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# TAX LAW CONFERENCE

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## Implications of *South Dakota v. Wayfair* for State Income Taxes

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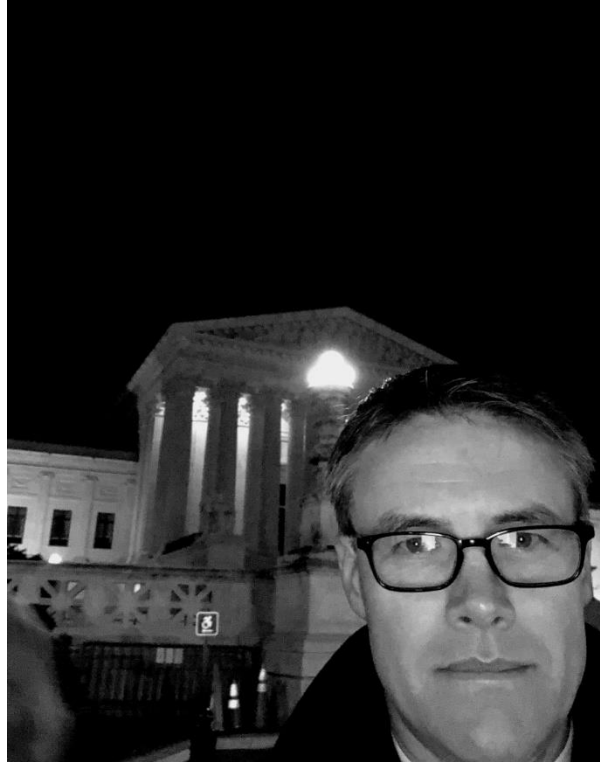
# Agenda

- Retroactivity
- Nexus with the taxpayer
- Nexus with the sale
- Indirect impacts
  - Combined reporting
  - PL86-272
  - Non-U.S. Companies

# Wayfair Oral Argument



# *Wayfair* Oral Argument



# *Wayfair* Oral Argument



# Wayfair

- The U.S. Supreme Court ruled in a 5-4 decision
- *Bellas Hess, Quill* overruled. Physical presence constitutional requirement is gone.
- The Court enshrined the 4-prong *Complete Auto* test, and focused on Prong 1
  - Prong 1: does the tax apply to an activity with a substantial nexus with the taxing state?
  - “Substantial nexus is established when a taxpayer [or collector] ‘avails itself of the substantial privilege of carrying on business’ in that jurisdiction.” *Polar Tankers v City of Valdez*, 557 US 1, 11 (2009)
    - Due process clause nexus: “whether the foreign corporation purposefully avails itself of the benefits of an economic market in the ...state.” “[D]ue process and commerce clause standards, though not identical or coterminous, have significant parallels.”
  - “This quantity of business could not have occurred unless the seller availed itself of the substantial privilege of carrying on business” in the state. Here nexus is clearly sufficient based on both the virtual and economic contacts respondents have with the state.”
- **Parties agreed state had nexus with transaction. Issue was only nexus with collector**
  - “Due process requires some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax”
  - May not be as clear that sale to in-state customer creates nexus with taxpayer’s income
- **The Court remanded (The parties have now settled)**
  - A state cannot discriminate against or place undue burdens upon interstate commerce

# Retroactivity

- Judicial decisions interpreting existing laws are generally presumed to be retroactive as well as prospective.
- South Dakota's and other states' sales tax statutes and guidance in the wake of *Wayfair* are clear that enforcement of economic nexus will be prospective only, usually as of some post-*Wayfair* date certain.
- However, other than in one state, Texas, no such guarantees have been announced for income taxpayers.
- States don't view *Wayfair*'s elimination of physical presence rule as having changed anything for income tax.
- States fear retroactive sales tax response *Wayfair* could spur Congressional response. Not so for income tax.
- Is due process notice required before a state can assert jurisdiction, even if clearly within constitutional bounds?

# In General - Apportionment and Nexus

## Historically, nexus created need for apportionment and sourcing

*Northwestern States Portland Cement Co. v. Minnesota*, 358 U.S. 450 (1959); Willis Report, *Special Subcommittee on State Taxation of Interstate Commerce* (1964); Multistate Tax Compact and Multistate Tax Commission (1967)

## Today, apportionment and sourcing create nexus

- Factor presence rules for income tax nexus. Objective is to locate source of taxpayer's activity. *E.g.* California:

[A] taxpayer is doing business in this state for a taxable year if . . . [s]ales, as defined in subdivision (e) or (f) of Section 25120 as applicable for the taxable year, of the taxpayer in this state exceed the lesser of five hundred thousand dollars (\$500,000) or 25 percent of the taxpayer's total sales.
- Sales thresholds for sales tax [and collection] nexus. Objective to locate use by the consumer, or parties to the transaction. *E.g.* South Dakota:

\$100,000 in receipts or 200 transactions

# Sourcing and Factor Based Nexus Statutes

## Income Tax

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- Alabama
- California
- Colorado
- Connecticut
- Michigan
- New York
- Ohio (CAT)
- Tennessee
- Virginia

## Sales Tax

11 in June 2018

33 in January 2019

- |                        |                |
|------------------------|----------------|
| • Alabama              | Nebraska       |
| • California           | Pennsylvania   |
| • Colorado             | New Jersey     |
| • Connecticut          | New York       |
| • Hawaii               | North Carolina |
| • Illinois             | North Dakota   |
| • Indiana              | South Carolina |
| • Iowa                 | Nevada         |
| • Utah                 | South Dakota   |
| • Louisiana            | Tennessee      |
| • Kentucky             | Vermont        |
| • Maine                | Washington     |
| • Maryland             | Wisconsin      |
| • Michigan             | Wyoming        |
| • Minnesota            | Mississippi    |
| • Texas                | West Virginia  |
| • District of Columbia |                |

# Sourcing Tangible Property

## **Not much variation across states or across tax types**

—Sales = destination

- but note unresolved “ultimate destination” issues

—Income = delivered or shipped

# Sourcing Services – Income Tax

Services generally not subject to sales tax (notable exceptions). For income tax:

Market Based Sourcing Customer Activity	Market Based Sourcing Taxpayer Activity	Cost of Performance
<p><b><u>Benefit Received</u></b></p> <ul style="list-style-type: none"><li>• Arizona (elective)*</li><li>• California*</li><li>• Iowa*</li><li>• Michigan*</li><li>• Missouri* (SSF beg. 2020)</li><li>• New Jersey* (beg. 2019)</li><li>• New York*</li><li>• Ohio (CAT)</li><li>• Rhode Island*</li><li>• Utah* (SSF phase in)</li><li>• Washington (B&amp;O)</li><li>• Wisconsin*</li></ul> <p><b><u>Service Received</u></b></p> <ul style="list-style-type: none"><li>• Illinois*</li><li>• Maine*</li><li>• Minnesota*</li></ul> <p><b><u>Service Used</u></b></p> <ul style="list-style-type: none"><li>• Connecticut*</li></ul> <p><b><u>Customer Located</u></b></p> <ul style="list-style-type: none"><li>• Georgia*</li><li>• Maryland* (SSF phase in)</li><li>• Nebraska*</li><li>• Oklahoma</li></ul>	<p><b><u>Service Delivered</u></b></p> <ul style="list-style-type: none"><li>• Alabama</li><li>• District of Columbia*</li><li>• Kentucky* (beg. 2018)</li><li>• Louisiana*</li><li>• Massachusetts</li><li>• Montana (beg. 2018)</li><li>• Oregon (beg. 2018)*</li><li>• Pennsylvania*</li><li>• Tennessee</li><li>• Colorado (beg. 2019)*</li></ul> <p><b><u>Service Performed</u></b></p> <ul style="list-style-type: none"><li>• New Jersey</li><li>• South Carolina</li><li>• Texas*</li></ul>	<ul style="list-style-type: none"><li>• Alaska</li><li>• Arkansas</li><li>• Delaware</li><li>• Florida</li><li>• Hawaii</li><li>• Idaho</li><li>• Indiana*</li><li>• Kansas</li><li>• Mississippi</li><li>• New Hampshire</li><li>• New Mexico</li><li>• North Carolina*</li><li>• North Dakota</li><li>• Vermont</li><li>• Virginia</li><li>• West Virginia</li></ul> <ul style="list-style-type: none"><li>• *Single Sales Factor</li></ul>

# Sourcing Intangibles – Income Tax

Services generally not subject to sales tax (notable exceptions). For income tax:

Market / Use	Cost of Performance	Other
<ul style="list-style-type: none"><li>• Alabama</li><li>• California</li><li>• Connecticut</li><li>• District of Columbia</li><li>• Georgia</li><li>• Illinois</li><li>• Iowa</li><li>• Louisiana</li><li>• Maine</li><li>• Massachusetts</li><li>• Michigan</li><li>• Minnesota</li><li>• Montana</li><li>• Nebraska</li><li>• New Jersey</li><li>• New York</li><li>• North Carolina</li><li>• Oregon</li><li>• Rhode Island</li><li>• South Carolina</li><li>• Tennessee</li><li>• Utah</li></ul>	<ul style="list-style-type: none"><li>• Alaska</li><li>• Arizona</li><li>• Arkansas</li><li>• Delaware</li><li>• Florida</li><li>• Hawaii</li><li>• Idaho</li><li>• Indiana</li><li>• Kansas</li><li>• Kentucky</li><li>• Mississippi</li><li>• Missouri</li><li>• New Hampshire</li><li>• New Mexico</li><li>• North Dakota</li><li>• Pennsylvania</li><li>• Virginia</li><li>• West Virginia</li></ul>	<p><b><u>Commercial Domicile</u></b></p> <ul style="list-style-type: none"><li>• Texas</li><li>• Oklahoma</li></ul> <p><b><u>Other</u></b></p> <ul style="list-style-type: none"><li>• Colorado (as TPP)</li><li>• Maryland (no guidance)</li><li>• Vermont (receipts earned)</li><li>• Wisconsin (use, commercial domicile, or billing)</li></ul>

# Sourcing Digital Goods – Income vs. Sales Tax

Sourcing Digital Goods			
Income Tax		Sales Tax	
Rule	No. of states	Rule	No. of states
Place of delivery	1	Place of delivery	3
Market/place of use	7	Electronically transferred, delivered or received	4
Cost of performance	1	SSUTA sourcing hierarchy	14
No specific guidance	30	Place of Order, then SSUTA hierarchy	1
No specific guidance, except to treat as		No guidance	7
- Intangibles (MBS, COP, other)	1		
- Services (MBS, COP, other)	5		
- TPP (Delivered)	1		
No income tax	5	Not subject to sales tax	22

# Indirect impacts of *Wayfair*

## —Combined Reporting

- If separate corporation will always have nexus where it has apportionment data, why not combine?
- Does transfer pricing matter as much when both payor and payee have nexus?

## —PL86-272

- Re-evaluate given realities of new economy
- E.g., for an online sale what does it mean for an order to be sent out of state for approval?
- Is anyone just selling TPP?

## —Considerations for Non-U.S. Companies

- Treaty protections
- Implications of effectively connected income



Thank you