

Market Sourcing and Factor Presence Nexus Trends

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Agenda

- (1) MTC's Market Sourcing Rules
- (2) Factor Presence Nexus
- (3) The Latest Trends in Market Sourcing
- (4) MTC Restatement Concerning P.L. 86-272
- (5) Questions

MTC's Market Sourcing Rules

Polling Question #1

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Theoretically, which is the better sourcing methodology for sales of services: market sourcing or cost-of-performance sourcing?

- a. Market sourcing**
- b. Cost-of-performance sourcing**
- c. Neither**

Polling Question #2

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From a compliance standpoint, which sourcing methodology for sales of services is less burdensome?

- a. Market sourcing**
- b. Cost-of-performance sourcing**
- c. Both are equally burdensome.**

State Nexus Requirements vs. Permanent Establishment (PE)

- States Generally Not Bound by Federal Treaty Requirements
- Federal Taxable Income as Starting Point

Economic Nexus Post-*Wayfair*

- Change in Constitutional Limits
- Due Process as Remaining Limits

P.L. 86-272 Protections

- MTC Restatement
- State Adoption

State Imposition Statutes

- Doing Business or Deriving Income
- Factor Presence (MTC Model)

Apportionment Now Equals Nexus?

- Sales Sourced to States Equals Filing Obligations
- Sales Factor Sourcing Now Required for Nexus Study

MTC's Market Sourcing Rules for Service Receipts

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MTC's Market Sourcing Rules for Service Receipts

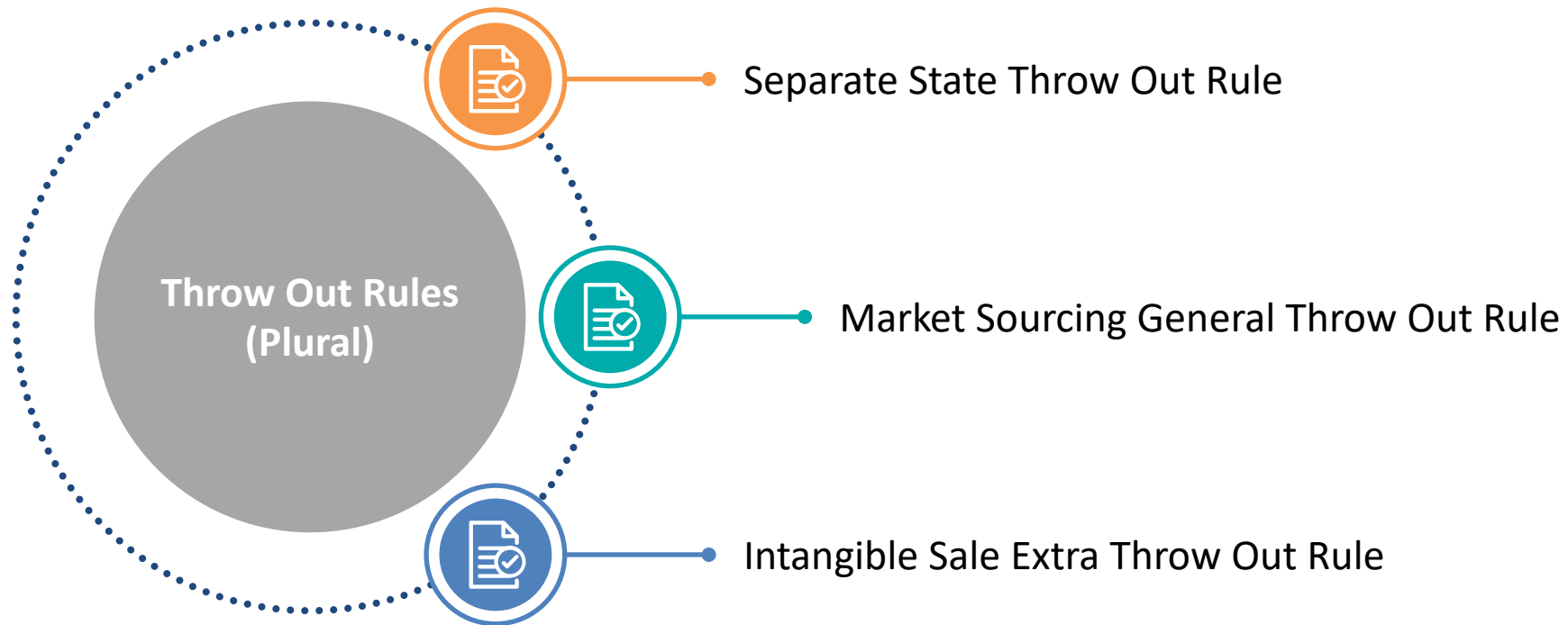


MTC's Market Sourcing Rules for Intangible Receipts

MTC's Market Sourcing Rules for Intangible Receipts

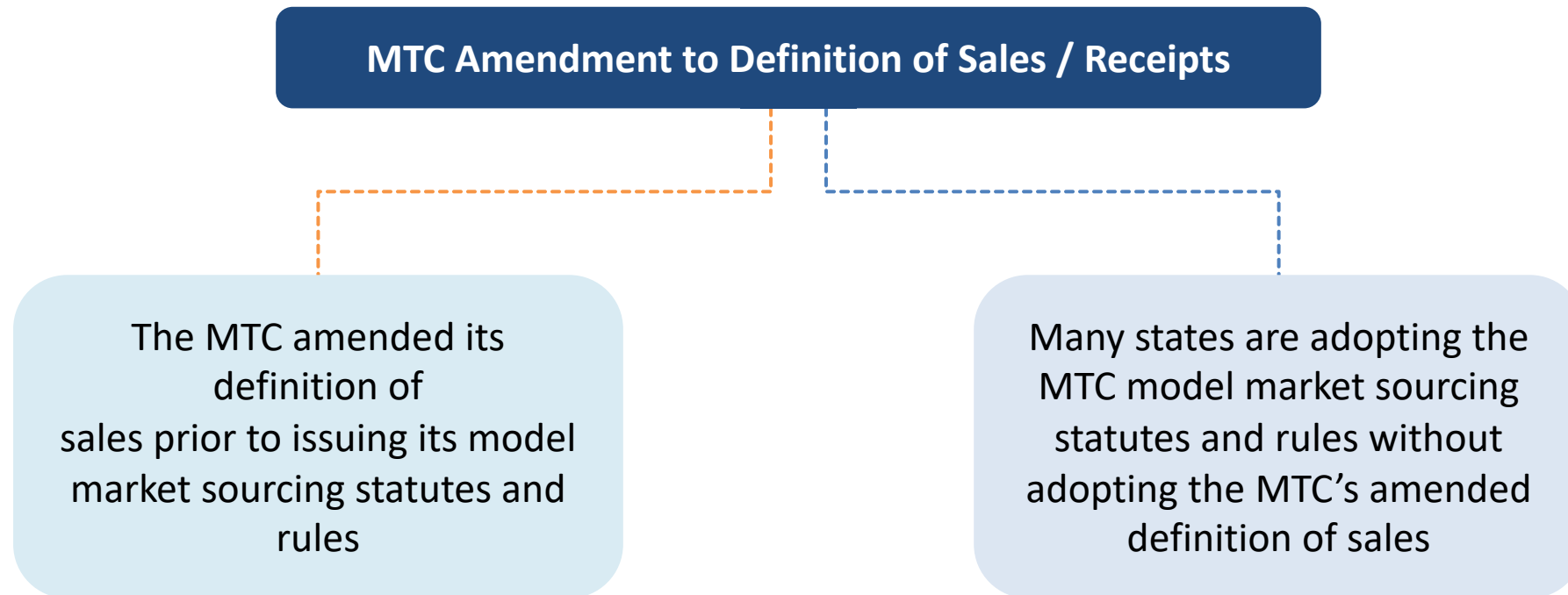


MTC's Market Sourcing Rules



MTC's Market Sourcing Rules

Amendment to Definition of Sales / Receipts



Market Sourcing Rulemaking Efforts

California

- Formal promulgation of amendments underway
- Amendments for sales of services
 - New “simplification rules” for sales of services would no longer distinguish between sales to individuals and business customers
 - Special rules for sales to the US government
 - New “predominantly relates to” test
- Amendments for sales of intangibles
 - Sales involving complete transfer of all property rights
- Other notable amendments
 - Reasonable approximation definition
 - Mixed sales rule

New York

- Draft regulations issued relating to state 2015 corporate tax reform
- Part 4 relates to apportionment
 - Due diligence standard including taking reasonable steps to update existing systems of recording information required to be maintained by law
 - Special rules to determine primary use location
 - If taxpayer is unable to apply special sourcing rule, it may use the reasonable approximation rules
 - New “billing address safe harbor”
 - Intermediary transaction rules
- Retroactive versus prospective application

Market Sourcing Rulemaking Efforts (Cont'd)

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Washington

- Draft amendments to Rule 19402 issued in October 2021
 - Would source services provided to business customers, where such services relate to the customer's business activity, to one of two places: (1) the customer's "market"; or (2) the customer's business location.
 - Related business activities occur in the customer's market if the service performed by the taxpayer is, among other things, "establishing or maintaining the customer's market."
 - Would require taxpayers to keep and provide upon request "all suitable books and records that are necessary to demonstrate that the attribution method used does not distort the apportionment of the taxpayer's apportionable receipts."
- The last public meeting was held January 19, 2022.

Economic Presence Nexus

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- A growing number of states have statutes, regulations, or rulings that assert nexus over taxpayers that have an economic presence in the state, even those that lack a physical presence in the state.
 - **Maine's explanation of economic nexus:** "Economic nexus is a short-hand term for the principle that a taxpayer's purposefully directed business activity in a State (other than solicitation of sales activity protected by P.L. 86-272) may be sufficient to subject that taxpayer to income tax in that State regardless of the level – or absence – of physical presence in that State."
- **Two types of economic presence laws:**
 - Objective: factor presence nexus
 - Subjective: "doing business" nexus

Objective Approach: Factor Presence Nexus

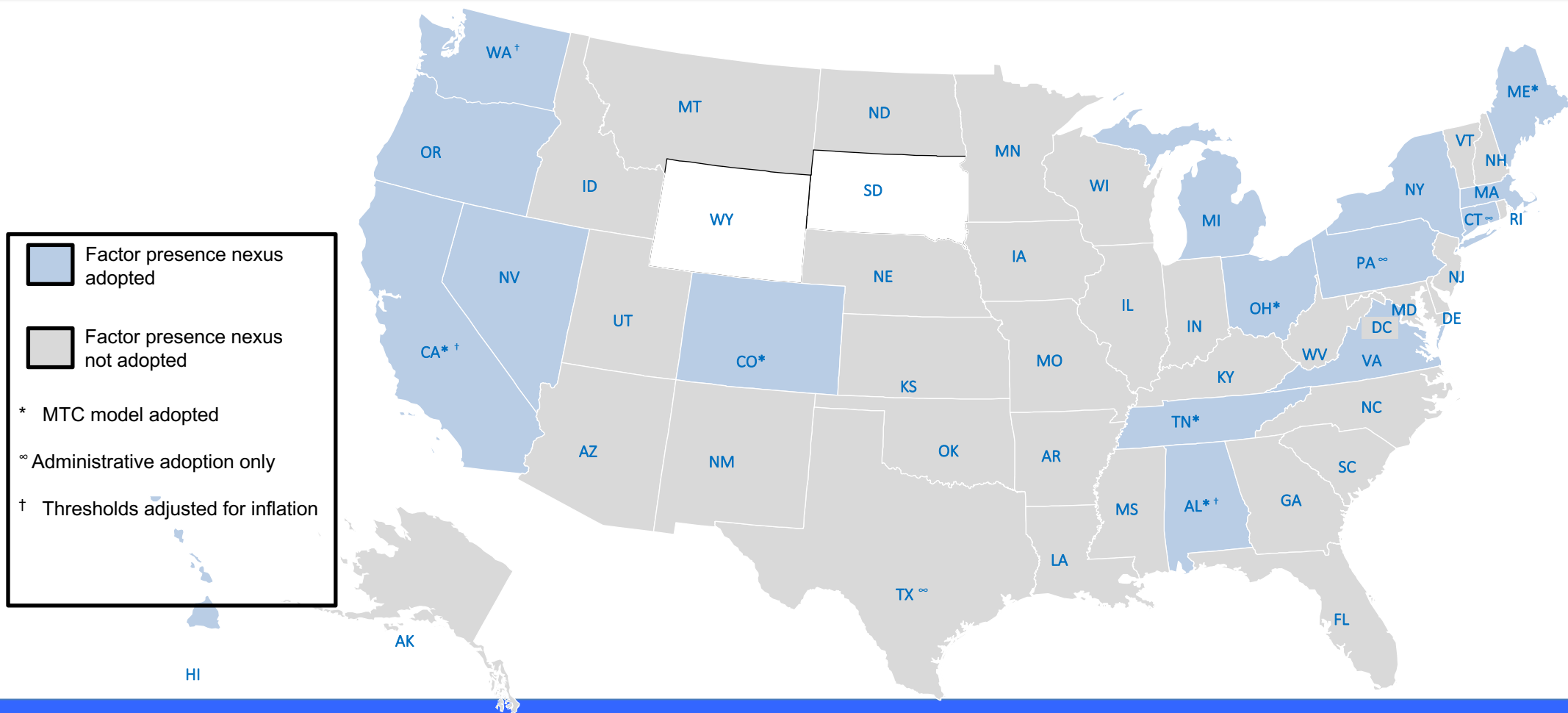
- Under a bright-line “factor-based” economic presence standard, nexus is created with a state when a minimum amount of property, payroll or sales in the state is met; certain states have adopted specific “bright-line” nexus standards.
- *South Dakota v. Wayfair*
 - Overruled *Quill*’s physical presence requirement for “**substantial nexus**” for use tax purposes. Court did not articulate a bright line substantial nexus standard. Dicta indicated Court would likely approve of South Dakota’s sales and use tax economic thresholds. Court said, “[h]ere, the nexus is clearly sufficient based **on both the economic and virtual contacts** respondents have with the State.”
 - In light of the Court’s unequivocal statement in *Wayfair* that physical presence is not a necessary element for “substantial nexus” under *Complete Auto*, it is clear that physical presence is not required under the U.S. Constitution for purposes of income or gross receipts tax nexus.
 - P.L. 86-272 provides statutory income tax protection against assertions of state taxing jurisdiction over businesses whose in-state activities satisfy applicable state factor presence or economic presence thresholds and are limited to solicitation.

Factor Presence Nexus

- **Multistate Tax Commission Model “Factor Presence Nexus” Statute** Substantial nexus is established if any of the following thresholds are exceeded during the tax period: \$50,000 of property; or \$50,000 of payroll; or \$500,000 of sales; or 25% of total property, total payroll or total sales. The factors are periodically adjusted for inflation.

States Adopting Factor Presence Nexus

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Factor Presence: State-to-State Variation

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- Has the state adopted the MTC model?
 - NY: No, \$1 million receipts. N.Y. Tax Law § 209(1)(b)
 - HI: No, \$100,000 gross income or 200 transactions. Haw. Rev. Stat. § 235-4.2
- Does the state adjust its thresholds for inflation?
 - AL: Yes, if CPI changes 5% or more. Ala. Code § 40-18-31.2(b)
 - CA: Yes, revised annually. Cal. Rev. & Tax. Code § 23101
- Do a pass-through entity's factors flow up to its owners?
 - ME: Yes, for direct *or indirect* owners. 36 M.R.S. § 5200-B(2)
- Does the state rely only on factor presence?
 - OR CAT: No, other tests include: owning/using capital in OR, holds certificate of authority from SOS, otherwise has nexus with Oregon under the United States Constitution. ORS § 317A.116

Impact of Market Sourcing on Nexus in Factor Presence States

- Factor presence means that a substantial in-state market could result in an income tax return filing obligation and tax liability.
 - 36 states, plus DC, have adopted market-based sourcing for sales of services/intangibles. Rules vary greatly from state to state.
 - CA: Where the benefit of the service is received. 18 Cal. Code Regs. § 25136-2.
 - CO: Where the service is delivered. Colo. Rev. Stat. § 39-22-303.6.
 - MTC: Where the intangible is used. Reg. IV.17.(e).
- Businesses that provide services or license intangibles may need to do a state-by-state analysis.

Subjective Approach: Doing Business

- States without a bright-line factor presence may seek to impose income tax filing and payment obligations through their “doing business” statutes.
 - IL: Income tax imposed “for the privilege of earning or receiving income in” IL. 86 Ill. Admin. Code § 100.9720.
 - ID: Income tax imposed on a corporation that “transacts or is authorized to transact business,” to the limit of the US or Idaho Constitution. Idaho Code § 63-3025.
 - VT: Income tax imposed on income “derived from any trade, business, or activity conducted” within VT.” 32 VSA § 5833.
- Is this statutory language enough?

Polling Question #3

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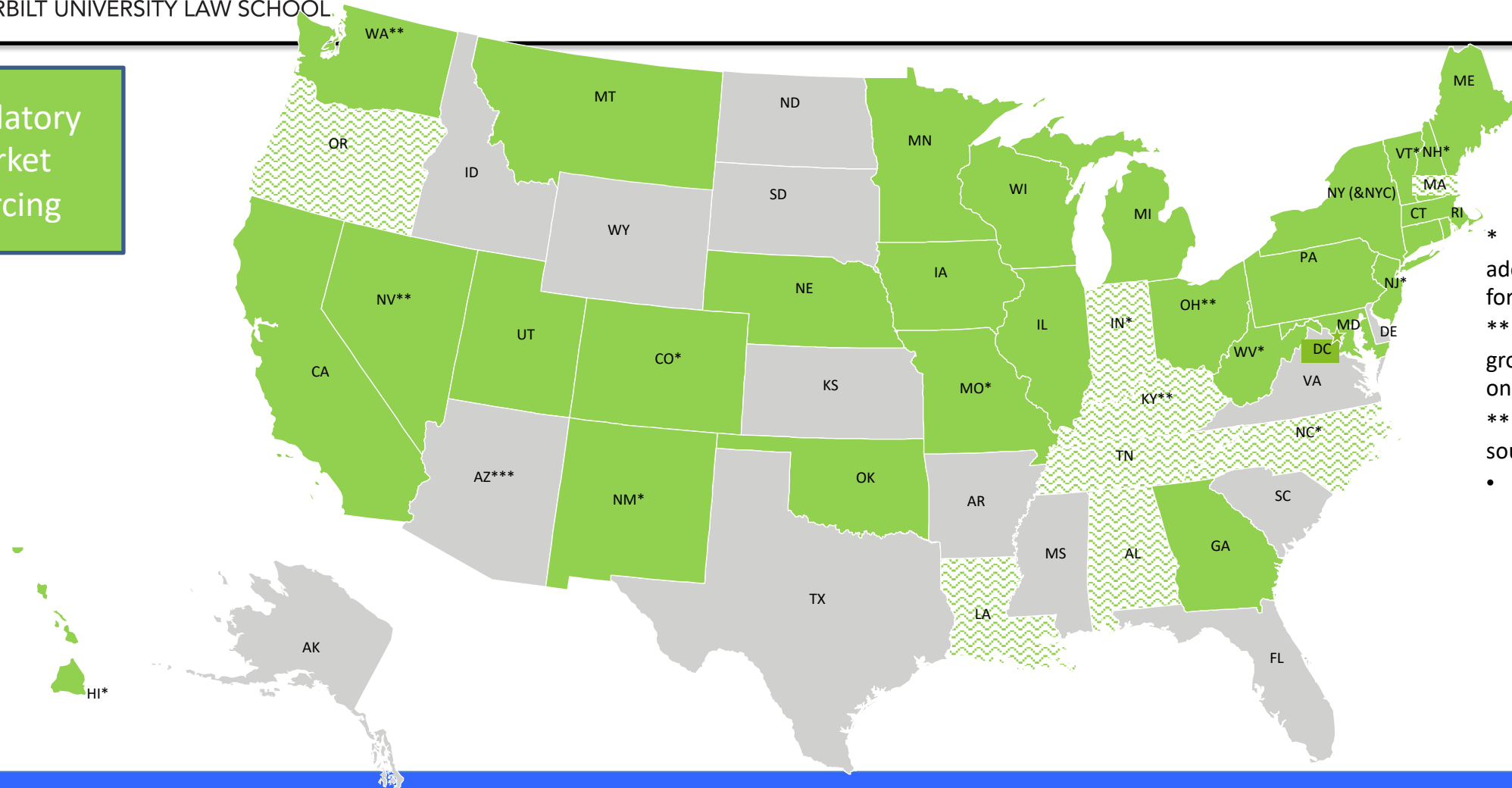
How old is the MTC factor presence nexus model?

- a. 5 years**
- b. 10 years**
- c. 20 years**
- d. 25 years**

The Latest Trends in Market Sourcing

Sales Factor: Mandatory Market Sourcing States for General Taxpayers

Mandatory
market
sourcing



* States that have adopted market sourcing for tax years 2019 or later

** States that impose a gross receipts tax based on sales

*** AZ: Elective market sourcing

- Patterned: States that have adopted MTC market sourcing model statutes (IN: partially adopted MTC model regulation)

Post *Wayfair* – Where are the boundaries?

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Factor Presence combined with Market Sourcing

State imposition statutes require filing obligation if taxpayer has sales (over threshold) sourced to state.

State sourcing rules can source taxpayers' service and / or intangible receipts to state based on very limited / indirect connection.

Examples that May Test the New Boundaries

1. App designer selling through online platform
2. Writer licensing rights to content to multi jurisdiction distribution businesses
3. Foreign company with treaty protection (no PE) selling into the U.S.

Issues With Look-Through Sourcing Issues

- *Matter of TD Ameritrade, Inc.* (NY 2022) – Attempt to source fees paid by banks to a broker-dealer for marketing, recordkeeping, and support services to the location of the brokerage clients rejected; an ALJ held the fees must be sourced to the location of the banks (i.e., the customers).”
- *Walter Dorwin Teague* (WA 2021) – Attempt to source fees for aircraft design services to the location of the airline that purchased the completed aircraft rejected; the court held the fees must be sourced to the location of the aircraft manufacturer.
- *Defender Security Co. v. McClain* (OH 2020) – An authorized dealer of security systems made sales of security monitoring services contracts to consumers and assigned the contracts to an alarm service company (ADT); the court held the payments for the assigned contracts must be sourced to the location of ADT, not ADT’s customers.
- What’s the common denominator in these cases?

Sirius XM Radio, Inc. v. Hegar (TX)

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- Sirius argued that Texas’s statute sourced receipts to where the service is “performed,” which for Sirius is where its personnel and equipment are located (i.e., origination sourcing).
- The Comptroller argued that a service is performed where the “receipt-producing, end-product act” occurred, and Sirius’s receipts-producing activity, end-product act was the decryption of programming at the subscriber’s satellite radio (i.e., destination sourcing).
- The Texas Supreme Court rejected the Comptroller’s argument, concluding that Sirius is in the business of producing and transmitting satellite radio, not decryption; Sirius “performed” its service where it had people and equipment.
- The court remanded the case for a determination of the fair value of Sirius’s services performed in Texas as determined using origination sourcing.

Sirius XM Radio, Inc. v. Hegar, 643 S.W.3d 402 (Tex. 2022).

NASCAR Holdings, Inc. v. McClain (OH)

- Commissioner assessed NASCAR for CAT on receipts from sales of race broadcasting rights to FOX, Turner, etc. based on “purchaser’s benefit,” i.e. usage of those rights in OH based on portion of audience in OH (from Nielsen Ratings); License and sponsor fees based on % US population in OH.
- Board of Tax Appeals affirmed assessment, taxpayer appealed to Ohio Supreme Court (pending) arguing assessment violates Commerce Clause/lacks nexus because receipts from broadcast rights sales were for worldwide use, not dependent on use in OH; factor presence nexus also challenged.

MTC's Restatement Concerning P.L. 86-272

The MTC's Revisions to P.L. 86-272 Statement of Information

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The revisions to the P.L. 86-272 Statement of Information were approved by the MTC at its annual meeting on August 4, 2021.

South Dakota v. Wayfair:

- “For example, a company with a website accessible in South Dakota may be said to have a physical presence in the State via the customers' computers. A website may leave cookies saved to the customers' hard drives, or customers may download the company's app onto their phones.”
- “Between targeted advertising and instant access to most consumers via any internet-enabled device, ‘a business may be present in a State in a meaningful way without’ that presence ‘being physical in the traditional sense of the term.’”

The MTC's Revisions to P.L. 86-272 Statement of Information (cont'd)

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Background:

- In November 2018, the MTC Uniformity Committee formed a Work Group to address the significant changes to the way that business is conducted since the Statement of Information was last revised in 2001.
- The Work Group's role was a limited one: to consider how P.L. 86-272 applies to business activities that have arisen in the last two decades, including activities conducted via the internet.
- The Work Group's task was statutory interpretation, not policy making.

The MTC Work Group's Adopted Framework:

- As a general rule, when a business interacts with a customer via the business's website or app, the business engages in a business activity within the customer's state. However, for purposes of this Statement, when a business presents static text or photos on its website, that presentation does not in itself constitute a business activity within those states where the business's customers are located.

The MTC's Revisions to P.L. 86-272 Statement of Information (cont'd)

State Adoption: How will we know?

- In the normal MTC Uniformity Process, there is a model rule/statute that states adopt through their normal rulemaking or legislative processes
- This, however, is a statement containing the MTC's interpretation of a longstanding federal statute
- A supporting state needs to expressly adopt the Statement by legislation, regulation, or other administrative action.
- The Commission recommends that states adopting the Statement also adopt the MTC Factor Presence Nexus Standard.
- States so far publishing guidance consistent with the Statement: California, New York.

American Catalog Mailers Assoc. v. FTB (CA)

- Complaint filed 8/19/2022 in state court seeks declaratory judgment:
 - TAM 2022-1 and FTB 1050 contradict P.L. 86-272, do not comply with the CA APA, and cannot be applied retroactively under the U.S. and California constitutions.

Online Merchants Guild v. Hassell (PA)

- Commonwealth Court of PA holding: Out-of-state marketplace sellers participating in the Amazon FBA Program with inventory located in Amazon facilities in PA have insufficient contacts with the state and lack necessary due process “purposeful availment” of state protections and benefits, so cannot be required to collect PA sales tax or pay PA tax on income from sales of such inventory through that Program.
- Contrary: see *Jenson Online Inc. et al v. Washington DOR*, Wash. Board of Tax Appeals, Docket Nos. 19-033 et al (2022); *Jon Bargains Inc. v. Washington DOR*, Wash. Board of Tax Appeals, Docket No. 19-078 (2022).

Polling Question #4

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Does P.L. 86-272 apply to the sale of electronically downloaded data?

- **Yes**
- **No**
- **It depends**
- **Don't know/Not applicable**

Questions?

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