

Hidden and Possible Future State Tax Liabilities

2008 SJSU-TEI High Tech Tax Institute

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- State Tax Trends
- Economic Nexus and Related Developments
- UDITPA Revision Effort
- The Sales Factor
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State Tax Trends

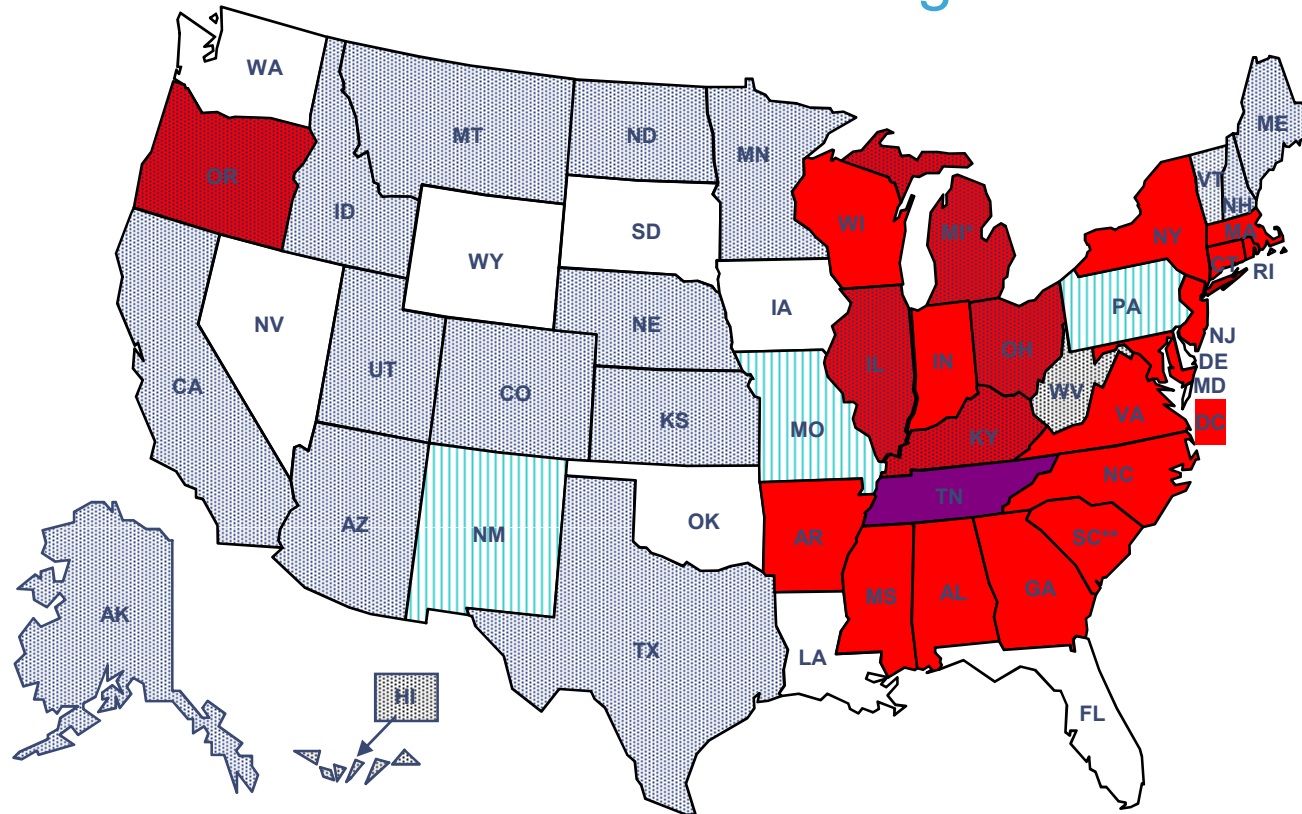
Trends in State Related Member Expense Addback

- Inclusion of related member interest payments as well as royalties.
- Broader provisions which require addback of intangible expenses along with expansive definitions of “intangibles.”
- Distinctions between trademark/trade name and patent royalties.
- Management fees included in Kentucky enacted legislation, as well Montana proposal (L.C. 626) that did not pass
- Typical “safe harbors”
 - Economic substance/arm’s length rates & terms for transactions
 - Purpose other than state income tax avoidance
 - Payment of income tax by royalty recipient
 - Royalty recipient not “primarily engaged” in maintenance and management of intangibles (i.e., not an IHC)

Trends in State Related Member Expense Addback

- Ultimate pass through of expense to unrelated party
- Requirement to “make a disclosure” to become eligible for a safe harbor
- “Unreasonableness” exceptions
- Expansion of tax authorities’ 482-type powers and authority under “sham transaction” doctrine.
 - Alabama DOR conducting 482 initiative, assessments issued

Overview of Related Member Addback Legislation



- Related member expense addback legislation adopted (including DC, NYC)
- Addback and unitary elements
- Related Party expenses must be disclosed or addback is required (TN only)
- Related member expense addback legislative proposals considered in recent years
- Unitary / Combined states (now including the Ohio CAT, Texas Margin Tax, and Michigan Business Tax)
- Remaining Separate Entity or elective consolidated reporting / other

**South Carolina disallows deductions for an expense between related parties where a payment is accrued, but not actually paid and on interest deductions on obligations issued as a dividend or paid instead of a dividend

Trends in Combined Reporting

As the amount of related party addback legislation has lessened, the number of combined reporting proposals has dramatically increased.

In addition, certain states have aggressively asserted forced combination with selected out-of-state entities. Typically, these entities have been IHCs which engage in substantial intercompany transactions with in-state affiliates.

Combined Reporting Legislation – Enactments

Pre-2007

- Vermont
- Kentucky – Nexus consolidation
- Ohio “CAT” – Consolidated or combined reporting required
- Texas Margin Tax

2007

- Michigan (effective January 1, 2008)
- New York (effective January 1, 2007)
- West Virginia (effective January 1, 2009)

2008

- Massachusetts (effective January 1, 2009)

Combined Reporting Legislation – 2008 Failed Proposals

- Alabama (H.B. 768)
- Connecticut (H.B. 4307; S.B. 39)
- Florida (S.B. 1237, S.B. 2766)
- Indiana (H.B. 1242)
- Iowa (S.S.B. 3236; H.S.B. 715)
- Kentucky (H.B. 302)
- Missouri (S.B. 743)
- New Mexico (H.B. 51)
- Tennessee (S.B. 3158)
- Wisconsin (S.B. 510)

Trends in Gross Receipts Taxes

States seeking a steadier source of revenue in order to fund education or pay for health coverage are beginning to turn to gross receipts based taxes in lieu of corporate income taxes.

These taxes are often imposed in conjunction with some other sort of tax relief (e.g., property taxes).

This trend has affected states in different regions of the country and, importantly, in major industrial and highly populated states.

Gross Receipts Tax Legislative Activity

Enacted

New Jersey AMA (generally expired, but retained for corporations claiming P.L. 86-272 immunity)

Kentucky AMC (repealed, but replaced with “LLE” tax)

Ohio CAT

Michigan Business Tax

Texas “Margin” Tax

Economic Nexus and Related Developments

Economic Nexus and Related Developments

- Trends in Nexus
- Economic Nexus
- Broader “Doing Business” Definitions
- “Factor Presence” Nexus

Trends in Nexus

Much of the recent activity concerning nexus deals with economic nexus—states trying to assert jurisdiction over the income of businesses that do not have a tangible physical presence in the state.

States are taxing the income of out-of-state intangible holding companies that license intangibles to in-state affiliates and taxing out-of-state companies whose contact with the state is limited to holding an interest in an in-state entity.

Courts have not always found nexus in all these situations, but the trend is apparent.

In addition, states are legislatively expanding or seeking to expand nexus standards based on an affiliate relationship or economic activity in the state.

Economic Nexus

A&F Trademark, Inc. v. Tolson, 605 S.E.2d 187 (N.C. Ct. App. 12/7/04)

- Out-of-state companies licensed trademarks to in-state retail affiliates, subject to North Carolina income and franchise taxes because they were doing business in the state, had Commerce Clause substantial nexus.
- Bright-line physical presence test does not apply to state income taxes.
- Finally, application of a special apportionment formula relating to intangible holding companies was also upheld.
- N.C. (3/3/05), U.S. (10/3/05) Supreme Courts deny review.

Economic Nexus

J.C. Penney National Bank v. Johnson, 19 S.W.3rd 831 (Tenn. Ct. App. Dec. 1999)

- The Tennessee Court of Appeals held that the imposition of the Tennessee franchise and excise tax on the bank violated the Commerce Clause because the bank's limited activities in Tennessee did not provide substantial nexus with the state.

Dillard National Bank, N.A., No. 96-545-III (Tenn. Chancery Ct., June 22, 2004)

- The Tennessee Chancery Court held that DNB was subject to Tennessee franchise and corporate excise (income) tax because of activities conducted within Tennessee on behalf of DNB by Dillard.

Economic Nexus

In the Matter of KFC Corporation, v. Department of Revenue, Department of Inspections and Appeals, Administrative Hearings Division, Dkt. No. 07DORFC016, 8/11/08

- An out-of-state franchisor with no in-state property or payroll is subject to Iowa income tax because physical presence is not required to establish income tax nexus, the income at issue is directly connected to the state, and the income is taxable under state law.

Economic Nexus

Kmart Corp. v. New Mexico Taxn. & Rev. Dept., No. 27,269
(N.M. Supreme Court 12/29/05)

- DOR asserts that out-of-state intangible holding company subject to New Mexico income and gross receipts tax due to trademark license to in-state affiliate.
- New Mexico Court of Appeals upholds assessment, finds that physical presence standard does not apply (2002).
- New Mexico Supreme Court reverses gross receipts tax holding based upon statutory language, but quashes certiorari on income tax issue (2005).
 - New Mexico statutes, as amended in 1991, treated licensing as a sale of intangibles sourced based upon where the sale activity occurred (in Michigan) as opposed to where the intangible was used (in New Mexico).

Economic Nexus

- Subsequent legislation has altered the impact of *Kmart* for gross receipts tax purposes:
 - 2006 legislation expanded the taxable receipts definition to include licensing of intangible property employed in the state effective July 2006.
 - 2007 legislation excludes licenses, copyrights, trademarks and patents from the definition of “property” effective June 2007. Royalties from the in-state use of franchises remain subject to tax.

Economic Nexus

Geoffrey, Inc. v. Oklahoma Tax Comn., No. 99,938 (Okla. Civ. App. 12/23/05)

- Oklahoma Court of Civil Appeals upholds economic nexus theory, dismisses *Quill* physical presence standard.
- Out-of-state subsidiary had Oklahoma nexus due to license of trademarks to parent for use in parent's Oklahoma retail stores.
- Court rejected Geoffrey's contention that the royalty should be allocated, not apportioned.
- Apportionment based upon a modified single sales factor formula with market-sourcing was upheld.
- Oklahoma Supreme Court declines to review decision (3/20/06).

Economic Nexus

Lanco, Inc. v. Director, Division of Taxation, No. A-89-05 (N.J. Supreme Court 10/12/06)

- Physical presence not required for income tax nexus.
- Delaware IHC had substantial nexus for corporate tax purposes because licensed trademarks to in-state retail affiliate.
- *Quill* physical presence requirement limited to sales and use taxes; “. . . we do not believe that the Supreme Court intended to create a universal physical-presence requirement for state taxation under the Commerce Clause.”
- U.S. Supreme Court cert. denied: June 2007

Economic Nexus

West Virginia Tax Commissioner v. MBNA America Bank, N.A., No. 33049
(W.Va. Supreme Court 11/21/06)

- West Virginia Supreme Court upheld income/franchise tax nexus holding with respect to an out-of-state credit card issuer based upon the presence of in-state customers.
- The “physical presence” test for substantial nexus under the Commerce Clause applies only to state sales and use taxes and not to state business franchise and corporation net income taxes.
- The court quoted a law review article in adopting a “significant economic presence” test that incorporates a “purposeful direction” inquiry similar to a Due Process Clause analysis, coupled with an examination of “the frequency, quantity, and systematic nature of a taxpayer’s economic contacts with a state.”
- Unlike other economic nexus cases, MBNA deals with third-party activity and does not involve trademark licensing.
- U.S. Supreme Court cert. denied: June 2007

Economic Nexus

St. Tammany Parish Tax Collector v. Barnesandnoble.com, U.S. Dist. Ct., E.D.La., No. 05-5695, order issued, 3/22/07

- barnesandnoble.com did not have substantial nexus for Commerce Clause purposes with St. Tammany Parish, Louisiana for use tax collection purposes.
- Neither the "close corporate relationship" between barnesandnoble.com and its in-state retail affiliates nor various business relationships between the parties were "of the order of magnitude" necessary to establish that products were being marketed in the Parish on barnesandnoble.com's behalf.
 - Such relationship included the preferential treatment of returns of merchandise purchased from barnesandnoble.com and cross promotion activity.

Economic Nexus

barnesandnoble.com, LLC v. State Board of Equalization, Cal. Super. Ct., No. CGC-06-456465, 10/11/2007

- barnesandnoble.com was not subject to state use tax although an affiliated company, Barnes & Noble, Inc., distributed coupons on its behalf to customers in California stores
- The actions of Barnes & Noble, Inc. did not rise to the level of agency required to find “substantial nexus” under the Commerce Clause
- The two were separate legal entities with no ownership or operational role in the other. Also, the management of the two entities were separate and each maintained its own employees, warehouses, and inventory.
- In 2005, the California Court of Appeal reached the opposite conclusion in *Borders Online*. However, the California Superior Court distinguished *barnesandnoble.com* based on:
 - The entities at issue in *Borders Online* were both wholly-owned subsidiaries of the same parent, whereas the parent of Barnes & Noble, Inc. only owned a 40% minority interest in barnesandnoble.com.
 - The entity physically located in California in *Borders Online* provided preferential services to online customers, including accepting returns of merchandise bought online. In *barnesandnoble.com*, Barnes & Noble, Inc. did not give preferential services to online customers.



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Economic Nexus

Arizona Department of Revenue, Appeals Section, No. 200700083-C, 03/27/08

- A taxpayer that licensed intellectual property to Arizona franchisees was subject to income tax despite having only a limited physical presence within the state.
- The taxpayer owns service marks, and entered into franchising agreements with four franchisees in Arizona during the audit period.
- The taxpayer also licensed computer software and loaned training and promotional aids to franchisees, and assigned employees to assist the franchisees and inspect franchisee locations
- Department found *Geoffrey* persuasive.

Economic Nexus

Or. Admin. R. 150-317.010, adopted 5/1/08.

Substantial nexus exists where a taxpayer regularly takes advantage of Oregon's economy to produce income, and may be established through a significant in-state economic presence. The department may consider whether a taxpayer:

- Maintains continuous and systematic contacts with Oregon's economy or market;
- Conducts deliberate marketing to or solicitation of Oregon customers;
- Files or is required to file reports or returns with Oregon regulatory bodies;
- Receives significant gross receipts attributable to customers in Oregon;
- Receives significant gross receipts attributable to the use of the taxpayer's intangible property in Oregon; or
- Receives certain benefits provided by the state (e.g., law and police protection, use of highways, access to courts)

Economic Nexus

Colorado Regulation (39-) 22-301.1, proposed 8/14/08

Substantial nexus exists if any of the following thresholds is exceeded during the tax period:

- \$50,000 of property in Colorado;
- \$50,000 of payroll in Colorado;
- \$500,000 of sales in Colorado;
- 25% of its total property, payroll, or total sales in Colorado

Broader “Doing Business” Definitions

Kentucky

- 2005 legislation (S.B. 272) adopted a doing business standard.
- “Doing business in this state” includes, but is not limited to:
 - Being organized under the laws of this state;
 - Having a commercial domicile in this state;
 - Owning or leasing property in this state;
 - Having one or more individuals performing services in this state;
 - Maintaining an interest in a general partnership doing business in this state;
 - Deriving income from or attributable to sources within this state, including deriving income directly or indirectly from a trust doing business in this state; or
 - ***Directing activities at Kentucky customers for the purpose of selling them goods or services.***

Broader “Doing Business” Definitions

Georgia

- 2005 legislation (H.B. 488) expanded Georgia’s imposition statute to provide that its income tax is imposed on every foreign or domestic corporation owning property within Georgia, doing business within Georgia, or deriving income from sources within Georgia to the extent permitted by the United States Constitution.

New Hampshire

- 2007 budget legislation (H.B. 2, enacted 06/29/07) redefines “business activity” for business profits tax to mean “a substantial economic presence evidenced by a purposeful direction of business toward the state examined in light of the frequency, quantity, and systematic nature of a business organization’s economic contacts with the state.”

Broader “Doing Business” Definitions

Texas

- Regulation 3.586 provides that nexus would be established by entering into one or more contracts with person, corporations, or other business entities located in Texas, by which
 1. 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
 2. 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.

Broader “Doing Business” Definition

New York

- NY Budget enacted 04/23/08
- A banking corporation is doing business if it has:
 - a) issued credit cards to 1,000 or more customers with NYS mailing addresses as of the last day of its taxable year;
 - b) merchant customer contracts that cover 1,000 or more NYS locations to whom the corporation remitted payments for credit card transactions during the taxable year;
 - c) receipts of \$1 million or more during the taxable year from customers who have been issued credit cards by the banking corporation and who have NYS mailing addresses;
 - d) receipts of \$1 million or more from merchant customer contracts relating to NYS locations; or if
 - e) the sum of the number of customers in (a) above plus the number of locations covered by contracts in (b) equals 1,000 or more, or the amount of its receipts described in (c) or (d) equals \$1 million or more.

Broader “Vendor” Definition

New York

- NY Budget enacted 04/23/08
- Presumption that a person making taxable sales of tangible personal property or services is a vendor if the seller enters an agreement with a resident of the state under which the resident, for a commission, refers potential customers by a link on a web site or otherwise to the seller, if the cumulative gross receipts from such sales are more than \$10,000 during the preceding four calendar quarters. T
- Presumption rebuttable by proof that the resident did not engage in, on behalf of the seller, solicitation that would satisfy U.S. constitutional nexus standards.
- Challenged on constitutional grounds by Amazon.com

Ohio CAT -- “Factor Presence” Nexus

Ohio

- The Commercial Activity Tax (“CAT”) is levied on persons with “substantial nexus” in Ohio.
- Substantial Nexus exists if a person:
 - owns or uses part or all of its capital in Ohio;
 - holds a certificate of compliance that authorizes the person to do business in Ohio;
 - ***has a “Bright-Line Presence” in Ohio;***
 - otherwise has nexus in accordance with the U.S. Constitution
- *Note:* Because the CAT is not an income tax, Public Law 86-272 protections do not apply and the nexus threshold will be very low.

Ohio CAT -- “Factor Presence” Nexus

- “Bright-Line Presence” in Ohio is defined as a taxpayer with any of the following:
 - greater than \$50,000 of property in Ohio;
 - greater than \$50,000 of payroll in Ohio;
 - ***greater than \$500,000 of taxable gross receipts in Ohio;***
 - 25% of its total property, payroll, or sales in Ohio; or
 - is domiciled in Ohio for corporate, commercial, or other business purposes.
- The law provides that any Constitutional challenges raised by taxpayers relative to the bright line nexus standard must be appealed directly to the Ohio Supreme Court.

Michigan Business Tax: A Hybrid Tax with a Hybrid Nexus Standard?

- A taxpayer has substantial nexus with Michigan if it is:
 - physically present in the state for more than one day during the tax year or
 - actively solicits sales in the state, and has gross receipts of \$350,000 or more sourced to the state.
- Physical presence is any activity conducted by the taxpayer or on behalf of the taxpayer by the taxpayer's employee, agent, or independent contractor acting in a representative capacity—excluding activities of professionals providing services in a professional capacity or other service providers if the activity is not significantly associated with the taxpayer's ability to establish and maintain a market in the state.

Michigan Business Tax: A Hybrid Tax with a Hybrid Nexus Standard?

Dept, of Treas. Revenue Administrative Bulletin, 2007-6, 12/28/2007

"Actively solicits" means the purposeful solicitation of persons within the state. "Solicitation is purposeful when it is directed at or intended to reach persons within Michigan or the Michigan market." Active solicitation includes, but is not limited to:

- the use of mail, telephone, and e-mail;
- advertising, including print, radio, internet, television, and other media; and
- maintenance of an internet site over or through which sales transactions occur with persons within Michigan

The Department will look to the quality, nature, and magnitude of the activity when evaluating whether acts of solicitation are sufficient to establish active solicitation.

Michigan Business Tax: A Hybrid Tax with a Hybrid Nexus Standard?

Dept, of Treas. Draft, Revenue Administrative Bulletin, 2008-X, 7/08

A taxpayer has physical presence when, for a period of 2 days or more during a tax year, the taxpayer, or an employee, agent or independent contractor acting on taxpayer's behalf:

1. conducts business activity in the state (includes: performing services; selling, renting, or leasing any property; soliciting sales; making repairs, doing warranty work, or providing maintenance or service to property that is sold or that is to be sold; collecting accounts related to sales of tpp; installing or supervising installation; training and seminars; providing customer technical assistance; investigating, handling, or assisting with customer complaints; consulting; soliciting, negotiating, and entering into franchise or license agreements);
2. owns, rents, leases, maintains, or has the right to use and uses, tpp or real property in the state;
3. delivers goods into the state, in vehicles the taxpayer owns, rents, leases, uses or maintains; or
4. conducts the following activities in the state: meeting with in-state suppliers; meeting in-state with government representatives in their official capacity; attending occasional meetings; holding recruiting or hiring events; renting to or from an in-state entity customer list; or attending or participating at a trade show. **NOTE** The activities listed in point 4 are a departure from SBT standards, under which they were presumed **not** to create nexus if not conducted for 10 days or more, and were said to 'not necessarily' create nexus if conducted for more than 10 days. The SBT also contained a trade show safe harbor.

Open Issues

- Is physical presence required for income/franchise tax? If so when might the physical presence of an affiliate be relevant?
- If economic nexus is a valid concept, is there distinction between licensing activities such as trademark licensing and licensing patents? Do all types of licensing raise the same economic nexus concerns?
- *MBNA* involves third party activity, not inter-company activity. Is this an important distinction?
- U.S. Supreme Court passes on review of *Lanco* and *MBNA*. Is this a “green light” for economic nexus standards?

UDITPA Revision

UDITPA Revision Timeline

- 1957- National Conference of Commissioners on Uniform State Laws (NCCUSL) adopted UDITPA
- 1966 – UDITPA last amended
- 2007 – In February, NCCUSL authorized a new committee to study the need to update UDITPA
- 2008 – In February, NCCUSL authorized a drafting committee to revise UDITPA
 - Focus on Section 17, which deals with sales factor sourcing for transactions other than sales of tangible goods.
 - However, the committee issued a section-by-section list of potential amendments to UDITPA, beyond Section 17.
- 2008 – In July, NCCUSL’s Executive Committee voted to convert the drafting committee back to a study committee to revisit the issue of whether UDITPA should be revised

UDITPA Revision – MTC Perspective

- Multistate Tax Commission (MTC) requested the UDITPA review
- MTC urges focus on five specific issues, warns against scope creep
 - *Business income definition* (UDITPA Sec. 1(a)). MTC recommends that the current definition of business income be replaced with "to the extent permitted by the U.S. Constitution." However, if the current framework is maintained, the existence of both a functional and transactional test, as well as the treatment of gain at liquidation, should be clarified.
 - *Gross receipts definition* (UDITPA Sec. 1(g)). MTC recommends that the current definition of "sales" be clarified, by including a definition of "gross receipts."

UDITPA Revision – MTC Perspective

- MTC Top 5 UDITPA Issues (continued)
 - *Factor weighting* (UDITPA Sec. 9). MTC argues that states are moving away from the UDITPA three-factor equal-weighted formula, and therefore NCCUSL should consider alternatives
 - *Sourcing from receipts other than receipts from the sale of personal property* (UDITPA Sec. 17). The MTC's highest priority issue. MTC argues for repeal of COP as outmoded, and recommends that the sourcing rules for services and intangibles be coordinated with the rules for tangible personal property (i.e., market-sourcing).
 - *Distortion relief* (UDITPA Sec. 18). MTC argues for explicit authority to adopt industry-wide or issue-wide apportionment rules.

UDITPA Revision – Practical Perspective

- Question of whether UDITPA revision is “desirable and practicable”
 - Effort may help certain interests while harming others
 - Could result in less rather than more uniformity as states “cherry-pick” the revised provisions for adoption
 - NCCUSL has not clearly stated its goals in the UDITPA revision process, or the standards to be used to evaluate proposals
- Concerns of state legislators and legislative groups has caused NCCUSL to reexamine the UDITPA revision project

The Sales Factor

The Sales Factor

- Single Sales Factor
- Treasury Receipts Inclusion/Exclusion
- Move Toward Market-Based Sourcing
- *Joyce/Finnigan*
- Throwout

The Sales Factor

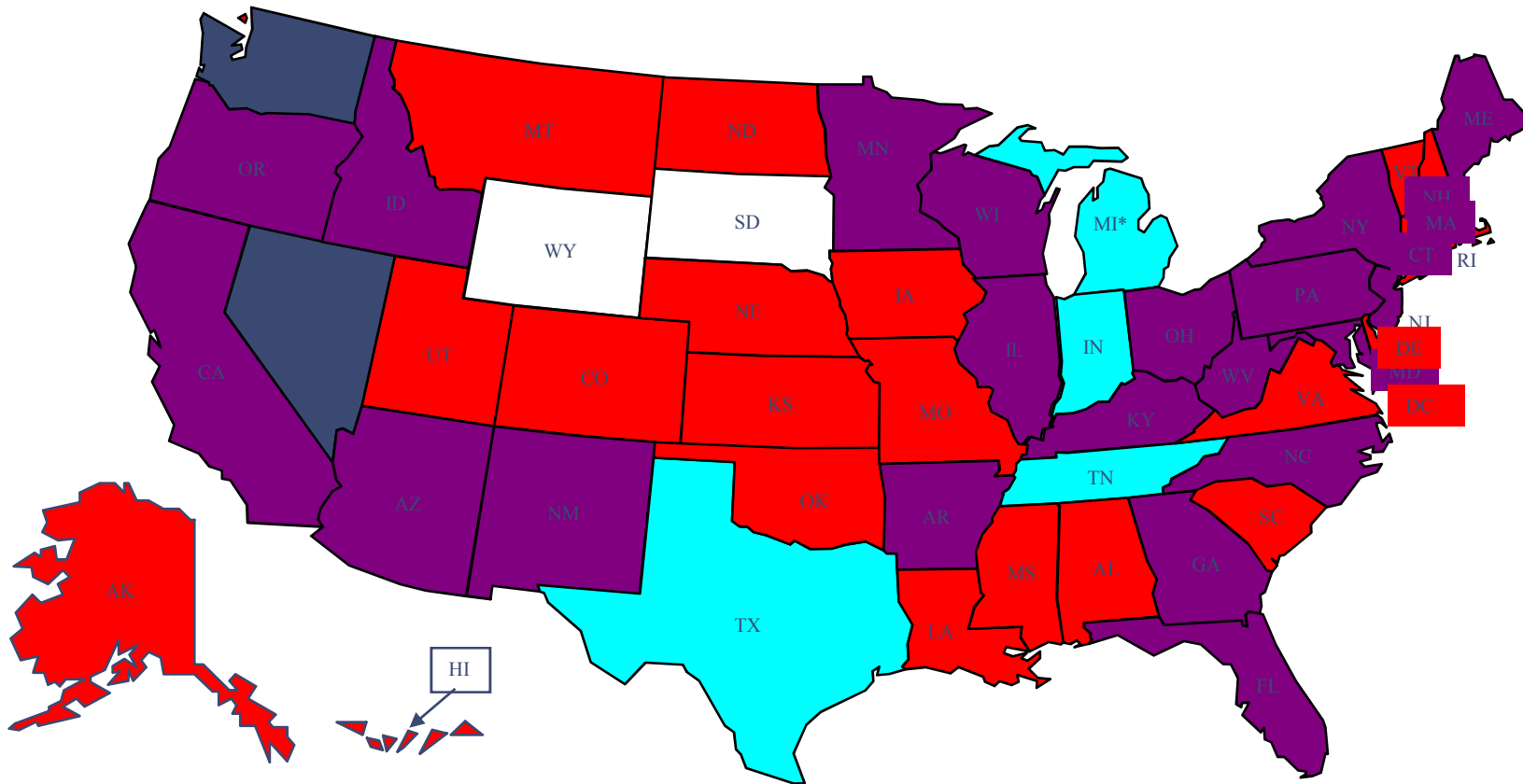
Single Sales Factor

States—in an effort to attract or retain businesses—to increase the weight of the factor or to eliminate the property and payroll factors in favor of a single sales factor.

The move towards single sales factor apportionment is problematic for several reasons, including:

- The apportionment percentage no longer reflects the true extent of a taxpayer's in-state activity ("External Consistency"). Consider where 99% of property and payroll is in State A but all sales are shipped to State B.
- Single sales factor apportionment creates great risk of multiple taxation where sourcing methodologies differ between states as is often the case with service and intangible revenues.
- Single sales factor apportionment heightens tension/pressures around nexus at a time when the "bright line" physical presence standard is being hotly debated.

Apportionment Formulas* – 1998



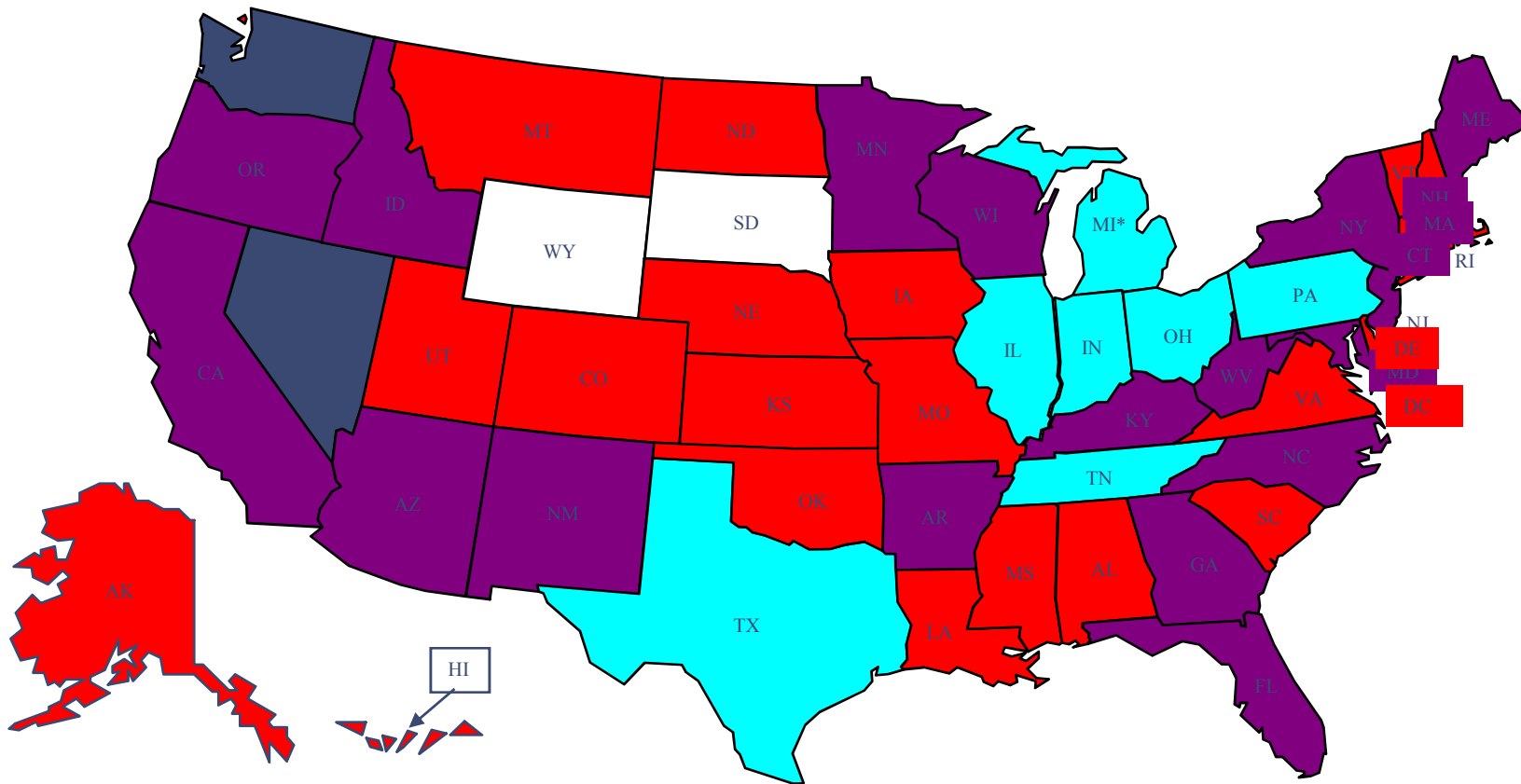
*Does not address industry-specific or optional formulas

- Equally weighted three factor formula
- Double weighted sales factor
- Triple or greater weighted or single sales factor



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Apportionment Formulas* – 2003



*Does not address industry-specific or optional formulas

- Equally weighted three factor formula
- Double weighted sales factor
- Triple or greater weighted or single sales factor



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Treasury Receipts Inclusion/Exclusion

Treasury Receipts Inclusion/Exclusion

California

Microsoft Corp. v. Franchise Tax Bd., 39 Cal. 4th 750 (Cal. 8/17/06)

- Entire redemption price of marketable securities includable as gross receipts in the sales factor.
- However, FTB may use alternative apportionment formula to include net rather than gross, if proves distortion by clear and convincing evidence.

General Motors Corp. v. Franchise Tax Bd., 39 Cal. 4th 773 (Cal. 8/17/06)

- “Repayment of a loan is never considered a receipt.”
- Economic reality of repurchase agreement transactions are akin to secured loans rather than sales of the underlying commodities used to secure the transactions.
- Accordingly, only the net proceeds (i.e., interest) generated from a repurchase transaction qualifies as a “gross receipt.”

Treasury Receipts Inclusion/Exclusion

General Mills, Inc. v. Franchise Tax Board, Cal. Super. Ct., Cty. of San Francisco, No. 439929 (9/26/07)

- Receipts from the buying and selling of commodity futures are not “gross receipts” for tax apportionment purposes and therefore are excluded from the sales factor
- The court distinguished commodity futures from the marketable securities at issue in *Microsoft*.

In response to *Microsoft/GM*, the Calif. FTB proposed regulation Sec. 25137(c)(1)(D) [see following page for proposed language]

Regulation §25137(c)(1)(D)

§ 25137(c)(1)(D). The numerator and denominator of the sales factor shall exclude interest and dividends from intangible assets held in connection with a treasury function of the taxpayer's unitary business as well as the gross receipts and overall net gains from the maturity, redemption, sale, exchange or other disposition of such intangible assets.

1. "Treasury function" is the pooling, management, and investment of intangible assets for the purpose of satisfying the cash flow needs of the trade or business, such as providing liquidity for a taxpayer's business cycle, providing a reserve for business contingencies, business acquisitions, etc. A treasury function includes the use of futures contracts and options contracts to hedge foreign currency fluctuations. A Treasury function does not include a taxpayer's trading function that engages in futures and option transactions for the purpose of hedging price risk of the products or commodities consumed, produced, or sold by the taxpayer. A taxpayer principally engaged in the trade or business of purchasing and selling intangible assets of the type typically held in a taxpayer's treasury function, such as a registered broker-dealer, is not performing a treasury function with respect to income so produced.

2. This subsection shall not apply to entities that apportion their income under the rules of regulation 25137-4.2.

3. This subsection is applicable to taxable years beginning on or after January 1, 2007.

Move Toward Market-Based Sourcing

Cost of Performance to Market Based Sourcing

As a result of the trend towards single and double weighted sales factor, sales factor planning is increasingly important particularly for multistate corporations:

- Sales of tangible personal property
 - Destination Based
- Sales of other than tangible personal property
 - Preponderance of Costs – UDITPA Method
 - Majority of Costs
 - Proportional or Pro Rata

Cost of Performance to Market Based Sourcing

The Multistate Tax Commission Regulations source receipts from sales other than sales of TPP to a state if:

- The ***income producing activity*** which gave rise to the receipts is performed wholly within the state or
- The income producing activity is performed within and without the state but the greater proportion of the income producing activity is performed in this state based on ***costs of performance***.

Cost of Performance to Market Based Sourcing

What does Income Producing Activity mean?

- Applies to each separate item of income? Transaction v. line of business?
- *Boston Professional Hockey Association v. Commissioner of Revenue*, 443 Mass. 276 (Jan 13, 2005). Court ruled that there was one overarching IPA-the operation of a hockey franchise instead of smaller IPAs based on games played. As a result, 100% of the receipts were sourced to MA.

Cost of Performance to Market Based Sourcing

What does Income Producing Activity mean (cont'd)?

- The Massachusetts Court of Appeals vacated and remanded an appellate tax board decision that a Massachusetts-based tour operator's sales of travel packages must be sourced in-state based on the income-producing activity of the overall sale and marketing of the tour packages and not the sale of individual vacations.
- The court said that the board must explain why it rejected the argument advanced by the taxpayer, that income-producing activity be determined on an individual transactional basis.
- See, *The Interface Group, and another vs. Commissioner of Revenue*, Mass Ct. of Appeals, Dkt No, 06-P-1875, 6/13/08.

Cost of Performance to Market Based Sourcing

Includes only transactions and activities directly engaged in by taxpayer?

- CA FTB Ruling No. 2006-02. The California Franchise Tax Board held that costs incurred by a subcontractor who is part of the taxpayer's combined reporting group can be included in the taxpayer's IPA.
- *GM v. Commonwealth of VA*, 268 Va. 289 (9/14/04): Supreme Court of VA ruled that independent contractor costs can be included in direct costs.
- Ruling of Commissioner, P.D. 07-57, Virginia Department of Taxation, May 10, 2007. The VA DOT has indicated that indirect expenses may be included when calculating the COP.
- Michigan Internal Policy Directive 2006-8: Direct costs include independent contractor activities.

Where does the IPA start and end?

- Solicitation, Negotiation, Customer Service?

Cost of Performance to Market Based Sourcing

On August 2, 2007, the MTC approved amendments to its Regulations and have removed language from the IPA definition that required that the transaction or activity be “directly” engaged in by the taxpayer, and to specifically state that such activity includes, rather than excludes, transactions and activities performed “on behalf of” the taxpayer, such as those conducted on its behalf by an independent contractor.

Further, the amendments specifically state that “[i]ncluded in the taxpayer's cost of performance are taxpayer's payments to an agent or independent contractor for the performance of personal services and utilization of tangible and intangible property which give rise to the particular item of income.”

Cost of Performance to Market Based Sourcing

Georgia

- Reg. 560-7-7.03 revised, effective January 1, 2006.
- Clarifies when receipts from services and intangibles are “attributable to the state’s marketplace.”
- Service receipts sourced to state where recipient receives all or part of the benefit.
- Intangible receipts sourced to state where used by purchaser.

Cost of Performance to Market Based Sourcing

Illinois

- On August 16, 2007, having already passed approval in both Houses of the Illinois legislature, the Illinois Governor signed into law a new tax bill, S.B. 1544. The new legislation, applicable to tax years beginning on or after December 31, 2008 and changes the Cost of Performance sales sourcing to Market-Based sourcing.

Michigan

- The new law that imposes the Michigan Business Tax eliminated the prior "cost of performance" based sourcing and adopted "market sourcing" for service receipts. Additionally, specific sourcing methods were adopted for services, transportation, various financial receipts, and telecommunications and utility receipts.

Cost of Performance to Market-Based Sourcing

- The MTC on July 31, 2008, adopted a model regulation governing telecommunications services apportionment.
 - The model borrows from the definitions and sourcing rules of the Streamlined Sales and Use Tax Agreement; throws-out outer jurisdictional property from the property factor; throws out gross receipts from the sales factor "which are not taxable in the State to which they would be apportioned"; and embraces market sourcing rules, including using proxy estimates compiled by the Federal Communications Commission (FCC Table 15.6) to determine sourcing of certain "wholesale" telecommunications receipts.
- MTC is examining apportionment for other industries as well, not limited to market-based sourcing.

Throwout

Throwout Provisions

State response to potential nowhere sales

- New Jersey
- West Virginia
- Illinois (service providers)

Throwout

New Jersey's "throwout rule" is not facially unconstitutional under the Commerce Clause, Due Process Clause, and Supremacy Clause of the U.S. Constitution.

A claim that a law is facially unconstitutional requires a showing that no circumstances exist under which the challenged law could be valid.

The court found that the throwout rule can satisfy the constitutional requirements at issue in some circumstances.

The opinion did not address whether the throwout rule is unconstitutional as it applied to the taxpayers. "Separate proceedings for each plaintiff will be scheduled with respect to these issues."

See, *Pfizer, Inc., et al. v. Director, Division of Taxation*, N.J. Tax Court, Dkt. Nos., 000055-2006, 008807-2006, 008806-2006, 000066-2007, 5/29/08

Note>Proposed legislation to repeal throwback rule has not advanced since introduction

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