

State Addbacks and Subtractions: Managing Rolling, Fixed Date, and Selective Federal Conformity

THURSDAY, MAY 5, 2022, 1:00-2:50 pm Eastern

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May 5, 2022

George W. Rendziperis, JD

Principal, SALT

REDW

george.rendziperis@redw.com

Jeanna Schenk, CPA, MST

SALT Manager

REDW

jeanna.schenk@redw.com

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STATE AND LOCAL TAX

Additions and
Subtractions

JEANNA SCHENK, CPA



Jeanna is a SALT manager at REDW. Her prior work history is in both public accounting and publicly traded companies. She has 10 years of experience in state income tax compliance and research, state income tax provisions, and managing state income tax audits.

GEORGE W. RENDZIPERIS, JD



George is a Principal at REDW. He provides state and local tax advice to companies in the oil and gas, manufacturing, financial services, private equity, real estate, technology and service sectors. He has more than 15 years of experience advising clients on controversy, litigation, planning, implementation and compliance issues related to income and franchise tax, sales and use tax, excise and property taxes, unclaimed property, and tax incentives and credits.

OVERVIEW AND LEARNING OBJECTIVES

- What is Nexus
- What is Conformity – fixed and rolling
- State taxable income formula
- Common addbacks and subtractions/decoupling
 - Depreciation
 - GILTI
 - State tax
 - Interest
- Specific state items – NY, CA, AZ, NM



TAKE AWAY

- Nexus
- State filing requirements
- Separate, combine or consolidated filing requirements
- State Modifications
- State agencies or departments (units) are sharing information
 - Example
 - Secretary of state and department of revenue
 - Withholding unit sharing information with income/franchise units
- States are sharing information with each other
- Audits have increased
 - Obtaining information via audits of other taxpayers
- Budgetary deficits

WHAT IS NEXUS?

WHAT IS NEXUS, GENERALLY?

- Taxpayer's contact with a state in order for the state to impose a tax on the taxpayer
- General Observations
 - Physical presence in the state
 - Employee, agents or independent representatives in the state
 - Maintaining an office in the state
 - Real or personal property in the state
 - Registered with the state's Secretary of State or licensed with agency in the state
 - Economic or factor presence
 - Deriving income from sources within the state

INCOME/FRANCHISE/GROSS RECEIPTS NEXUS STANDARDS

- Physical presence
 - Employee, inventory or assets in the state
- Economic presence
 - *Geoffrey v. South Carolina* and the use of an intangible in a state
- Agency nexus
 - Activities of in-state person creates nexus due to “agency relationship”
- Affiliate nexus
 - Related companies
- Factor Presence Nexus
 - Meet a threshold of sales into the state
 - California - \$500,000 of sales
 - New York - \$1,000,000 of sales
 - Texas - \$500,000 of sales

PUBLIC LAW 86-272

- Immunity from state *income tax*
 - Solicitation
 - By an employee or representative
 - On orders for **tangible personal property**
 - Sent outside the state for approval
 - Filled by shipment or delivery from a point outside the state
- Limitation
 - Sale of intangible property
 - Activities connected with the sale of a service
 - Taxes not based on income

WRIGLEY DECISION

- The Supreme Court of the United States held that, in addition to any speech or conduct that explicitly or implicitly proposes a sale, the term includes activities that are ancillary to requests for purchases. Solicitation does not include activities the company would have reason to engage in anyway, but has chosen to allocate to its in-state sales force. The Court illustrated the distinction with the following example:
 - Providing a car and a stock of free samples to sales representatives is part of the solicitation of orders because the only reason to do it is to facilitate requests for purchase
 - Employing sales representatives to repair or service the company's products is not part of the solicitation of orders because there is a reason to repair or service the products whether or not the company has a sales force. Repair and service may help to increase purchases, but they are not ancillary to requesting purchases and cannot be converted into solicitation merely by being assigned to sales representatives

NEXUS – INCOME TAX VS. SALES TAX

- Income tax
 - Physical presence, economic presence (Geoffrey) or factor presence (sales amount)
- Sales tax
 - Physical presence or economic presence (dollar amount or transaction count)
- Dollar amount threshold may be different for sales tax versus income tax
 - NY: \$100,000 for sales tax but \$1,000,000 for corporate income tax

HOW WILL A STATE FIND US?

- Customers or vendors located in the State and such taxpayers are being audited by the state
- Online searches by the State
- Nexus questionnaire
 - Purpose
 - States determine if you have nexus with the state
 - Precludes a company from the Voluntary Disclosure process
 - How does a state get a company's name?
 - Through an audit of your customer or vendor
 - Searches on the internet
 - How to proceed if you receive a questionnaire
 - Do not ignore
 - State will assess tax
 - Penalties
 - Signed under the penalty of perjury

TYPE OF STATE TAXES

TYPES OF STATE TAX BASES

- Income tax base
 - Starting point is federal taxable income
 - Pre or Post federal NOL
- Franchise tax
 - Minimum tax
 - Value of property in state
 - Value of company
- Gross Receipts
 - OH CAT, OR CAT, NV Commerce Tax, WA B&O Tax
 - Texas (allows 1 of 4 deductions, COGS, compensation, \$1M or 30%)

STATE INCOME TAX FORMULA

STATE INCOME TAX BASE

- State corporate income tax formula
 - Federal corporate income tax
 - Plus/minus: state adjustments
 - Equals: total state corporate income tax base
 - Minus: allocable income
 - Equals: Total apportionable income
 - Times: state apportionment formula
 - Equals: state apportioned income
 - Plus: allocated income
 - Times: tax rate
 - Equals: state income tax
 - Less: credits
 - Equals: state income tax liability

WHAT ARE ADDITIONS AND SUBTRACTIONS?

STATE INCOME TAX BASE

- Additions:
 - They're usually add-backs of any federal tax deductions that you might have taken that aren't allowed on your state return.
 - They might also be income items that are tax-exempt for federal purposes but are taxed at the state level.
- Subtractions
 - These are usually income items that are taxable under federal tax law but are not subject to state tax law.
 - Some of these subtractions can also be state-specific deductions.
- State conformity to the Internal Revenue code
 - The adjustments that are made on the state tax return will depend on the extent to which the state follows the federal tax code or conforms to the federal tax code

WHAT IS STATE CONFORMITY?

TYPES OF CONFORMITY

- State tax conformity is a state's adoption of the federal definitions of income, as contained in the IRC (Internal Revenue Code)
- Fixed date – a state conforms to the IRC as of a certain date and the state must decide whether to update their conformity after federal legislation updates
 - For example, if a state's conformity date was Jan. 1, 2016, the state does not automatically incorporate changes to federal tax law that occur after that date
 - AZ, FL, GA, ID, IA, KY, ME, MN, NC, SC, TX, VT, WV, WI
- Rolling conformity – state automatically ties to the IRC as changes are adopted
 - If a state does not want to conform to a new federal law, it must pass specific legislation to decouple from it
 - AK, CO, DE, DC, IL, KS, LA, MD, MA, MO, MT, NE, NM, ND, OK, PA, RI, TN, UT

TYPES OF CONFORMITY -

- Selective conformity – incorporate certain federal provisions by reference and decouples from other provisions

CONFORMITY DEVELOPMENTS

Florida

H.B. 7059 (enacted June 30, 2021)

- For tax years beginning on or after January 1, 2021, Florida updates its IRC conformity date to January 1, 2021.
- For tax years beginning after December 31, 2018, and before January 1, 2021, Florida decouples from the increase in the Section 163(j) limitation for 2019 and 2020.
- Decouples from the temporary increase to 100% for business meals, as well as the CARES Act technical correction to the treatment of QIP as 15-year property.

CONFORMITY DEVELOPMENTS

Florida (cont'd)

H.B. 7059 (enacted June 30, 2021)

- Retroactively conforms to the CARES Act suspension of the 80% NOL carryforward limitation for tax years 2019 and 2020.
- For tax years 2021 and 2022, taxpayers are required to add back to their federal taxable income an amount equal to the enhanced federal deduction for business meals when calculating their Florida taxable income. The federal deduction for business meals was increased from 50% of the cost of the meal to 100% of the cost of the meal.

CONFORMITY DEVELOPMENTS

North Carolina

S.B. 105 (enacted November 18, 2021)

- S.B. 105 updates North Carolina’s IRC conformity date to the IRC “as enacted as of April 1, 2021, including any provisions enacted as of that date that become effective either before or after that date.”
- Before enactment of S.B. 105, North Carolina did not allow taxpayers to deduct covered expenses on forgiven PPP loans. North Carolina will now conform to the federal tax treatment of PPP loans, Economic Injury Disaster Loans or Shuttered Venue and Restaurant Revitalization Grants, so that taxpayers will be allowed an income tax deduction for covered expenses paid using forgiven pandemic-related loans. North Carolina now conforms to the federal treatment of PPP loan forgiveness and covered expenses for tax years beginning before January 1, 2023.

CONFORMITY DEVELOPMENTS

Virginia

H.B. 971 (enacted February 23, 2022)

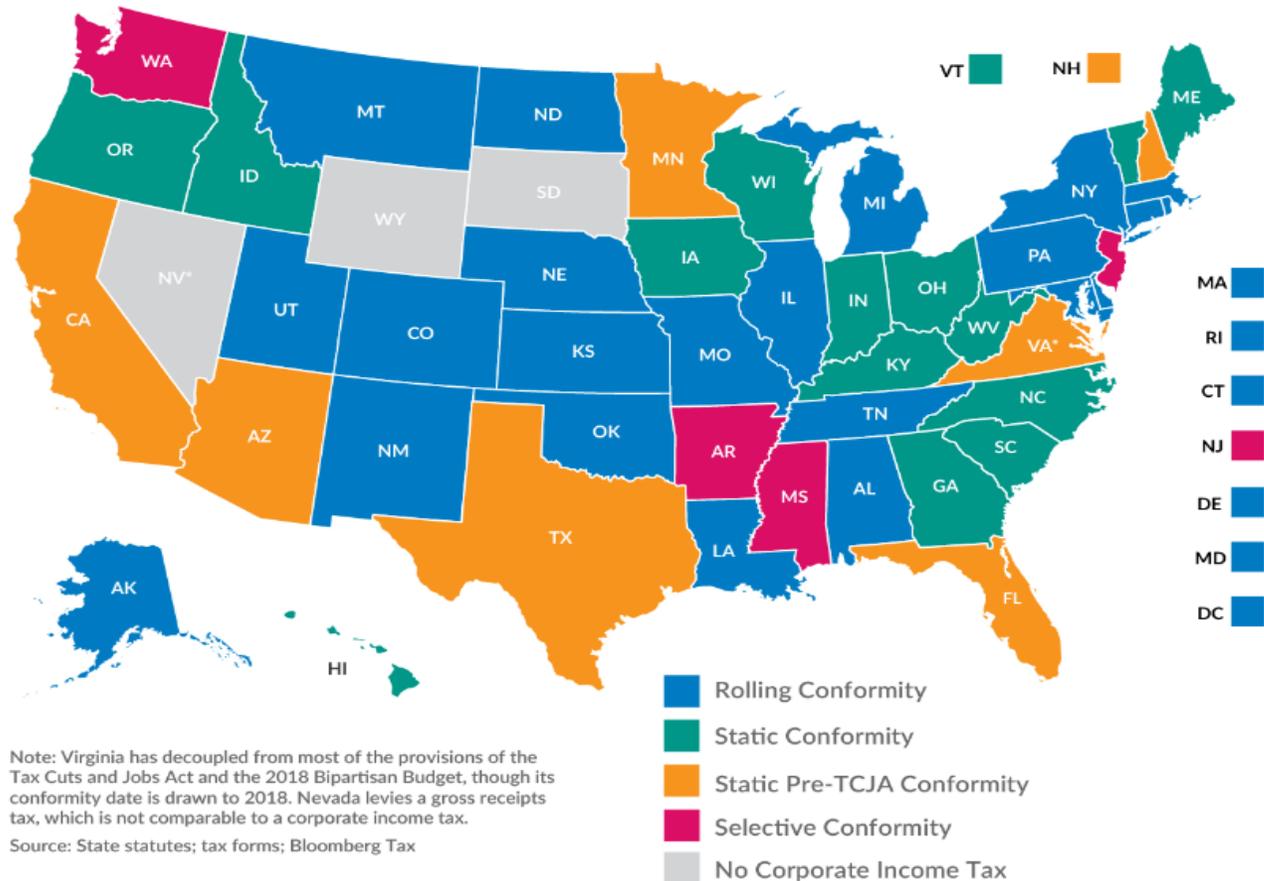
- Updates Virginia's IRC conformity date to the IRC as it "existed on" December 31, 2021.
- Additionally, for tax years beginning before January 1, 2021, the legislation allows a deduction of up to \$100,000 PPP loan covered expenses.
 - Previously, Virginia only allowed the \$100,000 deduction for taxable years beginning on or after January 1, 2020, but before January 1, 2021, meaning fiscal-year taxpayers with tax years starting in 2019 could not take the deduction.
 - H.B. 971 enacted that technical correction.
 - In addition, for tax years beginning on or after January 1, 2021, Virginia will fully conform to the federal treatment of PPP loans and covered expenses.

WHY DOES CONFORMITY MATTER?

- Conformity varies among states based on differing fiscal aims and goals
- States conform to the IRC for multiple reasons, but mostly to ease the compliance burden of state taxation
- Often a state would conform to federal provisions because they are usually more detailed than anything a state could create
- Conformity provides consistency for taxpayers filing in multiple states
- Can rely more on federal audits

WHY DOES CONFORMITY MATTER?

Corporate Income Tax Conformity

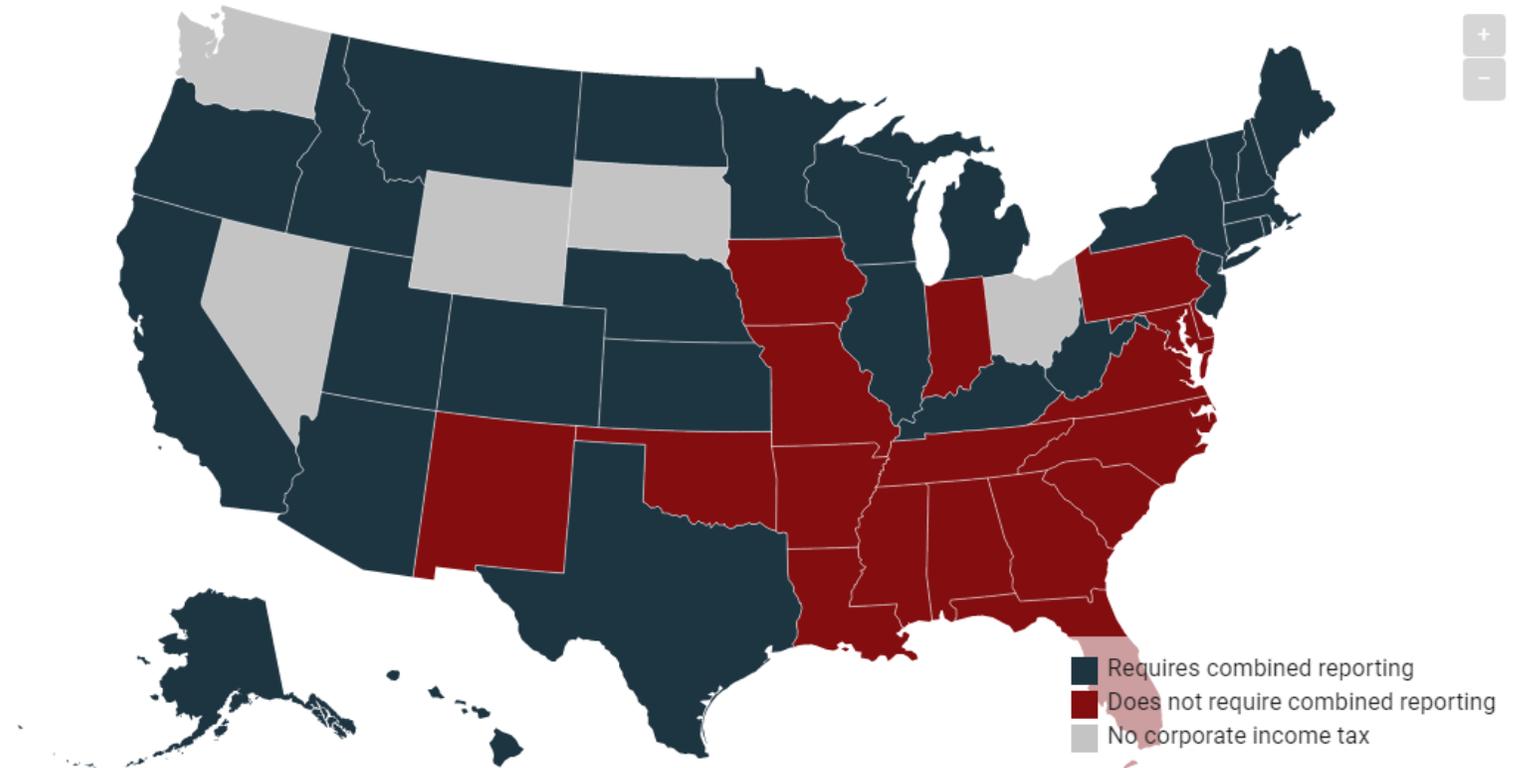


FILING METHODS

- Combined
 - Can be different from federal group – depends on the unitary group (which businesses are interdependent, common management, same line of business)
 - CA, DC, HI, WV, MA
- Nexus Combined
- Separate
 - Each entity files a separate return in the state where nexus exists
 - NC, GA, LA
- Consolidated
 - Generally matches up with federal group – may need election or permission to file consolidated (some require it for 5 years, etc)

FILING METHODS

- From 2019



Texas lacks a corporate income tax but requires combined reporting under its gross receipts tax.

Source: Center on Budget and Policy Priorities (CBPP) • Created with Datawrapper

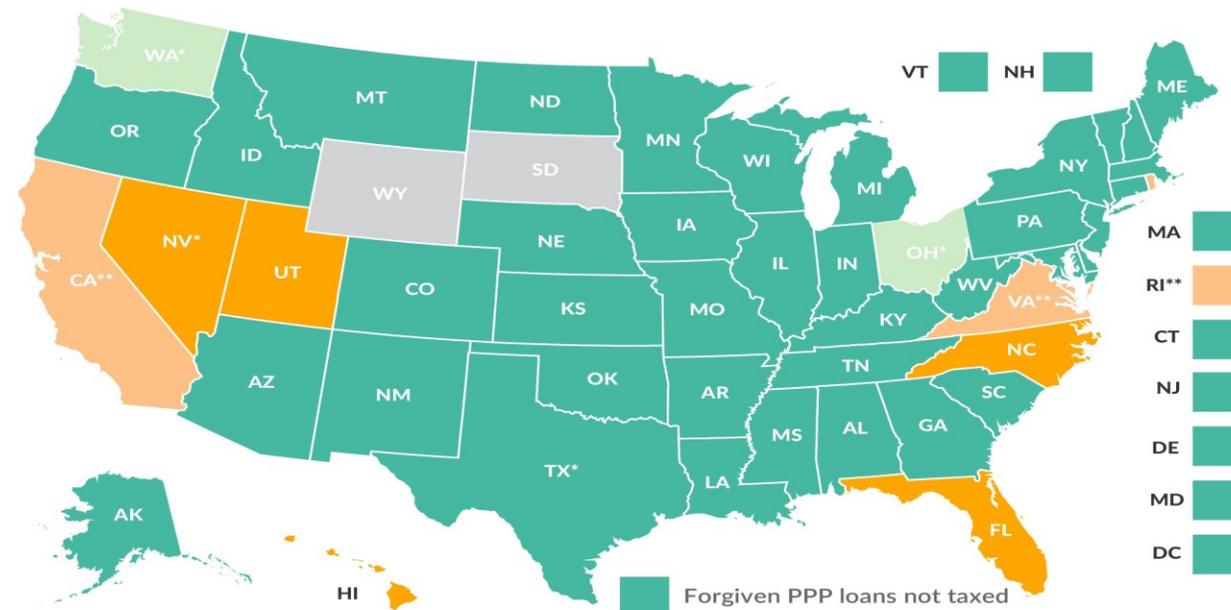
RECENT DEVELOPMENTS

- TCJA 2017 – Impacts to state income tax
 - Creation of GILTI
 - FDII deduction
 - Changes to bonus depreciation
 - Adjustments to NOLs
- CARES Act
 - PPP Loans
 - NOL carryback – 5 years

RECENT DEVELOPMENTS

Does Your State Tax Forgiven PPP Loans?

State Tax Treatment of Forgiven First Draw Paycheck Protection Program Loans Forgiven in 2020 (Last Updated August 23, 2021)



Note: (*) Nevada, Texas, and Washington levy a GRT instead of an income tax. Ohio has an individual income tax and a GRT. Nevada treats forgiven PPP loans as a taxable gross revenue; Ohio, Texas, and Washington do not. In Ohio, Nevada, and Washington, there is no deduction for business expenses, consistent with gross receipts taxation. Under Ohio's individual income tax, forgiven PPP loans are excluded from taxable income and the expense deduction is allowed, but under its GRT, there is no expense deduction.
 (**) Virginia allows only the first \$100,000 in expenses paid for using forgiven PPP loans to be deducted. California excludes forgiven PPP loans from taxation, but the expense deduction is disallowed for publicly traded companies and businesses that did not experience a 25 percent decline in gross receipts between 2019 and 2020. Rhode Island allows an exclusion from taxable income only for forgiven PPP loans of \$250,000 or less.
 Sources: Tax Foundation; state tax statutes, forms, and instructions; Bloomberg BNA.

MOST COMMON ADDITIONS AND SUBTRACTIONS

DEPRECIATION

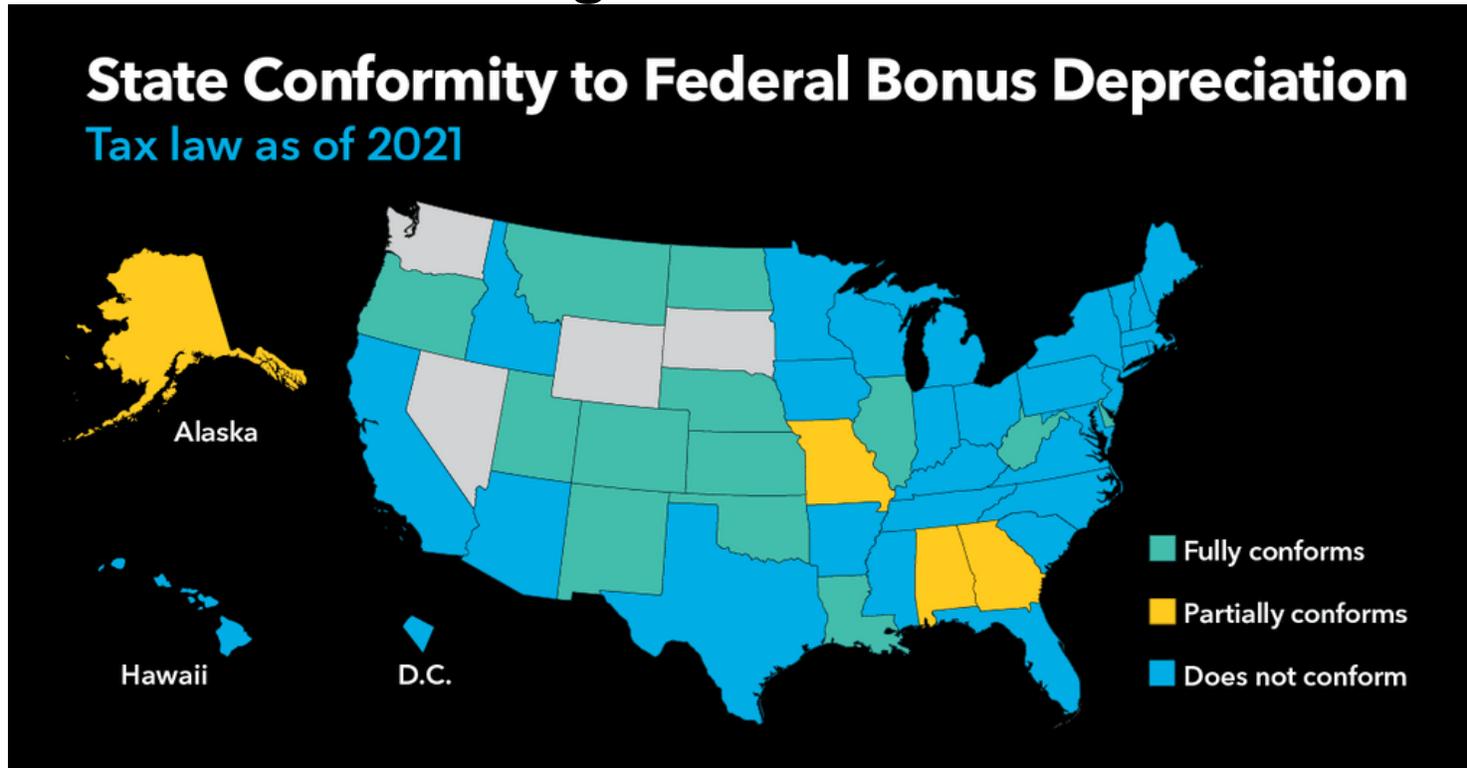
- Many states do not conform to federal bonus depreciation deductions
- Non-conforming states require their own separate depreciation calculations, such as:
 - Addition of the disallowed bonus depreciation with deduction for state differences
 - Addition with subsequent recapture OR
 - Addition of the entire federal depreciation deduction with state recalculation

DEPRECIATION

- Various state specific rules
 - Minnesota – you must addback 80% of MN allowable bonus. Then, starting with the next year after the addition, you recover the original addback by deducting 20% per year over 5 years
 - North Carolina – you must addback 85% of the bonus
 - Florida – addback bonus then claim deduction each year over the next 7 years (1/7)

DEPRECIATION

Source – Bloomberg



DIVIDENDS RECEIVED DEDUCTION

- A tax deduction received by a corporation on the dividends it received from other corporations in which it has an ownership stake
- State treatment – not consistent
 - Many states allow 100% DRD
 - Some allow a partial DRD, but tax an equal portion of domestic and foreign dividends
 - Some states also provide subtraction from TI for subpart F income

CHARITABLE CONTRIBUTIONS

- States vary on whether they conform to the charitable contribution deduction
 - Some states, like AZ, require addback for only specific types of contributions such as contributions to a school tuition organization for which a credit is claimed
- The CARES act increased a corporation's deduction limitation from 10% to 25% of TI during 2020

GILTI

- Created with TCJA (Global Intangible Low-Taxed Income)
- Intention was to return some foreign income to the US tax base (highly complex calculation)
- If a state taxes the GILTI income, the tax burden is increased on US multinationals for something that has nothing to do with that state.
- 250 deduction – excludes 50% of a company's GILTI from tax each year through 2025

GILTI

- Conformity
 - Many states automatically conform, unless expressly decoupled from GILTI OR the state considers GILTI to be a foreign dividend, in which case the income is subject to a 100% (depending on the state) dividends received deduction
 - KY, LA, MO consider GILTI a dividend with a state DRD
 - NE, MD say GILTI is not a dividend, not eligible for DRD
 - Even states that have starting point of line 30 (which includes 250 deduction) tax more than the fed does because states do not have credits for foreign taxes paid.
 - Some states include GILTI in state taxable income, but then allow a subtraction for part or all of the GILTI income

GILTI

- Apportionment concerns
 - “Factor relief” – allow GILTI income into the denominator to the extent GILTI included in state taxable income
 - Some states deny this factor relief – does not fairly represent the state share of income
 - GILTI is not subpart F income – a state’s inclusion or exclusion of subpart F income does not indicate GILTI treatment

GILTI

Alabama

H.B. 170/Act # 2021-1 (enacted Feb. 12, 2021)

- Under prior law, Alabama's subtraction modification for subpart F income as limited to an income inclusion under IRC 951(a). Because GILTI is an income inclusion under IRC 951A, the Alabama subtraction modification for subpart F income did not apply to GILTI.
- Effective for tax years beginning after December 31, 2017, Alabama now provides a 100% subtraction for the "net GILTI amount." However, no refunds will be allowed for prior tax years.
- In addition, H.B. 170 also requires a full addition modification for the GILTI deduction.

GILTI

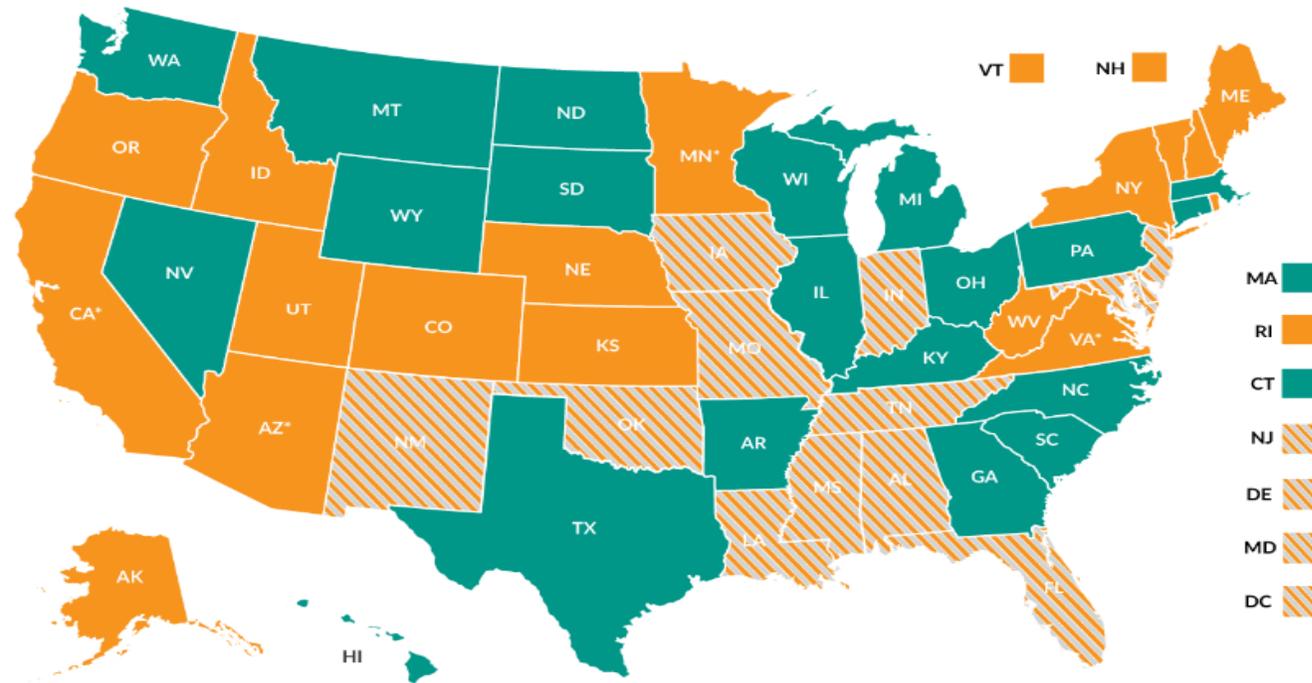
Illinois

S.B. 2017 (enacted June 17, 2021)

- For tax years ending on and after June 30, 2021, the IRC 250(a)(1)(B) GILTI deduction is required to be added back.
- Previously, there was no statutory authority or administrative guidance regarding the Illinois treatment of the GILTI deduction (IL form starts with line 30 so there may have been a position to not add-back the GILTI deduction in spite of the Illinois statute disallowing double deductions).
- The FDII deduction was already subject to an addition modification.

GILTI

Global Intangible Low-Taxed Income (GILTI)



Notes: In states with separate reporting, taxation of GILTI creates constitutional issues under the foreign commerce clause. Arizona, California, Minnesota, and Virginia still conform to pre-TCJA versions of the IRC, but stand to tax GILTI if their conformity date is updated.

Source: State statutes; revenue offices; Bloomberg Tax; Council on State Taxation

163(J)

Alabama

H.B. 170/Act #2021-1 (enacted Feb. 12, 2021)

- If an Alabama corporate taxpayer is a member of a federal affiliated group filing a federal consolidated return and the federal consolidated group does not have a federal Section 163(j) limitation, then the taxpayer does not have an Alabama separate return or nexus combined return limitation.
- If the federal group has a Section 163(j) limitation, then the taxpayer must calculate a separate Alabama Section 163(j) limitation.

163(J)

Florida

H.B. 7059 (enacted June 30, 2021)

- For tax years beginning after December 31, 2018, and before January 1, 2021, Florida retroactively decouples from the increase in the Section 163(j) limitation for 2019 and 2020 of the CARES Act.

163(J)

Iowa S.F. 619 (enacted June 16, 2021)

- For tax years beginning on or after January 1, 2020, Iowa fully decouples from IRC Section 163(j) business interest expense deduction limitation.
- S.F. 619 also enacted a special provision for the 2020 tax year only with respect to excess interest expense. Any Iowa excess interest expense carried forward from the 2019 tax year to the 2020 tax year may be fully deducted together with other business interest expense actually paid in 2020.

163(J)

Kansas

S.B. 50 (enacted May 3, 2021)

- Effective for tax years beginning after December 31, 2020, Kansas decouples from IRC 163(j).
- Unlike Iowa, Kansas (similar to all other states that have decoupled from IRC 163(j)) did not provide a mechanism to allow a deduction for excess interest carryforwards to 2021.

163(j)

North Carolina S.B. 105 (enacted Nov. 18, 2021)

- North Carolina already decoupled from the CARES Act temporary increase of the IRC Section 163(j) limitation from 30% to 50% of a taxpayer's adjusted taxable income for tax years 2019 and 2020.
- As a result, North Carolina taxpayers were required to add back the additional federal business interest expense deduction allowed for 2019 and 2020 by the CARES Act.
- S.B. 105 provides that the add-back is not required to the extent the amount was added back under another provision of state law, such as the addition modification for related party interest expense, to avoid a double add-back.
- In addition, if a taxpayer added back the increased federal CARES Act business interest expense in 2019 or 2020, S.B. 105 also allows taxpayers to deduct 20% of the addition each year for the first five taxable years beginning with tax year 2021.

163(J)

Virginia

H.B. 1006 (enacted April 11, 2022)

- VA did not conform to the CARES Act increase to the 163(j) limitation for the 2019 and 2020 tax years from 30% to 50%.
 - However, VA allowed an additional 20% business interest deduction.
- For tax years beginning on or after January 1, 2022, H.B. 1006 increases Virginia's additional individual and corporate income tax deduction for business interest expense disallowed as a deduction under Section 163(j) from 20% to 30%.

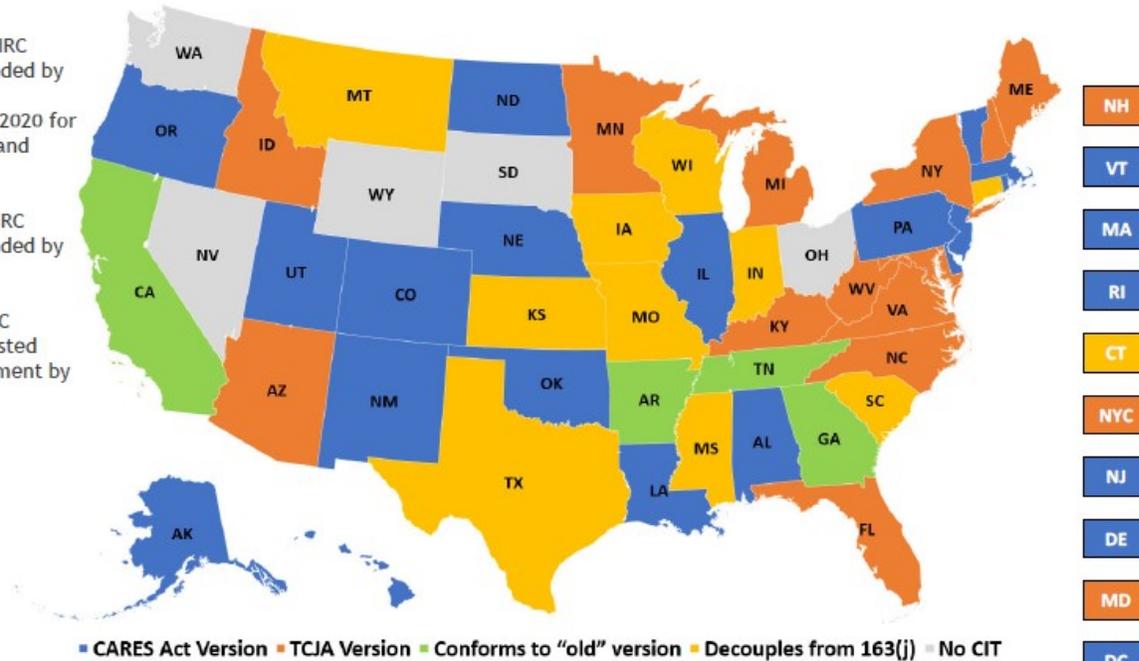
163(j)

State IRC 163(j) Conformity Methods - Corporate Income Tax (AS OF 4/15/2022)

“CARES” mean IRC 163(j), as amended by the CARES Act, effective 3/27/2020 for tax years 2019 and 2020.

“TCJA” means IRC 163(j), as amended by the TCJA.

“Old” means IRC 163(j), as it existed prior to amendment by the TCJA.



STATE INCOME TAX

- Addback of state income taxes deducted in determining federal taxable income when computing state taxable income
 - Measured by income
 - Taxes such as OH CAT, TX franchise and WA B&O generally are NOT
 - Some state only require its own state income tax to be added back

INTEREST INCOME

- Interest from US Bonds is generally a subtraction modification
 - Not taxable for state purposes
- Exemption doesn't apply to CA franchise tax (not an income based tax, is a privilege tax)
- Some states, like FL, MA, MT, OR have no modification

RELATED PARTY TRANSACTIONS

- Separate filing states may require addback of certain intercompany or related party transactions
 - North Carolina – requires addback to starting point for net interest expense to a related member to the extent it exceeds 30 percent of the AGI
- Not applicable in combine or consolidated filings because such related party transactions are eliminated

NET OPERATING LOSS

- Different states have different carryforward periods and generally no carryback allowed (eliminated by TCJA)
- Depending on state starting point (before or after federal NOL) a state may include the federal NOL in it's starting point and then add it back or it doesn't get included to begin with
- States then have their own state specific NOL schedule (can be pre-apportionment or post-apportionment)
- Corporations that file consolidated at federal level but also have separate states need to track state NOLs separately at each entity level to ensure correct NOL reporting

CONCLUSIONS

THINK ABOUT WHEN SUBMITTING STATE INCOME TAX RETURNS

- Nexus
- Separate, combined or consolidated filing requirements
- Additions and subtractions
 - State's conformity to the IRC
- 50 states, 50 different rules

TAKE AWAY

- Nexus
- State filing requirements
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- State Modifications
- State agencies or departments (units) are sharing information
 - Example
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 - Withholding unit sharing information with income/franchise units
- States are sharing information with each other
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QUESTIONS? |



Jeanna Schenk, CPA

Jeanna.schenk@redw.com



George W. Rendziperis, JD

George.rendziperis@redw.com

512.663.0132