tax in its own state on the income it receives. For an example and discussion of the "subject to" provision, see *Beneficial New Jersey, Inc. v. Director, Division of Taxation*, No. 009886-2007 (N.J. Tax Ct. Aug. 31, 2010).

It will come as no surprise that the MTC's proposed model legislation and the add-back legislation already passed by many states has met with serious criticism. Many commentators firmly believe the statutes to be unconstitutional. Unfortunately for those commentators and taxpayers, the Alabama Court of Civil Appeals recently rejected a corporation's attempt to argue that the state's add-back statute was unconstitutional. In addition to rejecting the company's constitutional pleas, the court rebuffed the taxpayer's argument that it met the two exceptions provided in the statute for add-backs, specifically, that the income was taxable in another state and the state adjustment was "unreasonable."[4] The Alabama Supreme Court affirmed the appeals court decision on September 19, 2008, stating that "in light of that thoughtful opinion, we see no need to explicate further."[5] A petition for *certiorari* was filed with the U.S. Supreme Court on January 21, 2009, but the Court declined to review the decision on April 27, 2009. These cases, however, are just the first salvo in what will be a protracted battle for some time. Several other cases are working their way up in the courts on this same issue.

State and Municipal Interest Income

Many states require that federal taxable income be increased by the amount of state and municipal interest income that had been excluded on the federal return. At the same time, if there were expenses related to this income that had been disallowed for federal purposes, those expenses can be offset against the add-back of interest income. Be sure that you do not add back interest income in those states that exempt that income received on their own or from their political subdivisions or obligations.

A couple from Kentucky recently challenged the constitutionality of the state's distinguishing between in-state and out-of-state interest income. Kentucky is one of 41 states that exempts from taxation interest income derived from bonds issued by the state or its subdivisions, while taxing the interest income from other states' obligations. The lower courts in Kentucky agreed with the taxpayers, holding that Kentucky's taxation of other states' bond interest was unconstitutional on its face because it violated the commerce clause by affording more favorable taxation treatment to in-state bonds than it did to out-of-state bonds. The U.S. Supreme Court rejected this argument in a splintered 7 to 2 decision, holding that the issuance of state municipal bonds was a government function not susceptible to commerce clause analysis. The opinion generated seven different opinions, but nevertheless held that Kentucky's position had been supported in amicus brief by the other 49 states (even states with no income tax). The Court found that Kentucky was motivated by legitimate political objectives apart from economic protectionism banned by the commerce clause and that the state's participation in the municipal bond market did not favor Kentucky taxpayers over

[4] See *Surtees v. VFJ Ventures, Inc.*, No. 2060478 (Ala. Civ. App. Feb. 8, 2008).

[5] *VFJ Ventures, Inc. v. Surtees*, No. 1070718 (Ala. Sept. 19, 2008).

other taxpayers, but simply aided the state government in making its bonds more marketable.[6]

State Income Taxes

Just as the federal government does not allow a deduction for its own income tax, neither do most states allow deductions for their own income taxes. Thus, any state income taxes deducted on the federal return must usually be added back to arrive at state taxable income. Curiously enough, a few states, such as Alabama and Missouri, do allow a deduction for federal income taxes for financial institutions.[7]

Care must be taken in considering just which types of state income taxes must be added back. For example, some states limit their add-back to state taxes based on or measured by net income. As a consequence, those states tax deductions involving a franchise tax on capital may not have to be added back to federal taxable income. Franchise taxes are usually a tax on a company's book value measured either by capital stock or net worth. Other states with a franchise tax element include New York and Pennsylvania.

Other state taxes that are not based on or measured by net income and, thus, may not have to be added back are Washington's business and occupation tax (B&O), the Michigan Business Tax (MBT), and Ohio's commercial activity tax (CAT). There is some debate about whether the new TMT is an income tax or a gross receipts tax or both. The Financial Accounting Standards Board (FASB) concluded that the TMT was an income tax for purposes of FASB Statement No. 109, *Accounting Income for Taxes*. Carole Keeton Strayhorn, the state comptroller at the time, claimed the TMT is an income tax, but the state legislature inserted section 21 into H.B. 3, insisting that the new margin tax "is not an income tax and P. L. 86-272 does not apply to the tax."

The confusion arises because the taxpayer has one of three options in calculating the tax, specifically, the taxpayer can elect to subtract the larger of (1) cost of goods sold, (2) compensation, or (3) 30 percent of revenue. Depending upon which election is made, the tax looks more or less like an income tax. In short, the confusion arises because the tax is a modified gross receipts tax with some deductions allowed. As a consequence, several states, including California, Kansas, Missouri, South Carolina, and Wisconsin, have ruled that it is an income tax for purposes of deduction against state income taxes. Nevertheless, many believe that because the tax must be paid whether a company is profitable or not, it is not an income tax. On July 29, 2011, a partner in the Allcat Claims Services, L.P. filed a petition with the Texas Supreme Court seeking a declaratory judgment on the question so perhaps we will find out.

The Federal NOL

State treatment of federal NOLs falls into one of three categories. A few states simply follow the federal treatment allowing the federal NOL in full. Most states, however, provide for a separate state NOL calculation that is often computed in the same manner as the federal.

---

[6] *Kentucky Dep't of Revenue v. Davis*, 127 S. Ct. 2451 (2008).

[7] See also *Kinney Shoe Corp. v. State*, 552 N.W.2d 788 (N.D. 1996).

States using the first approach often start with line 30 of IRS Form 1120. States using the second approach usually begin with line 28 of the Form 1120. Finally, some states use a hybrid of the first two approaches, tying the state NOL to the existence of a federal NOL. Whether there is an add-back for the federal NOL is determined, in part, by whether the starting point is line 28 or line 30 of the Form 1120.

State variations with respect to NOLs include the years allowed for carrybacks (if any) and carryforwards, ceiling caps, and complications arising from consolidated versus separate filing and mergers and acquisitions.

The IRC allows for the carryover of net operating losses incurred in one year to another year. Specifically, IRC § 172 provides for a carryback of two years and a carryforward of 20 years. The JCWAA extended the carryback for 2001 and 2002 NOLs to five years. Many states have already limited their carryback and carryforward provisions, and almost half the states have eliminated their carryback entirely. New York does not allow carrybacks (beyond $10,000), and Pennsylvania has created its own NOL calculation completely independent of the federal rules. States that have eliminated their NOL carrybacks include Alabama, Arizona, Arkansas, California, Colorado, Connecticut, Florida, Iowa, Kansas, Kentucky, Maine, Massachusetts, Michigan, Minnesota, Nebraska, New Hampshire, New Jersey, New Mexico, North Carolina, North Dakota, Ohio, Oregon, Pennsylvania, Rhode Island, South Carolina, Tennessee, Texas, and Wisconsin.

The WHBAA modified the expanded NOL carryback provisions provided for by the ARRA. The ARRA extended the maximum NOL carryback period from two years to three, four, or five years for 2008 NOLs for small businesses with gross receipts of $15 million or less. The WHBAA extends this benefit to most taxpayers and extends it to 2009 NOLs. However, the amount of the NOL that can be carried back to the fifth tax year may not offset more than 50 percent of the taxpayer's taxable income for that fifth preceding tax year.

Almost all the states have thus far decoupled from the federal extended three-, four-, or five-year carryback periods. Alaska, New York, Oklahoma, and West Virginia may be the only states conforming to the WHBAA's extended carryback periods.

States may limit a company's carryback and carryforward not only in number of years, but also in the amount that may be claimed in any given year. For example, Pennsylvania caps net losses at $3 million, and Utah caps its carryback at $1 million.

When a company in a separate filing state is filing a federal consolidated return, taxpayers generally must prepare a *pro forma* separate return "as if" the company had filed separate, rather than consolidated, federal returns. As a consequence, the allowable federal NOL is that which would have been allowed if the members of the consolidated return had each filed separate returns.

Generally, a company must have been subject to a state's tax in the year an NOL was incurred in order to avail itself of the state's NOL carryover provisions. Thus, there exist complications for companies with NOLs that expand into other states or acquire or merge with other multistate companies. For example, Rocky Mountain High (RMH) has been doing business in Colorado for the past three years. In 2004, the company suffered a loss of

$12 million, which it elected to carry forward. In 2005, RMH expands its operations into Georgia. Georgia will not allow RMH to carry forward any of its 2004 loss against Georgia taxable income.

The consequences to RMH in the previous example may or may not differ when RMH is merged into another company. The deciding factor in some states is whether the surviving company from the merger generated the initial losses and was previously doing business in that state. For example, the Tennessee Court of Appeals has held that the surviving corporation in a merger may not use the losses generated by the company that was dissolved.[8] For a similar decision in New Jersey see *Richard's Auto City, Inc. v. Director, Division of Taxation*, 636 A.2d 572 (N.J. App. Div. 1994), and more recently in Massachusetts, *Macy's East, Inc. v. Commissioner of Revenue*, No. F251009 (Mass. App. Tax Bd. Nov. 5, 2002), *cert. denied*, No. 04-252 (U.S. Nov. 1, 2004). Given the complexity of these issues, they are beyond the scope of this guide. Box 2-1 provides an overview of addition modifications discussed in this chapter.

Box 2-1: Overview of Addition Modifications

Typical Addition Modifications

- Federal net operating loss
- Tax-exempt interest income
- Exempt income for federal purposes
- State income taxes
- Federal depreciation
- Gains or losses due to different tax bases

Net Operating Loss

- Calculation differences
  - — Carrybacks and carryforwards
- Pre- or post-apportionment
- Impact of filing status
  - — Separate
  - — Consolidated
  - — Mergers and acquisitions

Tax-Exempt Interest Income

- Intergovernmental immunity doctrine
  - — Franchise taxes versus income taxes
- State or municipal bond interest income
  - — *Department of Revenue of Kentucky v. Davis*, 128 S. Ct. 1801 (2008), *rev'g*, *Davis v. Kentucky Department of Revenue*, 197 S.W.3d 557 (Ky. Ct. App. 2006), *rev. denied*, No. 2006-SC-105-D (Ky. Aug. 17, 2006)

[8] See *Little Six Corp. v. Tennessee Dep't of Revenue*, No. 01-A-01-9806-CH-00285 (Tenn. Ct. App. May 28, 1999).

State Income Taxes
- Michigan Business Tax (MBT)
- Ohio's commercial activity tax (CAT)
- Texas Margin Tax (TMT)
  - Is the TMT an income tax?
- Washington's business and occupation tax (B&O)
- Other franchise taxes

Federal Depreciation
- Worker, Homeownership, and Business Assistance Act of 2009
- American Recovery and Reinvestment Act of 2009
- Economic Stimulus Act of 2008
  - Bonus depreciation
  - IRC Section 179
- American Jobs Creation Act of 2004
  - IRC Section 199
  - IRC Section 965
- Jobs and Growth Tax Relief Reconciliation Act of 2003
- Job Creation and Worker Assistance Act of 2002
- MACRS

Related Party Addbacks
- Royalties and other intangibles
- Interest

Subtractions

Some of the more common subtractions from federal taxable income are discussed in the following sections.

Deduction for Federal Income Tax Paid

Only three states—Alabama, Iowa, and Missouri—report allowing a deduction for federal income taxes paid.[9]

Deduction for State Income Taxes Paid

Most states require that deductions for other state income taxes be added back (see previous discussion). However, several states, while requiring an add-back of their own corporate tax paid, will allow the deduction for other state taxes to stand. States denying a subtraction for their own income tax but allowing the deduction for other state income taxes include Arkansas, Colorado, Hawaii, Iowa, Louisiana, Maryland, North Dakota, Rhode Island, Tennessee, and West Virginia. Allowable deductions may be limited to state tax "based upon

[9] Healy, John C. and Michael S. Schadewalk, eds., 2011 Multistate Corporate Tax Guide (New York: Commerce Clearing House).

or measured by net income." As a consequence, deductions for capital, net worth, or other franchise taxes may be disallowed if they are measured by "net income."

State taxes that are generally deductible include the Michigan Single Business Tax, the gross receipts part of the MBT, the Kentucky Limited Liability Entity Tax, the New Hampshire Business Profits Tax, the Ohio CAT, the Pennsylvania Capital Stock Tax, the TMT, and the Washington B&O tax.

Expenses Related to Nontaxable State and Municipal Interest Income

(See addition modifications.)

Interest Income Earned on Federal or U.S. Obligations

Just as the federal government does not tax state or municipal bond interest, states do not tax interest earned on federal obligations. Often referred to as the intergovernmental immunity doctrine, the doctrine prohibits states from imposing a *direct* tax on net income from federal obligations. (The doctrine was first articulated by the U.S. Supreme Court in *McCulloch v. Maryland* [1819]. Contemporary application of the doctrine is codified at 31 U.S.C. § 3124.) However, the doctrine does not prohibit an *indirect* tax levied on federal obligations. Thus, states such as California and New York that have a franchise tax measured by net income can generally tax interest income on U.S. obligations. Federal interest income, then, is a subtraction for those states that impose a direct tax on net income, but not for those states levying a franchise tax measured by net income.

Not all interest income earned on federal or U.S. obligations is considered exempt under the intergovernmental immunity doctrine. Income that is issued by quasipublic entities such as Ginnie Mae (Government National Mortgage Association), Sallie Mae (Student Loan Marketing Association), or Fannie Mae (Federal National Mortgage Association) can be taxed by states. Although the federal government guarantees the debt issued by these institutions, it is not debt issued directly by the federal government. Because the debt obligation by the federal government is secondary and contingent, the U.S. Supreme Court ruled that states were not prohibited from taxing the interest from that debt.[10]

Other entities whose interest income is often taxable and thus not a subtraction from federal taxable income include the Federal Home Loan Board, the Federal Savings and Loan Insurance Corporation, the Federal Land Bank, the World Bank, and the Federal Farm Credit Bank. In addition, the U.S. Supreme Court has ruled that states can tax income from repurchase agreements (repos), and the New York Supreme Court ruled taxable interest income from specific loan pool certificates backed by the Small Business Administration.[11]

---

[10] See *Rockford Life Ins. v. Illinois*, 482 U.S. 182 (1987).

[11] See *Nebraska v. Lowenstein*, 513 U.S. 123 (1994), and *Sumitomo Trust and Banking Co. v. Comm'r*, 720 N.Y.S.2d (2001).

Refunds of State Income Taxes

If a state does not allow a deduction for state income taxes, it generally will not pick up as income any refunds of state income taxes, to the extent they are included in federal taxable income.

Deductions Disallowed by Federal Credits

Corporations may be entitled to a variety of federal credits on their returns for which there are no related state credits. When claiming the federal credit the corporation is often required to reduce the expense deduction related to the credit. For example, the research activities credit allowed under IRC § 41 provides a 20 percent tax credit against federal taxes. However, a taxpayer (depending upon the election chosen by the taxpayer) must reduce its expense deduction by the credit used. The expense disallowed because of the federal credit taken is a subtraction modification to arrive at state taxable income.

Most states also offer subtractions for IRC § 78 gross-ups and subpart F income. Sometimes viewed as credit subtractions or dividend subtractions, both are modifications due to foreign income. When a corporation is allowed a deemed paid foreign tax credit for foreign taxes paid by a foreign subsidiary, its federal taxable income is increased to the extent of the deemed paid credit. This federal inclusion is called a "Section 78 gross-up." Because states generally do not allow for such a credit, most of them provide for a subtraction modification to back out the included income.

States also generally allow a subtraction for any "subpart F" income. subpart F income arises because of federal requirements that a U.S. shareholder in a CFC include in its domestic income certain deemed *pro rata* shares of the CFC's income and earnings (IRC §§ 951–64).

Dividends Received Deduction

The purpose of the federal dividends received deduction (DRD) is to mitigate multiple taxation of corporate income. Problems arise in state taxation because the corporations paying the dividends, receiving the dividends, or both may not be subject to the state's income tax. State modification will also depend upon the state's starting point for federal taxable income. If the starting point is line 28 of Form 1120 (federal taxable income before NOLs and DRD), the state may allow a partial or total subtraction for any DRDs depending upon the state filing method (separate, consolidated, or combined). For those states starting with line 30 (federal taxable income after NOLs and DRD), no subtraction may be necessary. Nevertheless, some adjustments may have to be made due to the different federal treatment of domestic and foreign dividends.[12]

In *Kraft General Foods, Inc. v. Iowa*, the U.S. Supreme Court ruled that Iowa's taxation of dividends violated the foreign commerce clause. Iowa used federal taxable income as its starting point but provided no modifications for DRD. As a consequence, corporations were entitled to deduct domestic dividends to the same extent for Iowa as they did

[12] See *Kraft General Foods, Inc. v. Iowa*, 505 U.S. 71 (1992).

on their federal return. But, because there is no federal DRD for foreign dividends, the Court found that Iowa discriminated against foreign dividends over domestic dividends. It was "indisputable" the Court stated, that foreign dividends were treated less favorably than domestic dividends, making the Iowa statute an unconstitutional encroachment on the federal government's regulation of foreign commerce. Iowa tried to justify its approach based on administrative convenience, but the Court held that Iowa could have retained its tie to federal taxable income with very little modification.

Many states have amended their statutes since *Kraft*, but the problem still arises in those states with combined reporting that claim that the combined reporting method exempts them from the *Kraft* controversy.

Because dividends are paid out of a company's earnings and profits, it is important to verify that the dividend distributions were properly sourced given the taxpayer's filing method, that is, separate, consolidated, or combined. (See chapter 3 for a discussion of filing methods.) For most states, earnings and profits are calculated on a separate company basis. As a consequence, a company that is apportioned income on a unitary basis may have a loss for earnings and profits on a separate company basis, a circumstance that may affect the intercompany elimination of dividends on a unitary basis. The following is an example drawn from the California audit manual:

> Corporation P and unitary subsidiary S filed a combined report for the year in which S was formed. S's net income computed on a separate basis was $10,000; its apportioned share of the unitary business income was $50,000. S paid income taxes of $4,000. S distributed $9,000 to its parent during the taxable year. Although S's net income exceeded the amount of the distribution, S's earnings and profits were only $6,000 ($10,000 income − $4,000 taxes). Therefore, only $6,000 of the distribution is considered a dividend subject to elimination.

The additions and subtractions in the California example are far from complete. States vary significantly in their modifications to federal taxable income, and a corporation must examine the available modifications not only in light of that state's specific statutes but also with respect to the filing method (separate, consolidated, or combined) chosen for each state's specific adjustments.

California's treatment of the DRD has been particularly notorious. Briefly put, California had traditionally allowed a DRD for dividends that were paid out of income subject to California tax. If the dividends were received from a company that did not conduct business in California and accordingly did not pay tax in California, no DRD was allowed. (The actual calculation involved deriving a percentage based on a ratio of apportioned income over the corporation's earnings and profits.) The California Court of Appeals held in 2003 that California's position violated the commerce clause of the U.S. Constitution because it discriminated against corporations that did not do business in California.[13]

The appeals court in *Farmer Brothers Co. v. Franchise Tax Board*, 108 Cal. App. 4th 976 (2003), did not suggest possible remedies for California's unconstitutional DRD. The U.S.

---

[13] See *Farmer Bros. Co. v. Franchise Tax Bd.*, 108 Cal. App. 4th 976 (2003), *rev. denied* (Aug 27, 2003), *cert. denied*, (U.S. S. Ct. Feb. 23, 2004).

Supreme Court has provided that at least three possible remedies exist in this position: (1) a state could refund the taxes imposed on the discriminated victims; (2) the state could retroactively impose a tax on the beneficiaries of the decision to put them on an equal footing with the victims; or (3) the state could enforce some combination of the preceding two approaches.[14]

The franchise tax board (FTB) decided to deny the DRD to all taxpayers, a position that (surprise, surprise!) was most beneficial financially for the state of California. The FTB took its position, in part, on the grounds that if any part of the law was unconstitutional, it all had to go. Arguably, the FTB's decision was not consistent with the state legislature's intent, which was that if any portion of the state's corporation income tax is declared unconstitutional, the remainder should be severed and remain in effect. Nevertheless, the FTB's position was recently upheld in *Abbott Laboratories v. Franchise Tax Board*, 175 Cal. App. 4th 1346 (Calif. 2009).

Although the battle may not be over, recent decisions continue to go against taxpayers. See, for example, *River Garden Retirement Home v. Franchise Tax Board*, 186 Cal. App. 4th 922 (2010), in which the taxpayer not only lost its dividends received deduction, but was subject to additional penalties for failing to take advantage of California's earlier amnesty program. Nevertheless, it seems likely that other cases will come along and more appeals are in the wings. As a consequence, taxpayers may be wise to preserve their rights by filing protective refund claims for the taxes paid on dividend income. Box 2-2 provides an overview of the subtraction modifications discussed in this chapter.

Box 2-2: Overview of Subtraction Modifications

Typical Subtraction Modifications

- State net operating loss
- Interest on U.S. obligations
- Dividends received deduction
- Gains or losses due to different tax bases
- Federal income taxes
- State refund if included in federal return
- Federal credits

Tax-Exempt Interest

- Intergovernmental immunity doctrine
  - Federal and U.S. obligations
    - Government National Mortgage Association (Ginnie Mae)
    - Student Loan Marketing Association (Sallie Mae)
    - Federal National Mortgage Association (Fannie Mae)

[14] See *Fulton Corp. v. Faulkner*, 516 U.S. 325 (1996), and *McKesson Corp. v. Div. of Alcoholic Beverages and Tobacco*, 496 U.S. 18 (1990).

Dividends Received Deduction

- Dividends
  - — *Farmer Bros. Co. v. Franchise Tax Board*, 134 Cal. Rptr. 2d 390 (2003)
- Foreign dividends
  - — *Kraft General Foods, Inc. v. Iowa*, 505 U.S. 71 (1992)
- Earnings and profits
  - — Calculated on a combined, consolidated, or separate basis
- Nexus

Federal Credits

- IRC Section 41 research credit
- IRC Section 78 gross ups
- Subpart F income

Appendix 1: Multistate Tax Commission Model Statute

Model Statute Requiring the Add-back of Certain Intangible and Interest Expenses

As Adopted by the Full Commission, August 17, 2006

Section 1.

(a) As used in this section, the following words shall, unless the context requires otherwise, have the following meanings:

(i) "Aggregate effective rate of tax" means the sum of the effective rates of tax imposed by a state or U.S. possession or any combination thereof on a related member.

(ii) "Code" means the federal Internal Revenue Code as amended and in effect for the taxable year.

(iii) "Effective rate of tax" means, as to any state or U.S possession, the maximum statutory rate of tax imposed by the state or possession on a related member's net income multiplied by the apportionment percentage, if any, applicable to the related member under the laws of said jurisdiction. For purposes of this definition, the effective rate of tax as to any state or U.S. possession is zero where the related member's net income tax liability in said jurisdiction is reported on a combined or consolidated return including both the taxpayer and the related member where the reported transactions between the taxpayer and the related member are eliminated or offset. Also, for purposes of this definition, when computing the effective rate of tax for a jurisdiction in which a related member's net income is eliminated or offset by a credit or similar adjustment that is dependent upon the related member either maintaining or managing intangible property or collecting interest income in that jurisdiction, the maximum statutory rate of tax imposed by said jurisdiction shall be decreased to reflect the statutory rate of tax that applies to the related member as effectively reduced by such credit or similar adjustment.

(iv) "Intangible expense" includes (1) expenses, losses and costs for, related to, or in connection directly or indirectly with the direct or indirect acquisition, use, maintenance or management, ownership, sale, exchange, or any other disposition of intangible property to the extent such amounts are allowed as deductions or costs in determining taxable income before operating loss deductions and special deductions for the taxable year under the Code; (2) amounts directly or indirectly allowed as deductions under section 163 of the Code for purposes of determining taxable income under the Code to the extent such expenses and costs are directly or indirectly for, related to, or in connection with the expenses, losses and costs referenced in (1); (3) losses related to, or incurred in connection directly or indirectly with, factoring transactions or discounting transactions; (4) royalty, patent, technical and copyright fees; (5) licensing fees; and (6) other similar expenses and costs.

(v) "Intangible property" includes patents, patent applications, trade names, trademarks, service marks, copyrights, mask works, trade secrets and similar types of intangible assets.

(vi) "Related entity" means (1) a stockholder who is an individual, or a member of the stockholder's family set forth in section 318 of the Code if the stockholder and the members of the stockholder's family own, directly, indirectly, beneficially or constructively, in the aggregate, at least 50 per cent of the value of the taxpayer's outstanding stock; (2) a stockholder, or a stockholder's partnership, limited liability company, estate, trust or corporation, if the stockholder and the stockholder's partnerships, limited liability companies, estates, trusts and corporations own directly, indirectly, beneficially or constructively, in the aggregate, at least 50 per cent of the value of the taxpayer's outstanding stock; or (3) a corporation, or a party related to the corporation in a manner that would require an attribution of stock from the corporation to the party or from the party to the corporation under the attribution rules of the Code if the taxpayer owns, directly, indirectly, beneficially or constructively, at least 50 per cent of the value of the corporation's outstanding stock. The attribution rules of the Code shall apply for purposes of determining whether the ownership requirements of this definition have been met.

(vii) "Related member" means a person that, with respect to the taxpayer during all or any portion of the taxable year, is: (1) a related entity, (2) a component member as defined in subsection (b) of section 1563 of the Code; (3) a person to or from whom there is attribution of stock ownership in accordance with subsection (e) of section 1563 of the Code; or (4) a person that, notwithstanding its form of organization, bears the same relationship to the taxpayer as a person described in (1) to (3), inclusive.

(viii) “Valid business purpose” means one or more business purposes, other than the avoidance or reduction of taxation, which alone or in combination constitute the primary motivation for a business activity or transaction, which activity or transaction changes in a meaningful way, apart from tax effects, the economic position of the taxpayer. The economic position of the taxpayer includes an increase in the market share of the taxpayer or the entry by the taxpayer into new business markets.

(b) For purposes of computing its net income under this chapter, a taxpayer shall add back otherwise deductible intangible expense directly or indirectly paid, accrued or incurred in connection with one or more direct or indirect transactions with one or more related members.

(c) If the related member was subject to tax in this state or another state or possession of the United States or a foreign nation or some combination thereof on a tax base that included the intangible expense paid, accrued or incurred by the taxpayer, the taxpayer shall receive a credit against tax due in this state in an amount equal to the higher of the tax paid by the related member with respect to the portion of its income representing the intangible expense paid, accrued or incurred by the taxpayer, or the tax that would have been paid by the related member with respect to that portion of its income if (1) that portion of its income had not been offset by expenses or losses or (2) the tax liability had not been offset by a credit or credits. The credit so determined shall be multiplied by the apportionment factor of the taxpayer in

this state. However, in no case shall the credit exceed the taxpayer's liability in this state attributable to the net income taxed as a result of the adjustment required by subsection (b).

(d) (i)The adjustment required in subsection (b) and the credit allowed in subsection (c) shall not apply to the portion of the intangible expense that the taxpayer establishes by clear and convincing evidence meets both of the following requirements: (A) the related member during the same taxable year directly or indirectly paid, accrued or incurred such portion to a person that is not a related member, and (B) the transaction giving rise to the intangible expense between the taxpayer and the related member was undertaken for a valid business purpose.

(ii) The adjustment required in subsection (b) and the credit allowed in subsection (c) shall not apply if the taxpayer establishes by clear and convincing evidence of the type and in the form specified by the commissioner that (A) the related member was subject to tax on its net income in this state or another state or possession of the United States or some combination thereof; (B) the tax base for said tax included the intangible expense paid, accrued or incurred by the taxpayer; and (C) the aggregate effective rate of tax applied to the related member is no less than [X%] [the statutory rate of tax applied to the taxpayer under this chapter minus Y percentage points].

(iii) The adjustment required in subsection (b) and the credit allowed in subsection (c) shall not apply if the taxpayer establishes by clear and convincing evidence of the type and in the form specified by the commissioner that (A) the intangible expense was paid, accrued or incurred to a related member organized under the laws of a country other than the United States; (B) the related member's income from the transaction was subject to a comprehensive income tax treaty between such country and the United States, (C) the related member's income from the transaction was taxed in such country at a tax rate at least equal to that imposed by this state; and (D) the intangible expense was paid, accrued or incurred pursuant to a transaction that was undertaken for a valid business purpose and using terms that reflect an arm's length relationship.

(iv) The adjustment required in subsection (b) and the credit allowed in subsection (c) shall not apply if the corporation and the commissioner agree in writing to the application or use of alternative adjustments or computations. The commissioner may, in his/her discretion, agree to the application or use of alternative adjustments or computations when he/she concludes that in the absence of such agreement the income of the taxpayer would not be properly reflected.

(e) Nothing in this subsection shall be construed to limit or negate the commissioner's authority to otherwise enter into agreements and compromises otherwise allowed by law.

(f) Nothing in this section shall be construed to limit or negate the commissioner's authority to make adjustments under section __ [i.e., the state's transfer pricing authority, if any].

Section 2.

(a) As used in this section, the following words shall, unless the context requires otherwise, have the following meanings:-

(i) “Aggregate effective rate of tax” means the sum of the effective rates of tax imposed by a state or U.S. possession or any combination thereof on a related member.

(ii) "Code" means the federal Internal Revenue Code as amended and in effect for the taxable year.

(iii) “Effective rate of tax” means, as to any state or U.S possession, the maximum statutory rate of tax imposed by the state or possession on a related member’s net income multiplied by the apportionment percentage, if any, applicable to the related member under the laws of said jurisdiction. For purposes of this definition, the effective rate of tax as to any state or U.S. possession is zero where the related member’s net income tax liability in said jurisdiction is reported on a combined or consolidated return including both the taxpayer and the related member where the reported transactions between the taxpayer and the related member are eliminated or offset. Also, for purposes of this definition, when computing the effective rate of tax for a jurisdiction in which a related member’s net income is eliminated or offset by a credit or similar adjustment that is dependent upon the related member either maintaining or managing intangible property or collecting interest income in that jurisdiction, the maximum statutory rate of tax imposed by said jurisdiction shall be decreased to reflect the statutory rate of tax that applies to the related member as effectively reduced by such credit or similar adjustment.

(iv) "Interest expense" means amounts directly or indirectly allowed as deductions under section 163 of the Code for purposes of determining taxable income under the Code.

(v) "Related entity" means (1) a stockholder who is an individual, or a member of the stockholder's family set forth in section 318 of the Code if the stockholder and the members of the stockholder's family own, directly, indirectly, beneficially or constructively, in the aggregate, at least 50 per cent of the value of the taxpayer's outstanding stock; (2) a stockholder, or a stockholder's partnership, limited liability company, estate, trust or corporation, if the stockholder and the stockholder's partnerships, limited liability companies, estates, trusts and corporations own directly, indirectly, beneficially or constructively, in the aggregate, at least 50 per cent of the value of the taxpayer's outstanding stock; or (3) a corporation, or a party related to the corporation in a manner that would require an attribution of stock from the corporation to the party or from the party to the corporation under the attribution rules of the Code if the taxpayer owns, directly, indirectly, beneficially or constructively, at least 50 per cent of the value of the corporation's outstanding stock. The attribution rules of the Code shall apply for purposes of determining whether the ownership requirements of this definition have been met.

(vi) "Related member" means a person that, with respect to the taxpayer during all or any portion of the taxable year, is: (1) a related entity, (2) a component member as defined in subsection (b) of section 1563 of the Code; (3) a person to or from whom there is attribution of stock ownership in accordance with subsection (e) of section 1563 of the Code; or (4) a

person that, notwithstanding its form of organization, bears the same relationship to the taxpayer as a person described in (1) to (3), inclusive.

(vii) "Valid business purpose" means one or more business purposes, other than the avoidance or reduction of taxation, which alone or in combination constitute the primary motivation for a business activity or transaction, which activity or transaction changes in a meaningful way, apart from tax effects, the economic position of the taxpayer. The economic position of the taxpayer includes an increase in the market share of the taxpayer or the entry by the taxpayer into new business markets.

(b) For purposes of computing its net income under this chapter, a taxpayer shall add back otherwise deductible interest paid, accrued or incurred to a related member during the taxable year.

(c) If the related member was subject to tax in this state or another state or possession of the United States or a foreign nation or some combination thereof on a tax base that included the interest expense paid, accrued or incurred by the taxpayer, the taxpayer shall receive a credit against tax due in this state equal to the higher of the tax paid by the related member with respect to the portion of its income representing the interest expense paid, accrued or incurred by the taxpayer, or the tax that would have been paid by the related member with respect to that portion of its income if (1) that portion of its income had not been offset by expenses or losses or (2) the tax liability had not been offset by a credit or credits. The credit so determined shall be multiplied by the apportionment factor of the taxpayer in this state. However, in no case shall the credit exceed the taxpayer's liability in this state attributable to the net income taxed as a result of the adjustment required by subsection (b)

(d) (i) The adjustment required in subsection (b) and the credit allowed in subsection (c) shall not apply if the taxpayer establishes by clear and convincing evidence, of the type and in the form determined by the commissioner, that (A) the transaction giving rise to interest expense between the taxpayer and the related member was undertaken for a valid business purpose, and (B) the interest expense was paid, accrued or incurred using terms that reflect an arm's length relationship.

(ii) The adjustment required in subsection (b) and the credit allowed in subsection (c) shall not apply the if taxpayer establishes by clear and convincing evidence of the type and in the form specified by the commissioner that (A) the related member was subject to tax on its net income in this state or another state or possession of the United States or some combination thereof; (B) the tax base for said tax included the interest expense paid, accrued or incurred by the taxpayer; and (C) the aggregate effective rate of tax applied to the related member is no less than [_X_%] [the statutory rate of tax applied to the taxpayer under this chapter minus _Y_ percentage points].

(iii) The adjustment required in subsection (b) and the credit allowed in subsection (c) shall not apply if the taxpayer establishes by clear and convincing evidence of the type and in the form specified by the commissioner that (A) the interest expense is paid, accrued or incurred to a related member organized under the laws of a country other than the United States; (B) the related member's income from the transaction is subject to a comprehensive income tax treaty between such country and the United States; (C) the related member's

income from the transaction is taxed in such country at a tax rate at least equal to that imposed by this state; and (D) the interest expense was paid, accrued or incurred pursuant to a transaction that was undertaken for a valid business purpose and using terms that reflect an arm's length relationship.

(iv) The adjustment required in subsection (b) and the credit allowed in subsection (c) shall not apply if the corporation and the commissioner agree in writing to the application or use of alternative adjustments or computations. The commissioner may, in his/her discretion, agree to the application or use of alternative adjustments or computations when he/she concludes that in the absence of such agreement the income of the taxpayer would not be properly reflected.

(e) Nothing in this subsection shall be construed to limit or negate the commissioner's authority to otherwise enter into agreements and compromises otherwise allowed by law.

(f) Nothing in this section shall be construed to limit or negate the commissioner's authority to make adjustments under section ___ [i.e., the state's transfer pricing authority, if any].

3

Filing Methods for Multistate Taxpayers

Introduction

If a corporation is, by itself or as a member of an affiliated group, doing business in more than one state, the tax practitioner must not only grapple with questions of nexus, but also the methodology for determining the taxpayer's tax base. In other words, for any specific state, we must determine if we are filing separate company returns, a consolidated return, or a "combined" or "unitary" return.

Separate, Consolidated, or Combined Filing

Separate filing means just that. Each company with nexus in the state must file its own separate return, regardless of whether it is part of an affiliated or consolidated group. A number of states that allow only separate filing, that is, each and every company with nexus must file a separate return. It is irrelevant whether the corporation is a standalone entity or a member of a controlled, affiliated, or consolidated group. Those states requiring separate filing include Alabama, Arkansas, Connecticut, Delaware, Florida, Georgia, Indiana, Iowa, Kentucky, Louisiana, Maryland, Mississippi, Missouri, New Jersey, North Carolina, Ohio, Oklahoma, Pennsylvania, Rhode Island, South Carolina, Tennessee, and Virginia. In these states, consolidated or combined filing is generally not allowed. That said, there may be a trend toward combined reporting. Since 2006, seven states—Massachusetts, Michigan, New York, Texas, Vermont, and West Virginia—have adopted combined reporting.

New York is an example of the recent move of some states toward combined filing. New York has traditionally been a separate filing state, but it provided for combined reporting when three factors were present: (1) common ownership (80 percent), (2) a unitary business (the companies generally had to be in the same line of business, either vertical or horizontal integration), and (3) that the failure to file a combined report would lead to "distortion." Distortion was presumed to exist where there were "substantial" (defined as 50 percent or more) "intercorporate transactions" (a company's receipts or expenses). In short, separate filing was the default, but combined filing was a possibility if it more accurately represented

a taxpayer's income. Not surprisingly, there was significant disagreement over what constituted "distortion."

In 2007, New York, as part of its budget bill, changed the law making combination mandatory. "[R]elated corporations ... shall make a combined report covering any related corporations if there are substantial intercorporate transactions among the related corporations." In June, the New York State Department of Taxation and Finance issued a Technical Services Bureau Memorandum, TSB-M-07(6)C, "Combined Reporting for General Business Corporations," that provided a 10-step procedure for identifying the affiliates to be included in the combined report and detailing the tests for measuring "substantial intercorporate transactions." Interestingly, and somewhat confusedly, the intercompany transactions are now measured, not on a company by company basis, so much as among groups of companies. While the details are beyond the scope of this chapter, the important point is the dramatic change by a leading state in moving to mandatory combined reporting.

Separate filing has both advantages and disadvantages. The most obvious disadvantage is that a company is prohibited from offsetting profitable subsidiaries with subsidiaries with losses. However, separate filing states offer advantages when a multistate taxpayer can arrange its legal structure to isolate high-profit margin activities in low- or no-tax states and its low-profit margin activities in states with higher tax rates. For example, isolating a company's sales and marketing functions from its manufacturing activities and conducting each in separate companies may allow shifting of income from high- to low-tax states.

The majority of states, while allowing separate filing, will also permit consolidated filing if certain requirements are met. To elect consolidated filing, most states require the same stock ownership requirements (80 percent) as that of the federal consolidated rules.[1] In addition, a state may require that only the affiliated entities that have nexus with the state be part of the consolidated return, that is, a "nexus-consolidated" return. Consolidated filing may also be allowed or even required when separate filing does not fairly reflect a company's income or economic activities. Connecticut, Indiana, Mississippi, and Tennessee, for example, are generally separate filing states, but they will permit or require consolidated or combined filing when necessary to properly reflect income.

Combined reporting requires the members of a "unitary" group to calculate their taxable income on a combined or "unitary" basis. The combined or "unitary" reporting states include Alaska, Arizona, California, Colorado, Hawaii, Idaho, Illinois, Kansas, Maine, Massachusetts, Michigan, Minnesota, Montana, Nebraska, New Hampshire, New York, North Dakota, Oregon, Texas, Utah, Vermont, Wisconsin, and West Virginia.

Author's Note: Combined Report or "Unitary" Filing

- *The unitary or combined approach ignores legal entities and geographical boundaries and focuses on the economic unit.*
- *It may be worldwide but more likely is "water's edge."*

[1] See Internal Revenue Code §§ 1501–05 and accompanying regulations.

A combined report ignores the legal structure of a corporation or affiliated group in order to focus on the entities' underlying economic reality. If a group of companies is interrelated in certain specific ways and function as one economic unit, it will be taxed as one entity and any legal or geographic divisions or separations will be ignored. In other words, the focus is on whether or not there exists a single trade or business that can be viewed as a single economic enterprise. It does not matter whether that single trade or business is conducted by various divisions of a single company, numerous subsidiaries of a parent company, or through a group of commonly owned or controlled corporations. Thus, even though a company may not have nexus with a particular state, its income and factors may be included in the tax base to which that state's apportionment formula is applied. If the business meets the unitary tests, the requisite connections for nexus under the due process and commerce clauses are deemed met. If there exists a single trade or business acting as a single unit, it will be required to file a combined report and taxed accordingly.

Author's Note: On Terminology

The terminology can vary from state to state. For example, most states distinguish between consolidated and combined returns. However, Connecticut, for example, uses the term "combined return" for what most states would call a consolidated return. It is also important to distinguish between a "combined report" and a "unitary return." Strictly speaking, there is no such thing as a "unitary return." The unitary concept, discussed later in this chapter, is the underlying principle for requiring taxpayers to file a "combined report." So be careful with the terminology.

The following example illustrates the basic concepts of separate, consolidated, and combined filing.

An Incredibly Simplified Example

Take three corporations: a parent and two wholly owned subsidiaries. The Parent files a federal consolidated return with its subsidiaries. The Parent and Sub One are both doing business in, and have nexus with, State X. Sub Two does not have any employees, property, or sales in State X. It is not doing business in State X and, accordingly, does not have nexus with the state. Each company's income and state apportionment factors are as follows:

Corporation	Nexus In State X	Taxable Income	State X* Numerator	State X* Denominator	Apportionment Factor	Separate Filing	Consolidated Filing	Combined Filing
Parent	Y	300	40	400	10.00%	30	–	–
Sub One	Y	200	20	500	4.00%	8	–	–
Consolidated Total		500	60	900	6.67%	–	33	–
Sub Two	N	100	0	100	0.00%	–	–	–
Combined Total		600	60	1000	6.00%	–	–	36

* The numerator is the sum of the corporation's payroll, property, and sales in state X and the denominator is the corporation's payroll, property, and sales everywhere. The factors that will be discussed in detail in chapter 5.

Separate Filing

Parent	300 × 40/400	=	30
Sub One	200 × 20/500	=	8
Total taxable income			38

If State X allows only separate filing, the Parent and Sub One will each file a separate return, including only their own separate income and factors. Sub Two will not file a return in State X, because it is not doing business in State X and does not have nexus with the state.

Consolidated Filing

Parent and Sub One (nexus only)	500 × 60/900	=	33

If State X allows the filing of consolidated returns, but only among companies that have nexus with the State, the Parent and Sub One combine their respective income and apportionment factors to arrive at state taxable income. Again, because Sub Two does not have nexus with State X, it cannot file as part of the consolidated return.

Combined Reporting

Parent and Sub One	600 × 60/1000	=	36

If State X allows or requires combined reporting, then the income and apportionment factors of all the affiliated companies are summed to calculate the state taxable income for the Parent and Sub One. There are several key points to be noted. First, the income and apportionment factors of Sub Two are included in the calculation even though Sub Two is not doing business in State X and does not have nexus with the state. Second, combined reporting is not a return, per se, but a method for calculating the state taxable income of a "unitary" or "combined" group. Technically, State X is only taxing the Parent and Sub One, but it is measuring the tax base and factors of those two companies by including any other companies (Sub Two) that are deemed to be a part of the "unitary" group. As the Oregon Tax Court stated, "[I]t is important to remember that including the income of a nontaxable member of a unitary group does not subject that income to taxation by Oregon. It merely provides the base from which the taxable corporation's share is apportioned." *State Department of Revenue v. Penn Independent Corp.*, 15 Or. Tax 68, 74 (1999). Combined

reporting states differ in whether, after calculating the group's combined income, the Parent and Sub One will file a single return or each file separate returns.

Unitary Tax

The first thing to be said is that the term "unitary tax" is a misnomer. Unitary tax is not a separate tax. In the context of state income tax, the term "unitary" simply refers to the principle, or tests, that define the tax base to which a state can apply its formulary apportionment. It is an accounting method for determining the taxable income base of a multistate business. Or, to put it more simply, it is a method of determining the amount to which a state can apply its apportionment formula. The approach was first used in the nineteenth century in property tax cases involving railroads and telegraphs. The issue was, to use a simple example, how do you measure the value of a railroad track crossing Kansas from Missouri to Colorado, when the whole is worth more than the sum of its parts? After all, the track's worth would be severely impaired if it ended at the Missouri–Kansas border and started up again at the Kansas–Colorado border. In 1875, the U.S. Supreme Court held that the value of a railroad line depended upon the entire line as a unit, pointing out that each mile of track alone was worthless.[2]

> A railroad must be regarded ... as a unit ... Destroy by any means a few miles of this track within [a jurisdiction and] its effect upon the value of the remainder of the road is out of all proportion to the mere local value of the part of it destroyed. ...It may well be doubted whether any better mode of determining the value of that portion of the track within any one county has been devised than to ascertain the value of the whole road and apportion the value within the county by its relative length to the whole.

For example, to calculate the appropriate property tax due from the railroad property within its boundaries, the city of Cheyenne determined the total value of the railroad line, not just the few miles within its jurisdiction. The city then computed the per mile value of the line in Cheyenne by dividing the total value of the railroad line by the total number of miles of line.[3] The "unit method," as it was called in 1875, or the unitary theory, provides that the business activity in each state contributes to or enhances the activity of the whole entity and, therefore, should be included in computing an assessment. In other words, forget about corporate divisions, company lines, parents, and subsidiaries and disregard geographic boundaries; the key to understanding combined reporting is two words: "economic unit." It is this existence of an "economic unit," or unitary business, that determines whether a state can include income earned outside its borders in calculating through apportionment the taxable income and tax to which it is entitled. According to the U.S. Supreme Court, "the only reason for allowing a state to look beyond its borders when it taxes the property of foreign corporations is that it may get the true value of the things within it, when they are part of an organic system of wide extent, that gives them a value above what they would otherwise possess."[4]

---

[2] *In re State Railroad Tax Cases*, 92 U.S. 575, 608 (1875).

[3] *Union Pacific Ry. v. Cheyenne*, 113 U.S. 516 (1884).

[4] *Wallace v. Hines*, 253 U.S. 66, 69 (1920).

The Supreme Court first directly acknowledged the application of the unitary method to state income taxation in *Bass, Ratcliff & Gretton, Ltd. v. State Tax Commission*, 266 U.S. 271 (1924), when it stated,

> So in the present case we are of the opinion that, as the Company carried on the unitary business of manufacturing and selling ale, in which its profits were earned by a series of transactions beginning with the manufacture in England and ending in sales in New York and other places—the process of manufacturing resulting in no profits until it ends in sales—the state was justified in attributing to New York a just proportion of the profits earned by the Company from such unitary business.[5]

In addition to determining whether or not separate accounting is appropriate, and whether the income or factors of nonnexus entities can be included in apportionable tax base, the unitary concept has also been used to determine whether specific items, types, or categories of income, such as interest income, dividend income, and capital gains, are deemed apportionable business income or allocable nonbusiness income.

The combined method, also known as unitary apportionment, is based on a recognition that an integrated business may operate through several separately incorporated entities. In such case, transactions between corporations under common control may lack economic substance; therefore, it is necessary to consider the corporate group as a whole. This method combines the income of all related business entities which are engaged in the same integrated or unitary business to arrive at net income base. A percentage of the net income base is then apportioned to the relevant taxing jurisdiction according to a formula which measures the contribution of the business activities within the taxing jurisdiction (for example, Colorado) to the profit of the entire unitary business. This percentage of the net income base is then taxed by the state.[6]

The relationship between the unitary concept and a combined report can be confusing. A combined report is an accounting method used by a state to measure the taxable income of a single multistate corporation that is either conducting a unitary business or a member of a group of multistate corporations conducting a unitary business. As a consequence, the combined report may include affiliates that do not have nexus with the state. "Combined reporting is not designed to tax the income or other tax base of the nontaxable affiliates although taxpayers assert that the combined method frequently has that effect. The purpose of the combined report is to determine the income or other tax base of the in-state taxpayer by viewing the taxpayer as part of the unitary business, and applying the apportionment factors of the entire unitary business to the taxable net income of the unitary business."[7] The unitary concept is used to determine what divisions, operations, or parts of a single corporation doing business in more than one state or which commonly owned corporations are (1) engaged in a unitary business, (2) the net income of that business, and (3) how to apportion that income.

---

[5] *See also Underwood Typewriter Co. v. Chamberlain*, 254 U.S. 113 (1920).

[6] *Hewlett-Packard Co. v. State*, 749 P.2d 400, 401 (Colo. 1988).

[7] J. Hellerstein & W. Hellerstein, State Taxation, ¶ 8.11[1] (3d ed. 2001).

Unfortunately, there is little agreement among the states about what specifically constitutes a unitary group. (The Multistate Tax Commission [MTC], in its efforts to promote state uniformity, has proposed a regulation defining a unitary business. The regulation is included at the end of this chapter.) The factors for defining what companies belong in a combined report have evolved over time and still remain unsettled. In fact, the unitary method, and its application, traditionally has not been defined by statute. It has been created, like the doctrines of economic substance and business purpose, by the courts. Thus, the best approach to mastering this area is to follow the evolution of combined reporting through the landmark cases that have defined it.

Author's Note: Overview of Unitary Tests

- *Three unities test*
  - *Use*
  - *Ownership*
  - *Operations*
- *Contribution/Dependency test*
- *Factors of profitability test*
  - *Functional integration*
  - *Centralization of management*
  - *Economies of scale*

The Landmark Cases

Let us begin with a couple of the old landmark cases. While dated, these are still useful for understanding the history and context of the continuing disputes over the unitary method and combined reporting.

The Three Unities Tests

Butler Bros. v. McColgan, *111 P.2d 334 (1941),* aff'd, *315 U.S. 501 (1942)*

Butler Brothers was an Illinois corporation selling wholesale dry goods and general merchandise. It had wholesale distributing houses in seven states, including one in San Francisco, California. "Each of its houses in the seven states maintains stocks of goods, serves a separate territory, has its own sales force, handles its own sales and all solicitation, credit and collection arrangements ... [and] ... keeps its own books of account." However, Butler Brothers did maintain a central buying division and allocated certain overhead expenses (executive salaries, accounting, and advertising) to each wholesale house. (Please note that these houses were controlled branches or divisions of Butler Brothers, not separate corporate entities.) The company filed its California return using separate accounting and reported a loss ($82,851) in California, while the overall company reported a profit ($1,149,677).

California recomputed the company's income using a three-factor formula averaging the percentage of California payroll, sales, and property to total payroll, sales, and property. Using this formula, California figured that Butler Brothers taxable income in the state was a profit of $93,500. In the Supreme Court's first significant application of the unitary theory to an income tax case, it held two things. First, there did exist a unitary relationship among the branches based on "(1) unity of ownership; (2) unity of operation as evidenced by central purchasing, advertising, accounting and management divisions; and (3) unity of use in its centralized executive force and general system of operation." Second, the use of the three-part formula was not on its face unconstitutional, it was "fairly calculated," and its assignment of income to California "reasonably attributable" to the business done there. The Court acknowledged that the integrity of separate accounting need not be impeached, but it was up to the taxpayer to show by "clear and cogent evidence" that California's formula taxed extraterritorial values "out of all appropriate proportion to the business."

It is only if its business within this state is truly separate and distinct from its business without this state, so that the segregation of income may be made clearly and accurately, that the separate accounting method may property be used. When, however, interstate operations are carried on and that portion of the corporation's business done within the state cannot be clearly segregated from that done outside the state, the unit rule of assessment is employed as a device for allocating to the state for taxation its fair share of the taxable values of the taxpayer.

Observations

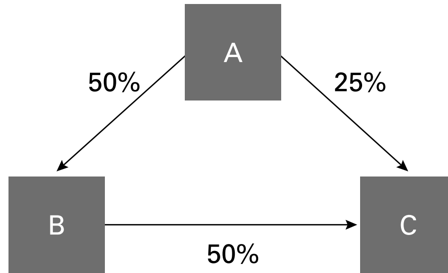
The *Butler Brothers* decision gives us our first definition of a unitary business, often called the "three unities" test. A business will be held to be operating a unitary business if there exists (1) unity of ownership, (2) unity of operation, and (3) unity of use.

Unity of ownership has generally been defined as either direct or indirect ownership of more than 50 percent of a corporation's voting stock. A bright-line rule, it remains the clearest test in defining a unitary group. Generally, auditors examining unity of ownership will use not only the IRS Form 1120 and Form 851 (affiliations schedule), but also will, for listed companies, examine the SEC Form 10-Ks for the audit period.

While usually the simplest of the unitary tests, even the unity of ownership test can vary from state to state. In the first example, A corporation owns 50 percent of B corporation and 25 percent of C corporation. B corporation owns 50 percent of C corporation. In many states this would not qualify as a combined group, because in most states the ownership percentage has to be more than 50 percent.

Example 1

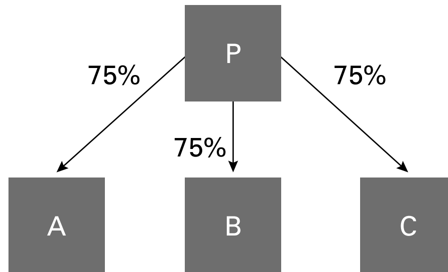
A, B, and C are not unitary because ownership must be more than 50%



The second example, drawn from the California audit manual, is counterintuitive, but it also illustrates a combined group. Entity P provides the necessary ownership to meet the unity of ownership test, but itself is not unitary with its subsidiaries. However, that would not prevent the subsidiaries from qualifying as a unitary group.

Example 2

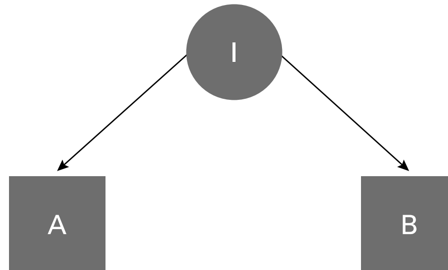
A, B, and C can be unitary without P



In jurisdictions that require that a unitary group be based on an affiliated group as that is defined in Internal Revenue Code (IRC) § 1504(a)(1), the following cannot file a combined group, because Entity I is an individual, and an individual cannot be a member of an affiliated group under IRC § 1504(a)(1). That said, in states that do not tie their definition of a unitary group to IRC § 1504(a)(1), this arrangement might very well qualify as a combined group.

Example 3

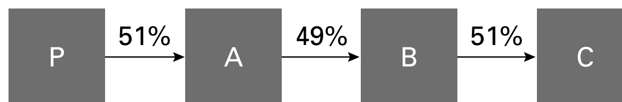
A and B may be unitary even though it isn't an affiliated group



In this last example, while entities P and A may file a combined report and entities B and C may file a combined report, neither entity P nor A can file a combined report with either entity B or C, or B and C together, because of the less than 50 percent ownership between entities B and C. This would also be true in states, whose definition of a unitary group is tied to IRC § 1504(a)(1), if a partnership or limited liability company were inserted between entities B and C, again, because a partnership cannot be a member of an affiliated group under IRC § 1504(a)(1).

Example 4

P is unitary with A and B is unitary with C, but P is not unitary with B or C



The difference between unity of operations and unity of use is not immediately apparent. A California court has described the difference this way: "Although there is not a clear demarcation between what is 'operation' and what is 'use,' in general it may be said that the acts falling within the category of 'operation' are the staff functions and those within 'use' are the line functions."[8] Thus, the unity of operations test will be met if corporations share certain staff functions, such as purchasing, advertising, personnel, legal and accounting services, insurance, and employee benefit plans. Box 3-1 shows examples of staff functions that auditors will examine.

[8] *Chase, Brass & Copper Co., Inc. v. Franchise Tax Bd.*, 10 Cal. App. 3d 496 (Calif. 1970), *cert. denied*, 400 U.S. 961 (1970).

Box 3-1: Staff Functions that Auditor will Review for Unity of Operations Test

- Centralized purchasing.
  - The auditors will ask whether a centralized purchasing department exists and will probably review some purchase invoices, vendor lists, purchase contracts, and order requirements.
- Manufacture and intercompany sales of raw materials, parts, packaging, or other products.
  - The auditors will review the intercompany accounts in the general ledger with some care both in terms of volume and whether the transactions are essential to either the buyer or seller.
- Centralized or common advertising.
  - The auditors will ask whether there is a centralized advertising department and whether the advertising is national or local in scope. They will also peruse the advertisements themselves, looking for uniform trademarks or logos and generally whether there is an emphasis in the advertising on a unitary identity.
- Equipment transfers.
- Sharing of information, technology, patents, or other intangibles.
- Centralized or common insurance programs, plans, or policies.
- Common employee benefit and pension programs.
  - The auditors will often review employee handbooks or personnel manuals to determine if there are common benefits and programs throughout the organizations.
- Centralized or common use of accounting, personnel, or legal staff.
  - Here the auditors are looking for common accounting procedure manuals, uniform labor contracts, standardized forms, and whether there is a single legal department providing in-house counsel across companies and organizations.
- Intercompany loans, receivables, or financing.
  - Intercompany financing can be used to integrate a conglomerate or to make it more diversified. As a consequence, it can be an element both for and against a unitary relationship. The auditors will look at the volume and importance of intercompany loans, the source and use of the funds, and the terms, guarantees, and collateral involved.

The staff functions must be significant. For example, a parent corporation's preparation of the affiliated group's corporate return is not an example of unity of operations. Every parent corporation probably engages in this activity. Thus, it is not a distinguishing feature of a unitary group. Centralized or common advertising is an activity that may or may not have any unitary significance. For example, the use of the same advertising agency by an affiliated group of corporations is hardly evidence, in and of itself, of a unitary relationship. However, if the advertising efforts are designed to create and maintain a single corporate identity or brand, then the centralized advertising is a meaningful unitary element.

Unity of use looks to whether there are shared line functions such as a centralized management and "general system of operation." In other words, unity of use is present when

there is integrated executive control exercised through the implementation of the business's major policies or direction. The development of vertical or horizontal business relationships to maximize profitability is an example of integrated executive control. An oil company that expands its operations from exploration and drilling through refining and distribution is an example of vertical integration. An oil refinery that expands by purchasing other refineries in the same market is an example of horizontal integration.

In practice, it is often difficult to distinguish between unity of operations and unity of use tests let alone determine the quantity and quality of the activities that supposedly define the tests. It is not enough to simply list the elements of operations and use, or to apply the labels indiscriminately; there must be some substance to the tests for them to mean anything.

> ***Author's Note: The Difference Between Unity of Operations and Unity of Use***
>
> *The difference between unity of operations and unity of use is not immediately apparent. "Although there is not a clear demarcation between what is 'operation' and what is 'use,' in general it may be said that the acts falling within the category of 'operation' are the staff functions and those within 'use' are the line functions."*
>
> Chase, Brass & Copper Co., Inc. v. Franchise Tax Board, *10 Cal. App. 3d 496 (Calif. 1970),* cert. denied, *400 US 961 (1970).*

Nevertheless, *Butler Brothers* made it clear that a single company doing business in more than one state could not segregate its income geographically and file accordingly when its activities were unified through use and operations.

The Contribution and Dependency Tests

Edison California Stores v. McColgan, *176 P.2d 697,* on reh'g, *183 P.2d 16 (Cal. 1947)*

Edison Stores took the *Butler Brothers* decision one step further. If anyone wondered after *Butler Brothers* whether the decision would have been different if the separate stores in the various states had been separate corporations, *Edison* answered that question with a resounding no. The *Edison Stores* decision provided that the unitary concept, applied to a single company with branches in different states, can also be applied to a group of corporations (subsidiaries) with one parent corporation. "Thus the business is unitary regardless of the fact that in the *Butler Brothers* case there was but one corporation involved, owning as parts of the unitary system seven different branches in as many states, and that in the present case there is a parent corporation owning and controlling as units of one system fifteen different branches organized as corporations in as many states. No difference in principle is discernible."

Edison also added a new test to the three unity tests of ownership, operation, and use proffered by *Butler Brothers*. The court wrote that "[i]f the operation of the portion of the business done within the state is dependent upon or contributes to the operation of the business without the state, the operations are unitary; otherwise, if there is no such dependency, the business within the state may be considered to be separate."

Observations

Edison Stores is important for illustrating that a company's legal structure will not protect it from a state's taxing powers when the company or companies act as one economic unit. This case represents a key step because the unitary concept is applied to an affiliated group, rather than just the divisions or segments of a single corporation.

Edison Stores also added a new unitary test, the contribution or dependency test. Thus, if the operations of a business in a state are dependent upon or contribute to the business operations outside the state, the business may be taxed as a single economic unit. Examples often cited as illustrative of dependency or contribution often overlap with the three unities test and include intercompany sales, loans, and line and staff activities. As with the three unities tests, measuring and defining what constitutes dependency and contribution in any distinguishable sense has been difficult.

It is not necessary that a company meet both the three unities test and the contribution or dependency test. The courts have confirmed that they are alternative tests and that only one of the two must be met.[9]

Factors of Profitability Test

In addition to the three unities tests and the tests of contribution and dependency, the Supreme Court has offered a factors of profitability test for defining a unitary group.

Mobil Oil Corp. v. Vermont, *445 U.S. 425 (1980)*

In *Mobil Oil*, Vermont included in the state's apportionable income the dividend income from Mobil's foreign subsidiaries. Vermont added the dividend income to its tax base holding that it had a right to do so because the subsidiaries and affiliates from which the dividend income was received were unitary with Mobil Oil. In other words, the dividend income was business (apportionable) income because of the unitary relationship between the parent and the foreign subsidiaries.

Mobil naturally disagreed, arguing that the dividends were not subject to Vermont tax under either the due process clause or the commerce clause. First, despite a unitary relationship there was no "minimum connection" as required by due process between Vermont, Mobil's management of its investments, or the business activities of the payor corporations. Second, taxing the dividends "would create an unconstitutional burden of multiple taxation," because New York, as the state of domicile, could tax the entire dividend income. Finally, the foreign source of the dividend income created a risk of international multiple taxation.

[9] See *A.M Castle & Co. v. Franchise Tax Bd.*, 36 Cal. App. 4th 1794 (Calif. 1995).

The Court rejected all of Mobil's arguments, stating in a now famous line, "the linchpin of apportionability in the field of state income taxation is the unitary business principle." Because there existed "factors of profitability" defined as "functional integration, centralization of management, and economies of scale," Mobil Oil was to be treated as a unitary entity, thereby making the income subject to apportionment. The fact that New York could tax the same income was irrelevant because, in fact, it did not. And the risk of international multiple taxation was also irrelevant because that risk existed for all income, not just dividend income.

> [T]he linchpin of apportionability in the field of state income taxation is the unitary principle ... what appellant must show, in order to establish that its dividend income is not subject to an apportioned tax in Vermont, is that the income was earned in the course of activities unrelated to the sale of petroleum products in that State ... appellant has made no effort to demonstrate that the foreign operations of its subsidiaries and affiliates are distinct in any business or economic sense from it petroleum sales activities in Vermont ... Indeed, all indications in the record are to the contrary, since it appears that these foreign activities are part of appellant's integrated petroleum enterprise.

Finally, the Court made it clear that its decision was not all encompassing. "Where the business activities of the dividend payor have nothing to do with the activities of the recipient in the taxing State, due process considerations might well preclude apportionability, because there would be no underlying unitary business."

Exxon Corp. v. Wisconsin, *447 U.S. 207 (1980)*

Exxon, like *Mobil Oil*, involved the "state taxation of the income of a vertically integrated corporation doing business in several States." Exxon divided its operations into three categories (marketing, exploration and production, and refining), accounting for each separately. In fact, Exxon argued that the three categories themselves represented three unitary businesses. The company's only activity in Wisconsin was marketing (which produced losses in the state), and Exxon attempted to report only those activities to Wisconsin. The company believed that its separate accounting of its three activities was sufficient to justify separate treatment for state tax purposes. "In order to exclude certain income from the apportionment formula, the company must prove that 'the income was earned in the course of activities unrelated to the sale of petroleum products in the State.' The court looks to the 'underlying economic realities of a unitary business,' and the income must derive from unrelated business activity, which constitutes a 'discrete business enterprise.' "

Exxon apparently failed to convince the Court that sufficient distortion existed. The Court held that Exxon's facts failed this test, stating that while "such evidence may be helpful," it is in no sense conclusive. Instead, the Court found that Exxon was a "highly integrated business which benefits from an umbrella of centralized management and controlled interaction." Accordingly, "if a company is a unitary business, then a State may apply an apportionment formula to the taxpayer's total income in order to obtain a 'rough approximation' of the corporate income that is 'reasonably related to the activities conducted within the taxing State.' " In other words, instead of having three unitary businesses, the Court told Exxon that in actuality, it had three operating functions of a single unitary business.

Author's Note: Factors of Profitability

- ***Functional integration***
  - *Functional integration refers to transfers between, or pooling among, business activities that significantly affect the operation of the business activities.*
  - *Functional integration includes, but is not limited to, transfers or pooling with respect to the unitary business's products or services, technical information, marketing information, distribution systems, purchasing, and intangibles such as patents, trademarks, service marks, copyrights, trade secrets, know-how, formulas, and processes.*
- ***Centralization of management***
  - *Centralization of management exists when directors, officers, or other management employees jointly participate in the management decisions that affect the respective business activities and that may also operate to the benefit of the entire economic enterprise.*
- ***Economies of scale***
  - *Economies of scale refers to a relation among and between business activities resulting in a significant decrease in the average per unit cost of operational or administrative functions due to the increase in operational size.*

Taxpayer Victories

After *Mobil Oil* and *Exxon*, some doubted that taxpayers could ever convince a court that a state's assertions of a unitary group or use of an apportionment method could ever be successfully challenged. Then, the decisions in *ASARCO Inc. v. Idaho*, 458 U.S. 307 (1982), and *F.W. Woolworth Co. v. New Mexico*, 458 U.S. 354 (1982) breathed new life into the debate.

ASARCO Inc. v. Idaho, *458 U.S. 307 (1982)*

At first blush, this case looks just like another *Mobil Oil* case. Again, you have a nondomiciliary state (this time Idaho, not Vermont) trying to include in its tax base dividends from foreign subsidiaries. ASARCO was a New Jersey corporation domiciled in New York. It mined, smelted, and refined nonferrous metals including gold, silver, copper, lead, and zinc.

It operated a silver mine in Idaho, and the state attempted to include in its apportionable (business) income dividend, interest, and capital gain income derived from ASARCO's ownership in five subsidiary corporations.

Six other wholly owned subsidiaries were included as unitary, but they were not part of the appeal. The appeal was limited to the inclusion of the dividend, interest, and capital gain income from the five subsidiaries in which ASARCO owned only a majority interest. This is an important point. When including the six wholly owned subsidiaries as unitary, Idaho pulled into the combined return both their income and payroll, property, and sales factors. In the five majority owned subsidiaries, however, Idaho was pulling in only the income, and not the factors. As a consequence, Idaho's apportionable income increases without any accompanying dilution from the foreign subsidiaries factors. Many taxpayers, then and now, have reacted to these kinds of attempts by crying, "no taxation without factor representation."

Idaho tried to argue that it was unnecessary to show that the subsidiaries were unitary with their parent to satisfy due process limitations. The Court rejected Idaho's attempt stating that the facts as presented simply did not support a unitary relationship. "In this case ... the record establishes that each of the ... subsidiaries in question operated a 'discrete business enterprise' having 'nothing to do with the activities of [ASARCO] in the taxing state.' " In other words, *Mobil Oil* still stands, and the dividend payor must be engaged in a unitary business with the dividend recipient. Further, it rejected Idaho's attempt to change the definition of a unitary business.

Idaho's proposal is that corporate purpose should define unitary business. It argues that intangible income should be considered a part of a unitary business if the intangible property (the share of stock) is "acquired, managed or disposed of for purposes relating or contributing to the taxpayer's business." Idaho asserts that "it is this integration—i.e., between the business use of the intangible asset (the shares of stock) and ASARCO's mining, smelting, and refining business—which makes the income part of the unitary business."

> This definition of unitary business would destroy the concept. The business of a corporation requires that it earn money to continue operations and to provide a return on its invested capital. Consequently, all of its operations, including any investment made, in some sense can be said to be "for purposes related to or contributing to the [corporation's] business." When pressed to its logical limit, this conception of the "unitary business" limitation becomes no limitation at all.

F.W. Woolworth Co. v. New Mexico, *458 U.S. 354 (1982)*

This case was decided with ASARCO and involved the same question: Can a nondomiciliary state (New Mexico, this time) pull in as taxable income dividend income from foreign subsidiaries?

Woolworth owns retail chain stores throughout the United States. It also owned four foreign subsidiaries (three of them wholly owned) with stores in Germany, Canada, Mexico, and England. The four subsidiaries paid Woolworth approximately $40 million in dividends and the question before the Court was whether or not New Mexico could tax those

dividends as part of the apportionable income of the U.S. parent. The Court found that the facts did not sustain a unitary relationship:

> We conclude, on the basis of undisputed facts, that the four subsidiaries in question are not a part of a unitary business under the principles articulated in *Mobil* and *Exxon*, and today reiterated in *ASARCO*. Except for the type of occasional oversight—with respect to capital structure, major debt, and dividends—that any parent gives to an investment in a subsidiary, there is little or no integration of the business activities or centralization of the management of these five corporations.

The important point about this case is that, like *Mobil Oil*, the payors of the dividend income were in the same line of business as the parent, but the relationship between them was not unitary. While there was certainly a potential to be unitary, potentiality is not enough. "But the *potential* to operate a company as part of a unitary business is not dispositive when, as here, the dividend income from the subsidiaries in fact is derived from unrelated business activity of the subsidiaries, each of which operates a discrete business enterprise." Instead, "the proper inquiry looks to 'the underlying unity or diversity of business enterprise' not to whether the nondomiciliary parent derives some economic benefit—as it virtually always will—from its ownership of stock in another corporation."

There was some comment in the case that the state of New Mexico just did not do a good job developing its facts. Perhaps it was easier in *Mobil* and *Exxon* to find a unitary business because those companies were vertically integrated oil and gas companies, not retailers.

Finally, Justices Sandra Day O'Connor, William Rehnquist, and Harold Blackmun issued a strong dissent arguing that because the dividend income constituted passive investment income it was unnecessary for the subsidiaries to be part of a unitary business with ASARCO. For example, even ASARCO admits that Idaho can tax the interest earned on short-term investments of its working capital. Then why not income from its long-term investments? As Justice O'Connor points out, ASARCO would certainly be quick to claim apportionable interest expense on its long-term investments. To be consistent, it should also claim the income.

Flow of Value Test and Worldwide Combination

The decision in *Container Corp. of America v. Franchise Tax Board*, 103 S. Ct. 2933 (1983), is important for two things. First, it provides a fourth, and so far final, test for measuring the existence of a unitary business, and, second, it held that state efforts at requiring combined reporting did not stop at the water's edge of the United States.

Container Corp. of America v. Franchise Tax Board, *103 S. Ct. 2933 (1983)*

The Supreme Court holds that the unitary concept can be extended to include foreign subsidiaries in a "combined" report. California recalculated Container's income tax on a "combined basis" pulling in its foreign subsidiaries (including their sales, property, and payroll factors). The Court found that California's reliance on intercompany loans, "advice and consultation regarding manufacturing techniques," cost accounting, agency relationship in purchasing equipment, and technical service help was sufficient to support unitary

treatment. "We need not decide whether any one of these factors would be sufficient as a constitutional matter to prove the existence of a unitary business. Taken in combination, at least, they clearly demonstrate that the state court reached a conclusion 'within the realm of permissible judgment.' "

Container argued that combined reporting resulted in double taxation, prohibited the federal government from speaking with one voice in international taxation, and, in any event, California had an obligation in international tax to use the arm's–length analysis used by the federal and other foreign governments. For example, Container pointed out that because property and labor costs in foreign countries were often lower than in the United States, the use of formulary apportionment utilizing those factors inevitably led to double taxation. The Court rejected this argument, noting that "of course, even the three-factor formula is necessarily imperfect. But we have seen no evidence demonstrating that the margin of error ... inherent in the three-factor formula is greater than the margin of error ... inherent in the sort of separate accounting urged upon us by appellant." Thus, "it would be perverse, simply for the sake of avoiding double taxation, to require California to give up one allocation method that sometimes results in double taxation in favor of another allocation method that also sometimes results in double taxation."

Observation

There are two points of note. First, worldwide combination. Second, the Court seems to back away from the factors of profitability tests set down in *Mobil*. After all, given the facts of the case and applying the standards of functional integration, centralization of management, and economies of scale, *Container* is arguably less unitary than *ASARCO* and *Woolworth*. In any case, the decision is not particularly helpful in clearing the ambiguity created between the *Mobil* and *Exxon* unitary holdings and the *ASARCO* and *Woolworth* nonunitary holdings. The Court stated that there need not be a flow of product to have a unitary relationship; a "flow of value" is sufficient. Is "flow of value" the same thing as the "factors of profitability?" If not, what is it?

Barclays Bank PLC and Colgate-Palmolive Co. v. Franchise Tax Board, *115 S. Ct. 2268 (1995)*

The Court revisited worldwide combination one more time over a decade later in *Barclays Bank*. In *Container*, the Court declined to say whether or not its application of worldwide combination applied also to corporations with foreign parents. The answer is yes. In *Barclays Bank*, the Court holds that the U.S. Constitution does not prohibit worldwide combined reporting. The Court noted that the U.S. Congress had eleven years to respond to its decision in *Container* and failed to do so. Thus, if the Court's decisions frustrated foreign policy under the foreign commerce clause it remained for Congress to correct.

Despite this decision, most states, because of political pressure from businesses and other countries, have backed away from mandatory worldwide combined reporting. Instead, most combined reporting is limited to "water's edge" combination. California has made worldwide combined reporting elective since 1988, as have other states such as Idaho, Montana, North Dakota, and Utah. Other states, such as Illinois and Colorado, limit combined

reporting to water's edge by prohibiting the inclusion of what is called "80/20 corporations." 80/20 corporations are defined as companies that have 80 percent or more of their business activities outside of the United States. The 80 percent measurement is usually a combination of the company's payroll and property factors. Alaska is the only state to require worldwide combined reporting, and even that is limited to the oil and gas industry.

Should the Unitary Business Principle Be Abandoned?

Allied-Signal, Inc. v. Director of Taxation, *112 S. Ct. 2251 (1992)*

Allied-Signal was the successor-in-interest to the Bendix Corporation. During the 1970s, Bendix had acquired 20.6 percent of the stock of ASARCO only to sell it back to ASARCO in 1981 for a $211.5 million dollar gain. (Yes, this is the same ASARCO as in *ASARCO v. Idaho*.) The question before the Court was whether or not New Jersey could apportion the gain. Both Allied-Signal and New Jersey stipulated that Bendix and ASARCO "were unrelated business enterprises each of whose activities had nothing to do with the other." In other words, there was no unitary relationship. Applying the factors of profitability (functional integration, centralization of management, and economies of scale), the Court found that "there is no serious contention that any of the three factors upon which we focused in *Woolworth* were present. Functional integration and economies of scale could not exist because ... the parties stipulated [they] were unrelated business enterprises." Finally, "there was no centralization of management." Thus, New Jersey could not tax the gain because (1) Bendix and ASARCO were not engaged in a unitary business, and (2) the gain was from an investment function and not an operational function.

Given the stipulation that the businesses were unrelated enterprises, New Jersey advanced a new argument, that is, "that the unitary business principle must be abandoned in its entirety, arguing that a nondomiciliary State should be permitted 'to apportion all the income of a separate multistate corporate taxpayer.'" The Court rejected New Jersey's suggestion, pointing out that "New Jersey's sweeping theory cannot be reconciled with the concept that the Constitution places limits on a State's power to tax value earned outside of its borders."

Perhaps responding to Justice O'Connor's dissent in *ASARCO*, the Court did try to distinguish between short- (operational) and long-term investments and the application of the unitary concept. "We agree that the payee and the payor need not be engaged in the same unitary business as a prerequisite to apportionment in all cases. *Container Corp.* says as much. What is required ... is that the capital transaction serve an operational rather than an investment function." "The existence of a unitary relation between payee and payor is one justification for apportionment, but not the only one." The Court cited short-term deposits that form a part of working capital as an example of income that may be apportioned even when no unitary relationship exists. "The existence of a unitary relation between the payor and the payee is one means of meeting the constitutional requirement ... we did not purport, however, to establish a general requirement that there be a unitary relation between the payor and the payee to justify apportionment, nor do we do so today."

In Justice O'Connor's dissent in *Allied-Signal*, she claimed that to maintain that a unitary relationship was the only foundation for a state to include foreign income in its apportionable tax base was "doctrinal foot fault." It seems evident in *Allied-Signal* that the Court took notice of that criticism when it wrote that "taxation of investment income received from a nondomiciliary taxpayer's investment in another corporation requires only that the investment income be sufficiently related to the taxpayer's in-state business, not that the taxpayer's business and the corporation in which it invests be unitary." Thus, while the unitary business principle may be the linchpin of apportionability, it is not the only linchpin. So just when we thought things were becoming clearer, they are not.

Nevertheless, if we remain confused it is not the Court's fault. "If lower courts have reached divergent results in applying the unitary business principle to different factual circumstances, that is because, as we have said, any number of variations on the unitary business theme 'are logically consistent with the underlying principles motivating the approach,' and also because the constitutional test is quite fact-sensitive." Indeed.

Author's Note: On Unitary Tests

Short-term out-of-state investments can be apportioned by the nondomiciliary state without a unitary relationship between the payor and payee, as long as the investments are unitary in that they serve an "operational function."

Let us sum up the unitary tests as laid out by the U.S. Supreme Court. They include

- *the three unities tests: unity of ownership, operation, and use.*
- *the dependency or contribution test.*
- *the factors of profitability tests: functional integration, centralization of management, and economies of scale.*
- *the flow of value test.*

One commentator, Franklin C. Latcham, has observed that "the difficulty with such tests, however, is that they are so vague that they can have different meanings for different courts when applied to similar fact situations."

MeadWestvaco Corp. v. Illinois, *553 U.S. 16 (2008)*

On April 15, 2008, the U.S. Supreme Court handed down its long-awaited decision on the relationship of the unitary concept and the operational function or operational purpose test. The issue before the Court was whether Illinois could tax a portion of the $1 billion capital gain arising from the sale of MeadWestvaco's (Mead) corporate division, Lexis/Nexis.[10]

[10] *MeadWestvaco Corp. v. Illinois*, 553 U.S. 16 (2008).

Mead had purchased Lexis/Nexis (then part of Data Corporation) in 1968 and, in the years since, Lexis-Nexis had been held by Mead as a separate corporate subsidiary, then a division, then a subsidiary, and then a division again when it was sold in 1994. Mead reported the sale as nonbusiness income allocable to its state of domicile, Ohio. Illinois took the position upon audit that the gain was apportionable business income and assessed Mead roughly $4 million in tax and penalties.

The Cook County Circuit Court held that while Mead and Lexis-Nexis were not unitary, the gain was nevertheless apportionable business income, not allocable nonbusiness income, because "Lexis served an operational function in Mead's business." The Illinois Appellate Court affirmed the lower court's decision citing several factors for holding that Lexis served an operational function in Mead's business. Specifically, the appellate court pointed out that, in addition to be being wholly owned, "Mead had exercised its control over Lexis in various ways, such as manipulating its corporate form, approving significant capital expenditures, and retaining tax benefits and control over Lexis' free cash." Because the court found that the operational function test was met, it did not address whether Mead and Lexis were part of a unitary business. After the Illinois Supreme Court declined to hear the case, Mead appealed to the U.S. Supreme Court, which heard the case on January 16, 2008.

The Supreme Court ruled in Mead's favor, holding that "the state courts erred in considering whether Lexis served an 'operational purpose' in Mead's business after determining that Lexis and Mead were not unitary." After tracing a history of the unitary business concept, the Court stated that the lower court's reading of Allied-Signal had been mistaken. "Our decisions ... did not announce a new ground for the constitutional apportionment of extrastate values in the absence of a unitary business. Because the Appellate Court of Illinois interpreted those decisions to the contrary, it erred." In fact, the Court stated, "Our references to 'operational function' ... were not intended to modify the unitary business principle by adding a new ground for apportionment. The concept of operational function simply recognizes that an asset can be a part of a taxpayer's unitary business, even if what we may term a 'unitary relationship' does not exist between the 'payor and payee.' "

It seems that while the Court did not simply discard the operational function test, it certainly limited its scope. "Whereas here, the asset in question is another business; we have described the 'hallmarks' of a unitary relationship as functional integration, centralized management, and economies of scale." In other words, once the courts had stipulated that a unitary relationship, based on the traditional tests, did not exist, that was sufficient for determining whether the gain was business or nonbusiness.

The *MeadWestvaco* decision will have significant ramifications for both asset and corporate dispositions. First, many tax advisers (author included) and tax administrators, as well as the Illinois Appellate Court, believed that Allied-Signal had established a separate alternative unitary test that involved distinguishing between operational versus investment functions. The *MeadWestvaco* Court has made it plain that that is simply not the case. In fact, that fact may be the most significant consequence of the *MeadWestvaco* decision—that the gain on a sale of a business, whether as an asset or stock sale, is to be determined solely by the traditional unitary tests articulated in *Butler Brothers, Edison Stores, Mobil Oil, Woolworth*, and

Container. To that extent, the Court has added some clarity. However, because the appellate court, unlike the circuit court, did not address whether a unitary relationship existed, the Supreme Court stated the appellate court "may take up that question on remand," and declined to express an opinion on whether there was indeed a unitary relationship between MeadWestvaco and Lexis-Nexis. In brief, the Court held that the sale of Lexis-Nexis could not be apportioned to Illinois based on the operational test; it is still an open question whether the gain could be apportioned to Illinois based on the traditional unitary tests, and the lower court was free to examine that issue upon remand. We may not have heard the last of this.

Summarizing the Cases

In *Butler Brothers*, the court found a single business activity of apportionable income when there was one corporation with multiple stores. In *Edison Stores*, the court found a single business activity of apportionable income when there were multiple corporations. In *Exxon*, the court rejected the taxpayer's argument that it had three separate business activities housed in a single corporation. Instead, the court found that Exxon had a single unitary business activity.

The courts were then confronted with another question. Does apportionable income include intangible income such as dividends, interest, royalties, and rents? The answer, found in *Mobil Oil, ASARCO*, and *Woolworth*, is that if the intangible income is a part of the taxpayer's unitary business activities connected to the state, it is subject to apportionment. When there is no unitary connection, as in *Allied-Signal*, the intangible income (capital gain) cannot be taxed. Finally, the courts were asked whether the unitary principle applied to foreign entities and operations, thereby becoming part of a state's apportionable income. Again, the answer was yes. If there exists a unitary relationship between the in-state and out-of-state business activities, the income is apportionable regardless of whether the taxpayer is a domestic (*Container*) or foreign (*Barclays Bank*) parent with subsidiaries.

In every instance, the determining focus is not company lines, geographic boundaries, corporate divisions, or legal entities, but whether a link exists between the state and the business activity, or income, it seeks to tax. As the U.S. Supreme Court stated in *Mobil Oil*, "the linchpin of apportionability in the field of state income taxation is the unitary principle."

Pulling It All Together

It is not unusual at this point to find oneself overwhelmed with the various interpretations, applications, definitions, and case law of what is, or is not, unitary.

Perhaps, it will help to focus on what it is that the various courts are trying specifically to define. In brief, it is this: A state can only tax the income connected to that state. In other words, the courts are trying to determine just what income should be apportioned among the states. What a state must show is that there is some link, some connection, between it and the business activity, or income, it seeks to tax. As the New Mexico Department of Revenue points out in its audit manual, "In general, a business will be considered to be unitary when the operations conducted in one state benefit and are benefited by the operations conducted in another state and if its various parts are so interdependent and of such mutual benefit that they form one integral business."

Multistate Tax Commission

In addition to the previously mentioned cases, there is one other influential national voice addressing the unitary business concept, and that is the MTC. The MTC is an organization originally formed in 1967 by Florida, Illinois, Kansas, Nevada, New Mexico, Texas, and Washington when they adopted the Multistate Tax Compact. The MTC's function is to be an advocate on the part of its members by facilitating taxpayer convenience and compliance, performing joint audits on behalf of its members, advising legislative and administrative bodies, and promoting uniformity.

Most states belong to the MTC in some form of membership, and the MTC policies often have a significant effect on state policy regardless of whether a state adopts any particular policy. The MTC released a proposed regulation in 2003 articulating the principles it believes should be used in determining the existence of a unitary business. For those states that have not adopted their own specific statutory unitary provisions, the proposed regulation is expected to, if nothing else, define the parameters of the debate over what constitutes a unitary business. The proposed regulation is presented here as exhibit 3-1.

Exhibit 3-1: Proposed Regulation Setting Forth Principles for Determining the Existence of a Unitary Business

I. UNITARY BUSINESS PRINCIPLE

A. The Concept of a Unitary Business. A unitary business is a single economic enterprise that is made up either of separate parts of a single business entity or of a commonly owned or controlled group of business entities that are sufficiently interdependent, integrated and interrelated through their activities so about provide a synergy and mutual benefit that produces a sharing or exchange of value among them and a significant flow of value to the separate parts. This flow of value to a business entity located in this state that comes from being part of a unitary business conducted both within and without this state is what provides the constitutional due process "definite link and minimum connection" necessary for this state to apportion business income of the unitary business, even if that income arises in part from activities conducted outside the state. The business income of the unitary business is then apportioned to this state using an apportionment percentage provided by [insert your state statute].

This sharing or exchange of value may also be described as requiring that the operation of one part of the business be dependent upon, or contribute to, the operation of another part of the business. Phrased in the disjunctive, the foregoing means that if the activities of one business either contributes to the activities of another business or are dependent upon the activities of another business, those businesses are part of a unitary business.

B. Constitutional Requirement for a Unitary Business. The sharing or exchange of value described in subsection (A) that defines the scope of a unitary business requires more than the mere flow of funds arising out of a passive investment or from the financial strength contributed by a distinct business undertaking that has no operational relationship to the unitary business. In this State, the unitary business principle shall be applied to the fullest extent allowed by the U.S. Constitution. The unitary business principle shall not be applied to result in the combination of business activities or entities under circumstances where, if it were adverse to the taxpayer, the combination of such activities or entities would not be allowed by the U.S. Constitution.

C. Separate Trades or Businesses Conducted within a Single Entity. A single entity may have more than one unitary business. In such cases it is necessary to determine the business, or apportionable, income attributable to each separate unitary business as well as its nonbusiness income, which is specifically allocated. The business income of each unitary business is then apportioned by a formula that takes into consideration the in-state and the out-of-state factors that relate to the respective unitary business whose income is being apportioned.

D. Unitary Business Unaffected by Formal Business Organization. A unitary business may exist within a single business entity or among a group of commonly owned or controlled business entities. The scope of what is included in a commonly owned or controlled group of business entities is set forth in Section V below.

II. DETERMINATION OF A UNITARY BUSINESS

A unitary business is characterized by significant flows of value evidenced by factors such as those described in *Mobil Oil Corp. v. Vermont*, 445 U.S. 425 (1980): functional integration, centralization of management, and economies of scale. These factors provide evidence of whether the business activities operate as an integrated whole or exhibit substantial mutual interdependence. [Reserved: See regulation concerning passive holding companies for special rules that govern the determination of whether a pure or passive holding company constitutes a part of a unitary business with one or more affiliates conducting active business operations.] Facts suggesting the presence of the factors mentioned above should be analyzed in combination for their cumulative effect and not in isolation.

A. Classification of Particular Business Operations. A particular business operation may be suggestive of one or more of the factors mentioned above.

B. Description and Illustration of Functional Integration, Centralization of Management and Economies of Scale.

1. *Functional integration:* Functional integration refers to transfers between, or pooling among, business activities that significantly affect the operation of the business activities. Functional integration includes, but is not limited to, transfers or pooling with respect to the unitary business's products or services, technical information, marketing information, distribution systems, purchasing, and intangibles such as patents, trademarks, service marks, copyrights, trade secrets, know-how, formulas, and processes. There is no specific type of functional integration that must be present. The following is a list of examples of business operations that can support the finding of functional integration. The order of the list does not establish a hierarchy of importance.

a. Sales, exchanges, or transfers (collectively "sales") of products, services, and/or intangibles between business activities provide evidence of functional integration. The significance of the intercompany sales to the finding of functional integration will be affected by the character of what is sold and/or the percentage of total sales or purchases represented by the intercompany sales. For example, sales among business entities that are part of a vertically integrated unitary business are indicative of functional integration. Functional integration is not negated by the use of a readily determinable market price to effect the intercompany sales, because such sales can represent an assured market for the seller or an assured source of supply for the purchaser.

b. *Common Marketing.* The sharing of common marketing features among business entities is an indication of functional integration when such marketing results in significant mutual advantage. Common marketing exists when a substantial portion of the business entities' products, services, or intangibles are distributed or sold to a common customer, when the business entities use a common trade name or other common identification, or when the business entities seek to identify themselves to 124 their customers as a member of the same enterprise. The use of a common advertising agency or a commonly owned or controlled in-house advertising office does not by itself establish common marketing that is suggestive of functional integration. (Such activity, however, is relevant to determining the existence of economies of scale and/or centralization of management.)

c. *Transfer or Pooling of Technical Information or Intellectual Property.* Transfers or pooling of technical information or intellectual property, such as patents, copyrights, trademarks and service marks, trade secrets, processes or formulas, know-how, research, or development, provide evidence of functional integration when the matter transferred is significant to the businesses' operations.

d. *Common Distribution System.* Use of a common distribution system by the business entities, under which inventory control and accounting, storage, trafficking, and/or transportation are controlled through a common network provides evidence of functional integration.

e. *Common Purchasing.* Common purchasing of substantial quantities of products, services, or intangibles from the same source by the business entities, particularly where the purchasing results in significant cost savings or where the products, services or intangibles are not readily available from other sources and are significant to each entity's operations or sales, provides evidence of functional integration.

f. *Common or Intercompany Financing.* Significant common or intercompany financing, including the guarantee by, or the pledging of the credit of, one or more business entities for the benefit of another business entity or entities provides evidence of functional integration, if the financing activity serves an operational purpose of both borrower and lender. Lending which serves an investment purpose of the lender does not necessarily provide evidence of functional integration. (See below for discussion of centralization of management.)

2. *Centralization of Management.* Centralization of management exists when directors, officers, and/or other management employees jointly participate in the management decisions that affect the respective business activities and that may also operate to the benefit of the entire economic enterprise. Centralization of management can exist whether the centralization is effected from a parent entity to a subsidiary entity, from a subsidiary entity to a parent entity, from one subsidiary entity to another, from one division within a single business entity to another division within a business entity, or from any combination of the foregoing. Centralization of management may exist even when day-to-day management responsibility and accountability has been decentralized, so long as the management has an ongoing operational role with respect to the business activities. An operational role can be effected 183 through mandates, consensus building, or an overall operational strategy of the business, or any other mechanism that establishes joint management.

a. *Facts Providing Evidence of Centralization of Management.* Evidence of centralization of management is provided when common officers participate in the decisions relating to the business operations of the different segments. Centralization of management may exist when management shares or applies knowledge and expertise among the parts of the business. Existence of common officers and directors, while relevant to a showing of centralization of management, does not alone provide evidence of centralization of management. Common officers are more likely to provide evidence of centralization of management than are common directors.

b. *Stewardship Distinguished.* Centralized efforts to fulfill stewardship oversight are not evidence of centralization of management. Stewardship oversight consists of those activities that any owner would take to review the performance of or safeguard an investment. Stewardship oversight is distinguished from those activities that an owner may take to enhance value by integrating one or more significant operating aspects of one business activity with the other business activities of the owner. For example, implementing reporting requirements or mere approval of capital expenditures may evidence only stewardship oversight.

3. *Economies of Scale.* Economies of scale refers to a relation among and between business activities resulting in a significant decrease in the average per unit cost of operational or administrative functions due to the increase in operational size. Economies of scale may exist from the inherent cost savings that arise from the presence of functional integration or centralization of management. The following are examples of business operations that can support the finding of economies of scale. The order of the list does not establish a hierarchy of importance.

a. *Centralized Purchasing.* Centralized purchasing designed to achieve savings due to the volume of purchases, the timing of purchases, or the interchangeability of purchased items among the parts of the business engaging in the purchasing provides evidence of economies of scale.

b. *Centralized Administrative Functions.* The performance of traditional corporate administrative functions, such as legal services, payroll services, pension and other employee benefit adminis-

tration, in common among the parts of the business may result in some degree of economies of scale. A business entity that secures savings in the performance of corporate administrative services due to its affiliation with other business entities that it would not otherwise reasonably be able to secure on its own because of its size, financial resources, or available market, provides evidence of economies of scale.

III. INFERENCES OF A UNITARY BUSINESS

A. *Same Type of Business.* Business activities that are in the same general line of business generally constitute a single unitary business, as, for example, a multistate grocery chain.

B. *Steps in a Vertical Process.* Business activities that are part of different steps in a vertically structured business almost always constitute a single unitary business. For example, a business engaged in the exploration, development, extraction, and processing of a natural resource and the subsequent sale of a product based upon the extracted natural resource, is engaged in a single unitary business, regardless of the fact that the various steps in the process are operated substantially independently of each other with only general supervision from the business's executive offices.

C. *Strong Centralized Management.* Business activities which might otherwise be considered as part of more than one unitary business may constitute one unitary business when there is a strong central management, coupled with the existence of centralized departments for such functions as financing, advertising, research, or purchasing. Strong centralized management exists when a central manager or group of managers makes substantially all of the operational decisions of the business. For example, some businesses conducting diverse lines of business may properly be considered as engaged in only one unitary business when the central executive officers are actively involved in the operations of the various business activities and there are centralized offices which perform for the business activities the normal matters which a truly independent business would perform for itself, such as personnel, purchasing, advertising, or financing.

IV. COMMONLY OWNED OR CONTROLLED GROUP OF BUSINESS ENTITIES

A. Separate corporations can be part of a unitary business only if they are members of a commonly controlled group.

B. A "commonly controlled group" means any of the following:

1. A parent corporation and any one or more corporations or chains of corporations, connected through stock ownership (or constructive ownership) with the parent, but only if—

a. The parent owns stock possessing more than 50 percent of the voting power of at least one corporation, and, if applicable,

b. Stock cumulatively representing more than 50 percent of the voting power of each of the corporations, except the parent, is owned by the parent, one or more corporations described in subparagraph (A), or one or more other corporations that satisfy the conditions of this subparagraph.

2. Any two or more corporations, if stock representing more than 50 percent of the voting power of the corporations is owned, or constructively owned, by the same person.

3. Any two or more corporations that constitute stapled entities.

a. For purposes of this paragraph, "stapled entities" means any group of two or more corporations if more than 50 percent of the ownership or beneficial ownership of the stock possessing voting power in each corporation consists of stapled interests.

b. Two or more interests are stapled interests if, by reason of form of ownership restrictions on transfer, or other terms or conditions, in connection with the transfer of one of the interests the other interest or interests are also transferred or required to be transferred.

4. Any two or more corporations, all of whose stock representing more than 50 percent of the voting power of the corporations is cumulatively owned (without regard to the constructive ownership rules of paragraph (a) of subdivision (5)) by, or for the benefit of, members of the same family. Members of the same family are limited to an individual, his or her spouse, parents, brothers or sisters, grandparents, children and grandchildren, and their respective spouses.

C. If, in the application of subdivision 2, a corporation is eligible to be treated as a member of more than one commonly controlled group of corporations, the corporation shall elect to be treated as a member of only one commonly controlled group. This election shall remain in effect unless revoked with the approval of the [state tax agency].

Membership in a commonly controlled group shall be treated as terminated in any year, or fraction thereof, in which the conditions of subdivision 2 are not met, except as follows:

1. When stock of a corporation is sold, exchanged, or otherwise disposed of, the membership of a corporation in a commonly controlled group shall not be terminated, if the requirements of subdivision (2) are again met immediately after the sale, exchange, or disposition.

2. The [state tax agency] may treat the commonly controlled group as remaining in place if the conditions of subdivision (b) are again met within a period not to exceed two years.

D. A taxpayer may exclude some or all corporations included in a "commonly controlled group" by reason of paragraph d of subdivision 2 by showing that those members of the group are not controlled directly or indirectly by the same interests, within the meaning of the same phrase in Section 482 of the Internal Revenue Code. For purposes of this subdivision, the term "controlled" includes any kind of control, direct or indirect, whether legally enforceable, and however exercisable or exercised.

E. Except as otherwise provided, stock is "owned" when title to the stock 349 is directly held or if the stock is constructively owned.

1. An individual constructively owns stock that is owned by any of the following:

a. His or her spouse.

b. Children, including adopted children, of that individual or the individual's spouse, who have not attained the age of 21 years.

c. An estate or trust, of which the individual is an executor, trustee, or grantor, to the extent that the estate or trust is for the benefit of that individual's spouse or children.

2. Stock owned by a corporation, or a member of a controlled group of which the corporation is the parent corporation, is constructively owned by any shareholder owning stock that represents more than 50 percent of the voting power of the corporation.

3. Stock owned by a partnership is constructively owned by any partner, other than a limited partner, in proportion to the partner's capital interest in the partnership. For this purpose, a partnership is treated as owning proportionately the stock owned by any other partnership in which it has a tiered interest, other than as a limited 1 partner.

4. In any case where a member of a commonly controlled group, or shareholders, officers, directors, or employees of a member of a commonly controlled group, is a general partner in a limited partnership, stock held by the limited partnership is constructively owned by a limited partner to the extent of its capital interest in the limited partnership.

F. For purposes of this definition, each of the following shall apply:

1. "Corporation" means a subchapter S corporation, limited liability company, any other incorporated entity, or any entity defined or treated as a corporation pursuant to [insert your State statute].

2. "Person" means an individual, a trust, an estate, a qualified employee benefit plan, a limited partnership, or a corporation.

3. "Voting power" means the power of all classes of stock entitled to vote that possess the power to elect the membership of the board of directors of the corporation.

4. "More than 50 percent of the voting power" means voting power sufficient to elect a majority of the membership of the board of directors of the corporation.

5. "Stock representing voting power" includes stock where ownership is retained but the actual voting power is transferred in either of the following manners:

a. For one year or less.

b. By proxy, voting trust, written shareholder agreement, or by similar device, where the transfer is revocable by the transferor.

G. The [state tax agency] may prescribe any regulations as may be necessary or appropriate to carry out the purposes of this section, including, but not limited to, regulations that do the following:

1. Prescribe terms and conditions relating to the election described by subdivision 3, and the revocation thereof.

2. Disregard transfers of voting power not described by paragraph e of subdivision

3. Treat entities not described by paragraph b of subdivision 6 as a person.

4. Treat warrants, obligations convertible into stock, options to acquire or sell stock, and similar instruments as stock.

5. Treat holders of a beneficial interest in, or executor or trustee powers over, stock held by an estate or trust as constructively owned by the holder.

6. Prescribe rules relating to the treatment of partnership agreements which authorize a particular partner or partners to exercise voting power of stock held by the partnership.

4

Apportionment and Allocation

Introduction

A company doing business in more than one state really has only three alternatives for sorting out what income goes to what state. They are (1) separate filing, (2) allocation, and (3) apportionment. As we have seen from looking at case law, separate accounting has gone the way of the horse and buggy whip. That leaves allocation and apportionment, and both methods are used in consolidated and combined filing. Allocation refers to income that is specifically allocated to a particular state. Apportionment is the sourcing of income based upon some formula, usually a combination of the company's payroll, property, and sales.

Current Rules

Today's rules regarding apportionment and allocation originated in the 1950s through the efforts of state representatives. In 1957, these representatives, through the National Conference of Commissioners, drafted the Uniform Division of Income for Tax Purposes Act (UDITPA). The goal of UDITPA was to promote uniformity among the states in the allocation and apportionment of multistate corporate income. Currently, some 30 states have adopted UDITPA in whole or in part, and even in those states that have not specifically adopted UDITPA, its influence is obvious. (See appendix B for a copy of UDITPA.)

Section 2 of UDITPA, which contains the legislation's scope, provides that "any taxpayer having income from business activity which is taxable both within and without this state, other than activity as a financial organization or public utility or the rendering of purely personal services by an individual, shall allocate and apportion his net income as provided in this Act." Thus, all taxpayers, except for individuals, banks, and public utilities, are generally included within UDITPA's scope. (See appendix C found on the CD-ROM for a copy of UDITPA.)

Right to Apportion

Before a company determines how to apportion and allocate its income, it must first determine if it indeed has the right to apportion its income. Section 3 of UDITPA provides that a taxpayer has the right to apportion if it is subject to tax in more than one state.

> For purposes of allocation and apportionment of income under this Act, a taxpayer is taxable in another state if (1) in that state he is subject to a net income tax, a franchise tax measured by net income, a franchise tax for the privilege of doing business, or a corporate stock tax, or (2) that state has jurisdiction to subject this taxpayer to a net income tax regardless of whether, in fact, the state does or does not.

The key point to note here is that a taxpayer need not actually have to pay a tax to another state. It is sufficient that the state has the right to tax the taxpayer. For example, if my company is doing business in both Wyoming and Colorado, I can apportion my income between the two states despite the fact that Wyoming has no income tax. Because I am doing business in the state, and Wyoming has the right to tax my income, it simply has decided not to do so. Do you have to file in every state in order to apportion income to that state? No. UDITPA only requires that a taxpayer be doing business "without this state." In other words, I need only be subject to tax in one other state in order to apportion among all the states in which I have activity.

> ***Author's Note: Example***
>
> ***Griffins-R-Us is headquartered in Colorado, but it does business in Kansas and Oklahoma, as well as in Wyoming. Griffins need only be subject to tax in one of the three states other than Colorado to have the right to apportion income among all the states.***

Does a company have to actually file returns in order to allocate or apportion its income? Not necessarily. The Massachusetts Tax Board has ruled that it is only necessary that the company be "subject to tax," not that the company had actually filed.[1] While it may be unconstitutional to do so, many states hold that filing in another state where it is not required to file is insufficient to establish the right to apportion even if the filing was through neglect, ignorance, materiality, or uncertainty about filing requirements. As a practical matter, many auditors will not allow a company to apportion and allocate its income unless it can show it is filing returns in other states.[2] Moreover, filings with a secretary of state, or other license fees, are often deemed insufficient. Fees are not taxes, and many auditors will not allow apportionment unless the fee is based on net income or capital and not simply a registration or licensing payment.

Business Versus Nonbusiness Income

Now that we have determined UDITPA's scope and established the right to apportion, what is it that a taxpayer can apportion? The answer is "business income," a seemingly innocuous term which has prompted continuing battles between taxpayers and tax administrators. UDITPA defines business income as follows:

---

[1] See *Amray, Inc. v. Comm'r*, No. 119875 (Mass. App. Tax Bd. Apr. 17, 1986).

[2] See, for example, *Technical Assistance Advisement* 95(C)1-008, Fla. Dept. of Rev., Aug. 30, 1995.

> "Business income" means income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations.

Author's Note: On Business Income

More and more states are considering everything business income.

Nonbusiness income is unhelpfully defined as all income other than business income. Furthermore, the Multistate Tax Commission (MTC), which has incorporated the UD-ITPA provisions within its own compact and regulations, holds that there is a presumption that income is business income. "The income of a taxpayer is business income unless clearly classifiable as nonbusiness income."

Why is this distinction between business and nonbusiness income significant? First, because for many states, business income is subject to *apportionment* among the states while nonbusiness income is *allocable* to a specific state, usually the taxpayer's state of commercial domicile. Of course, not all states follow this distinction. Some states specifically allocate certain identified types of income and other states apportion all income.

Author's Note: On Nonbusiness Income

Documentation, both from a paperwork and theory standpoint, is key to establishing something as nonbusiness income, but be sure to put your position together before the auditor arrives.

Two Tests or Three

Read the definition of business income again. Does the definition contain just one test for business income or are there two? The single-test advocates emphasize the phrase "activity in the regular course of a taxpayer's trade or business" and see the balance of the paragraph as an elaboration of the regular activity of the business. The two-test advocates argue that the word "and" separates a "transactional test" from a "functional test." That is, business income includes what the single-testers embrace and other income "from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations."

The MTC has proposed regulations which define the two tests.

Transactional Test

"… If the transaction or activity is in the regular course of the taxpayer's trade or business, part of which trade or business is conducted within [this State], the resulting income of the transaction or activity is business income for [this State]. Income may be business income even though the actual transaction or activity that gives rise to the income does not occur in [this State]."

Functional Test

Business income also includes income from tangible and intangible property, if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations.

Under the functional test, business income need not be derived from transactions or activities that are in the regular course of the taxpayer's own particular trade or business. It is sufficient, if the property from which the income is derived is or was an integral, functional, necessary, or operative component to the taxpayer's trade or business operations, part of which trade or business is or was conducted within a state.[3]

Most states hold that if either of the tests is satisfied, the income will be considered business income.

An oft-quoted example illustrating the difference between the transactional and functional tests is the sale of a factory. Under the transactional test, the sale would probably be deemed nonbusiness income. After all, selling a factory is an unusual, nonrecurring, extraordinary event not usually considered part of a company's regular daily transactions in the course of trade or business. However, under the functional test, the gain or loss on the factory sale would probably be deemed business income because the factory had been used in the company's regular trade or business.

The continuing disputes, then, in this area are, first, what is the distinction between business and nonbusiness income, and, second, (a subset of the first) does the business income definition have one or two tests? Most states today have settled the second question either through litigation or legislation holding that the definition has both tests.

The question of whether California has only a transactional test or a functional test was decisively answered in *Hoechst Celanese Corporation v. Franchise Tax Board*, 22 P.3d 324 (Cal. 2001), *cert. denied*, 534 U.S. 1040 (2001). The court held that the definition of business income contained both a transactional and a functional test. As mentioned, the trend among most states is to move toward two tests for defining business income. In the past several years, Alabama, Georgia, Kansas, Minnesota, Mississippi, New Jersey, North Carolina, Oregon, and Pennsylvania have all enacted legislation specifically broadening their definitions of business income.

The following example illustrates the importance of this seemingly ideological dispute among tax practitioners and tax administrators.

Salem Company does business in both State X and State Y. It sold one of its logging mills in State X for $13 million. State X believes the definition of business income contains only the transactional test and deems the sale to be nonbusiness income, therefore, allocating the entire gain to itself. After all, Salem Company is not in the business of selling its mills, and this is the first sale of a mill in more than 15 years. State Y, which believes there is both a transactional and functional test in the definition of business income, holds that the sale meets the functional test. State Y accordingly apportions some of the gain to itself. As a consequence, Salem is paying tax on more than 100 percent of the sale of the mill. The total sale is getting taxed by State X, and a portion of that same sale is being apportioned to State Y to be taxed.

[3] Multistate Tax Commission Prop. Regs. IV(a)(3) and (4).

Attempts to Define Business Versus Nonbusiness Income

Sometimes it is easy to determine business income, for example, the sale of inventory. The problem areas are in what is often called passive income. For example, interest income from temporary investments of working capital used to purchase additional inventory would probably be business income. But interest income from long-term investments isn't so easy to classify.

UDITPA provides for the allocation of five types of nonbusiness income to specific states. They are rents, royalties, capital gains, interest, and dividends.

> Section 4. Rents and royalties from real or tangible personal property, capital gains, interest, dividends, or patent or copyright royalties, to the extent that they constitute nonbusiness income, shall be allocated as provided…

The MTC has issued regulations interpreting UDITPA to read that all "income of the taxpayer is business income unless clearly classifiable as nonbusiness income." The burden of proof is put upon the taxpayer to show that the income is nonbusiness.

According to the MTC, what you may call the income is irrelevant. "The classification of income by the labels occasionally used, such as manufacturing income, compensation for services, sales income, interest, dividends, rents, royalties, gains, operating income, nonoperating income, etc., is of no aid in determining whether income is business or nonbusiness income." Instead, MTC's proposed amendments to its regulations provide that "business income means income of any type or class, and from any activity, that meets the relationship described either [as] the 'transactional test,' or the 'functional test.'"

Problem Areas

Rental and Royalty Income

The MTC regulations provide that if the property giving rise to the rental or royalty income is used in or incidental to the taxpayer's trade or business (that is, included in the property factor), it is business income. The MTC regulations offer seven examples:

Example 1: The taxpayer operates a multistate car rental business. The income from car rentals is business income.

Example 2: The taxpayer is engaged in the heavy construction business in which it uses equipment such as cranes, tractors, and earth-moving vehicles. The taxpayer makes short-term leases of the equipment when particular pieces of equipment are not needed on any particular project. The rental income is business income.

Example 3: The taxpayer operates a multistate chain of men's clothing stores. The taxpayer purchases a five-story office building for use in connection with its trade or business. It uses the street floor as one of its retail stores and the second and third floors for its general corporate headquarters. The remaining two floors are leased to others. The rental of the two floors is incidental to the operation of the taxpayer's trade or business. The rental income is business income.

Example 4: The taxpayer operates a multistate chain of grocery stores. It purchases as an investment an office building in another state with surplus funds and leases the entire building to others. The net rental income is not business income of the grocery store trade or business. Therefore, the net rental income is nonbusiness income.

Example 5: The taxpayer operates a multistate chain of men's clothing stores. The taxpayer invests in a 20-story office building and uses the street floor as one of its retail stores and the second floor for its general corporate headquarters. The remaining 18 floors are leased to others. The rental of the eighteen floors is not incidental to but rather is separate from the operation of the taxpayer trade or business. The net rental income is not business income of the clothing store trade or business. Therefore, the net rental income is nonbusiness income.

Example 6: The taxpayer constructed a plant for use in its multistate manufacturing business and 20 years later the plant was closed and put up for sale. The plant was rented for a temporary period from the time it was closed by the taxpayer until it was sold 18 months later. The rental income is business income and the gain on the sale of the plant is business income.

Example 7: The taxpayer operates a multistate chain of grocery stores. It owned an office building that it occupied as its corporate headquarters. Because of inadequate space, taxpayer acquired a new and larger building elsewhere for its corporate headquarters. The old building was rented to an investment company under a five-year lease. Upon expiration of the lease, taxpayer sold the building at a gain (or loss). The net rental income received over the lease period is nonbusiness and the gain (or loss) on the sale of the building is nonbusiness income.

Examples 3 and 5 illustrate the subjective nature of defining business income. In example 3, the rental of two floors is deemed incidental to the taxpayer's trade or business, and the rental income is classified as business income. However, in example 5, the rental of 18 floors is deemed not incidental and, therefore, classified as nonbusiness income.

> ***Author's Note: On Business vs. Nonbusiness Income***
>
> *At what point between the rental of 2 and 18 floors does the rental income transition from business to nonbusiness income?*

Gains and Losses From Real or Tangible Personal Property Dispositions

Sales of property provide for some of the most controversial arguments between taxpayers and tax administrators over business and nonbusiness income. States that adhere to the one-test interpretation of business income will not pick up a sale of property unless the taxpayer is regularly engaged in such sales. The two-test states find the sale to meet the functional

test and will pick it up as apportionable business income. As a consequence, the taxpayer is faced with the threat of double taxation.

The MTC states are two-test believers. "Gain or loss from the sale, exchange or other disposition of real property or of tangible or intangible personal property constitutes business income if the property while owned by the taxpayer was used in the taxpayer's trade or business."

MTC examples include the following:

Example 1: In conducting its multistate manufacturing business, the taxpayer systematically replaces automobiles, machines, and other equipment used in the business. The gains or losses resulting from those sales constitute business income.

Example 2: The taxpayer constructed a plant for use in its multistate manufacturing business and 20 years later sold the property at a gain while it was in operation by the taxpayer. The gain is business income.

Example 3: Same as 2 except that the plant was closed and put up for sale but was not, in fact, sold until a buyer was found 18 months later. The gain is business income.

Example 4: Same as 2 except the plant was rented while being held for sale. The rental income is business income and the gain on the sale of the plant is business income.

Example 5: The taxpayer operates a multistate chain of grocery stores. It owned an office building which it occupied as its corporate headquarters. Because of the inadequate space, taxpayer acquired a new and larger building elsewhere for its corporate headquarters. The old building was rented to an unrelated investment company under a five-year lease. Upon expiration of the lease, taxpayer sold the building at a gain (or loss). The gain (or loss) on the sale is nonbusiness income and the rental income received over the lease period is nonbusiness income.

Please note that the sale of a plant held for 18 months is business income, but the sale of a facility owned and leased for five years is nonbusiness income.

Author's Note: On Business vs. Nonbusiness Income

At what point between 18 months and 5 years does the sale move from being business to nonbusiness income?

Income from asset sales has traditionally been one of the most debated areas in distinguishing business from nonbusiness income. The following are some of the more well-known decisions and well illustrate the scope of this ongoing area of contention:

Phillips Petroleum Co. v. Iowa, 511 N.W.2d 608 (Iowa 1993)

Phillips sold a significant percentage of its assets to raise funds to purchase its own stock in an attempt to fend off a hostile takeover. None of the assets were located in Iowa. The court

ruled that Iowa's definition of business income had only a transactional test. The "unprecedented" and once-in-a-lifetime nature of the sale indicated that it was clearly not transactional in nature and, thus, the gain was nonbusiness income allocated outside of Iowa. The Iowa legislature immediately amended the state statute to include a functional test.

Firstar Corp. v. Commissioner of Revenue, 575 N.W.2d 835 (Minn. 1998)

A Wisconsin-based bank sold its headquarters building, and the Minnesota court ruled that all the gain is allocated to Wisconsin as nonbusiness income. Rather than running the justices out of town on a rail, the Minnesota legislature simply amended the statute to tax all the income it can constitutionally tax.

Laurel Pipeline Co. v. Commonwealth, 615 A.2d 841 (Pa. 1994)

The Pennsylvania Supreme Court found that the Pennsylvania statute contains both a transactional and functional test for determining business income. Nevertheless, the sale of a pipeline was nonbusiness income. The pipeline had been unused for three years, and the proceeds were distributed as a dividend. Because the pipeline was not an integral part of the business, the sale did not meet the functional test, and because the company was not in the business of selling pipelines, the sale did not meet the transactional test. Thus, it was allocable nonbusiness income. Compare *Laurel Pipeline to Texaco-Cities Service Pipeline Co. v. McGaw*, 695 N.E.2d 481 (Ill. 1998). In *Texaco-Cities Service*, the Illinois Supreme Court ruled that because the sale proceeds from the sale of pipeline were reinvested in the business, and because the Illinois statute had both transaction and functional tests, the sale was apportionable business income. When the gain was from a complete liquidation or termination of the business and the proceeds distributed to the shareholders, the Illinois Supreme Court has ruled that the gains were nonbusiness income.[4]

Patents, Copyrights, and Trademarks

Some states allocate intangible income from patents, copyrights, and trademarks to the taxpayer's commercial domicile; many more apportion the income. The MTC regulations offer three examples of how it believes this income should be treated:

Example 1: The taxpayer is engaged in the multistate business of manufacturing and selling industrial chemicals. In connection with that business the taxpayer obtained patents on certain of its products. The taxpayer licensed the production of the chemicals in foreign countries, in return for which the taxpayer receives royalties. The royalties received by the taxpayer are business income.

Example 2: The taxpayer is engaged in the music publishing business and holds copyrights on numerous songs. The taxpayer acquires the assets of a smaller publishing company, including music copyrights. These acquired copyrights are thereafter used by the taxpayer in its business. Any royalties received on these copyrights are business income.

[4] See *Blessing/White Inc. v. Zehnder*, 768 N.E.2d 332 (Ill. 2002), and *American States Ins. Co. v. Hamer*, 816 N.E.2d 659 (Ill. 2004).

Example 3: Same as Example 2 except that acquired company also held the patent on a type of phonograph needle. The taxpayer does not manufacture or sell phonographs or phonograph equipment. Any royalties received on the patent would be nonbusiness income.

Interest Income

UDITPA provides that interest income is business income if the underlying intangible was acquired, maintained, and disposed of as an integral part of the taxpayer's trade or business. The MTC's regulation reflects its consistently pro-apportionment stance. "Interest income is business income where the intangible with respect to which the interest received arises out of or was created in the regular course of the taxpayer's trade or business operations or where the purpose for acquiring and holding the intangible is related to or incidental to such trade or business operations."

The MTC regulations offer six examples:

Example 1: The taxpayer operates a multistate chain of department stores, selling for cash and on credit. Service charges, interest, or time-price differentials and the like are received with respect to installment sales and revolving charge accounts. These amounts are business income.

Example 2: The taxpayer conducts a multistate manufacturing business. During the year, the taxpayer receives a federal income tax refund and collects a judgment against a debtor of the business. Both the tax refund and the judgment bore interest. The interest income is business income.

Example 3: The taxpayer is engaged in a multistate manufacturing and wholesaling business. In connection with that business, the taxpayer maintains special accounts to cover such items as workmen's compensation claims, rain and storm damage, machinery replacement, etc. The monies in those accounts are invested at interest. Similarly, the taxpayer temporarily invests funds intended for payment of federal, state and local tax obligations. The interest income is business income.

Example 4: The taxpayer is engaged in a multistate money order and traveler's check business. In addition to the fees received in connection with the sale of the money orders and traveler's checks, the taxpayer earns interest income by the investment of the funds pending their redemption. The interest income is business income.

Example 5: The taxpayer is engaged in a multistate manufacturing and selling business. The taxpayer usually has working capital and extra cash totaling $200,000, which it regularly invests in short-term interest bearing securities. The interest income is business income.

Example 6: In January, the taxpayer sold all the stock of a subsidiary for $20,000,000. The funds are place in an interest-bearing account pending a decision by management as to how the funds are to be utilized. The interest income is nonbusiness income.

Example 6 in the previous section is an excellent example of an item that often receives contrary treatment by states. It is not unusual for one state to argue that the income is business income and apportionable while another state, following the MTC's lead, holds that the interest income is nonbusiness income. Several examples of different state rulings follow:

Siegel-Robert, Inc. v. Johnson, No. M2008-02228-COA-R3-CV (Tenn. Ct. App. Oct. 28, 2009).

The Tennessee Court of Appeals held for the taxpayer in holding that interest income from Treasury securities was not apportionable business income, but allocable nonbusiness income taxable to Missouri, not Tennessee. The taxpayer successfully showed that the income was unrelated to its Tennessee operations and served as an investment, not an operational, function.

W.R. Grace v. Commissioner, No. C271787 (Mass. App. Tax Bd. Apr. 6, 2009)

Keep in mind that there must be a unitary relationship or else the income cannot be apportioned. The taxpayer was able to convince the Massachusetts Appellate Tax Board that dividend and interest income received from affiliates was not apportionable business income, because no unitary relationship existed between the taxpayer and its affiliates.

Home Interiors and Gifts, Inc. v. Illinois, 741 N.E.2d 998 (2000), *app. denied* (Ill. 2001)

Home Interiors was a Texas corporation that had generated enough cash to not only cover its working capital needs but also to invest in short-term certificates of deposit, commercial paper, and municipal bonds while awaiting a better economic environment to expand its operations or business investments. The company had interest income of roughly $7.7 million in 1989 and $11 million in 1990 that it allocated to Texas as nonbusiness income. Illinois auditors believed that the interest income was business income and apportioned some of it to that state, arguing that the funds were available for business investment and were not separately segregated from the company's operational funds. The Illinois Appellate Court ruled in favor of Home Interiors, holding that the mere availability of the funds, as opposed to their use, was insufficient to render the interest business income rather than nonbusiness income. The company had treated the funds as investment, not operational, funds and reported them as such on its financial statements. In addition, the company had paid tax to Texas on all of its interest income from the investments.

Appeal of Consolidated Freightways, 2000-SBE-001 (Cal. State Bd. of Equalization Sept. 2000)

Consolidated Freightways received $281 million from the sale of a subsidiary that it invested in short- and long-term securities while awaiting the opportunity to use the funds to expand its transportation business. Although it was seven years before it used the funds to acquire another transportation company, the fact that the company engaged in an active and ongoing effort to acquire another transportation company, and that the funds were "earmarked" for acquisition of a specific business purchase, convinced the California State Board of Equalization that the interest income from the funds was business income.[5]

[5] See also *Appeal of Cullinet Software, Inc.*, 95-SBE-002 (Cal. State Bd. of Equalization May 4, 1995).

Income From Stock Sales

Income from the sale of stock continues to be one of the most litigated areas in the business or nonbusiness income arena. Of course, the landmark case in this area is *Allied-Signal, Inc. v. Director of Taxation*, 112 S. Ct. 2251 (1992) (discussed in the previous chapter), in which the U.S. Supreme Court held that New Jersey could not tax the gain on a sale of stock because no unitary relationship existed between the entities and the gain was not from business operations but from nonbusiness investments. The following three decisions reflect some of the ongoing differences in this area of contention:

In re Chief Industries, Inc., 875 P.2d 278 (Kan. 1994)

The Kansas Supreme Court ruled that the Kansas statute contains only a transactional test, not a functional test. Thus, the gain on the sale of a subsidiary's stock was nonbusiness income and allocable outside of Kansas. The Kansas legislature very quickly amended the state statute to include a functional test.

Ex Parte Uniroyal Tire Co., 779 So.2d 227 (Ala. 2000)

The Alabama Supreme Court ruled that the sale of a partnership interest was not business income because the state statute had only a transactional test. The court found that the transactional test does not apply to the complete termination or liquidation of a business. The fact that the underlying assets were used to generate business income was deemed irrelevant. The Alabama legislature overruled the decision in 2002 by changing the state statute.

Appeal of Crane Co., SBE Case No. 357027 (Cal. State Bd. of Equalization Nov. 2, 2009)

The California State Board of Equalization held that because the income from a stock sale served an operational rather than an investment function, the gain was business income subject to apportionment. The reader may ask themselves at this point—is *Crane* consistent with the Supreme Court's position in the *MeadWestvaco* decision discussed at the end of the prior chapter?

Dividend Income

Dividend income has presented a conundrum ever since *Mobil Oil Corp. v. Vermont*, 445 U.S. 425 (1980), and *ASARCO, Inc. v. Idaho*, 458 U.S. 307 (1982) (see discussion in chapter 3). In *Mobil Oil*, dividend income, because Mobil's operations were held to be unitary, was held to be business income apportionable to Vermont. In *ASARCO*, the Court held that dividend income could not be apportionable business income in the absence of a unitary relationship. The MTC regulations predictably provide that dividends are business income "where the stock with respect to which the dividends are received arises out of or was acquired in the regular course of the taxpayer's trade or business operations or where the purpose for acquiring and holding the stock is related to or incidental to such trade or business operations."

The MTC regulations provide six examples:

Example 1: The taxpayer operates a multistate chain of stock brokerage houses. During the year the taxpayer receives dividends on stock it owns. The dividends are business income.

Example 2: The taxpayer is engaged in a multistate manufacturing and wholesaling business. In connection with that business, the taxpayer maintains special accounts to cover such items as workmen's compensation claims, etc. A portion of the monies in those accounts is invested in interest-bearing bonds. The remainder is invested in various common stocks listed on national stock exchanges. Both the interest income and any dividends are business income.

Example 3: The taxpayer and several unrelated corporations own all of the stock of a corporation whose business operations consist solely of acquiring and processing materials for delivery to the corporate owners. The taxpayer acquired the stock in order to obtain a source of supply of materials used in its manufacturing business. The dividends are business income.

Example 4: The taxpayer is engaged in a multistate heavy construction business. Much of its construction work is performed for agencies of the federal government and various state governments. Under state and federal laws applicable to contracts for these agencies, a contractor must have adequate bonding capacity, as measured by the ratio of its current assets (cash and marketable securities) to current liabilities. In order to maintain an adequate bonding capacity the taxpayer holds various stocks and interest-bearing securities. Both the interest income and any dividends received are business income.

Example 5: The taxpayer receives dividends from the stock of its subsidiary or affiliate which acts as a marketing agency for products manufactured by the taxpayer. The dividends are business income.

Example 6: The taxpayer is engaged in a multistate glass manufacturing business. It also holds a portfolio of stock and interest-bearing securities, the acquisition and holding of which are unrelated to the manufacturing business. The dividends and interest income received are nonbusiness income.

Liquidations

It is difficult to see at first how going out of business can be business income, but the functional test in the definition of business income includes "the acquisition, management, and disposition of the property [that] constitute integral parts of the taxpayer's regular trade or business operations." The language seems to refer only to partial liquidations or the disposal of parts of a business's operations rather than a complete liquidation. Several state decisions have indicated that complete liquidations when the funds are not reinvested but distributed to the shareholder's will be treated as nonbusiness income. Nevertheless, California has treated complete liquidations as business income, arguing that the taxpayer has wrongly focused on the nature of the transaction rather than on the fact that the assets were an integral part of the business operations, thereby meeting the functional test of business income.

Jim Beam Brands Co. v. California, 133 Cal. App. 4th 514, 34 Cal. Rptr. 2d 874 (1st Dist. 2005)

Jim Beam acquired, managed, and later disposed of the stock of a subsidiary, Taylor Foods, and distributed the proceeds from the disposition rather than use them in its other operations. Beam reported the income as nonbusiness income. The California court rejected Beam's treatment, arguing that under the functional test, if an asset generated business income prior to its disposition, it should also generate business income upon its disposition.

Lenox v. Tolson, 548 S.E.2d 513 (2001)

Lenox, a New Jersey company that manufactured various consumer products, sold its fine jewelry division and distributed the proceeds to its sole shareholder, the parent company. Because the jewelry division was segregated both functionally and financially from the rest of the company's operations, and because the sale represented the cessation of the company's involvement with jewelry, Lenox treated the sale as nonbusiness income. The North Carolina Department of Revenue disagreed with this treatment and argued instead that the proceeds were apportionable business income under the functional test in the definition of business income. Both the North Carolina Court of Appeals and the state's supreme court held for the taxpayer, emphasizing that in addition to the transaction and functional tests, one had to look at the "totality of the circumstances" and that doing so dictated that Lenox was correct in treating the proceeds as nonbusiness income.

Other Income

Companies often receive income or receipts from other than sales, interest, dividends, rent, or royalties. The following well known cases illustrate yet again the widely divergent views and approaches to business and nonbusiness income issues.

Polaroid Corp. v. Offerman, 507 S.E.2d 284 (N.C. 1998), *cert. denied*, 526 U.S. 1098 (1999)

Polaroid received millions of dollars in damages in a successful patent infringement suit. Was it business income? Yes, at least according to the North Carolina Supreme Court. The court held that North Carolina law contains both transactional and functional tests and that "once a corporation's assets are found to constitute integral parts of the corporation's regular trade or business, income resulting from the acquisition, management, and/or disposition of those assets constitutes business income regardless of how that income is received." As a consequence, the damage award was treated as apportionable business income. (Note that this decision seems to conflict with the court's later holding in *Lenox*.)

Union Carbide Corp. v. Offerman, 526 S.E.2d 167 (N.C. 2000)

The North Carolina Supreme Court found that pension plan reversion income does not meet the functional test of the state's two tests for business income. The pension was not an integral or essential functional part of the company because Union Carbide held only a contingent property right to the income in the event of termination. In addition, the assets of the fund were not used in any transactional sense, that is, they were not used to generate sales, as working capital, for purchases, use in research and development, or as collateral. The question of how to treat pension reversion income was also addressed in *Hoechst Celanese Corp. v. Franchise Tax Board*, 22 P.3d 324 (Calif. 2001), *cert. denied*, 534 U.S. 1040 (2001).

Pennzoil Co. v. Department of Revenue, 33 P.3d 314 (Or. 2001), *cert. denied*, 535 U.S. 927 (2002).

Texaco paid Pennzoil $3 billion in settlement for Texaco's wrongful interference with Pennzoil's attempt to acquire Getty Oil Company. The Oregon Supreme Court held that the income was business income under the transactional test because Pennzoil's contract negotiations with Getty were part of its regular business and served an "operational function."

Internal Revenue Code Section 338(h)(10)

Taxpayers and tax advisers all too often focus on the federal advantages of a particular transaction and fail to pay proper attention to its state income tax consequences. Making an Internal Revenue Code (IRC) § 338(h)(10) election is often one of those circumstances. IRC § 338 provides that parties to a corporate acquisition may elect to treat a qualified stock purchase "as if" it were an asset purchase, providing for the step-up in the basis of the assets of the acquired corporation. Although IRC § 338 provides for two ways to achieve this purpose, the most popular is probably a IRC § 338(h)(10) election. If the election requirements are met, the stock sale is disregarded for federal income tax purposes, and the purchaser gets a stepped-up basis in the deemed asset sale. Because most states that piggyback off federal taxable income generally conform to the IRC § 338 rules, the key question at the state level is whether the gain from the deemed asset sale is apportionable business or allocable nonbusiness income.

Several recent court cases may indicate a trend that a deemed sale of assets under IRC § 338(h)(10) is nonbusiness income.[6] As these decisions indicate, state auditors generally take the position that IRC § 338 gains are business income (unless, of course, nonbusiness income treatment means it will all be allocated to the auditor's state). Other than factual matters, the key elements in the decisions include (1) whether the state statute defining business income has both a transactional and functional test and (2) the scope of the functional test (for example, does it include dispositions, liquidations, or dissolutions). Given this controversy, tax practitioners entertaining a IRC § 338(h)(10) election will do well to consider carefully the impact of such an election on the taxpayer's state taxes.

Partnership Interests: Business or Nonbusiness Income?

Partnership taxation is difficult in part because of the tension between two competing theories of a partnership's nature. The aggregate theory of partnerships sees the partnership as an aggregation of its owners, each of which is a direct owner of the partnership's assets. As a consequence, if the partnership is doing business in a particular state, then all the partners are deemed to be doing business there as well, that is, they each have nexus with the state and, consequently, a filing obligation in the state.

---

[6] See, for example, *ABB C-E Nuclear Power, Inc. v. Missouri*, 215 S.E.3d 85 (Mo. 2007); *Chambers v. Utah*, No. 050402915 (Utah Dist. Ct. Jan. 25, 2007); and *Canteen Corp. v. Pennsylvania*, 854 A.2d 440 (Pa. 2004), but see *Georgia v. Trawick Constr.* No. A08A2323 (Ga. Ct. App. Feb. 23, 2010).

The entity theory of partnerships, adopted by the Revised Uniform Partnership Act (RUPA), places more emphasis on the partnership as an entity separate from its partners. Thus, the partnership is treated more like a corporation with shareholders, and just as an investment in a corporation does not create nexus for its shareholders in whichever state the corporation is doing business, the ownership of a partnership interest, in and of itself, should not trigger nexus in those states that have adopted RUPA.

Whether a state leans more toward an aggregate or entity approach, many states have adopted specific rules with regard to limited partners or members of limited liability companies, thus requiring practitioners to inquire into each state's specific treatment.

In addition to specific treatment of limited partners, states vary in whether the business or nonbusiness income distinction is made at the partnership level or at the partner level. California, for example, makes the distinction at the partnership level.

Since the business or nonbusiness income distinction is often driven by whether there exists a unitary relationship, the latter will often determine the treatment of the partner's share of the partnership income. For example, if there is a unitary relationship, many jurisdictions will simply roll up the partner's share of income and factors into the rest of the partner's business income and factors. If there is no unitary relationship, then the income and its factors are treated as a separate trade of business. (See the example and a copy of the California regulation at the end of chapter 5.)

The Hercules Cases

There is no better example of the inconsistency of treatment with respect to business income, the unitary principle, and the difference between an operational and investment function than the cases involving Hercules, Inc., in Illinois, Kansas, Maryland, Minnesota, Utah, and Wisconsin.

Hercules was a manufacturer of polypropylene incorporated in Delaware, domiciled in New York, but doing business in many states. In 1983, Hercules and an unrelated Italian company, Montedison, each contributed their polypropylene manufacturing activities to a newly created entity, Himont. Hercules and Montedison each owned 50 percent of Himont. In 1987, Hercules sold its share of Himont to Montedison at a capital gain of more than $1.3 billion. Hercules treated the sale as nonbusiness income and, accordingly, allocated the entire gain to New York, its state of domicile.

The revenue departments of Illinois, Kansas, Maryland, Minnesota, Utah, and Wisconsin all believed that they too should share in taxing the $1.3 billion capital gain and, accordingly, treated the sale as business income apportionable to their states. Hercules sale received different treatment depending upon the court.

Illinois

The Illinois appellate court held that contrary to the revenue department's findings and the decision of the lower level circuit court, there was no unitary relationship, and, thus, the capital gain was properly allocated to New York as nonbusiness income. The court also

rejected the department's argument that the Himont investment served an operational function (as in *Allied-Signal*) and should be apportionable income on that basis.[7]

Kansas

The Kansas Board of Tax Appeals determined that because the Himont sale did not meet the "transaction" test, it was not business income and, thus, not apportionable to Kansas.[8]

Maryland

The Maryland Court of Appeals, in overturning a lower court decision, found there was no evidence of either a unitary relationship or that the investment served an operational function.[9]

Minnesota

The Minnesota Supreme Court, in reversing the state's tax court, found there was "scant evidence of a unitary relationship between Hercules and Himont." In addition, there was no evidence that the ownership of Himont served an operational rather than an investment function. Thus, the capital gain was not apportionable to Minnesota but properly allocated to New York.[10]

Utah

The Utah State Tax Commission ruled that the capital gain was business income apportionable to the state because it found both a unitary and operational relationship between Hercules and Himont.[11]

Wisconsin

The Wisconsin Tax Appeals Commission ruled that the capital gain was business income apportionable to the state because it found both a unitary and operational relationship between Hercules and Himont.[12]

In summary, given the exact same transaction, Kansas, and then upon appeal, Illinois, Maryland, and Minnesota, agreed with Hercules' allocation of the capital gain to New York, while Utah and Wisconsin apportioned part of that gain to themselves.

Having Your Cake and Eating It Too

Given the states' differing interpretations of business and nonbusiness income, is it appropriate for a taxpayer to take conflicting positions on the same transaction in different states? In fact, given the states' inconsistent positions, taxpayers routinely take inconsistent positions

[7] *Hercules, Inc. v. Dep't of Revenue*, 324 Ill. App. 3d 329, 753 N.E.2d 418 (1st Dist. 2001), *appeal denied*, 197 Ill. 2d 560, 763 N.E.2d 770 (2001).

[8] *Appeal of Hercules, Inc.*, No. 1998-1666-DT (Kan. 2000).

[9] *Hercules, Inc. v. Comptroller*, 351 Md. 101, 716 A.2d 276 (1998).

[10] *Hercules, Inc. v. Comm'r*, 575 N.W.2d 111 (Minn. 1998)

[11] *Hercules, Inc. v. Utah State Tax Comm'n*, 974 P.2d 286 (Utah 1999).

[12] *Hercules, Inc. v. Wisconsin Dep't of Revenue*, No. 94-I-1494, (Wis. Tax Appeals Comm'n Feb. 26, 1997).

when required by state law, court findings, or both. However, when the state guidance is arguably ambiguous, is it appropriate for a taxpayer to treat a transaction inconsistently between states? That question was recently addressed by the Oregon Tax Court in *Oracle v. Dept. of Revenue*, TC-MD 070762C (Or. Tax (Magis. Div.) Feb. 11, 2010).

Oracle treated certain gains from the sale of stock and other assets as *business income* on its California return and *nonbusiness income* not allocable to Oregon on its Oregon return. The filing position benefited Oracle, which is headquartered in California. Oregon challenged Oracle's filing position claiming that it "thwart(s) the goal of uniformity if they take inconsistent positions as to identical items of income in the same tax year." In addition, the state department of revenue (DOR) held that the taxpayer had a duty of consistency that required that it disclose inconsistent positions taken on returns. The court declined to adopt the state's position, pointing out that "a favorable ruling for Defendant would require the court to become an expert in the laws of 49 other states as they pertain to the definition of business and nonbusiness income, not only as set forth in the various states' statutes, but as those statutes are refined and clarified by years of judicial opinions." The court went on to ask, if it did adopt the DOR's position, which state's treatment would prevail?

For example, suppose a taxpayer reports an item of income as nonbusiness income in one state and business income in another, and that one of those states is Oregon. Which state's reporting would govern in determining how the income should be characterized for purposes of Oregon's tax? This case is a prime example. The plaintiffs reported certain income as business income in California and nonbusiness income in Oregon. Why should the plaintiffs' characterization of the income on its California return dictate how the income should be reported in Oregon?

If the court were to rule favorably on the defendant's motion, the result would be a ruling mandating that the plaintiffs' characterization of the income in another state (California) controls how that income is reported in Oregon for purposes of this state's tax. An obvious question raised by that outcome is whether Oregon will accept in all cases a taxpayer's characterization of an item of income in another state as controlling in Oregon, including situations in which the department felt that a "correct" application of the law dictated a contrary result.

> ***Author's Note: Filing Consistency for Business vs. Nonbusiness Income***
>
> *Does taking such an inconsistent filing position raise an issue related to Financial Accounting Standards Board Interpretation No. 48,* Accounting for Uncertainty in Income Taxes—an interpretation of FASB Statement No. 109*?*

The Supreme Court—Once Again

The landmark U.S. Supreme Court cases summarized in chapter 3 in the discussion of the unitary concept are equally useful in thinking about the distinctions between business and nonbusiness income. Given the interrelationship between the unitary concept, combined

filing, and business and nonbusiness income, it is common to confuse them. The following distinction may be used as a rule of thumb: The unitary concept generally refers to the *relationship* between entities while the business or nonbusiness income principle more often refers to the role a particular property, asset, or stream of income plays in the hands of its owner. In *MeadWestvaco Corp. v. Illinois*, 553 U.S. 16 (2008), the Supreme Court distinguished between "enterprise" unity and the operational or investment function test. The tests of functional integration, centralized management, and economies of scale are the "hallmarks" for determining whether a unitary relationship exists between enterprises. For example, in *Mobil Oil*; *Exxon Corp. v. Wisconsin*, 447 U.S. 207 (1980); *ASARCO*; and *F.W. Woolworth Co. v. New Mexico*, 458 U.S. 354 (1982), the Supreme Court focused on the *relationship* between the parents and subsidiaries. Once the relationship was determined to be unitary, the income was deemed business or apportionable income. Nevertheless, one can have business income absent a unitary relationship between businesses or enterprises. The unitary relationship is a sufficient but not necessary condition. As a logician might say, "A is a sufficient, but not necessary condition for B." In short, the *MeadWestvaco* decision provides that even if there is not a unitary relationship between two separate businesses, individual assets of a business can be treated as apportionable income if they serve an operational rather than investment function. You cannot use just the operational test or the investment function test as to determine a unitary relationship between two separate enterprises.

It was only with *Allied Signal* that the Court really began to explore business and nonbusiness income principles outside the unitary relationship. The change in focus prompted questions more in the order of: "Why does this company own this property and for what purpose?" Successfully or not, the Court tried to answer that question by distinguishing an *operational* from an *investment* function, that is, a business purpose from a nonbusiness purpose. The former may be apportionable income; the latter perhaps not.

In contrast to the U.S. Supreme Court's decision in *MeadWestvaco*, the decision in *Tate & Lyle Ingredients Americas, Inc. v. Alabama*, No. CORP. 07-162, (Ala. Adm. Law Div. Jan. 15, 2008), is a model of clarity. In *Tate & Lyle*, the taxpayer realized a $345 million gain upon the sale of its one-third stock interest in a foreign corporation based in Belgium. The key issues were (1) whether Alabama could even constitutionally tax the gain and (2) if the state could tax the gain, whether the gain apportionable business or allocable nonbusiness income. In short, there was a unitary question and a business or nonbusiness income question. Because both companies were in the business of selling cereal sweeteners and owned by the same holding company, the state of Alabama held that the gain was apportionable business income taxable to the state.

The judge found that despite the common ownership by a holding company, there was no unitary relationship between the two corporations.

The companies have no common directors. They separately purchase their own raw materials and have no shared facilities, employees, or officers. They also have separate accounting, payroll, legal, and tax departments and different customer and technical service employees. They have separate management teams and independently manufacture, price, market, and sell their respective products. They sell to some of the same customers, but the

sales are in different geographical locations, for separately negotiated prices, and with different terms and conditions.

In fact, "the taxpayer uses corn to manufacture its products and sells to customers in North America, whereas [the foreign company] uses wheat and sells to customers in Europe."

The court went on to examine whether the stock gain was business income "under the transactional, functional, or operationally related tests," and it determined that "the income was nonbusiness income and not apportionable to Alabama."

The *Tate & Lyle* decision is a particularly helpful one for the tax practitioner. The judge provides a clear and useful history of the unitary principle, its application, and its relationship with the business or nonbusiness income tests.

5

Apportionment Formulas and Factors

Introduction

Once we have established the right to apportion, we must turn our attention to the apportionment formula and the factors within that formula. The U.S. Supreme Court has declined to favor one apportionment method over another. For example, the Court upheld Iowa's use of a single factor (sales) in apportioning income in *Moorman Manufacturing Co. v. Bair*, 437 U.S. 267 (1978). With *Moorman*, the Court has let it be known that, absent clearly flagrant distortion (*Hans Rees' Sons, Inc. v. North Carolina*, perhaps), it is not going to be in the business of judging the validity of various state apportionment methods.

Although there is increasing variation in state formulas, most states have adopted some form of the "Massachusetts formula." (Supposedly, the drafters of Uniform Division of Income for Tax Purposes Act [UDITPA] used Massachusetts as an example in their drafting.) Historically, the "Massachusetts formula" was derived by determining the average of three separate factors: payroll, property, and sales.

Payroll, Property, and Sales Factors

Put simply the payroll factor is determined by comparing *in-state payroll* to *payroll everywhere*. The property factor is determined by comparing the *average value of in-state property* to *the average value of property everywhere*. The sales factor is determined by comparing *in-state sales* to *sales everywhere*. This three-factor approach is the basis of both the UDITPA provisions and Multistate Tax Commission (MTC) (with some modifications) regulations.

Each of the three factors is used in an attempt to represent fairly a business's activity in a state. The payroll factor is used because it represents both the contribution of labor toward the creation of wealth (Adam Smith and Karl Marx, both adherents to the labor theory of value, would be proud.) and is a measure of the taxpayer's physical presence in the state. The payroll factor includes all compensation paid to individuals, including wages and other taxable fringe benefits, such as meals and lodging.

The property factor, like the payroll factor, represents both the contribution of property towards the creation of wealth (Henry George, popular nineteenth century economist who proposed a single tax on land, would be proud.) and the measure of business presence in the state. Both rented and owned properties are included in the property factor. According to UDITPA and MTC regulations, owned property is measured at original cost and rented property at eight times its annual rent. Intangible property is not included in the property factor.

The sales, or gross receipts, factor provides for the contribution of the market states in the creation of wealth. Its use balances the effect of the payroll and property factors which favor the states in which a company's headquarters and manufacturing are located. Sales, with two exceptions, are apportioned to where the product is shipped. The two exceptions include (1) purchases by the United States and (2) sales into states where the taxpayer is not taxable. In both these instances, the sales are "thrown back" into the state of origin. Unlike the property factor, which does not include intangible property, the sales factor includes receipts from intangible property sales.

Finally, there are specific provisions in most states for the apportionment factors of certain industries in transportation (air, rail, ship, and truck), entertainment, and finance (banks, credit companies, insurance companies, and savings and loans).

> ***Author's Note: Fairly Represents Exception***
>
> ***Most states have a "fairly represents" exception to their apportionment statutes.***

Because each state has its own formula and interpretations thereof, generalization is difficult. In addition, change is continual. For example, there has been a trend lately to increase the role of the sales factor by doubling it. Why? Because it generally lessens the tax burden of in-state businesses at the expense of out-of-state businesses (probably the dream of local politicians everywhere). Colorado, Georgia, Illinois, Iowa, Maine, Michigan, Nebraska, New York, Oregon, Texas, and Wisconsin use a single factor (sales) in apportioning income. There are a number of states that use the traditional three-factor formula but double-weight the sales factor. They include Arizona, Arkansas, California, Connecticut, Florida, Idaho, Kentucky, Maryland, Massachusetts, New Hampshire, New Jersey, North Carolina, Tennessee, Utah (by election), Vermont, Virginia, and West Virginia. The states with a traditional equally weighted three-factor apportionment include Alabama, Alaska, Delaware, Hawaii, Kansas, Montana, New Mexico, North Dakota, Oklahoma, Rhode Island, and Utah (unless election is made to double weight the sales factor).

Many other states also place additional weight on the sales factor. For example, Indiana is phasing out its property and payroll factors by 10 percent each year. By 2011, Indiana will be a single sales factor state. Minnesota's factors are currently weighted at 90-5-5 percent (sales, property, and payroll), but it will be a single sales factor state after 2013. Pennsylvania's formula is weighted 90-5-5 percent (sales, property, and payroll).

Some states provide specific industries special weighting of the factors. For example, Mississippi provides a single sales factor for retailers, wholesalers, and service companies.

Manufacturers that sell at wholesale must use an evenly weighted three-factor formula, while manufacturers that sell at retail use a three-factor formula with double-weighted sales. (See appendix 1 at the end of the chapter for a summary of each state's various apportionment formulas and corporate tax rates.)

Our primary focus will be on the UDITPA and MTC rules and regulations.

Example 5-1

Before we begin a detailed examination of the individual factors, let us look at a simple example illustrating the previous discussion.

ABC Corporation does business in two states and has collected the following data with respect to their sales, property, and payroll. The company's federal taxable income after state modifications was $1,000,000.

	State X	State Y	Total
Sales	12,000,000	4,000,000	16,000,000
Property	3,000,000	2,000,000	5,000,000
Payroll	1,200,000	800,000	2,000,000

If both states use an equally balanced three-factor apportionment, ABC's taxable income is apportioned in the following manner:

State X	
Sales (12,000,000/16,000,000)	75%
Property (3,000,000/5,000,000)	60%
Payroll (1,200,000/2,000,000)	60%
Total of factors	195%
Divided by three (195/3)	65%
Times taxable income	× 1,000,000
State X taxable income	$ 650,000

State Y	
Sales (4,000,000/16,000,000)	25%
Property (2,000,000/5,000,000)	40%
Payroll (800,000/2,000,000)	40%
Total of factors	105%
Divided by three (105/3)	35%
Times taxable income	× 1,000,000
State Y taxable income	$ 350,000

In reality, companies rarely pay tax on exactly 100 percent of their income. Because many states differ in how they weight their factors and the composition of the factors, it is highly likely that a company may pay tax on more (or less) than 100 percent of its taxable income. For example, what if State X used only a single sales factor? Its factor would then be 75 percent and State Y's would still be 35 percent, meaning that ABC Corporation would be paying tax on 110 percent of its income.

The Payroll Factor

Let us begin with the simplest of factors—payroll. Section 13 of UDITPA defines the payroll factor as "a fraction, the numerator of which is the total amount paid in this state during the tax period by the taxpayer for compensation, and the denominator of which is the total compensation paid everywhere during the tax period."

As a practical matter compensation for the payroll factor is usually assigned to the state where the unemployment compensation is reported.

MTC regulations provide that in determining the amount of compensation to be included in the payroll factor, the business's accounting methods (cash or accrual) are to be followed. However, if a state requires the cash method to be used for unemployment taxes, then the business may use the cash method even if it otherwise uses the accrual method. Consequently, many states accept the IRS Form 940 and state unemployment returns to apportion payroll.

Payroll that is capitalized as part of a self-constructed asset is included in the payroll factor.

"Employee," while not specifically defined in UDITPA, is usually defined as anyone subject to the Federal Insurance Contributions Act rules. This approach implicitly excludes independent contractors. That said, given the trend by companies to outsource more and more of their operations, there have been recent discussions regarding revising the UDITPA to include independent contractors in the payroll factor.

"Throwbacks," usually associated with the sales factor, can exist with the payroll factor. Technically speaking, the throwback payroll rule provides that even though an employee is neither a resident of the state nor performing services in the state, the payroll will be thrown back if (*a*) the employee is directed or controlled from an office in the state to which he or she periodically returns and (*b*) the employer does not have nexus with the state of the employee's residency. For example, a Madison, Wisconsin, company doing business only in Wisconsin has a sales employee who lives in Cheyenne, Wyoming, soliciting sales. (This activity creates nexus for sales tax purposes but not income tax purposes.) The employee rarely stops in at the Madison office. Wisconsin will throw back that employee's compensation into the Wisconsin payroll factor.

Three states, Alabama, Missouri, and North Dakota, and the District of Columbia have payroll "throwbacks." Payroll throwbacks are necessary, according to those states, because if payroll is assigned to a state where the employer does not have nexus, it does not show up in any state numerator and results in the creation of "nowhere" income.

Generally, the payroll factor, unlike the sales and property factors, is simple to administer. Two controversial areas are the treatment of executive salaries and leased employees. Some states want to carve out executive's salaries for specific allocation rather than apportionment, arguing that the payroll factor is otherwise distorted. New York, however, excludes executives' salaries as an incentive for companies to establish themselves in New York City.

The dilemma with leased employees is which company should include them in their factor—the lessor or the lessee or both? Many states include them in both, arguing that both parties are using them in the state as a source of income. This is the same rationale for including leased property in both the lessor and lessee's property factors.

For employees who work in more than one state, UDITPA offers the following guidelines:

- "Compensation is paid in this state if
  - — The individual's service is performed entirely within the state; or
  - — The individual's service is performed both within and without the state, but the service performed without the state is incidental to the individual's service within the state; or
  - — Some of the service is performed in the state and (1) the base of operations or, if there is no base of operations, the place from which the service is directed or controlled is in the state, or (2) the base of operations or the place from which the service is directed or controlled is not in any state in which some part of the service is performed, but the individual's residence is in this state."

Please note that the preceding rules result in an employee's payroll being sourced to a single state. While this is certainly easy from an administrative point of view, it certainly does not reflect today's employment patterns when, for example, software consultants may work from home or move from job to job in different states.

Author's Note: Relationship Between Payroll Factor and Nexus

When you are reviewing your payroll factor, review your nexus exposure.

Example 5-2

ABC Corporation employs a pharmaceutical salesman whose region covers the Rocky Mountain West, including the states of Arizona, Nevada, Idaho, Montana, Wyoming, Colorado, and New Mexico. The salesman works out of his home in Colorado but receives his directions from the company's headquarters in California. The salesman's payroll will likely be sourced to Colorado. Why? The ABC Corporation cannot use California as a base of operations because the salesman never works in California and the salesman's activities are spread across seven states.

The Property Factor

The property factor, along with the sales factor, is the most difficult to interpret and apply. The difficulties arise from problems of definition (What is property?), problems of value (What cost is applied to the property?), computational problems (How do you use of "aver-ages" and moveable property?), and, finally, problems related to unusual and nonrecurring transactions.

Property Included in the Factor

UDITPA provides that "the property factor is a fraction, the numerator of which is the average value of the taxpayer's real and tangible personal property owned or rented and used in this state during the tax period and the denominator of which is the average value of all the taxpayer's real and tangible personal property owned or rented and used during the tax period."

The MTC regulations define "real and tangible personal property" as land, buildings, machinery, stock of goods, equipment, and other tangible property excluding cash used in the regular course of the taxpayer's trade or business. Property giving rise to nonbusiness income is generally excluded from the factor.

MTC Regulation § 10(b) provides that property is included in the property factor if it is actually used or is available for or capable of being used in the regular course of the taxpayer's trade or business. Thus, property held in reserve or standby is included in the factor. Specific examples include a temporarily idle plant and raw materials reserves. Property or equipment qualifying as construction-in-progress during the tax period is excluded. Thus, a plant under construction is excluded while an idled plant is included. But see *Commissioner of Revenue v. New England Power Co.*, 411 Mass. 418 (1991), in which property under construction was included in the property factor of an electric power company. The property was included because it contributed to the company's revenue by being a factor in setting the utility's rate base.

Once in the factor, the property stays there until it is disposed. The MTC regulations provide that "property used in the regular course of the trade or business of the taxpayer shall remain in the property factor until its permanent withdrawal is established by an identifiable event such as its conversion to the production of nonbusiness income, its sale, or the lapse of an extended period of time (normally, five years) during which the property is held for sale."

Section 10 of UDITPA requires that the property factor include rental property by multiplying the annual rentals by eight. Part year rent is not annualized.

MTC Regulation § 11(b)(3) defines annual rent as "the actual sum of money or other consideration payable, directly or indirectly, by the taxpayer for its own benefit for the use of the property." Indirect consideration paid includes real estate taxes and insurance, but not service charges for utilities, cleaning, or security. See *Nelson's Office Supply Stores v. Commissioner of Revenue*, 508 N.W.2d 776 (1993), in which the court held that the taxpayer include its *pro rata* share of property taxes and utilities in its property factor.

The MTC regulations offer the following examples:

Example 1: A taxpayer, pursuant to the terms of a lease, pays a lessor $1,000 per month as a base rental and at the end of the year pays the lessor one percent of the gross sales of $400,000. The annual rent is $16,000 ($12,000 plus one percent of $400,000 or $4,000).

Example 2: A taxpayer, pursuant to the terms of a lease, pays the lessor $12,000 a year plus taxes in the amount of $2,000 and interest on a mortgage in the amount of $1,000. The annual rent is $15,000.

Example 3: A taxpayer stores part of its inventory in a warehouse. The total charge for the year was $1,000 of which $700 was for the use of storage space and $300 for inventory insurance, handling and shipping charges, and C.O.D. collections. The annual rent is $700.

Leasehold improvements are included in the property factor at original cost, regardless of whether or not the property can be removed by the taxpayer at the end of the lease.

There is little consistency among the states in treating mobile property such as trucks, planes, and automobiles used in more than one state. Usually some apportionment method based upon miles or time is appropriate. But, see *Cooper Tire & Rubber Co. v. Tax Commissioner*, 639 N.E.2d 27 (1994), in which the court rejected the percentage of use method and required all leased trucks and aircraft to be included in the Ohio property factor.

Other areas of dispute over the property factor include sourcing satellites, off-shore drilling platforms and equipment, and work-in-process inventory. Be careful that your payroll factor does not get counted twice—once in the payroll factor and again in the property factor in manufactured equipment or construction.

Property Value

UDITPA defines a property's value as its cost. "Property owned by the taxpayer is valued at its original cost. Property rented by the taxpayer is valued at eight times the net annual rental rate. Net annual rental rate is the annual rental rate received by the taxpayer from sub-rentals."

Both UDITPA and the MTC provide that the property be valued at historical cost. Examples from the MTC regulations include:

Example 1: The taxpayer acquired a factory building in this state at a cost of $500,000 and 18 months later expended $100,000 for major remodeling of the building. Taxpayer files its return for the current taxable year on the calendar-year basis. Depreciation deductions in the amount of $22,000 were claimed on the building for its return for the current taxable year. The value of the building includable in the numerator and denominator of the property factor is $600,000 as the depreciation deduction is not taken into account in determining the value of the building for purposes of the factor.

Example 2: During the current taxable year, X Corporation merges into Y Corporation in a tax-free reorganization under the Internal Revenue Code. At the time of the merger, X Corporation owns a factory which X built five years earlier at a cost of $1,000,000. X has been depreciating the factory at the rate of two percent per year, and its basis in X's hands at the time of the merger is $900,000. Since the property is acquired by Y in a transaction in which, under the Internal Revenue Code, its basis in Y's hands is the same as its basis in X's, Y includes the property in Y's property factor at X's original cost, without adjustment for depreciation, i.e., $1,000,000.

Example 3: Corporation Y acquires the assets of Corporation X in a liquidation by which Y is entitled to use its stock cost as the basis of the X assets under §334(b)(2) of the 1954 Internal Revenue Code (i.e., stock possessing 80% control is purchased and liquidated within two years). Under these circumstances, Y's cost of the assets is the purchase price of the X stock, prorated over the X assets.

Inventory is to be valued as it is for federal income tax purposes including any uniform capitalization rules applicable. If the property's original cost is unknown, then the taxpayer is to use the property's fair market value at the time it was acquired.

Computational Problems

Finally, "the average value of property shall be determined by averaging the values at the beginning and ending of the tax period but the tax administrator may require the averaging of monthly values during the tax period if reasonably required to reflect properly the average value of the taxpayer's property."

Intangible property is not included in the factor, but see *Crocker Equipment Leasing, Inc. v. Department of Revenue*, 838 P.2d 552 (Ore. 1992), in which a bank is allowed to include intangible property, that is, loans and leases, in its property factor, because the intangibles were responsible for roughly 98 percent of the bank's income.

Some states treat inventory or property in transit at the end of the tax period as in the property factor of the state of destination. Some states simply delete the in-transit inventory from both the numerator and denominator. Many state's provisions are silent on the matter. In *Mercedes Benz of North America, Inc. v. Comptroller of the Treasury*, No. Income Tax 2813 (Md. Tax Ct. Oct. 7, 1988), the taxpayer included cars in-transit from Germany to Maryland in the Maryland denominator, but not the numerator. The court held that the cars must be either in both the numerator and denominator or neither.

See *Cooper Tire & Rubber Co.*, discussed previously, for problems associated with computing the inclusion of mobile property.

Author's Note: Problem Areas of The Property Factor

- *Intangible property*
- *Idle plant, property, or equipment*
- *Construction in progress*
- *Leasehold improvements*
- *Mobile property*
- *Calculation methods*
- *Nonjurisdictional property*

The Sales Factor

As with everything in tax law, we must begin by defining our terms. The term "sales factor" may cause more confusion than the other two factors. It is more helpful to think of the sales factor in terms of gross receipts because it will include not only sales from inventory, but interest, dividend, rental, and royalty income, as well. Keep in mind that the term is generally applied only to include "receipts" which generate apportionable business income.

Definitions

The UDITPA rules provide that "the sales factor is a fraction, the numerator of which is the total sales of the taxpayer in this state during the tax period, and the denominator of which is the total sales of the taxpayer everywhere during this period."

The MTC regulations add to that definition by including interest income, service and carrying charges, and federal and state (including sales) excise taxes. The MTC excludes from the sales factor receipts from an incidental or occasional sale of a fixed asset used in the regular course of business, insubstantial amounts of gross receipts arising from incidental or occasional transactions or activities, and business income from intangible property if the income cannot readily be attributable to any particular income-producing activity of the taxpayer. An example of the latter includes dividends and interest that result from the mere holding of the intangible property.

The California Supreme Court recently addressed one of the more controversial questions involving the sales factor. The question was simply this: When the statute states that gross receipts should be included in the sales factor, does it really mean "gross" receipts?

In one year, Microsoft's treasury department generated $5.7 billion in gross receipts on short-term investments such as repurchase agreements (repos). However, the income from those investments only amounted to $10.7 million. Microsoft included the gross receipts in the denominator of its sales factor for California, which cut the company's California income tax almost in half. The California Franchise Tax Board (FTB) disallowed the portion of the proceeds that represented return of capital. In *Microsoft Corp. v. Franchise Tax Board*, the question before the California Supreme Court then was whether the sales factor should include the gross proceeds from short-term securities investments, or only the net return.

The FTB argued that including the gross proceeds from such investments distorted the sales factor and proposed an alternative formula that excluded the return of principal from the sales factor. Microsoft pointed out that whether it was distortive or not, the plain language of the statute clearly stated that gross receipts were to be included in the sales factor.

The California Supreme Court determined that both parties were right. Gross receipts did mean gross receipts. However, the FTB was successful in arguing that, at least in this case, the numbers were distortive. Under California law (§ 25137), if the standard apportionment formula fails to "fairly represent the extent of the taxpayer's business activity in this state," the taxpayer may petition, or the FTB may require, an alternative method of calculation.

Given the court's ruling, how is a taxpayer to file? Because distortion is, at least to some extent, in the eye of the beholder, it is clear that this controversy is not over.[1] The most recent decision involves General Mills, which recently failed in its attempt to argue that futures transactions were gross receipts to be included in the sales factor. The San Francisco Superior Court ruled that while the sales may have been gross receipts, the inclusion distorted the sales factor and justified the use of an alternative formula.[2] For example, the court noted that in 1992 and 1996, the futures trading generated no income, but it did generate 8 percent and 30 percent of the company's sales respectively. Critics of the court point out that tying income to the sales factor is mixing apples with oranges. The first addresses the tax base, while the second addresses the apportionment of that tax base. If income is to be a measure in apportionment, then any company with losses has sales factor issues. It is unclear whether there will be an appeal.

The MTC responded to the question posed in *Microsoft* as early as 2001 by proposing that the definition of "gross receipts" exclude proceeds from the repayment of principal on the sales of intangibles such as bonds, loans, or investments in mutual funds. The MTC resolution amended MTC Regulation § IV.2(a) and was clearly an attempt to resolve whether net profits, or gross receipts, should be included in the sales factor.

Problem Areas

In addition to providing some definition of sales, UDITPA addressed what have become perennial areas for disagreement: destination sales, dock sales, throwbacks, and sales of services. The UDITPA rules provide that

- Sales of tangible personal property are in this state if
  - The property is delivered or shipped to a purchaser, other than the United States government, within this state regardless of the free on board point or other conditions of the sales; or
  - The property is shipped from an office, store, warehouse, factory, or other place of storage in this state and (1) the purchaser is the United States government or (2) the taxpayer is not taxable in the state of the purchaser.
- Sales, other than sales of tangible personal property, are in this state if
  - The income-producing activity is performed in this state; or
  - The income-producing activity is performed both in and outside this state and a greater proportion of the income-producing activity is performed in this state than in any other state, based on the costs of performance.

[1] See *Microsoft Corp. v. Franchise Tax Bd.*, 139 P.3d 1169 (Calif. 2006), and its companion case, *General Motors Corp. v. Franchise Tax Bd.*, 139 P.3d 1183 (Calif. 2006).

[2] *General Mills, Inc., et al. v. Franchise Tax Bd.*, No. CGC 05–439929 (Cal. Super. Ct. (San Francisco Cty.) November 1, 2010).

Destination Sales

Some 40 states follow the UDITPA rule that receipts from the sale of tangible personal property are sourced to the state of destination. The MTC regulations add that items such as FOB point, risk of loss, and passage of title are *not* to be considered in sourcing a sale. Some states and courts disagree in their interpretation of the phrase "state of destination."[3] Most commentators believe that UDITPA and the MTC indicate that sales are properly sourced when delivered or shipped to the buyer in the taxing state, ignoring the fact that the buyer may reship the property elsewhere.

The destination rule is further complicated by its interaction with the reporting requirements of combined filing unitary states. The confusion is created by differences in the definition of the phrase "taxable in another state" as used in defining "throwback" sales in Section 3 of UDITPA. "For purposes of allocation and apportionment of income under this Act, a taxpayer is taxable in another state if …" Does the term "taxpayer" mean an individual corporation or does it mean a unitary group?

In brief, the question is this: When determining whether you must throw back sales into your state numerator, do you look to each individual corporation, or do you look to the unitary group as a whole? (See the following discussion on throwbacks, in general.) If a state follows *Joyce*, it counts throwbacks on a separate company basis. If a state follows *Finnigan*, it counts throwbacks on a combined reporting or unitary method. The terms "*Joyce* state" and "*Finnigan* state" come from two court cases in California, *Appeal of Joyce, Inc.*, No. 66-SBE-070 (Cal. State Bd. of Equalization Nov. 23, 1966) and *Appeal of Finnigan Corp.* No. 88-SBE-022 (Cal. State Bd. of Equalization Aug. 25, 1988), *on reh'g*, Jan. 24, 1990.

California initially followed the *Joyce* rule, then later switched to the *Finnigan* rule, then back to *Joyce*, and effective January 1, 2011, back to *Finnigan*.

Example 5-3

Flintstone Corporation does business in California, Illinois, and Nebraska. The corporation has two subsidiaries: Fred, Inc., and Wilma, Inc. Fred has nexus only with California, and Wilma only has nexus with Colorado. Neither Fred nor Wilma have nexus, or do business, in any other state. However, Fred does have catalog and online sales into Colorado.

If California is following *Joyce*, then because Fred does not have nexus with Colorado, its Colorado sales will be thrown back into the California numerator. However, if California is following *Finnigan*, then because Wilma has nexus in Colorado and is filing a combined report with Flintstone in California, the sales are not thrown back into Fred's California numerator.

[3] See *Dep't of Revenue v. Parker Banana Co.*, 391 So.2d 762 (Fla. Dist. Ct. App. 1980).

States with throwbacks are split on whether to apply the *Joyce* or the *Finnigan* rule. According to the *Multistate Corporate Tax Guide*,[4] Finnigan states include Indiana, Kansas, Massachusetts, Utah, and Wisconsin. *Joyce* states include Arkansas, California (until January 1, 2011 when it goes back to being a *Finnigan* state), Colorado, Hawaii, Idaho, Illinois, Montana, New Hampshire, New Mexico, North Dakota, Oregon, and Vermont. A New York appellate court recently ruled that the state could include in the numerator of a company's sales factor the sales of a subsidiary that did not have nexus with the state.[5] The court's holding is not clear, and because the court did not mention either *Joyce* or *Finnigan* in its decision, it could be that the court was confusing unitary theory with an apportionment problem. Richard Pomp, a University of Connecticut law school professor, who testified for Disney, said that unitary theory "does not justify taking a sale made by one corporation and treating it as if it were made by another. The difficulty of measuring income when there are flows of value, which is the rationale for a combined report, has nothing to do with the difficulty of measuring the sales made by each corporation included in the combined report." Nevertheless, the New York Court of Appeals upheld the lower court's decision.[6]

Dock Sales

Dock sales occur when the purchaser takes delivery of the goods at the seller's location. Most states apply the general rule regarding destination sales to dock sales. Nevertheless, there remains enormous disparity in state's treatment of this issue. For example, the Minnesota Supreme Court, in a decision defining "ultimate destination," did not treat sales as Minnesota destination sales when the out-of-state customer picked the goods up in Minnesota and transported them back to its own state.[7] For a recent contrary holding see *Rohm and Haas Kentucky, Inc.*, 929 S.W.2d 741 (Ky. App. 1996).

According to the *Multistate Corporate Tax Guide*, states holding that dock sales be sourced to the state of destination include Alaska, Arizona, California, Colorado, Connecticut, Georgia, Hawaii, Idaho, Iowa, Kentucky, Louisiana, Michigan, Montana, Nebraska, New Jersey, New York, North Dakota, Ohio, Oregon, Tennessee, Vermont, Virginia, and Wisconsin. The District of Columbia and the following states hold that the dock sales be sourced to the dock state: Alabama, Arkansas, Delaware, Florida, Illinois, Indiana, Kansas, Minnesota, Mississippi, Missouri, New Mexico, Oklahoma, Rhode Island, Texas, Utah, and West Virginia.

Throwback Sales

"Throwback sales" are an exception to the destination test. The throwback rules provides that if the seller is not taxable in the destination state, then any sales to that state are "thrown back" into the sales numerator of the state of origin. Throwback sales apply to (1) sales to the U.S. government and (2) sales into states where the seller is not taxable. For example,

[4] 1 Healy, John C. and Michael S. Schadewald, Multistate Corporate Tax Guide 2010 680 (New York: Aspen Publishing, 2010).

[5] See *In the Matter of Disney Enterprises, Inc. v. Tax Appeals Tribunal*, No. 99719 (N.Y.S.3d March 1, 2007).

[6] See *In the Matter of Disney Enterprises, Inc. v. New York*, 888 N.E.2d 1029 (N.Y. 2008).

[7] *Olympia Brewing Co. v. Comm'r of Revenue*, 326 N.W. 2d 642 (Minn. 1982). So too in *Pabst Brewing Co. v. Wisconsin Dep't of Revenue*, Wis. Cir. Ct., No. 83 CV 4387 (January 31, 1984).

a Colorado computer retailer makes only mail-order sales into Nebraska. The retailer does not have nexus with Nebraska and is not subject to tax there. Consequently those Nebraska destination sales are thrown back into the Colorado sales numerator. (Only the Colorado three-factor apportionment allows for throwbacks. There are no throwbacks under Colorado's two-factor apportionment.)

The purpose of this rule, adopted by both UDITPA and MTC, is to avoid the creation of "nowhere" sales, that is, sales that do not show up in any state's numerator. The throwback rules try to ensure that the sales factor accounts for 100 percent of a company's sales. Naturally, some states do not have a throwback rule. Examples include Florida, Iowa, Kentucky, Nebraska, North Carolina, Ohio, and Pennsylvania. For an exception to the rule that sales to the U.S. government are thrown back, see *Jim Beam Brands Co.* (KBTA Order No. K-14942, 7/23/93).

Other states have adopted a "double throwback" rule to make certain that drop shipments are accounted for in the sales factor. The classic drop shipment scenario goes like this. Say, for example, that you have ordered some boots from L.L. Bean.[8] The boots are manufactured at a company in Kansas. Instead of L.L. Bean having the boots sent to its store in Maine and then reshipped to Colorado, it simply has the boots drop-shipped directly to Colorado. The double throwback provides that if L.L. Bean is not taxable in Colorado (it is not), the sale is thrown back into Kansas. If the company is not taxable in Kansas, the sale is thrown back again into Maine. Again, the function of the rule is to avoid the creation of "nowhere sales."

Because the throwback rule (aside from government sales) only comes into play when a seller is not taxable in the destination state, the question naturally arises—how is taxability in the other state defined? Following UDITPA, most state statutes read that a taxpayer is deemed to be taxable in another state if in that state the taxpayer is subject to a net income tax, a franchise tax measured by net income, a franchise tax for the privilege of doing business, or a corporate stock tax.

The Indiana Tax Court recently held that the Michigan' Single Business Tax (SBT) met the definition of a franchise tax, thereby deeming the taxpayer to be subject to tax in Michigan. The Indiana Department of Revenue argued that while the SBT was certainly a tax on the privilege of doing business, it was not a *franchise* tax on the privilege of doing business. The court rejected the revenue department's argument holding that the SBT is indeed a franchise tax on the privilege of doing business in Michigan. Therefore, the taxpayer did not have to throw back its Michigan sales into the Indiana numerator.[9] Given the move of several states to a gross receipts tax, such as Ohio's commercial activity tax and the Texas Margin Tax, we will be sure to see more cases of this nature.

Michigan courts have held in a series of cases that sales need not be thrown back into Michigan. The courts held that the test was not whether or not the business is subject to tax

[8] Author's note—I am using L.L. Bean for the simple reason that everyone knows who they are. I have no idea whether they drop ship their goods or not. But I do like their boots.

[9] *Welch Packaging Group, Inc. v. Indiana*, No. 49T10-0503-TA-21 (Ind. Tax Ct. Nov. 13, 2007).

in the delivery state, but whether or not the taxpayer demonstrated more than a "slightest presence" in the delivery state.[10]

A variation of the throwback rule is the throwout rule. Under this rule, if the business is not taxable in the state of destination, the sales are thrown out of both the numerator and denominator of the sales factor. For a multistate business, the interplay between two states, one using throwbacks and the other using throwouts, can result in the business paying tax on more than 100 percent of its income. Montana and West Virginia use a throwout rule. New Jersey enacted a throwout rule in its 2002 Business Tax Reform Act. Pfizer, Inc., challenged New Jersey's throwout rule and lost in 2008.[11] Pfizer appealed, and its appeal was consolidated with Whirlpool Properties.[12] The taxpayers lost on appeal, but, in the meantime, the New Jersey legislature has repealed its throwout rule for tax years beginning on or after July 1, 2010. Whirlpool and Pfizer have appealed to the New Jersey Supreme Court, which has agreed to hear the appeal, so affected taxpayers should file protective refund claims with the state of New Jersey.

Service Sales

Receipts from sales of services, unlike sales of tangible personal property, are not sourced under the destination test. Instead, sales, other than sales of tangible personal property, are sourced by looking at the income-producing activity and measuring that activity by its cost of performance. Specifically, UDITPA provides that service sales are in-state sales if (1) the income-producing activity is performed in the state or (2) "the income-producing activity is performed both in and outside this state and a greater proportion of the income-producing activity is performed in this state than in any other state, based on costs of performance." Simply put, Section 17 of UDITPA allocates sales of services to where the bulk of the income-producing activity takes place as measured by cost of performance.

UDITPA and MTC are not always consistent. For example, the MTC regulation for *personal services* provides that

> Gross receipts for the performance of personal services are attributable to this state to the extent that such services are performed in this state. If services relating to a single item of income are performed partly within and partly without this state, the gross receipts from the performance of such services shall be attributable to this state only if the greater proportion of such services was performed in the state, based on costs of performance. Usually, where services are performed partly within and partly without this state, the services performed in each state will constitute a separate income producing activity; in such case the gross receipts from the performance of services attributable to this state shall be measured by the ratio which the time spent in performing the services in this state bears to the total time spent in performing the services everywhere.

[10] See *Guardian Indus. Corp. v. Dep't of Treasury*, 499 N.W.2d 349 (Mich. 1993); *Howmet Corp. v. Michigan*, No. 87-11161-CM (Mich. Ct. Claims Jan. 1, 1989); and *Magnetek Controls, Inc. v. Revenue Div.*, 566 N.W.2d 219 (Mich. 1997).

[11] See *Pfizer, Inc. v. Director*, 24 N.J. Tax 116 (May 29, 2008).

[12] See also *Whirlpool Prop., Inc. v. Director, Div. of Taxation*, 25 N.J. Tax 519 (July 12, 2010).

Not surprisingly, there are at least two areas in which taxpayers and tax administrators differ. The first is in defining the "income-producing activity" and the other is in defining "cost of performance." For example, what is a travel agency's "income-producing activity?" Is it the individual sale of travel packages, or is it the "operation" of bundling the packages together? The difference is important because the costs of performance between the two vary. The costs of a European travel package may include airfare, hotel accommodations, and ground transportation, only some of which are incurred in the United States. But the costs of simply bundling the packages together may very well be done in offices in the United States. It is probably not too difficult to guess where Massachusetts thought those costs, and the accompanying, income-producing activity occurred.[13] Massachusetts has also tackled the question of whether the "income-producing activity" of a hockey team was the playing of individual games or the operation of the franchise as a whole. The department of revenue naturally argued that it was the latter because the cost of performance of each individual game would have sourced more income away from Massachusetts. The court upheld the Department's position.[14]

In *Bellsouth Advertising & Publishing Corp. v. Chumley*, 308 S.W.3d 350 (Tenn. Ct. App. 2009), *appeal denied*, Tenn. Sup. Ct (Mar. 1, 2010), Tennessee's commissioner held that, despite the fact that the bulk of the cost of performance occurred outside the state, the result was distortive since all the advertising itself (delivery of the telephone directories) occurred inside Tennessee. For a similar decision, see *Ameritech Publishing, Inc., v. Wisconsin*, 788 N.W.2d 383 (Wisc. Ct. App. Jun. 24, 2010).

Under UDITPA, the cost of performance (COP) is an all-or-nothing approach. If 75 percent of the cost of performance is in State A and 25 percent in State B, the entire sale is sourced to State A. However, the states vary from UDITPA rules by sometimes applying a preponderance or, "greater proportion" test or a *pro rata* approach. For example, in a preponderance state, if the cost of performance is apportioned among three states when 40 percent of the COP was in one state and 30 percent each in the other two states, the sale would be sourced entirely to the 40 percent state. A *pro rata* state would prorate the sale proportionately so each state would receive its applicable share. The risk, of course, is that in this example, the 40 percent state might put the entire sale in its numerator while one of the 30 percent states, being a *pro rata* state, would put 30 percent of the sale in its numerator. As a consequence, the taxpayer ends up paying tax on more than 100 percent of its income. As you can see, the inconsistency between the two methods presents tax traps for the unwary and opportunities for others. Some *pro rata* states include Louisiana, Mississippi, North Carolina, Rhode Island, and South Carolina.

The problem is compounded by the vague definition of cost of performance. In short, cost of performance is measured by direct costs determined in a manner consistent with generally accepted accounting principles and in accordance with accepted industry practices.

---

[13] See *Interface Group v. Comm'r of Revenue*, 918 N.E.2d 97 (Mass. App. Ct. 2009), *aff'g* nos. C266670-76, C266680, and C266677-79, 2008 WL 4642961 (Mass. App. Tax Bd. Oct. 17, 2008), *rev. denied*, 456 Mass. 1105 (2010).

[14] See *Boston Professional Hockey Association v. Commissioner of Revenue*, 820 N.E.2d 792 (2005).

Direct costs generally include such things as salaries and wages, taxes, interest, and depreciation. Indirect costs are usually defined as all costs that are not direct costs—not much help there.

As mentioned previously, personal services often are singled out for specific measurement. The MTC rule quoted previously is often referred to as the "time-spread" method, and in such cases, the income from the performance of the services is usually measured by the ratio of time spent in the state performing the services divided by the total time spent performing the services everywhere.

In 2005, California issued Legal Ruling 2005-01, holding that the term "personal services" for purposes of the sales factor included the performance of any service when capital was not a material income-producing factor. In personal service contracts, when capital is not a material income-producing factor, the special time-spread rule will be used to determine the corporation's costs of performance. Most importantly, the time each employee spends in each state will constitute a separate income-producing activity for purposes of determining the numerator of the sales factor. Finally, when capital is a material income-producing factor, the special time-spread rule does not apply. Instead, the standard cost of performance rule would assign the receipts to the state with the greatest cost of performance.

To Market, to Market

Several states are abandoning cost of performance and are moving toward a market- or destination-based approach to service sales. They include California (if using single sales apportionment), Georgia, Illinois, Iowa, Maine, Maryland, Michigan, Minnesota, New York, Ohio, Texas, and Wisconsin. Basically, the move is an effort to source sales of services in the same fashion as sales of goods—by destination. The belief is that this approach is more consistent with the rational for a sales factor, that is, that it represents the contribution of the market states. After all, cost of performance, particularly for services, often looks just like the payroll factor. Finally, one shouldn't forget the political appeal. Market-based sourcing generally shifts the tax burden to out-of-state sellers over their in-state counterparts, an appeal that is irresistible to most politicians.

Certain industries have always taken a market approach. In *The New Yorker Magazine, Inc. v. Department of Revenue of State of Illinois*, (Illinois Circuit Court (Cook County) Jan. 12, 1988), advertising revenue was deemed included in the sales factor to same extent as circulation revenue. See also *McGraw-Hill, Inc.*, TAT (H)93-64(GC) (Dec. 30, 1993), in which it was determined that advertising revenues are sourced based on the location of subscribers.

The move toward market-based sourcing of service sales has prompted a host of questions and problems. For example, when sourcing based on the market, does that mean where the service is performed or where the benefit is received? Louisiana looks to where the service is performed and Maryland to where it is received. Thus, a software developer writing code in Louisiana for a client in Maryland may very well end up having to source the sale to the numerators of both states. Because sourcing service sales by market may mean where the service is performed (so it looks like cost of performance), where the benefit is received, or where the customer is located, such sourcing may be just as problematical as the traditional cost of performance test.

Outsourcing and Independent Contractors

In 2007, the MTC added an amendment to its uniform regulations to include in the definition of an income-producing activity "transactions and activities performed on behalf of a taxpayer, such as those conducted on its behalf by an independent contractor." The amendment also includes "payments to an agent or independent contractor for the performance of personal services which give rise to the particular item of income." The change by the MTC is recognition of the growing importance of outsourcing in both manufacturing and services.

California addressed the application of a similar rule in the context of a combined report in Legal Ruling 2006-02. In the ruling, the FTB clarified the application of the "on behalf of" rule when a member of a combined reporting group has a sale of other than tangible personal property and that member pays another member of the combined reporting group to perform activities related to that sale.

Specifically, the ruling excludes from a taxpayer's income-producing activity any acts performed on its behalf by an independent contractor, unless the independent contractor is a member of the same unitary group. Payments made by one member of a combined reporting group to another member (that is, a subcontractor) are only counted as costs of performance for the member if the payment reflects an arm's–length price for the performance of the service. The payment will be considered a direct cost and will be used to measure the member's and not the subcontractor's costs of performance. If the member does not pay at an arm's–length price, the actual costs incurred by the subcontractor may be imputed to the member to measure the member's costs of performance.

Specialized Industries

Most states have special rules for specific industries such as financial organizations, construction companies, and transportation companies. The MTC has issued final or proposed regulations on construction contractors, railroads, airlines, radio and television broadcasting, and trucking. These rules vary from industry to industry and are beyond the scope of this chapter.

On November 17, 1994, the MTC adopted model special apportionment rules for financial institutions. The formula apportions all business income under the three-factor approach. Only interest, dividends, net gains, and other business income from investment assets and activities (including trading) are included in the receipts factor. Investment assets and activities include but are not limited to investment securities, federal funds, repurchase agreements (repos), swaps, futures contracts, equities, forward contracts, and foreign currency transactions. The MTC recommends adoption for tax years beginning after January 1, 1996. The definition of what is a financial institution is left up to the states.

So far, 18 states have adopted the MTC financial apportionment and allocation rules (or something similar) including Arkansas, California, Colorado, Hawaii, Idaho, Kansas, Kentucky, Maine, Maryland, Massachusetts, Mississippi, New Hampshire, New Mexico, North Dakota, Ohio, Oregon, Rhode Island, and Washington. Approval by North Carolina and Utah is expected shortly.

Author's Note: Income Apportionment Consideration

Rarely do taxpayers apportion exactly 100 percent of their income due to differing rules and treatment of certain transactions by different taxing jurisdictions.

The "Relief Provision"

Section 18 of UDITPA is commonly referred to as the relief provision because it provides for modification of the formula.

If the allocation and apportionment provisions of the UDITPA do not fairly represent the extent of the taxpayer's business activity in this state, the taxpayer may petition for, or the tax administrator may require, in respect to all or any part of the taxpayer's business activity, if reasonable,

- separate accounting,
- the exclusion of any one or more of the factors,
- the inclusion of one or more additional factors which will fairly represent the taxpayer's business activity in the state, or
- the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.

The taxpayer may petition for relief under Section 18 of UDITPA or the tax administrator may require "with respect to all or any part of the taxpayer's business activity, use of separate accounting, exclusion of any one or more of the factors, inclusion of one or more additional factors, or employment of any other method that will result in an equitable allocation and apportionment of the taxpayer's income." Because most courts provide a presumption of correctness on the part of the state, it is not surprising that tax administrators have been more successful invoking Section 18 relief than have taxpayers. See, for example, *Hans Rees' Sons, Inc. v. North Carolina*, 283 U.S. 123 (1931); *Container Corp. of America v. Franchise Tax Board*, 463 U.S. 159 (1983); and *Crocker Equipment Leasing v. Department of Revenue*, SC S38059 (Or. Aug. 20, 1992). Given the long history, as illustrated by the previous cases, of taxpayers failing in their efforts to receive "Section 18 relief," it was surprising to see a taxpayer, not only win relief, but to win relief based on combined filing in a separate-filing state.

South Carolina has traditionally been a separate-filing state and has rebuffed past attempts by taxpayers to file a combined report there. See *NCR Corp. v. South Carolina*, 402 S.E.2d 666 (1991), and *NCR Corp. v. South Carolina*, 439 S.E.2d 254 (1993), often known as NCR I and NCR II. However, since the NCR decisions, the state had enacted into South Carolina law an identical version of "Section 18 relief" at S.C. Code § 12-6-2320(A). Because the statute now provided for "the employment of any other method to effectuate an equitable allocation and apportionment" of income, Media General Communications petitioned, pursuant to an audit, for the use of combined reporting. While the department of revenue agreed with the taxpayer that separate filing did not fairly reflect the taxpayer's income and

that combined reporting did do so, the department declined to allow the taxpayer to use the latter method on the grounds that, as a separate-filing state, it did not have the authority to permit combined filing. The South Carolina Supreme Court ruled in favor of Media General stating that because the statute provided for "any other method," the plain language of the law provided for combined filing. In addition to the language of the statute, the court pointed out that both parties had stipulated that combined filing more fairly reflected income than separate filing, that the state had not offered any other filing methodology, and that the U.S. Supreme Court had recognized combined filing apportionment as an acceptable methodology for apportioning a company's income.[15]

How Much Distortion Is Enough?

Is there even enough distortion to overcome a state's apportionment methodology? That was the question facing the U.S. Supreme Court in *Hans Rees*.[16] *Hans Rees* was a victory for the taxpayer. Admittedly, there have not been many. In this case, North Carolina used a single factor—property—to apportion the income of a company with a manufacturing plant in North Carolina and its corporate offices in New York. Using its single formula, the state determined that 85 percent of the company's income was taxable in North Carolina. Hans Rees was able to show that only 20 percent of its income came from its manufacturing activities in North Carolina. Apparently, the gulf between 20 percent and 85 percent was such that the court held for Hans Rees, stating that apportionment formulas cannot be "intrinsically arbitrary," "unreasonable," or tax extraterritorial income. "The difficulty of making an exact apportionment is apparent and hence, when the State has adopted a method not intrinsically arbitrary, it will be sustained until proof is offered of an unreasonable and arbitrary application in particular cases."

The Treatment of Factors in Partnerships

The key question for partnerships is whether the apportionment and allocation take place at the partnership or partner level. Most states require apportionment and allocation at the partner level. For example, if a corporation owns 30 percent of a partnership, it simply picks up its share of the partnership's income and adds its 30 percent share of the partnership's factors (sales, property, and payroll) to its own.

[15] See *Media General v. South Carolina*, 694 S.E.2d 525 (2010).

[16] *Hans Rees' Sons, Inc. v. North Carolina*, 286 U.S. 123 (1931).

Example 5-4

Corporation A had $3,000,000 in taxable income last year and does business in states X and Y. Its factors are as follows:

	State X	State Y	Total
Sales	10,000,000	15,000,000	25,000,000
Property	3,000,000	4,000,000	7,000,000
Payroll	500,000	700,000	1,200,000

Corporation A owned 30 percent of Partnership B. Partnership B had $900,000 of taxable income and did business in states Y and Z. Its factors are as follows:

	State Y	State Z	Total
Sales	3,000,000	1,000,000	4,000,000
Property	600,000	900,000	1,500,000
Payroll	300,000	150,000	450,000

After adding its 30 percent share of Partnership B to its own activities, Corporation A will have $3,270,000 in taxable income and its apportionment factors will look like this:

	State X	State Y	State Z	Total
Sales	10,000,000	15,900,000	300,000	26,200,000
Property	3,000,000	4,180,000	270,000	7,450,000
Payroll	500,000	790,000	45,000	1,335,000

The income for State Y, which uses an equally-weighted three-factor formula, would be $1,918,182, calculated as follows:

	State Y	Total	Appt %
Sales	15,900,000	26,200,000	60.69
Property	4,180,000	7,450,000	56.11
Payroll	790,000	1,335,000	59.18
Total			175.98
Divided by 3 equals			58.66%

$3,270,000 × 58.66% = $1,918,182

Example 5-5

If the allocation and apportionment is done at the partnership level, the corporate partner simply adds the partnerships' resulting state income to the corporation's income for that state.

Using the numbers in the preceding example, Corporation A's taxable income for State Y would be:

	State Y	Total	Appt %
Sales	15,000,000	25,000,000	60.00
Property	4,000,000	7,000,000	57.14
Payroll	700,000	1,200,000	58.33
Total			175.47
Divided by 3 equals			58.49%

$3,000,000 × 58.49% = $1,754,700

Calculation of Partnership B's State Y income:

	State Y	Total	Appt %
Sales	3,000,000	4,000,000	75.00
Property	600,000	1,500,000	40.00
Payroll	300,000	450,000	66.67
Total			181.67
Divided by 3 equals			60.56%

$900,000 × 60.56% = $545,040

Corporation A's Total Taxable Income for State Y

From Corporation A:	$1,754,700
From Partnership B:	545,040
Total	$2,299,740

The preceding example assumed that the corporation and partnership were not unitary, nor were there any intercompany sales between the corporation and the partnership. Naturally, things become more complicated if there is a unitary relationship or intercompany sales. The majority of states simply do not address such issues either in their statutes, regulations, rulings, or policies. These states often follow the lead of larger states, such as California, that do address these issues. Appendix 2 is a portion of California Regulation 25137-1, which contains several helpful examples of how to calculate the appropriate corporate income of a partnership interest.

Appendix 1: Apportionment Formulas and Corporate Tax Rates by State

State	Formula*
Alabama	Three-factor formula; double-weighted sales
Alaska	Three-factor formula
Arizona	Three-factor formula; double-weighted sales; or enhanced sales factor formula of 80-10-10
Arkansas	Three-factor formula; double-weighted sales
California	Three-factor formula; double-weighted sales; single sales factor available upon election
Colorado	Single sales factor
Connecticut	Three-factor formula; double-weighted sales; single sales factor apportionment for nonproperty income
Delaware	Three-factor formula
District of Columbia	Three-factor formula
Florida	Three-factor formula; double-weighted sales
Georgia	Single sales factor
Hawaii	Three-factor formula
Idaho	Three-factor formula; double-weighted sales
Illinois	Single sales factor
Indiana	Single sales factor to be phased in by 2011; for 2009 three factor formula is 90-5-5
Iowa	Single sales factor
Kansas	Three-factor formula
Kentucky	Three-factor formula; double-weighted sales
Louisiana	Generally a single sales factor but varies with industry
Maine	Single sales factor
Maryland	Three-factor formula; double-weighted sales; single sales factor for manufacturers
Massachusetts	Three-factor formula; double-weighted sales
Michigan	Single sales factor
Minnesota	90% Sales, 5% Property, 5% Payroll for 2011
Mississippi	Generally a single sales factor but varies with industry
Missouri	Three-factor formula
Montana	Three-factor formula

State	Formula*
Nebraska	Single sales factor
Nevada	No income tax
New Hampshire	Three-factor formula; double-weighted sales
New Jersey	Three-factor formula; double-weighted sales
New Mexico	Three-factor formula; double-weighted sales factor for manufacturers
New York	Single sales factor
North Carolina	Three-factor formula; double-weighted sales
North Dakota	Three-factor formula
Ohio	Three-factor formula; triple-weighted sales
Oklahoma	Three-factor formula
Oregon	Single sales factor
Pennsylvania	90% Sales, 5% Property, 5% Payroll
Rhode Island	Three-factor formula
South Carolina	Single sales factor
South Dakota	No income tax
Tennessee	Three-factor formula; double-weighted sales
Texas	Single sales factor
Utah	Three-factor formula; may elect to double-weight sales
Vermont	Three-factor formula; double-weighted sales
Virginia	Three-factor formula; double-weighted sales
Washington	No income tax
West Virginia	Three-factor formula; double-weighted sales
Wisconsin	Single sales factor
Wyoming	No income tax

* Most states have special provisions for certain industries such as airlines, contractors, publishing, transportation, television and radio, and financial institutions. In addition, many states (such as Minnesota) are moving towards a single sales factor. Other states offer special provisions tied to investment. Arizona, for example, allows for corporations making investments in state in excess of $1 billion, additional weighting of the sales factor. These details are beyond the scope of this chart.

State	Corporate Income Tax Rate (%)
Alabama	6.5
Alaska	1.0 to 9.4
Arizona	6.968
Arkansas	1.0 to 6.5
California	8.84
Colorado	4.63
Connecticut	7.5
Delaware	8.7
District of Columbia	9.975
Florida	5.5
Georgia	6.0
Hawaii	4.4 to 6.4
Idaho	7.6
Illinois	7.0 for 2011
Indiana	8.5
Iowa	6.0 to 12.0
Kansas	4.0
Kentucky	4.0 to 6.0
Louisiana	4.0 to 8.0
Maine	3.5 to 8.93
Maryland	8.25
Massachusetts	8.25
Michigan	4.95 + 0.8
Minnesota	9.8
Mississippi	3.0 to 5.0
Missouri	6.25

State	Corporate Income Tax Rate (%)
Montana	6.75
Nebraska	5.58 to 7.81
Nevada	No income tax
New Hampshire	8.5
New Jersey	6.5 to 9.0
New Mexico	4.8 to 7.6
New York	7.1
North Carolina	6.9
North Dakota	1.68 to 5.15
Ohio	N/A
Oklahoma	6.0
Oregon	6.6 to 7.6
Pennsylvania	9.99
Rhode Island	9.0
South Carolina	5.0
South Dakota	No income tax
Tennessee	6.5
Texas	0.5 or 1.0
Utah	5.0
Vermont	6.0 to 8.5
Virginia	6.0
Washington	No income tax
West Virginia	8.5
Wisconsin	7.9
Wyoming	No income tax

Appendix 2: 25137-1. Apportionment and Allocation of Partnership Income

(a) In General.

When a taxpayer has an interest in a partnership as defined in Section 17008, Revenue and Taxation Code, the division of its distributive share of partnership items shall be determined in accordance with Chapter 10 of Part 10 of Division 2 of the Revenue and Taxation Code. The determination of the portion of such distributive share (constituting business and nonbusiness income) which has its source in this state or which is includable in the taxpayer's business income subject to apportionment, shall be made in accordance with these regulations provided that the taxpayer, or the partnership, or both, have income from sources within and without this state. The taxpayer in computing net income for its income year shall include its distributive share of partnership items referred to above for any partnership year ending within or with the taxpayer's income year.

The first step is to determine which portion of the taxpayer's income and its distributive share of the partnership items constitute "business income" and "nonbusiness income" under Section 25120, Revenue and Taxation Code, and the regulations thereunder. The various items of nonbusiness income are then directly allocated to specific states pursuant to the provisions of Section 25124 to 25127, Revenue and Taxation Code. The taxpayer's distributive share of partnership business income is apportioned by the formula set forth in subsections (f) or (g), whichever is applicable. The sum of

(1) the items of nonbusiness income directly allocated to this state, plus

(2) the amount of business income attributed to this state is the portion of the taxpayer's entire net income which is subject to tax.

Income arising from transactions and activity in the regular course of the partnership's trade or business constitutes business income. Thus, a corporate-partner's distributive share of partnership business income constitutes business income to the corporate-partner, but the determination of whether the partnership's activities and the activities of the corporate-partner constitutes a single trade or business or more than one trade or business turns on the facts in each case. If the partnership's activities and the taxpayer's activities constitute a unitary business under established standards, disregarding ownership requirements, the taxpayer's share of the partnership's trade or business shall be combined with the taxpayer's trade or business as constituting a single trade or business.

Example 1: Corporation A's distributive share of income in partnership P is 20%. Corporation A manufactures toys which are sold in the seven western states by partnership P. Corporation A's business income for the year was $1,000,000 and partnership P's business income for the same year was $800,000. The business income of Corporation A is $1,160,000 ($1,000,000 plus 20% of $800,000).

Example 2: Corporation A's distributive share of income in partnership P is 90%. Partnership P manufactures toys of which approximately 30% are sold by Corporation A in the seven western states. The remainder is sold to outsiders by partnership P. In addition, Corporation A also sells other lines of toys not manufactured by partnership P. Corporation A handles all financing, management, accounting, advertising, and purchasing functions for partnership P as well as for itself. Corporation A incurred a loss of $500,000 for the year but partnership P's income was $1,000,000. The business income of Corporation A is $400,000 (90% of $1,000 = $900,000 less the loss of $500,000).

When the activities of the partnership and the taxpayer do not constitute a unitary business under established standards, disregarding ownership requirements, the taxpayer's share of the partnership's trade or business shall be treated as a separate trade or business of the taxpayer. In such a case the taxpayer is engaged in two trades or businesses.

Corporation A's distributive share of income in partnership P is 20%. Corporation A manufactures and sells toys in the seven western states. Partnership P operates farms within and without this state. Corporation A's income for the year is $1,000,000 and partnership P's income is $800,000 for the same year. Corporation A is engaged in two trades or businesses, and will be required to apportion its income of $1,000,000 from its own operations to this state on the basis of a three factor apportionment formula. Partnership P would attribute part of its business income of $800,000 to this state on the basis of its own three factor apportionment formula. Accordingly, Corporation A would report 20% of the partnership income apportioned to this state plus a portion of its income from its toy manufacturing business.

* * * * *

(f) Apportionment of business income—single trade or business.

If the partnership's activities and the taxpayer's activities constitute a unitary business under established standards, disregarding ownership requirements, the business income or such single trade or business attributable to this state shall be determined by a three factor formula consisting of property, payroll and sales of the taxpayer and its share of the partnership's factors for any partnership year ending within or with the taxpayer's income year as follows:

(1) Property factor.

In general the numerator and denominator of the property factor shall be determined as set forth in Regulations 25129 to 25131, inclusive, and 25137(b). However, the following special rules shall apply:

(A) A portion of the partnership's real and tangible personal property, both owned or rented and used during the income year in the regular course of such trade or business, to the extent of the taxpayer's interest in the partnership, shall be included in the denominator of the taxpayer's property factor. The value of such property located in this state shall also be included in the numerator of the property factor.

(B) The value of property which is rented or leased by the taxpayer to the partnership or vice versa shall, with respect to the taxpayer, be excluded from the property factor of the partnership or eliminated to the extent of the taxpayer's interest in the partnership, whatever the case may be, in order to avoid duplication.

Example 1: Corporation A's interest in partnership P is 20%. Corporation A's distributive share of partnership P's income is included in business income of Corporation A to be apportioned by formula. Corporation A owns a building (original cost of $100,000) which is rented to partnership P for $12,000 per year. Corporation A must include the original cost of $100,000 for the building in its property factor. Therefore, no portion of the value of the rented property will be reflected in the property factor of Corporation A.

Example 2: Same facts as in Example 1 except partnership P owns the building and rents it to Corporation A. Corporation A will include $20,000 (20% of $100,000) in its property factor because of its interest in partnership P. In addition, Corporation A will take into account $9,600 ($12,000 less 20% thereof) of rental expense into its property factor in order to give weight in the property factor to the rented building used in Corporation A's operation. Thus, the value of the building to be used in the property factor of Corporation A is $96,800 ($20,000 plus 8 × $9,600).

(2) Payroll factor.

In general the numerator and denominator of the payroll factor shall be determined as set forth in Regulations 25132 and 25133. However, the following special rules shall apply:

The partnership's payroll used to produce business income, shall be included in the denominator of the taxpayer's payroll factor to the extent of the taxpayer's interest in the partnership. The amount of any such payroll applicable to this state shall also be included in the numerator of the taxpayer's payroll factor.

Example 1: Corporation A's interest in partnership P is 20% and its distributive share of partnership P's income is included in business income of Corporation A to be apportioned by formula. Corporation A's own payroll is $1,000,000 and the payroll of partnership P is $800,000. Corporation A's total payroll for purposes of the payroll factor is $1,160,000 ($1,000,000 plus 20% of $800,000).

(3) Sales factor.

In general the numerator and denominator of the sales factor shall be determined as set forth in Regulations 25134 to 25136, inclusive, and 25137(c). However, the following special rules shall apply:

(A) The partnership's sales which give rise to business income, shall be included in the denominator of the taxpayer's sales factor to the extent of the taxpayer's interest in the partnership. The amount of such sales attributable to this state shall also be included in the numerator of the taxpayer's sales factor. Intercompany sales between the partnership and the taxpayer shall be eliminated from the denominator and numerator of the taxpayer's sales factor as follows:

(i) Sales by the taxpayer to the partnership to the extent of the taxpayer's interest in the partnership.

(ii) Sales by the partnership to the taxpayer not to exceed the taxpayer's interest in all partnership sales.

(B) Notwithstanding any intercompany eliminations described in subparagraph (A) above, sales made to nonpartners shall be included in the denominator of the taxpayer's sales factor in an amount equal to such taxpayer's interest in the partnership.

(C) Application of the above rules is illustrated by the following examples:

Example 1: Corporation A's interest in partnership P is 20%, and its distributive share of partnership P's income is included in business income of Corporation A to be apportioned by formula. Corporation A's sales were $20,000,000 for the year, $5,000,000 of which were made to partnership P. Partnership P made sales of $10,000,000 during the same year, none of which were to Corporation A or the other partner(s). The denominator of Corporation A's sales factor is $21,000,000 determined as follows:

Sales by Corporation A	$20,000,000
Add: Corporation A's interest (20%) in Partnership P's sales	2,000,000
Less: Corporation A's interest (20%) in Corporation A's sales to Partnership P	<1,000,000>
Denominator of Sales Factor	$21,000,000

Example 2: The following facts are applicable to Examples 2(a) to (c), inclusive. Corporation A's interest in partnership P is 20% and Corporation B's interest is 80%. The distributive share of partnership income is included in business income of Corporation A and Corporation B, respectively.

(a) The sales made by Corporation A, Corporation B, and Partnership P are as follows:

Corporation A		$20,000,000
Corporation B		60,000,000
Partnership P:		
To Corporation A	$2,000,000	
To Corporation B	8,000,000	
		$10,000,000

The denominator of Corporation A's sales factor is $20,000,000 determined as follows:

Sales by Corporation A	$20,000,000
Add: Corporation A's interest (20%) in Partnership P's sales	2,000,000
Less: Partnership P's Sales to Corporation A	<2,000,000>
Denominator of Corporation A's sales factor	$20,000,000

The denominator of Corporation B's sales factor is $60,000,000 determined as follows:

Sales by Corporation B	$60,000,000
Add: Corporation B's interest (80%) in Partnership P's sales	8,000,000
Less: Partnership P's sales to Corporation B	<8,000,000>
	$60,000,000

(b) The sales made by Corporation A, Corporation B, and Partnership P are as follows:

Corporation A		$20,000,000
Corporation B		60,000,000
Partnership P:		
To Corporation A	$1,000,000	
To Corporation B	9,000,000	
		$10,000,000

The denominator of Corporation A's sales factor is $21,000,000 determined as follows:

Sales by Corporation A	$20,000,000
Add: Corporation A's interest (20%) in Partnership P's sales	2,000,000
Less: Partnership P's sales to Corporation A	<1,000,000>
Denominator of Corporation A's sales factor	$21,000,000

The denominator of Corporation B's sales factor is $60,000,000 determined as follows:

Sales by Corporation B	$60,000,000
Add: Corporation B's interest (80%) in Partnership P's sales	8,000,000
Less: Intercompany sales between Partnership P and Corporation B*	<8,000,000>
Denominator of Corporation B's sales factor	$60,000,000

(c) The sales made by Corporation A, Corporation B, and Partnership P are as follows:

Corporation A	$20,000,000
Corporation B	80,000,000

Partnership P:	
To Corporation A	$3,000,000
To Corporation B	6,000,000
To Corporation X	1,000,000
	$10,000,000

The denominator of Corporation A's sales factor is $20,200,000 determined as follows:

Sales by Corporation A	$20,000,000
Add: Corporation A's interest in Partnership P's sales to Nonpartner X Corporation (20% × $1,000,000)	200,000
Corporation A's interest in Partnership P's sales to Partners (20% × $9,000,000)	1,800,000
Less: Intercompany sales from Partnership P to Corporation A*	<1,800,000>
Denominator of Corporation A's sales factor	$20,200,000

The denominator of Corporation B's sales factor is $81,800,000 determined as follows:

Sales by Corporation B	$80,000,000
Add: Corporation B's interest in Partnership P's sales to Nonpartner X Corporation (80% × $1,000,000)	800,000
Corporation B's interest in Partnership P's sales to Partners (80% × $9,000,000)	7,200,000
Less: Intercompany sales from Partnership P to Corporation B	<6,000,000>
Denominator of Corporation B's sales factor	$82,000,000

* Not to exceed taxpayer's interest in Partnership P's sales.

* * * * *

(5) Common accounting period.

If a partnership and a corporation are engaged in a unitary business and their accounting periods are different, if necessary, in order to avoid distortion, the income and factors of the partnership will be determined on the basis of the corporate partner's accounting period.

(g) Apportionment of business income – two or more trades or businesses.

When the activities of the partnership and the taxpayer do not constitute a unitary business under established standards, disregarding ownership requirements, the taxpayer's share of the partnership's trade or business shall be treated as another trade or business of the taxpayer. The determination of the amount of the partnership's business income and the taxpayer's distributive share of that income attributable to sources within this state shall be as follows:

(1) If the partnership derives business income from sources within and without this state, the amount of business income derived from sources within this state shall be determined on the basis of a three factor formula of property, payroll and sales. The factors shall be determined in accordance with the provisions of Section 25129 to 25137, inclusive, Revenue and Taxation Code, and the regulations thereunder. After determining the amount of business income attributable to this state by the three factor formula, the taxpayer's distributive share of such business income shall be reported as business income from a separate business by the taxpayer. That income when added to the taxpayer's other business income apportioned to this state and nonbusiness income allocable to this state is the taxpayer's measure of tax for its income year.

Corporation A's distributive share of income in partnership P is 20%. Partnership P derives income from sources within and without this state but its business is unrelated to the business of Corporation A. Partnership P has business income of $500,000 for the year of which 40% is apportioned to this state by its three factor formula of property, payroll and sales. Corporation A shall include in its measure of tax its income received from partnership P $40,000 ($500,000 × 40% × 20).

(2) If the partnership derives business income from sources entirely within this state, or entirely without this state, such income shall not be subject to formula apportionment. The taxpayer's distributive share of such business income attributable to this state (if any) shall be added to the taxpayer's other business income apportioned to this state plus nonbusiness income, if any, allocable to this state, the total of which is the taxpayer's measure of tax for its income year.

Example 1: Corporation A's distributive share of income in partnership P is 20%. The distributive share of P's business income is not an integral part of A's trade or business so as to be considered one business. Corporation A derives business income from sources within and without this state. Partnership P is engaged in business wholly within this state. Corporation A's business income for the year is $5,000,000 of which 50% is apportioned to this state. Partnership P has a loss on its operations for the same year of $500,000. Corporation A's measure of tax is $2,400,000 ($5,000,000 × 50% = $2,500,000 × $100,000 ($500,000 × 20%)).

Example 2: Same facts as in Example 1 except partnership P operates its business wholly outside this state. Corporation A's measure of tax is $2,500,000 ($5,000,000 × 50%) as no portion of partnership P's loss is attributable to this state.

6

Basic Ideas of Multistate Income Tax Planning

Introduction

State and local taxes have, for many companies, become a much larger expense than federal taxes. In addition, the state and local field has become a "growth industry" with no end to the growth in sight, as state and local governments increasingly find their budgets strapped for cash. As a consequence, increased attention has been focused the past few years on reducing state tax liabilities.

We engage in this effort keeping in mind the oft-quoted words of Judge Learned Hand that "any one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes."[1]

Finally, any tax planning strategy must be considered in light of overall company objectives, implementation costs, administrative complexity, practical realities, economic substance, and business purpose. In our enthusiasm to save on taxes, we often forget that businesses do not exist to minimize taxes. Reducing a company's tax burden is only one of many tools used by management to achieve a company's larger objectives.

Identifying Goals and Methodologies

General Planning Goal

Our general planning goal is to shift income from states with high taxes to those with low tax rates by either moving income away from those states, decreasing the apportionment factors in those high rate states, or capitalizing on the inconsistencies among the states in their treatment of the unitary concept; business or nonbusiness income; state modifications; payroll, property, and sales factors; and filing elections.

[1] *Helvering v. Gregory*, 69 F.2d 809 (1934).

Specific Tactics

Review Your Factors

Examine the makeup and application of your apportionment factors. Can you isolate payroll, property, or sales that generate nonbusiness income from business income? Once separated, identify the allocation rules of the states in which you are doing business. Sometimes simple identification and separation will result in savings.

Compare, for example, the interaction of your specific sales factor with your state's treatment of such items as drop shipments, dock sales, throwbacks, throwouts, and cost-of-performance related to service sales. Savings are sometimes possible by changing the method or location of shipment and delivery. Identify property which is obsolete and remove it from your property factor. Check to see if leasing employees in your state will lower your payroll factor or whether certain employees can be replaced with independent contractors. The latter are not included in the payroll factor. Double-check to make sure that property or payroll that is generating nonbusiness income is not included in your apportionment factors for business income.

The overall goal in reviewing your factors is to move either operations or highly profitable activities into low-tax states and operations or activities that generate losses or low-profit margins into high-tax states. Computer spreadsheet models are particularly helpful in performing various "if-this-then-that" analyses. The following simple examples illustrate the benefits of shifting a company's factors.

Example 6-1

High-Value, Inc., does business in two states, A and B. State A has a 10 percent income tax rate, and State B has a 5 percent income tax rate. Both states utilize a traditional three-factor formula that equally weights sales, property, and payroll. High-Value manufactures, stores, and distributes its products in State A. The operations in State B are largely limited to sales, repair, and maintenance activities. The company's taxable income is $10,000,000, and its activities within the two states are as follows:

	State A	State B	Total
Sales	$70,000,000	$20,000,000	$90,000,000
Property	5,000,000	1,500,000	6,500,000
Payroll	3,000,000	1,000,000	4,000,000

High-Value's tax liability for both states currently totals $882,850.

	State A	State B
Sales factor	77.78%	22.22%
State A ($70,000,000/$90,000,000)		
State B ($20,000,000/$90,000,000)		
Property factor	76.92%	23.08%
State A ($5,000,000/$6,500,000)		
State B ($1,500,000/$6,500,000)		

	State A	State B
Payroll factor	75.00%	25.00%
State A ($3,000,000/$4,000,000)		
State B ($1,000,000/$4,000,000)		
Sum of apportionment factors	229.7%	70.3%
Divided by 3	÷ 3	÷ 3
Equals state apportionment percentage	76.57%	23.43%
Times business income	$10,000,000	$10,000,000
Equals state taxable income	$ 7,657,000	$ 2,343,000
Times state tax rate	10%	5%
State income tax	$ 765,700	$ 117,150

Example 6-2

If High-Value, Inc., were to move its inventory and distribution center, and research and development operations representing $2,000,000 in property, and $800,000 in payroll from State A to State B, its factors and apportionment would change as follows:

	State A	State B	Total
Sales	$70,000,000	$20,000,000	$90,000,000
Property	3,000,000	3,500,000	6,500,000
Payroll	2,200,000	1,800,000	4,000,000

	State A	State B
Sales factor	77.78%	22.22%
State A ($70,000,000/$90,000,000)		
State B ($20,000,000/$90,000,000)		
Property factor	46.15%	53.85%
State A ($3,000,000/$6,500,000)		
State B ($3,500,000/$6,500,000)		
Payroll factor	55.00%	45.00%
State A ($2,200,000/$4,000,000)		
State B ($1,800,000/$4,000,000)		
Sum of apportionment factors	178.93%	121.07%
Divided by 3	÷ 3	÷ 3
Equals state apportionment percentage	59.64%	40.36%

(continued)

Example 6-2 ***(continued)***

	State A	State B
Times business income	$10,000,000	$10,000,000
Equals state taxable income	$ 5,964,000	$ 4,036,000
Times state tax rate	10%	5%
State income tax	$ 596,400	$ 201,800

High-Value's tax liability for both states is now $798,200, a savings of $84,650 ($882,850 – $798,200).

Given that only 12 states and the District of Columbia still use equally weighted factors in their apportionment formulas, it is more critical than ever to analyze a company's operations in light of their impact on its apportionment factors. The following examples illustrate the dramatic distortion that can occur by doing business in states that double-weight the sales factor or those that use just sales as a single factor.

Example 6-3

High-Value, Inc., does business in two states, A and B. State A has a 10 percent income tax rate and State B has a 5 percent income tax rate. State A uses a single factor sales, and State B uses a traditional three-factor formula that equally weights sales, property, and payroll. High-Value manufactures, stores, and distributes its products in State A. The operations in State B are largely limited to sales, repair, and maintenance activities. The company's taxable income is $10,000,000, and its activities within the two states are as follows:

	State A	State B	Total
Sales	$70,000,000	$20,000,000	$90,000,000
Property	5,000,000	1,500,000	6,500,000
Payroll	3,000,000	1,000,000	4,000,000

High-Value's tax liability for both states currently totals $894,950.

	State A	State B
Sales factor	77.78%	22.22%
State A ($70,000,000/$90,000,000)		
State B ($20,000,000/$90,000,000)		
Property factor	N/A	23.08%
State A N/A		
State B ($1,500,000/$6,500,000)		
Payroll factor	N/A	25.00%
State A N/A		
State B ($1,000,000/$4,000,000)		

	State A	State B
Sum of apportionment factors	77.78%	70.3%
Divided by 3	N/A	÷ 3
Equals state apportionment percentage	77.78%	23.43%
Times business income	$10,000,000	$10,000,000
Equals state taxable income	$ 7,778,000	$ 2,343,000
Times state tax rate	10%	5%
State income tax	$ 777,800	$ 117,150

Reversing the percentages in the previous example illustrates the dramatic impact these factors have on a company's tax liability.

Example 6-4

High-Value's tax liability for both states currently totals $623,200.

	State A	State B
Sales factor	22.22%	77.78%
Property factor	23.08%	N/A
Payroll factor	25.00%	N/A
Sum of apportionment factors	70.3%	77.78%
Divided by 3	÷ 3	N/A
Equals state apportionment percentage	23.43%	77.78%
Times business income	$10,000,000	$10,000,000
Equals state taxable income	$ 2,343,000	$ 7,778,000
Times state tax rate	10%	5%
State income tax	$ 234,300	$ 388,900

Review Where You Are Doing Business

Nexus usually has bad connotations. We generally think of it as something you do not want to create. But that is not necessarily true. By creating nexus in a lower tax rate or no tax state, you can decrease your total state and local tax liability. For example, if your Colorado company makes mail-order sales into Wyoming, send an employee up there and deliberately create nexus. Doing so will allow you to apportion your income between Colorado and Wyoming (which, of course, has no income tax).

On the other hand, if your company is in a state in which you have limited sales activities, perhaps a single salesperson or small office, you may be able to break nexus with that state by closing the office and having the sales personnel operate out of their homes. The obvious rule here is to avoid nexus in high-tax states and create nexus in low-tax states.

Examine your state's cost-of-performance rules for service sales. Can you reduce your income by shifting costs between Uniform Division of Income for Tax Purpose Act (UDITPA) (all-or-nothing test) states and those which have adopted the Multistate Tax Commission (MTC) proportional allocation method? For example, if based on cost of performance, service income is apportioned 30 percent to State A, 30 percent to State B, and 40 percent to State C, then, under UDITPA's rules, all the income is sourced to State C. However, there may be non-UDITPA states that simply allocate the service income to the state where more than 50 percent of the cost of performance occurs. In this case, the sale would not be allocated to any state because no state has more than 50 percent of the cost of performance. Other states may source the service income to the state of the recipient. Finally, if the three states have adopted the MTC's rules (MTC Regulation IV.17[B]), then the service income is divided among the states based upon their apportioned percentage. As a consequence, depending upon the states and the cost of performance measurement, some service sales may be counted in more than one state.

Have you checked your state's rules on executive compensation or payroll throwbacks?

> ***Author's Note: Legal Considerations and Nexus***
>
> ***Be sure to check with your legal department before you go around creating nexus. There may be other business reasons, known only to your staff attorneys, for avoiding nexus in particular states.***

Move Income From Separate Filing States Into Combined Reporting States

Here are three examples. First, if your company is operating in a separate filing state and it owns a subsidiary operating in a combined filing state, sell property to the subsidiary and then lease it back. Your income in the combined reporting state will, of course, not change because the rental income of the subsidiary is offset by the rental expense of the parent. Your income, however, in the separate filing state will be reduced by the lease expense and decreased property factor. Second, if your company is considering selling an asset with a large capital gain, drop the asset down into an existing subsidiary in a low- or no-tax state. When the subsidiary sells the asset, deem the capital gain to be allocable nonbusiness income to the low- or no-tax state. Or break some of the ties between the parent and subsidiary and deem the latter to be nonunitary. Finally, create a unitary relationship with those subsidiaries which have losses or net operating losses.

Review the Tax Credits Available in the States in Which You Are Doing Business

It sounds simple. It is. And it is often overlooked. If you are wondering whether you are taking advantage of all the credits and incentives a jurisdiction offers, don't call the revenue department with questions, call the Department of Economic Development for that state, county, or city. Economic development agencies are happy to be of assistance and often

have gathered together in one publication brief summaries of all the tax deductions, credits, and incentives available. Use that publication to jump start or supplement your research into statutes, regulations, and cases.

Review Your State's Filing Elections

In addition to trying to match up for-profit divisions with loss operations, be sure to review your state's filing methods. Check to see if filing consolidated or combined reports will decrease your total tax bill. Make sure you are only including companies with nexus in "nexus-consolidated return" states and that all the proper elections have been made. Again, a simple step to take, but one often missed in the rush to file on time.

Unique State Provisions

The AICPA Tax Section provides an annual C Corporation Checklist for tax preparers that some taxpayers use as a template, a road map if you will, to identify the key areas that not only should be an object of tax prep review, but also a framework for building a framework for various tax planning projects. (See appendix E for a copy of the checklist.)

The prudent tax preparer is always aware that, given the number of states and their various and often inconsistent rules, there is no alternative to state-by-state research. Such research will often turn up unique state provisions. Some examples include the following:

- Alabama includes in its sales factor the gross proceeds from the sale of fixed assets, rather than the gain or loss.
- The Arizona consolidated return includes all the affiliated members of the federal consolidated return regardless of whether a member has nexus in Arizona or not.
- Arkansas has not adopted Internal Revenue Code (IRC) § 199.
- California does not allow consolidated returns but does require combined reports of a unitary group.
- California's interest offset rule was declared unconstitutional so, when direct tracing of interest is not possible, the taxpayer must use a proportional method based on gross income or assets.
- California taxes interest on federal and state and local bonds.
- In sourcing throwbacks, California started as a *Joyce* state, then became a *Finnigan* state, and then went back to being a *Joyce* state. Beginning January 1, 2011, California is a *Finnigan* state again.[2]
- California includes in its property factor property owned by the federal government but used by the taxpayer.[3]

---

[2] The terms "*Joyce* state" and "*Finnigan* state" come from two court cases in California: *Appeal of Joyce, Inc.*, No. 66-SBE-070 (Cal. State Bd. of Equalization Nov. 23, 1966), and *Appeal of Finnigan Corp.*, No. 88-SBE-022 (Cal. State Bd. of Equalization Aug. 25, 1988), *on reh'g*, Jan. 24, 1990. See the discussion in chapter 5.

[3] See *Appeal of Union Carbide Corp.*, No. 93-SBE-003 (Cal. State Bd. of Equalization Jan. 13, 1993), and *Appeal of Union Carbide Corp.*, No. 84-SBE-057 (Cal. State Bd. of Equalization Apr. 5, 1984).

- Colorado adopted single sales factor apportionment for all years beginning on or after January 1, 2009. There are no more throwbacks for government sales.
- A group of affiliated corporations having nexus in Connecticut may elect to file a unitary combined report. The election is binding for five years.
- Florida allows a federal consolidated group to elect to file a consolidated return in Florida. However, the parent corporation must be subject to Florida tax in the year the election is made.
- Florida does not allow the elimination of intercompany sales in calculating the apportionment factors in a consolidated return.[4]
- A Florida final return should be filed only when a taxpayer is also filing a final federal return. Ceasing to do business in Florida does not mean the filing of a final return.
- Georgia has adopted the federal IRC as of January 1, 2009. As a consequence, none of the changes of the American Recovery and Reinvestment Act of 2009 or The Worker, Homeownership, and Business Assistance Act of 2009 are applicable.
- Georgia, Iowa, Maryland, and Minnesota source service sales, not based on cost of performance, but to the state in which the recipient of the services resides.
- Idaho provides for combined reporting but not consolidated returns.
- Unitary groups in Illinois can include S corporations and partnerships.
- Illinois has adopted market-based sourcing for its sales factor for tax years beginning on or after January 1, 2009.
- Indiana is a nexus consolidated state; that is, each member of the consolidated return must have nexus with Indiana.
- Iowa does not require sales into states in which a taxpayer is not taxable to be thrown back into the Iowa sales numerator.
- Effective January 1, 2008, Kansas's definition of business income includes the functional test as well as the transactional test.
- Louisiana does not recognize S corporations. S corporations must file as C corporations. Their income, however, can be excluded from tax if the S corporation shareholders file individual returns with the state.
- Maryland calculates income from the sale of intangibles by using an average of the property and payroll factors.[5]
- Maryland does not allow consolidated returns.
- Massachusetts has adopted combined reporting.
- Massachusetts' throwback rule does not require that the goods be shipped from Massachusetts.[6]
- Unitary groups must file combined reports under the Michigan Business Tax (MBT).
- Michigan businesses with gross receipts less than $350,000 are exempt from the MBT.
- Nevada does not have either an individual or corporate income tax. Let us move there.

---

[4] Fla. Admin. Code Ann. r. 12C-1.0155(1)(j) (2006).

[5] Md. Regs. Code tit. 03 § 04.03.08.C(d) (2006).

[6] Mass. Regs. Code tit. 830 § 63.38.1(9)(c)(2) (2006).

- New Jersey has repealed its "throwout" rule for tax years beginning on or after July 1, 2010.
- New York excludes officer compensation from its payroll factor.
- Pennsylvania provides more than one apportionment method for calculating its capital stock and franchise tax and corporate net income tax. Be sure to review your alternatives.
- Connecticut, Louisiana, Mississippi, New Jersey, and Rhode Island value property for the property factor at net book value, not historical cost.
- Texas sources intangible income to the payor's legal domicile.[7]
- Texas taxpayers with less than $300,000 in total revenue are exempt from the Texas Margin Tax (TMT).
- Texas has adopted combined reporting under its TMT.
- Taxable entities in Texas now include partnerships, S corporations, and limited liability companies. (General partnerships with only natural persons as partners are exempt from the TMT.)

[7] 34 Tex. Admin. Code §§ 3.549(e)(3)(B), (e)(13) (2007) and §§ 3.557(e)(3)(B), (e)(13) (2007).

7

Audit Defense Strategies

Introduction

Going through an audit is, under the best of circumstances, always an adversarial process and not for the squeamish or weak of heart. The topics discussed in this guide are not pretty. Nevertheless, taxpayers and their advisers will find it useful to learn how audits get chosen, what auditors look for before they arrive, what they want to see once they do show up, and what, if anything, can be done about it.[1]

Audit Selection

Several things may prompt state or city taxing authorities to select a particular business for audit. First, and probably most frequent, is some sort of statistical modeling (kind of like winning a lottery, but not nearly as much fun). At the federal level, the IRS has its infamous statistical program—the computerized "discriminant function" (DIF) technique. The IRS selects returns for examination based on, for example, discrepancy with information returns, a history of deficiencies, random sampling, and the "questionable refund" program. Using DIF scores, the IRS ranks and selects returns having the greatest audit potential. With the IRS approach as a guide, many states and cities have fashioned their own models.

Formulas and Statistics

The process begins when taxpayers file their first sales tax or income tax return, and the data is entered, evaluated, and graded. Using formulas that everyone learned in college, but now generally have forgotten, the state or city tries to calculate which returns would likely produce the greatest yield on audit. Naturally, the formulas and analyses vary in sophistication, depending on the political jurisdiction involved. Although few people know exactly how these formulas are composed and applied, some uses are so common that they

---

[1] This material is reproduced, with the permission of the publisher, from the article by Bruce M. Nelson, titled "State and Local Audit Selection, Strategies, and Tactics," that appeared in the Journal of Multistate Taxation and Incentives, Vol. 9, No. 2, May 1999. Published by Warren, Gorham & Lamont, an imprint of Thomson Reuters. Copyright © 1999 RIA Group, Thomson Reuters/WG&L. All rights reserved.

are evident to anyone. For example, if a company is experiencing extremely rapid growth in sales or assets, an audit should not be a surprise. Face it—if a business is growing that quickly, mistakes are being made. Taxpayers know it, MBA students know it, and the government knows it.

Another example of statistical modeling is "trend analysis." By aggregating returns by industry, state revenue departments often can use trend analysis to spot specific taxpayer anomalies and assign audits accordingly. The technique is particularly helpful in cash-intensive businesses, such as restaurants and bars, for which trend analysis can highlight irregular relationships between sales, inventory, and cost of goods sold.

Prior Audits: Data from Outside Sources

Aside from the prosaic world of number crunching, several other situations may prompt a state to audit a particular company. Probably the most obvious is a previous audit. If the government found lots of mistakes, it will be back again and again until the taxpayer gets it right. Also consider, for example, a taxpayer's failure to charge a customer sales tax or the failure to issue 1099 forms. One generally would call those mistakes. An auditor examining the customer and finding the erroneous invoice or information omission, however, would call it an audit lead. In fact, for many small to medium businesses, it is these types of errors that usually trigger an audit. If, for example, you fail to properly charge sales tax to one of your customers and your customer is audited for sales and use tax, you can be sure that your error will probably lead to you being audited as well.

Audits also may be prompted by routine information exchanges between government entities. For example, the Federal Aviation Administration regularly reports on registration of aircraft, and a state's parks and recreation department may accumulate data on new boat registrations. (Was sales tax paid on those purchases?) Applicable regulatory agencies report information on licensed professionals such as CPAs, attorneys, doctors, and dentists. (One state found, for example, an unusually high number of income tax nonfilers among both attorneys and people who order vanity plates for their cars.) Also, departments of labor exchange wage and unemployment information, and secretaries of state provide data on bankruptcy filings. Counties and cities may report on the issuance of building permits. And last but not least, states maintain information exchange programs with the IRS. While all this exchange of information may sound scary, one may take some comfort in the fact that most large marketing and credit reporting agencies have more such information than the taxing authorities. Nevertheless, many state governments, like all good direct marketers, are beginning to buy that information.

And do not forget the proverbial "snitch." To avoid problems, happily married taxpayers should try to stay that way. Also, workers may be happy as long as they are employed. If any irregularities exist in a business, however, the next round of downsizing just may get that information to the local revenue department.

In any event, there is little that one can do to prevent an audit, other than following the common-sense rules of filing returns accurately and promptly. Prevention planning must begin long before a business is selected for audit, with accurate and complete recordkeeping, good internal control, and a competent and knowledgeable accounting staff.

The Pre-Audit

A taxpayer's initial contact with an auditor may be by telephone or letter, usually one followed by the other. In no case will an audit notice first be sent by e-mail. You should never be getting e-mails from revenue departments or auditors unless you have already established a relationship with the auditor or someone at the department. Once contacted by a revenue department, the taxpayer should take certain critical steps.

Whom to Contact

First, get the auditor's name, phone number, and e-mail address. This action may seem obvious, but it is amazing how often taxpayers fail to get this most basic information (people in shock are often like that).

Type of Tax: Audit Period

Second, find out precisely what taxes are under examination and for what period. For example, is it sales tax or use tax, income tax, or franchise tax? Some states' revenue departments encourage the examination of all state taxes (sales, use, withholding, and income being the most common) during one audit, thinking that this approach is more efficient (for example, like removing all four wisdom teeth on one visit to the dentist).

Required Documentation

Next, ask the auditor to specify exactly what records should be made available for examination. The initial answer will probably include every scrap of paper the business has. Nevertheless, any attempts to limit the scope of the audit should begin here.

Time and Place of Audit

Finally, settle on a mutually agreeable audit date and location. Generally, auditors schedule their examinations weeks, even months, in advance. Taxpayers also should allow plenty of time to prepare for the audit and to check staff scheduling and contact the company's outside tax professionals. Auditors should never be allowed to examine a taxpayer's records with only a day or two notice. Out-of-state auditors commonly bring "filler audits" with them when they travel. For example, a hard-working auditor from California on assignment in Colorado may finish one examination sooner than expected and call another local taxpayer to try and fit in another audit at the last minute. The taxpayer should be kind but should decline the auditor's invitation and suggest another, later date. Hard-working, conscientious auditors from out-of-state are to be admired but, perhaps, should be encouraged to take a little time to view the local scenery rather than show up on short notice to conduct the audit.

Once the audit is assigned and an appointment date established, the auditor will perform several pre-audit tasks, including

1. Reviewing any prior audits or department correspondence with the taxpayer.
2. Pulling a sampling of prior returns for review.

3. Determining all of the company's locations and taxing jurisdictions.
4. Learning exactly what the company's business is and how and where it is carried on.

The revenue agent should not be the only one doing pre-audit work. The taxpayer and its advisers should be preparing as well, performing the following tasks:

1. Review internal controls and the flow of records.
2. For an income tax audit, review your returns in light of that state's specific rules regarding state modifications, apportionment and allocation, business or nonbusiness income, throwback sales, and the specific makeup of the state's apportionment factors (sales, property, and payroll).
3. Take some time to review the state's current legislative activity and any recent state tax cases, not just for possible exposure, but also for potential refunds.
4. Be sure to scan the state's various income tax credit provisions. Surprisingly, income tax credits are often overlooked in the hurry to get the return filed on time.
5. If the state has a "taxpayer bill of rights," become familiar with the taxpayer's audit responsibilities and protections.
6. Identify the company's exposure (for example, gray areas of the law or weaknesses in the company's accounting system).
7. Ascertain the statute of limitations for the items and the taxes under audit.
8. Finally, identify the company's contact or liaison person to work with the auditor.

Initial Meeting and Audit Work

At the initial meeting with the auditor, review the scope of the audit and establish the company's liaisons. It is absolutely critical to know what tax will be audited and for what period. Strategies to pursue during the audit should include the following:

- Controlling the flow of information
- Avoiding commitments
- Setting limits (time and distance)
- Being personable and professional

Controlling the Flow of Information

Just what can auditors look at? Probably just about anything they please. *But* the fact of the matter is that auditors always ask for more than they want or ever intend to examine. So, help them out—give them limits. Specifically, a "document request" form of some fashion should be mandatory. With such a form, the taxpayer can keep track of exactly what the auditor has and has not seen. This may help in understanding a position the auditor is taking. In addition, it may keep the auditor from requesting additional documentation for items that have already been substantially supported. Taxpayers are often surprised at the breadth and depth of an auditor's first information request. Do not be alarmed. One of the goals of your first meeting with the auditor will be to determine just exactly what documentation is

necessary for the audit. Once the precise scope of the audit is defined, you can start eliminating unnecessary document requests.

Finally, it is a not good idea to turn the company into a local photocopy center. If the auditor wants something copied, the item should be given to an appropriate, close-lipped clerk who will make two copies, one for the auditor and another for the taxpayer's file.

Avoiding Commitments

Taxpayers should be very careful of entering into commitments. The key questions that usually arise in this regard are whether to (1) fill out nexus questionnaires, (2) agree to particular statistical sampling methodologies, and (3) sign statute of limitation waivers. The general rule is *never sign anything unless absolutely necessary*.

Nexus

States use nexus questionnaires to determine whether a company is doing business in their taxing jurisdiction. Taxpayers receiving such a questionnaire should not automatically fill it out. If a response is called for, do so by letter instead. If the questionnaire must be completed, do it carefully and provide supplemental information when necessary. The problem is that nexus questionnaires are often *just* a list of yes-and-no questions generally worded in such a way that the taxpayer cannot win (for example, "Have you stopped beating your dog?"). Given the complexity of the issues surrounding nexus, it is much easier to deal with them in an independently composed letter rather than by filling out the taxing authority's standardized form. Composing your own response allows you to describe the appropriate facts and circumstances with the appropriate references to statutes, regulations, and case law that support the fact, for example, that you may have sales and use tax nexus, but not income tax nexus.

Sampling

When possible, taxpayers should consider cooperating with a statistical sampling approach rather than specifically committing to it. For example, an auditor may propose a survey strategy for sampling the sales factor or accounts payables and ask the taxpayer to approve it. The taxpayer might be better off inviting the auditor to go ahead with that plan and then reviewing the results to see whether the sample really was valid. That way, if some items or issues seem distortive, the taxpayer still has some leverage in getting the auditor to change the sample. Once a taxpayer signs off on the sampling methodology, however, the taxpayer's leverage and options usually are gone.

Waivers

Auditors often ask taxpayers to agree to waive the statute of limitations in order to "lock in" the audit period (frequently four years for income tax). For example, the auditor may want the taxpayer to sign a waiver for a few months so that the limitations period will not expire before the audit is completed. Generally, such a request is reasonable, but the waiver should be restricted to a specific date, tax, and issue. Limiting the waiver in this manner helps limit the scope of the audit, in addition to encouraging the auditor not to dawdle during the

examination. And let's be frank, it encourages you as well to move forward on the audit. We all wish to avoid unpleasant situations, and it is sometimes too easy to keep putting the auditor off. But keep in mind, that no matter how capable your systems and people, everyone makes mistakes and, assuming there is going to be some assessment, no matter how small, the longer it takes to complete the audit, the more interest you will have to pay. Many states provide that whatever years are still open for the IRS are still open for the state.

Limits on Time and Distance

Try to get the auditor to commit to a time frame for the examination. In seeking to determine how long the audit will take, taxpayers might let the auditor know that, for example, they have other auditors and audits to schedule, as well as a business to run and a life to live.

Also, consider "isolating" the auditors. That is, do not let them work at a desk next to the company's accounts payable clerk, one of the audit contacts, or the company president. Do not make it that easy for the auditor to pop her head in every five minutes or so with a "quick" question. Specifically identifying who the auditor is to work with on particular issues, that is, their contact or liaison, is important because it assures you that the information provided to the auditor is done so by informed competent professionals on your staff rather than off-hand comments from someone who may not even work in the tax department.

Be Professional

In dealing with auditors (or even co-workers and other human beings) some interpersonal relationship rules should apply:

1. Be friendly, but do not be a friend. (Most of us probably have enough friends already.)
2. Do not be an enemy. (We also have enough enemies already, and hostility does not pay.)
3. Be cooperative without being a pushover. At the least, be nonconfrontational. Inevitably, the taxpayer and the auditor will disagree. Thus, starting with a professional demeanor is always a good strategy. (Yelling and screaming may come later but, once started, tends to discourage compromise.)
4. Do not offer comments about fiscal reform, politics, the chances of a flat tax, or what you would do if you were in charge. An auditor who has been around for a while has heard it all. Keep the small talk limited to, for example, the weather, who won last week's big game, and the latest trend in body piercing.

Closing Conference

Generally, the auditor will plan a closing conference. If not, the taxpayer should request one. In preparing for the closing conference, taxpayers should

1. Review the assessments and the underlying workpapers. Check for math or formula errors in the worksheets. Watch out for double-counting in the calculation of the factors, the treatment of dock sales, throwbacks, and the composition of business and nonbusiness income. Whenever possible, try to make adjustments at the audit level. It is almost

always easier to get something removed at the audit level before the audit is turned in for processing, than afterwards at appeal.

2. Identify and review with the auditor the problem areas, and make sure that the positions taken by the auditor and the reasons for them are clear. Ask for explanations of the adjustments and substantiation for the positions taken, including relevant statutes, regulations, policy positions, case law, and so on.
3. Discuss the billing process, protest procedures, and interest rates and be sure that they are understood. If contemplating an appeal, this is when the process really starts. Procedural matters now become critical. Do not rely on the auditor or anyone else to get it right. Rather, get written copies of the various due dates, appeal procedures, and so on directly from the statutes.
4. Do not miss deadlines. When the buzzer sounds, the referee does not allow extra time to make that last score—and neither will the government.
5. Finally, do not expect the auditor or taxing jurisdiction to just give in. Auditors are not paid to be easily intimidated. Further, the courts have stated more than once that government should constitutionally tax all that it can, and their resources are usually larger than the taxpayer's.

Conclusion

In considering all the ramifications of an audit, taxpayers and their advisers should keep things in perspective. Taxes and audits go back to the dawn of history. In fact, some of the earliest historical records in existence are written on clay tablets from the Sumerian civilization that flourished in Mesopotamia more than 4,000 years ago. Most of those writings deal with economic matters, largely the imposition of tax on grain, barley, and hops used in making beer. Taxpayers should keep that in mind the next time they sit down late at night with a pile of tax receipts and pop open a beer. They are participating in a long and respected historical tradition.

Appendix A: Public Law 86-272

Public Law 86-272, addresses the circumstances under which a multistate business may owe state income taxes. It was enacted as a stopgap measure on September 14, 1959. For the past several years, efforts to reform this law have raised issues similar to those in 1959.[1]

Public Law 86-272

§381. Imposition of net income tax

(a) Minimum Standards

No state or political subdivision thereof, shall have power to impose, for any taxable year ending after September 14, 1959, a net income tax on the income derived within such State by any person from interstate commerce if the only business activities within such State by or on behalf of such person during such taxable year are either, or both, of the following:

> (1) the solicitation of orders by such person, or his representative, in such State for sales of tangible personal property, which orders are sent outside the State for approval or rejection and, if approved, are filled by shipment or delivery from a point outside the State; and
>
> (2) the solicitation of orders by such person, or his representative, in such State in the name of or for the benefit of a prospective customer of such person, if orders by such customer to such person to enable such customer to fill orders resulting from such solicitation are orders described in paragraph (1).

(b) Domestic corporations; persons domiciled in or residents of a State

The provisions of subsection (a) of this section shall not apply to the imposition of a net income tax by any State, or political subdivision thereof, with respect to—

> (1) any corporation which is incorporated under the laws of such State; or
>
> (2) any individual who, under the laws of such State, is domiciled in, or a resident, of such State.

(c) Sales or solicitation of orders for sales by independent contractors

For purposes of subsection (a) of this section, a person shall not be considered to have engaged in business activities within a State during any taxable year merely by reason of sales in

[1] For a brief history and the issues surrounding Public Law 86-272, see Annette Nellen, "The 50th Anniversary of Public Law 86-272," March 27, 2008, www.cpa2biz.com/Content/media/PRODUCER_CONTENT/Newsletters/Articles_2008/CorpTax/Public_Law032708.jsp. See also her website, www.cob.sjsu.edu/nellen_a/TaxReform/PL86-272-50thAnniversary.htm, which contains articles and links on the past and current (and future?) status of this law.

such State, or the solicitation of orders for sales in such State, of tangible personal property on behalf of such person by one or more independent contractors, or by reason of the maintenance of an office in such State by one or more independent contractors whose activities on behalf of such person in such State consist solely of making sales, or soliciting orders for sales, of tangible personal property.

(d) Definitions

For purposes of this section—

(1) the term "independent contractor" means a commission agent, broker, or other independent contractor who is engaged in selling, or soliciting orders for the sale of, tangible personal property for more than one principle and who holds himself out as such in the regular course of his business activities; and

(2) the term "representative" does not include an independent contractor.

§382. Assessment of net income taxes; limitations; collection

(a) No State, or political subdivision thereof, shall have power to assess, after September 14, 1959, any net income tax which was imposed by such State or political subdivision, as the case may be, for any taxable year ending on or before such date, on the income derived within such State by any person from interstate commerce, if the imposition of such tax for a taxable year ending after such date is prohibited by section 381 of this title.

(b) the provisions of subsection (a) of this section shall not be construed—

(1) to invalidate the collection, on or before September 14, 1959, of any net income tax imposed for a taxable year ending on or before such date, or

(2) to prohibit the collection, after September 14, 1959, of any net income tax which was assessed on or before such date for a taxable year ending on or before such date.

§383. Definition.

For purpose of this chapter, the term "net income tax" means any tax imposed on, or measured by net income.

§384. Separability of provisions.

If any provision of this chapter or the application of such provision to any person or circumstance is held invalid, the remainder of this chapter or the application of such provision to persons or circumstances other than those to which it is held invalid, shall not be affected thereby.

Appendix B: Uniform Division of Income for Tax Purposes Act

Drafted by the

NATIONAL CONFERENCE OF COMMISSIONERS
ON UNIFORM STATE LAWS

and by it

APPROVED AND RECOMMENDED FOR ENACTMENT
IN ALL THE STATES

at its

ANNUAL CONFERENCE
MEETING IN ITS SIXTY-SIXTH YEAR
AT NEW YORK, NEW YORK
JULY 8 – 13, 1957

WITH PREFATORY NOTE AND COMMENTS

Approved by the American Bar Association at its Meeting at
New York, New York, July 16, 1957

UNIFORM DIVISION OF INCOME FOR TAX PURPOSES ACT

The Committee which acted for the National Conference of Commissioners on Uniform State Laws in preparing the Uniform Division of Income for Tax Purposes Act was as follows:

GEORGE V. POWELL, 1111 Dexter Horton Bldg., Seattle 4, Wash., *Chairman*.
GUY W. BOTTS, Barnett National Bank Bldg., Jacksonville, Fla.
RUPERT R. BULLIVANT, Pacific Bldg., Portland, Ore.
BARTON H. KUHNS, First National Bank Bldg., Omaha 2, Nebr.
JO. V. MORGAN, District of Columbia Tax Court, 4th & E Sts., N.W., Washington 1, D.C.
O. H. THORMODGSGARD, University of North Dakota Law School, University, N.D., *Chairman, Section C*.

Copies of all Uniform Acts and other printed matter issued by the Conference may be obtained from

NATIONAL CONFERENCE OF COMMISSIONERS ON
UNIFORM STATE LAWS
1155 East Sixtieth Street
Chicago, Illinois 60637

UNIFORM DIVISION OF INCOME FOR TAX PURPOSES ACT

PREFATORY NOTE

The Uniform Division of Income for Tax Purposes Act is designed for enactment in those states which levy taxes on or measured by net income.

The need for a uniform method of division of income for tax purposes among the several taxing jurisdictions has been recognized for many years and has long been recommended by the Council of State Governments. There is no other practical means of assuring that a taxpayer is not taxed on more than its net income. At present there are various formulae for determining the amount of income to be taxed in use by the states, and the differences in the formulae produce inequitable results. Many states now use the three factor formulae of this Act. The problem has been well analyzed and its historical background outlined in an article appearing in 18 Ohio State Law Journal, page 84.

The Uniform Division of Income for Tax Purposes Act is the result of conferences with the representatives of the Controller's Institute of America, the Council of State Governments and various interested individuals. It was promulgated in 1957. The comments in the present reprinting of the Act were revised and extended in February 1966 in order to clarify the solutions to some of the problems which have been experienced in securing enactment of the Act in the several states.

March 1, 1966

UNIFORM DIVISION OF INCOME FOR TAX PURPOSES ACT

[Be It Enacted . . .]

SECTION 1. As used in this Act, unless the context otherwise requires:

(a) "Business income" means income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations.

Comment

This definition refers to "the" taxpayer's trade or business as if he had one business. It is not intended by this language to require a taxpayer having several "businesses" to use the same allocation and apportionment methods for the businesses. The language permits separate treatment of different businesses of a single taxpayer. Section 18 clearly permits separate treatment.

Income from the disposition of property used in a trade or business of the taxpayer is includible within the meaning of business income.

(b) "Commercial domicile" means the principal place from which the trade or business of the taxpayer is directed or managed.

Comment

The phrase "directed or managed" is not intended to permit both the state where the board of directors meets and the state where the company is managed to claim the commercial domicile. The phrase "directed or managed" is intended as two words serving the same end; not as two separate concepts.

(c) "Compensation" means wages, salaries, commissions and any other form of remuneration paid to employees for personal services.

Comment

This definition is derived from the Model Unemployment Compensation Act which has been adopted in all states.

Compensation paid to "employees" becomes important in the payroll fraction in section 13. If a corporation is employed to provide personal services, section 18 may be used to include compensation paid to corporations in the fraction if exclusion of compensation paid to corporate agents fails to reflect adequately the business activity in the state.

(d) "Financial organization" means any bank, trust company, savings bank, [industrial bank, land bank, safe deposit company], private banker, savings and loan association, credit union, [cooperative bank], investment company, or any type of insurance company.

Comment

This definition and the definition of "public utility" in subsection (f) is necessary because section 2 excludes from allocation and apportionment under this Act, income from these two types of business activity. The exclusion is proposed because some states have separate legislation for apportionment and allocation of income of such taxpayers. If not, and the state proposes to change subsection (2) so as to apply the Act to such taxpayers, this would not necessarily detract from the uniformity objective of this Act.

(e) "Non-business income" means all income other than business income.

(f) "Public utility" means [any business entity which owns or operates for public use any plant, equipment, property, franchise, or license for the transmission of communications, transportation of goods or persons, or the production, storage, transmission, sale, delivery, or furnishing of electricity, water, steam, oil, oil products or gas].

Comment

It is expected that "public utility" will be defined to include all taxpayers subject to the control of the state's regulatory bodies on the theory that separate legislation will provide for the apportionment and allocation of the income of such taxpayers.

See Comment to the definition of "financial organization" for purpose of this definition. "Oil, oil products or gas" is not intended to be so restrictive as to treat differently a public utility, if any, which transmits or produces "gas products." The essential point of the definition is the requirement that the business excluded by this definition and subsection 2 be a "public utility." Private transmission lines and private production or storage companies are thus not excluded.

(g) "Sales" means all gross receipts of the taxpayer not allocated under sections 4 through 8 of this Act.

Comment

This all inclusive definition of sales is intended to make apportionable all income not allocated under sections 4 through 8. As indicated in the Comment to subsection 1(a) income from sales or property used in trade or business is included in apportionable income.

(h) "State" means any state of the United States, the District of Columbia, the Commonwealth of Puerto Rico, any territory or possession of the United States, and any foreign country or political subdivision thereof.

SECTION 2. Any Taxpayer having income from business activity which is taxable both within and without this state, other than activity as a financial organization or public utility or the rendering of purely personal services by an individual, shall allocate and apportion his net income as provided in this Act.

SECTION 3. For purposes of allocation and apportionment of income under this Act, a taxpayer is taxable in another state if (1) in that state he is subject to a net income tax, a franchise tax measured by net income, a franchise tax for the privilege of doing business, or a corporate stock tax, or (2) that state has jurisdiction to subject the taxpayer to a net income tax regardless of whether, in fact, the state does or does not.

Comment

This section defines, for purposes of section 2, where a taxpayer is "taxable both within and without this state." To bring this Act into operation a taxpayer must have income from business activity, and he must be taxable in this state, and also in some other state.

Two tests are used by this section to determine when a taxpayer is "taxable in another state." The first test is a fairly obvious one, the taxpayer is taxable in another state if he is actually subjected to the type of taxes listed in subparagraph (1).

The second test, in subparagraph (2) uses a "notional" or "hypothetical" standard rather than an actual one. Thus, if a corporation has its commercial domicile in state X, which has only a sales tax and no tax measured by net income, but that corporation has business activity in state A, which has this apportionment Act, state A must apportion the business income as provided in this Act so that some of it is allocated to state X, even though as a result of the tax system of state X a portion of the business income escapes income taxation. This is desirable in order to treat the business of all states equally, and in order to avoid having this Act as a factor in inducing a state to have an income tax. If it does not wish to tax income, that is no reason for a state which does wish to tax income to attempt to obtain more than its share of taxable income.

It should be noted that in subsection 1(h) the word "state" is defined broadly enough to include a foreign country. This means that "taxable in another state" within section 3 may mean a foreign country. The apportioning state, however, need consider only whether the foreign country "could have" taxed the income under the constitution of the United States if it had been a state.

While subparagraph (1) lists several types of taxes which might be actually in effect in another state, the reference in subparagraph (2) only to a "net income" tax is not intended to be more restricted in the hypothetical tax than the section is with respect to an actual tax.

SECTION 4. Rents and royalties from real or tangible personal property, capital gains, interest, dividends, or patent or copyright royalties, to the extent that they constitute non-business income, shall be allocated as provided in sections 5 through 8 of this Act.

Comment

This section is the general section on "allocating" non-business income to a state just as section 9 is the general section on apportionment of business income. Section 2 refers to an allocation and an apportionment of "net income." In "allocating" nonbusiness income to a state, the states concerned with this allocation may desire to allocate the expenses properly attributable to nonbusiness but allocable income in the same way that income is allocated so that these expenses will not be involved in determining net income from business activity where

apportionment is used. Section 18 of this Code empowers the state to make this adjustment if it wishes.

SECTION 5.

(a) Net rents and royalties from real property located in this state are allocable to this state.

(b) Net rents and royalties from tangible personal property are allocable to this state:

(1) if and to the extent that the property is utilized in this state, or

(2) in their entirety if the taxpayer's commercial domicile is in this state and the taxpayer is not organized under the laws of or taxable in the state in which the property is utilized.

(c) The extent of utilization of tangible personal property in a state is determined by multiplying the rents and royalties by a fraction, the numerator of which is the number of days of physical location of the property in the state during the rental or royalty period in the taxable year and the denominator of which is the number of days of physical location of the property everywhere during all rental or royalty periods in the taxable year. If the physical location of the property during the rental or royalty period is unknown or unascertainable by the taxpayer, tangible personal property is utilized in the state in which the property was located at the time the rental or royalty payer obtained possession.

Comment

Rents from mobile tangible property are to be allocated in accordance with section 5(c). This subsection apportions the rents by a fraction based on the number of days in the state on the assumption that the rents are generally based on time of use. If the rent itself is calculated on the basis of some factor other than time, section 18 would permit a state to substitute a fraction based on this substitute factor. Thus, if the rent for a drilling rig is calculated on the basis of number of feet drilled, the "extent of utilization" in the state might also be determined on the basis of a fraction which uses "feet drilled" rather than days in the state.

SECTION 6.

(a) Capital gains and losses from sales of real property located in this state are allocable to this state.

(b) Capital gains and losses from sales of tangible personal property are allocable to this state if

(1) the property had a situs in this state at the time of the sale, or

(2) the taxpayer's commercial domicile is in this state and the taxpayer is not taxable in the state in which the property had a situs.

(c) Capital gains and losses from sales of intangible personal property are allocable to this state if the taxpayer's commercial domicile is in this state.

SECTION 7. Interest and dividends are allocable to this state if the taxpayer's commercial domicile is in this state.

SECTION 8.

(a) Patent and copyright royalties are allocable to this state:

(1) if and to the extent that the patent or copyright is utilized by the payer in this state, or

(2) if and to the extent that the patent or copyright is utilized by the payer in a state in which the taxpayer is not taxable and the taxpayer's commercial domicile is in this state.

(b) A patent is utilized in a state to the extent that it is employed in production, fabrication, manufacturing, or other processing in the state or to the extent that a patented product is produced in the state. If the basis of receipts from patent royalties does not permit allocation to states or if the accounting procedures do not reflect states of utilization, the patent is utilized in the state in which the taxpayer's commercial domicile is located.

(c) A copyright is utilized in a state to the extent that printing or other publication originates in the state. If the basis of receipts from copyright royalties does not permit allocation to states or if the accounting procedures do not reflect

states of utilization, the copyright is utilized in the state in which the taxpayer's commercial domicile is located.

SECTION 9. All business income shall be apportioned to this state by multiplying the income by a fraction, the numerator of which is the property factor plus the payroll factor plus the sales factor, and the denominator of which is three.

SECTION 10. The property factor is a fraction, the numerator of which is the average value of the taxpayer's real and tangible personal property owned or rented and used in this state during the tax period and the denominator of which is the average value of all the taxpayer's real and tangible personal property owned or rented and used during the tax period.

Comment

The property to be included in the numerator and denominator is property producing the net income to be apportioned. If net income from property is allocated property under sections 5 through 8 such property should be excluded in constructing the fraction.

SECTION 11. Property owned by the taxpayer is valued at its original cost. Property rented by the taxpayer is valued at eight times the net annual rental rate. Net annual rental rate is the annual rental rate paid by the taxpayer less any annual rental rate received by the taxpayer from sub-rentals.

Comment

This section is admittedly arbitrary in using original cost rather than depreciated cost, and in valuing rented property as eight times the annual rental. This approach is justified because the act does not impose a tax, nor prescribe the depreciation allowable in computing the tax, but merely provides a basis for division of the taxable income among the several states. The use of original cost obviates any differences due to varying methods of depreciation, and has the advantage that the basic figure is readily ascertainable from the taxpayer's books. No method of valuing the property would probably be universally acceptable.

In any situation where it is impossible to ascertain original cost, section 18 may be used to determine a fair value for such property. Section 18 may also be necessary to aid in determining "net annual rental value" of tangible personal

property where the actual rent is so related to services that the part attributable to the object is difficult to determine.

Section 18 may also be used to determine a reasonable rental rate for this fraction where the actual rent is zero or nominal such as may be the case where a local government in attempting to induce an industry to come to a community supplies the property at a nominal rental.

SECTION 12. The average value of property shall be determined by averaging the values at the beginning and ending of the tax period but the [tax administrator] may require the averaging of monthly values during the tax period of reasonably required to reflect properly the average value of the taxpayer's property.

SECTION 13. The payroll factor is a fraction, the numerator of which is the total amount paid in this state during the tax period by the taxpayer for compensation, and the denominator of which is the total compensation paid everywhere during the tax period.

Comment

Payroll attributable to management or maintenance or otherwise allocable to nonbusiness property should be excluded from the fraction.

Payroll "paid" should be determined by the normal accounting methods of the business so that if the taxpayer "accrues" such matters the payroll should be treated as "paid" for purpose of this section.

SECTION 14. Compensation is paid in this state if:

(a) the individual's service is performed entirely within the state; or

(b) the individual's service is performed both within and without the state, but the service performed without the state is incidental to the individual's service within the state; or

(c) some of the service is performed in the state and (1) the base of operations or, if there is no base of operations, the place from which the service is directed or controlled is in the state, or (2) the base of operations or the place from which the service is directed or controlled is not in any state in which some part of the service is performed, but the individual's residence is in this state.

Comment

This section is derived from the Model Unemployment Compensation Act. This is the same figure which will be used by taxpayers for unemployment compensation purposes.

SECTION 15. The sales factor is a fraction, the numerator of which is the total sales of the taxpayer in this state during the tax period, and the denominator of which is the total sales of the taxpayer everywhere during the tax period.

Comment

The sales to be included in the fraction are only the sales which produce business income. Sales which produce "capital gains" are under section 6 and are to be allocated rather than apportioned.

"Total sales" means "total net sales" after discounts and returns.

SECTION 16. Sales of tangible personal property are in this state if:

(a) the property is delivered or shipped to a purchaser, other than the United States government, within this state regardless of the f.o.b. point or other conditions of the sale; or

(b) the property is shipped from an office, store, warehouse, factory, or other place of storage in this state and (1) the purchaser is the United States government or (2) the taxpayer is not taxable in the state of the purchaser.

Comment

The phrase "delivered or shipped to a purchaser" in this state includes shipments, at the designation of the purchaser, to a person in this state such as designating, while a shipment is enroute, the ultimate recipient.

Sales to the United States are treated separately. It is thought that this is justified because sales to the United States are not necessarily attributable to a market existing in the state to which the goods are originally shipped. This different treatment may also be justified because, if the goods are defense or war materials, it may be impossible to determine whether the goods ever come to rest in the state due to use of coded delivery instructions.

The section does not specify how sales from a subsidiary in the state to an out-of-state parent, such as a marketing corporation who thereupon redirects the goods back into the state, should be treated. If returns are not consolidated under existing state tax law, it may be necessary to use section 18 to make a fair representation of the business income in this situation.

SECTION 17. Sales, other than sales of tangible personal property, are in this state if:

(a) the income-producing activity is performed in this state; or

(b) the income-producing activity is performed both in and outside this state and a greater proportion of the income-producing activity is performed in this state than in any other state, based on costs of performance.

SECTION 18. If the allocation and apportionment provisions of this Act do not fairly represent the extent of the taxpayer's business activity in this state, the taxpayer may petition for or the [tax administrator] may require, in respect to all or any part of the taxpayer's business activity, if reasonable:

(a) separate accounting;

(b) the exclusion of any one or more of the factors;

(c) the inclusion of one or more additional factors which will fairly represent the taxpayer's business activity in this state; or

(d) the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.

Comment

It is anticipated that this Act will be made a part of the income tax acts of the several states. For that reason, this section does not spell out the procedure to be followed in the event of a disagreement between the taxpayer and the tax administrator. The income tax acts of each state presumably outline the procedure to be followed.

Section 18 is intended as a broad authority, within the principle of apportioning business income fairly among the states which have contact with the income, to the tax administrator to vary the apportionment formula and to vary the

system of allocation where the provisions of the Act do not fairly represent the extent of the taxpayer's business activity in the state. The phrases in section 18(d) do not foreclose the use of one method for some business activity and a different method for a different business activity. Neither does the phrase "method" limit the administrator to substituting factors in the formula. The phrase means any other method of fairly representing the extent of the taxpayer's business activity in the state.

SECTION 19. This Act shall be so construed so as to effectuate its general purpose to make uniform the law of those states which enact it.

SECTION 20. This Act may be cited as the Uniform Division of Income for Tax Purposes Act.

Appendix C: *Wisconsin vs. Wrigley*

WISCONSIN DEPARTMENT OF REVENUE, Petitioner v.
WILLIAM WRIGLEY, JR., CO.
505 US 214, 112 S Ct 2447, 120 L Ed 2d 174

Scalia, J., delivered the opinion of the Court, in which White, Stevens, Souter, and Thomas, JJ., joined, and in Parts I and II of which O'Connor, J., joined. O'Connor, J., filed an opinion concurring in part and concurring in the judgment. Kennedy, J., filed a dissenting opinion, in which Rehnquist, C. J., and Blackmun, J., joined.

F. Thomas Creeron, III argued the cause for petitioner.

E. Barrett Prettyman, Jr. argued the cause for respondent.

OPINION

OPINION OF THE COURT

Justice **Scalia** delivered the opinion of the Court.

Section 101(a) of Public Law 86-272, 73 Stat 555 (1959), 15 USC § 381 [15 USCS § 381], prohibits a State from taxing the income of a corporation whose only business activities within the State consist of "solicitation of orders" for tangible goods, provided that the orders are sent outside the State for approval and the goods are delivered from out-of-state. The issue in this case is whether respondent's activities in Wisconsin fell outside the protection of this provision.

I

Respondent William **Wrigley**, Jr., Co. is the world's largest manufacturer of chewing gum. Based in Chicago, it sells gum nationwide through a marketing system that divides the country into districts, regions, and territories. During the relevant period (1973–1978), the Midwestern district included a Milwaukee region, covering most of Wisconsin and parts of other States, which was subdivided into several geographic territories.

The district manager for the Midwestern district had his residence and company office in Illinois, and visited Wisconsin only six to nine days each year, usually for a sales meeting or to call on a particularly important account. The regional manager of the Milwaukee region resided in Wisconsin, but **Wrigley** did not provide him with a company office. He had general responsibility for sales activities in the region, and would typically spend 80-95% of his time working with the sales representatives in the field or contacting certain "key" accounts. The remainder of his time was devoted to administrative activities, including writing and reviewing company reports, recruiting new sales representatives, making

recommendations to the district manager concerning the hiring, firing, and compensation of sales representatives, and evaluating their performance. He would preside at full-day sales strategy meetings for all regional sales representatives once or twice a year. The manager from 1973 to 1976, John Kroyer, generally held these meetings in the "office" he maintained in the basement of his home, whereas his successor, Gary Hecht, usually held them at a hotel or motel. (Kroyer claimed income tax deductions for this office, but **Wrigley** did not reimburse him for it, though it provided a filing cabinet.) Mr. Kroyer also intervened two or three times a year to help arrange a solution to credit disputes between the Chicago office and important local accounts. Mr. Hecht testified that he never engaged in such activities, although **Wrigley's** formal position description for regional sales manager continued to list as one of the assigned duties "[r]epresent[ing] the company on credit problems as necessary."

The sales or "field" representatives in the Milwaukee region, each of whom was assigned his own territory, resided in Wisconsin. They were provided with company cars, but not with offices. They were also furnished a stock of gum (with an average wholesale value of about $1000), a supply of display racks, and promotional literature. These materials were kept at home, except that one salesman, whose apartment was too small, rented storage space at about $25 per month, for which he was reimbursed by **Wrigley**.

On a typical day, the sales representative would load up the company car with a supply of display racks and several cases of gum, and would visit accounts within his territory. In addition to handing out promotional materials and free samples, and directly requesting orders of **Wrigley** products, he would engage in a number of other activities which **Wrigley** asserts were designed to promote sales of its products. He would, for example, provide free display racks to retailers (perhaps several on any given day), and would seek to have these new racks, as well as pre-existing ones, prominently located. The new racks were usually filled from the retailer's existing stock of **Wrigley** gum, but it would sometimes happen—perhaps once a month—that the retailer had no **Wrigley** products on hand and did not want to wait until they could be ordered from the wholesaler. In that event, the rack would be filled from the stock of gum in the salesman's car. This gum, which would have a retail value of $15 to $20, was not provided without charge. The representative would issue an "agency stock check" to the retailer, indicating the quantity supplied; he would send a copy of this to the Chicago office or to the wholesaler, and the retailer would ultimately be billed (by the wholesaler) in the proper amount.

When visiting a retail account, **Wrigley's** sales representative would also check the retailer's stock of gum for freshness, and would replace stale gum at no cost to the retailer. This was a regular part of a representative's duties, and at any given time up to 40% of the stock of gum in his possession would be stale gum that had been removed from retail stores. After accumulating a sufficient amount of stale product, the representative either would ship it back to **Wrigley's** Chicago office or would dispose of it at a local Wisconsin landfill.

Wrigley did not own or lease real property in Wisconsin, did not operate any manufacturing, training, or warehouse facility, and did not have a telephone listing or bank account. All Wisconsin orders were sent to Chicago for acceptance, and were filled by shipment

through common carrier from outside the State. Credit and collection activities were similarly handled by the Chicago office. Although **Wrigley** engaged in print, radio, and television advertising in Wisconsin, the purchase and placement of that advertising was managed by an independent advertising agency located in Chicago.

Wrigley had never filed tax returns or paid taxes in Wisconsin; indeed, it was not licensed to do business in that State. In 1980, petitioner Wisconsin Department of Revenue concluded that the company's instate business activities during the years 1973-1978 had been sufficient to support imposition of a franchise tax, and issued a tax assessment on a percentage of the company's apportionable income for those years. **Wrigley** objected to the assessment, maintaining that its Wisconsin activities were limited to "solicitation of orders" within the meaning of 15 USC § 381 [15 USCS § 381], and that it was therefore immune from Wisconsin franchise taxes. After an evidentiary hearing, the Wisconsin Tax Appeals Commission unanimously upheld the imposition of the tax. CCH Wis Tax Rptr ¶ 202-792 (1986). It later reaffirmed this decision, with one commissioner dissenting, after the County Circuit Court vacated the original order on procedural grounds. CCH Wis Tax Rptr ¶ 202-926 (1987). The County Circuit Court then reversed on the merits, CCH Wis Tax Rptr ¶ 203-000 (1988), but that decision was in turn reversed by the Wisconsin Court of Appeals, with one judge dissenting. 153 Wis 2d 559, 451 NW2d 444 (1989). The Wisconsin Supreme Court, in a unanimous opinion, reversed yet once again, thus finally disallowing the Wisconsin tax. 160 Wis 2d 53, 465 NW2d 800 (1991). We granted the State's petition for certiorari, 502 US _______ , 116 L Ed 2d 27, 112 S Ct 49 (1991).

II

In Northwestern States Portland Cement Co. v Minnesota, 358 US 450, 454, 3 L Ed 2d 421, 79 S Ct 357, 67 ALR2d 1292 (1959), we considered Minnesota's imposition of a properly apportioned tax on the net income of an Iowa cement corporation whose "activities in Minnesota consisted of a regular and systematic course of solicitation of orders for the sale of its products, each order being subject to acceptance, filling and delivery by it from its plant [in Iowa]." The company's salesmen, operating out of a three-room office in Minneapolis rented by their employer, solicited purchases by cement dealers and by customers of cement dealers. They also received complaints about goods that had been lost or damaged in shipment, and forwarded these back to Iowa for further instructions. Id., at 454-455, 3 L Ed 2d 421, 79 S Ct 357, 67 ALR2d 1292. The cement company's contacts with Minnesota were otherwise very limited; it had no bank account, real property, or warehoused merchandise in the State. We nonetheless rejected Commerce Clause and due process challenges to the tax:

> "We conclude that net income from the interstate operations of a foreign corporation may be subjected to state taxation provided the levy is not discriminatory and is properly apportioned to local activities within the taxing State forming sufficient nexus to support the same." Id., at 452, 3 L Ed 2d 421, 79 S Ct 357, 67 ALR2d 1292.

The opinion in Northwestern States was handed down in February 1959. Less than a week later, we granted a motion to dismiss (apparently on mootness grounds) the appeal of

a Louisiana Supreme Court decision that had rejected due process and Commerce Clause challenges to the imposition of state net-income taxes based on local solicitation of orders that were sent out-of-state for approval and shipping. Brown-Forman Distillers Corp. v Collector of Revenue, 234 La 651, 101 So 2d 70 (1958), appeal dism'd, 359 US 28, 3 L Ed 2d 625, 79 S Ct 602 (1959). That decision was particularly significant because, unlike the Iowa cement company in Northwestern States, the Kentucky liquor company in Brown-Forman did *not* lease (or own) any real estate in the taxing state. Rather, its activities were limited to

> "the presence of 'missionary men' who call upon wholesale dealers [in Louisiana] and who, on occasion, accompany the salesmen of these wholesalers to assist them in obtaining a suitable display of appellant's merchandise at the business establishments of said retailers ...." 234 La, at 653-654, 101 So 2d, at 70.

Two months later, we denied certiorari in another Louisiana case upholding the imposition of state tax on the income of an out-of-state corporation that neither leased nor owned real property in Louisiana and whose only activities in that State "consist[ed] of the regular and systematic solicitation of orders for its product by fifteen salesmen."International Shoe Co. v Fontenot, 236 La 279, 280, 107 So 2d 640, 640 (1958), cert denied, 359 US 984, 3 L Ed 2d 933, 79 S Ct 943 (1959).

Although our refusals to disturb the Louisiana Supreme Court's decisions in Brown-Forman and International Shoe did not themselves have any legal significance, see Hopfmann v Connolly, 471 US 459, 460-461, 85 L Ed 2d 469, 105 S Ct 2106 (1985); United States v Carver, 260 US 482, 490, 67 L Ed 361, 43 S Ct 181 (1923), our actions in those cases raised concerns that the broad language of Northwestern States might ultimately be read to suggest that a company whose only contacts with a State consisted of sending "drummers" or salesmen into that State could lawfully be subjected to (properly apportioned) income taxation based on the interstate sales those representatives generated. In Heublein, Inc. v South Carolina Tax Comm'n, 409 US 275, 34 L Ed 2d 472, 93 S Ct 483 (1972), we reviewed the history of § 381 and noted that the complaints of the business community over the uncertainty created by these cases were the driving force behind the enactment of § 381:

> "'Persons engaged in interstate commerce are in doubt as to the amount of local activities within a State that will be regarded as forming a sufficient ... connectio[n] with the State to support the imposition of a tax on net income from interstate operations and 'properly apportioned' to the State.'" Id., at 280, 34 L Ed 2d 472, 93 S Ct 483 (quoting S Rep No. 658, 86th Cong, 1st Sess, p 2-3 (1959)).[1]

Within months after our actions in these three cases, Congress responded to the concerns that had been expressed by enacting Public Law 86-272, which established what the relevant section heading referred to as a "minimum standard" for imposition of a state net-income tax based on solicitation of interstate sales:

---

[1] See also HR Rep No. 936, 86th Cong, 1st Sess, p 2 (1959) ("While it is true that the denial of certiorari is not a decision on the merits, and although grounds other than the preceden[t] of the Northwestern [States] cas[e] were advanced as a basis for sustaining the Brown-Forman and International Shoe decisions, the fact that a tax was successfully imposed in those cases has given strength to the apprehensions which had already been generated among small and moderate size businesses").

> "No State ... shall have power to impose, for any taxable year ..., a net income tax on the income derived within such State by any person from interstate commerce if the only business activities within such State by or on behalf of such person during such taxable year are either, or both, of the following:
>
> "(1) the solicitation of orders by such person, or his representative, in such State for sales of tangible personal property, which orders are sent outside the State for approval or rejection, and, if approved, are filled by shipment or delivery from a point outside the State; and
>
> "(2) the solicitation of orders by such person, or his representative, in such State in the name of or for the benefit of a prospective customer of such person, if orders by such customer to such person to enable such customer to fill orders resulting from such solicitation are orders described in paragraph (1)."

73 Stat 555, 15 USC § 381(a) [15 USCS § 381(a)].

Although we have stated that § 381 was "designed to define clearly a lower limit" for the exercise of state taxing power, and that "Congress' primary goal" was to provide "[c]larity that would remove [the] uncertainty" created by Northwestern States, see Heublein, supra, at 280, 34 L Ed 2d 472, 93 S Ct 483, experience has proved § 381's "minimum standard" to be somewhat less than entirely clear. The primary sources of confusion, in this case as in others, have been two questions: (1) what is the scope of the crucial term "solicitation of orders"; and (2) whether there is a de minimis exception to the activity (beyond "solicitation of orders") that forfeits § 381 immunity. We address these issues in turn.

A

Section 381(a)(1) confers immunity from state income taxes on any company whose "only business activities" in that State consist of "solicitation of orders" for interstate sales. "Solicitation," commonly understood, means "[a]sking" for, or "enticing" to, something, see Black's Law Dictionary 1393 (6th ed 1990); Webster's Third New International Dictionary 2169 (1981) ("solicit" means "to approach with a request or plea (as in selling or begging)"). We think it evident that in this statute the term includes, not just explicit verbal requests for orders, but also any speech or conduct that implicitly invites an order. Thus, for example, a salesman who extols the virtues of his company's product to the retailer of a competitive brand is engaged in "solicitation" even if he does not come right out and ask the retailer to buy some. The key question in this case is whether, and to what extent, "solicitation of orders" covers activities that neither explicitly nor implicitly propose a sale.

In seeking the answer to that question, we reject the proposition put forward by Wisconsin and its amici that we must construe § 381 narrowly because we said in Heublein that "'unless Congress conveys its purpose clearly, it will not be deemed to have significantly changed the Federal-State balance,'" 409 US, at 281-282, 34 L Ed 2d 472, 93 S Ct 483 (citation omitted). That principle—which we applied in Heublein to reject a suggested inference from § 381 that States cannot regulate solicitation in a manner that might cause an out-of-state company to forfeit its tax immunity—has no application in the present case. Because § 381 unquestionably *does* limit the power of States to tax companies whose only in-state activity is "the solicitation of orders," our task is simply to ascertain the fair meaning

of that term. FMC Corp. v Holliday, 498 US _______ , _______ - _______ , 112 L Ed 2d 356, 111 S Ct 403 (1990).

Wisconsin views some courts as having adopted the position that an out-of-state company forfeits its § 381 immunity if it engages in "any activity other than requesting the customer to purchase the product." Brief for Petitioner 21; see also id., at 19, n 8 (citing Hervey v AMF Beaird, Inc., 250 Ark 147, 464 SW2d 557 (1971); Clairol, Inc. v Kingsley, 109 NJ Super 22, 262 A2d 213, aff'd, 57 NJ 199, 270 A2d 702 (1970), appeal dism'd, 402 US 902, 28 L Ed 2d 643, 91 S Ct 1377 (1971)).[2] Arguably supporting this interpretation is subsection (c) of § 381, which expands the immunity of subsection (a) when the out-of-state seller does its marketing though independent contractors, to include not only solicitation of orders for sales, but also actual sales, and *in addition* "the maintenance ... of an office ... by one or more independent contractors whose activities ... consist solely of making sales, or soliciting orders for sales ...."[3] The plain implication of this is that without that separate indulgence the maintenance of an office for the exclusive purpose of conducting the exempted solicitation and sales would have provided a basis for taxation—i.e., that the phrase "solicitation of orders" does not embrace the maintenance of an office for the exclusive purpose of soliciting orders. Of course the phrase "solicitation of orders" ought to be accorded a consistent meaning within the section, see Sorenson v Secretary of the Treasury, 475 US 851, 860, 89 L Ed 2d 855, 106 S Ct 1600 (1986), and if it does not embrace maintaining an office for soliciting in subsection (c), it does not do so in subsection (a) either. One might argue that the necessity of special permission for an office establishes that the phrase "solicitation of orders" covers only the actual requests for purchases or, at most, the actions absolutely essential to making those requests.

We think, however, that would be an unreasonable reading of the text. That the statutory phrase uses the term "solicitation" in a more general sense that includes not merely the ultimate act of inviting an order but the entire process associated with the invitation, is

---

[2] Amici New Jersey, et al. contend that our summary disposition of Clairol binds us to this narrow construction of § 381(a). Though Clairol is frequently cited for this construction, the opinion in the case does not in fact recite it. In any event, our summary disposition affirmed only the *judgment* below, and cannot be taken as adopting the reasoning of the lower court. Anderson v Celebrezze, 460 US 780, 784, n 5, 75 L Ed 2d 547, 103 S Ct 1564 (1983); Fusari v Steinberg, 419 US 379, 391-392, 42 L Ed 2d 521, 95 S Ct 533 (1975) (Burger, C. J., concurring). The judgment in Clairol would have been the same even under a broader construction of "solicitation of orders," since the company's in-state activities included sending nonsales representatives to provide customers technical assistance in the use of Clairol products, 109 NJ Super, at 29-30, 262 A2d, at 217. See United States Tobacco Co. v Commonwealth, 478 Pa 125, 136-137, 386 A2d 471, 476-477, cert denied, 439 US 880, 58 L Ed 2d 193, 99 S Ct 217 (1978); Gillette Co. v State Tax Comm'n, 56 App Div 2d 475, 479, 393 NYS2d 186, 189 (1977), aff'd, 45 NY2d 846, 382 NE2d 764 (1978).

[3] 15 USC § 381(c) [15 USCS § 381(c)] reads in its entirety as follows:

"For purposes of subsection (a) of this section, a person shall not be considered to have engaged in business activities within a State during any taxable year merely by reason of sales in such State, or the solicitation of orders for sales in such State, of tangible personal property on behalf of such person by one or more independent contractors, or by reason of the maintenance, of an office in such State by one or more independent contractors whose activities on behalf of such person in such State consist solely of making sales, or soliciting orders for sales, or [sic] tangible personal property."

suggested by the fact that § 381 describes "the solicitation of orders" as a subcategory, not of in-state *acts*, but rather of in-state "*business activities*"—a term that more naturally connotes courses of conduct. See Webster's Third New International Dictionary 22 (1981) (defining "activity" as "an occupation, pursuit, or recreation in which a person is active—often used in pl. <business *activities*>"). Moreover, limiting "solicitation of orders" to actual requests for purchases would reduce § 381(a)(1) to a nullity. (It is obviously impossible to make a request without some accompanying action, such as placing a phone call or driving a car to the customer's location.) And limiting it to acts "essential" for making requests would engender endless uncertainty, contrary to the whole purpose of the statute. (Is it "essential" to use a company car, or to take a taxi, in order to conduct in-person solicitation? For that matter, is it "essential" to solicit in person?) It seems to us evident that "solicitation of orders" embraces request-related activity that is not even, strictly speaking, essential, or else it would not cover salesmen's driving on the State's roads, spending the night in the State's hotels, or displaying within the State samples of their product. We hardly think the statute had in mind only day-trips into the taxing jurisdiction by empty-handed drummers on foot. See United States Tobacco Co. v Commonwealth, 478 Pa 125, 140, 386 A2d 471, 478 ("Congress could hardly have intended to exempt only walking solicitors"), cert denied, 439 US 880, 58 L Ed 2d 193, 99 S Ct 217 (1978). And finally, this extremely narrow interpretation of "solicitation" would cause § 381 to leave virtually unchanged the law that existed before its enactment. Both Brown-Forman (where the salesman assisted wholesalers in obtaining suitable displays for whiskey at retail stores) and International Shoe (where hotel rooms were used to display shoes) would be decided as they were before, upholding the taxation.

[7a] At the other extreme, **Wrigley** urges that we adopt a broad interpretation of "solicitation" which it describes as having been adopted by the Wisconsin Supreme Court based on that court's reading of cases in Pennsylvania and New York, see 160 Wis 2d, at 82, 465 NW2d, at 811-812 (citing United States Tobacco Co. v Commonwealth, supra; Gillette Co. v State Tax Comm'n, 56 App Div 2d 475, 393 NYS2d 186 (1977), aff'd, 45 NY2d 846, 382 NE2d 764 (1978)). See also Indiana Dept. of Revenue v Kimberly-Clark Corp., 275 Ind 378, 384, 416 NE2d 1264, 1268 (1981). According to **Wrigley**, this would treat as "solicitation of orders" any activities that are "ordinary and necessary 'business activities' accompanying the solicitation process" or are "routinely associated with deploying a sales force to conduct the solicitation, so long as there is no office, plant, warehouse or inventory in the State." Brief for Respondent 9, 19-20; see also J. Hellerstein, State Taxation ¶ 6.11[2], p 245 (1983) ("solicitation ought to be held to embrace other normal incidents of activities of salesmen" or the "customary functions of sales representatives of out-of-state merchants"). We reject this "routinely-associated-with-solicitation" or "customarily-performed-by-salesmen" approach, since it converts a standard embracing only a particular activity ("solicitation") into a standard embracing all activities routinely conducted by those who engage in that particular activity ("salesmen"). If, moreover, the approach were to be applied (as respondent apparently intends) on an industry-by-industry basis, it would render

the limitations of § 381(a) toothless, permitting "solicitation of orders" to be whatever a particular industry wants its salesmen to do.[4]

In any case, we do not regard respondent's proposed approach to be an accurate characterization of the Wisconsin Supreme Court's opinion. The Wisconsin court construed "solicitation of orders" to reach only those activities that are "closely associated" with solicitation, industry practice being only one factor to be considered in judging the "close[ness]" of the connection between the challenged activity and the actual requests for orders. 160 Wis 2d, at 82, 465 NW2d, at 811-812. The problem with that standard, it seems to us, is that it merely reformulates rather than answers the crucial question. "What constitutes the 'solicitation of orders'?" becomes "What is 'closely related' to a solicitation request?" This fails to provide the "[c]larity that would remove uncertainty" which we identified as the primary goal of § 381. Heublein, 409 US, at 280, 34 L Ed 2d 472, 93 S Ct 483.

We proceed, therefore, to describe what we think the proper standard to be. Once it is acknowledged, as we have concluded it must be, that "solicitation of orders" covers more than what is strictly *essential* to making requests for purchases, the next (and perhaps the only other) clear line is the one between those activities that are *entirely ancillary* to requests for purchases—those that serve no independent business function apart from their connection to the soliciting of orders—and those activities that the company would have reason to

[4] The dissent explicitly agrees with our rejection of the "ordinary and necessary" standard advocated by **Wrigley**. Post, at _______ , 120 L Ed 2d, at 194. It then proceeds, however, to adopt that very standard. It states that the test should be whether a given activity is one that "reasonable buyers would consider ... to be a part of the solicitation itself and not a significant and independent service or component of value." Post, at _______ , 120 L Ed 2d, at 194. It is obvious that those activities that a reasonable buyer would consider "part of the solicitation itself" rather than an "independent service" are those that are *customarily* performed in connection with solicitation. Any doubt that this is what the dissent intends is removed by its later elaboration of its test in the context of the facts of this case. The dissent repeatedly inquires whether an activity is a "*normal* ac[t] of courtesy from seller to buyer," post, at _______ , 120 L Ed 2d, at 197 (emphasis added); whether it is a "*common* solicitation practic[e]," post, at _______ , 120 L Ed 2d, at 199 (emphasis added); and whether **Wrigley** "exceed[ed] the *normal* scope of solicitation," post, at _______ , 120 L Ed 2d, at 198 (emphasis added). Of course, given **Wrigley's** significant share of the Wisconsin chewing gum market, *most* activities it chooses to "conduc[t] in the course of solicitation," post, at _______ , 120 L Ed 2d, at 200, will be viewed as a normal part of the solicitation process itself. Had **Wrigley's** sales representatives routinely approved orders on the spot; or accepted payments on past-due accounts; or even made outright sales of gum, it is difficult to see how a reasonable buyer would have thought that was *not* "part of the solicitation itself"—it certainly has no "independent value" to *him*. Nothing in the text of the statute suggests that it was intended to confer tax immunity on whatever activities are engaged in by sales agents in a particular industry.

engage in anyway but chooses to allocate to its in-state sales force.[5] Cf. National Tires, Inc. v Lindley, 68 Ohio App 2d 71, 78-79, 426 NE2d 793, 798 (1980) (company's activities went beyond solicitation to "functions more commonly related to maintaining an on-going business"). Providing a car and a stock of free samples to salesmen is part of the "solicitation of orders," because the only reason to do it is to facilitate requests for purchases. Contrariwise, employing salesmen to repair or service the company's products is not part of the "solicitation of orders," since there is good reason to get that done whether or not the company has a sales force. Repair and servicing may help to *increase* purchases; but it is not ancillary to *requesting purchases*, and cannot be converted into "solicitation" by merely being assigned to salesmen. See, e.g., Herff Jones Co. v State Tax Comm'n, 247 Ore 404, 412, 430 P2d 998, 1001-1002 (1967) (no § 381 immunity for sales representatives' collection activities).[6]

As we have discussed earlier, the text of the statute (the "office" exception in subsection (c)) requires one exception to this principle: Even if engaged in exclusively to facilitate requests for purchases, the maintenance of an office within the State, by the company or on its behalf, would go beyond the "solicitation of orders." We would not make any more generalized exception to our immunity standard on the basis of the "office" provision. It seemingly represents a judgment that a company office within a State is such a significant manifestation of company "presence" that, absent a specific exemption, income taxation should always be allowed. Jantzen, Inc. v District of Columbia, 395 A2d 29, 32 (DC 1978); see generally Hellerstein, supra, ¶ 6.4.

Wisconsin urges us to hold that no *post-sale* activities can be included within the scope of covered "solicitation." We decline to do so. Activities that take place after a sale will ordinarily not be entirely ancillary in the sense we have described, see, e.g., Miles Laboratories v Department of Revenue, 274 Ore 395, 400, 546 P2d 1081, 1083 (1976) (replacing damaged goods), but we are not prepared to say that will invariably be true. Moreover, the pre-sale/post-sale distinction is hopelessly unworkable. Even if one disregards the confusion that may exist concerning when a sale takes place, cf. Uniform Commercial Code § 2-401, 1A ULA 675 (1989), manufacturers and distributors ordinarily have ongoing relationships

---

[5] The dissent states that ancillarity should be judged, not from the perspective of the seller, but from the persective of the *buyer*. Post, at _______ , 120 L Ed 2d, at 194 (test is whether "reasonable *buyers* would consider [the activities] to be a part of the solicitation itself") (emphasis added); post, at _______ , 120 L Ed 2d, at 198 ("The test I propose ... requires an objective assessment from the vantage point of a reasonable *buyer*") (emphasis added); post, at _______ , 120 L Ed 2d, at 200 (question is whether the activities "possess independent value to the *customer*") (emphasis added). As explained earler, see n 4, supra, this rule inevitably results in a whatever-the-industry-wants standard, despite the dissent's unequivocal disavowal of such a test.

The dissent also suggests that ancillarity should be judged by asking whether a particular challenged activity is "*related* to a *particular* sales call or to a particular sales solicitation," post, at _______ , 120 L Ed 2d, at 199 (emphasis added). This standard, besides being amorphous, cannot be correct. Those activities that are most clearly *not* immunized by the statute—e.g., actual sales, collection of funds—would seem to be the ones *most* closely "related" to particular acts of actual solicitation. And activities the dissent finds immunized in the present case—maintenance of a storage facility, and use of a home office—are extremely remote.

[6] Contrary to the dissent's suggestion, post, at _______ , _______ , 120 L Ed 2d, at 197-198, 200, both Brown-Forman and International Shoe would have been decided differently under these principles. The various activities at issue in those cases (renting a room for temporary display of sample products; assisting wholesalers in obtaining suitable product display in retail shops) would be considered merely ancillary to either wholesale solicitation or downstream (consumer or retailer) solicitation.

that involve continuous sales, making it often impossible to determine whether a particular incidental activity was related to the sale that preceded it or the sale that followed it.

B

The Wisconsin Supreme Court also held that a company does not necessarily forfeit its tax immunity under § 381 by performing *some* instate business activities that go beyond "solicitation of orders"; rather, it said, "[c]ourts should also analyze" whether these additional activities were "'deviations from the norm'" or "de minimis activities." 160 Wis 2d, at 82, 465 NW2d, at 811 (citation omitted). Wisconsin asserts that the plain language of the statute bars this recognition of a de minimis exception, because the immunity is limited to situations where "the *only* business activities within [the] State" are those described, 15 USC § 381 [15 USCS § 381] (emphasis added). This ignores the fact that the venerable maxim de minimis non curat lex ("the law cares not for trifles") is part of the established background of legal principles against which all enactments are adopted, and which all enactments (absent contrary indication) are deemed to accept. See, e.g., Republic of Argentina v Weltover, Inc., 504 US_______ , _______ , 119 L Ed 2d 394, 112 S Ct _______ , (1992); Hudson v McMillian, 503 US _______ ,, _______ ,, 117 L Ed 2d 156, 112 S Ct 995 (1992); Ingraham v Wright, 430 US 651, 674, 51 L Ed 2d 711, 97 S Ct 1401 (1977); Abbott Laboratories v Portland Retail Druggists Assn., Inc., 425 US 1, 18, 47 L Ed 2d 537, 96 S Ct 1305 (1976); Industrial Assn. of San Francisco v United States, 268 US 64, 84, 69 L Ed 849, 45 S Ct 503 (1925). It would be especially unreasonable to abandon normal application of the de minimis principle in construing § 381, which operates in such stark, all-or-nothing fashion: A company either has complete net-income tax immunity or it has none at all, even for its solicitation activities. Wisconsin's reading of the statute renders a company liable for hundreds of thousands of dollars in taxes if one of its salesmen sells a 10¢ 34 item in-state. Finally, Wisconsin is wrong in asserting that application of the de minimis principle "excise[s] the word 'only' from the statute." Brief for Petitioner 27. The word "only" places a strict limit upon the *categories* of activities that are covered by § 381, not upon their *substantiality*. See, e.g., Drackett Prods. Co. v Conrad, 370 NW2d 723, 726 (ND 1985); Kimberly Clark, 275 Ind, at 383-384, 416 NE2d, at 1268.

Whether a particular activity is a de minimis deviation from a prescribed standard must, of course, be determined with reference to the purpose of the standard. Section 381 was designed to increase—beyond what Northwestern States suggested was required by the Constitution—the connection that a company could have with a State before subjecting itself to tax. Accordingly, whether in-state activity other than "solicitation of orders" is sufficiently de minimis to avoid loss of the tax immunity conferred by § 381 depends upon whether that activity establishes a nontrivial additional connection with the taxing State.

III

Wisconsin asserts that at least six activities performed by **Wrigley** within its borders went beyond the "solicitation of orders": the replacement of stale gum by sales representatives; the supplying of gum through "agency stock checks"; the storage of gum, racks, and promotional materials; the rental of space for storage; the regional manager's recruitment,

training, and evaluation of employees; and the regional manager's intervention in credit disputes.[7] Since none of these activities can reasonably be viewed as requests for orders covered by § 381, **Wrigley** was subject to tax unless they were either ancillary to requesting orders or de minimis.

We conclude that the replacement of stale gum, the supplying of gum through "agency stock checks," and the storage of gum were not ancillary. As to the first: **Wrigley** would wish to attend to the replacement of spoiled product whether or not it employed a sales force. Because that activity serves an independent business function quite separate from requesting orders, it does not qualify for § 381 immunity. Miles Laboratories, 274 Ore, at 400, 546 P2d, at 1083. Although **Wrigley** argues that gum replacement was a "promotional necessity" designed to ensure continued sales, Brief for Respondent 31, it is not enough that the activity facilitate *sales*; it must facilitate the *requesting of sales*, which this did not.[8]

The provision of gum through "agency stock checks" presents a somewhat more complicated question. It appears from the record that this activity occurred only in connection with the furnishing of display racks to retailers, so that it was arguably ancillary to a form of *consumer* solicitation. Section 381(a)(2) shields a manufacturer's "missionary" request that an indirect customer (such as a consumer) place an order, if a successful request would ultimately result in an order's being filled by a § 381 "*customer*" of the manufacturer, i.e., by the wholesaler who fills the orders of the retailer with goods shipped to the wholesaler from out-of-state. Cf. Gillette, 56 App Div 2d, at 482, 393 NYS2d, at 191 ("Advice to retailers on the art of displaying goods to the public can hardly be more thoroughly solicitation ..."). It might seem, therefore, that setting up gum-filled display racks, like **Wrigley's** general advertising in Wisconsin, would be immunized by § 381(a)(2). What destroys this analysis, however, is the fact that **Wrigley** *made the retailers pay for the gum*, thereby providing a business purpose for supplying the gum quite independent from the purpose of soliciting consumers. Since providing the gum was not entirely ancillary to requesting purchases, it was

---

[7] Wisconsin has also argued that the scope of the regional managers' activities caused their residences to be, "[in] economic reality," **Wrigley** offices in the State. Brief for Petitioner 32. If this means that having resident salesmen without offices can sometimes be as commercially effective as having nonresident salesmen with offices, perhaps it is true. But it does not establish that **Wrigley** "maintained an office" in the sense necessary to come within the exception to the "entirely ancillary" standard we have announced. See supra, at _______ , 120 L Ed 2d, at 190. Nor does the regional managers' occasional use of their homes for meetings with salesmen, or Kroyer's uncompensated dedication of a portion of his home basement to his own office. The maintenance of an office necessary to trigger the exception must be more formally attributed to the out-of-state company itself, or to the agents of that company in their agency capacity—as was, for example, the rented office in Northwestern States.

[8] The dissent argues that this activity must be considered part of "solicitation" because, inter alia, it was "minimal," and not "significant." Post, at _______ , - _______ , 120 L Ed 2d, at 198-199. We disagree. It was not, as the dissent suggests, a practice that involved simple "acts of courtesy" that occurred only because a salesman happened to be on the scene and did not wish to "harm the company." Post, at _______ - _______ , _______ , 120 L Ed 2d, at 197, 199. **Wrigley** deliberately chose to use its sales force to engage in regular and systematic replacement of stale product on a level that amounted to several thousand dollars per year, which is a lot of chewing gum.

not within the scope of "solicitation of orders."[9] And because the vast majority of the gum stored by **Wrigley** in Wisconsin was used in connection with stale gum swaps and agency stock checks, that storage (and the indirect rental of space for that storage) was in no sense ancillary to "solicitation."

By contrast, **Wrigley's** in-state recruitment, training, and evaluation of sales representatives and its use of hotels and homes for sales-related meetings served no purpose apart from their role in facilitating solicitation. The same must be said of the instances in which **Wrigley's** regional sales manager contacted the Chicago office about "rather nasty" credit disputes involving important accounts in order to "get the account and [**Wrigley's**] credit department communicating," App 71, 72. It hardly appears likely that this mediating function between the customer and the central office would have been performed by some other employee—some company ombudsman, so to speak—if the on-location sales staff did not exist. The purpose of the activity, in other words, was to ingratiate the salesman with the customer, thereby facilitating requests for purchases.

Finally, **Wrigley** argues that the various nonimmune activities, considered singly or together, are de minimis. In particular, **Wrigley** emphasizes that the gum sales through "agency stock checks" accounted for only 0.00007% of **Wrigley's** annual Wisconsin sales, and in absolute terms amounted to only several hundred dollars a year. We need not decide whether any of the nonimmune activities was de minimis in isolation; taken together, they clearly are not. **Wrigley's** sales representatives exchanged stale gum, as a matter of regular company policy, on a continuing basis, and **Wrigley** maintained a stock of gum worth several thousand dollars in the State for this purpose as well as for the less frequently pursued (but equally unprotected) purpose of selling gum through "agency stock checks." Although the relative magnitude of these activities was not large compared to **Wrigley's** other operations in Wisconsin, we have little difficulty concluding that they constituted a nontrivial additional connection with the State. Because **Wrigley's** business activities within Wisconsin were not limited to those specified in § 381, the prohibition on net-income taxation contained in that provision was inapplicable.

...

Accordingly, the judgment of the Supreme Court of Wisconsin is reversed, and the case is remanded for further proceedings not inconsistent with this opinion.

It is so ordered.

Justice **O'Connor**, concurring in Parts I and II, and concurring in the judgment.

I join sections I and II of the Court's opinion. I do not agree, however, that the replacement of stale gum served an independent business function. The replacement of stale gum

[9] The dissent speculates, without any basis in the record, that **Wrigley** might have chosen to charge for the gum, not for the profit, but because giving it away would "lower the per unit cost of all goods purchased," which "could create either the fact or the perception that retailers were not receiving the same price." Post, at _______ - _______ , 120 L Ed 2d, at 192-199. Though **Wrigley's** *motive* for choosing to make a profit on these items seems to us irrelevant in any event, we cannot avoid observing how unlikely it is that this was the reason **Wrigley** did not include free gum in its (per-unit-cost-distorting) free racks, although it did, as the record shows, regularly give away *other* (presumably per-unit-cost-distorting) free gum. **Wrigley** itself did not have the temerity to make this argument.

by the sales representatives was part of ensuring the product was available to the public in a form that may be purchased. Making sure that one's product is available and properly displayed serves no independent business function apart from requesting purchases; one cannot offer a product for sale if it is not available. I agree, however, that the storage of gum in the State and the use of agency stock checks were not ancillary to solicitation and were not de minimis. On that basis, I would hold that **Wrigley's** income is subject to taxation by Wisconsin.

Dissenting Opinion

Justice **Kennedy**, with whom The **Chief Justice** and Justice **Blackmun** join, dissenting.

Congress prohibits the States from imposing taxes on income derived from "business activities" in interstate commerce and limited to the "solicitation of orders" under certain conditions. 15 USC § 381(a) [15 USCS § 381(a)]. The question we face is whether **Wrigley** has this important tax immunity for its business activities in the State of Wisconsin. I agree with the Court that the statutory phrase "solicitation of orders" is but a subset of the phrase "business activities." Ibid.; ante, at _______ - _______ , 120 L Ed 2d, at 187-188. I submit with all respect, though, that the Court does not allow its own analysis to take the proper course. The Court instead devises a test that excludes business activities with a close relation to the solicitation of orders, activities that advance the purpose of the statute and its immunity.

The Court is correct, in my view, to reject the two polar arguments urged upon us: one, that ordinary and necessary business activities surrounding the solicitation of orders are part of the exempt solicitation itself; and the other, that the only exempt activities are those essential to the sale. Id., at _______ , _______ , 120 L Ed 2d, at 186, 188. Having done so, however, the Court exits a promising avenue of analysis and adopts a test with little relation to the practicalities of solicitation. The Court's rule will yield results most difficult to justify or explain. My submission is that the two polarities suggest the proper analysis and that the controlling standard lies between. It is difficult to formulate a complete test in one case, but the general rule ought to be that the statute exempts business activities performed in connection with solicitation if reasonable buyers would consider them to be a part of the solicitation itself and not a significant and independent service or component of value.

I begin with the statute. Section 381(a) provides as follows:

> "No State, or political subdivision thereof, shall have power to impose, for any taxable year ending after September 14, 1959, a net income tax on the income derived within such State by any person from interstate commerce if the only business activities within such State by or on behalf of such person during such taxable year are either, or both, of the following:
>
> "(1) the solicitation of orders by such person, or his representative, in such State for sales of tangible personal property, which orders are sent outside the State for approval or rejection, and, if approved, are filled by shipment or delivery from a point outside the State; and
>
> "(2) the solicitation of orders by such person, or his representative, in such State in the name of or for the benefit of a prospective customer of such person, if orders by such customer to such person to enable such customer to fill orders resulting from such solicitation are orders described in paragraph (1)."

15 USC § 381(a) [15 USCS § 381(a)].

The key phrases, as recognized by the Court, are "business activities" and "solicitation of orders." Ante, at _______ – _______ , 120 L Ed 2d, at 187-188. By using "solicitation of orders" to define a subset of "business activities," the text suggests that the immunity to be conferred encompasses more than a specific request for a purchase; it includes the process of solicitation, as distinguished from manufacturing, warehousing, or distribution. Congress could have written § 381(a) to exempt "acts" of "solicitation" or "solicitation of orders," but it did not. The decision to use the phrase "business activities," while not unambiguous, suggests that the statute must be read to accord with the practical realities of interstate sales solicitations, which, after all, Congress acted to protect.

The textual implication I find draws support from legal and historical context. Even those who approach legislative history with much trepidation must acknowledge that the statute was a response to three specific court decisions: Northwestern States Portland Cement Co. v Minnesota, 358 US 450, 3 L Ed 2d 421, 79 S Ct 357, 67 ALR2d 1292 (1959),International Shoe Co. v Fontenot, 236 La 279, 107 So 2d 640 (1958), cert denied, 359 US 984, 3 L Ed 2d 933, 79 S Ct 943 (1959), and Brown-Forman Distillers Corp. v Collector of Revenue, 234 La 651, 101 So 2d 70 (1958), appeal dism'd, cert denied, 359 US 28, 3 L Ed 2d 625, 79 S Ct 602 (1959). S Rep No. 658, 86th Cong, 1st Sess, 2-3 (1959) (hereinafter S Rep); HR Rep No. 936, 86th Cong, 1st Sess, 1-2 (1959) (hereinafter HR Rep). See ante, at _______ – _______ , 120 L Ed 2d, at 183-185, and n 1. These decisions departed from what had been perceived as a well-settled rule, stated in Norton Co. v Illinois Dept. of Revenue, 340 US 534, 95 L Ed 517, 71 S Ct 377 (1951), that solicitation in interstate commerce was protected from taxation in the State where the solicitation took place.

> "Where a corporation chooses to stay at home in all respects except to send abroad advertising or drummers to solicit orders which are sent directly to the home office for acceptance, filling, and delivery back to the buyer, it is obvious that the State of the buyer has no local grip on the seller. Unless some local incident occurs sufficient to bring the transaction within its taxing power, the vendor is not taxable." Id., at 537, 95 L Ed 517, 71 S Ct 377.

Firm expectations within the business community were built upon the rule as restated in Norton. Companies engaging in interstate commerce conformed their activities to the limits our cases seemed to have endorsed. To be sure, the decision to stay at home might have derived in some respects from independent business concerns. The expense and commitment of an in-state sales office, for example, might have informed a decision to send salesmen into a State without further staff support. Some interstate operations, though, carried the unmistakable mark of a legal rather than business justification. The technical requirement that orders be approved at the home office, unless approval required judgment or expertise (for example, if the order depended on an ancillary decision to give credit or to name an official retailer), was no doubt the product of the legal rule.

These settled expectations were upset in 1959, their continuing vitality put in doubt by Northwestern States, International Shoe, and Brown-Forman. In Northwestern States, the Court upheld state income taxation against two companies whose in-state operations included a sales staff and sales office. 358 US, at 454-455, 3 L Ed 2d 421, 79 S Ct 357,

67 ALR2d 1292. Our disposition was consistent with prior law, since both companies maintained offices within the taxing State. Ibid. But the Court's opinion was broader than the holding itself and marked a departure from prior law.

> "We conclude that net income from the interstate operations of a foreign corporation may be subject to state taxation provided the levy is not discriminatory and is properly apportioned to local activities within the taxing State forming sufficient nexus to support the same." Id., at 452, 3 L Ed 2d 421, 79 S Ct 357, 67 ALR2d 1292.

In the absence of case law giving meaning to "sufficient nexus," the Court's use of this indeterminate phrase created concern and apprehension in the business community. S Rep, at 2-4; HR Rep, at 1. Apprehension increased after our denial of certiorari in International Shoe and Brown-Forman, where the Louisiana Supreme Court upheld the taxation of companies whose business activities within the State were limited to solicitation by salespeople. S Rep, at 3; HR Rep, at 2. The concern stemmed not only from the prospect for tax liability in an increasing number of States but also from the uncertainty of its amount and apportionment, the burdens of compliance, a lack of uniformity under state law, the withdrawal of small businesses from States where the cost and complexity of compliance would be great, and the extent of liability for back taxes. S Rep, at 2-4.

As first drafted by the Senate Finance Committee, § 381(a) would have addressed the decisions in Northwestern States, International Shoe, and Brown-Forman. S Rep, at 2-3; HR Rep, at 3; 105 Cong Rec 16378, 16934 (1959). The Committee recommended a bill defining "business activities" in three subsections, with one subsection corresponding to the facts in each of the three cases. S 2524, 86th Cong, 1st Sess (1959). Before the bill was enacted, however, the Senate rejected the third of these subsections, corresponding to Northwestern States, which would have extended protection to companies with in-state sales offices. 105 Cong Rec 16469-16477 (1959) (Senate debate on an amendment proposed by Sen. Talmadge (Ga)). But the other two subsections, those dealing with the state-court decisions in International Shoe and Brown-Forman, were retained. Id., at 16367, 16376, 16471, 16934; HR Rep No., at 3. Thus, while Northwestern States provided the first impetus for the enactment of § 381(a), it does not explain the statute in its final form. By contrast, the history of enactment makes clear that § 381(a) exempts from state income taxation at least those business activities at issue in International Shoe and Brown-Forman. These cases must inform any attempt to give meaning to § 381(a).

International Shoe manufactured shoes in St. Louis, Missouri. Its only activity within the State of Louisiana consisted of regular and systematic solicitation by 15 salespeople. No office or warehouse was maintained inside Louisiana, and orders were accepted and shipped from outside the State. The salespeople carried product samples, drove in company-owned automobiles, and rented hotel rooms or rooms of public buildings in order to make displays. International Shoe, 236 La, at 280, 107 So 2d, at 640; Hartman, "Solicitation" and "Delivery" Under Public Law 86-272: An Uncharted Course, 29 Vand L Rev 353, 358 (1976).

Brown-Forman distilled and packaged whiskey in Louisville, Kentucky, for sale in Louisiana and elsewhere. It solicited orders in Louisiana with the assistance of an in-state sales staff. All orders were approved and shipped from outside the State. There was no in-state office

of any kind. Brown-Forman salespeople performed two functions: they solicited orders from wholesalers, who were direct customers of Brown-Forman; and they accompanied the wholesalers' own sales force on visits to retailers, who were solicited by the wholesalers. The Brown-Forman salespeople did not solicit orders at all when visiting retailers, nor could they sell direct to them. They did assist in arranging suitable displays of the distiller's merchandise in the retail establishments. Brown-Forman, 234 La, at 653-654, 101 So 2d, at 70.

The activities in International Shoe and Brown-Forman extended beyond specific acts of entreaty; they included merchandising and display, as well as other simple acts of courtesy from buyer to seller, such as arranging product displays and calling on the customer of a customer. The activities considered in International Shoe and Brown-Forman are by no means exceptional. Checking inventories, displaying products, replacing stale product, and verifying credit are all normal acts of courtesy from seller to buyer. J. Hellerstein, 1 State Taxation: Corporate Income and Franchise Taxes ¶ 6.11[2], p 245 (1983). A salesperson cannot solicit orders with any degree of effectiveness if he is constrained from performing small acts of courtesy. Note, State Taxation of Interstate Commerce: Public Law 86-272, 46 Va L Rev 297, 315 (1960).

The business activities of **Wrigley** within Wisconsin have substantial parallels to those considered in International Shoe and Brown-Forman. **Wrigley** has no manufacturing facility in the State. It maintains no offices or warehouses there. The only product it owns in the State is the small amount necessary for its salespeople to call upon their accounts. All orders solicited by its salespeople are approved or rejected outside of the State. All orders are shipped from outside of the State. Other activities, such as intervening in credit disputes, hiring salespeople, or holding sales meetings in hotel rooms, do not exceed the scope of § 381(a); I agree with the Court that these too are the business activities of solicitation. Ante, at_______ - _______ , 120 L Ed 2d, at 193; App 10-13.

The Department of Revenue, in an apparent concession of the point, does not contend that the business activities of **Wrigley** exceed the normal scope of solicitation; instead the Department relies on a distinction between business activities undertaken before and after the sale. Brief for Petitioner 18, 21. Under the Department's submission, acts leading to the sale are within the statutory safe-harbor, while any act following the sale is beyond it. Ibid. I agree with the Court, as well as with the Supreme Court of Wisconsin, that this distinction is unworkable in the context of a continuing business relation with many repeat sales. Ante, at _______ - _______ , 120 L Ed 2d, at 190; App to Pet for Cert A-41.

As the Court indicates, the case really turns upon our assessment of two practices: replacing stale product and providing gum in display racks. Ante, at _______ , 120 L Ed 2d, at 192. If the retailers relied on the **Wrigley** sales force to replace all stale product and that service was itself significant, say on the magnitude of routine deliveries of fresh bread, then a separate service would seem to be involved. But my understanding of the record is that replacement of stale gum took place only during the course of regular solicitation. App 27-28, 41, 58, 117-118. There was no contract to perform this service. There is no indication in the record that this was the only method dealers relied upon to remove stale product. It is not plausible to believe that by enacting § 381(a) Congress insisted that every sales representative in every industry would be prohibited from doing just what **Wrigley** did.

Acceptance of the stale gum replacement does not allow industry practices to replace objective statutory inquiry. The existence of a contract to perform this service, or an indication in the record that this service provided an independent component of significant value, would alter the case's disposition, regardless of the seller's intentions. The test I propose does not depend on the sellers' intentions or motives whatsoever; rather it requires an objective assessment from the vantage point of a reasonable buyer. If a reasonable buyer would consider the replacement of stale gum to provide significant independent value, then this service would subject **Wrigley** to taxation. The majority appears to concede the point in part when it observes **Wrigley** replaced stale gum free of charge, ante, at _______ , n 9, 120 L Ed 2d, at 192-193, which provides a strong indication that the replacement of stale gum is valuable to **Wrigley**, not its customers, as an assurance of quality given in the course of an ongoing solicitation.

I agree with the Court's approach, which is to provide guidance by some general rule that is faithful to the precise language of the statute. But it ought not to do so without recognition of some of the most essential aspects of solicitation techniques. No responsible company would expect its sales force to decline giving minimal assistance to a retailer in replacing damaged or stale product. In enacting § 381(a), Congress recognized the importance of interstate solicitation to the strength of our national economy. The statute must not to be interpreted to repeal the rules of good sales techniques or to forbid common solicitation practices under the threat of forfeiting this important tax exemption. Congress acted to protect interstate solicitation, not to mandate inefficiency.

Even accepting the majority's test on its own terms, the business activities which the Court finds to be within the safe harbor of the federal statute are less ancillary to a real sales solicitation than are the activities it condemns. The credit adjustment techniques and the training sessions the Court approves are not related to a particular sales call or to a particular sales solicitation, but the condemned display and replacement practices are. I do not understand why the Court thinks that a credit dispute over an old transaction, handled by telephone weeks or months later is exempt because it "ingratiate[s] the salesman with the customer, thereby facilitating requests for purchases," ante, at _______ , 120 L Ed 2d, at 193, but that this same process of ingratiation does not occur when a salesman who is on the spot to solicit an order refuses to harm the company by leaving the customer with bad product on the shelf. If there were any distinction between the two, I should think we would approve the replacement and condemn the credit adjustment. The majority fails to address this anomaly under its test, responding instead that my observation of it suggests ambiguity in my own. Id., at _______ , n 5, 120 L Ed 2d, at 189. In my view, both the gum replacement and credit adjustment are within the scope of solicitation.

I would agree with the Court that the furnishing of racks with gum that is sold to the customer presents a problem of a different order, id., at _______ , 120 L Ed 2d, at 192, but here too I think it adds no independent value apart from the solicitation itself. To begin with, I think it rather well accepted that the setting up of display racks and the giving of advice on sales presentation is central to the salesperson's role in cultivating customers. There are dangers for the manufacturer, however, if the salesperson spends the time to set up a display and then stocks it with free goods, because this could create either the fact or the perception that

retailers were not receiving the same price. Free goods lower the per unit cost of all goods purchased. The simplest policy to avoid this problem is to charge for the goods displayed, and that is what occurred here. Moreover, I cannot ignore, as the Court appears to do, that a minuscule amount of gum, no more than 0.00007% (seven one-hundred thousands of one percent) of **Wrigley's** in-state sales, was stocked into display racks in this fashion. Brief for Respondent 5; App to Pet for Cert A-43. Indeed, the testimony is that **Wrigley** salespeople would stock these display racks out of their own supply of samples only as a matter of last resort, in instances where the retailer possessed an inadequate supply of gum and could not await delivery in the normal course.

> "Q Well, I take it that if you put in the stand and it was a new stand, you took the gum out of your vehicle and transferred it to him there; is that correct?
>
> "A No, I would not say that's correct.
>
> "Q Well, did you ever stock new stands from your vehicle?
>
> "A I would say possibly on some—on a few occasions.
>
> "Q And how many few occasions were there during your tenure as a field representative in 1978?
>
> "A Boy. I would just be guessing. Maybe a dozen times.
>
> "Q And just what would—what all happened in that circumstance that you wound up putting in a new stand and taking the gum out of your vehicle and transferring it to the retailer?
>
> "A Well, like I said, primarily I wanted to get a stand in and then he wanted to get that order through his wholesaler; but if he couldn't wait, if he said my wholesaler was just in yesterday or something or he was not going to be in for a week, he didn't want a stand sitting around, so we would then fill it and then bill the wholesaler...." App 37-38.

Under the circumstances described here, I fail to see why the stocking of a gum display does not "ingratiate the salesman with the customer, thereby facilitating requests for purchases," ante, at ________ , 120 L Ed 2d, at 193, as is required under the rule formulated by the Court. The small amount of gum involved in stocking a display rack, no more than $15-20 worth, belies any speculation, id., at ________ , n 9, 120 L Ed 2d, at 192-193, that **Wrigley** was driven by a profit motive in charging customers for this gum. App 38.

The Court pursues a laudable effort to state a workable rule, but in the attempt condemns business activities that are bound to solicitation and do not possess independent value to the customer apart from what often accompanies a successful solicitation. The business activities of **Wrigley** in Wisconsin, just as those considered in International Shoe and Brown-Forman, are the solicitation of orders. The swapping of stale gum and the infrequent stocking of fresh gum into new displays are not services that **Wrigley** was under contract to perform; they are not activities that can be said to have provided their own component of significant value; rather they are activities conducted in the course of solicitation and whose legal effect should be the same. My examination of the language of the statute, considered in the context of its enactment, demonstrates that the concerns to which § 381(a) was directed, and for which its language was drafted, are misapprehended by the Court's decision today.

I would affirm the judgment of the Wisconsin Supreme Court.

Appendix D: *Geoffrey, Inc. v. South Carolina Tax Commission*

South Carolina Supreme Court, 437 SE2d 13, *cert denied*, 114 S.Ct. 550 (1993).

Geoffrey, Inc., a foreign corporation, appeals from a ruling that requires it to pay South Carolina income tax and business license fees. We affirm.

I. FACTS

Geoffrey is a wholly-owned, second-tier subsidiary of Toys R Us, Inc. (Toys R Us) incorporated in Delaware with its principal offices in that state. It has no employees or offices in South Carolina and owns no tangible property here.

In 1984, Geoffrey became the owner of several valuable trademarks and trade names, including "Toys R Us." Later that year, Geoffrey executed a License Agreement (Agreement) that allows Toys R Us to use the "Toys R Us" trade name, as well as other trademarks and trade names, in all states except New York, Texas, Pennsylvania, Massachusetts, and New Jersey. The Agreement further grants Toys R Us a right to use Geoffrey's merchandising skills, techniques, and "know-how" in connection with marketing, promotion, advertising, and sale of products covered by the Agreement.

As consideration for the licenses granted by the Agreement, Geoffrey receives a royalty of one percent "of the net sales by [Toys R Us], or any of its affiliated, associated, or subsidiary companies, of the Licensed Products sold or the Licensed Services rendered under the Licensed Mark." Toys R Us reports the aggregate sales of all stores to Geoffrey in a single figure on a monthly basis. The royalty payment is made annually via wire transfer from a Toys R Us account in Pennsylvania to a Geoffrey account in New York.[1]

Toys R Us began doing business in South Carolina in 1985 and has since then made royalty payments to Geoffrey based on South Carolina sales. In 1986 and 1987, Toys R Us deducted the royalty payments made to Geoffrey from its South Carolina taxable income. The South Carolina Tax Commission (Commission) initially disallowed the deduction, but later took the position that Toys R Us was entitled to the deduction and that Geoffrey was required to pay South Carolina income tax on the royalty income. The Commission also held that Geoffrey was required to pay the South Carolina corporate license fee.

[1] The net effect of this corporate structure has been the production of "nowhere' 'income that escapes all state income taxation. See Rosen, *Use of a Delaware Holding Company to Save State Income Taxes*, 20 Tax Adviser 180 (1989). One commentator has recognized such income as the "product of a divide and conquer strategy that some members of the corporate world have exercised effectively for decades." Corrigan, *Interstate Corporate Income Taxation—Recent Revolutions and a Modern Response*, 29 Vand. L. Rev. 423, 429 (1976). The strategy's effectiveness is unquestionable. In 1990, Geoffrey without any full-time employees, had an income of approximately $55 million and paid no income taxes to any state.

Geoffrey paid the taxes under protest and filed this action for a refund, claiming, among other things, that it did not do business in South Carolina and that it did not have a sufficient nexus with South Carolina for its royalty income to be taxable here. The trial judge upheld the Commission's assessment of taxes against Geoffrey. Geoffrey appealed.

II. DISCUSSION

S.C. Code Ann. §12-7-230 (Supp. 1992), pursuant to which both foreign and domestic corporations are taxed, provides:

> [E]xcept as otherwise provided, every foreign corporation transacting, conducting, doing business, or having an income within the jurisdiction of this State, whether or not the corporation is engaged in or the income derived from intrastate, interstate, or foreign commerce, shall make a return and shall pay annually an income tax equivalent to five percent of a proportion of its entire net income to be determined as provided in this chapter. The term "transacting", "conducting", or "doing business", as used in this section, includes the engaging in or the transacting of any activity in this State for the purpose of financial profit or gain.

Section 12-7-230 levies a tax on the income of foreign corporations "transacting, conducting, doing business, or having an income *within the jurisdiction of this State*," which "includes," but is not limited to, "the engaging in or the transacting of any activity in this State for the purpose of financial profit or gain." We construe this language as extending to the limits of the constitution South Carolina's authority to tax foreign corporations. Here, Geoffrey contends that the Due Process Clause, U.S. Const. amend, XIV, §1, and the Commerce Clause, U.S. Const. art. I, §8, cl. 3, prohibit the taxation of its royalty income by South Carolina. We disagree.

A. DUE PROCESS

The Due Process Clause requires "some definite link, some minimum connection, between a State and the person, property or transaction it seeks to tax," and that the "income attributed to the state for tax purposes must be rationally related to values connected with the taxing State." *Quill Corp. v. North Dakota*, U.S., 112 S.Ct. 1904, 1909-10, 119 L.Ed.2d 91, 102 (1992). Geoffrey argues that the Commission has failed to satisfy both of these requirements. We disagree.

The nexus requirement of the Due Process Clause can be satisfied even where the corporation has no physical presence in the taxing state if the corporation has purposefully directed its activity at the state's economic forum. *Quill*, U.S. at 112 S.Ct. at 1909-10, 119 L.Ed.2d at 104. Geoffrey asserts that it has not purposefully directed its activities toward South Carolina. To support its position, Geoffrey points out that Toys R Us had no South Carolina stores when it entered into the Agreement and urges, therefore, that Toys R Us's subsequent expansion into South Carolina was unilateral activity that cannot create the minimum connection between Geoffrey and South Carolina required by due process.

In our view, Geoffrey has not been unwillingly brought into contact with South Carolina through the unilateral activity of an independent party. Geoffrey's business is the ownership, licensing, and management of trademarks, trade names, and franchises. By electing to license its trademarks and trade names for use by Toys R Us in many states, Geoffrey contemplated and purposefully sought the benefit of economic contact with those states. Geoffrey has been aware of, consented to, and benefited from Toys R Us's use of Geoffrey intangibles in South Carolina. Moreover, Geoffrey had the ability to control its contact with South Carolina by prohibiting the use of its intangibles here as it did with other states. We reject Geoffrey claim that it has not purposefully directed its activities toward South Carolina's economic forum and hold that by licensing intangibles for use in South Carolina and receiving income in exchange for their use, Geoffrey has the "minimum connection" with this State that is required by due process. *See American Dairy Queen Corp. v. Taxation and Revenue Dep't*, 93 N.M. 743, 605 P.2d 251 (1979); *Aamco Transmissions, Inc. v. Taxation and Revenue Dep't*, 93 N.M. 389, 600 P.2d 841, *cert. denied*, 93 N.M. 205, 598 P.2d 1165 (1979).

In addition to our finding that Geoffrey purposefully directed its activities toward South Carolina, we find that the "minimum connection" required by due process also is satisfied by the presence of Geoffrey intangible property in this State. Geoffrey's Secretary, a certified public accountant, agreed during cross examination that sales by Toys R Us in South Carolina create an account receivable for Geoffrey. In addition, the trial judge found that Geoffrey had a franchise in South Carolina.[2] That the presence of these intangibles is sufficient to sustain a tax is settled law. In Virginia v. Imperial Coal Sales Co., Inc, 293 U.S. 15, 20, 55 S.Ct. 12, 14, 79 L.Ed. 171, 175 (1934), the United States Supreme Court stated:

> It is not the character of the property that makes it subject to such a tax, but the fact that the property has a situs within the state and that the owner should give appropriate support to the government that protects it. That duty is not less when the property is intangible than when it is tangible. Nor are we able to perceive any sound reason for holding that the owner must have real estate or tangible property within the state in order to subject its intangible property within the state to taxation.[3]

Geoffrey asserts that under the doctrine of *mobilia sequuntur personam*, the situs of its intangibles is its corporate headquarters in Delaware, not South Carolina. However, in *Mobil Oil Corp. v. Comm'r of Taxes of Vermont*, 445 U.S. 425, 100 S.Ct. 1223, 63 L.Ed.2d 510 (1980), the United States Supreme Court rejected the view that the constitution requires taxation

---

[2] "In its simplest terms, a franchise is a license from the owner of a trademark or trade name permitting another to sell a product or service under that name or mark. More broadly stated, a `franchise' has evolved into an elaborate agreement under which the franchisee undertakes to conduct a business or sell a product or service in accordance with methods and procedures prescribed by the franchisor, and the franchisor undertakes to assist the franchisee through advertising, promotion, and other advisory services." *Black's Law Dictionary* 592 (5th ed. 1979). Geoffrey has not challenged the trial judge's finding that the Agreement created a franchise.

[3] Although the tax at issue in *Imperial Coal* was an *ad valorem* property tax imposed upon the accounts receivable of a Virginia corporation, we do not find that fact distinguishing. Authority to tax the property extends to income produced by the property. "That [a state] may tax the land but not the crop, the tree but not the fruit, the mine or well but not the product, the business but not the profit derived from it is wholly inadmissible." *Shaffer v. Carter*, 252 U.S. 37, 49-50, 40 S.Ct. 221, 225, 64 L.Ed. 445 (1920).

of intangibles by allocation to a *single* situs, finding no adequate justification for preferring that rule over taxation by apportionment. The High Court concluded that:

> [a]lthough a fictionalized situs of intangible property sometimes has been invoked to avoid multiple taxation of ownership, there is nothing talismanic about the concepts of "business situs" or "commercial domicile" that automatically renders those concepts applicable when taxation of income from intangibles is at issue. The Court has observed that the maxim *mobilia sequuntur personam*, upon which these fictions of situs are based, "states a rule without disclosing the reasons for it." . . . The Court has also recognized that "the reason for a single place of taxation no longer obtains" when the taxpayer's activities with respect to the intangible property involve relations with more than one jurisdiction. . . . Even for property or franchise taxes, apportionment of intangible values is not unknown. . . . Moreover, cases upholding allocation to a single situs for property tax purposes have distinguished income tax situations where the apportionment principle prevails. (Citations omitted).

Id. at 445, 100 S.Ct. at 1235, 63 L.Ed.2d at 525-26. *See also Wheeling Steel Corp. v. Fox*, 298 U.S. 193, 56 S.Ct. 773, 80 L.Ed. 1143 (1936) (intangibles may acquire a situs for taxation other than at the domicile of the owner if they have become integral parts of some local business); *Southern Express Co. v. Spigener*, 118 S.C. 413, 110 S.E. 403 (1920) (the situs of intangible property is within this State if the right afforded by it is exercised here); Dexter, *Taxation of Income from Intangibles of Multistate-Multinational Corporations*, 29 Vand. L. Rev. 401 (1976); J. Hellerstein & W. Hellerstein, *State Taxation*, Para. 9.08-.09 (2d ed. 1992). We reject Geoffrey's claim that its intangible assets are located exclusively in Delaware. Accordingly, we find that Geoffrey's purposeful direction of activity toward South Carolina as well as its possessing intangible property here provide a definite link between South Carolina and the income derived by Geoffrey from the use of its trademarks and trade names in this State.

We also find that the second prong of *Quill* test has been met. Contrary to Geoffrey's assertion, South Carolina has conferred benefits upon Geoffrey to which the challenged tax is rationally related. As the United States Supreme Court recognized in *Curry v. McCanless*, 307 U.S. 357, 365-66, 59 S.Ct. 900, 905, 83 L.Ed. 1339, 1347 (1939):

> Very different considerations, both theoretical and practical, apply to the taxation of intangibles, that is, rights which are not related to physical things. Such rights are but relationships between persons, natural or corporate, which the law recognizes by attaching to them certain sanctions enforceable in courts. The power of government over them and the protection which it gives them cannot be exerted through control of a physical thing. *They can be made effective only through control over and protection afforded to those persons whose relationships are the origin of the rights*. . . . Obviously, as sources of actual or potential wealth—which is an appropriate measure of any tax imposed on ownership or its exercise—*they cannot be dissociated from the persons from whose relationships they are derived*. (Citations omitted). (Emphasis added).

The real source of Geoffrey's income is not a paper agreement, but South Carolina's Toys R Us customers. *Cf. Avco Financial Services Consumer Discount Co. v. Director, Division of Taxation*, 100 N.J. 27, 494 A.2d 788 (1985). By providing an orderly society in which Toys

R Us conducts business, South Carolina has made it possible for Geoffrey to earn income pursuant to the royalty agreement. *See, e.g., Allied Signal v. Comm'r of Finance*, 79 N.Y.2d, 588 N.E.2d 731, 580 N.Y.S.2d 696 (1991) (benefits afforded to an in-state corporation inure to non-resident shareholders). That Geoffrey has received protection, benefits, and opportunities from South Carolina is manifested by the fact that it earns income in this state. *Accord Aamco*, 93 N.M. at 393, 600 P.2d at 845 (quoting *Besser Co. v. Bureau of Revenue*, 74 N.M. 377, 394 P.2d 141 (1964)). That the tax is rationally related to these protections, benefits, and opportunities is evidenced by the fact that the State seeks to tax only that portion of Geoffrey's income generated within its borders. Based on the foregoing reasons, we hold that the Due Process Clause does not prohibit South Carolina's taxation of Geoffrey's royalty income.

B. Commerce Clause

A tax will survive challenge under the Commerce Clause so long as it 1) is applied to an activity with a substantial nexus with the taxing state, 2) is fairly apportioned, 3) does not discriminate against interstate commerce, and 4) is fairly related to the services provided by the State. *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279, 97 S.Ct. 1076, 1079, 61 L.Ed.2d 326, 331 (1977). Relying on *Nat'l Bellas Hess, Inc. v. Dep't of Revenue of Ill.*, 386 U.S. 753, 87 S.Ct. 1389, 18 L.Ed.2d 505 (1967), Geoffrey contends that it does not have a substantial nexus with South Carolina because it is not physically present in this state. In our view, Geoffrey's reliance on the physical presence requirement of *Bellas Hess* is misplaced.[4]

It is well settled that the taxpayer need not have a tangible, physical presence in a state for income to be taxable there. The presence of intangible property alone is sufficient to establish nexus. *American Dairy Queen*, 93 N.M. at 747, 605 P.2d at 255. *See also Int'l Harvester Co. v. Wisconsin Dep't of Taxation*, 322 U.S. 435, 441-442, 64 S.Ct. 1060, 1063-64, 88 L.Ed. 1373, 1379 (1944) (a state may tax such part of the income of a non-resident as is fairly attributable either to property located in the state or to events or transactions which, occurring there, are within the protection of the state and entitled to the numerous other benefits which its confers); J. Hellerstein & W. Hellerstein, *supra*, at 6.08 (any corporation that regularly exploits the markets of a state should be subject to its jurisdiction to impose an income tax even though not physically present). A taxpayer who is domiciled in one state but carries on business in another is subject to taxation measured by the value of the intangibles used in his business. *Curry*, 307 U.S. at 368, 59 S.Ct. at 906, 83 L.Ed. at 1348. We hold that by licensing intangibles for use in this State and deriving income from their use here, Geoffrey has a "substantial nexus" with South Carolina.[5]

---

[4] The U.S. Supreme Court recently revisited the physical presence requirement of *Bellas Hess* and, while reaffirming its vitality as to *sales and use taxes*, noted that the physical presence requirement had not been extended to other types of taxes. *Quill*, U.S. at 112 S.Ct. at 1914, 119 L.Ed.2d at 108.

[5] Further discussion of the remaining requirements of the Commerce Clause is unnecessary. Our Due Process analysis of the benefits conferred upon Geoffrey applies with equal force here and need not be repeated. Moreover, Geoffrey raised no constitutional claim that the challenged tax is not fairly apportioned or discriminates against interstate commerce.

Geoffrey finally contends that even if it is subject to South Carolina income tax, all of its royalty income would be allocated or apportioned to Delaware pursuant to S.C. Code Ann. §§12-7-1120(5) or 12-7-1140 (1977 and Supp. 1992). These statutes are inapplicable to the income received by Geoffrey Section 12-7-1120(5) allocates gains or losses from the sale of intangible personal property not connected with the business of the taxpayer, other than any intangible personal property held for sale to customers in the regular course of business. Section 12-7-1140 apportions the income of taxpayers whose principal business in this state is (a) manufacturing or any form of collecting, buying, assembling or processing goods and materials within this State, or (b) selling, distributing or dealing in tangible personal property within this State.

In conclusion, we hold that the taxation of Geoffrey's royalty income pursuant to section 12-7-230 is not prohibited by the Due Process Clause or the Commerce Clause of the United States Constitution. Our finding that Geoffrey may be taxed pursuant to section 12-7-230 settles the question whether Geoffrey must pay the corporate license fee. All corporations subject to section 12-7-230 are required to do so. See S.C. Code Ann. §§12-19-20, 12-19-70 (1977 & Supp. 1992). The order of the trial judge is

AFFIRMED.

Chandler, Finney, Toal and Moore, JJ., concur.

Appendix E: State C Corporation Income Tax Return Checklist 2010

STATE C CORPORATION INCOME TAX RETURN CHECKLIST 2010

Client Name and Number:____

Prepared by: ________________________ Date: _________________ Reviewed by: _______________ Date: ___________

	DONE	N/A	COMMENTS OR EXPLANATION
100) GENERAL INFORMATION			
101) For state tax forms, instructions, tax codes, cases, regulations, rulings, procedures, etc., refer to the AICPA's Internet web page at www.aicpa.org/yellow/index.htm.	________	______	______________
102) For comprehensive charts and lists of various items and requirements (e.g., tax rates, filing dates, extensions, estimated taxes, exemptions, reports, limitation periods, NOL deductions, etc.), refer to a state tax reporter service or the Federation of Tax Administrator's Internet web page at www.taxadmin.org.	________	______	______________
103) Obtain information concerning state tax audits and correspondence.	________	______	______________
104) If a federal audit has been settled, consider notifying state(s). Many states impose penalties or deny otherwise available refunds if the state is not notified or an amended return is not filed within a specified period of time, which varies per state.	________	______	______________
105) Determine if the client has sufficient connection with any other state that may require an income, franchise or privilege tax return. (Note that requirements for filing a franchise or privilege tax return may differ from requirements for filing an income tax return.) If multistate, see items under checklist section #500 and check nexus information.	________	______	______________
106) Consult the *Unique Considerations for State Business Tax Returns* (also in this AICPA *Tax Practice Guides and Checklists* publication package) for common problems and unique tax issues for each state tax return to be prepared. Also consult the various *Nexus, Allocation/Apportionment and State NOL Issues Practice Guides* in this AICPA *Tax Practice Guides and Checklists* publication package for further information relevant to the checklist question #111 and sections #500, #600, and #700.	________	______	______________
107) Obtain and review information related to state statutory, regulatory, judicial, administrative changes or amnesty programs since the filing of the prior return.	________	______	______________
108) Review prior year returns for elections and carryovers (e.g. NOLs, credits, etc.)	________	______	______________

© 2010 AICPA, Inc.

STATE C CORPORATION INCOME TAX RETURN CHECKLIST 2010

	DONE	N/A	COMMENTS OR EXPLANATION
109) Consider the impact of any acquisitions, divestitures and reorganizations on state income and franchise taxes.	________	______	______________
110) Determine if the operations of a division have changed substantially during the year, including a sale or transfer of a major portion of the assets located in a particular state.	________	______	______________
111) Determine with the client the proper filing status (separate, unitary, combined, or consolidated) for multicompany entities. (Note election possibilities or a mandatory method.)	________	______	______________
112) Determine if the impact of intercompany transactions (e.g. eliminations, deferred intercompany transactions, state specific disallowances of certain expenses, etc.) have been properly accounted for in the various state tax liabilities.	________	______	______________
113) Determine if the state has tax shelter disclosure requirements and if additional steps are necessary to properly identify and disclose any reportable transactions. Several states have adopted tax shelter disclosure provisions similar to the federal disclosure requirements.	________	______	______________
114) Consider if disaster relief provisions apply.	________	______	______________
200) INCOME			
201) If the state uses income on the federal return as a starting point, either before or after the net operating loss deduction or special deduction, transfer income information from the federal return.	________	______	______________
202) Determine if federally exempt (e.g., municipal) interest and dividends are subject to add back. (Note possible offset of direct and/or apportioned indirect expenses against the tax-exempt income.)	________	______	______________
203) Determine each state's tax-exempt interest and dividends for possible subtraction (e.g., home state interest if all states' interest was added back in checklist section #202). (Note possible offset of direct and/or apportioned indirect expenses against the tax-exempt income.)	________	______	______________
204) Determine the interest and dividends from U.S. government obligations for possible subtraction. (Note possible offset of direct and/or apportioned indirect expenses against the tax-exempt income.)	________	______	______________
205) Check for any other income taxable on the state return that was not taxed on the federal return.	________	______	______________
206) Check for any income taxable on the federal return that may not be taxable on the state return.	________	______	______________

© 2010 AICPA, Inc.

STATE C CORPORATION INCOME TAX RETURN CHECKLIST 2010

	DONE	N/A	COMMENTS OR EXPLANATION
300) DEDUCTIONS			
301) Determine any differences between federal and state deductions (e.g., state tax deduction, dividend received deduction, depreciation, intercompany interest, intangibles or management expenses, treatment of repatriation dividends, etc.).	________	______	______________
302) Determine any differences between federal and state carryovers (e.g., capital loss, excess charitable contributions, NOLs).	________	______	______________
303) Determine the state's treatment of 30% and 50% additional first-year depreciation prior to 2005 and the state's treatment of 50% bonus depreciation for property placed in service in 2008 established by the ESA 2008.	________	______	______________
304) Determine state treatment of current year asset items for §179 and §179D deduction and increased limits established by the ESA 2008.	________	______	______________
305) Determine the state's treatment of the deduction for qualified production activities (§199).	________	______	______________
306) Determine if the state has a disallowance provision for inter-company interest expenses, intangible expenses and/or management fees. (Note, if yes, review the various exceptions provided by the state to determine if the taxpayer's facts related to the intercompany transactions will meet an exception to the addback and therefore, will not need to be added-back.)	________	______	______________
400) TAX COMPUTATION AND CREDITS			
401) Determine any state alternative minimum tax or alternative tax.	________	______	______________
402) Compute any applicable tax credits (e.g., investment, jobs, enterprise, environmental, rehab) including carryovers.	________	______	______________
403) Compute any credit recapture.	________	______	______________
404) Confirm amounts and dates of any state and local estimated tax deposits/payments (including withholding) for the year, prior year overpayments, and extension payments.	________	______	______________
405) Prepare estimated tax vouchers.	________	______	______________
406) Compute tax underpayment penalties.	________	______	______________

© 2010 AICPA, Inc.

Page Completed ☐

STATE C CORPORATION INCOME TAX RETURN CHECKLIST 2010

	DONE	N/A	COMMENTS OR EXPLANATION
500) MULTISTATE ISSUES			
501) Determine in which states a multistate corporation is required to file income or franchise tax returns. Consult the AICPA *Nexus, Allocation/Apportionment and State NOL Issues Practice Guides* for guidance and for an overview of nexus and details on ordering the AICPA *State Tax Nexus Checklist/Practice Guide.*	____	____	____
502) Consult the *Nexus, Allocation/Apportionment and State NOL Issues Practice Guides* (also in this AICPA *Tax Practice Guides and Checklists* publication package) for information on multistate allocation and apportionment and net operating loss issues.	____	____	____
503) If the corporation is not taxable in more than one state, determine if the corporation is permitted to apportion its income.	____	____	____
504) Determine the available methods of dividing the income tax base of a multistate corporation for all states for which returns are required (e.g., separate accounting, specific allocation, formulary apportionment). (Note any states with special elections available.)	____	____	____
505) If separate accounting method is available and is a beneficial option, determine if necessary records for separate accounting are available.	____	____	____
506) Determine the need to distinguish between business income and nonbusiness income. (Note the respective tests.)	____	____	____
507) If the corporation has income subject to specific allocation:			
.1) Identify income subject to specific allocation.	____	____	____
.2) Determine treatment of expenses directly or indirectly related to allocated income. (These are generally added back or netted against the applicable income.)	____	____	____
508) Determine if the state in which you are filing requires or permits unitary, combined or consolidated reporting and which test(s) applies.	____	____	____
509) Determine each state's restriction on the offset of capital gains against capital losses.	____	____	____
510) Determine the total income that is to be apportioned.	____	____	____
511) Determine each state's apportionment formula for business income:			
.1) Check if any of the states' formulas differ from the standard three-factor formula (e.g., double weighted sales factor, a formula with less than three factors or a specific formula based on the corporation's industry).	____	____	____

Page Completed ☐

© 2010 AICPA, Inc.

STATE C CORPORATION INCOME TAX RETURN CHECKLIST 2010

	DONE	N/A	COMMENTS OR EXPLANATION
.2) Check the various states' rules that establish:			
.a) Which items are included in the factors,	________	______	______________
.b) The timing of entry and removal from the factors,	________	______	______________
.c) The evaluation of items included in the factors,	________	______	______________
.d) How revenue items are sourced to a particular state (e.g., sales of services vs. sales of tangible personal property) and included in that state's apportionment factor numerator, and	________	______	______________
.e) Which property is included in the factor and how it is sourced to the states (note, special rules typically apply to mobile property).	________	______	______________
512) Determine the amounts to be included in the property factor and check the various states' rules concerning the use of cost or adjusted book values in property values.	________	______	______________
513) Determine the amounts to be included in the payroll factor and check the various states' rules for treatment of special classes of compensation such as compensation of corporate officers, commissions and other compensation, or payments to independent contractors.	________	______	______________
514) Determine the amounts to be included in the sales factor considering each state's rules concerning "throwback" sales.	________	______	______________
515) Determine if state has adopted "throwout" rule in computing the denominator of the sales factor.	________	______	______________
516) If in a unitary combined return setting, consider the state's position on the *Joyce* v. *Finnegan* approach to the calculation of the sales factor.	________	______	______________
517) Reconcile the denominator of the sales factor to the amount of sales reported on the federal return.	________	______	______________
518) Determine the availability of like-kind exchange nonrecognition treatment if exchanged properties are located in different states.	________	______	______________
600) STATE NOL ISSUES			
601) Determine each state's rules concerning calculation of net operating losses (NOLs) and any related carrybacks or carryforwards.	________	______	______________
602) Determine each state's starting point for calculation of a NOL, such as federal taxable income with or without NOL modification, or federal taxable income before the federal NOL deduction with a state specific NOL calculation.	________	______	______________

© 2010 AICPA, Inc.

Page Completed ☐

STATE C CORPORATION INCOME TAX RETURN CHECKLIST 2010

	DONE	N/A	COMMENTS OR EXPLANATION
603) For multistate returns:			
.1) Determine each state's effect on the NOL and the amount of carryback or carryforward due to state modifications, apportionment factors, and the allocation of nonbusiness income.	________	______	______________
.2) Determine if the corporation filed a state return in the year the loss was generated and if that fact impacts the use of the loss.	________	______	______________
.3) Determine if NOL carryforwards and carrybacks use the apportionment factor for the year of the loss or for the year the loss is utilized.	________	______	______________
604) For affiliated groups of corporations filing a consolidated return:			
.1) Determine if state NOLs may need to be tracked on a separate entity basis.	________	______	______________
.2) Check for state requirements concerning separate return filing years and effects on NOL carryforwards and carrybacks.	________	______	______________
605) If combined corporate reporting is allowed or required by a state, check if combined or separate method is used for calculating the NOL for that state.	________	______	______________
606) Check on the treatment of any NOL carryovers if a corporation has had a reorganization, acquisition, or liquidation.	________	______	______________
607) Consult the *Nexus, Allocation/Apportionment and State NOL Issues Practice Guides* (also in this AICPA *Tax Practice Guides and Checklists* publication package) for an explanation of state net operating loss issues.	________	______	______________
700) OTHER			
701) Confirm due date of tax return or extension request.	________	______	______________
702) Attach extensions and other required attachments.	________	______	______________
703) Identify planning opportunities (e.g., economic incentives) for reducing state taxes.	________	______	______________
704) Identify and report any out of jurisdiction purchases for use tax.	________	______	______________
705) Advise the client of their exposure to other business tax programs (e.g., sales, gross receipts, license, employment, inventory, property, etc.) and unclaimed property obligations.	________	______	______________

© 2010 AICPA, Inc.

Page Completed ☐

STATE C CORPORATION INCOME TAX RETURN CHECKLIST 2010

		DONE	N/A	COMMENTS OR EXPLANATION
706)	Consider preparing a workpaper schedule for the file concerning state items to track, carryforward items, and any matters of future concern.	________	______	______________
707)	Check NAUPA Internet web page at www.unclaimed.org to determine if client is owed any unclaimed property.	________	______	______________
708)	Consider disclosure requirements for written tax advice. (See Circular 230 and state's comparable guidance.)	________	______	______________

COMMENTS OR EXPLANATIONS

____

____

____

____

© 2010 AICPA, Inc.

Page Completed ☐

Tax Glossary

401(k) plan. A qualified retirement plan to which contributions from salary are made from pre-tax dollars.

accelerated depreciation. Computation of depreciation to provide greater deductions in earlier years of equipment and other business or investment property.

accounting method. Rules applied in determining when and how to report income and expenses on tax returns.

accrual method. Method of accounting that reports income when it is earned, disregarding when it may be received, and expense when it is incurred, disregarding when it is actually paid.

acquisition debt. Mortgage taken to buy, hold, or substantially improve main or second home that serves as security.

active participation. Rental real estate activity involving property management at a level that permits deduction of losses.

adjusted basis. Basis in property increased by some expenses (for example, by capital improvements) or decreased by some tax benefit (for example, by depreciation).

adjusted gross income (AGI). Gross income minus above-the-line deductions (that is, deductions other than itemized deductions, the standard deduction, and personal and dependency exemptions).

alimony. Payments for the support or maintenance of one's spouse pursuant to a judicial decree or written agreement related to divorce or separation.

alternative minimum tax (AMT). System comparing the tax results with and without the benefit of tax preference items for the purpose of preventing tax avoidance.

amortization. Write-off of an intangible asset's cost over a number of years.

applicable federal rate. An interest rate determined by reference to the average market yield on U.S. government obligations. Used in Internal Revenue Code (IRC) § 7872 to determine the treatment of loans with below-market interest rates.

at-risk rules. Limits on tax losses to business activities in which an individual taxpayer has an economic stake.

backup withholding. Withholding at a rate of 31 percent on interest or dividend payments by a payor that has not received required taxpayer identification number information.

bad debt. Uncollectible debt deductible as an ordinary loss if associated with a business and otherwise deductible as short-term capital loss.

basis. Amount determined to by a taxpayer's investment in property for purposes of determining gain or loss on the sale of property or in computing depreciation.

cafeteria plan. Written plan allowing employees to choose among two or more benefits (consisting of cash and qualified benefits) and to pay for the benefits with pretax dollars. Must conform to IRC § 125 requirements.

capital asset. Investments (for example, stocks, bonds, and mutual funds) and personal property (for example, home).

capital gain or loss. Profit (net of losses) on the sale or exchange of a capital asset or IRC § 1231 property, subject to favorable tax rates, and loss on such sales or exchanges (net of gains) deductible against $3,000 of ordinary income.

capitalization. Addition of cost or expense to the basis of property.

carryovers (carryforwards) and carrybacks. Tax deductions and credits not fully used in one year and chargeable against prior or future tax years.

conservation reserve program. A voluntary program for soil, water, and wildlife conservation; wetland establishment; and restoration and reforestation, administered by the U.S. Department of Agriculture.

credit. Amount subtracted from income tax liability.

deduction. Expense subtracted in computing adjusted gross income.

defined benefit plan. Qualified retirement plan basing annual contributions on targeted benefit amounts.

defined contribution plan. Qualified retirement plan with annual contributions based on a percentage of compensation.

depletion. Deduction for the extent a natural resource is used.

depreciation. Proportionate deduction based on the cost of business or investment property with a useful life (or recovery period) greater than one year.

earned income. Wages, bonuses, vacation pay, and other remuneration, including self-employment income, for services rendered.

earned income credit. Refundable credit available to low-income individuals.

employee stock ownership plan. Defined contribution plan that is a stock bonus plan or a combined stock bonus and money purchase plan designed to invest primarily in qualifying employer securities.

estimated tax. Quarterly payments of income tax liability by individuals, corporations, trusts, and estates.

exemption. A deduction against net income based on taxpayer status (that is, single, head of household, married filing jointly or separately, trusts, and estates.

fair market value. The price that would be agreed upon by a willing seller and willing buyer, established by markets for publicly traded stocks or determined by appraisal.

fiscal year. A 12-month taxable period ending on any date other than December 31.

foreign tax. Income tax paid to a foreign country and deductible or creditable, at the taxpayer's election, against U.S. income tax.

gift. Transfer of money or property without expectation of anything in return and excludable from income by the recipient. A gift may still be affected by the unified estate and gift transfer tax applicable to the gift's maker.

goodwill. A business asset, intangible in nature, adding a value beyond the business's tangible assets.

gross income. Income from any and all sources, after any exclusions and before any deductions are taken into consideration.

half-year convention. A depreciation rule assuming property other than real estate is placed in service in the middle of the tax year.

head-of-household. An unmarried individual who provides and maintains a household for a qualifying dependent and therefore is subject to distinct tax rates.

health savings account. A trust operated exclusively for purposes of paying qualified medical expenses of the account beneficiary and, thus, providing for deductible contributions, tax-deferred earnings, and exclusion of tax on any monies withdrawn for medical purposes.

holding period. The period of time a taxpayer holds onto property, therefore affecting tax treatment on its disposition.

imputed interest. Income deemed attributable to deferred-payment transfers, such as below-market loans, for which no interest or unrealistically low interest is charged.

incentive stock option. An option to purchase stock in connection with an individual's employment, which defers tax liability until all of the stock acquired by means of the option is sold or exchanged.

income in respect of a decedent. Income earned by a person but not paid until after his or her death.

independent contractor. A self-employed individual whose work method or time is not controlled by an employer.

indexing. Adjustments in deductions, credits, exemptions and exclusions, plan contributions, AGI limits, and so on, to reflect annual inflation figures.

individual retirement account (IRA). Tax-exempt trust created or organized in the United States for the exclusive benefit of an individual or the individual's beneficiaries.

information returns. Statements of income and other items recognizable for tax purposes provided to the IRS and the taxpayer. Form W-2 and forms in the 1099 series, as well as Schedules K-1, are the prominent examples.

installment method. Tax accounting method for reporting gain on a sale over the period of tax years during which payments are made, that is, over the payment period specified in an installment sale agreement.

intangible property. Items such as patents, copyrights, and goodwill.

inventory. Goods held for sale to customers, including materials used in the production of those goods.

involuntary conversion. A forced disposition (for example, casualty, theft, or condemnation) for which deferral of gain may be available.

jeopardy. For tax purposes, a determination that payment of a tax deficiency may be assessed immediately as the most viable means of ensuring its payment.

Keogh plan. A qualified retirement plan available to self-employed persons.

key employee. Officers, employees, and officers defined by the IRC for purposes of determining whether a plan is "top heavy."

kiddie tax. Application of parents' maximum tax rate to unearned income of their child under age 18.

lien. A charge upon property after a tax assessment has been made and until tax liability is satisfied.

like-kind exchange. Tax-free exchange of business or investment property for property that is similar or related in service or use.

listed property. Items subject to special restrictions on depreciation (for example, cars, computers, and cell phones).

lump-sum distribution. Distribution of an individual's entire interest in a qualified retirement plan within one tax year.

marginal tax rate. The highest tax bracket applicable to an individual's income.

material participation. The measurement of an individual's involvement in business operations for purposes of the passive activity loss rules.

mid-month convention. Assumption, for purposes of computing depreciation, that all real property is placed in service in the middle of the month.

mid-quarter convention. Assumption, for purposes of computing depreciation, that all property other than real property is placed in service in the middle of the quarter, when the basis of property placed in service in the final quarter exceeds a statutory percentage of the basis of all property placed in service during the year.

minimum distribution. A retirement plan distribution, based on life expectancies, that an individual must take after age 70½ in order to avoid tax penalties.

minimum funding requirements. Associated with defined benefit plans and certain other plans, such as money purchase plans, assuring the plan has enough assets to satisfy its current, and anticipated liabilities.

miscellaneous itemized deduction. Deductions for certain expenses (for example, unreimursed employee expenses) limited to only the amount by which they exceed 2 percent of GI.

money purchase plan. Defined contribution plan in which the contributions by the employer are mandatory and established other than by reference to the employer's profits.

net operating loss. A business or casualty loss for which amounts exceeding the allowable deduction in the current tax year may be carried back two years to reduce previous tax liability and forward 20 years to cover any remaining unused loss deduction.

nonresident alien. An individual who is neither a citizen nor a resident of the United States and who is taxed on income effectively connected with a U.S. trade or business.

original issue discount. The excess of face value over issue price set by a purchase agreement.

passive activity loss. Losses allowable only to the extent of income derived each year (that is, by means of carryover) from rental property or business activities in which the taxpayer does not materially participate.

pass-through entities. Partnerships, limited liability corporations, limited liability partnerships, S corporations, and trusts and estates whose income or loss is reported by the partner, member, shareholder, or beneficiary.

personal holding company. A corporation, usually closely held, that exists to hold investments such as stocks, bonds, or personal service contracts and to time distributions of income in a manner that limits the owner(s) tax liability.

qualified Subchapter S trust. A trust that qualifies specific requirements for eligibility as an S corporation shareholder.

real estate investment trust. A form of investment in which a trust holds real estate or mortgages and distributes income, in whole or in part, to the beneficiaries (that is, investors).

real estate mortgage investment conduit. Treated as a partnership, investors purchase interests in this entity which holds a fixed pool of mortgages.

realized gain or loss. The difference between property's basis and the amount received upon its sale or exchange.

recapture. The amount of a prior deduction or credit recognized as income or affecting its characterization (capital gain versus ordinary income) when the property giving rise to the deduction or credit is disposed of.

recognized gain or loss. The amount of realized gain or loss that must be included in taxable income.

regulated investment company. A corporation serving as a mutual fund that acts as investment agents for shareholders and customarily dealing in government and corporate securities.

reorganization. Restructuring of corporations under specific IRC rules, resulting in nonrecognition of gain.

resident alien. An individual who is a permanent resident, has substantial presence, or, under specific election rules is taxed as a U.S. citizen.

Roth IRA. Form of individual retirement account that produces, subject to holding period requirements, nontaxable earnings.

S corporation. A corporation that, upon satisfying requirements concerning its ownership, may elect to act as a pass-through entity.

saver's credit. Term commonly used to describe IRC § 25B credit for qualified contributions to a retirement plan or via elective deferrals.

Section 1231 property. Depreciable business property eligible for capital gains treatment.

Section 1244 stock. Closely held stock whose sale may produce an ordinary, rather than capital, loss (subject to caps).

split-dollar life insurance. Arrangement between an employer and employee under which the life insurance policy benefits are contractually split, and the costs (premiums) are also split.

statutory employee. An insurance agent or other specified worker who is subject to social security taxes on wages but eligible to claim deductions available to the self-employed.

stock bonus plan. A plan established and maintained to provide benefits similar to those of a profit-sharing plan, except the benefits must be distributable in stock of the employer company.

tax preference items. Tax benefits deemed includable for purposes of the alternative minimum tax.

tax shelter. A tax-favored investment, typically in the form of a partnership or joint venture, that is subject to scrutiny as tax-avoidance device.

tentative tax. Income tax liability before taking into account certain credits, and AMT liability reduced regular tax liability.

transportation expense. The cost of transportation from one point to another.

travel expense. Transportation, meals, and lodging costs incurred away from home and for trade or business purposes.

unearned income. Income from investments (that is, interest, dividends, and capital gains).

uniform capitalization rules. Rules requiring capitalization of property used in a business or income-producing activity (for example, items used in producing inventory) and to certain property acquired for resale.

unrelated business income. Exempt organization income produced by activities beyond the organization's exempt purposes and therefore taxable.

wash sale. Sale of securities preceded or followed within 30 days by a purchase of substantially identical securities. Recognition of any loss on the sale is disallowed.