Bloomberg Tax

Executive Summary: 2018 Survey of State Tax Departments

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

For the 18th consecutive year, Bloomberg Tax has sought to clarify each state's position on nexus by sending questionnaires to senior state tax department officials in the District of Columbia, New York City, and the 46 states that impose a corporate income tax. Bloomberg Tax also sent questionnaires regarding sales and use tax nexus to the 45 jurisdictions that impose a sales and use tax. In addition to nexus, the questionnaire asked officials about their state's tax treatment of pass-through entities and intangible holding companies, conformity to federal tax reform, methods of sourcing income, sales tax refund actions, requirements for reporting federal changes, sales tax nexus, enforcement, and collection policies. The states were also queried about their throwback/throwout rules, combined reporting regimes, and conformity to the Multistate Tax Compact.

Bloomberg Tax's annual survey offers insights for practitioners who must gauge whether a corporation's activities within a state could result in a tax assessment. Since guidance in the form of case law or statutes setting forth the types of activities that trigger nexus and taxability is lacking in many states, this survey fills in essential details.

However, because nexus determinations are fact-specific and subject to interpretation, the states' answers should not be relied upon as definitive policy statements. Even when a state indicates that the performance of a particular activity by itself would not trigger nexus, it is not always clear whether nexus might arise if any additional activity was performed in the state.

For the income tax portion of the survey, every state that imposes an income tax, plus the District of Columbia, participated this year, with the exception of Arkansas, Florida, New York, and Ohio. For the portion of the survey addressing sales and use tax nexus, all but six states that impose a sales tax, plus the District of Columbia, participated. Arkansas, Florida, New York City, Ohio, Oklahoma, and South Carolina did not participate.

New Additions

New portions of the survey this year cover topics such as conformity to federal tax reform, general apportionment and sourcing rules, and nexus for pass-through entities. There were significant additions to the sales tax policy portion of the survey with the inclusion of new questions regarding economic nexus and notice and reporting requirements. The survey was also expanded in its coverage of nexus-creating activities.

Key Findings

Corporate Income Tax Nexus

Up one from last year, 14 states indicated that their nexus standard is based on factor presence. Of these states, five indicated that they conform, in whole or in part, to the Multistate Tax Compact's model statute, Factor Presence Nexus Standard for Business Activity. Alabama and Tennessee indicated that they generally conform to the model statute, while California, Colorado, and Connecticut indicated that they only partially conform to the model statute.

This year, we asked states whether merely having a client in the state would create nexus. Sixteen states responded that having at least one client in the state would create nexus.

We also asked states whether storing inventory in a bonded warehouse for fewer than 30 days would create nexus. Twenty-seven states indicated that this activity would create nexus. This is 11 fewer than the 38 states that responded that storing inventory in a public warehouse for fewer than 30 days would create nexus.

Response to Federal Tax Reform

New for 2018, we asked states about their reactions to federal tax reform. Very few states responded to these questions, however, 21 states indicated that they had already begun planning for or preparing a study or analysis of the revenue impact federal tax reform would have on their state.

Apportionment & Sourcing

For the first time, we asked states to identify their general apportionment formula. It should come as no surprise that a single-factor apportionment formula based on sales only was the most popular response.

We also asked states to identify their general sourcing method used to source receipts from sales, other than sales of tangible personal property. Twenty-two states indicated that they used a market-based sourcing approach, while 12 states indicated that they used a cost of performance approach. Seventeen states indicated that they apply different sourcing methods to different categories of receipts.

We asked states to identify the sourcing method used to source receipts from cloud computing or Software as a Service transactions. Nineteen states indicated that they use market-based sourcing, nine states reported that they use cost of performance, and four states said that they use a sourcing method other than cost of performance or market-based sourcing.

The survey also asks states whether they have industry-specific sourcing rules for a number of different industries. According to this year's responses, the most popular industries for which states have special sourcing rules are airlines (32 states), trucking companies (31 states), and banks and financial services companies (30 states).

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 two states indicated that they classify 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-seven states indicated 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. Eighteen states indicated 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.

Thirty states indicated that nonresident owners/members/partners subject to withholding or composite returns must file a return to receive a refund of amounts overwithheld.

This year, we asked states about the nexus implications of a Qualified Subchapter S Subsidiary (QSub) doing business in the state. Twenty-nine states indicated that a QSub doing business in the state would create nexus for the parent company.

Sales Tax Nexus

For the first time this year, we asked states to opine on their sales tax nexus policy. Sixteen states indicated that they have an economic presence standard for sales tax nexus. Six states indicated that they have an economic nexus standard that is not currently being enforced due to the legislation's effective date or pending litigation.

This year, we also asked states about notice and reporting requirements for sales and use taxes. Eleven states indicated that they require retailers to report sales made within the state. Seven states indicated that they require retailers to notify in-state customers of their obligation to pay use tax.

In addition to questions on nexus policy, we also asked states about "cookie" nexus. Only two states indicated that requiring visitors to download internet cookies onto electronic devices would create nexus.

Bloomberg Tax Answers The Call For Clear Compilation Of State Approaches

The state tax arena is fraught with variation, complexity, confusion, and ambiguity. The Bloomberg Tax survey provides a comprehensive comparison of each state's polices in areas that can be troublesome for multistate taxpayers. Unfortunately, as the survey shows, many states' policies in these areas are still being developed. To add madness to the mayhem, states lack uniformity in the interpretation and application of overarching principles in state taxation. It remains unclear, however, whether the creation of uniform rules would be the best solution.

"Assisted by state legislatures passing laws, the state tax departments continue to be very assertive in discovering and requiring out-of-state businesses to be subject to their taxes," Fred Nicely, a senior tax counsel for the Council on State Taxation, told Bloomberg Tax on March 26.

"The survey continues to be a wonderful tool for both states and taxpayers/tax practitioners to identify a particular state's position on nexus/apportionment/sourcing issues and compare it to the positions of other states," Richard Cram, director of the Multistate Tax Commission's National Nexus Program, told Bloomberg Tax in an April 5 email.

Wide Variety in State Tax Policies

Many practitioners attribute the diversity in state tax policy to the nature of a multistate system. "As Justice Brandeis put it, the states are the `laboratories of democracy,'" Joseph Bishop-Henchman, Executive Vice President of the Tax Foundation in Washington, D.C., told Bloomberg Tax in an April 6 email. "The case in which he said that involved a stupid state law establishing a monopoly for ice manufacturing. This survey shows there are still lots of stupid state laws, and that a lot of smart people spend a lot of money navigating them," Henchman said.

"The variety across states is a function of our institutions: 50 states deciding their own tax systems; 99 legislative bodies with 7,000+ legislators; and 50 unique different state economies. Each of those representative institutions fashions a tax system that fits well with their economy and creates incentives or avoids disincentives to create investment in that economy." Harley Duncan, a state and local tax managing director in KPMG's Washington National Tax Practice, told Bloomberg Tax on March 30. "Dealing with all differences and nuances is complex," he added.

"While much of the blame can be based on the United States' roots in federalism, Congress is also to blame for not requiring the states to have more uniform laws to impose their taxes against interstate businesses," Nicely told Bloomberg Tax on March 26.

This disparity may also be economically motivated, with states seeking to entice certain taxpayers to invest in their state. "Given that each state's tax system is shaped by the unique social and political landscape found within its borders, it is not unusual to see state tax policies run the spectrum. There are unique sets of factors at play in each state that lead to varying state tax policies," Priya D. Nair, a state and local tax manager at Grant Thornton's National Tax Practice in Washington, D.C., told Bloomberg Tax in an April 6 email.

"I think in the end a lot of states are just trying to close budget gaps and they are trying to do so in a manner to export their tax as much as they can. Most states, I think, prefer to give their own domiciled business a break and shift as much of the tax burden onto out of state business. That tends to lead towards disparate and aggressive nexus policies," Brian Kirkell, a principal with RSM US LLP's Washington National Tax Office, told Bloomberg Tax on March 30.

Variety Leads to Complexity

No matter the reason behind the patchwork of state tax policies, taxpayers and practitioners must be aware of the added complexity when complying with each state's rules. "While these variances reflect the freedom of a state to shape its tax policies in a way that best suits their objectives, it creates compliance complexities for multi-state taxpayers," Nair told Bloomberg Tax.

"The lack of uniformity creates compliance costs both for the tax departments and for taxpayers. Given we live in a world of international competition, this state tax complexity can make conducting business in the US more expensive than doing it abroad," Nicely said.

"The inconsistency in state tax policies certainly create uncertainty for taxpayers who may not be able to obtain a definitive answer unless they obtain a private letter ruling, which taxpayer may be reluctant to do," Sylvia Dion, founder and managing partner at PrietoDion Consulting Partners LLC in Westford, Mass., told Bloomberg Tax on April 3.

Uniformity: A Goal or a Flawed Reality?

One potential solution to the challenges stemming from the variety in state tax policy may be a uniform nexus standard. What that standard should be and how it may be achieved, however, remains unclear.

"State and local tax compliance has continued its trend of being overly complicated. While strict uniformity can create issues, minimum standards are needed," Nicely said, adding that "there is a dire need for federal legislation."

"In 1959, Congress passed Public Law 86-272, setting a temporary rule for door-to-door sales nexus and establishing the Willis Commission to recommend permanent changes. That report came out a few years later and recommended conformity in tax bases, uniformity in administration, and whatever the states want on rates. States recoiled in horror and convinced Congress that the law was unnecessary because they (the states) would set up the Multistate Tax Commission which would solve all those issues soon. And here we are, 51 years later with all those problems now worse," Bishop-Henchman told Bloomberg Tax.

"I predict increasingly determined federal uniformity legislation in the next 10 years, although it won't be one giant bill but an issue at a time," Henchman added.

"I think the states should have a consistent nexus standard," Bruce P. Ely, a tax partner at Bradley Arant Boult Cummings LLP in Birmingham, Ala., told Bloomberg Tax on April 2, before explaining what he'd like to avoid and how he thinks change may occur. "I'm not a fan of factor presence nexus. I think that is a cookie cutter response answer to a much more fact intensive analysis. I'd like to see uniformity among the states, but apparently the MTC can't convince its members. Perhaps Congress can, if they step in after *Wayfair* and try to mandate some level of uniformity between the states. Call me crazy, but that's the only way we'll ever achieve uniformity, since the states are quite defensive of their sovereignty," Ely said.

Some practitioners believe we already have a uniform nexus standard, albeit one that is not being applied uniformly.

"In a perfect world, the answer [to whether there should be a uniform nexus standard] should be yes, because last time I looked every state should follow the Constitution. In reality, will it happen? No," Marilyn A. Wethekam, a partner at Horwood Marcus & Berk in Chicago, told Bloomberg Tax on March 27.

Kirkell agreed with Wethekam. "Maybe the right answer is that every state does have the same nexus standard but they are all in denial." Kirkell said, adding that the same standard is "the Constitutional principles enumerated under due process clause and the commerce clause."

"They do [have the same standard] as a baseline matter— in other words, U.S. constitutional parameters apply uniformly to each state. What those standards are remains in flux, as must be the case given that our courts interpret and apply the Constitution as a `living document'," Kendall Houghton, practice group leader for Alston & Bird's State and Local Tax/Unclaimed Property practice in Washington, D.C., told Bloomberg Tax in an April 4 email.

"Now, if a state chooses to define a nexus standard that falls short of the furthest reach of Constitutional boundaries, then such non-uniformity—evidenced by various degrees of self-restraint, as it were—is an appropriate exercise of states' rights under a federalist regime, whether the variable state statutory standards are informed by economic, political, legal, or policy considerations," Houghton added.

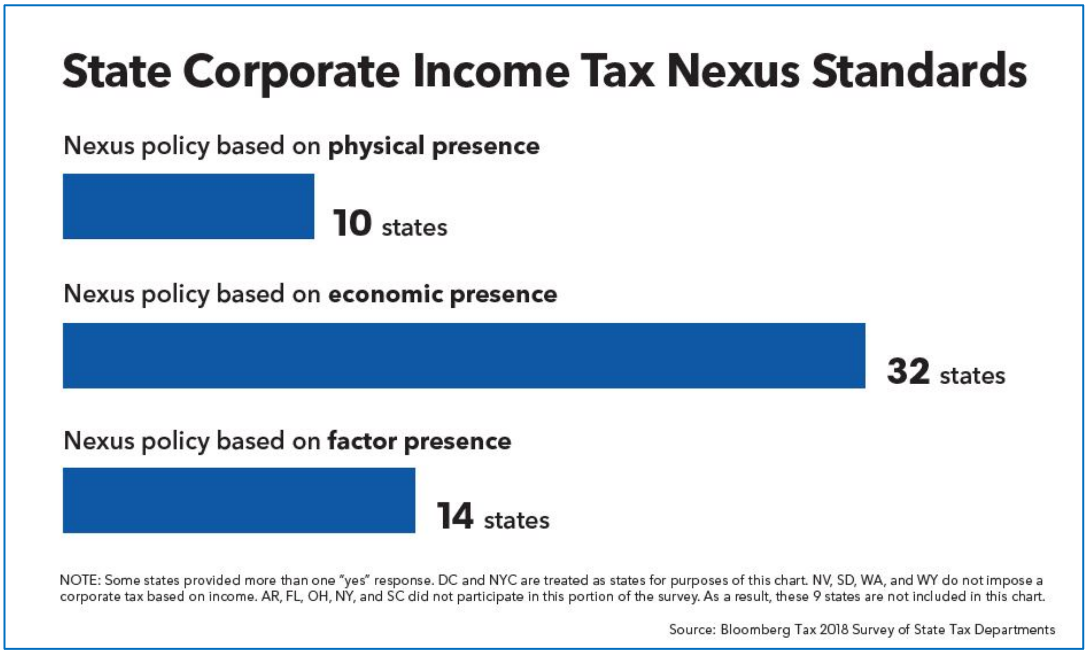
Until the day comes when states can all agree on a uniform set of state tax principles, the Bloomberg Tax Survey of State Tax Departments will remain a steady guide in a constant sea of change. Read on for the states' responses to questions addressing nexus policies and more.

Varying Corporate Income Tax Nexus Policies Create Uncertainty as States Enact Factor Presence Nexus Standards

The corporate income tax nexus policy portion of the survey asks questions regarding each jurisdiction's nexus standard and the mechanisms used by the states to enforce them. There is a need for corporations and their tax advisors 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 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.

Bloomberg Tax 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. Ten states indicated that their nexus policy is based on physical presence, 32 states indicated that their nexus policy is based on economic presence, and 14 states indicated that their nexus policy is based on factor presence, nearly double the number of states that have actually codified such a rule.

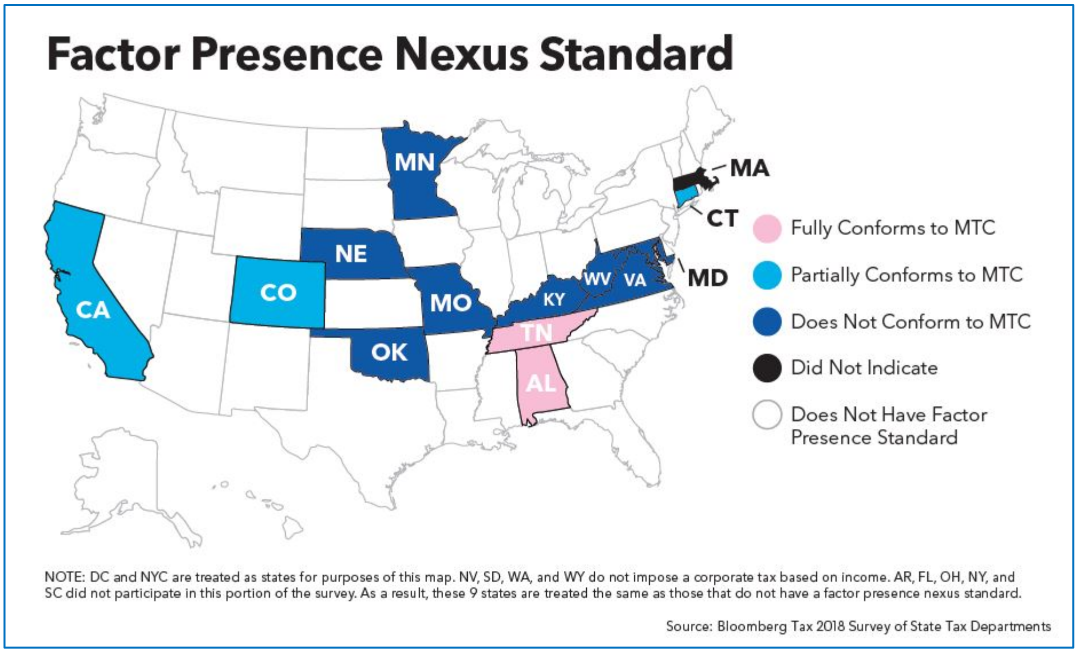


"It is interesting that some states without a clearly expressed law assert they are using factor presence nexus. One of the benefits of this survey is being able to obtain that view from a tax department, but it also is important to note that it is subject to challenge," Fred Nicely, senior tax counsel for the Council On State Taxation (COST), told Bloomberg Tax on March 26.

"This shows the state tax departments, even without clear legislative support, want to use an economic presence standard to require out-of-state businesses to be subject to their taxes. On the other side of the equation, it is beneficial, if a state uses it that way, to make it clear a state will not assert an tax imposition on a business if it falls under a state's factor nexus threshold (e.g., use it as a safe harbor)," Nicely said.

While Nicely was surprised that the number of states saying they use a factor presence nexus standard was so high, Joseph Bishop-Henchman, Executive Vice President of the Tax Foundation in Washington, D.C., told Bloomberg Tax in an April 6 e-mail that he was "surprised it's that low, since factor presence is tax speak for `we know it when we see it.'" "What tax administrator wouldn't dream of `I know it when I see it' as the rule they get to enforce? Luckily most states don't let things get that far," he added.

We then 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 five states indicated that their factor presence standard conforms (Alabama and Tennessee) or partially conforms (California, Colorado and Connecticut) to the model statute. Eight states, including Missouri and Oklahoma for the first time, said that their factor presence nexus standard does not conform to the model statute.



We also posed a series of questions regarding the adoption of the MTC Statements on Pub. L. No. 86-272. Eleven states indicated that they did not conform to any of the MTC's published guidance on Pub. L. No. 86-272. Of the remaining states, 10 indicated that they were a signatory to the Phase I statement (with or without exceptions), and 12 indicated that they were a signatory to the Phase II statement (with or without exceptions).

In addition to these questions on nexus standards and adoption of the MTC Statements on Pub. L. No. 86-272, we also asked questions about nexus enforcement and trailing nexus.

Survey Identifies Activities That Create Income Tax Nexus

In this year's survey, we asked the states about almost 140 different activities or relationships that could potentially 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' variable and often confusing application of nexus policy when determining activities that are sufficient to create nexus.

This year, we asked states whether simply having a single client in the state would create nexus. Sixteen states responded that it would do so.

We also asked states to distinguish between public warehouses and bonded warehouses when determining whether storing inventory or goods in a warehouse for fewer than 30 days per year creates nexus. Nearly all states (38) said storing inventory in a public warehouse creates nexus. Fewer states (27), but a still majority, said nexus is created when using a bonded warehouse.

Non-Sales Related Employee Activities

As in previous years, we asked the states a series of questions relating to whether an employee flying into the state under various circumstances would create nexus. First, we asked whether flying into the state on a commercial airline for business purposes would do so. Twenty-one states responded that this would create nexus for the corporation. The states' answers remained the same regardless of the number of flights (one to four vs. five or more) that the employee took during the year.

Flying into the state on a company plane is significantly less likely to create nexus. Only four states indicated that having an employee fly into the state on a company plane to attend a seminar would create nexus. Flying into the state on a company plane to attend sports events between four and 10 times per year was slightly more likely to create nexus, with six states responding "yes."

Having a minimal number of telecommuting employees who conduct non-solicitation activities is enough to create nexus in 38 states. A similar number of states also indicated that a single telecommuting employee would create nexus if they are performing back-office functions (37 states) or participating in product development functions (36 states).

Sales Related Employee Activities

States showed slightly more variety in their responses to employee sales-related activities. While 24 states indicated that negotiating prices would create nexus again this year, 16 states indicated that it would not. Fourteen states (up one from last year) indicated that checking a customer's inventory for reorder was enough to create nexus, but 24 states indicated that it would not create nexus.

States are split over whether a de minimis sale creates nexus, with 20 states responding that a single de minimis sale would create nexus, and 18 states responding that it would not. When it comes to one non-de minimis sale, however, there is no doubt that nexus is created. Thirty-six states responded "yes," and only three states said "no."

Ownership Interest in Pass-Through Entities

The states are uncharacteristically uniform in their nexus treatment of pass-through entity ownership, with the vast majority of states agreeing that owning an interest in a pass-through entity, no matter what type of ownership interest is held, creates nexus.

Over 80 percent of the states indicated 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 (36 states),
- general partnership interest (43 states),
- limited partnership interest (38 states),
- management LLC interest (42 states),
- non-management LLC interest (38 states), and
- disregarded entity interest (41 states).

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

We also asked questions addressing whether owning an interest in an entity that only generates passive income would create nexus. When the entity limits its activities in the state to managing investment assets, 35 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 37 states responding "yes" for a management interest and 36 states for a limited interest.

Cloud Computing and Software as a Service

When providing access to software and soliciting business in the state is classified as a sale of tangible property (and thus subject to Pub. L. No. 86-272), only 18 states indicated that the sale would create nexus. But when providing access to software and soliciting business in the state is not classified as the sale of tangible property (and is thus not under the protection of Pub. L. No. 86-272), the vast majority of states—33—would impose nexus.

While most states would find nexus if a corporation provides access to software and the customer has an in-state billing address, a substantial minority—11 states—would not find nexus in that case.

Almost all states responded that renting space on a third-party server located in the state creates nexus.

According to Survey, States Are Studying The Impact of Federal Tax Reform

On Dec. 22, 2017, President Trump signed into law Pub. L. No. 115-97, also known as the 2017 tax act, enacting sweeping changes to the Internal Revenue Code. Primary corporate income tax changes include lowering the corporate tax rate and creating a territorial tax system for multinational businesses. The Act made significant changes to the cost recovery mechanisms and deductions available for businesses. Now that the dust has begun to settle, taxpayers and practitioners are looking to the states for guidance on how these widespread changes will impact state income taxes.

In order to gauge the states' positions on some of the major corporate tax provisions of 2017 H.R. 1, which served as the basis for Pub. L. No. 115-97, we asked state tax officials to indicate whether their department would support legislation conforming to the following changes made under 2017 H.R. 1, as released on Nov. 2, 2017, which were most likely to have an impact on state income taxes:

- limited interest expense deduction;
- expanded bonus depreciation;
- net operating loss limitations;
- increased asset expensing; and
- repeal of the domestic production activities deduction.

The responses to these questions were limited, with many practitioners indicating that it was too early to expect definitive answers from the states. "The state revenue department responses to the tax reform questions were not surprising given that, at the time the question was posed, federal legislation had not yet been enacted so state legislatures could not act," Nair said.

Of the 44 states that responded to the income tax portion of the survey, only a handful of states (10) provided substantive responses to the questions. "It looks like most of the states are taking a wait and see approach on making changes to address issues with their corporate income tax," Fred Nicely, a senior tax counsel for the Council On State Taxation, commented.

"The low number of affirmative response to the questions regarding whether a state agency will support conforming to new federal provisions is not terribly surprising given that some 20 states indicated they are setting up study processes, and many more than that are actually engaged in such study. The timing of this survey is so close to the implementation of the new federal tax regime that it would be difficult for respondents to provide any real degree of certainty to readers," Brian Kirkell, a principal with RSM US LLP's Washington National Tax Office, told Bloomberg Tax.

Of the 10 states that provided responses to the questions on conformity to federal tax reform, only one state, West Virginia, responded "yes" to all of the questions. On the other hand, Colorado, Nebraska, and Utah responded "no" to all of the conformity questions. Several states, such as Indiana and North Carolina, pointed out that they already require special adjustments for bonus depreciation and asset expensing. New Mexico indicated that it would conform to major provisions impacting interest expenses, bonus depreciation, asset expensing, and the domestic production activities deduction, but that it would not conform to the provisions related to net operating losses.

Responses from some of the states were not surprising, according to Joseph Bishop-Henchman, Executive Vice President of the Tax Foundation. "Indiana and Utah are the best managed states in the country, with legislators who unfailingly ask thoughtful questions and officials who are always trying to find better ways of doing things. So I wasn't surprised that those two states, plus New Mexico, were the only ones to know their answers. Good for them, but I understand it's hard for officials to predict their state's conformity legislation regarding federal provisions that became law only a few weeks ago," he said.

Other practitioners also pointed out the difficulty that lies in determining how to react to federal tax reform. "Anytime you have high impact legislation passed entirely by one party, the next time the government flips, you potentially have a problem," Kirkell said, while highlighting the struggles with the Affordable Care Act. "When the inevitable happens and there is a flip in government, the very first thing that gets looked at is the Republican tax reform bill and states don't want to be caught in the middle of that," he added.

Planning Makes Perfect?

In addition to questions on conformity to the major provisions of 2017 H.R. 1, we also asked states whether they had begun studying the impact federal tax reform would have on their state. Twenty-one states indicated that they had already begun doing so.

Marilyn A. Wethekam, a partner at Horwood Marcus & Berk, told Bloomberg Tax that it was a "pleasant surprise" to see that so many states had already begun studying the impact of federal tax reform, noting that "it is a good sign that they were on top of it."

"Our hope is that the states will address this before the extended due date of the federal corporate returns, which should be right around September this year," Nicely told Bloomberg Tax. If the state legislatures do not act on the matter, it would be ideal if "tax departments came out with written guidance on how they are following federal tax changes," he added.

Bloomberg Tax Survey Identifies States' Apportionment, Sourcing Policies

This year, we added new questions 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 26 states responding "yes." The traditional three-factor formula and the weighted three-factor formula tied for second with 12 states each.

General Sourcing Methods

We also asked the states to identify the general sourcing method the states 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. Twelve states said they source receipts based on the costs of performance and only 8 said they apply a method other than cost of performance or market-based sourcing.

Arizona and Utah were the only states to select two of the three sourcing methods, while Missouri was the only state to respond "yes" to all three questions. All three states provided comments identifying various circumstances under which a different sourcing method was used.

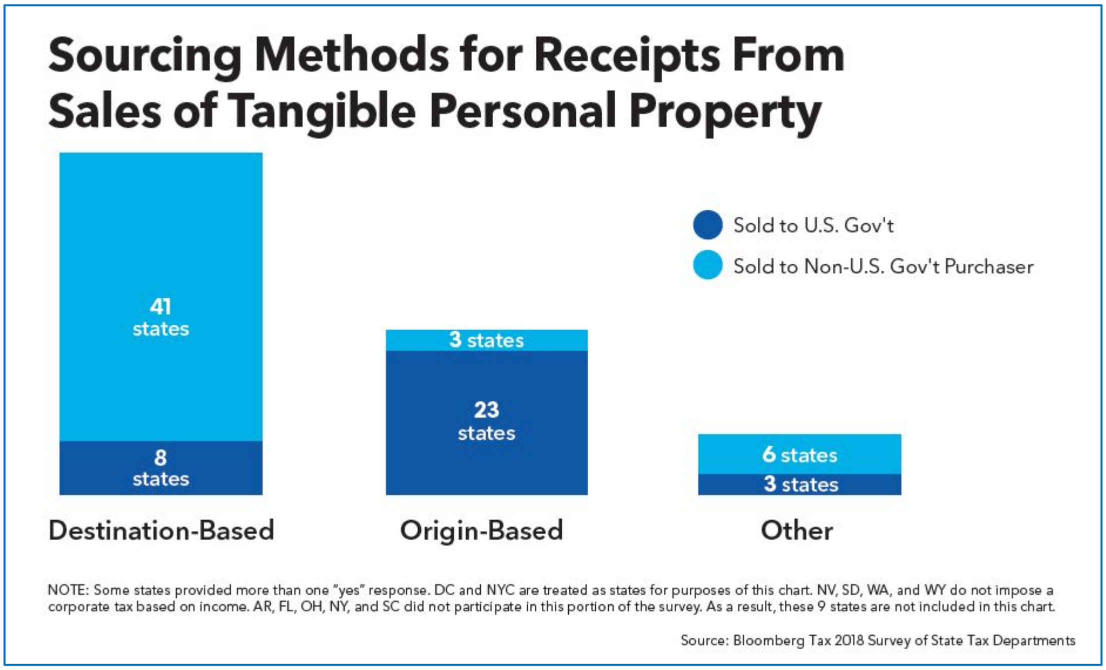
Although these three states were the only ones who selected multiple sourcing methods, 17 states responded "yes" when asked whether they apply different sourcing methods to different categories of receipts. An equal number, however, said they do not do so.

After asking states to identify their general sourcing method, we asked them to identify the methodology used to source receipts from each of the following categories: tangible personal property, real property, services, intangibles, and cloud computing or software as a service (SaaS) transactions. 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, 95 percent of the states responded "yes." Only one state, Texas, said "no." Texas indicated it that uses a sourcing method other than destination-based or origin-based sourcing but, when asked to identify what other method is used, 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."

Three states also indicated that they use origin-based sourcing, but most of these states included a comment limiting the application of this rule.



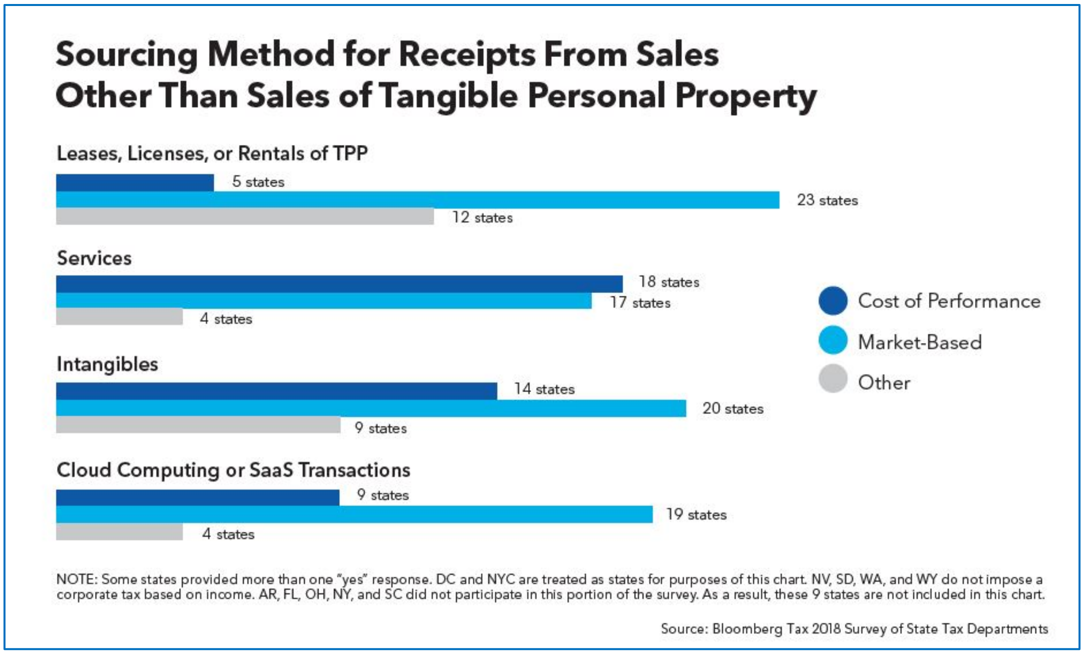
The survey also asked questions differentiating between the rules used to source receipts from sales of tangible personal property purchased by the U.S. government from sales to non-U.S. government purchasers.

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 — 23 — said they use origin-based sourcing, with only a limited number applying destination-based sourcing. However, 15 states indicated that they do not have special rules for sales to the U.S. government.

Unlike the uniformity seen almost nationwide when sourcing sales of tangible personal property, the states are all over the map when it comes to sourcing receipts from other sales. We 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; and
- cloud computing or software as a service (SaaS) transactions.

The results highlight the wide variety in sourcing methods used by the states for each category. This variation generally follows the same trends seen last year, with cost of performance rules being used by most states for receipts from services and market-based sourcing rules being used by most states for receipts from intangibles and cloud computing or SaaS transactions. This year, market-based sourcing was also the method most often used by states for receipts from leases, licenses, or rentals of tangible personal property.



Services

Even though most states still source receipts from services based on the costs of performance, gap is quickly closing with the number of jurisdictions using market-based sourcing rising to 17, just one state less than those applying cost of performance rules. This shift was in large part due to states like Louisiana, Montana, and Oregon changing their sourcing method of cost of performance to market-based this year.

"Montana is interesting because Montana is not a state that deals with a lot of sourcing of non-tangible personal property. The cases I have dealt with have all been pretty much with capital intensive industries that generally don't use market based sourcing," Marilyn A. Wethekam, a partner at Horwood Marcus & Berk in Chicago, told Bloomberg Tax. However, she then added that "Montana is a MTC state, so I can see why they would go that route," referring to the MTC's recent shift to market-based sourcing in its model rules.

Only California said it uses both cost of performance and market-based sourcing for services. Pennsylvania indicated that it uses both market-based sourcing and a method other than cost of performance or market-based sourcing for services.

Intangibles

The responses to which sourcing method is applied to receipts from intangibles mirrors the response for receipts from services. The 2018 survey saw an increase in the number of market-based sourcing states, while the number of cost of performance states decreased substantially.

By revising their answers to reflect only the use of market-based sourcing this year, Louisiana, Montana, and Oregon further widened the gap between market-based states (20) and cost of performance states (14) this year.

Some states indicated that they use multiple methods to source receipts from intangibles. For example, Illinois said it sources receipts using both cost of performance and market-based sourcing. 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.

Two states, Oklahoma and Vermont, may present an additional challenge for taxpayers sourcing receipts from intangibles. Neither state indicated the methodology used for sourcing these receipts and Oklahoma said its policy is not yet developed.

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 most likely to be characterized as receipts from services, with 16 states, up two from last year, responding in this manner. Included among these states for the first time are Louisiana and West Virginia. Montana, on the other hand, no longer characterizes these receipts as services.

Receipts characterized as a sale, lease, license, or rental of intangible personal property came in second with seven states indicating that they use this characterization again this year.

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

The states' continued struggles with developing definitive policies on this issue are clearly reflected in this year's survey results. Thirteen states, including California, Georgia, and Pennsylvania, did not identify how these receipts would be characterized, responding with either "no response" or "not applicable." Of these, eight states also provided the same responses when asked about the sourcing method used.

Hawaii, for example, said receipts from these transactions are subject to Hawaii income tax, but that Hawaii law does not specify how the receipts are characterized.

Other states, such as Arkansas and North Carolina, were able to characterize their receipts but did not respond to questions regarding the sourcing method.

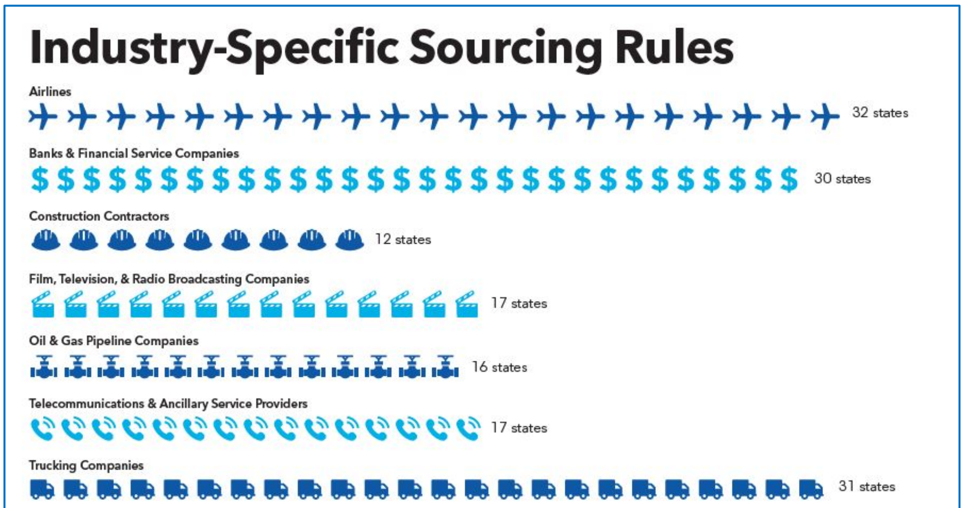
According to practitioners, one reason for the states' difficulty in determining clear policies in this area may be the lag between emerging technology and state policy. "You always have an issue when business models or technology get out in front of tax policy, and tax policy and tax statutes are always three to five years behind it. I think you see a lag in the policy trying to catch up," Wethekam told Bloomberg Tax. "I think there may be a reticence to jump on the bandwagon and really get out in front of it only to realize that the technology is going to change; it is difficult to change regulations or statutes," Wethekam added.

"I think the states will always be behind, and I think that practitioners will always be behind. In all honesty, a lot of this is in the legislature, and they are always going to be behind. Who's the most behind is always the question," Kirkell said, noting that "practitioners are generally in a better position to bring these issues to light because our clients are coming to us and saying `what do I do with this?'"

"The cloud is everywhere and nowhere. Two hundred years ago every corporation only existed within the state that chartered it, and few people crossed state lines regularly. Today nearly everyone does interstate digital transactions every day. That our governments are based on geography and provide benefits based on geography will prove a continuing challenge as the capital, labor, and services markets increasingly disregards geography altogether," Joseph Bishop-Henchman, Executive Vice President of the Tax Foundation in Washington, D.C., told Bloomberg Tax.

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.



NOTE: DC and NYC are treated as states for purposes of this chart. NV, SD, WA, and WY do not impose a corporate tax based on income. AR, FL, OH, NY, and SC did not participate in this portion of the survey. As a result, these 9 states are not included in this chart.

Source: Bloomberg Tax 2018 Survey of State Tax Departments

Of these industries, the use of industry-specific rules was most common for airlines, with 32 states indicating they provide special sourcing rules. Just over a third of these states (12) also said that their rules are the same as, or substantially similar to, the Multistate Tax Compact Special Industry Rules for Airlines in Reg. IV.18.(e).

Taxpayers in California, Iowa, and Oregon should pay careful attention to their state's sourcing rules. Each of these states indicated that they apply industry-specific rules for all seven of the industries addressed. Taxpayers in Delaware and Vermont, however, may only need to be familiar with the state's general sourcing rules. Both states said that they do not have industry-specific rules for any of the seven industries.

The states were asked to identify the rules and guidance taxpayers should refer to in the event that an alternative apportionment methodology is invoked and whether they conformed to specific provisions of the MTC's Multistate Tax Compact and model regulations.

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 in 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-one states said they require partnerships to classify income as business or nonbusiness income at the entity level. Several of those states also said they require such entities to make the classification at the owner level. States that said "yes" to both questions are Alabama, Colorado, Hawaii, Kansas, Mississippi, Oregon, and Wisconsin.

"It is inconsistent and sounds as if a state is double-dipping when it tests at both the entity level and the partner level," Bruce P. Ely, a tax partner with Bradley Arant Boult Cummings LLP in Birmingham, Ala., said.

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 professional services as business income. Only Mississippi indicated that 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.

Many states declined to give a "yes" or "no" answer to the question of whether they classified guaranteed payments for the use of capital as business or nonbusiness income. "It comes as no surprise that many states didn't answer the question," Ely told Bloomberg Tax.

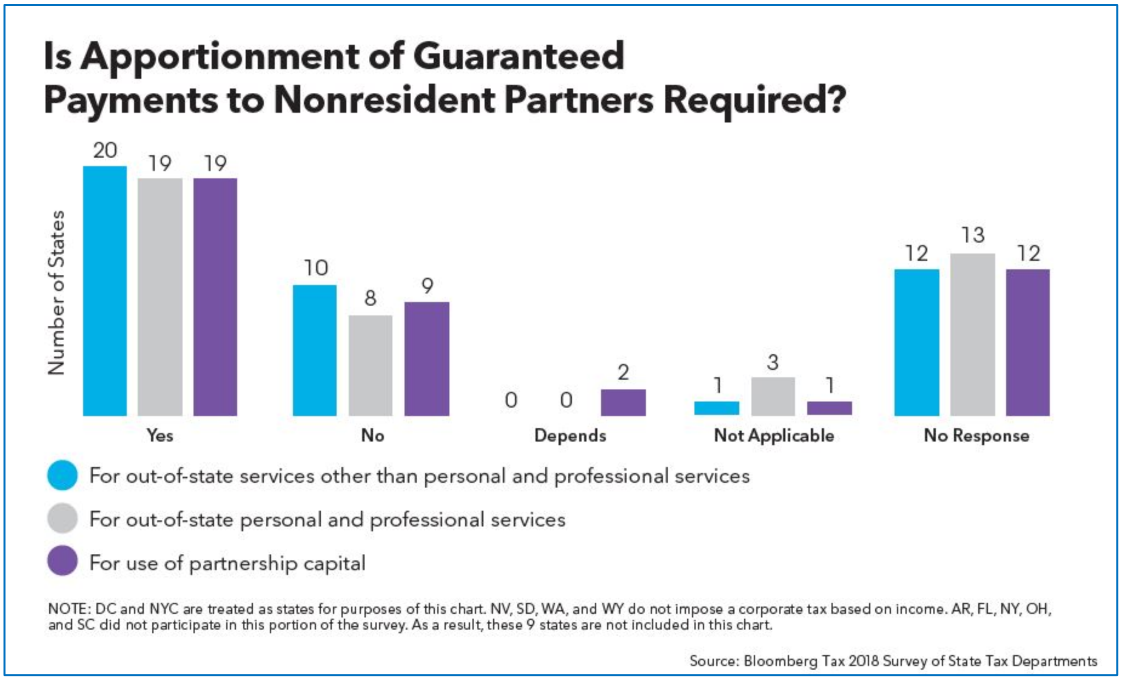
"In our own research for a multistate partnership client about two years ago, we found that many state departments of revenue (DORs) simply haven't focused on the issue and, in some cases, we received different answers from within the same state DOR," Ely said, adding he hopes the survey question will prompt states to look at the question more closely and arrive at a uniform answer.

Apportionment

The method used by pass-through entities to apportion income and source sales receipts is another gray area among the states. Twenty-nine states indicated they require partnerships to apportion income at the entity level. Alabama, Connecticut, Hawaii, Indiana, New Jersey, and Wisconsin indicated 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 Louisiana, Minnesota, and West Virginia 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.



There was only a slight difference in responses with 19 states indicating apportionment would be required for such payments made for out-of-state personal and professional services and 20 states indicating apportionment would be required for guaranteed payments to nonresident partners for out-of-state services other than personal and professional services. Nineteen 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.

Composite Returns and Withholding

"A significant disparity exists with respect to the states' treatment of nonresident partners—some states have both composite return and mandatory withholding provisions; some states have one or the other; while a few states don't have any statutory collection mechanism at all," Ely told Bloomberg Tax.

According to this year's survey responses, many states require nonresident owners of pass-through entities that do business in their jurisdiction to withhold tax on the owners' distributive share of income derived, or connected to, in-state sources. Twenty states indicated that they require withholding on distributive share payments made to nonresident individuals, while 15 indicated that they require withholding for payments made to out-of-state corporations.

Seven states said they require composite returns for nonresident individuals, namely Alabama, Connecticut, Indiana, New Mexico, Oregon, Utah, and West Virginia. Each of those states, with the exception of Connecticut, also said they would require a composite return for an out-of-state corporation.

Additional administrative requirements await those who overpay tax. Thirty 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. Two exceptions were Arizona and Kentucky.

Disposition of Pass-Through Entity Interest

Several states said they would impose income tax on the gain recognized by the disposition of an out-of-state corporation's interest of 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. Ely said he found the state's positions troubling from a constitutional perspective, noting that a recent Ohio Supreme Court case, *Corrigan v. Testa*, illustrates the type of analysis that states must go through when determining whether the state can tax the gain. "You have the conflux of old Latin maxims regarding the sourcing of gains from the sales of intangible assets with the states' single-mindedness that everything should be classified as business income. They often forget there's this thing called the commerce clause and this other thing called the due process clause," Ely told Bloomberg Tax.

Pass-Through Entity Level Nexus

This year, we added questions related to entity level nexus for pass-through entities. Most states indicated that there was no distinction with respect to whether an entity doing business in the state created nexus based on entity type. Interestingly, 29 states indicated that a qualified subchapter S subsidiary (QSub) doing business in the state would create nexus for the parent S corporation. Only three jurisdictions, the District of Columbia, Minnesota, and Texas, indicated that the activities of the QSub would not create nexus for the parent company.

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, policymakers 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 or use 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 due to advances in computer technology that have aided in the explosion of electronic commerce and the internet. These technological advances have posed new challenges affecting sales and use tax policy and procedure in a wide range of issues, including sourcing and tax collection.

Changing Landscape for Sales Tax Nexus

In recent years, states such as Alabama and South Dakota have been blatantly defying the long standing physical presence nexus policy under *Quill* by adopting regulations or enacting legislation containing an economic nexus standard similar to that used for corporate income taxes in an attempt to force the courts to revise its decades old policy in light of our growing digital economy. A pending U.S. Supreme Court case, *South Dakota v. Wayfair*, 901 N.W.2d 754, 2017 BL 324005 (S.D. 2017), cert. granted 138 S. Ct. 738, 2018 BL 11589 (2018), may finally settle the debate on whether to "kill *Quill*."

This landmark case, based on economic nexus legislation passed by South Dakota in 2016, worked its way up through state courts in 2017. 2016 S.D. S.B. 106 created an economic threshold for nexus, requiring sellers lacking physical presence to collect and remit South Dakota's sales tax if they make more than $100,000 in sales into the state or make deliveries into the state in 200 or more transactions in a calendar year. The South Dakota Supreme Court found the economic presence standard invalid under *Quill*, the 1992 U.S. Supreme case that established a "bright-line" physical presence standard for sales and use taxes.

Given the impact that the outcome of *Wayfair* may have, it should come as no surprise that practitioners have mixed predictions on how the Court will rule.

"I believe that the U.S. Supreme Court may very likely overturn *Quill*," Sylvia Dion, founder and managing partner at PrietoDion Consulting Partners LLC in Westford, Mass., told Bloomberg Tax. "Remember, *Quill* was an affirmation of the Supreme Court's decision in *National Bellas Hess v. Illinois*, a 1967 Supreme Court decision. In 1992, when SCOTUS addressed *Quill*, it was, in effect, applying the doctrine of stare decisis—adhering to what had previously been decided. When you consider this, the physical presence standard has now been the `law of the land' for 51 years," she added.

Marilyn A. Wethekam, a partner at Horwood Marcus & Berk in Chicago, also predicts that the Court will overturn *Quill*. "Certainly the court did not take *Wayfair* merely to affirm *Quill*. They could have done that by denying the petition for certiorari and letting the South Dakota Supreme Court decision stand. I think that the Court has the opportunity, should they choose to do it, and I think they will, to redefine what is substantial nexus in the current world," Wethekam told Bloomberg Tax.

"There exists a strong potential for the U.S. Supreme Court to move the nexus standard away from one based on physical presence to one based on economic nexus," Priya D. Nair, a state and local tax manager at Grant Thornton's National Tax Practice in Washington, D.C., told Bloomberg Tax. "While this is but one road the Supreme Court may take, it is relatively certain that the outcome of *Wayfair* will result in compliance complexity. However, the complexity that is sure to follow may be far less than what would have come about had this issue not dominated the landscape for the past several years," she went on to say.

Other practitioners, including Fred Nicely, senior tax counsel for the Council on State Taxation, and Harley Duncan, a state and local tax managing director in KPMG's Washington National Tax Practice, are less certain that South Dakota will prevail. Duncan told Bloomberg Tax he was "surprised the Court took the case, given the way it was presented."

"I am very concerned about the lack of an actual record at the South Dakota court level that substantiates whether the burden imposed on interstate businesses to collect the states' sales/use taxes has decreased, stayed the same, or increased. I think the Court needs to address the burden, and I'm not sure relying on amicus briefs is the best way to substantiate whether the burden has increased or decreased for remote sellers to collect the tax," Nicely told Bloomberg Tax.

"This will be a very significant case, whether it has a clear impact will depend on whether at least five justices agree or if we get several concurring opinions that differ in their conclusions on why remote sellers should (or should not) have to collect and remit the states' sales/use taxes," Nicely said.

Whatever the Outcome, Change Is Coming

One thing nearly all practitioners are predicting is a shift in sales tax nexus policy, regardless of *Wayfair's* outcome. Some expect change to come through federal legislation. "No matter what the Supreme Court does, we're probably going to see a new round of federal legislation. And if Wayfair loses, we're probably going to see something that is going to really make our eyes open," Brian Kirkell, a principal with RSM US LLP's Washington National Tax Office, told Bloomberg Tax.

Bruce P. Ely, a tax partner at Bradley Arant Boult Cummings LLP in Birmingham, Ala., who also predicts that the Court will overturn *Quill*, told Bloomberg Tax that "If the Court rules for South Dakota, then Congress should view itself in a different way—as rescuing multistate businesses from the ensuing chaos by passing a uniform statute. Call me Don Quixote, but I'm hoping that the Marketplace Fairness Act, or the Remote Transactions Parity Act, or some variation thereof, will pass after a pro-state ruling. If that happens, then we'll see a degree of uniformity we haven't seen since long prior to 1992."

Others believe that states will bring about the change themselves. Richard Cram, director of the Multistate Tax Commission's National Nexus Program, told Bloomberg Tax that if the Court "abandons the *Quill* physical presence requirement nexus statute" like he predicts, "states will likely enact legislation similar to South Dakota's statute."

"State legislatures have not hesitated to introduce bills that effectively follow economic nexus. If *Quill* is overturned, there's no doubt in my mind we're going to see a ton more states that are going to want to legislate the economic nexus approach. I think states are hungry for revenue and they are ready to pounce," Dion told Bloomberg Tax.

No matter what happens, "I think you are going to have potential chaos as to how nexus is going to be applied until people kind of get a grip on it a little bit," Wethekam said.

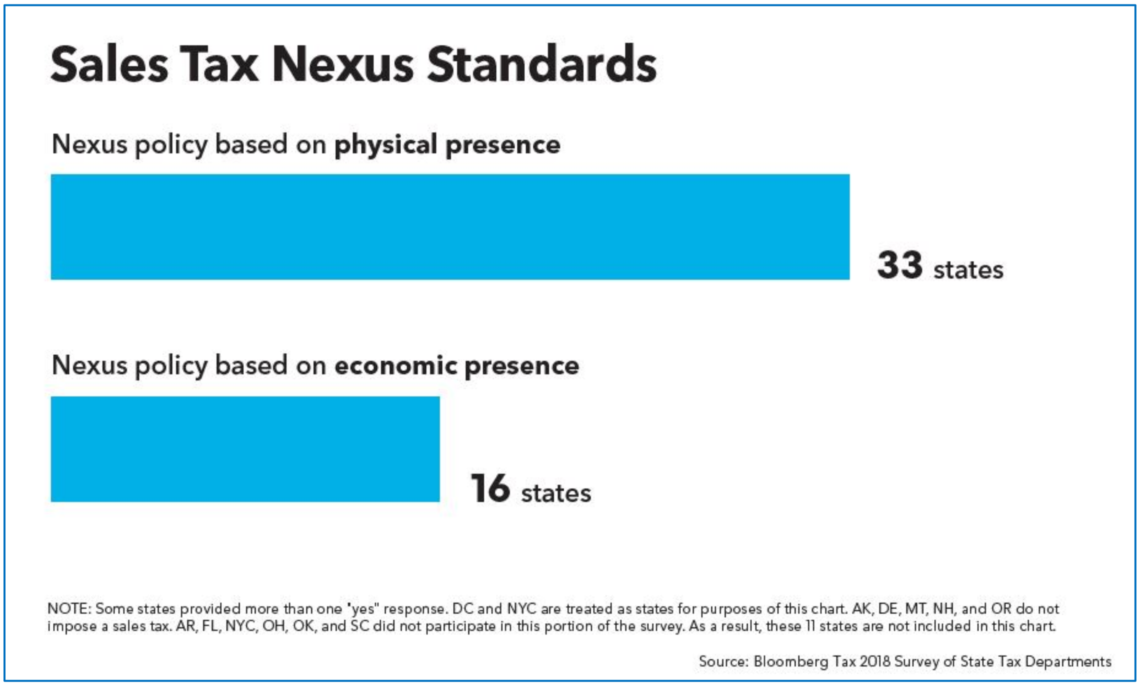
Bloomberg Tax Survey Clarifies States' Positions on Sales Tax Policy

Every year, the survey seeks to clarify the states' positions on a number of sales tax policy issues by addressing topics such as the nexus questionnaires, trailing nexus, sourcing rules for interstate and intrastate sales, and the sharing economy. This year, we also addressed nexus standards and notice and reporting requirements.

Nexus Standards

Given the growing number of states quickly adopting economic nexus standards to replace their existing physical presence standards, we added a new category of questions seeking to identify the state's current nexus standard.

Nearly all the states (33) indicated that their nexus policy is based on physical presence. Sixteen states indicated that their nexus policy was based on economic presence, most of whom (10) also said "yes" to physical presence.



We also asked the states whether they have passed legislation creating an economic nexus standard that is not currently being enforced due to either the legislation's effective date or pending litigation. Six states responded "yes." Of these six, all but Washington said their nexus policy is based on physical presence. In addition to Washington, South Dakota and Wyoming said "yes" when asked whether they have an economic presence nexus standard.

Nexus Enforcement Policies

We also added questions related to notice and reporting requirements for out-of-state retailers to this year's questionnaire.

Eleven states indicated that they require out-of-state retailers to report sales made within the state. Seven states indicated that they require out-of-state retailers to notify in-state customers of their obligation to pay use tax.

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-one states indicated they send a nexus questionnaire. Only half of these states identified the form number; however, some states, including Arkansas and Maryland, said that their questionnaire does not have a form number.

We also asked states to indicate how long an out-of-state entity would have nexus with the state after the nexus-creating activity ended. Seventeen states said they would find nexus for the entire taxable year for a corporation that stops an activity during the tax year that once created nexus.

Sourcing Tangible Personal Property and Software

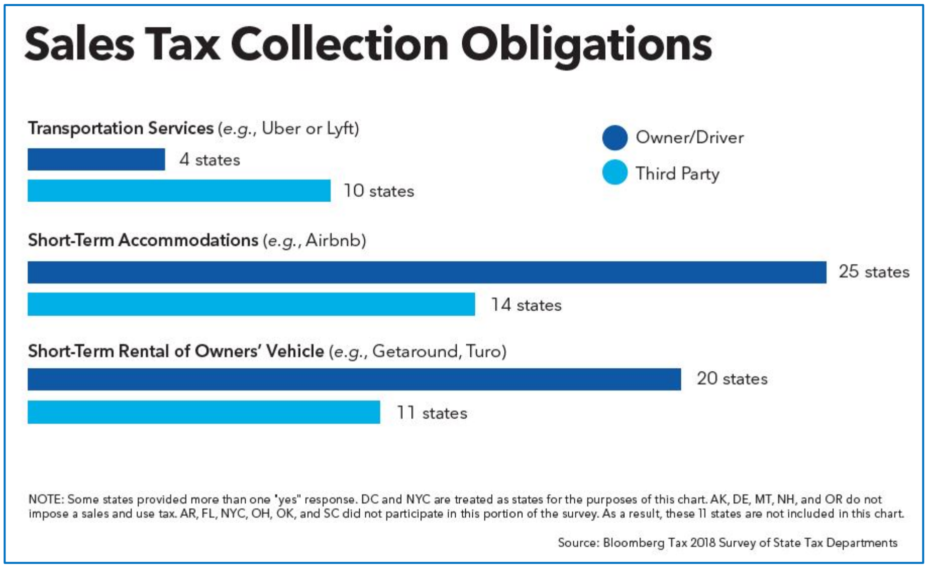
In light of the varying rules for sourcing currently in effect throughout the country, Bloomberg Tax asked the states to clarify their position with respect to specific types of transactions. State tax department personnel identified the sourcing rules in place for each state relating to interstate and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

With respect to the sourcing of intrastate sales of tangible personal property, 22 states said they use a destination-based sourcing method, and eight states said they use an origin-based sourcing method, both down one from last year.

We also asked the states to indicate 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. Four jurisdictions—the District of Columbia, Nebraska, North Dakota, and Rhode Island—indicated that they source based on the location of the server, and only Utah indicated it sources based on the billing address of the customer. Ten states indicated 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.

Sharing Economy

Again this year, the survey posed a series of questions addressing who bears the burden of sales tax collection in certain sharing-economy transactions. The survey sought to identify whether the owner or the third-party facilitator was required to collect sales tax on transactions for the provision of short-term accommodations or short-term rental of 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-five states said the collection obligation is imposed on the owner, and only 14 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 owner's vehicles facilitated by GetAround or another similar third-party vendor. Eleven states indicated that collection obligation is imposed on the third-party vendor, and 20 states said it was imposed on the owner of the vehicle.

Surprisingly, only 10 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. Four states said that they impose the sales tax collection obligations on the driver.

Survey Identifies Activities That Create Sales Tax Nexus

Sales and use taxes, a primary revenue source for many states, have become more difficult to comply with as sales transactions have become more complicated and the internet has made it easier for remote sellers to sell into a state without physical contact. We asked the states questions about 130 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' answers to these questions revealed the complexity of sales tax nexus and the broad variation among the states.

Temporary or Sporadic Presence

The majority of states indicated that merely attending a trade show or seminar was not enough to create nexus. In contrast, the majority of states said that holding at least two, one-day seminars 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 indicated that making a sale or accepting orders at a trade show was enough to create sales tax nexus. Thirty-six states indicated 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.

Eighteen states indicated 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 26 when the relationship results in more than $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 14 states, one state less than last year.

Digital Property

Overall, the majority of states indicated that selling remote access to digital products would not create nexus, despite continued growth in this market.

This year, nine states responded that selling remote access to canned software would create sales tax nexus. When the software is considered "custom," only four states indicated 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. Vermont and Virginia were the only states that did not impose nexus under these circumstances.

Twenty-three states indicated that the sale of data, such as music files, that is stored on an in-state server would create nexus, another result that seems to buck the general trend. 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.

Only five jurisdictions—Arizona, the District of Columbia, Hawaii, New Mexico, and Tennessee—responded that, when the digital content is downloaded by residents of the state, nexus is created. The likelihood that such sales would create nexus is even lower when the digital content is accessed, but not downloaded, by residents. Only three of the five states impose nexus, with the District of Columbia and New Mexico responding "no."

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

Cookie Nexus

This year, we added a new question 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."

Practitioners were not surprised by this result, with most questioning whether cookie nexus is a sound policy. "This nexus theory is of such questionable merit, both as a legal matter and as an administrable policy, that it explains the fact so few states have yet confirmed their adoption of it. One could say this theory remains half-baked," Kendall Houghton, the practice group leader for Alston & Bird's State and Local Tax/Unclaimed Property practice told Bloomberg Tax.

"The problem here is that a lot of states are nervous that this is a due process quagmire and, of course, a substantial nexus quagmire," Brian Kirkell, a principal at RSM US LLP's Washington National Tax Office, said, before asking "how substantial is a cookie, when all the cookie does is make easier for you to get back to somebody's website and they don't know who you are, and they are not shipping anything to you?"

Practitioners were surprised, however, by those states that responded that downloading cookies creates nexus for an out-of-state retailer. Hawaii and North Carolina responded "yes," while Massachusetts and Wisconsin shied away from taking a clear position either way, instead simply responding "depends."

Harley Duncan, a state and local tax managing director in KPMG's Washington National Tax Practice, told Bloomberg Tax he was surprised that Massachusetts answered "depends" because it was one of two states "that have put it in either regulation or law."

Sylvia Dion, founder and managing partner at PrietoDion Consulting Partners LLC in Westford, Massachusetts, was also "extremely surprised" by Massachusetts' response. "I really thought that it would be an affirmative yes," she said. "It's not in and of itself having cookie nexus, but having other activities that create nexus too. I see the rationale behind it," Dion said, when asked why Massachusetts may have answered this way.

"I wonder if Hawaii and North Carolina truly knew what they were admitting to, that they want to tax the whole world," Joseph Bishop-Henchman, Executive Vice President of the Tax Foundation in Washington, DC, told Bloomberg Tax.

"It is not surprising that a couple of states would take that position; however, I think it lacks constitutional support," Fred Nicely, senior counsel for the Council on State Taxation, told Bloomberg Tax. "In the *Quill* case, diskettes were referenced and whether that created a physical presence in North Dakota. The Court rejected that, and I think the same would hold true for cookies on computers," Nicely said.

Disaster Relief

We asked the states whether entering the state solely for the purposes of providing disaster relief would create nexus. Eighteen states, one less than in 2017, indicated that doing so was sufficient to create nexus, a result that garnered mixed reactions from practitioners.

"I clearly think the states should not impose nexus based on a business coming into a state solely to conduct emergency and/or disaster relief," Nicely told Bloomberg Tax, before pointing out the differences in how the issue should be treated for sales tax and income tax. "While there should be safe harbors for corporate income tax from an emergency situation, if sales tax is owed on items sold by any provider in the state, all providers (permanent or temporary) should be subject to the same collection and remittance responsibilities," he said.

"It's taking advantage of the situation where you've got this disaster and out-of-state companies want to provide relief, and states, being revenue-hungry, take advantage of that situation. This is definitely not good tax policy," Dion told Bloomberg Tax.

"States have been pretty good about changing this rule when it's brought to their attention," Henchman said. "No one wants a tractor-trailer of bottled water stuck on the wrong side of the state line because of some dumb tax rule. But this shows the physical presence rule can tax too much in some cases," he added.

Full Analysis of Survey Responses Available By Request

In addition to the topics addressed within this Executive Summary, the Bloomberg Tax 2018 Survey of State Tax Departments also identifies the states' positions on state-tax addbacks, treatment of intangible holding companies, throwback and throwout rules, combined reporting, tax treatment of non-U.S. entities, reporting federal changes, sales tax refund claims, and qui tam and class action lawsuits. For an analysis of the results on these topics, and to see the states' responses to almost 630 different questions, get a free trial to [State Tax research]() from Bloomberg Tax today.