

**TAXPAYERS' FEDERATION OF ILLINOIS
ANNUAL ILLINOIS STATE & LOCAL TAX CONFERENCE**



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**Income Tax Jeopardy!
A Potpourri of Hot Topics**



Speakers

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Income Tax Jeopardy!

Net Operating Losses	Pass-Through Entities	Gross Receipts Taxes	Potpourri	Audit Issues
<u>100</u>	<u>100</u>	<u>100</u>	<u>100</u>	<u>100</u>
<u>200</u>	<u>200</u>	<u>200</u>	<u>200</u>	<u>200</u>
<u>300</u>	<u>300</u>	<u>300</u>	<u>300</u>	<u>300</u>
<u>400</u>	<u>400</u>	<u>400</u>	<u>400</u>	<u>400</u>
<u>500</u>	<u>500</u>	<u>500</u>	<u>500</u>	<u>500</u>



Topic 1 – Net Operating Losses

Timing

- State rules for carryforward periods vary
- Some states require that an NOL be carried back before it may be carried forward
- States may also specify the order in which NOLs from more than one loss year can be deducted
- Many states generally assert the ability to adjust an NOL carryforward from an otherwise closed year
- But see *R.O.P. Aviation, Inc. v. Div. of Taxation*, Dkt. No. 001323-2018 (N.J. Tax Ct. May 27, 2021) (Division of Taxation could not eliminate a taxpayer's net operating losses generated during years beyond the statute of limitations)

Limitations on Amounts

- Federal limitation (i.e., 80% of taxable income)
- A percentage of taxable net income (e.g., Pennsylvania NOL deduction is limited to 40% of taxable income, applicable for taxable years beginning after December 31, 2018)
- A fixed-dollar amount (e.g., Delaware NOL deduction is limited to \$30,000 per year)
- Suspensions (California and Illinois)
- Recent litigation: *Alcatel-Lucent USA Inc. v. Commonwealth (Pennsylvania)*

Nexus

- A state may require that a corporation have nexus in the loss year for purposes of deducting NOL carried forward from subsequent year
- Even if a state's statutes does not explicitly require nexus in the loss year, consider whether a state may use its discretionary authority (applying the tax benefit rule) to achieve the same result
- But see *Sunbelt Rentals, Inc. v. Comptroller of Maryland*, No. 18-IN-00-0241 (Md. Tax Ct. Sept. 9, 2019)(no statutory authority for nexus rule)
- And *Int'l Auto. Components Grp. N. Am., Inc. v. Dep't of Treasury* (taxpayer transitioning from the Michigan Business Tax (MBT) to the corporate income tax (CIT) could not utilize losses calculated under the MBT on it first CIT return)

Allocation and Apportionment

- Pre-apportionment?
- Or post-apportionment?
- See New Hampshire 2022 SB 435 (applicable to tax years ending on or after December 31, 2022) (eliminating double apportionment of NOLs)
- NOLs derived from non-apportionable activities outside of a state might not be deductible against apportionable income

Combined Reporting

- Sharing of losses
- SRLY limitations
- Recent litigation: *Ally Fin. v. State of Ala. Dep't of Revenue*, No. 20-659-LP, (Ala. Tax Trib. May 13, 2024)(parent company could not use its losses to offset the income of a bank that it owned through an intermediate holding company for the purposes of the state's Financial Institution Excise Tax)



Topic 2 – Pass-Through Entities

MTC Partnership Project

- Prior MTC projects related to partnerships, including a project on state reporting of federal partnership audit adjustments, resulting from federal rules established by the Bipartisan Budget Act of 2015
- Steps taken during the project so far have included creating an outline of state tax common issues for partnerships and creating draft model rules for the Sourcing of Income from Investment Partnerships and the Sourcing of Guaranteed Payments for Services
- The project team's current focus is on Sourcing in Tiered Partnership Structures, including how a partner would determine its "share" of the partnership's apportionment factors

Investment Partnerships

- State rules variations include defining the qualifying partnership as not engaged in a trade or business if only trading for its own account, providing for specific treatment of the partnership and its partners if qualifying tests are met, and defining specified income as not resulting from trade or business activities
- Contrast with impact of holding investments in operating partnerships, even if partner allocates the partnership income based on holding a limited, non-unitary interest
- Recent changes were made to the Illinois Investment Partnership rules, including the adoption of nonresident withholding rules

Tax Basis of Partners

- Inside versus outside tax basis concepts
- Highlighted by CA Franchise Tax Board Notice 2022-01, FTB Notice 2023-01, and Instructions for the TY 2023 Form 565 (partnership) and Form 568 (LLC) returns
- Impact of state modifications and IRC conformity adjustments
- IL Department of Revenue guidance in IT 15-0005-GIL: “There is no provision in IITA Section 203 that authorizes the subtraction modification described in your letter. Similarly, the IITA does not provide for an asset basis that is different from the asset basis that applies for federal income tax purposes.”

Sales of Pass-Through Interests

- *VAS Holdings & Investments LLC v. MA Commissioner of Revenue*, Massachusetts Supreme Judicial Court (May 16, 2022) and “investee apportionment”
- Seller’s unitary or non-unitary relationship with the pass-through sold
- Seller’s connection to a trade/business, and its potential impact on the sourcing of the sale of a pass-through business entity
- IRC 751: *Indu Rawat* federal tax decisions, and CA Franchise Tax Board Legal Ruling 2022-02 contrasted with IL Department of Revenue guidance in IT 11-0010-GIL

Elective Pass-Through Entity Taxes

- Scheduled expiration of “SALT Cap” after tax year 2025
- Connecticut changes to elective pass-through entity tax (PTET) for tax year 2024
- Refinements to a state’s PTET will sometimes pass (e.g., NC various changes for tax year 2023) and other times will not (e.g., CA estimated payment deadline “cliff” changes)
- State PTET “automatic repeal” versus requirement of state legislative action to repeal the state’s PTET



Topic 3 – Gross Receipts Taxes

Nexus

- Economic Nexus/Factor Presence Standard
 - OH commercial activity tax (CAT): tax years 2023 and prior factor presence sales threshold is \$150,000 or more of OH sales or 25% of total sales sourced to OH.
 - Sales threshold increases to \$3,000,000 for tax year 2024 and \$6,000,000 for tax years 2025 and beyond
 - OR corporate activity (CAT): sales of at least \$750,000; or 25% of the taxpayer's total sales in Oregon
 - TX gross margins tax: \$500,000 or more of annual Texas receipts
 - WA business and occupation tax (B&O tax): tax years 2020 and beyond \$100,000 or more of WA sales; OR 25% of sales sourced to WA.
- No protections afforded under PL 86-272

Sourcing of Receipts

- Ultimate destination sourcing for tangible goods
 - Temporary storage of inventory
- Service revenue generally attributable to where the benefit is actually received
- Impact of *Chevron*: recent appeals to the Ohio Supreme Court over the state's gross receipts tax as taxpayers challenge states' attempts to over-source receipts and capture them in their gross receipts tax base.

Taxable Base & Exclusions

- Ohio: as of January 1, 2024, the first \$3,000,000 of taxable gross receipts are not subject to CAT. Each additional taxable gross receipt above \$3,000,000 is multiplied by the .0026 CAT rate. As of January 1, 2025, the \$3,000,000 exclusion increases to \$6,000,000.
 - As of January 1, 2024 the minimum OH CAT tax has been eliminated
- Oregon SB 1542 (in committee upon adjournment):
 - Increase exclusion for Commercial Activity Tax (CAT) from \$1 million to \$5 million.
 - Estimated that this would exempt more than 70 percent of the businesses currently subject to the tax.
- Washington: Antio, LLC v. Wash. State Dep't of Revenue, No. 57312-1-II (Wash. Ct. App. Apr. 11, 2023) Investment funds that invested in debt instruments were not eligible for Washington's business and occupation (B&O) tax deduction for amounts derived from investments because 100% of its income was investment income.
 - Deduction limited to investments that are “incidental to the main purposes of the taxpayer’s business”
 - Court's interpretation of “incidental” was 5% of total gross receipts

Lesser-Known Jurisdictions

- Delaware: (.0945% - .7468%) imposed on total receipts of a business received from goods sold and services rendered in the State.
- Nevada: (.051% - .331%) commerce tax on gross revenue in excess of \$4 million. Credit up to 50% of tax related to Nevada Modified Business Tax.
 - Favors companies with in-state payroll
- Tennessee: (.02% - .1875%) separate state and municipal taxes imposed only gross sales of tangible property and services delivered to a location in TN.
- Municipalities in: California, Pennsylvania, Virginia and West Virginia
 - Issues related to nexus standards and teleworking employees

Other News

- Oregon: Measure 118 the existing minimum tax regime would be replaced with a 3 percent gross receipts tax for large businesses, imposed on all Oregon revenue, regardless of level of profitability (or lack thereof). A business with \$100 million in gross sales into Oregon would pay \$2.75 million in taxes (3 percent on the amount above \$25 million)—even if it suffered losses.



Topic 4 – Potpourri

Conformity considerations

- States fall into the categories of Fixed, Rolling or Selective
- Fixed and selective conformity have two important subsets:
 - No prior rule - reversal of particular provision
 - IRC 162(r) – limitation on FDIC premiums (financial institutions)
 - IRC 250(a)(1)(A) – foreign derived intangible income (FDII) deduction
 - Prior treatment – reversion to particular version of the IRC
 - IRC 174 – capitalization and amortization vs. immediate expensing
 - IRC 163(j) – limitation on deductible business interest expense
 - IRC 172 – carryback of NOLs and carryforward limitations on use

Alternative apportionment

- States provide that if the apportionment rules do not fairly represent business activity in the state, taxpayer may petition (or tax director require) alternative apportionment
- Generally, does distortion exist and can you prove it?
 - Producing a different tax result may not be enough
 - Factor representation important, but not deciding factor
- May be better off asserting new sources of information produce result in line with statutory rule?

R&D Credits

- Generally many states allow R&D credits base on qualifying research expenditures that occur within the state (piggyback)
- Sampling techniques present challenges
- Texas
 - Current Litigation
 - Settlement Group
- Massachusetts – financial institutions allowed to claim R&D credit (see *State Street Corporation*, Case No. C344139, Mass App. Tax Bd. 8/15/2024)

General corp or financial institution?

- *Appeal of Schwab*
 - FTB's position – in 2012-2013, Schwab must apportion its business income using a 3-factor formula because its trade or business derived more than 50% of its gross business receipts from dealings in money or moneyed capital in substantial competition with the business of national banks.
 - Schwab dealing in Type I and II debt securities = dealing in money or moneyed capital and in substantial competition with the business of national banks
 - Schwab filed refund claims for 2018-2019 claiming the 3-factor formula

What's reasonable re: penalties?

- Showings of reasonable cause usually require ordinary business care and prudence being exercised
- Good history or first time abatement not followed in all states
- Other strategies to consider:
 - Annualizing income using impact of receipt of certain income, timing of elections, credits earned, etc.
 - Showing abatement by IRS for same matter in same year
 - Extended length of review/audit has led to greater interest approximating a penalty



Topic 5 – State Audit Trends

Wisconsin Audits

- State taxes deductible
- Wisconsin dividends received subtraction, preferred stock, and “entire taxable year”
- Apportionment
- Taxpayer opportunity for increasing or establishing NOL limited to four years after the original due date (or 180 days if federal change)

Partnership Audits

- IRS announcements
- Terminology includes Administrative Adjustment Request (AAR) and Imputed Underpayment (IU)
- MTC Model statute and related state legislation
- Tax year variation for state income change versus reporting of federal tax impact
- Timing for reporting

Transfer Pricing Audits

- Separate company reporting states
- States are devoting more resources to develop transfer pricing capabilities
- But there audit adjustments often seem to exceed reasonable adjustment
- The DOR's starting adjustment often makes it difficult to negotiate
- Is the taxpayer a retailer or manufacturer?
- Does the state follow IRC 482?
- Should a unitary/combined tax liability serve as a rough guide?

New York Audits

- Retroactive applicability of finalized corporate regulations
 - Limited availability of separate accounting election
 - Business and investment capital losses
 - Inclusion of occasional sales and sourcing the sale of goodwill
 - Sale of a partnership interest
 - New York-Source sales for service providers

Other Audit IDR Trends

- 50-state workpapers rather than in-state determinations
- Full federal returns with associated schedules rather than proformas
- Request(s) for information beyond tax workpapers (e.g., contracts)
 - When is it appropriate to provide?
- Short response times to extensive IDRs
- MTC audits present challenges in managing multiple audits

Thank you!

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