First Quarter 2017 State and Local Tax UPDATE

Income/Franchise Tax:

California - Taxpayer's LLC interest does not constitute "doing business" in California

On January 12, 2017, the California Court of Appeal, Fifth District, held that Swart Enterprises, Inc. ("Swart") was not "doing business" in California by virtue of owning a 0.2% non-managing interest in a Limited Liability Company ("LLC") that was doing business in California. The Court of Appeal ruled that Swart's LLC interest was a passive interest, similar to a limited partner, as such, Swart was not able to control or manage the LLC.[1]

Colorado – An intellectual property ("IP") company has economic nexus and the state's alternative apportionment methodology is unreasonable and must include the IP company's property and payroll.

The Colorado District Court in the case of Target Brands Inc. v. Colorado Department of Revenue found that Target Brands, Inc. ("Brands") was "doing business" in Colorado and subject to corporate income tax. Brands is an IP holding company formed as an 80/20 company with no physical presence in Colorado. Brands licenses its IP for use by its corporate parent in Colorado. Under the license agreement between Brands and its parents, Brands received significant income related to the use of its IP in Colorado. The Colorado District Court found that the imposition of tax on Brands did not violate the Commerce Clause of the US Constitution and physical presence is not required to establish substantial nexus.

The Colorado District Court also found that the Colorado Department of Revenue had met its burden of proof to impose an alternative apportionment formula on Brands. However the Colorado District Court determined the formula used, which excluded all of Brand's factors and was based on the parent company's sales factor only, was unreasonable. The Colorado District Court concluded the Colorado Department of Revenue must include Brand's payroll and property factors with the parent's sales factor in the apportionment formula.[2]

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[1] Swart Enterprises, Inc. v. California Franchise Tax Board, No. F070922 (Cal. Ct. App., 5th Dist., 1/1217).
[2] Target Brands Inc. v. Colorado Dept. of Rev., No. 2015CV33831 (Colo Dist. Ct., City and Cnty. of Denver, 1/27/17).

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Indiana – An IP company has economic nexus and a valid consolidated election was made

An out-of-state corporation operating an Indiana manufacturing facility made a valid original decision to file an Indiana consolidated income tax return with a related out-of-state IP holding company. The decision was based on the fact the IP holding company engaged in income-producing activity within Indiana by licensing its intellectual property to Indiana affiliates. Because the corporation properly filed original consolidated returns including the IP holding company, the corporation is allowed to file amended returns to include another related entity which was inadvertently omitted in the original filings. Regarding the IP holding company, the Indiana Department of Revenue said that it "has long and consistently held that the exploitation and monetization of intellectual property within the state constitutes activities within Indiana giving rise to Indiana source income."[3]

Iowa – A Parent company was property excluded from a consolidated return with its subsidiaries

The Iowa Supreme Court concluded that an out-of-state parent corporation could not join in a consolidated tax return with its subsidiaries that did business in the state. The Iowa Supreme Court's reasoning for not allowing the out-of-state parent to join the consolidated tax return was because the parent lacked taxable nexus with the state and its activities were limited to owning and controlling its subsidiaries.[4]

Maryland – Enterprise dependency and alternative apportionment

A Maryland circuit court issued its decision in the Petition of Staples, Inc. and Staples the Office Superstore, Inc. The Maryland circuit court affirmed the Maryland Tax Court's ruling that "enterprise dependency" existed between out-of-state corporations and in-state affiliates. As such, the out-of-state corporation and the in-state affiliates were not separate business entities and were part of a unitary business with nexus in Maryland. The Maryland circuit court also affirmed the Maryland Tax Court's approval of the Comptroller of Treasury's alternative apportionment methodology which attributed the in-state affiliates' apportionment factor to the out-of-state affiliated corporations.[5]

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[3] Indiana Letter of Findings No. 02-20160370R (1/25/17).
[4] Myria Holdings Inc. & Subs., v. Department of Revenue, Iowa Supreme Court, No 15-0296, (3/24/17).
[5] Petition of Staples Inc. and Staples the Office Superstore, LLC, and the Decision of the Maryland Tax Court; Anne Arundel County Circuit Court, No. C-02-CV-15-002009 (12/30/16).

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Massachusetts – a biotechnology company qualifies as a manufacturer and must use single factor sales apportionment

The Supreme Judicial Court of Massachusetts affirmed an Appellate Tax Board decision that a biotechnology company is qualified as a "manufacturing corporation" and as such must apportion its income utilizing a single sales factor methodology.

State law requires receipts from manufacturing activities be "substantial" in order for a company to qualify as a manufacturer and utilize single sales factor apportionment methodology. The Supreme Judicial Court of Massachusetts, when it determined the biotechnology company's manufacturing receipts were substantial, excluded receipts it deemed unrelated to manufacturing, including the redemption of short-term investments by the company's treasury department.[6]

New Jersey – Regulation denying preferential CBT treatment to owners of certain pass through entities invalidated

The New Jersey Tax Court voided regulation N.J.A.C.18:7-1.15(b)(9). The regulation disallowed taxpayers from regarding investments in flow-through entities (e.g., limited partnership interests), as securities for purposes of determining whether a taxpayer meets a 90% investment asset test to qualify for investment company status. The investment company status allowed a taxpayer to utilize a 3.6% un-apportioned tax rate, rather than 9% apportioned Corporate Business Tax rate (CBT) rate. When the New Jersey Tax Court ruled and voided the regulation, it concluded that the New Jersey Division of Taxation exceeded its rule-making authority when it excluded classes of securities beyond the scope of New Jersey's statutory investment company asset test.[7]

Oregon – Substantial nexus for corporate excise tax and income tax may be established by economic presence

In *Capital One Auto Finance Inc. v. Oregon Department of Revenue*, the Oregon Tax Court held that an auto finance company was required to include the sales apportionment factors of out-of-state related banks with no physical presence in Oregon in its Oregon corporate excise and corporate income tax returns. The Oregon Tax Court determined that the banks' in-state activities created an economic presence sufficient to establish substantial nexus with the state and physical presence was not a requirement to establish substantial nexus.[8]

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[6] Genentech, Inc. v. Mass. Comr. of Rev., No. SJC-12083 (Mass. S. Jud. Ct., 1/12/17).
[7] Manheim NJ Investments, Inc. v. Director, Div. of Taxation, No. 015083-2014, 2017 N.J. Tax Lexis 5 (N.J. Tax Ct., 2/27/17).
[8] Capital One Auto Finance Inc. v. Department of Revenue, State of Oregon, TC 5197 (12/23/16).

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Texas – Courts issue opinions regarding what are "costs of goods sold" for purposes of the Margin Tax

The Texas Court of Appeals for the Third District issued three opinions related to the calculation of cost of goods sold for purposes of computing the Texas Franchise Tax (or Texas Margin Tax). The opinions were in regard to the following three cases:

1. Hegar v. Autohaus LP, LLP
2. American Multi-Cinema Inc. v. Hegar
3. Hegar v. Sunstate Equipment Co., LLC

In *Hegar v. Autohaus*, the Texas Court of Appeals reversed the trial court and held that a car dealership cannot include auto repair labor costs (incurred as a part of repair work to install automobile parts on customer owned vehicles) in its cost of goods sold calculation. The Texas Court of Appeals deemed the labor costs to be costs of "services" which are excluded by statute from cost of goods sold, and not costs of "production" which are included in costs of goods sold.[9]

In *American Mutli-Cinema, Inc. v. Hegar*, the Texas Court of Appeals withdrew a prior opinion from 2015 and replaced it with a new opinion. The new opinion upheld the trial court's ruling that a movie theater company may include the costs of exhibiting movies and other content in its costs of goods sold calculation for purposes of determining its Texas Franchise Tax. The Texas Court of Appeals also held that costs associated with the square footage of the theater company's auditoriums are direct costs of producing its product and were properly included in the costs of goods sold calculations.[10]

In *Hegar v. Sunstate Equipment Co., LLC* the Texas Court of Appeals ruled that delivery and pickup charges made by a heavy machinery rental company as part of its rental contracts are not included in the cost of goods sold calculation because costs incurred in the selling or in the post-sale handing of goods are not included in cost of goods sold.[11]

Sales/Use Tax:

Alabama – State enacts use tax notification requirements for remote sellers and amends the simplified sellers use tax

On March 22, 2017, Alabama Governor Robert J. Bentley signed legislation requiring remote sellers with no physical presence in Alabama and do not collect sales, use, or simplified sellers use tax to report retail sales and customer notification, with penalties for noncompliance. The reporting requirements are effective beginning July 1, 2017 and penalties will apply for non-compliance with the requirements.[12]

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[9] Hegar v. Autohaus LP, LLP, No. 03-15-00427-CV (Tex. App. Ct., 3rd Dist., 2/24/17).
[10] American Multi-Cinema Inc. v. Hegar, No. 03-14-00397-CV (Tex. App. Ct., 3rd Dist., 1/6/17).
[11] Hegar v. Sunstate Equipment Co., LLC, No. 03-15-00738-CV (Texas App. Ct., 3rd Dist., 1/20/17).
[12] Alabama S.B. 86

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Colorado – Use tax notice and reporting law

In December 2016, The US Supreme Court decided not to review the 10th Circuit Court's ruling in the case of *Direct Marketing Association v. Brohl*. The 10th Circuit ruled that a Colorado statute requiring remote sellers with no physical presence in Colorado to file an annual statement with the Colorado Department of Revenue showing the total amount of Colorado purchases made during the preceding calendar year by each Colorado customer did not violate the dormant Commerce Clause of the US Constitution.

As a result of US Supreme Court's decision to not review the 10th Circuit Court's ruling, on February 22, 2017, Data & Marketing Association, f/k/a Direct Marketing Association, and Colorado Department of Revenue reached a settlement agreement in the dispute over the state's use tax notice and reporting law. Under the agreement, the state will begin enforcing the use tax notice and reporting requirements for transactions made on or after July 1, 2017.[13]

Indiana - Taxability of cloud computer services

The Indiana Department of Revenue issued an updated version of Information Bulletin #8 ("bulletin"), stating that the taxability of cloud computing depends upon the purchasers specific facts and circumstances. The bulletin previously indicated that cloud computing was subject to tax. In general, cloud computing services are taxable if the purchaser of the cloud computing services has a possessory or ownership interest in the service provided. There are a number of factors that should be evaluated to determine if a purchaser of cloud computer services meets the possessory or ownership requirements of the updated bulletin prior to determining the applicability of sales tax to the service.[14]

Ohio – Sales tax exemption certificates required for certain employment services

Beginning on or after January 1, 2017, Ohio requires vendors providing taxable employment services to charge and collect sales tax unless an exemption certificate is received from its customers.

The following services now require an exemption certificate:

1. Contractor/subcontractor services where the person/people are not under the direction or control of the customer;
2. Medical and health care services,
3. Services provided by permanently assigned personnel pursuant to a contract of at least one year,
4. Transactions between members of an affiliated group; and
5. Services that are resold.[15]

[13] Direct Marketing Ass'n v. Brohl, Colo. Dist. Ct., No. 13 CV 34855, Settlement Agreement (2/22/17)
[14] Information Bulletin #8, Indiana Department of Revenue, December 2016
[15] Ohio S.B. 235

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South Dakota - Economic nexus provisions are in violation of Quill

On March 6, 2017, a South Dakota Circuit Court held that South Dakota's economic nexus standard for sales and use tax is unconstitutional in light of the 1992 Supreme Court of the United States ruling in Quill (Quill required a physical presence for sales and use tax nexus).[16]

Wyoming - Economic nexus provisions enacted

House Bill 19 ("HB 19) adopts an economic nexus standard for sales and use tax purposes and become effective July 1, 2017. Under the provisions of HB 19 an out of state seller of tangible personal property ("TPP"), admissions or other taxable services, with no physical presence in Wyoming is required to collect and remit sales tax if the seller meets one of the following requirements during the current or immediately preceding calendar year:

1. Gross revenue for sales of TPP, admissions or other taxable services exceeds $100,000; or
2. The seller sold TPP, admissions or other taxable services into the state in 200 or more separate transaction.[17]

Other:

Delaware – Changes to unclaimed property tax laws enacted

On February 2, 2017, Delaware Governor John Carney signed Senate Bill 13 ("SB 13"). SB 13 amends the state's unclaimed property laws. The amendments to the state's unclaimed property laws were made in direct response to a recent federal district court ruling in Temple-Inland, Inc. v. Cook. The provisions of SB 13 became effective upon the governor's signature and included the following key provisions:

1. Establish a 10-year record retention requirement and statute of limitations in conjunction with a 10-year plus dormancy look-back period both while under examination and under Delaware's voluntary disclosure agreement program;
2. Establish a due diligence mailing requirement for general ledger type property;
3. Allow holders currently undergoing an audit to convert an older examination (which was initiated prior to July 22, 2015) to a voluntary disclosure agreement;
4. Delay resolution of Delaware's unclaimed property estimation and sampling techniques until July 1, 2017;
5. Revise the definition of "last-known address" to only require that the state be identified in a holder's books and records; and
6. Mandate the assessment of interest and provide Delaware the right to waive interest only by 50%.[18]

[16] South Dakota v. Wayfair, Inc., et al, S.D. Cir. Ct., No. 32 Civ. 16-000092 (3/6/17)
[17] Wyoming H.B. 19
[18] Delaware S.B. 13

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Pennsylvania – 2017 tax amnesty program

The Pennsylvania Tax Amnesty Program ("the Program") was established by Act 84 in 2016. The Amnesty Program period **begins Friday April 21, 2017**. The Program will continue for 60 days and will **end on Monday June 19, 2017**. All taxes administered by the Pennsylvania Department of Revenue ("DOR") and owed to Pennsylvania are eligible for the Program. Taxpayers with presence or operations in Pennsylvania should review their records for any potential exposure items and consider participation in the program.

Participants in the program will benefit from waiver of all penalties and lien fees as well as one half of the interest due. Unpaid taxes, penalties and interest from periods subsequent to December 31, 2015 are not eligible for the Program. Taxpayers must also file returns and pay taxes for periods not eligible under the Program (tax periods after December 31, 2015) for their participation in the Program to be approved. While the Tax Amnesty program is available to filers and non-filers alike, non-filers should also consider participation in Pennsylvania's voluntary disclosure program which allows for a limited lookback period but does not offer the benefit of reduced interest.[19]

[19] Pennsylvania Act 84 of 2016

Questions?

For any questions related to the state developments highlighted above, please contact one of the following individuals:

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