January 2016

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California

Construction and Building Contractors Tax Guidance Issued

The California State Board of Equalization has updated its publication on the sales and use tax treatment and responsibilities of construction and building contractors. Topics discussed include: subcontractors; liability by type of contract; application of tax to different types of construction contracts (e.g., repair, countertops and cabinets, signs, solar panels, landscape); tax liability on purchases; resale certificates; materials and fixtures used outside California; sales in interstate and foreign commerce; transportation charges; district taxes; and other tax issues (e.g., Indian Reservations, supplies and tools for self-use, and bad debts).

Publication 9, Construction and Building Contractors, California State Board of Equalization, December 2015

Gillette Opinion Issued: Taxpayers Not Entitled To Use Equally-Weighted Apportionment Formula

The California Supreme Court has reversed an earlier appellate court decision and held that multistate corporate taxpayers may no longer elect to use the Multistate Tax Compact's equally-weighted three-factor formula to apportion net income for California corporation franchise and income tax purposes. Instead, taxpayers must use the apportionment formula required under California law (i.e., a double-weighted sales factor formula for tax years beginning before to 2013, or a single-sales factor formula for tax years beginning after 2012). In so holding, the court determined that (1) the Compact was not a binding contract between the signatory states, (2) the California Legislature had the authority to repeal the Compact's election provision, (3) the California Legislature intended to repeal the election provision, and (4) the legislation repealing the election provision did not violate the state's "reenactment rule."

Background

California became a member of the Compact in 1974, several years after the Compact was adopted by the requisite seven states. At that time, the state enacted the Compact provisions, including Rev. & Tax Code §38006, which allowed taxpayers to elect to use either an equally-weighted three-factor apportionment formula or an alternative apportionment formula adopted by the state. However, in 1993, California enacted Rev. & Tax. Code §25128, which states that "notwithstanding Section 38006," all business income must be apportioned to California using a double-weighted sales-factor formula. Rev. & Tax. Code §25128.7, which requires use of a single-sales factor formula for tax years beginning after 2012, was added by Proposition 39 in 2012.

The taxpayers in the case at hand are all multistate corporations that had originally filed returns utilizing California's double-weighted sales factor formula under §25128, but subsequently filed refund claims for several tax years on the basis that they should have been allowed to make an election to use the Compact's equally-weighted formula. The Franchise Tax Board (FTB) claimed that the 1993 amendment repealed the taxpayers' option to elect to use the equally-weighted formula and, therefore, denied the taxpayers' refund claims. However, in 2012, a California court of appeal held that the state was bound by the Compact and did not have the authority to unilaterally enact subsequent legislation that amended, modified, or partially repealed any provision of the Compact.

Compact Not Binding

In determining that the Compact is not a binding contract among its members, the California Supreme Court applied a test derived from *Northeast Bancorp v. Board of Governors*, 472 U.S. 159 (1985), which looks for certain "indicia of binding interstate compacts" such as the establishment of reciprocal obligations, whether its effectiveness depends on the conduct of other members, the prohibition of unilateral member action, and the creation of regulatory organizations. First, the court noted that the Compact creates no reciprocal obligations, especially with respect to maintaining the election provision, since it does not create an obligation of member states *to each other*. In addition, even if maintenance of the election provision in one Compact member state might benefit taxpayers in another state, that benefit to the taxpayer applies whether the taxpayer is from a member or nonmember state. This application, said the court, is more akin to the adoption of a model law rather than the creation of any mutual obligations among Compact members.

With respect to the Compact's effectiveness being dependent on the conduct of its members, the court pointed out that the Compact has not required member action since 1967. By its terms, the Compact became effective once it had been enacted into law by any seven states. Nine states other than California enacted the Compact within six months of its initial draft. Thereafter, the Compact was effective as to any other state upon that state's enactment of it. Thus, said the court, the Compact had long been effective when California joined it in 1974, and no action by existing members was required to admit California.

Furthermore, the court agreed with the FTB's position that the ability of member states to unilaterally join or leave the Compact without notice prevents a finding that the Compact is a binding interstate agreement. The court also pointed to the fact that many member states have adopted different apportionment formulas to show that the Compact does not prohibit unilateral state action. According to the court, the freedom of members to engage in such unilateral conduct is inconsistent with the type of binding agreement contemplated by *Northeast Bancorp*.

Finally, although the taxpayers argued that the Compact's establishment of the Multistate Tax Commission (MTC) is a "classic characteristic of an interstate compact," the court pointed out that the MTC has no authority ordinarily associated with a *regulatory* organization. The MTC's powers are limited to advisory and informational roles. Even the MTC's regulations are only "advisory" and have no force in any member state unless formally adopted by that state. According to the court, the MTC's inability to bind member states to adopt its regulations further confirms it is not a regulatory organization within the meaning of *Northeast Bancorp*. Similarly, the MTC may conduct taxpayer audits, but only if the member state has passed separate authorizing legislation and expressly requests the audit.

Intent to Repeal Election Provision

Having concluded that the California Legislature had the unilateral *authority* to eliminate the Compact's election provision, the court then addressed the question of whether it *intended* to do so. The court determined that both the language of §25128 and its legislative history indicated that the Legislature did intend to repeal the election provision. First, §25128(a) explicitly provides that the double-sales factor formula is to be used "[n]otwithstanding Section 38006 [i.e., the Compact]. " According to the court, there is no ambiguity in this language. The court also noted that legislative analysis of the bill explaining the need for the amendment showed that proponents of the bill believed that California's continued reliance upon the Compact's formula would result in discriminatory taxation against California-based companies, particularly given the additional weight given to sales factors by other states. Thus, the court dismissed the argument that the Legislature intended to retain the Compact's election provision.

Reenactment Rule

As an alternative argument, the taxpayers claimed that the 1993 amendment of §25128 is invalid because it violates the California Constitution's reenactment rule, which states that a "section of a statute may not be amended unless the section is re-enacted as amended." Generally, however, the reenactment rule does not apply to statutes that act to "amend" others only by implication. The amendment of §25128 expressly referenced the Compact, stating that it applied "[n]otwithstanding Section 38006." Although the taxpayers noted that the legislative bill analyses did not refer to the Compact or the election provision expressly, the court said that reference to the Compact in §25128(a) itself is strong evidence that the Legislature acted with the Compact in mind. Thus, even without a reenactment of §38006, the legislators and the public were reasonably notified of the changes in the law so that the amendment of §25128 did not violate the reenactment rule.

The Gillette Company v. Franchise Tax Board, California Supreme Court, No. S206587, December 31, 2015

Connecticut

15-Day Rule for Nonresident Employees Explained

The Connecticut Department of Revenue Services has issued a policy statement that explains the personal income tax withholding requirements for nonresident employees who perform personal services in Connecticut for 15 days or less. Budget legislation enacted following a special session of the Connecticut General Assembly excludes from income tax any compensation for personal services that a nonresident employee performs in Connecticut, if the nonresident employee is present in the state for employment purposes for not more than 15 days during the taxable year. Presence in Connecticut for any part of a day constitutes presence for that entire day, unless this presence is purely for purposes of transit through Connecticut. Presence in Connecticut for reasons other than performing services as a nonresident employee are not relevant for purposes of the 15-day limitation. If a nonresident employee who was reasonably expected to work 15 or fewer days in Connecticut during a calendar year actually works more than 15 days in Connecticut during that calendar year, the employer must withhold on all the compensation paid to that nonresident employee for services performed in Connecticut, including the compensation paid for the first 15 days. The nonresident employee may be required to make estimated payments for compensation received for the first 15 days of performing personal services in Connecticut, if the employer did not withhold with respect to such income. The 15-day rule does not apply to income from a business, trade, profession, or occupation carried on in Connecticut. It also does not apply to payments made to entertainers, performing artists, or athletes, including members of athletic teams. The policy statement is effective January 1, 2016 and supersedes the 14-day withholding rule for nonresident employees discussed in *Announcement 2010(3)*.

Policy Statement 2015(6), Connecticut Department of Revenue Services, December 30, 2015

Illinois

Refund Delays Announced Due to Antifraud Efforts

The Illinois Department of Revenue (IDOR) announced in a press release that they do not anticipate releasing personal income tax refunds for the 2016 tax filing season until March 1, 2016, due to ongoing fraud prevention efforts. For electronic returns filed prior to March 1, 2016, IDOR anticipates refunds will be issued within two to three weeks from the March 1, 2016 date. For electronic returns submitted error-free on or after March 1, 2016, IDOR anticipates refunds will be issued within two to three weeks from the date the return was submitted. The press release notes that tax refunds are not subject to budgetary appropriation by the Illinois General Assembly and are, therefore, not impacted by the current budget impasse.

Press Release, Illinois Department of Revenue, January 4, 2016

Chicago Electronic Filing Mandate Discussed

For taxes administered by the Chicago Department of Finance (department), tax collectors and taxpayers generally must file their tax returns through the department's website, and all transfer tax declarations must be made through MyDec. The mandate, which is effective January 1, 2016, does not apply to the sale of stamps, stickers, and decals; the automatic amusement device tax; or the cigarette tax. In relation to the electronic filing mandate, the department discusses web-based applications for real property transfer declarations and other city taxes; use of city computers; late filing and payment penalties; and waiver of the mandatory web filing requirement.

Uniform Revenue Procedures Ordinance Ruling #5, Chicago Department of Finance, December 8, 2015

Massachusetts

Guidance Issued On 2016 Amnesty Program

The Massachusetts Department of Revenue has issued guidance on the 2016 amnesty program and how to apply for amnesty electronically. An online amnesty return will be available on the Department of Revenue (DOR) website starting April 1, 2016, and will continue through May 31, 2016. Amnesty is available to any individual or business who has not currently registered with the Department of Revenue, who has not filed a tax return, or who has not reported the full amount of tax owed on a previously filed return for any tax return due on or before December 31, 2015. However, amnesty is not available to individuals or businesses who are or have been the subject of a tax-related criminal investigation or prosecution, who have previously filed a false or fraudulent return or statement, or who file a fraudulent amnesty return. In addition, the 2016 amnesty program does not cover existing tax liabilities. Additionally, any taxpayer who participated in the 2014 or 2015 tax amnesties conducted by DOR is not eligible for the same tax types or tax periods.

The release is available on the Massachusetts DOR website http://www.mass.gov/dor/breaking-news/amnesty/tax-amnesty-info.html.

Michigan

Department Clarifies Policy on Taxability of Cloud Computing Products

The Michigan Department of Treasury has announced that in light of the Court of Appeals decision, *Auto-Owners Insurance Company v. Department of Treasury*, sections of RAB 1999-5 that suggest that access to software over the Internet is taxable without the delivery of either "the code that enables the program" to operate or a "desk top client" are inconsistent with the decision and do not represent the department's policy. If a portion of a software program is electronically delivered to a customer, the "incidental to service" test will be applied in order to determine whether the transaction qualifies as the rendition of nontaxable services or the sale of tangible personal property. A software program that is electronically downloaded in its entirety is taxable.

Taxpayers seeking a refund for taxes paid for a product falling within the *Auto-Owners* decision must file a written refund request to the department within the statute of limitations. If the refund is for a prior year, the taxpayer is required to include amended annual returns for the years involved. However, if the tax was paid to the vendor, the taxpayer must request a refund from the vendor.

Notice to Taxpayers Regarding Auto-Owners Insurance Company v. Department of Treasury, Michigan Department of Treasury, January 6, 2016

Streamlined Unclaimed Property Audit Process Created

Enacted legislation amends the Uniform Unclaimed Property Act to create a streamlined audit process for certain Michigan-related corporations. The streamlined audit process would apply to "eligible holders," defined as holders that are one or more of the following:

- a business whose principal place of business is in Michigan as evidenced by 20% or more of its payroll or 20% or more of its real and tangible personal property (except inventory) owned or rented in Michigan during the period subject to examination, or the majority of officers that direct, control, and coordinate the activities of the business are employed in Michigan;
- a corporation that wholly owns a corporation that has incorporated in Michigan, and the Michigan corporation meets the criteria above; or
- a corporation that is wholly owned by a corporation that is incorporated in Michigan, and the Michigan corporation meets the criteria above.

Eligible holders may elect the streamlined audit process by executing a nondisclosure agreement acceptable to the Administrator within 30 days from the receipt of the audit notice. An audit conducted under the streamlined process must be (1) completed within a timeframe jointly developed by the holder and the administrator, with the goal of completing the audit within 18 months from receipt of the audit notice; and (2) be conducted according to standards set forth in rules and regulations promulgated by the Department of Treasury. For an eligible holder participating in the streamlined audit process, the Treasurer may not begin an action or proceeding more than four years after any duty of a holder under the Act arose. Additionally, streamlined examinations may not include checks voided within 180 days of their issuance.

The law further provides that property worth $25 or less is not subject to the custody of the state as unclaimed property, subject to certain exceptions.

The enacted legislation is retroactive and applies to audits in progress as of August 15, 2015, but does not retroactively apply to contested determinations in litigation before the date of enactment.

Act 242 (S.B. 538), Laws 2015, effective December 22, 2015, and applicable as noted

Data Center Exemptions Authorized

Beginning January 1, 2016 through December 31, 2035, the sale of data center equipment to the owner or operator of a qualified data center or a collocated business for assembly, use or consumption in the operations of a data center is exempt from Michigan sales and use tax. Also exempt is the sale of data center equipment to a person engaged in constructing or improving the real estate of others to the extent the equipment is affixed to or made a structural part of a qualified data center.

The exemptions continue to apply after January 1, 2022 only if the qualified data centers, collocated businesses, and the contractors have established in the aggregate at least 400 data center industry jobs since January 1, 2016. The exemptions continue after January 1, 2026 only if established jobs have reached 1000 or more since January 1, 2016. Data center equipment does not include equipment owned by a third party that is used to supply the data center's primary power.

Act 251 (S.B. 616) and Act 252 (S.B. 617), Laws 2015, effective December 23, 2015

Pennsylvania

Final Phase-Out of Capital Stock and Foreign Franchise Tax Complete

Governor Tom Wolf has announced the successful January 1, 2016 phase-out of Pennsylvania's Capital Stock and Foreign Franchise tax. The governor notes that the phase-out had been proposed 15 years ago, but the elimination had been delayed several times. The tax was imposed on corporations with capital stock, joint-stock associations, limited liability companies, business trusts, and other companies doing business within Pennsylvania. Domestic corporations were subject to the capital stock tax, while foreign corporations were subject to the foreign franchise tax on capital stock apportioned to Pennsylvania. The Pennsylvania Department of Revenue noted that the elimination of the tax means that many business types, such as S corporations, LLCs taxed as pass-through entities, and business trusts will be filing their final corporation tax returns for 2015. These returns should be marked as final returns. More information will be available on the department's website at http://www.revenue.pa.gov.

Latest News, Office of Governor Tom Wolf, January 4, 2016

Rhode Island

Apportionment Regulation Provides Guidance on Combined Reporting, Single Sales Factor Apportionment Formula, and Market-Based Sourcing Rules

The Rhode Division of Taxation has adopted a final regulation that provides comprehensive guidance regarding apportionment of net income for taxpayers computing business corporation tax liability. The new regulation implements several major law changes effective for tax years beginning on or after January 1, 2015, including mandatory combined reporting, a single sales factor apportionment formula, and market-based sourcing rules for determining a taxpayer's sales that are attributable to the state. It replaces regulation CT 04-04, but incorporates a significant portion of that regulation unchanged. The regulation preserves the traditional three-factor apportionment formula in certain applicable circumstances. Similarly, the regulation preserves the applicability of special apportionment formulas for certain industries for tax years beginning January 1, 2015 and thereafter, and eliminates special apportionment formulas in some instances. The regulation discusses the Tax Administrator's authority to vary methods of apportionment and the process for resolution of disputes related to the applicable method of apportionment. In addition, the Division of Taxation's policy with regard to record-keeping requirements is clarified. Provisions and examples have been included to explain how principles of apportionment apply to entities in tax years before and after the tax law changes. Many definitions have been added to clarify the meaning of key terms. A series of comprehensive examples are set forth relating to the application of single sales factor apportionment and market-based sourcing.

Rules are established for mandatory uniform accounting periods for members of a combined group, determination of a combined group's net income attributable to Rhode Island on the basis of a combined apportionment percentage, and the use of the *Finnigan* method in calculating any sales factor for purposes of combined reporting. Under the *Finnigan* method, a corporation filing a combined return on behalf of a combined group must include all receipts attributable to Rhode Island for all members in the combined group, without regard to whether a member has corporate income tax nexus with the state.

The regulation states that sales or receipts within Rhode Island means all gross receipts of the taxpayer in the state, including interest income, dividends, service charges, carrying charges, time-price differentials incidental to a sale, and the entire reimbursed cost plus the fee in the case of cost-plus contracts. Sales include federal and state excise taxes, including sales taxes, if those taxes are passed on to the buyer or included as part of the selling price of the product. Sales related to manufacturing and selling, sales related to purchasing and reselling, and sales related to goods or products include gross sales, less returns and allowances.

The regulation follows the destination test with respect to determining whether sales of tangible personal property are in Rhode Island and imposes a throwback rule if the property is shipped or delivered to a state where the purchase is not subject to corporate income tax. Receipts from sales other than sales of tangible personal property, such as sales of services and the sale, leasing or licensing of intangible property, are in Rhode Island if and to the extent that the taxpayer's market for the sales is in Rhode Island. Rules, some of which must be applied in hierarchical order, have been adopted for determining whether and to what extent the market for a sale is in Rhode Island, reasonably approximating the state or states of assignment where such state or states cannot be determined by the taxpayer, and excluding the sale (i.e., throwout rule) where the state or states of assignment cannot be determined or reasonably approximated by the taxpayer. In the case of sales of in-person and professional services, the sale is sourced to Rhode Island if the recipient of the service receives the benefit of the service in the state or, if the recipient receives less than the full benefit of the service in the state, in proportion to the extent that the recipient receives the benefit in the state. Special rules apply to services, other than in-person or professional services, that are physically or electronically delivered to or on behalf of a customer and for services that are delivered electronically through a customer or on behalf of a customer. With respect to the licensing of intangibles, the regulation has distinct rules for marketing intangibles, production intangibles, mixed intangibles, and intangible property where the substance of a transaction resembles a sale of goods or services. Sourcing rules for the sale of intangible property depend on whether the property sold or exchanged is a contract right, or government license that authorizes business activity in specific geographic area, whether the sale or exchange is contingent on the productivity, use or disposition of the property, or whether the sale resembles a sale of goods and services. Special rules are also provided for software transactions, sales or licenses of digital goods or services, and gross receipts from broadcasting.

Reg. CT 15-04, Rhode Island Division of Taxation, January 12, 2016

Nexus Regulation Amended, Updated

The Rhode Island Division of Taxation has amended its regulation regarding nexus for business corporation tax effective January 12, 2016.

The amended regulation provides definitions of key terms and offers an overview on the general concept of nexus and how nexus principles may apply to corporations. The regulation is also amended to address the combined reporting requirements for C corporations and the combined groups factor-based nexus approach for tax years beginning on or after January 1, 2015 and to provided guidance for taxpayers. The regulation sets forth protected activities as well as nexus-creating activities and include examples. Developments in the relevant case law that occurred after the effective date of the prior regulation, CT 95-02, which became effective April 1, 1995, are incorporated into the regulation. CT 95-02 is superseded by the amended regulation.

Reg. CT 15-02, Rhode Island Division of Taxation, effective January 12, 2016

If you have any questions, please contact your tax advisor or:

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