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California

Corporation Could Exclude Sale of U.S. Business from Sales Factor

A corporation could exclude the sale of its U.S. business when determining the sales apportionment factor on its California return. When preparing a California tax return, a corporation need not include general asset sales in its apportionment factor when the sales are:

- substantial; and
- occasional.

For a taxpayer that is part of a combined reporting group, a sale is substantial if its exclusion results in a 5% or more decrease in the group's sales factor denominator. A sale is occasional if the transaction is outside of the taxpayer's normal course of business and occurs infrequently.

Here, the corporation divested of its U.S. business through three separate sales by members of its combined group. These sales generated almost all of the corporation's gross receipts for the taxable year. The sales were substantial, because each of them (evaluated separately) resulted in a 5% or more decrease in the combined group's sales factor denominator. Also, the sales were occasional, because the corporation did not normally sell businesses for profit, and the sales during the taxable year occurred infrequently.

Chief Counsel Ruling 2017-03, California Franchise Tax Board, October 18, 201

Colorado

Holding Company Properly Excluded from Colorado Combined Return

A taxpayer was not required to include a domestic subsidiary holding company in its Colorado combined corporate income tax returns. The taxpayer was a parent company of the holding company, which operated exclusively in Japan. The holding company had no property or payroll of its own, inside or outside of the United States.

Under Colorado law, a corporation must be included in a combined report if more than 20% of the corporation's property and payroll are assigned to locations in the United States. Because the holding company did not have property or payroll factors that could be assigned to any location:

- it was not considered an includible C corporation;
- cannot be a member of an affiliated group; and
- cannot be required to be included in a combined report.

While the appellate court agreed with the district court's decision that the holding company was not an includible C corporation under Colorado law, it disagreed with the court's conclusion that the statute at issue was ambiguous. The lack of reference in the law to holding companies that do not have property and employees does not create an ambiguity as to the 20% or more test for inclusion.

The court also rejected arguments that:

- an applicable Colorado Department of Revenue regulation was intended to apply only to foreign sales corporations;
- subsections of the law at issue also concerning the scope of combined reports should be read as also applying only to C corporations that conduct business outside of the United States; and
- that excluding the holding company from mandatory combined reporting would create an absurd result.

The court also determined that a Colorado law authorizing the department to allocate income and deductions among corporations that are owned or controlled by the same interests in order to properly reflect income and avoid abuse could not be applied as an alternative basis for including the holding company in the taxpayer's return.

Additionally, the facts of the case did not indicate that the taxpayer's formation of the holding company was an attempt to avoid paying state income taxes. Instead, the taxpayer formed the holding company for a reasonable business purpose, at the request of an independent third party, and no evidence of abuse was presented.

Oracle v. Department of Revenue, Colorado Court of Appeals, No. 2017COA152, November 30, 2017

Illinois

Lenders Not Entitled to Bad Debt Credit for Sales Tax

A third-party lender was denied a credit for the Illinois sales tax portion of debts that it financed then wrote off as bad. In this case, the Illinois Supreme Court ruled that only retailers are entitled to a bad debt credit. Under state law, only the person who made the tax payment can receive a credit for the tax if the tax was paid in error. A lender may be the source of money for the sales tax payment, but the lender does not pay the tax.

The lender denied the credit financed purchases for customers of Illinois retailers. It also bought credit lines from the retailers that the retailers had extended to customers. Each of the debts included financing for sales tax owed by customers on purchases.

While the retailers remitted the taxes on the purchases, they assigned the lender their rights to pursue refunds of the taxes. In some cases, the lender could not collect all of a customer's debt and wrote the debt off on its federal income tax return. When a retailer writes off debt that it finances, it can get a bad debt credit for finance sales taxes as sales taxes paid in error. Here, the lender sought the credit under the assignment it received from the retailers.

In addition to not being allowed to take a credit as a financier, the lender could not be assigned a retailer's right to a credit. A credit memorandum issued by the department to the person who claimed the credit maybe be assigned. However, a credit memorandum can be assigned only to the person obligated to pay the tax for which the credit memorandum was issued. Retailers cannot assign the right to pursue a refund or claim a credit.

As the court noted, lenders that finance retail transactions may have to adjust future agreements to take its holding into account.

Citibank, N.A. v. Ill. Dept. of Revenue, Illinois Supreme Court, No. 121634, November 30, 2017

Indiana

Market-Based Sourcing Disallowed for Online Course Revenue

A University's online course revenue could not be sourced to Indiana based on a student's billing address. The taxpayer was based in Arizona and provided private educational services to Indiana residents over the internet. In computing its Indiana corporate income tax, the taxpayer sourced all of its receipts attributable to its Indiana ground campus students to Indiana, but sourced none of its receipts from its online campus students to Indiana. The Department of Revenue assessed additional corporate income tax, claiming the taxpayer should have included income received from Indiana online students in the taxpayer's sales factor.

Income-Producing Activities

Indiana apportions business income received from performing services based on the location of the income-producing activities. The taxpayer's produced a cost study that found four activities directly benefited students and were income producing activities. The activities included: online eCampus platform, online faculty instruction, curriculum development, and graduation assistance. The department contended that the taxpayer only had one income-producing activity, providing the opportunity to attend a class online, and it was performed in Indiana. Indiana sources a taxpayer's revenue to the Indiana numerator based on the seller's acts, the performance of acts from the perspective of the seller, not from the view of the buyer or consumer. Accordingly, income producing activities are not limited to what those students directly pay for but encompass acts a seller directly engaged in with the purpose to generate revenue. Because the department did not put forth any probative evidence, the taxpayer's identification of its "income-producing activities" was accepted.

Costs of Performance Sourcing

The taxpayer also argued that its income-producing activities were performed both inside and outside Indiana and the department's market-based sourcing method was incorrect. The taxpayer's cost study identified and geographically located the direct costs the taxpayer incurred in performing its four income-producing activities. The study concluded that they occurred in Indiana as well as in other states. Again, the department provided no evidence in rebuttal. Thus, the income-producing activities were performed both in Indiana and in other states. Therefore, the taxpayer's online educational services income must be sourced based on the cost-based method. The department did not present facts or argument to show it was entitled to use market-based sourcing as an alternative apportionment method to the cost-based method, as it argued.

Proportion of Income-Producing Activities

Finally, the taxpayer asserted that none of its online educational services income should be sourced to Indiana. The taxpayer argued that the greater proportion of its income-producing activities were performed outside of Indiana. In Indiana if the greater proportion of the costs of performing the income-producing activities are performed within Indiana, all the service income is attributed to Indiana. Further, if the greater proportion of the costs are incurred outside the state, none of the income is attributed to Indiana. The department claimed the taxpayer's identification and location of the costs it incurred to perform its income-producing activities was unreliable. The department argued the cost study should have been based on a transaction-by-transaction approach, not the operational-level approach that was used. However, Indiana regulations did not require the taxpayer to use a transaction-by-transaction approach as the basis of its cost study. Accordingly, the taxpayer's cost study persuasively demonstrated that the greater proportion of the taxpayer's income-producing activities were performed outside Indiana. Thus, the court held that the department erroneously calculated the proposed assessment for 2009, 2010, and 2011 by sourcing the taxpayer's revenue according to the location of its market. Therefore, the proposed assessments were vacated.

The University of Phoenix, Inc. v. Indiana Department of State Revenue, Indiana Tax Court, No. 49T10-1411-TA-00065, November 30, 2017

Michigan

Principal Residence Qualified for Exemption Despite Renting Out Property

The Michigan Tax Tribunal's (MTT's) decision denying a property owner's request for principal residence exemption (PRE) was reversed and remanded because the PRE guideline provision relied on by the MTT was erroneous and inconsistent with the General Property Tax Act (GPTA). The town argued that the property was not the owner's principal residence and was rented out during the taxable period. The owner argued that the GPTA does not contain any provision that would disqualify him from the exemption and that the PRE guideline was contrary to the language of the GPTA. The owner satisfied the requirements to qualify for exemption under statute. Further, the owner submitted an affidavit stating that the property was his principal residence and presented evidence that he was registered to vote at that address and also listed that address on his driver's license and tax returns. Additionally, renting the property for more than 14 days did not disqualify the owner from the exemption. Therefore, the court of appeals concluded that the owner qualified for the exemption.

Rentschler v. Township of Melrose, Michigan Court of Appeals, No. 336333, November 28, 2017

Montana

Rules Updated to Adopt *Finnigan*, Implement Market-Based Sourcing

The Montana Department of Revenue has adopted and amended various rules affecting how multistate corporate taxpayers apportion their income.

***Finnigan* Rule**

The department has adopted the *Finnigan* rule to limit the risk of having a unitary combined group's apportionment factors manipulated. Accordingly, when calculating apportionment, taxpayers must include property, payroll, and receipts from all unitary group members, if one member has nexus.

Previously, the department followed the *Joyce* rule, which included a unitary group member only if that member itself had nexus.

Market-Based Sourcing

The rules also provide guidance on market-based sourcing, which was enacted earlier in the year. For example, a new rule specifies that service receipts are sourced to Montana if the service is delivered to a location in the state. Among other things, the rules also:

- explain principles to apply when sourcing receipts from sales other than sales of tangible personal property;
- address methods of reasonable approximation used when sourcing such receipts;
- discuss methods used in excluding certain receipts;
- explain provisions to be used for a change of methodology;
- explain when receipts from the sale, rental, lease, or license of real property are sourced to Montana;
- address when receipts from the rental, lease, or license of tangible personal property are sourced to Montana;
- address when receipts from the sale, license, or lease of intangible property are sourced to Montana; and
- include special receipts factor provisions for software transactions and sales or licenses of digital goods or services.

The updated rules are available at https://revenue.mt.gov/rules.

MAR Notice No. 42-2-985, Montana Department of Revenue, effective January 1, 2018

Tennessee

Self-Study Online Training Courses Are Subject to Tax

Self-study online training courses offered by a taxpayer who provides professional licensing education and test preparation services are subject to Tennessee sales and use tax. However, live instructor-led webinars provided by the taxpayer are not subject to tax.

Self-Study Online Training Courses

The taxpayer provides Tennessee users with web-based access to its platform where the users can select and pay for a specific program. The courses provide the user with the ability to study by accessing computer software via the Internet.

The taxable use of computer software in Tennessee that remains in possession of the dealer requires the access and use of computer software by a customer within the state. As a result, the online training courses are subject to tax when sold to a Tennessee customer because the students pay for the use of the remotely accessed computer software.

Live Instructor-Led Webinars

In addition, live instructor-led webinars provided by the taxpayer are not subject to Tennessee sales and use tax. The student does not purchase use of the software, but rather purchases access to a live training class. The software platform is merely incidental to the transaction. Only specific services are subject to tax, and the taxpayer's training services are not specifically listed as taxable.

Revenue Ruling No. 17-17, Tennessee Department of Revenue, October 31, 2017

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