Solutions to the unforeseen

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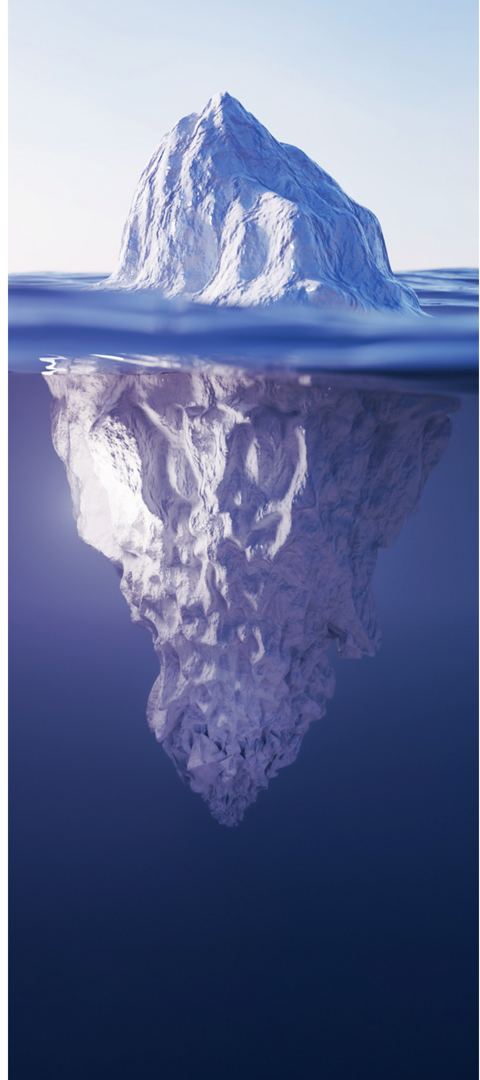
Current Developments in State Income Taxation: Individual and Business

Jamie Yesnowitz
Grant Thornton LLP

Learning Objectives

- Analyze major state income tax developments affecting individuals and businesses that have occurred in 2023.
- Examine how these developments may affect individual and business taxpayers.
- Provide initial guidance on how these developments might influence what may happen from a SALT income tax perspective in the coming year.



Significant 2023
State Income Tax
Developments

The State Income Tax Headlines for 2023

- State PTE tax regimes continued to reign in popularity
- States continued to wrestle with IRC conformity issues
- New York developed significant corporate tax regulations
- New Jersey adopted significant corporate tax legislation
- The cost-of-performance / market-based sourcing provisions continued to stoke national controversies
- Washington confirmed the constitutionality of the state’s capital gains tax

Income Tax Conformity to Federal Provisions

- Threshold question – how does a state conform to the IRC?
- To the extent the IRC changes as a result of federal tax reform, state conformity to those changes will vary from state to state based on the way each state's laws interact with the IRC:
  - Rolling conformity – automatically adopt the IRC currently in place.
  - Static conformity – adopt the IRC as of a certain date.
  - Selective conformity / distinctive approaches – adopt only selective portions of the IRC with state tax code conforming to, or decoupling from, IRC provisions.

Income Tax Conformity to Federal Provisions

- IRC Section 174 provides for preferential treatment of research and experimentation (“R&E”) expenditures.
- Prior to TCJA, taxpayers could deduct Sec. 174 expenses in year paid or incurred; capitalize and amortize them for a period not less than 60 months; or capitalize and amortize them over 10 years
- TCJA resulted in significant changes to the treatment of Sec. 174 R&E expenditures
  - For tax years beginning after December 31, 2021, taxpayers are required to capitalize and amortize all R&E expenditures regardless of how they were treated previously -- over 5 years for R&E performed in the US, and over 15 years for R&E performed outside the US

Income Tax Conformity to Federal Provisions

- What have states been doing on IRC Sec. 174 conformity?
  - Rolling conformity / static states with an IRC conformity date after 12/31/2021 – generally conform to the new federal rules of capitalizing/amortizing R&E expenditures
  - Static states with conformity dates preceding 1/1/2022 but conforming to new Sec. 174 – provisions use language requiring IRC provisions to be enacted / existing, or reach to IRC provisions with prospective effect
  - Static states with IRC conformity dates preceding 1/1/2022 and decoupling from new Sec. 174 – unlikely to conform until conformity dates are advanced past 1/1/2022
  - Outlier states: specifically decouple from the TCJA provision that enacted Sec. 174, or because they have not adopted the TCJA at all
- Other challenging conformity issues:
  - Interest expense deduction limitation under IRC Sec. 163(j) – decouple from changes in the interest limitation calculation, or completely decouple from the limit.
  - Bonus depreciation under IRC Sec. 168 – decouple by making it permanent 100% bonus depreciation, reduce the benefit as per federal, or remain decoupled by not allowing any bonus depreciation.

The Long-Awaited New York Regulatory Provisions

- New York corporate tax reform enacted in 2014, with applicability for the 2015 tax year and thereafter.
- Ongoing regulatory project interpreting the tax reform, with rules that are very likely to become final in the coming months
  - Economic nexus and P.L. 86-272 provisions
  - Changes to tax base computations and NOL regime
  - Inclusion of financial institutions in Art. 9-A tax
  - Apportionment provisions – market-based sourcing
  - Mandatory unitary combined reporting
- Will these rules be prospective only or have retroactive effect?

New Jersey Tax Reform Changes

- On July 3, 2023, NJ enacted major tax legislation which makes significant changes to the Corporation Business Tax (CBT) regime.
- For privilege periods ending on and after July 31, 2022:
  - Changes to net deferred tax liability deduction for combined groups
  - Worldwide combined group must include all members of the combined group, wherever located or formed
  - Interest deduction limitation under IRC Sec. 163(j) is applied to a combined group as though the combined group filed a federal consolidated return
- For taxable years beginning in 2023 and after, a gross income taxpayer engaging in a multistate trade or business, or is an owner of a multistate pass-through uses CBT sourcing provisions if income from NJ sources cannot be readily / accurately ascertained.

New Jersey Tax Reform Changes

- For privilege periods ending on and after July 31, 2023:
  - Bright-line economic nexus standard for CBT purposes adopted
  - Treatment of GILTI and FDII changed – GILTI is treated in the same manner as other dividend income; 100% of FDII is subject to CBT
  - Apportionment factor for unitary combined groups adopts *Finnigan* method
  - Changes to NOLs and prior NOL conversion carryovers
  - Certain captive REITs, RICs, and investment companies are included in combined groups and taxed in same manner as C corporations
  - Related-party addback repealed

PA Cost of Performance / Market-Based Sourcing Case

- *Synthes USA HQ, Inc. v. Commonwealth*
  - PA Supreme Court upheld a Pennsylvania Department of Revenue policy sourcing sales of services to the location where the benefit is received under pre-2014 rules
  - Pennsylvania-based corporation sourced sales to Pennsylvania using a traditional cost-of-performance rules
  - Taxpayer sought a refund by recalculating its sales using benefits-received rules, based on the PA Department of Revenue's interpretation of the sourcing statute, but lost at administrative level
  - At Commonwealth Court, Department took the position that sales are sourced using benefits-received rules
  - PA Attorney General's office took a contrary position that sales are sourced using traditional cost-of-performance rules
  - PA Supreme Court sided with the taxpayer / the Department reasoning the pre-2014 statute was ambiguous and the Department's policy interpretation controlled
  - Court ordered that the taxpayer receive a refund

FL Cost of Performance / Market-Based Sourcing Cases

- ***Target Enterprise v. Fla. Department of Revenue***
  - Florida circuit court ruled that a taxpayer's use of the cost-of-performance (COP) method to source service revenue for FL corporation income tax purposes was **correct.**
  - Taxpayer earned revenue from a retail operating services agreement with its corporate parent – sourced service revenue outside FL based on vast majority of payroll costs being incurred outside the state.
  - Circuit court sided with taxpayer on the COP method used, rejecting DOR's alternative apportionment method, which relied on the corporate parent's business activity.
- ***Billmatrix Corp. v. Fla. Department of Revenue***
  - Florida circuit court held that FL law required the use of the COP method to source taxpayers' service revenues for FL sales factor purposes.
  - Taxpayers provided financial technology services from locations outside FL and incurred majority of costs to perform services outside the state.
  - Court rejected FL DOR's application of market-based sourcing to taxpayer businesses based on the plain language of the FL apportionment regulation providing for use of COP sourcing.

The Washington (State) Capital Gains Tax

- Washington cannot impose a direct income tax on individuals.
- However, in *Quinn v. Washington*, the Washington Supreme Court upheld the constitutionality of Washington's long-term capital gains (LTCG) tax on individuals that became effective in 2022.
  - WA imposes a 7% tax on WA-allocated LTCG of individuals exceeding $250,000 resulting from the sale of certain capital assets.
  - Court held that LTCG constitutes a valid excise tax levied on the sale or exchange of capital assets that does not violate the WA Constitution or Commerce Clause of U.S. Constitution.
  - LTCG tax "falls on the excise tax side of the line because it taxes transactions involving capital assets – not the assets themselves or the income they generate."

Looking to 2024

Early Thoughts on What Might Happen in 2024

- A U.S. Supreme Court decision in *Moore v. U.S.* with far-reaching effect beyond federal tax?
- Controversies on residency issues, based on pandemic-related fact patterns?
- Further state income tax rate reductions?
- More states adopting P.L. 86-272 guidance?
- Controversies on the ability to utilize alternative apportionment?

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