State tax policy: Recent developments in Multistate taxation

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Agenda

• 2019 State Outlook: the Fiscal Health of the States and Post-Mid-Term Election Results
• Trends in Local Taxes
• Trends in State Tax Apportionment
• A word on New Jersey’s recent reforms...
• Recent Developments in “Chevron-deference”
2019 State Outlook: the Fiscal Health of the States and Post-Mid-Term Election Results
What Do Businesses Pay?*

- Businesses paid more than $738 Billion in U.S. state and local taxes in FY 2017, an increase of 2% from FY 2016
- How much do businesses contribute to State and Local Revenues?
  - U.S. Average for FY2017: 43.7% of all tax revenues
  - Remarkably, the business share of SALT nationally has been within 2% of 45% since 2000
- Moreover, C Corporations on average pay about three-fifths more in income tax than pass through businesses

Composition of State and Local Business Taxes by Type, FY 2017

**United States**

- Property Tax: 21%
- Excise Tax: 9%
- Unemployment Insurance Tax: 5%
- License & Other Taxes: 5%
- Sales Tax: 39%
- Corporate Income Tax: 5%
- Individual Income Tax pm Pass-Through Income: 5%

**Florida**

- Property Tax: 29%
- Excise Tax: 7%
- Unemployment Insurance Tax: 6%
- License & Other Taxes: 16%
- Sales Tax: 40%
- Corporate Income Tax: 2%
- Individual Income Tax pm Pass-Through Income: 2%

Source: Council On State Taxation
Year-Over-Year Change in Inflation-Adjusted Major State and Local Taxes

Notes: Year-over-year change is the percentage of four-quarter moving averages. Data are adjusted for inflation.
Only 7 States Made Mid-Year Budget Reductions in Fiscal 2018 Due to a Shortfall

Budget Cuts Made After The Budget Passed

Note: Beginning in Fiscal 2018, NASBO asked states reporting net mid-year budget reductions as to whether the reductions were made due, at least in part, to a revenue shortfall. Effective in FY2018 going forward, only states reporting mid-year budget cuts due to a shortfall are included in the totals reported in this figure. Prior to FY2018, particularly in non-recessionary periods, states that reported mid-year cuts that were due to other reasons, such as a reduction in caseload, would have been included in the counts above.

Source: NASBO, Fall 2018 Fiscal Survey of States
Nearly All States Met or Exceeded Revenue Projections for Fiscal 2018

General Fund Revenue Collections Compared To Budget Projections (By Fiscal Year)

*Fiscal 2019 revenue collections compared to budget projections are subject to change, as data were collected early in the fiscal year. Not all states draw conclusions based on a few months of results at the time of data collection.

Source: NASBO, Fall 2018 Fiscal Survey of States
Revenue Growth Picked Up in Fiscal 2018 After Two Years of Weakness

General Fund Revenue, Fiscal 2008 To Fiscal 2019 (In Billions)

Fiscal 2019 figure is based on states’ enacted budgets. Percentages shown represent total annual general fund revenue growth. The median preliminary actual growth rate for fiscal 2018 is 5.2 percent; the median projected growth rate for fiscal 2019 is 2.3 percent.

Source: NASBO, Fall 2018 Fiscal Survey of States
2018 Gubernatorial Elections
2018 Gubernatorial Elections - Before

- **Governor Running for Re-Election**
- **No Incumbent Running**

Source: Council On State Taxation
2018 Gubernatorial Elections - After

Source: Council On State Taxation
Key Gubernatorial Races

Florida: Andrew Gillum (D) v. Ron DeSantis (R)
Georgia: Stacey Abrams (D) v. Brian Kemp (R)
Illinois: J.B. Pritzker (D) v. Bruce Rauner (R)*
Iowa: Fred Hubbell (D) v. Kim Reynolds (R)*
Kansas: Laura Kelly (D) v. Kris Kobach (R)
Maine: Janet Mills (D) v. Shawn Moody (R)+ 2 (I)
Michigan: Gretchen Whitmer (D) v. Bill Schuette (R)
Nevada: Steve Sisolak (D) v. Adam Laxalt (R)
Ohio: Richard Cordray (D) v. Mike DeWine (R)
South Dakota: Billie Sutton (D) v. Kristi Noem (R)
Wisconsin: Tony Evers (D) v. Scott Walker(R)*

* Incumbent

Source: Council On State Taxation
2018 State Party Control
Pre-2018 Midterm Elections – State Legislative Party Control

Split - 4 Republican - 31 Democrat - 14

Source: National Conference of State Legislatures

Trifecta States*

Source: National Conference of State Legislatures
Post-2018 Midterm Elections –
State Legislative Party Control

Split - 1  Republican - 30  Democrat - 18

Trifecta States*

Source: National Conference of State Legislatures
State Legislatures & Executives

State Governors

2018
Before Midterms

- Republican: 16
- Democrat: 33
- Independent: 1

2018
After Midterms

- Republican: 23
- Democrat: 27

Source: Council On State Taxation
Legislative Supermajorities

Legislative Supermajorities Gained:
• California Senate Democrats
  • Trifecta, with existing Assembly supermajority and new D Governor
• Oregon House and Senate Democrats
  • Trifecta, with incumbent D Governor winning reelection

Legislative Supermajorities Lost:
• Michigan Senate Republicans
  • Retained Senate, lost supermajority, switch to D Governor (retained House, but did not have supermajority)
• North Carolina House and Senate Republicans
  • Retained both, lost supermajorities, sitting D Governor
• Pennsylvania Senate Republicans
  • Retained Senate, lost supermajority, incumbent D Governor wins reelection (retained House, but did not have supermajority)

New Supermajority Requirement to Raise Taxes:
• Florida Amendment 5, two-thirds vote requirement to raise taxes or fees

Source: Council On State Taxation
Trends in Local Taxes
Trends in Local Taxes: San Francisco

• **Current gross receipts tax:** Phasing in since 2014 (fully phased in starting in 2018), the San Francisco GRT is imposed on every person “engaging in business” within San Francisco (except administrative offices and small businesses (those with less than $300k of City payroll and $1,090,000 in City gross receipts).

  - Graduated rates: Rates vary based on industry and extent of gross receipts (top tax bracket across industries applies to gross receipts over $25 million)

  - Gross receipts broadly defined, but exclusions include:

    ◦ Investment receipts

    ◦ Amounts received from related entities

    ◦ Separately stated federal, state or local taxes

  - Gross receipts generally apportioned using payroll (San Francisco payroll/total payroll) as well as destination/market principles for sales of TPP, services and intangibles (varies by industry)

Effective 1/1/2019, San Francisco applies economic nexus – “engaging in business” in San Francisco includes $500,000 or more of annual gross receipts from sales to customers located in San Francisco

• **Payroll Expense Tax:** Originally planned to be phased out in 2018, tax remained in effect @ 0.38%.
• **Homelessness Gross Receipts Tax**: Beginning 1/1/2019, San Francisco imposes a new GRT in addition to the existing GRT on City gross receipts in excess of $50 million.

  – Tax base is the same as current GRT

  – Rates vary depending on type of industry, but not amount of gross receipts. Rates range from 0.175% (Retail trade, wholesale trade, certain services) to 0.690% (private education and health services, administrative and support services, and miscellaneous business activities)

• **Commercial Rents Tax**: Beginning 1/1/2019, San Francisco imposes a commercial rents tax on landlords.

  – Gross receipts from lease or sublease taxable at the following rates:
    ◦ 3.5% tax on gross receipts from the lease of commercial space; and
    ◦ 1% tax on gross receipts from the lease of warehouse space

  – Proposed regulations released that clarify the treatment of common costs landlords pass along to tenants as subject to the tax (except certain taxes)

• Both taxes being challenged due to passage as initiatives by simple majority rather than two-thirds supermajority approval required under California Constitution and Proposition 218.
Trends in Local Taxes: Portland, Oregon

• **CEO Surcharge:** Effective for tax years beginning on or after 1/1/2017, Portland requires publicly traded companies subject to U.S. Securities & Exchange Commission pay ratio reporting requirements to pay a surtax in addition to the City business license tax.

  –Rates:
    ◦ 10% of base tax liability if the reported pay ratio is at least 100:1 but less than 250:1
    ◦ 25% of base tax liability if the reported pay ratio is of 250:1 or greater

  –SEC Pay Ratio generally discloses and calculates the ratio of:
    ◦ Median annual total compensation of all employees (excluding the CEO)
    ◦ Annual total compensation of CEO

  –Filing Group: Portland follows Oregon, which uses the federal affiliated group as the starting point for filing the state consolidated corporate income tax return. Portland will look to the CEO of the parent corporation (usually the publicly-traded entity subject to the SEC pay ratio reporting requirement) for the CEO pay ratio. If the taxpayer believes this is inappropriate (e.g., the publicly-traded entity is excluded from the Oregon return), the taxpayer may petition the City to permit an exception.
Trends in Local Taxes: Portland, Oregon (cont’d)

• **Gross Receipts Tax**: Effective for tax years beginning on or after 1/1/2019, Portland imposes a 1% “surcharge on gross revenues from sales within the City, unless otherwise exempted,” on “Large Retailers”

  - Large Retailer is a “business” that:
    - Is subject to the Portland Business License Tax
    - Had annual gross revenue from retail sales from all locations in the U.S. where the taxpayer conducts business that exceeded $1 billion in prior year
    - Had annual gross revenue from retail sales within Portland of $500,000 or more in the prior tax year

  - Large Retailer excludes:
    - Any manufacturer or other business that is not engaged in retail sales within Portland
    - Any entity operating a utility within Portland
    - Any cooperative recognized under federal or state law
    - Any federal or state credit union
Gross Receipts Tax (cont’d): Effective for tax years beginning on or after 1/1/2019, Portland imposes a 1% “surcharge on gross revenues from sales within the City, unless otherwise exempted,” on “Large Retailers”

- “National Gross Revenue” is the “gross revenue a business receives nationally in a given year from retail sales”

- “Retail sale” is a sale to a consumer for use or consumption, not for resale, and includes services

- Measure imposes the surcharge on a “business” rather than “taxpayer” or “taxfiler”

- The following may be deducted from gross receipts:

- No penalties or interest will be charged for failure to make estimated payments on surcharge during the 2019 tax year

- No changes made to City apportionment statutes or rules

- The City Revenue Division will, by May 2019, prepare a list of businesses that it believes meet the definition of a Large Retailer and notify them of their surcharge obligations. This notice is *not* a prerequisite to being subject to the surcharge
Trends in Local Taxes: “Head Taxes”

• **Head Tax**: Tax based on employment head count/employee hours worked in jurisdiction

  - **Seattle**: City council passed, then repealed, the “employee hours tax” in 2018
    - Compromise proposal unanimously passed in May 2018 that imposed a $275-per-employee head tax on employers with gross revenues in excess of $20 million, subject to a renewal vote after 5 years
    - Head tax repealed by 7-2 vote in June 2018

  - **Mountain View, California**
    - Voters approved per-employee business tax on November 6, 2018
    - Businesses with employees pay flat fee and larger employers also pay per-employee fee
      - 1-50 employees: flat fee ranging from $100 to $445
      - 51-500 employees: flat fee of $445 + $75/employee over 50
      - 501 – 1,000 employees: flat fee of $34,150 + $100/employee over 500
      - 1,001 – 5,000 employees: flat fee of 84,150 + $125/employee over 1,000
      - 5,001+ - flat fee of $584,150 + $150/employee over 5,000
2018 State & Local Tax Ballot Initiatives

SALES TAXES:

• **Arizona** [Proposition 126](#) would place a bar on the state and on local governments from enacting new transaction taxes on services or increasing the tax rate applied to services as of December 31, 2017.

• **Nevada** [Question 2](#), referred to the ballot by 2017’s [S.B. 415](#), would exempt feminine hygiene products from sales tax.

• **Nevada** [Question 4](#) would establish a sales tax exemption for durable medical equipment prescribed by a doctor.

Source: Council On State Taxation
2018 State & Local Tax Ballot Initiatives

TAX LIMITATIONS:

• **California Proposition 6**, Voter Approval for Future Gas and Vehicle Taxes and 2017 Tax Repeal Initiative, would repeal the 12 cents per gallon gas tax increase enacted last year, and would require voters to approve new fuel taxes and vehicle fees going forward.

• **Florida Amendment 1** would increase the maximum homestead exemption from $50,000 to $75,000.

• **Florida Amendment 2** would reauthorize the current 10 percent cap on non-homestead property assessments, which is scheduled to be repealed on January 1, 2019.

• **Florida Amendment 5** would require any new or increased state tax or fee to be passed by a two-thirds majority by both chambers of the legislature.

• **North Carolina’s “Income Tax Cap Amendment”** would lower the state constitution’s cap on the state income tax rate from 10 to 7 percent. The amendment was referred to the ballot by the legislature through 2018’s S.B. 75.

• **Oregon Measure 103** would prohibit enactment of new state or local taxes on groceries in the state.

• **Oregon Measure 104**, formerly **Initiative 31**, would stipulate that the Legislature must secure a three-fifths supermajority vote to pass any bill that would increase revenue, either via a tax increase or the elimination of tax credits, exemptions, or credits, by establishing a broad definition of “raising revenue” in the state Constitution.

• **Washington Initiative 1634** would prohibit local governments from imposing any new taxes or fees on groceries.

Source: Council On State Taxation
2018 State & Local Tax Ballot Initiatives

GENERAL TAX INCREASES:

- **Colorado** Amendment 73, formerly Initiative 93, would among its provisions raise the state’s corporate income tax rate from 4.63 percent to 6 percent, convert the individual income tax to a graduated rate structure, and reduce school district property tax assessment rates to 7 percent for residential property and 24 percent for nonresidential property.

- **Maine** Question 1 would establish a new payroll tax and non-wage income tax to pay for a long-term healthcare and social services program for adults 65 years of age or older.

- **Washington** Initiative 1631 would impose a carbon emission fee in the state, to take effect on January 1, 2020 at the rate of $15 per metric ton of carbon. The measure provides that the fee would increase by $2 per metric ton each year until the state’s greenhouse gas reduction goals for 2035 are met and the 2050 goals are on track to be met, and the fee would be imposed on “large emitters” as defined by the measure.

OTHER:

- **Florida** Amendment 6 includes provisions prohibiting state courts from deferring to an administrative agency’s interpretation of a state statute or rule, requiring instead de novo interpretation of statutes on appeal from agency determinations.

- **California** Proposition 5 would expand some of Proposition 13’s benefits by allowing eligible homeowners (55 or older or severely disabled) to transfer the adjusted tax-assessed value from their previous home to their new home, regardless of the new home’s market value, location, or number of moves.

Source: Council On State Taxation
Trends in State Apportionment
Market-based sourcing states—More than thirty jurisdictions have currently adopted market-based sourcing rules for sales other than of tangible personal property

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What is market-based sourcing?

**States approaches to interpreting the “market” can vary**

**“Market” for Services**
- Customer location
- Where the benefit of the service is received by customer
- Where the service is received
- Where the service is delivered

**“Market” for intangibles**
- Where the intangible is used
- Where the intangible has a business situs
- Where the intangible is domiciled

**Look-through approach**
- Based on location of the customer’s customer
Market-based sourcing—Practical issues

Market sourcing can be difficult to apply regardless of whether based on location of delivery, client benefit or something else

- Based on terms of contract?
- Location from where request for service is made/ordered?
- Based on a look through to the client’s customer’s location?
- Location from which customer is billed and/or domiciled?
- What level of analysis and data collection is required by a seller?

Look-through approach

- Sourcing receipts based on the location of the customer’s customer.
- States have adopted this approach either through regulation or enforcement efforts.
Market Sourcing Rulemaking Continues

MTC Section 17 Rules Finalized in February 2017

• To date, Oregon and Montana have adopted
• Colorado is working on adopting – have committed to addressing the issue of hedging by rule

California Market Sourcing Rules (section 25136-2)

• In November 2016, the FTB announced it was seeking another round of amendments to its sales factor sourcing regulation for services and intangibles
• FTB held interested parties meetings in 2017 and 2018
• Draft released in mid-2018, which received considerable pushback from the business/practitioners
Market Sourcing Rulemaking Continues

Items to be considered include:

- Sourcing asset management fees, except for services to RICs
- Defining “reasonable approximation” if multiple interpretations
- Point in time for determining where benefit of a service is received
- Sourcing revenue from government contracts
- Sourcing revenue from R&D contracts and upfront/milestone payments
- Sourcing sales of intangibles where buyer use location is unknown
- Whether dividend income should be excluded from the sales factor
- Sourcing revenue for freight forwarding companies
- Interest from business entity borrowers
- Sourcing of revenue from marketing intangibles
North Carolina (Enacted S.B. 99)
Modification and Clarification of the Sales Factor

**Sales of Services**

- Retaining “Income-Producing Activity”: Receipts from sales of services are still sourced to North Carolina if the “income-producing activities” are in North Carolina

- Clarifying “Income-Producing Activity”
  - “Income-producing activity” means an “activity directly performed by the taxpayer or its agents for the ultimate purpose of generating the sale of the service”
  
  - If the “income-producing activity” is performed within and outside North Carolina, the receipts are sourced to North Carolina in proportion to the income-producing activities performed in North Carolina to the total income-producing activities performed everywhere that generate the sale of the service

**Intangibles**: Receipts from intangibles are sourced to the state to the extent the intangible is used in the state

- Previously, receipts from intangibles were sourced to North Carolina if received from sources in North Carolina

Source: Council On State Taxation
Who is a broadcaster?

The Oregon Supreme Court held that all of a taxpayer’s sales must be sourced pursuant to the “subscriber rules” when a taxpayer is found to be a broadcaster for any portion of their business.

During the years at issue, the taxpayer’s receipts were derived from providing cable television, internet, and voice over internet protocol services both in Oregon and in other states.

Although the taxpayer conceded that it met the definition of an interstate broadcaster for some of its services, it argued it should only be subject to subscriber apportionment for its broadcaster sales and its other revenues should be sourced pursuant to Oregon’s general apportionment provisions for sales of other than tangible personal property (i.e., Oregon’s prior cost of performance rules).

The Court affirmed the Tax Court’s determination that because it met the definition of an interstate broadcaster, the taxpayer was required to source all its receipts pursuant to the broadcasting apportionment rules and there was no indication the legislature intended the broadcaster statutes to allow for the bifurcation of receipts for purposes of sourcing.

Source: Council On State Taxation
South Carolina – “Flexible” Costs of Performance

Although the state’s apportionment statute largely tracks UDITPA, the South Carolina Court of Appeals (Court) notes that South Carolina’s apportionment statute omits the last phrase, “based on costs of performance,” and therefore is not technically a costs of performance state.

The Court upheld the trial court’s conclusion that the taxpayer should source its receipts based on “the delivery of the satellite signal into the subscriber’s home,” and stated that this did not constitute the adoption of a “market share approach.”

Rather, the Court explained that South Carolina “provides a flexible standard based upon the [income producing activity] for a given industry.”

Source: Council On State Taxation
Texas – Sourcing Subscription Receipts

The District Court of Travis County held that a radio broadcasting company correctly apportioned its subscription receipts for Texas franchise tax purposes based on the locations where it performed its activities – the locations of its headquarters, transmission equipment and production studios.

The court rejected the Comptroller’s position that the radio broadcasting company’s subscription receipts should be apportioned to Texas based on the percentage of its customers that received the satellite transmissions in Texas.

The court also held that the radio broadcasting company is entitled to deduct cost of goods sold (COGS) for the direct costs of producing, acquiring and using its live and prerecorded radio programs.

- The COGS statute expressly expands the definition of “tangible personal property” to include “films, sound recordings, videotapes, [and] live and prerecorded radio programming.”

Source: Council On State Taxation
A word on New Jersey’s recent reforms...
New Jersey – What’s new

Governor Murphy signed Assembly Bills A4202 on July 1 and A4495 on October 4, 2018 effecting broad and foundational changes in the New Jersey Corporate Business Tax (CBT), elements of which apply retroactively. There are significant CBT changes in the following areas, with noted effective dates:

• Mandatory Combined Filing (2019 forward)
  − Default Water’s-Edge Combined Filing Group with worldwide or affiliated group elections
  − Deduction to mitigate financial reporting impact for publicly-traded companies
  − Conversion of pre-combined filing net operating losses
  − DRE’s members not subject to minimum tax
  − GILTI treatment and IRC section 250 deduction, NJ GDP as sourcing (2018 forward)
• Conformity with IRC section 163(j)
• Added Surtax (2018-2021)
• Dividend Received Deduction Limitation (2017 forward)
• Other Responses to the 2017 Federal Tax Act (2018 forward)
Governor Murphy signed Assembly Bills A4202 on July 1 and A4495 on October 4, 2018 effecting broad and foundational changes in the New Jersey Corporate Business Tax (CBT), elements of which apply retroactively. There are significant CBT changes in the following areas, with noted effective dates:

- Apportionment, Tax Base and Credits
  - Market-based sourcing for services (2019 forward)
  - Amendments associated with treaty exemptions (2018 forward)
  - Non-refundability of Research and Development credit (2018 forward)

- Penalty and Interest Abatement Provisions (Various)
Chevron-Deference and SALT
**Chevron Deference**

  
  - A court will be compelled to grant deference to administrative regulations—in a way, taking the “interpretation of the law” function away from the judiciary and vesting this function in the agency.

- If it is determined that an agency was statutorily authorized to issue a regulation, then mandatory deference will be required if both parts of the “*Chevron two-step*” test are met:
  
  - (1) Congress must not have directly spoken to the statutory question at issue and
  
  - (2) the agency’s interpretation must be based on a permissible construction of the statute.

- *Chevron* requires the court to cede some of its Constitutionally-granted interpretive authority to the agency.

- **States**
  
  - Some expressly applied *Chevron* to state agency regulations, including tax department regulations. (Kentucky case)

  - Other states use a deference standard that is quite similar in effect. See, *e.g.*, *Tarrant Appraisal District v. Moore*, 845 S.W.2d 820 (Tex. 1993) (“[C]onstruction of a statute by an administrative agency charged with its enforcement is entitled to serious consideration, so long as the construction is reasonable and does not contradict the plain language of the statute.”)
**Chevron Deference**

- Current "Chevron deference" environment in state tax, what can a taxpayer argue?
  - No authority to issue regulation
  - Statute is unambiguous and means something different than the regulation
  - Agency’s interpretation is ambiguous.

- State Trends
    - “The Court shall decide all questions of law, including the interpretation of a constitutional or statutory provision or rule adopted by an agency, without deference to any previous determination that may have been made on the question by the agency.”
  - Florida passed Amendment 6 on November 6, 2018 which prohibits state courts from deferring to an administrative agency’s interpretation of a statute or rule.
    - Judicial interpretation of statutes and rules.—In interpreting a state statute or rule, a state court or an officer hearing an administrative action pursuant to general law may not defer to an administrative agency’s interpretation of such statute or rule, and must instead interpret such statute or rule de novo.”
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