

State & Local Tax **Alert**

Breaking state and local tax developments from Grant Thornton LLP

SALT Legislative Outlook, Trends and Predictions for 2012

In examining what to expect in the coming year, we again consider the threshold question that we have posed for the last several years but remains relevant – is it possible for the states and localities to somehow manage to avoid fiscal catastrophe without fundamentally altering their tax base or spending requirements? In 2011, with a slowly recovering economy, the landscape began to change for the better in some states, but not in others. Instead of practically all states facing fiscal nightmares, a chasm has begun to grow between states that will continue to have significant trouble meeting their obligations, and states that will be well-prepared for whatever the future brings. Many states will continue to face difficult fiscal situations over the next several years because of structural deficits, intractable political wrangling in the state legislative and executive branches, and other factors. On the other hand, a select number of states are in comparatively good fiscal shape because they hold significant natural resources and/or maintain good fiscal discipline.

States in fiscal trouble will likely continue to mine their existing tax systems for additional untapped sources of revenue, while considering groundbreaking changes to these systems, like alternative corporate tax regimes, broader imposition of the sales tax on growing sectors of the economy (including services and technology), and more progressive individual income taxes. In contrast, the more fiscally responsible states can afford to consider providing more beneficent tax treatment, including the potential for tax cuts, in an effort to spur local economic growth. Regarding existing costs, states are somewhat hamstrung by what they can do, as they uniformly have made significant cuts to services in the past several years. Restructuring pension costs to lower current and future expenses are a likely strategy, and the well-positioned states are more likely to be able to figure out palatable methods to make these changes on the fly.

Another option to balancing budgets may be to reduce the amount of direct aid the states provide to localities. However, many localities are dealing with fundamental fiscal problems of their own, and pushing down costs may only exacerbate these issues. From the local government level, continued weakness in the real estate market is eroding the property tax base, which along with the pressures of pension, health care and other fixed costs is likely to threaten the fiscal health of jurisdictions that cannot restructure their budgets through other sources of revenue or elimination of “nonessential” service costs.

On the revenue side of the ledger, localities may be forced to supplement their lagging property tax and sales tax receipts with additional local gross receipts taxes. On the

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expense side, cutting services will be tough, especially if states try to push their own costs onto localities' balance sheets. Many localities that are unable to bridge the gap may have to consider the "worst-case scenario," claiming bankruptcy under Chapter 9 of the U.S. Bankruptcy Code.¹ In 2011, Jefferson County, Alabama, and Harrisburg, Pennsylvania were the most prominent municipalities to claim Chapter 9 bankruptcy protection, and we would not be surprised in the least if more Chapter 9 cases arise this year.

With the broad state and local fiscal landscape in mind, significant changes to state and local tax structures are inevitable. In this alert, we briefly look back to see whether, and to what extent, the predictions that we made at the beginning of 2011 verified. Then, we consider what may happen in the state and local tax world in 2012.

2011 Predictions – A Review

- *Decoupling from federal 100 percent bonus depreciation provision.* Specifically, we predicted that once legislatures had a full opportunity to consider the federal 100 percent bonus depreciation provision during 2011, at least three-quarters of the states ultimately would decouple from this provision. While approximately two-thirds of the states ultimately maintained their opposition to bonus depreciation, this prediction fell a little short. Pennsylvania² and Illinois,³ two states which historically had decoupled from bonus depreciation, unexpectedly conformed to the federal provision due to quirks in their statutes which were not amended.
- *Reevaluation of gross receipts and margin taxes.* We predicted that one state would seriously consider a shift from a corporate income tax to a gross receipts tax, while Michigan would substantially modify or eliminate the modified gross receipts tax portion of the Michigan Business Tax (MBT). Michigan did, in fact, eliminate the modified gross receipts tax by converting to the Michigan corporation income tax.⁴ As for shifting to a gross receipts tax, Nevada, a state that currently does not have a corporate income tax, briefly considered, and then rejected, a margin tax akin to the Revised Texas Franchise Tax (RTFT).
- *A second year in a row without a move to combined reporting.* We predicted that while the issue would remain in play (and Connecticut, Rhode Island and Maryland would consider it), no states would adopt mandatory unitary combined reporting in 2011. Technically, this prediction verified, as the above-listed states considered and rejected combined reporting, in large part due to the states' uncertainty about how the change in filing methodology would impact overall revenues, as well as how such change would affect particular in-state businesses. However, the

¹ See 11 U.S.C. § 901 *et seq.* Notably, states are precluded from claiming bankruptcy under Chapter 9 or any other provision.

² 35 ILL. COMP. STAT. 5/203(b)(2)(E-10); Instructions, Form IL-4562, Special Depreciation.

³ 72 PA. CONS. STAT. § 7401(3)1(q), (r); Corporation Tax Bulletin 2011-01, Pennsylvania Department of Revenue, Feb. 24, 2011.

⁴ MICH. COMP. LAWS § 206.601 *et seq.*

District of Columbia, pursuant to previously enacted authority, retroactively adopted combined reporting for the 2011 tax year.⁵

- *Defeat of California tax hikes at the polls.* We had thought that to the extent Governor Brown could persuade two-thirds of the state legislature to authorize broad-based tax increases, the California electorate would defeat these tax increases in a referendum. The California electorate did not get the chance to vote on this issue in 2011, though we expect that Californians will have such an opportunity in 2012, as discussed below.
- *Disclosure becoming the avenue of choice in policing the sales and use tax.* Our prediction that at least five states would propose disclosure requirements for out-of-state retailers that are not currently subject to the sales and use tax, and at least one state would enact this requirement, easily verified. A total of seven states proposed disclosure / notification requirements in 2011, and South Dakota⁶ and Vermont⁷ adopted these requirements (South Carolina adopted a requirement specifically tailored towards the activities of one taxpayer).⁸ While our specific prediction with respect to disclosure requirements verified, a surprising development was the continued legislative activity in click-through nexus and affiliate nexus legislation, a trend that as we address below, will likely continue in 2012.
- *Sales taxes on a broad array of services to be examined by state legislatures.* We predicted that at least seven states would introduce legislation in 2011 proposing a broad-based sales tax on an array of services, and we expected at least one state to enact the legislation. This prediction was accurate, as numerous states proposed legislation that would have broadened the sales tax base to include additional services, and Connecticut,⁹ Hawaii¹⁰ and the District of Columbia¹¹ each adopted legislation subjecting more services to tax, in varying degrees.
- *Increase in individual income tax rates.* We expected states to consider broad-based individual income tax increases or enacting or extending “millionaire” taxes targeting high-income taxpayers. Our prediction that at least three states would enact legislation increasing individual income tax rates for at least some subset of their taxpayers verified. While Illinois remained the only state that imposed a huge tax rate increase on all of its taxpayers,¹² Connecticut,¹³ New York¹⁴ and the District of Columbia¹⁵ all raised individual income tax rates last year on certain high-income taxpayers.

⁵ D.C.B. 19-203, Laws 2011, signed July 11, 2011, effective Sep. 14, 2011 for tax years beginning on and after Jan. 1, 2011.

⁶ S.B. 146, Laws 2011, effective July 1, 2011.

⁷ Vt. STAT. ANN. tit. 32, § 9783.

⁸ S.C. CODE ANN. §§ 12-36-2691, 12-36-2692.

⁹ CONN. GEN. STAT. § 12-407(a)(37).

¹⁰ HAW. REV. STAT. § 237-XX(a)(1)-(23) (to be codified); HAW. REV. STAT. § 238-XX(a)(1)-(6) (to be codified).

¹¹ D.C. CODE ANN. § 47-2001(a-2), (i-2), and (q-1).

¹² 35 ILL. COMP. STAT. 5/201(b)(4), (5). The rate is scheduled to drop from 5 percent to 3.75 percent on Jan. 1, 2015, and then from 3.75 percent to 3.25 percent on Jan. 1, 2025. 35 ILL. COMP. STAT. 5/201(b)(5.1)-(5.4).

¹³ CONN. GEN. STAT. § 12-700(a).

¹⁴ N.Y. TAX LAW § 601(a)(1), (b)(1), (c)(1).

¹⁵ D.C. CODE ANN. § 47-1806.03(a)(8)(A).

- *Enactment / modification of more state estate or inheritance taxes.* Our prediction that at least three states would enact new state estate or inheritance taxes, or substantially modify existing state estate or inheritance taxes in the coming year did not prove accurate. However, some states adjusted their systems to decouple from the \$5 million federal exclusion amount applicable for 2011 and 2012, typically by lowering such exclusion for state estate tax purposes (for example, Connecticut¹⁶ and Illinois¹⁷ set their state estate exclusion at \$2 million in 2011). In fact, Ohio repealed its estate / inheritance tax during the 2011 budget session (effective in 2013).¹⁸
- *More emphasis on reportable and listed transactions.* We predicted that in 2011, at least two states would: (i) adopt new reportable and/or listed transaction statutes; (ii) provide further administrative guidance on what constitutes reportable and/or listed transactions; or (iii) adopt rules defining economic substance standards for transactions. In somewhat of a surprise, the only state that acted in this area was California, which provided guidance from the Franchise Tax Board adopting new listed transactions, including certain transactions between corporations and partnerships undertaken to improperly inflate the denominator of the California sales factor, and circular cash flow transactions, along with substantially similar transactions.¹⁹ No state adopted new reportable or listed transaction statutes, or economic substance standard regulations in 2011.
- *The U.S. Supreme Court's granting of certiorari on a case relevant to state and local taxation.* Despite the plethora of good state and local tax cases ripe for consideration by the U.S. Supreme Court, no significant substantive SALT matters were considered by the Court in 2011, as cases like *Lamtec*,²⁰ *KFC*,²¹ and *Asworth*²² were not heard by the Court. It is becoming increasingly obvious that the Court's limited schedule, as well as the Court's willingness to have Congress weigh in on notable SALT issues, means that a major SALT case is unlikely to be argued in the Court any time soon.

Our 2012 Predictions

1. *Federal legislation on remote sales issue will not be adopted in 2012, although signs point to adoption in 2013.*

In the last several months, three bills have been introduced in Congress that would allow states to require remote sellers to collect and remit state sales and use taxes if the state

¹⁶ CONN. GEN. STAT. § 12-391(g).

¹⁷ 35 ILL. COMP. STAT. 405/2(b).

¹⁸ H.B. 153, Laws 2011, effective July 1, 2011.

¹⁹ FTB Notice 2011-01, *Abusive Tax Shelters – California Listed Transactions – Abusive Sales Factor Manipulation* (Jan. 6, 2011); FTB Notice 2011-03, *Abusive Tax Shelters – California Listed Transactions – Circular Cash Flow* (Apr. 22, 2011).

²⁰ *Lamtec Corp. v. Dept. of Rev.*, 246 P.3d 788 (Wash. 2011), *cert. denied*, Dkt. 10-1289 (Oct. 3, 2011).

²¹ *KFC Corp. v. Iowa Dept. of Rev.*, 792 N.W.2d 308 (Iowa 2010), *cert. denied*, Dkt. 10-1340 (Oct. 3, 2011).

²² *Revenue Cabinet v. Asworth Corp.*, Nos. 2007-CA-002549-MR, 2008-CA-000023-MR, slip op., WL 3877518 (Ky. App. 2009), *rev. denied* (Ky. 2010), *cert. denied*, Dkt. 10-662 (Jan. 24, 2011).

commits to certain tax administration simplification requirements.²³ The House Judiciary Committee held a high-profile hearing on November 30, 2011 to discuss the three bills.²⁴ The presence of three separate bills on the remote sales issue is interesting, though it does not guarantee adoption, as several substantive differences between the bills remain and transforming the bill into law will require a level of cooperation in Congress that has been missing, particularly in tax legislation. **We predict that a hybrid version of the three bills ultimately will be considered, but is unlikely to pass the House this year. However, important developments will occur this year laying the groundwork for adoption in 2013.**

2. *State legislative frenzy will continue on click-through nexus, affiliate nexus and notification / disclosure requirements.*

As federal action on the remote sales issue remains in limbo, the scattershot approach will continue in the state legislatures. Some states will look to enact click-through nexus laws, others will strengthen their affiliate nexus laws, and still others will require out-of-state retailers to notify in-state purchasers of their potential use tax liabilities. And one or more states may try to adopt all three approaches. **We predict that at least four states will adopt click-through nexus laws, four states will adopt affiliate nexus rules and four states will adopt notification / disclosure requirements.**

3. *H.R. 1864 will pass the House but hit resistance in the Senate.*

H.R. 1864, also known as the mobile workforce bill, would limit the states' authority to tax the income of nonresident employees and would provide uniformity for employer withholding on such income.²⁵ H.R. 1864 would permit states to tax a nonresident employee's income only if the employee is present and performing employment duties in the state for more than 30 days during the calendar year. In addition, H.R. 1864 would require employers to withhold on that income once the 30-day threshold is met, and to catch up all required withholding at that time. The bill, which has passed the House Judiciary Committee and may be considered by the full House in the coming months, is perceived by many as exemplifying a bill representing sound, reasonable policy. Further, the bill has bipartisan support and a generally revenue-neutral effect in most states. But even this bill will face inevitable opposition from some legislators and other interested parties. For example, New York legislators may be strongly opposed to the bill in light of the potential revenue impact to New York. **Accordingly, we predict that H.R. 1864 is likely to pass the full House but unlikely to pass the Senate this year, primarily because of opposition from New York senators and others who believe that a federal bill of this nature unconstitutionally encroaches upon states' rights.**

²³ S. 1452, H.R. 2701, introduced July 29, 2011 (the Main Street Fairness Act); H.R. 3179, introduced Oct. 13, 2011 (the Marketplace Equity Act); S. 1832, introduced Nov. 9, 2011 (the Marketplace Fairness Act).

²⁴ House Judiciary Committee, "Constitutional Limitations on States' Authority to Collect Sales Taxes in E-Commerce," Nov. 30, 2011.

²⁵ H.R. 1864, Mobile Workforce State Income Tax Simplification Act, introduced May 12, 2011.

4. *The Texas Supreme Court will continue to decide expedited RTFT matters.*

In 2011, two RTFT cases reached the Texas Supreme Court under expedited circumstances, requiring a determination by the Court within 120 days of filing.²⁶ The first case, *Allcat Claims Service*, held that: (i) the RTFT did not facially violate the “Bullock Amendment” of the Texas Constitution because the RTFT does not impose a tax on a natural person’s share of partnership income; and (ii) the Court lacked jurisdiction to consider an “as applied” challenge made by the taxpayers.²⁷ The second case, *Nestle*, covering a host of additional RTFT issues, will be decided by the Court by mid-February 2012.²⁸ We expect 2012 to offer additional RTFT challenges that will need to be adjudicated by the Court, because of the novelty of the RTFT and the wide variety of potential issues arising from taxpayers that believe they are being treated unfairly compared with similarly situated taxpayers, caused by the disparity between the 0.5 percent and 1 percent rates, the ability to elect the cost of goods sold deduction in certain circumstances, and membership in the unitary combined group. **We predict that at least two more RTFT challenges will reach the Texas Supreme Court following the decision in *Nestle*, which decision will offer hope to taxpayers that some form of constitutional challenge to the RTFT is possible.**

5. *Market-based sourcing of items other than tangible personal property will gain momentum.*

In 2011, Alabama adopted market-based sourcing for sales of items other than tangible personal property, moving away from historic cost of performance principles, and following the lead of several other states.²⁹ In the last several years, approximately one state a year has moved to a market-based sourcing methodology. There is no reason to believe that the trend toward market-based sourcing will stop or somehow begin to reverse in 2012. **Accordingly, we predict that at least one state that has relied on cost of performance rules will endorse market-based sourcing.**

6. *California citizens will decide to vote against broad-based tax increases, and the single sales factor will remain elective.*

As noted above, we expected these issues to have been addressed in some manner in 2011. Currently, Governor Brown is backing a proposal to be the subject of a referendum that would temporarily increase the individual income tax rate for high-income taxpayers, as well as the sales tax rate for all transactions (in fact, the Governor’s budget assumed that these tax increases would be adopted). Governor Brown is also backing legislation that would mandate the use of the single sales factor for purposes of corporation income tax apportionment, instead of allowing taxpayers the option to choose three-factor (double-weighted sales) or single sales factor apportionment. The environment for tax increases, particularly those requiring voter endorsement, is not good. The adoption of a

²⁶ H.B. 3, Laws 2006, § 24(b).

²⁷ *In re Allcat Claims Service, L.P.*, Texas Supreme Court, No. 11-0589, Nov. 28, 2011.

²⁸ *In re Nestle USA, Inc., Switchplace, LLC, and NSBMA, L.P.*, Texas Supreme Court, filed Oct. 19, 2011.

²⁹ ALA. CODE § 40-27-1.IV.17(a).

mandatory single sales factor is likely to impact numerous businesses that want to maintain flexibility in their choice of apportionment formula. **With likely significant opposition on these issues, we predict that the broad-based tax increases and mandatory single sales factor provisions will not be adopted this year.**

7. *States will follow the lead of Illinois (Sears / CME) and California (Amazon) in completing more “sweetheart deals.”*

Several states provided extremely tailored tax relief to large, prominent companies in 2011 in order to retain jobs. In Illinois, Sears, along with several commodity exchanges, received significant incentives to keep their headquarters in the state.³⁰ In California, Amazon negotiated a deal with the state, under which the state legislature temporarily and retroactively repealed click-through and affiliate nexus provisions³¹ in exchange for Amazon dropping a planned referendum challenge to these provisions and promising to create substantial numbers of jobs and capital investment.³² In a struggling economy, every job that stays in a state counts, and state legislatures know that. **We predict that at least three states will again adopt significant SALT legislation targeting incentives to a very narrow class of taxpayers.**

8. *Significant New York corporate income tax reforms will not be adopted in budget legislation.*

There has been significant chatter about whether the New York State Department of Taxation and Finance will encourage the state to make significant tax policy changes during this year’s budget discussion, including the potential adoption of mandatory unitary combined reporting and the elimination of distinctions between the taxes imposed on business corporations and banking corporations. With a relatively new governor willing to challenge the status quo, and the apparent ability to get legislation passed through the New York legislature quickly and efficiently (as seen by the December 2011 individual income tax rate changes discussed above, which were adopted in a matter of days), some have thought that 2012 could be the year that significant changes to the state’s corporation franchise tax become a reality. The question is whether the Department will have Governor Cuomo’s ear on these issues this year, and our sense is that it will not, particularly in light of the tax reforms adopted last December. **We predict that the 2012 budget deal will not include significant corporation franchise tax reforms.**

9. *Sales tax bases will continue to expand to include certain services.*

In 2011, we noted significant state legislative activity dealing with the issue of subjecting services to the sales tax. While many approaches were considered, only a handful of states ultimately adopted an expanded base by eliminating exemptions or including additional taxable services. As the gap grows between states in good fiscal condition and states that

³⁰ P.A. 97-636 (S.B. 397), Laws 2011.

³¹ A.B. 28x, Laws 2011.

³² A.B. 155, Laws 2011. Amazon also obtained incentives in other states, including South Carolina, through similar efforts.

are in trouble, the lagging states will closely examine their sales tax bases, and likely view the inclusion of services as appealing. Despite continued opposition from groups that would feel the impact of a more pervasive sales tax on services, we expect this trend to continue to slowly take hold. **We predict that two states will marginally expand their sales tax bases by taxing more services.**

10. More unique and often industry-specific transactional taxes will emerge.

As noted above, Michigan engaged in a transformational change of its tax structure in 2011. As part of this change, Michigan enacted the Health Insurance Claims Assessment (HICA) Act, which applies to certain paid claims arising from health and medical services provided on or after January 1, 2012.³³ The HICA Act is a type of industry-specific tax that might become more appealing for legislatures to adopt, because such taxes can be targeted to generate a specific amount of revenue designed to finance particular industry-specific issues contained in budgets, and may not face the pervasive opposition that might accompany a broad-based tax increase. **We predict that at least one state will either adopt or make significant reforms to an industry-specific entity-level tax.**

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³³ Act 142 (S.B. 348), Laws 2011. Note that the tax is repealed effective Jan. 1, 2014.

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