1. FISCAL FORECAST IMPROVES IN 2014, BUT STORM IS BREWING OVER DIVERGENT POSITIONS ON SOCIAL POLICY ISSUES, ELECTRONIC COMMERCE

Client/matter: -None-
State Tax Outlook

In 2014, many states will continue to emerge from the lingering financial hardships of the Great Recession. But from a policy standpoint, the forecast is far from sunny. Controversies surrounding hot button issues such as gay marriage, marijuana use, and online gambling cloud the horizon. It is more than likely that the states’ divergent positions on these questions will find their way into state tax codes. Meanwhile, stakeholders will continue to debate nagging issues such as the tax treatment of online sales. At the same time, other basic state tax levies such as the gas tax and property tax are likely to receive renewed attention this year, as states continue their struggle to shore up eroding tax bases and modernize tax laws to address budgetary concerns and modern business practices.

The year ahead promises to be one of modest revenue growth and fiscal stability for the states as they move past the Great Recession. But lurking beneath this relative calm are multiple uncertainties arising from dramatic shifts in social policies and the continued growth of electronic commerce. In 2014, states and taxpayers will likely struggle to address novel questions regarding gay marriage, marijuana use, and online gambling. The federal recognition of same-sex marriages has forced state tax agencies in most jurisdictions to issue guidance in time for the filing season. New Jersey’s legalization of online gambling as well as Colorado and Washington’s laws allowing the recreational use of marijuana, have other jurisdictions eyeing the revenue impact that these policy initiatives are likely to have on state coffers.
At the same time, the states will continue to address nagging questions surrounding how to ebb the steady erosion of their tax bases. State tax codes were formulated during a time when the national economy centered around manufacturing and transactions generally conducted within easily ascertainable geographic boundaries.

Last year, several states considered, but did not enact, bills aimed at taxing additional services. Proponents of these measures argue tax codes need to be updated to reflect the nation’s decades-old shift to a service-based economy. But critics counter that taxes on services will be disproportionately borne by businesses. While fewer of these bills are likely to be introduced in 2014, the debate is sure to continue.

For most states, the continued growth of electronic commerce has made sales tax collection from remote vendors a critical issue. Last year, it seemed that federal lawmakers were on the verge of resolving part of the problem after the Marketplace Fairness Act—a bill granting states remote collection authority—was approved by the U.S. Senate. But the legislation remains stalled in the House. Meanwhile, the states are likely in 2014 to continue supplying their own answers for taxing online sales by enacting so-called click-through nexus statutes. These laws provide that an out-of-state vendor’s obligation to collect sales or use tax can be triggered from the presence of an in-state affiliate. An “affiliate” can include a resident who links to the retailer via his or her website. The first of these laws remains standing after New York’s highest court upheld it, and the U.S. Supreme Court declined to hear the case in 2013. But Illinois had its click-through nexus law struck down after the Illinois Supreme Court found that it violated the federal Internet Tax Freedom Act.

Also in the digital realm, cloud computing and other technological developments have spawned transactions that highlight a growing disconnect between new business models and old tax codes. These issues range from determining which state is allowed to tax a purchase from a mobile device to the proper tax treatment of a hotel room stay purchased through an online travel company such as Orbitz. With billions of dollars at stake, states are likely to pursue these revenue streams in 2014 and in years to come.

The relevance of state borders is becoming more hazy in the context of corporate income taxes as well. The validity of the Multistate Tax Commission’s Tax Compact was called into question after a 2012 California appellate ruling. Taxpayers operating in more than one state began challenging state apportionment provisions. Meanwhile, several states enacted legislation in 2013 aimed at heading off arguments that they are bound by the compact’s provisions.

The states will continue to struggle with sourcing laws governing the amount of sales from services and intangibles that a multistate corporation must attribute to a particular jurisdiction. In 2014, more states will likely move from a costs-of-performance method to a market-based approach.
Until recently, there seemed to be a close alignment between outdated tax laws and decaying state transportation infrastructure. But, 2013 illustrated a national trend toward a gas tax increase as a means of injecting much needed revenue into state highway or transportation funds. While there is likely to be less activity in this area in 2014, it may be that states will continue to keep a close eye on what their neighbors are doing. Last year, when Virginia passed its new law to raise money for transportation, Maryland, the District of Columbia, and ultimately Pennsylvania felt a sense of urgency to follow suit.

Captive insurance is another area that is receiving renewed interest by the states. In 2014, the states will likely continue to use a favorable interpretation of a federal law to attract captive insurers. While these laws generally create a favorable tax environment for captives, they also pose compliance challenges for such entities operating in more than one state.

Also vying for attention in 2014 will be property taxes. At least two states--New York and North Dakota--are likely to address property taxes in 2014. Property taxes account for the largest share of total state and local taxes by far, according to a recent study.

Fiscal Outlook

"Things are certainly better in the sense that we’re looking at a better economy,” Scott Pattison, executive director of the National Association of State Budget Officers (NASBO) told Bloomberg BNA Jan. 14.

Pattison used the analogy of a family recovering from the Great Recession to explain states’ fiscal positions. Both parents are back in the workforce, and they received unexpected raises from their jobs, but they will not necessarily be able to immediately repay the money they raided from the college funds, and they will still have to make monthly payments on the home equity loan they took out instead of paying it all off.

"They [the states] won’t be able to cover all of their priorities,” Pattison said. "It’s a good picture, not a great picture. But it’s so different from being in the mode of multiple periods of budget cuts.”

According to the NASBO report, state revenue collections typically lag behind the economic cycle and can take several years to fully recover from a recession. But fiscal 2014 is the fourth consecutive year in general fund spending growth, and states will enjoy more spending choices.

"They’re going to be able to discuss, should we have tax cuts, additional programmatic funding [such as pre-kindergarten], and whether they can restore some of the tax cuts from the past,” Pattison said.

Mid-year budget cuts--an indication of budget volatility and more common during recessions--occurred in 11 states in fiscal 2013. Compare that to fiscal 2010, when
39 states made mid-year budget cuts. According to NASBO’s report, improved revenue collections and spending controls have significantly reduced the number of states needing to make budget cuts in 2014.

The Nelson A. Rockefeller Institute of Government and the National League of Cities recently reported similar cautiously optimistic fiscal outlooks for 2014.

The Rockefeller Institute, the public policy research arm of the University at Albany, State University of New York, reported in December in its State Revenue Report that, based on preliminary figures, state tax collections for the first time are above the peak levels reported in fiscal 2008—showing 0.7 percent growth in inflation-adjusted terms. However, by the same measure, 28 states still had lower inflation-adjusted tax receipts at the end of fiscal 2013 compared to fiscal 2008.

Overall, the report found that state tax revenues are improving, but not as quickly as the broader economy.

At the local level, the National League of Cities, in its City Fiscal Conditions 2013 report, issued in October, painted a similar picture. Local and regional economies are improving slowly, but there are high levels of unemployment, uncertainty about federal and state actions, and long-term pension and health benefit obligations that can constrain fiscal outlooks, according to the report.

State Guidance for Same-Sex Married Couples.

While state finances are an important part of the picture, much of the states’ attention in late 2013 and early 2014 has been devoted to administrative requirements.

After the U.S. Supreme Court struck down the Defense of Marriage Act in United States v. Windsor, 570 U.S. 12 (2013), the IRS released Rev. Rul. 2013-17, which informed same-sex taxpayers that they could file their federal tax returns as married couples, using a status of married filing jointly, or married filing separately.

The ruling took a “state of celebration” approach, under which a same-sex couple is considered married if the same-sex marriage was legal in the state in which they celebrated their marriage. As a result, whether or not the state of residence recognizes same-sex marriages has no bearing on a couple’s federal filing status.

This was a great win for same-sex couples across the country, but it created uncertainty on a state tax level. Seventeen states recognize same-sex marriage and allow for joint state filing. But others have amended their constitutions to ban same-sex marriage. These jurisdictions have issued their own guidance regarding the state income tax filing status of same-sex couples.

The states that do not allow for joint filing for same-sex married couples responded in three ways. The first group of states chose to require same-sex married
couples to continue to file their state income taxes separately. As most states calculate state income tax using the federal income tax base as a starting point, this requires same-sex couples to create pro forma separate federal tax returns, because they would otherwise be filing joint tax returns for the IRS. This adds another layer of tax compliance for same-sex couples, creating “a huge burden on couples to not only have to file their state and federal returns, but to also have to prepare an extra federal return,” Nicole Pearl of McDermott Will & Emery LLP told Bloomberg BNA Jan. 7.

The second group of states chose to create a separate schedule for same-sex married residents, which essentially allocates joint federal income between the two partners. This allows same-sex couples to avoid having to fill out pro forma federal returns, but still requires them to fill out extra paperwork, and ultimately file as separate individuals.

A third group of states chose to allow for joint filing, even though their states do not recognize same-sex marriage. All of the states that took this route also have statutes requiring residents to file their state returns using the same filing status as they use for their federal return. This choice created controversy in the states that employed it. “I think it’s an administrative issue,” Pearl said. “To do otherwise means they have to come up with a way to tell couples how they should file their returns.”

While 2013 brought huge changes to state individual income tax filing for same-sex couples, the coming year promises further alterations to state tax policy.

In Utah, the same-sex marriage issue is pending in the Tenth Circuit Court of U.S. Appeals. In the meantime, same-sex couples who were married during a brief period in late December will be permitted to file joint 2013 state income tax returns so long as they also file joint 2013 federal income tax returns and they were married before the end of the tax year. The U.S. Supreme Court issued a stay Jan. 6 against the enforcement of a lower court’s injunction against the state’s constitutional ban on same-sex marriages. The fact that the U.S. Supreme Court was involved is telling, Pearl said. “It doesn’t necessarily mean that they are going to come out against same-sex marriage, but it does mean that they want it to go through the courts, and not have all these couples with marriages in limbo,” she said.

But same-sex couples wishing to file joint returns shouldn’t get their hopes up. The Supreme Court refused to rule on Hollingsworth v. Perry, No. 12-144 (U.S. June 26, 2013), which questioned the constitutionality of Prop. 8, a voter-approved ban on same-sex marriage, and dismissed the case for lack of standing. As a result, the district court’s decision that Proposition 8 is unconstitutional in California will stand, but will not apply to any other jurisdictions. As Pearl said, “until the United States Supreme Court rules definitively on the issue that was before them in Perry which they refused to answer, you’re going to have these state-by-state discrepancies.”
State Tax Treatment of Marijuana

Marijuana use is another social issue for which state laws are at odds with the federal government. Recently, Colorado and Washington legalized marijuana for recreational purposes. The road to approval was a highly debated one, but one thing is certain—the legalization of recreational marijuana will lead to an increase in tax revenue.

Legalizing recreational marijuana in Colorado was not a short-term endeavor. The Marijuana Policy Project in Denver began working on changing the public attitude toward recreational marijuana in 2005, spokesman Mason Tvert told Bloomberg BNA Jan. 6. "It is critical that voters recognize that marijuana is not as harmful as they were once led to believe," Tvert said.

Colorado approved Amendment 64 on Nov. 6, 2012, which essentially legalized recreational marijuana sales. A year later, under Proposition AA, voters approved associated tax rates and potential revenue allocations that come with legalization. Tvert said that "once [voters and lawmakers] understand that marijuana is actually far less harmful than alcohol, they tend to support taxing it and generating revenue that can be reinvested in the community."

A similar approach was taken to legalize recreational marijuana in Washington, through Initiative 502, which was approved in 2012. The Drug Policy Alliance worked to change the public attitude toward recreational marijuana. Part of the organization’s mission was to "replace Washington’s ineffective and unjust marijuana laws with a regulated public health approach that will redirect law enforcement resources to more pressing priorities, generate new tax revenues for critical social services, and take marijuana out of the hands of violent drug cartels," according to the alliance’s website.

The Liquor Control Board of Washington adopted rules to implement Initiative 502 on Oct. 16. The rules allow qualified applicants to obtain licenses for the in-state production, distribution and possession of recreational marijuana.

The most obvious state revenue impact of legalized marijuana sales comes from direct state excise taxes on marijuana, Carl Davis, senior analyst with the nonpartisan Institute on Taxation and Economic Policy, told Bloomberg BNA Jan. 3. Those sales are also subject to local excise and sales taxes.

In Colorado, an excise tax of 15 percent is imposed on recreational marijuana wholesaler transactions. Under Proposition AA, the first $40 million of the state excise tax revenue will go to the Public School Capital Construction Assistance Fund, which aims to improve schools with unmet needs, as well as other school construction needs. Any excise tax revenue exceeding the first $40 million will go into a general fund.
A special state sales tax of 10 percent per retail sale is imposed at the consumer level on recreational marijuana, or marijuana-related products. This special tax is paid by the consumer on each retail sale and is in addition to any general state sales tax. The tax revenue from these sales is earmarked for the administering and regulating of marijuana’s recreational use.

In addition to the special state tax and the general local sales tax, Colorado localities may enact special local taxes with respect to recreational marijuana, as in Denver’s 3.5 percent special tax.

Recreational marijuana is anticipated to bring Denver approximately $3.4 million in tax revenue the first fiscal year alone, said Denver City Council President, Mary Beth Susman, in a Bloomberg Television “Market Makers” interview earlier this month. She further noted that in the second fiscal year she expects tax revenue to more than double to approximately $7.5 million.

Higher excise taxes have been imposed in Washington, where the tax rate totals at approximately 44 percent.

The taxes imposed on a licensee in Washington state include excise taxes of:

-- 25 percent of the wholesale price charged by licensed marijuana producers;

-- 25 percent of the selling price on each wholesale transaction from licensed processor to retailer;

-- 25 percent of the selling price on each retail sale by a licensed marijuana retailer; plus

-- any applicable state and local excise taxes; and

-- any applicable state and local sales taxes.

Voters and lawmakers are likely intrigued by the idea of taxing recreational marijuana sales so that the tax revenue from the sales could benefit communities instead of drug cartels and other criminal enterprises, Tvert said.

In both states, a licensee of recreational marijuana, or marijuana-related products, will be subject to various license and application fees.

The legalization of marijuana for recreational purposes is likely to bring income out of the dark and into the light of an income tax return. Now that recreational marijuana is legal, and being regulated by state authorities, it becomes a tax-paying industry, Davis said. He anticipates income tax revenues will likely rise in both Colorado and Washington.

At the same time, the legality issues could lead to more audits. According to Davis, "people that sell marijuana illegally are almost never going to tell the govern-
ment about their earnings, for obvious reasons. But the regulated marijuana shops operating right now in Colorado are going to find themselves being audited very quickly if they try to do the same.”

Ultimately, Colorado’s income tax revenues should begin to rise now that “selling recreational marijuana is a legitimate profession, at least in the eyes of the state,” said Davis.

Colorado state officials have estimated that recreational marijuana sales will generate nearly $70 million in new tax revenue in the first year, which may have failed to take into account potential income tax revenue.

The prospect of legal marijuana is expected to attract dollars and people from outside the state as well. “It’ll be interesting to see what effect, if any, legalization has on these states’ tourism industries,” said Davis. Some people think that the legalization of recreational marijuana will draw people into the state, while “others have worried that marijuana legalization could actually prevent families from visiting if parents perceive it as being family-unfriendly,” said Davis.

However, there are a lot of reasons to come to Colorado and people will come to Denver for the recreational marijuana, also, said Susman, in the Bloomberg interview.

Recreational marijuana tours, similar to the ones being offered in the Netherlands, are already receiving a great deal of buzz. Colorado Highlife, a Colorado agency, offers “weed tours” with the slogan, “come get high on a mountain.” Colorado Highlife gives consumers the option of a private personalized tour or a retail tour.

In addition, Colorado Green Tours, a full service travel agency, encourages site visitors to call and book their own personal cannabis experience. “The Colorado Cannabis scene is awesome and the rest of the world needs to hear about it and see it in action--that’s why we’re here,” according to the website mission of Colorado Green Tours.

Whether tourists come in large or small groups, each visitor would potentially improve Colorado’s economy. Increased tourism would “increase revenue from hotel taxes, meals taxes, sales taxes and more,” said Davis.

According to Davis, this debate hasn’t been confined within Colorado and Washington’s borders. In fact, there are approximately 20 states considering legalizing recreational marijuana, said Susman.

We do not expect to see the legalization of recreational marijuana in states where there has not been a significant amount of public dialogue. Those states shying away from the issue would include: Mississippi, Alabama, Georgia, South Carolina, Nebraska, Oklahoma and Kansas, said Tvert. However, we should expect to see the legalization of recreational marijuana in Alaska this year. According to Tvert, local ac-
tivists are wrapping up a petition drive to place an initiative on the August 2014 ballot, and there is also a good chance Oregon will be voting on a similar measure in November 2014.

The Marijuana Policy Project plans to support initiatives in Arizona, California, Maine, Massachusetts, Montana, and Nevada, said Tvert.

The Marijuana Policy Project has also been lobbying to pass these measures in six other state legislatures over the next few years--Delaware, Hawaii, Maryland, New Hampshire, Rhode Island, and Vermont. Out of these six, Tvert anticipates Rhode Island to be the first to pass the measure via state legislature.

One thing seems clear, tax revenue will likely play a significant role in the decision for many voters and lawmakers, alike, said Tvert.

Similar to the legalization of recreational marijuana, changing social views have led a few states to attempt to cash in on the potential for greater tax revenues of another historically outlawed activity, namely online gambling.

Online Gambling

Three trend-setting states offer legalized, licensed and taxed Internet gambling within their borders: Nevada, Delaware and New Jersey.

Among them, Nevada was the first state to legalize online poker in the U.S. Delaware then broke through by launching the first full-scale Internet gambling operation, followed by New Jersey.

It is difficult to predict which states will be next to legalize Internet gaming, "but a number of states are currently considering introducing online gaming in a secure, regulated fashion," Andrew L. Smith, director of research at the American Gaming Association told Bloomberg BNA Jan. 10.

"It’s probably safe to say a number of states are watching what is happening right now in Nevada, New Jersey and Delaware, and as long as their online regulatory systems continue to perform as well as they have been, other states will likely take notice," said Smith.

"All eyes are on New Jersey," because New Jersey stands to have the greatest impact on Internet gambling, Robert Heller, president and CEO of Spectrum Gaming Capital, a consulting group that focuses exclusively on gaming, resorts, and leisure, told Bloomberg BNA Jan. 8.

The legalization of Internet gambling in New Jersey potentially stands to serve the greatest impact because it is the largest state to have legalized Internet gambling—the state has the largest population of the three and offers more games to the gambler, said Heller. New Jersey residents also have more disposable income compared to residents in Nevada and Delaware.
Ultimately, what provides success in the Internet gambling world is “liquidity” in the operation, Heller said. Liquidity in Internet gambling, especially poker, comes down to three things:

-- a lot of players;

-- those players gambling at one time; and

-- enough games being offered to the players.

The full-scale operation combined with more people gambling at the same time provides New Jersey’s Internet gambling with the liquidity it needs to succeed, said Heller.

Anticipated Revenue.

For some, there is no question that states should begin legalizing Internet gambling. States that have taken over other areas of gaming, such as a state lottery, have yielded great rewards. Today 43 states run their own lotteries, which bring in approximately $18 billion each year nationwide. Every lottery and casino that is legally operating within a state is directly controlled by that state which in turn yields a direct tax benefit for that state, said Heller.

States that have already legalized a form of Internet gambling anticipate more tax dollars. Both Nevada and Delaware estimate they will collect approximately $3 million more per year in tax revenue. Both Nevada and Delaware impose the same tax rate on Internet-based income as they do on land-based income driven from gambling operations. New Jersey, however, imposes a land-based income tax rate of 9.25 percent and an Internet-based income tax rate of 15 percent.

In New Jersey, Gov. Chris Christie’s (R) administration estimates the first year could bring the state as much as $160 million in tax revenue. Other studies have suggested the tax revenue may be lower, but one thing is certain: the state stands to collect a significant amount of tax revenue. With the combined liquidity of New Jersey’s operation and a higher tax rate imposed on Internet gambling income, the state estimates higher tax revenue than both Nevada and Delaware, combined.

Several other states are now considering legalizing, licensing and taxing Internet gaming in an effort to reap the same rewards. Colorado and the District of Columbia have already taken steps to authorize online poker. California, Illinois and Pennsylvania are considering legalizing some form of Internet gambling. In other states, such as Iowa, state officials are closely observing what happens within the states that have already legalized Internet gambling.

“States are likely motivated by a number of factors when they consider legalizing online gaming. Effectively regulated online gaming stimulates economic develop-
ment, creates jobs, generates tax revenues and gives consumers important protections unafforded to them by illegal offshore gaming sites,” said Smith.

While other states may be wary of the moral, social and regulatory issues associated with the legalization of Internet gambling, there are only seven states in the country that have regulations in place prohibiting it, according to Safe and Secure Internet Gambling Initiative’s website. The organization aims to promote “the freedom of individuals to gamble online with the proper safeguards to protect consumers and ensure the integrity of financial transactions.”

According to recent reports by Spectrum Gaming Capital, a state-by-state rollout of Internet gambling is predicted. The group anticipates California, Pennsylvania and Illinois to be the next states to legalize some form of Internet gambling, followed by Massachusetts, Maryland and New York. “Let us not forget about the Indian Tribes,” said Heller, they will want a piece of the action, too.

Spectrum Gaming Capital studied and ranked the likelihood of states legalizing Internet gambling by considering casino proliferation, lottery contributions, legislation, and whether the state had recently approved legalized gambling measures.

The legalization of Internet gambling in additional states means more tax revenue for the newly legalized states as well as the trend-setting states. Nevada alone estimates over $50 million in tax revenue from online poker if it is able to spread to other state markets.

Spreading into other state markets could take some time though, said Heller. To spread, states would have to enter some type of compact agreement, which would allow players to play between the states, Heller said. Such an agreement would be most beneficial for states like Nevada that lack the variety of games and Delaware which has a smaller population.

New Jersey is already considering whether other states as well as other countries may be made eligible to participate. Bringing New Jersey’s Internet gambling to an international level could take a great deal of time, and there are federal regulations that could interfere, said Heller.

Legalization of Internet Gambling: Federal Level.

On this note, legalization a federal level would yield massive increases in tax revenue, for both federal and state governments as well as Indian tribes, according to projections by Bloomberg Industries. Spectrum Gaming Capital reports states that 77 percent of Americans are Internet users, and there is a good chance a great number of them will take advantage of legalized Internet gambling.

Currently, there are two bills before Congress. The first, H.R. 2666, the Internet Poker Freedom Act of 2013, proposes to legalize the licensing of Internet poker within the U.S. In addition, the bill allows states to opt out of legalizing Internet gam-
bling within their borders. Under the bill, the Treasury Department would oversee Internet gambling.

The second, H.R. 3491, the Internet Gambling Regulation and Tax Enforcement Act of 2013, focuses on the tax implications and operations. The bill would require all authorized licensees to pay a tax of 4 percent on all funds deposited by customers for purposes of placing a bet. In an attempt to essentially eliminate the black market, the bill proposes a tax of 50 percent on all unauthorized bets or wagers. Further a credit may be afforded, with some limitations, for payments made to a state, Indian tribe or an overseas operation. The bill proposes an additional 8 percent state tax and Indian tribal governments tax.

According to Smith, the future for Internet gambling in the United States is still being determined on a national level as well as on a state-by-state basis. “The [American Gaming Association] strongly believes, however, that the Internet is not going away and that banning online gaming simply does not and will not work.”

There is no question that the nationwide impact of legalizing Internet gambling could be extremely significant. Bloomberg Industries projects annual Internet gambling revenue could reach $23 billion nationwide. But just because the national impact could be significant does not mean the state will want to give up direct control, says Heller.

As states continue to tap new online industries for potential streams of tax revenue, the passage of federal legislation extending a state’s power to impose tax collection requirements on vendors lacking a physical presence within their borders remains a top priority for most states.

Sales Tax

The proposed federal Marketplace Fairness Act (S. 743, H.R. 684) is likely to take center stage in 2014 among state and local tax practitioners, businesses engaged in remote sales, and consumers making online purchases. If it is enacted in its current form, the act would allow states to impose sales tax on remote sellers if their remote sales exceeded $1 million in the preceding calendar year. However, when the MFA might come up for discussion in Congress again is unclear. It passed the Senate in May, but it has been languishing in the House Judiciary Committee since then with no timeline on when the committee might take it up.

Rep. Bob Goodlatte (R-Va.), chairman of the House Judiciary Committee, issued seven “basic principles of Internet sales tax” in September, signaling that the MFA is on his radar but that amendments may be proposed to the version passed by the Senate. His principles include not using the Internet to create new or discriminatory taxes not faced in the offline world, the requirement that the sales tax compliance burden on online sellers be equal to those on similarly situated offline busi-
nesses, no regulation without representation, compliance simplicity, tax competition, state sovereignty, and privacy.

Congress recognizes that something needs to be done in the area of sales tax on remote sellers, Craig Johnson, executive director of the Streamlined Sales Tax Governing Board told Bloomberg BNA Jan. 7. He said this observation was based on the strong bipartisan support that the MFA had in the Senate and the conversations he has had with stakeholders. And if Congress decided to join the MFA with the Permanent Internet Tax Freedom Act (S. 31, H.R. 3086, which would make permanent the prohibition of taxing Internet access and prohibit multiple and discriminatory taxes on electronic commerce), it would really communicate to people that the MFA is not imposing a new tax, Johnson said.

“All it’s [the MFA] really doing is giving states power to collect tax that is already owing,” Johnson said. “This is a way to effectively collect the tax, and it will level the playing field for retailers.” Johnson said he thinks more legislative action on the MFA will occur this year, including changes to the MFA in the House.

Johnson said a good change to the bill would address tax calculation and reporting software to ensure that the system can correctly identify the jurisdiction where the tax will be imposed and the tax rate. He also expects legislators to bring up audit issues related to remote sellers, because auditing a taxpayer who has no physical presence in the state is a burden to both the state and to sellers. And finally, he expects legislators to push for more uniformity in taxability matrices and rates.

Until then, the law of the land is still Quill v. North Dakota, 504 U.S. 298 (1992), which requires that a taxpayer have a physical presence within a state’s borders to achieve substantial nexus and be obligated to collect sales tax. However, Johnson said the technology available today has taken away a lot of the burden on sellers of collecting sales tax from many jurisdictions.

For example, through the Streamlined Sales and Use Tax Agreement, the Streamlined Sales Tax Governing Board has a centralized registration system with more than 2,000 retailers who have voluntarily registered to collect tax in 24 member states. Rate and boundary databases are updated quarterly.

“The technology that’s there is really what makes it easy for the retailers,” Johnson said. “We think that’s a big plus for why retailers have been coming forward and registering and collecting the tax.”

Between October 2005 and the end of 2012, Johnson said Streamlined member states have collected nearly $1.5 billion in tax on a voluntary basis. If collection was not easy, retailers would not collect the tax, Johnson said.

Additionally, taking advantage of the provisions of the MFA, if it passes, is optional from a state perspective--the federal legislation gives states the power to tax remote sellers, but does not require it.
Johnson said he thinks that over time, remote sales could surpass sales at brick-and-mortar shops, and because states need a certain amount of revenue to operate, other options would include raising other rates and broadening the tax base. “I think it’s a problem we need to have a solution to as soon as possible,” Johnson said.

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Click-Through Nexus.

With the MFA stalled in the House, several states have taken the initiative to pass so-called click-through nexus laws, which aim to impose sales tax collection obligations on out-of-state online vendors.

In 2013, four more states--Kansas, Maine, Minnesota and Missouri--enacted provisions that establish a rebuttable presumption that a vendor has substantial nexus with the state when the vendor enters an agreement with a state resident to pay them a commission or other consideration for placing links on a website that, when clicked, direct Internet users to the vendor’s website.

Some tax practitioners may view click-through nexus provisions as a money grab by states that will eventually be found unconstitutional. However, Maryann B. Gall, founder/owner at M.B. Gall Tax in Columbus, Ohio, has been tracking nexus
cases for years and told Bloomberg BNA on Jan. 7 that tax practitioners might see more action on click-through nexus in 2014.


Meanwhile, Illinois struck down its click-through nexus law. The Illinois Supreme Court held that the state’s click-through nexus law was preempted by the federal Internet Tax Freedom Act (ITFA), in Performance Marketing Ass’n v. Hamer, No. 114496 (Oct. 18, 2013). The statute was found to violate the ITFA because it treats some forms of advertising differently from others, said Jeffrey A. Friedman, partner with Sutherland Asbill & Brennan LLP in Washington, D.C. on Dec. 12 during a panel presentation at the New York University Institute on State and Local Taxation. For example, click-through links give rise to nexus, but “regular” Internet advertising does not. The Illinois law deserved to fail because it was not well drafted, added co-panelist Richard Pomp, professor of law at the University of Connecticut. The provisions (35 ILCS 105/2(1.1) and 110/2(1.1)) specifically defined as retailers or servicemen maintaining a place of business in Illinois, and consequently subjected to tax, those who agreed to refer potential customers to a retailer’s products or services via their Internet website in exchange for consideration. The way retailers and servicemen were defined, thus, acted as an irrebuttable presumption of taxability. In contrast, New York’s statute (N.Y. Tax Law § 1101(b)(8)(vi)) imposes a rebuttable presumption of business solicitation on persons who use independent contractors or other representatives to refer potential customers to their products via the Internet or other means.

However, Gall does not necessarily view Illinois’ route as the one the rest of the country will take on this kind of nexus.

“I would say more states are going to look at drafting and introducing and passing click-through nexus,” Gall said, about the 2014 state legislative session.

“My view, really there’s nothing new in click-through nexus that wasn’t talked about in Scripto in 1960,” Gall said, referring to Scripto Inc. v. Carson, 362 U.S. 207 (1960). In that case, the U.S. Supreme Court held that 10 independent contractors “conducting continuous local solicitation in [the state] and forward[ing] the resulting orders …” to the taxpayer created nexus.

Years later, the Supreme Court decided Tyler Pipe Industries Inc. v. Washington Department of Revenue, 482 U.S. 232 (1987), in which the court noted, with approval, the Washington Supreme Court’s statement that “the crucial factor governing nexus is whether the activities performed in the state on behalf of a taxpayer are significantly associated with the taxpayer’s ability to establish and maintain a market in this state for sales.”
Even though technology has changed over the years, Gall said practitioners have to know the basics to apply these kind of concepts. She said that in the absence of state legislation on click-through nexus, states have these two Supreme Court decisions as authority to begin enforcing tax collections.

"If you have a living human being in a state that is getting you business (as a retailer) … you have nexus, we [referring to the Supreme Court] don’t care what you call them," Gall said. "You could call it a zombie, but if that person is doing something for your business," the court can find nexus.

A lot of retailers have click-through programs, but Gall said the shrewd taxpayer would ask, "Are we making any money here?" She said that if a retailer sells a product to an out-of-state customer, and the retailer did not charge the customer sales tax, and then the retailer gets assessed sales tax on the transaction, realistically the retailer would absorb the cost because the retailer would not try to extract more money from a party from whom the retailer wants to receive more business.

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<thead>
<tr>
<th>State</th>
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<td>Arkansas</td>
<td>6%, before July 1, 2013 (gross receipts and compensating tax)</td>
<td>6.5%, effective July 1, 2013 (gross receipts and compensating tax)</td>
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<td>Virginia</td>
<td>4%, before July 1, 2013</td>
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Cloud Computing.

Another issue that might prove stormy in 2014 is the state tax treatment of cloud computing, Stephen Kranz, partner at McDermott Will & Emery LLP in Washington, D.C., told Bloomberg BNA Jan. 8.

Current sales tax provisions generally impose sales tax at the customer’s location. This is known as a destination regime. But determining or accurately tracking a customer’s location can be difficult when cloud computing users are accessing services with mobile devices.

"The legislative destination regime that we have today doesn’t work in a mobile environment," Kranz said. For example, if a person makes a cloud purchase remotely in Colorado, but the billing address that the cloud provider has for the purchaser is in Washington, D.C., the District may collect the tax on the purchase even if that’s not what the law says should happen, Kranz said.

Theoretically states could face refund claims on the purchases, but realistically that is not happening. Even though the legal concept may dictate that destination-based sourcing requires the tax on the purchase to be directed to Colorado, the practical effect is that a digital seller only knows the purchaser’s billing address and
does not keep track of the purchaser as he moves from state to state making cloud-related purchases.

"The only way to get there is federal legislation," Kranz said. That federal legislation is pending in Congress and is known as the Digital Goods and Services Tax Fairness Act (S. 1364, H.R. 3724). It prohibits a state from taxing sales of digital goods and services unless the customer’s address is in that state.

Kranz said federal legislation is necessary for two reasons: it is the only way to cover all states, and it would include the sourcing that everyone thinks is the right answer.

Whether a cloud computing transaction is subject to sales tax depends on a state’s classification of multiple factors and the particular facts of the transaction. Does the state classify prewritten software as tangible personal property? How does the state tax digital property? How does the state tax services? Does the state conform to the Streamlined Sales and Use Tax Agreement?

A patchwork of laws among the states has led to taxpayer confusion and the potential for taxpayers to be exposed to multiple tax obligations. And states are losing money that some would argue they are already entitled to by virtue of the fact that the items are taxable when they are sold as tangible personal property.

The Center on Budget and Policy Priorities, a nonpartisan think tank in Washington, D.C., estimated in a December 2012 report that states lose more than $300 million per year by not imposing sales tax on digital goods and services.

Kranz said he thinks there is a desire to have uniformity in sourcing rules, but not necessarily to have uniformity in taxability of cloud transactions. And while he thinks that the Streamlined Sales and Use Tax Agreement would be able to do some good for taxpayers by putting forward uniform sourcing rules, it would not cover everything because the SSUTA does not cover all states.

There is a good chance that Congress will consider and possibly pass the Digital Goods and Services Tax Fairness Act, said Kranz. And although he thinks there is no chance that the SSTGB would work on any sort of uniform taxability provisions related to cloud computing, he does think the SSTGB will continue its progress in establishing more clarity on sourcing for digital products.

Kranz said there have been conversations about the MFA, the Permanent Internet Tax Freedom Act, the Business Activity Tax Simplification Act and other related pieces of legislation possibly progressing through Congress together.

"I think there’s a very realistic possibility that if anything starts to move, a number of those would go along together," Kranz said.

Aside from this, Kranz said he thinks that 2014 will bring more attention to the income tax treatment of cloud computing and digital content—such as how the result-
ing revenues should be sourced to states. On one hand, a state could view cloud computing as a sale of tangible personal property, which typically is subject to tax in the income tax world. On the other hand, the state could also view cloud computing as revenue from the sale of a service or an intangible, which could lead to a different tax outcome.

All of this could be influenced by how sales tax is imposed on cloud computing. For example, states could look at whether they are taxing cloud computing transactions as tangible personal property under sales tax, or whether they consider cloud computing to be a data-processing or information-processing service.

"How states address sales tax may affect how they source the revenue on the income tax side," Kranz said.

Taxation of Services.

While the emergence of electronic commerce has produced a fair amount of uncertainty concerning the application of sales tax, an old "new" issue that will continue to play out in 2014 is the state tax treatment of services. The U.S. economy long ago began to shift away from manufacturing and toward services, but efforts to reflect this change in state tax codes have mostly been unsuccessful. There are only four states (Hawaii, New Mexico, South Dakota and West Virginia) in which services are presumed to be subject to sales tax.

Finding new ways to tax services will come up again in state legislatures like it did in 2013, Loren Chumley, principal with the state and local tax practice at KPMG in Nashville and national practice leader for the firm’s U.S. indirect tax practice, told Bloomberg BNA Jan. 9. During the 2013 state legislation session, Chumley said the proposed sales-tax-related reforms were mostly tied to broadening the sales tax base, changing rates, or both.

Among the states that considered expanding the sales tax base on services in 2013, were Louisiana, Ohio, Minnesota and North Carolina, but only in North Carolina did a limited sales tax base expansion occur—to include admission charges to live performances, movies and museums and cultural sites, and service contracts in which the seller agrees to maintain or repair tangible personal property.

It is unlikely that states will consider the same kind of sweeping proposals to tax services in 2014 because of their poor success rate last year, Karl Frieden, vice president and general counsel at the Council On State Taxation (COST) told Bloomberg BNA Jan. 13. "We’ve never seen anything quite like that in one year," Frieden said.

But Chumley said "I think you’ll continue to see proposals filed," in 2014. "I do foresee a lot of debate."

Conditions could be ripe for these proposals, Chumley said, because many states lack partisan gridlock and 2014 is an election year. According to the National Con-
ference of State Legislatures, 37 states have single-party control of legislatures and governorships. North Carolina, where the limited sales tax base expansion occurred, was controlled completely by one party (Republicans) last year.

Whether more of those provisions will actually pass or survive though is a different story.

A false start by Massachusetts enacting a tax on computer services last year could prove instructive for other states. The tax was effective July 31, 2013, only to be retroactively repealed by the legislature on Sept. 27.

The repeal occurred because the business industry came to realize the huge impact the new law would have on it, Chumley said. The financial dent that the tax would make was disputed, but the figures were sizable regardless. The Massachusetts Taxpayers Foundation estimated the tax would cost employers an additional $500 million in annual taxes, while the state estimated it would cost employers an additional $161 million, according to local media reports.

Minnesota may find itself in a similar situation in the next few months if constituents seek to undo a new tax on services there as well.

Last year, the Minnesota enacted a tax on businesses that purchase storage or warehouse services from another entity, set to take effect April 1.

Historically, Chumley said sales taxes on services have been more commonly imposed on services rendered locally, such as repairs or installation, because those are relatively easy to source. However, with transactions like computer services or even warehousing services, businesses often have choices of jurisdiction based on sourcing, and that makes the tax compliance and administration more complicated.

Both Chumley and Frieden said policymakers should be wary of pyramiding of the sales tax. According to the COST/Ernst & Young study, “What’s Wrong With Taxing Business Services?” released April 4, 2013, pyramiding the sales tax means taxing the same goods and services multiple times as they move through production and distribution to final retail sale.

The COST study found that expansions of sales tax bases to include additional business-to-business sales of goods and services would result in significant tax increases imposed on businesses, to the tune of 70 to 80 percent of the increased revenue derived from sales tax on business input purchases. In Minnesota, for example, $1.9 billion of the $2.6 billion in additional revenue raised from a proposed sales tax base expansion would have come from business purchases of services, according to COST’s report.

Frieden said the general idea of a sales tax is that it is a tax on household consumption, and pyramiding the tax on business input services does not line up with that
idea. So Frieden said legislatures that are considering broadening the sales tax base to include more services should look first at how they can provide adequate exemptions for business-to-business services. Then, he recommended that they make changes to tax laws more incrementally with exemption protections worked into the laws.

As these proposals continue to come up, he suggested states take notes from the way other countries have designed the value-added tax -- it includes taxes on services but provides credits for taxpayers to avoid pyramiding of tax. This could be done with the sales tax, and Frieden said states have precedents for this in sales tax laws -- like exemptions for manufacturing.

"We just don’t have those in place right now with services," Frieden said.

Frieden said the ironic thing about states’ previous proposals is that the failure to exempt business inputs from an expansion of sales tax on services is that the tax is contrary to the trend that has evolved among states in the income tax arena to make their tax climates more business friendly -- single-sales factor apportionment.

"You curiously could end up with an income tax policy that’s contrary to the rest of your sales tax policy," Frieden said. "There will continue to be interest in changing the composition of sales and income taxes. Hopefully the lesson from 2013 is when states do that, they pay more attention to the design."

Besides legislation at the state level, taxpayers should also follow Congress’ progress on the Digital Goods and Services Tax Fairness Act. Regardless of how fast Congress moves on it, Chumley expects to see states continue to consider taxation of digital goods and services either legislatively or under traditional concepts of taxation of services and tangible personal property.

"It is an easy point for a legislator to make to say, why should a CD be subject to tax but a digital song should not," Chumley said.

Online Travel Companies

As states and taxpayers ring in 2014 another issue of contention is how to best tax transactions that have become fixtures of the online marketplace. For nearly a decade, the battle over the proper application of state and local hotel occupancy taxes, as well as related sales and excise taxes, on online travel companies (OTCs) has been waged in state and federal courts. Indeed, with potentially billions of dollars at stake, 2013 showed that these costly and often combative cases will be a fixture for years to come.

OTCs are the online version of traditional travel agents. Internet users can access popular websites such as Expedia, Orbitz, Priceline, and Travelocity, among others, to book travel accommodations. OTCs are used to reserve hotels, flights, rental cars, and other travel-related activities as part of a single-priced package.
For hotel booking purposes, OTCs play the role of "middle man" between the hotel and the consumers, acquiring rooms at a wholesale price and charging a retail price to consumers. Included also in the amount paid by the consumers are facilitation fees, service fees, commissions, and markups.

Hotel occupancy taxes, commonly called tourist development taxes, transient accommodation taxes, or transient occupancy taxes, are usually imposed at the local level and are sometimes accompanied by state sales, excise, or lodging taxes.

At the center of nearly a decade’s worth of litigation is the question whether to impose and collect the tax based on the lower wholesale amount the OTC pays the hotel for the room, or the amount the consumer pays, including the fees, to the OTC. Because hotel occupancy tax laws have typically been left untouched since their enactment, the controversy centers around whether the "outdated" tax law extends to the relatively new OTC model.

Hotel occupancy tax laws were originally drafted with the traditional hotel transaction in mind. Specifically, a hotel guest contacts the hotel to book a room and then directly pays the hotel for the accommodations. Therefore, these laws typically impose collection duties on those persons providing such accommodations, and the respective taxes are imposed and collected based on the amount paid to the hotel.

To date, OTCs have been successful in arguing that they only provide a booking service that facilitates the traditional hotel transaction model. As such, OTCs argue that they do not own, operate, or manage any of the hotel buildings or facilities, and accordingly, they often do not constitute a taxable person under the relevant statutory definitions.

Although OTCs have experienced a degree of success arguing their respective positions, taxing authorities nevertheless gained ground with some important court victories in 2013, setting the stage for a contentious 2014.

Specifically, the 2013 victories may signal a developing trend that courts may be judicially expanding the tax base to include OTCs. For example, in Chicago v. Hotels.com LP, No. 2005 L 051003 (Ill. Cir. Ct., June 21, 2013), the court found that, because the OTCs perform important managerial functions as well as "control the whole transaction with the customer up to the point where the customer physically arrives at the hotel," the OTCs fall within the plain meaning of "operator" of hotel accommodations.

Similarly, in In re Travelocity.com LP, No. 2010-112 (Wyo. State Bd. of Equal. Feb. 28, 2013), the Wyoming Board of Equalization affirmed a Wyoming Department of Revenue ruling that OTCs are "vendors" under the state’s sales tax law and are therefore liable for sales tax on the full price customers pay for hotel rooms.
through OTC websites. The board’s ruling is currently under appeal before the Wyoming Supreme Court.

In Expedia Inc. v. City and County of Denver, No. 2012cv1446 (Colo. Dist. Ct. April 13, 2013), the Colorado District Court also found that the term “vendors” extended to OTCs and, thus, held them liable for $3.56 million in unpaid lodging taxes. In San Antonio v. Hotels.com, No. 5:06-cv-00381-OLG (W.D. Tex. April 4, 2013), the court likewise determined that "the OTC steps into the shoes of the hotel as merchant of record.”

Maintaining any sort of momentum from this trend may prove difficult for taxing authorities however. These cases are most often brought at the local level and predictably turn on the specific language of the local statute or ordinance. As a result, a favorable ruling in one jurisdiction is often ignored in another, leaving both sides at the mercy of the appellate process as it plays out case by case.

OTC Gains.

While taxing authorities had some notable victories in 2013, OTCs had their share of favorable rulings as well.

For example, last February, in Transient Occupancy Tax Cases v. Hotels.com LP, et al., No. JCCP 4472, (Cal. Super. Ct. Feb. 6, 2013), a California Superior Court ruled that the marked-up price that OTCs charge customers is not subject to San Francisco’s transient occupancy tax and the OTCs are therefore owed almost $60 million in a tax refund. Specifically, the court ruled that the specific statutory language did not apply to the OTCs or to the marked-up price.

In addition, a Florida appellate court ruled in Alachua County v. Expedia Inc., No. 1D12-2421, (Fla. Dist. Ct. App. Feb. 28, 2013), that the state’s tourist development tax applied only to the privilege of renting rooms, meaning only the amount received by the hotels. The court determined that the amount retained by the OTCs is for the service of facilitating the reservation and is, therefore, not subject to tax. The Florida Supreme Court has agreed to review the decision.

Another important 2013 development came in late December when the Hawaii Supreme Court agreed to accept an OTC case, thereby bypassing the Hawaii Intermediate Court of Appeals in the process.

The state’s highest court agreed to hear Travelocity.com, LP v. Dir. of Taxation, No. SCAP-13-0002896, (Haw.), filed Dec. 24, 2013, in which hundreds of millions of dollars of alleged unpaid transient accommodation taxes (TAT) and general excise taxes (GET) are at stake.

In 2012, the lower court ruled that the OTCs did not owe TAT on the difference between the amount paid to the hotels for the rooms and the marked-up price paid by the consumer. However, in January 2013, the same court ruled that the GET ap-
plied to the marked-up amount and further found penalties applied to the unpaid taxes. The court later granted the state summary judgment on the issue of interest on the penalties.

The Hawaii high court will have the final say on these issues, with onlookers from other jurisdictions paying close attention.

As OTC litigation rolls into a new year, one discernible trend that a decade’s worth of case law has produced is that the disputes typically hinge on the exact wording of the relevant statute or ordinance or its legislative intent.

The statutes or ordinances at issue, however, were typically drafted long before the Internet made the OTC business model a profitable (and possible) business endeavor. Because states and municipalities typically neglected to amend their laws to account for OTCs, “the issue is a self inflicted wound,” Pomp told Bloomberg BNA Jan. 12.

Nonetheless, such a hurdle has not prevented courts from stepping beyond the scope of a statute or ordinance’s enabling provision by legislating from the bench, Breen Schiller of Horwood Marcus & Berk in Chicago, told Bloomberg BNA on Jan. 13. Accordingly, these cases typically fall into one of two categories: the first are decisions where courts follow the letter of the law, and the second are the aforementioned decisions where a court expands the breadth of the enabling statute or ordinance, Schiller said.

The troublesome issues arise in the latter scenario when a court upholds a state or municipality’s attempt to impose their antiquated laws on the OTC business model. Indeed, in circumstances where a law’s enactment pre-dates the OTC model, it is “disingenuous” to argue that the law’s true intent encompasses OTCs, Schiller said.

While litigation continues to be the most popular approach for states and municipalities, it is still an unpredictable gamble. Further, the approach has been criticized for being misguided. As the Sixth Circuit noted in both Columbus, Ohio v. Hotels.com LP, 693 F.3d 642 (6th Cir. 2012) and Louisville/Jefferson County v. Hotels.com LP, 590 F.3d 381 (6th Cir. 2009), “the decision to assign liability to online travel companies is one that remains in the hands of the legislature and not this Court.”

Accordingly, some states and municipalities have instead taken the more democratic approach and focused on a legislative solution to the OTC dilemma. While OTCs routinely challenge such action, last November, taxing authorities won an important decision, which helped to solidify a municipality’s authority to enact such legislation.

In Expedia Inc. v. New York City Department of Finance, No. 180, (N.Y. Nov. 21, 2013), the New York Court of Appeals, the state’s highest court, reversed an ap-
pellate court decision and ruled that New York City’s 2009 amendment to its hotel occupancy tax that targeted fees charged by OTCs is constitutional. Specifically, the court ruled that the city acted within its authority under the enabling statute to amend its tax laws to account for OTCs.

In addition to New York City and the District of Columbia, a few other jurisdictions have legislatively extended their statutes to cover OTC services “rather than declaring it law by fiat,” Joseph Henchman, Vice President of Legal and State Project at the Tax Foundation, told Bloomberg BNA Jan. 13

However, states that pursue a legislative approach could find themselves in a Catch-22. According to Pomp, “if they change their statutes in the midst of litigation, even if they characterize the change as a ‘clarification’ of law, they risk sending a message to a court that they are acknowledging that the statute as currently drafted is defective.” Thus, as Pomp further explained, “the trade off is that a change in the statute will ensure future collections but at the risk of leaving money on the table for past years.”

However, as Henchman explains in a May 2012 Tax Foundation Special Report, such “claims of ‘revenue losses’ are misplaced.” In his report, Henchman states that because “the collection of [hotel] taxes has not been expected prior to the lawsuits,” it is a disingenuous argument to claim that hotel tax on OTC services already exists and states and municipalities are simply attempting to collect back taxes. Accordingly, Henchman said, “it cannot be reasonably said the taxes are owed yet ‘uncollected’ . . . [thus], the revenue was never to have been gained, so it cannot have been lost.”

In addition, in his report, Henchman explains that state legislation potentially runs into constitutional issues. Specifically, he said, because most states and localities do not tax services, any state legislation taxing only Internet-based travel companies not only singles out OTCs, but also shifts the tax burdens to nonresidents and out-of-state visitors, thus running afoul of the Commerce Clause. Accordingly, a federal solution has been proposed to prevent states from interfering with the free flow of interstate commerce.

Further, as Pomp said, “there is also the possibility if there is widespread change in the statutes, or if the pendulum swings in favor of the jurisdictions in litigation, Congress might intervene on behalf of the [OTCs].”

In such a circumstance, congressional action would have pros and cons to both sides, Schiller said. Indeed, she said that “on the one hand, federal legislation raises questions of state sovereignty and whether this is an issue best left up to the individual states and localities to regulate. On the other hand, federal legislation would provide uniformity amongst the states [and] protect against risks associated with leaving it to the states’ discretion.”
After nearly a decade’s worth of litigation, the OTC issue has longevity. In 2014, there will likely be resolutions before state supreme courts in Hawaii, Wyoming, and Florida.

In addition, while unlikely in 2014, a federal solution may gain support should states and municipalities enact discriminatory legislation or should litigation begin to overwhelmingly favor states and municipalities.

Further, Schiller predicts states will begin conducting risk/benefit analyses of whether pursuing the issue via legislation or further litigation is worth the potential risk of losing tourism revenue. Specifically, Schiller said that "if this was just a money run or a revenue generator for a state, then the blow-back that it could see on its economy may not [be worth the] risk of pursuing [the issue] any further.”

Gas Tax Reform

Gas taxes—a decidedly offline activity—should continue to command state policymakers’ attention in 2014 as well. As the most significant source of revenue for funding transportation infrastructure repairs and maintenance, gas taxes have been long overdue for reform. Like the federal gas tax, which has been stuck at $0.184 for 20 years, many state gas taxes have likewise remained stagnant over that period of time. In 2013, however, states began to take important steps towards transforming their gas taxes into more sustainable streams of revenue.

Recently, states have struggled to provide funding to stem the erosion of highways, bridges, tunnels and other key elements of their transportation infrastructures. As states scramble for solutions for their insufficient highway funds, many jurisdictions have identified gas taxes as a resource for fixing deficiencies.

Indeed, as 2013 illustrated, a national trend toward a gas tax increase as a means to inject much needed revenue into state highway or transportation funds is currently underway. But while a gas tax increase may seem logical and may provide short-term relief, there is concern that simply increasing the tax may be inadequate for providing a long-term solution.

State-imposed taxes on gasoline, diesel fuels, and certain specialized fuels (collectively referred to as “gas taxes”) provide almost a third of the state funding revenues for highways, according to a December 2011 report issued by the Institute on Taxation and Economic Policy (ITEP).

Typically, state gas taxes are either fixed at a flat rate (e.g. Colorado’s rate is $0.22 per gallon of gasoline) or tied to a variable figure such as gas prices or inflation and is subject to adjustment on a routine basis—usually annually or biannually. Further, a state’s total, pay-at-the-pump gas tax amount includes the aforementioned rate, along with additional miscellaneous taxes and fees and the federal excise gas tax.
However, studies have established that gas taxes are either outdated or are otherwise insufficient or incapable of covering or keeping up with the operating costs of maintaining state highways. The problem stems from fixed rate taxes remaining stagnant while external factors that drive up the cost of infrastructure-related maintenance and repairs gradually out-pace the flow of revenue brought in from gas taxes, thus leaving a shortfall of funds and forcing states to draw from other resources.

There are 24 states that have gone more than a decade without raising their gas tax and, of those states, 16 have gone more than two decades without an increase, Carl Davis, Senior Policy Analyst at the ITEP, told Bloomberg Global.

Last February, when Wyoming Gov. Matt Mead (R) kicked off 2013 by signing legislation approving a $0.10 per gallon increase, a half dozen states and the District of Columbia followed his lead and enacted their own significant gas tax reforms.

According to Davis, such activity made 2013 an "unusual year" because, prior to Wyoming’s legislation, it had been three and a half years since a state had signed a gas tax increase into law. Further distinguishing 2013 from prior years was the trend of linking the gas tax to either inflation or gas prices, thus ensuring they will continue to rise over time, Davis said.

Even though Wyoming’s adjustment was by far the largest increase of the year, the state was also the only one that opted against structuring its gas tax based on a variable figure.

Variable Rate Reform.

Shortly after Wyoming’s bill, Virginia enacted legislation that eliminated the previous fixed tax rate and introduced a tax based on gas prices. According to the new Virginia law, the gas rate is subject to adjustment twice a year and is equal to 3.5 percent of the average per gallon wholesale price of gasoline, and 6 percent of the average per gallon wholesale price of diesel fuel.

As a result of the reform, in 2013, Virginia’s gas tax actually decreased from $0.175 per gallon to $0.111 for gasoline.

Another wrinkle to Virginia’s new law is its tie to the federal Marketplace Fairness Act (S. 743, H.R. 684) or similar online sales tax legislation. Specifically, the law includes a provision that will trigger a tax rate increase from 3.5 percent to 5.1 percent should Congress fail to enact the legislation by Jan. 1, 2015.

Following Virginia’s lead, the District of Columbia implemented a gasoline tax equal to 8 percent of the average wholesale price per gallon, subject to adjustment twice a year.

Maryland’s gas tax reform, on the other hand, replaced the general excise flat tax rate with a rate indexed to inflation. The reform also imposed a new 1 percent sales
and use tax equivalent rate on motor fuel, with an increase to 2 percent on Jan. 1, 2015, to 3 percent on July 1, 2015, and with the potential to reach 5 percent by fiscal 2017. Specifically, and similar to Virginia, the state linked the new sales tax rate to the passage of federal online sales tax legislation. For the rate to remain at 3 percent, federal legislation would need to take effect by Dec. 1, 2015, and if not, the rate would incrementally increase to 5 percent. As a result of the additional sales tax and the indexing change, Maryland’s rate increased by $0.035.

In addition, like Maryland, Massachusetts reformed its gas tax by also linking the rate to inflation. As a result, effective July 31, 2013, the gas tax rose from $0.21 to $0.24 per gallon.

Similarly, in 2013, Vermont structured its reform by imposing a new 2 percent assessment fee based on the tax-adjusted retail price of gasoline. The new law raised the rate by $0.059 per gallon. To help offset this new fee, however, the state decreased the current per gallon gasoline tax rate from $0.19 to $0.182. In addition, on July 1, 2014, the $0.182 rate will further decrease to $0.121, while the assessment fee will increase 4 percent. The law further increased the per gallon diesel fuel tax by $0.02, from $0.25 to $0.27.

In late November, Pennsylvania passed the Transportation Funding Act of 2013, which, beginning Jan. 1, 2014, eliminated both the flat $0.12 gas tax and increased the oil company franchise tax’s $1.25 per gallon cap on the average wholesale price of gasoline and diesel to $1.87. The amount will further be raised to $2.49 a year later, and eliminated on Jan. 1, 2017, when a $2.99 price floor will be established. As a result of the new law, the tax on gasoline increased from $0.312 to $0.407 and on diesel fuel from $0.381 to $0.510.

In addition, the California Board of Equalization voted 3-2 to raise the excise tax rate for gasoline from $0.36 to $0.395. As a result, California was able to maintain its position as the highest pay-at-the-pump gas tax state in the country. According to a 2014 study published by the American Petroleum Institute, motorists in California pay a total of $0.7097, compared to $0.6797 in New York, $0.6770 in Connecticut, and $0.6751 in Hawaii.

Other notable 2013 developments include North Carolina legislation implementing a $0.375 per gallon cap on its gas tax through June 30, 2015, and a Connecticut total gas tax hike of $0.043 due to a 2005 scheduled increase to the state’s gross receipts tax on gasoline.

While tying the gas tax to a variable figure is good policy because it ensures the tax will continue to rise in the future, linking the rate to gas prices can "introduce unwelcome volatility into [a state’s] transportation revenue streams” as gas prices can vary considerably from one year to the next, Davis said.
Therefore, Davis said, if states are going to raise gas taxes to pay specifically for transportation infrastructure maintenance and repair, the most efficient and sensible policy would be to base the rate using a construction-specific inflation measure.

Indeed, as Davis explained in the December 2011 ITEP report, this policy would be the "most direct route for ensuring that increases in the price of asphalt, machinery, and other transportation inputs do not prevent states from adequately maintaining their transportation networks."

However, a "very good second best option," according to Davis, is to link the rate to the general inflation rate in the economy. As Davis points out, "over the long term, the rate of inflation in construction costs isn’t all that different from the rate of inflation in the rest of the economy." To date, Maryland, Massachusetts, and Florida link their gas tax rates to the Consumer Price Index.

However, any shift away from the flat-rate structure tax that is currently used at the federal level and in 32 states and that is "guaranteed to fall short as inflation chips away at its value" is a step in the right direction, Davis said.

While the gas tax remains a major issue in states such as Utah, Washington, and New Hampshire, 2014 is unlikely to hit the level of activity that we saw in 2013, Davis said.

However, if 2013 tells us anything about future trends, it may be that states will monitor their neighbors. To illustrate, when Virginia passed its new law to raise money for transportation, Maryland, the District of Columbia, and ultimately Pennsylvania felt a sense of urgency to follow suit.

In addition, while gas tax reform may be sporadic in the future, the issue will likely persist because sustainability continues to be a problem for too many states. As ITEP’s 2011 report details, states continue to cling to their established and outdated flat gas tax rates at the expense of under funding transportation accounts and diverting other resources’ funds. For example, according to the report, Alaska’s rate hasn’t increased in over 40 years, Oklahoma’s rate has remained the same for over 25 years, and there are countless other states with similar lapses in gas tax increases. According to the same report, to account for the rising price of asphalt, concrete, labor, and other transportation inputs, the average state gas tax rate has declined by 20 percent since the last time it was increased.

"These states’ transportation budgets aren’t on a sustainable course, and sooner or later they’re going to have to revisit the gas tax. It’s not an issue that’s going away," Davis said.

Corporate Income Tax

Corporate income tax is joining the ranks of other types of levies that pose acute problems for businesses and states alike. The problems are especially pronounced for businesses operating in more than one state.
The Multistate Tax Compact, which addresses how businesses operating in more than one state should apportion their income, remains at the forefront of state tax developments. With states un-adopting, re-adopting, and disregarding the apportionment provisions of the compact, the Multistate Tax Commission spent 2013 brainstorming revisions that would allow for greater flexibility while still maintaining the uniformity that is the compact’s purpose. At the same time, states have modified their sourcing provisions, with more and more states switching to a market-based sourcing method. However, as state revenue departments and legislatures attempt to modify their apportionment and sourcing provisions to ensure their state receives sufficient revenue, the same departments and legislatures are lowering corporate income tax rates in an attempt to attract businesses and economic stimulus.

The Multistate Tax Compact is an agreement among member states to follow a uniform set of rules in certain components of their tax systems. Article IV, which is currently under the most scrutiny, outlines the methods member states should use to apportion and source corporate income.

In Gillette Co. v. California Franchise Tax Board, 147 Cal. Rptr. 3d 603 (Cal. Ct. App. 2012); petition for review granted, 291 P.3d 327 (Cal. 2013), the taxpayer sought to avoid using the state’s double-weighted sales factor apportionment formula and elected to use the three-factor formula specified in the compact.

The court of appeals ruled that such an election was available to allow taxpayers to apportion their in-state income using the compact’s formula. By allowing taxpayers to elect to use the three-factor formula, the court of appeals found that the compact is a valid, binding multistate compact. In wake of the ruling, the California legislature chose to remove the state from the compact entirely.

The case has spawned litigation on the same issue in Michigan, Texas and other states. The District of Columbia, Oregon, Utah, Minnesota and South Dakota all enacted legislation in 2013 that repealed all or some portions of the compact.

The California Supreme Court’s forthcoming decision in Gillette will likely inform many states’ decisions on whether to remain members of the compact, or to sever ties with the MTC. "The states are going to look closely at what California ultimately decides," Jamie Yesnowitz, principal at Grant Thornton, told Bloomberg BNA Jan. 8.

Litigation such as Gillette and the sudden departure of member states from the compact threatens the compact’s ultimate goal of uniformity. Accordingly, the Multistate Tax Commission Executive Committee held a hearing in December 2012 to discuss possible revision to the compact, in the hopes such a revision would lead to greater uniformity amongst the states that had adopted the compact, as well as a new flexibility that may encourage non-member states to adopt (or re-adopt) the compact.
Specifically, the MTC amendments proposed in December 2012 would:

-- give states the option to choose their own factor weighting, but include a recommendation that states double-weight the sales factor (Compact Article IV.9);

-- revise the distortion relief provision to allow states to adopt alternative apportionment rules for taxpayers involved in a particular industry, transaction, or activity (Compact Art. IV.18);

-- broaden the definition and scope of "business income" to all income that is apportionable under the U.S. Constitution (Compact Art. IV.1(a));

-- move from cost-of-performance to market-based sourcing for services and intangibles (Compact Art. IV.17); and

-- narrow the definition of sales to exclude hedging transactions and treasury receipts from the sales factor (Compact Art. IV.17).

Hearing Officer Richard Pomp of the University of Connecticut Law School Oct. 30 released a report of his findings, in which he showed little confidence that the proposed revisions would do anything to improve uniformity among the states.

Yesnowitz agrees with Pomp’s assessment, noting that while the MTC Executive Committee’s attempted revisions are laudable, "I just don’t think they are going to come to any uniform solution."

Pomp and Yesnowitz’s concern with uniformity and enforceability underlines the core issues surrounding the corporate tax world’s current focus on apportionment and sourcing methods. Yesnowitz predicts the focus will continue, and that as state courts decide what weight to give the compact, "we are going to have a lot of jurisprudence on what the compact means, whether taxpayers may make this election on their original return, whether they may make it retroactively, and my sense of it is, there’s not going to be a whole lot of uniformity in those decisions."

Apportionment Election.

One of the proposed revisions to the compact would replace an equally weighted three-factor formula with a recommendation for the use of a double-weighted sales factor. However, the revision ultimately allows each state to customize the formula, leading each state to choose the sourcing rule that aligns with its own priorities.

And a state’s priorities tend to involve the greatest tax revenue possible, which in many states would arise from the use of a single-sales factor formula. "The states have gone towards a single-sales factor, and there’s no sign that things are letting up," Yesnowitz said. "To effectively say to states, 'hey, we recommend double-weighted sales but you can use what you want' kind of defeats the terms of the compact--for a compact you want uniform terms."
The MTC Executive Committee’s decision may have been the most uniform option; however, the committee also considered giving the taxpayers themselves apportionment formula options from which to select.

The appeal of the single-sales factor is especially strong in a faltering economy, as "the single-factor sales formula encourages businesses to locate or expand in the state if they are going to be selling outside the state, and that, it seems to me, is the movement that we are witnessing," Pomp said Oct. 21 at a Bloomberg BNA webinar shortly before releasing his hearing officer’s report regarding the proposed changes.

In states where the apportionment method is still uncertain, some corporations are attempting to file refund claims under the apportionment provision that is best for them. "The advice we’ve been giving the taxpayers who are considering these types of positions and retroactive refund claims is to do it with adequate disclosure, if it’s going to provide you a benefit," Yesnowitz said, "but beware that states are not going to pay on this until the highest court rules on it, and maybe even after."

Some of the apportionment issues being litigated could put state courts in an ethical quandary because of the potential impact on state coffers. The court’s position as an unbiased arbitrator could be jeopardized by the fact that their state’s interests are at stake. "When you have an issue that involves several hundred million dollars, and the state has to pay on these refunds, a state supreme court is going to look at the merits of the case, of course, but there is always the specter that a state supreme court may think it’s going to really harm its state if they rule in favor of the taxpayers," Yesnowitz said.

Apportionment issues are likely to remain a focus of the states in the coming year. "With all the issues that are triggered by this compact issue, there’s going to be a challenge in the U.S. Supreme Court at some point," Yesnowitz said.

Shift to Market-Based Sourcing.

The MTC Executive Committee also tackled the issue of sourcing income to be used in the sales factor of the apportionment method. The proposed compact revisions explicitly adopt a market-based sourcing method, which while still a minority rule among the states, is becoming more and more popular.

The compact now prescribes the all-or-nothing costs of performance method, which sources income to a state if the income-producing activity is performed inside the state, or if the income-producing activity is performed both in and outside the state and a greater proportion of those activities occur in that state than any other, based on costs of performance.

The majority of states that follow the costs-of-performance method use an all-or-nothing approach, in which all of the receipts are sourced to the jurisdiction in which
most of the costs of performance occur. Some states use a plurality method, which looks to whether more income-producing activity is performed in one state than in any other state. Other jurisdictions use the majority method, which focuses on whether more than 50 percent of the income-producing activity is actually sourced to any one state.

Under the proposed market-based sourcing method, tangible personal property and leased property are sourced to where the property is located, intangibles are sourced to where the intangible is used and services are sourced to where they are delivered. For example, the profit from machinery that is delivered to one state but used in an adjoining state would be sourced to the state that initially received the machinery, rather than the state where the machinery was ultimately used.

Market-based sourcing may be more intuitive for the taxpayer, as it focuses on where the benefits are delivered, rather than where the benefits are received, which is more difficult for a taxpayer to track, Shirley Sicilian, general counsel for the MTC said at the Oct. 21 Bloomberg BNA webinar. Market-based sourcing also eliminates the difference in treatment between the sale of tangible personal property and the delivery of services, as both income-producing activities now depend on where the property or service is delivered.

States are already shifting from the costs of performance method to the market-based sourcing method of their own volition. Massachusetts and Pennsylvania enacted legislation that requires a market-based approach for certain transactions beginning in 2014.

Pomp states in his hearing officer’s report that changing the compact sourcing rule will allow for flexibility and the ability to deal with definitional issues on an industry-wide basis, although MTC leadership is required if they are to provide a uniform set of sourcing rules.

Taxpayers and state departments of revenue occasionally use alternative methods of apportionment when the method otherwise prescribed would result in too much distortion of income. While some states offer clear statutory rules for whether the taxpayer or department may use an alternative apportionment method, other states are not so clear. Taxpayer uncertainty concerning basic tenants for imposing or requesting an alternative apportionment formula continues into 2014.

The controversial decision in Equifax Inc. v. Mississippi Department of Revenue, No. 2010-CT-01857 (Miss. 2013) has raised this issue to the forefront of corporate taxation. In Equifax, the taxpayer used the state’s standard costs of performance apportionment formula to calculate its in-state business income. Upon audit, the Mississippi Department of Revenue determined that the state’s statutory apportionment formula--with which the taxpayer had complied--distorted the taxpayer’s business activity in the state. The department recalculated the taxpayer’s income using an alternative, market-based sourcing apportionment method, but also added
penalties and interest, even though the taxpayer had properly computed its in-state business income according to the department’s own regulations.

The court ruled that the burden of proving the unreasonableness of the department’s decision to use an alternative method fell to the taxpayers. The court further upheld the imposition of penalties because the taxpayer had likewise failed to meet its burden of proving the penalties were not reasonable. In effect, the Equifax taxpayers were penalized for following the statutory apportionment formula. “If a taxpayer is following the statute, but a department wants to use an alternative apportionment formula, the taxpayer shouldn’t have the burden of proof,” Yesnowitz said.

The case has caused increased focus on who has the burden of proof in showing entitlement to alternative methods of apportionment.

“We expect that in coming year, alternative apportionment is going to become more important,” Yesnowitz said. “I wouldn’t be surprised if another state’s highest court looks to see whether a department’s use of alternative apportionment was valid in a particular situation.”

<table>
<thead>
<tr>
<th>Jurisdiction</th>
<th>2014 Corporate Tax Rate</th>
<th>2013 Corporate Tax Rate</th>
<th>Change in Rate</th>
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</thead>
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<tr>
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<td>6.97%</td>
<td>6.5%</td>
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<tr>
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<td>8%</td>
<td>7.75%</td>
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<td>New Mexico</td>
<td>7.6% (top bracket)</td>
<td>7.3% (top bracket)</td>
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<tr>
<td>West Virginia</td>
<td>7%</td>
<td>6.5%</td>
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</table>

Captive Insurance Companies

While some states are seeking to preserve their portion of corporate income, many states are also tinkering with their tax laws in a targeted attempt to lure more companies to operate within their jurisdictions.

“A significant number of states are attempting to attract captive insurance companies to form or move to their jurisdictions, as is evident from the rapid growth of captive legislation being enacted throughout the United States,” P. Bruce Wright, partner at Sutherland Asbill & Brennan LLP in New York, told Bloomberg BNA Jan. 10.

“States see captive growth as both a revenue raiser and a professional job creator,” Thomas M. Jones, partner at McDermott Will & Emery LLP in Chicago told Bloomberg BNA.

Just a few years ago, captive-friendly states were few and far between. However, today, by using a favorable interpretation of the wording of the Federal Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank; Pub. L. No. 111-
203), which became effective July 21, 2010, states are luring captive insurance companies to jurisdictions, said Jones. In turn, the states “seem to be focusing on tax revenues that may arise from these new entities,” Wright said.

This is a “challenging area” for captives, their owners and policyholders, said Jones. The federal Dodd-Frank Act, which arguably provides that a state may “keep 100 percent of the tax revenue imposed on multi-state captive self-insurance program premiums,” made this area even more complex, Jones noted.

Dodd-Frank contains within it the Non-admitted and Reinsurance Reform Act (NRRA). When the NRRA became effective on July 21, 2011, it provided that no state other than the “home state” of an insured could require payment of direct placement taxes to a non-admitted insurer (e.g., a captive in another state), said Wright. As such, “under the NRRA the home state could retain tax on 100 percent of the premium,” Wright said.

The NRRA provides that the home state with respect to the insured means “the state in which an insured maintains its principal place of business or, in the case of an individual, the individual’s primary residence.” If 100 percent of the insured risk is located out of the state as set forth in the statute, then, Wright said, the law essentially defaults “to the state with the greatest allocation of premium.”

Some states have taken advantage of the ambiguity of the act’s application to captives by passing state laws allowing “home” states to keep 100 percent of the tax even in a national risk or policyholder situation, said Jones. As a result, in certain circumstances a potential for double taxation of the same transaction by two states exists, Wright said.

Given the regulation of insurance by each state, captives are now left to decide “whether they should create a home state captive and merge existing captives elsewhere into the home state one,” Wright said.

States with captive facilitating statutes are now beginning to hunt for tax revenue in this area, said Wright. Within the insurance industry, there are generally two ways a captive may be taxed, either on its premiums or on its income. Depending on the state, either “the insurance code or the tax code will govern” which agency enforces the tax, said Jones. However, with respect to most captives, Wright said, these tax revenues come from the following three sources:

-- premium tax imposed by the domiciliary state in which the captive is formed. Such premium taxes are typically a fraction of a percentage point with a cap or total annual tax based on direct or reinsurance premium paid to the captive.

-- a tax on the insured which pays a premium to a captive in another state. This tax is imposed by most states and referred to as direct procurement or industrial insured taxes, which typically range between 3 and 5 percent of direct premium paid by the insured.
-- a tax on the income of the captive (underwriting and investment income) which until recently was not generally considered subject to state taxation. Prior to the states’ regulations, the income tax was imposed at the federal level.

"Several states have now questioned whether this income earned by the captive should be subject to state income tax, whether based on a theory that the captive is not an insurance company for state tax purposes or the captive is not 'subject to' the state premium tax if it is indeed not doing business in the state and paying such premium tax," said Wright.

Most captive insurers would prefer to be taxed on premiums rather than on income. With respect to "surplus lines" or "independently procured" insurance coverage, premium tax means any tax, fee, assessment or other charge imposed directly or indirectly based on any payment made as consideration for an insurance contract. Consideration for an insurance contract includes premium deposits, assessments, registration fees and any other compensation given in consideration for a contract for insurance.

The tests and reasoning for whether a captive insurer will qualify as an insurance company for state tax purposes varies among states, said Jones. Some states defer to the federal determination of whether the captive is an insurer. But other states, such as New York, have enacted special legislation. "In New York’s case, the legislation indicates that if the gross premium written by the captive is less than its investment income, the captive will have to be included in its parent’s combined return and, as such, all of the income of the captive will have to be subject to the state’s income tax law," said Wright. The answer could depend simply on whether the captive has an insurance license and the contract says it is for the purposes of insurance coverage.

The captive may be subject to state income tax, in some instances, such as when a captive does not qualify as a bona fide insurance company for tax purposes. If the captive does not qualify as an insurance company under a state’s law, then it may become subject to state income tax, usually as part of a combined or unitary tax filing of its parent, Jones said.

Potential for Double Taxation.

Now that states have decided to take advantage of the ambiguity of Dodd-Franks application to captives, state laws have been passed which allow a "home" state to keep 100 percent of the tax even in a national risk or policyholder situation. Meanwhile, other states have enacted laws that would essentially impose an unauthorized insurance premium tax on certain captive insurers. In such a circumstance, the potential for double taxation of the same transaction by two states exists, said Wright. Take for instance the implications surrounding a recent rule adopted in Texas.

The Texas Comptroller of Public Accounts, adopted a sui generis rule regarding the taxes in this area, said Wright. Texas Rule 34 TAC § 3.835, effective Oct. 16,
2013, which governs the reporting of unauthorized insurance premium tax by non-admitted captive insurers, seeks to clarify the obligations of captive insurers not domiciled or licensed in Texas to pay the unauthorized insurance premium tax required by Chapter 226 of the Texas Insurance Code on insurance policies that provide coverage for risks located in Texas, said Wright.

Texas imposes a 4.85 percent tax on the premiums received by an insurer that relate to insurance "on a subject resident, located, or to be performed in [Texas]," said Wright. "This tax does not apply to Texas-licensed insurers (including Texas captives), surplus lines eligible insurers, or insurance on which the insured pays the independently procured insurance premium tax to the state of Texas," said Wright.

Wright provided the following example: "a parent company located outside of Texas, e.g., New York, with a captive located outside of Texas is in a state other than the parent’s state of domicile, e.g., Delaware, insures risk of the parent and all of its subsidiaries, one of which is located in Texas and represents 10 percent of the total risk insured.”

Here, New York would seek to tax the Parent on 100 percent of the premium paid to the Delaware captive. Meanwhile Texas would still seek to impose a tax at the rate of 4.85 percent on the 10 percent of the premium relating to Texas risk, said Wright, subjecting the captive to double taxation.

However, if the captive were located in the home state of New York, rather than Delaware, the direct procurement tax would no longer be imposed by New York, said Wright. This is because New York would now only charge a captive premium tax. Texas, however, would still seek to impose tax at a rate of 4.85 percent on 10 percent of the premium, said Wright.

The Texas rule also seems to indicate that if an indemnity policy form is utilized then all of the risk is deemed to be located in the home state of the entity securing the policy. Thus, if that is not Texas, ostensibly this tax provision may not be applicable as no portion of the risk may be deemed Texas risk.

Companies are now beginning to relocate the captive to the home state in an effort to reduce the tax due. This means locating the captive to the state in which a company’s headquarters are located, as reflected in the example above. The state most affected by this trend is Vermont, with the most captives but with very few corporate headquarters, said Jones.

With approximately 35 states currently encouraging captive formations in their state, a company is left to decide whether or not to create a captive in its home state. Relocating to the home state would likely result in much less state tax being imposed on the premiums paid to the captive, Jones said.
The home state captive is becoming especially attractive to companies holding an offshore captive, or a captive located in an alternate onshore jurisdiction, which is likely subject to higher taxation.

With the relocating and merging of captives, Jones expects to see more state tax audits "as revenue enhancing enforcement ramps up" and states look for tax to be found in fact patterns they were not looking at in the past.

In addition to state tax incentives for "home state" captives, a trend is emerging where companies are creating captive programs within "cells" or "series." These "cell companies" or "series LLCs" technically are a single legal entity. But by statute they can create legally segregated pockets generically called "cells" such that creditors of one cell are not allowed to attach or otherwise attack the assets of a different cell, Jones said.

Many states have begun to adopt cell laws and regulate them as such. However, the regulation and taxation varies between states. For example, in Washington, D.C., if several cells are created there would be a franchise fee imposed for every cell. In contrast, Delaware does not impose a separate fee on every series of its series LLC structures.

The cell captive provides many benefits, especially the asset/liability separation between and among the cells or the series.

Examples of common captive programs placed in a cell include transformers (which convert a capital market instrument into an insurance contract), mutual funds and financial guaranty companies, and hospital captives forming cells for associated medical clinics, among others, Jones said.

In addition to deciding whether to create a "home state" captive, captive owners must decide what captive programs may be best suited for a cell company structure. After all, as Jones put it, "cell companies, with either "standard" or incorporated cells, could well become the next generation in captive structures."

Property Tax Reform

The property tax burden on business is another area that is likely to come in to sharper focus in 2014, and as in the area of captive insurance, business decisions could be influenced by tax reforms. Businesses paid a total of nearly $230 billion in property taxes in fiscal year 2012, which accounted for more than 35 percent of the roughly $650 billion in total state and local taxes paid by businesses, according to a joint report by Ernst & Young LLP and the Council on State Taxation (COST), released July 2013.

Property taxes accounted for the largest share of total state and local taxes by far--corporate income taxes, in contrast, accounted for less than $50 billion, less than 8 percent of total taxes paid. When looking only at the local level, the relative im-
The importance of property taxes is even greater, as property taxes comprised 74 percent of taxes paid by businesses, seven times more than the amount paid for local sales tax, for instance.

With the 35 percent figure being the average share of taxes paid by businesses, several states have tax systems featuring property taxes even more prominently than other taxes. Vermont and Maine led the way with property taxes making up 53.1 and 52.4 percent, respectively, of all taxes paid by businesses in those states.

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<tr>
<th>Rank</th>
<th>State</th>
<th>Tax as Percentage of Business Taxes</th>
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<tr>
<td>1</td>
<td>Vermont</td>
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<tr>
<td>2</td>
<td>Maine</td>
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<td>District of Columbia</td>
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<td>10</td>
<td>Florida</td>
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</tr>
</tbody>
</table>


With those numbers in mind, it is not surprising that 2013 saw a handful of states pass legislation to provide tax cuts for business and agriculture.

For example, Montana passed a new law (S.B. 96) that will effectively exempt more than 10,000 Montana businesses from paying tax on business equipment, a move that is expected to save more than $11 million annually for state businesses. The law will exempt the first $100,000 worth of equipment, up from $20,000, from property taxes, and lowers the tax rate for equipment that exceeds the $100,000 threshold.

“This tax cut is an example of the good things that can be accomplished when we put politics aside, and instead look for common ground,” said state Sen. Bruce Tutevedt (R) in a Dec. 6 press release. Gov. Steve Bullock (D) added that the exemp-
tion will help the state “balance the budget, maintain a rainy day fund, invest in [its] priorities and maintain Montana’s friendly environment.”

Likewise, in June 2013, Iowa passed a business property tax credit as part of the largest tax cut in state history (S.F. 295), cutting taxes for certain commercial, industrial and railroad properties. The legislature appropriated $50 million for the credit for 2013, and the average credit amount for eligible taxpayers is expected to be more than $500.

At a signing ceremony for the bipartisan measure, Gov. Terry Branstad (R) said, “[t]his tax relief bill will put more money in the pockets of Iowa families and make it easier for Iowa businesses to invest and grow in our state.” A press release issued by the governor also added that the bill will provide an estimated $4.4 billion in property tax relief, affecting all classes of property.

New York helped out its agricultural industry by capping increases in assessed values for agricultural land at 2 percent, down from the previous limit of 10 percent (S.B. 1952). Gov. Andrew Cuomo (D) stated that roughly one-fourth of state land is used for agriculture, and that base assessment values of the land had nearly doubled in just the past seven years. New York’s average property tax burden per farm acre was four times the national average in 2013.

“Protecting our farmers from unsustainable tax hikes is part of our work to change our state’s reputation as the tax capital of the nation,” Cuomo said in an Oct. 22 press release. Dean Norton, president of the New York Farm Bureau called the measure “a big step forward in reducing the increasing property tax burden that has limited our farmers’ ability to grow.”

Additionally, in October 2013, the New York Apple Association, New York Corn and Soybean Growers Association, Northeast Dairy Producers Association, and New York Wine and Grape Foundation all expressed satisfaction with the measure.

Be on the lookout for more business- and agriculture-friendly property tax cuts in 2014. Indiana may be the next state to join the pack, with Gov. Mike Pence (R) proposing an incremental phase-out of the state’s business personal property tax by 2024. This coincides with a trend among states to reduce taxes on tangible personal property, wrote the Tax Foundation’s Scott Drenkard in a Dec. 20 article. He called the proposal “a step toward better tax policy in a state that has already made serious strides toward a simpler, more neutral tax code.”

Likewise, Michigan Gov. Rick Snyder (R) signed legislation in 2012 to phase out its personal property tax beginning in 2016, although the phaseout is conditioned on voter approval in 2014 of a plan to reimburse local governments for the revenue they will lose.

The Tax Foundation noted that the area of tangible personal property might be an area where businesses can see meaningful change in the amount of property taxes they
An October 2012 report stated that seven states had completely eliminated property taxes on tangible personal property, while four others had eliminated “most” taxes on tangible personal property.

The report notes an important reason why many businesses may celebrate the elimination of personal property taxes, other than the money savings alone—is that, unlike real property, which is valued by state assessors, personal property must be reported by filling out forms, a process that creates compliance costs for businesses. Further, taxes on business property force businesses to make decisions on equipment purchases based on tax concerns rather than business needs, the report states.

Complete Overhauls.

While some states provided property tax relief specifically targeted toward business and agriculture, at least two states made notable strides toward major overhauls of their entire property tax systems.

At Cuomo’s request, the New York State Tax Reform and Fairness Commission reviewed the state’s property tax system and recommended several considerations in a final report issued in November. The commission noted that New York has been ranked among the lowest in the country by COST for the fairness of its property tax administration, and suggested a system that is more fair and transparent, and less burdensome for businesses to comply with.

The commission’s primary recommendation was to create uniform assessment standards and revaluation cycles. Unlike most states, New York does not currently have either, so many local tax rolls are outdated—some have not been fully revalued since before World War II, according to the commission.

In a July 29 letter to the commission, COST President and Executive Director Douglas Lindholm wrote, “New York was the only state to receive an ‘F’ grade on the [COST Property Tax] scorecard—a result due primarily from the State’s lack of standardized procedures.” However, Lindholm added, “Fortunately, many of the items noted in COST’s property tax scorecard can be fixed at no or very limited cost.”

Examples of fixes that would have minimal costs include consistent due dates across the state for filing and payment deadlines, uniform forms, and an exclusion for tax based on de minimis amounts of property, Fred Nicely, Senior Tax Counsel at COST, told Bloomberg BNA Jan. 10. However, adopting a valuation cycle every two or three years would carry implementation costs for the state, Nicely said, adding that while New York had proposed funding for local assessors to facilitate more frequent valuations, the measure was eventually removed from the state’s budget.

The commission also suggested that real property tax relief in New York should be targeted toward businesses, which bear a relatively large burden of the property
tax, especially in New York City. In its Scorecard on State Property Tax Administrative Practices, COST asserts that for a fair system, property tax rates imposed on business and residential properties should not significantly differ.

An earlier study by the Minnesota Taxpayers Association found that New York City had the highest ratio in the country of effective tax rates on commercial property compared to homestead property, indicating a property tax system that is substantially skewed toward businesses bearing the financial brunt.

New York City’s ratio of 6.016—meaning the effective tax rate on commercial property was more than six times that of homestead property—was nearly double the next closest city, Honolulu (3.73), and more than triple that of several other major cities, such as Chicago (1.719), Philadelphia (1.559), Atlanta (1.361), and Los Angeles (1.021). While New York made strides to lower the amount that agricultural taxpayers will pay by capping annual valuation increases, it still has a long way to go before business and residential taxpayers are on even footing.

Meanwhile, North Dakota Gov. Jack Dalrymple (R) announced Dec. 3 the creation of a similar task force to make recommendations for improving North Dakota’s property tax system. Despite providing roughly $1.5 billion in property tax relief since 2009, the governor stated that increasing property values have offset most of those efforts, causing property owners to see only small reductions in their taxes during that period. The governor said he would like to simplify the tax system, create more transparency and shift toward user-based fees as alternate sources of revenue.

“I have formed this task force because the citizens of North Dakota have asked their elected state officials to address the issue of property tax increases,” Dalrymple said. He added that “the members of this task force represent the many stakeholders who have a vested interest in our property tax system including home owners, commercial property owners, taxpayers engaged in agricultural production, officials who represent local tax authorities and Legislators.”

While businesses would welcome further property tax relief, North Dakota businesses already had the lowest percentage of property taxes compared to total taxes paid by businesses, at under 11 percent. Similarly, commercial property in North Dakota is taxed at 10 percent of its assessed value, while residential property is taxed at 9 percent of its assessed value. For Fargo, the state’s largest city, this yields a commercial-homestead effective tax ratio of 1.098, indicating that business and residential taxpayers share relatively equal burdens in property taxation, a far cry from New York City’s ratio of over six.

Energy Cases.

While the state legislatures were active in 2013, they were not the only ones who had a say in property tax policy—state high courts also had a noticeable impact, specifically within the realm of taxation of energy companies.
Notably, in a major victory for business taxpayers in California, the California Supreme Court affirmed rulings from the 1960s in its first case involving the treatment of intangibles in 51 years, holding that state and local taxing authorities cannot directly include the value of intangibles when assessing property, but can only value intangibles indirectly, based on how they enhance the value of taxable property.

Specifically, Elk Hills Power LLC v. California Board of Equalization, 304 P.3d 1052 (Cal. Aug. 12, 2013), addressed the taxation of emission reduction credits held by an electric power plant—credits the plant was required to purchase to begin operating to offset its future emissions.

In overturning the lower court’s decision, the supreme court reaffirmed longstanding California precedent that intangible assets can only be valued for property taxation indirectly, based on how they enhance the value of taxable property.

The decision has broader implications for the taxation of all intangible property, not just energy property. The court’s ruling makes it “crystal clear” that assessors cannot add the value of intangibles to property values under the cost approach, Douglas Mo, an attorney with Sutherland Asbill & Brennan LLP told Bloomberg BNA shortly after the court issued its ruling in August.

Also, the Kansas Supreme Court determined that property taxation of natural gas stored at in-state facilities under contracts with interstate pipeline companies does not violate the commerce clause of the U.S. Constitution (In re: Div. of Prop. Valuation of Kan., 2013 BL 339075, No. 105,785 (Kan. Dec. 6, 2013)). The court emphasized that storing natural gas in Kansas created substantial nexus with the state, and the taxes were fairly related to that in-state storage.

States Moving Into the 21st Century.

While the following changes might not affect how much a taxpayer will owe, they might make property tax administration simpler and more efficient. Several states made steps forward in 2013 by embracing technology as part of their property tax administration.

For example, Washington (H.B. 1576) and Maui County, Hawaii (Ord. 4057) both authorized property tax assessors to send assessments, notices and other information to taxpayers by email rather than regular mail if the taxpayer authorizes such notice.

Also, several states have begun posting online videos highlighting important aspects of their tax systems, or providing explanations of their tax system as a whole. For example, in March, the District of Columbia Office of Tax and Revenue released a video explaining their valuation and assessment process. The New York Department of Taxation and Finance has several videos, covering topics such as how to apply for exemptions and how to contest property assessments.
The Washington Department of Revenue also recently published advice for county assessors to help them improve their websites, recommending basic information to have on the website, and more advanced features, such as detailed explanations of the valuation process and mass appraisal, a calendar of the assessor’s duties, and information about property inspections.

More states are expected to embrace technology in 2014 to simplify the property tax process for taxpayers. Louisiana is one such state that would benefit from modernizing its approach to property tax administration. Louisiana only requires physical notice if a taxpayer’s property value increases by more than 15 percent from the previous year; otherwise, notice is simply provided by newspaper, Nicely said.

Conclusion

The headlines that dominated the state tax landscape in 2013 were issues that will likely persist in 2014 and beyond. As electronic commerce continues to dramatically alter spending habits, pressure will mount for Congress to take appropriate action. As social views towards same-sex marriage, marijuana use, and gambling continue to shift, states will feel an urgency to either adapt their existing tax policies to account for these changes or they will be compelled to adopt new ones. Further, as our nation’s transportation infrastructure continues to crumble, states will recognize the necessity of addressing their respective gas taxes.

In addition, costly and tenuous litigation concerning the validity of the Multistate Tax Compact and the proper application of state and local hotel occupancy taxes on online travel companies has left hundreds of millions and likely billions of dollars in limbo. Accordingly, as the nation continues to heal from the effects of a harsh recession, the stakes in these matters (as well as others) will continue to be extremely high for both states and taxpayers.

As technology continues to evolve, perceptions of possibility could slowly meld into reality. States have struggled to keep pace with such progress and well-publicized and contentious lawsuits concerning these deficiencies have sprung up as a result. Looking forward, from both a fiscal and a policy standpoint, taxpayers and states share a mutual interest in preventing this cycle from continuing. On the one hand, taxpayers deserve certainty when it comes to compliance requirements, and on the other hand, states deserve abidance in return for unambiguous and efficient tax laws. In 2014, however, a state’s political climate will likely be the driving force behind either the narrowing or the widening of this delicate balance. But as 2013 and prior years have demonstrated, volatile political times usually means similar volatility between taxpayers and states.

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