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SHOP TALK

Five SALT Controversy Areas for the 2020s

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The state tax field underwent many momentous changes during the 2010s. Among other impactful changes, roughly a dozen states reformed their corporate income tax systems to implement market-based sourcing and mandatory combined reporting. And, of course, in *South Dakota v. Wayfair*[1] the Supreme Court upended the longstanding physical presence substantial nexus standard. This article highlights five likely sources of state tax controversies for the new decade based on changes to the state tax world from the past decade.

Sales tax—taxability

One consequence of the 2018 and 2019 state responses to *Wayfair* is that many internet and service-based businesses, even smaller ones, are now considered "doing business" in new states due to exceeding state economic nexus filing thresholds. Nevertheless, in the case of internet and service-based businesses it is not always clear if what they are selling is subject to sales tax, such that they must register and start collecting tax from customers in the new states in which the thresholds have been exceeded. In many states, the law in this area is fluid and could change over the next decade.

Even in states that, as of today, assert the ability to impose sales tax on services provided over the internet, it is not clear that all legal requirements necessary to force tax collection are satisfied. In particular, there is some doubt whether customers accessing a service through the cloud have been "transferred" software that is subject to sales tax, or if instead they are merely paying for use of a service that has never been transferred to them and accordingly is not subject to sales tax. A case pending at the Massachusetts Supreme Judicial Court presents this issue.[2]

It seems likely that over the next decade state revenue departments will audit progressively smaller internet and service-based businesses that exceed the state filing thresholds. When that happens, it will have to be resolved on audit or as part of the appeal process whether what is being sold is taxable, whether there has been a transfer of possession to customers within the meaning of state law, and whether certain exemptions or exclusions are applicable. This is an area to monitor this decade, especially as technological advancements continue and more and more services are provided over the cloud.

Corporate income tax—sourcing

During the past decade, roughly a dozen states reformed their corporate income tax systems to implement mandatory unitary combined reporting and market-based sourcing. As this was happening, many experts opined that a consequence would be increased focus on whether certain entities are unitary, such that they are subject to inclusion in state combined returns. To date, this has not been as material an audit area as might have been anticipated, with many companies only excluding clearly non-unitary entities from combined returns.

There may be increased fights over whether companies are unitary in the 2020s. But this author's best guess is that sourcing will be the bigger controversy area arising from the corporate income tax modernization wave. In particular, most corporate taxpayers are sensibly using customer address for sourcing purposes. This works cleanly in most fact patterns. However, there are areas where there is uncertainty. For example, some companies provide a service for their customer's customer or there may be multiple points of use by the customer such that using the customer's billing address does not fully capture where the benefit is being received. Fortunately, state revenue departments have for the most part been reasonable in auditing market-based sourcing and have generally accepted the use of billing address.

That said, many state statutes and regulations require taxpayers to make an investigation before defaulting to billing address.[3] It would not be entirely surprising if, in the 2020s, auditors in at least a few aggressive states start taking a hard line, such as by requiring documentation that an investigation has been made before accepting billing address sourcing or by otherwise second-guessing use of billing address to source services and proposing some alternative sourcing methodology on audit. This author hopes that that does not happen, but if auditors wish to play hardball in state corporate income tax audits, challenging market-based sourcing methodologies used by corporate taxpayers is one ready way that they could do so.

Corporate income tax—treatment of foreign source income

It might be thought that the move to mandatory unitary combined reporting would erase many intercompany tax base questions, since intercompany transactions are generally eliminated in combined returns. But there remain questions about the treatment of income from foreign affiliates or 80/20 companies in water's-edge state combined returns. In particular, income from foreign affiliates is sometimes excluded from the tax base in whole or in part because of state conformity to the federal dividend received deduction or because other exclusions such as the 80/20 company exclusion apply. Just in the last 12 months there have been a handful of cases addressing related issues.[4]

Controversies concerning foreign income and its inclusion in combined returns are only likely to increase once the states more heavily audit returns that include GILTI,[5] BEAT,[6] and the Transition Tax.[7] The outcome of these controversies will likely hinge on the wording of state law conformity provisions, although there could be arguments centered around the intent of the federal and state tax foreign income regimes and how well the taxpayer's facts line up with what the regimes intended to accomplish.

Corporate and personal income taxes—sales of interests in pass-through entities

The 2010s saw a growth in small businesses organized as pass-through entities. This surge was not strictly a consequence of state tax developments, but rather a mix of a variety of factors, many of which are economic. That said, the generally favorable state tax treatment of pass-through entities has certainly not hampered their popularity.

As larger corporations continue to purchase smaller pass-through entities, there will likely be controversies concerning the taxability of non-resident sellers of interests in pass-through entities. In particular, a key question is whether to apply the source rules applicable to the seller or the source rules applicable to the entity that has been sold. There are often completely different results depending on which rule applies. If the former rule applies, the sale of a pass-through interest is generally treated as the sale of an intangible capital asset sourced to the non-resident seller's state of domicile. Application of this approach means that non-resident sellers of pass-through interests may not have any tax liability in some states in which the pass-through entity operates. Auditors do not like this result, so will instead sometimes apply the sold pass-through entity's apportionment to the sale of the nonresident's pass-through interest.

There was recently a case that addresses an analogous issue for federal income tax purposes.[8] Over the past year there have also been several cases on this issue in the state tax area.[9] This author would not be surprised to see continued controversy on this issue throughout the 2020s as pass-through entities continue to surge in popularity and as state auditors seek to capture as many tax dollars from their sale as possible.

Personal income tax—residency audits

The Tax Cuts and Jobs Act, enacted in December 2017, limited the state and local tax deduction to $10,000.[10] High-income earners now stand to net a lot more if they make the exact same amount of money in a state without a personal income tax, like Florida or Nevada, rather than in a state with a high personal income tax rate, like California or New York. This is causing some individuals who have the ability to work anywhere to seek residency in a no-tax or low-tax state. If ties are not completely severed in their previous state, such individuals can expect a residency audit in the previous state. Case in point: the mother of all residency audits likely awaits the current occupant of 1600 Pennsylvania Avenue, who has filed a Florida declaration of domicile and has announced that he will become a Florida resident after his time in office. Less famous high-earners should similarly be prepared for a residency audit if they do not fully abandon their high-income tax state in the process of establishing residency in their new low-income tax or no-income tax state.

Conclusion

The 2010s was a significant decade in state tax. Changes from that era have paved the way for five significant sources of state tax controversy this author expects to see in the new decade: (1) taxability questions for internet services businesses; (2) market-based sourcing controversies; (3) foreign-source income tax base inclusion issues; (4) sourcing issues for sellers of interests in pass-through entities; and (5) residency audits.

[1] 138 S. Ct. 2080 (2018).

[2] *See Citrix Systems Inc. v. Commissioner of Revenue*, case number SJC-12741.

[3] California and New York are two of the bigger states with regulations or proposed regulations that, on their face, require at least some investigation of books and records before defaulting to where the benefit is received or billing address.

[4] *See, e.g., Exxon Mobil Corp. v. Montana Department of Revenue*, 444 P.3d 407 (Mont. 2019); *Colorado Dept. of Rev. v. Agilent Technologies, Inc.*, 2019 CO 41 (Colo. 2019); *Walt Disney Co. and Consolidated Subs*, N.Y. DTA No. 828304 (ALJ May 30, 2019); *Deere & Co. v. Wis. Dep't of Rev.*, Wis. Tax App. Comm., Docket No. 18-I-135 (August 21, 2019).

[5] IRC Section 951A.

[6] IRC Section 59A.

[7] IRC Section 965.

[8] *Grecian Magnesite Mining v. Commissioner*, 926 F.3d 819 (D.C. Cir. 2019). The result in the case was reversed by subsequent legislation. *See* IRC Section 1446(f).

[9] *See, e.g., John Paz v. Director, Division of Tax'n*, Docket No. A-4452-16T4 (N.J. App. Div. 2019); *Matter of Franklin C. Lewis*, N.Y. DTA No. 827791 (ALJ Determination June 20, 2019); *Goldman Sachs Petershill Fund Offshore Holdings (DE) Corp.*, N.Y.C. TAT(H) 16-9(GC) (Dec. 6, 2018).

[10] IRC Section 164(b)(6)(B).