State & Local Tax Alert

SALT top stories of 2018

After a year in which state and local tax (SALT) professionals experienced a veritable Super Bowl and Olympics in the form of South Dakota v. Wayfair\(^1\) and the SALT implications of federal tax reform contained in H.R. 1,\(^2\) it is a good time to reflect on how much things have changed in just one year.

When we released last year’s SALT Top Stories alert, we were watching closely as federal tax reform took center stage, culminating in the enactment of H.R. 1 right before the holidays. From a SALT perspective, this development ensured a voluminous reaction from states that would see the composition of their corporation income tax bases dramatically change in the coming year. With state legislatures heading into session, the method in which states conformed to, or decoupled from the federal income tax code surely would come under scrutiny. Ultimately, SALT professionals endured the grueling challenge of considering state reactions to federal tax reform throughout the year, tracking the 2017 tax year effect of repatriation provisions in IRC Sec. 965 and bonus depreciation provisions in IRC Sec. 168(k) as well as a slew of new provisions and limitations taking effect for the 2018 tax year.

And in most years, that grueling challenge would have been more than enough for SALT professionals to think about. But just a couple weeks into 2018, the U.S. Supreme Court added to the chaos by agreeing to hear Wayfair. The Court’s decision to hear Wayfair was far from guaranteed. Numerous times before, challenges to the sales tax physical presence nexus rule set forth in prior Court precedent were denied a Court hearing. Ultimately, on June 21, 2018, in a 5-4 decision, the Court overruled its precedent, concluding that the South Dakota statute at issue, which required remote sellers to collect and remit sales tax if certain economic nexus standards were met, satisfied the substantial nexus standard.\(^3\)

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\(^1\)138 S. Ct. 2080 (2018).
\(^2\)P.L. 115-97. Commonly referred to as the Tax Cuts and Jobs Act (TCJA), the legislation was enacted on De. 22, 2017. For a discussion of this Act, see GT Alert: Tax Reform Law Transforming Business and Tax Planning.
\(^3\)Justices Kennedy, Thomas, Ginsburg, Alito and Gorsuch joined the majority opinion. Justices Thomas and Gorsuch also filed concurring opinions. Chief Justice Roberts filed a dissenting opinion, joined by Justices Breyer, Sotomayor and Kagan.
Again, SALT professionals scrambled to track state reactions to this groundbreaking development, and think about how such a change would impact businesses from a SALT perspective, and beyond.

While we probably could come up with a top stories list that solely relates to Wayfair and the SALT implications surrounding tax reform, other notable developments did occur in the SALT world that deserve mention. Several states, perhaps inspired by the federal tax reform efforts and the Wayfair decision, sensed that the time was right to enact historic state-specific tax reforms. Michigan and Texas, two states that had adopted their own dramatic tax reforms in the 2000s, continued to narrowly interpret the scope of some of the key deductions taken by taxpayers to minimize the tax base. And taxpayers and states continued to engage in litigation on the issue of sales factor sourcing, which has become more prominent in determining state corporation income tax apportionment factors over time.

Outside of the sales and corporate income tax world, a number of SALT issues received a fair amount of press. Municipalities continued to wrestle with the propriety of enacting taxes designed to fund targeted initiatives. These same municipalities engaged in intense competition to fight for relocating and expanding businesses, most notably Amazon. Even not-for-profit entities had their moment in the sun, with a critical Illinois decision providing some finality on property tax obligations of hospitals.

So let’s go deep on the topics that made 2018 a memorable year in SALT.

1. Impact of Wayfair and South Dakota’s response

The Wayfair controversy arose from years of attempts by states to circumvent the physical presence requirement to achieve substantial nexus for sales and use taxes under the Court’s decision in Quill Corp. v. North Dakota. Following numerous indirect efforts to subject remote businesses with material in-state relationships to sales tax collection and remittance responsibilities, South Dakota took a direct approach at killing Quill in legislation adopted in 2016. The South Dakota legislation provided that certain remote sellers that sell tangible personal property, products transferred electronically, or services for delivery into South Dakota would be subject to the state’s provisions governing the retail sales and service tax and uniform municipal non-ad valorem tax, and would be required to remit sales tax as if they had a physical presence in the state. Remote sellers would be subject to these provisions if they met one of two thresholds in either the previous or the current calendar year:

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• The seller’s gross revenue from the sale of tangible personal property, any product transferred electronically, or services delivered into South Dakota exceeded $100,000.
• The seller sold tangible personal property, any product transferred electronically, or services for delivery into South Dakota in 200 or more separate transactions.  

Notably, the legislation was designed not to take effect until the constitutional challenge to Quill was resolved by the U.S. Supreme Court. After the legislation was immediately challenged and fast-tracked through the South Dakota court system, the South Dakota Supreme Court determined that the legislation was unconstitutional because it violated the physical presence requirement for sales and use taxes under Quill and the application of the Dormant Commerce Clause.  

Following its consideration of the South Dakota legislation, the U.S. Supreme Court vacated the South Dakota Supreme Court’s decision by expressly overruling Quill, determining that the physical presence rule was “unsound and incorrect.” The Court concluded that the South Dakota statute satisfied the substantial nexus standard under a Dormant Commerce Clause analysis. Although the Court generally is very reluctant under the principle of stare decisis to overrule its prior decisions, in Wayfair the Court explained that overruling precedent in this matter was warranted and necessary, reflecting that the Internet’s dramatic growth has changed the national economy’s dynamics. The Court determined that reversing prior precedent was appropriate here because these prior decisions prevented the states from exercising their lawful sovereign power to collect sales tax.

After conceding that Congress could change the physical presence rule (the core position of the dissenting opinion in Wayfair), the Court explained that it should not ask Congress to rectify the Court’s false interpretation of the Constitution. Implementation of the Commerce Clause doctrines to the modern business world necessitated rejection of the physical presence rule. The Court opined that Quill was wrongly decided in 1992, but the growth of the Internet exaggerated the decision’s negative effects. The Court noted that the dramatic increase in online retail sales over time substantially increased the sales and use tax revenue shortfall experienced by the states. The decline in revenue created an urgency for overturning the physical presence rule. In rejecting the argument that the physical presence rule is clear and easy to apply, the Court explained that “[a]ttempts to apply the physical presence rule to online retail sales are proving unworkable.”

The Court acknowledged in Wayfair that the rejection of the physical presence rule may place a heavy burden on small Internet retailers that have a small volume of business in many states. However,

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6 S.D. CODIFIED LAWS § 10-64-2.
available software should ease this burden and Congress may decide to enact legislation to address this problem. The Court noted that the South Dakota law provides small merchants with a reasonable level of protection because remote sellers only are required to collect sales tax if they do a considerable amount of business in the state, as measured by the economic thresholds. Also, the law is not retroactive and South Dakota is a member of the Streamlined Sales and Use Tax Agreement. Finally, other aspects of the Court’s Commerce Clause doctrine may serve to protect against an undue burden on interstate commerce.

While the Court vacated the South Dakota Supreme Court’s decision, it remanded the case to consider whether the South Dakota statute could be challenged on an alternative basis under the Commerce Clause. Following the Court’s decision, the South Dakota Department of Revenue explained that the injunction was still in place and it was unable to enforce the remote seller nexus law. In response to Wayfair, Gov. Dennis Daugaard called for a special one-day legislative session, in which the South Dakota legislature swiftly passed S.B. 1 and S.B. 2, sales tax bills affecting remote sellers and marketplace providers. Gov. Daugaard signed the bills into law on Sept. 12, 2018.

S.B. 1, the remote seller bill, amended certain aspects of the original 2016 legislation, but retained the substantive economic nexus thresholds endorsed in Wayfair. On Nov. 1, 2018, remote sellers (other than Wayfair, Overstock and Newegg, the three remaining Wayfair litigants) meeting at least one of the economic nexus thresholds became required to collect and remit sales tax, as the legislation served to dissolve and lift the South Dakota court injunction. S.B. 2 expanded the concepts introduced in S.B. 106 and S.B. 1 to marketplace providers. On or after March 1, 2019, certain marketplace providers will be required to collect and remit sales tax on behalf of sellers using their services, when certain specified conditions are met.

The legislation left one open item to resolve. The remaining litigants in Wayfair were still in active litigation with South Dakota. Thus, their tax collection requirements were temporarily left in limbo, as these requirements would still be either subject to judicial determination, or be governed by a potential settlement agreement. On Oct. 31, 2018, Governor Daugaard announced that South Dakota had indeed entered into a final settlement agreement and stipulation of dismissal in Wayfair, resolving all issues not addressed by the U.S. Supreme Court. The settlement removed the injunction as applied to the Wayfair

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8 According to the Streamlined Sales Tax Web site, “[t]he purpose of the Agreement is to simplify and modernize sales and use tax administration in order to substantially reduce the burden of tax compliance.” At present, 24 states have adopted the Agreement’s simplification measures.

9 See S.D. CODIFIED LAWS §§ 10-64-4; 10-64-7. The legislation confirmed that such an obligation would not be imposed on a retroactive basis. S.D. CODIFIED LAWS § 10-64-6.

litigants to comply with the remote seller law. Under the terms of the settlement, the Wayfair litigants will comply with the law beginning Jan. 1, 2019. The state also reached a settlement agreement in related litigation, American Catalog Mailers Association v. Gerlach.\textsuperscript{11}

As expected, the effect of this decision has been widespread based on the immediate reaction by the states to adopt their own rules in this area. Not only are businesses of all sizes and across all industries impacted, but the wave of economic nexus policy will be felt substantially by foreign entities as well. While treaty protection on foreign sellers is often granted with respect to federal income tax, this protection does not generally apply to state taxes. Accordingly, foreign entities making sales into the United States now must track their sales and transactional data in the same manner as domestic entities. Likewise, documentation, collection, and maintenance has become a far more important part of foreign sellers’ business activities here in the United States than in the past.

Compliance efforts have also increased as a result of these new economic nexus provisions. Businesses of all sizes have had to reevaluate their footprint, both from a historical physical presence and from an economic nexus perspective. As a result, increased registrations and ongoing compliance have quickly become a reality. Implementing in-house compliance options and reviewing outsourcing opportunities are necessary elements for companies doing business nationwide to consider. Further, evaluation and remediation of past exposures due to physical presence must be reviewed prior to registering with new jurisdictions due to activities that result in economic nexus.

2. State responses to Wayfair

In response to the Wayfair decision, more than 30 states have moved forward with a consistent stream of economic nexus legislation and regulatory policies, many of which have been put into effect. The market thresholds in these economic nexus provisions have ranged from $10,000 to $500,000, and in most cases include the transactional threshold outlined in South Dakota as an alternative option to meeting the market threshold.\textsuperscript{12}

While states have rushed to adopt economic nexus standards that at first blush look similar following Wayfair, there have been some noteworthy departures from the South Dakota statute that will complicate matters for multistate taxpayers trying to comply with these new rules. For example, the effective dates of the states’ enactment of these rules are not uniform, with a handful of states immediately going effective with their economic nexus provisions, and others using effective dates

\textsuperscript{11} No. 32CIV16-000096 (S.D. 6th Cir. Ct.), filed April 29, 2016. In this separate litigation, remote sellers sued South Dakota and challenged the facial constitutionality of the law.

\textsuperscript{12} States generally following this approach include Colorado, Hawaii, Illinois, Indiana, Iowa, Kentucky, Louisiana, Maine, Maryland, Michigan, Nebraska, Nevada, New Jersey, North Carolina, North Dakota, Rhode Island, Utah, Vermont, West Virginia, Wisconsin, and Wyoming.
ranging from July 1, 2018, to Jan. 1, 2019, and beyond. Further, a handful of states, including Connecticut and Massachusetts, have taken the position that the dollar threshold and transaction threshold should be a joint standard, thus using the “and” terminology in place of the “or” used by South Dakota. Other variations from South Dakota have come in the form of different dollar thresholds. In addition to Connecticut and Massachusetts, Alabama, Georgia, and Mississippi have enacted rules with thresholds of $250,000. Pennsylvania and Oklahoma have taken the opposite approach, enacting thresholds of $10,000.

An interesting evolution in the varied thresholds is occurring in some of the larger market states, including Texas and California. While California has not adopted an economic nexus policy to date, there was, at one point in time, draft language released that would have set a $500,000 dollar threshold for economic nexus creating activity in the state, without a transactional threshold. However, little has been issued from the state since, other than a notice recognizing that the state is considering economic nexus provisions in light of Wayfair, and that the South Dakota standard of $100,000 of gross revenue or 200 or more separate transactions could indeed suffice. Texas has issued proposed revisions to an existing regulation, implementing remote seller nexus rules effective Oct. 1, 2019, with a $500,000 safe harbor and no transactional threshold. Shortly after releasing these proposed revisions, the Texas Comptroller issued draft proposed regulatory amendments that would, among its provisions, expand the state’s definition of “engaged in business” to impose a sales tax economic nexus threshold of $500,000 in the preceding 12 months. This too came with an Oct. 1, 2019, effective date.

Left unaddressed by the Court in Wayfair was the constitutionality of marketplace facilitator/provider rules that are being adopted by many states. The question as to whether the Wayfair economic nexus provisions can be applied to marketplace facilitators/providers remains, as the South Dakota law at issue in the Wayfair decision did not impose collection and remittance responsibilities on marketplaces. Extending the Wayfair analysis to these marketplaces may lead to significant logistical issues whereby marketplaces may become arbiters of whether a particular transaction between an unrelated buyer and seller is taxable or not, leading to potential collection errors.

With the rapid adoption of economic nexus provisions across the states, it would come as a surprise if the remaining states that impose sales and use taxes fail to adopt some type of expanded nexus rules in the next few months. What will be interesting to see is whether marketplace rules continue to be adopted, the manner in which states define includable sales (within the economic nexus thresholds), the

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13 Effective Dec. 1, 2018, Connecticut has adopted economic nexus rules that establish nexus when gross revenue greater than $250,000 and 200 or more separate retail sales into the state are made. S.B. 417, Laws 2018.


15 Ala. Admin. Code r. 810-6-2-.90.03; H.B. 61, Laws 2018; Sales and Use Tax Guidance for Online Sellers, State of Mississippi Department of Revenue (Aug. 6, 2018).


17 34 Tex. Admin. Code § 3.286.
actual dollar and transaction thresholds adopted by the states, and the manner in which these rules are
adopted (via statute, regulation or otherwise). Further, the lack of consistency in the adopted thresholds
may warrant further litigation.

Finally, not to be lost in the massive push for state regulation in this area are continued attempts by
Congress to enact federal legislation over these types of sales tax matters. Countless efforts have been
made, dating back to the first Marketplace Fairness Act, all the way through the two most current bills
filed during the current lame-duck Congressional session, the No Retroactive Online Taxation Act of 2018
and the Online Sales Simplicity and Small Business Relief Act. With a newly elected divide in party
control between the U.S. House and Senate, and with a rapidly dwindling window to pass legislation
before the end of 2018, it will be interesting to see what kind of future these bills may have.

3. The next frontier: Sales tax on cloud-based sales post-Wayfair
Through 2018, only 17 states impose a state-level sales tax on software as a service, and approximately
26 states impose a state-level sales tax on digital goods and products. However, with the changing
nexus landscape, as decided in Wayfair, along with the continued growth in the digital economy, it is
likely that we will begin to see states more broadly tax Internet/cloud based sales. As states have
adopted economic nexus provisions, many have included in their definition of what makes up gross or
taxable sales (subject to economic nexus thresholds). Digital products, items transferred electronically,
intangibles, and sales over the Internet are examples of the types of transactions being targeted by
many states in a concerted effort to expand the sales tax base.

Iowa, Rhode Island and the District of Columbia are examples of jurisdictions that took action in this
area in 2018. Iowa adopted legislation that beginning Jan. 1, 2019, the state will begin taxing software as
a service [SaaS], with an exemption applicable to software as a service furnished to commercial
enterprises for exclusive use.17 Rhode Island enacted legislation effective for transactions on and after
Oct. 1, 2018, under which the sale, storage, use, or other consumption of vendor-hosted prewritten
computer software,18 including SaaS, is subject to 7% sales and use tax.19 Regulatory guidance clarifies

17 IOWA CODE § 423.2(6)(b); IOWA CODE § 423.3(103)(b).
18 Vendor-hosted prewritten computer software is defined as prewritten computer software that is accessed through
the Internet and/or a vendor-hosted server regardless of whether the access is permanent or temporary and
regardless of whether any downloading occurs.R.I. GEN. LAWS § 44-18-7.1(g)(vii).
19 R.I. GEN. LAWS §§ 44-18-7; 44-18-8; 44-18-16(a); 44-18-20(a); 44-18-21(a); 44-18-22; 44-18-23; 44-18-25; 44-19.7. The
Division’s guidance explains that in general, the term “prewritten computer software” means computer software,
including prewritten upgrades, which is not designed and developed by the author or other creator to the
specifications of a specific purchaser. Prewritten computer software delivered electronically or by “load and leave”
became subject to Rhode Island sales and use tax on Oct. 1, 2011.
that the new law applies to software for accounting, invoicing, human resources, payroll, sales tracking, and a number of other functions.\textsuperscript{20}

In the District of Columbia, legislation was passed at the start of December, imposing collection and remittance obligations on remote sellers and marketplace facilitators for sales and use taxes. The legislation is expected to take effect on Jan. 1, 2019, and adopts the same market and transactional thresholds as South Dakota.\textsuperscript{21} The legislation also serves to clarify and expand the sales tax base by defining the term “digital goods” to mean “digital audiovisual works, digital audio works, digital books, digital codes, digital applications and games, and any other otherwise taxable tangible personal property electronically or digitally delivered, whether electronically or digitally delivered, streamed, or accessed and whether purchased singly, by subscription, or in any other manner, including maintenance, updates, and support.”\textsuperscript{22}

The expansion of definitions and taxability of goods and services, especially those in the realm of digital/software services, is being pursued in tandem with the new economic nexus threshold provisions. Given the developments in Iowa, Rhode Island and the District of Columbia, it is fair to conclude that the states will continue to reach for the next frontier of sales taxability. Issues to watch in the coming year that go beyond pure compliance with Wayfair standards include how broadly services may become part of the sales tax base, and whether states will be able to align definitions in the realm of digital goods and beyond.

4. \textbf{State responses to federal tax reform}

The enactment of the TCJA, which resulted in a significant overhaul of the federal income tax system, created entirely new sections of the Internal Revenue Code (IRC) and made substantial changes to existing law. While most changes resulting from the TCJA apply to tax years beginning after Dec. 31, 2017, certain aspects of the TCJA, including foreign income repatriation and bonus depreciation, were applicable to the 2017 tax year.

A state’s response to the TCJA is dependent on the methodology that the state generally employs to adopt the IRC. Traditionally, state conformity to the IRC is achieved in one of three ways: (i) rolling conformity (i.e., automatically conforming to the IRC that is currently in effect); (ii) fixed date conformity (“static conformity,” i.e., conforming to the IRC as of a fixed date, which may or may not be

\textsuperscript{20} Advisory 2018-38, Rhode Island Division of Taxation, Sept. 4, 2018.
\textsuperscript{21} The Internet Sales Tax Amendment Act of 2018 (B22-0914).
\textsuperscript{22} Id.
the most recent version of the IRC); and (iii) selective conformity (i.e., conforming to only specific IRC sections).23

Following adoption of the TCJA, states needed to immediately consider and react to the two major tax reform provisions that applied to the 2017 tax year. Under IRC Sec. 965, the TCJA provides for a one-time transition tax on certain foreign earnings that have traditionally not been subject to federal income tax.24 Accumulated foreign earnings held by controlled foreign corporations (CFCs) of a U.S. shareholder are deemed repatriated and taxed federally at a rate of 15.5% if attributable to cash or cash equivalents and at a rate of 8% if attributable to illiquid assets. The tax may apply to C corporations, owners of passthrough entities and individuals, and is due on 2017 tax year returns, but taxpayers may elect to pay the federal income tax liability over an eight-year period.26

States took various approaches regarding IRC Sec. 965 and released guidance throughout the year.26 Due to the lack of uniformity concerning a state’s treatment of repatriated income, taxpayers evaluating a state’s position had to examine whether the state enacted legislation or released guidance on the topic. Also, taxpayers had to consider a state’s policy on allowing a dividends received deduction (DRD). Some states that conformed to IRC Sec. 965 allowed less than a 100% DRD through a clearly defined offset or statutorily reduced DRD.27 Other states that conformed to IRC Sec. 965 never developed concrete guidance concerning the treatment of repatriated income.28 A third category of states conformed to IRC Sec. 965 and allowed a 100% DRD if certain ownership thresholds are met.29 Finally, some states did not conform to IRC Sec. 965 because the IRC conformity date was not advanced past the TCJA enactment date, specific decoupling legislation was enacted, or general

23 As a general matter, rolling conformity states automatically incorporate tax base changes contained in the TCJA and must pass legislation in order to decouple from any of those provisions. By contrast, in static conformity states, legislation must be passed in order to adopt any of the new provisions or modifications contained in the TCJA. The static conformity states generally adopt the TCJA when they adopt a version of the IRC that is in effect on or after Dec. 22, 2017. Although states rarely change the methodology that they use to adopt the IRC, Iowa enacted legislation that changes the state from static conformity to rolling conformity for tax years beginning on or after Jan. 1, 2020. S.F. 2417, Laws 2018. For a discussion of this legislation, see GT SALT Alert: Iowa Enacts Legislation Updating IRC Conformity, Reducing Income Tax Rates, Expanding Sales Tax.
24 IRC § 965.
25 On March 13, 2018, the IRS released “Questions and Answers about Reporting Related to Section 965 on 2017 Tax Returns.” For further information, see GT SALT Alert: State Preliminary Assessment of IRC Section 965 Reporting Guidance Only Oklahoma and Utah are allowing the eight-year deferral election.
26 However, states such as Louisiana, Maryland, Massachusetts and Missouri did not release guidance until October 2018.
27 These states include Connecticut, Louisiana and Massachusetts.
28 States in this category include Colorado, Kansas and Mississippi.
29 For example, Alabama, Illinois, Indiana, Maryland and Pennsylvania follow this approach.
conformity to IRC Section 965 with a full DRD or income exclusion was adopted, or had already existed.\(^\text{30}\)

Somewhat easier to understand was the state approach to conformity with the TCJA provision concerning bonus depreciation. The TCJA provides 100% bonus depreciation for property placed in service after Sept. 27, 2017, and before Jan. 1, 2023.\(^\text{31}\) The bonus depreciation rate then phases down over the following five years. Because many states traditionally have decoupled from bonus depreciation, these states typically did not adopt the new provisions. However, some states, including Colorado, Kansas and Louisiana, did not enact legislation requiring the addback of bonus depreciation. Pennsylvania garnered considerable attention late last year when the Department of Revenue issued guidance disallowing all depreciation on property subject to 100% federal bonus depreciation.\(^\text{32}\) On June 28, 2018, Pennsylvania enacted legislation in direct response to this guidance that allows accelerated depreciation on this property, without a deduction for bonus depreciation.\(^\text{33}\)

States also needed to consider the numerous tax reform provisions applicable to tax years beginning on or after Dec. 31, 2017. For example, the TCJA amended IRC Sec. 179 to increase the expensing limit to $1 million for tax years beginning after 2017 and before 2023.\(^\text{34}\) A significant number of states have continued to decouple from this provision, but states including Florida,\(^\text{35}\) Illinois,\(^\text{36}\) New York\(^\text{37}\) and Pennsylvania\(^\text{38}\) follow the new expensing provisions.

Under IRC Sec. 163(j), the TCJA provides for a disallowance of a deduction for net interest expense in excess of 30% of the business’s adjusted taxable income for tax years beginning after Dec. 31, 2017, but

\(^{30}\) This category includes California, Georgia, Michigan, New York and Wisconsin.

\(^{31}\) IRC § 168(k).


\(^{33}\) Act 72 (S.B. 1056), Laws 2018. For a discussion of this legislation, see GT SALT Alert: Pennsylvania Enacts Legislation Addressing Depreciation.

\(^{34}\) IRC § 179.


\(^{36}\) 36 Ill. Comp. Stat. 5/102; 5/203.

\(^{37}\) N.Y. Tax Law § 208.9.

\(^{38}\) See Pennsylvania Tax Update No. 108, Pennsylvania Department of Revenue, Feb./March 2004, for historic conformity position.
the disallowed amount can be carried forward indefinitely. The majority of states currently conform to this provision. However, states including Connecticut and Georgia have enacted legislation to specifically decouple from IRC Section 163(j).

The TCJA provides that net operating losses (NOLs) arising in tax years beginning after Dec. 31, 2017, are limited to 80% of taxable income, but NOLs can be carried forward indefinitely. NOLs may not be carried back. There has been some level of conformity by states to the revised federal NOL provisions, but many states provide state-specific NOL attributes with limited ties to the federal NOL law. Some states including Georgia and Kentucky generally conform to the new federal NOL provisions. States such as Indiana, Missouri and Oregon conform to the 80% limitation, but do not conform to the indefinite carryforward provision.

For tax years beginning after Dec. 31, 2017, the TCJA subjects U.S. shareholders of CFCs to a tax on global intangible low-taxed income (GILTI) through IRC Section 951A. Specifically, the tax is imposed on foreign intangible income to the extent it exceeds a 10% rate of return on invested foreign assets. IRC Section 250 provides a deduction equal to 50% of the GILTI inclusion and a portion of foreign-derived intangible income (FDII). In addition, the TCJA imposes a base erosion anti-abuse tax (BEAT) that is a minimum tax on modified taxable income on certain large multinational companies.

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39 IRC § 163(j). Adjusted taxable income is defined as taxable income computed without interest expense, interest income, NOL deductions, and the 20 percent deduction for certain qualified business income under IRC § 199A. Note that the IRS recently has released proposed regulations for this provision.


41 Act 284 [H.B. 918], Laws 2018. For further information, see GT SALT Alert: Georgia Enacts Tax Reform Legislation.

42 IRC § 172. The new carryforward period applies to NOLs arising in tax years ending after December 31, 2017.

43 For example, Arizona, Illinois, Massachusetts, Michigan, New York and Pennsylvania have state-specific NOLs.

44 Act 284 [H.B. 918], Laws 2018. For further information, see GT SALT Alert: Georgia Enacts Tax Reform Legislation.

45 Ch. 207 [H.B. 487], Laws 2018. For further discussion, see GT SALT Alert: Kentucky Enacts Tax Reform Including Mandatory Unitary Combined Reporting, Single Sales Factor Apportionment and Remote Seller Nexus.

46 IND. CODE § 6-3-2-2.6.

47 MO. REV. STAT. § 143.1212 (4).

48 OR. REV. STAT. §§ 317.010(9); 317.476.

49 In general, GILTI is defined as the excess of a U.S. shareholder’s aggregated net “tested income” from CFCs over a routine return on certain qualified tangible assets.

50 FDII is broadly defined to include income received from the sale of property for foreign use or services rendered to persons outside the U.S.

51 To date, states have not taken any action to conform to the BEAT provisions.
States are taking different approaches concerning their treatment of GILTI and the deduction provided by IRC Section 250. Many of the states that have rolling IRC conformity have not expressly addressed the treatment of GILTI, but states such as Alabama and Connecticut have released administrative guidance on this topic. Some of the static conformity states that have enacted legislation advancing their IRC conformity date to include the TCJA have decoupled from the federal GILTI provisions.\(^52\) Maine has enacted an addition modification for the taxpayer’s GILTI deduction claimed under IRC Sec. 250(a)(3)(B).\(^53\) A subtraction is provided equal to 50% of the apportionable GILTI that the taxpayer included in federal gross income during the taxable year under IRC Section 951A, net of related expenses and other related deductions in computing federal taxable income.\(^54\) Massachusetts has enacted legislation providing that “dividend” includes amounts included in federal gross income under IRC Section 951A.\(^55\) Also, an addback is required for GILTI and FDII deductions allowed by IRC Sec. 250.\(^56\) Finally, New Jersey added a new statutory section providing a Corporation Business Tax (CBT) deduction equal to the federal deduction taken under IRC Sec. 250.\(^57\) More states are expected to consider legislation addressing GILTI during their 2019 legislative sessions.

## 5. Major tax reform enacted by several states

As discussed above, many states enacted legislation in response to federal tax reform and accomplished corresponding state tax reform. However, states such as New Jersey, Connecticut, Kentucky and Missouri enacted significant state-specific tax reform that went far beyond adopting or decoupling from federal tax reform provisions.

On July 1, 2018, New Jersey enacted legislation, A.B. 4202, overhauling the CBT.\(^58\) Most notably, the legislation imposed mandatory unitary combined reporting and market-based sourcing for sales factor purposes. The legislation also imposed a temporary surtax on corporations and modified New Jersey’s

\(^{52}\) For example, states such as Hawaii, North Carolina, South Carolina and Wisconsin have enacted legislation expressly decoupling from GILTI.

\(^{53}\) Ch. 474 (S.P. 612), Laws 2018.

\(^{54}\) Id.

\(^{55}\) Ch. 273 (H.B. 4930), Laws 2018.

\(^{56}\) Id.

\(^{57}\) Ch. 131 (A.B. 4495), Laws 2018, enacting N.J. REV. STAT. § 54:10A4.15. For further discussion, see GT SALT Alert: New Jersey Enacts Legislation Adopting Federal Foreign Income Deduction, Amending State Tax Reform Provisions. Note that in order to prevent a potential double deduction, the deduction only is allowed in computing entire net income to the extent the corresponding amounts of income have not been excluded or exempted under any CBT provision.

\(^{58}\) Ch. 48 (A.B. 4202), Laws 2018. For a discussion of this legislation, see GT SALT Alert: New Jersey Enacts Major Legislation Adopting Mandatory Combined Reporting, Market-Based Sourcing.
DRD and NOL deduction. On Oct. 4, 2018, New Jersey enacted follow-up legislation, A.B. 4495, to make extensive technical corrections and substantive amendments to A.B. 4202.\(^\text{59}\)

Under the legislation, New Jersey is adopting mandatory combined filing for combined groups that have common ownership, conduct a unitary business, and have at least one member corporation subject to the CBT.\(^\text{60}\) A combined group may make a binding election (for the current plus five succeeding tax years) to have the group file on a worldwide basis or on an affiliated group basis.\(^\text{61}\) Absent any such election, combined groups will file their returns on a water’s-edge basis. Also, market-based sourcing is adopted for sales of services.\(^\text{62}\) The combined reporting and market-based sourcing provisions enacted by A.B. 4202 originally were scheduled to apply to tax years beginning on or after Jan. 1, 2019.\(^\text{63}\) As amended by A.B. 4495, these provisions now apply to tax years ending on or after July 31, 2019.\(^\text{64}\)

The legislation imposes an additional “surtax” on corporations subject to the CBT for their next four tax years. \(^\text{65}\) Corporations with more than $1 million of allocated net income will pay a surtax of 2.5% for tax years beginning in 2018 or 2019, and a surtax of 1.5% for tax years beginning in 2020 or 2021.

For tax years beginning on or before Dec. 31, 2016, New Jersey allowed a 100% DRD for dividends paid by 80% or more owned subsidiaries.\(^\text{66}\) For subsequent tax years, the DRD is permanently reduced to 95% and covers both dividends paid and those “deemed paid.”\(^\text{67}\) For tax years beginning after 2016 and before 2019, deemed dividends are specially allocated by the lower of: (i) the three-year average of the taxpayer’s 2014-2016 allocation factors; or (ii) 3.5% of the deemed dividend.

The legislation significantly changed the computation and carryover of NOLs in New Jersey. The only NOL carryover deduction for losses incurred in tax years ending prior to July 31, 2019, is the prior net operating loss conversion carryover (PNOLCC) which recomputes NOLs from such earlier years on a post-allocation basis.\(^\text{68}\) Under existing law, for tax years beginning on or after Jan. 1, 2018, NOLs are


\(^{63}\) A.B. 4202, § 33.

\(^{64}\) A.B. 4495, § 9.


\(^{68}\) N.J. Rev. Stat. § 54:10A-4(k)(6), (u).
computed on a post-allocation basis. As amended, this provision applies to NOLs for tax years ending on or after July 31, 2019. For tax years ending on or after July 31, 2019, the legislation adds a new NOL deduction provision when there is a change in ownership.

Connecticut also enacted major tax reform legislation this year. For tax years beginning on or after Jan. 1, 2018, Connecticut has a new pass-through entity (PTE) tax that applies to partnerships, limited liability companies treated as partnerships and S corporations. The PTE tax is imposed at a rate of 6.99% and is generally calculated based on the affected business entity’s taxable income as determined for federal tax purposes under IRC Section 702(a) on both separately and non-separately stated items flowing to equity holders to the extent they are derived from or connected to sources within the state as adjusted for state modifications. Alternatively, an affected business entity may make an annual election to compute the PTE tax based on income associated with nonresident individuals and the portion of in-state residents’ income that is not taxed elsewhere. Each affected business entity’s individual shareholder, partner or member is allowed a Connecticut credit equal to a person’s direct and indirect pro rata share of the tax paid multiplied by 93.01%. Corporate PTE members of an affected business entity are permitted a similar credit, which is applied after all other credits are applied, but is not limited to 50.01% of the corporation business tax liability as are other business credits.

In April 2018, Kentucky enacted significant tax reform that included the adoption of mandatory unitary combined reporting, single sales factor apportionment and market-based sourcing. The legislation requires combined reporting for members of a unitary business group, effective for tax years beginning on or after Jan. 1, 2019. Groups may, however, elect to file a consolidated return with all members of the affiliated group. For tax years beginning on or after Jan. 1, 2018, Kentucky is using a single sales

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69 N.J. REV. STAT. § 54:10A-4(v), (w).
70 N.J. REV. STAT. § 54:10A-4(v)(5).
72 S.B. 11, § 1(c). Note that this section will be codified as CONN. GEN. STAT. § 12-699.
73 S.B. 11, § 1(k), (l).
74 S.B. 11, § 1(g)(1)(A).
75 S.B. 11, § 1(g)(2). The business credit limitation is provided by CONN. GEN. STAT. § 12-217zz.
76 Ch. 207 (H.B. 487), Laws 2018. For further discussion, see GT SALT Alert: Kentucky Enacts Tax Reform Including Mandatory Unitary Combined Reporting, Single Sales Factor Apportionment and Remote Seller Nexus.
78 KY. REV. STAT. ANN. § 141.201.
factor formula to determine apportionable income.\textsuperscript{79} Prior to the tax reform legislation, business income was apportioned to Kentucky using a three-factor formula consisting of a property, payroll and double-weighted sales factor.\textsuperscript{80} Also, sales are sourced to Kentucky if the taxpayer’s market for the sales is in the state for tax years beginning on or after Jan. 1, 2018.\textsuperscript{81} The statute includes provisions for determining whether a taxpayer’s market for sales is deemed to be in Kentucky. Previously, receipts from sales of other than tangible personal property were sourced based on costs of performance.\textsuperscript{82}

Missouri enacted major legislation to reduce the corporate income tax rate, adopt mandatory single sales factor apportionment and modify consolidated return requirements.\textsuperscript{83} For taxable years beginning in 2020 and thereafter, Missouri’s corporate income tax rate is reduced from 6.25% to 4%.\textsuperscript{84} Missouri lawmakers repealed the three-factor apportionment option previously available to taxpayers under the model terms of the Multistate Tax Compact pursuant to statute.\textsuperscript{85} For tax years ending before 2020, Missouri taxpayers may elect to use either a three-factor apportionment method, a business-transacted single-sales factor formula, or an elective single sales factor method.\textsuperscript{86} For tax years beginning in 2020 and thereafter, all taxpayers will be required to use the single sales factor method of apportionment.\textsuperscript{87} Furthermore, simplified sourcing rules apply to all taxpayers for tax years beginning in 2020 and thereafter.\textsuperscript{88} Effective for tax returns filed on or after Aug. 28, 2018, the legislation made several changes to consolidated return requirements for corporate taxpayers. First, it repealed the previously existing requirement that an affiliated group of corporations have 50% or more of its income derived from

\textsuperscript{79} KY. REV. STAT. ANN. § 141.120(9). The legislation replaces the historic “business income” terminology with “apportionable income.”

\textsuperscript{80} Former KY. REV. STAT. ANN. § 141.120(8).

\textsuperscript{81} KY. REV. STAT. ANN. § 141.120(11)(a).

\textsuperscript{82} Former KY. REV. STAT. ANN. § 141.120(8)(c).3.


\textsuperscript{84} MO. REV. STAT. § 143.071(2), (3).

\textsuperscript{85} MO. REV. STAT. § 32.200.

\textsuperscript{86} MO. REV. STAT. § 143.451.

\textsuperscript{87} MO. REV. STAT. § 143.455.

\textsuperscript{88} MO. REV. STAT. § 143.465.11, .12. Specifically, sales of tangible personal property are sourced based on where the purchaser ultimately receives the property, and sales other than sales of tangible personal property are sourced based on the taxpayer’s market. For tax years ending before 2020, taxpayers using the business-transacted single-sales factor apportionment formula are required to bifurcate Missouri sales between transactions wholly within and partially within the state. Taxpayers electing the optional single sales factor apportionment method use the purchaser’s destination point to source sales of tangible personal property and market-based sourcing rules to source all other sales. MO. REV. STAT. § 143.451.2(2), (3).
sources within the state in order to file a consolidated return. Also, affiliated groups filing a consolidated return are required to eliminate transactions between members of the group under the revised statute. Finally, intercompany transactions between corporations filing a Missouri consolidated return are not considered sales.

6. Texas and Michigan scrutinize deductions against their gross receipts tax bases

As part of an overall effort to stabilize revenue streams from businesses, several states, including Michigan and Texas, adopted gross receipts or other non-income taxes in the 2000s. Due to the nature of the taxes, which limit allowable deductions from the tax base to a few concentrated, material items, many taxpayer controversies have materialized which focus on the scope of these deductions from the tax base. During 2018, both Michigan and Texas narrowly interpreted these deductions, via judicial and regulation action respectively.

In Total Armored Car Service, Inc. v. Department of Treasury, the Michigan Court of Appeals clarified the parameters of a deduction allowed in computing the former Michigan Business Tax (MBT), which was effective from 2008 through 2011 and comprised of a business income tax and a modified gross receipts tax. Specifically, the Court ruled that the materials and supplies deduction contained in the MBT means tangible personal property purchased in the tax year that is an ordinary and necessary expense to be used in carrying on a trade or business. In the case at issue, the taxpayer had included intangible expenses in computing the deduction, and the Michigan Department of Treasury denied this treatment.

Focusing on the entire deduction, the Court noted that, based on plain language and when read as a whole, the statute implies that “materials and supplies” only refers to tangible personal property (which includes inventory, depreciable assets and other materials and supplies). Further, the Court cited the dictionary definition of “materials and supplies,” noting that the MBT Act does not define these terms. Specifically, “material” is defined as “relating to, derived from, or consisting of matter,” and “being of a physical or worldly nature.” “Supplies” are defined as “provisions” or “stores.” Finally, the Court stated that the “qualifying clause immediately following ‘materials and supplies’ – ‘including repair parts and fuel’ – indicates an intent to limit ‘materials and supplies’ to tangible property.” Accordingly, the Court

89 Mo. Rev. Stat. § 143.431.3(1). Notably, the Missouri Supreme Court previously held that the prior 50% Missouri-source income requirement was unconstitutional in General Motors Corp. v. Director of Revenue, 981 S.W.2d 561 (Mo. 1998).
90 Mo. Rev. Stat. § 143.431.3(1). Previously, taxpayers filing a Missouri consolidated return were not able to eliminate transactions between affiliates, even if such transactions were eliminated on the federal consolidated return.
91 Mo. Rev. Stat. § 143.451.2(6). Thus, they are excluded from both the apportionment calculation and the computation of Missouri taxable income.
determined that the type of property included in the definition of “materials and supplies” is limited to tangible items. Thus, the taxpayer’s intangible expenses at issue were properly excluded from the deduction by the Department. While the Department had consistently maintained a similar position, as evidenced by Departmental guidance, several taxpayers had challenged this interpretation.93

In Texas, the Comptroller of Public Accounts amended an administrative rule governing the Revised Texas Franchise Tax (RTFT) cost of goods sold (COGS) deduction.94 Specifically, the changes impact the determination of which taxable entity is the “owner of the goods” and entitled to the COGS deduction, as well as the costs includible in the COGS deduction for taxable entities furnishing labor or materials to certain real property projects.

Statutorily, to compute their RTFT base, taxpayers may generally include a deduction based on the maximum of four amounts: (i) 30% of total revenue; (ii) $1 million; (iii) COGS; or (iv) compensation. The COGS deduction is allowed only to taxpayers who acquire or produce “goods” and excludes costs to acquire or produce a service or intangible property. Further, a taxable entity may only include costs related to goods the entity owns. The determination of ownership is statutorily based upon all facts and circumstances, including the various benefits and burdens of ownership vested with the taxable entity.

The Comptroller’s 2018 amendments to its rule interpret the existing statute that authorizes and defines the COGS deduction. The most significant modification is the addition of a presumption that the legal title holder is the owner of the goods.95 A taxable entity may rebut the presumption by proving an ownership right superior to the legal title holder. Other notable changes include the adoption of new definitions for labor and materials includible in the COGS deduction when furnished to certain real property projects96 and modifications to rules concerning movie theaters, pipelines, taxable entities renting and leasing certain tangible personal property, and research and development costs for non-producers.97

Despite these clarifications, in the absence of statutory definitions for key terms, both Michigan and Texas are likely to experience ongoing controversies regarding these allowable deductions. Other pending cases focused on the same issue remain in various stages of litigation in Michigan. Notably, if

95 34 TEX. ADMIN. CODE § 3.588(c)(9)(A).
96 34 TEX. ADMIN. CODE § 3.588(c)(9)(B). Included projects relate to the construction, improvement, remodeling, repair, or industrial maintenance of real property.
97 34 TEX. ADMIN. CODE §§ 3.588(c)(8)-(11).
the Court of Appeals reaches a different conclusion in one of the other cases, Michigan court rules maintain that a prior published decision will have precedent over a subsequent decision. For Total Armored Car Service to lose its precedential treatment, it would have to be overturned by the Michigan Supreme Court or by a special panel of the Court of Appeals that rehears the case and comes to a different determination. With respect to the Texas COGS rule, many of the significant changes to the rule were made in reaction to court decisions interpreting the COGS deduction and several of the adopted rule provisions appear to be more restrictive than their statutory counterparts. Further, the Comptroller declined to conduct a public hearing or a roundtable discussion regarding the amendments. As such, the rule amendments could be indicative of an overall trend toward more stringent tax enforcement by the Comptroller’s office.

7. Continuing sales factor sourcing uncertainty

During the past decade, many states have changed their methodology for sourcing receipts from sales other than sales of tangible personal property. States have been replacing the traditional cost of performance sourcing methodology with market-based sourcing. In some states, however, there remains a level of uncertainty regarding the sourcing of service revenue. For example, Texas is widely considered to be a cost of performance state, but the Comptroller of Public Accounts has attempted to apply market-based sourcing in certain instances. In Sirius XM Radio Inc. v. Hegar, a Texas District Court rejected market-based sourcing and applied cost of performance sourcing. Although Wisconsin is a market-based sourcing state, the Wisconsin Department of Revenue was unsuccessful in sourcing software royalty income received from original equipment manufacturers (OEMs) to the location where the software is ultimately used, as reflected in Microsoft Corporation v. Wisconsin Department of Revenue.

In Sirius, a Texas District Court ruled that cost of performance sourcing rules applied to source subscription revenues received by a satellite radio company. For the relevant tax years, Sirius maintained its headquarters and produced, recorded, edited and transmitted its audio entertainment services almost exclusively outside Texas. Sirius filed RTFT returns and apportioned its subscription revenues based on the locations where its primary production facilities were located. The Comptroller audited Sirius’s returns and concluded that market-based sourcing should be applied and the subscription receipts reapportioned to Texas based on the locations where the satellite transmissions were received by subscribers.

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98 District Court, 261st District (Texas), No. D-1-GN-16-000739, Aug. 14, 2018. For further discussion of this decision, see GT SALT Alert: Texas District Court Applies Cost of Performance Sourcing Rules.

RTFT apportionment rules provide that “[r]eceipts from a service are apportioned to the location where the service is performed. If services are performed both inside and outside Texas, then such receipts are Texas receipts on the basis of the fair value of the services that are rendered in Texas.”\textsuperscript{100} Texas has historically applied an end product test in determining where a service is performed, focusing on “the specific, end-product act for which the customer contracts and pays to receive, not on non-receipt producing, albeit essential, support activities.”\textsuperscript{101}

With no detailed written analysis, the Court cited the end product test and noted that it was applicable to Sirius, as it was an origin-based method of sourcing. Since Sirius performed its satellite radio subscription service both within and outside Texas, its receipts were properly apportioned to Texas based on the fair value of the service performed in Texas. Further, the apportionment factors Sirius reported on its originally filed RTFT returns were consistent with the fair value and Sirius was entitled to a refund. The decision rejected the Comptroller’s effort to apply market-based sourcing principles to source revenues from services. Specifically, the decision contradicts a 2017 ruling,\textsuperscript{102} in which the Comptroller concluded that a taxpayer’s gross receipts from sales of payment risk and fraud prevention solutions were receipts from the sale of services and apportioned based on the location of the taxpayer’s customers. The Court’s decision calls into question whether services can be sourced under a market-based concept under the RTFT.

In Microsoft, a Wisconsin Circuit Court affirmed the Wisconsin Tax Appeal Commission’s decision that the Department could not assess taxes based on royalty income received by the taxpayer from licensing its software to out-of-state OEMs that ultimately sold computers containing the software to Wisconsin purchasers. A Wisconsin law in effect during the 2006-2009 tax years at issue sourced receipts to where the income-producing activity occurred.\textsuperscript{103} Under a different statute, gross receipts from the use of computer software are sourced to Wisconsin if the purchaser or licensee uses the software in the state.\textsuperscript{104} The Court held that the computer software sourcing statute did not apply because Microsoft received the royalties from OEMs that did not use the software in Wisconsin. The Court rejected the Department’s argument that it must “look-through” the OEM purchasers to the end-users of the software to properly source the royalty receipts. Because none of the income-producing activities occurred in Wisconsin, the royalty receipts were not sourced to the state. The Department has appealed this case to the Wisconsin Court of Appeals.

8. The rise of municipal-level taxes targeted towards special initiatives

\textsuperscript{100} \textsc{Tex. Tax Code Ann.} § 171.103(a)(2); \textsc{Tex. Admin. Code} § 3.591(a)(26).
\textsuperscript{103} Former \textsc{Wis. Stat.} § 71.25(9)(d).
\textsuperscript{104} \textsc{Wis. Stat.} § 71.25(9)(df).
In efforts to raise much-needed revenue dedicated to special initiatives, several municipalities attempted to raise taxes in some manner during 2018. These efforts are representative of an ongoing push to increase local resources to meet specific public needs and/or demands.

Homelessness initiatives, in particular, were a point of focus this year. The city of Seattle briefly enacted an employee hours tax for the privilege of engaging in business in the city in May 2018, only to repeal the tax several weeks later in response to the outcry of affected businesses. The measure was intended to raise revenue to address the city’s homelessness and affordable housing issues. San Francisco enacted a gross receipts tax with a similar goal via voter approval in November. Specifically, San Francisco’s Proposition C implements an increase in the business tax rates on gross receipts that will be directed to fund homelessness services. The measure requires the city to deposit all the revenue from the additional tax into a new special fund for the following purposes: (i) at least 50% to permanent housing through the Mayor’s Office of Housing and Community Development (MOHCD); (ii) at least 25% to mental health services for homeless individuals through the Department of Public Health; (iii) up to 15% to homelessness prevention through MOHCD or the Department of Homelessness and Supportive Housing (HSH); and (iv) up to 10% to short-term shelters through HSH. San Diego also considered, but then postponed, a ballot measure to increase property taxes in an effort to provide affordable housing intended to address homelessness. The reaction from the companies impacted by these types of new taxes could determine how widespread they will become.

Also, while no additional large cities adopted soda taxes as a means to counteract obesity, the Philadelphia Beverage Tax (PBT) Tax sustained challenge during 2018. Specifically, the Pennsylvania

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105 Ordinance 125578, § 1, enacting SEATTLE, WA., CODE § 5.37. See GT SALT Alert: Seattle Enacts, Then Quickly Repeals Employee Hours Tax.
106 Ordinance 125592, repealing Ordinance 125578. Seattle Mayor Jenny Durkan signed the ordinance on June 13, 2018.
107 City and County of San Francisco, Department of Elections, Nov. 6, 2018, Election Results – Summary (updated Nov. 20, 2018). See GT SALT Alert: Ballot Initiatives in 2018 Midterm Elections Address Income, Sales/Use, and Specialty Taxes. Approximately 61 percent of San Francisco voters approved Proposition C. In California, a special tax generally requires a two-thirds vote for approval. Due to the California Supreme Court’s decision in California Cannabis Coalition v. City of Upland, 401 P.3d 49 (Cal. 2017), it is unclear whether Proposition C requires a two-thirds vote. Proposition C is expected to face a legal challenge because it was not approved by two-thirds of the voters.
108 San Diego Proposition 2, sponsored by San Diego Housing Federation.
110 The Sterling Act provides certain taxing powers to Philadelphia and prevents the city from imposing a tax on any transaction that is also subject to state tax.
Supreme Court affirmed a Commonwealth Court’s ruling finding the PBT to be a valid tax, holding that it does not duplicate Pennsylvania’s state sales tax and is not preempted by the Sterling Act.

9. ‘Megadeals’ and taxability of incentives post-tax reform

In the pursuit of increased market share, many large businesses continue to expand operations through both organic growth and acquisitions of, or mergers with other companies. When businesses expand, they open new offices or plants, and often reconsider where their headquarters should be located. Through the use of lucrative state and local tax credits and incentives, states continually compete for businesses engaging in these activities. Two of the more noteworthy “megadeals” that occurred this year included Toyota and Mazda’s joint plant opening and the expansion of Amazon with its HQ2 project.

In early 2018, Toyota and Mazda announced a joint-venture auto plant to begin operating by 2021. The venture is estimated to employ approximately 4,000 people and build 300,000 vehicles per year, producing Toyota’s Corolla and a new small SUV to be introduced by Mazda.111 Further, the two companies announced their plan to work together on various advanced auto technologies, including electric vehicles, safety features and connected cars and associated products.112 When exploring locations for this joint venture, Toyota and Mazda narrowed the search to two southern states, North Carolina and Alabama.113 After negotiations, and perhaps as a partial nod to Toyota’s current operation of an engine factory in Huntsville, Alabama, the companies chose to build the plant in Alabama. The state offered up approximately $350 million in incentives, the majority of which consisted of the jobs credit, worth $90.6 million over a decade, and an investment credit, valued at $210 million over the same period.114 Additionally, the state offered reimbursement for eligible capital costs, state sales tax abatement, a non-educational property tax abatement and a promise that the state employment agency would build and operate a training center.115 The city of Huntsville also offered local incentives, bringing the total incentives package to approximately $700 million.116

The other megadeal that made headlines was the consummation of the high-profile location search conducted by Amazon’s HQ2 for its second headquarters intended to house at least 50,000 employees.

112 Id.
113 Id.
114 Id.
After a nationwide effort by states and cities to land the project, in January, 2018, Amazon narrowed the list of potential locations to 20. It is instructive to consider some of the incentives offered by the final candidates:

- Philadelphia – $5.7 billion\(^{117}\)
  - From the state: $4.6 billion in financial assistance over a 25-year period and $100 million to improve transportation around the proposed headquarters.
  - From the city of Philadelphia: $1.1 billion in tax increment financing.
- Chicago – $2 billion\(^{118}\)
  - From the state: $1.32 billion in EDGE tax credits over 17 years, $172.5 million in waivers for sales and utility taxes, and $450 million in transportation infrastructure investment.
  - From the city of Chicago and Cook County: $61.4 million in property tax discounts, reducing the typical 25% tax to 10% in the first three years, and to 20% by the fifth year.
- Newark, N.J. – $7 billion\(^{119}\)
  - From the state: $5 billion in tax incentives over a 10-year period (contingent on the company producing 50,000 jobs).
  - From the city of Newark: $1 billion property tax abatement and $1 billion in waived local wage taxes for Amazon workers over the following 20 years.

Amazon eventually made the decision to spread its HQ2 between New York (Long Island City) and northern Virginia (Arlington), with a third, smaller hub in Nashville.\(^{120}\) New York and Virginia, between the two jurisdictions, offered Amazon more than $2 billion in incentives, less than many of the other candidates.\(^{121}\) Specifically, New York made an offer of $1.525 billion in incentives and Virginia, $573 million, based upon Amazon’s promise to create 25,000 jobs in each location.\(^{122}\) Tennessee offered up to

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\(^{121}\) Id.

\(^{122}\) Id.
$102 million for the creation of 5,000 jobs. All three of these agreements included the condition that the positions created by Amazon must have an average wage of $150,000 per year.

The fierce competition from the more than 200 jurisdictions that made proposals for Amazon’s HQ2 proved that for Amazon, location truly mattered the most. Despite individual locations offering up to four times the amounts offered by New York and Virginia, Amazon still chose to locate in well-established cities along the east coast with easy access to airports.

It will be interesting to see whether a TCJA provision amending IRC Section 118 will serve to dampen incentive megadeals in the future. Amended IRC Section 118, which expands gross income for federal income tax purposes to include many previously untaxed state and local tax incentives, could lessen the impact of economic incentives offered to companies, or force states and localities to offer more in consideration of an immediate tax offset. The expansion of gross income for federal income tax purposes occurs by providing that “any contribution by any governmental entity or civic group (other than a contribution made by a shareholder as such)” to a corporation is no longer excluded from its gross income. The amendment generally applies to contributions made after Dec. 22, 2017, but does not apply to contributions that were made pursuant to a master development plan that was approved prior to this date. As a result, many payments made as a result of incentive agreements offered by governmental units or civic groups to a business are now potentially subject to federal and state income tax, reducing the overall benefit of a given incentive to the business. Recognizing this issue, a number of states currently do not conform to IRC Section 118 conformity.

10. Illinois Supreme Court decides hospital property tax case

In 2018, the Illinois Supreme Court finally resolved longstanding uncertainty surrounding its property tax exemption for non-profit hospitals. At issue was a 2012 amendment to the Illinois property tax creating a new category of charitable exemption tailored to hospitals, generally referenced as Section 15-86. In Oswald v. Hamer, the Court unanimously held that the Illinois property tax exemption for hospitals and

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123 Id.
124 Id.
125 The TCJA retains the general rule in IRC § 118 that, in the case of a corporation, gross income does not include any contribution to its capital. IRC § 118(a). It is possible that taxpayers may decide to challenge the new statute on the basis that the new legislation violates constitutional principles. In Edwards v. Cuba Railroad Co., 268 U.S. 628 (1925), for example, the U.S. Supreme Court held that contributions to capital are not income under the Sixteenth Amendment of the U.S. Constitution.
126 IRC § 118(b).
127 H.R. 1, § 13312(b).
128 States that have decoupled include: Arizona, Arkansas, California, Georgia, Indiana, Iowa, Maine, Minnesota, New Hampshire, Ohio, South Carolina, Texas, and Virginia.
their affiliates contained in Illinois Property Tax Code Section 15-86 is constitutional.\textsuperscript{130} Previously, two districts of the Illinois Appellate Court had issued conflicting opinions concerning the constitutionality of the hospital property tax exemption statute on its face. Specifically, in Carle Foundation v. Cunningham Township,\textsuperscript{131} the Illinois Appellate Court, Fourth District, held that Section 15-86 is facially unconstitutional and unenforceable, while the First District of the Illinois Appellate Court issued a decision in Oswald v. Hame\textsuperscript{132} upholding its constitutionality.

Section 15-86 was enacted in response to a 2010 Illinois Supreme Court decision which held that a religiously-affiliated Illinois hospital was not entitled to an exemption from property tax because it failed to establish that it was a charitable institution and that its property was used exclusively for charitable purposes.\textsuperscript{133} The property tax exemption added by Section 15-86 is offered to hospitals that provide benefits to low-income individuals and other services that relieve the burden of the government in an amount that exceeds the value of its property tax exemption. The value of this hospital property tax exemption is explicitly based on the amount of property taxes that would be due if the property were not exempt.

In its opinion, the Supreme Court carefully considered the statutory language of Section 15-86 and held that the statute satisfies the constitutional “exclusive charitable use” requirement. The decision hinged on one word in Section 15-86: “shall.” Specifically, the statute provides:

\begin{quote}
A hospital applicant satisfies the conditions for an exemption under this Section with respect to the subject property, and shall be issued a charitable exemption for that property, if the value of services or activities listed in subsection (e) for the hospital year equals or exceeds the relevant hospital entity’s estimated property tax liability, as determined under subsection (g), for the year for which exemption is sought.\textsuperscript{134}
\end{quote}

At issue was whether the use of the word “shall” was unconstitutional because it mandates the issuance of a property exemption without considering the constitutional requirement that property subject to exemption must be “used exclusively for . . . charitable purposes.”\textsuperscript{135} The Supreme Court reasoned that, when read as a whole, the statute permits a hospital to qualify for an exemption only once it meets the constitutional test of exclusive charitable use. To avoid any possible constitutional violation, the

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\textsuperscript{130} Illinois Supreme Court, No. 122203, Sept. 20, 2018. See GT SALT Alert: Illinois Supreme Court Upholds Hospital Property Tax Exemption.
\textsuperscript{131} 455 N.E.3d 1173 (Ill. App. Ct. 2016).
\textsuperscript{132} 73 N.E.3d 536 (Ill. App. Ct. 2016).
\textsuperscript{133} Provena Covenant Medical Ctr. v. Department of Revenue, 925 N.E.2d 1131 (Ill. 2010).
\textsuperscript{134} 35 Ill. Comp. Stat. 200/15-86(c) [emphasis added].
\textsuperscript{135} Ill. Const. art. IX, § 6.
\end{flushleft}
Supreme Court determined that the word “shall” in the statute must be construed to be permissive and not mandatory. Notably, the Supreme Court emphasized that its decision was limited to a facial challenge of the hospital property tax exemption statute. Thus, there is always a possibility that an “as applied” future constitutional challenge could be raised in Illinois.

With this decision, it appears that the issues besetting the Illinois hospital property tax exemption have been resolved. As all states provide statutory property tax exemption in some manner for nonprofit hospitals, and most of the statutes were drafted in an earlier era when their care primarily focused on indigent patients, this decision could prove instructive. Particularly as nonprofit hospitals have evolved to provide services to patients with varying abilities to pay, dated statutes have contributed to confusion regarding taxpayer eligibility for these exemptions. This decision could provide valuable insight for both medical providers and state legislatures seeking to avoid confusion and controversy.

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