Domestic and Multistate Tax Update

38th Annual TEI-SJSU High Tech Tax Institute
November 8, 2022

John Clausen
Managing Director, State and Local Tax
Moss Adams LLP

Josh Grossman
Tax Principal
Grant Thornton LLP

Annette Nellen
MST Program Director/Professor
San Jose State University

Tax Executives Institute, Inc. Silicon Valley Chapter

SJSU | Lucas College and Graduate School of Business MST Program

Agenda

1. Domestic Income Tax Update
2. Developments in State Apportionment & Sourcing Methodologies
3. Update on State Approaches to Applying P.L. 86-272
4. Miscellaneous Income Tax Updates
5. Questions

1. Domestic Income Tax Update
(not covered elsewhere at this conference)

New Laws & Reminders from Older Laws

1. Infrastructure Investment and Jobs Act (P.L. 117-58, 11/15/21)
   - Early termination of Employee Retention Credit (generally ends 9/30/21 but recovery start-up business can claim for 4th qtr 2021)
     - https://www.irs.gov/newsroom/employee-retention-credit-2020-vs-2021-comparison-chart
   - Broker reporting for digital assets (§6045 change) effective starting 2023 (1099-B (or might be a new form 1099-DA)) due in January 2024.
   - Business reporting for digital assets > $10K (§6050I change) effective after 2023, but Form 8300 (or a new version) due within 15 days of receipt of digital assets valued at over $10,000

2. **Creating Helpful Incentives to Produce Semiconductors (CHIPS) Act (P.L. 117-167, 8/9/22)**
   - Adds §48D, *Advanced Manufacturing Investment Credit*, effective for property placed in service after 12/31/22; n/a to property if construction begins after 12/31/26.

3. **Inflation Reduction Act of 2022 (P.L. 117-169, 8/16/22)**
   - Corporate changes:
     - AMT for C corps with 3-tax year average annual adjusted financial statement income > $1 billion
     - 1% excise tax on stock repurchased by domestic corp with stock traded on established securities market
   - Changes to and extension of various energy credits

IRA 2022: Energy Credit Observations for Businesses

- Numerous energy credits added, modified and extended, generally through 2032
- Will lead to changes in business practices to qualify.
- Categorization per Congress: (see JCT list on next slide)
  - Clean electricity and reducing carbon emissions
  - Clean fuels
  - Clean energy and efficiency incentives for individuals
  - Clean vehicles (individuals and businesses)
  - Investment in clean energy manufacturing and energy security
  - Incentives for clean electricity and clean transportation
  - Credit monetization and appropriations – elective payment for energy property and electricity produced from certain renewable resources, and transfer of credits (new §6417 & §6418)
- For some credits, need to meet wage and apprenticeship requirements either for credit or larger credit, numerous special rules (such as for domestic activity) and definitions. Some have direct pay option (way to get cash even if $0 tax owed).

Energy Security Provisions – List from JCT

SUBTITLE D - ENERGY SECURITY

Part 1 - Clean Electricity and Reducing Carbon Emissions

1. Extension and modification of credit for electricity produced from certain renewable resources (sunset 12/31/24) [1]
2. Extension and modification of energy credit (sunset 12/31/24) [1]
3. Increase in energy credit for solar facilities placed in service in connection with low-income communities
4. Extension and modification of credit for carbon oxide sequestration (sunset 12/31/32) [1]
5. Zero-emission nuclear power production credit (sunset 12/31/32) [1]

Part 2 - Clean Fuels

1. Extension of incentives for biodiesel, renewable diesel and alternative fuels (sunset 12/31/24)
2. Extension of second generation biofuel incentives (sunset 12/31/24)
3. Sustainable aviation fuel credit (sunset 12/31/24)
4. Credit for production of clean hydrogen (sunset 12/31/32) [1]

Part 3 - Clean Energy and Efficiency Incentives for Individuals

1. Extension, increase, and modifications of nonbusiness energy property credit (sunset 12/31/32)
2. Extension and modification of the residential energy efficient property credit (sunset 12/31/34)
3. Energy efficient commercial buildings deduction
4. Extension, increase, and modifications of new energy efficient home credit (sunset 12/31/32)

Part 4 - Clean Vehicles

1. Clean vehicle credit (sunset 12/31/32) [1]
2. Credit for previously-owned clean vehicles (sunset 12/31/32) [1]
3. Credit for qualified commercial clean vehicles (sunset 12/31/32)
4. Alternative fuel refueling property credit (sunset 12/31/32)

Part 5 - Investment in Clean Energy Manufacturing and Energy Security

1. Extension of the advanced energy project credit [1]
2. Advanced manufacturing production credit (sunset 12/31/32) [1]

Part 6 - Reinstatement of Superfund

Part 7 - Incentives for Clean Electricity and Clean Transportation

1. Clean electricity production credit [1]
2. Clean electricity investment credit [1]
3. Cost recovery for qualified facilities, qualified property, and energy storage technology
4. Clean fuel production credit (sunset 12/31/27) [1]

Part 8 - Credit Monetization and Appropriations - Elective Payment for Energy Property and Electricity Produced from Certain Renewable Resources, etc., and Transfer of Credits [1]

CARES Act Reminder for 2022

If employer or self-employed deferred payroll of SE tax for March 27 to December 31, 2020 –

50% was due 12/31/21

Balance is due 12/31/22 (really 1/3/23)

See footnote 2 in PMTA 2021-07

https://www.irs.gov/pub/lanoa/pmta-2021-07.pdf

Will IRS issue CP256V Notice or other notice?

Other COVID Legislation Reminders

1. Any ERC claimed on amended 941? Be sure to reduce payroll expense on income tax return for same period.
   - What if you did not prepare the 941Xs or you question reliability of the computations or client eligibility?
2. 5-year time period for IRS to examine paid leave credits (if claimed for 4/1/21 through 9/30/21) and ERC (if claimed for last two quarters of 2021).

Tax Increases Built into TCJA

- Several of the items are timing (generally pushing deductions to later years) but some are immediate tax increases (when effective).
- Beer, wine and distilled spirits – special rule on interest capitalization (§263A(f)(4) and excise tax rates expire 12/31/20.
  - Made permanent by CAA-21 (PL 116-260; 12/27/20)
- §45S, Employer credit for paid family and medical leave, terminates for wages paid in tyba 12/31/20.
  - Extended 5 years by CAA-21 (PL 116-260; 12/27/20) (to 12/31/25)
- Tax years beginning after 12/31/21 – must capitalize annual R&D expenditures (§174) and amortize over 5 years using mid-year convention (15 years for foreign research).
  - WARNING – If not changed, taxpayers likely have not paid sufficient estimated taxes for 2022.
- §163(j) interest limitation – calculation becomes less favorable for tax years beginning after 12/31/21 (depreciation, amortization and depletion will reduce adjusted taxable income).
- 100% bonus depreciation of 168(k) begins to phase down generally for property placed in service after 12/31/22 through 12/31/26.
- Deduction for foreign-derived intangible income (FDII) and global intangible low-taxed income (GILTI) are reduced from 37.5% to 21.875% for FDII and from 50% to 37.5% for GILTI for tax years beginning after 12/31/25
- Individual provisions expiring after 2025 such as doubled CTC, higher standard deduction, lowered brackets, SALT cap

No Deduction for Deferred Comp – *Hoops, LP, et al*, TC Memo 2022-9 (2/23/22)

- 2000 - H formed to acquire, own and operate an NBA team
  - 2001 – acquired Vancouver Grizzlies and moved them to Memphis, TN
- 2012 – IRS disallowed $10.7 million of salaries and wages claimed on H's 1065X for deferred comp liabilities of 2 players assumed by buyer of substantially all of H's assets in 2012.
  - $10.7 million is total of $12,640,000 discounted 3%
  - H uses accrual method
  - Issue: Is H entitled to (1) deduction for the comp, or (2) offset to amount realized (§1231 gain) from sale of assets?
    - H filed return using (1). Later amended return to use (2) because no deduction was claimed on 2012 return for the comp, following Reg. 1.461-4(d)(5).
    - IRS disallowed the deduction.
- https://dawson.ustaxcourt.gov/case-detail/11308-18

Hoops - continued

- Deferred comp governed by §404(a).
  - Generally deductible when recipient reports as income.
- (1) H argues that per §461(h) economic performance rule can deduct.
  - Court – No. §404 then limits the deduction to year paid and included in recipient's income. Reg. 1.461-1(a)(2) – how taken into account - must also consider other relevant rules.
    - Doesn't violate clear reflection of income because Congress provided §404(a)(5) to deviate from that, in order to match timing of deduction and income among payor and payee for deferred comp.
- (2) §1001 – Gain realized includes assumed liabilities
  - H – but only if H got a deduction for that liability
  - Court – H relieved of liability in sale, so include in amount realized
    - H argued should get deduction in year of sale as if constructively paid the liability to buyer
      - "by accepting less cash than the seller otherwise would have received had it retained the liability, it effectively made a constructive payment to the buyer to satisfy the liability." *James M. Pierce Corp*, 326 F2d 67 (8th Cir. 1964)

Hoops – Tax Court

- *James M. Pierce* case did not involve deferred comp subject to §404(a)(5) [no deduction until recipient reports in income]
- H must include deferred comp in amounts realized; no deduction.

- *Observations*: Why isn't this a regular decision? Isn't much case law on contingent liabilities assumed in an acquisition. Will buyer get a deduction when it pays the deferred comp? Arguably yes. Should purchase price have been adjusted for this liability? Yes.
  - Could the deferred liability amount realized be viewed as installment sale? When buyer pays, H has income and deduction?
  - What if instead, liability was for utilities?
    - As accrual basis taxpayer, H would have already deducted. Would include amount assumed as part of purchase price. No deduction to buyer when pays?
  - Is this what Congress intended?
  - Would it be better for seller to keep the liability? Would lower gain and provide a deduction when paid (but what if not in business later)?
  - Guidance needed in this area for a long time.

Patent Litigation Expenditures Found Deductible – *Actavis Laboratories, Fl, Inc*., No. 1:19-cv-00798 (Fed Cls, 8/19/22)

- First line from Judge Holte: ""[N]othing can be said to be certain, except death and taxes." The exception to that exception is taxes on Hatch-Waxman patent litigation expenses."
- Branded drug companies sued Watson Pharmaceuticals, Inc., manufacturer of generic drugs, for Abbreviated New Drug Applications (ANDAs) it filed for 7 drugs, alleging patent infringement. Did not challenge that eligible for generic drug approval or that ANDAs technically deficient – alleged patent infringement.
- 2008 – 2009 - W deducted its legal defense expenses.
  - **2008: $3,882,951 2009: $8,481,237**
- 2011 – IRS issued Reg. 1.263(a)-4 – costs of defending patents must be capitalized per origin of claim doctrine.
- Actavis became substitute agent for returns; filed for refund of taxes paid per IRS deficiency notice.

Actavis Laboratories – Party Positions and Court's Explanation of Hatch-Waxman Law

- Actavis position – ordinary and necessary expenses of defending its business practices.
- IRS – Hatch-Waxman related expenses facilitate acquisition of FDA-approved ANDAs—intangible assets, so must capitalize
- Court – Deductible because "do not enhance the finally approved ANDAs"
- Court explains HW law and its purpose and complexities; gives benefits to first-to-file ANDA applicant
  - "Congress wanted to promote the introduction of affordable generic drugs to the market as quickly as possible, so it provided an incentive to spur generics into action."

Actavis Laboratories – Law Review

- Origin-of-the-claim:
  - "taxpayer's motives or purposes in undertaking defense of the litigation, as well as the consequences of the litigation, are irrelevant to the costs' deductibility."
- Capitalization:
  - ""[e]xpenses must generally be capitalized when they either: (1) [c]reate or enhance a separate and distinct asset, or (2) otherwise generate significant benefits for the taxpayer extending beyond the end of the taxable year.""
  - To simplify, IRS issued Reg. 1.263(a)-4 – "that "defined the exclusive scope of the significant future benefit test through the specific categories of intangible assets for which capitalization is required.""
    - Only have to capitalize if reg calls for that (preamble to 2002 regs).
    - No specific guidance exists on H-W litigation expenses
  - Tax Court in *Mylan, Inc.,* 156 TC 137 (2021) – "e litigation expenses that [petitioner] incurred in defending Section 271(e)(2) suits arose out of the ordinary and necessary activities of its generic drug business and accordingly are deductible.""

Actavis Laboratories – Law Review

- IRS explanation of approach:
  - "When legal fees are incurred in litigation, there is a two-step process for determining whether the fees must be capitalized. First, the origin of the claim doctrine must be applied to ascertain the character and nature of the expenditures. Second, the capitalization of intangibles regulations must be applied to determine, *based on the ascertained character and nature*, whether the expenditures are within any of the categories of expenditures that must be capitalized under the regulations.
- Court: finds above approach persuasive.
  1. Origin of claim: "§ 271(e)(2) claims against plaintiff arose out of patentee efforts to protect their intellectual property from infringement, not generic drug company efforts to acquire an approved ANDA. … As such, the substance of Hatch-Waxman litigation is the same as any other patent infringement litigation—a property trespass action originating in tort."
     - "origin of the § 271(e)(2) claims is the branded drug companies' patent enforcement efforts to maintain their business profits and cease plaintiff's generic drug business activities."
  2. Reg. 1.263(a)-4 – "Hatch-Waxman litigation is not a part of the ANDA transaction, [thus] expenses also do not "facilitate" the "acquisition or creation" of an approved ANDA." Also do not *enhance* an ANDA.
     - Nothing in Reg. 1.263(a)-4 requires capitalization of the H-W expenditures.

Start-up vs. Carrying On and Software Development Issues – *Kellett*, TC Memo 2022-62 (6/14/22)

- 2011 - K had full-time job but worked part-time to create “an online repository of demographic, social, and economic data” from free resources. Figured he could design something better than was already in existence with a “single user-friendly interface”
- 2013 purchased domain name and formed Vizala, LLC. K was sole owner.
- Hired engineers to help build platform; they used open-source software. Finished March 2015.
- Sept 2015 – opened site to public. Expected to make money via ads on website, charging fee for certain uses of the website, selling personalized reports, and licensing data from the website to other companies. Did not use any of these ideas until 2019.
- https://dawson.ustaxcourt.gov/case-detail/21518-18

Kellett - continued

- 2015 – deducted $25,922 expenses on Schedule C, mostly payments to engineers.
  - IRS disallowed – are §195 start-up expenses, not §162 expenses.
- When does business begin? No regs so apply *Richmond Television*, 345 F2d 901 (4th Cir., 1965).
  - “taxpayer does not begin carrying on a trade or business “until such time as the business has begun to function as a going concern and performed those activities for which it was organized.”
  - V could have no customers until website opened; no revenue until after 2015.

Kellett – Court's application of *Richmond Television* to Internet Based Business

- Court: "Even though [K] made no attempt to earn revenue in 2015, his business began providing the services "for which it was organized," with an eye to long-term profit, once he opened the website. … Such activity, at least under these circumstances, constitutes an active trade or business."
    - So, started Sept 2015. Expenses prior to that fall under §195.

- *Observations*: Revenue not crucial to show start of business. But was performing activities Vizala was organized for.

Kellett – But aren't these §174 costs excepted from §195?

- No – were not §174 items. Court found K did not encounter "uncertainty" required for R&D as defined under Reg. 1.174-2.
    - Used open-source software "to solve a complex but familiar problem"
    - K created a data aggregation site.

- *Observations*: Don't forget that §174 expenses are not start-up expenses and as long as have business intent, should be allowed under §174 (§174 uses term "in connection with" a T or B rather than the §162 term "carrying on" a T or B).

Kellett – But aren't software development activities eligible for accounting similar to §174 – Rev. Proc. 2000-50?

- Court:
  - IRS "failed to explain how to coherently apply Rev. Proc. 2000-50."
  - RP 2000-50 "exists to supersede" §195 and §263.
  - But is a revenue procedure binding for taxpayers?
    - "Courts generally treat revenue procedures as governing internal IRS operations and hold that they do not create substantive rights in the public."
    - Congress creates tax law, not the IRS. "IRS guidance that operates to create a rule out of harmony with the Code is a mere nullity."
    - Equitable estoppel? Unfair to deny taxpayer use of rule IRS created?

- *Queries*: What about fact that Congress was aware of Rev. Proc. 2000-50 (started as Rev. Proc. 69-21)? Will IRS continue to allow anyone to follow Rev. Proc. 2000-50?

Kellett – Would the TCJA change on software development effective for tyba 12/31/21 help?

- TCJA Sec. 13206(b), effective for tyba 12/31/21
  - §174 expensing changed to required capitalization and amortize that capitalized amount over 5 years using half-year convention (15 years for foreign research).
  - Makes corresponding changes to §41 research credit and §280C(c).
  - AND – adds new §174(c)(3): *SOFTWARE DEVELOPMENT.—For purposes of this section, any amount paid or incurred in connection with the development of any software shall be treated as a research or experimental expenditure.*
    - Making software development be §174 costs, pulls them out of §195.
  - https://www.congress.gov/115/plaws/publ97/PLAW-115publ97.pdf
- Build Back Better Act (H.R. 5376) passed in House 11/19/21 would extend effective date of TCJA Sec. 13206 4 years (for tyba 12/31/25)
  - https://rules.house.gov/sites/democrats.rules.house.gov/files/BILLS-117HR5376RH-RCP117-18.pdf
- *Query*: Should §174(c)(3) be added to replace Rev. Proc. 2000-50 and avoid the result in *Kellett* and Tax Court?

2. Developments in State Apportionment & Sourcing Methodologies

Background on California's Adoption of Market-Based Sourcing

- In tax years beginning on or after January 1, 2011 and before January 1, 2013 in which a single sales factor election was made, and in all tax years beginning on or after January 1, 2013, Cal. Rev. & Tax. Code § 25136 employs the following market-based sourcing provisions for sales other than sales of tangible personal property:
  - Receipts from "sales from services" are attributable to California "to the extent the purchaser of the service received the benefit of the service" in California.
  - Receipts from "sales from intangible property" are attributable to California "to the extent the property is used" in California.
  - Receipts from the "sale, lease, rental, or licensing of real property" are attributable to California if "the real property is located" in California.
  - Receipts from the "rental, lease, or licensing of tangible personal property" are attributable to California if "the property is located" in California.
- Cal. Code Regs. ("CCR") § 25136-2 was promulgated to give guidance on sourcing sales from services and intangibles to implement the rules described above.

2. Developments in State Apportionment & Sourcing Methodologies

CCR § 25136-2 currently provides the following cascading rules:

For services:

- To individual customers
  - Presumed to be billing address unless customer contract or books/records show otherwise
  - Reasonable approximation
- To corporation or business entity customers.
  - Customer contract or books/records
  - Reasonable approximation
  - Where customer placed order
  - Billing address

For sales of intangible property:

- Complete Transfer of Intangible Property Rights
  - Where used based upon contract or taxpayer's books and records
  - Reasonable approximation
  - Billing address
- Separate rules for interest income that that parallel those in CCR § 25137-4.2
- Separate rules for dividends and goodwill
- License of Intangible Property
  - Different cascading rules depending on whether marketing, non-marketing, manufacturing or mixed intangible property

2. Developments in State Apportionment & Sourcing Methodologies

2022 California Developments in Market-Based Sourcing

- FTB Legal Ruling 2022-01, issued on March 25, 2022, addresses the application of California's market-based sourcing rules to certain services provided to business entity customers.
- This new Legal Ruling reaches a "look through" approach in circumstances where a service is directed at a customer's customer (*i.e.*, it concludes that receipts may be sourced to the location of the ultimate customer).
- This Legal Ruling also outlines the FTB's line analysis to determine the assignment of gross receipts from the sales of services to business customers. The ruling provides three scenarios for evaluation that each apply the following four-question framework:
    i. who is the customer?
    ii. what is the service being provided?;
    iii. what is the benefit of the service being received by the customer?
    iv. where is the benefit of the service being received by the customer?
- Legal Ruling 2022-01 also *revokes* two prior Chief Counsel Rulings (2015-03 and 2017-01) that taxpayers may have relied on and likely has retroactive implications.

2. Developments in State Apportionment & Sourcing Methodologies

FTB Legal Ruling 2022-01, Continued

- The revoked Chief Counsel Rulings 2017-01 and 2015-03 applied a different framework that generally looked to whether a service is a "marketing service" or a "non-marketing service" for purposes of determining whether to stop at the direct customer or look-through to the customer's customer when applying CCR § 25136-2.
- By contrast, Legal Ruling 2022-01 provides that "when the service provided by the taxpayer is directed at the customer's customer(s), the benefit received by the customer is likely located at the customer's customer(s)' location."
- The FTB's new legal ruling contains no effective date, but indicates that it supersedes any conflicting prior guidance issued by the FTB.

2. Developments in State Apportionment & Sourcing Methodologies

FTB Announces Approach to Applying Legal Ruling 2022-01 Regarding Penalties

- In the June edition of the FTB's Tax News publication, the following guidance was included:

> **What happens if a taxpayer followed either CCR 2015-03 or 2017-01 when determining its tax filing position**
>
> The Large Corporate Understatement Penalty (LCUP) will not be assessed against these taxpayers. An Accuracy Related Penalty (ARP) will also not apply, assuming the taxpayer filed a California return. However, if a taxpayer followed the CCRs' analyses to determine it did not have a filing requirement, and consequently filed a late return, a delinquent penalty will apply. Furthermore, interest will be assessed on any underpayment amounts resulting from a taxpayer's reliance on the CCRs.

- See https://www.ftb.ca.gov/about-ftb/newsroom/tax-news/june-2022/index.html

Draft Amendments to Title 18, California Code of Regulations, Section 25136-2

Amended California Regulations, Title 18, Section 25136-2

- Regulation project has now been in process at the FTB for over five years. In September, 2021, the FTB directed its staff to move forward with the formal rulemaking process. There is a possibility that the regulations could be further amended as part of the formal rulemaking process at the Office of Administrative Law (OAL). Final adoption is likely to occur in 2023.
- While the amendments to the regulations are still not final, the regulations currently include language making them effective for tax years beginning on or after January 1, 2023.

Amended California Regulations, Title 18, Section 25136-2

- New "presumptions" for sourcing services revenues that "predominately relate" to:
  - Tangible property in state when service is received
  - Intangible property that is used in the state
  - Individuals who are physically present in the state at the time the service is delivered
- These presumptions can be overcome by the taxpayer or the FTB.

Amended California Regulations, Title 18, Section 25136-2

- If presumption is overcome, but location of benefit cannot be substantiated, then a sourcing hierarchy is applied:
  - First, look to books and records
  - If books and records are nondeterminative, reasonable approximation
  - If reasonable approximation isn't possible, then look to billing address

Amended California Regulations, Title 18, Section 25136-2

- New methods:
  - "Large Volume Professional Services" – cutoff is 250 customers
  - Extensive guidance is added related to receipts for asset management services
- Upon sale of stock or an interest in a flow-through entity, cash is now excluded when determining whether 50% of assets of the entity sold consist of tangible or intangible assets. The impact is that if >50% are intangible, then sales factor is used. Otherwise the average of the payroll and property factors are used.
- Not an all-inclusive list – Regulations are long and after six rounds of amendments contain multiple new examples impacting multiple industries. Notable examples for biotechnology, and Online Advertising.

P.L. 86-272 Developments

Background on California and the Multistate Tax Commission

- The Multistate Tax Commission (MTC) came into being in 1967
- States were concerned that congress would enact state income tax apportionment rules to make the states more uniform, so in order to address congress' concerns regarding uniformity, they entered into an agreement, called the Multistate Tax Compact.
- California withdrew from the Compact in 2012.

MTC's P.L. 86-272 Guidance

- Adopted by the MTC in August 2021 – adds a section to its previous guidance for "activities conducted via the internet"

    - *The Supreme Court recently opined, in South Dakota v. Wayfair, Inc., construing the Commerce Clause, that an Internet seller "may be present in a State in a meaningful way without that presence being physical in the traditional sense of the term." 138 S. Ct. 2080, 2095 (2018). Although the Wayfair Court was not interpreting P.L. 86-272, the Supporting States consider the Court's analysis as to virtual contacts to be relevant to the question of whether a seller is engaged in business activities in states where its customers are located for purposes of the statute.*

FTB Publication 1050 – Historical guidance on P.L. 86-272

- Demonstrates California's historically strict interpretation of P.L. 86-272

- Activities that seek to promote sales are not "ancillary" to the solicitation of sales. P.L. 86-272 "does not protect activity that facilitates sales; it only protects ancillary activity that facilitates the request for an order."

    - Example: A winery employs a salesperson to travel to various states to visit with prospective customers and provide tastings of wines. If the prospective customers like the wines, then the salesperson will solicit orders for the wine.

Technical Advice Memorandum 2022-01

- Referred to as a “TAM” and Released February 14, 2022
- Lists twelve fact patterns of a business making sales to California, which has no activities other than those mentioned in the fact pattern.
- For 9 of the fact patterns, the TAM reaches the conclusion that the listed activities exceed P.L. 86-272 protection.

Technical Advice Memorandum 2022-01

“New economy” fact patterns outlined in the TAM:

- Employee telecommutes from within California performing business management and accounting tasks. **(Not protected)**
- Businesses’ website invites viewers in California to apply for non-sales positions. The website enables viewers to fill our and submit an electronic application, and also to upload a cover letter and resume. **(Not protected)**
- Business places Internet cookies on the computers or other devices of customers. Cookies are used to gather information about customers to aid in product development or identifying new items to offer for sale. **(Not protected)**

Technical Advice Memorandum 2022-01

“New economy” fact patterns outlined in the TAM (continued):

- Business sends product upgrades by transmitting code via the internet. **(Not protected)**

- Business contracts with a marketplace facilitator, who maintains inventory in various states **(Not protected)**

- Business streams videos to customers. **(Not protected)**

Technical Advice Memorandum 2022-01

“New economy” fact patterns outlined in the TAM (continued):

- Business provides post-sale assistance to California customers via electronic chat or email which customers initiate by clicking on an icon on the businesses’ website. For example, for how to use products. **(Not protected)**

- Business solicits applications for its branded credit card via the company’s website from California customers. **(Not protected)**

- Business offers and sells extended warranty plans via its website to California customers. **(Not protected)**

Technical Advice Memorandum 2022-01

“New economy” fact patterns outlined in the TAM (continued):

- Business provides post-sale assistance via static FAQs with answers **(Protected)**
- Business places “cookies” on devices of customers used only to gather information that is used for purposes considered “ancillary” such as remembering items in the customer’s cart. **(Protected)**
- Business only sells TPP on its website and allows customers to browse and pay for items. **(Protected)**

American Catalog Mailers Association (ACMA) Lawsuit

- The ACMA requests a judgment that TAM 2022-01 and FTB Publication 1050 are invalid.
- In the alternative, ACMA requests a judgment that the FTB’s new guidance applies on a prospective basis only.
- Arguments are to heard by the San Francisco County Superior Court in November.

California Economic Nexus

Year	CA sales exceed (either the threshold amount or 25% of total sales)	CA real and tangible personal property exceed (either the threshold amount or 25% of total property)	CA payroll compensation exceeds (either the threshold amount or 25% of total payroll)
2021	$637,252	$63,726	$63,726

California Throwback

- Only applies to Tangible Personal Property sales (not services)
- Property is shipped from California
- The customer is either the U.S. Government or the customer is in a state where the taxpayer is “not taxable.”

California Throwback

- Not required to PAY tax in another state, in order to avoid throwback.

- The threshold that must be crossed to avoid throwback is that a taxpayer must be "taxable" in the destination state.

  - Taxpayer is taxable in another state if in that state it is "SUBJECT TO" :
    - A net income tax
    - A franchise tax measured by net income
    - A franchise tax for the privilege of doing business
    - A corporate stock tax, OR
    - A state has jurisdiction to subject the taxpayer to a net income tax regardless of whether it does or does not.

Throwback avoidance example #1

- Taxpayer sells $200,000 of tangible property to customers in Nevada. Taxpayer has $2M of sales everywhere. Taxpayer has an administrative employee who regularly works out of her home in Las Vegas.

  - Even though Nevada does not have an income tax, this taxpayer would not throwback its Nevada sales to California, since it would be considered "doing business" in Nevada due to the regular presence of an employee in the state (which gives Nevada jurisdiction to subject the taxpayer to tax).

  - Note that if the taxpayer did not have an employee working in the state in this example it would throwback sales to California (assuming it does not engage in activities discussed in TAM 2022-01).

Throwback avoidance example #2

- Taxpayer sells $200,000 of tangible property to customers in Nevada. Taxpayer has $2M of sales everywhere. Taxpayer's website invites viewers to apply for non-sales positions. Taxpayer has no other activity in Nevada.
  - Taxpayer avoids throwback, due to the website activity, following the interpretation of TAM 2022-01.

Inbound Taxpayers

- A taxpayer making sales into California that is engaging in any of the "non-protected" activities may be at risk of an assessment, if they have been treating their activities as "protected."
- Taxpayers may qualify for voluntary disclosure program relief, but not if the taxpayers had been filing returns (e.g., claiming protection and paying minimum tax). For such taxpayers, an amnesty would be helpful, though has not yet been announced. Good news for those taxpayers is that there would be a statute of limitations.
- Potential to reduce throwback sales if origination state has a throwback rule.

Outbound Taxpayers

- Taxpayers should consider whether the destination state has adopted or is likely to adopt the MTC's interpretation.
- Taxpayers may qualify for voluntary disclosure program relief in destination states.
- Potential to reduce throwback sales and file amended California tax returns.
- Differences in the interpretation of states could lead to denial of credit for taxes paid to other states (for individuals and flow-through entities)

American Catalog Mailers Association v. Franchise Tax Board, Superior Court of California, San Francisco County.

- Seeks to have FTB Technical Advice Memorandum 2022-01 declared invalid.
- Alternatively, ACMA seeks a declaration that the guidance applies on a prospective basis only.
- States that FTB did not properly follow the California Administrative Procedure Act's required rulemaking process before publishing the TAM.

2. Developments in State Apportionment & Sourcing Methodologies

Is it COP or Market? Recent Market-Based Sourcing Developments Outside of California

Florida: Technical Assistance Advisement (TAA) 21C1-005

- For corporate income tax purposes, the TAA concludes that service income under the facts should be sourced to the location to which deliverables from the services are "forwarded, sent, delivered, or provided, on a market basis."
- The TAA minimizes the potential application of Florida's rule for "other sales in Florida" which includes an approach based on where the "income producing activity" occurred.

Texas: *Sirius XM Radio, Inc. v. Hegar*, No. 20-0462 (Tex. Sup. Ct. Mar. 25, 2022)

- The taxpayer provided subscription-based satellite radio services nationwide.
- The taxpayer originally sourced subscription receipts to the location of programming production.
- The Texas Comptroller assessed tax on the basis that Sirius should have apportioned its subscription receipts based on the locations where the satellite transmissions were received by Sirius's subscribers.
- The Texas Supreme Court reversed the ruling by the Texas Court of Appeals, concluding that the service is performed in the state "if the labor for the benefit of another is done in Texas."

2. Developments in State Apportionment & Sourcing Methodologies

Pennsylvania: *Synthes USA HQ, Inc. v. Commnw. of PA*, 108 F.R. 2016 (July 24, 2020)

- The taxpayer originally sourced sales using a costs of performance methodology, resulting in all receipts being sourced to Pennsylvania.
- Refund claims were filed on the theory that the Department had been consistently applying a "benefits-received" sourcing methodology for sales factor purposes.
- On appeal, the Commonwealth Court rejected an argument by the Attorney General that the refund should be denied because the Department's interpretation was in error.
- The court noted that the Department has consistently applied the benefits-received method for many years and that the state legislature acquiesced in that interpretation.
- Therefore, the court upheld the use of the "benefits-received" method of calculating the sales factor in a year where the language in the statute was based on a costs of performance methodology.

4. Miscellaneous Income Tax Updates

Background on A.B. 85, Signed June 29, 2020 (NOL Suspension & Credit Limitation)

- Three-year suspension of NOLS (2020-2022) with the following Small Business Exemption:
  - *… this section shall not apply to a taxpayer with a net business income of less than one million dollars ($1,000,000) for the taxable year.*
  - *… this section shall not apply to a taxpayer with a modified adjusted gross income of less than one million dollars ($1,000,000) for the taxable year.*
  - For any NOL for which a deduction is denied because of the suspension, California will extend the carryover period.
- Importantly, the small business exemption has been specified to apply on a post-apportioned and allocated basis to each taxpayer member in a California combined reporting group.

4. Miscellaneous Income Tax Updates

S.B. 113, Signed February 9, 2022, Made Significant Changes to California's NOL Suspension & Credit Limitation

- As previously noted, A.B. 85 had imposed a three-year suspension of California NOLS (2020-2022) and a three-year limitation on most credits requiring that they not offset tax in excess of $5,000,000 between 2020 and 2022.
- S.B. 113 amends the NOL suspension and credit limitation traceable to A.B. 85 as follows:
  - The NOL deduction is restored for 2022.
  - The $5,000,000 annual business tax credit cap is lifted for 2022.
- Note: S.B. 113 also made important changes to California's PTE tax regime, and credit ordering rules for Personal Income Tax purposes. Effective in 2022, S.B. 113 amended California's credit ordering statute, CRTC Sec. 17039, to provide that PTE tax credits described in CRTC § 17052.10 be taken into account *after* any other state tax credits allowed by CRTC § 18001.

4. Miscellaneous Income Tax Updates

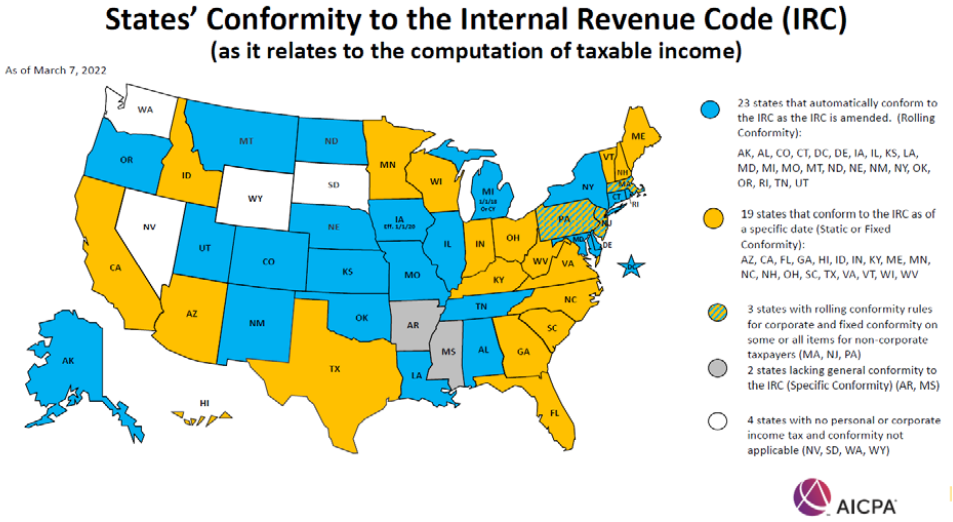
The 2009 Metropoulos Family Trust v. FTB, Case No. D078790, May 27, 2022.

- Consistent with the Office of Tax Appeals' 2019 decision, on May 27, 2022, the California Court of Appeal affirmed that a nonresident shareholder's California source income from a S corporation's sale of intangible property (goodwill) was partially from California sources and not sourced entirely to the shareholders' states of domicile under CRTC § 17952.
- After deciding the issue of nonresident sourcing on the basis that the S corporation's business income is apportioned at the entity level and that associated California sourcing is retained in the hands of the S corporation's owner, although not essential to the decision, the Court of Appeal went on to note that even if CRTC § 17952 had applied, the same result would potentially occur because the goodwill had partially acquired a business situs in California through the S corporation's historical in-state activities.

Online Merchants Guild v. Hassell, No. 179 M.D. 2021, Pennsylvania Commonwealth Court, Sept. 9, 2022.

- Aka "Amazon inventory nexus case".
- Concept of "purposeful availment"
- State cannot collect business information solely for purposes of determining a business' status as a taxpayer.
- Decision could impact ongoing controversy and litigation in other states.

Consider state conformity when planning around requirement to capitalize IRC Section 174 expenses



Joshua Grossman
State Tax Principal, California Subject Matter Lead
Grant Thornton LLP, San Francisco
(415) 354-4796
josh.grossman@us.gt.com

John Clausen
State and Local Tax Managing Director
Moss Adams, LLP
408-558-5775
john.clausen@mossadams.com