

The Struggle for Clarity

by Brian Strahle

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The SALT Effect will discuss the effect state tax challenges (statutes, regulations, cases, rulings, etc.) have on taxpayers, government, and the tax practitioner community.

I. The SALT Effect

If you Google "the salt effect," you may get this: "The salt effect refers to the fact that the presence of a salt which has no ion in common with the solute, has an effect on the ionic strength of the solution and hence on activity coefficients, so that the equilibrium constant, expressed as a concentration quotient, changes."

Fortunately or unfortunately, depending on your viewpoint, this column is not about scientific experiments or chemistry (although you could argue that state taxes feel like an experiment in search of a cure. I will let you hypothesize about that).

In life, each choice we make has an effect. The same can be said for each state and local tax statute, regulation, ruling, and court case. The effects can be negative or positive, depending on your position.

II. SALT Effect: Lack of Uniformity

The terms "simplicity" and "uniformity" are not usually discussed in the same breath as state and local tax. With all the taxing jurisdictions in the United States, there is little uniformity and nothing seems simple.

For example, states do not uniformly apportion a company's income, determine business vs. nonbusiness income, or define a unitary group.

Despite their best efforts, states also lack uniformity in how transactions are taxed for sales and use tax purposes. Cloud computing is an example of a new business trend causing disruption for the states, forcing them to play catch-up. As cloud com-

puting has grown, states have struggled to update their laws, but only some have provided clear guidelines.

The lack of uniformity creates complexity resulting in burdens and opportunities for taxpayers and states. But do state governments really care about uniformity? States generally conform to other states when it is not economically detrimental. Further, states use the lack of uniformity as a marketing tool or incentive for businesses to locate to their state. They actively market and solicit businesses by touting their economic climate, workforce, infrastructure, and low taxes (plus credits and incentives).

Despite states joining organizations such as the Multistate Tax Commission and the Streamlined Sales Tax Project, uniformity appears to remain out of reach. Therefore, is uniformity a realistic goal? Should it be a goal at all?

This article argues:

- Uniformity across all state tax laws is impossible because of the uniqueness of each state's industry or economic composition and demographics;
- Complexity among state tax laws is inevitable even if uniformity is achieved;
- Taxpayers want clarity, not uniformity;
- Clarity does not equal bright-line tests; and
- Clarity depends on the state.

A. Uniformity Is Impossible

The states appear to act uniformly in some ways by playing follow the leader. For example, in 2009 it appeared that most, if not all, states were experiencing budget and financial difficulties of historical proportions. Tax revenue was down. The states began proposing or passing legislation to close loopholes, raise or create taxes, and attempt to encourage economic development. They also proposed legislation enacting new minimum fees or taxes and amnesty programs to encourage delinquent taxpayers to pay back taxes without penalties. States began drafting legislation to adopt combined reporting, single-sales-factor apportionment, market-based sourcing, economic nexus, and "Amazon" nexus.

Today states act uniformly in several areas. Many have adopted Amazon, or click-through, nexus rules, as well as nexus presumption rules based on state

activities and connections of a related or affiliated entity. States have or are adopting or proposing rules to require remote sellers to collect sales tax, with the hope that the Marketplace Fairness Act (MFA) will become law. They also want to disallow the use of the equally weighted, three-factor MTC apportionment formula and are revoking their membership in the MTC to accomplish that.

Despite imitating each other, states still lack uniform rules, perhaps because each state must balance its budget every year and raise enough revenue to support government services. To do that, each state has created its own unique tax regime, which appears to be based on that state's industry, demographic, and political makeup. Hence, even though each state may adopt or propose similar tax law changes related to Amazon click-through nexus, cloud computing, and the MFA, the implementation and application of those changes will most likely vary.

B. Complexity Is Inevitable

Examples of attempts to increase or achieve uniformity over the years include the SSTP, the MTC, and the Uniform Division of Income for Tax Purposes Act. When a state becomes a member of those organizations or adopts provisions from those agreements, it generally tweaks the provisions or doesn't adopt them all. Therefore, despite efforts to make things uniform across the states, uniformity exists only in part, which creates more complexity, not less.

Twenty-two states are full members of the Streamlined Sales Tax Agreement, and two are associate members. That creates some uniformity across those states to simplify and reduce the burden of sales tax compliance, but it doesn't create uniformity across all states.

Seventeen states conform to UDITPA, but almost all with modifications. Thus, even the states that conform are not uniform. The rest of the states that have an income tax don't conform to UDITPA, but they may have similar provisions within their own statutes. Therefore, complexity is inevitable.

C. Taxpayers Want Clarity, Not Uniformity

If we assume that uniformity won't be achieved or will continue to result in complexity, clarity is vital. If taxpayers are expected to comply with the rules, they should be able to determine what the rules are.

Practitioners and taxpayers are used to working in a gray state tax world, meaning that statutes, regulations, and court cases are open to interpretation when applied to specific fact patterns. Practitioners accept the gray as long as they can analyze and interpret statutes, regulations, and cases, and reach some level of certainty or authority to support a position taken in a tax return filing.

The gray cannot always be turned into black and white, because the state's guidelines may be unclear or because official interpretations may not match

the guidelines. That is common when new laws are enacted and taxpayers must scramble to apply them to their businesses. A recent example is the application of the District of Columbia's regime combined reporting to unincorporated businesses.

The district originally enacted legislation that did not include unincorporated businesses. It then issued proposed and final regulations including those entities and passed emergency legislation to make the statutes match the regs. The district recently enacted the Combined Reporting Clarification Act of 2013 as part of its Fiscal Year 2014 Budget Support Act of 2013 to clarify its treatment of unincorporated businesses.

Taxpayers and tax practitioners have struggled to understand how the district's combined reporting regulations apply to unincorporated businesses. Taxpayers and practitioners have talked with the district officials to gain clarity yet still remain confused. Hence, taxpayers are concerned about taking a position on a return that will later be deemed inaccurate. They're afraid that interpretations or intentions by the writers of the regulations may not be the interpretation by the audit or legal division three years down the road. If uncertainty remains after taxpayers ask officials to explain the state's interpretation or intent, taxpayers may request a letter ruling.

Some states issue letter rulings only for specific questions. But even when a letter ruling is an option, taxpayers often do not seek one because of the expense and effort of requesting one. In that case, taxpayers are left with two options: (1) take a reasonable position that can be supported, and thoroughly document the basis for that position; or (2) guess what the tax authority's position will be on audit (based on historical information) and take a more conservative position.

How the district treats unincorporated businesses is just one example of unclear state rules. The question remains, what can state governments and taxpayers do differently?

D. Clarity Does Not Equal Bright-Line Tests

Some states have enacted bright-line tests to create clarity.

Bright-lines and boundaries clearly tell whether something is right or wrong, allowed or disallowed, legal or illegal. Sounds great, right? In most cases, yes. However, most would agree that in the state tax world, bright-line tests may be the root of both good and evil — that is, even though bright-line tests may provide clarity, they often create winners and losers, which raises questions about their constitutionality.

Examples of bright-line tests may include:

- economic nexus standards or factor presence nexus;
- intercompany expense addback statutes;
- sales tax exemptions;

- credits and incentives;
- apportionment definitions; and
- apportionment sourcing rules for sales.

Examples of items that lack clarity or bright-line tests:

- nexus determinations;
- business vs. nonbusiness income;
- whether a group of companies is unitary;
- a state's discretionary authority to force companies to file a combined return; and
- a state's or taxpayer's proposal to use an alternative apportionment method.

Further, some bright-line tests may cause more confusion when trying to apply other standards.

For example, P.L. 86-272 provided uniformity and clarity, but each state has provided for taxpayers operating there additional interpretation and guidelines on the definition of solicitation, activities ancillary to solicitation, and what level of activity is de minimus. State rules establishing economic nexus or factor-presence nexus standards could conflict with the law. Some taxpayers could have nexus based on the factor-presence standards, but could be protected by P.L. 86-272. That creates confusion. Most states with factor-presence nexus standards address how P.L. 86-272 should be applied, but the interaction creates an extra layer of complexity.

E. Clarity Depends on the State

Federal legislation and the U.S. Supreme Court can provide uniformity, but it is up to the states to provide clarity.

Some say the MFA will level the playing field between remote retailers and brick and mortar stores. Others say it will create a burden on small remote retailers. In either case, the MFA would

create uniformity, but because uniformity does not equal simplicity, complexity is the likely outcome.

Regardless if the MFA passes, clarity will most likely be up to the states. In 1992, the U.S. Supreme Court held in *Quill* that a taxpayer must have a physical presence in a state before it can be required to collect sales tax. The *Quill* standard is still followed, but subsequent challenges to the rule in various states have provided additional clarity.

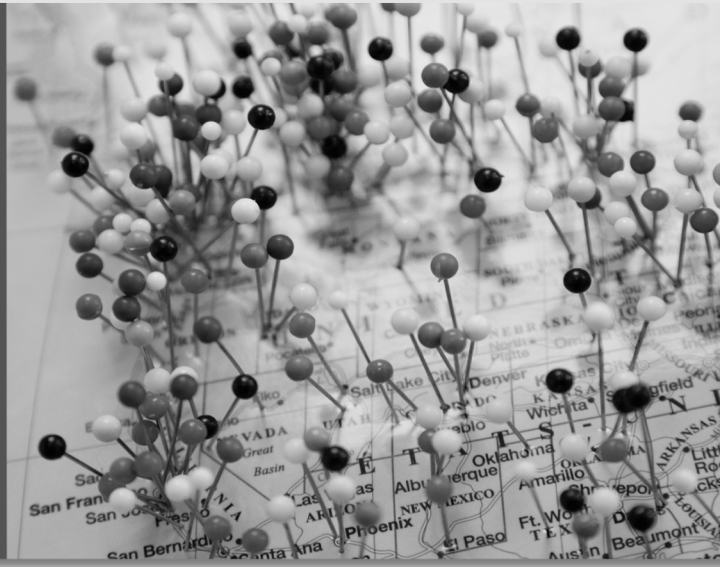
U.S. Rep. James F. Sensenbrenner Jr., R-Wis., recently proposed the Business Activity Tax Simplification Act of 2013 (BATSA). Similar legislation has been proposed several times in the past decade. If enacted, would BATSA create a uniform standard? Yes. Would states need to provide additional clarity? Probably.

III. Conclusion

Uniformity is an honorable goal, but it does not appear to be entirely achievable by the states, multistate compacts, or organizations. Thus, any attempt at uniformity creates additional complexity, not simplicity. Further, both states and taxpayers accept the lack of uniformity and use it to their advantage.

Federal legislation and the U.S. Supreme Court can provide uniform standards for the states to follow, but it is still up to the states to provide clarity. State governments cannot anticipate every possible scenario when writing statutes or regulations, so there will always be some lack of clarity. Therefore, state governments and taxpayers should work together to make the process of obtaining clarity easier to increase compliance and reduce uncertainty. ☆

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