AFTER THE STORM

Apportionment: Special Treatment of Items

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Agenda

Overview of Apportionment: Sales & Use Tax

Allocating the Sales & Use Tax Base

Overview of Apportionment: Income Tax

Throwback/Throwout

Extraordinary Sales

Sales of Subsidiary Stock

Overview of Apportionment: Sales & Use Tax

Sales & Use Tax Apportionment (or Allocation)

- Is it appropriate to apportion/allocate the sales and use tax base for:
  - Services
    - If a service is provided in more than one location, where should the service be subject to tax?
  - Sales of Tangible Personal Property
    - What about moveable property?
    - What about tangible personal property that can be concurrently used in multiple locations (i.e., prewritten computer software)?

Allocating the Tax Base

Consider *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977):

- the tax must be applied to an activity with a substantial nexus with the taxing state;
- the tax must be fairly apportioned to activities carried on by the taxpayer in the taxing state;
- the tax must not discriminate against interstate commerce; and
- the tax must be fairly related to the services provided by the state.

Allocating the Sales & Use Tax Base

Goldberg v. Sweet, 488 U.S. 252 (1989)

- The U.S. Supreme Court has looked specifically at this issue with respect to the telecommunications industry in *Goldberg v. Sweet* and the transportation industry in *Oklahoma Tax Commission v. Jefferson Lines, Inc.*, 514 U.S. 175 (1995).
- Illinois imposed tax upon the "act or privilege" of "originating" or "receiving" interstate communications in Illinois so long as the call was charged to an in-state service address (i.e. to equipment in Illinois). The tax was imposed at a rate of 5% of the gross charge for the telecommunications.

Allocating the Sales & Use Tax Base

Goldberg v. Sweet, cont.

- The Appellants contended that the Illinois tax violated the apportionment prong of *Complete Auto* because the tax was levied upon the gross charge for each telephone call, instead of the portion of the gross charge that reflected the ratio of in-state activity to total activity associated with the telecommunication.
- The U.S. Supreme Court, however, viewed the issue as whether the tax was internally and externally consistent; meaning whether the tax was rationally related to the activity in the state and whether if all states imposed the same method of taxation there would be double taxation.

Allocating the Sales & Use Tax Base

Goldberg v. Sweet, cont.

- The Court recognized only a limited opportunity for multiple taxation because only two types of states had a sufficient nexus to impose a tax on telecommunications: (i) those like Illinois that keyed the imposition of the tax to the service address, and (ii) those like Arkansas that taxed calls either billed or paid within their boundaries.
- The Court doubted that a state could tax a call merely because electronic signals passed through it, or that the termination of an interstate call, by itself, provided a substantial enough nexus for taxation.

Allocating the Sales & Use Tax Base

Goldberg v. Sweet, cont.

- Illinois avoided “actual multistate taxation” pitfalls by providing a credit for the amount of tax any taxpayer paid in another state on the same call that triggered the Illinois tax.
- In determining that the tax was fairly apportioned among the states, even though based on the gross charge for the call and not just the portion attributable to mileage traveled within Illinois, the Court likened the tax to a sales tax: it was assessed on individual consumers, collected by the retailer providing the service, and accompanied the retail purchase of an interstate telephone call.

Allocating the Sales & Use Tax Base

Goldberg v. Sweet, cont.

- The Court noted that if all states passed the same statute, only one state would tax each interstate telephone call. Even with different statutes, the credit provision in the Illinois statute avoided multiple taxation.
- The Court further found that the tax was fairly related to benefits provided by the state to its taxpayers and, because it fell only on in-state consumers, it did not discriminate unfairly against interstate commerce.

Allocating the Sales & Use Tax Base

Central Greyhound Lines, Inc. v. Mealy et al., 334 U.S. 653 (1948)

- New York sought to tax the total receipts of Central Greyhound Lines for transportation services of which 43% of the mileage lay in New Jersey and Pennsylvania.
- The Court held that transactions that substantially took place in New Jersey and Pennsylvania could not be deemed legally to have taken place in New York.
- Unfair burden of being taxed in multiple states on same revenue
- Even if neither Pennsylvania nor New Jersey taxed the income, New York could not.

Allocating the Sales & Use Tax Base

Oklahoma Tax Commission v. Jefferson Lines, Inc., 514 U.S. 175 (1995)

- Jefferson Lines, Inc. provided bus services as a common carrier in Oklahoma.
- Jefferson Lines, Inc. did not collect sales tax on tickets it had sold in Oklahoma for bus travel from Oklahoma to other states.
- Oklahoma imposes a tax on transportation for hire.
- Jefferson Lines, Inc. objected.
  - The tax imposes an undue burden on interstate commerce.
  - The danger of double taxation.

Allocating the Sales & Use Tax Base

Oklahoma Tax Commission v. Jefferson Lines, Inc., 514 U.S. 175 (1995)

- The Court, however, upheld the tax as being constitutional and distinguished *Greyhound Lines:*
  - The identity of the taxpayers.
  - The opportunities that existed for multiple taxation of the same taxpayer.
- The Court reserved the question as to whether the Commerce Clause would sanction taxation of tickets sold in Oklahoma for travel wholly outside of the state or for travel on routes originating in other states and terminating in Oklahoma.

Impact of SST on Apportioning or Allocating the Tax Base

Sourcing Rules for Software, Software Maintenance Agreements & Computer Services

- The Multiple Points of Use (MPU) Exemption was repealed at the December, 2006 Governing Board Meeting.
- Sourcing rules related to the sourcing of sales of prewritten computer software, software maintenance agreements and computer services were adopted at this same meeting. The sourcing rules essentially follow the hierarchy of Section 310 in the Streamlined Sales and Use Tax Agreement .

Impact of SST on Apportioning or Allocating the Tax Base

The sourcing rules generally provide as follows:

1. Over the counter sales are sourced to the business location of the seller where the sale occurs.
2. If not over the counter sale, sale is sourced to location where receipt occurs (which can be multiple locations).
3. When (1) and (2) do not apply, the sale is sourced to the location indicated by an address for the Purchaser that is available from the business records of the Seller that are maintained in the ordinary course of business when use of this address does not constitute bad faith.
4. When (1), (2), and (3) do not apply, the sale is sourced to the location indicated by an address for the Purchaser obtained during the consummation of the sale, including the address of a Purchaser's payment instrument, if no other address is available, when this address does not constitute bad faith.
5. When none of the previous rules apply, then the location is determined by the address from which the prewritten software was shipped or, if delivered electronically, was first available for transmission by the Seller.

Impact of SST on Allocating Sales & Use Tax Base

SSTP Sourcing “Computer-Related Services”

- “Computer-Related Services” are undefined, and are sourced to where purchaser makes “first use.”
- Contains a “delivery” concept:
  - “Over-the-counter” sales are sourced to seller’s business location.
  - Services performed at purchaser’s location are sourced to that location.
  - Presumption in favor of purchaser’s location, not the seller’s:
    - Purchaser, with a single location in State A, accesses, but does not license, software located on Seller's server located in State B, which is characterized in both States A and B as a computer-related service. The Seller knows that the Purchaser makes first use of this service at its location in State A. Seller sources the transaction to State A.
  - Allocation is allowed when purchaser and seller agree on the allocation method.

Tips for Allocating Sales & Use Tax Base

Develop a Sensible and Uniform Approach

- State statutory and regulatory guidance often does not provide an answer/approach. Rather, a "range" of acceptable answers is the norm.
  - Tex. Tax Code 151.330(f)
    - Services performed for use both within and outside this state are exempt to the extent the services are for use outside this state and made taxable on or after September 1, 1987.
  - DC Mun. Reg. 9-474.5
    - Data processing services performed or delivered outside of the District for use within other jurisdictions as well as for use within the District shall be subject to the District use tax on a prorated share of the charge; provided, that no sales tax was required to be paid on that prorated share to the other jurisdiction.
- Most auditors will look for a sensible approach that reflects a system of assigning sales to locations where the service is being "received."

Tips on Allocating Sales & Use Tax Base

BUT, how does one source between States A, B, C & D?

- Based on expected usage?
- Based on actual usage?
- Based on a pro-rata split?
- Based on "value" of the usage (management versus line employees)?
- Others?

Sales & Use Tax Sourcing Example

Sourcing Sales of E-mail and Similar Services

- A consumer's computer may not be located in one jurisdiction.
- Multiple servers supplying the same information.

500 Different "User" Locations in ten different states

- Where does "Use" occur?
- Where does the transaction take place?
  - Server
  - Corporate headquarters
  - Customer's location
  - Customer's billing address
  - Other

Overview of Apportionment: Income Tax

Income Tax Apportionment

- UDITPA
- The Transactional Test
- The Functional Test

Throwback /Throwout

Throwback

- Overview
- UDITPA
- Variations
- Arguments
  - For
  - Against

Throwback /Throwout

From a Sales Tax Perspective, consider the following:

Electronically delivered software delivered to a server located in New York.

- New York sources software based on “user location.” Many other states source based on server location. Result could be “nowhere purchases.”

Throwback /Throwout

Throwout

- Overview
- West Virginia
- New Jersey
- Administratively Imposed Rules
- Constitutional Limitations
- Arguments
  - For
  - Against

Sales & Use Tax Issue – Moveable Property

Irwin Industrial Tool Co. v. Ill. Dept. of Rev., Ill. App. Ct., 1st Dist., 6th Div., Dkt. No. 1-07-3331 (9/11/2009)

- In December 1999, an aircraft purchase agreement was executed out of state by a wholly-owned subsidiary of a tool manufacturing and distribution company. The subsidiary (which later merged with the tool company) was incorporated in Nebraska and its sole corporate purpose was to provide air transportation services to the tool company.
- Delivery of the aircraft was accepted in Arkansas and immediately flown to Nebraska, where it was hangared. The bill of sale and FAA registration listed an Illinois corporate office as the subsidiary's primary address (in 2000, it was changed to a Nebraska address). At the time of purchase, the tool company's CEO had an office in Illinois. In 2000, four of the tool company's corporate officers had offices in Illinois.
- The airplane was owned from April 12, 2000 through April 30, 2002 and used for three primary purposes: customer visits, transporting employees from one location to another, and matters relating to acquisitions and lawsuits.

Sales & Use Tax Issue – Moveable Property

Irwin Industrial Tool Co. v. Ill. Dept. of Rev., Ill. App. Ct., 1st Dist., 6th Div., Dkt. No. 1-07-3331 (9/11/2009)

- Even though the aircraft was hangared and maintained outside of Illinois, the aircraft made 290 takeoffs and landings at Illinois airports, which included flights in and out of Illinois on nearly half of the days for which any flights were made. In fact, one-third of the total flight segments for the aircraft was logged on flights to and from Illinois, although some of those flights included landings in other places as well as Illinois. In addition, the aircraft was present overnight at one of Illinois's four airports on 25 occasions.
- The appellate court determined that there was substantial nexus between the aircraft purchased and hangared out of state and Illinois, such that the Department could tax the company’s use of the plane in Illinois based on the entire purchase price of the plane rather than the actual use of the plane in Illinois.

Extraordinary Sales

- Gain from Sale of Out-of-State Real Property
- Depreciation Recapture
- Liquidation of Target Corporation

Sale of Subsidiary Stock

- Federal Tax Treatment
- State Taxation of Gain/Loss
- Apportionment or Allocation of Gain
- Section 338(h)(10) Sales

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I. WHERE ARE SERVICES TAXED?

A. The Destination Principle

1. The destination principle holds that the sales or use tax will apply at the destination of the taxable property or service irrespective of where title transfers.

2. Destination generally means where the property is delivered to the ultimate consumer. Delivery to the ultimate consumer may include delivery to a purchaser's agent.

3. This principle is generally followed throughout the country even though virtually every state’s statute imposes tax on the transfer of title or possession.

4. Although their are some issues with respect to where delivery occurs and who is responsible to collect the tax (e.g. drop shipments), it is generally easier to pinpoint the state in which tangible personal property is delivered. The same cannot be said of services.

B. Where are services delivered?

1. As stated above, services are generally taxed where they are delivered to the ultimate consumer or the consumer's agent. However, unlike sales of tangible personal property, the location of the delivery of a service is a little harder to pinpoint.

2. Obviously, when the service provider is in the same state as the ultimate consumer and the service is not provided outside of that state, the service is delivered in that state. However, what happens when more the service provider and the customer are in different states or the service is provided in more than one state.

   a) For example: An architect/engineer based in New York visits Illinois to oversee a project and to make modifications to the blueprints.

   b) A consulting firm has staff in five states working on a project at multiple locations.

C. Allocation or apportionment of services for sale/use tax purposes

1. If a service is provided in more than one location, where should the service be subject to tax. The United States Supreme Court has looked specifically at this issue with respect to the telecommunications industry in Goldberg v. Sweet, 488 U.S. 252 (1989) and the transportation industry in Oklahoma Tax Commission v. Jefferson Lines, Inc., 514 U.S. 175 (1995).

2. Constitutional Limitations

   a) Complete Auto Transit, Inc. v. Brady, 430 U.S. 274 (1977)

      (1) The tax must be applied to an activity with a substantial nexus with the taxing State;

(2) the tax must be fairly apportioned to activities carried on by the taxpayer in the taxing state;

(3) the tax must not discriminate against intestate commerce; and

(4) the tax must be fairly related to the services provided by the State.

b) <u>Goldberg v. Sweet</u>

(1) Illinois imposed upon the "act or privilege" of "originating" or "receiving" interstate communications in Illinois so long as the call was charged to an in-state service address (i.e. to equipment in Illinois. The tax was imposed at a rate of five percent of the gross charge for the telecommunications.

(2) The Appellants contended that the Illinois tax violated the apportionment prong of <u>Complete Auto</u> because the tax was levied upon the gross charge for each telephone call instead of the portion of the gross charge that reflected the ratio of in-state activity to total activity associated with the telecommunication.

(3) The Supreme Court, however, viewed the issue as to whether the tax was internally and externally consistent; meaning whether the tax was rationally related to the activity in the state and whether if all states imposed the same method of taxation there would be double taxation.

(4) The Court recognized only a limited opportunity for multiple taxation since only two types of states had a sufficient nexus to impose a tax on telecommunications: (a) those like Illinois that keyed the imposition of the tax to the service address and (b) those like Arkansas that taxed calls either billed or paid within their boundaries.

(5) The Court doubted that a state could tax a call merely because electronic signals passed through it, or that the termination of an interstate call, by itself, provided a substantial enough nexus for taxation.

(6) Illinois avoided “actual multistate taxation” pitfalls by providing a credit for the amount of tax any taxpayer paid in another state on the same call that triggered the Illinois tax.

(7) In determining that the tax was fairly apportioned among the states, even though based on the gross charge for the call and not just the portion attributable to mileage traveled within Illinois, the Court likened the tax to a sales tax: it was assessed on individual consumers, collected by the retailer providing the service, and accompanied the retail purchase of an interstate telephone call.

(8) The Court noted that if all states passed the same statute, only one state would tax each interstate telephone call. Even with different statutes, the credit provision in the Illinois statute avoided multiple taxation.

(9) The Court further found that the tax was fairly related to benefits provided by the state to its taxpayers and, since it fell only on in-state consumers, did not discriminate unfairly against interstate commerce.

c) Central Greyhound Lines, Inc. v. Mealey et al., 334 U.S. 653 (1948)

(1) The State of New York sought to tax the total receipts of Greyhound Lines from transportation of

which 43 percent of the mileage lay in New Jersey and Pennsylvania.

(2) The Court held that transactions that substantially took place in New Jersey and Pennsylvania could not be deemed legally to have taken place in New York.

(3) If New York were to have been allowed to impose a tax on the gross receipts for the entire mileage of a trip that had not taken place totally in New York, this would have subjected interstate commerce to an unfair burden of being taxed as to portions of its revenue by states that gave protection to those portions, as well as by a state that did not give such protections.

(4) Additionally, if neither Pennsylvania nor New Jersey had sought to tax their proportionate share of the revenue from this transportation, it would still not have justified the taxing by New York of the entire revenue.

d) <u>Oklahoma Tax Commission v. Jefferson Lines, Inc</u>.

(1) Jefferson Lines, Inc. is a Minnesota corporation that provided bus services as a common carrier in Oklahoma.

(2) Jefferson Lines, Inc. did not collect sales tax on tickets it had sold in Oklahoma for bus travel from Oklahoma to other states, although it did collect and remit taxes for all tickets it had sold in Oklahoma for travel that originated and terminated in that state.

(3) Oklahoma imposes a tax on certain services including transportation for hire and assessed Jefferson Lines, Inc. tax on the tickets it sold in Oklahoma that originated Oklahoma, but terminated outside of Oklahoma.

(4) Jefferson Lines, Inc. objected to the assessment and claimed that: (a) the tax imposes an undue burden on interstate commerce by permitting Oklahoma to collect a percentage of full purchase price of all tickets for interstate bus travel, even though some of the value derives from bus travel through other states, and (b) the danger of double taxation exists because any other state through which a bus travels

while providing the services sold in Oklahoma will be able to impose a tax of their own upon Jefferson Lines, Inc. or its passengers.

(5) Jefferson Lines, Inc. relied upon the Court's decision in Greyhound Lines for support.

(6) The Court, however upheld the tax as being constitutional and distinguished Greyhound Lines.

(7) The features that distinguished the New York tax from the Oklahoma tax were (a) the identity of the taxpayers and (b) the opportunities that existed for multiple taxation of the same taxpayer. The taxpayer in New York was the interstate carrier and the carrier was subject to possible taxation on its income in other states. The taxpayer in Oklahoma was the purchaser who was not subject to tax in other states.

(8) In Oklahoma, the taxable event comprised an agreement, payment and delivery of some of the services. Because no other state could claim to be the site of such a combination, there was no threat of multiple taxation.

(9) The Court reserved the question as to whether the Commerce Clause would sanction taxes for tickets sold in Oklahoma for travel wholly outside of the state for travel on routes originating in other states and terminating in Oklahoma.

e) Origination, termination and payment or billing appears to be the key to situsing the sale of service when the service takes place in more than one state. However, how will this formula work with e-business remains to be seen.

II. ELECTRONIC COMMERCE

A. When trying to source sales of e-mail and similar services, situsing the sale is complicated by the fact that a consumer's computer may not be located in one jurisdiction but may instead be moving (e.g. laptop computers, cellular phones, pagers, personal communications networks).

B. When a vendor of Internet access or on-line services is considered the consumer of purchased telecommunication services, not the reseller, should the call be sourced to where the vendor is headquartered, or to the locations of the ultimate consumers of the end product? Does it make a difference if the on-line vendor has centralized server or switching pin through which all calls are routed?

C. A computer software company sells a multistate customer the right to utilize its software in 500 different "user" locations in ten different states.

The computer software company then electronically transfers a single version of the software to a single server site from which the software is accessed by the 500 employees. Is the sale of the software taxable in just the single jurisdiction where the server is located? What if that jurisdiction considers such a transaction to be the sale of nontaxable intangible property? Would a use tax be due in some or all of the other nine states from which the purchaser's employees access the software?

III. IMPACT OF THE STREAMLINED SALES TAX PROJECT ("SSTP")

1. While the SSTP has, with some exceptions (i.e., bundling, sourcing, etc.), avoided addressing services, SSTP has offered some clarity in participating states at least with respect to prewritten computer software and digital goods. These definitions have introduced a greater degree of predictability for both sellers and purchasers transacting business in these areas. It is unlikely, however, that the SSTP will venture too far into the broader enumerated services arena and the problem of state tax legislation failing to keep pace with rapidly changing technology and business models is likely to continue to be a challenge for businesses struggling to meet their state tax compliance responsibilities.

   a) Prewritten Computer Software

      (1) The SSTP has defined tangible personal property to include prewritten computer software (regardless of form of delivery). However, the SSTP has also developed definitions for both "delivered electronically" and "load

and leave." States have the ability to carve out exemptions for prewritten computer software delivered via one of these alternative methods.

b) Digital Goods

(1) The SSTP has defined specified digital products. The definition is somewhat narrow in scope, including the terms digital audio visual works, digital audio works, and digital books. However, of significance is the fact that the digital products provisions expressly state that no state shall include specified digital products, among those items defined with specified digital products, in its definition of ancillary services, computer software, telecommunications services or tangible personal property.

c) Sourcing

(1) SST has developed sourcing rules for both sales of tangible personal property and services. While guidance is still being developed to further clarify the sourcing rules related to services, in general, specific sourcing rules have been developed addressing computer services and software maintenance agreements. See *Appendix* for the SST sourcing rules.