**Tax Base**

**States, Local Agencies Pushing the Envelope On Pass-Throughs, Nexus, Practitioners Say**

Taxpayers need to pay close attention to states’ increased willingness to seek additional sources of revenue, determine nexus and apply their tax laws retroactively, prominent attorneys and accountants told attendees at New York University’s 33rd Institute on State and Local Taxation Dec. 8 and 9 in New York City.

Why might state tax administrators be getting more aggressive than in past years? Perhaps because state corporate income tax collections are still at pre-recession levels, said Steve Wlodychak, principal with Ernst & Young LLP in Washington. Plus, more than 90 percent of businesses are now structured as pass-through entities, said Bruce Ely, a partner with Bradley Arant Boult Cummings LLP in Birmingham, Ala. With business income flowing through and being reported on individual income tax returns, states could be losing out on a valuable revenue source.

**Pass-Through Entities.** States have become more aggressive in applying the business tax concept of nexus to pass-through entities. It is unclear whether a taxpayer can trigger income tax nexus in a state by owning an interest in a pass-through entity that operates within the jurisdiction’s borders, said Wlodychak. While the U.S. Supreme Court has held that merely holding stock in a corporation is not enough to create nexus, the court has never addressed the question as it applies to pass-through entities.

State court decisions haven’t provided much clear guidance either. “It’s like watching a pinball bounce back and forth; there’s no clear answer,” said Wlodychak. For example, in *Swart Enterprises Inc. v. Cal. Franchise Tax Bd.*, No. 13CECG02171 (Cal. Super. Ct. 2014), a California Superior Court held that an Iowa hog farmer with a 0.02 percent interest in a California pass-through did not have nexus through such a small ownership interest.

However, in another case, *BIS LP Inc. v. New Jersey Div. of Taxn.*, 26 N.J. Tax 489 N.J. Super. Ct. App. Div. 2011, New Jersey found a U.K. company to not have nexus despite having a 99 percent ownership interest in a New Jersey company. There, the court said that despite the large ownership interest, the U.K. company was a limited partner with no management control. In another New Jersey case, *Village Super Market of PA Inc. v. New Jersey Div. of Taxn.*, 27 N.J. Tax 394 (N.J. Tax Ct. 2013), nexus was found for a limited partner because it had the same officers and directors and shared a mailing address. Thus, decisions cannot always be predicted based solely on the level of ownership or on whether the owner is a limited or general partner, Wlodychak explained.

**Don’t Mess With Nexus.** Corporate entities subject to business taxes continue to struggle with nexus issues.

Maureen Pechacek, partner with PricewaterhouseCoopers LLP in San Diego, described how Minnesota is becoming “the new Iowa,” establishing itself as the most aggressive state for nexus determinations, adding that Minnesota has increasingly found nexus for foreign corporations, many of which are Canadian-owned.

States are becoming increasingly aggressive with nexus determinations where a taxpayer has in-state employees. For example, Colorado recently enacted a statute that establishes nexus for any company that employs a Colorado resident, noted Maryann Gall, of MBGALLTAX in Columbus, Ohio. Taxpayers should be careful to monitor the job descriptions of their employees, both Gall and Pechacek agreed, including what their business cards say and what addresses they use. While an employer may see an in-state employee as a mere deliverer of goods, an auditor may have a different opinion if the employee is performing set up services, collecting payment or fixing issues with a product.

Taxpayers should also be careful in concluding that an in-state employee’s actions are de minimis, Pechacek advised, explaining that even if an employee enters the state for one day, it might not be considered de minimis if it is a regular part of that employee’s job duties.

Pechacek noted several recent cases dealing with agency, or attributional, nexus, giving examples of a parent corporation that was held to have nexus with a state through its subsidiary, and a foreign-owned company that was held to have nexus through a distributor in the U.S., even though the distributors were independent contractors.

In a later panel, Susan Haffield, Partner with PricewaterhouseCoopers LLP in Minneapolis, brought up New Jersey’s recent adoption of click-through nexus, adding that she thinks more states will consider similar statutes because of their success in the states that already have them. Texas’ trailing nexus statute, under which a taxpayer has nexus for 12 months after leaving the state, was another area of concern, Haffield noted.

Taxpayers have faced unpleasant surprises even when a state’s laws seemed clear.
Due Process. Craig Fields, a partner with Morrison & Foerster LLP in New York, cited as an example the Equifax case in which a taxpayer apportioned its income based on costs of performance per tax agency guidance, but was then hit with penalties for failing to use a market-based approach to source its receipt. However, Fields sees taxpayer willingness to seek redress from state legislatures after unfavorable court decisions as a silver lining, such as in Mississippi after the Equifax ruling. “If you can’t get a win in the courts, there are other avenues,” Fields said. Mississippi amended its alternative apportionment statute on a prospective basis to prevent similar results.

The scales of justice are beginning to tilt more in taxpayers’ favor though as more states are adopting tax tribunals that operate independently from the jurisdiction’s tax agency. Alabama recently established an independent tribunal after a 15-year process. Independent tax tribunals provide for appeals to be heard by bodies with tax experience, and also give the taxpayer a better perception of the tribunal’s independence compared to reviews done by the department itself, said Judge William Thompson, the Chief Tax Tribunal Judge of Alabama’s Tax Tribunal.

With Alabama, now approximately two-thirds of the states have independent tax tribunals. This is important because the U.S. is one of the few countries with both a robust national tax system and a robust sub-national tax system, said Karl Frieden, Vice President and General Counsel of the Council On State Taxation (COST).

The presence of an independent tax tribunal is one criterion included in COST’s state tax administration scorecard, along with even-handed statutes of limitations for assessments and refunds, reasonable protest times, fair interest rates and transparency in decision-making. “More than half the states still fail the mark,” said Frieden, noting that interest rates is one area where states have much room for improvement.

For example, the District of Columbia assesses 12 percent interest on assessments, but provides only 3 percent interest on refunds, Frieden explained. Similarly, Frieden said Maryland is “hedging its bets” in case of a loss in the Comptroller v. Wynne, No. 13-485 case by providing for only 3 percent interest on certain refunds instead of the usual 13 percent. But states, like Alabama, are showing a willingness to make improvements based on COST’s standards. “I thought I was done with grades after law school, but you can’t believe how many commissioners are concerned about their grades,” Frieden joked.

Retroactive Taxation. Another important area of discussion regarding due process related to retroactive application of tax laws. U.S. v. Carlton, 512 U.S. 26 (1994), is the most recent U.S. Supreme Court decision dealing with tax retroactivity, said Jorge Rodriguez, of the Rodriguez Law Firm PLLC in New York. The Carlton test focuses on the legislature’s purpose in establishing retroactivity, an extremely deferential standard that has allowed states to stretch the limits of retroactive application, because the legislative purpose often revolves around preserving revenue.

“Revenue will always be a purpose in taxation,” Rodriguez said. “States are always going to be hungry for additional revenue, and there’s no limit to the constitutionality if we only look at the legislative purpose.”

Because Carlton only dealt with a 14-month retroactivity period, Rodriguez thinks that recent state court decisions with retroactivity periods of six or eight years may provide the U.S. Supreme Court with a good opportunity to revisit its earlier decisions. For example, in In re Estate of Hambleton and MacBride, No. 89419-1 (Wash. 2014), the Washington Supreme Court found that an eight-year retroactive period for a change to the state’s estate and transfer tax did not violate either the federal or state due process clauses.

The court held that the state’s desire to avoid a “fiscal shortfall” satisfied rational basis review, and that the eight-year retroactive period was not arbitrary, nor far greater than periods accepted by other courts.

States often classify their retroactivity decisions as simply “clarifying” their original laws, something Fields called “an end run around.” Fields predicted that more retroactivity challenges will surface. “If a court rules on something, the legislature can’t then change it retroactively. Once the judiciary interprets the law, it can only be applied prospectively,” Fields said.

Mandatory Combined Reporting. Some states are bolstering their tax bases by implementing combined reporting requirements aimed at assessing tax based on an in-state entity’s connection with out-of-state affiliates. States’ interest in requiring combined reporting is simply that they think they will generate more revenue, said Dennis Rimkus of Jones Day in New York.

Mandatory combined reporting neutralizes a taxpayer’s ability to perform tax planning and may increase their tax base. In New York, there will likely be a lot of litigation challenging combined reporting because of the state’s lack of a definition regarding what “unitary” actually means, Rimkus predicts, adding that other states also have limited and unclear definitions.

Decisions on what is considered unitary are not always clear, Rimkus said, contrasting the example of two California cases. First, Tenneco West Inc. v. Franchise Tax Bd., 234 Cal.App.3d 1510 (Cal. 1991) held that two entities were not unitary to despite strong centralized management, while the other, Dental Insurance Consultants Inc. v. Franchise Tax Bd., 1 Cal.App.4th 343 (Cal. 1991), found a dental insurance business unitary with a farm. Taxpayers should be aware of how decisions regarding the definition of unitary are highly fact-sensitive, Rimkus concluded.

COST’s policy statement against mandatory combined reporting was highlighted by Philip Tatarowicz, of Morrison and Foerster LLP in Washington. Mandatory combined reporting subjects taxpayers to the significant risk of having more of their income arbitrarily attributed to a state than is justified by their actual economic activity in that state, according to the COST statement.

By contrast, the Multistate Tax Commission (MTC) has adopted a model combined reporting statute, which provides for mandatory combined reporting for all taxpayers engaged in a unitary business with an affiliated corporation and leaves it to the states to decide what factors should exist to require combination. Massachusetts, West Virginia, Wisconsin and the District of Columbia have all adopted variations of the MTC model statute.

One result under a combined reporting statute could be a transaction between two foreign entities being included in a taxpayer’s combined water’s-edge report,
explained Jack Kramer, Principal with PricewaterhouseCoopers LLP in New York, because some states provide for the inclusion of entities that have been set up in tax havens.

Some states, such as Massachusetts, New York and Wisconsin, have enacted laws allowing for affiliated group elections, allowing taxpayers to make a ten-year election to include all members that are in its affiliated group. States will be surprised by how many companies make such an election, opined Prentiss Willson Jr., of Sutherland Asbill & Brennan LLP in Sacramento, suggesting that companies are interested in certainty above all else.

**All Taxes Are Local.** Taxpayers also need to be wary of local tax assessors. More and more businesses are being contacted by local taxing authorities about taxes they never even knew they were subject to, said Stephanie Anne Lipinski Galland, a partner with Williams Mullen in Washington. Galland referred to examples of "borderline extortion," where taxpayers were being denied local business licenses or fire safety certificates unless they paid the taxes.

This is problematic, according to Galland, because the local authorities have enough power to completely shut down a company over a local assessment of, say, $50,000, a comparatively miniscule assessment compared to a company's state or federal tax liability. The problem is exacerbated by the fact that many state constitutions are either silent or vague on what localities are authorized to do, Galland said, encouraging taxpayers to go to their state constitutions to see exactly what is allowed.

Galland also suggested that taxpayers should pay careful attention to how their states distinguish taxes from fees. "Localities play fast and loose with the distinction. They might not even have the authority to enact a fee."

Like states using retroactivity to preserve precious revenue, localities have the same concerns, noted Debra Kloske Reason, Master Commissioner of the Revenue for the city of Hopewell, Va. "An increasing number of localities are looking for additional revenue, especially since they are not getting as much funding from the state." Reason told Bloomberg BNA. "Localities are looking for money anywhere they can. We are trying to raise revenue through the audit process and the enforcement of existing revenue provisions."

**Looming U.S. Supreme Court Decisions.** The conference also came at an auspicious time—on the two days it was held, the U.S. Supreme Court heard oral arguments in two important tax cases.

In *Direct Mktg. Ass'n v. Brohl*, No. 13-1032, the court addressed the question of whether Colorado's requirement that remote sellers provide information about in-state buyers' use tax obligations amounts to "tax collection" for purposes of the Tax Injunction Act. That law bars federal courts from hearing disputes over state tax assessment and collection.

Under the *Quill* standard, remote vendors with no physical presence are not required to collect tax, but what is less clear is whether *Quill* also prohibits the reporting requirement at issue here. In an amicus brief filed with the court, Joe Huddleston of the MTC argued that because Colorado's collection rate is so low absent any reporting requirement, the requirement essentially becomes "collection" if it's the only practical way for the state to collect.

The court's decision in DMA could have downstream effects on similar reporting requirements used for cigarette and liquor taxes, said Richard Pomp, a law professor at the University of Connecticut.

The U.S. Supreme Court heard oral argument in *Alabama Dept. of Rev. v. CSX Transp. Inc.*, No. 13-553, on whether Alabama discriminates against rail carriers by subjecting them to sales tax on fuel, while exempting truckers, who are instead subject to a per-gallon excise tax. The court shouldn't find discrimination here, Pomp opined, because whether the percentage sales tax or per-gallon excise tax is more favorable depends on the current price of fuel, and may change over time.

One difficulty with this case is that it will be difficult for the court to find discrimination because rail carriers and truckers use different apportionment methods and different valuation methods, said Jeffrey Friedman, a partner with Sutherland Asbill & Brennan LLP in Washington. "You will never find discrimination because it's too complicated to even assess whether there's discrimination," Friedman said, adding that the court will need to clarify what Congress intended when it prohibited discrimination in the 4R Act.

A case that could have dramatic consequences on state taxation is *Comptroller v. Wynne*, No. 13-485, said Friedman and Pomp. The case, which was argued before the high court in November, revolves around Maryland's policy of not including county income taxes when crediting state residents for income taxes they pay to other states on income earned outside of Maryland. Because the state is broadly attacking the commerce clause, the court's decision will have major consequences, Friedman said, while joking that as a Maryland resident the case held special importance to him.

The dark horse of the state tax cases before the U.S. Supreme Court is *Town of Hilton Head v. Kigre Inc.*, No. 14-00475, which Pomp called the "sleeper of the year." Hilton Head imposes a business license tax on manufacturing, and because Kigre performs all of its manufacturing activity within Hilton Head, it was assessed an excise tax on all of its business activity. One problem, according to Friedman, is that despite performing all of its manufacturing activity in Hilton Head, more than 99 percent of Kigre's receipts come from customers outside of the jurisdiction. More alarming was that the South Carolina Supreme Court's decision affirming the tax provided hardly any analysis, something Friedman called "shameful."

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☐ For more information on the taxation of pass-
through entities, see 1500-2nd T.M., State Taxation of Pass-Through Entities: General Principles. For ad-
ditional discussion of combined reporting, including when combined reporting is required, see 1130-2nd T.M., Income Taxes: Consolidated Returns and Com-
bined Reporting; at 1130.02. For more information on sales tax nexus issues, see 1400-2nd T.M., Limita-
tions on States' Jurisdiction to Impose Sales and Use Taxes, at 1400.02.C.