Multistate Taxation

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Developments in Multistate Taxation

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New York

The New York Department of Taxation and Finance ("Department") issued an advisory opinion determining that a taxpayer qualified for P.L. 86-282 because the taxpayer's business within New York was limited to the sale of tangible personal property and the taxpayer's use of third-party fulfillment services located in New York fell under an exemption from the franchise tax. The taxpayer sold products that were manufactured in its own North Carolina factory and sold products acquired from third-party vendors, some of which were located in New York. The taxpayer used sales representatives to solicit sales throughout the United States, including in New York. The Department determined that the taxpayer was not employing capital, owning or leasing property in New York, or maintaining an office in New York. Furthermore, the taxpayer was not doing business in New York because of the exemption provided in New York Tax Law Section 208.19 for using third-party fulfillment services in New York. Therefore, because the taxpayer's activities fell within the scope of P.L. 86-282, the taxpayer was not subject to the franchise tax.[1]

North Carolina

The North Carolina Department of Revenue ("Department") promulgated a corporation income tax directive explaining its authority to require corporate taxpayers to eliminate intercompany transactions and/or file a combined return for tax years beginning before and after January 1, 2012.[2]

Pre-2012 Tax Years

The first part of the directive explains the Department's current practice with the Secretary's authority under General Statutes Sections 105-130.6, 105-130.15 and 105-130.16 to require combined returns for tax years beginning before January 1, 2012. For these years, the directive states that, in addition to requiring combination or disallowing deductions, the Secretary is authorized to adjust a taxpayer's income under judicially created doctrines. The conditions under which the Secretary will require a combined return include:

- common ownership or control (the 50-percent test);
- engaging in a unitary business; and
- when separate entity reporting does not disclose the net income of the corporation properly attributable to North Carolina.

The directive provides a list of factors that the Department will consider in determining whether a report by a corporation properly discloses the net income attributable to North Carolina. A combined return will include only those entities in the unitary business whose intercompany transactions cause net income of the business carried on in North Carolina not to be properly disclosed on a separate entity basis. However, certain entities will be excluded from a combined return, such as S corporations, partnerships and limited liability companies. Additionally, there are procedures that must be followed in filing a combined return.

Post-2012 Tax Years

The second part of the directive explains the Secretary's authority under the recently enacted General Statute Section 105-130.5A to redetermine a corporation's net income by adjusting the corporation's intercompany transactions or requiring combined returns for tax years beginning on or after January 1, 2012. For these years, the Secretary may redetermine the net income of a corporation if the Secretary finds that the corporation's intercompany transactions lack economic substance or are not at fair market value. A transaction is considered to have economic substance if there are one or more reasonable business purposes other than the creation of tax benefits and the transaction has economic effects other than the creation of tax benefits. The burden of proof lies with the taxpayer.

The Secretary may redetermine net income by adding back, eliminating or otherwise adjusting intercompany transactions. The Secretary may require combined returns but only if other adjustments are not adequate to redetermine net income. Additionally, the Secretary and a corporation may agree to an alternative filing methodology without finding that the corporation's intercompany transactions lack economic substance or are not at fair market value.

Oregon

The Oregon Tax Court held that the parent company of a taxpayer had nexus with Oregon on the basis of the activities of its employees, distributors and authorized service representatives (ASRs) in Oregon, and therefore, the taxpayer was required to include the parent company's payroll and sales numbers in its apportionment numerator for its consolidated Oregon corporation excise tax return. During the tax years at issue, the parent company used sales representatives to solicit orders from Oregon customers and entered into contracts with local distributors and ASRs to provide warranty repair work for some of its products to Oregon customers. The parent company also sent employees to Oregon to provide technology assistance and administrative services for one of its subsidiaries.[3]

The Tax Court determined that the activities of the local distributors and ASRs went beyond the protections of P.L. 86-272 because warranty work activities that serve a business purpose independent from the solicitation of sales do not qualify for immunity from taxation under *Wisconsin Department of Revenue v. Wrigley Co.*,[4] Furthermore, the in-state activities of the parent company's employees also went beyond the protected solicitation activities of P.L. 86-272 because the scope of the employees' work and number of visits were more than *de minimis* under *Wrigley*. Therefore, the parent company was subject to the corporation excise tax, and the taxpayer was required to include the parent company's payroll and sales numbers in its apportionment numerator.

Rhode Island

After holding a public hearing on November 29, 2011, the Rhode Island Division of Taxation adopted regulations governing Rhode Island's *pro forma* combined reporting requirement.[5] Under the requirement, corporations that are part of a unitary business must file a report for the combined group containing the group's combined net income for returns filed for tax years beginning after December 31, 2010, and before January 1, 2013.[6]

The regulations provide the following defined terms:

- ***Combined group.*** A "combined group" is a group of two or more corporations in which more than 50 percent of the voting stock of each member corporation is directly or indirectly owned by a common owner or owners, either corporate or noncorporate, or by one or more of the member corporations, and that are engaged in a unitary business.
- ***Unitary business.*** "Unitary business" means the activities 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. "Unitary business" is construed to the broadest extent permitted under the U. S. Constitution.

The following entities are not required to file combined reports: S corporations; partnerships; disregarded entities; public service corporations; state banks; national banks; credit unions; insurance companies; and, in general, any corporation incorporated in a foreign jurisdiction if the average of its property, payroll and sales factors outside the United States is 80 percent or more.

In determining the unitary group, taxpayers may elect to use the same members included on the taxpayer's federal consolidated return. However, the election is binding for all tax years beginning after December 31, 2010, and before January 1, 2013 (*i.e.*, for both *pro forma* combined reporting years). For purposes of calculating the combined net income of the group, each member is responsible for the tax based on apportionable income, including the *pro rata* share of any passthrough entity income, determined using a three-factor apportionment formula. Net operating losses created before the tax year 2011 cannot be shared, but credits earned in the tax year 2011 may be shared for the purpose of *pro forma* combined reporting.

Tennessee

The Tennessee Chancery Court ruled that a taxpayer's purchase of an aircraft outside of Tennessee and subsequent transportation into Tennessee was exempt from use tax as a sale for resale when the aircraft was leased to a third party. The taxpayer purchased an aircraft outside of Tennessee and immediately leased it to an affiliated company that managed and operated the aircraft and provided air transportation services to third parties. Contrary to the Department's argument, the Chancery Court determined that the taxpayer was not the user of the aircraft. Moreover, the Chancery Court rejected the Department's argument that the transaction should be disregarded because it lacked economic substance, reasoning that Tennessee has not adopted the economic substance doctrine.[7]

Texas

The Texas Supreme Court ruled that the Texas Margins Tax does not violate the Texas Constitution's ban on taxing the income of individuals. The taxpayer argued that the tax, as imposed on a partnership, was unconstitutional because it taxed the income of natural persons. The Supreme Court rejected the taxpayer's argument, determining instead that the tax was imposed on the business and not the partners and therefore constitutional.[8]

Virginia

The Virginia Department of Taxation ("Department") issued a letter ruling concluding that a nationally chartered bank headquartered outside of Virginia maintaining a mortgage loan office in Virginia was subject to the bank franchise tax because the mortgage loan office is considered a bank. The bank argued that it met the definition of a bank under Virginia Code Section 58.1-1201 because it is a nationally chartered bank, maintains an office in Virginia and does business in Virginia. The Department agreed with the bank, pursuant to the Circuit Court decision in *AMG National Trust Bank v. Commonwealth of Virginia, Department of Taxation*,[9] which held that a bank was not required to be conducting a banking business (*i.e.*, accepting deposits from customers at its Virginia branches) in order to be subject to the bank franchise tax. Additionally, the Department ruled that, because the bank was subject to the bank franchise tax, it was exempt from the Business, Professional and Occupational License tax.[10]

Endnotes

1. TSB-A-11(10)C (N.Y. Dep't of Tax. and Fin. Nov. 1, 2011).
2. Directive No. CD-11-01 (N.C. Dep't of Rev. Nov. 16, 2011).

[3] *Ann Sacks Tile & Stone, Inc. v. Dep't of Rev.*, Oregon Tax Court, No. TC 4879 (Or. Tax. Ct. Nov. 29, 2011).
[4] *Wis. Dept. of Rev. v. Wrigley Co.*, SCt, 505 US 214, 112 SCt 2447 (1992).
[5] R.I. Reg. CT 11-15.
[6] R.I. H.B. 5894 (enacted June 30, 2011).
[7] Opinion No. 11-71, Tenn. Att'y Gen. (Oct. 3, 2011).
[8] *In re Allcat Claims Serv., L.P. & John Weakly, Realtors*, No. 11-0589 (Tex. Nov. 28, 2011).
[9] *AMG National Trust Bank v. Va. Dep't of Tax'n*, Civ. Dkt. No. CL10-3031 (Va. Cir. Ct. July 6, 2011).
[10] Ruling of the Tax Commissioner, No. 11-182 (Va. Dep't of Taxation, Nov. 3, 2011).