NATIONAL SURVEY OF THE SALT LANDSCAPE

FICPA's MEGA Conference
Disney's Contemporary Resort

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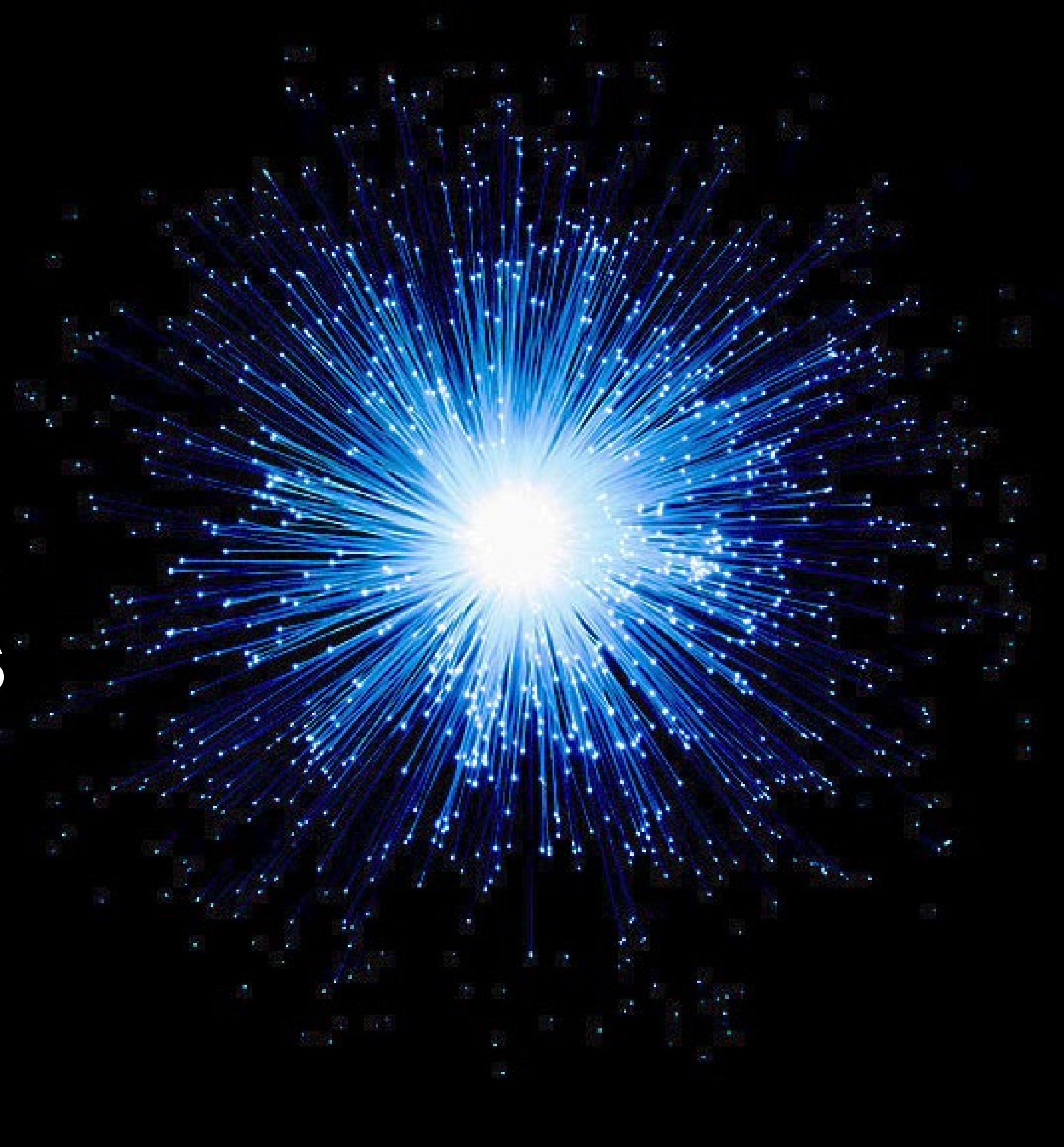
Agenda

- Multistate Tax Commission and P.L. 86-272
- Nexus
- Tax Base Issues
- Apportionment Issues
- The SALT Effect of Pass Through Entity Taxes
- Miscellaneous State Tax Issues

Multistate Tax Commission’ s Uniformity Committee’s Actions P. L. 86-272



Multistate Tax Commission Statements

- Statement of Information Concerning Practices of Multistate Tax Commission and Signatory States under Public Law 86-272
  - Originally adopted in 1986
  - Subsequently revised in 1993, 1994, and 2001
  - Provides a list of “unprotected activities,” including:
    - Making repairs or providing maintenance
    - Collecting on delinquent accounts
    - Investigating credit worthiness
    - Installation
    - Training for non-sales personnel
    - Providing technical assistances
    - Investigating complaints
    - Approving or accepting orders
    - Repossessing property
    - The list goes on…

Multistate Tax Commission’s Uniformity Committee

- The MTC Uniformity Committee undertook an initiative to update its Statement of Information Concerning Practices of Multistate Tax Commission and Signatory States Under Public Law 86-272 as it applied to modern business activities. The focus was the interaction of the concept of solicitation and the internet.
  - The Working Group of the Committee applied a two-part analysis to determine if the statute provided immunity:
    - Did the business activities conducted by the business constitute the solicitation of orders of tangible personal property?
    - If the business’s activities extend beyond solicitation, do they take place within the taxiing state?
- The Wayfair language was utilized as support for the concepts set forth in the revised statement:
  - Between targeted advertising and instant access to most consumers via any internet-enabled device, “a business may be present in a State in a meaningful way without” that presence “being physical in the traditional sense of the term.” . . ..
- The proposed revisions to the statement were approved on August 4, 2021
- California Franchise Tax Board on February 14, 2022, issued Technical Advice Memorandum 2022-01 adopting the provisions to the statement

MTC Uniformity Committee

- The revised statement added eleven factual scenarios to illustrate whether business activities involving Internet sellers were protected.
- Examples of unprotected activities are:
  - A business has an employee that telecommutes on a regular basis unless the activities are limited to the solicitation of orders for tangible personal property.
  - The company provides post-sale assistance to customers via either electronic chat or email that is accessed through a link on the company’s website.
  - The company solicits and receives on-line applications for its branded credit cards via the company’s website.
  - The company contracts with a marketplace facilitator, whose marketplace offers for sale the company’s products via a website. The marketplace maintains inventory, including the company’s products, at fulfillment centers around the country.
  - The company (a) inserts Internet “cookies” into the computers or other electronic devices of customers who access the company’s website and (b) uses customer search information gathered by its cookies to adjust production schedules and inventory amounts, develop new products, or identify new items to offer for sale.
  - The company remotely fixes products via the Internet and WIFI.

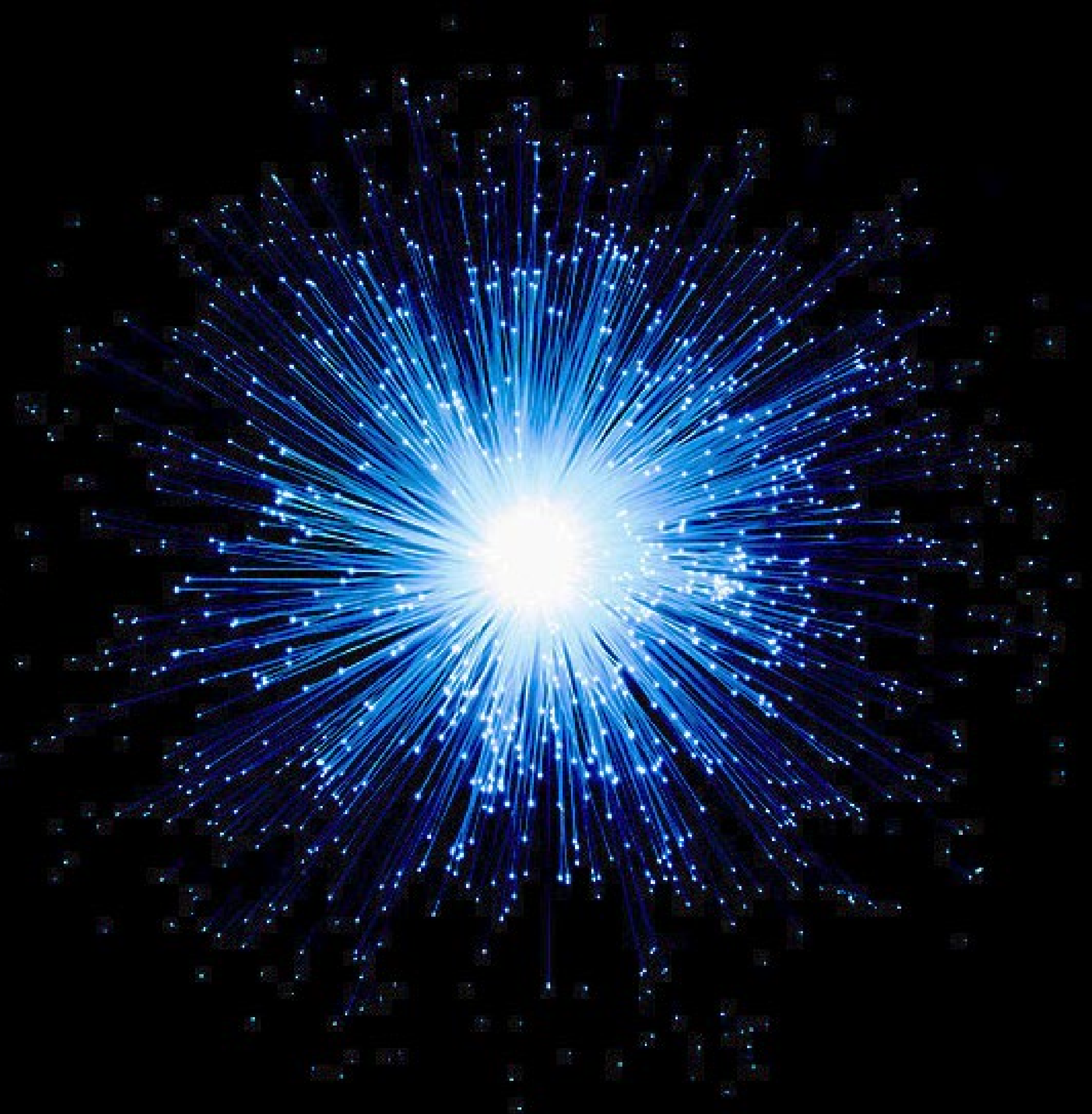
Multistate Tax Commission Uniformity Committee

- Examples of unprotected activities cont.:
  - The business sells extended warranty plans via a website to customers who purchase the company's products.
  - The company streams videos and music to electronic devices for a charge.
- Examples of protected activities:
  - The company provides post –sale assistance by posting a list of FAQ with answers on its website.
  - The business places Internet "cookies" on to customer's computers for the purpose of gathering information that is entirely ancillary to the solicitation of orders for tangible personal property, ex. store personal information of the customer, remind the customer of what is in their shopping cart.
  - The company website only offers for sale items of tangible personal property and does no engage in any in-state business activities.

Open Questions Resulting from the Adoption of the Statement

- Considerations following the adoption of the Statement:
  - Will there be more litigation?
    - How will taxpayers test the Statement?
  - What is the impact on apportionment?
    - Throwback?
    - Throwout?
  - What about combined reporting states?
    - New Jersey TB-100 (Jan. 25, 2021)
      - Addresses the applicability of P.L. 86-272 to combined groups and clarifies that "if one member of the combined group exceeds the protections of P.L. 86-272, the entire combined group exceeds P.L. 86-272."
  - Impact on foreign business operations

Nexus Issues



Nexus – P.L. 86-272

Santa Fe Natural Tobacco Co. v. Dep't, No. TC-MD 170251G (OR Tax Court Magistrate Div. February. 26, 2019) Pending Tax Court

- Taxpayer made sales primarily to in-state wholesalers. The wholesalers accepted returns from retailers pursuant to a "distributor incentive program" where taxpayer made cash payments/credits to wholesalers accepting returns. Wholesalers, in some instances, accepted and processed orders pursuant to the distributor incentive program.
  - The wholesaler's acceptance of returns caused the taxpayer to lose its P.L.86-272 immunity.

Stanislaus Food Products Co. v. Div. of Tax'n, Dkt. No. 011050-2017 (N.J. Tax Court June 28, 2019), Motion for Reconsideration denied April 22, 2021

- State alternative minimum assessment applied only to P.L. 86-272 protected entities.
- Tax was not measured by "net income."
- "The Legislature cannot create a special tax, whether it be a gross receipts, gross profits or some other tax, that only applies to entities protected by P.L. 86-272 in a transparent attempt to garner lost net income tax."

Nexus – P.L. 86-272

Procacci Brothers Sales Corp. v. Division of Taxation, Dkt. No. 015626-2014 (N.J. Tax Ct. May 25, 2021)

- The New Jersey Tax Court ruled that the in-state activities of an out-of-state wholesale produce distributor were protected from the corporation business tax under P.L. 86-272.
- The taxpayer had no offices, property, or employees in New Jersey and delivered produce to in-state customers primarily using third-party trucks.
- The court found that the produce deliveries and returns before produce acceptance were "ancillary to solicitation of sales" and protected under P.L. 86-272.
- However, the taxpayer's practice of sending its own trucks into the state to pick up returned produce after delivery and the customer's acceptance was not protected unless de minimus

Nexus - Addback Statutes

Reynolds Brands Inc., Lorillard Licensing Co., LLC and R.J. Reynolds Tobacco Co. v. Alabama Department of Revenue, Ala. Tax Trib., Docket Nos. BIT. 19-1160-JP, BIT. 19-1161-JP, BIT. 20-419-JP, October 22, 2021

- The Alabama Tax Tribunal concluded it had jurisdiction over the constitutional challenges to corporate income tax assessments.
- Reynolds Brands, R.J. Reynolds and Lorillard, all licensed intellectual property to, and collected royalties from their licensees. The licensees filed state tax returns, adding back the royalties paid. The Department of Revenue audited the licensees, found the intellectual property companies had nexus based on the factor-presence nexus standard, and issued assessments. The intellectual property companies protested, arguing the factor-presence nexus standard was unconstitutional when applied to them.
- The Department asserted that the Tribunal did not have jurisdiction because companies challenged the constitutionality of the standard on its face. The Tribunal rejected the Department’s challenge.
- The Tribunal found: 1) The constitutional challenges concerned the standard when applied to the respective companies under particular facts; 2) The ruling sought would leave Alabama’s factor-presence nexus statute intact and to be applied to others; and 3) The challenges were as-applied.

Nexus - Physical Presence v. Economic Nexus

Citibank South Dakota v. Washington, Wash. Super. Ct., No. 21-2-02141-34, (petition for review filed December 27, 2021)

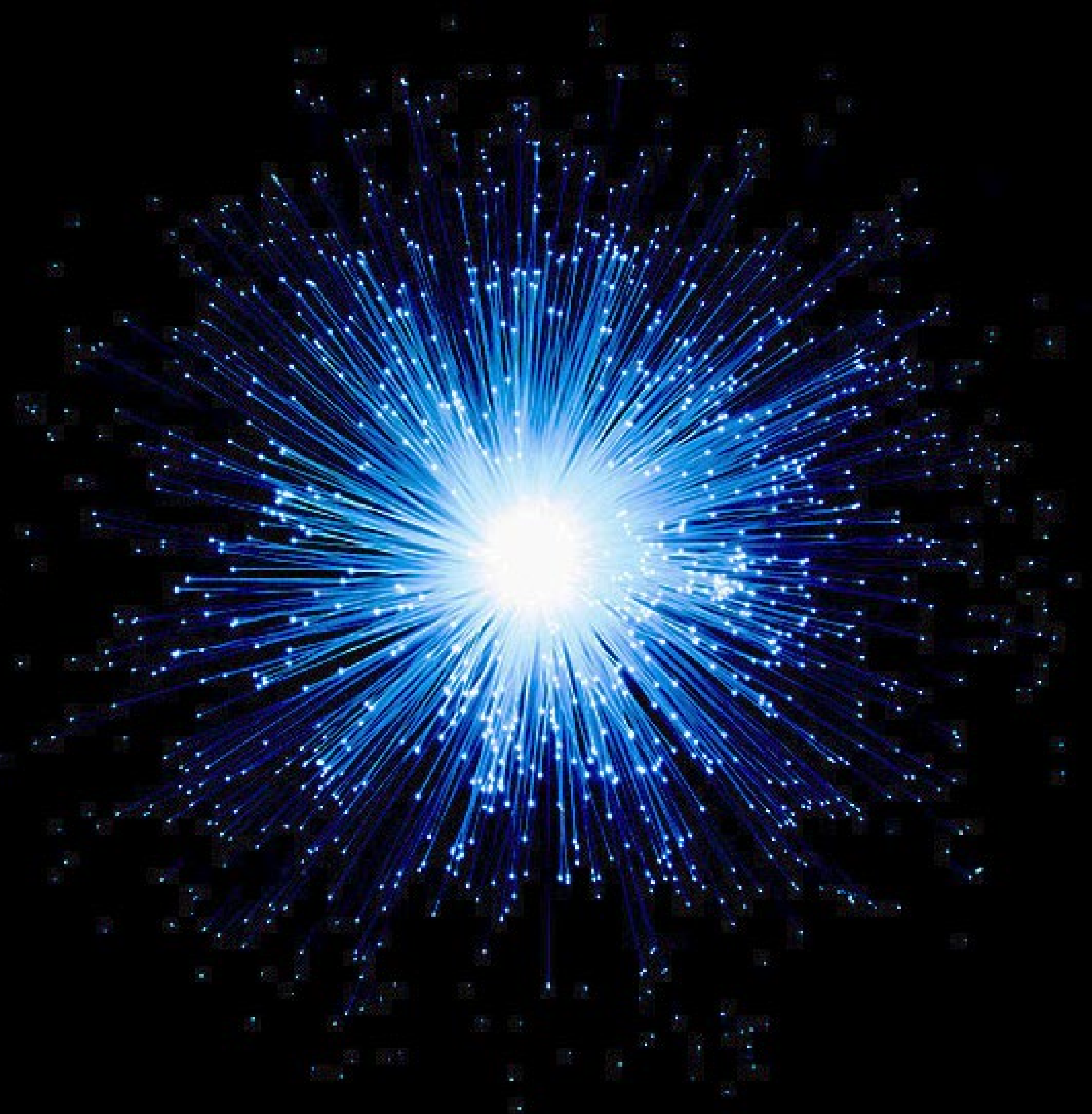
- The Washington Board of Tax Appeals upheld the state's assessment of business and occupation tax for the tax periods January 2007 through May 2010.
- The Board concluded Citibank had a physical presence through its contracts with companies located in the state used to promote their credit cards and accept payments using those cards at Washington stores. In addition, the bank employed Washington attorneys to file more than 3,000 lawsuits in state courts to recover past due debts from 2007 to 2010.
- Citibank is taking the position its income isn't taxable in Washington for the years at issue because it lacked a physical presence in the state.
    - It should be noted that Washington in 2010 amended its statute to adopt economic nexus.

Nexus- Post WAYFAIR Local Tax Issues

Halstead Bead Inc. v. Richard (Civil Action No. 2:21-cv-02106) (Pending litigation)

- Days after voters rejected a constitutional change that would have centralized tax collection, an out-of-state business has sued Louisiana and several parishes to challenge the state's patchwork approach to collecting taxes
- Halstead Bead, an Arizona-based business that sells jewelry-making supplies online, says that Louisiana's parish-by-parish registration and reporting system violates the federal due process and commerce clauses

Tax Base Issues



Tax Base Issues - Characterization Of Income

VAS Holdings & Investment LLC v. Commissioner of Revenue, MA Appellate Tax Board, Dkt. Nos. C332269 & C332270 (October 23, 2020) (Appeal pending)

- The Massachusetts Appellate Tax Board ruled that capital gain recognized on a Florida S corporation's sale of its subsidiary a Massachusetts LLC was subject to corporate excise tax and nonresident composite tax.
- The S corporation did not have any activities in Massachusetts, and none of its shareholders were Massachusetts residents. The taxpayer contended that the Due Process and Commerce Clauses prohibited Massachusetts from taxing the income because the LLC's sale did not involve a minimum connection to Massachusetts or the availment of the protections and benefits of Massachusetts law.
- The Board concluded that the increase in value of the subsidiary was "inextricably connected to and in large measure derived from property and business activities in Massachusetts," which included improved management and staffing of a call center business.
- The Board ruled that these business activities "necessarily involved availment of the protection, opportunities and benefits given by Massachusetts" and these facets "supplied the requisite connection between Massachusetts and business activities that resulted in the" capital gain.

Tax Base Issues - Net Operating Losses

General Motors Corp. v. Commonwealth, PA S.Ct. No. 12 MAP 2020, 12/22/21]

- The Pennsylvania Supreme Court affirmed the Commonwealth Court's decision regarding recalculation of General Motors Corporation's corporate income tax without capping the net loss carryover deduction and awarded a refund.
- General Motors deducted net losses only up to a $2 million cap and claimed a refund, asserting that the cap on the NOL carry over violated the state constitution's uniformity clause.
  - The Board of Finance and Revenue denied the claim.
  - General Motors filed a review petition before the commonwealth court, which reversed the BF&R's order, instructing the board to recalculate the tax and issue the refund.
  - The Department appealed.
- The supreme court held:
  - The statute capping the NOL carry over violated General Motor's rights under the state constitution's uniformity clause;
  - The supreme court's earlier decision striking down that statute applied retroactively; and
  - The entire deduction, disallowing any net loss carryover was struck down. However, to remedy the impact on General Motors, the supreme court affirmed the commonwealth court's order to recalculate Taxpayer's taxes without capping the net operating loss deduction and issue a refund.

Tax Base Issues - Net Operating Losses

Alcatel-Lucent USA Inc. v. Commonwealth, Pa. Commonwealth. Ct., (Dkt. No. 803 F.R. 2017, September 13, 2021)

- The Pennsylvania Commonwealth Court affirmed in the Department of Revenue's decision denying the taxpayer's request for a refund of corporate net income tax.
- The taxpayer calculated its tax liability using a 2014 net loss carryover (NLC) deduction provision, which was the greater of 25% of income apportioned to Pennsylvania or $4 million. The commonwealth held that the DOR's decision to prospectively apply a 2017 state supreme court decision striking the flat-dollar cap while preserving the percentage cap from the net operating loss provision rather than recalculating the tax liability of small corporations that used the dollar cap did not violate the state constitution's uniformity clause.
- The court determined that retroactively assessing thousands of taxpayers that justifiably relied upon the legality of the flat-dollar deduction prior to the state supreme court decision would produce a substantially inequitable result; and noted that this is sufficient justification for applying the state supreme court decision prospectively in order to avoid injustice or hardship.

Tax Base Issues - Net Operating Losses

Somerset Tel. Co. v. St. Tax Assessor, Me., No. BCD-20-59, June 10, 2021

- The Maine Supreme Judicial Court revised a decision affirming the trial court's judgment denying Somerset's request for a corporate income tax refund.
- The company is a Maine telecommunications company and a subset of a unitary group, that earned income inside and outside of Maine. Somerset filed a return that carried over the unitary group's 2012 net loss deduction and sought a refund. The State Tax Assessor denied it. Somerset appealed and the trial court ruled against Somerset.
- Somerset appealed, arguing that the denial of a loss carryover violated the U.S. Constitution by imposing an indirect tax on nonunitary income. In its initial ruling the Supreme Court found: 1) Somerset attempted to create a hypothetical scenario in which the group didn't have nonunitary income in 2012, so as to render the amount of 2013 federal taxable income different; 2) this scenario didn't comport with the state's statutory scheme; 3) Maine didn't tax 2012 nonunitary income in 2013 but merely denied a deduction in 2013 because the state's statutes didn't provide one; and 4) the carryover sought wasn't constitutionally required.
- The supreme court affirmed the original judgment and revised it, finding: 1) Maine's taxation scheme didn't violate the dormant Commerce Clause; and 2) applying the internal consistency test concluded no state authorizes a carryover of a net operating loss that could have been realized at the federal level if the group had received no nonunitary income in another year. Therefore, there was no discrimination against interstate commerce because every state would be imposing the tax based on the current year's federal taxable income.

Tax Base Issues - Net Operating Losses

R.O.P. Aviation Inc. v. Division of Taxation, Dkt. No. 001323-2018 (N.J. Tax Ct. May 27, 2021)

- The New Jersey Tax Court held that the Division of Taxation could not eliminate a taxpayer's NOLs generated during years beyond the statute of limitations.
- The Division's proposed reduction in the taxpayer's NOL carryforward was based on a transfer pricing adjustment between related entities for years never audited by the Division and otherwise closed under the applicable statute of limitations.
- The Tax Court held that although the division had broad authority to determine the proper tax amount due from available information, this mandate did not permit the division to audit closed years to reduce an NOL carryforward. The Tax Court also held that permitting the division to audit and adjust the taxpayer's NOL carryforward from these closed years would be tantamount to an adjustment of the income reported in those years and thus constitute an impermissible audit of closed years.

Tax Base Issues - Addback Statutes

Lorillard Tobacco Company v. Director, Division of Taxation, Superior Court of New Jersey, Appellate Division Docket No A-3444-18 &A0002-19 (September 21, 2021)

- Lorillard claimed an unreasonable exception for purposes of adding back royalty expenses. At issue is the Division's policy, to narrowly construe the exception based on the regulation providing that the exception applies only to "the extent that the payee pays tax to New Jersey on the income stream."
- Lorillard, argued that it would be unreasonable to add back the related-party royalty expense because the affiliate paid New Jersey tax on the royalty stream. The Tax Court agreed.
- The, Appellate Division reversed the Tax Court's finding that the Division's regulation was consistent with the legislative intent to prevent income shifting.
- The Appellate Division ruled that the taxpayer was only entitled to an exception to addback for the amount of tax that the taxpayer's subsidiary paid to New Jersey on the royalty income stream.
- The Appellate Division remanded the case to the Tax Court for consideration of constitutional issues that the taxpayer presented.

Tax Base - Deductions for Foreign Source Income

Oracle Corp. & Subsidiaries v. Dep't of Revenue, Or. T.C., No. TC 5340, October 6, 2021

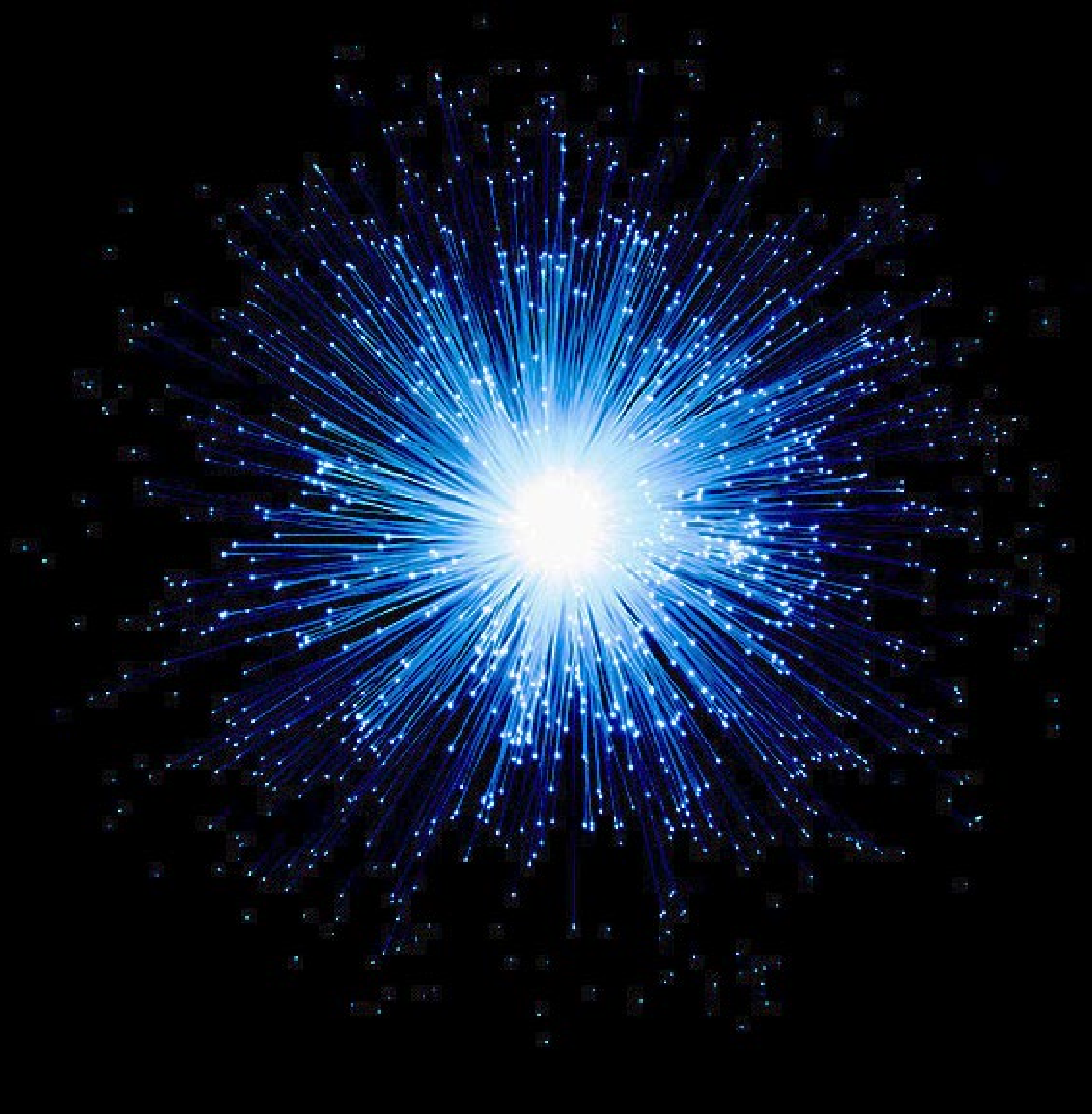
- The Oregon Tax Court held on reconsideration that its previous ruling in Oracle Corporation's corporation excise tax appeal was incorrect. The Tax Court denied the parties' partial summary judgment motions and ordered the text of its prior order replaced
- Oracle conducted its software business through controlled foreign corporations ("CFCs") that paid it dividends. Oracle partially subtracted dividends and Subpart F income in computing state taxable income for corporate income tax purposes. In the original decision the Tax Court found:
  - These items were additional income, not gross receipts, and they didn't match any item of actual gross receipts accounted for in the apportionment factor.
  - It also found a genuine issue of material fact as to whether the dividends arose from Taxpayer's "holding" of the CFC stock, and whether they were derived from Taxpayer's primary business activity if that was the case.
- Both parties sought reconsideration. The Tax Court on reconsideration held
  - The Subpart F income constituted gross receipts for apportionment purposes and should be treated in the same manor as the dividends; and
  - The dividends and unsubtracted amounts were excluded from "sales" arising from the holding of the CFC stock. However, these amounts could be included in "sales" if derived from an activity constituting the principal business activity of the CFCs and Taxpayer.

Tax Base - 80/20 Companies

PepsiCo Inc. & Affiliates v. Ill. Dep’t of Rev., No. 16 TT 82 & 17 TT 16 (IL Tax Tribunal May 4, 2021)

- The Tax Tribunal held that PepsiCo must include Frito-Lay North America Inc. in its combined group because Frito-Lay did not qualify for the exclusion, *e.g.* 80/20 company exclusion, granted to companies that conduct most of their business internationally.
- The Tribunal rejected PepsiCo’s position that Frito-Lay’s payroll factor should include payroll costs reported by PepsiCo Global Mobility, LLC (“PGM”), a single-member LLC owned by Frito-Lay.
- The Tribunal found that, under the substance over form doctrine, PGM was “simply a shell corporation” and although PGM was formed to employ expatriates and administer the expatriate program previously administered by PepsiCo, the “negligible change” implemented was illusory in nature.

Apportionment Issues



Apportionment - What Is A Gross Receipt?

Chevron USA v. Department of Revenue, Oregon Tax Court Magistrate Division, TC-MD-190031N (April 2021)

- The Tax Court held that commodities hedging receipts could not be included in the denominator of the sales factor.
  - The parties agreed the receipts constituted gross receipts as the term was defined.
  - The hedging transactions do not result in the physical delivery of the commodity and therefore are not tangible personal property under the statute and should not be treated as such for purposes of the apportionment factor.

CITGO Petroleum Corp. v. Hegar; TX App. Ct. No. 03-21-00011-CV; No. D-1-GN-18-002457 (October 4, 2021) (Appeal pending)

- The Appellate Court held that CITGO was not entitled to a franchise tax refund.
- The Appellate Court determined the company's net proceeds, not the gross proceeds, from sales of commodity futures contracts and options on commodity contracts are included in the denominator of the apportionment factor.

Apportionment - Market Based Sourcing v. Cost of Performance

Synthes USA HQ Inc. v. Commonwealth of Pennsylvania, No. 108 F.R. 2016 (July 24, 2020) (Appeal pending)

- The Pennsylvania Commonwealth Court overturned a Board of Finance and Revenue decision denying Synthes a $2.1 million refund, holding that State law permitted the company to apportion its receipts to where its customers received the benefits.
- The court rejected arguments from the Attorney General's Office, which broke ranks with the Department of Revenue and contended that while the refund should be denied, the tax agency's interpretation of the sourcing statute, under which Synthes sought the refund, was incorrect.
- Synthes originally filed its taxes using the cost-of-performance method but later petitioned the department for a refund under the benefits-received method.
- Synthes, argued it was entitled to the refund because the department had consistently interpreted the state law to source services to where customers were located. The department, however, denied the refund, saying the company failed to establish where the sales occurred. The Board affirmed that decision.

Apportionment - What is a Direct Cost of Performance?

Vesta Corporation v. Department of Revenue, OR Tax Court Magistrate Division Dkt. TC-MD 200019G (March 28, 2022)

- Vesta processes payments for prepaid wireless services for telecommunications companies including AT&T Mobility LLC, Sprint, and T-Mobile. Vesta submits card transactions to First National Bank of Omaha and JP Morgan Chase Bank NA payment acquirers.
- On its 2010 and 2011 tax returns, Vesta took the position that its fees were primarily earned for work performed outside of Oregon because the fees paid to payment acquirers were direct costs of performance. The Department found the fees weren't direct costs of performance.
- The Magistrate granted partial summary judgment to the Department finding that the payment acquirers didn't act on behalf of Vesta but provided it a service when the banks processed payments for Vesta's customers. Therefore, Vesta incurred those costs in Oregon and can't reduce its taxable income by excluding the receipts from the numerator of the sales factor in the apportionment equation.

Apportionment - Sourcing of Services – What Is The Service?

Sirius XM Radio, Inc v. Hegar, TX S. Ct. No. 20-0462 (March 25, 2022)

- The Texas Supreme Court held Sirius XM's receipts from Texas subscribers are apportioned to the state based on where the company's personnel or equipment performing the service is physically located, not where the satellite-enabled radio is located.
- In so doing, the court reversed the Appellate Court. The Appellate Court held the company's service receipts should be sourced where the "receipt-producing end-product act" of decrypting the radio signal occurred. The supreme court rejected that argument and concluded that a service is performed in Texas "if the labor for the benefit of another is done in Texas."
- The court recognized the disagreement was "largely one of statutory interpretation," and found there was no reason to depart from the straightforward understanding of the words used in the statute.
  - The statutory language supports locating the performance of the service at the place where the taxpayer's personnel or equipment is physically doing useful work for the customer.
  - The receipt-producing end-product act test, as originally used in an administrative hearing decision, "aimed to tell the Comptroller *what* qualifies as the 'service performed". The court found that the test was used in this case to determine the location of the service, which is not consistent with the statute.
  - The court concluded that the focus should be on the words in the statute themselves.

Apportionment - Sourcing of Services – What Is The Service?

Sirius XM Radio, Inc. v. Hegar, con't.

- The court also rejected the argument that decryption of the radio signal was for Sirius XM's benefit, finding that encryption was a barrier to access imposed by the company to extract subscription payments. The decryption was not performed in Texas. The court concluded that the decryption was performed at the point of transmission and not at the chipsets located in the customer's radio.
- The court remanded the case to the appellate court, noting that the comptroller had also argued that Sirius XM had not provided sufficient evidence to establish the fair value of the services it performed in Texas. The court said that the comptroller may raise the issue before the appellate court.

Apportioning Services

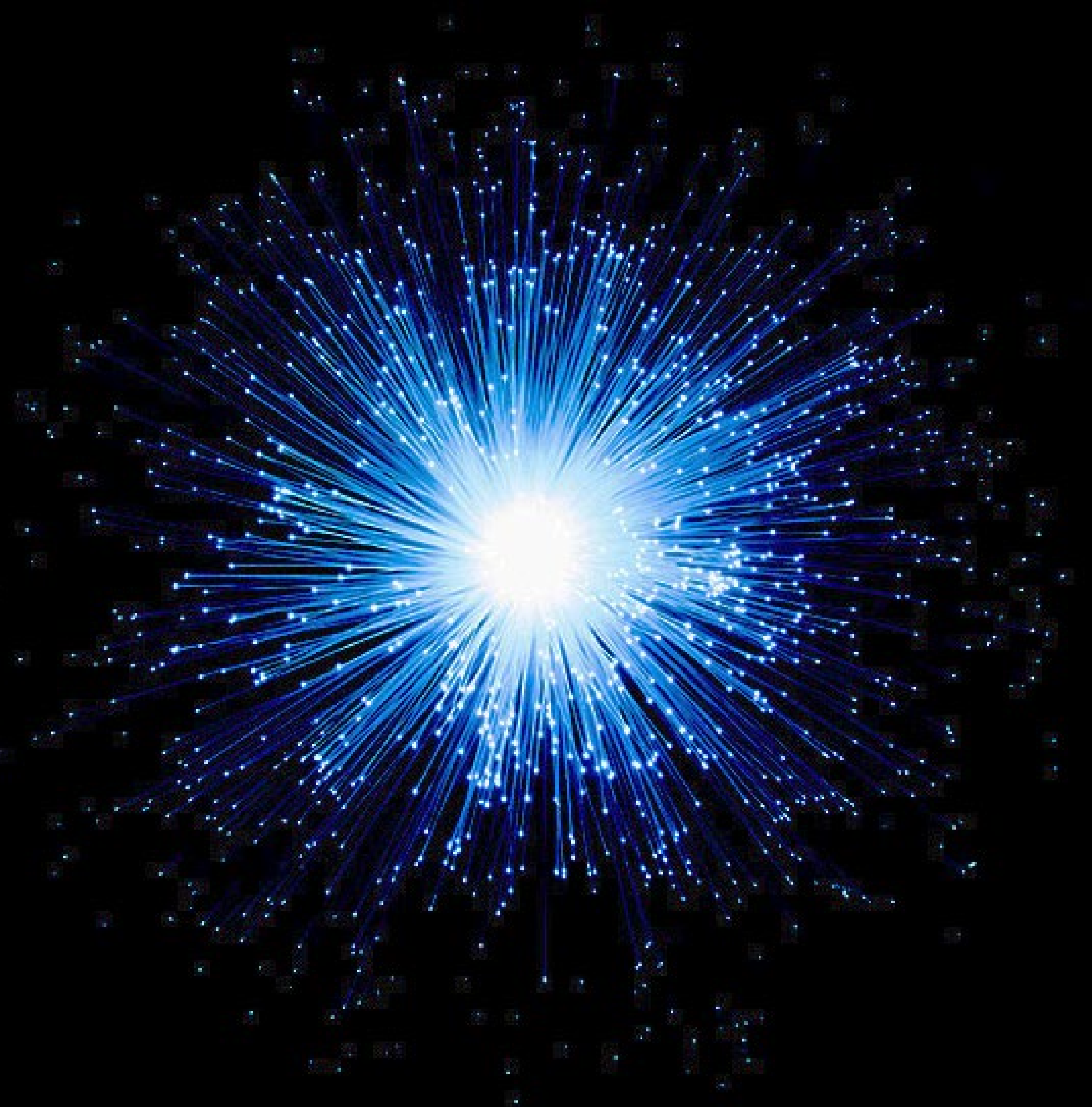
NASCAR Holdings, Inc. v. McClain, 2012 WL 1406067 (Ohio Bd. Tax. App. 4/15/2021) (Pending Ohio Supreme Court)

- For Ohio Commercial Activity Tax purposes (CAT), broadcast and media revenue should be sourced to the where the purchaser has the right to use the property (population and Nielsen ratings)

Express Scripts v. Indiana Department of Revenue, 2021 WL 1940858 (Ind. Tax. Ct. 5/14/2021)

- Holding that a pharmacy benefit management company was a service provider, not a seller of prescription drugs, the court applied the costs of performance sourcing rules

The SALT Effects of Pass-Through Entity Tax Elections



Introduction

- The pass-through entity (PTE) tax regimes developed by states in response to the $10,000 annual state and local tax (SALT) deduction limitation in the Tax Cuts and Jobs Act (TCJA) – commonly referenced as the SALT cap -- have dramatically proliferated in 2021
- While states have been responsible for creating these PTE tax regimes, the tax benefit accorded to the owners of the PTE is federal in nature
- Therefore, understanding the operation of these novel regimes requires knowledge of both federal and state income tax principles
- With numerous distinctions between how the states are approaching this issue, and many technical points to consider, care must be taken prior to moving forward with PTE tax elections
- It is important to understand that fundamentally the decision to seek PTE regime benefits is not solely an entity level one but rather a decision that must acknowledge and consider the various and often conflicting interests of individual entity owners

PTE Tax Regimes – Tidal Wave

Background

- TCJA imposes a limit on the amount of SALT that individuals may deduct for federal income tax purposes until 2025 (then reverts back to 2017 law for individuals)
  - Beginning with the 2018 tax year, most individuals and married couples filing a joint return are now limited to a $10,000 annual SALT deduction
  - In response to the SALT cap, many states have created an election to impose an entity-level tax on PTEs. Such state regimes did not necessarily consider the overall complexity and risk typically associated with PTEs and their owners with significant multistate presence.
  - The tax provides the PTE's owners either a corresponding individual tax credit or an exemption from tax for the individual's pass-through income
  - Notice 2020-75, issued by the IRS on Nov. 9, 2020, confirmed that PTEs can claim an entity-level deduction for state tax paid under state laws that shift the tax burden from individual owners to the business entity
  - Cap upheld in *New York v. Yellen*, US No. 21-966

Mechanics of the Election

- Most states that have an income tax regime do not subject PTEs to income tax – the income earned by PTEs ultimately flow through to the PTE's owners, which pay income tax on such amounts
- Under a PTE elective tax regime, the flow-through nature of the PTE is turned off once an election is made
- PTEs that make elections will be required to pay income tax to states at designated tax rates (often, but not always, correlating with individual income tax rates imposed on individuals in those states)
    - Whether a partnership can even make an election will be dependent upon the terms of the partnership agreement and/or state requirements
        - Tax matters partner vs. majority vote

Mechanics of the Election

- The income tax payments made by the PTE (rather than the owners under the default flow-through concept) serve to benefit the owners
- Why? Because the PTE's payment of taxes are intended to be deductible for federal income tax purposes, which lowers the amount of federal taxable income reported by the PTE to the owners
- At the state income tax level, individual owners of electing PTEs either receive a corresponding tax credit or exemption from tax for the individual's income from the PTE, and the SALT cap workaround is complete

Mechanics of the Election

- A very basic, bare bones example shows how this works:
  - Partnership is owned 50-50 by two individual partners
  - The partnership and the partners are all doing business and located in one state which imposes a 10% individual income tax, and allows partnerships to elect to pay a 10% PTE tax, with full credit to owners
  - The partnership generates $1 million of taxable income in 2021, and accordingly, each partner receives a $500,000 distributive share
  - Assume each partner has no other income or deductions, but elects to itemize for federal income tax purposes and is subject to a 30% tax rate

Mechanics of the Election

- **If the PTE tax election is not made:**
  - State income tax – each partner would pay $50,000 [$500,000 * 10%]
  - Federal income tax – each partner would pay $147,000 [($500,000 - $10,000 capped SALT deduction) * 30%]
- **If the PTE tax election is made:**
  - State income tax -- the partnership would pay $100,000 in PTE tax, and each partner would pay $0 (full credit given for the PTE tax paid)
  - Federal income tax – each partner would pay $135,000 [($500,000 -$50,000 uncapped deduction representing share of PTE tax paid) * 30%]
- **In this example, each partner saves $12,000 in federal income tax**

Mechanics of the Election Uncertainty

- Determining whether to make an election is a complicated and uncertain matter, in part because the PTE is making a decision that will impact the tax liability of its owners
- In many instances the PTE will not possess all of the information necessary for the entity or any owner to make an informed decision
    - Various unknowns – e.g. owner-level attributes, tax basis, etc.
- Owners that benefit from the election vs. those disadvantaged by the election
    - Possible conflicts between entity and owners or between owners
    - Possible inability to satisfy owners disadvantaged by the election
- Change in law
    - Election is generally irrevocable for year in which election is made

Distinctions Between the Elections

- Of course, the prior example is deceptively simple, because PTEs and their owners often have multistate reach, and every state is quirky – for example:
  - Timing of election – some states allow PTEs to make the election on an extended tax return, while others require earlier election
  - Eligibility – federally classified partnerships and S corps are eligible, but lower-tier PTEs owned by other PTEs may not be
  - Substantial differences in mechanics – different tax rates, estimated payments, election procedures, and first year in which election is made
  - Nonresident owner filing obligations may still exist
  - Type of benefit – does PTE owner get credit, or exclusion from income?

Distinctions Between the Elections

State	First Applicable Tax Year	Election	Election Due Date (Calendar Year)	Nonresident Owner Filing Requirements	PTE Credit Tax Rate(s)
Alabama	2021	Until Revoked	March 15 following end of year	To be determined	5%
Arizona	2022	Annual	Extended due date of PTE tax return	To be determined	4.5%
Arkansas	2022	Annual	April 15 following end of year	None	5.9% and 2.95% (cap gains)
California	2021	Annual	March 15 following end of year	Yes	9.30%
Colorado	2022	Annual	Date PTE tax return is filed	None	4.55%
Connecticut	2018	N/A (mandatory)	N/A (mandatory)	None	6.99% of tax base
Georgia	2022	Annual	Extended due date of PTE tax return	To be determined	5.75%
Idaho	2021	Annual	April 15 following end of year	None	6.925%
Illinois	2021	Annual	To be determined	None	4.95%
Louisiana	2019	Until Revoked	April 15 following end of year	Yes	2% - 6% (highest rate on amounts over $100K)
Maryland	2020	Annual	Extended due date of PTE tax return	Yes, unless PTE files composite	5.75% plus 2.25% NR tax; 8.25% for NR entities
Minnesota	2021	Annual	Extended due date of PTE tax return	None	9.85%
New Jersey	2020	Annual	March 15 following end of year	Yes	5.675% - 10.9% (highest rate on amounts over $5M)
New York	2021	Annual	October 15 (2021), March 15 during current year (2022 and beyond)	Yes	6.85% - 10.9% (highest rate on amounts over $25M)
Oklahoma	2019	Until Revoked	March 15 during current year	None	5% (individual owners) or 6% (entity owners)
Oregon	2022	Annual	Extended due date of PTE tax return	To be determined	9%-9.9% (highest rate on amounts over $250K)
Rhode Island	2019	Annual	March 15 following end of year	Yes	5.99%
South Carolina	2021	Annual	Extended due date of PTE tax return	To be determined	3.00%
Wisconsin	2018 (S Corps); 2019 (all PTEs)	Annual	Extended due date of PTE tax return	Yes	7.90%

As of 9/10/2021

Distinctions Between the Elections

California

- The California PTE tax regime introduces the concepts of qualifying PTEs that can elect to pay the tax, and qualifying taxpayers (i.e. owners of the qualifying PTE) that can take the PTE tax credit
- Beginning in 2022, the PTE must make an initial payment of the elective tax (greater of $1,000 or 50% of the elective tax paid in the prior taxable year) to California by June 15 during the tax year in which an election is intended, in order to be able to make the PTE tax election on its originally filed return
- The Franchise Tax Board has developed a webpage, with additional information to come, including forms for payment vouchers, a PTE elective tax calculation and tax credit: https://www.ftb.ca.gov/file/business/credits/pass-through-entity-elective-tax/index.html

Distinctions Between the Elections

New York

- The New York PTE tax regime is imposed at progressive tax rates that range from 6.85%-10.9% of PTE taxable income
- For 2021, PTEs may elect to pay PTE tax estimates; owners subject to NY personal income tax must make estimates as if they were not entitled to the PTE tax credit. For 2022 and beyond, PTEs that elect must pay estimates
- For 2021, the due date to make the election is October 15, 2021. For 2022 and beyond, the due date to make the election is March 15 of the calendar year for which the election is being made
- Additional guidance has been released addressing the PTE taxable income calculation: TSB-M-21(1)C, (1)I:(8/25):Pass-Through Entity Tax (ny.gov)

Technical Considerations

- Given how new these regimes are, there are many technical points to consider that generally fall into three categories:
  - Dealing with Federal income tax uncertainty
  - Dealing with state income tax uncertainty
  - Additional logistical hurdles

Technical Considerations

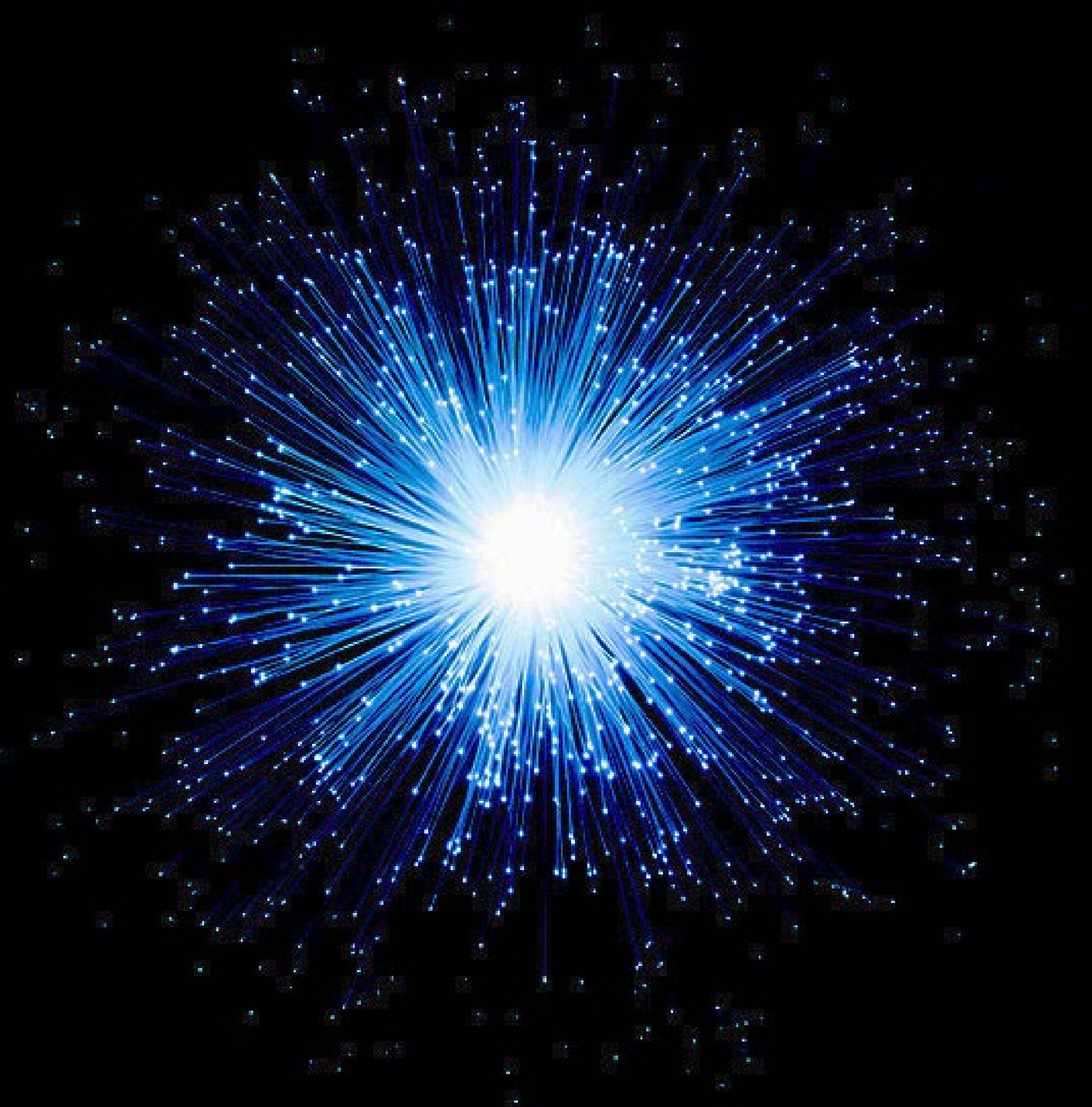
What to think about

- Thorough holistic analysis is necessary to determine whether, and to what extent PTE elections should be made
- Research and data gathering are important steps to take
- Potential outcomes should be modeled annually, with consideration to how the election can impact owners
- PTEs should openly communicate with their owners on PTE elections, including addressing disparities between how owners may be impacted
- Monitoring and maintenance activities also a must
- Tracking legislation and possible administrative guidance for each state

Caution – Rocky Road Ahead

- The only certainty is uncertainty
- Sufficient information to make an informed decision will not likely be available
    - Underlying owner tax attributes
    - Very little state and federal authority on the topic
- Inherent conflicts
    - Ownership winners and ownership losers
- Likely inability to make losers whole

Miscellaneous State Tax Issues



Information Services, Data Processing Services Or Something Else?

- New York – increased audit activity but taxpayer-friendly decisions
  - *In the Matter of Lending Tree, New York* – ALJ held that Lending Tree's services to lenders through its online loan marketplace are not taxable information services because primary function is to ensure that loans between lenders and borrowers are eventually closed
- Texas – difficult state because SaaS and most services are taxable
  - *Apple Inc. v. Hegar*; D-1-GN-20-004108 (Pending) – Apple filed a refund claim arguing that its iCloud Storage and iTunes Match services are not "computerized data and information storage" or "data processing" services

Nontaxable Service Or Taxable Lease?

Gott v. Director of Revenue, 2020 WL 7260879 (MO. 2020)

- What is the true object of transaction a rental of tangible personal property or a nontaxable service?
- Under an agreement, Gott charged a fixed price for portable toilets based on the number of portables as well as charges for delivery, rental, labor, and supplies. He did not collect sales tax because the “true object” of the transaction was a nontaxable waste removal service
- The Missouri Supreme Court held he was providing a taxable rental because he charged a single fixed price for rentals and failed to properly separate the charges

Chicago Local Taxes

Amusement Tax

- In 2015, Chicago broke new ground by targeting streaming services for the Amusement Tax
- *Apple* itself is now challenging this tax in Illinois Circuit Court with slightly different and more refined arguments

Personal Property Lease Transaction Tax

- Applies to leases of equipment and licenses of SaaS with users in Chicago
- Because the incidence of the tax is on the lessee, the City is auditing both the licensor and licensee of SaaS

First Amendment Challenges

Clear Channel Outdoor Inc. v. Baltimore, Case No. 24-C-18-001778 (MD 2020)

- The Baltimore billboard tax does not violate the First Amendment

Lamar Advantage Gp Company, L.L.C., D.B.A. Lamar Advertising of Cincinnati, Oh, et all. v. The City Of Cincinnati et al., Ohio S. Ct. Opinion No. 2021-Ohio-3155, September 16, 2021.

- The Cincinnati billboard excise tax violates the First Amendment

Statute of Limitation Issues

Bed Bath & Beyond Inc. v. Dep't of Revenue, Or. T.C., TC-MD 200272G, May 24, 2021

- The Oregon Tax Court affirmed the Department of Revenue's decision, denying Bed Bath and Beyond's request for a refund on an amended tax return for corporate income tax purposes.
- Bed Bath & Beyond Inc. and its subsidiaries filed an amended federal return, and the Internal Revenue Service granted a refund. Bed Bath & Beyond filed an amended Oregon corporation excise tax return to reflect the changes reported on the federal return and requested a refund. The Department denied the requested refund.
- Upon review, the Tax Court found:
  - Bed Bath and Beyond filed amended returns in 5 other states seeking a refund. The company argued that those amended returns were the equivalent of another state's audit adjustments. However, the company didn't provide a statute or precedent under which an exception would apply to taxpayers whose taxable income has changed due to their out-of-state filings, rather than an out-of-state audit; and
  - Oregon law bars the Department from issuing the refund because the claim was filed more than three years after its original return and wasn't based on adjustments made by another taxing authority.

Statute of Limitations Issues

Chapman Enterprises, Inc., v. McClain, Tax Commr., OH S.Ct. Dkt.2021-OHIO-2386 (July 15, 2021)

- At issue was whether the Comr. taxpayer timely filed its appeal with the Board of Tax Appeals. March 27, 2020 the Ohio General Assembly tolled the statute of limitations for any administrative proceedings due to COVID.
- Chapman had been served with final assessment on May 4,2020 and had 60 days to appeal to the BTA. The BTA appeal was filed on July 27, 2020. The Tax Commission filed Motions t Dismiss due to untimely filing arguing the tolling statute did not apply to BTA matter.
- The court found the BTA erred in dismissing the case as the Notices of final assessments were filed within the tolling period and that the appeal to the BTA was timely filed.

Sales Tax Nexus

Quad Graphics Inc. v. North Carolina Department of Revenue, Dkt. No. 20-CVS-7449 (June 23, 2021)

- The North Carolina Superior Court held that Quad Graphics does not have the required nexus to impose sales and use tax on its book and catalog sales to North Carolina customers because title to the items transferred outside the state

- Under the contracts between Quad Graphics and its customers, title and possession to the sold products transferred outside North Carolina, according to the court. This meant that under the U.S. Supreme Court's 1944 holding in *McLeod v. J.E. Dilworth Co.*, North Carolina did not have sufficient transactional nexus — the nexus between a state and the activity being taxed — to the disputed sales under the U.S. Constitution's commerce clause, the court said. *Dilworth* precluded sales tax liability in cases where out-of-state goods were delivered by a common carrier into a state and title and possession to the goods transferred to the purchasers outside the taxing state.

- The court agreed with Quad Graphics that the holdings in *Dilworth* remain good law, saying that the Supreme Court's 2018 decision in *South Dakota v. Wayfair Inc*. did not overrule Dilworth formalism.

QUESTIONS?

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