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TXSCPA Convergence 2024:

MULTISTATE TAX DEVELOPMENTS - TRAPS FOR THE UNWARY

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AGENDA

- Recent Texas Developments
- Income Tax Nexus (including U.S. Public Law 86-272)
- State Apportionment Developments

RECENT TEXAS DEVELOPMENTS

FRANCHISE TAX – RECENT CHANGES

- Starting with the 2024 report year, no franchise tax report filing requirement if the business entity (or combined reporting group) has total gross revenue of $2.47M or less (up from $1.23M for the 2023 report year).
- The NO TAX DUE information report has been abolished.
- However, each business entity (including each member of a combined reporting group) registered to do business in the state must still file an annual Public (Owner) Information Report to remaining in good standing with the Secretary of State.

[S.B. 3, Laws 2023, effective January 1, 2024]

FRANCHISE TAX – STATUTE OF LIMITATIONS

Texas Comptroller issued a letter ruling providing when a valid extension is filed as to when the statute of limitations starts for all filers meeting their prior year filing requirements as of May 14 of the current year.

NON-EFT FILERS

- Extension request filed by May 15 AND 100% of prior year report tax paid by then - **SOL begins Nov. 16 even if no report is filed with additional tax due by Nov. 15**.

- Extension request filed by May 15, 90% of current tax eventually due paid with timely extension, AND report filed on or before Nov. 15 with all remaining tax due then – **SOL begins Nov. 16. Otherwise, SOL begins on May 16 since a valid extension was not made**.

REQUIRED EFT FILERS

- Extension request filed by May 15 AND 100% of prior year report tax paid by then - **SOL begins Aug. 16 unless a 2nd extension or return is timely filed for the SOL to begin on Nov. 16**.

- Extension request filed by May 15, 90% of current tax eventually due paid with timely extension, AND 2nd extension filed on or before Aug. 15 with all remaining tax due filed and paid by Nov 15 – **SOL begins Nov. 16**. **Otherwise, SOL begins on Aug 16 since a valid 2nd extension was not made**.

[Texas Comptroller of Public Accounts, TX–Letter No.202404001L, April 12, 2024]

FRANCHISE TAX – COST OF GOODS SOLD DEDUCTION

COGS Deduction Denied for Maintenance, Repair, and Overhaul (MRO) Service Provider

- Aircraft instrument, avionics, accessory services and support MRO provider denied COGS deduction on their repair and maintenance labor charges since their customer (vs. the MRO provider) owned the equipment being serviced.
- In following precedence set regarding mixed transactions in *Hegar v. Autohaus (No. 03-15-00427-CV, February 24, 2017)*, only the purchased and resold repair and replacement parts were availed the COGS deduction. **All direct labor and repair service costs were not incurred for the production of goods as required under statute since the MRO provider did not own the property undergoing such services.**

[Comptroller Decision Hearing No. 116,007, Accession No. 202401016H, 01/24/24]

FRANCHISE TAX – SOURCING SALES OF TANGIBLE GOODS

Sales of Tangible Personal Property (TPP) Sourced to Customer's Location of Delivery

- Sales of fuel sold and delivered to oceangoing foreign vessels in Texas were found by the state Court of Appeals to be sourced as Texas sales despite the vessels ultimately transporting the sold fuel overseas.
- Ruling was consistent with Texas statute & regulation looking to where sold property transfer of control or possession to the buyer occurs……"*each sale of tangible personal property* ***if the property is delivered or shipped to a buyer in this state*** *regardless of the FOB point or another condition of the sale*" – see *Texas Tax Code §171.103(a)(1) & 34 TAC §3.591(29)(A) & (C)*.
- Taxpayer unsuccessfully challenged the regulation being inconsistent with the statute in asserting ultimate destination sourcing of the sold fuel vs. **where the regulation specifically looks to where transfer of control or possession to the purchaser takes place**.

*[**NuStar Energy, L.P. v. Hegar**, Court of Appeals of Texas, Third District, Austin, No. 03-21-00669-CV, December 21, 2023]*

FRANCHISE TAX – IRC CONFORMITY

- For franchise tax purposes, Texas conforms to the Internal Revenue Code **as in effect as of 1/1/2007** *[Texas Tax Code §171.0001(9)]*.
- Texas regulation references specific gross income line items off federal partnership, C, and S corporation income tax return forms; however, the regulation has not been amended since 2012 – see *34 TAC §3.587(d)*
- The 2024 Texas Franchise Tax Instructions states the following..

  "The statute and administrative rules base total revenue on specific line items from the 2006 IRS forms and state that in computing total revenue for a subsequent report year, total revenue:

  *• is **based on the 2006 equivalent line numbers on any subsequent version of that form** and*

  *• is **computed based on the Internal Revenue Code in effect for the federal tax year beginning on Jan. 1, 2007.**"*

FRANCHISE TAX – IRC CONFORMITY (CONT'D)

- Gross income items reported on the first 8 lines of the report should exclude any federally includible items that were enacted after 1/1/2007. Examples of which include…
  - IRC §951A Global Intangible Low-Taxed Income
  - IRC §965 Repatriation Income
  - IRC §250 Foreign-Derived Intangible Income
- Select Texas Comptroller auditors have been improperly denying gross revenue exclusions of federal TCJA and other post 1/1/2007 IRC item items despite the statute and franchise tax report instructions' guidance.

STATE INCOME TAX NEXUS (INCLUDING PUBLIC LAW 86-272)

STATE INCOME TAX NEXUS

What is nexus?

- Before a state can tax an out-of-state business, that business must first have “nexus” with the taxing state.
- Nexus refers to the nature and frequency of contacts that an out-of-state business must establish in a state before the state may subject that business to taxation.
- US Constitutional Guidelines require that any state tax must be imposed within the Commerce (connection to services provided by taxing state) & Due Process (minimal connection) Clauses of the US Constitution

STATE INCOME TAX NEXUS STANDARDS

- De-Minimis Standard
  - Activities (i.e. non-routine) that when taken together establish only a trivial connection with a state.
- Physical Presence
  - May include being an owner/member/partner in a pass-through entity doing business in the state despite a lack of direct activity in that state
- Economic Nexus (“Substantial Nexus”)
  - Intangibles
  - Income derived from sources within the state
  - Apportionment Factor Presence – some states have bright line amounts while others do not
- U.S. Public Law 86-272

ECONOMIC / SUBSTANTIAL NEXUS

Multistate Tax Commission Nexus Standard (Adopted October 17, 2002)

- Sales Threshold: **$500,000 in sales** (TPP, Services (Market vs. Cost of Performance Sourcing), Intangibles),
- Property Threshold: **$50,000 in property,**
- Payroll Threshold: **$50,000 in payroll, OR**
- 25% of “total factor” of any of these three in state.

FACTOR PRESENCE ECONOMIC NEXUS (Based on Gross Receipts) as of 12/31/2023			
State	*Threshold*	*Effective*	*Tax Type*
AL	**635,000**	1/1/2015	Business Privilege, Gross Receipts, Financial Institution Excise, & Income Taxes
CA	**711,538**	1/1/2011	Income or Gross Receipts Taxes (minimum $800 fee or sliding scale)
CO	500,000	1/1/2019	Income Tax
CT	500,000	4/30/2010	Income Tax
HI* **	100,000	1/1/2010	Income Tax
MA	500,000	10/1/2018	Income Tax
MI**	350,000	1/1/2012	Corporate Income Tax
NJ* **	100,000	7/31/2023	Income Tax
NY	**1,283,000**	1/1/2015	C & S Corporations
OH	500,000	7/1/2005	Commercial Activity (gross receipts) Tax
OR	750,000	1/1/2020	Corporate Activity (gross margin) Tax
PA	500,000	1/1/2020	Corporate Income Tax
Philadelphia	100,000	1/1/2019	Business Income & Receipts Tax
TN	500,000	1/1/2016	Franchise & Excise and Business (gross receipts) Tax
TX	500,000	1/1/2020	Franchise Tax
WA	100,000	6/1/2010	Business & Occupation Excise Tax

***WI - No factor presence thresholds but very aggressive**

****MI - nexus created if taxpayer actively solicits sales in MI with $350K or more of MI gross receipts.**

*****HI & NJ economic nexus thresholds both are $100K or more of in-state sales OR 200+ transactions in the state in a year**

******U.S. Public Law 86-272 may still apply if tax is solely based on "net" income and only TPP is sold in state.**

*******Many states have "substantial nexus" or "deriving income from sources within the state" thresholds with no minimums**

U.S. PUBLIC LAW 86-272 (PL 86-272)

- PL 86-272 is a federal law that prohibits a state from imposing a “net” income based tax on non-domiciled businesses that limit their in-state activities to solicitation of sales of TPP to where all orders are approved outside of the state and fulfilled (originate) from a location outside of the taxing state in question.
- The US Supreme Court expanded the federal law to include activities that are merely ancillary to the solicitation of sales of TPP with no independent business function or purpose – i.e. salesperson working from home in a state utilizing company owned / issued laptop, cell phone, company car solely to engage in sales solicitation activities) – see *Wisconsin Department of Revenue v. William Wrigley Jr. Co., 505 U.S. 214 (1992)*
- Texas franchise tax is not deemed to be a “net” income tax per regulation; thus, PL 86-272 protections do not apply to Texas in-state sales solicitation activities – see *34 TAC §3.586(i)*.

U.S. PUBLIC LAW 86-272 (PL 86-272)

Protected Activities

- Soliciting orders for sales by any type of advertising
- Soliciting orders by an in-state employee or representative as long as they don't maintain an office other than working from home
- Providing samples or promotional materials
- Automobiles used by employees soliciting
- Passing orders, inquiries, or complaints to the home office out of state
- Checking customer inventories without a charge (i.e. for reorder, but not for quality control)
- Recruiting, training, or evaluating sales personnel
- Using company owned/leased vehicles to deliver sold goods to customers in the state*
- Salesforce receiving on-site in person feedback on previously sold products even if data is solely used to solicit future sales*

* Certain states may render such activities as unprotected going beyond their definition of "solicitation" of sales

U.S. PUBLIC LAW 86-272 (PL 86-272)

Unprotected Activities

- Making repairs, providing maintenance, or other services to the property sold or to be sold.
- Collecting current or delinquent accounts using employees or third parties
- Checking credit worthiness
- Installation or supervision of installation at or after shipment or delivery
- Conducting training courses, seminars or lectures for personnel other than personnel soliciting sales
- Approving or accepting orders
- Repossessing property
- Picking up or replacing damaged property
- Sample or display room in excess of 14 days at one location within a tax year
- Consigned stock of goods or other tangible personal property

U.S. PUBLIC LAW 86-272 (PL 86-272)

- Traveling sales reps of a Connecticut domiciled manufacturer of premium dog food were found to exceed immunity availed under PL 86-272.
- Although in-state activities challenged by the lower state Tax Court involving consumer relations intended to build customer relationships and community goodwill and product training designed to educate retailers on sold products were found to be immune on appeal, **the regular collection of competitive information by the account manager and in-store representatives was not ancillary to the solicitation and exceeded the protection granted to the solicitation of orders.**

*[**Blue Buffalo Company, Ltd. v. Comptroller**, Maryland Court of Special Appeals, No. 495, December 20, 2019]*

U.S. PUBLIC LAW 86-272 (PL 86-272)

- The traveling salesforce of a business-to-business catalog and web-based distributor of industrial and packaging products was found to engage in unprotected activities not immune under PL 86-272.
- Pursuant to the Company's training manual, sales reps conducted competitor market research at their customer locations that included including detailed product information such as manufacturer and brand, competitors' product pricing, product lead time, payment terms, annual rebates, and discounts. **Such competitor market research was found to have an independent business function from the solicitation of the taxpayer's product sales.**
- The 2019 Maryland *Blue Buffalo Company, Ltd. v. Comptroller* decision was cited in the Minnesota Tax Court's ruling.

***[Uline, Inc. v. Commissioner of Revenue**, Minnesota Tax Court, No. 9435-R, June 23, 2023]*

PL 86-272 INTERNET ACTIVITIES

Multistate Tax Commission ("MTC") Updated Statement of Information and Supporting States Under P.L. 86-272 issued August 4, 2021

The Statement listed the following internet activities as Unprotected even though such activity through other non-physical means (i.e. phone, e-mail not initiated via seller's website) was not rendered to be Unprotected.

- Providing post-sale assistance to customers through electronic chat or email initiated through the company website.
- Soliciting or receiving online credit card applications.
- Inviting applications for non-sales positions in the company with the ability to submit an application through their website
- Placing internet "cookies" used for product development or product management onto computers or electronic devices of customers.

PL 86-272 INTERNET ACTIVITIES (CONT'D)

- Providing remote fixes or upgrades to products previously purchased by transmitting code or other electronic instructions through the internet
- Providing extended warranty plans through the internet to customers purchasing the company's products
- Contracting with a marketplace facilitator to sell the company's products through the facilitator's online marketplace.

PL 86-272 INTERNET ACTIVITIES – STATES REACTIONS

California

- The Franchise Tax Board ("FTB") updated their PL 86-272 guidelines to include the MTC's unprotected internet activities via revisions to FTB Publication 1050, Application and Interpretation of Public Law 86-272 & issue of Technical Advice Memorandum (TAM) 2022-01.
- FTB is aggressively applying such guidelines retroactively on audit.

New Jersey

- New Jersey enacted Assembly Bill 5323 expanding their economic nexus thresholds on all income taxpayers taking effect for all tax years ending on or after July 31, 2023 with no express adoption of the MTC's unprotected internet activities; however, the NJ Division of Taxation issued Technical Bulletin TB-108(R) in January 2024 adopting these expanded MTC unprotected internet activities on a prospective basis.

New York

- Issued NY Reg. § 1-2.10 effective 12/27/2023 adopting the MTC's unprotected internet activities for C & S corporations. Currently, the NYS Dept. of Taxation & Finance is assessing whether to apply retroactively.

Oregon

- DOR had explored adopting the MTC's statement and applying to all periods open for examination but has since postponed such adoption and reconsidering retroactive application.

PL 86-272 INTERNET ACTIVITIES – STATES REACTIONS

California - Epilogue

- On December 13, 2023, the California Superior Court, San Francisco County, granted a motion for summary judgement declaring the FTB's revised statement regarding unprotected internet activities void due to their failure to follow the California Administrative Procedures Act ("APA") when publishing the guidance. *[American Catalog Mailers Association v. Franchise Tax Board (Case No. CGC-22-601363)]*
- The procedural ruling did not answer the question as to whether or not such administrative guidance violates PL 86-272.
- Despite the ruling, the FTB is the process of readopting the guidance within the required APA guidelines as they have continued applying their voided guidance on audit.

PL 86-272 INTERNET ACTIVITIES – STATES REACTIONS

New York - Epilogue

- The American Catalog Mailers Association ("ACMA"), asked a New York trial court to overturn the state's regulation imposing additional income tax obligations on out-of-state retailers that do business over the internet.
- The ACMA told the New York Supreme Court for Albany County that the challenged portions of the Department of Taxation and Finance's regulation "effectively erase longstanding federal protections against overreach by state tax agencies"; thus, asserting that such rules contradict P.L. 86-272.

[Am. Catalog Mailers Ass'n v. Dep't of Tax'n & Fin. N.Y. Sup. Ct., No. 903320-24, complaint filed April 5, 2024]

STATE APPORTIONMENT DEVELOPMENTS

CALIFORNIA – SALES FACTOR DIVIDENDS

- In a nonprecedential ruling, the California Office of Tax Appeals ("OTA") ruled that Microsoft Corp. was allowed to include 100% of dividends received from foreign subsidiaries in their sales factor denominator despite attaining a 75% waters edge group dividends received deduction pursuant to CRTC § 24401.
- The FTB had unsuccessfully asserted that only 25% of such dividends were includible in Microsoft's sales factor based on their issued FTB Legal Ruling 2006-01 calling for the exclusion of gross revenues not included in taxable income.
- The OTA ruled that FTB Legal Ruling 2006-01 was inconsistent with CRTC § 25134 allowing for the inclusion of all taxpayer sales in the sales factor.
- In its ruling, the OTA cited their precedential March 17, 2023 ruling in *Appeal of Southern Minnesota Beet Sugar Cooperative & Subsidiary, OTA Case No. 19034447* declaring that inclusion of foreign subsidiary dividends in the sales factor was not casual or occasional in nature to result in a distortion of the taxpayer's apportioned activity in the state.
- OTA denied the FTB petition for rehearing of this matter.

*[**Appeal of Microsoft Corp. and Subsidiaries**, OTA Case No. 21037336 (7/27/23); California Office of Tax Appeals, 2024-OTA-130 and -131]*

MAINE – MARKET SOURCING OF SERVICES

- The Maine Supreme Judicial Court held that a nationwide mail-order prescription drug insurance business **was required to apportion its receipts to the locations of the retail pharmacies from which prescriptions were delivered to end customers**.
- Maine market sources service receipts based on **where such services are "received"** by the customer. - *see 18-125 CMR §801.06.F.(1)*.
- Various health insurance providers contracted with the taxpayer to administer and provide prescription drug coverage to their members. The taxpayer provided claims administration services and distributed prescribed drugs to members via mail order. **Taxpayer argued that its receipts should instead be apportioned to the locations of the health insurance providers who contracted with the business, not the locations where the members ultimately received their prescriptions, as it contracted only with the health insurance providers and not the members**. However, the Maine Supreme Judicial Court found that the taxpayer regularly provided services to their customers' members directly.
- **The Court defined location of services "received" to be where the customer's customer is the ultimate recipient of such services since such information was readily available.**

[Express Scripts Inc. et al. v. State Tax Assessor, Me. Sup. Jud. Ct., No. 2023 ME 68 (11/7/23)]

MASSACHUSETTS – APPORTIONMENT FORMULA

- Currently, all business entities, except those meeting the definition of (Section 38) manufacturer are required to apply a three-factor formula with a double weighting of sales including property & payroll in apportioning their income to the state.
- Manufacturers are already required to use a single sales factor formula. The definition of "manufacturer" was expanded to include computer software developers based on prior state court rulings - *see Technical Information Release 23-8, Massachusetts Department of Revenue, July 12, 2023*.
- For tax years beginning on or after January 1, 2025, all business entities will apportion their net income using a single sales factor formula.

[H. 4101 (Ch. 50), enacted on October 4, 2023]

NEW JERSEY – SOURCING OF SERVICE RECEIPTS

- In an unpublished ruling, the NJ Tax Court allowed a New Jersey headquartered web-based business solutions services corporation to market (customer destination) sourcing of their gross receipts for apportionment purposes for their 2011 and 2012 tax years when the "cost of performance" (COP) method was the primary sourcing methodology of service receipts provided under statute and regulations on the grounds that market-based sourcing was "*more reflective of the economic realities of the Taxpayer's business*".
- The Tax Court asserted "*there is no hard and-fast rule as to the use of COP method*" under corporate business (income) tax law; thus, it is not unusual for a taxpayer or the New Jersey Division of Taxation (NJDOT) to "*prefer the approach most conducive to their respective positions, as is evident in this case*.".
- NJ did not statutorily adopt market sourcing for corporations until tax years starting in 2019; however, the NJDOT has applied it for pre-2019 tax years on select corporate income tax audits as a preferred method of apportionment at their discretion to better represent a corporation's in-state business activity.

*[**Solix v. Director, Division of Taxation**, NJ Tax Court, Docket No. 011113-2019, April 11, 2024]*

PENNSYLVANIA – CORPORATE APPORTIONMENT

- Prior to the amendment of state statute *[72 P.S. § 7401(3)2.(a)(16) & (17)]*, C Corporations were required to apply market sourcing (based on delivery location) on revenue from services but apply COP sourcing on all other non-TPP sales (including intangibles).
- For tax years beginning after December 31, 2022, this bulletin explains the following statutory changes to income tax sourcing of the following revenue streams.
  - Sales from the lease or license of intangible property (including sale or exchange of such property where receipts are contingent upon its productivity, use, or disposition) are sourced to where such property is "used".
  - Sales of intangible property where property sold is a contract right, government license, or similar property authorizing holder to conduct business in a specific geographic area are sourced to where such property is "used".
  - Gross receipts from the regular lending of funds including fees, interest, & penalties are sourced to location of collateral or borrower.

[Corporation Income Tax Bulletin 2024-01, Pennsylvania Dept. of Revenue (1/5/2024)]

SOUTH CAROLINA – FORCED COMBINATION

- South Carolina enacted legislation placing a higher threshold upon the Department of Revenue (SCDOR) in requiring a corporate taxpayer to file on a mandatory combined basis. Prior to the law change, the state had been applying broad discretion in the forced combination of corporations under audit for state income tax filing purposes.
- The SCDOR is required to the following under the enacted statute;
  - Provide written notice to the taxpayer requiring any information necessary to determine whether intercompany transactions are at FMV for accurate computation of their state net income property attributable to its in-state business activity with a 90 day taxpayer written response deadline from the notice date;
  - In response to taxpayer's written response, the SCDOR can redetermine net income properly attributable to its in-state business activity by
    (1) adding back, eliminating, or otherwise adjusting intercompany transactions, OR
    (2) requiring the taxpayer to file a return reflecting the net income on a combined basis of all members of its affiliated group that are conducting a unitary business. Such determinations must be made by applying federal transfer pricing standards pursuant to IRC §482; and
  - If a combined return is required, such return must be filed within 90 days of notice. Either party can request a combined return with less than all members of the combined unitary group of corporations; however, the SCDOR can no longer mandate a combined group excluding unitary group members without the taxpayer's consent.

[S.B. 298, Laws 2024, effective March 11, 2024]

TENNESSEE – APPORTIONMENT FORMULA

- Currently, all limited liability business entities have been required to apply a three-factor formula with a triple weighting of sales including property & payroll in apportioning their income to the state through tax years ending 12/31/2022.
- For tax years beginning on or after January 1, 2023;
  - Property and payroll will be phased out of the apportionment formula with a single sales factor in tax years starting in 2026 and
  - An excise (income) tax deduction for the first $50,000 of net earnings (taxable income).

[H.B. 323, Laws 2023 enacted 5/16/2023]

TENNESSEE – FRANCHISE TAX ON PROPERTY REPEAL REFUND OPPORTUNITY

- For tax years beginning on or after January 1, 2024, the property measure of the franchise tax will be repealed leaving only the apportioned net worth of the tax as sole measure.
- For tax years prior to 2024, refunds will be authorized on the excess amount of franchise tax paid on the property measure under the following conditions:
  - Only return periods that ended on or after March 31, 2020 on tax returns filed on or after January 1, 2021 would be eligible.
  - The refund claim must be filed between May 15 and November 30, 2024.
  - **Such claim will need to be filed on a form prescribed by the Commissioner exclusively for the purpose of seeking a refund under this provision. The form will include a signed waiver of any U.S. constitutional challenges to the franchise tax due to failure of the internal consistency test.**
  - The names of all taxpayer issued a refund under this provision would be publicly disclosed on the DOR's website.
  - Interest would accrue at the federal short term AFR plus 0.5% starting 90 days after the DOR received the refund claim with supporting documentation.

[SB2103, passed legislature 4/25/2024 – automatically enacted after 10 days in the event on non-action by the Governor]

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