

2014 Chapman Law Review
Symposium

BUSINESS TAX REFORM:
EMERGING ISSUES
IN THE TAXATION OF
U.S. ENTITIES

Friday, March 14, 2014

HOW FEDERAL BUSINESS TAX REFORM AFFECTS STATE AND LOCAL TAX

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FEDERAL BUSINESS TAX REFORM AND CALIFORNIA

- ◉ Federal business tax reform and its potential impact on state and local taxation
 - Direct impact via conformity
 - Direct or indirect impact on state and local governments and their revenues and tax administration systems
 - Direct impact due to the potential imposition of a new federal tax
 - New federal limitations or prohibitions on state taxation
- ◉ Areas where federal guidance may be beneficial

HOW WOULD CHANGES TO THE FEDERAL CORPORATE TAX SYSTEM IMPACT CALIFORNIA?

○ State Corporate Tax System

- State governments traditionally rely on the federal income tax system (definitions, forms, reporting requirements, federal regulations and other administrative pronouncements) in administering their own corporate tax laws.
- In California, corporations doing business in the state or with California income are generally subject to either the Corporation Franchise Tax (if incorporated or organized in the state, qualified or registered to do business in the state, or doing business in the state) or the Corporation Income Tax (if entity does not meet the standard for the franchise tax but derives income from the state).
- In the 2014-15 FY, California's Corporation Tax is projected to bring in approximately \$8.6 billion (5.8% of total state revenues).

STATE CONFORMITY TO FEDERAL INCOME TAX LAWS

⦿ Tax Conformity: Approaches

- “Rolling” conformity (automatic conformity to the latest version of the Internal Revenue Code (IRC)).
- “Fixed” or “static” conformity (where the IRC is followed as of a certain, fixed date).
- “Selective” conformity (adoption of only certain provisions or certain provisions as of certain dates). California is a “selective” conformity state.

⦿ Advantages of State Tax Conformity

- Uniformity and simplicity promotes ease of compliance and the efficient administration of taxes.
- Reduced compliance costs for both tax agencies and taxpayers.
- Increased predictability when taxpayers and state administrative personnel can rely on federal administrative guidance.
- Minimization of tax avoidance.

CAN CALIFORNIA CONFORM?

◉ Challenges of State Tax Conformity

- Loss of legislative decision-making authority over state tax policy.
- Delays in legislative action when a state needs to conform to new legislation affirmatively (political gridlock).
- Loss of control over state revenues.
- The acceptance of federal administrative guidance as persuasive authority in interpreting California statutes may lead to unanticipated results.
- CA may not follow the federal lead if the change will have a negative financial impact. Conversely, CA may not be able to broaden its CT base due to a potential increase in the tax burden for some taxpayers (Proposition 26).

HOW WOULD CHANGES TO THE FEDERAL CORPORATE TAX SYSTEM IMPACT STATES?

- Federal Corporate Tax Reform Proposals: Potential State Impact.
 - In the last few years, Congress evaluated various options for corporate tax reform. The House Ways and Means Committee and the Senate Finance Committee had a series of hearings on corporate tax reform, and much discussion was centered on broadening the base (by eliminating various tax incentives) and reducing statutory rates. On February 26, 2014, the House Ways and Means Committee Chair Dave Camp introduced the Tax Reform Act of 2014.
 - Federal Corporate Tax Rate Reduction (25%)
 - Quasi-Territorial Tax System
 - Repatriation Holiday (one-time 8.75% tax imposed on previously untaxed earning and profits of foreign subsidiaries)
 - Participation exemption (95% of dividends distributed by foreign corporations to US shareholders (10% or more) would be excluded)
 - Taxation of foreign intangible income at a 15% rate
 - CFC treatment for US parent foreign branches
 - Interest expense limitation
 - Broadening or Narrowing the Tax Base (possible elimination of many tax expenditures and preferences)

HOW WOULD CHANGES TO THE FEDERAL CORPORATE TAX SYSTEM IMPACT CALIFORNIA?

- Federal Corporate Tax Reform and California (overview)
 - Direct impact on federal tax liabilities of California residents.
 - Indirect impact on state tax liabilities for corporations, either due to state corporate tax linkages to the federal tax system (via conformity) or to changes in taxpayer behavior induced by federal tax reform.
 - Direct and indirect impact on the State and local governments. California may have to augment the FTB's budget if the federal CT system is fundamentally reformed and the state does not conform.

HOW WOULD CHANGES TO THE FEDERAL CORPORATE TAX SYSTEM IMPACT CALIFORNIA?

- Federal Corporate Tax Reform Proposals: Impact on California.
 - *Repeal of the Federal CT* will most likely lead to a repeal, or a substantial revision, of California's corporate tax system. The state will lose all the benefits of federal enforcement efforts, which may lead to increased tax penalties or augmentation of FTB's enforcement budget.
 - *If a Flat Tax or Some Type of a Federal Business Tax* is imposed, California may repeal its CT system and conform to a new federal tax regime (provided the new tax is broad-based, imposed at a low rate and easily implementable).
 - *A Simple Reduction of the Federal CT Rate* will not have much impact on California (other than a potential push to lower the state tax rate). However, a lower tax rate reduces the incentive for taxpayers to engage in tax avoidance. California may benefit because fewer taxpayers will find it cost-effective to engage in creative tax planning.
 - Most likely, the federal rate reduction will be implemented in conjunction with the corporate tax base broadening, which will impact CA.

HOW WOULD CHANGES TO THE FEDERAL CORPORATE TAX SYSTEM IMPACT CALIFORNIA?

- *Broadening or Narrowing the Federal Tax Base* (repeal or extension of tax expenditures)
 - The Feds may choose to eliminate, revise or extend certain tax incentives that would *directly* impact the state of California.
 - Exclusion of Interest on State and Local Bonds (federally-subsidized debt, removal of which will significantly raise the borrowing costs for state and local governments).
 - Deduction for State and Local Taxes.
 - Special tax incentives, such as the new markets tax credit, low-income housing credit, empowerment zone employment credit and others that indirectly benefit state and local governments.
 - The Feds may choose to eliminate, revise or extend certain tax incentives that would *indirectly* impact California through its corporate taxpayers.
 - The research and development credit, accelerated depreciation, adoption of a “patent box” idea, etc.
 - The charitable contribution deduction, employer-provided health insurance, amortization of advertising expenses, etc.

HOW WOULD CHANGES TO THE FEDERAL CORPORATE TAX SYSTEM IMPACT STATES?

- International tax reform: Territorial System of Taxation.
 - US federal tax system is a blend of residence-based and territorial concepts. It taxes U.S. residents on their worldwide income and it taxes non-residents on certain U.S.-source income (ECI, FDAP income or gains).
 - Foreign earnings of controlled foreign corporations (CFCs) are deferred but for Subpart F income. Deferral of active income of U.S. subsidiaries operating abroad is the third largest corporate tax expenditure.
 - Foreign dividends remitted out of previously untaxed income are taxable at full US tax rate.
- What is “Territorial” Tax System?
 - Only U.S.-source income is subject to tax.
 - No deferral of tax on foreign earnings.
 - Complicated “mechanics” to make it work.
- California’s corporate tax system is a source-based system, which generally taxes worldwide income, as apportioned to the state. However, California allows corporations to elect to file on a water’s-edge basis.

HOW WOULD CHANGES TO THE FEDERAL CORPORATE TAX SYSTEM IMPACT CALIFORNIA?

- Proposed domestic dividend-received deduction (DRD) of 95% allowed for foreign-source portion of dividends received from CFCs.
 - Proposal will most likely increase the amount of foreign earnings repatriated to the US due to a lower federal tax cost to companies.
 - Most states allow a state DRD for foreign dividends but percentages vary (AZ 100%, OR 80%, ME 50%).
 - State revenues will generally increase in those states with static conformity due to increase in dividends and will generally decrease in states with rolling conformity due to federal 95% DRD.
 - *The 95% DRD Exclusion* will not affect California's law, since California does not conform to the federal DRD provisions. However, California *may* see an increase in revenues because of the potential increase in the amount of earnings brought back to the US and a lower 75% DRD in the case of a water's-edge election (Section 24111 of the R&T Code) than the proposed federal one of 95%. It may even act as an incentive for companies to move back to worldwide combined reporting, instead of a water's-edge election, because intercompany dividends are generally eliminated under the worldwide method.

HOW WOULD CHANGES TO THE FEDERAL CORPORATE TAX SYSTEM IMPACT CALIFORNIA?

- Proposed “repatriation holiday” would allow a U.S. company to pay a one-time federal tax of 8.75% on previously undistributed and untaxed earnings and profits of CFCs.
 - Classification of this income by the federal government: dividend or non-dividend income?
 - Federal election to pay net liability over 8 years, but states may not follow the federal election.
 - If classified as dividend income, California *may* see an increase in revenues because of the potential increase in the amount of earnings brought back to the US and a lower 75% DRD in the case of a water’s-edge election (Section 24111 of the R&T Code) than the proposed federal one of 95%. No impact for California worldwide filers.
 - If not classified as dividend income, then depends on the type of income and whether or not it is apportionable business income.

HOW WOULD CHANGES TO THE FEDERAL CORPORATE TAX SYSTEM IMPACT CALIFORNIA?

- ⦿ A *pure* territorial approach - an exclusion of foreign source income.
 - Would be detrimental to California's administration of its CT laws. Federal Form 1120 is a starting point for the CA corporate tax return. If foreign-source income is excluded from that return, CA will have no information readily available to it to identify if the taxpayer should have included that income in its CA return. Thus, it would present certain compliance and enforcement issues for the Franchise Tax Board.

- ⦿ Proposed expansion of the definition of Subpart F income by creating *additional categories of Subpart F income*.
 - Would directly impact California because of the state's automatic conformity to the definition of Subpart F income (Sec. 25116, Cal. Revenue and Taxation Code).

- ⦿ Proposed limitations on *Interest Expense* Deductions.
 - Existing CA law has its own rules governing interest expense deductions, so the proposed limitations will not have much of an impact on California CT system. (Reg. 24344(c)).

FEDERAL TAX REFORM: DIRECT AND INDIRECT IMPACT ON CALIFORNIA

○ Potential New Federal Taxes:

■ Value-Added Tax (VAT)

- Currently 135 Countries have a VAT (US is only OECD Country that doesn't impose a VAT)
- European Union VAT Rates of 15% - 27% (Avg. 20%)
- Competition for consumption tax base
- Would states conform?
- If the federal income tax is repealed, what does it mean for the states?

■ Federal Sales Tax

- Federal-state coordination
- Encroachment on states' authority to tax?

FEDERAL TAX REFORM: DIRECT AND INDIRECT IMPACT ON CALIFORNIA

- ◉ “Not-so-Dormant” Commerce Clause: restraints on state tax incentives: is reform or guidance needed?
 - *Cutler v. FTB* (2012) (208 Cal.App.4th 1247) (holding that the “active business” requirements of the CA qualified small business stock statute were discriminatory, and thus, unconstitutional)
 - *Cuno v. Daimler Chrysler* (2004) 386 F.3d 738 (holding that Ohio’s investment tax credit violates the U.S. Commerce Clause, overruled by *Daimler Chrysler Corporation v. Cuno* (2006) 547 U.S. 332 (holding the plaintiffs have no standing to challenge the credit and vacating the judgment of the Sixth Circuit in part, remanding the cases for dismissal of plaintiff’s challenge to the franchise tax credit)
- ◉ Exercising Federal authority to establish uniform rules among the states (e.g., economic nexus, apportionment formula, taxation of digital goods and services, etc.)
- ◉ Authorizing states to require out-of-state vendors to collect use tax (Marketplace Fairness Act)
- ◉ Prohibiting the imposition of certain state and local taxes (the moratorium on Internet access taxes, new local and state taxes on wireless services, occupancy taxes on booking fees of online travel companies, etc.)

BUSINESS ACTIVITY TAX SIMPLIFICATION ACT (“BATSA”)

- ⦿ Business activity tax simplification act (BATSA) was introduced on August 2, 2013 (H.R. 2992)
 - ⦿ Expands Public Law 86-272 protection to all business activity taxes (not just net income taxes) and all sellers (not just sellers of tangible personal property).
 - ⦿ Codifies a physical presence nexus standard and outlaws the economic nexus.
 - ⦿ Requires that apportionment provisions follow the *Joyce* standard, effective for tax periods beginning on or after January 1, 2014 (in the context of a consolidated/combined return, the state is precluded from including in the numerator of the sales factor sales made by a member of a unitary group where the member itself does not independently have nexus in the state).

MARKETPLACE FAIRNESS ACT (MFA)

- ⦿ Creates a federal standard for state remote seller use tax collection authority: U.S. Senate passed S. 743 on 5/6/2013 (69 to 27); and referred to House on 5/20/2013

- ⦿ S. 743 provides two alternatives for states to affirmatively choose to exercise MFA authority:
 - (1) SSUTA member states (so long as SSUTA contains minimum simplification requirements and the state *publishes* its intent to collect tax with 180 days notice), or
 - (2) SSUTA non-member states that *enact legislation* and meet the minimum simplification requirements (but cannot commence prior to the first day of the calendar quarter that is at least 6 months after the enacted legislation and implementation of simplification requirements).

- ⦿ For non-member states, enacting legislation must:
 - Specify the taxable items that are excluded from the Act
 - Provide for a single administrative agency (return, audit, etc.)
 - Provide a uniform tax base
 - Provide free compliance software

- ⦿ Small seller exception
 - The remote seller must have total remote sales **in the U.S.** exceeding \$1,000,000. For purposes of determining total remote sales, sales of affiliated entities are aggregated.

- ⦿ Sourcing
 - Member states must comply with the agreement's destination-based sourcing provisions, while non-member states must source according to delivery destination.

MOBILE WORKFORCE STATE INCOME TAX SIMPLIFICATION ACT OF 2013

- Protects nonresident employees (and employers) from a state's income tax if a person works in the state 30 days or less.
- 112th Congress: HR 1864, by Reps. Howard Coble (R-NC) and Hank Johnson (D-GA), passed the House on May 15, 2012 on Consent Calendar / Voice Vote.
- HR 1129; introduced on March 13, 2013 by Rep. Howard Coble (R-NC) and Rep. Hank Johnson (D-GA), identical bill to that which passed the full U.S. House in May 2012 on voice vote. In House Judiciary Committee.
- S. 1645; introduced on November 5, 2013 by Sens. Sherrod Brown (D-OH) and John Thune (R-SD), and 6 additional original cosponsors (Menendez (D-NJ); Nelson (D-FL); Johnson (D-SD); Portman (R-OH); Collins (R-ME); Blunt (R-MO).) In Senate Finance Committee.

WIRELESS TAX FAIRNESS ACT

- The Wireless Tax Fairness Act (H.R. 2309) would place a five-year moratorium on any new state or local discriminatory taxes or fees on wireless services.
- A “discriminatory tax” is defined as one that is imposed on mobile services that generally is not imposed, or is imposed at a lower rate, on other services involving tangible personal property or persons engaged in businesses other than mobile services.
- A companion Senate bill (S. 1235) was introduced by Senator Wyden on June 26, 2013.

INTERNET TAX FREEDOM ACT (ITFA) (H.R. 434, H.R. 3086, S. 31, AND S. 1431)

- ❑ Would make permanent the moratorium on state and local governments taxing internet access or imposing discriminatory taxes on electronic commerce.
- ❑ The original legislation will expire November 1, 2014.
- ❑ A recent Illinois Supreme Court decision finding that the current federal moratorium preempted the state's "click thru" nexus law. (*Performance Marketing Association, Inc. v. Hamer* (2013) 998 N.E. 2d 54).

DIGITAL GOODS AND SERVICES TAX FAIRNESS ACT (S. 1364)

- Would prevent discriminatory and duplicative taxes on digital goods and services.
- Congressional Budget Office estimated that a similar 2011 version of this legislation would result in \$3 billion of foregone revenue to state and local governments in the first year of enactment.
- Would define a digital transaction and clarify the jurisdiction that has the right to tax it.
- Organizations representing state and local governments have opposed the legislation.

HOW FEDERAL BUSINESS TAX REFORM MAY AFFECT STATE AND LOCAL TAXES

Questions?