



Blackman Kallick

CPAs and Consultants

State and Local Tax Issues

Deborah K. Rood

Drood@blackmankallick.com

P 312.980.2995

F 312.756.3995



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What Constituted Nexus Yesterday?

- *National Bellas Hess v. Dept. of Revenue of the State of Illinois*, 386 US 753 (1967)
 - Sales tax case
 - Mail order house with principal place of business in Kansas City, Missouri and no physical presence in Illinois
 - Required a physical presence in order to prevent restriction of free trade among the states under the Interstate Commerce Clause

What Constituted Nexus Yesterday?

- *Quill Corporation v. North Dakota*, 112 S.Ct. 1904 (1992)
 - Sales tax case
 - Catalog sales but no physical presence in North Dakota
 - Required a physical presence in order to impose the tax

What Constituted Nexus Yesterday?

- *Quill Corporation v. North Dakota*, 112 S.Ct. 1904 (1992)
 - Due Process Clause Nexus – concern is fairness of tax
 - Standard – purposeful direction of activities towards residents
 - Commerce Clause Nexus – concern is effect of state regulation on the national economy
 - Standard – substantial nexus

What Constitutes Nexus Today?

- *Geoffrey, Inc. v. South Carolina Tax Commission*, 437 SE2d 13 (1993)
 - Step 1 – Operating company (Toys R Us) sells intangibles to intangible holding company (Geoffrey)
 - Step 2 – Geoffrey licenses intangibles to Toys R Us at fair market value
 - Results in Separate Company States – Expense paid to Geoffrey reduces income subject to tax

What Constitutes Nexus Today?

- *Geoffrey, Inc. v. South Carolina Tax Commission*, 437 SE2d 13 (1993)
 - A tangible, physical presence is not necessary
 - The presence of intangible property alone is sufficient to establish substantial nexus
 - Geoffrey is subject to South Carolina tax
 - U.S. Supreme Court refused certiorari

What Constitutes Nexus Today?

- How states “fight” Intangible Holding Companies
 - Courts (K Mart Properties, Sonic Burgers, Syms, Sherwin Williams, SYL, A&F Trademark, etc.)
 - Shell company not following corporate governance
 - Presence of intangible property is sufficient to create substantial nexus
 - Only business purpose is tax avoidance and that’s not a valid business purpose
 - Combined or unitary reporting
 - Expense disallowance/Add-back statutes

What Constitutes Nexus Today?

- *Lanco, Inc. v. Director, Division of Taxation*, NJ SCt. (2006) 188 NJ 380, petition for cert denied, US SCt, Dkt. No. 06-1236, 6/18/2007
 - Lanco was an intangibles holding company that licensed trademarks to Lane Bryant
 - Lanco had economic substance and was found to have nexus in New Jersey by the New Jersey Supreme Court
 - U.S. Supreme Court denied certiorari June 18th, 2007

What Constitutes Nexus Today?

- *FIA Card Services NA (formerly known as MBNA America Bank NA) v. Tax Commissioner of West Virginia* (2006) 640 SE 2d 226, cert. denied, US SCt, Dkt. No. 06-1228, 6/18/2007
 - MBNA solicited, issued and serviced credit card sales from West Virginia residents
 - MBNA sent credit card applications into West Virginia and generated revenue from West Virginia residents
 - West Virginia argued economic nexus was substantial
 - MBNA argued no physical presence
 - West Virginia Supreme Court found nexus
 - U.S. Supreme Court denied certiorari June 18, 2007

What Constitutes Nexus Today?

- Sales Tax
 - Physical presence still required
- Income Tax
 - Economic presence?
 - Exploitation of the market?
 - P.L. 86-272 applies to sales of tangible personal property
- Other Taxes (Gross receipts, Capital Stock, Margin)
 - Economic presence?
 - Exploitation of the market?

What will Nexus be Tomorrow?

- States will continue to be aggressive in applying economic nexus
- Examples
 - Michigan's Business Tax
 - Texas' Margin Tax
 - Ohio's Commercial Activity Tax
 - Kentucky Limited Liability Entity Tax
 - Massachusetts Financial Entities Excise Tax
 - New Jersey Alternative Minimum Assessment
 - Proposed Illinois Gross Receipts Tax

Michigan's New Tax System

- Senate Bill No. 94
- Signed by Gov. Granholm July 5, 2007
- Effective January 1, 2008

Michigan's New Tax System

- Nexus Standard (Chapter 3)
 - Physical presence of more than 1 day
 - Physical presence does not include activities of professionals providing services in a professional capacity or
 - Other service providers if the activity is not significantly associated with the taxpayer's ability to establish and maintain a market in this state
 - If the taxpayer actively solicits sales in Michigan and has gross receipts of \$350,000 or more sourced to Michigan
 - Active solicitation will be defined by the Department through written guidance that shall be applied prospectively
 - Mailing catalogs into the state?
 - Having a web site?

Michigan's New Tax System

- Income Tax (Chapter 2, Section 200)
 - P.L. 86-272 applies
 - Rate of 4.95%
 - Unitary calculation for unitary businesses including corporations, partnerships, LLC's, sole proprietorships, etc.

Michigan's New Tax System

- Income Tax (Chapter 2, Section 200)

- Adjustments to income include:

Additions

- Non-Michigan municipal interest
- Income taxes and Michigan taxes
- Federal net operating losses
- Royalties, interest and other expenses paid to related taxpayers for use of intangible property unless there is a non-tax business purpose

Subtractions

- Dividend and royalty income from persons other than U.S. persons and foreign operating entities
- Income subject to double taxation
- U.S. Government interest
- Earnings from self employment
- Michigan apportioned net operating loss (10 year carryforward)

Michigan's New Tax System

- Modified Gross Receipts Tax (Chapter 2, Section 203)
 - Gross receipts less
 - purchases from other firms before apportionment
 - 65% of Single Business Tax net operating losses incurred in 2006 or 2007 and not previously deducted (2008 only)
 - Purchases from other firms includes inventory and capital expenditures
 - Rate 0.80%
 - Detrimental to service providers – minimal deductions
 - Unitary concepts apply

Michigan's New Tax System

- Modified Gross Receipts Tax (Chapter 2, Section 203)
 - Special provisions reduce the tax base for:
 - Automobile dealers
 - Construction contractors
 - Self-employed individuals
 - Members of partnerships
 - Members of LLC's

Michigan's New Tax System

- Exemptions from the Taxes (Chapter 2, Section 207)
 - Most governmental entities
 - Entities exempt from federal income tax
 - Non-profit cooperative housing corporations
 - A farmers' cooperative exempt under IRC Section 521
 - The portion of the tax base attributable to
 - Production of agricultural goods by a person whose primary activity is the production of agricultural goods
 - Direct and indirect marketing activities of a farmers' cooperative not exempt under IRC Section 521
 - Services provided by an attorney-in-fact to a reciprocal insurer
 - Multiple employer welfare arrangements that provide dental benefits only

Michigan's New Tax System

- Apportionment (Chapter 3)
 - Single sales factor used to apportion both tax bases
 - The following provisions are used to calculate the sales factor:
 - For a unitary business group, sales of members without nexus in Michigan are included but intercompany sales are eliminated
 - Sourcing of Sales
 - Tangible personal property – based on *ultimate* destination
 - Sale, lease, rental or licensing of real property if the property is located in Michigan
 - Sale, lease, rental or licensing of personal property if the property is utilized in Michigan

Michigan's New Tax System

- Apportionment (Chapter 3)
 - Sourcing of Sales
 - Lease or rental of mobile transportation property to the extent the property is used in Michigan
 - Royalties if the property is used in Michigan
 - Services
 - > All the receipts are included in the numerator if the recipient receives all of the benefits in Michigan
 - > Otherwise, Michigan receipts for the portion of the benefits of the services received in Michigan

Michigan's New Tax System

- Small Business Provisions
 - Applies as long as:
 - Gross receipts are less than \$18 million, phased out between \$18 and \$20 million AND
 - Business income is less than \$1,300,000 AND
 - Officer compensation is less than \$160,000, phased out between \$160,000 and \$180,000
 - Not subject to income or modified gross receipts taxes
 - Similar to current small business tax
 - Tax rate is reduced from 2% to 1.8%

Michigan's New Tax System

- Special Taxes for Certain Taxpayers
 - Financial Institutions (Chapter 2B, Section 263)
 - 0.235% of the financial institution's apportioned net capital
 - Insurance Companies (Chapter 2A, Section 235)
 - 1.25% of premiums written on property or risk residing in Michigan

Michigan's New Tax System

- Personal Property Tax Relief (H4369 through H4372)
 - 12 mills for commercial property
 - 24 mills for industrial property
 - 35% refundable credit on remaining industrial property
- Credits (Chapter 4)
 - Credits cannot exceed 65% of total tax liability
 - SBT credits carryover
 - Compensation credit
 - Credit for Michigan improvements
 - Research and development credit
 - Credit for investing in an eligible business

Texas Margin Tax

- Effective for tax returns due on or after January 1, 2008
- Applies to most business forms including unincorporated businesses, disregarded entities, LLC's, general partnerships (unless composed entirely of natural persons), limited partnerships and business trusts, etc.
- Certain passive entities and exempt organizations are not subject to the tax

Texas Margin Tax

- According to legislation, not an income tax so P.L. 86-272 does not apply
- Economic nexus standard? Exploitation of the market?
- Combined reporting required for related entities meeting the ownership and unitary business activity tests
- Not required to pay tax if tax is less than \$1,000 or the total revenue is less than \$300,000

Texas Margin Tax

- Based on taxable margin which is the lower of:
 - 70% of total revenue or
 - Total revenue reduced by
 - Cost of goods sold or
 - Compensation
 - Certain businesses have special rules for the computation of cost of goods sold or compensation
- Single sales factor apportionment
- 1% rate for most entities, .5% rate if primarily engaged in retail or wholesale trade

Texas Margin Tax

- Technical corrections passed in June
 - If total revenue is between \$300,000 and \$900,000, a reduced rate of tax applies
 - If total revenue is less than \$10,000,000, the taxpayer can elect an alternative calculation that applies a 0.575% rate to apportioned total revenue
 - Deduction for small employers who initiate health care coverage
 - Gross rental revenue subject to tax (not net)
 - Definition of a control reduced to more than 50% (from 80%)

Ohio Commercial Activities Tax

- Enacted July 1, 2005
- Applies to most businesses, including sole proprietors and disregarded entities
- 5 year phase-in period
- Returns are due 40 days after the end of each calendar quarter
- If the taxpayer anticipates taxable receipts less than \$1,000,000, they file the minimum tax of \$150 on an annual basis – due 40 days after year-end (February 9th)

Ohio Commercial Activities Tax

- Nexus Standard – Substantial Presence
 - Owning or using part of capital in Ohio OR
 - Holding a certificate of compliance authorizing the person to do business in Ohio OR
 - Having bright-line presence in Ohio OR
 - Otherwise having nexus under the U.S. Constitution
- Bright-Line Presence
 - Taxable gross receipts sourced to Ohio of \$500,000 OR
 - In-state property of at least \$50,000 OR
 - \$50,000 of Ohio payroll OR
 - 25% of its property, payroll or gross receipts in Ohio at any point in time during the year
- Applies to gross receipts over \$150,000

Ohio Commercial Activities Tax

- Exemptions
 - Non-profit organizations
 - Most governmental entities
 - Some public utilities
 - Dealers in intangibles
 - Financial institutions and certain affiliates
 - Insurance companies

Ohio Commercial Activities Tax

- How are receipts sourced?
 - Tangible personal property – destination
 - Services – where the purchaser receives the benefit (see CAT 2005-06 for 51 examples)
 - If purchaser is only in Ohio, 100% of gross receipts are Ohio receipts
 - If purchaser is within and outside Ohio, gross receipts are Ohio receipts if only Ohio operations benefit
 - If purchaser is within and outside Ohio and service relates to all operations, gross receipts are situated to Ohio using any reasonable, consistent and uniform method of apportionment
 - Taxpayer can elect to situs based on purchaser’s “principal place of business”
 - Branch where services performed, management operations and billing address are considerations

Ohio Commercial Activities Tax

- Planning opportunities
 - Combined groups versus consolidated groups
 - Alternative Method to Source Services – available when the taxpayer has difficulty or is unable to obtain records required to follow stated rules
 - Focus on the location where the purchaser ultimately uses or receives the benefit of the service

Kentucky Limited Liability Entity Tax

- Replaces the alternative minimum calculation
- Applies to tax years beginning on or after January 1, 2007
- Applies to C corporations, S corporations, LLC's, limited partnerships, and limited liability partnerships doing business in Kentucky
- First payments were due June 15, 2007

Kentucky Limited Liability Entity Tax

- Based on Kentucky gross receipts or Kentucky gross profits
- Tax is lesser of
 - \$0.095 per \$100 of the entity's Kentucky gross receipts or
 - \$0.75 per \$100 of Kentucky gross profits
 - But there is a \$175 minimum tax
- Exemptions – include REITs, RICs, REMICs, PSCs, co-ops, and others
- Credit for tax paid by lower-tier limited liability entities
- Qualifies for an income tax credit

Introduced Legislation - The Business Activity Tax Simplification Act of 2007

- S. 1726
- Introduced June 28th
- Introduced by Schumer (D, NY) and Crapo (R, ID)
- Previous versions (2000 & 2006) did not get out of committee
- Seeks to create a bright-line nexus standard for business activity taxes

Introduced Legislation - The Business Activity Tax Simplification Act of 2007

- Expands P.L. 86-272
 - Includes sales “Other than Tangible Personal Property”
 - Application to Other Taxes
 - Expanded to include “other business activity tax”
 - Taxes in the nature of a net income tax, or
 - Tax measured by the amount of, or economic results of, business, or
 - Related activity conducted in the state
 - Exclusions
 - Sales, use and other transaction taxes

Introduced Legislation - The Business Activity Tax Simplification Act of 2007

- Expands P.L. 86-272
 - Exempts the following physical presences
 - 15 or fewer days considered *de minimis*
 - Storage of inventory with an independent contractor
 - Presence in the state is to conduct limited or transient business activity
- Applies to taxable periods beginning on or after January 1, 2008
- What can I do?
 - Ask Congress to enact this law

Nexus and Talking to Clients

- Client, you need to file income/gross receipts and sales tax returns in more states
- Reaction 1 – I’m not doing it!
 - Income Tax
 - Are you paying tax in your “home” state via the throwback rule?
 - Risks – Double taxation, penalties and interest
 - Not paying tax on this activity
 - Risks – Penalties and interest
 - Sales Tax
 - Risk – Paying tax your customer should be paying!
 - Other Risks – Penalties and interest
 - FIN 48 – Disclosure may be required if material
 - SFAS 5 disclosure for sales taxes not collected and remitted

Nexus and Talking to Clients

- Reaction 2 – Oh my! I can't believe I'm not following the law 100%. How did you let this happen?
 - Not filing tax returns is like speeding – it's against the law, but if you're willing to pay the ticket, go ahead and do it
 - What is the amount really at risk?
- What can I do?
 - File prospectively
 - Voluntary disclosure
 - Amnesty programs

Amnesty Programs

- Texas
 - June 15 – August 15, 2007
 - Penalties and interest abated
 - Sales, franchise and all other state and local taxes and fees administered by the comptroller
- Iowa
 - September 4 – October 31, 2007
 - Penalties and ½ of interest abated
 - Taxes must have been delinquent as of December 31, 2006
 - Individual income, corporate income, franchise, sales, excise, fuel, inheritance, estate and other taxes

FIN 48 and Other Financial Statement Considerations

- Who does it apply to?
 - Anyone who issues audited, reviewed or *compiled* financial statements
- FIN 48 only applies to income tax
- But all my clients are S corporations, LLC's or partnerships, they don't pay tax!
 - Do you have a valid S election?
 - Do you have a valuation on the date of the S election so your built-in-gains tax exposure is minimal?
- What about entity level taxes?

FIN 48 and Other Financial Statement Considerations

- Potential state and local issues
 - Nexus
 - One-time activity or recurring activity
 - What are employees doing in the state
 - How has the state treated economic presence
 - Is activity in the state substantial
 - Apportionment
 - Gross or net proceeds
 - Throw-back, throw-out, throw-up
 - Sourcing of services – cost of performance

FIN 48 and Other Financial Statement Considerations

- Potential state and local issues
 - Calculation of taxable income
 - Add-backs and subtractions
 - Depreciation adjustments
 - Business/non-business income
 - Transfer pricing
 - Flow-thru of federal tax changes
 - Tax Attributes
 - Federal and state net operating losses
 - Credits
 - Unitary/combined filing groups

Introduced Legislation - Streamlined Sales Tax Project

- Introduced May 22, 2007
- Introduced by Enzi (R-Wyo)
- S. 34

Introduced Legislation - Streamlined Sales Tax Project

- Purpose – Simplify the sales tax system enough so that Congress will lift the physical presence standard
- How has this been accomplished?
 - Centralized registration
 - Amnesty
 - Uniform product definitions
 - Uniform administrative definitions
 - Uniform sourcing rules
 - Uniformity with exemption certificates
 - Single tax rate
 - Centralized administration

Introduced Legislation - Streamlined Sales Tax Project

- How has this been accomplished?
 - Local tax base conformity
 - Elimination of caps and thresholds
 - Rate and boundary notification and database safe harbor
 - Uniform procedures
 - Bad debt recovery
 - Sales tax holidays
 - Returns
 - Rounding
 - Refunds
 - Certified service providers
 - Interplay between product definitions and exemptions

Introduced Legislation - Streamlined Sales Tax Project

- Who's on board?
 - Member States – Indiana, Iowa, Kansas, Kentucky, Michigan, Minnesota, Nebraska, New Jersey, North Carolina, North Dakota, Oklahoma, Rhode Island, South Dakota, Vermont and West Virginia
 - Associate Member States – Arkansas, Nevada, Ohio, Tennessee, Utah and Wyoming
 - Associate members have until December 31, 2007 to become full members or else they will have to start the process from scratch again

Introduced Legislation - Federal Mobile Workforce State Income Tax Fairness & Simplification Act

- Problem – Where do you withhold for these individuals
 - Traveling employees
 - Transferred employees
 - Semi-retired employees
 - Retired employees
- Purpose – Prevent a state from taxing the income of nonresidents who work 60 days or less in the state

Introduced Legislation - Telecommuter Tax Fairness Act

- Introduced March 6, 2007
- Senators Dodd (D, Conn) and Lieberman (I, Conn)
- Representative Shays (R, Conn)
- Problem – Convenience of the employer rule

Introduced Legislation - Telecommuter Tax Fairness Act

- States with the convenience of the employer rule
 - New York
 - New Jersey
 - Pennsylvania
 - Nebraska
- Proposal – States are prohibited from imposing a personal income tax on the salary of a non-resident for any period of time when the individual is physically present in another state

Other Supreme Court Activity

- *Davis v. Dept. of Revenue, KY, Appl.*, Dkt. No. 2004-CA-001940-MR, 1/06/2006, *review denied* Ky. S.Ct., Dkt. No. 2006-SC-105-D, 8/17/2006, *petition for cert. granted*, US SCt, Dkt. No. 06-666, 5/21/2007
 - Kentucky exempts municipal interest from Kentucky sources
 - Davis is challenging under the Commerce Clause as an impediment to free trade
 - Kentucky Court of Appeals found this to be facially unconstitutional – more favorable treatment to in-state bonds than out-of-state bonds
 - Kentucky Supreme Court refused to review the case

Other Supreme Court Activity

- *Davis v. Dept. of Revenue, KY, Appl.*
 - Question – how does the Commerce Clause Apply?
 - Is Kentucky a market participant in the sale of bonds and can treat the sale of its bonds differently than sale of other bonds?
 - Is Kentucky acting as a market regulator when it chooses to tax out-of-state bonds versus exempting its bonds?
 - Decision expected early in 2008
 - Implications
 - Municipal bond market turmoil
 - What about 529 plan income tax exemptions for participation in in-state plans?

California LLC Fees – Pending Legislation

- In 2006, two California superior courts found the LLC fee violated the Commerce and Due Process Clauses of the U.S. Constitution because it was not apportioned
- Have you filed protective refund claims?
- Proposal would prospectively apply the LLC fee based on the LLC's level of activity in California (apportioned)
- Would apply to tax years beginning on or after January 1, 2007

State Tax Trends

- Business Trends
 - Increased filing obligations - nexus
 - Single sales factor
 - Unitary business concepts and consolidated tax returns
 - Mandatory withholding for non-resident partners/shareholders
- Individual Trends
 - Rate reductions

State Tax Trends

- Other Trends
 - Mandatory withholding on payments to contractors
 - Mandatory registration in order to do business with the state
 - Reportable transaction disclosure
 - Sales tax base expanding, including more services

Recent (and Not-so-Recent) Changes to Keep in Mind

- New Jersey Throw-out Provision
- Pennsylvania – S corporations are now treated as S corporations and you have to file an election to be treated as a C corporation
- Business/Non-business Income on sale of a segment of your business
- Segregating nexus creating activities from other activities
- California amnesty penalty protective claim procedures

New York Legislation

- Effective for tax years beginning on or after January 1, 2007
- Corporate tax rate reductions
 - Entire net income tax rate reduced from 7.5% to 7.1%
 - Entire net income tax rate for qualified manufacturers and emerging technology companies reduced to 6.5%
 - Alternative minimum tax rate reduced from 2.5% to 1.5%
- Acceleration of single sales factor apportionment

New York Legislation

- Mandatory S corporation treatment if more than 50% of gross income is from investment
- Tax shelter reporting
- Mandatory combined reporting
 - 80% or more common ownership
 - Substantial intercompany transactions
 - Guidance in TSB-M-07(6)C (June 25, 2007)

New Jersey Legislation

- Signed by Governor Corzine June 28, 2007
- Allows the following to expire:
 - Alternative minimum assessment unless claiming protection from income tax under P.L. 86-272
 - Net operating loss suspension (NOL's can be used again)
 - Subchapter S provisions – fully phased-out for periods ending after July 1, 2007

Rhode Island Legislation

- Legislature overrode Governor Carcieri's veto June 21, 2007
- Sales factor modified to include the throwback rule
- Eliminates phase-out of the capital gains rate for assets held more than 5 years

Maine Legislation

- Signed by Governor Baldacci June 7, 2007
- Single sales factor – for tax years beginning on or after January 1, 2007
- Continued non-conformity with IRC Section 179 limitations

Oklahoma Legislation

- Signed by Governor Henry May 14, 2007
- Maximum personal income tax rate reduced to 5.5% (for 2008 tax year) and further reduced to 5.25% for 2009 and subsequent tax years
- For years beginning after December 31, 2007, a new credit is allowed equal to the greater of 20% of child care expenses or 5% of the federal credit (income limitation applies)

Utah Legislation

- Signed by Governor Huntsman
- Most provisions are effective for tax years beginning on or after January 1, 2008
- Personal income tax rate reduced to 5%
- Personal income tax credit of 6% of federal standard deduction or 6% of difference between itemized and state and local taxes claimed as an itemized deduction
- Retiree credit of \$450 (reduced if under 65 or income exceeds thresholds)
- Sales tax rate reduced from 4.75% to 4.65%
- Sales tax rate on food reduced from 2.75% to 1.75%



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