First quarter 2016
State income tax developments

State income and franchise tax

Quarterly update

To our readers:

The following provides a summary of the significant legislative, administrative and judicial actions that affected state and local income/franchise taxes during the third quarter of 2015.

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Key developments

Louisiana enacts corporate income and franchise tax law changes

During the 2016 First Extraordinary Session, the Legislature approved and the Governor signed a number of bills that implemented business and individual tax increases to help close the state's budget gap. The following is a brief summary of these franchise and corporate income tax law changes.

Act 12 (enacted 10 March 2016) effectively and prospectively reverses the Louisiana appeals court ruling in *UTELCOM,*[1] by expanding the incidents of taxation to include the owning or using of any part or all of certain entities' capital, plant, or other property in Louisiana whether owned "directly or indirectly" through a partnership, joint venture, or any other business organization of which the domestic or foreign corporation is a related party. Additionally, Act 12 expands the types of entities subject to franchise tax to include all entities that are taxed as corporations for federal income tax purposes, but excludes from the tax limited liability companies (LLCs) that are qualified and eligible to make elections to be taxed as S corporations. Act 12 also provides a holding company deduction to relieve the pyramiding effects due to the expansion of taxable entities. These changes are effective for all taxable periods beginning on or after 1 January 2017.

Act 6 (enacted 9 March 2016) clarifies a 2015 law change related to net operating losses (NOLs) to make clear that the NOL deduction is the lesser of 72% of the NOL carryforward for the year or 72% of Louisiana net income. Stated differently, a taxpayer with current year income will be subject to tax on at least 28% of current year income, regardless of the amount of total NOL carryforwards. Additionally, Act 6 removes the 2018 sunset date, making the reduction permanent. This change applies to Louisiana corporate income tax returns filed on or after 1 July 2015.

Effective 1 January 2017, Act 24 (enacted 10 March 2016) changes the ordering for the use of NOLs to require that the most recent or newest loss be used first (e.g., last in, first out).

Act 16 (enacted 10 March 2016), effective for tax years beginning on or after 1 January 2016, requires that corporations add-back otherwise deductible intangible and interest expenses and costs and management fees directly or indirectly paid, accrued or incurred to, or in connection with one or more direct or indirect transactions, with one or more related members. Add–back is not required if the payment is made: (1) to a related party that is taxable in another state or is taxable in a treaty country; (2) in an arm's-length transaction that has substantial business purpose and economic substance and the payments are not made with a principal purpose to avoid Louisiana taxes; or (3) to a related party that pays an unrelated party for the same expenses (i.e., acts as a conduit).

Act 1 (enacted 4 March 2016) reversed the 72% limitation imposed during the 2015 session by making dividend income received from Louisiana banking corporations, national banking corporations doing business in Louisiana and capital stock associations whose stock is subject to ad valorem taxation exempt from corporate income tax. This change applies to exclusions claimed on any return filed for any taxable year beginning on or after 1 January 2015. Other dividends are still subject to the 72% limitation.

Ernst & Young LLP's insights

With many of the income tax changes becoming effective retroactively to years beginning on or after 1 January 2016 or 1 January 2017, Louisiana taxpayers will not have much time to respond to and prepare for these tax law changes prior to their effective dates.

These income tax changes make Louisiana's tax law even more unique, creating additional disconnects from basic state tax norms and generating traps for the unwary. For example, Louisiana's new NOL ordering and priority rules are now completely decoupled from the federal provisions, do not follow the rules that either the federal government or any other state use and will require taxpayers to track their NOLs in a way that is simply counterintuitive. As such, taxpayers must carefully consider their Louisiana tax posture, as generally accepted workpapers or calculation methods that may have worked in the past or still work for other states will be irrelevant for Louisiana tax purposes.

Bills that were heavily considered in this First Extraordinary Session, but failed to pass, including proposals to adopt a single sales factor apportionment formula and market–based sourcing for sales of services and non-tangible personal property, will likely be considered in future sessions.

Tennessee Supreme Court upholds tax commissioner's use of alternative apportionment

The Tennessee Supreme Court (Court) recently issued its much anticipated ruling in *Vodafone,*[2] upholding the imposition by the Tennessee Commissioner of Revenue (Commissioner) of a variance requiring a multistate mobile telecommunications company to use an alternative apportionment method to source its sales receipts for services to Tennessee customers in order to more accurately reflect its business activity in the state. The Court further held the Commissioner's variance, which uses the primary-place-of-use (PPU) (effectively, a market-based sourcing method) instead of the statutory costs of performance method (COP), is not an abuse of discretion as it is within the range of acceptable alternatives available to the Commissioner.

The Court explained that the threshold inquiry in reviewing the Commissioner's decision to impose a variance is: (1) whether the statutory apportionment formula fairly represents the extent of the taxpayer's business activity in Tennessee; and (2) if it does not, whether the Commissioner's alternate formula in the variance is reasonable.

The taxpayer argued that application of the statutory COP method fairly represents its business activity within Tennessee because "that is the mathematical result from application of the formula the legislature chose." The Court, however, rejected this argument, finding this reasoning to be circular, and further stating that the variance statute "presupposes" that there will be instances in which "an arithmetically correct tax computation utilizing the statutory apportionment formula will not fairly represent the extent of the taxpayer's business activity in Tennessee." In this instance, if the taxpayer were allowed to apply the standard COP sourcing method to exclude service receipts from its Tennessee apportionment formula, the resulting sales factor would decrease from $1.3 billion in receipts from telecommunication services for Tennessee customers to approximately $150 million in such receipts, thus excluding 89% of its total Tennessee sales receipts from taxation.

Next, the Court addressed whether the Commissioner's alternate apportionment formula – the PPU method used by Vodafone on its original return – is reasonable. The PPU method treats payments from Tennessee customers/residents as Tennessee receipts if the customer/resident has a Tennessee billing address. The Commissioner noted that this method not only is straightforward and conceptually satisfying, but is also administrable because the Tennessee Department of Revenue could verify through audit the state to which receipts from Vodafone's cellphone services should be attributable. The Court agreed with the Commissioner that the PPU method imposed in the variance fairly represented Vodafone's business activity in Tennessee.

The Court also considered whether the Commissioner's alternate formula was consistent with the goal of the Uniform Division of Income for Tax Purposes Act (UDITPA) to not tax more than 100% of a taxpayer's receipts. As urged by the Commissioner, if the variance was not imposed and the statutory COP method applied, the taxpayer's Tennessee receipts would go untaxed, as "nowhere income." The Court found that the Commissioner's alternative method "appears to present no danger of double taxation, and it comports with the overarching UDITPA goals." Accordingly, the Court found that the statutory requirement that the alternative formula be reasonable had been satisfied.

The Court also considered whether the variance regulation, which states that the variance statute permits a departure from the statutory apportionment method only in limited and specific cases, where unusual fact situations produce incongruous results and that such situations "ordinarily will be unique and nonrecurring," limits the Commissioner's authority to impose a variance. The taxpayer argued that the Commissioner's variance in this case did not fall within these limits as its business model is not "unusual." Thus, the variance is not imposed in a "limited and specific" case, but in essence is imposed on the entire telecommunications industry. The Commissioner, on the other hand, asserted that the phrase "unusual fact situation" does not mean "peculiar to a specific taxpayer" or "rare," but rather means a situation in which application of the standard apportionment formula does not reflect the extent of the taxpayer's economic activity in the state, or, alternatively, that it may arise where, as in this case, the application of the standard apportionment is not administrable.

The Court agreed with the Commissioner that the subject variance is in fact applied in a "limited and specific case," and found the taxpayer's argument that the Commissioner will impose similar variances on the entire telecommunications industry, thereby effectuating industry-wide change in tax policy, is without any basis, noting that there was no evidence in the record of other similar variances.

Lastly, the Court considered whether the Commissioner's alternative method was within the range of acceptable alternatives. The Court determined that the Commissioner did not abuse his discretion in imposing the variance because the alternative formula was within the range of acceptable alternatives available to the Commissioner.

It's worth mentioning the dissenting opinion in this case. While Justice Bivins agreed with the majority that the Commissioner demonstrated that application of the statutory apportionment formula does not fairly represent the extent of the taxpayer's business activity in Tennessee, he disagreed with the majority on the issue of the Commissioner's compliance with his own variance regulation. Justice Bivins found the Commissioner's variance letter made no attempt to demonstrate his compliance with the variance regulation and found the Commissioner's approach "incorrectly places the burden of proof upon the taxpayer."

Ernst & Young LLP's insights

Although the decision by the Court is binding only in Tennessee, many states have variance or alternative apportionment statutes that mirror those of Tennessee. Moreover, this ruling shows a great deal of deference by the state's highest court to the determinations of the state's executive taxing authority and it bears striking similarities to the Mississippi Supreme Court's ruling in *Equifax,*[3] which ultimately resulted in a change of Mississippi law to clarify that the party propounding an alternative method of apportionment has the burden of proof in all such cases as well as the adoption by the Multistate Tax Commission of changes to the model alternative apportionment rule in UDITPA. Additionally, since the Court agreed with the Commissioner, taxpayers should be wary that even if they follow the state's statutorily prescribed method, this decision's application of the abuse of discretion standard likely makes it easier for the Commissioner to impose a variance.

Further, the Court upheld the justification that Vodafone presented a fact scenario that was "specific," "nonrecurring," and "unique," which may allow the Commissioner to require a variance with a lower burden of proof in other scenarios. In his letter imposing the variance on Vodafone, the Commissioner concluded that the COP method was not straightforward but rather complex, unreliable and difficult to verify. In contrast, the Commissioner asserted that the PPU method was straightforward and easy to determine. Even if it is true that use of the PPU method may ease an administrative burden, the Court seems to have applied a standard to which the Commissioner is held to issue a variance that does not necessarily more accurately reflect a taxpayer's business in Tennessee. As a result, the decision permits the Commissioner to enact a policy decision that controverts that which has been established by the legislature.

Colorado district court excludes holding company with no property or payroll from group's combined return, finds DOR not required to follow check-the-box designation

In *Agilent Technologies Inc.*,[4] a Colorado District Court (court) held that the Colorado Department of Revenue (CO DOR) erred in requiring a holding company with no property or payroll of its own to be included in an affiliate corporation's Colorado combined return because the holding company does not meet the definition of an "includable C corporation" under C.R.S. Section 39-22-303(12)(c). The court also held that the CO DOR, for Colorado income tax purposes, is not required to treat the holding company and its foreign subsidiaries as a single C corporation merely because they elected to be treated as disregarded entities for federal income tax purposes.

In January 2016, the CO DOR issued Notice Regarding Revenue Regulation 39-22-303.12(c), to advise taxpayers not to rely on Regulation 39-22-303.12(c), which generally provides that corporations that have no property or payroll cannot have 20% or more of property or payroll located in the US and, therefore, cannot be included in a Colorado combined report, except as it applies to foreign sales corporations (FSC) until further notice. The CO DOR explained that the regulation was intended to address the treatment of FSCs under C.R.S. Section 39-22-303(12)(c), and that it disagrees with some taxpayers' interpretations that the exclusion also applies to domestic holding companies with no foreign operations. The CO DOR indicated that it will not take further action on the regulation until a final ruling is issued by the court.

Ernst & Young LLP's insights

It is likely the CO DOR will appeal this decision, and there is also said to be another similar case currently before the court. As it may take years for this issue to make its way through the judicial process, taxpayers filing a Colorado combined report with holding company subsidiaries with no payroll or property of their own should consider their procedural options (e.g., filing amended returns to exclude such corporations from their Colorado combined reporting groups).

The court's ruling that federal entity classifications do not apply when testing the status of an 80/20 company was surprising, and could have implications beyond the facts of this case. While the case specifically dealt with 80-20 company testing in the context of disregarded foreign entities, the court's rationale could extend to all determinations made with respect to Colorado's combined reporting rules. For example, when considering whether corporations meet the three of six unity tests, the court's rationale suggests that testing should be applied without consideration of federal entity classification rules (e.g., tests applied between and among corporations and disregarded entities as single entities). In yet another example, the court's rationale could be read to suggest that, when a corporation forms or acquires a disregarded domestic single member LLC, that LLC would be separately removed from the Colorado combined return under the "two-year rule."

Other noteworthy developments

Legislative

Delaware: HB 235 (enacted 27 January 2016) phases in a single sales factor apportionment formula by 2020, but allows certain taxpayers to use either a single sales factor or an equally weighted three-factor apportionment formula. The current equally weighted three-factor apportionment formula will be phased into a single sales factor apportionment formula as follows:

- For taxable periods beginning after 31 December 2016 and before 1 January 2018 – a property, a payroll and a double-weighted sales factor and a denominator of four
- For taxable periods beginning after 31 December 2017 and before 1 January 2019 – a property, a payroll and a triple-weighted sales factor and a denominator of five
- For taxable periods beginning after 31 December 2018 and before 1 January 2020 – a property, a payroll and a sextuple-weighted sales factor and a denominator of eight
- For taxable periods beginning after 31 December 2019 and thereafter, a single sales factor formula

A foreign corporation doing business in Delaware cannot include non-US payroll and property in the denominator of the payroll and property factors, and the new phased-in formula does not apply to an asset management corporation, a telecommunications corporation or a worldwide headquarters corporation. Lastly, for taxable years beginning after 31 December 2016, a telecommunications corporation and a worldwide headquarters corporation can annually elect to use either a single sales factor or an equally weighted three-factor apportionment formula.

Georgia: Legislation (HB 742) enacted 23 February 2016, updates Georgia's date of conformity to the Internal Revenue Code (IRC) as amended and in effect on or before 1 January 2016, effective for taxable years beginning on or after 1 January, 2015. The state continues to decouple from bonus depreciation, the IRC Section 199 production deduction and various other federal income tax law provisions.

Idaho: HB 425 (enacted 9 February 2016) updates Idaho's date of conformity to the IRC to 1 January 2016, effective retroactively to 1 January 2016.

Indiana: Provisions of HB 1290 (enacted 24 March 2016) update the state's date of conformity to the IRC as amended and in effect on 1 January 2016. This change is retroactively effective to 1 January 2016.

Iowa: Legislation (HF 2433) enacted 21 March 2016 updates Iowa's conformity date to the IRC to 1 January 2016 and decouples from the 2015 bonus depreciation provisions under IRC Section 168(k), effective for purposes of computing state net income for tax years ending on or after 1 January 2015 but before 1 January 2016.

Maine: Effective for taxable years beginning on or after 1 January 2015, LD 1583 (enacted 10 March 2016), updates Maine's date of conformity to the IRC to 31 December 2015. The state also decouples from the bonus depreciation provisions under IRC Section 168(k); however, taxpayers claiming bonus depreciation for property placed in service in Maine are allowed a credit as follows: (1) the credit for corporations equals 9% of the amount of the net increase in the depreciation deduction reported as an addition to income for the taxable year and (2) the credit for individuals is 8% of the amount of the net increase in the depreciation deduction reported as an addition to income for the taxable year (for 2016 and thereafter, decreased to 7%). The credit does not apply to certain, excluded property, it cannot reduce the tax otherwise due to less than zero and any unused portion of the credit may be carried forward for up to 20 years. The credit must be fully recaptured to the extent claimed by the taxpayer if the property forming the basis for the credit is not used in Maine for the entire 12-month period following the date it is placed into service in the state.

Oregon: HB 4025 (enacted 14 March 2016) updates the state's IRC conformity date to 31 December 2015, applicable to transactions or activities occurring on or after 1 January 2016.

South Dakota: SB 53 (enacted 1 March 2016) modifies the bank franchise tax by: (1) removing "interest and dividends from obligations of the US government and its agencies that the state is prohibited from taxing" from the list of items to be subtracted from taxable income; (2) amending carryback and carryforward deduction provisions to remove "capital losses"; and (3) amending the payroll factor to provide that "compensation" does not include any payment to an independent contractor or any other person not classified as an employee. These changes apply to returns related to tax years ending in 2015 and thereafter and filed after 31 December 2015.

On 12 February 2016, for purposes of the income tax imposed on financial corporations, South Dakota enacted legislation (HB 1049) updating its date of conformity with the IRC to the IRC as amended and in effect on 1 January 2016.

Utah: Effective for taxable years beginning on or after 1 January 2016, HB 61 (enacted 28 March 2016) modifies the state's apportionment provisions for purposes of the corporate franchise and income taxes. Under the revised law, a taxpayer (except for a sales factor weighted taxpayer and an optional sales factor weighted taxpayer), can elect to use either an equally weighted three factor (property, payroll and sales) apportionment formula or a double-weighted sales factor (property, payroll and twice the sales) apportionment formula. A sales factor weighted taxpayer must use a single sales factor apportionment formula. An optional sales factor weighted taxpayer may use any of these formulae.

HB 190 (enacted 29 March 2016) modifies adjustments that certain manufacturers that pay an income tax to a foreign country have to make to adjusted gross income, applicable to taxable years beginning on or after 1 January 2017.

SB 16 (enacted 18 March 2016) repeals a provision that prohibits a person from carrying forward a tax credit if the State Tax Commission is required to remove it from a tax return. The changes apply retroactively to taxable years beginning on or after 1 January 2016.

Virginia: Legislation (HB 402) enacted 5 February 2016, moves Virginia's date of conformity to the IRC to 31 December 2015. Virginia continues to decouple from bonus depreciation provisions.

HB 95 (enacted 14 March 2016) excludes any voting power or value of the beneficial interests or shares in a real estate investment trust (REIT) that is held in a segregated asset account of a life insurance corporation when determining whether a REIT is a captive REIT subject to Virginia income tax. This change is effective for taxable years beginning on and after 1 January 2016.

West Virginia: HB 4148 (enact 25 February 2016) updates the state's conformity to the IRC and adopts the federal law in effect after 31 December 2014 but before 1 January 2016.

Wisconsin: Legislation (SB 503) enacted 1 March 2016, amends the factors used to determine whether a transaction has economic substance for Wisconsin income and franchise tax purposes. Under the revised provisions, which apply to taxable years beginning on and after 1 January 2016, a transaction has economic substance only if the transaction is treated as having economic substance for federal income tax purposes under IRC Section 7701(o), except that the tax effect is determined using federal, state, local and foreign taxes. Under former law, a transaction was deemed to have economic substance if the taxpayer showed that the transaction changed its economic position in a meaningful way, apart from federal, state, local and foreign tax effects and the taxpayer had a substantial nontax purpose for entering into the transaction and the transaction is a reasonable means of accomplishing this purpose.

Judicial

Michigan: In reversing a lower court ruling, the Michigan Court of Appeals (MI COA) held that a group of three entities – two corporations and a limited partnership – were not a "unitary business group" as defined in Mich. Code Laws Section 208.1117(6) because no one member of the group owns, through an intermediary or otherwise, more than 50% of any other entity. In reaching this conclusion, the Court held that the Michigan Department of Treasury in using the federal income tax law's definition of "constructive" ownership when defining Michigan's "indirectly" ownership requirement improperly broadened its interpretation of "unitary business group" beyond the scope intended by the Legislature. The Michigan Business Tax Act (MBTA) did not define indirect ownership or control, but provided that if a term was not defined by the MBTA it shall have the same meaning as when used in comparable context in federal income tax laws. The MI COA found that there is not a directly comparable federal income tax provision and, therefore, the lower court should have resorted to normal rules of statutory construction to determine the meaning of the undefined terms. After reviewing various definitions of "indirect" and "indirect possession," the MI COA determined that "indirect ownership" means "ownership through an intermediary, not ownership by operation of legal fiction... ."[5]

New Jersey: A foreign multistate bank (bank) must include in the numerator of its New Jersey receipts factor interest income, origination fee income and gross proceeds from sales attributed to mortgage loans to New Jersey borrowers because such income constitutes other business income earned within New Jersey for purposes of the corporation business tax. The bank, however, is not required to include mortgage service fee income or income from mortgage servicing rights in the sales factor as neither is subject to the Corporate Business Tax.[6]

Oregon: The Oregon Tax Court held that a title insurance company's gains from the sale of its stock in a workers' compensation administrator and income attributable to a holding company are allocable nonbusiness income.[7]

South Carolina: The South Carolina Supreme Court ruled that a multistate energy corporation is not allowed to include the principal recovered from the sale of short-term securities in the determination of its sales factor for formulary apportionment purposes because such inclusion "leads to absurd results by distorting the sales factor within the formula, and by defeating the legislative intent of the apportionment statutes."[8]

Texas: A geoseismic company is entitled to use the cost of goods sold (COGS) deduction to determine its tax liability under the revised franchise "margin" tax, because the company furnished labor and materials to projects for the construction, improvement, remodeling or repair of oil and gas wells within the meaning of the COGS deduction. In reaching this conclusion, a Texas Court of Appeals rejected the argument of the Texas Comptroller of Public Accounts that the company provides only services to companies engaged in the exploration and production of oil and gas, none of its costs were associated with furnishing labor to a project and as a matter of law the company was not entitled to take a COGS deduction at all. [9]

Virginia: A circuit court ruled against a multistate retailer and found that it is required to add-back royalties paid to an out-of-state related entity (Illinois entity) because these payments do not qualify for the "subject to tax" safe harbor exception to Virginia's intercompany add-back provisions. The circuit court held that in order to meet the exception, under the plain language of the add-back statute, the intangible expense paid to a related member must be subject to tax in another state, and tax must actually be imposed.[10]

A circuit court held that a multinational corporation, with a Virginia headquarters, was not entitled to use an alternative apportionment method to source its income to Virginia because it failed to prove that its proposed formula more accurately assigned its income to the state.[11]

Administrative

Alabama: Adopted Reg. 810-9-1-.05 amends Alabama's rules related to apportionment and allocation of net income of financial institutions to bring the provision into conformity with the Multistate Tax Commission's model statute. The amended rules make several changes to the receipts factor provisions, including provisions related to: (1) receipts from interest, fee and penalties imposed in connection with loans secured by real property as well as loans not secured by real property; (2) receipts from fees, interest and penalties charged to card holders; (3) card issuer's reimbursement fees; and (4) receipts from merchant discount, ATM fees, services, financial institution's investment/trading assets and activity, and all other receipts. The rules also amend the denominator of the property factor. Other changes include new or amended definitions of card issuer's reimbursement fee, credit card, debit card and merchant discount. The amended regulation became final on 28 March 2016 and is effective for operating years beginning on or after 1 January 2017.

California: In Notice 2016–01 (issued 23 February 2016) the California Franchise Tax Board (FTB) advised taxpayers and their representatives of its intended course of action following the California Supreme Court's ruling in *Gillette*[12] regarding the use of the Multistate Tax Compact apportionment election (Compact election). The FTB said that given the taxpayer's intent to appeal the ruling in *Gillette* to the US Supreme Court (USSC), it will take no action on refund claims that have been made to avoid the bar of refunds by the statute of limitations. The FTB will take action on these claims once the case has been resolved either by a denial of certiorari by the USSC or final state court action after a decision by the USSC. The FTB also said that it will seek to defer administrative appeals pending before the State Board of Equalization until all litigation has concluded. In regard to audits where the Compact election is an issue, the FTB indicated that it will proceed with the audit in the normal course of business. If the statute of limitations barring additional proposed assessments will expire before the conclusion of the litigation, the FTB will request a waiver from the taxpayer to extend the statute of limitations. If the taxpayer agrees to execute a waiver, the case will be held until the litigation concludes, but if the taxpayer declines to execute the waiver, the FTB will issue the proposed assessment.

In its Chief Counsel Rulings 2016–01 and 2016–02 (issued 17 February 2016), the FTB advised a regulated investment company (RIC) organized as a Massachusetts Business Trust, and a RIC organized as a Delaware Business Trust that each are not a "corporation" for California franchise tax purposes and, therefore, are not subject to California's minimum franchise tax. Although a business trust is considered a "corporation" for California corporation income tax purposes, it is not a "corporation" for franchise tax purposes because the definition of "corporation" under the franchise tax law was not expanded to include business trusts as it was under the corporate franchise tax.

In its Chief Counsel Ruling 2015–02 (issued 1 February 2016), the FTB explained the application of market-based sourcing rules for non-marketing services. Under California law, sales from services are in California to the extent the purchaser of the service receives the benefit of the service in California. The FTB's Chief Counsel ruling advised that for purposes of assigning sales of non-marketing services under these provisions, the taxpayer must assign the sales of its services to California to the extent its customers (and not its customer's customers) receive the benefit of the service in California. In so holding, the FTB's Chief Counsel noted that because the provisions do not specify how to determine where the benefit of the service is received for a non-marketing service where both the taxpayer's customer and the taxpayer's customer's customers receive a benefit from use of the service in the taxpayer's customer's business operations, it applied comparable guidance for non-marketing intangibles.

The FTB in Technical Advice Memorandum 2016-01 (issued 12 January 2016) determined that the payment of the revised Texas franchise tax (i.e., Margin Tax) is not eligible for California's other state tax credit. Under California law, a credit is allowed for "net income taxes" paid to another state. The FTB determined that the Margin Tax "is not a 'net income tax' under California law because it is a tax on, or measured by, gross receipts." The FTB indicated that it will issue a more detailed legal ruling on credits and deductions for taxes paid to other states sometime before the third quarter of this year.

Connecticut: In Special Notice 2016(1) (issued 2 March 2016) the Connecticut Department of Revenue Services provides comprehensive guidance on the new combined reporting provisions, which are effective for tax years beginning on or after 1 January 2016. The special notice "describes the mechanics of identifying the groups of companies that must file a combined unitary tax return and the calculation of the group's Corporation Business Tax liability." Topics addressed include: determination of the combined group, determination of the combined group's net income, apportionment of a combined group's net income, application of NOLs, application of tax against apportioned net income, capital base tax, application of credits, net deferred tax liability (DTL) deduction, tax havens, maximum tax calculations/nexus combined base tax and miscellaneous provisions. The notice includes examples on charitable contribution limitations, capital gains/losses, assignment of non-taxable members' receipts, apportionment by taxable members, elimination of pass-through entity receipts, NOLs, capital base tax, proration of capital base tax, comparison of net income and capital bases, credit ordering, calculation of net DTL deduction and attribution of maximum tax.

Illinois: Adopted amendments to alternative apportionment Regulation Section 100.3380 add guidance on hedging transactions and IRC Section 988 transactions related to foreign currency gain or loss. These changes apply only to the determination of the sales factor under Section 304(a)(3) of the Illinois Income Tax Act and, therefore, do not apply to insurance companies, financial organizations, federally regulated exchanges and persons providing transportation services. There is, however, a possible exception for a financial organization that has receipts from hedging or IRC Section 988 transactions that are not covered by one of the eight specific categories addressed in the financial organization apportionment statute and regulation. These amendments took effect 5 January 2016, and apply to tax years beginning on or after the effective date of the rulemaking.

Massachusetts: Two new procedures are now available to resolve existing Massachusetts state tax exposures – the 2016 tax amnesty program and the new voluntary disclosure program (VDP) for uncertain tax positions. The 2016 amnesty program begins on 1 April 2016 and ends on 31 May 2016. During this time, taxpayers can file delinquent returns or file amended returns for tax years ending prior to 31 December 2015 and for the prior two tax years. If tax and interest is paid for those years, the Massachusetts Department of Revenue (MA DOR) will not require returns or assess additional tax for any other prior years. Thus, taxpayers receive the benefit of a three year look-back. Further, the MA DOR will waive penalties and interest on penalties for the three-year filing period. The MA DOR states that it will apply unlimited look-back and impose penalties to the fullest extent with regard to taxpayers that are eligible for amnesty and do not participate.

The new VDP allows business taxpayers to seek settlement of amounts that they have reserved in their books and records for uncertain Massachusetts tax positions. If the taxpayer is accepted into, and completes, the VDP, the MA DOR will waive all penalties relating to the underpayment of tax, whether the case is actually settled. If settlement is not reached, the MA DOR will impose the full amount of tax related to the uncertain tax position. This settlement procedure is available for Massachusetts uncertain tax positions relating to corporate excise (including the financial institution excise and insurance premiums excise) and other taxes administered by the MA DOR. In order to be considered for the VDP, the amount of tax relating to the uncertain tax position generally must be $100,000 or more, not including interest and penalties.

New York: A convenience store chain was not allowed to reduce its entire net income by amounts it paid to its captive insurer (captive). In reaching this conclusion, an administrative law judge of the New York Division of Tax Appeals reasoned that payments from a parent to a wholly owned captive do not qualify as deductible insurance premiums for federal income tax purposes because the arrangement lacks risk shifting and risk distribution.[13]

In TSB–M–15(4.1)C, (5.1)I (issued 7 January 2016) the New York Department of Taxation and Finance (NY DOTF) provided supplemental information regarding investment capital identification requirements for Article 9-A taxpayers by granting additional investment capital identification periods for certain non-dealers. The additional investment identification periods apply to specified circumstances involving non-dealer corporations and non-dealer partnerships occurring on and after 1 October 2015. The additional periods do not apply to corporations and partnerships that are dealers under IRC Section 1236 (dealers in securities). New York City will follow these rules (see Finance Memorandum 16-3, issued 26 February 2016).

Pennsylvania: Effective for taxable years beginning after 31 December 2014, the Pennsylvania Department of Revenue (PA DOR) states that under newly enacted law taxpayers will be required to add-back intangible and interest expenses or costs paid, accrued or incurred directly or indirectly in connection with one or more transactions with an affiliated entity, unless one of the exceptions is met. Information Notice Corporation Taxes 2016-1 (issued 19 February 2016), sets forth the PA DOR's view of the scope of the add-back rule, the exceptions to the add-back rule and the manner in which the credit to the add-back is to be calculated.

On 4 January 2016, Governor Tom Wolf announced that the Pennsylvania capital stock and foreign franchise tax has been phased-out as of 1 January 2016.

Rhode Island: Final regulation (CT 16-11) provides guidance on Rhode Island's mandatory combined reporting provisions, which are effective for tax returns filed for tax years beginning on or after 1 January 2015. The comprehensive regulation addresses a number of topics, including the following: (1) definitions; (2) combined reporting – overview; (3) combined group – composition, water's edge, tax havens; (4) unitary business – further defined; (5) election to use federal consolidated group; (6) apportionment, single sales factor, market–based sourcing; (7) combined net income group; (8) corporate minimum tax; (9) net operating losses; (10) add–backs; (11) tax rate; (12) tax credits, tracing, Jobs Development Act, Life Sciences rate reduction; (13) filing of return, estimated tax, designated agent; and (14) tax administrator's authority, special appeals and tax administrator's report. The final regulation was posted to the website of the Rhode Island Department of Revenue on 10 March 2016.

Texas: In Policy Letter 201603710L (issued 3 March 2016) the Texas Comptroller of Public Accounts clarified the applicability of the COGS deduction for transmission and distribution costs for integrated utility companies as well as deregulated markets (which includes transmission and distribution utilities (TDU) and retail electricity providers (REP)). An integrated utility company owns the electricity and can, therefore, include in its COGS deduction the costs of transmission to the point of step-down and at the step-down. It cannot include the cost of distributing the electricity once it has been stepped down. An integrated utility also may include in its COGS deduction franchise fees, property tax and the costs of insurance related to its transmission assets. In deregulated markets, a REP may include in COGS the costs of acquiring the electricity it resells, including handing costs. Thus, the REP may deduct any fees or charges it pays for the transmission of the electricity to the point of step-down and at the step-down, but cannot include fees or charges it pays for the distribution of the electricity once it has been stepped down. TDUs do not own the electricity and only provide transmission and distribution services and, as such, may not include transmission or distribution costs in COGS. Further, because TDUs do not own the electricity, they cannot deduct from COGS, franchise fees, real or personal property taxes or insurance paid related to transmission assets.

Virginia: In PD Ruling No. 16-22 (issued 8 March 2016) the Virginia Department of Taxation clarified that a fixed date conformity subtraction (FDCS) can be carried forward when the FDCS exceeds the taxpayer's federal taxable income (FTI) and fixed date conformity addition (FDCA), because this results in a negative Virginia FTI resulting in a NOL. The NOL could be carried back and then carried forward as a NOL deduction pursuant to Virginia's conformity with IRC Section 172.

Developments to watch

Alabama: Department of Revenue proposed rule amendments would repeal the current rule (Ala. Admin. Rule 810-27-1-4) on the Multistate Tax Compact (Compact) regulations and replace it with new rule (Ala. Admin. Rule 810-27-1). The new rule would set forth guidance on the application of the apportionment and allocation provisions of Article IV of the Compact.

Connecticut: A bill (SB 448) being considered by the legislature would adopt market–based sourcing rules for sourcing sales of non-tangible personal property, effective for income tax years commencing on or after 1 January 2016.

District of Columbia: The Mayor's budget proposal for fiscal year 2017 would delay for a five-year period (from 2016 to 2021) the ability to take the Financial Accounting Standard 109 deduction related to the enactment of combined reporting.

Louisiana: Starting in 2017, Act 8 (enacted 8 March 2016) would change Louisiana's current graduated tax rates to a flat 6.5% corporate income tax rate and HB 95 (enacted 16 March 2016) would repeal the statutory provisions that authorize the deduction for federal income taxes paid by corporations. These changes, however, will take effect only if voters during the 8 November 2016 statewide election approve HB 31's proposed constitutional amendment that would eliminate the constitutional requirement that federal income taxes paid be deducted when computing corporate income tax liability.

Mississippi: Proposed bill (SB 2858) would phase out the corporate franchise tax, with an annual decrease until fully phased out effective 1 January 2025.

New York: On 31 March 2016, the New York State legislature passed the fiscal year 2016–17 budget, A9009–C/S6409–C (Final Bill), which provides technical amendments to New York State and New York City corporate tax reform as previously enacted in 2014 and 2015. For New York State and City corporate tax purposes, the technical amendments modify the definition of qualified financial instrument and amend various special bank subtractions. In addition, the New York State corporate tax amendments allow taxpayers to elect to treat the unused portion of special additional mortgage recording tax credits as an overpayment of tax to be credited or refunded rather than carried forward. Other technical amendments to the New York City corporate tax provisions include an amendment to the calculation of the unincorporated business tax credit. The Final Bill also extends the tax shelter reporting requirements through 1 July 2019, conforms New York State and New York City filing deadlines to the new federal tax filing dates and generally looks to the second preceding year's tax to determine the amount of the mandatory first installment. On 1 April 2016, the Final Bill was sent to Governor Cuomo for his approval.

The NY DOTF released draft regulations (Draft Regs. tit. 20 Section 6-2.1 through 6-2.8) on the new combined reporting filing requirements for Article 9-A taxpayers (i.e., business corporations) enacted as part of the New York State and New York City corporate tax reform in 2014 and 2015. Under the Tax Reform, and effective for tax years beginning on or after 1 January 2015, New York State and City business corporation taxpayers must file a combined report when the capital stock and the unitary business requirements are met. In addition, a group of corporations satisfying certain capital stock ownership requirements may elect to file a combined report. The draft regulations provide an in-depth description of the new filing requirements. Taxpayers may provide comments on the draft regulations to the NY DOTF by 21 April 2016.

Tennessee: The Tennessee Department of Revenue (TN DOR) issued a number of proposed amendments to current regulations as well as new regulations related to law changes enacted in 2015, including a new regulation on the state's market-based sourcing provisions. Comments on the proposals are due by 26 April 2016, the same day the TN DOR will hold hearings on these proposed regulations.

Endnotes

1–*UTELCOM, Inc. and UCOM, Inc. v. Bridges*, 77 So. 3d 39 (La. App. 1 Cir. 2011) (Court ruled that two corporations that were limited partners in limited partnerships did not have franchise tax nexus when their only contact with Louisiana was ownership of limited partnership interests in a limited partnership that conducted business in Louisiana).

2–*Vodafone Americas Holdings Inc. v. Roberts*, No. M2013-00947-SC-R11-CV (Tenn. S. Ct. 23 March 2016).

3–*Equifax, Inc. v. Miss. Dep't of Revenue*, 125 So. 3d 36 (Miss. 2013) *rehearing denied*, modified by *Equifax, Inc. v. Miss. Dept. of Revenue*, 2013 Miss. LEXIS 604 (Miss., Nov. 21, 2013) *cert. denied* 134 S. Ct. 2872 (US 2014).

4–*Agilent Technologies, Inc. v. Colorado Department of Revenue*, No. 2014CV393 (Colo. Dist. Ct., Denver Cnty., 20 January 2016).

5–*LaBelle Management, Inc. v. Mich. Dept. of Treas.*, No. 324062 (Mich. Ct. App. 31 March 2016).

6–*Flagstar Bank, FSB v. N.J. Dir., Div. of Taxn.*, No. 019335-2010 (N.J. Tax Ct. 22 March 2016).

7–*Fidelity Nat'l Fin., Inc. v. Or. Dept. of Rev.*, No. TC-MD 140440D (Or. Tax Ct., Magistrate Div., 15 January 2016).

8–*Duke Energy Corp. v. South Carolina Dept. of Rev.*, No. 27606 (S.C. S. Ct. 17 February 2016).

9–*Hegar v. CGG Veritas Services*, No.03-14-00713-CV (Tex. Ct. App., 3rd Dist., 9 March 2016).

10–*Kohl's Dept. Stores Inc. v. Virginia Dept. of Taxn.*, No. CL12-1774 (Va. Cir. Ct., City of Richmond, 3 February 2016).

11–*Corporate Executive Board v. Virginia Dept. of Taxn.*, No. CL13-3104 (Va. Cir. Ct., Arlington Cnty., 25 February 2016).

12–*The Gillette Co. v. Franchise Tax Board*, 62 Cal. 4th 468 (Cal. S. Ct. 31 December 2015).

13–*In re Stewart's Shops Corp.*, No. 825745 (N.Y. Div. Tax App. 10 March 2016).

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