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In this installment of Inside Deloitte, the authors provide a snapshot of five practical state tax measures to consider during these extraordinary times.

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Although today's volatile economic and state tax environment may present varying degrees of challenges for companies, it also may provide them with an opportunity to manage risk and address those challenges. Keeping the fluid dynamics of the economy and tax policy in mind, this article provides a snapshot of five practical state tax measures to consider during these extraordinary times.

These proactive measures are intended to help companies conserve cash and respond nimbly to an evolving economic and state tax environment by generating potential cash tax benefits through the review of prior-period returns, managing complexities associated with state tax attributes following the enactment of recent federal relief legislation, maintaining and possibly expanding credits and incentives, reviewing property tax valuations, and investing in the tax department to effectively meet compliance and controversy challenges.

Prior-Period Return Reviews

In an attempt to conserve or generate cash, companies should consider reviewing prior-period returns. By reviewing previously filed state tax returns, companies can better understand and manage near- and long-term income tax obligations, as well as identify potential refunds of prior tax payments. The unique circumstances of the current economic climate may result in more refund opportunities.

Being proactive in reviewing prior-year returns for both direct and indirect taxes may result in cash tax savings now and in future savings as well, such as by streamlining taxability processes or reducing the organizational footprint.

Income, Net Worth, and Gross Receipts Tax Returns

State income tax systems are finding it challenging to keep up with new economic revenue streams and account for the value of intangibles in today's businesses. Changes to state income tax approaches, particularly the movement toward market sourcing and single-sales-factor apportionment, may create both uncertainty and opportunities as companies translate new forms of businesses onto state income tax returns. For example, uncertainty and opportunity have been generated by federal tax reform, the Tax Cuts and Jobs Act,[1] and the states' uneven and uncertain conformity to the TCJA or some of its provisions.

A review of a company's state income tax returns may be even more meaningful right now. In some circumstances, cash flow concerns may be

[1] P.L. 115-97.

addressed through refund opportunities or the reduction of estimated payments. In other circumstances, a review of a company's returns may reveal inefficiencies in the legal entity structure that may be rectified through a restructuring or through changes to the organization's intercompany transactions and pricing. It is particularly important to consider a company's transfer pricing and whether the economics upon which it is based have changed so as to require a change in transfer pricing arrangements.

Indirect Tax Payments and Returns

A review of indirect tax filings and accruals, such as a company's sales and use tax returns, can also identify potential cash tax savings through decreased future use tax payments and refunds of overpayments of sales and use tax, excise tax, and severance tax.

Technological advancements in recent years have produced tremendous change both in our economy and in the sales tax landscape. New businesses, new products, and new mechanisms to deliver goods and services, all driven by technology and the connectivity of the internet, have fundamentally changed the way we transact business with one another. Digital goods, software as a service, and streaming subscription services are all large parts of many businesses. The delivery of these goods and services remotely and to dispersed consumers has become commonplace.

Most state sales tax systems have not kept up with the pace of economic change. Many are still built around a core of taxing sales of tangible personal property. Instead of enacting modern broad-based transaction taxes, some states have attempted to stretch the definition of tangible personal property to tax the economy's new digital goods and services. Others have adopted new laws, which usually aren't uniform with each other and are often focused on different and narrow parts of the digital economy. And the federal government, specifically the Supreme Court, recently removed some barriers to state jurisdiction.[2] Post-*Wayfair*, state jurisdiction over remote vendors has increased to the point that most vendors of any size are now collecting state tax.

This combination of the new economy; a large volume of outdated state law mixed with sporadic, nonuniform, narrow new laws; and greatly expanded state jurisdiction over remote vendors may lead to concerns about overcollection and overpayments. Faced with change and uncertainty, many vendors choose to collect sales tax, believing it is the safest course of action, even when it may not be appropriate. Companies that pay their use tax directly are faced with the same uncertainty and often make similar mistakes overpaying the use tax.

Consequently, a review of indirect tax filings may help companies identify overpayments associated with purchases of goods and services that were incorrectly classified as taxable, that should have been taxed at a lower rate, or that were incorrectly sourced. Identifying these issues may help companies correct systems and eliminate future problems, besides reaping the cash benefit of potential refunds.

State Tax Attributes and Federal Relief Legislation

The second area for companies to be aware of concerns state tax attributes following the enactment of recent federal relief legislation. With various sectors of the economy affected by the COVID-19 pandemic, it may be a good time for taxpayers to focus on tax attribute planning. Through proactive tax attribute planning and effectively applying federal relief provisions to state tax returns, companies may be able to monetize net operating losses, increase their interest expense deductions, and identify correlating state tax benefits.

CARES Act

In response to COVID-19, Congress enacted significant federal tax relief, the Coronavirus Aid, Relief, and Economic Security (CARES) Act,[3] to provide companies flexibility as they manage their federal tax attributes. Some companies will be particularly interested in CARES Act

[2] *See South Dakota v. Wayfair Inc.*, 138 S. Ct. 2080 (2018).

[3] P.L. 116-136.

provisions that may allow them to monetize NOLs. The interaction between the state and the federal rules (particularly regarding the newly enacted federal NOL carryback provisions) is highly complex, given the potential for different filing groups, allowable carryback periods, and income limitations. Companies may want to invest in complex scenario planning to enhance the benefit of their state tax attributes, especially their NOL carrybacks and carryforwards.

Many state corporate income tax regimes are affected by federal tax law and regulatory changes because they conform to the Internal Revenue Code for administrative ease by either incorporating the IRC in whole or in part, or by using federal taxable income as a starting point when calculating state taxable income. When considering the state income tax impact of a federal tax law or regulatory change, taxpayers should be mindful of the state's level of conformity.

Approximately half the states, so-called rolling conformity states, have provisions that tie to the federal income tax calculation in such a way that they automatically pick up specific federal changes as they occur. Other states that tie to the federal system as of a specified date, so-called static conformity states, may pick up CARES Act changes when those states' legislatures update their IRC conformity provisions. However, even in states that follow the version of the IRC that includes the CARES Act provisions, federal and state differences may remain as states decouple from or modify the federal treatment of some provisions for state income tax purposes.

Net Operating Losses

The CARES Act amends NOL provisions under IRC section 172. The amendments lift restrictions that the TCJA placed on the use of NOLs. Most notably, these changes temporarily lift the 80 percent taxable income limitation and institute a five-year NOL carryback.

While these federal NOL-related relief provisions are often beneficial, they can create complexity at the state level that may require some companies to invest significant time and resources to accurately and effectively manage NOL use across the states. States commonly conform to most IRC provisions; however, they commonly decouple from or specifically modify the NOL provisions under section 172, leading to differences in federal and state NOL balances. Differences also arise between federal and state carryback provisions. Generally, states tend to decouple from the federal NOL carryback provisions, and even in conforming states, some states may limit the annual amount of NOLs that may be carried back. Other states have carryback provisions that are subject to several nuances, including the amount of the carryback and the timing of when it may be claimed. Only a few states allow for NOL carrybacks so that they will pick up the full CARES Act carryback reinstatement.

Thus, the use of state NOLs continues to become more complex. The complexity flows from the combination of possible unexpected losses along with changing NOL rules. Companies may consider proactively investing time and resources into state NOL use planning to secure these valuable assets as they move through the current economic situation and into more stable conditions.

163(j) Interest Expense Limits

The CARES Act temporarily loosens the business interest expense limitation under IRC section 163(j) from 30 percent to 50 percent of adjusted taxable income. Many states — those that conform to the federal system on a rolling basis — automatically pick up these CARES Act changes easing limits on the deductibility of interest expense. Other states will pick them up when or if they update their statutory conformity provisions. And still other states have decoupled from the section 163(j) provisions altogether and should not be affected by the CARES Act change.

Maintaining tax-efficient levels of interest expense at the state level may be a challenge as states have their own mechanisms that limit its deductibility. Now many companies will likely be faced with rising debt and interest expense levels, falling incomes, and changing federal limitations. For some, the challenge of enhancing the benefit of interest expense may be more important now than ever.

Credits and Incentives

Operational changes made in reaction to the changing economic environment may create both risks and opportunities when considering the impact of a third area, credits and incentives. While credits and incentives are commonly top priorities during times of expansion, companies may still be able to seek benefits even during economic uncertainty. Whether they are conducting supply chain scenario planning, facility rationalization, or increasing levels of capital investment and personnel, they can seek statutory credits as well as above-the-line incentives. Also, moving jobs and capital investment from one jurisdiction to another may trigger credits and incentive eligibility. Proactively managing this area may prove beneficial.

When reacting to current economic conditions, companies may risk losing future credits because of difficulties meeting job creation and capital investment requirements. Some credits require a multiyear delivery period. For example, job creation tax credits may require that the jobs be maintained over a specified period of years. Investment tax credits often require that related assets remain in service for a defined period. If facilities are downsizing, closing, or consolidating into other jurisdictions, it can jeopardize the company's ability to enhance existing credits or even trigger a jurisdiction's attempt to claw back previously claimed credits. Companies should analyze the impact on credits and incentives before making operational changes.

For companies facing performance noncompliance with existing incentive agreements, relief may be found by negotiating extensions of timelines, the addition of grace periods, relaxation of some reporting requirements, and clawback restructuring. Incentives that fall into the category of negotiated agreements include cash grants, forgivable loans, property tax abatements, tax increment financing, and discretionary credits. These incentives are likely to have performance requirements such as job creation, capital investment, and timeline commitments that are monitored quarterly or annually. Companies may want to proactively engage state officials now to pursue mutually beneficial resolutions of issues that may otherwise be difficult to resolve after the fact.

States will address the current uncertainty in various ways. Some may enact new programs and policies that support headcount retention and maintenance of capital investments, and some may consider relief efforts, such as extensions of timelines and additions of grace periods. However, some may enforce clawback clauses, and those can be complex and difficult to navigate. Companies should consider asking strategic questions when negotiating clawbacks. Many states may be working on developing solutions to ease further negative impact on the overall business climate, but being proactive with these discussions can help companies find solutions to enhance benefits.

Property Taxes

Property tax is another area for consideration as the economic conditions created by COVID-19 may affect the value of real and personal property for many industries. Many companies might expect that reduced values will lead to lower property taxes; however, property tax is unique in that economic decline is not automatically reflected in property tax reporting or assessed values as it may be in other areas, such as sales tax reporting.

Companies can be proactive in facing potential property tax issues by working with jurisdictions to ensure that the assessed values of their real and personal property reflect the economic realities of their industries and businesses. Many jurisdictions use mass appraisal methods for the valuation of real estate and statutory formulas for the valuation of business personal property. These methods may be efficient for administrative purposes but may not address the unique business issues of some industries in extraordinary times. In asset-intensive industries like airlines or manufacturing, companies may also face challenges such as property tax assessments that may be backward-looking, under which past performance is considered as the basis for future assessments. A backward-looking approach can be problematic as it often creates a lag between when a company experiences a downturn and

when it could experience relief through the jurisdiction's standard valuation method.

Companies may also want to think beyond their physical property. The value of real estate and business personal property is affected by several external factors. Supply chain disruptions, travel bans, and forced shutdowns may create economic obsolescence, when factors external to the property may impair its value or earnings ability. The rules governing recognition of obsolescence in property tax assessments vary by state. Jurisdictions may look to whether the external factors were within the company's control and the degree to which they could have been reasonably anticipated or foreseen. Taxpayers may have a position under today's unusual circumstances for obsolescence resulting from government and consumer responses to the pandemic.

For companies that are now experiencing business disruptions, timing may be critical. Assessing jurisdictions may have greater flexibility to grant relief on matters that are raised proactively versus through the appeals process. By engaging assessing jurisdictions during the assessment period, companies may also avoid additional fees and costs that could arise in the appeals processes. It is also important to be aware of appeal deadlines, which vary by state.

Property tax and the proactive management of valuations and assessments might not always be at the top of a company's list of priorities, but they should be considered during extraordinary times.

Compliance and Controversy Team Management and Investment

The final area for consideration is compliance and controversy management. The displacement of personnel and tightened budgets may present challenges to many companies as they manage the tax function through this time of disruption. While one initial reaction may be for companies to cut costs (investments) in the tax department, doing so could prove shortsighted.

Federal and state relief responses to COVID-19, while often beneficial, may create more compliance complexity to navigate over the weeks and months ahead. Simply tracking due dates can be a challenge as almost every state and locality adjusts its rules to provide some form of compliance relief. The CARES Act business tax relief measures may offer tax savings to many companies, but complicated state tax implications may need to be considered. For example, implementing the CARES Act section 163(j) and NOL provisions for federal purposes may trigger a requirement to file large numbers of amended state returns.

In addition to a tax department's increased compliance work, its work in the controversy space is likely to increase too. While some audits may be delayed as both taxpayers and tax administrators adjust to new working arrangements, others will proceed through the disruption, making them more difficult to schedule and manage. Many parts of the process that have historically been handled on paper and through the mail may have to change. This may result in long-term efficiencies as tax administrators potentially reevaluate administrative processes; however, it could create confusion in the short term.

Companies should consider reviewing their tax controversy calendar for the next six months and determine if the stated or unstated goals can be met in the current environment. This may include day-to-day audit management in addition to communicating with state tax agencies and tax consultants assisting with negotiations, appeals, or other processes. Companies may consider whether they have adequate staffing, skills, availability, and technology support to be responsive to requests for information and data, and whether there are gaps in coverage that may compel additional statutory or administrative extension requests.

Also, companies should not lose sight of the value of timely communications with a state tax agency, as they will be facing many of the same challenges. How they handle pending controversy matters will be determined by their access to technology and their ability to communicate effectively. It may be necessary to advise the state representatives that taxpayers may lack access to physical mail, which may inhibit their ability to timely handle routine notices and key notifications, such as assessments and determinations. Some notices may also present unique challenges if, for example, the

state tax agency requires "wet" signatures in a taxpayer response. Therefore, it may be necessary to request that the state agency consider emailing notices and accepting electronic signatures.

Another important reason to proactively contact state tax agencies is to confirm status, timelines, and hearing extensions, as many states have not changed these deadlines and statutory response periods. If deadlines have not been officially changed, as state tax agencies are changing or limiting their operations, the process may continue to advance. It is important to stay in touch with auditors and hearing officers and seek permission to file electronically whenever possible. If appearing before a forum that typically requires paper filing, companies should consider requesting permission in writing to file or communicate electronically. In many states, the statute of limitations for assessments or refunds will likely not be extended absent specific legislation. As such, it is important to continue to monitor statutes to avoid missing key deadlines.

Finally, agreed-to processes outside the normal course may at times lead to a misunderstanding between the parties on the procedural next steps. In some instances, this may result in the imposition of penalties and interest. However, states typically have broad discretionary authority to abate penalties and sometimes associated interest. But when requesting abatement of penalties and potentially interest, it is often key to provide documentation that supports an effort to comply, or when compliance fails, whether there was a reasonable attempt to cure. As a result, companies should be diligent in documenting any efforts to communicate limitations that prevented their ability to comply and agreed-to processes to address these limitations.

Therefore, when considering the current portfolio of state tax controversies, companies should be diligent in contacting state tax agencies to determine if they are adopting any policies that will affect taxpayer audits (for example, shifting planned audit visits to desk audits, delaying audits, requesting extensions of statutes, and so forth). Companies should stay in communication with the various agencies to ensure that payments are timely sent and processed as states may now have a more flexible tolerance for an electronic payment — with confirmation via their internal access to taxpayer accounts, as opposed to physical checks, to resolve a controversy matter. Companies should also determine whether the states have facilitated a secure, electronic process in which to gain access (for example, via secured portal) to notices or other official communications. And again, companies should always document these efforts.

Conclusion

Yes, these times are certainly extraordinary, but companies can have the opportunity to position themselves to navigate and address many of the challenges ahead. By identifying potential cash tax benefits through the review of prior-period returns, managing complexities associated with state tax attributes following the enactment of recent federal relief legislation, maintaining and possibly expanding credits and incentives, reviewing property tax valuations, and investing in the tax department to effectively meet compliance and controversy challenges, companies may conserve cash and respond nimbly to the evolving economic and state tax environment. These proactive planning measures may help them manage the current environment and be positioned for the future. ■