2020 Survey of State Tax Departments Executive Summary

Bloomberg Tax & Accounting

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States Specify Nexus Policies, Clarify Sourcing Issues, Address Other Ambiguities

For the 20th consecutive year, Bloomberg Tax & Accounting endeavored to clarify each state's nexus positions by sending questionnaires to senior state tax department officials in the District of Columbia, New York City, and the 45 states that impose a corporate income tax. Bloomberg Tax & Accounting also sent questionnaires regarding sales and use tax nexus to the 47 jurisdictions that impose a sales and use tax. The questionnaire also covers states' tax treatment of pass-through entities, conformity to federal tax reform, methods of sourcing income, sales tax refund actions, requirements for reporting federal changes, enforcement, and collection policies. Additionally, Bloomberg Tax & Accounting asked the states about their combined reporting regimes and conformity to the Multistate Tax Compact.

Bloomberg Tax & Accounting's annual survey offers insights for practitioners who must gauge whether a corporation's activities within a state could result in a tax liability. Given the states' lack of clear guidance in the form of case law or statutes setting forth the types of activities that trigger nexus and taxability, this survey provides essential details.

This year, the majority of states, plus the District of Columbia, participated in both the income tax and sales tax portions of the survey. However, not all states were able to respond this year, with many citing the need to reallocate resources or close offices because of the new coronavirus. Colorado, Delaware, Michigan, New York City, and Oklahoma did not participate in either portion of the survey. Other states participated in one half of the survey, but not the other. Florida and Minnesota participated in the income tax portion of the survey but not sales tax. Conversely, New York and South Carolina participated in the sales tax portion of the survey but not the income tax portion.

Additions

This year, we expanded the sales tax portion of our survey by creating categories addressing marketplace facilitators and whether remote sales exceeding economic nexus thresholds create nexus. New questions also cover topics such as add-backs and alternative apportionment for corporate income tax and economic nexus thresholds, sourcing of digital goods, taxation of delivery and errand services, and local taxes for sales tax. We also expanded the survey's coverage of nexus-creating activities.

Key Findings

Corporate Income Tax Nexus

The prevalence of remote working due to Covid-19 drew great attention to the states' positions on whether or not telecommuting creates nexus. The vast majority of states responded that various telecommuting situations would trigger nexus, with 36 states saying that one to six employees who perform non-solicitation activities would create nexus for an out-of-state corporation if the employee is telecommuting from within their state. The answers varied only slightly for telecommuting employees performing back-office administrative functions, with 33 states stating this would create nexus, and for telecommuting employees performing product development functions, with 34 states responding in the affirmative.

Thirteen states stated that their nexus standard is based on factor presence, one less than last year, although this change is because Colorado did not participate for 2020. Only two states, Alabama and Tennessee, said that they fully conform to the Multistate Tax Compact's model statute, Factor Presence Nexus Standard for Business Activity. California and Connecticut stated that they partially conform to the model statute.

Apportionment & Sourcing

We asked states to identify their general sourcing method for receipts from sales other than sales of tangible personal property. Twenty-six states said that they use a market-based sourcing approach, while only six states, five less than last year, said they use a cost-of-performance approach. Fifteen states said they apply different sourcing methods to different categories of receipts.

We also asked states to identify the sourcing method used to source receipts from cloud computing or Software as a Service transactions. Twenty-three states stated that they use market-based sourcing, an increase from 19 in 2019; four states reported that they use cost-of-performance; and two states said that they use a sourcing method other than cost-of-performance or market-based sourcing for cloud computing transactions.

The survey also looks at whether the states have industry-specific sourcing rules. According to this year's responses, the most popular industries for which states have special sourcing rules are airlines (30 states), trucking companies (27 states), and banks and financial services companies (29 states).

As in previous years, we asked the states to identify which formula they use to apportion an out-of-state corporation's business income to their state. As expected, the sales-factor-only formula was most popular, with 27 states responding "yes."

This year, we added a question asking whether taxpayers are required to request alternative apportionment prior to filing. The majority of states have this requirement, with 28 states answering "yes."

Pass-Through Entities

According to the survey results, 17 states classify guaranteed payments for services, other than personal or professional services, as business income. Only one state, Mississippi, stated that it classifies these payments as nonbusiness income. Similar questions were asked about guaranteed payments for personal and professional services and use of partnership capital.

We asked states about the tax treatment of gain recognized by the disposition of an interest in a pass-through entity doing business in their state. Twenty-five states responded that they would impose income tax on the gain recognized by the disposition of an out-of-state corporation's limited interest in a pass-through entity doing business in the state. Seventeen states responded that they would impose income tax on the gain recognized by the disposition of a nonresident individual's limited interest in a pass-through entity doing business in the state.

Twenty-eight states said nonresident owners/members/partners subject to withholding or composite returns must file a return to receive a refund of amounts over withheld.

We asked the states to identify the extent to which they comply with the federal partnership audit rules. Among these questions, we asked states whether they make adjustments, determine

imputed tax, and assess and collect tax at the partner level or at the entity level. Thirteen states responded that they conduct these activities at the entity level, while nearly double the number of states (25) said they do so at the individual partner level. Nine states, including Illinois and Pennsylvania, responded "yes" to both questions.

We also asked questions about entity-level nexus for pass-through entities. Based on their responses, most states make no distinction based on entity type with respect to whether an entity doing business in the state creates nexus.

Interestingly, 32 states said that a qualified subchapter S subsidiary (QSub) doing business in the state would create nexus for the parent S corporation. Only three jurisdictions – Alaska, the District of Columbia, and Texas – said that the activities of the QSub would not create nexus for the parent company.

Sales Tax Nexus

We asked states for their sales tax nexus policy, with particular attention to economic nexus standards. Thirty-six states, more than double the number of our pre-*Wayfair* responses in 2018, said they have an economic nexus standard for sales tax nexus. Four states, including Louisiana and Maryland, said they have an economic nexus standard that is not currently being enforced because of the legislation's effective date or pending litigation.

We asked states to identify the time frame used and type of transactions counted toward meeting their economic nexus sales thresholds. Most states said they use sales made in the current or previous calendar year when determining whether the threshold has been met. The responses also showed that sales for resale, tax-exempt sales of tangible personal property, sales of services, and sales of electronically delivered items are almost always counted, but sales of intangibles are counted less frequently.

For 2020, we added questions about whether sales of digital items accessed via the cloud (e.g., SaaS) and sales made through a marketplace count toward economic nexus thresholds. These options appear to be popular with the states, with most jurisdictions indicating that both would be counted.

This year, we also added questions addressing sales made on marketplace platforms. Twenty-seven states responded that marketplace facilitators are required to collect sales and use tax on sales made via their platforms by marketplace sellers, provided they have nexus with the taxing jurisdiction. Further, 23 of these states stated that marketplace sellers are relieved of liability for tax that is supposed to be collected by a marketplace facilitator, but in 16 of those states, the liability can be shifted back to the seller under certain circumstances.

This year, we expanded our questions on sharing economy transactions to address delivery or errand services that are arranged by a third-party vendor, such as Postmates, Grubhub, and TaskRabbit. Sixteen states said that the third-party vendor is obligated to collect the tax, while only five said this obligation was imposed on the delivery or errand person.

Bloomberg Tax Answers the Call for Clear Compilation of State Approaches

The state tax arena is fraught with variation, complexity, confusion, and ambiguity. The survey provides a comprehensive comparison of each state's policies in areas that can be troublesome for multistate taxpayers. To add madness to the mayhem, states lack uniformity in their interpretation and application of overarching principles in state taxation. On top of this all, a global pandemic brought drastic and widespread changes to the way companies and tax departments conduct business, piling additional challenges and complexity onto already difficult issues. It remains unclear, however, what the future holds for state taxation, especially in the wake of Covid-19.

Bloomberg Tax & Accounting hopes that the survey will provide practitioners with a helpful and unique perspective. "I always enjoy looking at the Bloomberg survey because it provides an excellent high-level view of what multistate companies and tax practitioners face on a daily basis: a complex and non-uniform enforcement landscape. In a post-*Wayfair*, post-TCJA, Covid-19 universe the complexity is only increasing. While it is inherently difficult to capture nuance in a survey, it again shows the lack of uniformity across the states. The lack of uniformity can be attributed both to the lack of clarity in the law, but also varying policy positions across the states despite some common trends," Matt Hedstrom, partner at Alston & Bird in New York, said in a June 4 email.

Variety Creates Compliance Challenges

The lack of uniformity across states tax policies is due in large part to the nature of our multistate system, with each state having the sovereign right to determine its own laws as it sees fit. This disparity may also be economically, politically, or culturally motivated, with states seeking to entice certain taxpayers to invest in their state or influence behavior of businesses already in the state. "The variances in state tax policy can be attributed to the unique political and tax landscape found within the borders of each state. State tax policy is, in large part, driven by a state's fiscal needs," Priya Nair, staff attorney at the Council On State Taxation, said in a June 11 email.

A state's economy may determine its taxation regime. "Generally, state tax policy is based on that state's economy. What is beneficial for one state can be detrimental to another. Unfortunately, this increases the burdens on taxpayers in attempting to comply with the wide variety of laws," Nicole Johnson, partner at Blank Rome in New York, told Bloomberg Tax & Accounting in a June 1 email.

For Bruce Ely, tax partner at Bradley Arant Boult Cummings LLP in Birmingham, Ala., this variation can be attributed to "a number of factors, including which political party is in power, the state's view on how aggressive they should be in offering various tax incentives to potentially new or expanding industries, how badly the state was hit financially by the fall-out from the Covid-19 pandemic, strong personalities, what neighboring states are doing, etc."

Just as there are a multitude of reasons that state tax policies and law vary, there are also a number of challenges for taxpayers and tax departments alike. "The myriad of variations in tax laws and policies increases compliance complexities for taxpayers trying to navigate the subtle variations among states," Nair said.

"The inconsistency among states causes two problems. One is the complex compliance burdens, and second is the common experience of having to pay tax on more than 100% of income and perhaps having to be liable for sales and use tax in multiple jurisdictions in an unexpected

way," Art Rosen, senior counsel at McDermott Will & Emery LLP in Miami, told Bloomberg Tax & Accounting on May 28.

In addition to inconsistency, practitioners can face ambiguity because of states' variable positions. "Frightening uncertainty and the inability to plan or budget well" are other issues caused by the lack of uniformity, according to Ely.

"It is difficult for state tax administrators, or anyone for that matter, to articulate broad-based policy positions because tax is so fact-driven," Hedstrom said, providing a good reminder that even those responsible for applying and interpreting the law may face difficulty in doing so.

Several practitioners pointed out that these challenges may also be used to the taxpayer's advantage. "For every challenge, there's probably an opportunity out there as well," Marilyn Wethekam, partner at HMB Legal Counsel in Chicago, told Bloomberg Tax & Accounting on May 28, adding that one challenge is "dealing with this on a 50-state basis and trying to interpret where we're going."

"If there was a little more consistency among the states, it would make it a lot easier for taxpayers to probably adhere to the requirements that they set forth and the inconsistencies create problems," Fred O. Marcus, principal at HMB Legal Counsel in Chicago, told Bloomberg Tax & Accounting on May 26. "Although they also create some opportunity for generally playing the states against each other. I'm sure taxpayers take advantage of that, and if not, they should," he added.

"There are different ways of looking at the non-uniformity. One is a compliance challenge and an audit risk. On the other hand, it creates a lot of room for negotiation. It creates room for planning. It creates more room for interpretation and creativity about how to apply these rules that are inconsistently applied or, in some cases, not elaborated on in guidance provided by the state. There is an opportunity to take more aggressive positions on tax returns and maybe get some good tax settlements as a result of the ambiguity among the states," Jeffrey Friedman, practice group leader of the State and Local Tax Group at Eversheds Sutherland LLP in Washington, told Bloomberg Tax & Accounting on May 28.

Coronavirus Adds Complexity

In addition to the difficulties posed by the variety in state taxation on a daily basis, taxpayers, state tax departments, and practitioners are now faced with added complexity stemming from the nation's attempts to slow the spread of the coronavirus.

"The coronavirus pandemic is challenging for both taxpayers and tax practitioners because it is an event unlike anything we have seen before. It has brought about simultaneous fiscal challenges for all states and the District of Columbia and created new tax challenges, such as the appropriate tax treatment of teleworking by a company workforce. As a result, practitioners must determine how to address these new challenges with no prior blueprint to build from," Nair told Bloomberg Tax & Accounting.

The coronavirus has created a multitude of unforeseen difficulties. "It's just harder to do everything. It is harder to file returns. It's harder to make payments. It's harder to deal with audits because you have the state tax authority contacts that are working from home. They have to face their own challenges," Jamie Yesnowitz, state and local tax national office leader at Grant Thornton in Washington, told Bloomberg Tax & Accounting on May 27.

One of these problems is the difficulty taxpayers, practitioners, and tax departments may have communicating. "I think you will find that the challenges for tax practitioners are mirrored in the states in that so many of us are working from home now. It makes it really difficult to communicate with one another, let alone communicate with the various jurisdictions. So, it starts with the communication problem, both between taxpayers and tax practitioners, and the states themselves. So while I've identified that as a major problem, I also think that it's remarkable how well we've all adapted to being able to do that," Joe Huddleston, managing director, national tax at Ernst & Young in Washington, told Bloomberg Tax & Accounting on May 29.

Covid-19 Complicates Compliance

Practitioners again spoke of compliance issues as being one of the major issues arising from the effects of Covid-19, especially because of working remotely outside of the office.

"I think there are challenges now because you are working remotely with pulling returns together or pulling audit data together. It's not as easy because you have to depend on how sophisticated the company systems are. It's not as easy as picking up the phone and calling somebody in the appropriate accounting section to say 'help me with this,'" Wethekam said.

She also pointed out additional difficulties. "You have the mismatch of a filing date. You have the mismatch of now some statute of limitations issues where certain states have suspended the statute. You're dealing with kind of the unknown and that always complicates things."

It's more than just audit difficulties and administrative issues. For example, Marcus explained, "I think it's created compliance issues, especially with respect to timing of estimated payments and filing of returns."

Fred Nicely, senior counsel at the Council On State Taxation in Washington, also emphasized potential compliance challenges. Specifically, Nicely told Bloomberg Tax & Accounting on June 1 that coronavirus has created compliance challenges for both state tax administrators and business tax professionals. "Most of them are working at home and that creates major issues when you have certain types of tax forms that have to be notarized. You know, at the local level, you have a lot of taxes that are still on paper, you can't file electronically, and make payments by paper check. That's very difficult," he said.

Audits and Enforcement Awlso Up in the Air

It's not just taxpayers who are dealing with the ramifications of the coronavirus. Experts frequently spoke of the effects telecommuting is having on audits and other enforcement issues.

"From the state tax authority perspective, there's the issue of enforcement. And I think it's going to be difficult for states to keep things moving along during a pandemic. My hope is that the authorities understand what's going on, what they're dealing with. And I think that from the perspective of audits, my sense is that assessments and agreements on assessments might be somewhat easier, as long as the taxpayer is still paying some amount. In contrast, refunds are going to be harder to get because states are really hard up for money, and so my sense is their perspective will be 'grab as much money as you can, but by the same token, don't release any money in the form of refunds,'" Yesnowitz said.

The inability for auditors to visit taxpayers on-site creates further difficulties. Marcus told Bloomberg Tax & Accounting that the challenge for audits is "whether or not they can actually get their auditors out conducting audits. Some states have successfully conducted their audits remotely, but I'm sure there are states which are either incapable of doing it or are doing that with difficulty. So I think that's creating problems for them."

In addition to being homebound, auditors have faced difficulties with taxpayer data concerns and lack of access to their files. Leah Robinson, partner at Mayer Brown in New York, described challenges state auditors are facing. "I have a lot of state auditors who have told me that basically things are on hold because they don't have their files or that they don't have a computer with a good enough security at home to do anything," she told Bloomberg Tax & Accounting on June 1.

Unlike Marcus and Robinson, Friedman has found that working from home has been a positive experience when it comes to audits. "It seems like audits are getting cleaned out of the system. Whereas before, audits were sitting around. Things are moving now. Less new audits are starting, although they are starting. There's more intention on cleaning up the old inventory, which I think is quite helpful," he said.

Other practitioners echoed Friedman's sentiment that audits and enforcement haven't been as affected as others believe. "I think the states may be more on top of that than the taxpayer," Wethekam said.

Rosen also said he hasn't seen audit issues, adding that "enforcement tools, such as serving notice, whether a statutory notice or a warrant, can still be done. And courts, I think, are still open in most states for executing on an attachment, for example, if the revenue agency wants to enforce a lien."

In addition to the technical aspects of conducting audits, practitioners also believe that additional nexus issues will be created as employees continue to work from home.

"The single biggest change is the plethora of different approaches that states have taken toward nexus and temporary nexus during these times. But I also think it's accelerating that trend that we really do need to visit what nexus matters and who should be subject to tax based upon activities that are occurring outside the borders of the states," Steve Wlodychak, principal at Ernst & Young in Washington, told Bloomberg Tax & Accounting on May 27.

Questions of purposeful availment may also inform nexus inquiries. "From a more theoretical side, the whole telecommuting angle: what does it mean for a company that hadn't purposefully availed itself of a particular state, but now has employees working from home in that state? What does that mean for nexus? What does that mean for apportionment?" Robinson asked.

"One issue that we come across that's becoming more and more important is at-home workers and where they might be locally and whether or not that creates a taxing jurisdiction, if they can be in a state where the taxpayer really isn't engaged," Marcus said.

These novel nexus issues caused by the coronavirus may take some time for states and taxpayers to resolve. "We are only beginning to see the challenges created by Covid-19 – for both taxpayers and states. As states struggle to adapt their tax policies to the changing world, taxpayers are struggling to keep up," Johnson said.

Does Covid-19 Call for State Cooperation?

As taxpayers, practitioners, and revenue departments continue to grapple with the challenges posed by the states' responses to the coronavirus, our experts are also wondering what the future will look like and what can be done to easily transition to something similar to the system that worked in the past. Many think some sort of uniformity among state tax policies will help taxpayers navigate the tax system now and in the future.

"We really do need to get some kind of standard instead of the crazy quilt patchwork that we have right now of temporary responses. And what's going to happen when the coronavirus issue dies away? We go back to standard policies, but now we're in an environment where people are comfortable working from home. This is going to dramatically change the tax profile," Wlodychak said.

The various ways in which the states will enforce their nexus rules during the pandemic remain unclear. "In light of Covid-19 and what may be a changing workforce, it remains to be seen whether states will strictly enforce nexus based on the presence of remote employees as a matter of policy. Many states have issued Covid-19 guidance that would restrain the states from asserting nexus during a temporary period, but it is possible that Covid-19 changes the remote working landscape for years to come," Hedstrom said.

"If that happens, there may be a need for more long-lasting policy changes or federal action to ensure interstate commerce is not burdened. On the corporate income tax side, however, Congress has shown little enthusiasm for taking up such legislation. For example, the Business Activity Tax Simplification Act (BATSA) has been around for many years and has failed to achieve meaningful traction," he added.

Although experts seem to agree that some degree of uniformity would ease the compliance burdens taxpayers are currently facing, they are split on whether that is best achieved through federal legislation or simply state collaboration.

"I'm not sure that the pandemic itself has raised the need for these. I think it's raised the awareness of the crucial need for greater uniformity and consistency among the states," Rosen told Bloomberg Tax & Accounting.

Uniformity would require the states to communicate and coordinate, according to Huddleston. "It shouldn't be too surprising that states don't have a large degree of uniformity, and Covid-19 just absolutely demonstrates the problems of lack of uniformity at the state level. The states should find ways to work more closely together on some of the fundamental issues like filing deadlines, statutes of limitation, and other procedural issues. There's no really good reason why the states can't be much more uniform in the procedural issues relative to filing. And all that requires is them actually sitting down and doing it," Huddleston said.

The problems highlighted by Covid-19 reinforce the need for congressional approval, according to Ely. "We definitely need Congress to finally pass the Mobile Workforce Simplification Act, but now with an amendment contemplating an extension of the 30-day grace period for the next pandemic, etc.," Ely said. "I compliment the Illinois Legislature for passing a state-level safe harbor and encourage other states to follow suit," he added.

Some experts think that state cooperation is the more likely path to increased uniformity. According to Wethekam, "if anything is going to be achieved with some more uniformity, it's going to be the states working together. And I think even maybe Covid-19 will do that because they all are suffering from the same issues now. So it may drive them to work together, but there's always going to be an outlier."

Joseph Bishop-Henchman, counsel at McDermott Will & Emery in Washington, believes that legislative action may spur state cooperation. "Sometimes it takes the threat of Congress doing something to get states to get their act together," he told Bloomberg Tax & Accounting on June 1.

The Future of State Tax: A Myriad of Possibilities

Although it's unclear what the world, and the future of state tax, will look like post-coronavirus, one thing is certain: anything can happen to the state tax landscape in the months and years to come.

"I think the future holds problems from the perspective of states trying to figure out how to bridge this revenue gap over the course of the next couple of years. What it's likely to do is drive state tax reform efforts. So you'll see at the beginning states looking at the federal provisions that have changed and then trying to address those and decoupling from those that have negative revenue impact," Yesnowitz predicted.

Nicely also addressed the states' need to balance their budgets as a driver for future tax changes. "The immediate future is going to be about what the states do to balance their budgets and what are they going to look at, for trying to enhance their depleted revenue base? It'll be interesting to see more long term, is this going to be something that's going to cause states to look at tax reform and what do they need to do to make sure that they have a more balanced, taxing system that can handle a recession and also work in good times," he said.

"We tax practitioners must understand and maintain that grasp on new technologies and new industries because we must first and foremost understand our clients' businesses and how they are continually evolving. Nexus will continue to evolve," Ely told Bloomberg Tax & Accounting.

In addition to focusing on new technologies, some states may focus on increased enforcement actions, according to Darcy Kooiker, state and local tax partner at Armanino LLP in Seattle. "I think the states are buoyed by *Wayfair*. They think that they can do anything they want, that the Supreme Court upheld them. And I think they are going to be more aggressive in the future in terms of auditing," she told Bloomberg Tax & Accounting on June 1.

Others predict continued inconsistent state policies. "For better and for worse, the lack of conformity among the states is a constant," Johnson said.

"I suppose my plea for simplification, greater consistency, and uniformity across states is just not going to be particularly compelling or appealing and that we're going to see complexity grow," Harley Duncan, managing director, state and local tax at KPMG in Washington, told Bloomberg Tax & Accounting on May 26, echoing Johnson's thoughts about a lack of conformity.

In addition to a lack of conformity, others see a future of tumult and uncertainty. "During my career in state taxes, there's been tremendous change and tremendous confusion, and I would be willing to bet that in the years to come, we will see the same," Huddleston predicted.

"In sum, it's an exciting time to be focused on state tax. There is no shortage of compelling legal and policy issues nationwide. To sum up the future of state taxes in one word, I would say 'more': more decoupling from federal income tax; more variations on market-based sourcing; more efforts to expand nexus; more audits; more taxes on services; more attention to local taxes; and even more tax types, as gross receipts taxes seem to be having a moment, and more jurisdictions will consider," Hedstrom said.

As we wait to see what more is in store for state tax, the Bloomberg Tax Survey of State Tax Departments will remain a steady guide in a constant sea of change. Read on for the states' responses to questions addressing nexus policies and more.

Varying Nexus Policies Create Uncertainty as States Enact Factor Presence Nexus Standards

The nexus policy portion of the survey asks questions regarding each jurisdiction's nexus standard and the mechanisms used by the states to enforce it. There is a need for corporations and their tax advisers to determine nexus in a variety of contexts. In some cases, a corporation that started off doing business in only one state grows quickly and fails to recognize it may have triggered nexus in a number of states.

In other cases, a company may need to review the nexus positions it took in various states after it changes tax managers. A company might change an earlier position after deciding that the former tax manager either incorrectly concluded that the company was not subject to tax or pursued an overly aggressive nexus policy.

Theories Underlying Policies

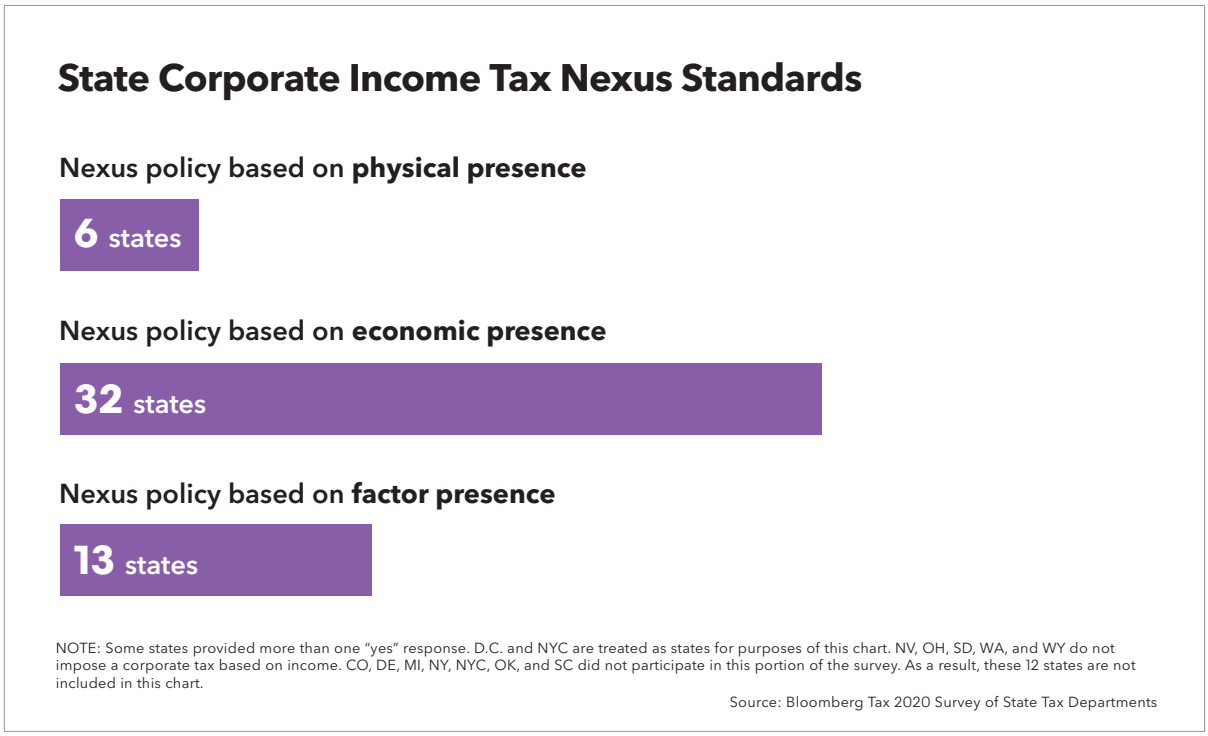
States typically follow one of three general approaches to make income tax nexus determinations. States that adhere to a physical presence standard base nexus on the presence of employees or property within their borders. States that adhere to an economic nexus standard consider nexus to be triggered merely by making sales into the state. States that adhere to a factor presence nexus standard base nexus on taxpayers exceeding a specified threshold of physical or economic presence in the state.

For state tax purposes, "nexus" generally means the threshold of contact that must exist between a taxpayer and a state before the state has jurisdiction to tax the taxpayer. The due process clause of the U.S. Constitution requires that there be some minimum connection between a state and the person, property, or transaction it seeks to tax. Similarly, the U.S. commerce clause, which governs the taxation of interstate commerce, requires that there be a "substantial nexus" between the taxed activity and the taxing state.

In addition to constitutional limitations, the states are further limited by Pub. L. No. 86-272, which prohibits states from taxing the net income of a business if its only activities in the taxing state consist of the "solicitation of orders" for the sale of tangible personal property, provided the orders are sent outside the state for acceptance and, if accepted, the goods are delivered from a point located outside the state. The Multistate Tax Commission (MTC) has published guidance designed to help states uniformly interpret and apply Pub. L. No. 86-272.

Survey Addresses Varying Corporate Income Tax Nexus Policies

Bloomberg Tax & Accounting asked each state if its income tax nexus policies are based on a physical presence standard, an economic presence standard, or a factor presence standard. Six states (three fewer than last year) responded that their nexus policy is based on physical presence, 32 states responded that their nexus policy is based on economic presence, and 13 states responded that their nexus policy is based on factor presence, nearly double the number of states that have actually codified such a standard.



Experts were surprised that these results were nearly identical to those in 2019, especially when it came to factor presence nexus standards.

"I would expect more states to adopt an economic nexus policy in the wake of *Wayfair,*" Clark Calhoun, partner at Alston & Bird, told Bloomberg Tax & Accounting.

"The responses are interesting. For example, Arizona, Kentucky, Maryland, Minnesota, Missouri, Virginia, and West Virginia are not states that are typically viewed as having adopted a true 'factor-presence' nexus standard. Some states, including Pennsylvania, have issued guidance effective for the 2020 tax year, so I would expect this list to continue to change," Hedstrom said.

"Whether they want to call that factor presence or they want to call it something else, I think that the end result of that is that there are more than 13 states that are actually using a form of factor presence," Huddleston told Bloomberg Tax & Accounting.

For Marcus, however, the low number of states utilizing a factor presence nexus standard is indicative of a larger question. "This raises a question of whether or not factor presence in and of itself is sufficient to create taxing jurisdiction. Why haven't more states jumped on the bandwagon? I think they're questioning whether or not that would be wise to do and whether or not it's sufficient," he said, adding that he does not personally believe it is sufficient to do so.

Physical Presence

On June 21, 2018, the U.S. Supreme Court's holding in *South Dakota v. Wayfair* overruled the physical presence requirement of *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992), leaving practitioners and taxpayers alike wondering how this would impact nexus rulings across all tax types.[1] For decades, a key constitutional question undecided by the U.S. Supreme Court has been whether the states must use the physical presence test established in *Quill* when making corporate income tax nexus determinations. Although *Quill*'s physical presence requirement has been overruled, it leaves a trail of state-level court decisions and administrative guidance on whether physical presence should be the standard for corporate income tax nexus.

In *Quill*, the Court declared that for a state tax to satisfy the requirements under the U.S. Constitution's commerce clause, the potential taxpayer must have a substantial connection with the state. In the context of sales and use tax collection obligations, substantial nexus meant that the potential taxpayer had a physical presence in the state, and that such physical presence was more than de minimis.

However, the Court left open the question of whether the same requirements for nexus apply to corporate income taxes. In the absence of clear guidance from the high court, many state appellate courts have found that an out-of-state corporation need not be physically present within their jurisdiction to establish nexus.

***Wayfair*'s Impact on Corporate Nexus**

Immediately following the Supreme Court's decision in *Wayfair*, the state tax landscape was abuzz with questions regarding what impact the holding would have on corporate income taxes. Now, two years later, most practitioners have seen minimal impact on corporate nexus standards and trends.

Robinson told Bloomberg Tax & Accounting that she doesn't think "it has actually changed policy that much. It was already an area where states were aggressive." She then went on to say that "on the taxpayer side, since *Wayfair*, we've added a *Wayfair* argument as a nexus defense in some matters."

"I don't think it was a monumental change, but I think it's given the states a greater level of confidence to ascertain nexus based upon just mere economic presence. I don't think this is any huge surprise or any sea change," Wlodychak told Bloomberg Tax & Accounting.

Marcus echoed Wlodychak's sentiments. "I personally haven't seen any impact yet, but I would expect that states are going to take the position that if you've exploited the marketplace in some way, then you would be subject to tax," he said.

"I thought that because of *Wayfair*, a slew of states would add factor presence nexus standards. And while some did back in 2019, and some did even without a legislative mandate, Pennsylvania being a perfect example of that, we have not seen the states by and large go that route this year," Yesnowitz told Bloomberg Tax & Accounting.

Other practitioners have seen a convergence of nexus standards for corporate income tax and sales tax following *Wayfair*.

"Most states apparently believe that since *Wayfair* lowered the nexus standard for sales and use taxes, then *a' fortiori*, the income tax nexus threshold should be the same or perhaps even lower," Ely said.

1 *See South Dakota v. Wayfair, Inc.*, 138 S. Ct. 2080, 2018 BL 219995 (2018) (holding that a bright-line physical presence standard is no longer a U.S. constitutional requirement for sales and use tax nexus).

"I'm seeing more consistent filing between the two tax types and more frequently taxpayers were saying 'if I'm filing a sales tax return there, I'm also going to file an income tax return there,' and vice versa," Friedman told Bloomberg Tax & Accounting.

For Hedstrom, however, "it is too early to definitively know the multistate impacts that *Wayfair* will have on corporate income tax nexus standards."

"Prior to *Wayfair* the prevailing consensus among states is that physical presence is not required for income and other business activity tax purposes. It is fair to say that *Wayfair* put an official end to the narrow question of whether physical presence was required to create substantial nexus for income tax purposes; but, it by no means resolved what constitutes taxable presence more broadly. I expect that there will continue to be debate on what constitutes substantial nexus at the margins and on particular fact patterns. It is very likely that taxable presence disputes will more frequently adjudicated through the lens of the Due Process Clause," Hedstrom explained.

Economic Presence

The first tribunal to wrestle with the issue of economic nexus was the South Carolina Supreme Court with its decision in *Geoffrey Inc. v. South Carolina Tax Dept.*, 437 S.E.2d 13 (S.C. 1993), cert. denied, 510 U.S. 992 (1993). In *Geoffrey*, the state supreme court, ostensibly utilizing the U.S. Supreme Court's analytical framework in *Quill*, held that an out-of-state corporation, Geoffrey, was subject to the state's income tax (and license fees) even though the company had no physical presence in the state.

After the U.S. Supreme Court denied certiorari to the *Geoffrey* taxpayer, several other state appellate courts have found that the physical presence standard established in *Quill* is limited to sales and use tax determinations. As a result, unless the U.S. Supreme Court rules otherwise or federal legislation is enacted, there is no uniform bright-line standard for determining whether substantial nexus exists for corporate income taxes.

Without clear guidance in this area, states and corporations often disagree on the level of economic activity within a given jurisdiction that creates substantial nexus.

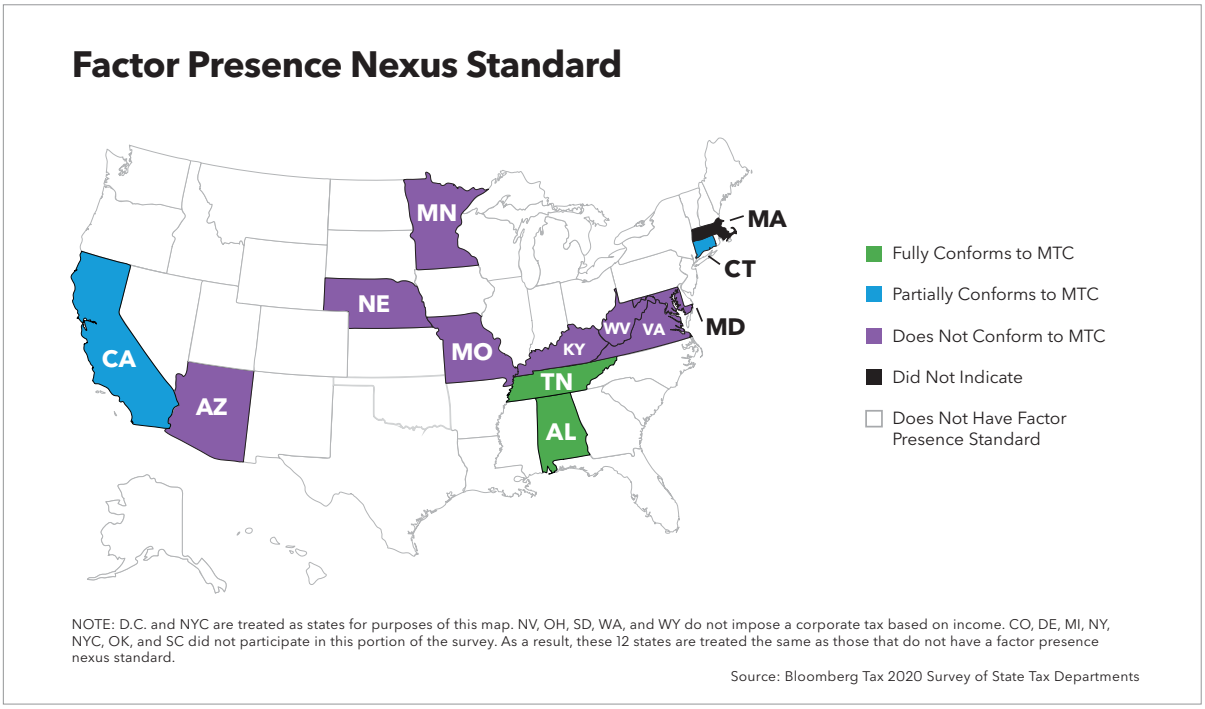
Factor Presence

The MTC's model statute on factor presence, Factor Presence Nexus Standard for Business Activity Taxes, uses both economic and physical presence to determine nexus. The model statute quantifies the level of activity that constitutes economic nexus. Nexus is triggered under this standard only if the following thresholds are exceeded during the tax period:

- $50,000 of property;
- $50,000 of payroll;
- $500,000 of sales; or
- 25% of total property, total payroll, or total sales.

We asked states whether they conformed to the MTC's model statute, Factor Presence Nexus Standard for Business Activity Taxes. Despite the model statute's purported benefits, adoption by states has been slow. According to this year's survey responses, only four states stated that their factor presence standard fully conforms (Alabama and Tennessee) or partially conforms (California

and Connecticut) to the model statute. Eight states, including Maryland and Virginia, said that their factor presence nexus standard does not conform to the model statute. Massachusetts did not specify whether it conforms.



We also posed a series of questions regarding the adoption of the MTC Statements on Pub. L. No. 86-272. Eleven states responded that they did not conform to any of the MTC's published guidance on Pub. L. No. 86-272. Of the remaining states, 11 stated that they were a signatory to the Phase I statement (with or without exceptions), and 13 stated that they were a signatory to the Phase II statement (with or without exceptions).

Survey Identifies Activities That Create Income Tax Nexus

In this year's survey, we asked the states whether nearly 140 different activities or relationships would create income tax nexus for corporations. We instructed the states to assume the listed activity or relationship is the only such activity or relationship that a corporation has in the state. The resulting responses highlight the states' different and often confusing application of nexus policies when determining activities that are sufficient to create nexus.

We asked states whether registering with a variety of state agencies would create nexus for the out-of-state corporation. Taxpayers may be relieved to hear that complying with their registration obligations is unlikely to create nexus in most states.

Registering to transact business in the state is the most likely type of registration to create nexus, with 13 states saying yes. Holding a specialty license or registering as a government vendor or contractor is also likely to do so in about a quarter of the states, with 10 and 12 states responding "yes," respectively. This year, we also asked whether registering with the state for sales tax purposes will create nexus for corporate income tax purposes. Only six states said it would do so.

Telecommuting and Other Non-Sales-Related Employee Activities

We asked the states a series of questions related to whether an employee working from home under various circumstances would create nexus. Although we've asked this question for many years, it's become particularly relevant as workforces nationwide went remote in an effort to slow the spread of the new coronavirus and some states decided to temporarily pause enforcement of their nexus provisions if employees are working remotely only because of the pandemic. Notably, this guidance would not be reflected in our survey responses, as the states were directed to respond based on their nexus laws as of Jan. 1, 2020, and most responses were received before the guidance was issued.

Despite the unique circumstances we currently find ourselves in, employers will want to pay careful attention to the location from which their employees are working remotely, as nearly every state responded that doing so creates nexus. Having a minimal number of telecommuting employees who conduct non-solicitation activities is enough to create nexus in 36 states. A similar number of states also responded that a single telecommuting employee would create nexus if they are performing back-office functions (33 states) or participating in product development functions (34 states).

Practitioners were not surprised by these results, especially when looking at them through a pre-coronavirus lens, but disagreed with the states' positions on whether employees performing non-sales-related tasks creates nexus.

"In normal times, I can understand that a telecommuter doing significant types of services for a business would result in a nexus requirement for businesses," Yesnowitz told Bloomberg Tax & Accounting. "The touch point is, it has to be beyond the de minimis types of services. It can't just be back-office administrative, non-selling types of services that the person performs," he went on to point out.

Marcus was also concerned with the number of states asserting nexus when the employee was not engaged in sales-related activities. "I've always had a problem with a state taking a position that a telecommuting employee who's not engaged in solicitation of any kind or in sales of any kind, who might be providing back office services of some kind, creates taxing jurisdiction," he said.

These responses may be particularly concerning given the numerous work-from-home orders issued by companies and state governments alike in the wake of the coronavirus, especially when employees will likely continue working from home well after states have reopened and employees are permitted to return to the office.

"Given this backdrop that states were already positioning themselves to assert jurisdiction over remote employees, even those performing administrative functions, and the business trend to have more and more remote employees, basically everywhere, I think companies better expect to be filing in more jurisdictions," Friedman said.

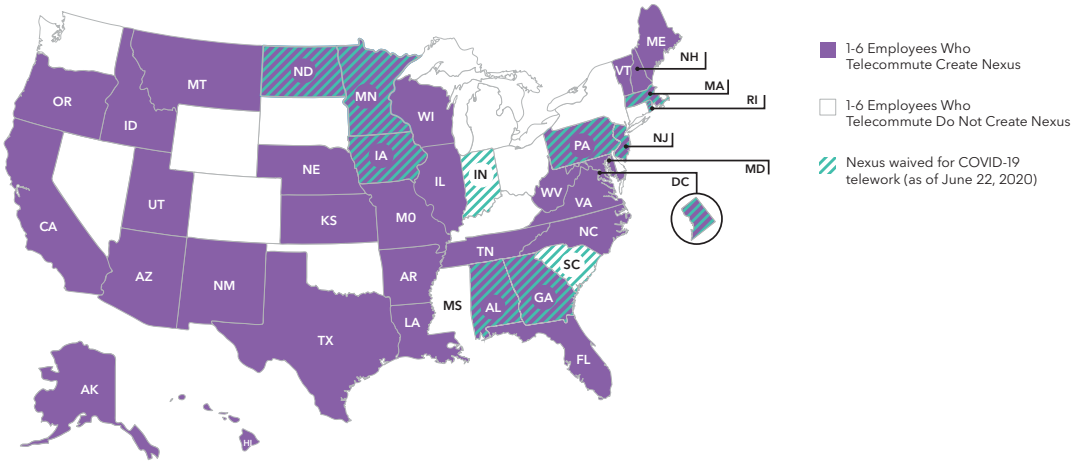
Wethekam predicts that the number of states responding "yes" to our telecommuting questions will increase next year. "I think you may see a shift in responses because I think you're going to see more nexus created by people working from home," she said.

States Hit Pause on Nexus During Pandemic

Some states have responded to the increased number of telecommuting employees by issuing administrative guidance stating that employees temporarily working from home in their state

because of Covid-19 will not create nexus. Other states, such as Illinois, Maryland, and New York, have continued to assert nexus over employees working from home, whatever the reason.

Will Telecommuting Employees Create Nexus?



NOTE: DC and NYC are treated as states for purposes of this chart. OH, NV, SD, WA, and WY do not impose a corporate tax based on income. CO, DE, MI, NY, NYC, OK, and SC did not participate in this portion of the survey. As a result, these 12 states are not included in this chart.

Source: Bloomberg Tax 2020 Survey of State Tax Departments

"As with most tax matters, the states' guidance varies greatly. Some states' guidance provides that the non-nexus telecommuting activity is only for the period of that state's work from home order, while other states' guidance is much broader. Taxpayers' biggest struggle will be tracking the various guidance and their employees' locations," Johnson told Bloomberg Tax & Accounting.

Despite the additional compliance changes created by the need to track and adhere to this guidance, experts believe that these states have taken positive steps in responding to the effects of the coronavirus. However, some are less confident about how they will respond going forward.

"I thought the states pivoted really well and the guidance was very clear considering the circumstances. I can agree or disagree with different policy positions, but at least it was pretty darn clear, and I've got to applaud the states for those responses this year," Wlodychak said.

"Given the widespread nature of teleworking, states may be willing to consider a change to their nexus rules after the declared emergency periods are over (or after a state determines that it is safe to return to the workplace). The relaxation by states of the nexus rules during the declared emergency periods are a reflection of policy decisions that emphasize the safety and welfare of employees. However, once these safety concerns are no longer present, states will inevitably focus on how to recover from the fiscal impact of Covid-19," Nair told Bloomberg Tax & Accounting.

"This, in turn, may encourage states to reassess their nexus rules on telecommuting, and, indeed, may also nudge them to take a more reasonable approach to imposing personal income taxes and withholding requirements on nonresident employees (and their employers) generally, consistent with the federal Mobile Workforce State Income Tax Simplification Act," Nair added.

"I am skeptical that states will — as a broad policy — relax nexus standards as applied to remote employees beyond what has already been articulated in guidance. There are certainly strong policy arguments for why they should in light of Covid-19, particularly true where remote work is/was effectively mandated by state so-called 'shutdowns.' But, many states have historically viewed the presence of a full-time employee as sufficient even prior to Covid-19 and barring administrative grace I expect states to continue their historic positions," Hedstrom told Bloomberg Tax & Accounting.

"The more compelling question, in my mind, is a prospective one. When the workforce possibly becomes more remote in a more general response to Covid-19, it remains to be seen how the states will approach that from a policy perspective. States will inevitably be facing budget shortfalls and it may be overly optimistic to assume that they will loosen nexus standards in the face of dramatic needs to raise revenue. That said, one could very reasonably argue that states should show restraint at least through 2020," Hedstrom added.

"A question arises when it becomes a matter of the employee's choice versus mandated working from home;I could see states start to change their policies, align with that, and start to say 'well, if you're doing this because you want to, or because the business model has changed, then we can now say that that's a nexus causing activity.' So there will be a line and it's going to be a very blurry line," Yesnowitz said.

Despite the uncertainty of how telecommuting will affect nexus determinations in the future, one thing is clear: this issue will continue to provide challenges for both tax departments and taxpayers alike. "Ultimately, we're going to see non-uniformity both on the state side, how they're administering, and on the taxpayer side in terms of how they're complying," Friedman said.

Hiring and Training Employees

We also asked the states whether a number of different activities regarding hiring and training their employees would create nexus. About half the states (20) said that holding job fairs, hiring events, or conducting other recruiting activities in their state would create nexus for the out-of-state corporation.

Hiring, supervising, or training employees in the state creates nexus for a majority of states. However, attending an annual training seminar, convention, tradeshow, retreat, or board meeting for up to 14 consecutive days each year will create nexus in only 12 states.

Sales-Related Employee Activities

States showed slightly more variety in their responses to employee sales-related activities. While 22 states responded that negotiating prices would create nexus, 14 states responded that it would not. Eleven states said that checking a customer's inventory for reorder was enough to create nexus, but 23 states responded that it would not create nexus.

States are split over whether a de minimis sale creates nexus, with 19 states responding that a single de minimis sale would create nexus, and 16 states responding that it would not. When it comes to one non-de minimis sale, however, there is much less variety in whether nexus is created. Thirty-seven states responded "yes," and only one state, Pennsylvania, said "no."

Ownership Interest in Pass-Through Entities

The states are uncharacteristically uniform in their treatment of pass-through entity ownership for purposes of creating nexus, with the vast majority of states agreeing that owning an interest in a

pass-through entity doing business in the state, no matter what type of ownership interest is held, creates nexus.

Over 80% of the participating states responded that nexus would be created when an out-of-state corporation owns any of the following pass-through entity interests:

- investment LLC or partnership interest (33 states)
- general partnership interest (38 states)
- limited partnership interest (33 states)
- management LLC interest (37 states)
- non-management LLC interest (33 states)
- disregarded entity interest (36 states)

In stark contrast to the majority position, ownership of a general partnership interest is the only ownership interest that would create nexus in Tennessee.

We also asked questions addressing whether owning an interest in an entity that generates only passive income would create nexus. When the entity limits its activities in the state to managing investment assets, 33 states said owning a managing interest would create nexus, but only 29 states said owning a limited interest would. In most states, an ownership interest in an entity that only manages real property located in state would create nexus. The type of interest owned was of little consequence in this case, with 34 states responding "yes" for a management interest and 33 states for a limited interest.

Trend Toward Market-Based Sourcing Continues; States Provide Industry-Specific Sourcing Rules

When preparing corporate income tax returns, a multistate corporation must use a state's apportionment formula to apportion a percentage of their business income to each state in which it has nexus. Traditionally, states used an equally weighted three-factor apportionment formula based on property, payroll, and sales.

As our nation's economy evolved from one heavily focused on manufacturing to a more service-based economy, the states' apportionment formulas evolved as well. The states now generally employ one of three main apportionment formulas: the traditional three-factor formula, a weighted three-factor formula placing extra emphasis on the sales factor, or a single-factor formula focusing solely on the sales factor.

When calculating the sales factor, receipts from sales of tangible personal property are commonly sourced to states using a different methodology than receipts from other sales, including receipts from leases, licenses, or rentals of tangible personal property, real property, services, intangibles, and cloud computing or software as a service (SaaS) transactions.

Under section 16 the Uniform Division of Income for Tax Purposes Act (UDITPA), which is used by nearly all the states, sales of tangible personal property are sourced to a state if the property is delivered or shipped to a purchaser, other than the U.S. government, within the state (destination-based sourcing). Sales of tangible personal property are sourced to the state from which the property is shipped if the purchaser is the U.S. government or the taxpayer is not taxable in the

purchaser's state (origin-based sourcing). Additionally, special sourcing rules may also apply when the property is purchased by the U.S. government.

For receipts other than those from sales of tangible personal property, states generally follow the cost-of-performance method, the market-based sourcing method, or a hybrid of the two approaches.

Cost-of-Performance

For years, nearly all states used the cost-of-performance rule when sourcing receipts from sales other than sales of tangible personal property, as set forth by the since-revised section 17 of UDITPA. Under the cost-of-performance rule, these receipts are sourced to a state if the greatest proportion of the income-producing activity is performed in the state.

While only a limited number of states still follow this approach, jurisdictions differ in the way this sourcing method is applied when the income-producing activity is performed in more than one state. The majority of these states use an "all-or-nothing" approach, where all of the receipts are sourced to a single jurisdiction based on where the greatest proportion of the costs of performance occur. Other states use a proportionate method, or pro rata approach, in which receipts from the income-producing activity are sourced proportionately to each state where the cost of activity occurs.

Market-Based Sourcing

Over time, states moved away from the cost-of-performance method and now source receipts from sales other than sales of tangible personal property using a market-based approach based on the state where the taxpayer's market for the sale is located.

Despite the majority of states now using a marked-based approach, practitioners generally believe that this trend will continue and eventually all states will make the shift away from cost-of-performance.

Hedstrom told Bloomberg Tax & Accounting that he believes "the market-based sourcing trend will continue, although it is likely the majority approach today."

"I would certainly hope this trend continues because cost-of-performance is very, very difficult to comply with or defend if the state raises the issue," Marcus told Bloomberg Tax & Accounting.

"I'm assuming that in-state businesses will be able to convince the remaining legislatures to enact market-based sourcing," Rosen said. "And when you do that with single sales factor, you've totally abandoned the underlying concept of an income tax. You're not paying tax to the jurisdiction that's providing the wherewithal to earn the income," he added.

Johnson agrees that "cost-of-performance states are definitely in the minority." Unlike other experts, however, she is not sure that market-based sourcing will continue to reign supreme. "With the difficulties of market-based sourcing emerging, I anticipate a new method emerging in the coming years, she said. "I wish I had the answer to what that would look like. It could be as simple as a new method of apportioning sales or it could be a new factor entirely," she added.

Many Approaches to Market-Based Sourcing

Although market-based sourcing continues to gain widespread acceptance, the implementation of this method varies greatly among market-based sourcing states and takes into consideration a number of different factors when determining the location of the market. Implementation of this

approach may also vary among categories of receipts within a single state. This variation adds additional complexities to any already difficult area of state taxation.

"The problem with saying that market-based sourcing by and large is uniform for everybody is that it's not uniform because market-based sourcing income comes with many different flavors," Yesnowitz told Bloomberg Tax & Accounting. "You can look at the billing location. You could look to where the location of delivery is. And so even the states that are striving for uniformity by going to one type of methodology, they're not really because that methodology can be performed in a number of ways," he added.

"There are subcategories within market-based sourcing that have proven to be troublesome. And frankly, perhaps even a bigger compliance and audit mess than cost-of-performance sourcing," Friedman said, adding that "we're going to continue to see a ton of litigation, a ton of audit issues on apportionment because of market-based sourcing and the states themselves, aren't really quite sure as to what they're doing with it."

"The lack of uniformity across the states in defining the 'market' makes it difficult to adopt a multistate approach. Even within a state and where guidance exists, there is considerable uncertainty and taxpayers are learning about the states' positions often 'live time' in the context of an audit," Hedstrom said.

To further complicate sourcing issues, some states apply different sourcing methods to different categories of receipts (e.g., receipts from services, intangibles, or cloud computing transactions), even when the different receipts are all considered receipts from sales other than sales of tangible personal property. Yet other states use the same sourcing method for receipts from all types of sales other than sales of tangible personal property, but will apply the method differently depending on the type of transaction from which the receipts arose. In many cases, states define "the market" and "cost-of-performance" differently, and taxpayers are left to interpret complex sourcing statutes.

Likewise, state tax departments are likely to protest that they are not getting their fair share if a taxpayer's aggregate sales factor is less than expected. This situation may occur when receipts are not sourced to any state because of variation in sourcing methods and rules between the states.

Market-Based Sourcing Principles Used When Applying Cost-of-Performance Rules

Recently, even those states retaining the cost-of-performance methodology have applied market-based sourcing rules to identify the location where an income producing activity occurred. This approach adds complications to an already challenging area of tax law.

"I think a substantial number of the cost-of-performance holdout states have decided that they want to get to market-based sourcing through a variety of methods, either interpreting cost-of-performance in a very aggressive nature or by saying that cost-of-performance is where the customer is located," Yesnowitz said.

"Are those states really, truly using cost performance?" Nicely asked. "You know, I think they do when it comes to their in-state on businesses that are providing services. But when it comes to out-of-state businesses, I think they do whatever they can to be able to stretch the cost performance to, in many ways, look like they're a market-based state."

No Matter the Method, Compliance Burdens Abound

The differences in sourcing methods and how they are applied "creates compliance issues," Wethekam told Bloomberg Tax & Accounting. "But also what it creates is the need to retain records for audits. You need to document what you're doing, whether it's cost-of-performance or market-based sourcing – the documentation may be different for those two. So I think you also have an administrative burden that can result from it," she added.

"The lack of uniform application of 'cost-of-performance' in those states that still utilize that language in their laws is a source of frustration and can undermine expectations and fairness. The different applications of market-based sourcing (e.g., look-through sourcing to customers or customers' customers) can also create inconsistencies and potential double taxation," Calhoun told Bloomberg Tax & Accounting. "Taxpayers and practitioners need to keep pressing for guidance and challenging assessments where states are applying rules inconsistently (e.g., seeking one application for one context and a contrary application in another context)," he said.

"It is critical for taxpayers to isolate the various revenue streams and proactively review their sourcing determinations. Documenting the approach before it is addressed on audit can put taxpayers in a far better position to defend against proposed adjustments," Hedstrom told Bloomberg Tax & Accounting.

Taxpayers must also make sure they are keeping up with the ever-changing state laws, not just their own documentation. "Having a tracking method is important; looking at the daily news every day is also important to make sure that states aren't changing their views on it. You're seeing some changes come about through case law. So the courts are coming up with decisions and coming up with potential different analysis of the issue, which is also important to track," Yesnowitz said.

Survey Identifies States' Apportionment, Sourcing Policies

As in previous years, we began by asking the states to identify which formula they use to apportion an out-of-state corporation's business income to their state. The sales-factor-only formula was most popular, with 27 states responding "yes." The traditional three-factor formula, a weighted three-factor formula, and an apportionment formula other than the traditional three-factor formula were all tied for second this year, with 12 states saying "yes" to each option.

General Sourcing Methods

We also asked the states to identify the general sourcing method used for receipts from sales other than sales of tangible personal property. In keeping with current trends, most states said they follow market-based sourcing rules. There was a steep decline in states that said they source receipts based on the costs of performance, with only six states responding "yes" this year, compared to 11 last year. Similarly, only seven said they apply a method other than cost-of-performance or market-based sourcing.

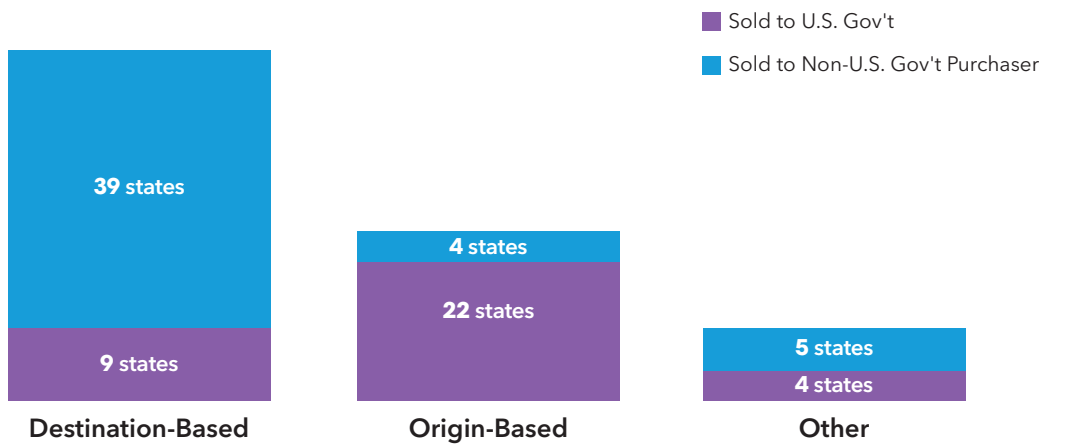
Alaska, Arizona, Utah, and West Virginia were the only states to select two of the three sourcing methods, but only Arizona explained the circumstances under which a different sourcing method was used.

Although these four states were the only ones who selected multiple sourcing methods, 15 states responded "yes" when asked whether they apply different sourcing methods to different categories of receipts. Slightly more states (19), however, said they do not do so.

After asking states to identify their general sourcing method, we asked them to identify the methodology used to source receipts from specific categories applicable to all businesses. We also asked whether receipts from a variety of transactions would be sourced to the state.

Sales of Tangible Personal Property

Despite the movement away from the traditional cost-of-performance sourcing rules provided by UDITPA § 17 for receipts from sales other than sales of tangible personal property, destination-based sourcing rules mirroring those in UDITPA § 16 continue to be used by almost every state for receipts from sales of tangible personal property. When asked whether they apply this method, nearly every state responded "yes." Only one state, Texas, said "no." Texas responded that it uses a sourcing method other than destination-based or origin-based sourcing but, when asked to identify what other method is used, it stated "sales of tangible personal property result in Texas receipts when the property is delivered in Texas to a purchaser, regardless of the ultimate destination of the property."



NOTE: Some states provided more than one "yes" response. D.C. and NYC are treated as states for purposes of this chart. NV, OH, SD, WA, and WY do not impose a corporate tax based on income. CO, DE, MI, NY, NYC, OK, and SC did not participate in this portion of the survey. As a result, these 12 states are not included in this chart.

Source: Bloomberg Tax 2020 Survey of State Tax Departments

Four states also indicated that they use origin-based sourcing, but three included a comment limiting the application of this rule to instances where the taxpayer was not subject to tax in the destination state.

The survey also asked questions differentiating between the rules used to source receipts from sales of tangible personal property purchased by the U.S. government from sales to non-U.S. government purchasers.

The states' responses to whether origin-based or destination-based sourcing is used when tangible personal property is sold to the U.S. government were generally the opposite of those for sales to other purchasers. Most states – 22 – said they use origin-based sourcing, with only a

limited number applying destination-based sourcing. However, 11 states, down four from last year, indicated that they do not have special rules for sales to the U.S. government.

We also asked the states to identify the sourcing methods used for receipts from each of the following categories:

- leases, licenses, or rentals of tangible personal property
- services
- intangibles
- cloud computing or software as a service (SaaS) transactions

This year's results show the ongoing uniformity among the states' sourcing rules for these receipts. When asked to identify their general sourcing method, 30 states selected marked-based sourcing, but only six chose cost-of-performance. Similarly, market-based sourcing reigned supreme among all four categories, proving that market-based sourcing is here to stay, despite the challenges in uniform application across the nation.

Services

In keeping with the current trends, market-based sourcing once again took the lead over cost-of-performance as the most popular sourcing method for receipts from sales of services. This year, the gap between market-based sourcing and cost-of-performance widened even more, with 26 states using market-based sourcing and 12 using cost-of-performance.

There were no states this year that responded "yes" to more than one sourcing method, a result that may reduce confusion regarding which method should be used in each state.

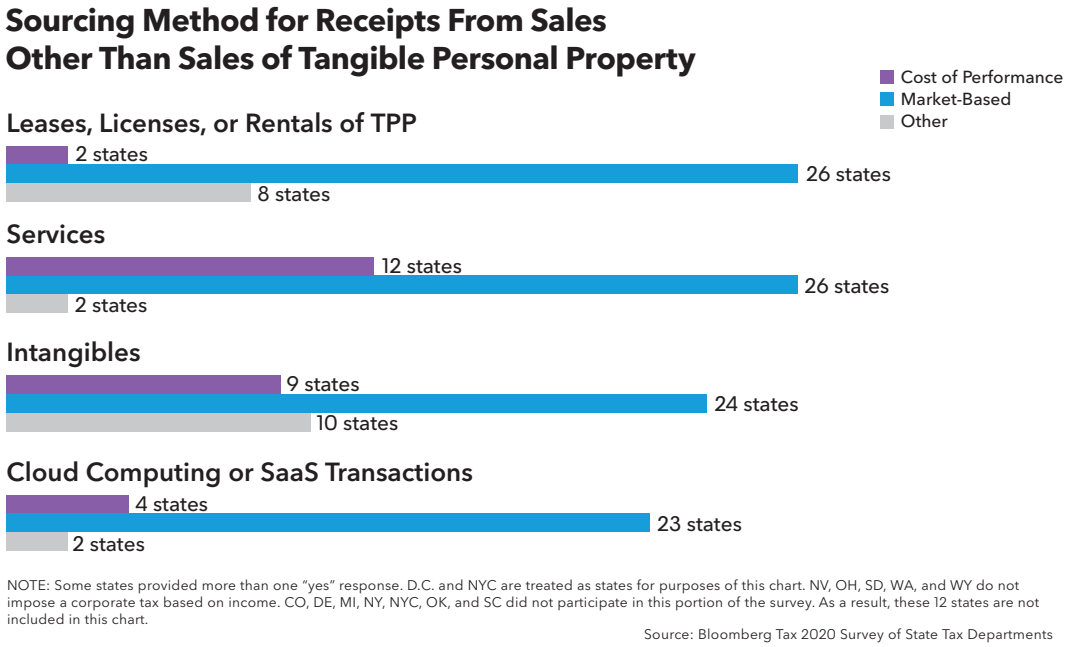
Intangibles

The response to which sourcing method is applied to receipts from intangibles mirrors the response for receipts from services. Again in 2020, market-based sourcing was used by most states, and the number of cost-of-performance states decreased.

By revising their answers to reflect only the use of market-based sourcing, Indiana and New Mexico further widened the gap between market-based states (24) and cost-of-performance states (9).

Some states indicated that they use multiple methods to source receipts from intangibles. For example, Alaska and Illinois said they source receipts using both cost-of-performance and market-based sourcing. Florida and Utah indicated that they use both market-based sourcing and a method other than cost-of-performance or market-based sourcing. Hawaii said it uses cost-of-performance and a method other than cost-of-performance or market-based sourcing.

Vermont may present an additional challenge for taxpayers sourcing receipts from intangibles. The state did not indicate the methodology used for sourcing these receipts and did not provide any additional information in the comments.



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Source: Bloomberg Tax 2020 Survey of State Tax Departments

Cloud Computing

In order to properly source receipts from cloud computing or SaaS transactions, a corporation must first characterize these receipts to determine which of the state's sourcing rules should be applied. As in previous years, we asked the states whether they characterize receipts from in-state customers that access an out-of-state corporation's software via a third-party's cloud infrastructure as receipts from sales of tangible personal property, leases, licenses, or rentals of tangible personal property, intangibles, or services. We also asked them to identify the method that is generally used when sourcing cloud computing or SaaS receipts.

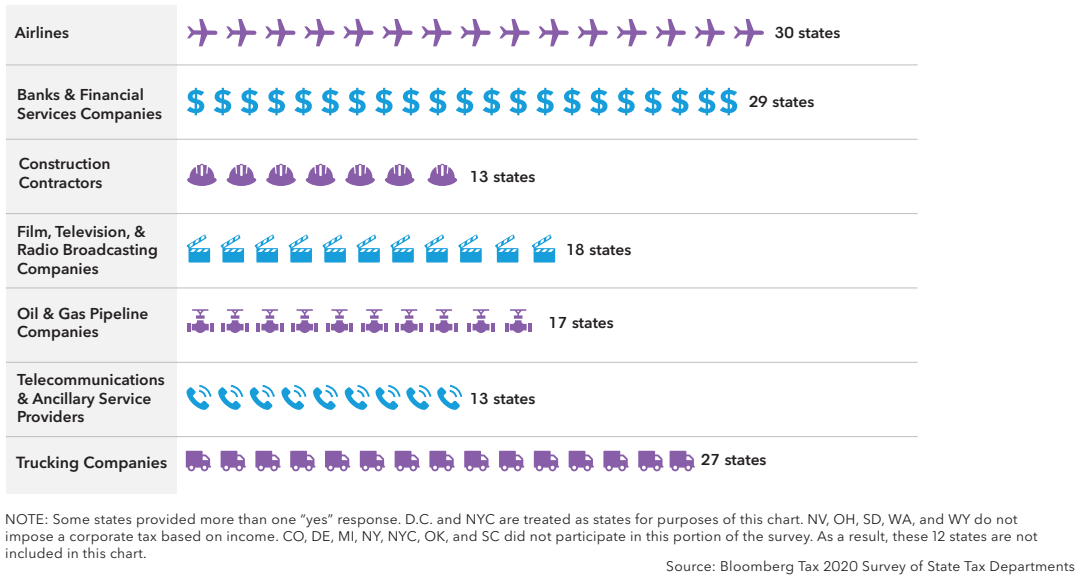
Receipts from cloud-based transactions are often characterized as receipts from services, with 15 states responding "yes" again this year.

Receipts characterized as a sale, lease, license, or rental of intangible personal property came in second with eight states, up one from 2019, indicating that they use this characterization.

The increased popularity of market-based sourcing is clearly demonstrated by the states' responses to questions addressing the sourcing method used for cloud computing receipts. Not only is it still the most common method used, but it also has the largest increase over cost-of-performance. Twenty-three states said market-based sourcing rules are followed, but only four states follow cost-of-performance rules.

Survey Results Identify Industry-Specific Sourcing Rules

We also asked the states to identify the sourcing methods they apply to receipts received by taxpayers in certain industries and to indicate whether those rules are industry-specific. As in previous years, we addressed industry-specific sourcing rules for seven different industries: airlines; banks and financial services companies; construction contractors; film, television, and radio broadcasters; oil and gas pipelines; telecommunications and ancillary services providers; and trucking companies.



Of these industries, the use of industry-specific rules was most common for airlines, with 30 states indicating they provide special sourcing rules.

Taxpayers in Florida, Iowa, and Oregon should pay careful attention to their state's sourcing rules. According to their survey responses, each of these states apply industry-specific rules for all seven of the industries addressed. Taxpayers in West Virginia, however, may only need to be familiar with the state's general sourcing rules. This year, it was the only state that said it does not have industry-specific rules for any of the seven industries.

Pass-Through Entities: States Take Varied Approaches Applying Corporate Tax Law Concepts, Reporting Requirements

Pass-through entities are the hybrids of business taxation: they are business entities for which tax liability is generally attributable to the amount of individual income tax imposed on partners, members, owners, or shareholders. However, states are increasingly applying corporate income tax concepts, such as business or nonbusiness income and apportionment, to pass-through entities operating in more than one state, and it is often unclear how these concepts are applied in each jurisdiction. The states also take different approaches on how they impose income tax on the gain recognized by the disposition of an out-of-state corporation's or nonresident individual's ownership interest in a pass-through entity that does business within their jurisdiction.

Another area of uncertainty arises from the varying mechanisms states use to collect tax from nonresident owners, members, partners, or shareholders of pass-through entities. There is little uniformity among the jurisdictions with respect to how these collection procedures are applied. Therefore, complying with each state's unique rules requires a careful analysis of each jurisdiction's laws.

Classification of Income

Twenty states said they require partnerships to classify income as business or nonbusiness income at the entity level. Fourteen states said they require such entities to make the classification at the owner level. States that said "yes" to both questions are Alabama, Arkansas, Hawaii, Kansas, Mississippi, Oregon, and Wisconsin.

In response to the question of how guaranteed payments to nonresident partners for professional or personal services performed in another state are classified, 17 states said they deemed them to be business income. The same 17 states also said that they would classify guaranteed payments to nonresident partners for other than personal and professional services as business income. Only Mississippi said it would classify these guaranteed payments as nonbusiness income.

Arizona did not answer these questions because it said it does not have a rule for classifying guaranteed payments. Guaranteed payments are treated like wages, the state said. "Compensation paid to individuals in the regular course of the taxpayer's business is included in the payroll factor. Compensation of individuals for activities that are connected with the production of nonbusiness income is excluded from the payroll factor," the state said.

Other states, such as North Dakota and Virginia, included comments explaining that they did not answer these questions because their state does not distinguish between business and nonbusiness income. Connecticut included a similar explanation but answered "no" to these questions.

We also asked the states whether they classified guaranteed payments for the use of capital as business or nonbusiness income. Fourteen states indicated that they classified guaranteed payments for the use of capital as business income. Those same states conversely responded "no" to the question of whether they classified guaranteed payments for the use of capital as nonbusiness income.

Apportionment

The method used by pass-through entities to apportion income and source sales receipts is another gray area among the states. According to their survey responses, 28 states require partnerships to apportion income at the entity level. Alabama, Hawaii, Indiana, New Jersey, and Wisconsin responded that income is apportioned at both the entity and owner levels.

Nearly every state said their sourcing method would remain the same regardless of whether the partners were individuals or corporations. Only Arkansas, Louisiana, and Minnesota said different sourcing methods would apply.

We also asked the states questions about apportionment of guaranteed payments, making a distinction between guaranteed payments for personal and professional services versus guaranteed payments for other types of services. The states' responses were tied this year, with 18 states requiring apportionment for such payments made for out-of-state personal and professional services, and 18 states requiring apportionment for guaranteed payments to nonresident partners for out-of-state services other than personal and professional services. Eighteen states also said they require apportionment of guaranteed payments to nonresident partners for use of their partnership capital in states where the partnership does business. A significant number of states did not respond to these questions, highlighting the confusion that exists with respect to apportioning partnership income.

"I continue to be surprised at the wide variation of answers on how the states apply their apportionment rules to Subchapter K entities," Ely told Bloomberg Tax & Accounting. "I just don't think some of the states have thought this through yet," he added.

Disposition of Pass-Through Entity Interest

A significant number of states said they would impose income tax on the gain recognized by the disposition of an out-of-state corporation's interest in a pass-through entity doing business in their state. For many of these states, the answer stayed the same for dispositions of a nonresident individual's managing ownership interest and a non-managing or limited partner-type ownership interest.

Composite Returns and Withholding

According to this year's survey responses, many states require pass-through entities doing business in the jurisdiction to withhold tax on the nonresident owners' distributive share of income derived, or connected to, in-state sources. Eighteen states said that they require withholding on distributive share payments made to nonresident individuals, while 14 said they require withholding for payments made to out-of-state corporations.

Seven states said they require composite returns to be filed on behalf of nonresident individuals, namely Alabama, Indiana, Louisiana, New Mexico, Oregon, Utah, and West Virginia. Each of those states also said they require an out-of-state corporation to be included on a composite return.

Additional administrative requirements await those who overpay tax. Twenty-eight states said they would require nonresident owners, members, or partners subject to withholding or composite return requirements to file a return to receive a refund of any amounts withheld. Three exceptions were Arizona, Florida, and Kentucky.

Pass-Through Entity Level Nexus

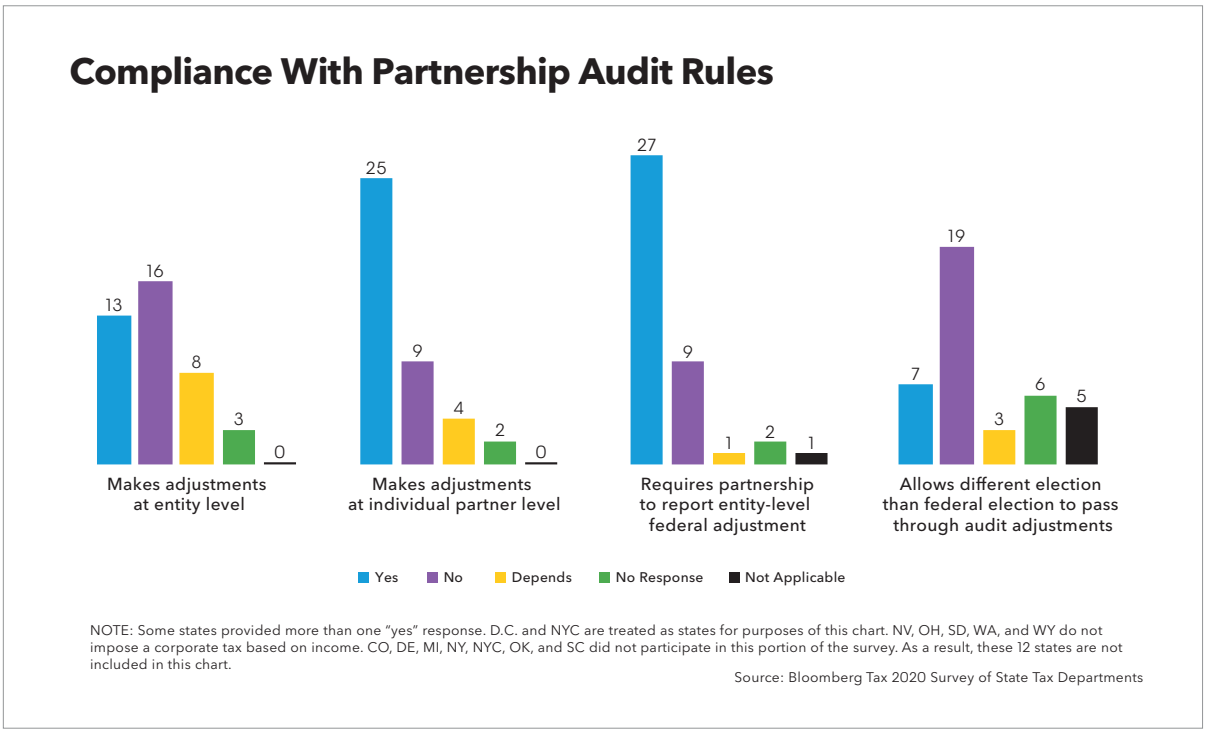
We also asked questions about entity-level nexus for pass-through entities. Based on their responses, most states make no distinction based on entity type with respect to whether an entity doing business in the state creates nexus.

Interestingly, 32 states said that a qualified subchapter S subsidiary (QSub) doing business in the state would create nexus for the parent S corporation. Only three jurisdictions – Alaska, the District of Columbia, and Texas – said that the activities of the QSub would not create nexus for the parent company.

Partnership Audit Rules

Finally, we asked the states to identify the extent to which they comply with the federal partnership audit rules.

First, we asked states whether they make adjustments, determine imputed tax, and assess and collect tax at the partner or entity level. Thirteen states responded that they conduct these activities at the entity level, while nearly double the number of states (25) said they do so at the individual partner level. Nine states, including Illinois and Pennsylvania, responded "yes" to both questions.



We also asked states how adjustments or elections at the federal level would affect compliance at the state level. While a majority of the states indicated that they require partnerships to file a report with their department of revenue if they receive an entity-level adjustment at the federal level, only a handful of jurisdictions (Arizona, the District of Columbia, Georgia, Oregon, Rhode Island, Utah, and West Virginia) responded that they would allow partnerships to make a different election from the federal election to pass through the audit adjustment to partners in the reviewed year.

States Provide Clarity on Ever-Changing Sales Tax Policy

When the majority of state sales tax systems were established in the early to mid-20th century, policy makers crafted their laws and rules to address relatively simple transactions, typically involving a seller furnishing tangible personal property or services directly to a buyer for consideration. Sales tax was generally collected at the point of sale.

Over time, however, the manner in which products and services are bought and sold has changed drastically because of advances in technology and the explosion of electronic commerce. These technological advances have posed new challenges affecting sales and use tax policy and procedure for a wide range of issues, including sourcing and tax collection.

Every year, the survey seeks to clarify the states' positions on sales tax policy issues by asking them to identify their positions in a number of uncertain areas. This year, in addition to topics covered in prior years, states answered questions about marketplace facilitators and sourcing for digital goods.

As Nexus Standards Shift, Compliance Complexities Increase

In response to the *Wayfair* decision, an increasing number of states have enacted their own versions of South Dakota's economic nexus standard. This does not mean, however, that physical

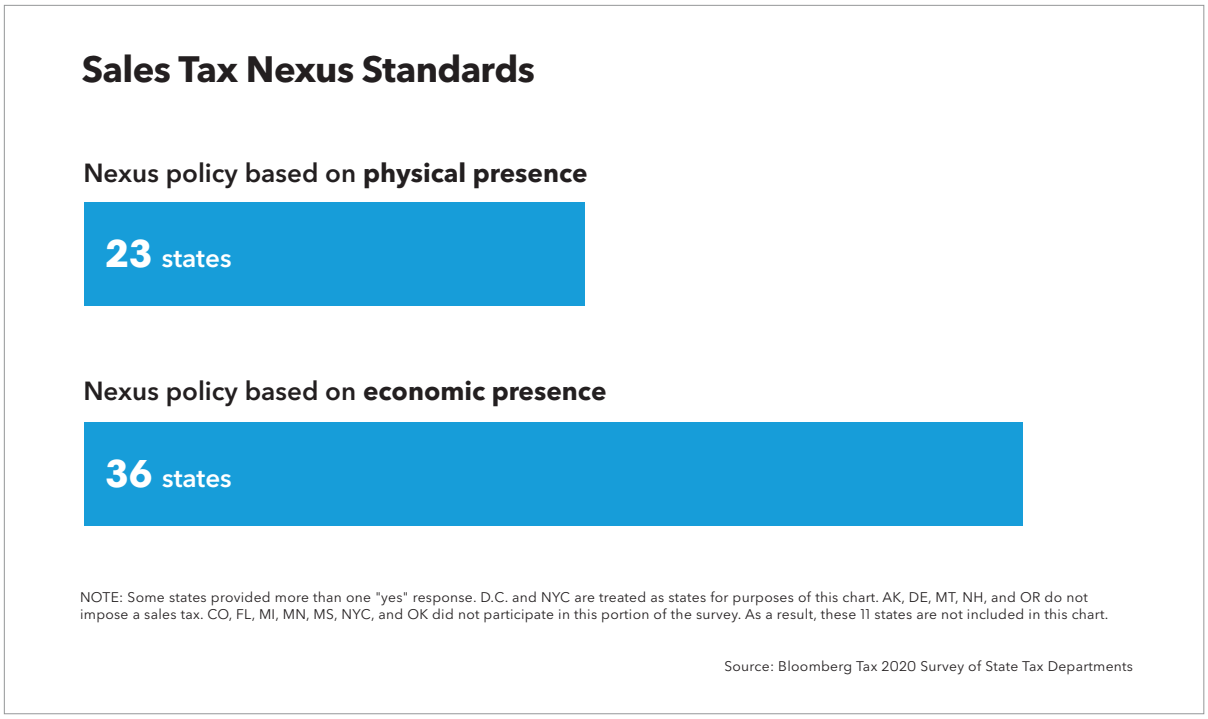
presence is gone for good. States that have not passed economic nexus legislation or regulations continue to apply physical presence rules for sales and use tax nexus purposes, and significantly, having a physical presence will generally still create nexus in states that have adopted economic nexus provisions.

As states continue to respond to *Wayfair*, taxpayers and practitioners must grapple with the effect these changes will have on the complexity of sales tax nexus and the related compliance issues.

Physical Presence vs. Economic Nexus

Given the swift pace of states adopting economic nexus standards since the *Wayfair* decision, we asked questions seeking to identify the state's current nexus standard. States' responses to these questions have changed dramatically since 2018, when the vast majority of states stated they had a physical presence standard and only 16 said they had an economic nexus standard.

This year, more than three-fourths of states that impose a sales tax (36) responded that their nexus policy was based on economic presence, an increase from 33 states in 2019 and more than double the number of states that said "yes" in 2018 (16 states). Further, the number of states using a physical presence standard dropped from 28 states in 2019 to 23 in 2020. Notably, 21 of these states also said "yes" to economic nexus.



Tax practitioners are split about whether this approach is a good thing. Huddleston said, "it just generates confusion when you look at a state that says they're a physical presence standard state, and then their regulations or audit standards are based on economic presence. It's very difficult to deal with. So much of that comes out of the audit process. We find auditors beginning to implement changing standards for their states when their historical and regulatory direction indicates a physical presence standard. So, it's very difficult."

Wethekam also felt that this could be confusing for taxpayers, stating, "if a state has adopted an economic nexus standard, and then they come back and say, 'but you have to have a physical presence here,' it makes no sense. Those two are inconsistent with each other."

Other experts felt that the overlap between economic nexus and physical presence was only logical. "There are different situations that require different nexus standards. If you're not a remote seller and you have a little bit of presence in the state, the physical presence test isn't dead because of *Wayfair*. You still have companies that are brick and mortar businesses that go into other states. And if they go in there, and they have physical presence, the Quill rule still lives with respect to that," explained Yesnowitz.

We also asked the states whether they have passed legislation creating an economic nexus standard that is not currently being enforced because of either the legislation's effective date or pending litigation. Four states – Georgia, Louisiana, Maryland, and South Dakota – responded "yes."

Of these four, Georgia and Maryland said their nexus policy is based solely on economic nexus, Louisiana responded that its policy is based solely on physical presence, and South Dakota indicated that their nexus policy is based on both physical presence and economic nexus.

Economic Nexus Threshold Calculations

The advent of economic nexus has not created uniformity among the states. The economic nexus thresholds vary from state to state. These thresholds describe the extent of sales made into a state, in terms of dollar amounts and/or number of transactions, needed to establish an economic presence in the state sufficient to require a remote seller to collect and remit the state's sales tax.

Beyond the differences in economic nexus thresholds, the standards have created new gray areas in determining how to apply economic nexus. States have different rules on which sales count toward the threshold (e.g., exempt or wholesale sales), and have varying time frames within which the thresholds are calculated. As more states implement economic nexus laws, an increasing number of taxpayers will require more guidance.

To help provide clarity on how states calculate the sales threshold used when determining whether a retailer has economic nexus with the state, we asked the states to identify the time frame used and type of transactions counted when determining whether their economic nexus sales threshold has been met.

Most states responded that they use sales made in the current calendar year (26 states) or previous calendar year (27 states) when determining whether economic thresholds have been met.

Fewer than 30% of the states that responded to this year's survey said they use sales made in a time frame based on something other than the calendar year in determining whether economic thresholds have been met. Nine jurisdictions (Arizona, the District of Columbia, Massachusetts, Mississippi, New Mexico, Tennessee, Texas, Vermont, and West Virginia) base their nexus threshold on sales made in the immediately preceding 12-month period. The District of Columbia, Massachusetts, New Mexico, and New York were also the only four jurisdictions that said they use sales made in the immediately preceding four quarters. Connecticut and Wisconsin said they include sales made over a different time frame, and both included additional commentary describing the time frame used.

We also asked the states whether the following transactions were counted when determining whether the out-of-state corporation has nexus with the state:

- wholesale sales (e.g., sales for resale) delivered into the state
- tax-exempt sales of tangible personal property delivered into the state
- sales of services delivered into or sourced to the state
- sales of items delivered electronically into the state
- sales of intangible personal property delivered into the state

According to the states' responses, sales for resale, tax-exempt sales of tangible personal property, sales of services, and sales of electronically delivered items are almost always counted when making an economic nexus determination. For example, 32 states answered in the affirmative when asked whether sales of tax-exempt items such as medical products are counted toward economic nexus thresholds. Sales of intangibles are counted less frequently, with only 15 states responding "yes."

For 2020, we added questions about whether sales of digital items accessed via the cloud (e.g., SaaS) and sales made through a marketplace count toward economic nexus thresholds. These options appear to be popular with the states, with most jurisdictions indicating that both would be counted. Our experts were unsurprised by these results.

"There isn't great guidance on what constitutes a 'transaction,' but it is not overly surprising that states are interpreting that concept broadly," said Hedstrom.

Marcus agreed, telling Bloomberg Tax, "the question I would ask is 'why not?' It's a transaction, just like any other transaction, and it seems to me that if you can identify the transaction, it should, in the state's view, count toward meeting the threshold."

Some practitioners are advising the states to be cautious when it comes to including cloud computing transactions in their economic nexus thresholds, however. Hedstrom also told Bloomberg Tax & Accounting that "it's unclear transactions of this nature would necessarily meet the constitutional standard if other factors were not met. The Supreme Court concluded that 'the [substantial] nexus is clearly sufficient based on both the economic and virtual contacts respondents have with the state.' In articulating this new, fact-based standard, it is interesting to note that the Court did not stop at 'economic' but added 'virtual.' Which begs the question, what is a 'virtual' presence? Where sales are solely made through a marketplace, is that 'virtual presence'? Is that sufficient?"

Wlodychak had concerns outside the constitutional issues raised by Hedstrom. "Do you want to impose a burden on an out-of-state retailer to collect if they really don't have a substantial portion of their sales from taxable sales? The questions states are raising are from the efficiency standpoint of administering their tax policy. Do they want to do the test based upon all sales in the state or just upon the taxable sales? And I think they're leaning in the right direction, which is only on the taxable sales. Why impose a burden on the taxpayer? If they're engaged only in exempt sales in the state, that doesn't make any sense, and it doesn't raise revenue for the state. It's not the due process test. It's just the efficiency of administering taxes. Why impose the tax burden on people who don't have a tax liability in the state?"

Nexus Enforcement Policies

This year, we continued to ask questions related to notice and reporting requirements for out-of-state retailers. Eighteen states, the same number as last year, responded that they require out-of-state retailers to report sales made within the state. Only five states said that they require out-of-state retailers to notify in-state customers of their obligation to pay use tax, down from the 10 states who answered "yes" last year.

The states were also asked whether they send a nexus questionnaire to retailers the state believes may be doing business within its borders and, if so, to identify the form number for the questionnaire. Thirty-two states stated they send a nexus questionnaire. Only half of these states identified the form number; however, some states, including Alabama and Maryland, said that their questionnaire does not have a form number.

Destination-Based Sourcing, Origin-Based Sourcing

Every state imposing sales and use taxes provides sourcing rules to identify the location of a sale and to determine which jurisdiction is entitled to the revenue generated from the transaction. Yet sourcing has become a complicated endeavor for taxpayers. Sourcing rules vary from state to state and may depend upon the object of the transaction; they may be further complicated by the type of transaction and mode of delivery.

As a practical matter, sourcing rules generally attempt to incorporate the destination concept in order to impose the tax where the good or service is consumed. However, a state may choose to source sales on either a destination basis or on an origin basis, or even vary rules for interstate and intrastate transactions.

Destination-based sourcing is often used for sales of tangible personal property, as the final destination of a transferred good can usually be determined. Because determining the destination of a sale of services can be difficult, some states use origin-based sourcing rules for those transactions.

Origin-based sourcing rules, on the other hand, are easily enforced but can lead to economic distortion as they often result in a destination state's receiving little or no tax.

In light of the varying rules for sourcing currently in effect throughout the country, Bloomberg Tax & Accounting asked the states to clarify their position with respect to specific types of transactions. State tax department personnel identified the sourcing rules in place for each state relating to interstate and intrastate sales of tangible personal property and services. The vast majority of states stated they use destination-based sourcing for interstate sales of tangible personal property, with only three states saying they use origin-based sourcing.

With respect to the sourcing of intrastate sales of tangible personal property, 20 states said they use a destination-based sourcing method, and nine states said they use an origin-based sourcing method.

Different Approaches to Sourcing Software, Cloud Computing

Technological advancements have made it necessary for states to address the application of sourcing rules to sales of software delivered via tangible media versus electronic download. States must now also address how to source amounts paid by customers to access software that is not actually delivered to the customer, as well as for the use of cloud-based software.

Varying state sourcing rules frequently provide that amounts paid by out-of-state customers to access software that is not physically delivered to the customer are sourced to: the location where the software is used, the location of the customer's billing address, the location of the server, or to another location such as the retailer's place of business.

Sourcing to the location of the seller is easier to determine and enforce both for sales of software and for Software as a Service transactions (SaaS). However, some taxpayers argue that the transactions should be sourced to the location where the customer uses, consumes, or takes possession of the software because this approach is more consistent with the consumption nature of the sales tax.

We asked the states to specify the method used to source amounts paid for software that is accessed by, but not physically delivered to, an in-state customer. Thirteen states said their sourcing method is based on where the software is used.

Only two jurisdictions – the District of Columbia and North Dakota – stated that they source based on the location of the server where the software is stored. Similarly, only Alabama, Iowa, Mississippi, and Utah said they source based on the billing address of the customer. Four states – Kansas, Maryland, Texas, and Wyoming – responded that they use a method other than the location of the server, customer's billing address, or location where the software is used, thus illustrating the huge variance that exists in this area.

Tax Collection in the Sharing Economy

The "sharing economy," also sometimes called the "on-demand economy," has created an opportunity for individuals who are not ordinarily in the business of selling to offer their homes, cars, transportation services, and other items for sale, use, lease, or rent to a global customer base through online platforms.

These third-party platforms handle the details, usually for a fee, of arranging the transactions between the buyer and the owner-seller or service provider. Many of these platforms have no ownership interest in the goods and do not directly provide the service offered for sale. Some third-party vendors, such as online travel companies, acquire hotel rooms or airline seats and then resell them to customers.

For goods and services flowing through the sharing economy that are subject to state and local sales and use tax, one of the major questions is: Who is responsible for collecting and remitting the tax due – the owner of the property, the provider of the services, or the third-party platform? Existing state tax laws and rules, drafted for a different era, often provide no clear answer for sales made as part of the sharing economy.

The survey posed a series of questions addressing who bears the burden of sales tax collection in certain sharing-economy transactions. Additionally, the survey sought to identify whether the owner-seller or the third-party platform was required to collect sales tax on transactions for the provision of short-term accommodations or short-term rental of the owner's vehicles. We also asked whether the third-party vendor or the driver was responsible for collecting the tax on transactions for the provision of transportation services. In addition, we asked states to clarify whether fees and commissions were included in the taxable price for short term accommodations and vehicle rentals.

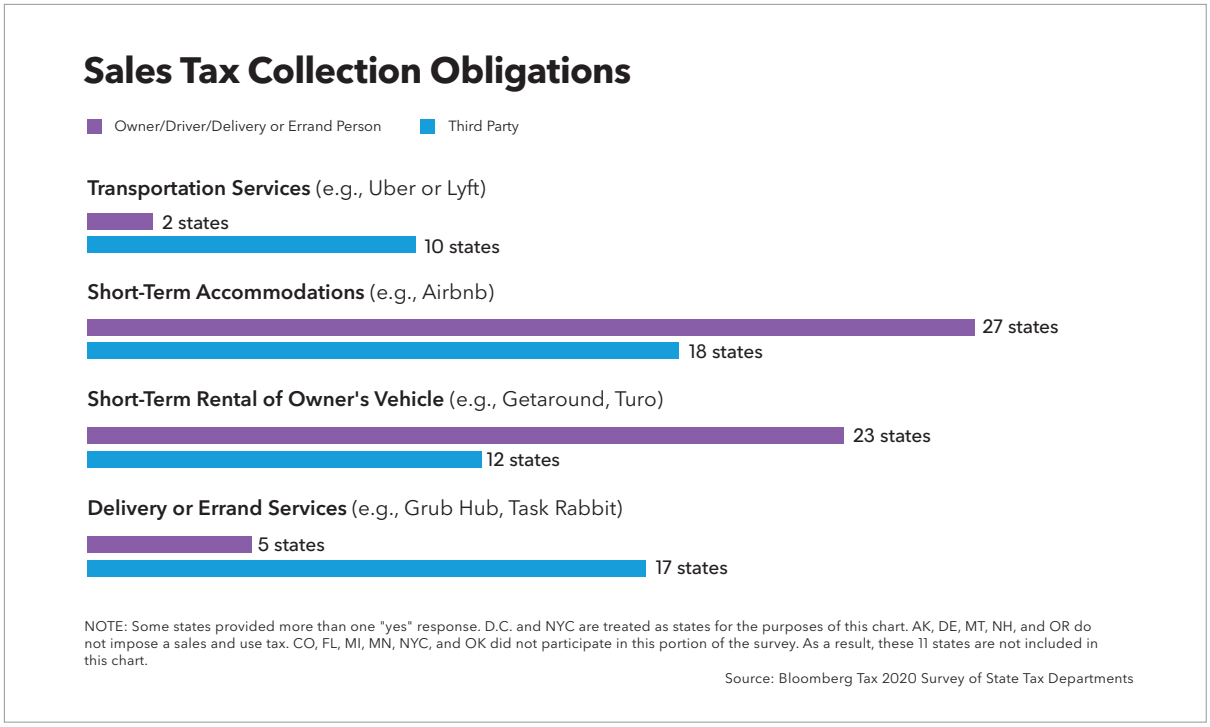
The states' responses were most closely aligned when it comes to imposing the tax collection obligation on transactions for the provision of short-term accommodations facilitated by a third party such as Airbnb. Twenty-two states said the collection obligation is imposed on the owner, and 25 states said they impose this obligation on the third-party facilitator.

States were split, however, on who must collect the tax on transactions for the short-term rental of an owner's vehicle facilitated by Getaround or another similar third-party vendor. Eighteen states responded that the collection obligation is imposed on the third-party vendor, and 19 states said it was imposed on the owner of the vehicle.

Surprisingly, only nine states responded that they impose the tax collection obligation on third-party vendors, such as Uber or Lyft, who arrange the provision of transportation services for passengers. Two jurisdictions – the District of Columbia and Ohio – said that they impose the sales tax collection obligations on the driver.

This year, we expanded our questions in this category to address delivery or errand services that are arranged by a third-party vendor, such as Postmates, Grubhub, and TaskRabbit. Sixteen states said that the third-party vendor is obligated to collect the tax, while only five said this obligation was imposed on the delivery or errand person.

We also asked the states to identify how they source amounts paid for deliveries to customers in the state. Significantly, fewer states responded to these questions than to other survey questions. Two states source these payments based on the location of the server, six states source them based on the customer's billing address, and four states source them to the location where the goods are used. The most popular sourcing method was something different than those described above, but only nine states selected this option.



Practitioners expect that more and more states will try to find ways to collect tax on sharing economy transactions, with some experts raising the possibility that these transactions will be classified as marketplace facilitator sales.

Calhoun told Bloomberg Tax & Accounting that "many states would contend that these are covered by their marketplace facilitator laws. There are a number of gaps in the application of those laws to the various aspects of those transactions (e.g., rates and service fees)." Marcus also said that sharing economy platforms are "not too dissimilar from a marketplace facilitator."

Marketplace Facilitator Transactions

Another area where we have seen rapid policy changes is the tax collection obligations of retail marketplaces. An increasing number of small sellers are using marketplace platforms to facilitate their sales of tangible personal property online. Due to their size, many of these sellers are unlikely to ever satisfy the nexus requirements of any state outside the place where they are headquartered.

However, the total sales by all small sellers made through these marketplace platforms represent a large amount of uncollected sales tax revenue. This has led to a push to require the marketplace facilitators to collect tax on behalf of all sellers using their platforms, raising questions about whether this burden should fall on sellers or marketplace facilitators.

For 2020, we asked a series of new questions aimed at illustrating the obligations of both marketplace facilitators and marketplace sellers. It is clear that marketplace facilitator laws have become very popular in a short amount of time, as 27 states responded that marketplace facilitators are required to collect sales and use tax on sales made over their platforms by marketplace sellers, provided they have nexus with the taxing jurisdiction.

This result does not absolve marketplace sellers of all administrative requirements, however. In over half of the states that require marketplace facilitators to collect sales tax on behalf of marketplace sellers (14), sellers are still required to register with the state taxing department and may have reporting or other administrative obligations.

Twenty-three states out of 27 stated that marketplace sellers are relieved of liability for tax that is supposed to be collected by a marketplace facilitator, but in 16 of those states, the liability can be shifted back to the seller under certain circumstances. This provision may prove troublesome for states down the road, according to Duncan.

"They did do a good thing about saying if [marketplace facilitators] rely on information from the seller, and if that's erroneous, then you're off the hook. Well, we all know the stories yet to be written there. When we get down to what's erroneous information, what's reliance, where's the error, and whose taxes. … So that will just be one way that plays out. I don't see states beginning to spell out those rules. Hopefully they're thinking about it, because it's only one audit away," he said.

Survey Identifies Activities That Create Sales Tax Nexus

The rules regarding the collection of sales and use taxes, a primary revenue source for many states, have become more difficult to comply with in recent years. This added difficulty is the result of sales transactions becoming more complicated and the increasing ease with which remote sellers can sell into a state without physical contact because of the internet. We asked the states questions

about 136 specific activities that may create nexus and instructed the states to assume the listed activity is the only activity the taxpayer has in the state. The states' responses as to whether various activities will create nexus revealed the complexity of sales tax nexus determinations as well as the broad variation among the states.

Remote Sales Exceeding Economic Nexus Thresholds

For the first time since the *Wayfair* decision, we asked whether exceeding certain economic nexus thresholds creates nexus. Twenty-nine states responded that annual sales totaling $100,000 or more would create nexus, while only one state, New Mexico, said that annual sales totaling less than $100,000 would create nexus.

Regarding transaction thresholds, 23 states said that 200 or more separate sales made into a state would create nexus, and 10 states responded that it would not. No states said that fewer than 200 transactions made into the state in a calendar year would create nexus, in and of itself.

The states' answers indicate that more of them rely on dollar thresholds than transaction thresholds. This may be a part of a larger trend. Yesnowitz told Bloomberg Tax & Accounting that he believes "a number of states will, over time, do away with the transactional threshold that was approved as an alternative to the sales threshold *Wayfair*."

Nicely agreed, stating, "I do think there will be a trend, which we've already seen occurring in a couple of states, of taking focus off the 200 transactions and just looking at the $100,000 threshold."

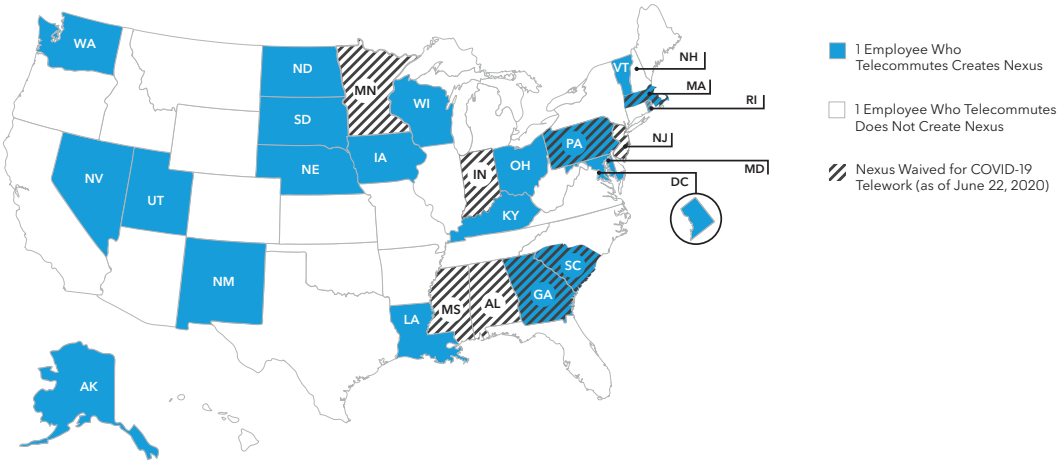
Yesnowitz feels that the future holds changes for the dollar thresholds as well. "I also think that the appropriate level of the sales threshold will continue to be evaluated. Some might decide that $500,000 is too much, and they will push that level down. Others might think the opposite. I think that there will be some changes to the numbers over time."

General Activities

We asked states a series of questions about whether general sales and business activities would create nexus. States were nearly unanimous in responding that reimbursing an in-state salesperson for the costs of maintaining a home office would create nexus. A large number of states, 35, also responded that storing inventory in state would create nexus for sales and use tax purposes. Potential nexus-creating activities involving telephone communications were less popular, with nine states saying that using a local phone number that is forwarded to a business's headquarters in another state would create nexus, and 10 states saying that being listed in a local telephone book would create nexus.

We also asked about telecommuting, and 20 states told us that one employee who performs back-office administrative business functions would create nexus if that employee telecommutes from a home located in state. However, taxpayers in some of these states may be off the temporarily off the hook. Several states, including Massachusetts and New Jersey, have issued administrative guidance indicating that employees temporarily working remotely because of Covid-19 will not create nexus.

Will Telecommuting Employees Create Sales Tax Nexus?



NOTE: DC and NYC are treated as states for purposes of this chart. AK, DE, MT, NH, and OR do not impose a state sales and use tax. CO, FL, MI, MN, NYC, and OK did not participate in this portion of the survey. As a result, these 11 states are not included in this chart.

Source: Bloomberg Tax 2020 Survey of State Tax Departments

Temporary or Sporadic Presence

While our questions don't specify in-person vs. online trade shows or seminars, a plurality of states responded that merely attending a trade show or seminar held in state was not enough to create nexus. In contrast, the majority of states said that holding at least two, one-day seminars in state was sufficient to create nexus.

Furthermore, once a sale is made in a state, temporary presence is more likely to cause nexus. Thirty-two states stated that making a sale or accepting orders at a trade show held in state was enough to create sales tax nexus. Thirty-five states responded that making sales while in the state for three or fewer days is enough to create nexus.

Click-Through Nexus

As electronic commerce continues to increase, the states are taking a closer look at whether arrangements with affiliates utilizing internet tools have the potential to create nexus.

Sixteen states responded that using an internet link or entering into a linking arrangement with a third party in the state is sufficient to create nexus if the relationship results in sales under $10,000. The number of states imposing nexus increases to 24 when the relationship results in at least $10,000 in sales.

Making remote sales into a state and hiring a third party to refer a customer via internet click-through is also enough to create nexus in 18 states, one state less than last year.

Digital Property

This year, the survey again attempted to ascertain what activities related to digital goods would create nexus. Overall, the majority of states stated that selling remote access to digital products in a state would not create nexus, despite continued growth in this market.

Fourteen states responded that selling remote access to canned software would create sales tax nexus, two more than last year. When the software is considered "custom," only nine states stated that remote sales would create nexus.

However, states almost unanimously agreed that nexus is created when a representative visits the state in order to customize canned software. Arizona, Nevada, Vermont, and Virginia were the only states that did not impose nexus under these circumstances.

Twenty-six states responded that the sale of data, such as music files, that is stored on an in-state server would create nexus, a result that seems to buck the general trend of states not viewing the sale of digital goods into a state as a nexus-creating activity. The trend continues to hold true for other remote sales of digital content, however, which are also unlikely to create nexus for the vast majority of states.

Seventeen jurisdictions, a substantial increase from last year's 11, responded that when the digital content is downloaded by residents of the state, nexus is created. The likelihood that sales of digital content would create nexus is lower when the digital content is accessed, but not downloaded, by residents. Twelve of the 17 jurisdictions would impose nexus on transactions with residents accessing content, with Alabama, the District of Columbia, Maine, and New Mexico responding "no" to accessing versus downloading digital content as creating content.

Similarly, selling the digital version of a tangible magazine or newspaper would not create nexus in a plurality of states.

Cloud Computing

In addition to asking questions about digital property, we also asked the states whether various cloud computing transactions would create nexus for sales and use tax purposes. Perhaps unsurprisingly, the results seemed to track with the states' responses regarding digital property.

Few states said that nexus is created when an out-of-state retailer charges in-state customers for the right to access, but not download, prewritten software (SaaS) that is hosted on a server in another state. However, the vast majority of states indicated that sending an employee into the state to perform initial setup services for non-downloadable prewritten software would create nexus, with 32 states responding "yes" to this question.

Cloud computing may be an area of potential concern moving forward. Regarding the in-state use of an out-of-state cloud services provider creating nexus, Friedman said that this is "getting to be a bridge too far."

He continued, stating that this implicates the "bounds of economic nexus. The survey results seem to be indicating is that there is no bound. There is no guardrail. There is no end if you're doing business with another company by buying services from it, not selling to it, but buying services from it. And that company has its own physical presence or own activities, or it engages with yet another company that it is consuming services from. Where does this end? Right now it seems like, at least for purposes of some states, there is no end. I really do think that some states think that everybody has nexus everywhere and that can't be it. It doesn't reflect reality."

Cookie Nexus

We asked questions addressing "cookie nexus," a concept that imposes nexus on an out-of-state retailer if the retailer requires visitors to its website to download internet cookies, or other similar items, onto computers or other electronic devices located in the state. The states' responses to this question followed the same trends seen with other forms of digital property, with the majority responding "no."

This year, four jurisdictions responded "yes," when asked whether downloading internet cookies would create nexus, the same number as last year. However, these answers represented different jurisdictions. In 2019, Hawaii, North Carolina, Ohio, and Rhode Island responded "yes," but this year, North Carolina and Ohio were swapped out for the District of Columbia and Nevada. Connecticut, Massachusetts, and Wisconsin shied away from taking a clear position either way, instead simply responding "depends."

Full Analysis Of Survey Responses Available By Request

In addition to the topics addressed within this Executive Summary, the Bloomberg Tax 2020 Survey of State Tax Departments also identifies the states' positions on state-tax addbacks, federal tax reform, combined reporting, tax treatment of non-U.S. entities, reporting federal changes, sales tax refund claims, qui tam and class actions, and local taxes. For an analysis of the results on these topics, and to see the states' responses to almost 700 different questions, request a demo to Bloomberg Tax.

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1801 South Bell Street, Arlington, VA 22202