

Could You Benefit From A Little SALT? (State and Local Tax)

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Interstate Activity and Nexus

- Nexus is a term of art in state and local tax that refers to the quantity and quality of links between a taxpayer and a political jurisdiction before that jurisdiction can impose a tax filing obligation on the taxpayer

- **What is Nexus?**
 - Minimum connection to the state
 - Different threshold for Sales and Income Tax
- **What exactly creates Nexus?**
 - Company owned property
 - Employees
 - Agents
 - Economic benefits derived
 - Qualification

Due Process Hurdles

- There must be “a minimal connection” between the activities or taxpayer and the state
 - *Wisconsin v. J.C. Penney Co.*, 311 U.S. 435 (1940)
- There must be “a rational relationship between the incomes attributed to the State and the intrastate values of the enterprise”
 - *Exxon Corp. v. Wisconsin*, 447 U.S. 207 (1980)

- The tax must be applied to an activity with *substantial nexus*
- The tax must be fairly apportioned
- The tax must not discriminate against interstate commerce
- The tax must be fairly related to the services provided by the state
 - *Complete Auto Transit v. Brady*, 430 U.S. 274 (1977)

Sales Tax vs. Income Tax Nexus



- Sales tax – Physical presence under *Quill*
- Income tax – Physical presence
 - P.L. 86-272 protects certain activities

National Bellas Hess: 386 U.S. 753 (1967)

- State could not force taxpayer with no physical presence to collect tax
- Concern expressed over burden that would be imposed on remote sellers
- Seemingly decided based upon both the due process and commerce clauses
- In a dissenting opinion to the majority decision, it said that the “continuous and systematic exploitation of a market by a remote seller” created nexus and a filing obligation
- This became a clarion call in many states for legislation, designed to overturn the Supreme Court’s decision in *National Bellas Hess*

Quill Corp. v. North Dakota: 504 U.S. 298 (1992)

- North Dakota enacted “anti-Bellas Hess” statute saying that remote sellers had an obligation to collect the tax because they were economically exploiting the state
- Mail order seller
- No employees, offices, or warehouses in North Dakota
- All sales shipped into North Dakota via common carrier
- North Dakota took the position that Quill had nexus and should be collecting its use tax

Continuing Questions

- How much physical presence?
- Nexus through affiliation, attribution, and agency.
- Is physical presence necessary for income tax nexus?

How Much Physical Presence?

- *Miller Bros. Co. v. Maryland*, 347 U.S. 340 (1954); *Brown's Furniture, Inc. v. Wagner*, 171 Ill.2d 410, cert. denied, 519 U.S. 866 (1996)

- *Scripto Inc. v. Carson*, 362 U.S. 207 (1960)
- *Tyler Pipe Industries Inc. v. Washington*, 483 U.S. 232 (1987)
- *Scholastic Book Clubs v. State Board of Equalization*, 207 Cal.App.2d 734 (1st Dist. 1989); *Scholastic Book Clubs Inc. v. Commissioner of Revenue*, 38 A.3d 1183 (Conn. 2012); *Scholastic Book Clubs v. Tennessee*, 373 S.W.3d 558 (Tenn. 2012)

- MTC Nexus Program Bulletin 95-1
- *SFA Folio Collections Inc. v. Bannon*, 585 A.2d 666 (Conn. 1991)
- *Borders Online, LLC v. State Board of Equalization*, No. A105488 (Cal. App., May 31, 2005); *Barnes & Noble.com*, No. 89872 (Cal. State Bd. Equal., Sept. 12, 2002)

Public Law 86-272

- Out-of-state corporation whose only in-state activity is
 - Representatives engaged in “solicitation of orders”
 - For tangible personal property
 - Sent outside state for approval, and
 - Filled by shipment or delivery from point outside state
- Out-of-state corporation whose only in-state activity is use of independent agents who solicit or make sales, or maintain offices

What Is “Solicitation”?

- *Wisconsin v. William Wrigley, Co.*, 112 S.Ct. 2447 (1992)
 - Defining solicitation
- Multistate Tax Commission (MTC) guidelines

Attributional Nexus

- Theory of agency, alter ego, and unitary business.
 - Parent- Subsidiary relationship does not normally establish nexus for the other company, unless one is acting as an agent or performing service in state for the nexus company.
 - Same is normally true even if they are part of a unitary business.
- Use of Company of Vehicles vs. Common Carrier

- Internet Tax Freedom Act-
 - The ITFA provides that states may not collect a tax if “the sole ability to access a site on a remote seller’s out-of-state computer server is considered a factor in determining a remote seller’s tax collection obligation.”
 - Note that ITFA provisions specifically relate to a remote seller’s “out-of-state computer server.” This language opens the door to a nexus claim where a server is located in a state.
 - ITFA was extended to October 1, 2015. The ITFA was first passed in 1998.

- Location of servers and contracts with third parties
 - If the transaction occurs in the “cloud,” does the transaction have sufficient contacts with any state to establish nexus?
 - Virginia- Vendor’s mere ownership of in-state server maintained and operated by a third party and unrelated to vendor’s solicitation activities in-state would appear to create nexus, at least for Corporate Income Tax purposes. Virginia Tax Commissioner Ruling 12-36 (Mar. 28, 2012)

Click Through Nexus

States that have passed “click-through” and/or affiliate sales tax nexus legislation:

- Arkansas
- California
- Connecticut
- Georgia
- Illinois- Ruled unconstitutional; *Performance Marketing Association, Inc. v Hamer*, Ill. Cir. Ct. (Cook County), May 7, 2012

Click Through Nexus

- Maine
- Michigan (9/1/15)
- North Carolina
- Nevada
- Minnesota
- New Jersey
- New York
- Pennsylvania
- Rhode Island
- Tennessee (7/1/15)
- Vermont

P.L. 86-272 Does *Not* Protect Taxpayers from:



- Income tax nexus if in-state activities involve
 - Leasing of tangible personal property
 - Sales of services
 - Sale or lease of realty
 - Sale or license of intangibles
- Washington “business and occupation tax” nexus
- Franchise taxes on capital or net worth (e.g., PA)
- Ohio Commercial Activity Tax (CAT)
- Texas Margin Tax (TMT)

Physical Presence and “Substantial Nexus”

- *Geoffrey, Inc. v. South Carolina*, 437 S.E.2d 13, cert. denied, 114 S.Ct. 550 (1993)
- *Lanco, Inc. v. Director*, 879 A2d 1234 (N.J. Super. Ct. App. Div., 2005)
- *West Virginia v. MBNA*, 640 S.E.2d 226 (W.Va. 2006)



Texas Adopts New Rule Regarding Research and Development Activities Credit

On March 30, 2015, the Comptroller of Public Accounts, adopted 34 Texas Administrative Code (TAC) § 3.599 which provides either a franchise tax credit or sales tax exemption for research and development activities conducted in Texas. The effective date of this provision is for reports due on or after January 1, 2014.

Texas: Increase Homestead Exemptions and Reduce Franchise Tax

On June 1, 2015, the Texas Legislature passed bills H.B. 32 and S.B. 1 that implemented a franchise tax rate reduction for retailers, wholesalers and other taxpayers and increased the homestead exemption. Although, S.B. 1 effective date is contingent on taxpayers' approval of the constitutionality of the Senate Joint Resolution 1, in a November 3rd elections this year, H.B. 32 takes effect on January 1, 2016.



Texas Enterprise Zone Program

The Texas Enterprise Zone Program is an economic development tool for local communities to partner with the State of Texas to promote job creation and capital investment in economically distressed areas of the state. The newly amended legislation becomes effective on September 1, 2015.



Texas Adopts New Rule Regarding Vehicle Purchases to Certain Manufacturers or Distributors

On May 15, 2015, the Comptroller of Public Accounts amended Texas Tax Code § 152.001(2) which exempts the sale of a motor vehicle by allowing certain vehicle manufacturers or distributors to obtain manufacturer's license plates on vehicles used for either test driving purposes or on loan for a temporary basis to a consumer. The new legislation is effective September 1, 2015.



Administrative and Procedural Issues

- Many states have voluntary disclosure and compliance programs
 - An eligible taxpayer (not under audit, etc.) approaches the state on an anonymous basis (usually through its tax advisor).
 - Taxpayer describes its business, the tax liability, and its reasons for delinquency.

- If accepted, the tax payer and the state enter into an agreement in which:
 - Taxpayer agrees to comply going forward
 - Taxpayer pays taxes and interest for a limited number of back years
 - The state waives penalties (and criminal prosecution)

Amnesty Programs

Amnesty Programs

- Many states have periodically enacted tax amnesty programs.
- Terms vary but typically include the following features:
 - A limited time period (often just two or three months) in which eligible taxpayers can voluntarily pay unpaid back taxes.
 - The state agrees to waive all or part of otherwise applicable penalties and interest.
 - A post amnesty penalty for amnesty eligible taxes if the taxpayer does not take advantage of the amnesty program.

Pre-audit Activities

Pre-audit Activities

- Prior to an audit, the auditor will mail to the taxpayer a letter that
 - States the type of audit to be conducted
 - The audit period, and
 - A detailed list of books and records that the auditor would like to have available during the audit.
- The taxpayer should promptly respond to the notice and schedule a date that is acceptable to the auditor and the taxpayer.

Pre-audit Activities

- The taxpayer should review the rest of the information requested by the auditor and determine whether that information exists and if it is relevant to the type of audit being conducted.
- Any information that does not appear to be relevant or which the taxpayer does not possess in the format requested by the auditor should be noted.
- The taxpayer should ascertain why the auditor wants to review the requested information and whether the information can be presented in an alternative format.

Audit Activities DO'S AND DON'TS

DO'S AND DON'TS

1. The taxpayer should gather all relevant materials requested and have it available for the auditor.
2. The taxpayer should assign someone as the audit contact.
3. The taxpayer should verify the auditor's credentials and request all communications in writing.
4. The taxpayer should provide the auditor with a reasonable work place but do not allow the auditor free access to the entire building.

DO'S AND DON'TS

5. The taxpayer should control the records provided to the auditor, keep a list of all documents reviewed and a copy of all documents copied by the auditor, and meet with the auditor at least daily to review issues.
6. The taxpayer should attempt to resolve issues before they are written up.
7. The taxpayer should agree to disagree on certain issues and do not attempt to bully or intimidate the auditor.
8. The taxpayer should obtain copies of all the work papers and ask for an explanation of any issues that are not clear.

DO'S AND DON'TS

9. Sampling considerations. Generally, for sales and use tax audits the auditor will examine a sample of a taxpayer's books and records to determine an error percentage for the audit period.

10. The auditor might use a variety of sampling techniques to determine the error % for the audit period, e.g.,

- Block sample
- Random sample
- Statistical sample, and
- Hybrid sample.

DO'S AND DON'TS

11. Sampling techniques (cont.)

- There has been a trend for auditors to use a block sample in which the auditor reviews a particular month or months during the audit period to determine the error percentage.
- Alternatively, the auditor may choose to use or be requested to use a random sample where invoices are randomly selected throughout the audit period.

12. The taxpayer and the auditor should agree upon a sampling methodology.

Post-audit Activities

Post-audit Activities

- Review the auditor's work papers to get an idea of the potential assessment.
- Attempt to negotiate, resolve and/or trade off issues to reach an agreed audit.
- Consider whether to pay tax on the agreed adjustments to stop interest from accruing while reserving the right to protest the disputed issues.

- Watch for penalty imposition.
 - Many states will automatically impose penalties if there is an adjustment, but some states will abate penalty when requested by the taxpayer. However, consider delaying payment of the penalty during negotiations in order to obtain leverage in closing the audit.
 - Develop an argument which will allow the state to rescind penalties. Determine whether “reasonable cause” exists.

TEXAS ADOPTS NEW RULE REGARDING RESEARCH AND DEVELOPMENT ACTIVITIES CREDIT

Summary

On March 30, 2015, the Comptroller of Public Accounts, adopted 34 Texas Administrative Code (TAC) § 3.599 which provides either a franchise tax credit or sales tax exemption for research and development activities conducted in Texas. The effective date of this provision is for reports due on or after January 1, 2014.

Discussion

The new rule 34 TAC § 3.599 implements House Bill (HB) 800, 83rd Legislature 2013, which added Tax Code, Chapter 171, Subchapter M to create a mechanism for taxpayers to either claim a credit against their franchise tax report or a sales tax exemption for expenses incurred in conducting certain research and development activities. The new rule covers many important compliance topics including, but not limited to, the credit effective date and eligibility requirements; general method for calculating the amount of the credit; maximum allowable credit per report; credit carryforwards; and credit application, schedule, and forms.

It is important to note that the credit cannot be assigned, conveyed or transferred unless all of the assets of the taxable entity are also transferred in the same transaction.

The new rule aims to strengthen incentives for research and development that are scheduled to expire on December 31, 2026. Taxpayers have a unique opportunity to carryforward any unused credit established before the expiration of 20 consecutive reports.

How does this affect my business?

This rule provides significant benefits to Texas taxpayers engaged in qualified research, as defined by IRC § 41(d). Since many taxpayers have conducted extensive studies to determine their federal research and development credit, Texas has joined the many other states that offer a complementary state tax research and development credit. In addition, since a Texas taxpayer can make a yearly election to take either a franchise tax credit or a sales tax exemption, we recommend that this issue should be analyzed yearly to obtain the maximum benefit.

For more information on the new rule 34 TAC § 3.599 and how it may apply to your business, please contact Mike Goral, Partner-in-Charge, [State and Local Tax Services](#), at 972.448.9230 or by email at mike.goral@weaver.com.

TEXAS: INCREASE HOMESTEAD EXEMPTIONS AND REDUCE FRANCHISE TAX

On June 1, 2015, the Texas Legislature passed bills H.B. 32 and S.B. 1 that implemented a franchise tax rate reduction for retailers, wholesalers and other taxpayers and increased the homestead exemption. Although, S.B. 1 effective date is contingent on taxpayers' approval of the constitutionality of the Senate Joint Resolution 1, in a November 3rd elections this year, H.B. 32 takes effect on January 1, 2016.

Franchise Tax Reduction:

H.B. 32 creates a permanent 25 % reduction to the franchise tax rate. This bill came timely because H.B. 500 provisions of 2013 were about to expire on December 31, 2015. Effective January 1, 2016, H.B. 32 amends the Texas Tax Code to decrease the franchise tax rate for retailers and wholesalers from **0.5% to 0.375%** and for other taxpayers from **1.0% to 0.75%** of taxable margin.

The bill also revises the provisions that relate to the E-Z filing method. As a result, the upper limit on a taxable entity's eligibility to file an E-Z return has been increased from \$10 million to \$20 million. Similar to taxpayers above, E-Z filers will also benefit from a tax rate reduction from 0.575% to 0.331%. The bill clarifies that these changes apply only to a report originally due on or after the bill's January 1, 2016 effective date.

Property Tax Discussion:

S.B. 1 adopted during the same legislative session seeks to provide a reduction on the property tax burden for homeowners. As a result, S.B. 1 amends the Texas Tax Code to increase the amount of the residence homestead exemption from **\$15,000 to \$25,000** per home. In addition, this new rule maintains current provisions for the elderly and disabled. Another important provision deals with local taxing units. It clarifies that any local taxing unit that currently offers the optional homestead exemption must maintain the current exemptions offered for 5 years to support this long-awaited increase in the homestead exemption.

How does this affect my business?

Taxpayers should note the change to the franchise tax rate and how this reduction will affect their future reserves and cash requirement calculations due after the effective date. In addition, all homeowners should watch for any updates on S.B. 1 after a November 3 election.

Contact:

For more information about the homestead exemption and franchise tax reductions and how it may affect you personally or your business, please contact:

[Mike Goral](#), Partner-in-Charge, State and Local Tax Services
972-448-9230

[Michael Regan](#), Manager, State and Local Tax Services
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TEXAS ENTERPRISE ZONE PROGRAM

SUMMARY

The Texas Enterprise Zone Program is an economic development tool for local communities to partner with the State of Texas to promote job creation and capital investment in economically distressed areas of the state. The newly amended legislation becomes effective on September 1, 2015.

DISCUSSION

The amendments expand the definition of an enterprise zone allowing more taxpayers to qualify for refunds through this program. These changes affect applications for enterprise project designations filed on or after the effective date.

The definition of a qualified business has been altered to reflect the addition of new permanent jobs instead of the previously worded “employees.” A business will now qualify for the program if at least 25% of new permanent jobs located in a designated enterprise zone are held by residents of any enterprise zone, economically disadvantaged individuals, or veterans. They also qualify if at least 35% of new permanent jobs located in an area that *does not* qualify as an enterprise zone are held by residents of any enterprise zone, economically disadvantaged individuals, or veterans.

The definition of a qualified employee is a person who lives within 50 miles of and reports to the qualified business site and engages in the transportation of goods and services; And a person who works for and receives wages from the qualified business which employment taxes are withheld. Qualified employees include veterans honorably discharged from the Army, Navy, Air Force, Coast Guard, or Marine Corps.

The benefits of this program are received in the form of a sales and use tax refund. The franchise tax credits previously available are no longer allowed under the Enterprise Zone Program. The amount of refund available is based on the capital investment and number of new permanent jobs from the project. The refund for an enterprise zone project is \$2,500 per new permanent job with a maximum refund up to \$1,250,000. There are increased refunds per new permanent position for projects designated as double jumbo enterprise or triple jumbo enterprise projects of \$5,000 and \$7,500 respectively. A double jumbo enterprise project increases the maximum refund available to \$2,500,000 and a triple jumbo enterprise project increases the maximum refund to \$3,750,000.

HOW DOES THIS AFFECT MY BUSINESS?

When considering when to apply for a new enterprise zone project designation, consider whether these changes may affect your maximum refund available. Examples of some factors to consider are whether you have employees transporting goods and the number of veterans that may be hired as a result of the project.

For more information on this enterprise zone program and how it may apply your clients, please contact K. Shane Stewart, Director-in-Charge, Indirect Tax, State and Local Tax Services at 972.448.9250 or by email at shane.stewart@weaver.com or Mike Goral, Partner-in-charge, State and Local Tax services at 972.448.9230 or by email at mike.goral@weaver.com.

TEXAS ADOPTS NEW RULE REGARDING VEHICLE PURCHASES TO CERTAIN MANUFACTURERS OR DISTRIBUTORS

SUMMARY

On May 15, 2015, the Comptroller of Public Accounts amended Texas Tax Code § 152.001(2) which exempts the sale of a motor vehicle by allowing certain vehicle manufacturers or distributors to obtain manufacturer's license plates on vehicles used for either test driving purposes or on loan for a temporary basis to a consumer. The new legislation is effective September 1, 2015.

DISCUSSION

Texas Tax Code Annotated § 152.001(2) has been amended to include subsection (d) as an exception to what defines a "retail sale" of a motor vehicle. This amended rule now exempts the retail sale of motor vehicles to manufacturers, brokers, distributors, vehicle lessors and agents or other representatives that work on behalf of manufacturers or distributors or convertors. The definition now includes manufacturers of ambulances, chassis, fire-fighting vehicles, mobile and motor homes.

Convertors who modify the previously manufactured vehicle (not motor homes, ambulances, or fire-fighting vehicles) are also exempt. Under Transportation Code § 503.064, these manufacturers or distributors can now be issued a manufacturer's license plate for the purpose of testing the vehicle on a public street or highway or loaned to a consumer. The loaned vehicle is a temporary replacement for vehicles that are out of service for a total of 30 or more days in 24 months (or 24,000 miles) and at least 2 repair attempts were made in 12 months (or 12,000 miles) following the original delivery to the owner.

HOW DOES THIS AFFECT MY BUSINESS?

This new rule will benefit Texas taxpayers under Section 2301.002 involved in wholesale distribution of motor vehicles, vehicle customizers and manufacturers. This could mean additional vehicle inventory savings for taxpayers who would normally incur motor vehicle sales tax registration fee.

For more information on the amended rule and how it may apply to your clients, please contact K. Shane Stewart, Director-in-Charge, Indirect Tax, State and Local Tax Services at 972.448.9250 or by email at shane.stewart@weaver.com.