



presents

Economic Nexus and State Income Taxes: The Growing Threat

Analyzing State Policies and Standards to Minimize Tax and Penalties

A Live 110-Minute Teleconference/Webinar with Interactive Q&A

Today's panel features:

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Thursday, February 25, 2010

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**Economic Nexus and State Income
Taxes: The Growing Threat
Webinar**

Feb. 25, 2010

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Today's Program

- Historical Background In Economic Nexus, slides 3 through 40 (*Owen Knopping and Thomas Steele*)
- Economic Nexus And FIN 48, slides 41 through 56 (*Patrick Duffany*)
- Possible Responses By Corporate Tax Departments, slides 57 through 86 (*Helen Young*)
- Developments On The Horizon, slides 87 through 92 (*Thomas Steele*)

Historical Background In Economic Nexus

The Current Economic Crisis

- It's all about the revenue
 - Revenue-strapped states are looking for ways to increase their tax revenue
 - One target → Out-of-state corporations that only maintain an “economic presence” – no actual physical presence – in the state
 - Impose a variety of taxes, including:
 - Corporate income tax
 - Franchise tax
 - Gross receipts tax
 - Sales tax

“Substantial Nexus” Requirement

- In Complete Auto Transit, Inc. v. Brady, 430 U.S. 274 (1977), the Supreme Court articulated a four-part test to determine if a state tax (in this case, a tax for the privilege of doing business in Mississippi based on the gross receipts of Complete Auto) violates the Commerce Clause
 - **Nexus: There must be a sufficient connection – a substantial nexus – between the taxpayer and the state to warrant the imposition of state tax authority**
 - **Fair apportionment**: The state must not tax more than its fair share of the income of a taxpayer
 - **No discrimination**: The state must not treat out-of-state taxpayers differently than in-state taxpayers
 - **Related to services**: The tax must be fairly related to services provided to the taxpayer by the state

Bright-Line Rule – Physical Presence – Use Tax

- Quill Corp. v. North Dakota, 504 U.S. 298 (1992).
 - Quill was a Delaware corporation that solicited business in North Dakota through the use of catalogues
 - Quill had no **physical presence** in North Dakota
 - North Dakota attempted to force Quill collect a **use tax** from North Dakota residents who made purchases through Quill's catalogue
 - Bright-line rule adopted by the U.S. Supreme Court said:
 - The “substantial nexus” required by the Commerce Clause to allow a state to force an out-of-state company to collect a use tax from in-state customers is only satisfied by a **physical presence in the state** by the out-of state company

The Big Question

- Does, or should, the Quill bright-line physical presence test for the imposition of sales and use taxes apply to income taxes or other business activity taxes?

Point – Counterpoint

- Taxpayers argue that Quill should apply
 - A physical presence is necessary before a state can impose an income tax or other business activity taxes on an out-of-state company
- States argue that the holding in Quill was strictly limited to sales and use taxes
 - An economic nexus is sufficient to allow a state to impose an income tax on an out-of-state company

Point – Counterpoint (Cont.)

- States have won the majority of cases regarding the imposition of income tax on out-of-state companies
- General rule from cases won by the states is:
 - “Economic nexus” fulfills a substantial nexus requirement

Key Cases – Economic Nexus Intangibles

- Geoffrey, Inc. v. South Carolina Tax Commission, 437 S.E.2d 13 (S.C. 1993), *cert. den.*, 510 U.S. 992 (1993).
 - Toys ‘R’ Us, a South Carolina retailer, incorporated Geoffrey, Inc. (“Geoffrey”) in Delaware and transferred its trademarks and trade names to Geoffrey
 - Geoffrey licensed these intangibles back to Toys ‘R’ Us in exchange for royalty payments
 - The South Carolina Tax Commission imposed an income tax on Geoffrey, despite the fact that Geoffrey had no physical presence in the state
 - The South Carolina Supreme Court affirmed the income tax assessment, holding that the Toys ‘R’ Us retailers’ use of Geoffrey’s intangible property in the state rendered Geoffrey physically present in South Carolina

Key Cases – Economic Nexus Intangibles (Cont.)

- Geoffrey, Inc. (Cont.)
 - Three-fold reasoning provided by the court:
 - Geoffrey derived income from in-state intangible property
 - Geoffrey exploited South Carolina's market
 - South Carolina provided Geoffrey with certain benefits and protection

Key Cases – Economic Nexus Intangibles (Cont.)

- A&F Trademark v. Tolson, 605 S.E.2d. 187 (N.C. Ct. App. 2004).
 - The Limited, an Ohio corporation engaged in retail clothing sales, incorporated several intangible holding companies in Delaware, and transferred all of its trademarks to these companies
 - The holding companies then licensed the trademarks to the Limited's retail stores throughout the country, including the stores that operated in North Carolina
 - The North Carolina Court of Appeals held that it was appropriate for North Carolina to impose corporate income and franchise taxes on the holding companies

Key Cases – Economic Nexus Intangibles (Cont.)

- Lanco, Inc. v. Director, Division of Taxation, 908 A.2d 176 (N.J. 2006).
 - Lanco was a Delaware corporation that licensed trademarks to retail stores in New Jersey for royalty payments
 - Lanco had no physical presence in New Jersey
 - New Jersey Supreme Court held that New Jersey may impose a corporate income tax on Lanco
 - Court's reasoning:
 - Quill was limited only to sales and use taxes
 - No universal physical presence requirement for all types of taxes

Key Cases – Credit Cards

- J.C. Penney National Bank v. Johnson, 19 S.W.3d 831 (Tenn. Ct. App. 1999).
 - J.C. Penney's only activity in Tennessee was offering credit card lending services to Tennessee residents
 - Tennessee imposed a franchise and excise tax on J.C. Penney
 - The Tennessee Court of Appeals adopted the physical presence test for these business activities taxes
 - J.C. Penney did not have to pay the tax

Key Cases – Credit Cards (Cont.)

- MBNA v. West Virginia, 640 SE2d 226 (2006), cert denied 127 S. Ct. 2997 (2007).
 - MBNA's sole activity in West Virginia was issuing and maintaining its West Virginia customer's credit cards through mail and telephone communication
 - West Virginia imposed a business activity tax on MBNA
 - West Virginia Supreme Court held that MBNA's economic presence in West Virginia satisfied the requirement of a substantial nexus

Key Cases – Credit Cards (Cont.)

■ MBNA (Cont.)

- The court also provided four reasons why states were not bound to the Quill bright-line rule for business activity taxes:
 - Quill was based largely on *stare decisis*
 - Quill's holding was limited only to sales and use taxes
 - The compliance and administration for sales and use tax is more burdensome than for business activities taxes
 - Technological innovations since Quill (decided in 1992) had made the physical presence standard obsolete

Supreme Court Refusal To Review Application Of Economic Nexus To State Income Taxes

- The Supreme Court has not granted *certiorari* to hear any of the preceding cases
- Possible theories:
 - Provide states implicit permission to develop their own nexus standards for the imposition of business activities taxes
 - Telling Congress to enact legislation to address the issue
 - Nothing

Federal Limitation On Imposition Of Net Income Tax

- P.L. 86-272
 - Provides that a foreign state cannot impose a net income tax on an out-of-state company if the activities in the foreign state are limited to the following:
 - (1) The activities are limited to the solicitation for sales of tangible personal property
 - (2) All sales are approved outside the foreign state, and
 - (3) The ordered tangible personal property is shipped from outside the foreign state into the foreign state. Note:
 - P.L. 86-272 only applies to:
 - The imposition of **net income taxes**
 - Sales of **tangible personal property**
 - Does not apply to the sale of **intangible property**, *e.g.*, intellectual property
 - Does not apply to services rendered in a state

States' Efforts To Broaden Economic Nexus

- Michigan Business Tax (“MBT”)
 - The MBT is comprised of four components
 - Business income tax
 - Modified gross receipts tax
 - Gross direct premiums tax
 - Franchise tax
 - A taxpayer has a nexus with Michigan and is subject to the MBT if the taxpayer has:
 - Physical presence in Michigan for more than one day, or
 - Actively solicits sales in Michigan and has Michigan gross receipts of \$350,000 or more

States' Efforts To Broaden Economic Nexus (Cont.)

- MBT (Cont.)
 - P.L. 86-272 provides limited protection from the MBT
 - If a taxpayer's activities satisfies one of the nexus requirements of the MBT, but also satisfies the requirements of P.L. 86-272, then Michigan cannot impose a business income tax on that taxpayer
 - Michigan is still able to impose the modified gross receipts, gross direct premiums, and franchise tax portions of the MBT

States' Efforts To Broaden Economic Nexus (Cont.)

- Ohio Commercial Activity Tax (“CAT”)
 - The CAT is a low rate tax (0.26% when fully phased in) imposed on gross receipts “for the privilege of doing business” in Ohio
 - A taxpayer has substantial nexus with Ohio and is subject to CAT if the person:
 - Owns or uses part or all of its capital in Ohio, or
 - Holds a certificate of authority authorizing it to do business in Ohio, or
 - Has “bright-line” presence in Ohio, or
 - Otherwise has a nexus under the U.S. Constitution

States' Efforts To Broaden Economic Nexus (Cont.)

- CAT (cont.)
 - A person has a “bright-line” presence in Ohio if:
 - 1) It has a property or payroll in Ohio of at least \$50,000, or
 - 2) It has gross receipts of at least \$500,000 from Ohio sources, or
 - 3) At least 25% of its total property, payroll or gross receipts are in Ohio, or
 - 4) It is domiciled in Ohio
 - Note: The second criteria conflicts with the physical presence bright-line test provided in Quill
 - A person could have no physical presence in Ohio and still be subject to the CAT

States' Efforts To Broaden Economic Nexus (Cont.)

- Texas franchise tax
 - 34 Tex. Admin. Code § 3.546
 - Franchise tax - Taxable capital: Nexus
 - (a) A foreign corporation is liable for the franchise tax if it is doing business in this state
 - (b) A corporation is doing business in this state, for the taxable capital component of the franchise tax, when it has sufficient contact with this state to be taxed without violating the United States Constitution. A corporation may be subject to the taxable capital component, but not subject to the earned surplus component because of Public Law 86-272

States' Efforts To Broaden Economic Nexus (Cont.)

- Texas franchise tax (Cont.)

- (c) Some specific activities which constitute doing business in Texas are:

- • •
 - (8) franchisors: entering into one or more contracts with persons, corporations, or other business entities located in Texas, by which:

- (A) the franchisee is granted the right to engage in the business of offering, selling, or distributing goods or services under a marketing plan or system prescribed in substantial part by the franchisor; and

- (B) the operation of a franchisee's business pursuant to such plan is substantially associated with the franchisor's trademark, service mark, trade name, logotype, advertising, or other commercial symbol designating the franchisor or its affiliate;

Federal Government's Action

- H.R. 1083 - Business Activity Tax Simplification Act (“BATSA”) of 2009
 - Sponsored by Rep. Frederick Boucher (D-VA)
 - On March 16, 2009: Referred to the Subcommittee on Commercial and Administrative Law
 - Intent was to “modernize” P.L. 86-272
 - If passed, would expand the federal prohibition against state taxation of interstate commerce to:
 - (1) Include taxation of out-of-state transactions involving all forms of property, including intangible personal property and services; and
 - (2) Prohibit imposition of any business activity taxes on an out-of-state entity unless such entity has a physical presence in the taxing state

Federal Government's Action (Cont.)

- **BATSA (Cont.)**
 - Provides the requirements for “physical presence”
 - Personally present in state, or assigning one or more employees to be in state
 - Using the services of an agent to establish or maintain the market in the state, if such agent does not do the same for any other person
 - The leasing or owning of tangible personal property or of real property in the state
 - Includes a *de minimis* exception
 - No “physical presence” if presence in state is:
 - For less than 15 days in a taxable year, or
 - To conduct limited or transient business activity

Introduction

- **The U.S. Supreme Court’s recent rejections of cert. petitions challenging State Court decisions approving economic nexus places taxpayers at risk for significant taxes**
 - **Traditionally, many taxpayers have assumed they faced little or no risk of meaningful tax exposure in states where they lacked physical presence**
 - **As a consequence, many taxpayers chose not to submit to nexus inquiries or file state income tax returns**
 - **Those taxpayers now may face open statutes of limitations that reach back for many years**
 - **The movement toward single-sales factor or enhanced sales factor apportionment formulas has enhanced the magnitude of the exposure since, by definition, economic nexus is essentially a sales factor issue**

Introduction (Cont.)

- **In the following two segments of the program, we will be discussing the implications of these exposures**
 - **For financial accounting (FIN 48)**
 - **In considering whether to pursue voluntary disclosure agreements (VDAs)**

Introduction (Cont.)

- **In this presentation, we focus upon arguments that remain viable for avoiding or reducing exposure, even if the taxpayer is found to have nexus under the economic nexus standard**
 - **These arguments may limit the amount of exposure under financial accounting standards**
 - **They also have often proven persuasive in obtaining favorable voluntary disclosure agreements**

The Current State Of Affairs

- **There is a split among state courts concerning whether a taxpayer that is not physically present in the state may be subjected to an income, gross receipts or franchise tax on the basis of significant customer relationships in the State that produce significant revenues**
 - **Three states: Tennessee (*J.C. Penny Nat'l Bank*), Michigan (*Guardian Indus. Corp.*) and Texas (*Bandag Licensing Corp.*) have rejected that standard in reliance on *Quill***
 - **The latest of these opinions was issued in 2004**
 - **None involved a state Supreme Court**

The Current State Of Affairs (Cont.)

- **On the other side, at least seven states have endorsed economic nexus and restricted the physical presence standard to sales and use taxes**
 - **North Carolina (*A&F Trademark, Inc.*); South Carolina (*Geoffrey, Inc.*); New Jersey (*Lanco*); New Mexico (*Kmart Props., Inc.*); Massachusetts (*Capital One Bank & Geoffrey, Inc.*); West Virginia (*MBNA*); and Louisiana (*Geoffrey, Inc.*)**
 - **A number of these decisions are state Supreme Court decisions**
 - **The most recent decision was issued in 2009**
- **Numerous trade groups and taxpayer associations have joined in unsuccessful attempts to obtain U.S. Supreme Court review of these decisions**

The Current State Of Affairs (Cont.)

- **Although compelling arguments exist for requiring physical presence in order for a state to assert nexus for all taxes, until the U.S. Supreme Court grants review, other state courts are unlikely to require physical presence as a requirement for nexus for taxes other than sales/use taxes**
 - **Most states are currently desperate for revenue**
 - **It will take a particularly independent judiciary to reject the trend of the cases**
- **The U.S. Supreme Court is not likely to hear this issue until a case arises under facts that demonstrate profound overreaching by the state, producing a patently unfair result for the taxpayer**

How To Approach A Nexus Question

- **Until the U.S. Supreme Court confirms that *Quill* is applicable to all taxes, taxpayers must approach nexus simply as the opening issue**
 - **Where reasonable, taxpayers should always make the nexus argument (even if unfavorable state authority exists) in order to provide context for other arguments that either eliminate or reduce exposure for taxes**
 - **Hereafter are a list of questions to ask, and a sample of the other arguments a taxpayer may be able to make, when facing an assessment based on economic nexus**

Is The Taxpayer “Doing Business” In The State?

- **A taxpayer may be able to argue that it is not “doing business” under state law, even if it has economic nexus with the state**
 - **Although the current trend of state legislatures is to expand what constitutes doing business in the state, state statutes defining activities that lead to the imposition of tax are occasionally drawn more narrowly than a standard based simply upon whether the taxpayer derives revenue from the state**
 - **In an effort to promote local business, some states adopt more restrictive standards for particular industries**
 - **See, e.g., 23 Va. Admin. Code 10-120-20 (indicating that a taxpayer is not doing business in Virginia simply because the taxpayer receives interest from Virginia borrowers)**

Does State Have Nexus Over The Transaction?

- **The taxpayer may be able to argue that the state does not have nexus with the transaction it seeks to tax, even if it has economic nexus over the taxpayer**
 - ***Allied-Signal, Inc. v. Dir., Div. of Taxation*, 504 U.S. 768 (1992), established that the state must not only have nexus with the taxpayer, it must also have a meaningful connection with the transaction giving rise to the income it seeks to tax**
- **As states expand the types of connections considered sufficient to establish nexus with the taxpayer, the *Allied Signal* limitations will increase in importance**
 - **See *Goldberg v. Sweet*, 488 U.S. 252 (1989) (only the states in which a telephone call is initiated or terminated and the call is billed have nexus to tax the transaction)**
 - **Such issues typically will be presented as whether the income is apportionable (e.g. business) income**

Is It Constitutional To Source Income To The State?

- **The taxpayer may be able to argue that sourcing its income to the state under a single-sales factor or enhanced sales factor is unconstitutional, because the single-factor formula produces unreasonable results**
 - **A taxpayer may take this position notwithstanding *Moorman Mfg. Co. v. Bair*, 437 U.S. 267 (1978)**
 - **Particularly where it is clear from legislative history that the state is seeking to export the tax burden to out-of-state companies, good arguments exist that such a formula discriminates against interstate commerce**
 - **The U.S. Supreme Court has also required that income and gross receipts taxes be apportioned based upon the activities producing the income**
 - **In contrast to sales taxes, which may be based entirely on consumption or the location of the sale**
 - ***Oklahoma Tax Comm'n v. Jefferson Lines*, 514 U.S. 175 (1995)**
 - **Permitting a state to rely entirely on a single-sales factor that sources the revenue to the state solely on the basis of the location of the sale would seem to undercut, if not eliminate, this distinction**

Should Income Be Sourced To State Under State Law?

- **The taxpayer may be able to argue that the state lacks a statutory basis for sourcing the sale into the state**
 - **Some states have statutes that require the in-state presence of some activity with which the income is associated in order to tax the income**
 - **Under these statutes, the mere presence of the customer is not sufficient grounds to tax the income**
 - **See, e.g., 48-030-001 Miss. Code R. § 806(III)(B)(9)(c) (gross receipts are attributable to Mississippi to the extent the gross receipt “represent[s] services or activities actually performed within this state”)**
 - **Other states may source the sale based upon the cost of performance which will typically source the income to a state where the taxpayer has employees and property (i.e. physical presence)**
 - **See, e.g., Mo. Rev. Stat. § 32.200, art. IV, § 1(7) and 17 (suggesting that business interest is sourced based upon the cost of performance for sales factor purposes)**

Does Sales Factor Fully Reflect Receipts Of Business?

- The taxpayer may be able to rely on a broad statutory definition of “receipts,” in order to dilute the effect of asserting nexus by increasing the sales factor denominator with out-of-state receipts
 - In *Microsoft Corp. v. Franchise Tax Board*, 39 Cal. 4th 750 (2006), *reh’g denied*, 2006 Cal. LEXIS 14122 (Oct. 25, 2006), the California Supreme Court held that “receipts” means “receipts” and the redemption of marketable securities at maturity generates gross receipts that are includible in the sales factor formula
 - In *General Mills et al. v. Franchise Tax Board*, 172 Cal. App. 4th 1535 (2009), *cert. denied*, 2009 Cal. LEXIS 7862 (July 9, 2009), the California Court of Appeal extended this principle to include receipts from commodity futures sales contracts

Does Economic Nexus Result In Distortion?

- **The taxpayer may be able to argue that the assertion of economic nexus, combined with aggressive reliance on the sales factor, produces a distortive report of the income earned within the state**
 - **Under *Hans Rees' Sons, Inc. v. North Carolina*, 283 U.S. 123 (1931) attribution of income that is out of all proportion to the taxpayer's presence in the state violates the Due Process and Commerce clauses**
 - **Section 18 of UDITPA authorizes the use of an alternative apportionment formula when the standard formula produces unreasonable results**
 - **There is litigation underway in California in which the taxpayer is arguing that the exclusion of intangible values from the standard apportionment formula (e.g., the property factor) creates distortion where the taxpayer's income depends upon such intangible property**
 - **The New Jersey Tax Court has used the standard three-factor apportionment formula as a benchmark against which distortion is to measured**
 - **See *New Jersey Natural Gas Co. v. Dir., Div. of Taxation*, 24 N.J. Tax 59 (2008)**

Closing Observations

- **Currently, a taxpayer must approach the question of nexus on an individual state-by-state basis to determine the state's position on economic nexus in both the courts and the statutes (e.g., whether the taxpayer is doing business in the state)**
- **Even where state law appears to support the assertion of nexus over the taxpayer, a careful analysis of state law, constitutional standards and the state's apportionment mechanisms may reduce significantly the sting of any tax that may be imposed**

Economic Nexus And FIN 48

Contents

- Overview and refresher of FIN 48
- Applying FIN48 to economic nexus matters

Overview Of FIN 48

- FASB Interpretation to FAS 109
- Provides guidance on:
 - Recognizing
 - Derecognizing
 - Measuring, and
 - Classifying
- ... tax effects of “uncertain tax positions”
- Prohibits recognizing tax benefits unless the tax position will “**more likely than not**” be sustained

Overview Of FIN 48 (Cont.)

- Why was FIN48 issued?
 - “. . . diverse accounting practices have developed resulting in inconsistency in the criteria used to recognize, derecognize, and measure benefits related to income taxes. This diversity in practice has resulted in noncomparability in reporting income tax assets and liabilities.”
 - Basically, GAAP financial statements did not set forth tax positions in a uniform manner.

Overview Of FIN 48 (Cont.)

- Goal of FIN48 is to:
 - Increase the relevance and comparability of income taxes in financial statement reporting.
 - Financial statement preparers must use consistent criteria in:
 - Recognizing
 - Derecognizing
 - Measuring, and
 - Classifying

Overview Of FIN 48 (Cont.)

- What is a tax position?
 - “. . . a position in a previously filed tax return or a position expected to be taken in a future tax return that is reflected in measuring” tax assets and liabilities.
 - Includes a position to not file a return.
- When is a tax position “uncertain”?

Overview Of FIN 48 (Cont.)

- A company can recognize a tax benefit of an “uncertain tax position”:
 - Only if it is MLTN that the tax position will be sustained
 - In making this determination, company must:
 - Assume that the matter will be challenged
 - Assume that the taxing authorities have full knowledge of all relevant information
 - Consider all relevant legal authority (including appeals processes)
 - Consider all facts, circumstances and information available at the reporting date

Overview Of FIN 48 (Cont.)

- Once an “uncertain tax position” has been “recognized”, we must consider:
 - Measurement
 - Derecognition
 - Classification

Applying FIN48 To Economic Nexus

- So, what does all this mean in an “economic nexus” situation?
 - Recognizing
 - Derecognizing
 - Measuring, and
 - Classifying

Applying FIN48 To Economic Nexus (Cont.)

- State income tax considerations relating to economic nexus
 - What are the facts?
 - Is the transaction with a related party?
 - Is the transaction with a third party?
 - Do we comprise a unitary business with the related party?
 - What is our “tax benefit”?
 - Deduction?
 - Decision to not file a return?
 - Combined return filing position?

Applying FIN48 To Economic Nexus (Cont.)

- Typical “uncertain tax positions”
 - Decision to not file
 - Decision to not “addback” an inter-company expense
- Do we even know if we’ve taken a “position”?

Applying FIN48 To Economic Nexus (Cont.)

- Economic nexus and doing business . . .
 - Praxair Technology, Inc. v. Director, Div. of Tax., (NJSC, Dec., 15, 2009)
 - Facts: Taxpayer's activities were limited to licensing technology (to an affiliate).
 - Issue: Was taxpayer doing business in NJ during 1996 and earlier years?
 - Holding: Yes

Applying FIN48 To Economic Nexus (Cont.)

- Praxair (Cont.)
 - NJ's "doing business statute"
 - "Every ... foreign corporation ... for the privilege of having or exercising its corporate franchise in this State, or for the privilege of doing business ... in this State" is subject to NJ's corporation tax.
 - Regulation added in 1996
 - NJAC 18:7-1.9: Added an example that applied to taxpayer facts.
 - Department's position
 - No "economic nexus" pre-1996

Applying FIN48 To Economic Nexus (Cont.)

- Court's holding
 - We reject the notion that the scope of a taxing statute somehow can be expanded by the adoption of or amendment to a regulation
...

Applying FIN48 To Economic Nexus (Cont.)

- FIN 48 considerations:
 - How do we account for states that have similar “doing business” provisions but have not indicated they adopt “economic nexus” provisions - yet?
 - Have we taken a “tax position” to not file a return?
 - How can one determine whether a taxpayer is MLTN to prevail on the matter?

Applying FIN48 To Economic Nexus (Cont.)

- Other considerations
 - String of cases saying that economic nexus is sufficient nexus
 - Will Congress (BAT legislation) or USSC weigh in?
 - If a return is not filed, the statute will not run.
 - If a return is filed, is the tax “substantially understated”?
 - What is the statute of limitations?
 - Textron (104 AFTR 2nd 2009-5719 (8/13/09)) and the IRS’ new “disclosure” requirements

Possible Responses By Corporate Tax Departments

Value Of A Nexus Review

- Companies without experienced tax personnel are less likely to understand where they may have nexus.
- States share information, surf Web sites, hang out in the strangest places, and diligently search for out-of-state companies doing business in the state.

Methods States Use To Locate Potential Non-Filers

- States and localities have become increasingly aggressive in recent years in discovering non-filers. Among the discovery techniques used are:
 - Cross-checking with filings of other taxes
 - Information exchanges with other states
 - Reviewing licensing lists of state agencies
 - Identifying non-filers through telephone listings (White Pages, Yellow Pages or advertising)
 - Checking trade journals
 - Following up on complaints from other taxpayers' auditor contacts and observations

Methods States Use To Locate Potential Non-Filers (Cont.)

Example

New York lists the following enforcement strategies:

- Cross-checking police traffic violation records with taxpayer registrations (commercial vehicles in the state could mean nexus)
- Monitoring trade shows
- Matching federal returns
- Reviewing the Yellow Pages
- Reading ads in the back of *New York Magazine*
- Sending questionnaires to *Inc.* magazine's annual list of fastest-growing companies

State Voluntary Procedures

- Most states provide some “come-forward” mechanism for taxpayers.

Informal Programs

Most states informally allow non-filers to come forward voluntarily and clean up past liabilities. Usually they offer some kind of discount from the actual amount owed.

Generally these informal agreements permit taxpayers to:

- Limiting the number of years for which tax may be assessed, and
- Providing for partial or complete abatement of penalties, in return for filing returns and paying tax and interest for some specified period.

Voluntary agreements are important, considering that unless a return is filed, the statute of limitations does not begin to run for that tax year.

State Voluntary Procedures (Cont.)

Formal programs

Such informal programs should not be confused with formal amnesty programs.

- States occasionally enact formal amnesty programs covering specific taxes for specific periods of time.
- These programs have strict eligibility requirements and are frequently less advantageous to our clients than negotiating an informal agreement.

Voluntary Disclosure Compliance Agreements

1. Resolution
2. Qualify
3. Approach
4. Facts and assumptions
5. Benefits to compliance

Qualifying For Voluntary Disclosure

- For most states, voluntary disclosure can cover all types of taxes for which the taxpayer may be liable (sales, income, franchise, etc.) in the same negotiation. Some states will require that a company cover all tax reporting (generally corporate level and sales/use) for which it is liable in the voluntary disclosure process.
- Voluntary disclosure is typically available only if the taxpayer contacts the state prior to the state having made any contact with the taxpayer (in rare instances, a state may disregard a nexus questionnaire as initial contact).

What Is Voluntary Disclosure?

- Voluntary disclosure is a process that enables the taxpayer to obtain positive resolution of historical tax compliance issues by taking advantage of limited lookback, penalty abatement, and possible reduction of interest.
- Voluntary disclosure is typically a negotiation process and is anonymous in most states. Therefore, taxpayer confidentiality is maintained until a resolution that is acceptable to both parties (the taxpayer and the taxing jurisdiction) is achieved.

Statute Of Limitations Vs. Limited Lookback

- Voluntary disclosure is an important process in states with high outstanding historical tax liability. To the extent returns have not been filed, there is no statute of limitations running.
- Without a statute of limitations running, most states can go back to the initial year nexus was created to assess back tax, interest and penalties. However, for practical purposes, most states go back eight to 10 years.

Why Come Forward Voluntarily?

- Favorable terms typically include the following:
 - The taxpayer pays back taxes for the previous zero to four years rather than eight to 10 years. Three to four years is typical, depending on the situation.
 - All penalties are waived.
 - Some states will offer reduced interest
 - The statute of limitations is closed.
 - Registration going forward is obtained.

Results Of The Process

- The process involves multiple levels of communication, with both the taxpayer and each state involved. The result of the process is typically a written agreement prepared by the state and signed by the taxpayer. At the time the taxpayer signs the agreement, the taxpayer must disclose who they are.
- After disclosure, the state will verify whether or not first contact was made by the taxpayer. If not, the taxpayer could be disqualified.
- The taxpayer will be required to comply with the terms of the agreement within a specified period of time.

Benefits To Compliance

- The longer the taxpayer has been out of compliance, the greater the exposure and the greater the likelihood the taxpayer could be double-taxed (lose the ability to amend to claim a home state refund).
- Taxpayers that are planning to sell the company are likely to be motivated to clear up outstanding exposures.
- If look-back period is less than four years, eliminating penalties and the possibility of reducing interest on a significant tax exposure may be a motivator for voluntary disclosure.

Settlement Format

- There is no set format for informal agreements; however, the following terms are covered:

Prior contact

A taxpayer can have no prior contact with the state. The incentive for the state to enter the agreement is that the state did not expend the time and resources to discover the taxpayer. Obviously, once a state makes contact, it becomes increasingly difficult to negotiate a favorable settlement.

Disclosure of all pertinent facts

Most agreements specify that misrepresentations of material facts will render the agreement null and void. The following information will usually be requested:

- Description of company business and number of years in business
- Description of the nature and extent of the company's operations in the state.

Settlement Format (Cont.)

Action is key

Once a taxpayer decides to pursue a voluntary compliance agreement, it must determine to:

- Reveal all pertinent information
- Complete compliance quickly
- Abide by all terms of the agreement

Failure will nullify the agreement. The taxpayer will be known to the state and could be subject to unlimited liability.

Initiating Contact

Clients could be best served if they use a third-party service provider to make contact and negotiate with the state.

MTC National Nexus Program

The Multistate Tax Commission is also trying to promote use of its negotiation service.

- Touted as a “one-stop shopping” experience, companies can negotiate with several states at once.
- MTC representatives work with the taxpayer to achieve settlements acceptable under their member states’ guidelines.

Initiating Contact - MTC National Nexus Program (Cont.)

- In actuality, the taxpayer is negotiating directly with each state but through the MTC. No two states will be alike.
- The MTC then forwards the settlements to the states for their approval.
- Once notified of which states have approved the settlements, the company has 10 days in which to identify itself and complete the settlement.

Initiating Contact - MTC National Nexus Program (Cont.)

- Although the MTC says it will not reveal the identity of the taxpayer to any state that does not accept the settlement offer, the MTC will still share information in reports that do not identify the taxpayer, and will share information if the state identifies the taxpayer on its own.
- Because of the boomerang potential with non-agreeing states, we do not recommend the program with most clients. However if voluntary disclosure involves a large number of states, the taxpayer might want to use the MTC program for cost considerations.

Voluntary Compliance

Voluntary agreements can be very useful for taxpayers that want to establish the right to apportion. Refunds from the domiciliary state can dwarf taxes due under the agreement.

Agreements as planning tools

Finally, voluntary compliance agreements can offer a way to eliminate material financial statement disclosures for companies dealing with FIN 48 or FAS 5 issues.

Amnesty Programs

1. Different from voluntary disclosure
2. Inclusion
3. Expiration and penalty
4. Voluntary compliance vs. amnesty
5. Different from VCAs

What Is An Amnesty Program?

- Another method of inducing taxpayers to come forward and pay any outstanding tax liabilities is an amnesty program. The vast majority of states have offered such programs, usually in an attempt to obtain a short-term boost in state tax revenues. The Federation of Tax Administrators provides a listing of state tax amnesty programs offered since 1982 at its Web site [www.taxadmin.org]. The list is current as of January 2010.
- Amnesty programs come about through specific legislative action and are short in duration. E.g., Calif. had amnesty legislation enacted in 2004 that ran from 2/1/05 – 3/31/05. Blink and you missed it!

Terms Of Amnesty Programs Widely Vary

- To encourage taxpayers to come forward, amnesty programs typically waive part or all of the interest and/or penalties that would otherwise be due on the unpaid taxes if those taxes are paid during the amnesty period (or a short period after the close of amnesty).
- For example, in 2007, Texas offered an amnesty program called Project Fresh Start (Texas Comptroller of Public Accounts, Apr. 23, 2007), which ran from June 15 to Aug. 15, 2007 and covered most state taxes administered by the comptroller.

Project Fresh Start (Cont.)

- The program offered a waiver of penalties and interest for taxpayers that underreported or did not file returns with respect to reports originally due before April 1, 2007.
- The program did not apply to assessments already identified by the comptroller, taxpayers currently under audit or review, or taxpayers the comptroller had already contacted about an audit or possible deficiency.
- Taxpayers that had signed a settlement agreement or voluntary disclosure agreement before the beginning of the amnesty were not eligible.

Examples Of Amnesty Programs

- In response to shortfalls in tax revenues caused by an economic recession during 2008 and 2009, numerous states enacted amnesty programs. Examples include Connecticut [H.B. 7601 and S.B. 1200, Nov. 24, 2008], Maryland [S.B. 552, May 7, 2009], Massachusetts [H.B. 5143, Jan. 7, 2009], and New Jersey [A.B. 3819, March 17, 2009].
- Illinois amnesty just ended Feb. 15, 2010.
- New York amnesty ends March 15, 2010.

Wisconsin Amnesty Program

- Wisconsin is offering a sales tax amnesty program to all businesses that are not currently registered to collect Wisconsin sales tax, if certain eligibility requirements are met.
- A business interested in participating in this amnesty program must voluntarily register to collect and remit not only Wisconsin sales taxes, but also any sales taxes due on the sales it makes in any of the states whose laws have been found to be in compliance with the requirements of the Streamlined Sales and Use Tax Agreement (SSUTA).
- The Wisconsin amnesty period will begin July 1, 2009, the date Wisconsin becomes an associate member of the Streamlined Sales Tax Governing Board (SSTGB), and will end Sept. 30, 2010.

Pennsylvania Tax Amnesty Program

- A tax amnesty program will occur from April 26 through June 18, 2010. Taxpayers that are delinquent for eligible taxes as of June 30, 2009, may apply to the department to participate in the program.
- Qualifying taxpayers will be required to file an amnesty return with the department and pay all delinquent taxes, along with 50% of the interest. All penalties for qualifying participants will be abated.
- Taxpayers will also be required to submit all unfiled tax returns and reports. Taxpayers reporting taxes due that are unknown to the department will be required to pay up to five years of taxes due in order to qualify for amnesty. Anyone interested in more information on the tax amnesty program should periodically check the Department of Revenue's Web site at www.revenue.state.pa.us for information as the amnesty period approaches.

Massachusetts Amnesty Program

- The commissioner of revenue shall establish a tax amnesty program, during which all penalties that could be assessed by the commissioner for the failure of the taxpayer to:
 1. Timely file any proper return for any tax type and for any tax period,
 2. File proper returns which report the full amount of the taxpayer's liability for any tax type and for any tax period,
 3. Timely pay any tax liability, or
 4. Pay the proper amount of any required estimated payment toward a tax liability

Penalties will be waived without the need for any showing by the taxpayer of reasonable cause or the absence of willful neglect.

Massachusetts Amnesty Program (Cont.)

- The waiver of a taxpayer's liability under this section shall apply if the taxpayer files returns, makes payments as required by the commissioner or otherwise comes into compliance with the tax laws of the commonwealth as required by the commissioner pursuant to the tax amnesty.
- The scope of the amnesty program in terms of the particular tax types and periods covered, including any limited look-back period for unfiled returns, shall be determined by the commissioner.

Massachusetts Amnesty Program (Cont.)

- The amnesty program shall be established for a period of two consecutive months within fiscal year 2010 to be determined by the commissioner, such period to expire not later than June 30, 2010. All required payments shall be made on or before June 30, 2010, in order for the amnesty to apply.
- If a taxpayer fails to pay the full liability before June 30, 2010, the commissioner shall retain any payments made and shall apply said payments against the outstanding liability, and the provisions of the tax amnesty program other than the additional penalty authorized by Sect. 2 shall not apply.

Amnesty And Voluntary Disclosure Are Not The Same

- VD programs tend to be fairly standard, and most states have them available year-round.
- Amnesty programs are generally enacted in response to economic crises.
- Amnesty programs are generally followed by increased audit activity and harsher penalties for failure to take advantage of the amnesty program. E.g., 150% of statutory interest was tacked on to the tax (plus regular interest) after Calif.'s amnesty period ended in 2005.

Developments On The Horizon

National Legislative Developments

- **Business Activity Tax Simplification Act, H.R. 1083, 111th Cong. (2009)**
 - Expand P.L. 86-272 to impose a physical presence nexus standard for more business activity taxes
 - Identical to a bill introduced in the prior Congress, which failed to obtain passage
- **Mobile Workforce State Income Tax Fairness and Simplification Act, H.R. 2110, 111th Cong. (2009)**
 - Provides a grace period whereby employees would not be subject to state income tax, and employers would not be obligated to withhold for employees traveling and working in states other than those of their residence ,if they remain within the state for 30 days or less

State Legislative Developments

- **States are on the move legislatively**
 - **For example, in 2009, California adopted an economic nexus standard which asserts that a taxpayer is “doing business” and subject to tax in the state if sales in the state exceed the lesser of \$500,000 or 25% of the taxpayer’s total sales**
 - **Revised Rev. & Tax. Code Sect. 23101, effective Feb. 20, 2009**

Other Cases In The Courts

- Numerous other cases challenging economic nexus are working through the administrative process
- In addition to litigation challenging economic nexus, the issue of whether a state can tax remote owners of a pass-through entity has generated controversy
 - See, e.g., *Revenue Cabinet v. Asworth Corp.*, Nos. 2007-CA-002549-MR, 2008-CA-000023-MR, 2009 Ky. App. LEXIS 229 (Nov. 20, 2009), holding that a corporation and its affiliates with no physical presence in Kentucky, but with a 99% ownership interest in a Delaware limited partnership doing business in Kentucky, had taxable nexus with Kentucky, and therefore was required to pay corporation income tax on its distributive share of partnership income.

Expanding What Constitutes “Physical Presence”

- Even if the U.S. Supreme Court confirms that *Quill*’s physical presence standard is required for all taxes, controversies will continue
- Consider, e.g., sales tax controversies where states have developed new theories for finding “physical presence”
 - New York’s so-called Amazon law (Tax Law Section 1101(b)(8)) creates an evidentiary presumption that certain sellers who contract with New York residents to refer potential customers are essentially treated as physically present in the state. for sales and use tax purposes
 - Amazon.com and Overstock.com both challenged the law as violating *Quill*
 - In *Amazon.com LLC v. New York State Department of Taxation & Finance*, No. 601247/08, 2009 NY Slip. Op. 29007 (N.Y. App. Div. 2009), a New York trial court rejected those arguments
 - A five-judge panel of the New York Supreme Court, Appellate Division, First Department, heard oral argument on October 29 in the Amazon.com LLC and Overstock.com Inc. cases
 - These theories are sometimes exported to the income tax arena

Other Theories

- **States may be expected to continue to press other theories for reaching out-of-state taxpayers**
 - **Addback statutes**
 - **Combined reporting statutes with *Finnigan***