

# Federal Tax Reform Doesn't End With the 1120: SALT Implications of Potential Federal Tax Reform

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**I.R.C. Conformity**

Congressional tax writers have long been talking about tax reform and have been holding hearings, establishing bipartisan working groups and soliciting recommendations and proposals from fellow lawmakers. In this article, Valerie C. Dickerson, Jeff Kummer and Sarah Laszlo, of Deloitte Tax LLP, examine potential federal tax law changes and discuss their potential impact on state taxation.

## **Federal Tax Reform Doesn't End With the 1120: SALT Implications of Potential Federal Tax Reform**

By VALERIE C. DICKERSON, JEFF KUMMER AND  
SARAH LASZLO<sup>1</sup>

### **I. Introduction**

**M**any people think federal tax reform is necessary but few people know what that means. Still fewer know what that means for the states. This article will examine potential federal tax law changes looming on the horizon and their potential impact on state taxation.

Annual federal tax law changes have a varying degree of impact on the states. In recent years the largest

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impact has been with respect to implementation and continuation of "bonus" depreciation, section 179 expense and the research and experimentation credit. Many states are affected by federal tax law changes because they "piggy-back" off the Internal Revenue Code ("I.R.C.") by either incorporating the I.R.C. provisions, in whole or part, or using federal taxable income as the starting point.

As an overview, states with automatic or "rolling" conformity generally will adopt I.R.C. changes unless there is specific state legislation that decouples from the federal law. Some states effectively adopt the I.R.C. by using federal taxable income as the state starting point, even though the I.R.C. itself has not been adopted in whole or in part. Other states, such as California and Texas, adopt the I.R.C. as of a specific date, do not adopt the I.R.C. provisions in totality, or provide modifications or exceptions to certain adopted I.R.C. provisions. For these states, further analysis is needed to determine how federal tax reform will affect the state tax regime.

There is additional complexity with changing I.R.C. provisions for states that conform to the I.R.C. at a certain point in time or require specific adoption of new provisions. Further, some states' statutes and regulations simply do not address all the potential possibilities for application and changes to the I.R.C. Such complexities add to the risk of tax professionals missing state modifications and/or not using the proper "federal" taxable income starting point. Analyzing and preparing for federal tax law changes can mitigate such risks.

With increasing state budgetary concerns, it is likely that states may start to decouple from additional federal provisions that decrease the state tax base. In contrast, increased decoupling results in additional recordkeeping and possibly increased state compliance mistakes due to the complexities of having multiple tax bases. Adding to complaints that the federal tax code is too complicated, multistate businesses have the additional challenge of following up to forty-five state income tax laws and filing what may seem to be a limitless number of returns.<sup>2</sup>

## A. Major Developments So Far

Congressional tax writers have long been talking about tax reform and have been taking concrete steps toward enactment by holding hearings (including the first joint hearings between the Senate Finance and House Ways and Means committees in decades), establishing bipartisan working groups, soliciting recommendations and proposals from fellow lawmakers for specific changes to the tax code, and releasing background “options” papers and draft legislative proposals.

On the House side, Ways and Means Chairman Dave Camp, R-Mich., has released three tax reform discussion drafts. The first deals with the international tax system, assumes a drop in the corporate rate to 25 percent and outlines a detailed plan to move the United States toward a territorial system for taxing U.S. multinational corporations. The second explores financial products taxation and attempts to address long-standing concerns that the maze of tax treatments available under the current rules and the creativity used in designing financial instruments can result in very different tax treatments for economically similar products. The third examines passthrough issues by proposing some overall changes and then laying out two options for broader reform, including the more far-reaching “Option 2,” which would repeal Subchapters S and K and replace them with a uniform tax regime for passthroughs. It also includes several provisions intended to “simplify tax compliance for small businesses and provide certainty with respect to the ability of small businesses to recover certain costs immediately.”

Although the drafts include legislative language, they have not been formally introduced in the House nor have they been taken up by the full Ways and Means Committee. Camp has indicated that they are meant to stimulate debate and encourage input from stakeholders as the committee prepares legislative proposals. (Highlights of the three drafts appear at the end of this section.)

In February of this year, Camp and Ways and Means Committee ranking member Sander Levin, D-Mich., also established 11 bipartisan working groups to study specific topics in the tax code.<sup>3</sup> These groups were not

directed to make specific recommendations for reform but instead to examine the state of the law and note concerns with its current structure in those specific areas. Recommendations and comments that the working groups received from stakeholders and the general public were compiled in a report by the Joint Committee on Taxation (JCT) staff that was released in early May.

More recently, House Ways and Means Committee Republicans have been holding closed-door, member-only briefings in an effort to reach consensus on an approach to a comprehensive tax reform proposal. Although few details of the meetings have been made public (members have been sworn to secrecy), House Republican tax writers reportedly have been submitting draft legislation to the JCT staff for revenue estimates as they prepare for a mark-up later this year.

Across the Capitol, both Senate Finance Committee Chairman Max Baucus, D-Mont., and ranking member Orrin Hatch, R-Utah, support base-broadening and rate-lowering reform; but while the committee has also held numerous public hearings, it has not yet released the sort of detailed proposals or discussion drafts we have seen from Ways and Means. The Finance Committee, earlier this year, launched a series of weekly members-only meetings to discuss tax reform. Since March, the Finance Committee staff has released a series of 10 options papers addressing specific issues in tax reform.<sup>4</sup> These papers are largely compilations of sometimes contradictory reform proposals that have been offered by lawmakers, presidential commissions, and think tanks, as well as suggestions from witnesses who have testified at one of the many hearings on tax reform convened by House and Senate tax writers since 2011. The papers provide no clear indication of the Finance Committee’s current thinking on tax reform, and the options presented are “not necessarily endorsed” by Baucus or Hatch.

In June, Baucus and Hatch announced in a letter to their Senate colleagues that the Finance Committee was proceeding with tax reform from a “blank slate” which assumes that all tax expenditures and preferences are expunged from the tax code unless there is a compelling policy reason for retaining specific provisions. Senators were given until July 26 to submit legislative language or detailed proposals explaining which preferences should be retained and why. They were also told they could suggest new or expanded tax preferences as well as other changes to the code – including additional ways to raise revenue – as part of their submissions. Baucus and Hatch indicated that they would review these submissions as they prepare a comprehensive tax reform bill for mark-up in the Finance Committee later this year.

In their letter, Baucus and Hatch did not target a top tax rate for individuals and corporations, nor did they address the issue of whether revenue generated from

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tional tax issues; debt, equity, and capital; real estate; income and tax distribution; financial services; and manufacturing.

<sup>4</sup> Topics of the Finance Committee options papers include: simplifying the tax system for families and businesses; business investment and innovation; families, work, and education; infrastructure, energy, and natural resources; international competitiveness; economic and community development; economic security (employee benefits and retirement savings incentives); types of income and business entities; tax-exempt organizations and charitable giving; and nonincome tax issues and related reform.

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<sup>2</sup> Some states follow the federal filing rules for corporate consolidated groups and federally disregarded entities. However, other states impose filing requirements on disregarded entities and use separate company reporting. Accordingly, a complex entity structure that results in one federal return may require hundreds of state return filings with which to comply.

<sup>3</sup> Issues addressed by the Ways and Means Committee working groups include: small businesses and passthroughs; education and family benefits; pensions and retirement; energy; charitable giving and exempt organizations; interna-

tax reform should be applied to lowering rates, reducing the deficit, or some combination of the two.

We may never know exactly how many senators actually filed comments and what they contained. To encourage candor and to address concerns raised by some lawmakers that their comments might be leaked to the press, Baucus and Hatch promised that all submissions would remain locked in a safe until 2064. Moreover, some senators indicated that they would meet privately with Baucus and Hatch to discuss some of their thoughts on tax reform without memorializing them in writing. A number of lawmakers who did submit formal comments – including some Finance Committee members – opted to make their submissions public, however. Although many of these senators limited their comments to statements of broad principles, some advocated for specific business and individual tax policies.

## II. International Tax Reform: Highlights of Camp's Multinational Tax Reform Discussion Draft

Ways and Means Chairman Dave Camp's first tax reform discussion draft, which was released in October 2011, addresses corporate tax reform with an emphasis on the tax treatment of multinational companies.

Such changes to the U.S. international tax regime would have various impacts on the states. In general, it would seem that state taxes should increase as the federal tax base increases. However, there are several reasons why that may not, in fact, be true. First, the state filing method will need to be considered. The various state filing methods include separate entity filings, unitary worldwide or water's edge combined filings, consolidated filings and exclusion of 80/20 companies. If the taxpayer is already filing on a worldwide basis in the state, a change to a territorial tax regime may have little effect on the state taxes. Another consideration to be analyzed is the state treatment of Subpart F income and taxation of foreign source income. Many states allow for varying degrees of deductions for Subpart F and foreign source income.

Furthermore, states historically have been subject to a different standard when it comes to taxing foreign income than the federal government, due to the Foreign Commerce clause of the U.S. Constitution.<sup>5</sup> In other words, the federal government can discriminate against foreign commerce where the states cannot;<sup>6</sup> thus creating additional state tax considerations for the impact of U.S. international tax law changes on state tax regimes to ensure the state does not violate the Foreign Commerce clause.

### A. Territorial Tax System

The 2011 discussion draft calls for the United States to move from its current worldwide system for international taxation toward a territorial system using a dividend exemption. Under this plan, domestic corporations that are at least 10 percent shareholders of con-

trolled foreign corporations ("CFCs") would be allowed a 95 percent deduction for the foreign-source portion of dividends received from those CFCs. The proposal would treat branches of domestic corporations as CFCs.

No deductions would be allowed for expenses incurred to generate foreign exempt income (so that foreign taxes become an absolute cost). Only income from the conduct of an active foreign business would qualify for exemption. Subpart F would be retained so that certain "highly mobile" and passive income would continue to be currently taxed (foreign tax credits would be available for this income).

This change in federal law is most likely going to affect the states based on state law dividends received deductions, which can vary greatly from the federal rules. For example:

- Alabama allows a deduction for dividends from non-U.S. corporations that are at least 20 percent owned.<sup>7</sup> In this case, the federal law only requires 10 percent ownership in the CFC but the state law requires 20 percent, thus potentially causing a difference in the amount deducted.

- Arizona allows a 100 percent deduction for dividends received from foreign corporations.<sup>8</sup> Therefore, the additional 5 percent and any other foreign dividend would be allowed as a subtraction in Arizona.

- Delaware allows a 100 percent deduction for dividends from foreign corporations but only if paid, deemed paid or accrued under the applicable provisions of the I.R.C.<sup>9</sup>

- Nebraska allows a 100 percent deduction for dividends from foreign corporations.<sup>10</sup> So the full dividend would be deductible in Nebraska.

- North Dakota requires an addition for federal special deductions, including the dividends received deduction and does not allow a corresponding subtraction.<sup>11</sup> Accordingly, this change in federal legislation would increase the North Dakota tax base as no amounts would be excluded.

Based on the above sample of states, it appears that there is no general rule with regard to how states treat foreign dividends. The facts of each taxpayer's situation need to be individually analyzed and applied to the state law for the states in which the taxpayer is required to file a corporate income tax return.

To address concerns that a territorial system would lead to more income shifting to low-tax jurisdictions, the draft offers three alternative "base erosion" options. They would:

- Treat excess income from the transfer of intangibles to affiliates in low-tax jurisdictions (less than 10 percent effective rate) as Subpart F income;

- Treat certain income that is neither active business income nor taxed at an effective rate of at least 10 percent as Subpart F income (and therefore subjecting it to immediate inclusion on the taxpayer's return); or

- Create a new category of Subpart F income for income derived from intangibles that is subject to a low

<sup>7</sup> Ala. Code § 40-18-34(d).

<sup>8</sup> Ariz. Rev. Stat. Ann. § 43-1122(6). As a cautionary note, Arizona also requires the addback of any related expenses under the provisions of Ariz. Rev. Stat. Ann. § 43-961.5.

<sup>9</sup> Del. Code Ann. tit. 30 § 1903(a)(1).

<sup>10</sup> Neb. Rev. Stat. § 77-2716(5).

<sup>11</sup> N.D. Cent. Code § 57-38-01.3(1)(g).

<sup>5</sup> *Kraft General Foods Inc. v. Iowa Dept. of Rev. and Fin.*, 505 U.S. 71 (1992).

<sup>6</sup> *Id.* at 82 (citing the Foreign Commerce clause, ["The Congress shall have Power. . . To regulate Commerce with foreign Nations. . ." U.S. Const., Art. I, § 8.]).

effective foreign tax rate but provide a new deduction for foreign intangible income.

## B. Mandatory Repatriation

The draft also provides a transition tax on domestic shareholders of the CFC through a mandatory income inclusion of the CFC's undistributed and previously untaxed foreign earnings. The income would be taxed at an effective rate of 5.25 percent (an 85 percent exclusion at the prior 35 percent rate), but the tax could be paid over a period of eight years.

Again, states with rolling or automatic conformity would follow the federal law and include this income in their tax base. With that being said, some states have full or partial exceptions for foreign source income, such as Colorado,<sup>12</sup> or foreign dividends, such as Arizona,<sup>13</sup> (depending on how the income is ultimately classified for federal purposes). Also, the type of filing required by the state will have an impact on whether this federal law change ultimately affects state taxable income. For example, some states have worldwide filing methods that may include foreign entities. Several states have rules regarding inclusion or exclusion of 80/20 companies. California's water's edge return has a partial inclusion for entities with Subpart F income<sup>14</sup> and Massachusetts has special rules regarding inclusion of foreign entities and their income.<sup>15</sup>

Such a change is likely to have the largest effect on separate company states that do not have foreign income exclusions, such as Arkansas, as there would be no intercompany or other income exclusions.

## C. Interest Expense Limitation

The draft would expand the present law limitation on the current deductibility of interest expense in a manner similar to rules applied to foreign companies investing in the United States through U.S. subsidiaries.

This interest expense limitation would have an impact on certain state tax regimes. As discussed above, states with rolling conformity would follow this provision if enacted. It would create an interesting application for states that require separate return filing such that the disallowance may not apply at the federal consolidated group level but could apply at the individual entity level, or may not apply at the individual entity level but could apply at the federal consolidated group level. Furthermore, a number of states already require a full interest add-back for intercompany interest expense, such as Georgia,<sup>16</sup> in which case this provision would have no effect in those states on those transactions. Note, the general exceptions to the state intercompany interest add-backs may be different than the proposed federal exception.

For states that do not automatically conform to federal law changes or states that pass their own legislation to decouple from these provisions, there will be increased administrative burdens on tracking state tax-

able income and the federal/state tax differences that would result.

## III. Other Proposed Federal Business Income Tax Legislation

### A. Reduced Corporate Tax Rate

The Ways and Means Chairman Dave Camp's first tax reform discussion draft (October 2011) proposes reducing the top U.S. statutory corporate rate from 35 to 25 percent, but does not specify what tax expenditures might be cut to achieve that rate.<sup>17</sup> Such change would have a relatively minor impact on states taxes. Only the minority of states (*e.g.*, Louisiana<sup>18</sup>) that allow a deduction for federal income taxes would be affected by such change. Also, it is worth noting, the additional disposable corporate income resulting from the reduced tax rate could trickle down to increased spending money and more state sales tax revenue for the states.

### B. Small Business Tax Reform: Highlights of Camp's Passthroughs Discussion Draft

Chairman Camp's third discussion draft, released in March 2013, offers several provisions to simplify tax compliance for small businesses and proposes two possible options for overhauling the taxation of pass-through entities. One option would revise the current rules, while the second would replace them with a unified system. Below is an overview of the changes discussed and the anticipated state tax impact.

**1. Various Small Business Reforms.** The draft's simplification reforms would address immediate expensing of certain items and start-up costs, and would streamline filing dates for tax returns. It would make changes to the cash method of accounting, limiting it to natural persons and taxpayers other than tax shelters that have less than \$10 million annual average gross receipts for the three prior taxable years. Further, certain small businesses would not be subject to the uniform capitalization rules that generally require certain costs allocable to real or tangible personal property produced by the taxpayer to be included in inventory or capitalized into the basis of the property.

**a. Permanent Section 179 Expensing:** Many states decouple from the federal section 179 expense rules. Depending on how the state statute is written, those states may need to take further legislative action to continue to decouple from section 179 expensing rules if the draft proposal becomes federal law. Such state decoupling increases the state tax base in the year the asset is purchased, but as depreciation expense is allowed in future years the state tax base will be smaller than the federal tax base. Any decoupling from federal law in this respect is a timing difference. Practically speaking, however, there is a chance the timing difference is not taken into account on some state tax returns due to the additional compliance costs of keeping another set of

<sup>12</sup> Colo. Rev. Stat. §39-22-303(10).

<sup>13</sup> Ariz. Rev. Stat. §43-1122(6). As a cautionary note, Arizona also requires the addback of any related expenses under the provisions of Ariz. Rev. Stat. §43-961.5.

<sup>14</sup> Cal. Rev. & Tax. Code §25110(a)(6).

<sup>15</sup> Mass. Regs. Code tit. 830, §63.32B.2(5)(b).

<sup>16</sup> Ga. Code Ann. §48-7-28.3(b).

<sup>17</sup> House Ways and Means Committee Discussion Draft (Oct. 26, 2011) available at [http://waysandmeans.house.gov/UploadedFiles/Discussion\\_Draft.pdf](http://waysandmeans.house.gov/UploadedFiles/Discussion_Draft.pdf).

<sup>18</sup> La. Rev. Stat. Ann. §47:287.85.A.

depreciable books and a lack of communication between taxpayers and outside tax return preparers.

For purposes of examples, here is how a few large states would be affected by this change:

- California refers to I.R.C. Sec. 179 and modifies its provisions.<sup>19</sup> Therefore, California tax law is not affected by changes to the federal Sec. 179 rules.

- Illinois has rolling federal conformity and would follow changes to Sec. 179 without additional state legislation.<sup>20</sup>

- The Texas Margin Tax cost of goods sold deduction may include Sec. 179 expenses under the I.R.C. (as of Jan. 1, 2007) that are specifically related to equipment used in the production of goods.<sup>21</sup> Accordingly, Texas would not automatically conform to federal changes to I.R.C. Sec. 179 absent additional state legislation.

**b. Unified Deduction for Start-up and Organizational Expenses:** Most states conform to the federal rules for expensing of start-up costs. Accordingly, whether states will conform to this provision depends on whether the state has rolling I.R.C. conformity or fixed-date conformity. The states with effective rolling I.R.C. conformity, like New York, will likely automatically adopt this change, while states with fixed-date conformity, like California, would not automatically adopt this change.

**c. Streamline Compliance Due Dates:** A few states “piggy-back” off the federal return due dates by either following the same date as the federal due date, such as Maine, Minnesota and Nebraska<sup>22</sup> or using the federal due date plus 15 or 30 days, such as Alaska, Florida and Oregon.<sup>23</sup> However, the majority of the states have codified their own return due dates. Accordingly, additional legislative action would be required for those states to conform to this proposed change even if the state previously had the same return due date as the federal return.

**d. Simplify and Expand the Use of Cash Accounting Method:** Most state laws do not require or allow use of an accounting method different from the federal method used.<sup>24</sup> With that being said, changes in accounting method for entities already in existence often result in section 481 adjustments that can affect the state tax returns in a variety of ways. However, for new companies that chose the cash method, there will not likely be any state tax implications of this proposed federal change.

**2. New Tax Regime: Option 1.** Under Option 1, which preserves Subchapters S and K, statutory amendments are proposed to provide flexibility for S corporations and to clarify partnership law.

For S corporations, this option incorporates a number of existing reform proposals. For example, the draft would make permanent the current temporary provision relating to the five-year recognition period for built-in gains tax. It would repeal the current law provision that terminates an S corporation’s passthrough status if it has excess passive investment income for three consecutive taxable years. It also would permit nonresident aliens to become indirect S corporation shareholders through an electing small business trust.

Option 1 also would significantly revise the tax rules for partnerships. It would repeal the rules for guaranteed payments to partners and treat them as either payments received in their capacity as partners (distributions of partnership income or capital) or in their capacity as nonpartners. It would require mandatory adjustment of a partnership’s basis in partnership property when a partnership distributes property to a partner or a partner transfers its partnership interest. It would apply the section 704(d) loss limitation to a partner’s distributive share of charitable contributions and foreign taxes, bringing partnership rules into conformity with those for S corporations. And Option 1 would require that partners contributing property with built-in gains or losses be subject to tax on the pre-contribution gain or loss when the partnership distributes the property to another partner or distributes other property to the contributing partner without the current limitation of seven years for recognition of the pre-contribution gains or losses.

By way of examples, permanently changing the built-in gains period for S corporations to five years will have the following effect on a few of the larger states:

- California’s fixed-date conformity of Jan. 1, 2009, means the state would not be affected by this federal tax law change.<sup>25</sup>

- Illinois does not impose an S corporation built-in gains tax<sup>26</sup> and, therefore, would not be affected by this proposed federal change.

- In Texas, S corporations are subject to the Margin Tax<sup>27</sup> so federal S corporation provisions do not apply, and Texas would not be affected by this change to the federal law.

In general, states with rolling or automatic conformity will follow these proposed rules if adopted. States with fixed-date conformity will not follow the rules absent additional state legislation. Some states have specific rules regarding guaranteed payments<sup>28</sup> that need to be considered in determining whether the states will follow the proposed changes. Otherwise it is unlikely that states have specific decoupling or rules regarding the other proposed tax law changes in this area.

**3. New Tax Regime: Option 2.** The draft’s second option would repeal current Subchapters K and S of the code and replace them with a uniform passthrough system. This system would apply to partnerships and corporations that elect passthrough status. The draft does not stipulate a limit on the number of shareholders for electing corporations, but publicly traded corporations,

<sup>19</sup> Cal. Rev. & Tax. Code §24356(b).

<sup>20</sup> 35 ILCS 5/102.

<sup>21</sup> Tex. Tax Code Ann. §17.0001(9); *see also*, Frequently Asked Questions – Cost of Goods Sold, Texas Comptroller of Public Accounts, Question 19 (Updated April 4, 2012).

<sup>22</sup> Me. Rev. Stat. Ann. tit. 36, §5227; Minn. Stat. §289A.18.Subd.1.(1); Neb. Rev. Stat. §77-2768, respectively, for Subchapter C corporation income tax return due dates not including extensions.

<sup>23</sup> Alaska Stat. §43.20.030(a); Fla. Stat. ch. 220.222(1); Or. Rev. Stat. §314.385(1), respectively, for Subchapter C corporation income tax return due dates not including extensions.

<sup>24</sup> For example, Arkansas specifically requires taxpayers to use the same accounting method as used to calculate federal taxable income. *See*, Ark. Code. Ann. §26-51-401.

<sup>25</sup> Cal. Rev. & Tax. Code §23800, §23051.5(a)(1) & §17024.5(a).

<sup>26</sup> 35 ILCS 5/205(c).

<sup>27</sup> Tex. Tax Code Ann. §171.0002.

<sup>28</sup> Such states include Louisiana (*see*, La. Rev. Stat. Ann. §47:208) and Ohio (*see*, Ohio Rev. Code Ann. §5733.40(A)(7)).

certain financial institutions, and insurance companies would not be allowed to elect passthrough status.

Under this option, a passthrough's income, gain, loss, credits, and deductions would be calculated in the same manner as for an individual, with some exceptions. Each owner's distributive share would be determined by the ownership agreement, or, in the absence of one, by the owner's economic interest in the passthrough. However, the distributive share could be adjusted if the agreement is inconsistent with the owner's economic interest. The unified system also would require generally that the owner's distributive share be equal within each of three classes: ordinary items, capital gain rate items, and tax credits. This is a significant change and one that could substantially impact many normal business relationships.

Option 2 also would impose withholding tax on passthroughs for income allocated to each owner on the excess of the owner's distributive share of items of income and gain over items of deduction and loss. Tax withheld would be treated as distributed to the owner, and the owner's basis in the passthrough interest would be decreased by the amount withheld. The owner would treat any amounts withheld as a refundable credit against its income tax liability.

It would seem likely that at least some states would respond with their own legislation if such a sweeping federal tax law change were enacted. However, without regard to state legislative changes, how would such a change affect the states if Subchapter K and Subchapter S were repealed? Certain states with rolling conformity to the complete I.R.C. for all entity types would follow the changes, such as Missouri.<sup>29</sup> However, certain changes may make decoupling provisions difficult to apply, depending on how they are worded (*i.e.*, specifically referring to I.R.C. sections that may be repealed<sup>30</sup> versus not referencing the I.R.C. at all<sup>31</sup>).

## IV. Federal Legislation Affecting State Sales Tax

Although historically not a federal topic, recent years have shown that the federal government may enact legislation giving states authority to collect sales and use tax on out-of-state purchases in an effort to "even" the playing field where the states may not otherwise be able to do so themselves. Such legislation has received a lot of press and will have a tremendous impact on the states and state sales tax compliance for companies.

The concept of nexus or some "minimum connection" is an important concept in state law and state taxation and is a standard required by the Commerce Clause and Due Process Clause of the U.S. Constitu-

tion.<sup>32</sup> In the *Quill* case, the U.S. Supreme Court ruled that before an out-of-state company can be obligated to register and collect state use tax, it must have "substantial nexus" in the taxing state.<sup>33</sup> The substantial nexus standard derives from the Commerce Clause of the U.S. Constitution and requires some level of physical presence. In other words, remote sellers typically do not have nexus with states where they do not have an office or some "physical presence." The *Quill* decision does, however, allow for the possibility that Congress can enact legislation giving states the authority to require that use taxes be collected by remote sellers. Currently the Marketplace Fairness Act of 2013 (S. 743, "the Act") is the proposed federal legislation that would do just that. Note, the Act does not create a state tax where one would not otherwise exist but simply allows a state to require that out-of-state companies collect and remit the tax.

Historically, the sales tax nexus standard has been broadened by the courts. The "physical presence" nexus standard was expanded by the U.S. Supreme Court in the *Scripto* and *Tyler Pipe Industries* cases. In *Scripto* the U.S. Supreme Court sanctioned the agency theory of nexus, finding that an out-of-state seller who used independent contractors to solicit business could be required to collect the state's sales tax.<sup>34</sup> While in *Tyler Pipe Industries*, the U.S. Supreme Court found that representatives performing activities on behalf of a seller, while physically present in a state, may create sales tax nexus for a seller if such activities are significantly associated with the seller's ability to establish and maintain a marketplace in the state for its sales.<sup>35</sup>

The expansion of e-commerce has broadened the concept of remote seller sales far beyond mail order catalogs, all but forcing the federal government to consider getting involved in the issue. In the meantime states, such as New York, have tried to expand the traditional nexus standards with what is sometimes called "click-through" nexus laws. Such laws are enacted in an effort to address the relationship between Internet retailers and in-state companies with websites that provide a link to the Internet retailer's website. "Click-through" nexus statutes create a presumption of nexus for out-of-state sellers who compensate an in-state company based upon a percentage of sales from referrals through the in-state company's website. The seller may rebut the presumption provided it can document that the in-state person is not actively soliciting sales within the state on its behalf.<sup>36</sup>

The Act passed the Senate by a vote of 69-27 on May 6 of this year. The Act's fate in the House is unclear.<sup>37</sup>

<sup>32</sup> *International Shoe Co. v. Washington*, 326 U.S. 310 (1945).

<sup>33</sup> *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992).

<sup>34</sup> *Scripto v. Carson*, 262 U.S. 207 (1960).

<sup>35</sup> *Tyler Pipe Indus. Inc. v. Washington Dept. of Rev.*, 483 U.S. 232 (1987).

<sup>36</sup> Note that certain on-line retailers have sought to challenge the constitutionality of these "click-through" nexus laws. See, *Overstock.com Inc. v. New York State Dept. of Taxn. & Fin.*, 2013 NY Slip Op 02102 (N.Y. Mar. 28, 2013).

<sup>37</sup> Note that, on Sept. 18, 2013, the U.S. House of Representatives Judiciary Committee issued a press release addressing "principles pertaining to the issue of Internet sales tax" (the "Press Release"). Although it does not reference the Act (S. 743), the Press Release appears to represent the House's next step in considering the matter of sales tax collection on remote

<sup>29</sup> Mo. Rev. Stat. §143.091.

<sup>30</sup> For example, see Alabama Code §40-18-24(a). If the cited I.R.C. sections were repealed from the I.R.C. it would seem the last version of the sections may be applied in order to interpret Alabama's tax laws. However, it is conceivable that the Alabama legislature would take action to address such a drastic change to the I.R.C.

<sup>31</sup> Presumably, state tax law provisions that do not refer to I.R.C. Subchapters K or S would not be affected by a repeal of the two subchapters, but taxpayers would still have to contend with state / federal differences in an already murky area of state tax law.

The Act would authorize each member state under the Streamlined Sales and Use Tax Agreement to enact laws requiring remote sellers to collect and remit sales and use taxes to the state<sup>38</sup> with respect to “remote sales” sourced to the state.<sup>39</sup> Further, states that are not members of the Streamlined Sales and Use Tax Agreement would be able to exercise such authority to require such collection, if they meet certain “minimum simplification requirements” regarding administration of the tax. As part of these minimum simplification requirements, the state must provide free software for remote sellers to calculate the sales and use tax due on each transaction at the time the transaction is completed and to file the sales and use tax returns.<sup>40</sup>

Streamlined Sales and Use Tax Agreement states could begin implementing their sales and use tax on remote sales as soon as the first day of the calendar quarter that is 180 days after enactment of the Act and the publishing of a notice of the state’s intent to exercise authority under the Act.<sup>41</sup>

Other states may commence their authority beginning no earlier than the first day of the calendar quarter that is at least six months after the date that the state enacts legislation to exercise the authority granted by the Act, and implements the minimum simplification requirements.<sup>42</sup> For non-Streamlined Sales and Use Tax Agreement states, the “minimum simplification requirements” provide:

- i. a single entity within the State responsible for all State and local sales and use tax administration, return processing, and audit for remote sales sourced to the State;<sup>43</sup>
- ii. a single audit of a remote seller for all State and local taxing jurisdictions within that State;<sup>44</sup> and
- iii. a single sales and use tax return to be used by remote sellers to be filed with the single entity responsible for tax administration.<sup>45</sup>

The states must also provide a single sales tax base across the state and source all remote sales according to the sourcing rules in the Act.<sup>46</sup> States and local jurisdictions may not place more stringent requirements on remote sellers than are in place for non-remote sellers.<sup>47</sup> Moreover, the states must have in place “certifi-

cation procedures for persons to be approved as certified software providers.”<sup>48</sup>

Under the Act, remote sales would be sourced according to “the location where the product or service sold is received by the purchaser, based on the location indicated by instructions for delivery that the purchaser furnishes to the seller.”<sup>49</sup> If no delivery location is specified by the customer, it defaults to the customer’s address, including “the address of the customer’s payment instructions if no other address is available.”<sup>50</sup> If no customer address is given or possible to obtain, the sale is sourced to “the address of the seller from which the remote sale was made.”<sup>51</sup>

Member states under the Streamlined Sales and Use Tax Agreement, exercising authority to require remote sellers to collect and remit sales and use taxes, would comply with the sourcing rules under the Streamlined Sales and Use Tax Agreement.<sup>52</sup>

The bill also includes a “small seller exception” that provides relief from collecting and remitting sales and use tax for remote sellers with annual gross receipts from remote sales in the United States of \$1 million or less in the preceding calendar year.<sup>53</sup>

Other notable provisions of the Act are as follows:

- A statement that the Act shall not be interpreted to create any nexus or alter the standards for determining nexus.<sup>54</sup>
- An acknowledgement that remote sellers may deploy or utilize a certified software provider of their choice.<sup>55</sup>
- Adoption of a cascading sourcing rule to determine the location where the product or service is sold.<sup>56</sup>
- An acknowledgement that the Act has no impact on the Mobile Telecommunications Sourcing Act (4 U.S.C. 116-126).<sup>57</sup>
- Relief provided to remote sellers for liability from incorrect collection of sales and use tax if the error was caused by a certified software provider.<sup>58</sup>
- A required 90-day notice period of a rate change by the state or locality.<sup>59</sup>

The National Conference of State Legislatures estimates over \$23 billion of state use tax on remote sales went uncollected in 2012.<sup>60</sup> The state with the highest estimated uncollected use tax is California.<sup>61</sup> Texas and New York come in second and third highest, respectively,<sup>62</sup> but have less than half of California’s estimated amount.

sales transacted via the Internet. The Press Release included statements from House Judiciary Committee Chairman Bob Goodlatte and from House Subcommittee Chairman Spencer Bachus, who stated, “The principles [issued by Chairman Goodlatte] provide a thoughtful framework for discussion on the Internet sales tax issue. As chair of the subcommittee with jurisdiction over Internet tax issues, I appreciate that the Chairman is giving it serious consideration.” Representative Bachus is a co-sponsor of the HR 684, which is also called “The Marketplace Fairness Act of 2013.”

<sup>38</sup> S.743, Sec. 2(a).

<sup>39</sup> The term “remote sale” is defined to mean “a sale into a State, as determined under the sourcing rules under paragraph (7), in which the seller would not legally be required to pay, collect or remit State or local sales and use taxes unless provided by this Act.” S.743, Sec. 4(5).

<sup>40</sup> S.743, Sec. 2(b)(2)(A), (B), & (D).

<sup>41</sup> S.743, Sec. 2(a).

<sup>42</sup> S.743, Sec. 2(b).

<sup>43</sup> S.743, Sec. 2(b)(2)(A)(i).

<sup>44</sup> S.743, Sec. 2(b)(2)(A)(ii).

<sup>45</sup> S.743, Sec. 2(b)(2)(A)(iii).

<sup>46</sup> S.743, Sec. 2(b)(B)&(C).

<sup>47</sup> S.743, Sec. 2(b).

<sup>48</sup> S.743, Sec. 2(b)(2)(D)(iii), such certification procedures apply to those creating the software for calculating and filing sales and use taxes.

<sup>49</sup> S.743, Sec. 4(7).

<sup>50</sup> *Id.*

<sup>51</sup> *Id.*

<sup>52</sup> *Id.*

<sup>53</sup> S.743, Sec. 2(c), certain aggregation rules apply between related parties for purposes of determining this exception.

<sup>54</sup> S.743, Sec. 3(b).

<sup>55</sup> S.743, Sec. 3(c).

<sup>56</sup> S.743, Sec. 4(7).

<sup>57</sup> S.743, Sec. 3(g).

<sup>58</sup> S.743, Sec. 2(b)(2)(E).

<sup>59</sup> S.743, Sec. 2(b)(2)(H).

<sup>60</sup> Available at: <http://www.ncsl.org/issues-research/telecom/2012-uncollected-use-tax.aspx>.

<sup>61</sup> *Id.* (Estimating over \$4 billion in uncollected use tax in California in 2012).

<sup>62</sup> *Id.* (Estimating over \$1.7 billion each in uncollected use tax in Texas and New York in 2012).

Currently 45 states<sup>63</sup> and the District of Columbia impose sales and use tax on sales of tangible personal property and certain services. The state and local impact if such legislation is adopted is clear on its face. If states follow the requirements of the proposed legislation, they will be able to require remote sellers to collect and remit sales and use tax, despite not meeting traditional nexus standards with the state. It seems very likely this will result in increased revenues to the states. One conceivable potential negative impact would be a change in consumer behavior and a decrease in purchases.

The law would also have an overwhelming impact on out-of-state businesses with “remote sales.” Such businesses with over \$1 million of annual receipts would be required to collect and remit sales tax in states where they do not have a “physical presence.” In an extreme example, a business that is located in a state such as Delaware that does not currently impose sales or use tax could go from not collecting any sales or use tax to collecting sales and use tax in 45 states if it has remote sales to each of those states. This would also result in a massive compliance obligation for such businesses.

## V. Other Potential Federal Legislation

### A. Tax Benefits for Individual Home Owners

Currently under the I.R.C., individuals are allowed an itemized deduction for mortgage interest expense on home loans with certain restrictions.<sup>64</sup> The primary restrictions include that the individual occupies the home subject to the loan, up to two homes can qualify and qualifying mortgages can total up to \$1 million. Potential proposed changes in this area involve repealing or phasing out the deduction in whole or in part, limiting the deduction, converting it to an above-the-line deduction,<sup>65</sup> and converting the deduction to a credit.<sup>66</sup>

Some states follow the federal itemized deduction rules, including Colorado<sup>67</sup> and North Carolina.<sup>68</sup> Depending on conformity dates, these states may automatically follow a change to this federal deduction. The effect of changing it to a credit would likely have a bigger impact on the states than phasing out or limiting the deduction. Certain other states, such as Connecticut<sup>69</sup> and Illinois,<sup>70</sup> use federal adjusted gross income as the state taxable income starting point and do not follow

the federal itemized deduction rules or the mortgage interest deduction and likely would not be affected by this change.

The I.R.C. currently allows individuals to exclude up to \$250,000 of gain (\$500,000 for a joint return or a return of a surviving spouse) on the sale of their principal home.<sup>71</sup> Potential changes that have been suggested with respect to this federal exclusion include phase out or extending the exclusion over a period of years.

Many states follow this federal income exclusion either directly or indirectly by using Adjusted Gross Income<sup>72</sup> or some other federal amount as the state starting point.<sup>73</sup> These states would follow this change if they have rolling or automatic conformity, such as Colorado. Other states, such as Kentucky with fixed date conformity, would require additional legislation in order to conform to such a change.

Currently the I.R.C. allows an itemized deduction for state and local income and property taxes.<sup>74</sup> There is potential legislation discussed that would limit or eliminate this deduction.<sup>75</sup> Some states follow the itemized deduction rules, including Colorado,<sup>76</sup> North Carolina<sup>77</sup> and South Carolina.<sup>78</sup> Depending on conformity dates, these states may automatically follow a change to this federal deduction. With that being said, many states decouple from this particular deduction, including Colorado,<sup>79</sup> North Carolina<sup>80</sup> and South Carolina,<sup>81</sup> which do not allow a deduction for state income taxes. In that respect, this potential law change would have little effect on Colorado taxpayers who are not allowed a deduction for state income taxes under Colorado law, regardless of the I.R.C. Other states do not follow the federal itemized deduction rules and generally start with federal adjusted gross income; as such they would not likely be affected by this change.

### B. Permanent Internet Tax Freedom Act of 2013

Pending federal legislation would make the current federal moratorium against the imposition of state and local taxes on Internet access permanent. The morato-

<sup>71</sup> I.R.C. § 121.

<sup>72</sup> For example, Kentucky (*see*, Ky. Rev. Stat. Ann. § 141.010(10)).

<sup>73</sup> For example, Colorado uses Federal taxable income under I.R.C. § 63 as the state starting point. (*See*, Colo. Rev. Stat. § 39-22-104(1.7)).

<sup>74</sup> I.R.C. § 164(a).

<sup>75</sup> FY14 Administration Budget Proposal; S. 3125 (110th Congress).

<sup>76</sup> Colo. Rev. Stat. § 39-22-104(1.7), adopting federal taxable income as the state taxable income starting point.

<sup>77</sup> N.C. Gen. Stat. § 105-134.6(a2).

<sup>78</sup> S.C. Code Ann. § 12-6-560, stating “taxable income is computed as determined under the Internal Revenue Code. . . .”

<sup>79</sup> Colo. Rev. Stat. § 39-22-104(3)(d), state income taxes are required to be added back to the extent they are included in itemized deductions, but only to the extent the total itemized deductions exceed the federal standard deduction under I.R.C. Sec. 63(c).

<sup>80</sup> N.C. Gen. Stat. § 105-134.6(c)(3), state income taxes are required to be added back to the extent they are included in itemized deductions, but only to the extent the total itemized deductions exceed the North Carolina standard deduction allowed.

<sup>81</sup> S.C. Code Ann. § 12-6-1130(2).

<sup>63</sup> The states are: Alabama, Arizona, Arkansas, California, Colorado, Connecticut, Florida, Georgia, Hawaii, Idaho, Illinois, Indiana, Iowa, Kansas, Kentucky, Louisiana, Maine, Maryland, Massachusetts, Michigan, Minnesota, Mississippi, Missouri, Nebraska, Nevada, New Jersey, New Mexico, New York, North Carolina, North Dakota, Ohio, Oklahoma, Pennsylvania, Rhode Island, South Carolina, South Dakota, Tennessee, Texas, Utah, Vermont, Virginia, Washington, West Virginia, Wisconsin and Wyoming. Sales Tax Institute. Available at: <http://www.salestaxinstitute.com/resources/rates>.

<sup>64</sup> I.R.C. § 163(h).

<sup>65</sup> Instead of an itemized “below-the-line” deduction.

<sup>66</sup> FY14 Administration Budget Proposal; H.R. 3608 (110th Congress); H.R. 1213 (113th Congress).

<sup>67</sup> Colo. Rev. Stat. § 39-22-104(1.7) adopting federal taxable income as the state taxable income starting point.

<sup>68</sup> N.C. Gen. Stat. § 105-134.6(a2).

<sup>69</sup> Conn. Gen. Stat. § 12-701(a)(20).

<sup>70</sup> 35 ILCS 5/203(a). *See also*, Ill. Admin. Code § 100.2450(b).

rium was originally enacted by the 1998 Internet Tax Freedom Act (ITFA), extended by the Internet Tax Non-discrimination Act (ITNA), and then extended again, until Nov. 1, 2014, under the Internet Tax Freedom Act Amendments Act of 2007 (Pub. L. No. 110-108).<sup>82</sup>

States would be required to follow this legislation and the current ban on Internet access taxes would continue,<sup>83</sup> except for states where the ability to tax Internet access is “grandfathered” into this legislation.

### C. Mobile Workforce State Income Tax Simplification Act

This pending legislation, the Mobile Workforce State Income Tax Simplification Act of 2013,<sup>84</sup> “the Mobile Workforce Act,” limits state taxation of the wages or other remuneration of any employee who performs duties in more than one state to: (1) the state of the employee’s residence; and (2) the state(s) in which the employee is “present and performing employment duties for more than thirty days during the calendar year in which the wages or remuneration is earned.”<sup>85</sup> This limitation specifically includes a limitation on withholding taxes and reporting requirements according to the same standards.<sup>86</sup>

In general, under the Mobile Workforce Act an employer may rely on an employee’s determination of the time he or she will spend in each state during the year.<sup>87</sup> This is true unless the employer maintains a “time and attendance system” that records and tracks where employees perform their daily duties, in which case this “time and attendance system” should be used to determine the number of days an employee works in each state.<sup>88</sup>

The Mobile Workforce Act generally defines “employee” according to the state definition where the em-

ployee performs his or her duties.<sup>89</sup> However, for purposes of the Mobile Workforce Act, a professional athlete or entertainer or certain public figure is exempt from the definition of “employee.”<sup>90</sup> The Mobile Workforce Act states that an employee is deemed to work a “day” in the state where he or she performs the most duties for the day,<sup>91</sup> not including travel time.<sup>92</sup> However, if an employee performs duties in his or her resident state and only one nonresident state during the day, the employee is considered to perform more employment duties in the nonresident state for that day.<sup>93</sup>

The MTC adopted a uniformity recommendation for the states on this mobile workforce issue in 2011, but it uses a 20-day threshold, instead of 30.

Note that this legislation would affect all the states regardless of I.R.C. conformity, as the Mobile Workforce Act limits a state’s ability to tax compensation of certain employees and would preempt current state laws. However, this federal legislation generally relies on each state’s definition of “employee” for determining to whom it applies. As such, states may potentially have to amend their current laws to conform to the Mobile Workforce Act, if enacted into law, to avoid future confusion.

## VI. Summary

Regardless of which federal tax reform regime is ultimately passed, it will impact the states. Accordingly, it is important for state tax practitioners to understand and be able to respond when such federal legislation is passed. The areas of tax law and degree of change may vary, but it seems talk of federal tax reform is far from over.

<sup>82</sup> S. 31 (113th Congress), Permanent Internet Tax Freedom Act of 2013, sponsored by Sen. Ayotte.

<sup>83</sup> Recently, the Illinois Supreme Court affirmed an Illinois circuit court’s 2012 ruling, holding that Illinois legislation enacted during 2011 that imposes sales/use tax nexus on certain out-of-state remote sellers for periods beginning July 1, 2011, violates the federal Internet Tax Freedom Act (ITFA) by imposing a discriminatory tax on electronic commerce. The court reasoned that Illinois’s “click-through” nexus provisions impose a discriminatory tax on electronic commerce within the meaning of the ITFA and are, thus, expressly preempted by the ITFA, rendering them void and unenforceable. *Performance Mktg. Assn. Inc. v. Hamer*, Ill., No. 114496, 10/18/13.

<sup>84</sup> H.R.1129, Sec. 1.

<sup>85</sup> H.R.1129, Sec. 2(a)(1)&(2).

<sup>86</sup> H.R.1129, Sec. 2(b).

<sup>87</sup> H.R.1129, Sec. 2(c)(1).

<sup>88</sup> H.R.1129, Sec. 2(c)(3), *see also*, Sec. 2(d)(8) for the definition of “time and attendance system.”

<sup>89</sup> H.R.1129, Sec. 2(d)(2).

<sup>90</sup> *Id.*

<sup>91</sup> H.R.1129, Sec. 2(d)(1)(A).

<sup>92</sup> H.R.1129, Sec. 2(d)(1)(C).

<sup>93</sup> H.R.1129, Sec. 2(d)(1)(B).

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