The 2016 CFO *State Tax Survey*

Going to the Source

States are reaching across borders to raise tax revenue from companies

By Edward Teach

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From a tax perspective, the 50 states are in better shape today than they were before the Great Recession. Adjusted for inflation, they collected 5.6% more tax revenue in mid-2015 than at the peak in the third quarter of 2008, according to the Pew Charitable Trusts.

But the recovery has been uneven. More than 20 states still collect less tax revenue than they did at their prerecession peaks, says Pew, as economic conditions vary widely across the country. Meanwhile, a number of states face serious long-term fiscal challenges in the form of debt and unfunded retirement costs.

As a result, states are increasingly reaching beyond their borders for more tax revenue. Some have enacted nexus rules to levy income taxes on out-of-state companies with a significant economic presence, but no physical presence, in their states. Others are widening the notion of physical presence to collect sales tax from remote sellers through "click-through nexus."

Many states now have sales-only apportionment formulas, hoping to shift some of the tax burden from in-state businesses to out-of-state companies and encourage more investment within their borders. And an increasing number of states are taxing companies' service revenue based on where their customers benefit from the service.

Expanding Nexus

With the lion's share of retail growth moving to the Internet, states have been hungering for tax revenues from remote sellers while trying to protect brick-and-mortar retailers. In recent years, a handful of states have enacted economic nexus laws that enable them to impose an income tax on companies with no physical presence in the state if their sales in the state exceed a given threshold during the tax period.

The Supreme Court has not weighed in on economic nexus for income tax purposes, but sales tax nexus is another story. In the landmark 1992 case of *Quill* v. *North Dakota,* the Court held that a state could not require out-of-state retailers with no physical presence in the state to collect sales and use taxes on the products they sell there. For the states, which rely heavily on sales tax revenues, the decision would prove a serious setback.

Congressional attempts to pass a federal law requiring remote sellers to collect sales tax have failed to gain traction. But starting with New York in 2008, 18 states have expanded the concept of physical presence by passing so-called "click-through nexus" laws. Such laws mandate that if an affiliate in the state refers, say, $10,000 in sales to a remote seller by providing a link on its website, the seller is presumed to have a physical presence in the state and must collect sales tax

in that state (that is, unless the seller can prove that the affiliate did not engage in solicitation on its behalf).

Click-through nexus has not been tested by the Supreme Court. But last year, in a concurrence to the Court's ruling in the sales-tax-related case of *Direct Marketing Association* v. *Brohl,* Justice Anthony Kennedy said the Court should reexamine the 1992 decision in *Quill.* "There is a powerful case to be made that a retailer doing extensive business within a state has a sufficiently 'substantial nexus' to justify imposing some minor tax-collection duty, even if that business is done through mail or the Internet," Kennedy wrote. "The legal system," he concluded, "should find an appropriate case for this Court to reexamine *Quill.*"

Some states are eager to provide a test case. "Justice Kennedy's concurrence has emboldened a number of states to reexamine nexus laws," says Pilar Mata, tax counsel at the Tax Executives Institute. Alabama's Department of Revenue, for example, adopted a rule in October requiring an out-of-state seller that sells more than $250,000 in tangible personal property to collect sales tax, even if the retailer has no physical presence in the state — a rule clearly at odds with *Quill.* South Dakota's legislature passed a similar law this year.

Such rules will create quandaries for tax directors at remote sellers that exceed the sales threshold. "They may think the Alabama rule or the South Dakota law is unconstitutional and that the federal courts will overrule it, but that's a long way down the road," says Harley Duncan, managing director and state and local tax leader in KPMG's Washington National Tax Practice. Will sellers comply with the new rules, and if not, will the states enforce them? "Remote sellers have to figure out how they're going to respond," he says.

Market-Based Sourcing

Another trend is the adoption by states of a market-based approach to apportioning revenue from the sale of services and intangibles. "This is one of the fastest-moving changes I've seen in corporate taxation in the 30-plus years I've been working in this field," says Duncan.

Formerly, most states followed the cost-of-performance method, which sources 100% of a company's service income to the state where the greater costs of providing the service are incurred. Now, more than 20 states have switched to market-based sourcing, which apportions such income to the states where either the service is delivered or the benefit of the service is received. As a result, multistate firms may pay taxes to multiple states on services sold, not just one.

The migration to market-based sourcing "has opened up a whole new set of issues for corporate taxpayers," says Duncan. There are considerable differences in the ways that states have adopted the method. In some states, for example, service income is apportioned to where the taxpayer's direct customers are located. "Other states will say that if you're providing a service to your customer and they ultimately use that to provide a service to their customers, you have to look through your customer to your customer's customers," says Duncan.

In short, market-based sourcing poses a considerable compliance challenge. "Implementing it in a company that may have dozens of entities and filing obligations in dozens of states is not simple," says Duncan.

Meanwhile, a number of states still use the cost-of-performance method, which means a company can end up being taxed on more than 100% of its service revenue if some of that revenue is generated in a state that uses market-based sourcing. "You can end up getting whipsawed," says Duncan.

Retroactive Laws

During the past decade, there has been an increase in retroactive tax legislation, says Mata. Such legislation stems from the 1994 case *United States* v. *Carlton,* when the Supreme Court upheld a retroactive amendment to federal estate tax law that disallowed a previous deduction taken by the defendant.

"The Court said the legislation was fine because it was curing a mistake and Congress had acted quickly in doing so," says Mata. "Since then, we've had a number of state legislatures retroactively change a statute where there's been a taxpayer victory in court." But the periods between the enactment of the initial legislation and the retroactive legislation are getting longer, she says, and the circumstances are changing.

Perhaps the most famous of these cases, *IBM* v. *Michigan Department of Treasury,* involved IBM's decision in 2008 to use the Multistate Tax Compact's three-factor (property, payroll, sales) apportionment formula, instead of the state's new single sales factor formula. (Michigan had adopted the compact in 1970.) In 2014 the Michigan Supreme Court affirmed the validity of the compact and IBM's choice, prompting the state legislature to retroactively eliminate the compact (and thereby stick IBM with a bigger tax bill).

Gillette and other taxpayers have since challenged the retroactive legislation, and the state's supreme court is considering whether to accept the case. Meanwhile, legislation concerning the validity of the Multistate Tax Compact is active in a handful of other states. If other states uphold the compact, their legislatures may also decide to retroactively amend their laws, says Mata.

"This is an important area in state tax," she says. The ability of a state to retroactively change a statute "really injects risk into tax planning."

The Survey

CFO's latest biennial state tax survey was conducted in March and April in cooperation with KPMG and the Tax Executives Institute. Ninety-eight tax directors and other finance executives responded to the survey.

As in previous surveys, Wyoming, South Dakota, and Nevada were considered among the fairest of the fair in terms of their tax climate for business. That isn't very surprising, since none of these states levies a corporate income tax.

And also as in previous surveys, respondents ranked states like California, New York, New Jersey, and Illinois as providing the least fair and predictable tax environments for business. These states are also seen as very aggressive in pursuing economic nexus and adversarial in tax audits.

"In many cases, you have a clear disagreement where you need the court to resolve the question for everyone," comments Mata. "In other cases, how the law should be applied isn't clear. Some

states are more willing to work with taxpayers to get to a right answer that works for everybody; other states are not."

Edward Teach is editor-in-chief of CFO *Magazine.*

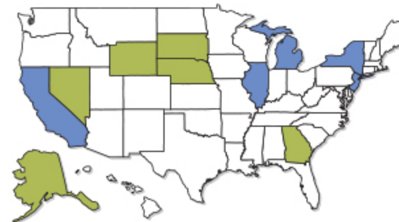
METHODOLOGY

This survey has been conducted biennially since 1996 with the help of KPMG LLP, the audit, tax, and advisory firm, and this year with the additional help of the Tax Executives Institute. The survey aims to capture tax executives' impressions about differing tax environments in each state in which they do business. The results presented here represent those impressions, rather than quantitative assessments of actual policies, tax rates, or other criteria.

The 2016 *CFO* State Tax Survey Results

The charts on this page and the following pages highlight states ranked best and worst on six key measures.

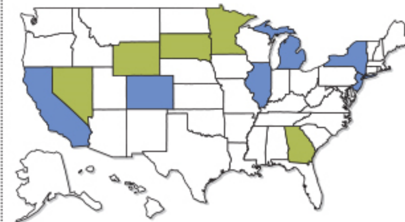
1 What is your overall impression of the tax environment in each state?



Survey respondents ranked states on a scale, with:
1 = Very fair and predictable
5 = Very unfair and unpredictable

VERY FAIR AND PREDICTABLE	VERY UNFAIR AND UNPREDICTABLE
1. **WY** [2.29]	46. **NJ** [3.44]
2. **AK** [2.32]	47. **MI** [3.53]
3. **NV** [2.33]	48. **IL** [3.59]
4. **SD** [2.35]	49. **NY** [3.79]
5. **GA, NE** [2.38]	50. **CA** [3.87]

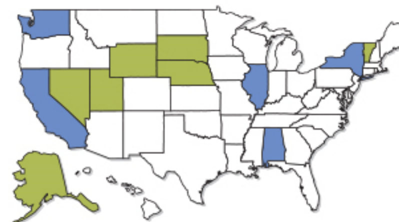
2 How fair and transparent are corporate income tax audits in each state?



1 = Very fair and transparent
5 = Very unfair and nontransparent

VERY FAIR AND TRANSPARENT	VERY UNFAIR AND NONTRANSPARENT
1. **NV** [2.01]	46. **CO** [3.16]
2. **SD** [2.12]	47. **IL** [3.24]
3. **WY** [2.17]	48. **NJ** [3.28]
4. **MN** [2.20]	49. **MI, CA** [3.39]
5. **GA** [2.27]	50. **NY** [3.52]

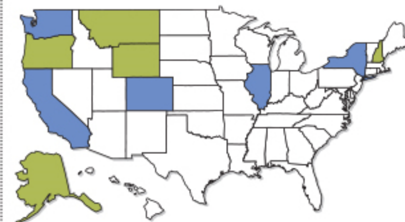
3 How would you rate each state's stance on asserting income tax nexus when companies have only an economic presence in the state?



1 = Not Aggressive
5 = Very Aggressive

NOT AGGRESSIVE	VERY AGGRESSIVE
1. **WY** [2.41]	46. **WA** [3.61]
2. **AK, NV** [2.50]	47. **IL** [3.63]
3. **NE** [2.57]	48. **AL** [3.74]
4. **SD, VT** [2.58]	49. **NY** [4.10]
5. **UT** [2.61]	50. **CA** [4.16]

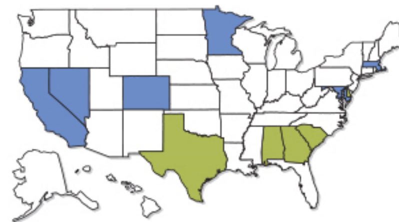
4 How would you rate each state's stance on asserting sales and use tax nexus?



1 = Not aggressive
5 = Very aggressive

NOT AGGRESSIVE	VERY AGGRESSIVE
1. **MT** [2.58]	46. **WA** [3.88]
2. **AK** [2.63]	47. **CO** [3.92]
3. **OR** [2.68]	48. **IL** [4.04]
4. **WY** [2.77]	49. **NY** [4.22]
5. **NH** [2.78]	50. **CA** [4.40]

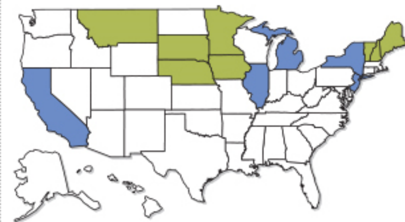
5 How would you rate each state's willingness to grant business tax incentives to individual companies?



1 = Very willing
5 = Not willing

VERY WILLING	NOT WILLING
1. **GA** [2.48]	46. **NV** [3.13]
2. **DE** [2.50]	47. **MI** [3.15]
3. **TX** [2.53]	48. **MA** [3.18]
4. **AL** [2.57]	49. **CO, MD** [3.22]
5. **SC** [2.61]	50. **CA** [3.28]

6 How concerned are you that your state's fiscal condition will negatively affect your company in some way in the next 12 months?



1 = Not concerned
5 = Very concerned

NOT CONCERNED	VERY CONCERNED
1. **MT** [2.06]	46. **MI** [3.45]
2. **VT** [2.19]	47. **NJ** [3.53]
3. **NE** [2.20]	48. **NY** [3.60]
4. **MN, SD** [2.22]	49. **CA** [3.74]
5. **IA, ME, NH** [2.24]	50. **IL** [4.03]