

Hot State Tax Topics

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Agenda

- Nexus Expansion
- COP vs. Market
- Taxation of SaaS
- California DISA
- Sourcing TPP: Ultimate Destination & Dock-Sale Rules
- State Legislation Targeting “Tax Havens”
- California Apportionment for Start-Ups
- IRC Section 385
- Oregon Gross Receipts Tax
- Other Noteworthy Developments

Nexus Expansion

Nexus Expansion

- *Quill* (1992): Physical presence required for sales and use tax
- *Geoffrey, Inc.* (SC Supreme Court, 1993)
- Deriving income from in-state sources creates income tax nexus (*cert. denied* in all cases)
 - *Lanco* (NJ 2006): Trademark holding company
 - *MBNA Amer. Bank* (WV 2006) & *Capital One Bank* (MA 2006): Credit card banks
 - *Geoffrey* (MA 2009) & *KFC* (IA 2010): Intangible holding companies
 - *Gore Enterprises* (Md. Ct. of App. 2014)

Nexus Expansion: Online Retailers

- *Direct Marketing Ass'n* (2015)
 - CO statute: Out-of-state retailers who do more than \$100K worth of business in the state must report on the purchases of their in-state customers
 - Kennedy concurrence: “It should be left in place only if a powerful showing can be made that its rationale is still correct”
 - Commissioner Kevin Sullivan (CT): “It’s like getting a letter from Santa Claus”
 - 10th Cir. (2016): The CO statute is valid under the Dormant Commerce Clause (*cert. pending*)
- *Newegg, Inc.* (2016)
 - AL & SD statutes establish economic nexus for major out-of-state retailers that lack physical presence
 - Both states are using challenges to their statutes by Newegg and other online retailers as an opportunity to overturn *Quill*

Nexus Expansion: Telecommuters

- *Telebright* (NJ 2012): A corporation whose only contact with the state is the presence of a single telecommuting employee working out of her own home has nexus with NJ for purposes of the corporate income tax
- TN Letter Ruling No. 97-04 (1997): A corporation is not subject to corporate income tax in TN just because one of its officers works out of his home in TN
- *Zelinsky* (NY Ct. App. 2003): If the employee of a NY employer works outside of New York for the convenience of the employee (*not* the employer), the employee’s wages are sourced in NY

COP vs Market

COP vs Market

- Applies to sales of other than tangible personal property
- Cost of Performance (COP)
 - UDITPA rule: Assign sales receipts to state with highest portion of income-producing activity (IPA), measured by COP
 - Generally, all-or-nothing rule
 - Some jurisdictions treat each state as a separate IPA and prorate sales based on proportionate COP

COP vs Market

- Market-Based Sourcing
 - Economy shifting towards service and technology industries and away from manufacturing
 - Assign sales receipts to state where benefit is enjoyed

AT&T Corp. vs. Department of Revenue,
357 Or. 691 (2015)

- OR is a COP state
- ORS 314.665(4) - Sales sourced to OR if:
 - IPA is in the state, or
 - IPA is performed in and out of state and greater proportion of IPA is in OR, based on COP

AT&T Corp. vs. Department of Revenue,
357 Or. 691 (2015)

- AT&T filed amended tax return to claim refund
 - Performed cost study to show no sales should be sourced to OR:
 1. Overall US network managed in NJ, thus NJ costs vastly outnumbered OR costs.
 2. NJ costs to support OR demand were much larger than OR costs to support OR demand.
- OR DOR argued that IPA is transaction-based
 - The IPA is each interstate or international transmission from an OR customer
 - The direct costs were the cost of electricity and access charges levied by the local exchange carrier

AT&T Corp. vs. Department of Revenue,
357 Or. 691 (2015)

- OR Supreme Court found in favor of DOR
 - Agreed with the DOR's application of IPA to each individual transaction between a buyer and seller
 - Direct costs do not include network costs (a sunk cost) but rather incremental costs.
 - AT&T did not meet its burden of proof to show that another state had greater COP than OR
- The decision effectively sourced sales receipts on a market-based approach

Taxation of SaaS

Taxation of SaaS

- Income tax sourcing –
 - CA – Regulation 25136-2 – rules depend on whether customer is a business entity or an individual, and also depend on whether there is a “marketing value” associated with the service or whether the service benefits a customer’s business functions [Chief Counsel Ruling 2015-03].
 - TX – Rulings support looking to location of servers - often produces a favorable result. [Letter Ruling Nos. 201604750L and 200305904L]. Question – If a company uses AWS, can it assume that the service is performed from outside the state?

Taxation of SaaS

- New York – Economic Nexus if more than \$1M of sales in the state – new sourcing regulations are in “draft” form and the state is accepting comments through January 2017.
- Taxed for sales tax purposes and income tax purposes – 86-272 inapplicable to services.
- Treatment of “intermediary transactions” under New York’s draft regulations.

Developments in Taxation of SaaS

- Sales Tax –
 - Chicago’s “Lease Transaction Tax” - 9% tax on SaaS and PaaS if “performed within the city.”
 - Pennsylvania legislation effective 8/1/2016 includes electronically delivered “canned software.

California DISA

Federal Excess Loss Account

- Purpose of Excess Loss Account (ELA)
 - To recapture in consolidated taxable income a member's negative adjustments with respect to a subsidiary's stock to the extent the negative adjustments exceed the member's basis in the stock. Treas. Reg. 1.1502-19.
- When can an ELA be created?
 - IRC 301 distribution,
 - From a subsidiary to a parent in the same consolidated group,
 - Where the distribution exceeds both:
 - The distributor's E&P, AND
 - The distributee's basis in the distributor's stock

California Deferred Intercompany Stock Account

- California does not incorporate the concept of an ELA, but instead uses a Deferred Intercompany Stock Account (DISA)
- Creation
 - Tiered distributions
- Reporting
 - FTB Form 3726 and consequences of non-reporting
- Trigger/Recognition
 - Gain recognition election
- Mitigation
 - Subsequent capital contribution
 - Intercompany transfer
 - Intercompany merger

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Practical Considerations

- Reasons for DISA-ELA differences
 - Group composition variations
 - Treatment as deferred income, not negative basis
 - E&P Differences
- Issues with leveraged or push down of debt transactions

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Sourcing TPP: Ultimate Destination & Dock-Sale Rules

Sourcing TPP: Dock-Sale or Ultimate Destination Rule?

- UDITPA section 16
 - "Sales of tangible personal property are in this state if any of the following occur: The property is **delivered** or shipped to a **purchaser**, other than the federal government, **within this state** regardless of the f.o.b. point or other conditions of sale."
 - Text is ambiguous:
 - "Delivered . . . within this state"
 - OR
 - "Delivered . . . to a purchaser . . . within this state"

Sourcing TPP: Dock-Sale or Ultimate Destination Rule?

- *McDonnell Douglas Corp. v. Franchise Tax Bd.*, 26 Cal. App. 4th 1789 (1994)
 - UDITPA drafting history of Section 16 supports ultimate destination
- Example of Clear Dock-Sale Statute:
 - "Sales of tangible personal property are made within this state if the property is **received by a purchaser** at a point within this state, **regardless of** the f.o.b. point, other conditions of the sale, or **the ultimate destination of the property.**" Minn. Stat. § 290.191(5)(b).

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Sourcing TPP: Ultimate Destination

- *Appeal of Mazda Motors of America (Central), Inc.*, Cal. St. Bd. of Equal., Nov. 29, 1994.
- California Franchise Tax Bd., Legal Ruling 95-3
 - Warehousing
 - Repacking
 - Repairing
 - Adding accessories
- When does the shipment terminate?
 - What if subsequent transfer by “purchaser” to another location?
 - Illinois Private Letter Ruling IT-14-0002
 - May not terminate if predetermined destination

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Sourcing TPP: Dock-Sales

- When is the product “received” by or “delivered” to the purchaser?
 - “Delivery is complete upon transfer of possession or control of the property to the purchaser, an employee of the purchaser, or transportation vehicles that the purchaser leases or owns.” 34 Tex. Admin. Code § 3.591(e)(29)(A).
- Transfer using third-party shipping
 - Common carrier (generally destination)
 - Contract carrier (might be pick-up location)
 - What if shipping is arranged by buyer?
 - What if seller does not know the destination?

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State Legislation Targeting “Tax Havens”

State Legislation Targeting “Tax Havens”

- Requires taxable income inclusion – not just reporting and disclosure
- Water’s edge return for multinational enterprises
- Two methods
 1. “Blacklist” (e.g., MT (2004), OR (2013))
 - Based on “discredited” OECD “tax havens” list
 - Not only the “usual suspects” (e.g., Cayman, Isle of Man, Bermuda, Luxembourg), but also Ireland, Switzerland, Netherlands
 2. Definitional (e.g., AK (2013), RI (2014), CT, DC, WV)
 - Jurisdiction’s tax rate is lower than state’s

State Legislation Targeting “Tax Havens”

- Related parties not included in combined return
- Factors (payroll, property, sales)
- Is state “tax haven” legislation constitutional?
- Foreign commerce clause – U.S. Const. Art. I, §8, cl. 3

The Congress shall have Power . . . To regulate Commerce with foreign Nations, and among the several States, and with the Indian tribes.

- Japan Line Ltd. v. County of Los Angeles, 441 U.S. 434, 450 (1979).

“... when a State seeks to tax instrumentalities of foreign, rather than interstate commerce ... a court must also inquire, first, whether the tax ... creates a substantial risk of multiple taxation and, second, whether the tax prevents the [U.S.] Federal Government from ‘speaking with one voice when regulating commercial relations with foreign governments.’”

State Legislation Targeting “Tax Havens”

- **Recent Proposals**

- Alabama (2015 – died)
- Colorado (2015 & 2016)
- Indiana (2016 – study group)
- Kentucky (2016 – blacklist/died)
- Kansas (2016 – blacklist/died)
- Louisiana (2015 – died)
- Maine
- Massachusetts (2015 – active)
- Minnesota (2016 – active)
- New Hampshire (2015 – died)
- New Jersey (2016 – active)
- Pennsylvania (2015 – active)
- Vermont (2015 – not enacted)

- **California** considered such legislation in 2010

California Apportionment for Start-Ups

California Apportionment for Start-Ups

- Who must apportion – Longstanding rule of California Revenue and Taxation Code Section 25121 says “any taxpayer having business activity which is taxable within and without this state shall allocate and apportion.....”
- “Doing business” thresholds of Section 23101, i.e., “economic nexus,” means more taxpayers are “apportionable businesses.”
- Problem – what happens to a start-up company that is “apportionable,” but isn’t yet generating receipts? Are net operating losses (NOLs) lost due to 0% apportionment?

CA Apportionment for Start-Ups

- Is the fraction $0/0=0$? In the world of state apportionment, probably “yes.” [Mathematicians have issues with this].
- Does California’s codification of “Finnegan” principle for purposes of tangible property sourcing also mean that any domestic company is apportionable if it files on a worldwide basis with a foreign affiliate? A water’s edge election could make this question moot.

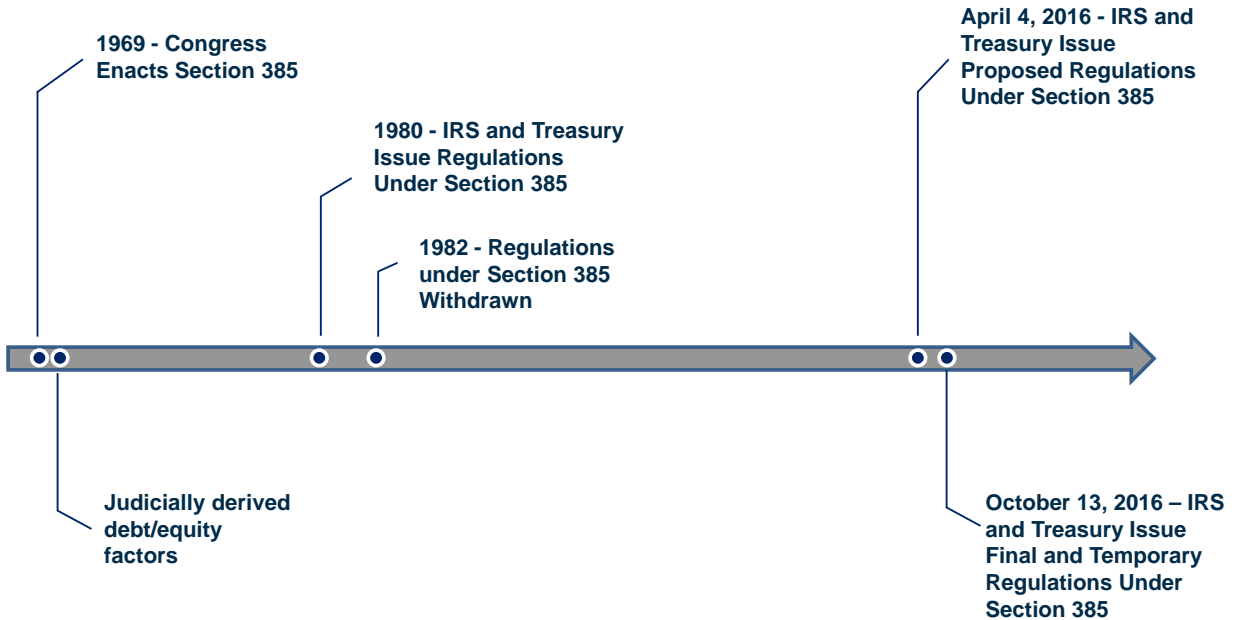
CA Apportionment for Start-Ups

- IRC Section 59(e) capitalization election – if currently at 0% apportionment, could be beneficial to defer deductions.
- Alternative Apportionment – California FTB has acknowledged the problem and has suggested that taxpayers may petition the state for an alternative apportionment method when regular rules result in 0%. These petitions can sometimes take months to be processed, though can be applied retroactively to a previously filed return.

IRC Section 385

SECTION 385 REGULATIONS TIMELINE

Section 385 authorized the Treasury to issue Regulations to determine whether a related-party instrument is to be treated as debt or equity



OVERVIEW OF REGULATIONS: HISTORY

Historically a facts and circumstances analysis was based almost entirely on case law

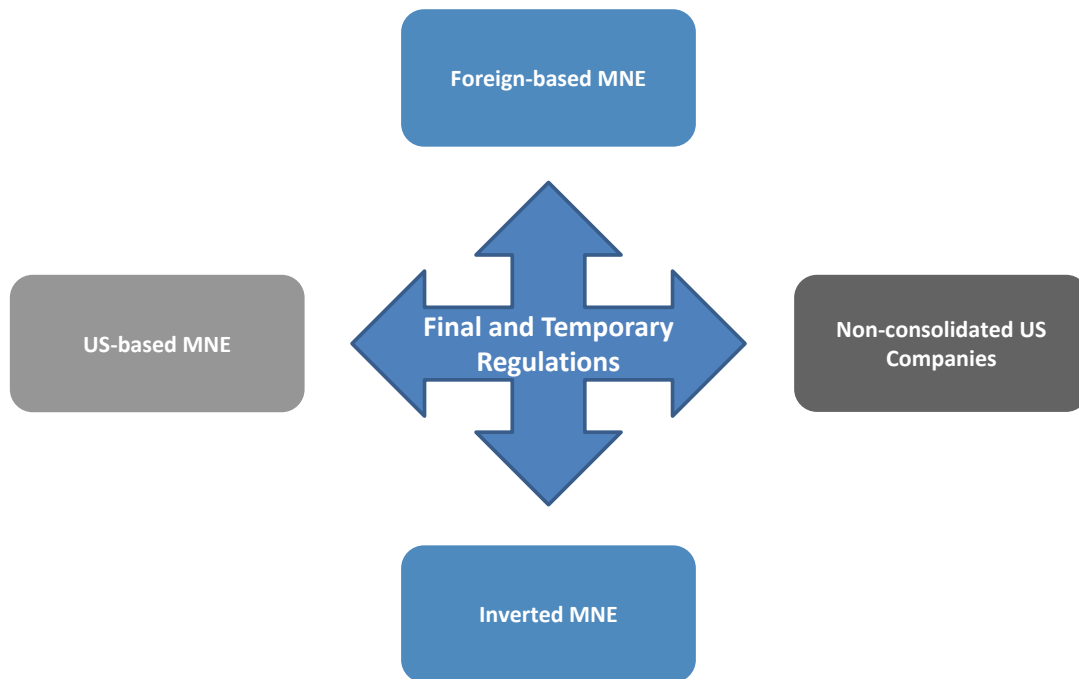
– Court Authority

- Historic case law developed applicable debt/equity rules
- Courts inconsistently applied factors to seemingly similar facts (highlighting the inherent subjective nature of the analysis)

Historic Case Law Factors Considered	
Naming of instrument	Issuance of debt in proportion to shareholdings
Presence/absence of a fixed maturity date	Convertibility of interest into stock
Source of payments	Ability to obtain third-party loans
Creditors rights provided to holder	Use of advance to acquire capital assets
Availability of increased right to manage	Timely repayment on due date
Subordination	Adequately capitalized recipient
Intent of the parties	Reasonable expectation of repayment

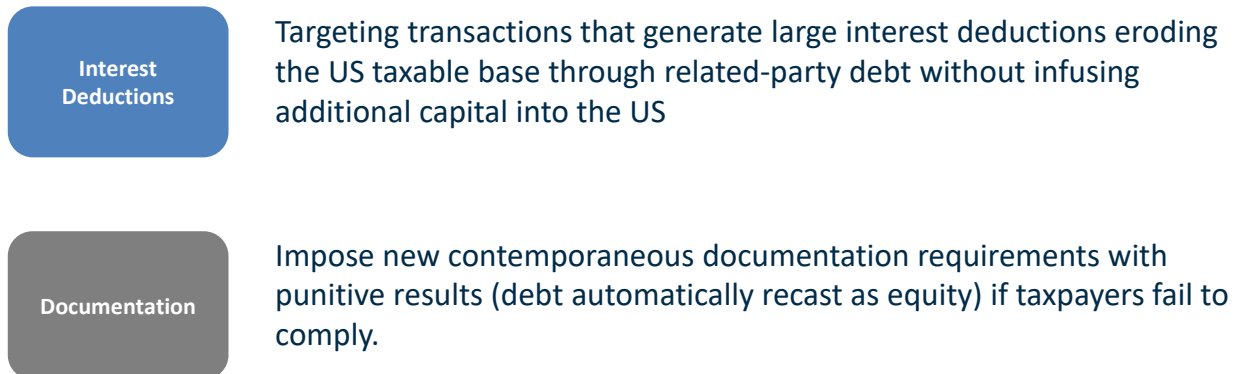
OVERVIEW OF REGULATIONS: APPLICABILITY

Applicable to debt issued (or deemed issued) among members of a multinational enterprises (“MNEs”) and US groups



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OVERVIEW OF REGULATIONS: OBJECTIVES



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OVERVIEW OF REGULATIONS: IMPACT

General Issues

- Increased Due Diligence on M&A Transactions
- Potentially increased cost and complexity associated with integration of acquired entities
 - Section 304 sales
 - Asset reorganizations
- Audit and FIN48 Uncertainty
- Increased Administrative Burden

Other Issues

- Proliferation of hybrid instruments due to US re-characterizations
 - Loss of foreign tax credits
 - Loss of interest deductions/offsets to Subpart F income
 - Loss of tax hedging/integration
 - Unintended E&P shifts
- Treaty qualification and withholding tax rate benefits
- Coordination with non-US affiliates

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OVERVIEW OF REGULATIONS: FRAMEWORK

The Final and Temporary Regulations are divided into four main sections

§1.385-1

Definitions and operating rules on deemed exchanges (i.e., distributions, certain stock acquisitions and certain asset reorganizations)

§1.385-2

Contemporaneous documentation requirements (generally must evidence four category minimum standards)

§1.385-3
and
§1.385-3T

General Rule - recast when issued (i) in a distribution, (ii) in certain exchanges for related-party stock; and (iii) in certain assets reorganizations

Funding Rule - recast where a "prohibited transaction" (similar to (i) through (iii) above) occurs within 72 months of certain financing or funding transactions

§1.385-4

Special rules regarding transactions described in 1.385-3 as they relate to consolidated groups (generally treated as a single taxpayer, application when an intercompany debt is no longer part of the US consolidated group)

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OVERVIEW OF REGULATIONS: EFFECTIVE DATES

The Final and Temporary Regulations have differing effective dates

<p>Pre 4/4/16</p> <p>§1.385-4</p> <p>Pre-existing Debt & Transition Rule</p>	<p>Transition rule: a prohibited transaction occurring prior to April 4, 2016 will not be taken into account (even if the debt instrument is issued on or after April 4, 2016)</p>
<p>Prop Regs 4/4/16</p> <p>§1.385-3, 4</p> <p>Auto Equity Recast Rules</p>	<p>General rule: Applicable to debt instruments issued on or after April 4, 2016</p>
<p>1/1/18</p> <p>§1.385-1, 2</p> <p>Documentation Rules Apply</p>	<p>Documentation rules apply to instruments issued or deemed issued on or after January 1, 2018</p>
<p>Final Regs + 90 Days</p> <p>§1.385-3, 4</p> <p>Cleanse Tainted Debt</p>	<p>Post-April 4, 2016 debt instruments that would be re-characterized as stock are treated as indebtedness until 90 days after the regulations are published as final, January 19, 2017, at which time the debt instrument will be deemed to be exchanged for stock</p>

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DEFINITION OF GROUP & DEBT TERMS

Treas. Reg. §1.385-1

**Expanded Group
(EG)**

An **Affiliated Group** with certain modifications:

- At least 80% vote **OR** value
- Count both direct and indirect ownership
- Foreign entities included
- S corporations excluded
- RICs and REITs are generally excluded

**Modified Expanded
Group
(MEG)**

An **EG** substituting 50% for 80% and including:

- Partnerships owned 50% or more by EG members

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DEFINITION OF GROUP & DEBT TERMS

Treas. Reg. §1.385-1

Expanded Group
Instrument
(EGI)

An **Applicable Instrument** wherein:

- an **Issuer** is one member of an EG; and
- the Holder is another member of an EG

Applicable
Instrument
(AI)

Any Interest issued (or deemed issued) in the form of a debt instrument

- Regulations reserve on exclusions

Issuer

Person (including disregarded entities) **obligated** to satisfy **material obligations** created under terms of an EGI

- Applies even if not primary obligor
- Domestic corporation (excludes foreign issuers)
- A guarantor is not an issuer (unless expected to be primary obligor)

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POTENTIAL IMPLICATIONS FOR STATE TAXES

Final and Temporary Regulations could have far-reaching effects for state tax purposes, particularly on the deductibility of intercompany interest expenses

– General

- Any increase in a taxpayer's federal taxable income resulting from the IRS's application of the regulations (e.g., reduced interest expense deductions on debt to foreign affiliates, or increased income from characterization of principal repayments as dividends) may have an associated state tax cost, because states generally adopt federal taxable income as the starting point for calculating the state tax base

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POTENTIAL IMPLICATIONS FOR STATE TAXES

– Separate Reporting States

- Separate company reporting states (i.e., states that do not adopt consolidated returns or similar rules) might seek to apply the regulations as a tool to disallow interest deductions on intercompany debt
 - States could seek to use their IRC conformity laws to argue that the regulations also apply for state income tax purposes, as many states adopt most or all of the IRC through varying mechanisms
 - Separate company reporting states routinely apply the IRC and relevant IRS regulations "as if" each corporation had filed a separate federal tax return
 - If states were to apply this approach to the regulations, states could potentially argue that the regulations provide authority to reclassify intercompany debt as equity and thereby deny the related interest expense deductions
- Separate company reporting states may seek to adopt their own comparable regulations under other state law authority

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POTENTIAL IMPLICATIONS FOR STATE TAXES

– Add Back States

- Many state legislatures have adopted statutes that generally require interest deductions to be "added back" if the interest is paid to a related party, unless the taxpayer qualifies for an exception to the add back statute
- Even where the add back statute does not apply, states could attempt to deny an interest expense deduction by applying the regulations to treat the debt as equity.
 - This would be particularly relevant where a states add back statute applies narrowly (e.g., only to interest related to intangible assets)

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POTENTIAL IMPLICATIONS FOR STATE TAXES

– Combined/Consolidated Reporting States

- Regulations could impact taxpayers in states that require combined or consolidated reporting by changing the ownership percentages of subsidiaries and resulting in a different composition of the combined/consolidated group
- Certain states may not adopt the federal consolidated exemption

– Franchise Taxes

- Net-worth-based franchise taxes generally include equity in the tax base but exclude debt.
 - A recast from debt to equity for state income tax purposes may carry over from income to franchise tax purposes

Oregon Gross Receipts Tax

Oregon Gross Receipts Tax

- Current corporate income tax – pay the greater of:
 - Minimum tax based on 0.1% of sales (bracketed and capped at \$100,000), or
 - 6.6% of taxable income up to \$1MM and 7.6% over \$1MM

Oregon Gross Receipts Tax

- Measure 97
 - Removes minimum tax cap of \$100,000
 - Minimum tax rate for sales up to \$25MM remains at 0.1%
 - Minimum tax for sales over \$25MM increases to \$30,001 plus 2.5% of sales over \$25MM
 - Applies to tax years on or after January 1, 2017
- Estimated to raise an additional \$3B in state revenue
- Costliest OR ballot measure campaign ever – over \$33MM spent so far

Other Noteworthy Developments

Noteworthy Developments

- MTC election a dead issue?
 - U.S. Supreme Court will not hear *Gillette Company, et al. v. Franchise Tax Board* appeal
- When does a state's retroactive tax law change (to neutralize impact of taxpayer favorable litigation) violate constitutional Due Process requirements?
 - Michigan Court of Appeals' decision in *Gillette Commercial Operations v. Department of Treasury*
 - Cert request expected to be filed with U.S. Supreme Court by end of November
- Connecticut: Combined reporting and *Finnigan* for tax years beginning on or after 1/1/16
- Tennessee: Adopts economic nexus for tax years beginning on or after 1/1/16

Noteworthy Developments

- *Lucent & Nortel* update
- NY - Preferential rate for emerging tech companies
 - 5.7% rather than 7.1%
- DC - High-Tech Tax Credit
 - Requires having 2 or more employees and “office” in DC
 - Must receive 51% of revenue from “permitted” activities
 - Credits for certain types of wages and exemptions for certain types of taxes, and lower rate

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