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State Tax Matters

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Income/Franchise: The State Side of Federal Corporate Income Tax Reforms

In the upcoming months, the 2016 US Presidential race will tighten as both political parties hold their respective conventions, formally nominate their candidates, and greet the announced Vice Presidential running mates. As the chosen nominees then campaign for votes across the country and share their vision, they will explain their platforms to voters – and it's relatively safe to say that various proposals to change or drastically reform the federal tax code will be part of the conversation. As the candidates' respective tax plans are scrutinized, the resulting federal budget implications and their expenditure policies will be front-and-center in the dialogue. What's likely to get side-tracked in this debate, however, are the potential repercussions to the states – i.e., how the various federal tax reform plans may impact revenue collections, tax structures, and borrowing at the state and local levels – thereby leaving it up to state policymakers to respond to the federal changes after the fact.

Take, for example, the recently enacted federal Protecting Americans from Tax Hikes Act of 2015. That legislation made permanent several lapsed business incentives, including the research credit and the subpart F exception for active financing income; renewed a handful of taxpayer-friendly provisions (such as bonus depreciation) for five years; and extended various other tax benefits through 2016 – all without much analysis afforded to the resulting effect on state corporate income tax collections. These recently enacted federal tax law changes may have a significant effect on state corporate income taxes depending on a state's adoption of the Internal Revenue Code (IRC) and/or its conformity updates, as well as the state's IRC decoupling provisions, modifications, variations, and/or exceptions.[1] However, the states have been left to decide if, when, and/or how they will adopt these federal tax law changes in the context of their respective budgetary and political landscapes – often not making such determinations until well into their own impacted corporate tax filing seasons.

The federal tax reforms made in 2002[2] may provide some insight as to how – if at all – the states may react to any upcoming federal corporate income tax reforms. The federal tax law changes enacted as part of the Job Creation and Worker Assistance Act of 2002 first implemented the federal bonus depreciation deduction to help encourage investment in certain new equipment and manufacturing machinery. Prior to this change, most states had generally incorporated the federal tax calculation of depreciation in their own respective state corporate income tax computation and thus were directly impacted by the increased federal deduction. As a result of this change, within seven months of the federal enactment of bonus depreciation, 23 states and the District of Columbia had taken legislative action to wholly or partially decouple from these federal provisions to avoid the resulting revenue loss in their own economically-stressed state and local environments.[3] Another state response to resulting tax collection reductions from a flow-through effect of federal changes may be to couple with the IRC changes, but then increase state corporate income tax rates and/or eliminate certain other existing state business incentives or preferences to offset the resulting revenue loss – a move that is not often well-received in a sluggish or struggling state and local economy.

On the flip side, federal tax reform that reduces or eliminates certain deductions, credits, and exclusions (including, for example, transfer pricing or debt re-characterization-related reforms that may result in reduced deductions) may flow through to the states and potentially result in increased state and local revenues. In such cases, the local budgetary and political environment may be crucial in determining how a state responds. For instance, state policymakers may opt to conform to the federal changes to ease the associated taxpayer compliance burdens and essentially reap the benefits. They may perhaps also implement ever-popular tax rate reductions or other pro-business incentives and preferences to offset some of the resulting state revenue gains. Should state policymakers choose to decouple from such federal tax changes, they may maintain the status quo for state corporate income tax collections but may also run the risk of augmented complexity in the state tax code, as well as increased state and local tax compliance and enforcement costs.

Aside from various federal corporate income tax proposals potentially impacting the calculation of federal taxable income (and thus potential state conformity or nonconformity to the IRC),

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[1] Additional details regarding the multistate tax impact of the federal PATH Act's "business extenders" provisions are available in our External Multistate Tax Alert issued on January 14, 2016.
URL: http://www2.deloitte.com/us/en/pages/tax/articles/multistate-tax-alert-multistate-impact-of-federal-path-act-business-extenders-provisions.html?id=us:2em:3na:stm:awa:tax:051316
[2] P.L. 107-147; H.R. 3090 107th Cong. (Mar. 9, 2002) – Job Creation and Worker Assistance Act of 2002.
[3] The Pew Charitable Trusts, "What States Have at Stake in Federal Tax Reform Proposals" by Anne Stauffer and Mark Robyn. (July 22, 2015).

there has also been discussion among the US Presidential candidates over a host of other proposed federal tax changes that could impact the states, such as drastic corporate tax rate reductions coupled with broadened tax bases. From a state perspective, this move may potentially result in tax-exempt government bonds becoming less attractive and cause heightened borrowing costs for both state governments and local municipalities. Another proffered change involves replacing the federal corporate income tax with a business transfer tax (often cited as a value-added tax (VAT)) – thereby leaving states to decide whether it would be better to revamp their own corporate income and indirect tax systems to conform or instead maintain their current tax administration scheme and structures. If a federal carbon tax is implemented, fossil fuel-producing states may be faced with increased demands from impacted businesses to provide some sort of state and local corporate income tax relief.

A possible tax increase on “carried interest” income – generally earned by certain high net-worth individuals – has also been suggested, and may impact revenue generated at the state and local levels not only from such individuals, but also from the underlying pass-through entities and the lower-tier corporate structures. The general ongoing federal tax campaign to curb perceived international “domicile shifting” – which is arguably intensified with the Organization for Economic Co-operation and Development’s (OECD) continuing global project to identify solutions to the so-called base erosion and profit shifting (BEPS) problem – may also play an important role in influencing state lawmakers to enact their own revenue-generating legislation addressing the income and apportionment factors of related corporations incorporated or doing business in purported foreign ‘‘tax haven’’ jurisdictions. Lastly, at a very high level, because many states rely on federal grants for vast portions of their own respective budgets, any federal tax reform policies that significantly impact the federal budget (i.e. drastically increasing the current deficit, or resulting in a surplus) may have consequent significant state repercussions as such changes would ultimately impact state coffers for transportation, education, Medicaid, housing, and public safety funds. These potential impacts fall most heavily on those states that, unlike the federal government, are required by their own respective state laws to maintain a balanced budget.

It remains to be seen how the states will respond to another set of tax law changes at the federal level – the only certainty seems to be that it will be reactive. Much of it will largely depend on what kinds of federal tax reforms are ultimately enacted and implemented under the new President’s administration, and how much revenue must be raised to meet state budgetary demands. All this occurring as state and local governments strive to manage a slow economic recovery and generate more revenue, while many state lawmakers continue to promote “tax relief” and reduced tax burdens as the best means for growing their state and local economies.

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Income/Franchise:
California: FTB Moves Forward with Possibly Amending Regulations for Treatment of Mixed Financial and Non-Financial Combined Reporting Groups

FTB Regulation Information: Comment Period – Regulations 25137-10 and 25137-4.2, Cal. FTB (5/9/16). The California Franchise Tax Board (FTB) continues to move forward with eliciting public input on possibly amending California Code of Regulations, title 18, sections 25137-10 and 25137-4.2, regarding the proper treatment of mixed financial and non-financial combined reporting groups. On April 20, 2016, the FTB held its second "Interested Parties Meeting" to discuss potential approaches for resolving the supposed "distortive effect" of including banking entities and security broker-dealers that are non-financial entities in the same combined reporting group. Four proposals have been suggested:

1. Inclusion of principal trade gross receipts based upon the percentage of security broker-dealer assets – this approach includes security broker-dealer principal trade gross receipts in the sales factor based on the percentage the security broker-dealer's assets bear to the combined reporting group's total assets;
2. Sales factor reflecting a simple blend of net and gross receipts – e.g., if a security broker-dealer's principal trades represent 95 percent of the combined reporting group's gross receipts, the combined reporting group's sales factor will include 95 percent of the net gain and 5 percent of the gross receipts of the security broker-dealer principal trades;
3. Sales factor reflecting a weighted blend of net and gross receipts – this method calculates both a "gross sales factor" that includes the gross receipts from principal trades and a "net sales factor" that includes the net gain from principal trades; a "blended sales factor" is then computed for inclusion in the overall apportionment formula that reflects a weighting of the gross sales factor and the net sales factor (which is based on the income generating activities' contribution toward the combined reporting group's overall gross business income); and
4. Net receipts approach – for purposes of apportionment, but not for purposes of imposing corporate franchise tax, treat security broker-dealers the same as banks and financial corporations (i.e., the combined reporting group will include in the sales factor net gains from security broker-dealer principal trade transactions).

As the next step in this process, the FTB is now accepting written comments on these proposals until June 30, 2016. For more information or questions please reach out to any of the following individuals listed below.

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Income/Franchise:
South Carolina: Department Issues Working Draft Ruling on Nexus-Creating Activities for State Income Tax Purposes

SC Revenue Ruling #16-xx (Draft), S.C. Dept. of Rev. (5/3/16). The South Carolina Department of Revenue (Department) has released for public comment a seventeen-page draft revenue ruling addressing nexus-creating activities for state income tax purposes, intending that such document eventually will reflect the Department's official position regarding income tax nexus when finalized and issued. As currently posted, the draft ruling explains that over the years courts have provided limitations and guidelines in determining whether certain activities create nexus with a taxing state – e.g., "see *Quill Corp. v. North Dakota* 504 US 298 (1992), *Wisconsin Department of Revenue v. William Wrigley, Jr., Co.*, 505 US 214 (1992), *Burger King Corp. v. Rudzewicz*, 471 US 462 (1985), *Helicopteros Nacionales de Columbia, S.A. v. Hall*, 466 US 408 (1984), *Complete Auto Transit, Inc. v. Brady*, 430 US 274 (1977), and *Geoffrey, Inc. v. South Carolina Tax Commission*, 313 S.C. 15, 437 S.E.2d 13 (1993) cert. denied 510 US 992 (1993)." The draft ruling addresses the following areas and categories:
URL: https://dor.sc.gov/resources-site/lawandpolicy/Advisory%20Opinions/Public%20Draft%20-Nexus%20rr%202016.pdf

1. General Activities;
2. Registration with State Agencies/Departments;
3. Ownership/Leasing of In-State Property;
4. Ownership Interest of In-State Pass-Through Entities;
5. Licensing Intangibles;
6. Employee Activities – Sales Related;
7. Employee Activities – Non-Sales Related;
8. Activities of Unrelated Parties;
9. Distribution and Delivery;
10. Financial Activities/Transactions;
11. Transactions with South Carolina Printers;
12. Cloud Computing or Software as a Service (SaaS) Transactions; and
13. Internet-Based Activities.

Public comments on this draft revenue ruling are due by June 1, 2016.

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Sales/Use/Indirect:
Wisconsin: Department of Revenue Reminds Online Marketplace Sellers of Potential Tax Liability on Third-Party Sales

News for Tax Professionals: Online Marketplace Sellers are Liable for Wisconsin Tax on Third-Party Sales, Wis. Dept. of Rev. (5/2/16). The Wisconsin Department of Revenue (Department) reminds taxpayers that online marketplace sellers that sell taxable products owned by a third-party seller on their respective websites may be liable for Wisconsin sales or use tax on their Wisconsin sales. In doing so, the Department explains that retailers engaged in business in Wisconsin are liable for Wisconsin sales or use tax on sales that take place in Wisconsin, and that this includes sales made by a retailer on behalf of a third-party seller as provided in sec. 77.51(13)(c), Wis. Stats., unless the retailer can show that tax has been remitted on the transaction by the third-party seller. Effective July 14, 2015, Wisconsin's definition of "retailer" was amended to allow an online marketplace to make sales of tangible personal property and items under sec. 77.52(1)(b), Wis. Stats., on behalf of third-party sellers, "without becoming liable for the tax on such sales if the online marketplace or one of its affiliates operates a distribution facility." However, the Department explains, this exception does *not* apply to an online marketplace or its affiliates if any sales are made in which a customer takes possession of taxable products at a location (i.e., storefront) operated by the marketplace or one of its affiliates (sec. 71.51(13b)(b)4., Wis. Stats.) The Department additionally explains that the third-party seller may also be liable for the tax, but this does not relieve the online marketplace seller of its liability to remit the tax. Also, when more than one party is liable for the tax, the liability for the tax is extinguished for both parties when either party remits the tax to the Department.
URL: https://www.revenue.wi.gov/taxpro/news/2016/160502.html

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Archive: http://www2.deloitte.com/us/en/pages/tax/articles/multistate-tax-alert-archive0.html?id=us:2em:3na:stm:awa:tax

California Supreme Court denies review of *Lucent*, BOE addresses refunds
On January 20, 2016, the California Supreme Court denied the California State Board of Equalization's (BOE) petition for review of *Lucent Technologies, Inc. v. Board of Equalization*, a California Court of Appeals ruling involving the sales and use tax treatment of switch-specific software programs.

In response to the California Supreme Court's denial of review, Randy Ferris, Chief Counsel of the California State BOE, issued a Chief Counsel Memorandum (Chief Counsel Memo) discussing the following topics: (1) the BOE's interpretation of the holdings set forth in *Nortel* and *Lucent*, as well as their application under three different scenarios; (2) the BOE Legal Department's recommended approach to implementing the *Lucent* holding; and (3) the BOE's potential approach to addressing the California sales and use tax treatment for embedded and pre-loaded software under *Lucent*. Moreover, during a BOE meeting held on March 30, 2016, the BOE heard oral testimony from the BOE Legal Department Staff regarding the BOE Legal Department's recommended approach to implementing the *Lucent* holding (BOE Meeting).

This Multistate Tax Alert incorporates information from our previous Multistate Tax Alert involving the *Lucent* case, summarizes the recent Chief Counsel Memo and BOE Meeting, as well as provides some related taxpayer considerations.
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URL: http://www2.deloitte.com/us/en/pages/tax/articles/california-supreme-court-denies-review-of-lucent-boe-addresses-refunds.html?id=us:2em:3na:stm:awa:tax:051316