

State of the States

2023 UNC Tax Summit

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This is Me.



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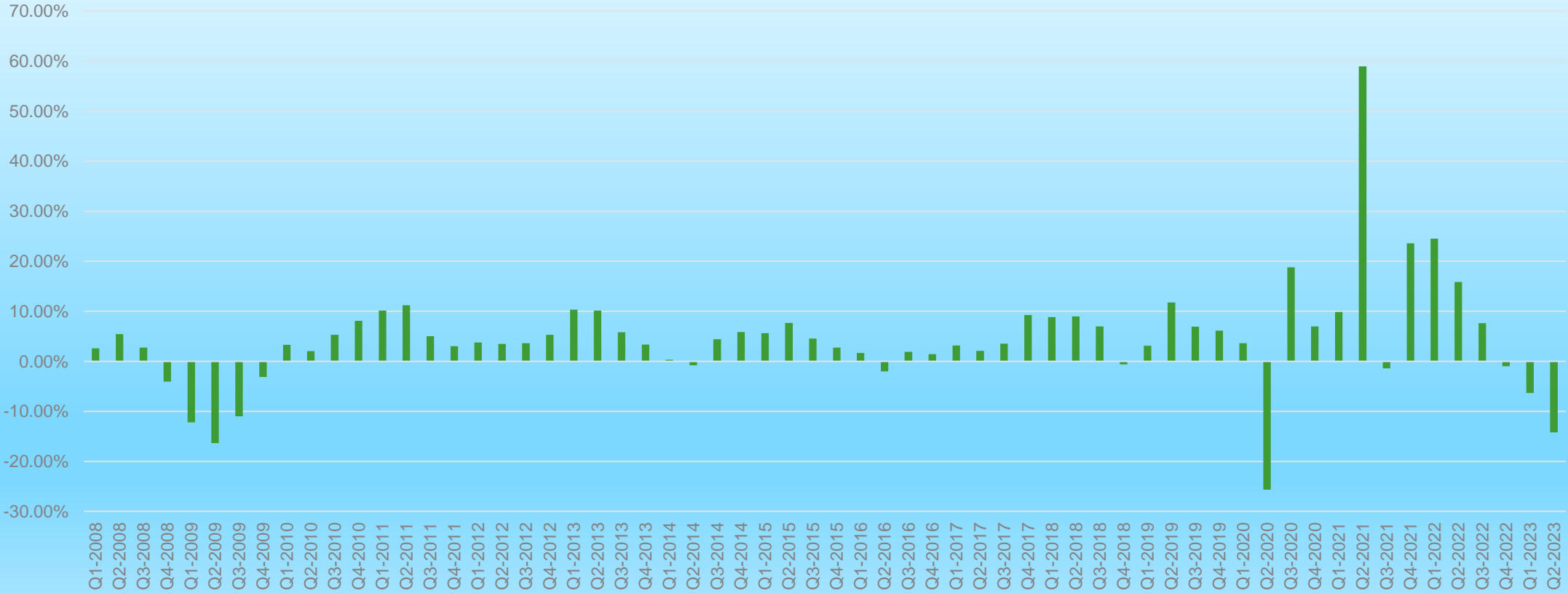
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State of the States

Fiscal Conditions

Overall state tax collections

Year-over-year quarterly percentage change in total state tax collections – Q1 2008 through Q2 2023

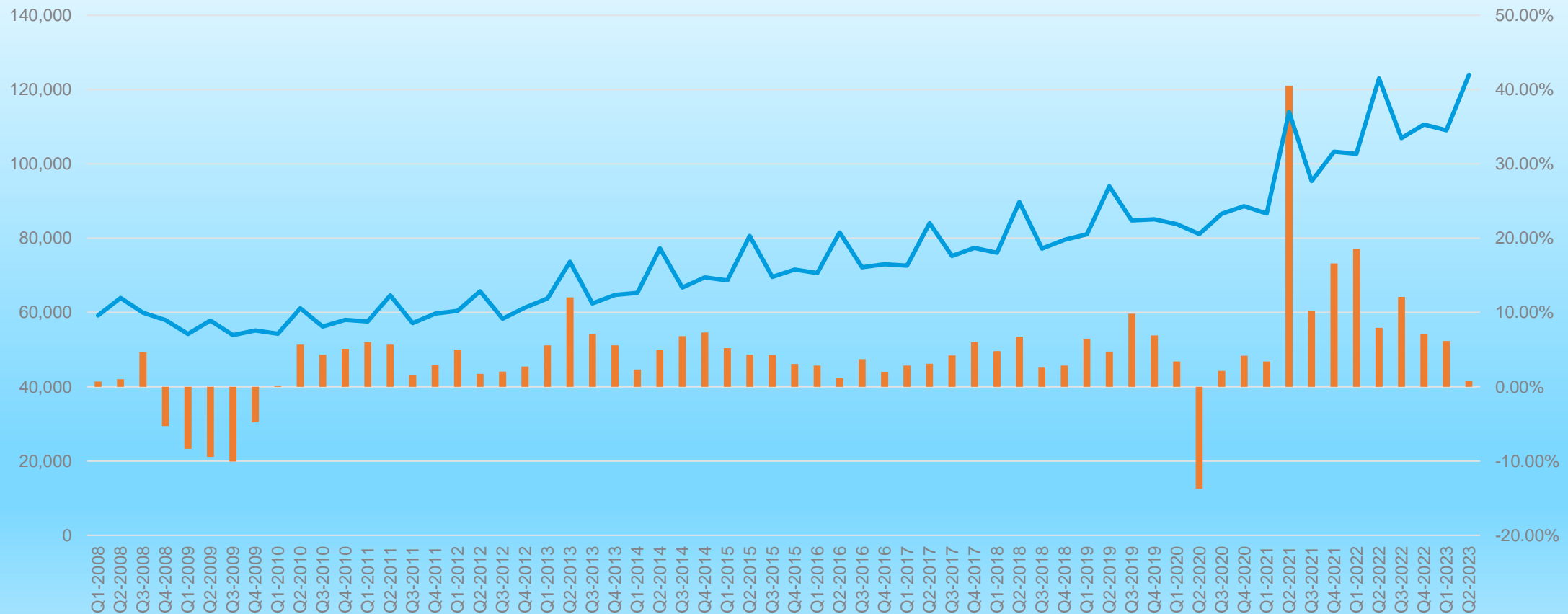


Causes and headwinds: Individual income taxes

- Individual income tax collections have seen negative growth four consecutive quarters through Q2 2023
 - Three years of state individual income tax cuts
 - Refunds and rebates
 - Poor market performance in 2022 and pending average performance in 2023
 - 12 months of declining wage growth
 - PTE election income re-classification to non-individual income taxes

State sales tax collections

Year-over-year quarterly percentage change in total state sales tax collections – Q1 2008 through Q2 2023



Causes and headwinds: Sales and use taxes

- Post-pandemic jump in revenues
 - Post-pandemic spending
 - Full implementation of Wayfair in 2023
 - Higher-earners insulated from inflation driving spending
 - Inflation initially assisting sales tax revenues
- Three quarters of sales tax growth declines with almost zero change in Q2 2023
 - Post-pandemic spending returning to trend
 - Inflation impact more widespread two years in
 - Macro-economic factors like housing costs and gas prices generally trending up since 12/22
 - Individual savings rates drop from double digits 24 months ago to low single digits
 - Recession and general anxiety

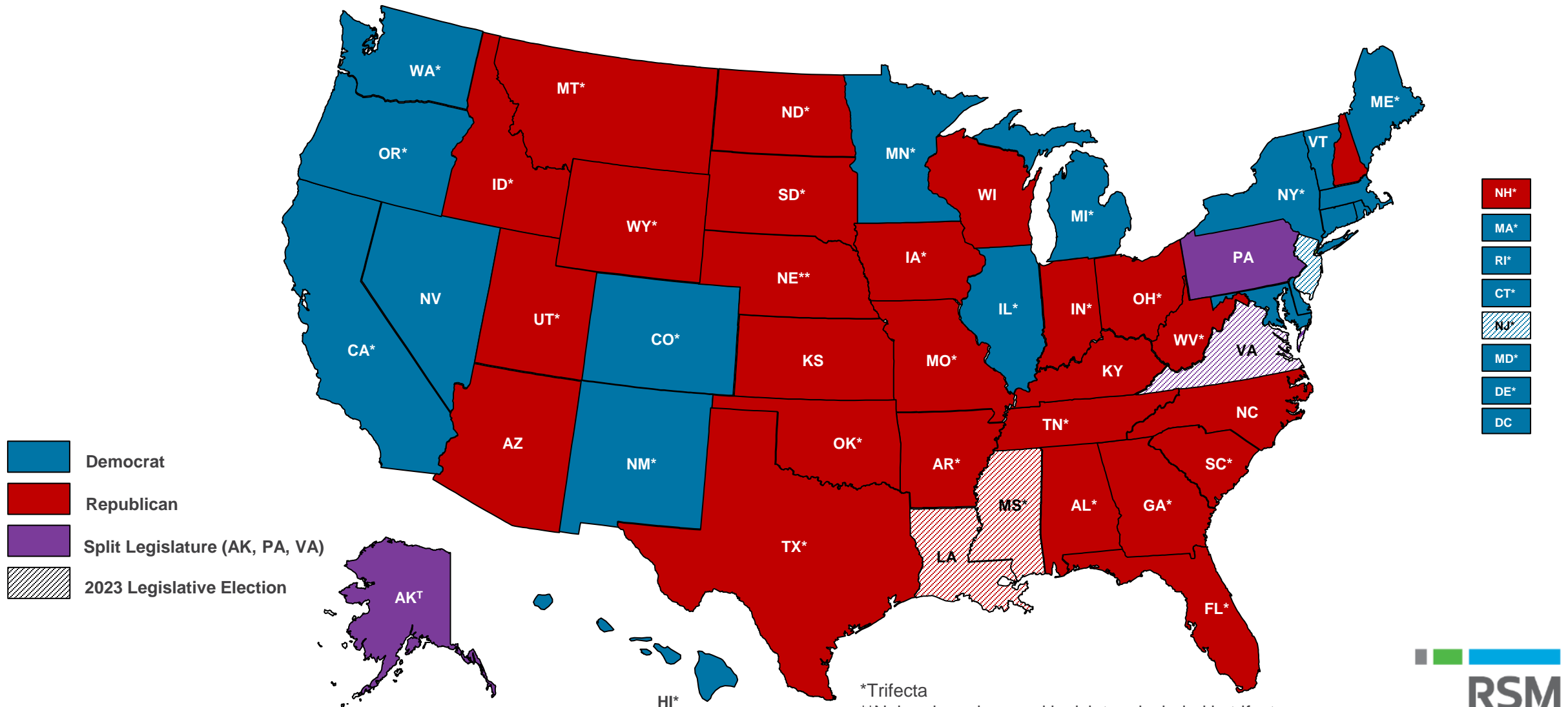
Where are we now?

- After two-three strong years of state tax collection growth cracks are forming, but caution treating the nation as one economy
- The current state fiscal environment is much different than five years ago and indicates a better chance to weather a short downturn
 - Full implementation of *Wayfair* (6/2018) and other economic nexus
 - Marijuana revenues through sales taxes and excise taxes in two dozen states
 - Gambling revenues, some as high as 50% (*Murphy* 5/18)
 - Expanded taxes to vaping
 - NASBO: Rainy day balances at \$155B in FY23 compared to \$68B in FY17

2023 SALT elections and all-to-early 2024 preview

Elections matter, sort of

State legislative status and 2023 elections

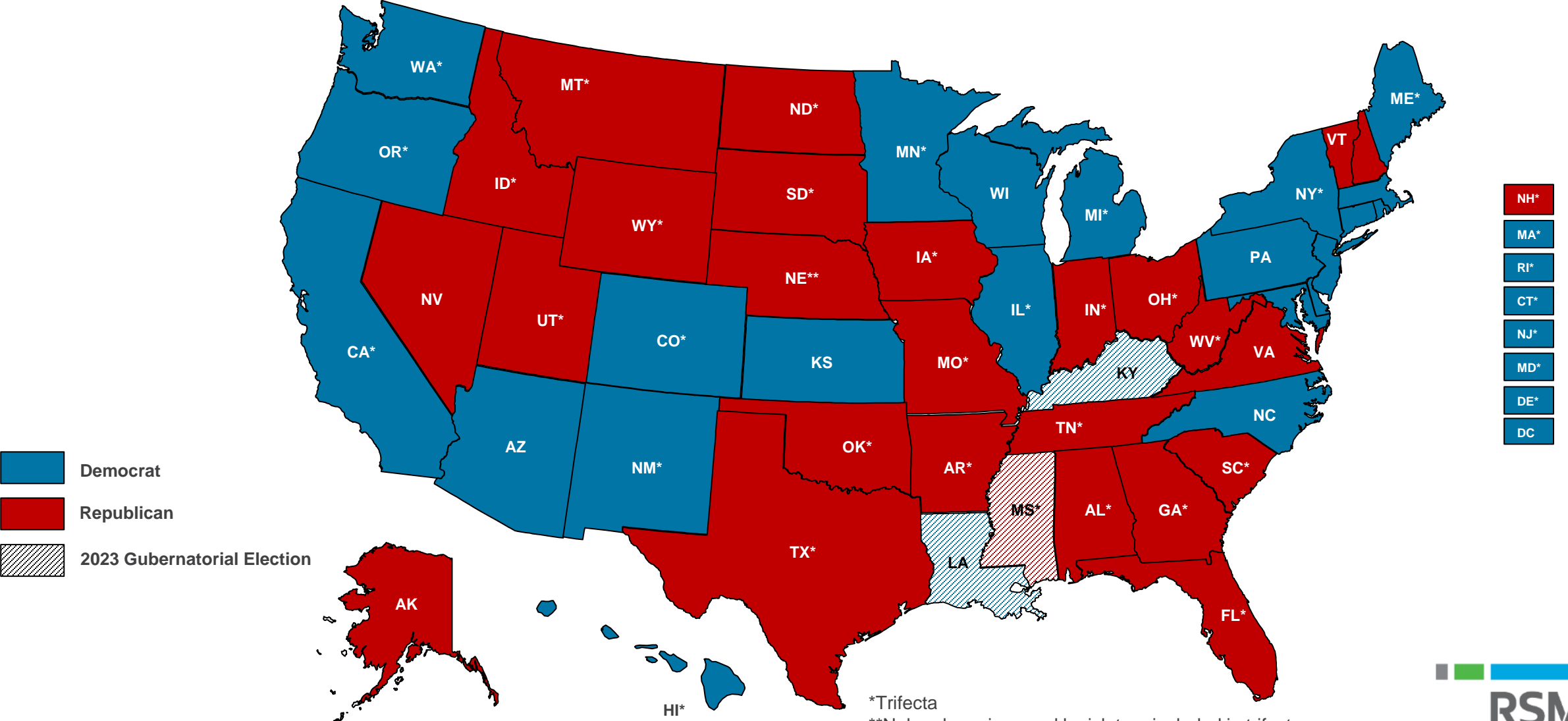


*Trifecta

**Nebraska unicameral legislature included in trifectas

[†]Alaska legislature has more R members but each chamber is coalition controlled

State gubernatorial status and 2023 elections



*Trifecta
 **Nebraska unicameral legislature included in trifectas

Pending ballot measures

- 2023 General Election
 - Colorado Proposition HH would reduce property tax rates
 - Ohio Issue 2 would legalize marijuana and impose a 10% sales tax on marijuana sales
 - Texas Proposition 3 would prohibit a tax based on wealth or net wealth
- 2024 California General Election (tentative)
 - ACA 1 – 55% majority to pass certain local taxes and GO bonds
 - ACA 13 – Constitutional initiatives would require same threshold to pass as the threshold proposed in the initiative
 - I. 21-0042 – Voter approval for state tax increases and 2/3 for special taxes

Broad-stroke policy trends

Very broad

Policy trends to watch

- Individual and corporate rate cuts to continue, but narrower with revenue triggers
- Digital goods, products and services tax expansion
 - Digital assets, e.g., NFTs and cryptocurrency enforcement
 - Digital goods and services and digital advertising
- Income tax nexus expansion
- Audit activity
 - Sales tax
 - Digital goods
 - Transfer pricing

Legislative updates

Quick hits from an active 2023 state legislative season



Quick hits: Rates and franchise tax changes

- Corporate Rate developments
 - Arkansas highest corporate tax rate bracket to fall to 4.8% from 5.1% effective January 1, 2024
 - Connecticut extends 10% corp income tax surcharge through 2025
 - Iowa confirms highest corporate tax rate to drop to 7.1% from 8.4%
 - Kansas confirms rate reduction to 3.5% from 4% effective January 1, 2024
 - Nebraska reduces corporate rates annually until reaching 3.99% in 2027
 - New York extends 7.25% corp tax rate and 0.1875% capital base tax rate through 2026
 - Philadelphia reduces net income portion of BIRT to 5.81% from 5.99%
 - San Francisco delays GRT increases for 2023/24 to 2025/26
 - Utah HB 54 reduces corporate income tax rates to 4.65% from 4.85%, effective January 1, 2023
- Corporate/franchise taxes
 - Illinois increases franchise tax exemption to \$5,000 in 2024 (from \$1,000)
 - North Carolina provides adjustment to corporate franchise tax to reduce base
 - Ohio CAT exclusion amount increases from \$150,000 to \$3M in 2024 and \$6M in 2025
 - Oklahoma eliminates franchise tax for 2024
 - Texas franchise tax exemption increased to \$2.47. No franchise tax return due when no tax owed

Quick hits: Other developments

- Single-sales factor
 - Arkansas election for railroads to use SSF or three-factor with double-weighted sales
 - Massachusetts adopts single-sales factor beginning Jan. 1, 2025
 - Montana adopts single-sales factor beginning January 1, 2025
 - Virginia adopts single-sales factor for certain retailer groups beginning January 1, 2023
 - Tennessee single-sales factor phase-in beginning January 1, 2024 for excise/franchise taxes
- Throwback
 - Arkansas scheduled an elimination of throwback by reducing in-state percentages through 2030
 - Louisiana eliminated effective January 1, 2024
- Net operating losses
 - Utah allows carry forward of NOLs from tax years beginning on or after January 1, 2008; capped at 80%
 - New Jersey relaxing of utilization on combined reports and computation of NOL after DRD
- Rolling conformity
 - Virginia adopts rolling conformity beginning January 1, 2023 (previously fixed-date)
- Colorado and Minnesota to give corps another 30 days to file from federal

Quick hits: Other developments

- Section 163(j)
 - New Hampshire decoupled effective tax years beginning Jan. 1, 2024. The law allows a deduction equal to the amount disallowed under section 163(j). An addition is required equal to the amount deducted by reason of a carry forward of disallowed business interest under section 163(j) generated in tax years commencing after Jan. 1, 2024. The amount of the carry forward of disallowed business interest as of the tax year ending before Jan. 1, 2024 shall be allowed as a deduction over three consecutive years, beginning with the first tax year commencing on or after Jan. 1, 2024.
 - Virginia increased interest deduction from 30% to 50% effective Jan. 1, 2024
- International provisions
 - New Jersey GILTI deduction increased to 95%; No FDII deduction
 - Minnesota GILTI conformity and section 250 decoupling; DRD to 50% and NOL cap to 70%

Quick hits: Section 174

- Section 174 – Research and Expenditures R&E
 - Tax years beginning after December 31, 2021
 - Some states decouple (or never conformed to this TCJA change)
 - CA (never conformed), TN (decoupled), TX, WI (decoupled)
- State conformity changes through 2023 sessions
 - Georgia and Indiana decouple for 2022
 - Mississippi election to decouple for 2023
- There are a number of nuanced issues related to section 174 and state conformity

PL 86-272 guidance

Providing post-sales assistance through chat/email/web

Soliciting or receiving online credit card applications

Inviting/ accepting applications for employment

“Cookies” used for market/product research

Code or electronic instructions to fix or upgrade products

Offering or selling extended warranty services online

Contracting with a marketplace facilitator to house products or inventory or to fulfill orders

Contracting with in-state customers to stream videos/music to electronic devices

- Updated MTC guidance in fall 2021
- States respond
 - California TAM 2022-01 and pending litigation
 - New York proposed regulations
 - New Jersey guidance
- Uncertainty for taxpayers
 - Effective dates, retroactive treatment
 - States with verbal guidance only
 - Treatment of throwback sales

Pass-through entity workarounds

- As of today, 36 states/1 city
- 2023 PTE elections enacted and proposed (green=enacted blue=proposed in 2023)→
- Considerations
 - Connecticut will become elective in 2024
 - Connecticut and Massachusetts provide less than full credit

Indiana SB 2,
effective 2022

Iowa HF 352,
effective 2022

Kentucky HB
360, effective
2022

Montana SB
554, effective
2023

Montana SB
554, effective
2023

West Virginia
SB 151,
effective 2022

Hawaii SB
1437, effective
2023

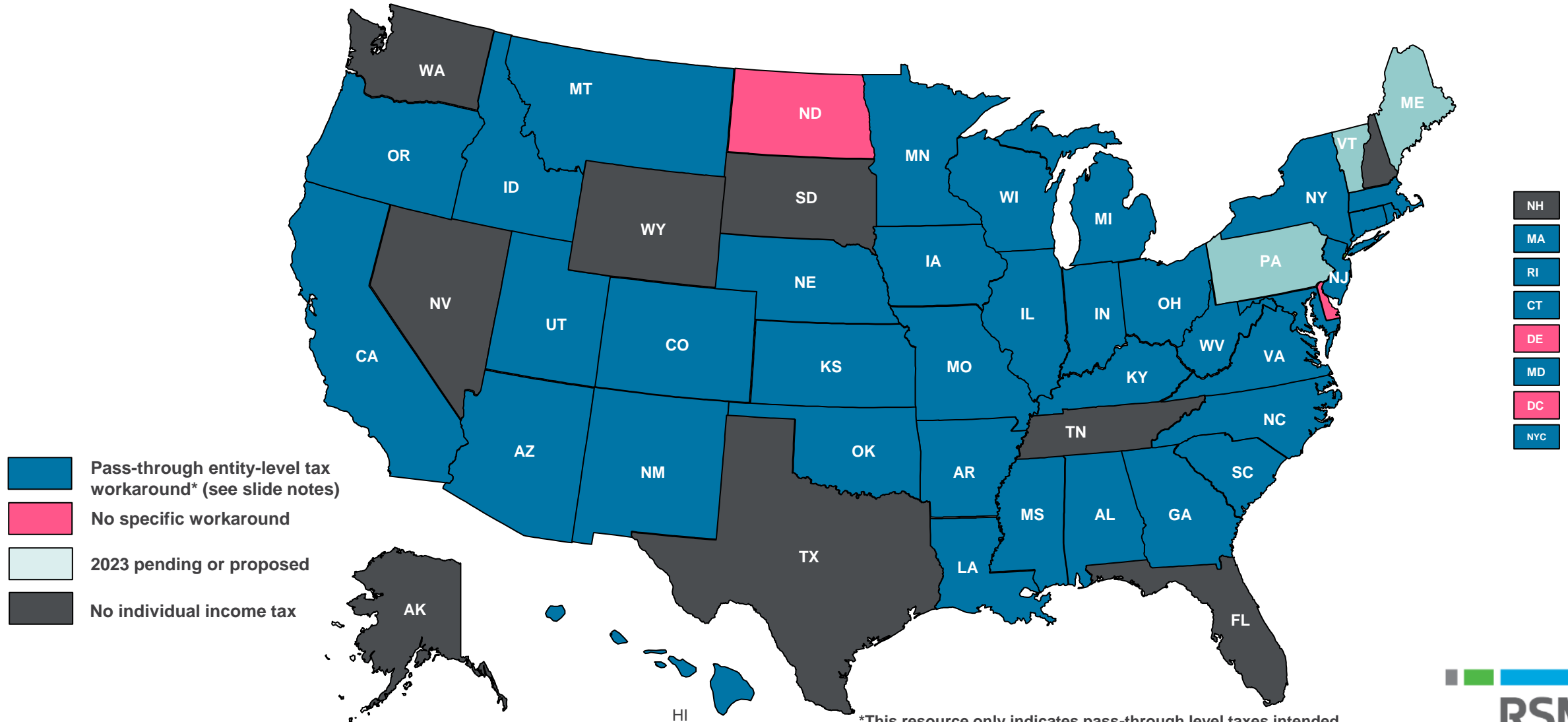
Conn AB
6941, effective
2024 (makes
elective)

Pennsylvania
SB 659,
effective 2023

Maine LD
1891, effective
2023

Vermont SB
45, effective
2023

State pass-through entity-level taxes (State and local tax (SALT) deduction limitation workaround as of Oct. 15, 2023)*



Sales and use tax developments

- Rate reductions
 - South Dakota .3% state sales tax rate decrease until June 30, 2027 (HB 1137)
 - Utah 1.75% sales tax on food elimination will go to voters in 2025
 - Vetoed state sales tax reduction in New Mexico
- Digital goods
 - Georgia to tax digital goods and products
 - Mississippi clarifies that software and software services are subject to tax, provides numerous exclusions and explains that software maintained outside the state and accessible in the state is exempt. PaaS and IaaS are also excluded from computer software.
- Delivery fees
 - Colorado amends its fee by raising threshold to \$500,000 and offering option for retailer to pay
 - Minnesota adopts delivery fee effective July 1, 2024

Litigation update

There is always litigation

Maryland digital advertising tax lives another day

***Comcast et al. v. Comptroller of the Treasury of Maryland*, No. C-02-cv-21-000509 (Md. S.Ct., May 9, 2023)**

- A Maryland County Circuit Court had held that digital advertising tax violates the Internet Tax Freedom Act, the US Constitution's Dormant Commerce Clause, as well as the First and Fourteenth amendments.
- Maryland Supreme Court found that the taxpayers had not exhausted their administrative remedies in filing the declaratory judgment, thus circuit court did not have jurisdiction

Pennsylvania marketplace inventory

***Online Merchants Guild v. Hassell*, 282 A.3d 871 (Pa. Commw. Ct. 2022)**

- Commonwealth Court of Pennsylvania held that an out of state business does not have sales and use tax or personal income tax nexus simply by virtue of having inventory located within Pennsylvania where the inventory is in an Amazon owned facility and there at the direction of Amazon.

Washington capital gains not an income tax

***Quinn v. State of Washington*, No. 100769-8 (Wash. 2023)**

- On March 24, 2023, the Washington Supreme Court has upheld the state's capital gains tax, ruling that the levy was a lawful excise tax, not an unconstitutional income tax.
- Reversed a lower court decision that determined the Washington capital gains tax was an unconstitutional tax on property. Washington case law establishes income as property, and taxes on property in Washington have strict uniformity and levy limitations that the capital gains tax would violate if it were characterized as such.

Arizona software is the rental of tangible personal property

***ADP, LLC v. Ariz. Dep't of Revenue*, 1 CA-TX 21-0009 (Ariz. Ct. App. January 31, 2023)**

- The Arizona Court of Appeals held that ADP's contract with Maricopa County for the licensing of its Enterprise eTime software was subject to the Transaction Privilege Tax under the tangible personal property rental classification.
- The court likened the software to the sale of jukebox music; which a 1943 Arizona Supreme Court case held was the sale of TPP. The court explained that both jukeboxes and computers produce perceptible effects, for which their users are willing to pay.

Massachusetts cookie nexus crumbles

U.S. Auto Parts Network, Inc. v. Comm'r of Revenue, No. SJC-13283 (Mass. December 22, 2022)

- The Massachusetts Supreme Court held that the Department could not apply Wayfair retroactively to impose nexus on a taxpayer whose only contact with the state was through internet cookies. (The taxpayer sold auto parts entirely online and utilized cookies to track customers that visited its website.)
- The court refused to apply Wayfair’s holding retroactively because “the regulation, [at issue] by its own terms, limited its reach to nondomiciliary Internet vendors that satisfied the physical presence test set forth in Quill.”

South Carolina “BAM” memberships are taxable

Books-A-Million, Inc. vs. South Carolina Department of Revenue, Appellate Case No. 2020-001102, (S.C. Sup. Ct., September 14, 2022)

- Books-a-million offers customers a membership for \$25. Benefits of the membership club include free shipping and discounts on the sales price of tangible personal property, like CDs and books.
- The South Carolina Supreme Court affirmed that the chain’s club membership fees are subject to state sales tax. While the membership itself is an intangible good, members gain a tangible good because they receive discounts on taxable transactions, which makes the sales taxable under state statute.

New York vendor management fees

In the Matter of the Petition of Beeline.com, Inc., DTA No. 829516, (N.Y. Div. Tax App. February 9, 2023)

- The New York Division of Tax Appeals found that a company's vendor management fees were taxable as the sale of pre-written software. The company offered a web-based application that helps to manage and procure staffing services from requisition through billing.
- The ALJ found the company used the same software for all of its customers; thus, the product was pre-written software – a type of tangible personal property and the primary function test should not apply. The primary function of the sale was a license of software because the software technology and license were “completely intertwined with all the services petitioner offers in the contract.”

U.S. court of appeals for the 9th circuit addresses streaming services

***City of Reno v. Netflix, Inc., et al.*, No. 21-16560 (9th Cir. October 28, 2022)**

- The U.S. court of appeals for the Ninth Circuit held that the City of Reno was not entitled to file a lawsuit against streaming video providers for franchise fee payments. The court held that the law does not create a private right of action for cities to sue for unpaid franchise fees. Reno therefore failed to state a claim against the streaming service providers.
- The court also noted because the city lacks a cause of action under a separate statute, it could not use the state's Declaratory Judgment Act to obtain affirmative relief.

Market-based sourcing developments

- Major litigation addressing state apportionment rules in 2022:
 - Texas – *Sirius XM Radio v. Hegar*: TX Supreme Court clarified that service revenue is sourced to the state where the service is performed for TX franchise tax purposes.
 - Florida – *Target Enterprise, Inc. v. Dept. of Revenue*: FL trial court rules taxpayer's use of cost-of-performance method to source service revenue for FL corporate income tax purposes was correct.

Alaska combined reporting

***Dep't of Revenue v. Nabors Intl. Finance, Inc.*, 514 P.3d 893 (Alaska 2022)**

- The Alaska Supreme Court found that Alaska's combined reporting statute requiring taxpayers to include certain foreign affiliates in its income tax return was constitutional
- The court rejected the taxpayer's Commerce Clause challenge, finding that the law was not facially discriminatory because filing a return was not a discriminatory burden, and the law had no discriminatory effect on interstate commerce—which depends on the apportionment formula, which was not challenged. The law was also not arbitrary and irrational under the Due Process Clause, noting that the law was based on the reporting threshold used by the IRS, and simply because a law is characterized as numerically arbitrary does not make it constitutionally arbitrary

Pennsylvania net operating losses

***Alcatel-Lucent USA Inc. v. Commonwealth*, 290 A.3d 1285 (Pa. Commw. Ct. 2022)**

- The Pennsylvania Commonwealth Court held that Alcatel was entitled to refund and that the flat dollar net loss cap should be severed from net loss statute
- The taxpayer was not able to deduct all of its losses due to the state's flat dollar net loss cap of \$4 million. The taxpayer asked the court to apply the decision in Nextel retroactively to sever the cap from the statute. The court agreed, noting that Chevron test favored retroactive application. Namely, that the decision did not introduce a new principle of law
- Taxpayer was entitled to a refund under uniformity pursuant to Due Process

Federal tax changes

SALT considerations for a pie-in-the-sky federal tax compromise

Potential SALT considerations for federal tax bill

- Section 174 “fix”
- SALT deduction limitation modification or extension
- Section 163(j)
- Bonus depreciation extension
- Other extenders for TCJA provisions
- Mobile workforce



QUESTIONS AND ANSWERS

THANK YOU FOR
YOUR TIME AND
ATTENTION

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