Introductions

Robert Garvey
robert.a.garvey@us.pwc.com
858-677-2536

Monica Hoyt
monica.hoyt@us.pwc.com
858-677-2486
Disclosures & Disclaimers

This document is for general information purposes only, and should not be used as a substitute for consultation with professional advisors.

This document was not intended or written to be used, and it cannot be used, for the purpose of avoiding U.S. federal, state or local tax penalties.

Past performance is no indication of future returns.

Your mileage may vary.
State of the States
State of the States

- Tax Reform/Tax Proposals
- Combined Reporting
- More aggressive nexus approaches
- Tax Base Changes
  - Decoupling from federal stimulus provisions
  - Related Party Addbacks
  - Anti-REIT/RIC Provisions
  - NOL Suspensions
- Apportionment Changes
  - Sales Factor Weighting
  - Market – Based Sourcing
- Other Changes
  - Surcharges
  - Tax on Wealthy
  - Amnesty
  - Increased Penalties
Tax Reform & Tax Proposals
Tax Reform

Many States Are Proposing Deep Tax Cuts

Source: CBPP Survey

Center on Budget and Policy Priorities | cbpp.org
Massachusetts

- Budget bill (HB 3538) - enacted 7/12/13
  - Delay FAS 109 deduction until 2015
- Transportation finance bill (HB 3535) - enacted
  - Switch to market-based sourcing for sales of other than tangible personal property (see section on apportionment)
  - Adopt throwout rule for sale of other than tangible personal property
- Repeal of security and utility classifications
- Subject computer system design services to sales/use tax
Minnesota

- H.F. 677, enacted 5/23/13
  - MTC repeal (see section on apportionment)
  - Repeal of foreign operating corporation provisions
  - Repeal of foreign royalty deduction
  - Inclusion of foreign check-the-box entities in a unitary group
  - *Finnigan* sales factor sourcing adopted
  - Dividends from a REIT do not qualify for DRD
  - Research and development credit no longer refundable
  - Creates new tax bracket for higher wage earners
  - Sales tax changes
**North Carolina**

- H.B. 998, signed 7/23/13
  - Creates flat personal income tax rate of 5.8%
  - Corporate income tax rate reduction to 6.0% effective for tax years beginning on or after January 1, 2014. The tax rate is reduced to 5.0% for tax years beginning on or after January 1, 2015.
  - Research and development credit extended for two years, now scheduled to be repealed for tax years beginning on or after January 1, 2016.
  - Also expands sales tax base
**Ohio**

- H.B. 59, enacted 6/30/13
  - Increased sales tax rate to 5.75%
  - Taxation of digital products, exemption for cable, video, audio and broadcast services
  - Increase CAT minimum tax
  - Allows investors in a pass-through entity participating in a composite return to elect to also file a separate individual income tax return and claim refundable credit
  - Phased in reduction of personal income tax rates
  - Other changes
Pennsylvania

- H.B. 465, enacted 7/9/13
  - adopts intangible expense addbacks (see section on tax base)
  - expands the cap on the net operating loss deduction
  - adopts market based sourcing for services (see section on apportionment)
  - extends the phase-out of the Capital Stock/Franchise Tax for two years
  - implements comprehensive Bank Shares Tax reform
  - modifies and creates certain tax credit programs
  - broadens the application of the realty transfer tax.
**Texas**

- H.B. 500, enacted, 6/14/13
  - enacts a temporary margin tax rate reduction
  - allows additional businesses to qualify for a reduced rate
  - provides a new minimum deduction of $1 million
  - expands deductions (including the cost of goods sold deduction)
  - provides customer based sourcing for Internet hosting receipts,
  - repeals information reporting requirements for combined group non-nexus members
Combined Reporting
Combined Reporting

Recent Enactments

- Vermont – Applies to tax years beginning on or after January 1, 2006
- West Virginia – Any taxpayer engaged in a unitary business with one or more other corporations must file a combined report, effective January 1, 2009
- Ohio “CAT” – Consolidated or combined reporting required
- Texas Margin Tax – Taxable entities that are part of an affiliated group engaged in a unitary business must file a combined report
- Michigan – Taxpayers are required to file based on a unitary combined reporting system, effective January 1, 2008 (MBT) and effective January 1, 2012 (corporate income tax)
- Massachusetts adopted combined reporting, effective January 1, 2009
- Wisconsin adopted combined reporting, effective for tax years beginning on or after January 1, 2009
- District of Columbia – Applies to tax years beginning after December 31, 2010
Combined Reporting – 2013

Combined Reporting Proposals Considered Recently and/or Currently Proposed

Unitary/Combined States (now including the Ohio CAT, Texas Margin Tax and Michigan Business Tax)

Remaining Separate Entity or Elective Consolidated Reporting/Other

*New York requires related corporations to file a combined report upon the existence of substantial intercorporate transactions

*New Mexico requires certain unitary large retailers to file combined returns (2014).
## Combined Reporting Legislation – 2013 Activity

<table>
<thead>
<tr>
<th>State</th>
<th>Legislation Details</th>
</tr>
</thead>
<tbody>
<tr>
<td>Alabama</td>
<td>H.B. 203, failed</td>
</tr>
<tr>
<td>Arkansas</td>
<td>H.B. 1845, failed</td>
</tr>
<tr>
<td>Maryland</td>
<td>H.B. 1246, failed</td>
</tr>
<tr>
<td>Montana</td>
<td>S.B. 208, (repeal water’s-edge election), failed</td>
</tr>
<tr>
<td>New Mexico</td>
<td>H.B. 641, enacted, 4/4/13 (large retailers, with exceptions)</td>
</tr>
</tbody>
</table>
District of Columbia
Legislation Enacting Combined Reporting

A19-0098, enacted 9/14/11

• Effective for tax years beginning on or after December 31, 2010.
• Adopts combined reporting for any taxpayer engaged in a unitary business with one or more corporations that are part of a water’s edge combined group.
District of Columbia
Timeline

- Legislation requiring combined reporting effective 9/14/11
- Proposed Regulations released 1/20/12
- Proposed Regulations re-released 8/31/12
- FAS 109 Worksheet due date extended 9/5/12
- Extension for returns due 9/17/12 extended 9/7/12
- Final Regulations adopted 9/14/12
- Emergency / Temporary Legislation proposed 9/12
  - Emergency bill approved by D.C. Council 9/19/12
  - Emergency bill signed by Mayor 10/12/12
**District of Columbia**

**Current Status**

- Calendar year 2011 returns originally due 9/17/12, due date extended to 10/15/12.
- Fiscal-year filers: No filing deadline.
- FAS 109 Worksheet due date extended to due date of 2012 returns.
- Open Issues:
  - Effect of Emergency bill signed by Mayor 10/12/12
  - Treatment of unincorporated businesses
District of Columbia
2012 Emergency Legislation – enacted 10/12/12

- Conforms treatment of unincorporated businesses with treatment detailed in Final Regulations.
- Formally withdraws taxpayer’s election to file consolidated return.
- Addresses treatment of partnerships that are not unincorporated businesses.
- Allows designated agent election to continue once initial election is made, eliminates requirement to make election annually.
- Subpart F income excluded from combined reporting.
- Worldwide election, if not renewed after the ten-year period, does not automatically default to a new ten-year period.
District of Columbia
Fiscal Year 2014 Budget Support Emergency Act of 2013—enacted 7/30/13

• Partnership and unincorporated business income treatment to be addressed by regulation.

• Modifies the definition of a ‘corporation’ to include S corporations.

• Includes the activity of a partnership within the definition of ‘doing business’.

• Excludes Qualified High Technology Companies from the definition of a ‘person,’ therefore excluding them from a combined return.

• Revokes the taxpayer election to file a consolidated return.

• Removes ‘international financial reporting’ from the computation of a group’s ‘net deferred tax liability.’

• Subpart F income excluded from group’s water’s-edge unitary combined income.
**Legislation – New Mexico**

H.B. 641, enacted 4/4/13

- Unitary corporations that make retail sales of goods in a facility in New Mexico that is larger than 30,000 square feet must file a combined return with other unitary corporations.

- There is an exception for large retailers that employ at least 750 employees at facilities that do not provide retail sales of goods.

- Effective for tax years on or after 1/1/14.
Legislation – Oregon

H.B. 2460, signed 8/1/13

• Requires the income and apportionment factors of unitary corporations incorporated in certain ‘tax haven’ countries to be included in a taxpayer’s Oregon combined unitary tax return.

• Effective for tax years on or after 1/1/14.
The New York Department of Taxation and Finance adopted regulation amendments (Dec. 2012; published January 2013) that update rules and codify Department interpretation regarding combined reports.

- **Department's discretion, Secs. 7 and 8** - remove discretionary language with respect to when a combined report is permitted or required. As proposed, if the capital stock requirement is met, but there are insufficient intercorporate transactions, a combined report may be required or permitted at the Department's discretion to properly reflect tax liability. The Department may require a combined report to be filed where there are intercompany transactions, or where there is some agreement, understanding, arrangement, or transaction between corporations engaged in a unitary business.

- **Capital stock requirement, Sec. 9** - clarify that capital stock ownership is a measurement between one corporation and any other corporation.

- **Substantial intercorporate transactions, Sec. 10** - provide guidance in determining whether substantial intercorporate transactions among related corporations exist.
  - The amendments consider interest paid and received on loans constituting subsidiary capital between related corporations in determining whether substantial intercorporate transactions exist.
New York – Regulation Amendments Adopted

• **Substantial intercorporate transactions, Sec. 10 –**
  
  • The amendments do not consider intercorporate cost allocations in the substantial intercorporate transaction determination.
  
  • Transfer price of intercorporate transactions are irrelevant for purposes of determining whether substantial intercorporate transactions exist.
  
  • Centralized payroll is included in the proposed amendments as an example of a service function that is not considered in the substantial intercorporate transaction determination when such functions are incidental to the corporation's business providing such service. T
  
  • The regulations clarify that intercorporate cost allocations of expenditures that benefit related companies are not considered receipts or expenditures in determining if there are substantial intercorporate transactions.
  
  • Expenditures for service functions, such as payroll processing and personnel services, are not considered expenditures that benefit related corporations.
New York – Regulation Amendments Adopted

- **Multi-year test, Sec. 10** - The regulations substantially adopt the multi-year test articulated in TSB-M08(2)C, except that the test may alternatively be used to prove that the substantial intercorporate test is *not satisfied*.

- **Ten-Step analysis, Sec. 11** – provide a ten-step analysis to determine whether a combined report is required and, if so, which corporations are included in that combined report. The analysis is substantially similar to guidance provided in the TSB-M.
New York – Regulation Amendments Adopted

- **Foreign corporations, Sec. 14** - explicitly provide that corporations organized under the laws of a country other than the United States may not be included in a combined report.

- **Excluded corporations, Sec. 14** - corporations taxable under another New York State franchise tax (or would be taxable under another franchise tax if subject to tax) may not be included in a combined report.

- **Same Accounting Periods, Sec. 18** - reverse the current requirement that all corporations in a combined group have the same accounting period.

- **REITs and RICs, Secs. 2 and 3** - taxpayers to NY Tax Law Sec. 211.4 for rules relating to the inclusion of REITs and RICs in a combined report.

- The amendments will take effect on the date the Notice of Adoption is published in the State Register and apply to taxable years beginning on or after January 1, 2013.
**Cases – New York**

*In the Matter of the Petitions of Knowledge Learning Corporation and Kindercare Learning Centers, Inc.*, NY Division of Tax Appeals, Nos. 823962 and 823963, 6/27/13

- In a case of first impression under New York’s post-2006 combined reporting provisions, the decombination of two affiliated companies by the Division of Taxation was upheld by an administrative law judge where the companies failed to demonstrate the existence of substantial intercorporate transactions.

- The ALJ declined to consider arguments that combined filing should be allowed to avoid distortion.

- This case highlights the Division’s continued audit focus on combination and decombination, including situations where filing on a combined basis benefits taxpayers.
Nationwide Trends – Nexus and Related Developments

• Economic Nexus and Factor Presence
• Nexus - Agency
• Business Activity Tax Legislation
**Cases - California**

*Harley-Davidson, Inc. & Subsidiaries v. California Franchise Tax Board,* Superior Court, San Diego County (California), No. 37-2011-00100846-CU-MC-CTL, 5/1/13

- Special purpose entities created as securitization subsidiaries had substantial nexus, even though they had no physical presence in California.

- The entities had substantial nexus with the state through their California agents—the parent company, the parent’s financial subsidiary, and the various in-state dealerships—and, therefore, their California-sourced sales could be included in the sales factor of their combined reporting group for apportionment purposes.

- The fact that the entities were established in a certain way to be bankruptcy remote was irrelevant to the determination of whether they had nexus with the state.
Cases - Maryland

Maryland State Comptroller v. Gore Enterprise Holdings, Nos. 1696, 1697, September Term, 2011, (1/24/13)

- The Maryland Court of Special Appeals held that the Comptroller may tax a company that lacks physical presence in Maryland based on its unitary relationship with an affiliate operating in the state.
**Cases - Massachusetts**

*Allied Domecq Spirits and Wines USA, Inc. v. Commissioner of Revenue*, Massachusetts Appellate Tax Board, Nos. C282807, C293684, and C297779 (5/27/13)

- The transfer of Massachusetts employees from an in-state company to its out-of-state parent was disregarded for tax purposes.
- The transfer, which established Massachusetts nexus for the parent and caused the parent to be included in the ‘nexus combined’ corporate excise tax return, allowed the parent’s losses to offset the income of other members of the nexus combined group.
- The Board found that, pursuant to the sham transaction doctrine, the transfers had no valid business purpose other than tax avoidance.
Federal Legislation - Business Activity Tax Nexus

• Business Activity Tax Simplification Act of 2011 (H.R. 1439)
  – Expansion of Public Law 86-272
  – Codified physical presence nexus standard
  – 15-day de minimis period for the imposition of a business activity tax
  – Passed out of full House Judiciary Committee by voice vote, 7/7/11
• As of 2013, there will be a meeting to discuss feasibility of BATSA in 113\textsuperscript{th} Congress.
• State opposition to any type of physical presence standard.
Federal Legislation - Business Activity Tax Simplification Act of 2013

- H.R. 2992, introduced in the House August 2, 2013
  - provides for modernization of Public Law 86-272
  - provides that a state can only impose corporate income and similar taxes on companies that have minimum physical presence in that state
  - provides that physical presence would be required to be taxed as part of a group return
Tax Base

- Internal Revenue Code conformity
  - Rolling conformity
  - Fixed-date conformity
  - Select provisions adopted
- States likely to decouple from provisions deemed to costly
  - Majority of states decoupled from bonus depreciation
  - Numerous states limited expense allowance
  - State-specific NOL provisions often limit carryover
  - Section 199 Domestic Production Activity
  - COD income deferral
**Nationwide Trends – Tax Base/Related Party Addbacks**

- Inclusion of related member interest payments and management fees, as well as royalties
- Broader provisions which require addback of intangible expenses along with expansive definitions of “intangibles”
- Typical “safe harbors”
  - Economic substance/arm’s length rates & terms for transactions
  - Purpose other than state income tax avoidance
  - Payment of income tax by royalty recipient
  - Royalty recipient not “primarily engaged” in maintenance and management of intangibles (i.e., not an IHC)
  - Ultimate pass-through of expense to unrelated party
  - Requirement to “make a disclosure” to become eligible for a safe harbor
  - “Unreasonableness” exceptions
Nationwide Trends – Tax Base/Related Party Addbacks

- Deductibility of all types of intercompany charges are being challenged by state auditors, including intercompany management fees, finance charges and other overhead costs.
- States are concerned that deductions do not have a valid business purpose, are not based on arm’s length pricing or are otherwise not “legitimate.”
- States are looking for transfer pricing studies for each type of charge.
- If taxpayers do not have transfer pricing studies, states are disallowing deductions, reallocating income and expenses, or adjusting mark-ups.
Nationwide Trends – Tax Base/Related Party Addbacks

- Intercompany Expenses: Questions
  - Intercompany expenses subject to addback –
    ◦ does an exemption apply and can a claim of exemption be supported?
  - Intercompany charges other than interest and royalties –
    ◦ are deductions valid, what is business purpose, is charge at arm’s length, are charges “settled”?
- Challenges to the "Add-back" statutes
  ◦ Will Taxpayer more likely than not be able to sustain a challenge when states' interpretation of "subject to tax in another state" or other exceptions are vague.
Related member expense addback required (including DC, NYC)

Related member expense addback legislative proposals considered in recent years

No related party addback provisions imposed

Repealed eff. 1/1/13

*South Carolina disallows deductions for an expense between related parties where a payment is accrued, but not actually paid and on interest deductions on obligations issued as a dividend or paid instead of a dividend

**Minnesota requires addback of interest and intangible expenses, losses, and costs paid, accrued, or incurred by any member of the taxpayer’s unitary group to a foreign operating corporation that is a member of the taxpayer’s unitary business group.
New York - 2013 Budget

SB 2609 – D, enacted 3/28/13

• Current law - New York requires taxpayers to add back royalty payments to a related member during the taxable year to the extent deductible in calculating federal taxable income. Current law allows for an exclusion of royalty income received if the related member that made the royalty payment is required to add back the payment to its income.

• Proposal eliminates royalty income inclusion, and rewrites addback (MTC addback statute)

• Taxpayers must add back royalty payments directly or indirectly paid, accrued, or incurred to, or in connection directly or indirectly with one or more direct or indirect transactions with, one or more related members.

• Three exceptions: a 'conduit' exception, 'subject to tax' exception, and a ‘treaty’ exception
Pennsylvania - 2013 Legislation

H.B. 465, enacted 7/9/13

- For taxable years beginning after 12/31/14, addback required for: (1) intangible expenses and (2) interest expenses related to an intangible that are paid, accrued, or incurred directly or indirectly in connection with one or more transactions with an affiliated entity.

- Addback does not apply:
  - when a taxpayer receives an apportioned credit to the extent that the affiliated entity was subject to a tax that includes the expense in its tax base.
  - to a transaction that did not have as its principal purpose the avoidance of the tax and was done at arm's length rates and terms.
  - when the affiliated entity is domiciled in a foreign nation that has in force a comprehensive income tax treaty with the US with certain provisions.
  - when the affiliated entity directly or indirectly paid the expense to a non-affiliated entity, with certain conditions.
Oregon - 2013 Legislation

H.B. 3069, enacted 6/24/13

• repeals addback of intangible expenses and costs paid to related members repealed, effective for tax years beginning on or after January 1, 2013.

• retroactively expands the safe harbor for a related member that is a foreign corporation not connected with a US trade or business
**Cases - Massachusetts**

*Kimberly-Clark Corp. v. Commissioner*, Mass. App. Ct., slip opinion No. 11-P-632, 1/11/13

- Court upheld decision disallowing certain expenses that occurred between related entities during the 2001 to 2003 tax years, including interest expenses on transfers made through the taxpayer's cash-management system, patent royalties paid to an affiliate, and rebate payments made to related entities.

- Because the add back statutes were not effective in the 2001 tax year, the Court upheld the disallowance of Kimberly-Clark's 2001 intercompany interest expense by holding that such expense did not relate to a bona-fide debt.

- Applying a 'clear and convincing' review standard of proof, the Court upheld board's decision found that Kimberly-Clark failed to support the elements that would make the application of add back unreasonable: (1) that the reduction of tax was not a principal purpose of the transactions; (2) that the transactions served a business purpose; and (3) that the transactions had economic substance.

- The Court of Appeals found that the Board's findings supported the conclusion that the rebate payments were expenses "for, related to, or in connection directly or indirectly" with the use of intangible property.

- Accordingly, tax avoidance was a "principal purpose" of the transactions, and the taxpayer did not carry its burden of proving by clear and convincing evidence that the required add backs were unreasonable.
**Cases - Minnesota**

*Express Scripts, Inc. v. Commissioner of Revenue*, Minnesota Tax Court, Ramsey County, Docket No. 8272R, 8/20/12

- A taxpayer's corporate acquisition triggered an IRC Sec. 382 limitation of the acquired company's net operating loss carryovers equal to approximately $30 million. The Minnesota Department of Revenue apportioned that limitation using the apportionment ratio of the income years, which reduced the amount of available loss to approximately $120,000.

- Despite Department guidance to the contrary, there was no statutory authority for the Department's position to apportion the section 382 limitation.

- Additionally, the Tax Court found that the taxpayer was not unitary with one of its LLC subsidiaries because the facts did not support a flow of value, nor was there sufficient control over the subsidiary.
Mississippi Department of Revenue v. AT&T Corporation, Miss. Supreme Court, No. 2010-SA-02013-SCT, 9/6/12

- The Mississippi Supreme Court vacated a chancery court's ruling that the following were unconstitutional: (1) the state's limitation of its dividends received deduction (DRD) to dividends paid by an entity that does business and files a return in Mississippi; and (2) the consolidated filing election available only to an affiliated group conducting 100% of its business in the state.

- The Mississippi Supreme Court found that the chancery court lacked appellate jurisdiction and should not have reached the merits of the case. Accordingly, the Commissioner's order (from which the chancery court's dispute was appealed) imposing the DRD limitation and combined return remained in effect.
Cases - Pennsylvania


• Goodwill recorder on a taxpayer’s balance sheet was an asset includable in the “actual value” of the taxpayer’s stock in its wholly-owned subsidiary.
• Thus, taxpayer qualified as a holding company and was able to utilize favorable “10% holding company apportionment” method.

- “Fatal error” was found in a contract auditor's "comparable profits" transfer pricing audit methodology that included all of the taxpayer's income rather than narrowing its analysis to only controlled transactions among affiliated entities.

- By failing to separate Microsoft's controlled transactions (those between affiliates) from its uncontrolled transactions (those made at arm's length with third parties), the ALJ found the transfer pricing analysis “arbitrary, capricious and unreasonable.”

- Additionally, the ALJ found fault in the analysis because it failed to separately measure similar types of transactions.
**Other Developments – Massachusetts**

*Massachusetts Department of Revenue, Corporate Excise/Income Tax Directive 12-3, 6/27/12*

- Certain NOLs generated by QSubs prior to their treatment as disregarded entities may be carried forward and used by the parent S corporation.

- Since 2003, Massachusetts has changed how it subjects S corporations and their QSubs to the income and non-income measures of the corporate excise.

- Tax Directive 12-3 provides the rules for how an S corporate calculates and applies NOL carryforwards generated by its QSubs in prior years.

- Generally, an S corporation may use a QSub's NOL carryforward generated in a tax year before 2009 if the loss was generated by the QSubs in a taxable year in which it was a QSub of the same S corporation, subject to certain adjustments.
Other Developments – Texas

Comptroller of Public Accounts News Release, 6/12/12

• Taxpayers can change their margin tax deduction method (COGS or payroll) on an amended return.

• Previously, the Comptroller provided by rule that taxpayers could not file amended reports to change or make their election after the due date of the report.
Other Developments – Texas

Amendments to regulation 3.588, adopted May 2013

- Allows taxpayers to include as COGS both direct labor costs and those indirect labor costs, other than service costs, that are subject to capitalization under Treasury Rules interpreting IRC §263A or §460 without regard to whether the taxpayer is required to or actually capitalizes the costs for federal income tax purposes.

- Labor costs include W-2 wages, IRS Form 1099 payments for labor, temporary labor expenses, payroll taxes, pension contributions, and employee benefit expenses including per diem reimbursements for travel expenses, to the extent deductible for federal tax purposes.

- Allows taxpayers to change their margin tax computation method on an amended report and while under audit.

- A taxable entity may subtract as COGS service costs that it can demonstrate are reasonably allocable to the acquisition or production goods, up to 4% of total indirect and administrative overhead costs.

- Service costs are further defined as “indirect labor costs and administrative overhead costs that can be identified with a service department or function, or that directly benefit or are incurred by reason of a service department or function.”
**Legislative Proposal - Pennsylvania**

H.B. 440, approved in House, 5/6/13

- For taxable years beginning after 2014, taxpayers would not be allowed to deduct “affiliated entity” intangible expenses, including interest expenses relating to intangibles.

- Legislation provides for four exceptions: subject to tax, business purpose, treaty and conduit.

- Legislation also include rate reduction and market sourcing provisions (see allocation and apportionment section of this outline).
Allocation and Apportionment
Nationwide Trends – Allocation and Apportionment

- Apportionment Trends
  - Shift in factor weighting
  - Sales factor
    - Gross versus net
    - Market source versus cost of performance
  - Use of discretionary authority to adjust formula (UDIPTA Sec. 18)
Apportionment Formulas* - 1998

*Does not address industry-specific or optional formulas

Equally weighted three factor formula

Double weighted sales factor

Triple or greater weighted or single sales factor
Apportionment Formulas* - 2003

*Does not address industry-specific or optional formulas

Equally weighted three factor formula
Double weighted sales factor
Triple or greater weighted or single sales factor
Apportionment Formulas* - 2013

*Does not address industry-specific or optional formulas
Sales Factor Weighting/Market Based Sourcing – California Proposition

- Proposition 39 passed and requires single sales factor apportionment for California business taxpayers, unless specifically exempted, beginning January 1, 2013.

- This initiative also mandates market-based sourcing for sales other than sales of tangible personal property for all business taxpayers, irrespective of apportionment formula used.
Sales Factor Weighting – Missouri Enactment

House Bill 128, enacted, 7/12/13, effective August 28, 2013

• Provides alternative single sales factor income tax apportionment formula, which provides that:
  - sales of tangible personal property are included in the numerator if the purchaser’s destination point is in Missouri (without regard to the FOB point or other condition of the sale)
  - sales of tangible personal property are not included in the numerator if the destination point is outside Missouri, regardless of the shipping point location
  - investment or reinvestment of taxpayer’s own funds, or the sale of any such investment or reinvestment, is excluded from the sales numerator or denominator.
*Effective in 2011, for taxpayers that elect single sales factor only, but see Prop. 39
**Elective for deemed multistate service providers
***In 2014
#service receipts only effective in 2014
2013 – Massachusetts Enactment

- House Bill 3535
  - Currently – Sales are services are sourced under an IPA/COP standard
  - Effective 1/1/14
    - Sales of services sourced to Massachusetts if a corporation’s market for the sale is in the state. A corporation’s market is considered to be in Massachusetts if and to the extent the services are “delivered” to a location in the state.
    - If the state of assignment cannot be determined, it shall be reasonably approximated; and if a corporation is not taxable in the state to which a sale is assigned, or if the state or states of assignment cannot be determined or reasonably approximated, such sale should be excluded from the numerator and denominator of the sales factor (i.e. thrown-out).
2013 – Massachusetts Enactment

- House Bill 3535 (cont’d)
  - In the case of a sale, rental, lease or license of real property, a corporation's market is in Massachusetts if and to the extent the property is located in Massachusetts.
  - In the case of a rental, lease or license of tangible personal property, a corporation's market is in Massachusetts if and to the extent the property is located in Massachusetts.
  - In the case of a lease or license of intangible property, a corporation's market is in Massachusetts if and to the extent the intangible property is used in Massachusetts.
  - In the case of the sale of intangible property (other than referenced above), where the property sold is a contract right, government license or similar intangible property that authorizes the holder to conduct a business activity in a specific geographic area, the market is in Massachusetts if and to the extent that the intangible property is used in or otherwise associated with the state.
  - The throwout rule also applies to these receipts as well.
2013 – Pennsylvania Enactment

• H.B. 465, enacted 7/9/13, effective for tax years beginning after 12/31/13
  - Sales from the sale, lease, rental or other use of real property, if the real
    property is located in Pennsylvania.
  - Sales from the rental, lease, or licensing of tangible personal property if
    the customer first obtained possession of the tangible personal property in
    Pennsylvania. If the tangible personal property is subsequently taken out
    of Pennsylvania, the taxpayer may use a reasonably determined estimate
    of usage in Pennsylvania.
  - Sales of services delivered to a location in Pennsylvania.
  - Sales of services delivered to a location in and outside Pennsylvania are
    sourced based upon the percentage of ‘total value’ of the service delivered
    to the Pennsylvania location.
  - All other sales (other than sales of tangible personal property), such as
    sales of intangible assets, continue to be sourced based on income
    producing activity/costs of performance.
2013 – Proposed Regulation
New Jersey

- Proposed Sec. 18:7-8.10A, 4/15/13
  - Would institute a market based sourcing system for receipts from the sale of services, effective for tax years beginning on or after January 1, 2014.
  - Market based sourcing for services would thus coincide with the complete phase in of the state’s single sales factor apportionment formula.
  - Under the proposal, in determining whether services are performed within the state, the sales factor numerator must include receipts derived from customers within the state.
  - A customer within the state is either a recipient that is: engaged in a trade or business and maintains a regular place of business in the state; or not engaged in a trade or business whose billing address is in the state.
**Legislation – New Mexico**

H.B. 641, enacted 4/4/13

- Under current law, manufacturers may elect to apportion business income to New Mexico using a double-weighted sales factor.

- H.B. 641 provides an election, binding for three years, to phase in single sales factor apportionment for tax years beginning on or after:
  - 1/1/14 and before 1/1/15, a double-weighted sales factor;
  - 1/1/15 and before 1/1/16, a triple-weighted sales factor;
  - 1/1/16 and before 1/1/17, sales factor multiplied by seven;
  - 1/1/17 and before 1/1/18 sales factor multiplied by eight;
  - 1/1/18 and there after, single sales factor.

- H.B. 641 removes the sales factor throwback rule for manufacturers making the election to apportion income using the phased-in single sales factor formula.
Cases – California

Appeal of Emmis Communications Corp.,  SBE Case No. 547964, 6/11/13

• The California State Board of Equalization found that gross receipts from a diversified media corporation’s sales of 13 television stations located outside of California were not excluded from the sales factor under the occasional sale rule of California Code of Regulations (CCR) section 25137(c)(1)(A).
**Cases – Indiana**

*Vodafone Americas Inc. v. Indiana Department of State Revenue*, Indiana Tax Court, No. 49T10-1002-TA-7. 6/18/13

- A general partner’s distributive income is operational income.
- An out-of-state corporation’s only connection with Indiana was its general partnership interest in an partnership doing business in Indiana.
- The corporation argued that, although a general partner, its absence of any management control over the partnership should render any partnership income as investment income and therefore sourced to the corporation’s domicile (which was outside of Indiana).
- The tax court disagreed, finding that the mere fact that the corporation was a general partner gives its income from the partnership the character of operational income.
Cases – Mississippi

Equifax, Inc. and Equifax Credit Information Services, Inc. v. Dept. of Rev., Miss. No. 2010-CT—01857-SCT, 6/20/13

- On audit, Department invoked alternative approach – a market based sourcing method, and issued assessment.
- Trial court upheld assessment.
- The appeals court concluded that deference to the Department’s use of alternative apportionment would interfere with the court’s ability for a “de novo” review and that as the party invoking alternative apportionment, the Department had the burden to prove standard apportionment method was not a fair representation of taxpayer’s in-state business activity.
- State Supreme Court reversed – burden is on the taxpayer

- Interest income and capital gains earned from a taxpayer's investment in a rabbi trust were classified as allocable nonbusiness income for reasons including the taxpayer's 'total lack of control' over the trust.

- The income failed the transactional test because the corporation's investment in the trust was not a business transaction in which it regularly engaged and the trust income failed the functional test because it was not attributable to the acquisition, management, and disposition of property constituting an integral part of the corporation's regular business operations.
**Ruling - California**

Chief Counsel Ruling 2012-03, 8/28/12

- The Franchise Tax Board found that a taxpayer does not have to throw back tangible personal property sales where it has more than $500,000 of sales in a foreign jurisdiction.

- A taxpayer does not have to throw back domestic tangible personal property sales when a member of its California unitary group has more than $500,000 of sales, including sales of other than tangible personal property, in the destination state.
**Ruling - California**

Technical Advice Memorandum 2012-01, 11/29/12

- For tax years beginning before January 1, 2011, a California taxpayer must demonstrate physical presence (either directly or through agents or independent contractors) in the destination state in order to avoid the application of the throwback rule.
Other Nationwide Developments
California – Enterprise Zone Changes

• AB 93 and SB 90, enacted 7/11/13, applicable 2014
  - New hiring credit over next 7 calendar years
    ◦ allows businesses to claim Hiring Credits in certain economic development areas
      (former Enterprise Zones and LAMBRAs, with some exceptions), as well as in
      designated census tracts with high unemployment and poverty rates
    ◦ available for hiring employees who are long-term unemployed; unemployed
      veterans; ex-felons; or recipients of the federal earned income tax credit,
      CalWORKs, or general assistance
    ◦ available only to employers that create net new jobs statewide
    ◦ equal to 35% of wages paid in first five years of employment (up to $56,000),
      but only wages in excess of 150% of California minimum wage (currently $12 per
      hour or $10 per hour in designated pilot areas), and not greater than 350% of
      California minimum wage (currently $28 per hour)
    ◦ must be requested soon after employment start date (at most, 50 days), along
      with other reporting requirements
    ◦ available for hires on or after January 1, 2014, and sunsets on January 1, 2021,
      but the credit may continue to be taken for qualified employees hired before
      January 1, 2021.
California – Enterprise Zone Changes

• AB 93 and SB 90, enacted 7/11/13, applicable 2014
  - Partial sales and use tax exemption for purchases over next 8 fiscal years
    ◦ provides a statewide sales tax exemption for a portion (approximately 4.19%) of the state sales and use tax on up to $200 million of certain manufacturing and research and development equipment (and certain related equipment)
    ◦ available to manufacturers (NAICS codes 3111 to 3399) and also certain Biotechnology, Physical, Engineering, and Life Sciences companies conducting research and development (NAICS codes 541711 and 521712)
    ◦ not available to certain financial institutions, agricultural, and extractive taxpayers
    ◦ applies to purchases made on or after July 1, 2014, and sunsets on July 1, 2022.
Federal Legislation - Nonresident Withholding

- The Mobile Workforce State Income Tax Simplification Act of 2011 (H.R. 1864) would provide a 30-day threshold for the state taxation of a nonresident employee’s income, and for the requirement to withhold taxes from such nonresident employee’s wages
  - Introduced on 5/12/11
  - Hearing held in the House Judiciary Subcommittee on Courts, Commercial and Administrative Law, 5/25/11
  - Reported favorably in committee, 11/17/11
  - Measure approved by voice vote in full House, 5/15/12
  - Introduced in Senate, 8/2/12
Cases - Illinois


- The Illinois Appellate Court held that a taxpayer failing to pay a tax liability under the state's 2003 amnesty was subject to a 200% interest penalty even though the taxpayer did not know it owed the tax until after a federal audit.

- A divided appeals court reached the opposite conclusion in a recent case, Metropolitan Life, holding the penalty did not apply when the taxpayer's tax obligation was determined as a result of a federal audit that concluded after the amnesty period.

- The conflicting opinions, coming from different divisions of the same Illinois Appellate Court District, may make an Illinois Supreme Court review on this matter likely.
**Cases - Illinois**

- On September 26, 2012, the Illinois Supreme Court agreed to hear the appeal in *Metropolitan Life*, which held that a taxpayer was not subject to a double interest amnesty penalty for additional Illinois income tax resulting from an IRS audit.

- Less than six months after the *Metropolitan Life* decision, the same appellate court found in *Marriott International* that the double interest amnesty penalty applied in a similar fact scenario following an IRS audit.
Cases – Michigan


- A Revenue Administrative Bulletin required taxpayers to employ the same tax calculation method on their short period initial MBT returns as they used for their short period final SBT returns.

- However, the Michigan Appellate Court found that the Bulletin was not controlling because it contradicted the plain language of Michigan law, which provides taxpayers the option of using either the "annual" or the "actual" calculation method.

- Accordingly, taxpayers may elect to use either the annual or the actual calculation method when filing their short period initial MBT return.
Cases – Michigan


• Individual taxpayers could combine the profits and losses from unitary flow-through businesses and apportion such income on the basis of the businesses’ combined apportionment factors for purposes of the Michigan Individual Income Tax.

• Such apportionment could properly be applied to a foreign entity if the foreign entity and the individual taxpayer’s in-state business were unitary.
**Cases – New York**

*James Square Associates LP et al. v Commissioner, New York State Department of Economic Development*, N.Y. Court of Appeals, Nos. 87 – 91, 6/4/13

- The retroactive application of amendments enacted in 2009 to the Empire Zone Program was a violation of program recipients’ due process.
- Due process was violated because the taxpayers had no forewarning of the amendments, the length of retroactivity was excessive, and the state lacked a valid public purpose for the retroactivity.
**Cases – Oklahoma**

*CDR Systems Corporation v. Oklahoma Tax Commission*, Okla. Ct. of App., Case No. 109,886, 1/17/13

- In an unpublished opinion, the Oklahoma Court of Appeals held that the Oklahoma capital gains deduction is facially discriminatory and unconstitutional in violation of the Commerce Clause of the US Constitution.

- The capital gains deduction is generally available when certain property is held for at least three years by an Oklahoma company or held for at least five years by a non-Oklahoma company.

- The court did not provide a remedy to cure the constitutional defect
Amnesty Programs

Arkansas

- Amnesty program for revoked entities runs from September 1, 2013 to December 31, 2013.

Connecticut

- Amnesty program runs from September 16, 2013 to November 15, 2013.

Louisiana

- Amnesty program runs from September 23, 2013 to November 22, 2013.
Ohio - HB 601 proposes municipal tax reform

- Ohio House Bill 601, introduced on October 30, would bring definitional uniformity to Ohio’s municipal tax structure, improve Ohio’s tax climate for both individual and businesses, and remove Ohio as an outlier for municipal tax collection across the country.

San Francisco - new gross receipts tax passes

- Local Measure E passed with 71% voting in favor of phasing out the current payroll tax on businesses and phase in a new gross receipts tax.
Thank You!

This document is for general information purposes only, and should not be used as a substitute for consultation with professional advisors.

This document was not intended or written to be used, and it cannot be used, for the purpose of avoiding U.S. federal, state or local tax penalties.

This document has been prepared pursuant to an engagement between PricewaterhouseCoopers LLP and its Client and is intended solely for the use and benefit of that Client and not for reliance by any other person.

© 2013PwC. All rights reserved. In this document, “PwC” refers to PricewaterhouseCoopers LLP, a Delaware limited liability partnership, which is a member firm of PricewaterhouseCoopers International Limited, each member firm of which is a separate legal entity.