

Advanced Income Tax Apportionment Issues Confronting Multi-State Companies

THURSDAY, JULY 20, 2017, 1:00-2:50 pm Eastern

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AGENDA

- Sourcing of Receipts from Services and Intangibles – Mark Nachbar
- MTC – Article III - Equally weighted three factor sourcing election – Mark Nachbar
- Alternative Apportionment – Mark Nachbar
- Throwback / Throwout – Gary Bingel
 - Foreign Sales
 - Economic Nexus
- Dock Sales
- Joyce / Finnigan Issues – Gary Bingel
- Pass-through Entity Issues

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SOURCING OF SALES FROM SERVICES AND INTANGIBLES

Sourcing Of Receipts From The Sale Of Non-Tangible Property

- Cost of performance
 - Receipts from the sales of other than tangible personal property
 - UDITPA Sect. 17
 - Provides sales of tangible personal property are in a state if:
 - Income producing activity is in the state, or
 - A greater proportion of income producing is in the state.
 - Sect. 17 prescribes the preponderance method.
 - Alternative cost of performance measurements
 - Majority of costs
 - Proportionate method

Sourcing Of Receipts From The Sale Of Non-Tangible Property (Cont.)

- Basic issues
 - What is an income-producing activity?
 - At what level is it determined?
 - Services performed in more than one state
 - Location where services performed is not readily determinable
 - What are direct costs?
 - What costs are actually included?
 - Administrative costs
 - Third-party costs
 - Independent contractors
 - On the “behalf rule”
 - Costs from other members of the unitary group

Sourcing Of Receipts From The Sale Of Non-Tangible Property (Cont.)

- Recent Developments
 - Vesta v. Oregon DOR, TC-MD 130546D, 6/2/2015
 - Limiting COP to the uploading of minutes to customer’s mobile phone, not including the payment processing.
 - Dish v. South Carolina DOR, Docket No.: 14-ALJ-17-0396-CC, 5/20/2016
 - S.C is not a market or COP state but a state which determines sourcing based on “income producing activity”
 - Activity producing income was the dissemination of signal to subscribers at their S.C. residence
- Indiana LOF 02-20140455 (1/28/2015)
 - On-line education services
 - Development of materials out of state was not a COP
 - “Income producing activity” is where the student accesses the education

Sourcing Of Receipts From The Sale Of Non-Tangible Property (Cont.)

- Indiana LOF 02-20150523 (11/30/2016)
 - Direct mail services
 - Cost of performance related to maintenance of databases, not the physical handling of the mailings
- Expedia, NY Div. of Tax Apps., ALJ, DTA 825025 and 825026, 2/5/2015
 - Receipts were for services, not “other business receipts”
 - Human involvement was required to provide the service
 - Law change to “market approach” on 1/1/2015, would be unnecessary.
- Checkfree, NY Div. of Tax Apps., ALJ, DTA 825971 and 825972, 1/5/2017
 - Electronic bill payment and presentment services involved human activity
 - Income is service income, not “other business receipts”
 - No need for law change on 1/1/2015 if DOR’s interpretation was correct

Sourcing Of Receipts From The Sale Of Non-Tangible Property (Cont.)

- Market-based sourcing
 - Shift to market-based sourcing
 - In 2014 and 2015 made changes to the model apportionment statute adopting market based sourcing, and “recommending” that states use a double weighted sales factor.
 - Only 8 states continue to use an equally weighted three factor apportionment formula, 15 states use a super weighted sales formula and 22 use a sales only formula
 - Currently 22 states source services based on a COP analysis, while the remaining 23 use that new market approach
 - MTC follows MA regulations of market based sourcing
 - 2016 CA promulgates detailed regulations on the sourcing of services, and June 2017 holds interested parties meeting on amendments including rules for satellite launching and space travel.
 - Rationale for the shift
 - The complexity of sourcing receipts from non-tangible property
 - Administrative burden on all parties to determine cost of performance components

Sourcing Of Receipts From The Sale Of Non-Tangible Property (Cont.)

- Alternative methods for defining the “market”
 - Where benefit of services is received by customers
 - Where services are performed
 - Where intangibles are used
 - Where the customers are situated
- Where benefit of services is received - issues and approaches
 - Generally, benefit is received at the customer location.
 - Benefits received in more than one state
 - Individual customers vs. business customers
 - Order location vs. billing location
 - Benefit location is indeterminable.
 - No nexus or fixed place of business in benefit location

Sourcing Of Receipts From The Sale Of Non-Tangible Property (Cont.)

- Receipts from intangibles
 - Sourcing receipts derived from the sale or license of intangible property is difficult because intangibles, by their nature, do not have a definite geographical locations.
 - Receipts are derived from intangibles through the following transactions:
 - Sales of intangibles
 - Licensing of intangibles in exchange for royalties
- Where intangibles are utilized - issues
 - Where utilized by payor (e.g., licensee)
 - Is utilization where licensee is located?
 - Where licensee manufactures product?
 - Where licensee sells product?
 - What if location of utilization cannot be determined?
 - What if taxpayer/licensor not taxable where intangibles utilized?

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MTC – ARTICLE III - EQUALLY WEIGHTED THREE FACTOR SOURCING ELECTION

Apportionment: MTC Article III

- US Supreme Court Activity:
 - October 2016 - Cert Denied in California's *Gillette* case
 - December 2016 - Cert Denied in Minnesota's *Kimberly Clark* case
 - May 2017 - Cert Denied for Michigan's retroactive repeal
- Cases still pending at state Supreme Court:
 - Oregon - *Health Net, Incorporated and Subsidiaries v. Department of Revenue*
 - Texas - *Graphic Packaging Corp. v. Hegar*

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ALTERNATIVE APPORTIONMENT

History

- Due Process
 - States may only tax the income earned within their borders
 - The tax must be fairly related to the services derived from the state
- Historically, states used separate accounting to determine in-state income
- Apportionment was adopted as separate; accounting was time-consuming and unreliable
 - Initial formulas were for property tax purposes and relied solely on a property factor

Purpose of Apportionment

- Fictional approximation of income earned in a taxable jurisdiction
 - Property
 - Payroll
 - Sales
- Tax planner's role is to determine if the approximation is appropriate

Alternative Apportionment

- The standard Alternative Apportionment provision is found in UDITPA § 18
 - If the allocation and apportionment provisions of this Act do not fairly represent the extent of the taxpayer's business activity in this state, the taxpayer may petition or the [tax administrator] may require alternative apportionment
- Burden of Proof varies based on state specific law.
 - States responding to BNA 2017 survey:
 - 25 states place the burden of proof on the party seeking alternative apportionment
 - 13 states place the burden of proof on the taxpayer

Alternative Methodologies

- Separate accounting
- The exclusion of any one or more of the factors
- The inclusion of one or more additional factors
- The employment of any other reasonable method
 - Unitary filing permitted
 - *Media General Communications, Inc. v. South Carolina*, (South Carolina Supreme Court, 2010)

Statutory Alternative Apportionment

- Industry Specific
 - Transportation
 - Financial Services
 - Insurance
 - Media

Invoking Alternative Apportionment

- Burden of Proof
 - What standard of proof must be met for a taxpayer or state to prove distortion?
 - Clear and Convincing Evidence. Somewhere between preponderance of evidence and beyond a reasonable doubt
 - Example: California - *Microsoft v. Franchise Tax Board*, 139 P.3d 1169 (Cal. 2006)
 - Clear and Cogent Evidence
 - Example: New York - Must demonstrate by clear and cogent evidence that the standard apportionment formula does not properly reflect a taxpayer's presence. *British Land (Maryland) Inc. v. N.Y. Tax App. Trib.*, 85 N.Y.2d 139, 147-48 (N.Y. Ct. App. 1995)
 - Prima facie evidence

Distortion

- What level of distortion must be shown in order for a taxpayer or state to be entitled to alternative apportionment?
 - Constitutional “Gross Distortion”
 - *Twentieth Century-Fox Films v. Dep’t of Revenue*, 700 P.2d 1035 (Ore. 1985)
 - Oregon Supreme Court reviewed whether the Department proved that the statutory three-factor apportionment formula did not fairly represent the extent of taxpayer’s business activity in this state, thus permitting the department to employ a different method
 - Court held that alternative apportionment is only applicable to remedy unconstitutional situations or where the UDITPA formula does not fairly represent the business activity of the taxpayer
 - Florida and Illinois - Regulations provide if the statutory formula will lead to “grossly distorted” results in a particular case, a fair and accurate alternative method is appropriate. Fla. Admin. Code Ann. §12C-1.0152; 86 Ill. Admin. Code § 100.3390(c)

-
- Most states have found that the constitutional “gross” requirement is not necessary to justify alternative apportionment - some lesser standard usually applies
 - Consistent with Section 18, many states require only a showing that the statutory formula does not fairly reflect the extent of the taxpayer’s activities in the state

Indications of Unfair Apportionment

- Use of separate accounting
 - Hans Rees' Sons
 - Moorman Mfg. Co.
 - Rejected in Exxon and Mobil
- Separate accounting alone will not support alternative apportionment, as this was the method withdrawn in favor of formulary apportionment
 - In re: Appeal of Crista Corp. (California State Board of Equalization, No. 2002-SBE-004, June 20, 2002)

Indications of Unfair Apportionment

- Factor does not represent income earned in the state
 - Treasury receipts
 - *Microsoft v. FTB*, (California Supreme Court, 2006)
- Missing factor
 - Inventory
 - *Georgia v. Coca-Cola Bottling Co.* (GA Supreme Court, 1956)
 - Intangibles
 - *Microsoft v. FTB*, (San Francisco Superior Court Case No. CGC08471260, 3/21/11, case appealed to the California Court of Appeals)
 - Futures contracts
 - *General Mills v. FTB*, (California Court of Appeals, 2009; remanded California Superior Court)

Alternative Apportionment

- *CarMax Auto Superstores West Coast, Inc. v. S.C. Department of Revenue*
 - The Department of Revenue (DOR) determined that CarMax West’s income from royalties and financing should be determined separately from its retail income.
 - The South Carolina Court of Appeals had determined that the DOR had two burdens to meet in order to impose alternative apportionment.
 - The statutory formula does not fairly reflect the taxpayer’s business activities in the state.
 - The alternative method is more appropriate than any other method.
 - In finding for the taxpayer, the S.C. Supreme Court agreed that a two-part test exists.
 - The proponent of the alternative formula must prove by a preponderance of the evidence that the statutory formula does not fairly represent the taxpayer’s business activity.
 - The alternative formula is reasonable.

Alternative Apportionment

- *Vodafone Americas Holdings, Inc. v. Roberts*
 - June 23, 2014, the Tennessee Court of Appeals upheld a lower court's and revenue agency's decision to require Vodafone to use an alternative method of apportionment.
 - Vodafone had sourced revenue for the sale of cell phone services to Tennessee based on the statutory cost of performance rule, where services are sourced to a single state in which the bulk of the taxpayer's cost of performing the service is incurred.
 - The Court upheld the Commissioner of Revenue's decision to use a market-based sourcing rule to report Tennessee receipts.
 - The Court found that the Commissioner had shown by clear and cogent evidence that unusual circumstances existed to warrant a deviation from the statutory formula.

Alternative Apportionment

- Arkansas ALJ Docket Numbers 16-202 and 16-213, 5/27/2016
 - Taxpayer used market sourcing on it's original return
 - Taxpayer filed amended return using COP resulting in a refund
 - Department found market approach more appropriately reflected income, despite no evidence to this result
 - Burden is on the taxpayer to demonstrate, by a preponderance of evidence, that the statutory method of apportionment is the appropriate formula.
- Arkansas ALJ Docket Numbers 16-267, 169-268 and 16-269, 6/21/2016
 - ALJ uses *identical* wording to find for the Department in its holding the the alternative apportionment was appropriate

Alternative Apportionment

- Equifax Legislation
 - June 20, 2013, the Mississippi Supreme Court upheld an assessment, including penalties, against Equifax for failure to apportion its income using a sales factor based on its market presence in Mississippi. In that case, the Court did not find it necessary that the Department of Revenue had the burden to prove that the statutory method of apportionment, cost of performance, resulted in distortion.
 - H.B. 799, enacted April 10, 2014, effective January 1, 2015, clarifies the ability of the Department of Revenue and taxpayers to utilize alternative apportionment.
 - Specifically, the legislation requires the party requesting alternative apportionment show by a preponderance of the evidence that the statutory method of apportionment does not fairly represent the extent of a taxpayer's Mississippi business activity, and that the proposed method does more fairly represent the activity more than any other reasonable method.

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THROWBACK/THROWOUT: COMMON ISSUES

Some States with Throwback / Throwout:

States with Throwback Provisions:

- California (double-TB)
- Colorado
- Idaho (double-TB)
- Illinois (double-TB)
- Kansas (double-TB)
- Missouri (double-TB)
- New Mexico (double-TB)
- Oregon (double-TB)
- Wisconsin (double-TB)

States with Throw-out Provisions:

- Illinois (for services)
- Massachusetts (for services)
- Maine
- West Virginia

Throwback Rule

- Under the MTC, sales of tangible personal property (TPP) are included in the numerator of the sales factor if (Art IV, Sec 16):
 - The property is delivered or shipped to a purchaser, other than the U.S. government, within the state, or
 - The property is shipped from a location in the state and (1) the purchaser is the U.S. government, or (2) the taxpayer is not taxable in the state of the purchaser.
- The second clause is known as the “throwback rule”. Sales that would otherwise be included in the numerator of another state’s sales factor are “thrown back” to the state of origination, if the taxpayer is not taxable in the state of the purchaser.
- Has the effect of increasing the numerator of the state’s sales factor, with no effect on the denominator — causing the sales factor (and thus, the apportionment factor) to increase.

Throwback Rule: Common Issues

- The phrase “taxable in the state of the purchaser” is not defined in the MTC.
 - However, another section of UDITPA (relating to whether the taxpayer has the right to apportion) provides that a taxpayer is “taxable in another State” if:
 - (1) In that state, it is subject to a net income tax, a franchise tax measured by net income, a franchise tax for the privilege of doing business, or a corporate stock tax; or (2) that state has jurisdiction to subject the taxpayer to a net income tax regardless of whether, in fact, the state does or does not.
 - Some common circumstances in which a state might attempt to require throwback:
 - The taxpayer does not have nexus with the destination state.
 - The taxpayer is protected by P.L 86-272 in the destination state.
 - The destination state does not impose an income tax or franchise tax.
 - The taxpayer does not actually file an income or franchise tax return in the destination state.

Throw-Out Rule

- While the throwback rule affects the calculation of the numerator, the throw-out rule affects the calculation of the denominator. Specifically, if a sale would otherwise not be attributed to a state, it is “thrown-out” (removed) from the denominator. Decreasing the denominator has a similar impact of increasing the receipts factor.
- Throw-out rules may be applied in one of two ways:
 - All nowhere receipts are thrown-out, or
 - Only those nowhere receipts that originate in the state in question are thrown out.

Throw-Out Rule

- MTC Art IV, Sec 17(c):

“If the taxpayer is not taxable in a state to which a receipt is assigned under subsection (a) or (b), or if the state of assignment cannot be determined under subsection (a) or reasonably approximated under subsection (b), such receipt shall be excluded from the denominator of the receipts factor.”
- Notice that this rule throws out all otherwise un-sourced receipts.
- Further, while throw-out rules were historically applicable only to sales of tangible personal property, the above applies to sales of services and intangibles as well.

Throwback Rule Illustration

I. Illustration Facts:

- ACME Co. is headquartered in state A with a warehouse in state B.
- Acme has sales as follows:
 - State X: 25
 - State Y: 40
 - State B: 35
- Further, ACME has nexus with X & B but lacks nexus with Y
- What are the consequences to ACME Co. where state B has a throwback rule vs. where state B does lacks a throwback rule? Where B has a throwout rule?

Throwback Rule Illustration

I. State B without throwback or throwout rule

- State B sales factor: $35/100 = 0.35$

I. State B with throwback rule

- State B sales factor: $75/100 = 0.75$

- Because ACME Does not have nexus with Y, the sales to that state are thrown back to the origin of the sale: state B

1. State B with throwout rule

- State B sales factor: $35/60 = 0.583$

- Because ACME does not have nexus with Y, the Y sales are removed from the Denominator

Sales Apportionment

- State X sales: 25
- State Y sales: 40
- State B sales: 35

***working under the assumption that we have a single sales factor**

Double Throwback Rule

- I. **Double Throwback** – The MTC Regs provides for a double throwback rule – Reg. IV.16.(a)(7)
 - A. (7) If a taxpayer whose salesman operates from an office located in this state makes a sales to a purchaser in another sate in which the taxpayer is not taxable and the property is shipped directly by a third party to the purchaser, the following rules apply:
 - 1. (A) If a taxpayer is taxable in the state from which the third party ships the property, then the sale is in such state.
 - 2. (B) If the taxpayer is not taxable in the state from which the property is shipped, then the sales is in this state.
 - B. *e.g.* Illinois follows this rule.

Double Throwback Illustration

I. Illustration Facts:

- ACME Co. is headquartered (including sales force) in state A. It uses a 3rd party manufacturer located in state X to drop-ship its sales. ACME has sales as follows:
 - State A: 20
 - State B: 35
 - State X: 15
 - State Y: 30
- Further, ACME has nexus with A and B but lacks nexus with X and Y
- What are the consequences to ACME Co. where state A has a double-throwback rule vs. where state A does lacks a double throwback rule? Where A has a throwout rule?

Double Throwback Illustration

- Sales:
- State A: 20
 - State B: 35
 - State X: 15
 - State Y: 30
- I. State A without throwback or throwout rule
 - State A sales factor: $20/100 = 0.20$
 - II. State A with normal throwback rule
 - State A sales factor: $20/100 = 0.20$
 - ACME lacking nexus with X and Y has no impact on state A.
 - III. State A with throwout rule
 - State A sales factor: $20/55 = 0.364$
 - Because ACME lacks nexus with X and Y, the X and Y sales are removed from the denominator.
 - IV. State A with double-throwback rule
 - State A sales factor: $65/100 = 0.65$
 - Because ACME lacks nexus with X & Y, these sales are thrown back to the State where sales person is located (state A) under double-throwback provisions. Note that sales to both X and Y are thrown-back.

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ECONOMIC NEXUS IMPACT ON THROWBACK/THROWOUT

Throwback/Throwout: Economic Nexus Provisions

- How do state “doing business” rules affect throwback/throwout?
 - Specifically, if a state has an economic nexus statute, to determine throwback/throwout, should a taxpayer apply those economic nexus provisions?
 - Yes - otherwise, would violate “internal consistency” doctrine
 - Example
 - Assume a California taxpayer has more than \$500,000 in sales of TPP destined for State X. Further assume that the taxpayer is not protected by P.L. 86-272 in State X.
 - Under these facts, the taxpayer would not have to throw back sales made into State X to California. Chief Counsel Ruling 2012-03

Throwout Rule: *Lorillard Licensing*

Lorillard Licensing Company Co., LLC v. Div. of Tax, NJ NJ Superior Ct., App Dev., No. A-2033-13T1 (12/4/2015).

- Affirmed earlier Tax Court Decision
- Held that New Jersey must apply the same nexus standard when applying the throw-out rule as it applies when imposing nexus on foreign companies.
- Thus, New Jersey must use an economic nexus standard for determining whether the throw-out rule applies to an intangible holding company.
- Decision essentially negates the application of the throw-out rule for IHC's.

Throwout Rule: *Elan Pharmaceuticals*

NJ Tax Court No. 010589-2010 (2/6/2017)

Make sure you know wording of statute, and potential application:

- NJ's throw-out rule applied to sales to states where the taxpayer "is not subject to tax on or measured by profits or income, or business presence, or business activity."
 - Thus, need to look at more than just income tax "nowhere sales"
 - E.g., Although DE had no throwback rule, there was inventory in DE, which meant it could impose a business activity tax.
- Court also applied external consistency argument, and quoted *Whirlpool Prop. Inc. V. Director*: "Whether another state chooses to tax a receipt has no bearing on how much income is attributable to New Jersey."
- Finally, the court held that NJ could not ignore the application of the throwback rule by other states.
- Essentially, only sales to those states where the company had no presence whatsoever could be subjected to the throw-out rule

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FOREIGN SALES INCOME AND THROWBACK/THROWOUT

Throwback/Throwout: Foreign Sales

- How does a taxpayer apply a throwback or throwout rule, when a sale is made into a foreign country?
 - Note that UDITPA's definition of "state" includes foreign countries. Accordingly, sales into a foreign country may be thrown back if both (1) the taxpayer is not subject to tax in the foreign country, and (2) the foreign country does not have jurisdiction to tax the taxpayer.
- One of the more difficult questions: How does a taxpayer determine whether the foreign country has jurisdiction to tax the taxpayer?
 - Apply U.S. jurisdictional principles?
 - Apply jurisdictional principles of the foreign country?
 - How does an income tax treaty affect the analysis, if at all?

Throwback/Throwout: Foreign Sales (Cont.)

- Apply U.S. jurisdictional principles to determine taxability
 - Some states apply U.S. constitutional nexus principles and P.L. 86-272 to foreign countries.
 - Basically, treat the foreign country as if it is one of the states
 - Other states may apply U.S. constitutional nexus principles but not P.L. 86-272.
 - By its terms, P.L. 86-272 applies to “interstate” – and not international – commerce.
 - This is favorable for taxpayers in the throwback context; solicitation of sales of TPP alone may be enough to prevent throwback.

Throwback/Throwout: Foreign Sales (Cont.)

- Apply the foreign country's jurisdictional principles
 - Requires a taxpayer to understand and apply the country's jurisdictional principles
 - To the extent that these rules are less favorable than an application of U.S. jurisdictional standards, it is questionable as to whether a state can constitutionally apply those rules for throwback purposes.

Throwback/Throwout: Foreign Sales (Cont.)

- Treaty protection
 - Suppose that a treaty protects a taxpayer from income taxation in a particular country. Three possibilities:
 - (1) The treaty has no bearing on whether a receipt may be thrown back or thrown out (in other words, apply the principles given in the previous slides).
 - (2) The treaty protection is viewed as depriving the country of jurisdiction to tax.
 - (3) Treaty protection prohibits throwback/throwout.
 - Under the logic of *Whirlpool*, one might view the foreign country as choosing not to impose an income tax.

Dock Sales vs. Destination Sales

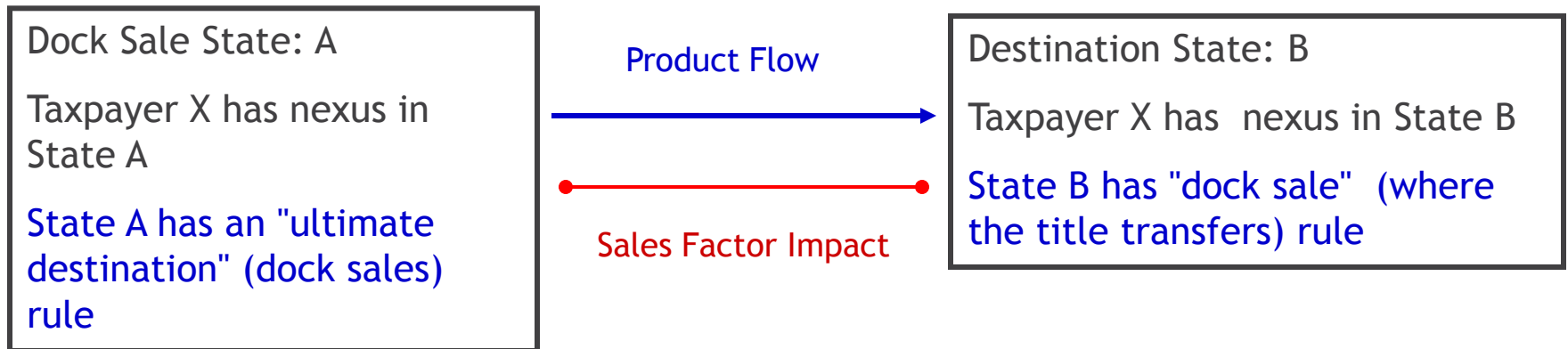
- Most states have an “ultimate destination” regarding the sourcing of sales of TPP.
- States have differing rules regarding dock sales.
- “Dock sales” occurs when:
 - A) A customer uses its own trucks, or a common carrier hired by the customer;
 - B) To pick up goods at the taxpayer’s place of business in one state; and,
 - C) Takes those goods back to the customer’s business location in another state.

Dock Sales vs. Destination Sales (Cont.)

- Some states source dock sales to the state of the dock (seller's location / where items picked up)
 - E.g., NY, NJ, WV, IN
- Other states are true destination states and source to the state of ultimate destination.
 - E.g., PA, FL, GA, AL, TN, IL, CA, KY,
- Many states lack specific guidance.

Dock Sales Example 1

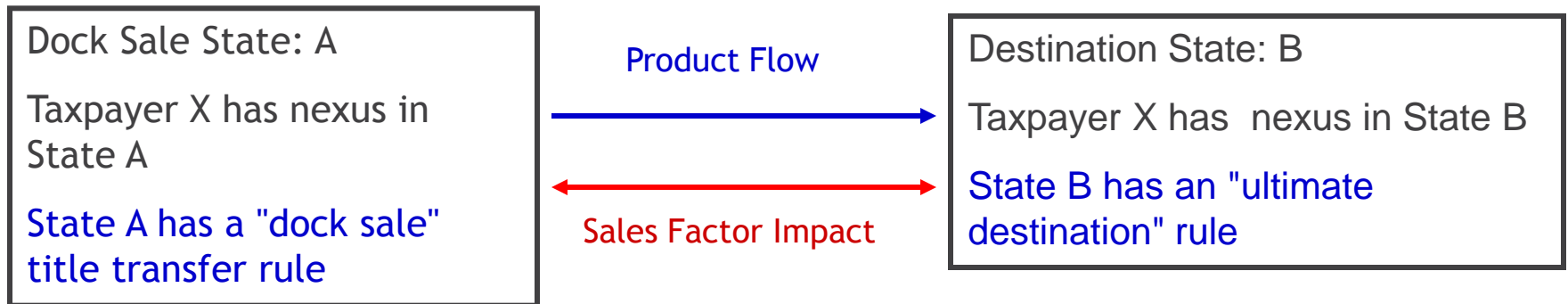
Assume for the purpose of the next two slides that the transaction is a dock sale.



Issue: In which states' sales factor numerator will the sale be reported?

Answer: No states numerator

Dock Sales Example 2



Issue: In which state's sales factor numerator will the sale be reported?

Answer: Both states numerator

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***JOYCE / FINNIGAN* POSITIONS**

Joyce vs. Finnigan

- Sales of tangible personal property are in this state if:
 - (b) The property is shipped from an office, store, warehouse, factory, or other place of storage in this state and ... *the taxpayer* is not taxable in the state of the purchaser.
 - Joyce: “Taxpayer” means particular entity making the sale.
 - Finnigan: “Taxpayer” means the combined group.
- *Joyce* example: Texas receipts include “the gross receipts of each taxable entity that is a member of the combined group and *that has a nexus with this state* for the purpose of taxation.”(TX Tax Code Sect. 171.103)
- *Finnigan* example: In Wisconsin, “a taxpayer is considered to be within the jurisdiction for income or franchise tax purposes of any state in which *any member of its combined group is within the jurisdiction* for income or franchise tax purposes.” (Wis. Statute Sect. 71.255(5)(a)(8))

Joyce vs. Finnigan

- Application of *Joyce/Finnigan* rules in the context of throwback
 - Recall, in the “inbound” context:
 - Sales by a combined group member into a *Joyce* state, when the member does not have nexus or is P.L. 86-272-protected in that state, are excluded from the combined group’s sales factor in the state.
 - Sales by a combined group member into a *Finnigan* state, when the member does not have nexus or is P.L. 86-272-protected in that state, are included in the combined group’s sales factor in the state.
 - But, in the “outbound” context, when the origination state has a throwback rule:
 - Sales by a combined group member from a *Joyce* state destined for a state in which the member does not have nexus or is P.L. 86-272-protected are thrown back and are included in the combined group’s sales factor in the state.
 - Sales by a combined group member from a *Finnigan* state destined for a state in which the member does not have nexus or is P.L.-86-272 protected are thrown back and are excluded from the combined group’s sales factor in the state.

Joyce vs. Finnigan

- Application of *Joyce/Finnigan* rules in the context of throwback
 - May cause perceived under-inclusion or over-inclusion of sales
 - Sales of TPP made by a combined group member from a *Joyce* state that has a throwback rule into a *Finnigan* state in which another group member is taxable will be included in the combined group's sales factor numerator in both states.
 - Potentially beneficial to create a taxable presence in the *Finnigan* state by the entity in the *Joyce* state, which would cause the throwback rule to not apply
 - Sales of TPP made by a combined group member from a *Finnigan* state that has a throwback rule into a *Joyce* state in which another group member is taxable will be excluded from the combined group's sales factor numerator in both states.

Major *Joyce* And *Finnigan* States

<i>Joyce</i>	<i>Finnigan</i>
Colorado	
Illinois	California
Montana	Indiana
Nebraska	Kansas
New Hampshire	Maine
North Dakota	Massachusetts
Oregon	Michigan
Texas	New York
West Virginia	Wisconsin

Joyce / Finnigan Nexus Controversies

- Texas receipts include “the gross receipts of each taxable entity that is a member of the combined group and *that has a nexus with this state* for the purpose of taxation.” (TX Tax Code Sect. 171.103)
- What nexus standard applies?
 - Physical presence (Quill v. N. Dakota)
 - P.L. 86-272 (in-state solicitation protected)
 - Economic presence?
 - Factor presence?

Joyce / Finnigan PTE Issues

- Even in separate reporting jurisdictions there may be Joyce / Finnigan-type issues where Pass-Through Entities (“PTE’s”) are involved.
- Specifically, at what level does nexus and/or the sales factor get determined? At the PTE level or at the partner / member level? Does PL 86-272 protection pass-through to the partner / member?
 - AZ - PL 86-272 protection doesn’t flow-up to owners of PTE’s. Factors of otherwise 86-272 protected PTE are included in numerator of owner subject to AZ taxation. *AZ Dept. of Rev. V. Central Newspapers, Inc.*, AZ CT. App, Div. 1, 218 P3d 1083 (11/3/09).
 - Arizona is a Finnigan state and this decision is consistent with Finnigan. Although Arizona is a combined state, this reasoning applies equally to stand-alone corporations with an interest in a PTE.

Joyce / Finnigan PTE Issues

- What about states that directly tax various PTE's / DE's? E.g., Texas?
- Companies often overlook the Joyce / Finnigan impacts on otherwise disregarded entities. Assume a stand-alone corporation with a SMLLC subsidiary. The parent corporation has Texas nexus, but the SMLLC does not, although it does have significant sales into Texas.
- Since Texas is a Joyce state, and the SMLLC does not have nexus, you should not include the sales of the SMLLC in the combined Texas receipts factor.
- Many companies overlook this, especially where PTE's and combined reporting is involved.

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OTHER PTE APPORTIONMENT ISSUES

Other PTE / Apportionment Issues

- Generally, absent a unitary relationship, a state should not require the flow-through of factors. However, some states do require just this.
 - E.g., NY flows up factors apparently without regard to whether a unitary relationship exists. NY Reg. Sec. 1-3.2(a)(5)

Other PTE Apportionment Issues

- I. Possible factors to consider include:
 - Is there a unitary relationship?
 - Did the owner elect flow-through treatment for the PTE (as opposed to it being the default)?
 - Limited liability?
 - Is ownership freely transferable?
 - Is ownership greater than 50%?
 - Is the ownership an investment?

Other PTE Apportionment Issues

- I. The following states require partnership income to be specifically allocated based on where earned:
 - LA – Sec. 47:287.93.A(5).
 - OK – Reg. Sec. 710:50-17-51(15).

Other PTE Apportionment Issues

- I. Some states that treat PTE income as apportionable income treat distributive share as a “receipt” and include as part of receipts factor without flowing up property and payroll factors.
 - Kentucky – KY Rev. Policy 41P200 (6/1/83).

Other PTE Apportionment Issues

- I. What about business / non-business income determination? Is it made at the owner's level or the PTE level?
 - Most states don't address
 - Illinois – determination is made at the partnership level. 86 ILAC 100.3500(b)(1).
 - Pennsylvania – determination is made at the owner's level. PA Sec. 153.29(c)(2).

Other PTE Apportionment Issues

- I. When flowing-through the apportionment factors of the PTE to the owners, should intercompany transactions be eliminated?
 - Transactions between the PTE and the owner?
 - Transactions between commonly owned PTE's?

Other PTE Apportionment Issues

- For Illinois purposes, transactions between PTE and its owner are eliminated.
 - IL DOR Ruling IT 08-0001-PLR (5/19/08).
- California provides for eliminations.
 - CA Reg. Sec. 25137-1(f).
- Pennsylvania also eliminates intercompany transactions
 - PA Reg. Sec. 153.29.
- Oregon provides for elimination between a corporate member and LLC's.
 - OR Reg. Sec. 150-314.650(9)

Other PTE Apportionment Issues

I. When calculating the apportionment factors of the owner of a PTE, what percentage do you use to determine the owner's share of the PTE's factors?

A. Profits %?

- i. MA Reg. Sec. 63.38.1(12)(f).

B. Capital %?

- i. AK – Reg. Sec. 20.320(a)
- ii. CA – Reg. Sec 25137-1(f)(4)

C. What about special allocations?

- i. MA Reg. Sec. 63.38.1(12)(f).