# Managing change*

## State and Local Tax Trends Affecting Businesses in 2009: Looking Back, Looking Ahead

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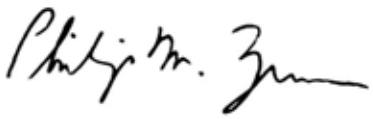
In 2008, the world joined the United States in undergoing an economic crisis of confidence, to say the least. State and local governments, hardly immune from the difficulties of this past year, continue to change their laws in efforts to increase revenues. More states have moved to unitary combined reporting; the new Massachusetts legislation is an example of how onerous this tax regime can be. At the same time, states have—through statutes and case law—continued to impose an economic nexus regime—for sales tax as well as income tax. New York's new vendor law is an ex ample of this effort.

Other areas in which we have seen greater efforts to collect taxes include withholding on pass-through entities and more complex administrative burdens for international assignees. To make matters even more difficult, the Financial Accounting Standards Board is considering changes in FAS 5 that would impose more disclosure requirements for non-income tax contingencies and International Financial Reporting Standards are coming in the not-too-distant future.

The message we want to leave you with is simple—in the face of seemingly constant changes, you can deal with them if you team across your company and stay on top of the issues impacting your business. Your business decisions will continue to drive your tax decisions and we hope this year's Journal, *State and Local Tax Trends Affecting Businesses in 2009, Looking Back, Looking Ahead*, will help you and your team in these efforts.

As usual, we are not covering all of the year's changes, nor are we providing specific tax advice. We are providing a broad overview that we hope will help you cope with the many changes that have occurred as well as those you can expect going forward.



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# Introduction

Unlike the past several years, in which we indicated that the times were much like those of earlier years, 2008 was a year like few others…and hopefully a year unlike those to come. The economic meltdown has resulted in strains not only on Wall Street and Main Street—as the presidential candidates and media put it—but also to an unprecedented degree on state and local governments.

Consider a report released in July 2008 by the National Conference of State Legislatures (NCSL), in which the NCSL stated that states enacted fewer tax changes in their 2008 legislative sessions than in the previous year because of "a cautious economic outlook." Now it is clear that recent economic events have changed even that less-than-rosy picture. By November of 2008, Donald J. Boyd and Lucy Dadayan of New York's Rockefeller Institute, in an article printed in Tax Analysts, found that "tax revenue was not as strong in the April–June quarter, as a cursory glance at the data suggests; developments since June suggest a substantial weakening in tax revenue; and several states have adopted midyear budget cuts, and we expect more states to do the same."

David Brunori, in another November 2008 Tax Analyst article, wrote that "An increasing number of governors are requesting that the federal government write their states checks to help kick-start the economy—and alleviate their budget shortfalls. Arizona Gov. Janet Napolitano (D) was the latest to join the chorus of state politicians asking for help. California Gov. Arnold Schwarzenegger (R), New York Gov. David Paterson (D), Massachusetts Gov. Deval Patrick (D), and many others have made similar pleas. They want to use federal aid for road and bridge construction, which would directly stimulate the economy. But they also want to use the money to defray service cutbacks and avoid more layoffs of public workers, which they believe would have a detrimental effect on the economy."

While it is true that the states have attempted to cut spending to match decreased revenue, they have also taken steps to increase revenue, as several articles in this Journal point out. Looking back, looking ahead, these articles are intended to help you learn what happened in 2008 and how those actions can affect your businesses in 2009.

## Budget deficits challenge state policymakers

As cited in the Rockefeller Institute report, states hurt particularly hard by the decline in housing values and related drops in consumer spending—Arizona, California, Florida, Michigan, and Rhode Island—had the largest tax shortfalls and faced the largest budget gaps. However, the newest states facing severe fiscal crisis are those that rely heavily either on the financial services industry or on "steeply progressive income taxes." With dramatic declines in industry profits and sharp decreases in capital gains and high-wage income expected to be reported in 2009, these states are likely only beginning to feel the front edge of the fiscal crisis. While the last fiscal crisis for the states occurred in what the Rockefeller Institute termed "a mild recession," the "real economy now appears likely to perform much worse than it did in the last recession," meaning that the impact to state revenue is likely to be at least as bad, but likely worse.

## The Lady or the Tiger: Unitary combined reporting or economic nexus?

Can there be a distinction between the possible detriments of unitary combined reporting and the economic nexus regimes imposed by an increasing number of states? Combined unitary reporting affects any unitary group of entities regardless of the type of business in which it is engaged. It is notable that the most difficult aspect of this methodology is the determination of a "unitary" business. Much litigation is based on defining the relationship, particularly when the various units, whether divisions or separate entities, are engaged in different lines of business. Economic nexus, based on the cases that have been decided in this area of state taxation, would appear to fall hardest on holding companies and financial institutions. However, if coupled with the concepts of affiliate, agency and factor nexus, a finding that sales into a state could constitute sufficient grounds for a jurisdiction to tax could subject any affiliate of an in-state company into the state's taxing authority based on the presence of customers into a state. Unitary combined reporting or economic nexus: Which is better, which is worse? The strong possibility exists that there are no "ladies" out there, only tigers.

## Emerging developments in financial reporting for state taxes

As more focus has been given to the state tax provision in recent years, tax departments have found that a significant amount of time is needed to monitor state income tax changes and developments that may impact the state tax provision. FIN 48 has meant a lot more work for tax departments, and it is not the end of the line for changes in accounting for state taxes. The Financial Accounting Standards Board (FASB) is considering changes to FAS 5 that would provide for disclosures similar to those required under FIN 48 for all contingencies, including reserves for a number of state taxes. If such changes are enacted, taxpayers would need to also monitor indirect tax developments each quarter to determine whether a potential loss requires disclosure.

In addition, the U.S. is expected to adopt International Financial Reporting Standards within the next seven to eight years. The impact of IFRS on federal income tax issues will also apply in the computation of state taxable income. The conversion to IFRS is also likely to have an impact on a number of other states taxes. In addition, there may be implications to the apportionment factors, state modifications, credits and incentives, etc. The more familiar a state tax group is with the requirements and nuances of FAS 109, FIN 48, FAS 5 and IFRS, the more value they can provide to the organization.

## The new Massachusetts combined reporting rules: Another layer of complexity

On July 3, 2008, Governor Deval Patrick signed Massachusetts House Bill 4904, making Massachusetts the latest state to migrate from a separate entity regime to combined reporting, effective for tax years beginning on or after January 1, 2009. The Massachusetts legislation creates many challenges, as the changes were made to an already complex corporate tax system that imposes different taxes, apportionment rules, and rates on different taxpayers depending upon their particular classification for Massachusetts tax purposes. Under the new legislation, a corporation engaged in a unitary business with one or more corporations "subject to combination" must calculate its taxable net income based on its share of the apportionable income or loss of the combined group attributable to Massachusetts. The legislation makes clear that the definition of unitary business is intended to be broad and should be construed "to the fullest extent permitted under the United States Constitution." One of the complexities of administering the Massachusetts combined reporting regime is that taxpayers included in a combined group may be subject to different tax regimes, different apportionment formulas, and even different rates. The legislation also makes changes in the corporate excise tax rate, conformity to federal entity classification rules, the taxation of S corporations and corporate trusts, and the reach of Public Law 86-272.

## Taxing e-commerce: New York and other states try new approaches

New York State is currently attempting to skirt the physical presence requirement of the U.S. Constitution for certain e-commerce companies that use affiliate marketing programs. Under the new law, the presumption of who is considered to be a vendor for sales tax purposes includes sellers with over $10,000 in sales as a result of affiliate referrals to New York customers in the previous four quarters. The change to the New York law raises several constitutional red flags. The first issue is Commerce Clause nexus. The Commerce Clause mandates that a company be physically present in the taxing state before that state can impose on the company the duties to collect and remit sales/use tax. The New York law also raises potential Due Process Clause concerns. As long as affiliates do not act on behalf of the retailer and do not significantly affect the retailer's ability to establish or maintain a market in New York, the connection between an affiliate and the retailer may not be sufficient to establish nexus for sales and use tax purposes. Other states have taken steps in the direction of the New York law and a bill has been introduced in the U.S. Congress that would bar states from requiring "collection and remittance of a State tax" by any person where the collection would result from the electronic commerce of that person and the person lacks a physical presence in the state during the taxable year. Taxpayers are likely to continue challenging efforts by states to circumvent constitutional requirements. Until Congress or the U.S. Supreme Court speaks on the issue, states must adhere to the established constitutional mandate that physical presence is required for sales and use tax nexus.

## State withholding requirements: A tricky issue for pass-through entities and their nonresident owners

In recent years, there has been a dramatic rise in the use of multistate pass-through entities, accompanied by a rise in state attempts to tax the entities' nonresident owners. Some states have adopted procedures to reduce the revenue loss while shifting the collection burden. One state response has been to require pass-through entities to withhold on the distributive shares of income to nonresident owners. Since 2002, eleven states have enacted legislation that requires pass-through entities to withhold income taxes on distributions made to certain nonresident owners, bringing the number of states that require withholding to thirty-two. Constitutional concerns also arise in this context. The U.S. Supreme Court has held that the Due Process Clause "requires some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax." With regard to requiring pass-through entities to withhold, the question will be whether a non-resident owner has availed itself of the privilege of conducting business in the state if such owner's only activity is the passive holding of an interest in the pass-through entity. Commerce Clause considerations involve both the requirement for substantial nexus and the possible discrimination that could occur if the withholding on non-residents is more onerous than that on residents. While the constitutional issues may eventually be settled by state courts or the U.S. Supreme Court, it is important that businesses using pass-through entities familiarize themselves with current filing requirements and possible responses.

## International assignees: The difficulties of multistate reporting in the U.S.

Multinational companies may have two types of international assignees whose activities trigger U.S. payroll reporting and individual taxation: non-U.S. employees working in various locations within the United States and U.S. employees assigned abroad who may travel to the United States for business trips during their foreign assignment period. In each case, there are U.S. tax compliance requirements for both the individual (federal and state individual income tax returns and perhaps estimated payments) and the employer (income tax withholding). However, even employers who comply with federal payroll requirements often are not aware of the state tax compliance issues for international assignees, particularly when an employee performs activities in more than one state. Each state has its own rules for determining whether an employee is subject to tax in that state, either as a resident or nonresident. The rules are just as varied with respect to the treatment of U.S. citizens that work abroad and non-U.S. employees working in the United States. These multiple layers of complexity can create difficulties in determining state income tax reporting and withholding requirements. A further level of complexity arises from the fact that states have diverse threshold rules for determining how many work days an employee must conduct in the state before becoming subject to nonresident taxation and withholding. In order to minimize the burdens and the possible penalties that may be imposed, businesses should utilize a working approach that includes three elements: knowledge of the thresholds for reporting and withholding in each state, development of a practical tracking system for target groups of employees, and a team approach involving a company's HR, tax and payroll departments.

# Budget deficits challenge state policymakers

State budget watchers warned after the first quarter of 2008 that state tax revenues showed significant weakening, and many states indeed faced mid-year (fiscal year 2009) budget gaps after struggling to balance budgets at the close of the prior fiscal year. Moreover, on the heels of this news came a historic collapse in the financial market and the anticipated announcement of a recession. Against this backdrop, states are bracing for a sustained hit to revenues and increasing deficits, leaving hard choices for state policymakers in 2009. Should they drain reserves (where they exist), cut services, and/or raise revenues through tax increases? How states respond will have a dramatic impact on state residents and the businesses that the states rely on to generate jobs and growth as a means of reversing the current economic downturn.

## State fiscal crisis looms

For most states, running a deficit is not an option: many state laws require the budget to be balanced for each fiscal year. In lean times, achieving a balanced budget can result in painful cuts to state services and investments. Decreases in state spending can result in further economic contraction due to fewer public sector jobs, fewer private sector contracts, and less investment in education, infrastructure, and other essential catalysts for economic growth. However, the alternative—increasing state revenues through tax increases—creates a drag on the economy through the taxation of production and consumption of goods and services, and creates a disincentive for wealth generators to locate in, expand operations in, or otherwise conduct business in a state.

During 2008, state tax revenue reports reflected the broader weakening in the national economy and the resulting declining state tax revenues in 2008 created budget gaps in many states. More ominously, current economic conditions indicate that 2009 could see a more significant decline, ushering in a prolonged period of state fiscal struggles. As stated in an October 2008 report of the Nelson A. Rockefeller Institute of Government, titled “The Damage is Just Beginning,” while the 2001 recession may have been referred to as “a perfect storm” for state finances, the current downturn “could be more perfect.”

As cited in the Rockefeller Institute report, states hurt particularly hard by the decline in housing values and fall in consumer spending—Arizona, California, Florida, Michigan, and Rhode Island—had the largest tax shortfalls and faced the largest budget gaps. However, the newest states facing severe fiscal crisis are those relying heavily on the financial services industry and those that rely heavily on “steeply progressive income taxes.” With dramatic declines in industry profits and sharp decreases in both capital gains and high-wage income expected to be reported in 2009, these states are likely only beginning to feel the front edge of the fiscal crisis. While the last fiscal crisis for the states occurred in what the Rockefeller Institute termed “a mild recession,” the “real economy now appears likely to perform much worse than it did in the last recession,” meaning that the impact to state revenue is likely to be at least as bad, but likely worse.

## Indicators of a precipitous revenue drop

The Rockefeller Institute reported in July 2008 that, for the first quarter (January–March) of 2008, state tax revenue increased only 1.7 percent over the same quarter the previous year. However, when the effects of enacted tax cuts and inflation for state and local government purchases are factored into this calculation, the Rockefeller Institute reported that "real adjusted state tax revenue" actually decreased by 5.3 percent from the previous year, constituting "the weakest performance since January–March 2003." Updated numbers for the second quarter (April–June) of 2008 showed "superficial" improvements, with an increase of 3.6 percent from the same quarter in 2007. When the overall increase is broken down by tax types, individual income tax receipts increased 6.6 percent, while sales tax receipts decreased 1.4 percent and corporate income tax receipts decreased 8.3 percent. Because the individual income tax receipts reflect payments accompanying the 2007 tax returns, these receipts do not reflect the current economic trends evidenced by the decrease in other tax payments.

Some states reported strong revenue performance in spite of the overall downward trend: total tax collections increased more than 10 percent in Alaska, Iowa, North Dakota, and West Virginia for the first quarter of 2008 from the same quarter in 2007. These states—with concentrated agricultural or natural resources—have tended to be insulated from the economic downturn that is affecting the rest of the nation. However, for many states, the outlook is much bleaker.

The Rockefeller Institute report notes that, for the second quarter of 2008, personal income tax revenue accounted for at least 50 percent of the total tax revenue in 11 states, and at least 40 percent of total tax revenue in 15 additional states. While personal income tax receipts strengthened in the second quarter, these receipts are more likely to feel the hit from the recent economic downturn than other state revenue streams, particularly in light of the decrease in wealth resulting from declining stock values and rising unemployment. Further, general sales tax receipts fell slightly in the first quarter of 2008 versus the previous year, representing the first decline in six years, and fell further in the second quarter of 2008. While the sales tax is more stable than the personal income tax in terms of generating revenue for states, it takes longer for sales tax collections to recover from economic downturns. Localities are also struggling to maintain property tax receipts in the face of substantially decreased property values, which are projected to fall even farther.

## Impact on state budgets

The Center on Budget and Policy Priorities (CBPP) estimated in a September 2008 report that while 29 states needed to close gaps in adopting a balanced fiscal year 2009 budget, new gaps had opened in the budgets of at least 15 states. Citing the data in the Rockefeller Institute report, and noting subsequent weakness in the second quarter of 2008, the CBPP report includes the following states as projecting mid-year budget gaps: Arizona, Connecticut, Florida, Georgia, Hawaii, Illinois, Massachusetts, Maryland, Nevada, New Hampshire, New York, Ohio, South Carolina, Vermont, and Virginia. Further, the report cites seven more states as projecting gaps for fiscal year 2010 and beyond: California, Kansas, Maryland, Minnesota, Oregon, Washington, and Wisconsin, in addition to Connecticut, Florida, Hawaii, New York, and Vermont cited above (although by no means are any of the other states mentioned above immune from experiencing budget deficits beyond fiscal year 2009). Some of the largest states are feeling the pinch most acutely.

On September 23, 2008—85 days late—California finally enacted a fiscal year 2009 budget, addressing a $15.2 billion shortfall. Needing a two-thirds majority to pass the budget, the majority Democrats failed to achieve sufficient support for proposed sales tax increases. The final budget provisions include a suspension of net operating loss deductions, credit limitations, and a 20 percent penalty on corporate franchise tax underpayments, as well as accelerated estimated tax payments. These tax provisions were offset in part, however, by extension of the net operating loss carryforward period, granting a net operating loss carryback, and granting assignability of credits among combined group members. Still, the final budget has been described as a “temporary fix” that relys on recognition of receipts in the current fiscal year and borrowing against future lottery earnings (subject to voter approval).

In fact, on October 28, 2008, Governor Arnold Schwarzenegger announced that he would call the legislature back into session in November to address a ballooning budget deficit that became apparent almost as soon as the fiscal year 2009 budget was signed. Current estimates put the budget gap in California at around $11 billion. California’s perilous fiscal situation was further underlined when, in an October 2, 2008 letter to Treasury Secretary Henry Paulson, Governor Schwarzenegger advised that without a restoration of liquidity to the credit markets, the state could be forced to turn to the Federal Treasury for short-term financing of up to $7 billion. The state subsequently was able to issue notes for at least $5 billion in short-term financing. Further, the dramatic decrease in housing prices has particularly affected the budgets of California’s localities, a problem compounded by salary and benefits commitments under long-term contracts with municipal employees.

In April 2008, New York approved a budget with several revenue-raisers, including requiring captive real estate investment trusts and regulated investment companies to file combined returns with their owners, expanding nexus provisions for out-of-state credit card companies, decoupling from the federal domestic production activities deduction, and creating a "vendor presumption" for out-of-state sellers. While this budget closed a $5.2 billion gap, the Division of the Budget projected that the state faces a $5.4 billion deficit in 2009–10, and a $24.4 billion deficit over the next three years. To deal with the budget crisis, Governor David Paterson called an August 2008 special session resulting, according to the Governor's office, in "savings of $1 billion over two years."

As with California, the budget situation in New York has shown no signs of improvement. Notably, the Division of Budget projections were made before the September turmoil in the financial markets, which normally contribute up to 20 percent of the state's revenues. On September 29, 2008, Comptroller Thomas DiNapoli released a preliminary estimate that the Wall Street crisis could cost the state up to $3.5 billion in tax revenues by March 2010. The number of job losses in the securities industry could reach 40,000, according to the report, with each job lost on Wall Street translating to as many as three jobs lost elsewhere.

In response, New York Governor Patterson called for a second special legislative session, to begin November 18, 2008, and indicated that he would submit an executive budget in mid-December, more than a month ahead of time, to head off a decline in the state's credit rating. Likewise, New York City Mayor Michael Bloomberg indicated that the city would "probably" be forced to raise taxes to close an estimated $2.3 billion budget shortfall for the next fiscal year. Mayor Bloomberg also announced spending cuts of 2.5 percent this fiscal year, followed by cuts of 5 percent next year, and has indicated that a current 7 percent reduction in property taxes may need to be rescinded in face of the financial outlook.

Massachusetts struggled to close a budget gap of more than $1 billion for the 2009 fiscal year. Legislation enacted on July 3, 2008 included numerous tax changes, including conformity to the federal entity classification rules, mandatory unitary combined reporting, and taxation of S corporations and corporate trusts, paired with a corporate excise tax rate reduction. According to estimates by the Department of Revenue, the changes will result in revenue increases of $285 million in fiscal year 2009, $390 million in 2010, $269 million in 2011, $190 million in 2012, and $163 million in 2013. In spite of these revenue increases, however, on October 2, Governor Deval Patrick reported a $233 million shortfall in tax collections. In response, Governor Patrick announced a $310 million withdrawal from budget reserves and ordered a 7 percent reduction in spending by the executive branch.

This trend is not confined to the largest states. According to a Bureau of National Affairs, Inc. (BNA) report dated August 11, 2008, several other states encountered major budget shortfalls for fiscal year 2009. Arizona's shortfall of over $2 billion amounted to 19.3 percent of its general fund, exceeding on a percentage basis even the shortfall in California. Other major shortfalls include $3 billion in New Jersey (9.1 percent of the state's general fund), $2.3 billion in Illinois (7.5 percent of the general fund), and $1.6 billion in Maryland (12 percent of the general fund).

## Outlook

States have relied on a combination of belt-tightening and revenue increases to weather economic downturns in preparing their 2009 fiscal-year budgets. However, the first few months of the fiscal year made clear that mid-year budget shortfalls would force states to make still tougher choices when the 2009 regular sessions begin. State legislatures not only must focus on making up the current revenue shortfall caused by weak tax collections and increasingly expensive credit, but also must address the larger projected shortfalls for their 2010 budgets. Further, states will be under pressure to bring in budget plans on time or even ahead of schedule to avoid a further crippling downgrade in financial ratings. Because of the time it takes for an economic recovery to register in the form of strengthening tax receipts, this year-to-year budget crisis mode will likely be the status quo for the near future.

In this environment, businesses need to be mindful of the perception of responsibility for the financial downturn, as media focuses on the role of business rather than personal investment decisions in the current situation. States may look to plug holes in budget gaps while still providing relief to residents already dealing with the fallout from the housing crisis and the stock market decline. Although businesses may not fare any better in the face of these difficult conditions, states will be forced to make hard choices that could hit businesses harder than the voting population. Out-of-state businesses will likely take the biggest hit, as states will be hard-pressed to exacerbate an already perilous situation with the local economy by enacting stunting tax increases. Thus, nexus, apportionment, reporting methods, credits and incentives, and other areas that can benefit in-state businesses at the expense of out-of-state business could be major parts of budget legislation considered during 2009. Major tax overhauls could also be on the table as a means of providing trade-offs to benefit in-state over out-of-state businesses, while producing a net increase in revenues. In this environment, businesses should continue to make the case to both elected decision-makers and to the public of how tax policy decisions affect the economy as a whole, and that increasing the business tax burden can be a shortsighted means of plugging budget holes.

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# The Lady or the Tiger: Unitary combined reporting or economic nexus?

In Frank Stockton's well-known story, a "semi-barbaric" king used chance to mete out justice: a person could choose to open either of two doors to determine their fate. Behind one of the doors a tiger was prowling; behind the other, a lady waited. In today's world, where states are concerned that businesses are taking too much advantage of "loopholes" to reduce their tax liability, taxpayers may well feel they are facing this choice. Economic nexus or forced combination—it is hard to tell which is the tiger, and which (if either) is the "lady."

The answer to which is more disadvantageous depends on how a business is organized, and where it does business. It is necessary to examine unitary combined apportionment in today's environment and contrast it with economic nexus to see how each would affect your operations—always with the idea that chance—and state legislatures—may dictate the outcome. For example, at a luncheon sponsored by the District of Columbia Bar Taxation Section's State and Local Taxes Committee on February 7, 2007, a panel discussed nexus cases and possible action by Congress or the Supreme Court. Panelists speculated that if economic nexus is found unconstitutional, states may respond by enacting more statutes requiring unitary combined apportionment.

At the outset, it is necessary to note that state tax administrators and state courts generally maintain that combined reporting is not a tax nexus issue but, rather, an apportionment methodology. That being said, companies that must include the income of all members of their unitary group in the measure of their tax may believe that the difference is slight—particularly in states that employ what is called the *Finnigan* method of apportionment. In this instance, the numerators of the apportionment formula include the receipts of members with no stand-alone nexus. It is hard to see how such a system differs from claiming that all unitary members have nexus. In fact, Arizona and Kansas have concluded that a unitary relationship automatically confers nexus on all members of the group and, most recently, New York has done the same.

That being said, although we are beginning to see more states consider the *Finnigan* approach, most unitary states do not impose it. Rather, most include only the factors in the numerator of those companies that do have nexus (the so-called *Joyce* rule). Therefore, it is more reasonable to compare economic nexus to the standard *Joyce* method of unitary combined reporting scheme.

## Overview of the two methodologies

### Combined reporting

Twenty-one states currently require combined reporting. Under a unitary combined reporting system, affiliated entities conducting a unitary business are treated as a single taxable entity. Generally, members of a unitary group must be more than 50 percent controlled, directly or indirectly, by a common owner, and the business activity of the

related companies must be integrated with, dependent upon, and contribute to each other. However, certain state statutes exclude specific types of entities that would otherwise qualify under the general definition. For example, some states might exclude foreign entities, entities in a different line of business or entities that use different income apportionment methods.

In general, under a unitary combined reporting system the income and losses of all members of the group are combined and any intercompany transactions among the unitary group members are eliminated. Apportionment is calculated at the group level after eliminating the effects of intercompany transactions. The combined group income is multiplied by the combined apportionment factor to arrive at the unitary group's combined reporting income.

### Economic nexus

Much of the recent activity concerning nexus deals with economic nexus, wherein states are trying to assert jurisdiction over the income of businesses that do not have a tangible physical presence in the state by claiming such presence is a Constitutional requirement only for sales/use tax collection, based on the U.S. Supreme Court's decision in *Quill Corp. v. North Dakota*, 504 U.S. 278 (1992). For example, states are taxing the income of out-of-state intangible holding companies that license intangibles (i.e., trademarks, trade names) 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. Notably, state courts and revenue departments, which could assert nexus in these instances based on an affiliate relationship, have chosen to assert nexus based on an economic nexus theory. These decisions and rulings therefore potentially impact all out-of-state taxpayers that direct economic activity into a state, regardless of whether such taxpayers are represented in the state by an affiliate.

## Recent enactments and cases

### Combined reporting

The most recent enactments of combined reporting are those by Texas, Michigan, New York, and Massachusetts.

One of the most significant aspects of the Texas Margin Tax—and a clear departure from the former franchise tax—is the adoption of a unitary combined reporting regime. Taxable entities included in an affiliated group engaged in a unitary business must file a combined report based on the unitary group's business. The state follows the *Joyce* rule and only includes foreign entities if 20 percent or more of their property and payroll are assigned to U.S. locations.

The new Michigan business tax also adopts a unitary combined reporting regime. Although foreign operating entities—entities with substantial operations outside the U.S. with at least 80% of their income being active foreign business income—are excluded from a unitary business group, such entities might nevertheless be subject to tax based on the "actively solicits sales" nexus provisions, and nothing in the definitions of taxpayer or person precludes the taxation of foreign entities. Michigan adopts the *Finnigan* rule but, given the breath of its new nexus provisions, it is possible that these entities may be considered taxable outside of the combined reporting rules.

Recent New York legislation requires taxpayers that own or control the capital stock of another corporation, or are so controlled by another corporation, to file a combined franchise tax report where there are substantial intercorporate transactions, regardless of the transfer price for such transactions. New York follows the *Finnigan* rule and declares that all members of the group have nexus. New York does not permit alien (non-U.S.) entities to be included in the combined report.

Massachusetts' unitary rules are discussed in more detail in "The new Massachusetts combined reporting rules: Another layer of complexity" beginning on page 29, but of particular note, it should be pointed out that corporations subject to combination would include financial institutions, general business corporations, S corporations, utility corporations, certain insurance companies not classified as such for federal tax purposes, real estate investment trusts, and regulated investment companies (although regulated investment companies are exempt from the general corporate excise). Corporations not subject to combination would include Massachusetts security corporations, most insurance companies, and tax-exempt organizations.

**Economic nexus**

Perhaps the strongest case for economic nexus was articulated by the West Virginia Supreme Court of Appeals in *West Virginia Tax Commissioner v. MBNA America Bank, N.A.*, No. 33049 (W.Va. 11/21/06); U.S., No. 06-1228, *cert. petition denied*, 6/18/07. 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." Of interest is the fact that Justice Brent D. Benjamin filed a dissenting opinion on January 2, 2007, arguing that the majority's decision had "no precedential support whatsoever for [its] conclusions" and that the imposition of the taxes on an out-of-state financial organization with no employees or property—tangible or intangible—located in the state violates the Commerce Clause.

It should be noted that U.S. Representatives Rick Boucher (D-VA) and Bob Goodlatte (R-VA) introduced H.R. 5267 on February 7, 2008, a bill that would establish a bright-line "physical presence" standard for the imposition of state and local "business activity taxes," as well as "modernize" Public Law 86-272. It should also be noted that the bill, with slightly different provisions, has previously been introduced and that to date, passage of the bill is speculative at best.

## Who is impacted?

### Combined reporting

This methodology affects any unitary group of entities regardless of the type of business in which it is engaged. It is notable that the most difficult aspect of this methodology is the determination of a "unitary" business. Much litigation is based on defining the relationship, particularly when the various units, be they divisions or separate entities, are engaged in different lines of business. While the U.S. Supreme Court in *MeadWestvaco Corp. v. Illinois Dept. of Revenue*, U.S., No. 06-1413, vacated and remanded, 4/15/08, noted that the lower Illinois court had found that Mead and its Lexis/Nexis division did not have a unitary relationship, a review of California cases to determine whether a unitary business exists would indicate that the two most frequently recurring attributes of a unitary business are intercompany product flow and strong centralized management. With the exception of a few cases, the facts have shown some form of intercompany product flow or use. Similarly, integration of top level, policy-making executives and directors has consistently been considered to weigh heavily in the balance. Under these circumstances, it is probable that any integrated business would be subject to combined reporting.

### Economic nexus

Based on the cases decided in this area of state taxation, it would appear that much of the activity to date concerns holding companies and financial institutions. However, if coupled with the concepts of affiliate, agency and factor nexus, a finding that sales into a state could constitute sufficient grounds for jurisdiction to tax might bring any affiliate of an in-state company into the state's taxing jurisdiction as well as providing cover for taxing companies with no affiliates based on the presence of customers into a state.

## Which is the lady, which is the tiger?

There are those—perhaps the majority of us—who believe that both unitary combined reporting and economic nexus are tigers and that neither can be considered a "lady." While companies may wish to react to proposed legislation establishing either regime, it is necessary to understand the ramifications of each before any lobbying effort is undertaken. It is clear that unitary combined reporting may be beneficial to companies that can realize a lower effective tax rate by offsetting profitable companies with loss companies, or by reducing the overall factor by increasing the denominator without a concomitant increase in the numerator. It is difficult to see how becoming subject to tax through economic nexus can ever be an advantage. But keep one thought in mind—the choice is not likely to be yours. As always, while we do not want to think of states as "semi-barbaric kings," they still make the decisions.

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# Emerging developments in financial reporting for state taxes

By now, most companies have completed—or are in the midst of—their third year of financial reporting for income taxes under FIN 48 and have established procedures to review and update the state tax accounts each reporting period. As tax departments have focused more on the state tax provision in recent years, they have found that they need a significant amount of time to monitor state income tax changes and developments that may impact the state tax provision.

While, by any measure, FIN 48 has meant a lot more work for tax departments, it is not the end of the line for changes in accounting for state taxes. The Financial Accounting Standards Board (FASB) is considering changes to FAS 5 that would provide for disclosures similar to those required under FIN 48 for all contingencies. In addition, sometime between 2014 and 2016, the U.S. is expected to make the switch from GAAP to International Financial Reporting Standards (IFRS). The impacts on state tax positions of the future conversion to IFRS are just beginning to be considered. The conversion to IFRS will require significant effort and input from tax departments and the implications to accounting for income and non-income taxes are expected to be far reaching. The corporate state tax professional will likely need to be involved in the conversion process both within the tax department and with finance and business unit implementation teams.

This article discusses the primary challenges that FIN 48, FAS 109, FAS 5 and IFRS pose for state tax professionals in financial reporting for state taxes.

## FIN 48 challenges for the state tax team

FIN 48 requires companies to track changes in state laws and regulations, state administrative guidance and pronouncements, and judicial decisions each quarter and evaluate the significance of the developments to the state FIN 48 positions. In addition, tax professionals must consider the state tax impact of any changes to the federal provision, as well as any changes to the taxpayer's business operations. If a development that would have a material impact on the state tax provision is overlooked, there is the risk that it could result in an error in the financial statements or a finding that there was a material weakness in the tax department's 404 controls.

The FIN 48 requirement to track these developments has become more challenging than ever, as state revenue departments have been more aggressive in challenging tax positions taken by taxpayers on their returns. From assertions of nexus despite no physical presence in a jurisdiction, to disallowing deductions for transactions with affiliates and forcing combined filings of affiliates, state auditors have focused on identifying and asserting tax on perceived erroneous or abusive tax positions.

With the slowing of the economy, states are facing unprecedented budget shortfalls. In the quest for more stable revenue streams that do not fluctuate dramatically with the economy, Michigan and Texas followed the example first set by Ohio and have enacted taxes partly based on gross revenues. Other states, such as Massachusetts, Vermont and West Virginia, have chosen to enact mandatory combined reporting provisions. “Loophole” closures, such as decoupling from federal bonus depreciation and disallowance of deductions for intercompany expenses, are still popular revenue raisers as are changes to the apportionment methods used to apportion income among the states. It is expected that more states will consider the road that Ohio, Michigan, and Texas have followed, and move away from a strictly income-based tax. A number of others will likely explore a move to some form of unitary combined reporting to remove any incentive for companies to save state taxes through intercompany income and deductions.

For the tax professional who must monitor state developments, legislative changes are generally the easiest to follow. In most cases, proposed legislation is introduced well in advance of enactment and while there may be last-minute changes to the language of the statute, it is generally possible to track the progress of the bill. Occasionally a significant piece of legislation will be signed into law on the last day of a quarterly reporting period. Since FAS 109 requires the impact of tax law and other changes to be accounted for in the quarter in which the law was enacted or the change was implemented, changes that happen at the end of a reporting period mean limited time in which to analyze the impact to the tax accounts. For example, the West Virginia legislation requiring combined reporting along with a phased tax rate reduction was signed into law in the early morning hours on April 1, 2008. Initially, taxpayers were under the impression that they needed to account for this change in the quarterly reporting period that included April 2008. However, West Virginia effectively “stopped the clock” on the late-running legislative session and therefore the official signing date of the tax legislation was actually March 31. It took a few days for tax professionals to realize that the law became effective in the previous quarter and many had to scramble to quantify the effect and determine whether it had a significant impact on the tax accounts. In contrast, when Massachusetts enacted its combined reporting legislation, the governor signed the bill on July 3, 2008, giving most taxpayers a reasonable amount of time to analyze the FAS 109 and FIN 48 impact before the end of the quarter.

It is a challenge to monitor state judicial and administrative developments to ensure that those that are significant to a particular taxpayer are identified and analyzed in a timely manner. Often, a case is overlooked or misinterpreted or a change in a jurisdiction's administrative position on a particular item is not considered and it is later found that the impact of the change was significant. It is important that tax professionals have access to information from a variety of sources. Such sources can include state legislative and revenue department websites and newsletters, communications and updates from outside specialists, advisors, and the audit firm, information from tax and industry trade organizations and insights from tax professionals at other companies. All aspects of uncertain state tax positions, including the units of account, the recognition, and the measurement of the tax benefit need to be re-evaluated each reporting cycle. If state tax professionals do not have access to the right resources and information, key state tax developments may be missed and the state tax accounts may not be accurate.

It is also necessary to monitor changes and developments within the business organization so those can be accounted for in a timely manner. For example, if the business gains or loses a key customer, there could be an impact on how revenues are apportioned among the states. It might also impact whether the business has nexus in a state. If a decision is made to expand or contract a particular business location or line of business, such a change could also affect apportionment, nexus, filing methods, etc.

State revenue agencies have become familiar with the information reported in companies' financial statements. State tax auditors review the FIN 48 disclosures in detail and ask questions about the issues and reserves. Taxpayers have noted that assessments issued by some of the state auditors seem to be a close match to the amounts reported in the financial statement disclosures. At least one state has even sent written requests to several taxpayers asking for copies of all FIN 48 work papers and supporting documentation.

Another challenge in evaluating state FIN 48 positions is the need to determine whether penalties on the state tax amounts should be included in the reserves. While, in the past, state auditors routinely did not assess many of the penalties included in the state tax statutes, it has become much more common for such penalties to be added to assessments. It is also less likely that such penalties will be easily abated. In addition, over the last few years, states have enacted additional penalties for failure to disclosure listed or reportable transactions, taxes still owed after tax amnesty periods expire and, in California, a non-abatable 20 percent penalty for any corporate franchise tax underpayments for tax years beginning on or after January 1, 2003 in excess of one million dollars. It is difficult to determine whether there is a basis, such as a widely known administrative practice,

that can be relied upon to conclude that it is more likely than not that a statutory penalty will ultimately not be paid. Since FIN 48 was enacted, more taxpayers have made the decision to include state penalties in their FIN 48 liability.

FIN 48 still poses challenges for state tax professionals. Each reporting period, key transactions should be reviewed, and companies should confirm that there are no new issues or uncertain tax positions that have been overlooked and that all significant state income tax developments that could impact the taxpayer have been identified. It is also important to coordinate with the audit firm to understand their expectations on documentation and support that all significant issues are addressed.

## From FIN 48 to FAS 5: Disclose, disclose, disclose

Subsequent to the release of FIN 48, the FASB amended FAS 5 to exclude all references to income taxes. The FASB then turned its attention to the concerns expressed by investors and users of financial statements that disclosures about loss contingencies under current guidance provided in FAS 5, Accounting for Contingencies, are not adequate to assist users of financial information in assessing the likelihood, timing and amount of future cash flows associated with those loss contingencies. The FASB has proposed changes to FAS 5 that would expand the required disclosures about certain loss contingencies. The FASB's original intent was for the proposed changes to be effective for years ending after December 15, 2008 but, because of the number of comment letters received that were not supportive of many of the provisions in the exposure draft, the proposed effective date has been delayed and will be no earlier than fiscal years ending after December 15, 2009.

The proposed changes to FAS 5 include increased disclosure requirements for loss contingencies that will be recognized in the financial statements, including disclosure of specific quantitative and qualitative information about the loss contingencies. The financial statements would also need to include a tabular reconciliation of any recognized loss contingencies. Disclosure would not be required for certain information if such disclosure would be prejudicial to an entity's position in a dispute.

FAS 5 would still require that an estimated loss from a loss contingency be accrued if it is probable that the liability has been incurred by the date of the financial statements and the amount of the liability is reasonably estimable. In addition, an estimated loss would be required to be disclosed, but not accrued, if it is probable that the liability has been incurred as of the date of the financial statements and the amount of the loss is not reasonably estimable or it is reasonably possible that a liability has been incurred at the date of the financial statements and the amount is material to those financial statements.

State tax professionals need to be aware of the FASB's proposed changes to FAS 5 because the loss contingencies subject to disclosure include exposures for indirect taxes including sales/use taxes, franchise and net worth taxes, employment and withholding taxes, gross receipts taxes, property taxes, etc. If the proposed changes to FAS 5 are finalized, tax professionals will need to consider whether disclosures are required for these "above the line" taxes. For example, consider an entity that has historically taken a position that certain items are not subject to sales tax where the state tax statute is not clear. The entity has not reserved for this position because the loss is not probable. However, under the proposed revised FAS 5 standard, the entity will be required to disclose the potential loss if it is reasonably possible that the state revenue auditor would successfully assert that the items are subject to tax.

Businesses need to monitor income tax developments quarterly for FIN 48 purposes. If the proposed FAS 5 changes are enacted, taxpayers would also need to monitor indirect tax developments each quarter for FAS 5 purposes, in order to determine whether a potential loss requires disclosure. The FASB's requirements for disclosure of uncertainties in FIN 48 has, in many cases, resulted in taxpayers' reluctance to take any income tax position that is not highly certain. If the FAS 5 changes are enacted, requiring similar disclosures for potential losses, one might expect a similar resistance to transactions that result in uncertain indirect tax positions.

It is certainly possible that the proposed changes to FAS 5 will never be enacted. However, it would be prudent for a business to both evaluate its indirect tax exposures and to consider what positions it has taken for indirect taxes that are not reserved and where it might be reasonably possible that tax will ultimately be paid in anticipation of the need to provide disclosure.

## IFRS: Change is coming!

More than 100 countries currently utilize IFRS accounting standards and the U.S. is expected to adopt those standards within the next seven to eight years. The adoption of IFRS will result in fundamental changes to both pre-tax income and the income tax base. The conversion will therefore likely have a material impact on the effective tax rate and after-tax cash flows, as well as on a company's tax policies, processes, technology and related controls. The adoption of IFRS will effectively allow a "fresh start" review of all book accounting policies and may provide an opportunity for a company to change its tax accounting methods.

The tax group will need to be involved in all phases of the conversion effort and will need to evaluate the tax accounting implications, the accounting method issues, the impact on federal, state and international tax planning, the impact on transfer pricing documentation as well as the impact on resources. It is anticipated that the conversion to IFRS will primarily result in changes in the computation of, or elimination of, book-tax differences and may require or provide an opportunity for method changes.

For the state tax professional, the conversion to IFRS will likely have impacts on operational taxes, including property taxes, gross receipts taxes, capital and franchise taxes and employment taxes. In the state income tax area, the impact of IFRS on federal income tax issues will also apply in the computation of state taxable income. In addition, there may be implications for the apportionment factors, state modifications, credits and incentives, etc.

## The expanding role of the state tax team

The role of the state tax team in the tax accounting process continues to evolve and expand. State taxes touch most facets of the operations of the business, domestically and sometimes internationally. The more familiar the state tax group is with the requirements and nuances of FAS 109, FIN 48, FAS 5 and IFRS, the more value they can provide to the organization.

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# The new Massachusetts combined reporting rules: Another layer of complexity

On July 3, 2008, Governor Deval Patrick signed Massachusetts House Bill 4904, making Massachusetts the latest state to migrate from a separate entity regime to combined reporting, effective for tax years beginning on or after January 1, 2009. Given the recent trend for states to adopt combined reporting, businesses might find these changes routine. However, the Massachusetts legislation creates many challenges, as the changes were made to an already complex corporate tax system that imposes different tax regimes, apportionment rules, and rates on different taxpayers depending upon their particular classification for Massachusetts tax purposes.

What was the reason for the change? Combined reporting had certainly been on the wish list of the Massachusetts Department of Revenue ("Department") for a number of years, based on its belief that it would curb the ability of businesses to shift income away from where the income was earned to no-tax or low-tax jurisdictions. In addition, Massachusetts (like many states) is currently facing a significant revenue shortfall and there is a belief that combined reporting will quickly provide much needed revenue. Whether this is true or not is subject to some debate, since it has not been proven that combined reporting will, in fact, increase corporate tax revenues in the short run.

This article discusses some of the complexities of the new combined reporting approach and what it means for taxpayers doing business in Massachusetts.

## Combined reporting generally

Massachusetts has always been considered a "separate reporting" state, requiring each corporation subject to Massachusetts tax jurisdiction to file a separate return and determine its corporate excise liability on a separate entity basis. Massachusetts law provided the option to file a combined return. However, unlike states that require traditional "combined reporting," participation was generally limited to those entities in the federal consolidated group that had nexus in Massachusetts. In addition, the combined net income of the group was computed by adding the separately determined and separately apportionable taxable income of each member of the Massachusetts combined group (rather than combining the income and apportionment factors of the group as if they were effectively one taxpayer).

Under House Bill 4904 (H 4904), Massachusetts adopts combined reporting for tax years beginning on or after January 1, 2009. Specifically, H 4904 requires a corporation engaged in a unitary business with one or more corporations "subject to combination" to calculate its taxable net income based on its share of the apportionable income or loss of the combined group attributable to Massachusetts. (It should be noted that the non-income measure of the corporate excise tax—to the extent applicable—will continue to be calculated on a separate entity basis.)

Not surprisingly, H 4904 makes clear that the definition of unitary business is intended to be broad and should be construed "to the fullest extent permitted under the United States Constitution." Specifically, "unitary business" means the activities of a group of two or more corporations under common ownership that are sufficiently interdependent, integrated or interrelated through their activities so as to provide mutual benefit and produce a significant sharing or exchange of value among them or a significant flow of value between the separate parts. For these purposes, "common ownership" means more than 50 percent of the voting control of each member of the group directly or indirectly owned by a common owner or owners (whether such owners are corporate or non-corporate and whether such owners are included in the combined group).

## Determining the Massachusetts combined group

Massachusetts has separate corporate tax regimes for business entities classified as general business corporations, financial institutions, utility corporations, and insurance companies. The rules that apply to each of these regimes can be very different and produce very different results. In addition, significant differences in apportionment formulas and rules may exist within those taxpayers that are considered general business corporations. Under the new world of combined reporting, many of these entities will be required to be part of the same Massachusetts combined group. Corporations subject to combination include financial institutions, general business corporations, S corporations, utility corporations, certain insurance companies not classified as such for federal tax purposes, real estate investment trusts, and regulated investment companies (although regulated investment companies are exempt from the general corporate excise). Corporations not subject to combination include Massachusetts security corporations, most insurance companies, and tax-exempt organizations.

The combined group must be determined on a water's-edge basis unless a worldwide election or an affiliated group election is made. The following members are included in the water's-edge combined group:

- any member incorporated in the United States or formed under the laws of the United States, any state, the District of Columbia, or any territory or possession of the United States;
- any member (regardless of the place of incorporation or formation) if the average of its property, payroll, and sales factors within the United States is 20 percent or more; and
- any member that earns more than 20 percent of its income (directly or indirectly) from intangible property or service-related activities, the costs of which generally are deductible for federal income tax purposes against the business income of other members of the group, but only to the extent of such intercompany income and related apportionment factors.

The members of a combined group may make a "worldwide election" on a timely filed original return to determine the combined group's taxable income. The election will be binding for a period of 10 years, subject to regulations adopted by the Department of Revenue.

H 4904 also allows a corporation to make a voluntary 10-year election on an original, timely filed return to define its Massachusetts combined group as all corporations that are members of its affiliated group. For these purposes, an affiliated group will include any corporation participating in the filing of a federal consolidated return. However, the group is expanded to include corporations more than 50 percent of whose voting interests are commonly controlled (rather than the 80 percent control by vote and value for purposes of determining inclusion for federal consolidated return purposes). In addition, the Department has issued administrative guidance confirming that control of members of the Massachusetts affiliated group may be direct or indirect, and the common owner or owners may be corporate or non-corporate. Consequently, the Department agrees that two or more federal consolidated groups could be required to be included within a Massachusetts affiliated group if they were both commonly owned by a non-U.S. corporation. Finally, the Department has indicated that certain corporations included in a water's-edge group would also be included in an affiliated group, even though such corporations generally would not be included in a federal consolidated return.

## The apportionment thicket

One of the complexities of administering a combined reporting regime in Massachusetts is that taxpayers included in a combined group may be subject to different tax regimes, different apportionment formulas, and even different rates. H 4904 attempts to preserve these diverse rules through its apportionment provisions. Specifically, each taxable member of the Massachusetts combined group should determine its own apportionment percentage (as described below) to apply against the group's combined taxable income based on the particular apportionment formula such taxpayer is required to utilize under Massachusetts law (e.g., a three factor formula consisting of property, payroll, and sales vs. single sales factor for certain industries). Each taxable member then multiplies its apportioned taxable income by the tax rate applicable to such member.

In order to determine the Massachusetts apportionment percentage of a particular taxable member, H 4904 adopts a "common denominator" approach, under which:

- the apportionment factor denominator(s) of every member of the group are determined based upon the apportionment provisions that apply to each member; and

- the apportionment factor denominators of each member are aggregated.

The property and payroll factor denominators are determined by including the property and payroll of all members of the group, including those members subject to a single sales factor apportionment formula. The Massachusetts property and payroll of those members subject to a single sales factor apportionment formula should not be included in the numerators of the property and payroll fractions, which preserves the results that the single sales factor apportionment formula was intended to provide to taxpayers in certain industries (i.e., manufacturing corporations and mutual fund service corporations).

For purposes of determining whether sales of tangible personal property are included in the Massachusetts sales factor numerator, a taxpayer is considered taxable in any state in which any member of its combined group is subject to tax (i.e., adopting what is commonly referred to as the *Finnigan* approach). Such approach is generally viewed as being favorable to Massachusetts-based businesses subject to throwback, but adds complexity to the calculation of a combined group's apportionment percentage, especially where members are subject to different apportionment regimes.

Under the *Finnigan* approach, each "taxable member" (i.e., those members of the Massachusetts combined group that are subject to Massachusetts tax jurisdiction) must first compute the numerator of its apportionment factors pursuant to the rules that apply to such member. In addition, each taxable member of the group must then include in its sales factor numerator a portion of the aggregate Massachusetts sales of non-taxable members based on its Massachusetts sales over the total Massachusetts sales of all taxable members.

H 4904 requires several adjustments to both the numerator and denominators of the property and sales factor where the Massachusetts combined group includes both financial institutions and non-financial institutions ("general corporations"). First, the property factor of financial institution members only includes 20 percent of the value of intangible property. In addition, the sales factor of general corporations includes certain receipts otherwise excluded from the sales factor (e.g., interest and dividends) if such amounts would have been included under the financial institution apportionment rules. However, receipts from trading and investments (e.g., interest, dividends and capital gain from investment activities) are not included in the general corporation's sales factor. In addition, general corporations are not subject to the "throwback" provisions that otherwise apply when determining the sales factor of a financial institution.

## Issues reserved for regulation

The Commissioner is authorized to adopt regulations with respect to interpreting and administering the legislation's combined reporting provisions, including rules to address:

- the worldwide election;
- the elimination of intercompany transactions;
- the sharing of credits;
- the application of any carry forwards of tax attributes attributable to the combined group's unitary business (although H 4904 states that the carry forward of losses, credits and other tax benefits that arise in tax years before the effective date are available only to the extent permitted by law as in effect before the effective date); and
- the relationship of the combined reporting provisions to the statutory addback rules for certain payments of interest, royalties, etc. to related parties.

## Special deduction to reflect financial statement impact of combined reporting

The legislation also provides a qualifying publicly-traded corporation (and affiliated corporations included in its financial statements) a unique corporate income tax deduction on its Massachusetts combined return if the enactment of the combined reporting provisions results in an increase to its net deferred tax liability (NDTL). For purposes of the deduction, the term NDTL is defined as the net increase, if any, of the overall deferred tax liability (DTL) minus the net increase, if any, of the overall deferred tax asset (DTA) that results from the imposition of the new combined reporting provisions, both computed in accordance with generally accepted accounting principles.

Although a publicly traded corporation is eligible for the deduction because it has an increase to its NDTL from application of the new combined reporting provisions, the amount of its deduction will not necessarily equal such increase. Rather, the deduction (which must be taken ratably over a seven-year period starting with the taxpayer's tax year that begins in 2012) is equal to *the lesser* of: (1) the Massachusetts tax basis modification or (2) the amount necessary to offset the increase in NDTL that would result from the enactment of the combined reporting requirements. For these purposes, "Massachusetts tax basis modification" is defined as the aggregate adjusted book basis of the combined group's non-taxable members' eligible assets less the aggregate adjusted tax basis of the combined group's non-taxable members' eligible assets. "Eligible assets" means, and is limited to, those tangible or intangible assets that are subject to depreciation, amortization, or other

cost recovery allowable under Massachusetts law and placed in service before the legislation was enacted. Any taxpayer intending to claim this deduction is required to file a statement with the Department (on a form prescribed by the Department) on or before July 1, 2009, specifying the total amount of the deduction that the taxpayer will claim.

## What else is there?

*Corporate excise rate reduction.* Typical of many combined reporting enactments is an accompanying rate reduction—often done to mitigate the impact that combined reporting has on businesses. Massachusetts did the same, reducing its corporate tax rate. However, because of the state's complex tax structure, there are numerous rate changes. The basic corporate excise tax rate imposed on the net income of corporations is gradually reduced starting in 2010 from the current 9.5 percent to 8 percent; for financial institutions, the rate is gradually reduced from 10.5 percent to 9 percent. S corporations that are subject to the state's "sting tax" (see *Taxation of S Corporations*, below) will also have their rates gradually reduced over this period.

*Conformity to federal entity classification rules.* Prior to H 4904, Massachusetts had adopted, with certain exceptions, the federal entity classification rules only with respect to limited liability companies and had its own rules for determining whether other types of unincorporated legal entities were taxed as corporations, partnerships, corporate trusts, etc. H 4904 expands the application of the federal entity classification rules to most all business entities for purposes of determining their Massachusetts tax classification.

*Taxation of S corporations.* Under H 4904, qualified subchapter S subsidiaries (QSUBs) are no longer subject to separate entity level taxation. Under the previous rules, (1) all income, property, etc., was required to be reported on a Massachusetts return filed by its S corporation parent, and (2) QSUBs were regarded entities in Massachusetts generally subject to the non-income measure of the corporate excise tax and the net income measure on a separate entity basis to the same extent as S corporations.

In addition, financial institutions that were S corporations federally were subject to the financial institution excise tax at the same income tax rate as other financial institutions. Under the new legislation, such S corporations are subject to a "sting tax" similar to that imposed on S corporations subject to the general corporate excise tax (which is imposed at a rate lower than that imposed on financial institutions).

*Taxation of corporate trusts.* Under the previous rules, corporate trusts were subject to the Massachusetts personal income tax on a separate entity basis. H 4904 repeals this regime and such entities will now be taxed in accordance with their classification for federal income tax purposes. H 4904 makes clear that its intent is to ensure that any tax-free earnings and profits accumulated by an entity formerly treated as a corporate

trust are subject to Massachusetts tax (at either the owner or the entity level). In addition, H 4904 gives the Commissioner the authority to issue regulations to determine the methods for taxing these previously untaxed amounts. The legislation also permits corporations to deduct dividends received from corporate trusts to the extent such dividends do not represent tax-free earnings and profits of the entity (as such term was defined and in effect on December 31, 2008). Currently, corporations subject to the general corporate excise tax are not permitted to deduct dividends received from a corporate trust.

*Other changes.* For tax years beginning on or after January 1, 2009, a corporation that is protected by Public Law 86-272 and, thus, would not be subject to the net income measure of the general corporate excise tax would be subject to the non-income measure of the tax. Under current Massachusetts regulations, both components of the corporate excise tax are not imposed in cases where the corporation is protected by Public Law 86-272. In addition, when determining the Massachusetts sales factor, the term "sales" does not include receipts from "good will" or similar intangible value (including "going concern value" and "workforce in place") resulting from the sale or deemed sale of a business. Currently, receipts from good will resulting from a sale or deemed sale of a business are included in the Massachusetts sales factor and can have a significant impact on a taxpayer's Massachusetts apportionment percentage.

## What it all means

Some of the complexities of Massachusetts tax law have been magnified by the enactment of combined reporting. In addition, H 4904 leaves many questions that are expected to be addressed via regulation and will likely increase the challenges in complying with this new regime. Consequently, taxpayers are encouraged to examine their structures (taking into account administrative guidance as it becomes available) to determine the impact that H 4904 will have on their overall Massachusetts corporate tax liability.

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# Taxing e-commerce: New York and other states try new approaches

E-commerce has created a host of challenges for state tax officials. Arguably, one of the most significant challenges is trying to ensure that online purchases from remote e-commerce retailers do not escape sales and use taxation. Although individual purchasers are required to pay use tax on out-of-state purchases, most never do. Many state officials believe it would be much easier for states to require out-of-state retailers to collect and remit sales tax than it would to try to force millions of individuals to pay use tax on out-of-state purchases. While that may be true, such an approach has a major problem: some out-of-state retailers have no physical presence in the state; however, that state may attempt to impose sales and use tax collection and remittance duties on them. And if retailers lack physical presence in the taxing state, the state cannot constitutionally require them to collect and remit the tax.

That has not, of course, stopped states from trying. This article addresses the constitutionality of New York's recent attempt to require online sellers to collect sales and use tax on purchases made by residents in the state. It also examines other state and federal initiatives to use related entities as a means to tax e-commerce.

## New York targets affiliate marketing

New York State is currently attempting to skirt the physical presence requirement for certain companies that use affiliate marketing programs. Affiliate marketing is an Internet-based marketing practice that rewards "affiliates" for driving customers to a company's website. With an affiliate marketing program, affiliates add content to their websites by linking to products and services offered by the e-commerce retailer. In return for those links, affiliates typically earn a small commission. Effective June 1, 2008, New York broadened its definition of "vendor" in NY Tax Law §1101(b)(8) to provide that persons making sales of property or services are "presumed to be soliciting business through an independent contractor or other representatives if the seller enters into an agreement with a resident of that state under which the resident" is paid a commission or other consideration for referring customers to the seller. Vendors are required to collect and remit New York sales tax.

Amazon.com, Inc. and Overstock.com, Inc., two companies that use affiliate marketing programs, have filed lawsuits challenging the constitutionality of the new law on grounds it violates the Commerce and Due Process Clauses of the U.S. Constitution. Although they are challenging the law, both companies have taken steps to comply with the new law while it is in effect. Amazon has begun collecting sales tax on purchases shipped to New York, while Overstock has discontinued its affiliate program with any New York residents.

## The new definition of a New York "vendor"

Under the new law, the presumption of who is considered to be a vendor for sales tax purposes includes sellers with over $10,000 in sales as a result of affiliate referrals to New York customers in the previous four quarters.

In May 2008, the New York Department of Taxation and Finance issued TSB-M-08(3)S to further explain the new vendor definition. According to that memo, two conditions must be met. First, the retailer must enter into an agreement with a New York State resident under which the resident directly or indirectly refers potential customers to the retailer, whether by a link on a website or otherwise, for a commission or other consideration. Second, the retailer's gross receipts from sales to customers in the state as a result of those referrals must total more than $10,000 during the preceding four quarterly sales tax periods. The retailer is also considered to have an agreement with a New York resident if the retailer enters into an agreement with a third party where the third party enters into an agreement with a New York resident to act as the retailer's representative. Finally, although an agreement to place an advertisement does not give rise to the presumption, placing a link on a website that, directly or indirectly, links to the retailer's website does give rise to the presumption, provided consideration is given for placement of the link on the affiliate's website.

## Rebutting the presumption

New York provides a means for an e-commerce retailer to rebut the presumption that it is soliciting sales in the state through any in-state affiliates. Each year, the retailer must submit an annual certification, signed by the in-state affiliates, indicating that the affiliates have not engaged in any activities in the previous year that would create the presumption that affiliates are soliciting business. The tax department has said that it will deem the presumption rebutted if the retailer is able to establish that the only activity of the affiliates in the state is a link provided on the representatives' websites to the retailer's website. The affiliate cannot engage in any solicitation activity targeted at New York customers on behalf of the retailer. It is presumed that New York will construe what constitutes a solicitation activity very broadly. Language in an agreement between the retailer and the affiliate indicating that the affiliate is not permitted to engage in solicitation activities on behalf of the retailer is not sufficient to rebut the presumption. The retailer must also be able to demonstrate that there is a real prohibition against solicitation activities by New York affiliates and that the affiliates are complying with that prohibition.

## Constitutional implications of the New York legislation

The change to the New York law raises several constitutional red flags. The first issue is Commerce Clause nexus. The Commerce Clause mandates that a company be physically present in the taxing state before that state can impose on the company the duties to collect and remit sales/use tax. The U.S. Supreme Court's opinion in *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992), is the most recent Supreme Court pronouncement on that issue. The Supreme Court held that an out-of-state seller must have "substantial nexus" with the taxing state before the state can require the company to collect and remit sales and use tax. The Supreme Court also concluded that "substantial nexus" requires physical presence in the taxing state. The result was that *Quill* established a bright-line physical presence requirement before a state can impose sales and use tax responsibilities on an out-of-state company.

While *Quill* might appear to immediately render New York's vendor law unconstitutional if a retailer is not physically present in the state, New York believes that in the case of an affiliate marketing or other similar program, a retailer's in-state affiliates can satisfy *Quill's* physical presence requirement and therefore create sales tax nexus for the retailer. Two U.S. Supreme Court cases, *Scripto Inc. v. Carson,* 362 U.S. 207 (1960), and *Tyler Pipe v. Washington Dep't of Revenue*, 483 U.S. 232 (1987), address the issue of using sales representatives to create nexus and are insightful for an analysis of the New York law.

In *Scripto*, the Court held that Florida could make a Georgia corporation responsible for collecting use tax on its Florida sales because the corporation had 10 independent contractors who were "actively engaged" on the ground in Florida. In *Tyler Pipe*, the Court addressed the issue of independent contractors with respect to a business and occupation tax exemption. The Court concluded that Tyler Pipe had nexus with Washington based on the activities of independent contractors, who were sales representatives responsible for calling on customers in Washington, soliciting orders, and maintaining "long-established and valuable relationships."

While both of these cases found nexus based on the salespersons' activities, the facts are distinguishable from most affiliate marketing situations in which the New York definition of vendor would apply. The relationships between the sales representatives in *Scripto* and *Tyler Pipe* and the respective companies were far more extensive than the relationship of an e-commerce retailer with participants in an affiliate marketing program. With Amazon, for example, affiliates (which Amazon also refers to as "associates") provide Web links to Amazon products and services. Their work is passive in nature. Amazon has little control

over the work of the associates and the associates have no control over the sales transaction after a customer leaves the associates' websites. Associates do not call on customers, directly solicit orders, or establish long-term customer relationships on behalf of Amazon. Participation in the Amazon associate program is typically a very part-time job, with many associates earning less than $100 per month. In essence, the relationship between an Amazon associate and the company is limited.

While there may be support that the New York law violates the Commerce Clause as it applies to vendors that use an affiliate or associate program, the New York law also raises potential Due Process Clause concerns. In *Quill*, the U.S. Supreme Court reiterated its holding that the Due Process Clause requires "some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax." In essence, as the Court stated in, *Murdock v. Commonwealth of Pennsylvania*, 319 U.S. 105 (1943), the ultimate question is "whether the state has given something for which it can ask a return." Unlike Commerce Clause nexus, physical presence is not required for Due Process nexus. Also, under the attributional nexus theory, an in-state representative or associate may create Due Process nexus for an out-of-state retailer. To evaluate whether Due Process nexus exists, a court would focus on the existence of an agency relationship between the affiliate and the retailer or on whether the retailer had purposefully availed itself of the benefit of a particular state's economic market such that it could expect to defend a law suit there.

Establishing Due Process nexus is certainly easier for the state than establishing Commerce Clause nexus, but New York could still encounter problems with the Due Process Clause if a court examined whether an agency relationship exists between the in-state affiliate and the retailer because such a relationship simply does not exist. An e-commerce retailer does not have control over affiliates in an affiliate marketing program and the affiliates do not consider that they work on behalf of or are under the control of the retailer. In fact, the agreement between a retailer and an affiliate generally states that the affiliate cannot act on behalf of the company. Affiliates also have no involvement in the sales transactions after a customer clicks through the link on an affiliate's website.

No matter how one analyzes or views the New York vendor law, New York faces serious challenges to its law from the lawsuit. The new law seems to encounter Commerce Clause problems and is also on questionable legal ground with the Due Process Clause.

## Actions by other states

Although New York is the first and currently only state to attempt to use affiliate marketing as a means of establishing nexus for sales tax purposes, it is not the only state exploring the issue of how to use affiliates of related entities to create sales and use tax nexus for an out-of-state retailer. Texas has announced it is examining the business presence in the state of affiliate marketing companies to determine whether they should collect Texas sales and use tax. The issue in Texas would be slightly different than in New York if, for example, a distribution center is located in Texas, even if such a center were independently operated by a subsidiary.

The California State Board of Equalization (SBOE) issued a memo in June 2008 addressing the change in New York law. SBOE staff concluded that affiliates are advertisers that simply maintain links on a Web page. They are not salespersons operating on behalf of an out-of-state retailer. In California, an out-of-state company is only considered to have nexus in the state if it has salespersons engaged in actual selling activities on behalf of the out-of-state retailer. As a result, out-of-state retailers are not required to collect sales/use tax from purchases driven by a link on an affiliate's website. The memo warns, however, that an affiliate may engage in activities to promote the link, which may suffice to establish that the affiliate is a salesperson for the retailer. Nonetheless, simply maintaining a link is not sufficient to create nexus in California.

Other states have taken steps in the direction of the New York law. Arkansas enacted legislation in 2001 requiring that remote vendors collect use tax if the vendor is related to another vendor with physical presence in the state. In 2002, the Minnesota Legislature clarified that the definition of a "retailer maintaining a place of business in the state" includes an affiliate of a retailer. An entity is considered an in-state affiliate of an out-of-state retailer if it promotes the business of or provides services to the out-of-state entity and the entities are related parties.

The Idaho Legislature passed a bill, effective July 1, 2008, stating that if an out-of-state retailer and an in-state business are related and use "an identical or substantially similar name, trade name, trademark or good will to develop, promote or maintain sales," substantial nexus is created for the out-of-state retailer. In April 2008, Missouri issued a letter ruling explaining that an out-of-state company that sells non-prescription durable medical supplies was not required to collect or remit use tax on its sales to Missouri customers because it lacked nexus. The ruling also noted that "advertising in the state

through media" is not a sufficient connection to create nexus. Arizona has issued a ruling explaining the imposition of transaction privilege tax or the responsibility for use tax collection by out-of-state or Internet-based vendors. The ruling states that the crucial factor governing nexus is whether the activities performed in the taxing state on behalf of the vendor are "significantly associated" with the vendor's ability to establish and maintain a market in Arizona.

Finally, no discussion of attempts to require remote sellers to collect sales tax would be complete without a mention of the Streamlined Sales and Use Tax Agreement (SSUTA). The SSUTA was designed to simplify states' sales tax systems by providing states with uniform definitions, paperwork, and registration. Twenty-three states currently participate, meaning they have brought their laws into conformance with the SSUTA or will do so in the future. One of the largest issues the SSUTA is trying to deal with is the taxation of remote e-commerce sales. Many states joined the SSUTA in the hope that either sales tax systems will be simplified enough so that Congress can pass legislation to require remote sellers to collect sales/use tax or that the U.S. Supreme Court will determine that requiring remote sellers to collect sales tax is not burdensome on interstate commerce, thereby overturning the *Quill* decision.

## Federal action

On October 1, 2008, U.S. Senator Jim Bunning (R-KY) introduced a bill (S 3670) that would bar states from requiring "collection and remittance of a State tax" by any person where the collection would result from the electronic commerce of that person and the person lacks a physical presence in the state during the taxable year. The bill borrows nexus language from the proposed business activity tax nexus legislation, including the definition of physical presence. The bill would also establish a de minimis physical presence standard, where physical presence does not include "entering into an agreement to share revenue generated by an electronic commerce presence owned and operated by a person who is physically present in a State." Although sales and use taxes are not singled out in this bill, there is no question that passage of this bill would prevent New York and any other state from imposing tax collection duties on e-commerce vendors like Amazon and Overstock that use individuals to push Internet traffic to their websites in exchange for a small commission.

## Going forward

If the New York law is struck down as a violation of the constitutional requirements set forth by the U.S. Supreme Court, the discussion is not likely to end. States, hard-pressed for revenue, will continue to push the envelope. New York will likely be just the first in a long line of states that attempt to require out-of-state e-commerce retailers to collect sales and use tax, despite a lack of physical presence in the taxing state. Taxpayers should continue to challenge efforts by states to circumvent constitutional requirements. Until Congress or the U.S. Supreme Court speaks on the issue, states must adhere to the established constitutional mandate that physical presence is required for sales and use tax nexus. Taxpayers could also throw their support behind the SSUTA or other federal efforts to simplify sales and use tax collection. Although the SSUTA has had only limited success, a nationwide simplification program is likely the only way to prevent states from enacting burdensome legislation like the New York vendor law.

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# State withholding requirements: A tricky issue for pass-through entities and their nonresident owners

In recent years, there has been a dramatic rise in the number of businesses operating in pass-through entity form. Case in point: the use of pass-through entities in Wisconsin increased 265% from 1996 to 2004 and, by the end of 2004, there were approximately three times as many pass-through entities in Wisconsin than "C" corporations. This explosion in the number of pass-through entities is representative of a trend across the country.

Both states and taxpayers face challenges with respect to the taxation of owners of a pass-through entity who are not residents of the state(s) where the entity does business. As the number of pass-through entities has risen, the magnitude of those challenges has likewise increased.

States perceive non-compliance with nonresident income tax reporting by owners of pass-through entities as creating huge revenue losses. However, similar to collecting use tax owed to the state on out-of-state purchases, collecting revenue by going after nonresident owners of pass-through entities one-by-one creates significant costs and heavy administrative burdens on state departments of revenue.

In response to these perceived losses, some states have adopted procedures to minimize the revenue loss while shifting the collection burden. This has included requiring pass-through entities to withhold on the distributive shares of income to nonresident owners. Since 2002, eleven states have enacted legislation that requires pass-through entities to withhold income taxes on distributions made to certain nonresident owners, bringing the number of states that require withholding or mandatory composite returns to thirty-two.

Each time new legislation is enacted, the pass-through entity must evaluate the impact on its compliance requirements to ensure that it does not inadvertently miss a tax payment or a filing deadline. Not fully complying with withholding requirements could subject a pass-through entity to late filing and accuracy-related penalties as well as penalties for failure to file estimated taxes. Accordingly, a failure by a business to actively track state developments regarding withholding requirements and accurately incorporate those requirements into its compliance function can quickly blossom into a significant penalty and/or interest liability.

As companies struggle to keep up with these burdensome filing requirements, they may not have time to examine whether the requirements are constitutional. Is there a constitutional basis for requiring the pass-through entity to withhold and remit payment on behalf of its nonresident owners? Do these withholding requirements unconstitutionally discriminate against the nonresident owners if they are forced to submit to lower filing thresholds than their similarly positioned resident owners? Does the policy of compliance simplification posed by the states provide the constitutional footing for the increasingly complex burdens being placed on the pass-through entities? This article will address some of the administrative and constitutional aspects of pass-through entity state withholding compliance.

## The administrative burdens of withholding on distributions to nonresidents

When looking at a single state's withholding requirements, compliance may seem like a relatively straightforward exercise. But as with most state tax issues, even the most straightforward compliance requirements can quickly turn into a complex research project because each state has its own unique requirements.

For example, a state may require withholding on a nonresident owner whose annual distribution from the pass-through entity exceeds $1,000. This requirement seems relatively simple, but even with the simplest example, questions arise. Which nonresident owners are subject to withholding—all nonresident owners or only non-corporate owners? Does "non-corporate owners" include estates, other pass-through entities, trusts, and exempt organizations? Does the term "nonresident individual" include grantor trusts, which are not considered entities separate from their individual owner at the federal level? Does the state require withholding on "distributive" income or "distributed" income? Are the withholding rates the same for both corporate and non-corporate owners? Is there an ability for some or all of these nonresident owners to elect out of withholding and, if so, what process is necessary to document this election? Clearly, as the number and types of owners grow so do the issues that must be examined to accurately and completely meet each state's compliance requirements.

In addition to the complex determinations regarding the types of nonresident owners whose pass-through income must be withheld, there are also significant administrative compliance issues, such as whether estimated payments are required and, if so, what are the thresholds, rates, and due dates. Further, there may be possible exceptions or affirmative elections out of the withholding requirements.

When these issues are researched in one state only, the task may not be overwhelming; however, for most business organizations that are conducting business through a pass-through structure, "simple" is rarely an adjective that describes either the structure or the mix of owners. Often the pass-through entity is an owner in a much larger tiered pass-through structure that has been established to facilitate investments and contributions among its owners. As an investment vehicle, the pass-through entity's owners may be widely varied, including individuals, funds, tax-free entities, foreign and domestic corporations, etc. Additionally, the investments are often in many states, necessitating research for each jurisdiction.

## Constitutional limitations on states' jurisdiction over nonresident owners of pass-through entities

Clearly, the lack of uniformity in nonresident withholding requirements among the states has created a significant compliance burden for multistate pass-through entities and their nonresident owners. In addition to these burdens, one must also consider whether withholding requirements on nonresident owners of pass-through entities are constitutional.

### The Due Process Clause

The U.S. Supreme Court has held that the Due Process Clause of the U.S. Constitution "requires some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax." In the context of requiring pass-through entities to withhold, the question will be whether a nonresident member has availed itself of the privilege of conducting business in the state if such member's only activity is the passive holding of an interest in the pass-through entity. The Due Process Clause decisions shaping the debate on the legality of requiring pass-through entities to withhold are *State of Wisconsin v. J.C. Penney Co*., 311 U.S. 435 (1940), and *International Harvester Co. v. Wisconsin*, 322 U.S. 435 (1944).

The tax at issue in *International Harvester* was the Wisconsin Privilege Dividend Tax, which was imposed on both foreign and domestic corporations doing business in the state "for the privilege of declaring and receiving dividends" out of income derived from property located and business transacted in the state. The payor corporation was required to deduct tax from the dividends payable to both resident and nonresident stockholders. The tax was measured by a formula that purportedly determined how much of the dividends were derived from the income earned in Wisconsin.

The taxpayers in the case were non-domiciliary corporations doing business in Wisconsin. Their dividends were declared at a directors' meeting held outside Wisconsin and drawn on accounts held outside the state. Although the tax was upheld, according to the Court the substance of the question on the constitutionality of the tax had been decided a few years earlier in *J.C. Penney*.

In *J.C. Penney*, the Court sustained the constitutionality of the Privilege Dividend Tax under the Due Process Clause, stating that the "practical operation" of the tax was not to impose payment of the tax until the earnings were paid out in dividends. The general income tax was considered a tax on income taken in, while the dividend privilege tax was a tax on corporate income that was paid out.

There is a clear distinction, however, between income earned and dividends paid out of earnings and profits. The *J.C. Penney* Court tried to get around this issue by saying it is still a tax on the corporation. The true burden of the tax, though, remained on the shareholder. Furthermore, if the tax was truly on the dividend declaring activities, how can one say that these activities, which occurred in New York, were purposefully directed at Wisconsin?

The U.S. Supreme Court offered clarification on this issue in its opinion in *International Harvester*, by stating that "in point of substance, [the tax is] laid upon and paid by the stockholders." However, the Court did not find this classification made any difference as to its constitutionality. The Court stated:

> In taxing such distributions, Wisconsin may impose the burden of the tax either upon the corporation or upon the stockholders who derive the ultimate benefit from the corporation's Wisconsin activities. Personal presence within the state of the stockholder-taxpayers is not essential to the constitutional levy of a tax taken out of so much of the corporation's Wisconsin earnings as is distributed to them. A state may tax such part of the income…of a non-resident as is fairly attributable either to property located in the state or to events or transactions which, occurring there, are subject to state regulation and which are within the protection of the state and entitled to the numerous other benefits which it confers.

The *J.C. Penney* Court ruled that because the tax was imposed on the dividend payor, there wasn't a constitutional problem because the corporation was doing business in the state. The problem, however, is that in *International Harvester*, the majority stated there was no real difference between the payor and the recipient. However, as Justice Jackson made clear in his dissent:

> These dividends of course are income to the stockholder, and any state with jurisdiction to tax him may tax them as such. But I am unable to agree that having 'afforded protection and benefits' to a corporation gives jurisdiction to tax the incomes of all its stockholders. Nor do I think that because the state has once permitted the corporation to do business and make earnings in the state its taxing power follows those earnings into the hands of third persons to whom they may be paid… If there is power in Wisconsin, because funds were earned there, to tax the receipt of a dividend, there is no reason why it should not also have power to tax the recipients of corporate funds as wages, salaries, or as payment of any other obligation.

It appears logical to assume that there is a distinct difference between taxing the payor or the recipient and, should the Court ever revisit this case, that difference may lead it to a different decision.

### The Commerce Clause

Because nonresident withholding affects interstate commerce, any examination into its constitutionality should include an examination of the Commerce Clause. Although the Court did not undertake a Commerce Clause analysis in either *J.C. Penney* or *International Harvester*, how would the cases fare under a modern-day Commerce Clause analysis? Under *Complete Auto Transit Inc. v. Brady*, 430 U.S. 274 (1977), had Wisconsin imposed a tax directly on the shareholders, the Court would have to determine whether the nonresident shareholders had substantial nexus with the state. Given the fact that the corporation is by statute a separate legal entity, unless the activities of the Wisconsin corporate dividend payors were performed for the benefit of the separate businesses of the shareholders, it is unlikely substantial nexus over the corporate shareholders would exist.

Also, assuming nonresident owners do nothing in the forum state that benefits the pass-through entity doing business in the state, it can be argued that the holders of the interests are mere investors holding intangible property and cannot be taxed on income from that investment any more than a state—*International Harvester* notwithstanding—would tax dividends received by nonresident individuals or corporations with no entity nexus in the taxing state.

However, given the rush by states today to assert economic presence nexus, the outcome of such an argument may be that any person can be taxed on any income derived from any state. Under an economic nexus theory, a state may assert nexus between income earned by a nonresident and the state where that income was generated notwithstanding the fact that the income recipient had no other connection to the state. States faced with the difficulty of directly collecting taxes from nonresidents are devising practical ways to indirectly collect the tax, yet they are possibly ignoring the constitutional substantial nexus issue.

Another Commerce Clause issue with nonresident withholding is discrimination. Is it possible to argue that a withholding requirement on distributions to nonresidents only, and not on residents, creates a classification based on residence that unduly burdens interstate commerce?

In *Panhandle Producers and Royalty Owners Association v. Oklahoma Tax Commission*, 2007 OK CIV APP 68, 162 P.3d 960, decided 3/28/07, the Oklahoma Court of Civil Appeals was asked to address the constitutionality of an Oklahoma statute requiring operators to withhold income tax from oil and gas royalty payments made to nonresidents of Oklahoma.

The statute required payors of oil and gas royalties to withhold five percent from the royalties paid to nonresidents and remit that amount to the state. The statute exempted from the withholding requirement those royalty payments made to Oklahoma residents.

It granted nonresidents a credit toward taxes owed for the amounts withheld and a refund if the amount withheld exceeded their income tax liability. The taxpayer, Panhandle, asserted that the statute imposed disparate taxation based on state of residence, in violation of, among other things, the Commerce Clause of the Constitution.

In rejecting Panhandle's claim, the Court of Civil Appeals was guided by the 1920 U.S. Supreme Court opinion in *Travis v. Yale & Towne Mfg. Co.* In that case, the Court upheld a New York statute that required employers to withhold taxes from the wages of employees who worked in, but lived outside the state. There was no similar withholding requirement from the wages of New York residents. The Supreme Court found there was no discrimination because the tax owed was the same for residents and nonresidents, regardless of the collection method.

In determining that the statute did not run afoul of the dormant Commerce Clause, the *Panhandle* court first observed that the statute, by way of the credit and refund mechanism, does not facially discriminate against nonresidents. Second, the court looked at the history of cases that involved Commerce Clause challenges to state taxes. Those cases involved statutes that actually impose a tax. In this instance, the statute at issue did not impose a tax, but rather merely directed a method of collecting a tax.

The *Panhandle* court stated: "Statutes requiring withholding of taxes from certain groups, including nonresidents of the taxing state, have long been upheld so long as the tax itself is not more onerous than that applicable to those not subject to withholding. That withholding may result in the temporary loss of use of the withheld amounts has not been found to be a constitutionally protected interest." The court found that the state has a "legitimate local purpose" for requiring the withholding of tax and that Panhandle did not show anything more than an incidental burden on interstate commerce.

The question in *Panhandle* was not nexus between the nonresidents and the taxing state or whether the tax was due the state, but, rather, whether the method of collecting it was unconstitutionally discriminatory. Based on the Oklahoma court's reasoning, it would appear that withholding is not per se unconstitutional when the state has no reasonable alternative to collecting a legal tax. By extension, it would follow that withholding on payments to nonresidents while not doing so for residents would be constitutionally justified.

## Conclusion

A state is permitted to tax income properly attributable to property or transactions occurring within its boundaries. However, whether a state can require a pass-through entity to withhold tax on distributions to nonresident owners is an entirely different question. In addition to the complex administrative burdens associated with pass-through entity withholding, there are constitutional questions inherent when this requirement is imposed. The strongest argument is likely that an interest alone in a pass-through entity does not create substantial nexus in the state for the owner of that interest. While the constitutional issues may eventually be settled by state courts or the U.S. Supreme Court, it is important that businesses using pass-through entities familiarize themselves with the current administrative requirements. The safest course of action, in order to avoid penalties and interest, may be to comply with the myriad of state tax requirements and then seek a refund on constitutional grounds.

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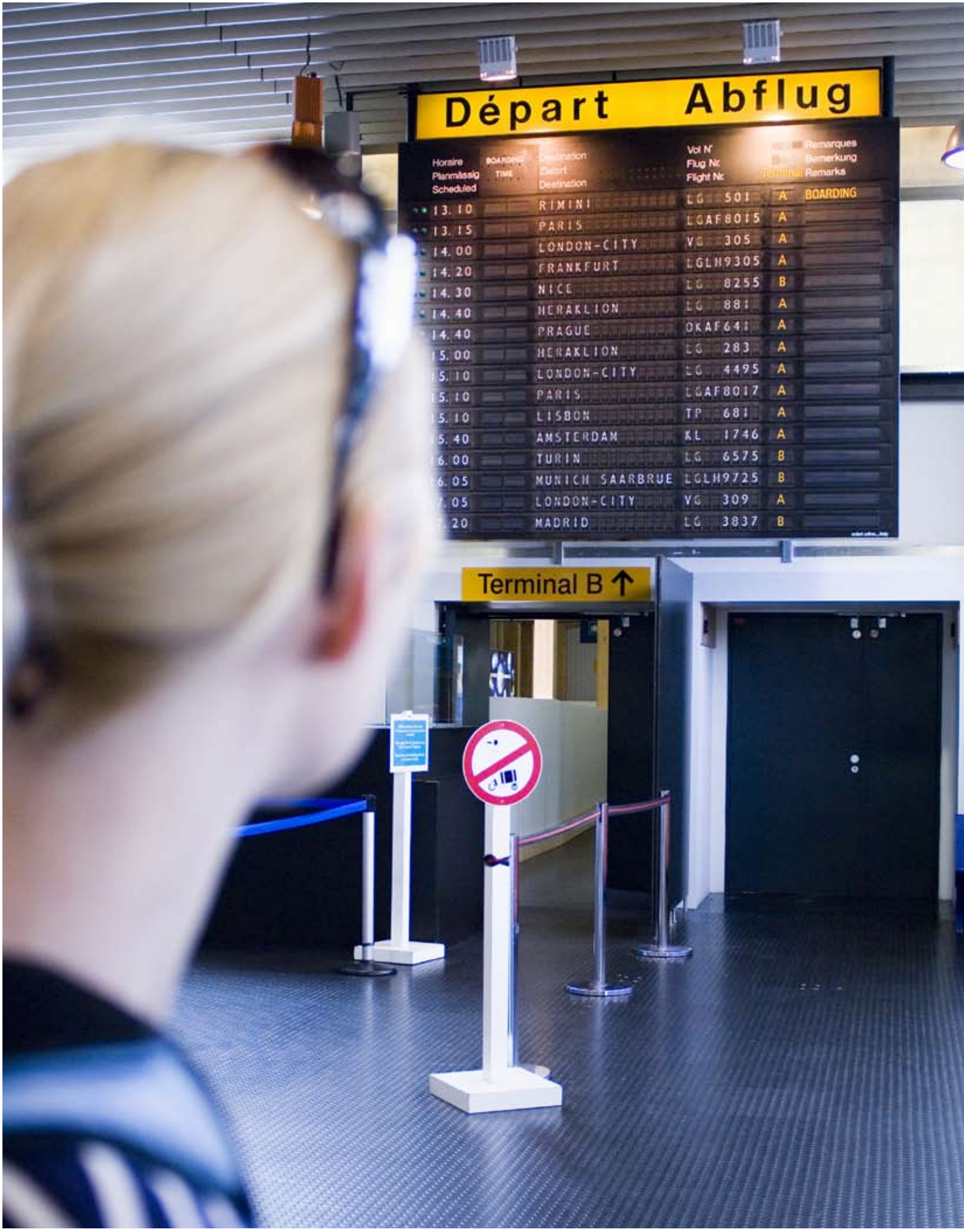
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# International assignees: The difficulties of multistate reporting in the U.S.

Multinational companies may have two types of international assignees whose activities trigger U.S. payroll reporting and individual taxation: non-U.S. employees working in various locations within the United States and U.S. employees assigned abroad who may travel to the United States for business trips during their foreign assignment period. In each case, there are U.S. tax compliance requirements for both the individual (federal and state individual income tax returns and perhaps estimated payments) and the employer (income tax withholding).

However, even employers who comply with federal payroll requirements often are not aware of the state tax compliance issues for international assignees, particularly when an employee performs activities in more than one state. In today's increased regulatory environment, higher levels of awareness and compliance are necessary to mitigate companies' and employees' heightened risks for audits, interest and penalties.

This article will explore the state tax compliance issues that companies face with respect to international assignees, including the difficulties of determining the individual tax filing requirements for assignees in their nonresident state locations, tracking multistate workdays for assignees, and employer payroll withholding and reporting requirements.

## Complex rules, complex situations

Each state has its own rules for determining whether an employee is subject to tax in that state, either as a resident or nonresident. The rules are just as varied with respect to the treatment of U.S. citizens that work abroad and non-U.S. employees working in the United States. These multiple layers of complexity can create difficulties in determining state income tax reporting and withholding requirements.

Foreign employees on an expatriate assignment in the United States are generally subject to the same state tax requirements as U.S. citizens: those who live and work in only one state and meet state residency requirements file resident individual income tax returns and are subject to withholding on all income earned in that state. However, since foreign employees may work in the United States for limited periods, it is important to look at each state's definition of a residency period, as some states allow these employees to file as nonresidents.

Generally, it may not be difficult to track the requirements for employees who work and live in one place for the entire year, e.g., a foreign employee who arrives in the United States and works and lives for an extended period within a single state. Likewise, when a U.S. employee goes abroad and stays abroad for an extended period without traveling back to the United States, tracking for these assignees can be manageable.

But reality is often less straightforward. For example, a foreign employee working in the United States may actually work in multiple states during his or her stay. Also, U.S. employees working abroad often return to the United States for vacations during their

foreign assignment period, and they may return temporarily for business meetings or other necessary work before returning abroad. While in the United States, these assignees may also spend time working in several states.

This reality often leads to noncompliance on both the part of the employee and the employer. One area that can be problematic is income tax reporting, i.e., does the employee who works in multiple states file nonresident returns as required in those states? These filing requirements often are identified, but typically, the identification is done after year-end by the tax preparer of the individual's tax returns. Even if proper nonresident state returns are filed, the individual's tax return may still be assessed with penalties and interest if there have not been adequate withholding and/or estimated payments made throughout the year. Generally, tax equalization agreements for international assignees direct companies to reimburse such interest and penalties.

Many states permit a U.S. expatriate to be classified as a nonresident during an overseas assignment. In these cases, generally only the amounts earned for work performed within that state are subject to state withholding. For example, in Illinois, residency generally ceases during the overseas assignment of an individual who was an Illinois resident immediately preceding the assignment, provided they are outside of the state for more than 12 months.

Conversely, for Colorado purposes, residency generally continues during the overseas assignment of an individual who was a Colorado resident immediately preceding the assignment, and amounts in excess of the foreign earned income exclusion (i.e., Internal Revenue Code Section 911) are subject to withholding.

A further level of complexity arises from the fact that states have diverse threshold rules for determining how many work days an employee must conduct in the state before becoming subject to nonresident taxation and withholding. As a result, adequate compliance requires that an employer accurately track the workdays of these international assignees on a state-by-state basis in order to determine which states require:

- the employee to file a nonresident individual tax return;
- the company to withhold state income taxes from the employee's wages; and
- the company to file payroll, unemployment tax and other returns.

## Easier said than done

For companies that have a payroll system capable of tracking each employee's state of work activity on a daily basis, identifying multistate workdays can be manageable. However, many payroll systems either do not or cannot capture this information. In such instances, the information would need to be tracked and updated manually by the payroll department, which is an extremely tedious process. When internal or outsourced systems do not identify the time an employee spends in multiple states, they generally also do not capture the time a U.S. expatriate works when returning temporarily to the United States.

Take the case of a U.S. employee who formerly lived and worked in Illinois, then moved, along with his family, to Italy for a three-year overseas assignment. Near the end of the first year, the employee and his family came back for an extended vacation. While the family remained in Illinois on vacation, the employee worked in Michigan for a few weeks and then worked in New York for a few weeks before they all returned to Italy. It is likely the payroll department never learned that the employee was working in any of these states, much less in the United States at all. As a result, even if the employee was subject to state tax in any of these states, there is all too frequently no withholding or payroll reporting, which leads to penalties and interest if and when the employee later files state individual income tax returns for this work activity. In addition, the employer may be assessed up to 100 percent of the tax that should have been withheld, as well as penalties and interest for failure to withhold and remit the appropriate state income taxes.

The same problem occurs for inbound foreign assignees. To the extent the employee remains in his or her resident state, withholding and reporting will generally be done correctly as long as the individual is correctly set up on U.S. payroll. The compliance problem arises in the same situations as the U.S. expatriate, commonly when the foreign assignee travels to other states to work and the company does not have the ability or the proper process in place to track the workdays and state payroll requirements.

## Paths toward compliance

Many companies do not have a system for tracking employee time (e.g., daily timesheets) in terms of workdays by state. In today's environment, a wait-and-see noncompliance strategy is far riskier than in the past because states have become increasingly aggressive about targeting temporary workers, increasing the likelihood of audits and resulting penalties and interest.

Consider a case in which an employee working abroad returns temporarily to the United States and works during his or her stay. One might erroneously conclude that a state has no way of knowing about these U.S. workdays. For example, one way that states—New York, for one—are combating noncompliance is by reviewing employee expense reports. Auditors may request expense reports for the top 100 highly paid employees that are nonresidents of New York (and not assigned to a New York work location). This review can identify which non-New York employees worked in New York and for exactly how long. The auditor can then extrapolate the result for those 100 employees to a larger employee population to arrive at an estimate of total under-withholding. The employer can be assessed up to 100 percent of the tax that should have been withheld, plus penalties and interest. Since there is a dual responsibility for state income tax, to the extent the employee has filed his or her individual income tax return and paid the correct tax to the state, the employer may not be assessed the withholding tax. However, the penalties and interest for failure to withhold would still likely be imposed.

If a company wishes to move toward compliance but is not able or ready to take on a comprehensive time reporting system that can track multistate workdays, are there solutions? We can offer some ideas that companies have successfully used as they begin to work toward multistate compliance for their international employees. A working approach includes three elements:

- knowledge of the thresholds for reporting and withholding in each state;
- development of a practical tracking system for target groups of employees; and
- a team approach involving a company's HR, tax and payroll departments.

## Know the rules

Many states have a de minimus threshold that determines when an employee working within a state becomes subject to reporting and withholding requirements; however, each state's rules are a bit different. The chart in the appendix at the end of this article summarizes the de minimus withholding requirements for nonresidents in several states in order to provide an idea of the wide variety of state rules. For example, while non-residents have a personal filing obligation, New York has a 14-day rule stating that no withholding is required if a nonresident is assigned to a work location outside the state and works 14 days or less during the year in New York. Both Georgia and Hawaii maintain several thresholds used in determining whether nonresident withholding is required, as shown in the chart. On the other hand, the de minimus withholding thresholds are so low in other states such as California and Ohio that an employee can be subject to withholding from the first day services are performed within the state.

It is important to note that some states maintain reciprocal agreements with their neighboring states, which can also affect nonresident withholding. A reciprocal agreement generally provides that if an employee lives in one state and works in another, withholding is permitted in the employee's resident state rather than in the employee's work state, which is normally required. For example, an employee who lives in Pennsylvania and works in Ohio would be subject to Pennsylvania withholding rather than Ohio, as indicated by Appendix I.

## Develop a practical tracking system

Knowledge of the rules must go hand in hand with tracking employee time to identify withholding and reporting requirements for specific employees. For those companies who cannot or are not ready to implement a daily state-by-state reporting system for all employees, a company can consider moving toward compliance by identifying specific target groups of employees representing the most significant exposure (e.g., highly paid employees, those employees who travel frequently or the expatriate population). A company could then develop an alternate system for tracking multistate working days for these employees.

A company might utilize a variety of tracking mechanisms. Here are two possibilities:

*Expense report based system.* One way to identify multistate workdays and withholding/reporting requirements is by utilizing employee travel and expense reports. This method requires communication between the payroll department and those responsible for reviewing, approving and reimbursing employee travel and expense reports. One approach is to conduct quarterly or semiannual expense report reviews in which the payroll department would perform a "day count" to determine how many days an employee has performed services in other states and whether they meet the de minimus threshold in the state for withholding. The review could be conducted for a specific group of employees or a random sample of employees.

*Calendar system.* International assignees meeting certain thresholds (e.g., based on pay levels) could be required to report their whereabouts on a regular basis to the payroll department. An electronic reporting system that tracks state workdays on a real-time basis can be utilized for certain employees. A simplified system could ask employees to estimate their planned workdays by state at the beginning of the year, and payroll could develop percentages by state and take those percentages from each paycheck throughout the year. The limitation with this approach is that, in January, an employee may not know that he or she will need to go to a particular state later in the year, or for how long, but it may work for those employees whose work tends to follow a pattern.

## A team approach

We often see a disconnect between HR, payroll and tax departments when it comes to reporting for international assignees, and no specific group assumes responsibility for compliance in this area. For example, the HR group may consider its responsibilities fulfilled for an employee going abroad when they have arranged the move, housing allowance and other aspects of the relocation. The tax department may consider its role complete when the employee's tax returns have been finished, while the payroll department may not be aware of an employee's multistate travels or aware of the reporting rules for international assignees.

Add to the mix the fact that many companies use third-party payroll providers and the opportunity for noncompliance increases yet again because everyone may assume that the third-party provider has attended to all withholding and reporting requirements. Companies need a coordinated effort that looks at what is actually happening and asks where employees are, where they are traveling and whether they are being taxed in the proper jurisdictions.

In order to work toward compliance, HR, payroll and tax will most likely need to work together within an organization to find a workable solution that accounts for the unique characteristics of its systems and its employees.

## Prepare for a bumpier road ahead

Always in search of revenue, states are beginning to more aggressively audit in this area, compelling companies to take a second look at their practices. New York is already auditing aggressively, and there are rumblings that Connecticut and California are considering audit programs similar to New York's.

In light of this increased regulatory environment, companies with international assignees working in the United States, even on a temporary basis, are well-advised to revisit their process for identifying reporting and withholding requirements across state lines, both in terms of identifying the need for employees to file nonresident returns and in terms of the company's obligation for withholding and payroll tax reporting. Even for companies whose payroll systems cannot track multistate workdays, a higher level of compliance is possible when the HR, payroll and tax departments collaborate to create customized and practical solutions.

## Appendix I—Chart of sample state withholding rules

The following chart summarizes the withholding rules in several states in order to illustrate the wide variety of approaches to this issue.

Note: This information is based on state rules as of March 31, 2008, and it is subject to change.

| State | Nonresident Withholding Required | Minimum Withholding Threshold for Employer | Current Withholding Reciprocity Agreements |
|---|---|---|---|
| CA | Yes | Wages in excess of "Low Income Exemption Table" amounts—see Method A, Table 1, of the California withholding tables (i.e., a semimonthly wage amount of $485 or less for a single individual is exempt from CA withholding) | None |
| GA | Yes | Withholding is not required if services performed are casual or intermittent and for no more than 23 days in a calendar quarter, or if no more than 5% of their total income is attributable to Georgia, or if no more than $5,000 of their wages are attributable to Georgia | None |
| HI | Yes | Withholding is not required on wages if ALL of the following conditions are met:<br>1. The employee can show that he or she is a nonresident.<br>2. The employee is temporarily performing services in the state.<br>3. The employer can reasonably expect the employee to be in the state, in the aggregate, for less than 60 days during the calendar year.<br>4. The employee is paid for his or her services in the state from an office outside the state.<br>5. The employee does not have his or her regular place of employment for services for the employer in the state. | None |
| NY | Yes | Wages paid in excess of the employee's personal exemption; wages paid for services performed in the state for more than 14 days per year | None |
| OH | Yes | Wages paid in excess of $300 in any calendar quarter | Ohio maintains reciprocal agreements with Indiana, Kentucky, Michigan, Pennsylvania and West Virginia. Residents of these states should have their resident state tax withheld rather than Ohio tax. Employees must complete Form IT-4NR and submit to employer. |

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# Give me a break! The complicated connection between the legislative process and tax incentives

Much of the 2008 U.S. presidential campaign was devoted to discussions of how tax policy should be used as a tool to help ease the financial crisis. Should taxes be raised? If so, whose should go up? Or should rates be lowered, and if so, for whom? Should new subsidy tax breaks be offered and/or new incentive breaks? If incentives, who should get them?

To the extent that legislators consider incentives, they have a daunting task ahead of them. First, tax policy analysts disagree on the extent to which tax incentives work as intended. Some say it is difficult to determine the impact of incentives because it is difficult to know what might have happened without the incentives. In a 2006 article, "Do Incentives Affect Behavior? Would an Economist Know?" one economic consultant believes that, while economists may be unable to agree on how to measure the value of an incentive, it does not mean incentives are not effective; in fact, he believes in "the great power of some incentives even if they can't be measured well."[1] But he does point out the complexity in measurement:

> How much, then, do incentives change behavior? It depends on such factors as the size of the incentive, the way it is presented to the public, the ease with which the financial reward can be obtained through mere portfolio shifts rather than real changes in work or saving, the lag in time before people react, and often most importantly, the power of the signal on crowd or societal understanding.[2]

If the issue is complicated when considered in economic terms, consider the effect of the legislative process. For example, legislative outcomes are affected by the pressure of legislators to keep their constituents happy. The late U.S. Senator Russell Long said that when politicians consider tax reform, it is in terms of, "Don't tax you, don't tax me, tax that fellow behind the tree!" Tax legislation, like any legislation, is affected not only by tax policy but also by re-election concerns and the many other political compromises perhaps inevitable in the legislative process. In addition, the legislative process has resulted over time in overlapping tax provisions and a complicated tax code that may at times undermine the very effectiveness of a particular incentive.

Then there is the issue of information. At times, legislators may not have adequate information to make "optimal" decisions. One commentator believes that "Congress and the executive branch have made virtually no attempts to monitor whether all these tax 'gee gaws' get to the right people or promote the ends they are supposed to."[3] On the other hand, there is often too much information. For example, in one four-year period, "Congress received nearly 400 reports on energy policy, totaling some 20,000 pages, just from one source, the General Accounting Office. As a former presidential advisor [Henry Kissinger] said over [four] decades ago when the supply of information was a fraction of its current level, 'Our policymakers do not lack advice; they are in many respects overwhelmed by it.'[4]

1 Gene Steuerle, "Do Incentives Affect Behavior? Would an Economist Know?" *Tax Notes*, April 3, 2006.

2 Ibid.

3 Janet Novack, "A Tax Credit for Every Problem," *Forbes*, September 26, 2007.

4 Charles E. Lindblom and Edward J. Woodhouse, *The Policy-Making Process*, 3rd ed. (New Jersey: Prentice-Hall, Inc., 1993), 16.

The outcome of tax policy is also affected by how tax authorities and courts interpret laws. The articles in this journal provide a number of examples of the varied ways in which state tax authorities and federal and state courts interpret tax laws. One more example: In a case of a tax incentive run amuck in the Netherlands in 2005, tax authorities held that a Dutch actress training to be a witch was eligible for an educational tax deduction for course fees because she used the course "'to extend her professional knowledge'. Students learn[ed] to cast spells, prepare herbs and potions and use crystal balls as well as other aspects of witchcraft."[5]

Tax incentives are almost as old as history itself. King Antiochus of ancient Jerusalem, seeking faster inhabitation of the city, issued a decree in which he granted "both to the present inhabitants and to those who may return before the month of Hyperberetaios exemption from taxes for three years." Likewise, the Ptolemaic rulers of Egypt in the third century B.C. gave tax breaks to teachers of Greek to encourage the spread of the language. Later, the Roman emperor Augustus Caesar faced declining birth rates among the upper classes. His solution? Tax incentives for those who married and had children.

Throughout history, tax policies have been the result of trial and error to see what will work at any given moment in the face of incomplete or inconsistent information, the political process and the complexity and unpredictability of both economies and human behavior. Whatever tax legislation is passed in 2009 will be, at best, a difficult guess by policymakers and legislators at what might work best at a time of unprecedented complexity. Ogden Nash once wrote: "I never saw a purple cow, I hope I never see one. But I can tell you anyhow, I'd rather see than be one." The legislators that will decide who gets tax hikes and tax breaks in 2009 have a formidable task ahead of them—some of them may well wish they could be watching from the sidelines.

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5 http://news.bbc.co.uk/2/hi/europe/4290768.stm.

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