State & Local Tax Subcommittee Meeting

Tuesday, March 31st
4:30pm – 6pm
JW Marriot Desert Ridge Resort & Spa
Phoenix, AZ

Moderator:
Sam Melehani, Partner, PwC

Panelists:
Thomas Bone, VP-Tax, Crown Castle International Corp.
Theresa Esparza, VP-Tax, Spirit Realty Capital
Joe Gurney, Director, Deloitte LLP
Sean Kanousis, Partner-State & Local Tax, PwC
Michele Randall, Tax Partner, Ernst & Young LLP

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March 31- April 2
2015

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JW Marriott Desert Ridge Resort & Spa
Phoenix, AZ

State Tax Update

March 31-April 2, 2015

State Tax Update

Agenda

- Real Estate Income/Franchise Tax Update
  - California Update
  - New York Update
  - Other Significant Tax Legislation – enacted and proposed
  - Combined Reporting
  - Nexus
  - Tax Base
  - Allocation and Apportionment
  - Other State Tax Developments

California Update

California – Like-kind Exchanges

Required disclosure for like-kind exchanges of out-of-state property

- *Enacted on June 27, 2013, A.B. 92* personal and corporate taxpayers are required to file an information return with the Franchise Tax Board if the taxpayer exchanges California property for out-of-state property in an IRC Sec. 1031 like-kind exchange.
- Return must be filed in the taxable year of the exchange, and each subsequent year in which the gain or loss has not been recognized.
- Effective for tax years beginning on or after January 1, 2014.

California – Economic Nexus

Asset management limited liability companies are facing unique challenges under California's new 'doing business' standard

- Over the past several years, the standard for 'doing business' in California has evolved due to statutory changes in the definition of 'doing business' and apportionment sourcing rules.
  - 'Doing business,' is determined by the amount of gross receipts derived from California, subject to thresholds.
- California's recent switch to mandatory market-based sourcing could result in an out-of-state asset manager, organized as an LLC to be subject to the LLC tax, individual income taxes and income tax withholding, even though the company has no property or payroll in the state.

California Proposition 13 Update

- *Ocean Avenue LLC v. County of Los Angeles*
  - Facts
    - 100% of the interest in an LLC owning a hotel in California was sold to multiple persons and entities
    - Following the purchase, Mr. Dell effectively owned 48% while his wife's separate property trust owned 49%
    - A change of ownership was found to have occurred despite no one party acquiring a greater than 50% interest because 100% of the ownership rights in the LCC had been transferred
  - Holding
    - The Court of Appeals agreed with the Superior Court's ruling that there was no change in ownership because no one person acquired a greater than 50% interest in the LLC
- For now, legislative changes to Prop 13 are on hold

California Documentary Transfer Tax Update

- Local Controlling Interest Transfer Taxes - Prior Rule:
  - Generally, transfer taxes were imposed at the local level only when a direct interest in realty was sold unless an IRC Sec 708 tech term occurs
  - The majority of localities had not attempted to apply the tax following a Change in Ownership under Prop13
- *926 North Ardmore Avenue, LLC v County of Los Angeles*
  - The court equated the terms “realty sold” and “change in ownership”
  - As applied, all localities would be authorized to levy a controlling interest transfer tax whenever there is a change in ownership under Prop 13
  - An appeal is being filed with the California Supreme Court

California Mandatory e-filing

- For taxable years beginning on or after January 1, 2014, California requires all business entities, e.g., corps, S corps, partnerships and LLCs, that prepare an original or amended return using tax preparation software to electronically file (e-file) their return with the Franchise Tax Board (FTB)
- Note that an amended return filed after January 1, 2015, for a tax year beginning prior to January 1, 2014, is not required to be e-filed
- Failing to e-file will result in a noncompliance penalty, but the penalty will not take effect until tax years beginning on or after January 1, 2017
- In limited circumstances, taxpayers may request a waiver of this requirement
- Consider impact of DRE's filing under this rule

New York Update

New York State Tax Reform

- Effects on Real Estate/Private Equity Industry
  - Interest on loans secured by real property are sourced to location of real property (corporate taxpayers)
  - Economic nexus for corporate taxpayers with receipts from New York of $1M or greater (including as a corporate partner).
  - No economic nexus for partnerships (reporting for above unclear)
  - Market sourcing for Article 9-A (corporate taxpayers)
  - Will we see a shift to S-Corporations for management companies?

New York State Tax Reform

- Effects on Non-Captive REITs
  - Non-captive REITS are excluded from combined reporting
- Effects on Captive REITs
  - The definition of a captive REIT remains unchanged
  - Captive REITs will be required to file a combined report with any related corporation that meets the new combined filing requirements
  - A captive REIT included in a combined report will still be denied the DPD for any dividends paid to members of its affiliated group and will be subject to the state's FT
  - Care should be taken to analyze the impact of any captive REIT filing a combined return with any related corporations

Proposed - New York City

A.3009/B. 2009 Introduced on January 21, 2015

- Current Proposal:
  - The changes would mirror the changes enacted by New York State last year, and will be retroactive to January 1, 2015.
  - The proposed city changes include:
    - adopting a unitary combined reporting system;
    - instituting market-based sourcing;
    - modifying the corporate tax base;
    - and providing tax breaks to manufacturers.
  - Notably, the bills do not modify the city unincorporated business tax
- Captive REITs in New York City
  - Currently the definition of a captive REIT in the City is not exactly the same as at the state level. Consider the impact of any differences on your privately owned REITs

Significant Tax Enactments and Proposals

District of Columbia

FY2015 Budget Support Second Congressional Review Emergency Act of 2014 enacted December 17, 2014, set to expire April 8, 2015.

- Reduces the rate on the new individual income tax middle bracket
- The unincorporated and incorporated business franchise tax rate will be phased in reductions in subsequent years to 8.25%
- Adopts single weighted sales factor formula and market-based sourcing for sales of other than tangible personal property
- Exempts certain investment funds' income from the Unincorporated Business Franchise Tax via a 'trading safe harbor'
- Effective Date??

Hawaii – proposed legislation would remove DPD

- On January 22, 2015, S.B. 118 was introduced in the Hawaii Senate to remove the dividends paid deduction for REITs in the state. S.B. 118 was referred to the Senate Ways and means Committee, and has been scheduled for a public hearing on February 18, 2015.
- S.B. 118 was revised to require "the department of business, economic development, and tourism, with the assistance of the department of taxation, shall study the impact of real estate investment trusts in Hawaii and the possible effect of repealing the dividends paid deduction for real estate investment trusts." Passed Senate as amended (S.B. 118 SD1) on March 10, 2015. Joint hearing scheduled before House Consumer Protection & Commerce/Judiciary Committees for March 18, 2015.
- A similar bill, H.B. 82, was also introduced in the Hawaii House of Representatives, however, on February 4, 2015, this bill was deferred by the Committee on Consumer Protection & Commerce/Committee on Judiciary. No further action is expected.

Indiana

Senate Bill 1, enacted on March 25, 2014

- Phases down the corporate income tax rate.
- Currently, the rate from July 1, 2013 to June 30, 2014, is 7.5%; from July 1, 2014 to June 30, 2015 the rate is 7.0%; and after June 30, 2015 the rate is 6.5%.
- Continues an annual rate reduction of 0.25% until the rate settles at 4.9% after June 30, 2021.
- Accordingly, the first rate change created under S.B. 1 is the 6.25% imposed from July 1, 2016 to June 30, 2017.

Massachusetts

Budget Bill (H.B. 4001), enacted on July 11, 2014

- Delays the FAS 109 deduction until 2016
- Provides that filing of a combined report will satisfy the filing requirements for any business corporation or financial institution that calculates and reports the income or non-income measure of its own individual corporate excise tax liability and the minimum excise tax.
- Provides the framework for an amnesty, the scope of the program, including types of tax and periods covered will be determined by the commissioner.
- Provides a property tax exemption for certain financial institutions and corporations.
- Simplifies the Appellate Tax Board small claims process.

Massachusetts

H.B 52 Signed by Governor February 13, 2015

- Enacted Massachusetts legislation provides for a tax amnesty program for a 60-day period during fiscal year 2015 that must apply to, at the minimum, corporate excise taxes.
- Amnesty participants will be granted a waiver of penalties. The legislation requires the Commissioner of Revenue to determine the exact periods covered, including any look back period for unfiled returns, and the other taxes that are eligible for the program.

- Massachusetts had a limited amnesty program in 2014, that did not apply to corporate excise tax.

New Hampshire Transfer Tax Update

- The general imposition statute has been expanded to cover “each sale, granting and transfer” rather than just transfers
  - The term “sale, granting and transfer” is statutorily defined as a “contractual transfer” which is defined as “a bargained-for exchange”
- Taxation of Restructuring Transactions
  - Transfer tax will not apply to single-entity reorganizations under IRC § 368(a)(1)(F) or IRC § 368(a)(1)(E)
  - Changes in an owner’s carried interest in a REHC or an entity owning an REHC are exempt from transfer taxes
  - The conversion of a business entity to an LLC under New Hampshire law will be viewed as a contractual transfer without consideration only subject to the $20 minimum transfer tax

New Jersey

- **A.B. 3486, enacted June 30, 2014**
  - Applicable to privilege periods ending on or after July 1, 2014
    - the business income functional test is modified
      - the definition of operational income has been modified to include income from tangible or intangible property if the acquisition, management, **or** (*was* 'and') disposition of the property constitute an integral part of the taxpayer's regular trade or business operations.
    - requires certain nonresident partners to file a tax return as a prerequisite to receive credit and refunds related to partnership activities taxable to New Jersey
    - net operating losses reduced for certain debt cancellations

Rhode Island

H.B. 7133, enacted June 19, 2014

- adopts unitary combined reporting
- reduces tax rate from 9% to 7%
- provides for special treatment for entities organized in tax haven countries
- adopts single sales factor apportionment
- repeals related party expense addbacks
- repeals the state's franchise tax
- requires the establishment of an independent appeals process to resolve alternative apportionment disputes

Ohio

H.B. 5, signed December 19, 2014

- Implements substantial modifications to Ohio's municipal income tax law.
- Key modifications include:
  - Five year NOL carry forward deduction, for NOLs incurred in taxable years beginning after 2016
  - A taxpayer may elect to file a 'full' consolidated, pre-apportionment income tax return. Election binding for five years
  - Alternative apportionment method
  - Pass-through entities taxed on net profits and losses at the entity level
  - Other municipal tax matters

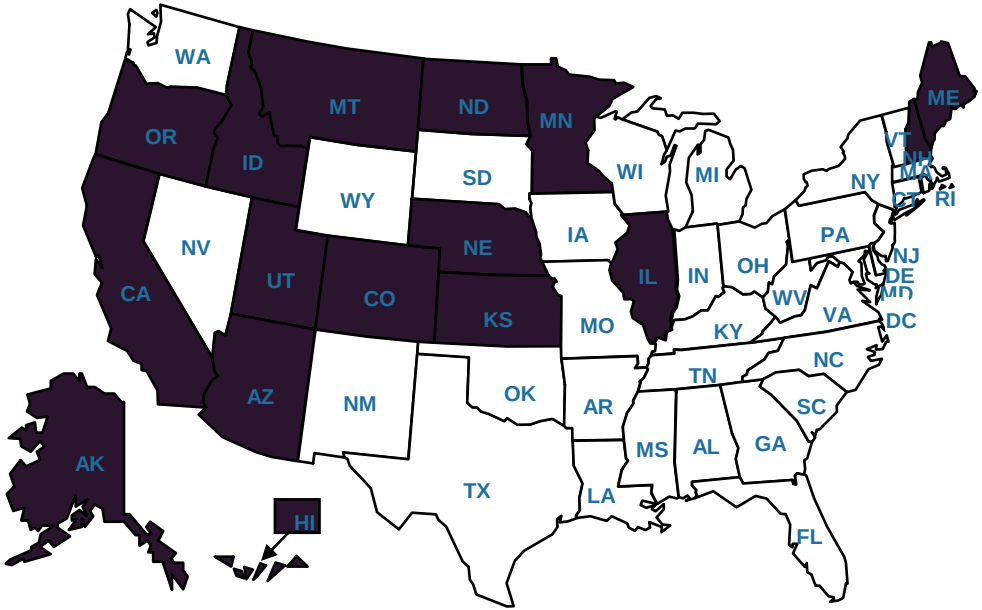
Tennessee

H.B. 644; S.B. 603, introduced, February 10, 2015

- Adopts factor presence nexus standards for corporate excise (income) tax
- Adopts market based sourcing provisions for sales of other than tangible personal property
- Creates alternative excise tax calculation for taxpayers that use Tennessee distribution centers and that have sales of tangible personal property in the state in excess of $1 billon
- Modifies provisions regarded related party deductions
- Adopts click-through nexus for sales tax
- The unincorporated and incorporated business franchise tax

Combined Reporting

Combined Reporting - 2001

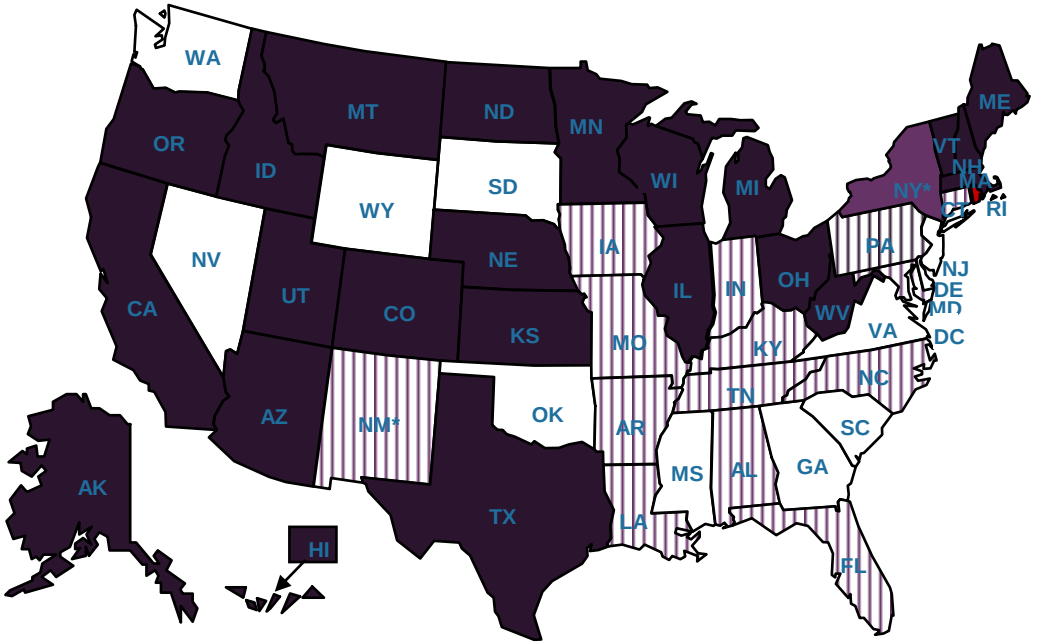


Combined Reporting Proposals

Unitary/Combined States

Remaining Separate Entity or Elective Consolidated Reporting/Other

Combined Reporting – 2014



Combined Reporting Proposals Considered Recently and/or Currently Proposed

Unitary/Combined States *(now including the Ohio CAT, Texas Margin Tax and Michigan Business Tax)*

Remaining Separate Entity or Elective Consolidated Reporting/Other

*New Mexico requires certain unitary large retailers to file combined returns (2014).

**New York and Rhode Island adopt unitary combined reporting in 2015*

Combined Reporting Legislation – 2014 Activity

Kentucky	H.B. 220, introduced 1/16/14, (1/21/14 to House), information hearing on 2/11/14, no additional hearings on tax reform took place
Maryland	S.B. 395, introduced to Senate 1/23/14
New Mexico	S.B. 17, introduced 1/21/14 (requires combined reporting for a bank that is unitary corporation), Action postponed indefinitely
New York	A.B. 8559 and S.B. 6359, enacted 3/31/14
Rhode Island	H.B. 7133, enacted 6/19/14

Legislation – Rhode Island

- H.B. 7133, enacted on June 19, 2014
  - Require combined reporting for corporations that are part of a unitary business.
    - An affiliated group of corporations may elect to be treated as a combined group.
  - Special rules for tax haven entities
  - Effective for tax years beginning on or after January 1, 2015.

Cases – New York

- *SunGard Capital Corporation and Subsidiaries, et al.,* New York, Division of Tax Appeals Nos., 823631, 823632, 823680, 824167, and 824256, April 3, 2014

- A New York administrative law judge concluded that a corporate group was not engaged in a unitary business, notwithstanding numerous unreimbursed services provided by the parent to the subsidiaries.

- In ruling that the entities did not exhibit the requisite flow of value, the ALJ drew a distinction between management oversight activities versus centralized management based on operational expertise.

- The group's attempt to file on a combined basis so as to prevent distortion was rejected.

Cases – Vermont

- *AIG Insurance Management Services Inc. v. Department of Taxes, Vermont Superior Court*, Docket No. 589-9-13, July 30, 2014

- The Vermont Superior Court held that the Commissioner's determination that a ski resort was part of the parent's unitary group was not within the constitutional scope of the unitary business principle.

- The ski resort was determined to run a discrete business enterprise unrelated to the parent's insurance and financial businesses.

Nexus

Nationwide Trends – Nexus and Related Developments

- Economic Nexus and Factor Presence
- Nexus - Agency
- Business Activity Tax Legislation

California

- *Swart Enterprises, Inc. v. California Franchise Tax Board*, Superior Court of California, Fresno County, No, 13CECG02171 (November 14, 2014)
  - A California trial court held that a corporate taxpayer was not doing business in California based on its 0.2% interest in an LLC that leased and disposed of interests in California capital equipment.
  - The taxpayer had no connection to California aside from its LLC interest.
  - The court held that the doing business exception is dependent on a limited partner's lack of right to manage or control the decision making process of the entity.

California

- **California Franchise Tax Board, Legal Ruling 2014-01 (July 22, 2014)**

- The California Franchise Tax Board provided in a letter ruling, that LLC corporate members are not ‘doing business’ in the state when the LLC’s only California activity consists of:

  (1) registering to do business or

  (2) being organized in the state.

- If the LLC’s only contact with the state is registering or being organized in the state the Corporate LLC members are not subject to the requirement to file a tax return based on 'doing business' in the state and are not subject to the state's franchise tax regime.

Cases - Maryland

- *Gore Enterprise Holdings, Inc. v. Comptroller of the Treasury*, Md. Ct. App., No 36 (March 24, 2014)
  - The Maryland Court of Appeals ruled that two subsidiaries of an in-state parent had nexus with Maryland because the subsidiaries had no real economic substance as business entities separate from their parent.
  - The court rejected the lower court's ruling that established nexus between Maryland and the subsidiaries due to their unitary relationship with their in-state parent.
  - Although rejecting unitary nexus, the entities' unitary relationship justified the state applying to the subsidiaries an alternative apportionment formula that incorporated unitary elements.

Cases - Missouri

UTELCOM, Inc. and UCOM, Inc. v. Dept. of Rev., writ denied, La. Sup. Ct., No. 2011-C-2632, 3/2/12; La. Ct. of App., Dkt. No. 535, 407, Division "D", 9/12/11

- Taxpayers that have filed franchise tax refund claims consistent with *UTELCOM*, a 2011 Louisiana appellate court decision holding that a passive ownership interest in a limited partnership doing business in the state, by itself, is not sufficient to subject an out-of-state foreign corporate limited partner to Louisiana corporate franchise tax.

- Recent Board decision in KCS Holdings I, Inc. impact on refund claims and audits

Tax Base

Nationwide Trends – Tax Base/Decoupling From I.R.C. Stimulus Provisions

- Internal Revenue Code conformity
  - Rolling conformity
  - Fixed-date conformity
  - Select provisions adopted
- States likely to decouple from provisions deemed too costly
  - Majority of states decoupled from bonus depreciation
  - Numerous states limited expense allowance
  - State-specific NOL provisions often limit carryover
  - Section 199 Domestic Production Activity
  - COD income deferral

Nationwide Trends – Tax Base/Related Party Addbacks

- Inclusion of related member interest payments and management fees, as well as royalties
- Broader provisions which require addback of intangible expenses along with expansive definitions of “intangibles”
- Typical “safe harbors”
  - Economic substance/arm’s length rates & terms for transactions
  - Purpose other than state income tax avoidance
  - Payment of income tax by royalty recipient
  - Royalty recipient not “primarily engaged” in maintenance and management of intangibles (i.e., not an IHC)
  - Ultimate pass-through of expense to unrelated party
  - Requirement to “make a disclosure” to become eligible for a safe harbor
  - “Unreasonableness” exceptions

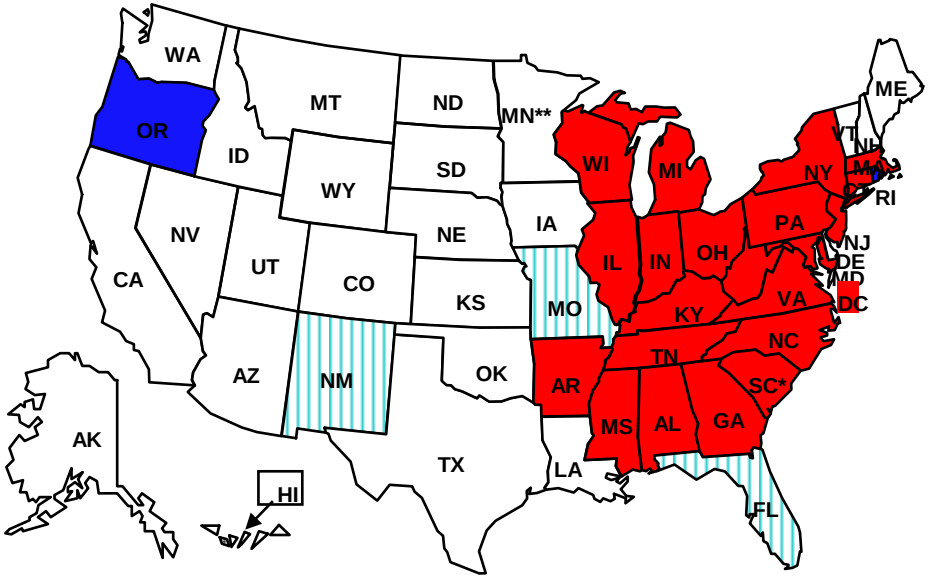
Nationwide Trends – Tax Base/Related Party Addbacks

- Deductibility of all types of intercompany charges are being challenged by state auditors, including intercompany management fees, finance charges and other overhead costs.
- States are concerned that deductions do not have a valid business purpose, are not based on arm's length pricing or are otherwise not "legitimate."
- States are looking for transfer pricing studies for each type of charge.
- If taxpayers do not have transfer pricing studies, states are disallowing deductions, reallocating income and expenses, or adjusting mark-ups.

Nationwide Trends – Tax Base/Related Party Addbacks

- Intercompany Expenses: Questions
  - Intercompany expenses subject to addback –
    - does an exemption apply and can a claim of exemption be supported?
  - Intercompany charges other than interest and royalties –
    - are deductions valid, what is business purpose, is charge at arm’s length, are charges “settled”?
  - Challenges to the "Add-back" statutes
    - Will taxpayer more likely than not be able to sustain a challenge when states' interpretation of "subject to tax in another state" or other exceptions are vague.

Nationwide Trends – Related Party Addbacks



Related member expense addback required (including DC, NYC)

Related member expense addback legislative proposals considered in recent years

No related party addback provisions imposed

Repealed in OR eff. 1/1/13 and in RI eff. 1/1/15

*South Carolina disallows deductions for an expense between related parties where a payment is accrued, but not actually paid and on interest deductions on obligations issued as a dividend or paid instead of a dividend

**Minnesota requires addback of interest and intangible expenses, losses, and costs paid, accrued, or incurred by any member of the taxpayer's unitary group to a foreign operating corporation that is a member of the taxpayer's unitary business group,

Other Developments – Texas

Texas Policy Letter Ruling 201404878L, April 9, 2014

- Effective April 9, 2014, a change to a group's common owner will no longer determine whether the Texas temporary credit for business loss carryforwards terminates.
- Under the new policy, the credit disallowance will be determined on an entity-by-entity basis and lays out three situations in which an entity changes combined groups:
  1. the entity leaves a combined group,
  2. an entity joins an existing combined group, or
  3. an entity's acquisition results in the creation of a new combined group.

Other Developments – Texas

Texas Policy Letter Ruling 201411985L, November 20, 2014

- Effective November 20, 2014, the Texas Comptroller's Tax Policy Division issued revised guidance on a recent policy change concerning when a taxable entity that changes combined groups may claim a temporary credit for business loss carryforward.
- Under the new policy, a taxable entity changes combined groups and will lose the right to claim the credit in three situations
  1. entity leaves a combined group
  2. entity joins an existing combined group
  3. entity's acquisition results in the creation of a new combined group
- The recently revised policy provides taxpayers an exception by establishing that if a common owner changes without any change in the members of the combined group, other than the addition of a newly-formed entity, the group is considered to have not changed and may continue to claim the credit of the member entities.

Other Developments – Texas

Texas Comptroller of Public Accounts, Decision, Hearing No. 109,310, Docket No. 304-14-2297, November 13, 2014, (released, January 2015)

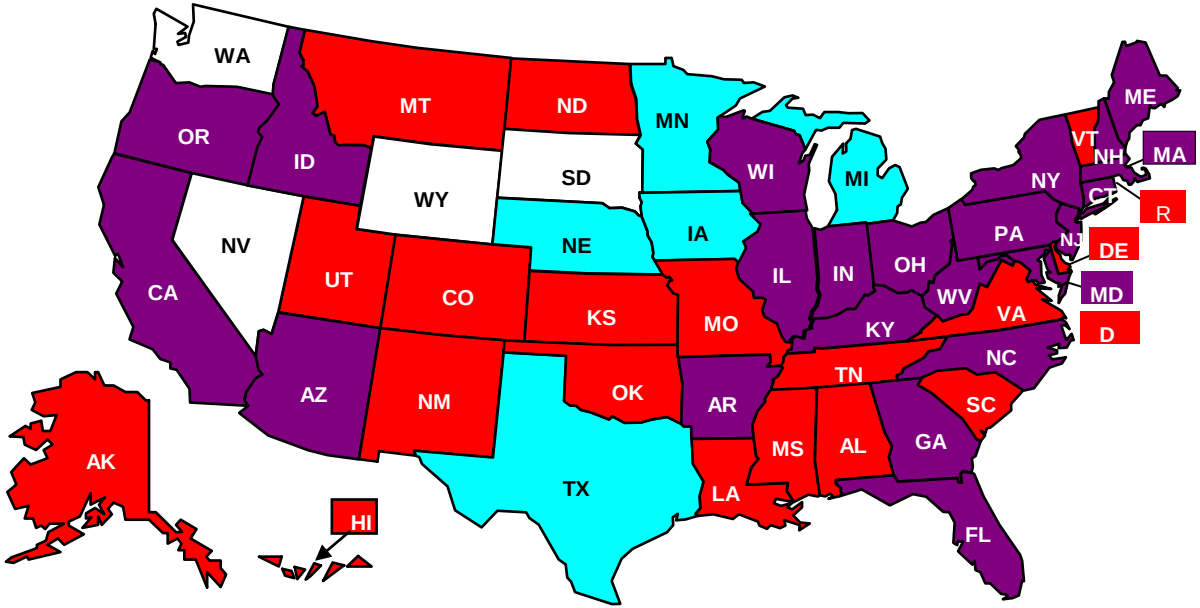
- A taxpayer, the designated reporting entity of a combined group, was not entitled to Texas temporary business loss carryover credits because the entities of the combined group had changed.
- In order to claim the credit, a member of a combined group may not change combined groups after June 30, 2007.
- During an audit, it was determined that on July 31, 2007, a corporation acquired the stock of all the entities in the taxpayer's combined group, including the taxpayer.
- This constituted the forming of a new combined group and thus made the taxpayer ineligible to claim the credit as the new group was created after June 30, 2007.

Allocation and Apportionment

Nationwide Trends – Allocation and Apportionment

- Apportionment Trends
  - Shift in factor weighting
  - Sales factor
    - Gross versus net
    - Market source versus cost of performance
  - Use of discretionary authority to adjust formula (UDIPTA Sec. 18)

Apportionment Formulas* - 1998



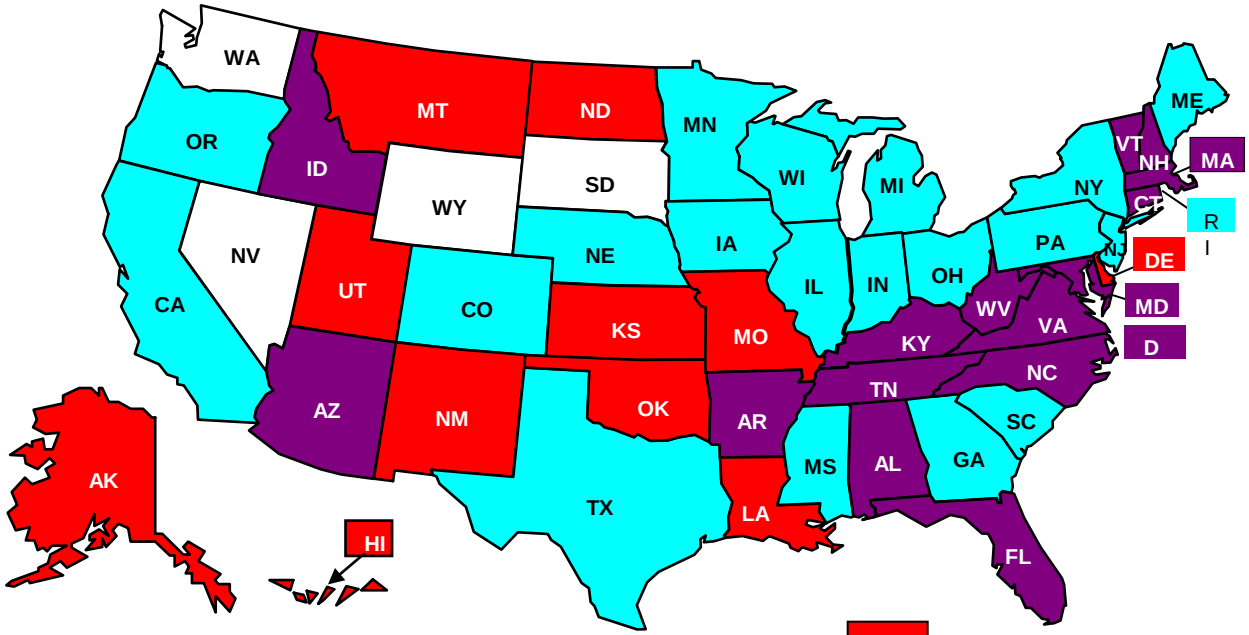
***Does not address industry-specific or optional formulas**

Equally weighted three factor formula

Double weighted sales factor

Triple or greater weighted or single sales factor

Apportionment Formulas* - 2014



Equally weighted three factor formula

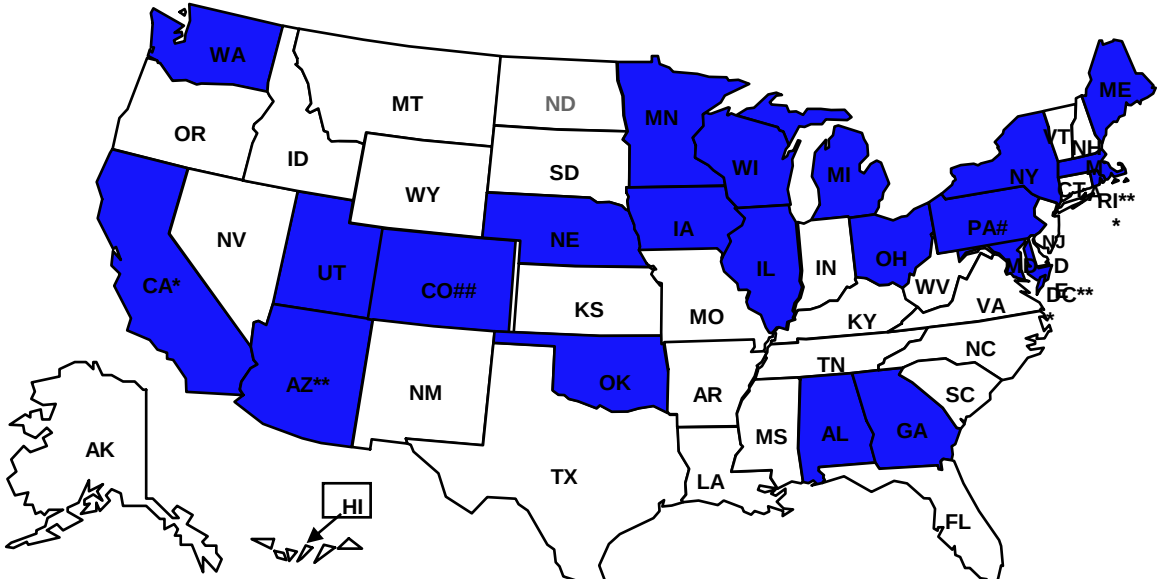
Double weighted sales factor

Triple or greater weighted or single sales factor

***Does not address industry-specific or optional formulas**

Reflects changes enacted in 2014 that might take effect later

Market-Based Sourcing



***Effective in 2011, for taxpayers that elect single sales factor only, but see Prop. 39**

****Elective for deemed multistate service providers**

*****in 2015**

#service receipts only effective in 2014

intangible property receipts only

Cases and Administrative Guidance

Tennessee Clarification and Ruling on DREs

- Prior Rule
  - Notice #13-16 provided that a SMLLC is disregarded for TN franchise and excise tax purposes if:
    - It is a DRE for federal tax purposes
    - Its sole owner must be treated as a corporation for federal tax purposes
  - Tennessee took the position that a REIT did not qualify as a "corporation" in this context
    - This resulted in SMLLCs owned by REITs being treated a separate taxpayers for franchise and excise tax purposes
  - Under prior Tennessee law, it was unclear whether any DREs owned by a REIT could benefit from the DPD

Tennessee Clarification and Ruling on DREs (Continued)

- New Rule
  - Notice #14-12 reversed Tennessee's prior stance on REITs and clarified that they can be considered "corporations"
    - SMLLCs owned by REITs will now be treated as DREs for franchise and excise tax purposes
    - A REIT owning a SMLLC will now have a Tennessee filing requirement but will receive a deduction for the DPD as long as it is not a captive REIT
  - However, Rev. Rul. #13-22 states that non-SMLLC DREs owned by REITs (such as QRSs and disregarded partnerships) will still be treated as separate taxpayers for franchise and excise tax purposes

Pennsylvania Local Business Privilege Tax

- Previously, all localities (other than Philadelphia) were able to subject rental real estate receipts to local Business Privilege Taxes pursuant to the Local Tax Enabling Act (LTEA)
- In *Fish, Hrabrick and Briskin v. Township of Lower Merion*, the Commonwealth Court held that the LTEA does not authorize direct or indirect taxes on “leases or lease transactions”
  - This ruling prevents future taxation of rental real estate receipts
  - This ruling also allows taxpayers to claim refunds for taxes paid on rental real estate receipts on any returns still within the statute of limitations
  - This ruling may still be appealed to the Pennsylvania Supreme Court

Other Developments

General State Tax Updates

- Louisiana Franchise Tax – Refund Claims
- Others??