

State Tax Roundup:  
Significant State and Local Developments  
States' Reaction to Wayfair and Federal Tax Reform

TEI New York Chapter

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# Agenda

- Impact of *Wayfair*
- Federal Tax Reform Impact on SALT Landscape
  - Repatriation Transition Tax
  - Global Intangible Low Tax Income and Foreign Derived Income Inclusion
  - Interest Expense Deduction Limitation
  - Cost Recovery

*South Dakota v. Wayfair, Inc. et al.*

# Wayfair

- South Dakota passed remote use tax collection (“economic nexus”) legislation in response to J. Kennedy’s comments in the *DMA* decision
  - \$100,000+ in sales or 200 separate transactions during previous or current year
  - Prospective application
- Legislation designed to get a case before the U.S. Supreme Court as quickly as possible
- Supreme Court Justices concerns raised during oral argument:
  - Lack of record in the lower court about the true cost of compliance and revenue impact
  - Congress could have addressed the issue but chose not to for 25+ years
  - Congress could act even if *Quill* is overturned
  - Retroactivity concerns
  - Lack of unified nexus standard

# Wayfair

- On June 21, 2018, the Supreme Court issued its decision (Kennedy, J.) overturning the *Quill* physical presence standard, finding economic contacts with the state to be sufficient.
  - 5-4 decision
  - Court determined that *Quill* was wrongly decided because:
    - Physical presence requirement is not a necessary interpretation of the Commerce Clause substantial nexus requirement
    - Physical presence requirement is arbitrary and formalistic, overlooking current economic realities
    - *Quill* creates market distortion and is perceived as “judicially created tax shelter”
  - New nexus standard: **economic and virtual contacts**

# Nexus

- What is a substantial nexus?
  - The degree of contact a taxpayer must have with a state for a state to constitutionally impose a tax on the taxpayer.
- Setting the Stage for Income Tax Nexus Challenges
  - *National Bellas Hess v. Ill. Dept. of Rev.*, 386 U.S. 753 (1967) – U.S. Supreme Court sets physical presence nexus standard for sales tax purposes.
  - *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992) – U.S. Supreme Court upholds bright line physical presence rule for sales tax purposes.
- The U.S. Supreme Court’s decisions left open the question of whether the physical presence nexus standard applied for income tax purposes.

# Nexus

- Challenges to States' Expansion of Income Tax Nexus
  - *Geoffrey, Inc. v. South Carolina Tax Comm'n* (S.C. 1993) – The South Carolina Supreme Court upheld the states' economic presence nexus standard for corporate income tax purposes. The court disposed of *Quill* in a footnote, explaining it applied only to sales and use taxes.
    - U.S. Supreme Court denied certiorari.
  - *MBNA* (W. Va. 2006) – The West Virginia Supreme Court determined *Quill* applies only to sales and use taxes
- State taxing authorities aggressive nexus policies re. physical presence
  - Cookie/software nexus
  - Content Distribution Network nexus
  - Online marketplace (*Amazon v. South Carolina*)

# Wayfair Developments

- 10 states have fully adopted the factors provided in *Wayfair* through SSUTA membership.
- 13 states have partially adopted the *Wayfair* factors.
- 21 states require legislation to be compliant with the *Wayfair* factors
- 10 states have marketplace legislation that target marketplace sellers and facilitators



# Constitutional Framework

- The U.S. Supreme Court in *Complete Auto Transit* set the framework for when a state may constitutionally tax a foreign corporation's activities under the Dormant Commerce Clause.
- *Complete Auto Transit, Inc. v. Brady* (U.S. 1977) – A state may constitutionally tax a foreign corporation's activities if the tax:
  - (1) Applies to an activity with a substantial nexus with the taxing state;
  - (2) Is fairly apportioned;
  - (3) Does not discriminate against interstate commerce; and
  - (4) Is fairly related to the services provided by the state.

# Open Questions

- Does *Wayfair* apply beyond the sales tax context and into income taxes? Are income tax nexus challenges dead?
  - Direct vs. indirect taxes
  - States already have income tax statutes on the books or economic nexus jurisprudence
- Potential challenges to state collection systems for taxpayers with *de minimis* activities?
- Potential increase in False Claims Act / class action lawsuits for under/over-collection of tax?
- Amnesty/voluntary disclosure?
- Federal legislation?
- Move towards challenges under the discrimination and fairly related prongs.
  - Compared with fair apportionment external consistency prong.
- Challenges to distortive state taxes

# Impact of Tax Cuts and Jobs Act

# General Overview

- The state impact of nearly all TCJA provisions is conformity dependent
  - Floating conformity – selective
  - Static conformity – rolling, annual, fixed
- Filing methodology will impact the application of TCJA
  - Separate v. combined
  - Composition of group
  - Definition of state taxable income (world-wide v. federal taxable income)
  - Application of the federal consolidated return rules

# Repatriation Transition Tax

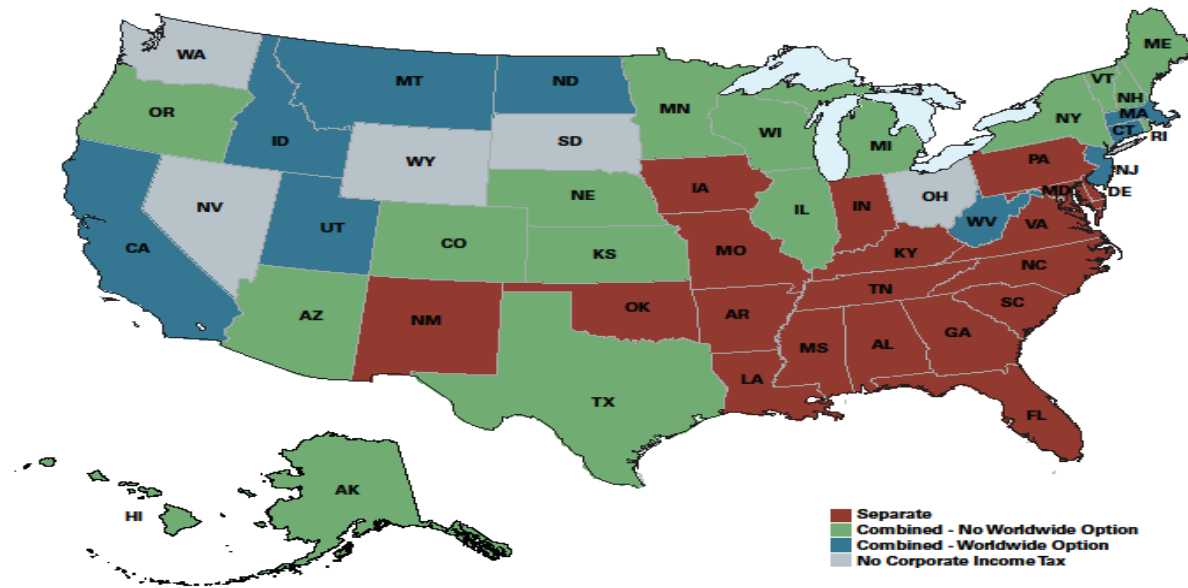
# Transition Tax – IRC § 965

- General concepts:
  - One time tax on untaxed foreign earnings of certain foreign subsidiaries (accumulated post-1986); deemed repatriation
  - Included in Taxpayer's gross income as Subpart F income
  - Potential foreign commerce clause issues (*Kraft*)
- Repatriation
  - Mitigated to extent of state's DRD
  - Factor representation/distortion
  - Character of income
  - Previous taxation of income
    - World-Wide Combined Reporting
    - Taxation of world-wide income
    - Taxation of effectively connected income without treaty exemptions
    - Tax Havens

# *Transition Tax – IRC § 965 (cont'd)*

- States responses:
  - Included in Income After Deduction (IRC § 965(a) inclusion and IRC § 965(c) deduction).
  - Included in Income Without Deduction (IRC § 965(a) inclusion without IRC § 965(c) deduction)
  - Excluded from Income
  - Installment payments allowed vs. not allowed
- Most Recent Developments
  - OR tax haven credit (10/12/18)
  - ME (9/12/18) – 20% of 965 income taxable; 50% amount of GILTI pre-apportionment
  - NJ (10/5/18) – No 965 conformity but 965 income taxable with 95% DRD; surtax

# Effect of Combined Reporting Trend



Note: Elective, industry-specific, and like provisions are not taken into consideration. This map is intended to represent general filing methods.



# Global Intangible Low Tax Income and Foreign Derived Intangible Income IRC §§ 951A, 250

# Global Intangible Low Taxed Income and Foreign Derived Intangible Income – IRC §§ 951A, 250

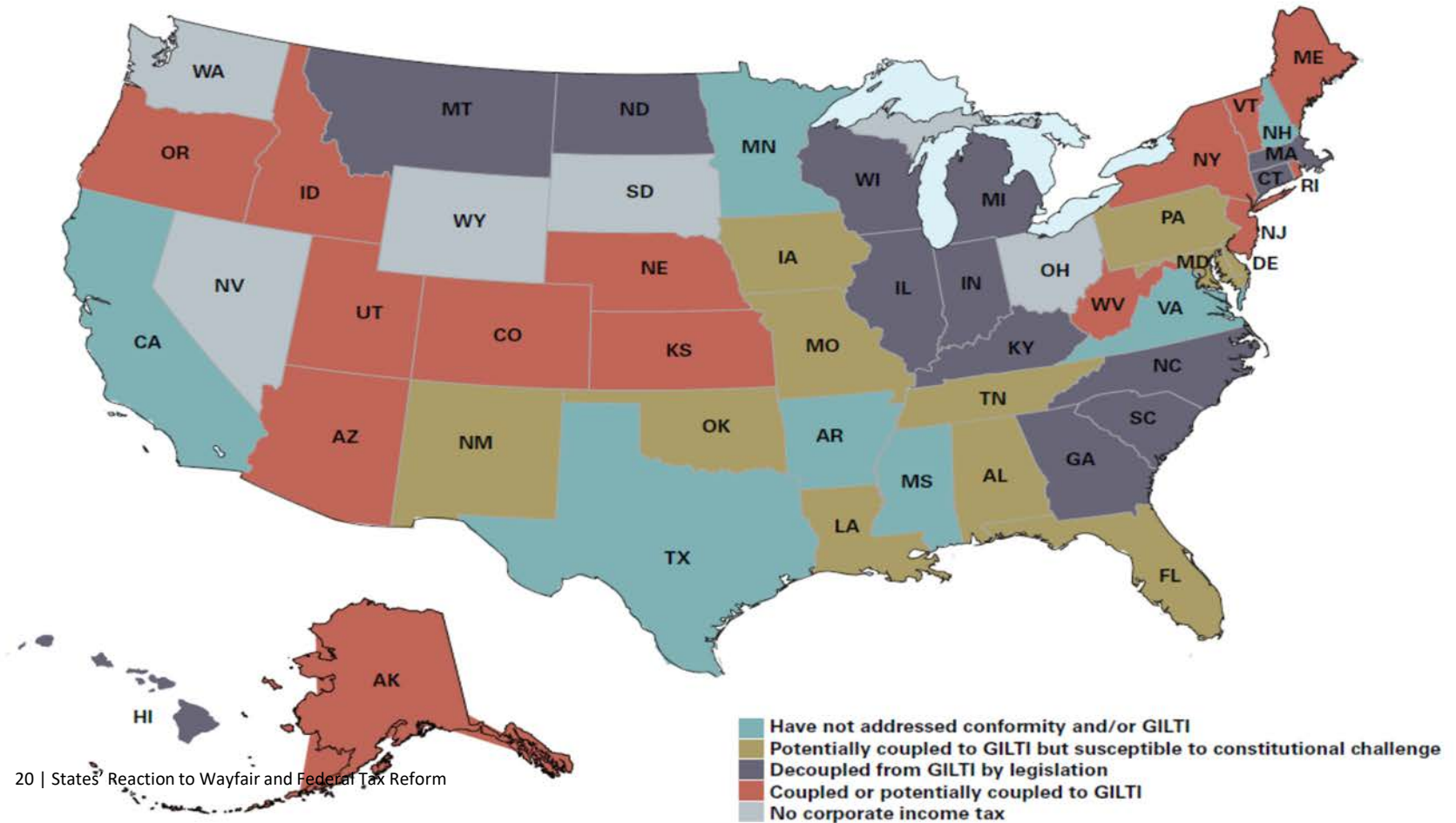
- “GILTI” – Name is a misnomer – targeted at all low taxed income outside the US, from intangibles or otherwise
- General Concepts:
  - Essentially the moving forward version of 965.
  - Unclear that it’s subpart F income at all despite some states leaping to that conclusion and murkiness of federal legislation (housed in Subpart F income IRC statutes)
- GILTI Conformity with vs. without deduction; impact at state level
  - State tax policy behind conformity – completely arbitrary vs. federal reform to fund corporation tax rate cuts
  - Factor representation

# Foreign Derived Intangible Income (“FDII”)

- 50Cent is Rapper
- FDII is a deduction that represents a partial offset to GILTI
- 50Cent is half of \$1
- FDII is half of GILTI
- Both are good for business



# Global Intangible Low Taxed Income and Foreign Derived Intangible Income – IRC §§951A, 250



# Global Intangible Low Taxed Income and Foreign Derived Intangible Income – IRC §§ 951A, 250

## State Tax Implications

- Theoretically inconsistent with formulary apportionment
- Conformity
  - Application to the Federal Consolidated Group will cause filing method inconsistency
  - More or less expansive definition of federal taxable income
  - Worldwide group filers
- Proper calculation of GILTI for state tax purposes
  - Inclusion of GILTI in state taxable income (DRDs, subpart F treatment)
  - Inclusion of deduction to effect rate reduction
- Apportionment
  - May very well create dilution of the apportion factors
  - Addition of foreign factors to the denominator, no correlative numerator increase

# Interest Expense Deduction Limitation IRC § 163(j)

# Interest Limitation – IRC § 163(j)

## Federal Tax Treatment

- Limits deductibility of interest expense to 30% of adjusted taxable income
- Proposed regulations provide that the limitation applies at the consolidated group level; consolidated group has a single limitation
- Does not deem the interest expense not paid (recipient still has income)

## State Tax Issues

- Conformity
- Calculation of the interest expense limitation (filing methodology)
  - Multiple state groups will create double taxation of income
- Impact on related party addback provisions
  - Deductibility – Is it still an “otherwise deductible interest expense”
  - Exceptions – How do you calculate the exceptions to the addback?

# Cost Recovery – Immediate Expensing IRC § 168(k)



# Bonus Depreciation – IRC § 168(k)

- IRC § 168(k) expanded to include full expensing of cost of new and used qualified property between 9/27/17 and 1/1/23
- Basis differences galore
- Every transactions must be reviewed for state tax purposes
- Decoupling from accelerated, bonus and full cost recovery has created significant differences between state and federal basis.
  - State basis will always be better than federal basis
  - Independent analysis is critical to reducing the gain on transactions

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