

State Tax Updates and What's in Store for 2019

TEI Fort Worth Chapter February 27, 2019

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The Pillsbury logo, featuring the word "pillsbury" in a lowercase, sans-serif font. The letters are a reddish-brown color. The logo is positioned in the bottom right corner of the slide, set against a white rectangular background.

Agenda

- Federal Tax Changes Rocking the SALT Landscape
- *Wayfair* Update
- Administrative Developments
- Trends to Watch in 2019
 - Apportionment – Market Sourcing & Alternative Apportionment
 - Combined Reporting
 - Business/Nonbusiness Income
 - Taxable Income – Discretionary Adjustments
 - City Tax Updates

SALT IMPACT OF TCJA PROVISIONS

TCJA: General Overview

- The state tax impact of TCJA provisions is conformity dependent
 - Floating conformity
 - Static conformity – fixed, annual update
 - Selective
- Filing methodology will impact the application of TCJA
 - Definition of state taxable income (worldwide v. federal taxable income)
 - Separate v. combined filing method
 - Composition of combined group filing
 - Application of state combination provisions
 - Application of the federal consolidated return rules

SALT Impact of TCJA Provisions:
Repatriation Transition Tax
IRC § 965

TCJA: Transition Tax

- 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
 - Worldwide combined reporting
 - Taxation of worldwide income
 - Taxation of effectively connected income without treaty exemptions

TCJA: Transition Tax

- State 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
- 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
 - NY – Excluded as Subpart F income; potential inclusion if alien corporation included to the extent of effectively connected income

TCJA: Transition Tax – California Treatment?

- California – A Selective Conformity State
 - No automatic conformity to changes made to the Internal Revenue Code (IRC)
 - Currently, California conforms to the IRC as of January 1, 2015
- Deemed Repatriation
 - No current conformity to IRC § 965
 - For water’s-edge purposes, Subpart F income means “Subpart F income as defined in IRC § 952”
 - Inclusion ratio numerator not affected by IRC § 965 amendments
- Actual Repatriation
 - No conformity to IRC § 245A
 - Dividend deductions depend on whether filing on a worldwide or water’s-edge basis
 - Full elimination of unitary dividends under Revenue and Taxation Code (RTC) § 25106
 - 75% deduction under RTC § 24411
 - Foreign investment interest offset under RTC § 24344
 - Inclusion ratio issues with respect to Subpart F income

SALT Impact of TCJA Provisions:

GILTI and FDII

IRC §§ 951A, 250

TCJA: GILTI and FDII

- “GILTI” name is a misnomer – targeted at all low taxed income outside the US, from intangibles or otherwise
- General concepts:
 - Basically the prospective application of the Repatriation Transition Tax (IRC § 965)
 - IRC § 951A resides in Subpart F of the Code, but is not Subpart F Income as defined in the code
 - IRC § 951A states that the GILTI is to be treated like it was Subpart F Income defined in IRC § 952
 - State conformity may not necessarily conform to the IRC § 951A directive to treat GILTI the same as Subpart F income defined in IRC § 952
- GILTI is reduced by 50% pursuant to IRC § 250

TCJA: GILTI and FDII

State Tax Implications

- Theoretically inconsistent with formulary apportionment
 - Territorial tax systems allocate income versus apportioning income by formula
- Conformity
 - More or less expansive definition of federal taxable income
 - Federal consolidated return rules will cause filing method inconsistency
 - Worldwide group filers will have already included such income
- Proper calculation of GILTI for state tax purposes
 - Inclusion of GILTI in state taxable income (DRDs, subpart F treatment)
 - Inclusion of IRC § 250 deduction to effect rate reduction
- Apportionment
 - GILTI inclusion may create dilution of the apportionment factors
 - Addition of foreign factors to the denominator, no correlative numerator increase
 - Application of IRC § 250 deduction ensures dilution
- State reaction – statutory proposals to exclude GILTI (NJ)

SALT Impact of TCJA Provisions:

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

TCJA: Immediate Expensing

Federal Tax Treatment

- Immediate expensing of business expenses accelerates basis reduction
- IRC § 168(k) expanded to include full expensing of cost of new and used qualified property between 9.27.17 and 1.1.23

State Tax Treatment

- Most states do not conform to immediate expensing
- Significant basis differences on all property results from decomformity
- Every transaction must be reviewed for state tax purposes
- Decoupling from accelerated, bonus and full cost recovery has created significant differences between state basis and federal basis
 - State basis will always be better than federal basis
 - Independent analysis is critical to reducing the gain on transactions

SALT Impact of TCJA Provisions:

Interest Expense Deduction Limitation

IRC § 163(j)

TCJA: Interest Limitation

Federal Tax Treatment

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

State Tax Issues

- Conformity (NY conforms; CA does not)
- 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?

TCJA: Interest Limitation

State Tax Issues

- Interest expense limitation
 - New York has rolling conformity to current IRC § 163(j)
 - California conforms to prior version of IRC § 163(j)
 - No automatic conformity to amendments to IRC § 163(j)
 - Compare RTC § 25116
 - California has two expense attribution type statutes that are applied to limit interest deductions
 - RTC § 24425 – expenses disallowed where they were incurred for the primary purpose of providing non-taxable income
 - RTC § 24344 – foreign investment interest offset – interest expense incurred for the purposes of foreign investment may be disallowed
 - New York also employs expense attribution provisions

SOUTH DAKOTA V. WAYFAIR

Wayfair: Overview

- On June 21, 2018, the Supreme Court issued its decision (Kennedy, J.), overturning the *Quill v. North Dakota* physical presence standard:
 - Not a necessary interpretation of the Commerce Clause
 - Arbitrary and formalistic, overlooking current economic realities
 - Creates market distortion and is perceived as a “judicially created tax shelter”
- New Commerce Clause substantial nexus standard: **economic and virtual contacts**

Wayfair Overview (Cont.)

- While other avenues remain to challenge tax collection systems under the Commerce Clause, the South Dakota statute has certain safeguards:
 - Not retroactive
 - Small business safe harbor
 - Compliance with Streamlined Sales and Use Tax Agreement

Unanswered Questions

- Does *Wayfair* prohibit the retroactive application of the new nexus standard for sales and use tax collection?
- Does *Wayfair* establish a nexus standard for other state and local taxes?

Wayfair Fallout: States' Responses

- 36 states have enacted economic factor presence nexus requirements
- Texas
 - Postpones collection requirements until October 1, 2019
 - Sales in excess of \$500,000
 - No retroactive application
- Hawaii
 - Sales in excess of \$100,000 or at least 200 transactions
 - Retroactive as of January 1, 2018 but the department will not pursue retroactive enforcement
- California
 - Special Notice L-565
 - Collection will begin on April 1, 2019
 - Sales in excess of \$100,000 or at least 200 transactions
 - No retroactive application
 - AB 147
 - Joint legislation introduced on December 17, 2018
 - Threshold raised to \$500,000

Wayfair Fallout: Congressional Action

- Is there any incentive for Congress to act?
 - Chief Justice Roberts (dissent): *Wayfair* will have a chilling effect on congressional action, including pending bills
- S. 3725 - Online Sales Simplicity and Small Business Relief Act
 - Introduced on December 6, 2018
 - No retroactive tax
 - No collections until 2020
 - Require states to join a compact to collect online sales taxes
- H.R. 7184 - No Retroactive Online Taxation Act of 2018
 - Introduced on November 28, 2018
 - No retroactive tax

Wayfair: Taxpayer Considerations

- Reevaluate state-by-state nexus thresholds
- Evaluate whether a state's statute may violate the discrimination and undue burden prongs of *Complete Auto*
- Be aware of sourcing rules for assignment of sales for sales/use tax and corporate income tax purposes within the same jurisdiction
- Potential conflict with jurisdictions' occasional sale rules
- Potential vulnerability to False Claims Act/Class Action lawsuits for under/over-collection of use tax
- Reevaluate reserves
- Consider amnesty/voluntary disclosure options

ADMINISTRATIVE DEVELOPMENTS

Tax Administration Reform - California

- Taxpayer Transparency and Fairness Act of 2017 (AB 102)
 - Enacted on June 27, 2017
 - Eliminated SBE's authority to administer most taxes and to adjudicate most tax appeals, including tax appeals for corporate income and franchise tax, personal income tax and sales and use tax
 - SBE continues to administer and hear all tax appeals only for property, insurance and alcoholic beverage taxes
- On July 1, 2017, the newly created CDTFA began administering sales and other excise taxes
- On January 1, 2018, tax appeals for income and sales and use taxes began being heard by the newly created Office of Tax Appeals (OTA)
 - Cases heard by panels of three administrative law judges (ALJs)
 - ALJs designated by the director of the OTA, who is appointed by Governor
 - Tax appeals panels required to issue written opinions in all appeals
 - Hearings are generally required to be conducted under the Administrative Procedures Act
 - Formal regulations adopted

Tax Administration Reform – California (Cont.)

- Examples of Pushing Back Against State Agency
 - *Appeal of Satview Broadband, Ltd.*, 2018-OTA-121 (rejected FTB’s broad interpretation of “doing business” standard)
 - *Appeal of Gilbert P. Hyatt*, 2019-OTA-001 and 2019-OTA-002 (denied FTB’s petition for rehearing)
- Waiting for first big corporate tax case

STATE TAX TRENDS – APPORTIONMENT

Apportionment: Market-Based Sourcing v. Costs of Performance

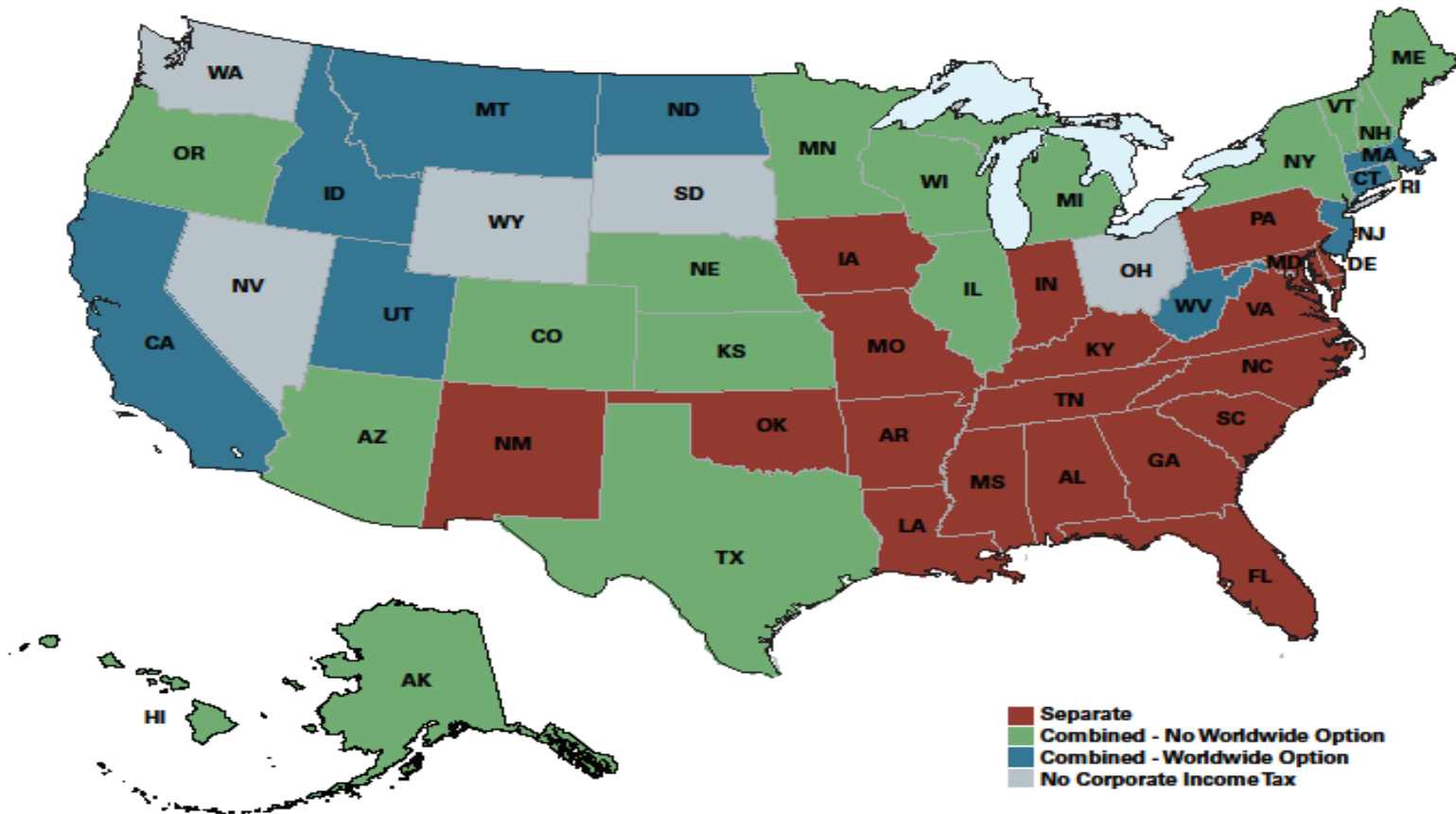
- Market-based sourcing of sales of services and intangibles
 - Where is the benefit of the service received?
 - In California, FTB Regulation 25136-2 contains elaborate set of cascading rules
 - Difficulties in reasonable approximation
- Costs of performance
 - *Corporate Executive Board Co. v. Virginia Department of Taxation*, 2019 WL 476707 (Va. 2019)
 - Application of Virginia’s “all or nothing” COP sourcing rules for sales of services/intangibles did not violate fair apportionment
 - Based on the taxpayer’s activity in Virginia, the Court found the apportionment method reasonably reflected the in-state component of the activity being taxed despite the fact over 95 percent of the taxpayer’s sales occurred outside of Virginia and some double-taxation occurred
 - Alternative apportionment not warranted

Alternative Apportionment

- California FTB is currently undergoing rulemaking process for alternative apportionment petitions under RTC § 25137
 - Focuses on appeals to the FTB three-member board after FTB staff denies a 25137 petition
 - Adds a provision allowing the FTB three-member board to elect to hear an initial 25137 petition
 - Fails to fix the lack of confidentiality provided to taxpayers in front of the three-member board
 - Interested Parties Meeting held November 26, 2018 to consider potential amendments to Regulation 25137 pertaining to hearings before the 3-member FTB on RTC § 25137 Petitions
 - Taxpayers and their representatives are now permitted to make oral presentations before the FTB 25137 Committee in support of petitions for relief and in opposition to staff's request
 - FTB Notices 2017-05 and 2018-02

STATE TAX TRENDS – COMBINED REPORTING

Combined Reporting v. Separate Reporting States



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

Combined Reporting: New Jersey Tax Reform

- New Jersey A. 4495, signed into law on October 4, 2018, amends the state's Corporation Business Tax law
 - Many changes are technical corrections in response to the tax reform legislation (A.B. 4202), enacted on July 1, 2018
- Law addresses: (1) TCJA; (2) combined reporting; (3) market-based sourcing; (4) surtax on corporation
- Effective January 1, 2018, NJ taxes GILTI (IRC §951A)
 - NJ coupled to the federal treatment of GILTI and the FDII deduction
 - Open question → Apportionment *i.e.*, how much GILTI is subject to NJ taxation
- Effective for TYE on or after July 31, 2019, NJ adopts combined reporting and market-based sourcing
 - Require members of unitary business groups to file water's-edge combined reports (with election to file using worldwide income)
- Trend towards combined reporting continues

Combined Reporting: Decisions

- *Agilent Technologies, Inc. v. Dep't of Revenue*, 2017 WL 4986232 (Colo. Ct. App. 2017), & *Oracle Corp. v. Dep't of Revenue*, 2017 WL 5898393 (Colo. Ct. App. 2017)
 - Taxpayers excluded wholly-owned domestic holding companies from combined returns because statutory test for combination
 - Held: Water's-edge exemption not limited to foreign sales corporations and Department could not use discretionary authority to reallocate income between holding companies
 - Pending before Colorado Supreme Court – oral argument on April 9, 2019
- *Harley Davidson, Inc. v. FTB*, 27 Cal.App.5th 245 (2018)
 - Case involved issue of whether California improperly discriminates against multistate unitary corporate taxpayers by requiring combined reporting and not allowing them to choose separate reporting
 - Court of Appeal held that since there is a legitimate state interest to accurately measure and tax all income, California can require interstate unitary businesses to use combined reporting

STATE TAX TRENDS – BUSINESS/NONBUSINESS INCOME

Business/Non-Business Income: Court Decisions

- *ComCon Production Services v. FTB*, Court of Appeal No. B259619, 2016 Cal. App. Unpub. LEXIS 9078 (2016)
 - Trial court held that termination fee received in connection with a failed merger was business income
 - Trial court also held that Comcast and QVC were not engaged in a unitary business
 - Court of Appeal affirmed in unpublished opinion

Business/Non-Business Income: Court Decisions

- *Fidelity National Information Services v. FTB*, No. C081522, 2017 Cal. App. Unpub. LEXIS 5148 (2017)
 - Sale of minority stock interest
 - Trial court held the gain was business income
 - In an unpublished opinion, Court of Appeal reversed and remanded case back to the trial court to determine whether the stock was a business asset when decision was made to sell it
 - On remand, trial court again found the gain to be business income
 - After appeal filed, case was dismissed in 2018

Business/Non-Business Income: Administrative Guidance

- Mississippi Department of Revenue Notice 80-19-001 (Jan. 28, 2019)
 - Both repatriation dividends and GILTI considered allocable nonbusiness income
 - Nonbusiness dividends allocated to the state of commercial domicile (35 Miss. Code 303.06)

Business/Non-Business Income: Administrative Guidance

- *Bank of America Corp.*, SBE Case No. 983272 (2017)
 - On November 14, 2017, the SBE held that dividends received by the bank from one of its Chinese affiliates was nonbusiness income because of lack of integration and interwoven ties between the affiliates
 - FTB filed petition for rehearing
 - OTA denied FTB's petition on February 21, 2019

STATE TAX TRENDS – DISCRETIONARY AUTHORITY

Discretionary Authority: IRC § 482-Type Adjustments

Utah State Tax Commission v. See's Candies, Inc.

- The Utah Supreme Court affirmed the trial court's decision to seek interpretive guidance from IRC § 482 and the accompanying federal regulations and to employ the federal arm's-length transaction standard in determining whether See's income was clearly reflected on its returns

STATE TAX TRENDS – CITY TAX DEVELOPMENTS

City Tax Developments

- Philadelphia Business Income & Receipts Tax (BIRT)
 - Proposed amendment to adopt economic nexus provisions (following *Wayfair*)
 - Repatriation Transition Tax income and GILTI included in BIRT income tax base, excluded from BIRT gross receipts tax calculation
- San Francisco Business Tax
 - Combination of Payroll Expense Tax and a Gross Receipts Tax
 - Worldwide/water's-edge unitary tax at local level
 - Proposition C
 - Passed November 6, 2018
 - Would levy an additional gross receipts tax on corporate revenues greater than \$50 million to fund homelessness
 - May be subject to challenge since did not obtain 2/3 voter approval
 - Ordinance passed to validate through court action

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