Multitstate Taxation

By Phil Tatarowicz and Bee-Seon Keum

Developments in Multistate Taxation California

The California Franchise Tax Board ("Board") issued a letter ruling stating that a company that bought space on Internet publishers (*i.e.,* website owners or operators) and displayed advertisements provided by the company's customers was allowed to treat its customers' billing addresses as a reasonable proxy for the customers' commercial domiciles for purposes of determining where the income-producing activity occurred under cost-of-performance sourcing rules. The Board reasoned that, because the company's services were offered in more than one state, and the contracts with the Internet publishers and the customers did not contain information as to where the services were to be performed, it was proper to use the customers' domiciles as the place where the income-producing activity occurred.[1]

Maryland

A Maryland Circuit Court reversed a Maryland Tax Court decision on remand affirming the Comptroller's assessment against NIHC, an out-of-state company that owned trademarks and licensed the trademarks to N2HC, its parent company. The Comptroller assessed NIHC on its transfer of a license agreement to N2HC, on which N2HC reported a deferred Code Sec. 311(b) gain under the federal consolidated reporting rules. Following the transfer of the license agreement, N2HC's parent, Nordstrom, paid royalties to N2HC for the use of the trademarks in Maryland.

The Tax Court affirmed the Comptroller's assessment, finding that NIHC and N2HC engaged in substantial activities in Maryland. On appeal, the Circuit Court determined that the Tax Court failed to consider whether the Code Sec. 311(b) gain was

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connected to any activity in Maryland and whether Maryland, a separate company reporting state, can tax a deferred gain reported on the federal consolidated return. The Circuit Court remanded the case to the Tax Court.

On remand, the Tax Court reaffirmed its earlier decision. On subsequent appeal, the Circuit Court reversed the Tax Court on the basis that the deferred gain reported on the federal consolidated return is not included in the Maryland income tax return because, under Maryland's separate company reporting regime, each member of a consolidated group reports its separate income without regard to consolidation.[2]

Michigan

On December 27, 2011, Lieutenant Governor Brian Calley signed a series of cleanup bills clarifying provisions of old business tax laws and implementing the new Michigan Corporate Income Tax (CIT) that took effect on January 1, 2012. The bills signed included the following:

- S.B. 368 (P.A. 304), prohibiting the Department of Treasury from assessing tax or reducing overpayments under the former Single Business Tax (SBT) on some forms of individual, estate and investment income;
- S.B. 369 (P.A. 305), requiring that a person treated as a disregarded entity for federal income tax purposes be classified as a disregarded entity under the Michigan Business Tax (MBT);
- S.B. 653 (P.A. 306), amending the definition of a flow-through entity in the CIT to exclude any entity disregarded by Section 699 (added to the Michigan Income Tax Act by S.B. 678);
- S.B. 666 (P.A. 307), removing a previous definition of a disregarded entity;
- S.B. 673 (P.A. 308), providing that a taxpayer must include the sales of a flow-through entity that is unitary with the taxpayer when calculating its sales factor to determine its tax base for purposes of the CIT;
- S.B. 678 (P.A. 309), adding Section 699 to the Income Tax Act to clarify that any entity disregarded for federal income tax purposes by the Internal Revenue Code ("the Code") is a disregarded entity for purposes of the CIT and withholding requirements;
- S.B. 807 (P.A. 310), providing for the apportionment of income of a flow-through entity that is unitary with a taxpayer;
- H.B. 4940 (P.A. 311), amending the definition of a flow-through entity to exclude a disregarded entity under Section 699;
- H.B. 4949 (P.A. 312), allowing a business loss to be carried forward to the year after the loss year as an offset to the allocated or apportioned CIT base and then to the next nine tax years after the loss year or until the loss is used up, whichever occurs first;
- H.B. 4950 (P.A. 313), clarifying rules for claiming a small business tax credit under the CIT;
- S.B. 748 (P.A. 314), protecting income tax credits for residents of qualified renaissance zones through the length of each zone's existing designation; and
- H.B. 5157 (P.A. 315), adding a citation to deductions from individual gross income provided by S.B. 748 to statutes on state income tax deductions for residents of renaissance zones and businesses that conduct business activity in renaissance zones.

South Carolina

The Supreme Court of South Carolina held that a multistate corporation located outside of South Carolina was required to allocate related expense deductions to its principal place of business and not South Carolina. The corporation filed consolidated South Carolina income tax returns with its subsidiaries and claimed a deduction for expenses related to its receipt of dividends from its subsidiaries. The court held that the corporation could not claim the related expense deductions because South Carolina's allocation statute required the dividend income to be allocated to the corporation's principal place of business, and South Carolina's "matching principle" required that the expenses incurred in generating the dividend income also be allocated to the corporation's principal place of business. The court rejected the corporation's Constitutional argument, determining that the South Carolina allocation statute did not discriminate against interstate commerce because it was not a taxing statute.[3]

Virginia

The Virginia Tax Commissioner ruled that the Department of Taxation ("Department") properly removed two affiliates from a Virginia corporation's consolidated income tax return because the affiliates lacked nexus with Virginia. The Commissioner concluded that, because the affiliates did not derive income from Virginia sources, they were not subject to tax and therefore not eligible to be included in a consolidated Virginia return. However, the Commissioner ruled that the corporation was allowed to claim a deduction for a net operating loss incurred by one of the affiliates.[4]

In another letter ruling, the Commissioner concluded that a company's equipment transfers to affiliates for use in the provision of engineering and construction services were subject to sales tax because the job-cost accounting entries associated with the equipment transferred between the company and its affiliates constituted a consideration for sales tax purposes. There were no formal lease agreements and no cash payments between the company and the affiliates, and there was no use of receivable and payable accounts to record accounting entries related to the equipment provided by the company to its affiliates. However, the job costs for the equipment were accounted for on the books of the company and its affiliates. The Commissioner concluded that the company was effectively leasing or renting equipment to the affiliates and therefore liable for sales tax.[5]

Washington

The Washington Department of Revenue ("Department") determined that an out-of-state mail order retailer had substantial nexus with Washington for purposes of retail sales tax and business and occupation tax ("B & O tax") because its in-state affiliate performed significant services on behalf of the retailer in relation to the retailer's ability to establish or maintain a market in Washington for its sales. The retailer operated from offices outside of Washington and had no employees or inventory in Washington. The in-state affiliate distributed the retailer's catalogs free of charge, provided limited assistance to the retailer's customers with respect to returns of purchases and sold gift cards that could be redeemed by mail order, online or at retail locations. The Department found that the affiliate's activities constituted the facilitation of a sale on behalf of the retailer and, because such activity was significantly associated with the retailer's ability to establish or maintain a market in Washington, the Department properly assessed retail sales tax and B & O tax on the retailer.[6]

Endnotes

1 Chief Counsel Ruling 2011-01 (Cal. Franchise Tax Bd. Aug. 23, 2011) (released Dec. 2011).

2 *NIHC, Inc. v. Comptroller of the Treasury,* No. 03-C-10-9151 (Md. Cir. Ct. Dec. 12, 2011).

3 *Emerson Electric Co., & Affiliates v. South Carolina Dep't of Revenue,* No. 27073 (S.C. Dec. 12, 2011).

4 Ruling of the Tax Comm'r, No. 11-199 (Va. Dep't of Taxation, Dec. 9, 2011).

5 Ruling of the Tax Comm'r, No. 11-207 (Va. Dep't of Taxation, Dec. 29, 2011).

6 Determination No. 10-0057, 30 WTD 82 (Wa. Dep't of Revenue, Dec. 20, 2011).