IPT Insider

Institute for Professionals in Taxation®

The SALT Professionals Community

December 2016

Credits and Incentives

How States Are Targeting Data Centers Using Incentives

Tax incentives for data centers are strong factors in bringing business and tax revenue to states. This article will describe how the state of Iowa enacted legislation in 2007 that was a major factor in bringing Google, Microsoft, and Facebook data centers into the state. These data centers expand the tax base for the states and create jobs for their inhabitants. Other states have seen the impact that tax incentives can have on their economy and have enacted similar legislation to be able to compete for data center business.

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State Taxation on Services

Multistate Developments in Taxation of Personal and Professional Services

In recent years, rapidly changing economics, growing budget deficits, and skyrocketing infrastructure and healthcare costs have forced state governments to seek new sources of revenue.

One option that states regularly consider is the taxation of personal and professional services, the history of which goes back at least 30 years. Historically, state legislators have found it easier to pass legislation to tax personal, rather than professional, services.

This article provides an overview of proposed legislation in a number of states, including Arizona, California, and Illinois. With persistent budget shortfalls and an uncertain future, one or more states are looking more and more likely to push forward with one of these substantial proposed reforms.

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Income Tax

Crutchfield v. Testa and Its Implications for Nexus

On November 17, 2016, the Ohio Supreme Court upheld the constitutionality of a bright-line quantitative test for establishing jurisdiction to impose the Ohio Commercial Activity Tax ("CAT") over out-of-state taxpayers with no physical presence in Ohio in *Crutchfield Corp. v. Testa*. This article discusses the Court's reasoning and the implications of the decision.[1]

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1 Slip Op. No. 2016-Ohio-7760

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need to change their tax structures in order to reflect the growing predominance of services in the national economy. Any proposed tax reforms by President-elect Trump will affect the nature and speed of legislation developed on the state levels. If the post-election economy will not produce desirable growth, moving with taxation of professional services will become one of the top priorities for numerous jurisdictions.

INCOME TAX

Crutchfield v. Testa and Its Implications for Nexus

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Background on Crutchfield Dispute

Under the U.S. Supreme Court's dormant Commerce Clause jurisprudence, a state may only tax an out-of-state person with "substantial nexus" with the taxing state.[1] Although the precise contours of "substantial nexus" are still being explored by state courts, the Supreme Court stated definitively in *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992), that physical presence in the taxing state is necessary to establish substantial nexus in the context of sales and use taxes. Thus, despite recent challenges to the contrary[2] under *Quill*, a state may not require an out-of-state retailer to collect and remit sales and use taxes from in-state purchasers unless the retailer is physically present in the state seeking to impose the tax.

In contrast to the physical presence requirement for sales and use taxes, the prevailing consensus among the states is that physical presence is not required for income and other business activity tax purposes. Various state court decisions have agreed with that position in certain contexts, for example, in the context of the intangible holding company[3] structures and credit card issuing banks.[4]

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1 *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279 (1977).

2 *See* Michael M. Giovannini and Matthew P. Hedstrom, "Losing the Forest for the Trees: Is It Really All About Physical Presence?" IPT Insider, July 2016.

3 *See, e.g.*, *Geoffrey, Inc. v. South Carolina Tax Com'n*, 437 S.E.2d 13 (S.C. 1993); *Lanco, Inc. v. Director, Div. of Taxation*, 908 A.2d 176 (N.J. 2006).

4 *See, e.g., Tax Com'r of State v. MBNA America Bank*, *N.A.*, 640 S.E.2d 226 (W. Va. 2006); *Capital One Bank v. Com'r of Revenue*, 1899 N.E.2d 76 (Mass. 2009).

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A number of states have adopted what is known as "factor-presence" nexus thresholds for income tax purposes, which seeks to assert nexus over an out-of-state company based solely on meeting certain quantitative measurements, irrespective of whether the out-of-state company possesses a physical presence or utilizes intangible property in the state. Specifically, under a factor-presence standard, a taxpayer establishes "substantial nexus" and is required to file returns and pay income tax if the in-state value of the taxpayer's property, payroll, or sales meets a statutorily fixed dollar amount. With its enactment of the CAT, Ohio became the first state to implement a factor-presence nexus standard. The CAT is imposed on the privilege of doing business in Ohio and is measured by the gross receipts. By statute, any person with $50,000 of Ohio property or payroll, or $500,000 of gross receipts from Ohio sources is subject to the CAT. Following Ohio's lead, a significant number of states have adopted similar factor-presence standards, and many other states are considering doing the same. However, such a standard had never been endorsed by any state supreme court (outside of the context of intellectual property licensing companies/credit card issuing banks) – until now.[5]

The Decision

Crutchfield Corp., a Virginia-based corporation with no offices or employees in Ohio, challenged the CAT's receipts-based threshold, asserting that it is inconsistent with the physical-presence requirement established by the Supreme Court in *Quill*. Although *Quill* addressed the nexus requirement for sales and use tax purposes, Crutchfield argued that the CAT should be evaluated under the *Quill* standard because the CAT, which is based on gross receipts, is functionally equivalent (from a constitutional perspective) to a sales tax insofar as both taxes are measured by receipts from property sold to in-state customers. The Ohio Supreme Court distinguished the CAT from a sales tax on grounds that the CAT is imposed on in-state income producing activity rather than on in-state transactions and, therefore, "should be viewed as occupying the same constitutional category as an income tax on the seller—whereas the sales tax on the instate purchaser occupies a different category."[6] The Ohio Supreme Court further found that the Supreme Court intended its holding in *Quill* to apply narrowly to sales and use taxes. Thus, the CAT, which the majority viewed as "simply a variety of tax on income,"[7] is not subject to *Quill's* physical-presence standard for evaluating whether an out-of-state retailer has "substantial nexus" in Ohio:

> *Quill*'s holding that physical presence is a necessary condition for imposing the tax obligation does not apply to a business-privilege tax such as the CAT, as long as the privilege tax is imposed with an **adequate quantitative standard that ensures that the taxpayer's nexus with the state is substantial.**[8]

After distinguishing *Quill*,[9] the court found that substantial nexus under the Commerce Clause is satisfied as long as the taxpayer's in-state connection satisfies the due process standard (i.e., purposeful availment) **and** the measure of tax is not "clearly excessive." Although the court acknowledged that a quantitative receipts-based threshold is "arbitrary to some degree," it ultimately concluded that $500,000 is a sufficient amount of in-state activity to ensure the CAT is imposed on persons with substantial nexus. However, the court arrived at that conclusion without a great deal of substantive analysis as to why a receipts-based threshold generally, or why $500,000 specifically, is sufficient to create nexus in every instance or as a general matter. Notably, the court failed to discuss the relevance of the taxpayer's qualitative activities. Can a standard that ignores the *quality* of a taxpayer's in-state contacts truly survive constitutional scrutiny? The dissenting opinion suggests not:

> The physical-presence requirement is grounded in the reasoning that the dormant Commerce Clause is designed to prevent regulation and taxation from being an undue burden on interstate commerce . . . . This reasoning is in line with common sense because these companies should

"Although the court acknowledged that a quantitative receipts-based threshold is 'arbitrary to some degree,' it ultimately concluded that $500,000 is a sufficient amount of in-state activity to ensure the CAT is imposed on persons with substantial nexus."

5 The U.S. Supreme Court has never endorsed a factor-presence nexus standard in any context.

6 *Crutchfield*, Slip Op. at 19.

7 *But see Crutchfield*, Slip Op. at 28 (Kennedy, J., dissenting) ("I see no evidence that gross receipts taxes are meaningfully different from use taxes for substantial-nexus purposes . . . .").

8 *Crutchfield*, Slip Op. at 17 (emphasis added).

9 The court also found that the U.S. Supreme Court, in *Tyler Pipe Industries, Inc. v. Washington State Dept. of Revenue*, 483 U.S. 232 (1987), did not establish a physical-presence type requirement for gross receipts tax purposes. Rather, the *Crutchfield* court found that *Tyler Pipe* stands for the proposition that physical presence is a sufficient—not a necessary—condition for imposing a business privilege tax and that the market-making reference in Tyler Pipe did not establish a "constitutional standard for nexus."

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> not be forced to comply with Ohio's CAT based solely on the fact that Ohioans chose to buy products from them. Under the CAT as construed by the majority, a business could be forced to pay Ohio taxes if just one Ohioan spent more than $500,000 on its products. It is easy to imagine an Ohio manufacturing business ordering one machine from an out-of-state business, and that would trigger a requirement for that business to comply with the CAT. The business could have no other connection with the state, but Ohio could drag it into Ohio's taxing scheme based on one act of interstate commerce. This is an undue burden on interstate commerce of the sort that the Quill court was attempting to avoid.

The dissenting Justice's explanation of why the majority's approach can lead to absurd results is well taken, in our view. The majority failed to analyze, much less answer, this fundamental problem raised in the dissent, perhaps because it found reconciling a pure receipts-driven threshold with the dormant Commerce Clause a very difficult task. The court simply stated that, in addition to due process, the tax cannot be "clearly excessive." One can easily argue that an analysis of a taxpayer's qualitative activities is necessary to make that assessment. In that regard, the $500,000 rule that Ohio seeks to enforce as a "bright line" starts to look instead like a "fine line" test– something the states wish to avoid.

"As the first state supreme court that has ruled on this issue, the Ohio Supreme Court's endorsement of the standard may embolden other states to adopt similar standards in the business activity tax context."

Implications

While the decision is not surprising insofar as it represents the continued expansion of economic nexus by the states, there is more to the decision to consider. As an initial matter, as the first state supreme court that has ruled on this issue, the Ohio Supreme Court's endorsement of the standard may embolden other states to adopt similar standards in the business activity tax context. Ohio was an early adopter of the bright-line quantitative threshold for establishing "substantial nexus." Since then, a number of other states, including New York and California, have enacted similar receipts-based tests for establishing nexus. To be sure, these states are looking to the *Crutchfield* analysis to determine whether their taxing regimes will withstand constitutional scrutiny.

The decision is also important with respect to the ongoing debate about the continued viability of the *Quill* physical presence nexus standard. As an initial matter, states should take notice that, in contrast to the ever-building wave of the "kill-*Quill*" movement, that the Ohio Supreme Court did not call into question *Quill's* viability. The court's silence should be viewed in contrast to Justice Kennedy's concurrence in *Direct Marketing Ass'n v. Brohl*.

The court also shed some light on the notion of what constitutes "substantial nexus" in the context of a pure receipts threshold. The court noted that a tax like Ohio's would violate the constitution under the substantial nexus prong if it was "clearly excessive." While it concluded that $500,000 is a sufficient threshold to satisfy "substantial nexus," the court's difficulty rationalizing its decision and truly differentiating a $500,000 threshold from a due process analysis should be instructive in the current debate surrounding sales and use taxes in which South Dakota, Alabama and Tennessee are essentially asserting nexus receipts thresholds in the context of sales and use taxes. The Supreme Court, in *Quill,* concluded that a corporation "may have the 'minimum contacts' with a taxing State as required by the Due Process Clause, and yet lack the 'substantial nexus' with that State as required by the Commerce Clause," thereby specifically bifurcating the two tests.[10] To the extent that the line between these two standards cannot meaningfully be identified, then there is a constitutional problem – unless you believe that the Supreme Court is inclined to reunite the standards. Even if that were true, the Due Process Clause should still prevent a state from asserting jurisdiction over the out-of-state retailer if the state does not provide such retailer with constitutionally sufficient benefits and protections "for which it can ask in return" – said differently perhaps, a "clearly excessive" tax.

South Dakota has arguably the most aggressive sales and use tax nexus standard to date, and one that blurs the line between Due Process and Commerce Clause nexus insofar as it seeks to assert *Commerce Clause* nexus over out-of-state retailers solely as a result of having made sales to customers in the state. We question whether the Supreme Court is willing to essentially obliterate the substantial nexus prong of *Complete Auto* in the manner sought by South Dakota. Why not simply abandon the substantial nexus prong altogether? It is one thing to argue that *Quill*'s physical presence nexus standard is tired (we do not agree), but it is entirely another matter to suggest that the right answer is to walk back the Commerce Clause nexus to essentially a Due Process Clause standard, as South Dakota is seeking to do.

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10 *Quill*, 504 U.S. at 299.

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Thus, while *Crutchfield* is a victory for the states given that it endorses nexus over an out-of-state company based solely on meeting certain thresholds, query whether (1) its endorsement of *Quill* in the context of sales and use taxes; (2) its difficulty in rationalizing its decision from a substantial nexus standpoint; and (3) its inability to persuasively differentiate its analysis from a due process analysis is something taxpayers can build upon in the ongoing debate.

SALES TAX

Comments and Insight on the Alabama Allocation and Apportionment Regulations

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With tax season quickly approaching, we begin with addressing the revised rules that took effect on November 20, 2016.

Petition for Alternative Method

Although Alabama had previously proposed rules to address the ability for a taxpayer to petition for an alternative method of apportionment, it took a few tries to get it right. In the earlier rules, the state required taxpayers to submit a petition for alternative method at least six months prior to the due date of their tax return. In that situation, a taxpayer may not have had adequate time to conduct an internal review and analysis of whether there is a need or opportunity for an alternative filing method if the return has been filed or six month period was nearing close. This approach was not present in the MTC model regulations, and created a difficult obstacle for a taxpayer who might otherwise be entitled to alternative apportionment.

Under the revised rules, a taxpayer may file a petition with the Department Secretary in writing for a proposed alternative method. A taxpayer **is not** permitted to submit a petition as an attachment to an original or amended return. Once a method is approved in writing by the Department, the taxpayer is permitted to file an amended or original return with the approved alternative apportionment method. If the proposed alternative method is not approved within 90 days of the postmarked petition, the proposed method is deemed denied unless the taxpayer and Department have agreed in writing to extend the 90-day review period. If denied, the taxpayer can file an amended return using the proposed method as an appeal of the denial if filed

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