



# State income/franchise tax quarterly update

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The following provides a summary of the legislative, administrative and judicial updates that occurred during the fourth quarter of 2011.

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## Key developments

### Illinois enacts business tax changes

On 16 December 2011, Illinois Governor Pat Quinn signed a comprehensive tax bill, S.B. 397 (Pub. Act 97-06-36). Among other changes, the Act modifies the temporary net loss deduction suspension that was enacted in January 2011 to allow a partial deduction, establish a new apportionment provision for federally regulated exchanges and extend the research and development (R&D) credit.

**Net loss deduction suspension.** Legislation (Pub. Act 096-1496) enacted on 13 January 2011 suspended for any taxable year ending after 31 December 2010 and prior to 31 December 2014 the separately determined Illinois net loss deduction (NLD) – except for S corporations. Years in which the NLD is disallowed do not count toward determining the period in which the NLD can be carried forward.<sup>1</sup> Provisions of S.B. 397 modify this suspension to allow a carryover deduction, not to exceed \$100,000, for a taxable year ending on or after 31 December 2012 and prior to 31 December 2014. The carryover period, which does not count suspension years, is changed such that the year will still not count if the deduction would have exceeded \$100,000.

**New apportionment provision for “federally regulated exchanges.”** A new code provision – IITA §304(c-1) – provides an elective apportionment methodology for defined federally regulated exchanges. The new subsection applies, at the option of the federally regulated exchange, to taxable years ending on or after 31 December 2012. The new apportionment formula consists of a numerator that is based on business income from sources within Illinois and a denominator based on business income from all sources. Business income from Illinois sources is:

1. Receipts attributable to transactions executed on a physical trading floor located in Illinois
2. Receipts attributable to all other matching, execution, or clearing transactions, including without limitation, receipts from the provision of matching, execution, or clearing services to another entity, multiplied by 63.77% for years ending on or after 31 December 2012, but before 31 December 2012 and 27.54% thereafter
3. All other receipts that constitute “sales in this State” under IITA §304(a)(3)

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<sup>1</sup>See first quarter 2011 newsletter for additional information.



In no event can the Illinois apportionment percentage computed under new subsection (c-1) for any tax year be less than the Illinois apportionment percentage computed under (c-1) for that taxpayer for the first full tax year ending on or after 31 December 2013, for which (c-1) applied to the taxpayer.

Related to the addition of new code provision IITA §304(c-1), a new item was added to IITA §804(c).<sup>2</sup> This new item requires that a federally regulated exchange compute each installment of estimated tax due prior to 30 June of the first taxable year to which the election applies, to be equal to 25% of the tax, which would have been shown on the return if the election had not been made.

This particular subsection is designed to reduce the apportionment percentage of federally regulated exchanges that are headquartered in Illinois without adversely impacting the apportionment percentage of federally regulated exchanges that are headquartered outside of Illinois.

**R&D credit.** The Act extends the R&D credit five years, until 1 January 2016. The five-year carryover rule still applies. As this amendment effectively negates any lapse in the credit, there should be no issue regarding use of available carryover credits that would have otherwise expired for years ending on or after 1 January 2011. Certain fiscal year taxpayers, however, may need to amend previously filed returns to claim the credit.

The Act also includes the following provisions:

- ▶ It mandate the creation of an independent tax tribunal that, beginning 1 July 2013, will assume, exercise, and administer all rights, powers, duties, and responsibilities pertaining to protests. It should be noted that as S.B. 397 merely mandates creation of a tax tribunal, it remains to be seen how this mandate will be implemented and how the tax tribunal will impact and/or interact with the Illinois court system.
- ▶ It amend the EDGE Tax Credit Act to give certain eligible companies the ability to apply tax credits issued pursuant to an agreement as a payment against their withholding tax liability as opposed to their corporate income tax liability. This legislation only applies to a few targeted industry sectors, and qualifying companies must meet specific requirements.
- ▶ It extend the New Markets Development Tax Credit five years through the end of fiscal year 2017.
- ▶ It extend the Business Location Efficiency Act, which allows for certain EDGE Tax Credit agreements to be longer than 10 years if certain parameters are met by an eligible applicant, for five years, through 31 December 2016.
- ▶ It extend the Economic Development Area Tax Increment Allocation Act (EDA) for a period of time not to exceed 15 years. Provisions of the Act also make certain technical changes as to how the EDA formula is set for distribution of property taxes to local taxing bodies.
- ▶ It amend various sections of the Illinois Income Tax Act extending scheduled sunset dates.

For more on this development, see 14 December 2011 *Tax Alert* 2011-2104.

<sup>2</sup>IITA §804(c)(3).



## Philadelphia approves single sales factor apportionment, makes other changes to the business privilege tax

On 14 November 2011, Philadelphia Mayor Michael Nutter signed Bill 110554, which changes the Philadelphia Business Privilege Tax's (BPT) standard apportionment formula to a single sales factor from a three-factor property, payroll and double-weighted sales. Additionally, Bill 110554 and Bill 110548-A grant a two-year exemption from the BPT for qualifying "new businesses," adjust the BPT tax rates, grant an exemption of \$100,000 from the definition of net income for the net income portion of the BPT, and eliminate the permanent and annual license fees.

**Single sales factor apportionment tax credit.** Starting with the 2013 tax year (which includes the tax year that ends in 2013 for all fiscal year taxpayers), the BPT will phase in an apportionment method that effectively uses a single sales factor. However, the liability will be determined by calculating the "current business privilege tax liability," which utilizes a three-factor apportionment fraction with a double-weighted sales factor, and the "single sales factor apportionment liability," which utilizes only a single sales factor, and then applying a credit for the difference between the "current business privilege tax liability" and the "single sales factor apportionment liability." Any unused portion of the "single sales factor apportionment" tax credit is non-refundable and cannot be carried forward or back. The single sales factor tax credit will become 100% effective starting with the 2015 tax year. For tax years 2013 and 2014, the portion of the single sales factor tax credit shall be determined by the City of Philadelphia Department of Revenue by regulation based upon what is "fiscally prudent in light of the City's budget needs."

### **Two-year BPT exemption for "new businesses."**

Effective for the 2012 tax year, "new businesses" are eligible for a two-year BPT tax exemption. "New Business" is defined as "a business that is subject to the BPT, but was not subject to the BPT at any time during the five tax years preceding tax year 2012." Existing businesses that are not currently subject to business privilege taxes (because they are not currently engaged in business within the City of Philadelphia) are also eligible for "new business" status. The bill lists what does not qualify as "new business," and it sets forth criteria that must be met in order to maintain "new business" status.

**Change in tax rates.** The rate for the gross receipts portion of the BPT will be held at 1.415 mills (0.1415%). The previous scheduled reductions in the gross receipts tax rate until it sunsetted in 2022 have been terminated. However, the rate for the income tax portion of the BPT will be reduced to 6% from the current 6.45%, but the reduction will occur incrementally over 10 years starting in the 2014 tax year.

### **Phase-in of \$100,000 BPT gross receipts exemption.**

Beginning with tax year 2014, an exemption of the business' first \$100,000 of gross receipts (and a proportionate share of net income) will be phased in over three years, beginning in 2014.

**Elimination of license fees.** Starting in the 2014 tax year, new taxpayers will no longer be subject to the one-time permanent license fee of \$300 or any additional \$50 annual license fee. Also, starting in the 2012 tax year, as part of the exemption from BPT for "new businesses," "new business" will be provided a waiver of any of the enumerated license fees.

**Ernst & Young LLP's take.** The increased weighting of the sales factor will likely result in tax savings for some Philadelphia taxpayers that have a significant physical presence in the city, while creating new opportunities for taxpayers to review their current tax structure.



## Time of uncertainty for California's IRC conformity

In April 2010, California enacted S.B. 401 (Stats. 2010, Ch. 14), which advanced California's income tax conformity date to the provisions of the Internal Revenue Code of 1986 (IRC) that were "enacted" before 1 January 2009 (note, not "effective" as of 1 January 2009 but "enacted" before 1 January 2009). Prior to enactment of this legislation, California conformed to the IRC in effect on 1 January 2005.

Subsequently, in November 2010, California voters passed Proposition 26 (Prop 26). The main purpose of Prop 26 was to hold that a "fee" should be treated the same as a "tax" for purposes of the California Constitutional mandate requiring a supermajority vote of both houses of the Legislature to enact any tax legislation (i.e., a two-thirds affirmative vote in each house). The proposition also clarified the definition of a tax increase that is subject to such supermajority to mean "any change in state statute which results in any taxpayer paying a higher tax." Previously, the Legislature has operated on the notion that a tax increase on one taxpayer that was offset by a tax decrease on another was subject merely to a majority vote. Under this rubric, S.B. 401 was adopted by only a majority of both houses of the Legislature.

Included in Prop 26 was a separate provision that stated that any tax legislation adopted during 2010 that did not pass with the requisite two-thirds vote of both houses was "void" unless it was reenacted by the Legislature with the requisite two-thirds vote of each house within one year of passage of Prop 26 (i.e., by 3 November 2011). As indicated above, S.B. 401 was not adopted with a two-thirds vote. Therefore, it is subject to the limitations under Prop 26. A significant interpretative problem with Prop 26 is what it means for a statute to be "void." Prop 26 offers no definition. Moreover, no California court has ever determined what it means for a statute to be "void." For example, does it mean that the statute is void:

- ▶ From the date of enactment (i.e., 12 April 2010)?
- ▶ Just as of the date of enactment of Prop 26 (i.e., 3 November 2010)?
- ▶ As of the last date provided for the Legislature to adopt the provisions of S.B. 401 to meet the new requirement (i.e., 3 November 2011)?

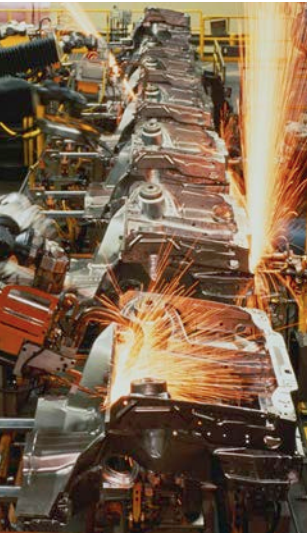
These distinctions create the current uncertainty regarding the potential impact on California's current IRC conformity date.

Shortly after enactment of Prop 26 and well before the reenactment deadline of 3 November 2011 passed, the California Franchise Tax Board (FTB) released Legal Division Guidance 2011-01-01 wherein the FTB's Legal Division acknowledged this ambiguity of Prop 26 and its impact on California's IRC conformity legislation. In short, the FTB's Legal Division stated that it would follow S.B. 401 during the period set out for "reenactment" of S.B. 401. The FTB's Legal Division further stated that, should the Legislature fail to reenact S.B. 401 in conformity with the provisions of Prop 26, the FTB will continue to apply S.B. 401 until a California appellate court or the California Supreme Court determines that some or all of S.B. 401 is void and, therefore, unenforceable.

So long as the FTB does not take any action challenging the enforceability of S.B. 401 and continues to respect the conformity date as of 1 January 2009, as tax years close pursuant to the applicable statutes of limitation the FTB will not be permitted to make assessments consistent with the roll-back of the IRC conformity date to 1 January 2005.

**Ernst & Young LLP's take.** Absent legislation, there can be no certainty regarding the issue of California's conformity with the IRC for periods after 1 January 2009 (i.e., the conformity date established in S.B. 401, which is now deemed void). Moreover, considering the high threshold for approval of any tax legislation (i.e., a two-thirds vote of both houses of the state legislature), it seems highly probable that any conformity legislation may not be enacted for many years (possibly 8-10 years). Thus, California taxpayers who are involved with any transactions that rely on provisions of the IRC enacted after 1 January 2005 (the last California federal conformity date) should consider taking actions that will potentially reduce any California tax exposure arising from the state's failure to conform to the IRC for any period after 1 January 2005.

## Other noteworthy developments



### Indiana

In *AE Outfitters Retailer Co.*,<sup>3</sup> the Indiana Tax Court, in an unpublished opinion, found that the Department of Revenue could not force a company and its affiliates to file on a combined basis because it failed to first apply all of the alternative apportionment methodology set forth in Ind. Code § 6-3-2-2(l) and (m). Per Ind. Code § 6-3-2-2(p). Before the Department can use combined reporting to more accurately reflect the taxpayer's business income in Indiana, it must determine whether application of all of the methodologies listed in Ind. Code § 6-3-2-2(l) and (m) (i.e., separate accounting; exclusion of one or more factors, excepting the sales factor for tax years between 1 January 2007 and 1 January 2011; the inclusion of any one or more additional factors; or the employment of any other reasonable method) would result in an equitable allocation and apportionment of the taxpayer's income.

### Michigan

On 27 December 2011, Acting and Lieutenant Governor Brian Calley signed S.B. 369 that adopts federal disregarded entity classification for purposes of the Michigan Business Tax (MBT). This legislation effectively rescinds the Department of Treasury's notice regarding the filing of amended MBT returns as a result of the decision in *Kmart Michigan Property Services LLC v Department of Treasury*. For additional information on this development, see 19 December 2011 *Tax Alert* 2011-2136.

### New Jersey

In TAM 2011-22, issued 7 December 2011, the New Jersey Division of Taxation provides guidance on the corporate business tax treatment of related party transactions involving charges and claimed deductions for intangible expenses, where the recipient or payee is not a US income taxpayer. Generally, New Jersey law requires a taxpayer to add back to entire net income those amounts deducted on its federal income tax return for intangible expenses paid to a related member or entity. Intangible expenses are defined under N.J.S.A. §54:10A-4.4 and include deductions allowed under IRC §163 including interest expense; licensing fees; losses related to factoring transactions; and royalty, patent and copyright fees. Add-back of intangible expenses paid to a related member is not required if one of several statutory exceptions applies. At issue in this TAM is the exception that applies if the intangible expenses are paid, accrued or incurred to a related member in a foreign nation that has in force a comprehensive income tax treaty with the US. Other exceptions are discussed in TAM 2011-13, which was issued by the Division following the New Jersey Tax Court's ruling in *Beneficial of New Jersey*.

According to TAM 2011-22, when the domestic affiliate pays royalties or expenses to a foreign affiliate or parent for the use of an intangible right in New Jersey, the Division will use existing authority found under N.J.S.A. §§54:10A-4(k)(3), 54:10A-8 and 54:10A-10, and N.J.A.C. §18:7-5.10 to examine the transactions to ensure that the domestic entity "doing business" or "exercising its franchise" in New Jersey reports an accurate amount of expenses and deductions resulting from use of these transactions. This analysis is similar to an arm's-length pricing requirement in IRC §482, and is consistent with New Jersey's own transfer pricing regulation set forth in N.J.A.C. §18:7-5.10. If the Division determines that the domestic taxpayer's entire net income is not fairly reflected, it can make adjustments that are necessary "to reach a 'fair and reasonable determination' of tax liabilities." For more on this development, see 20 December 2011 *Tax Alert* 2011-2143.

<sup>3</sup>*AE Outfitters Retail Co. v. Indiana Department of Revenue*, No. 49T10-1012-TA-66 (Ind. Tax Ct. 25 October 2011)(not for publication).



## North Carolina

On 16 November 2011, the North Carolina Department of Revenue (Department) issued CD-11-1, a much anticipated directive that explains how it will interpret and enforce the changes contained in House Bill 619, which specifies when the Secretary of Revenue can adjust the net income of a corporation or require a corporation to file a combined return. The Directive explains in considerable detail the Department's current practice in connection with the Secretary's ability to force combine taxpayers for tax years beginning before 1 January 2012, and for tax years beginning on or after 1 January 2012, the date of the law change. For more on this development, see 22 November 2011 *Tax Alert* 2011-1958.

## New York

On 9 December 2011, New York Governor Andrew Cuomo signed S.50002, which made a number of changes to New York's tax system. A key corporate income tax change reduces the tax rate for eligible qualified New York manufacturers, effective for taxable years beginning on and after 1 January 2012 and before 1 January 2015. Specifically, the tax rate for qualified New York manufacturers is reduced from 6.5% to 3.25% of the taxpayer's entire net income base. In addition, for qualified corporate manufacturers, the alternative minimum tax rate is reduced to .75% (from 1.5%) of the taxpayer's minimum tax, and the fixed dollar minimum, which generally ranges from \$100 to \$1,500, is reduced by half. For more on this development and other tax changes contained in S. 50002, see 9 December 2011 *Tax Alert* 2011-2082.

## South Carolina

In *Emerson Electric Co.*<sup>4</sup> the South Carolina Supreme Court held that provisions of the state's income allocation statute that allocates interest expenses related to a non-resident corporation's excluded dividends to the corporation's principal place of business do not violate the US Constitution. Under South Carolina law, business income is apportioned among the states in which a multistate corporation conducts business, while non-business income is allocated to or deemed to be earned in a particular state depending on its form.

During the period at issue (1999-2001), South Carolina law excluded from apportioned income dividends received from corporate stocks owned, less all related expenses, and required that it be directly allocated to the state of the corporation's principal place of business. Further, South Carolina employs a "matching principle," which provides that if income is taxable in the state, the expenses incurred in generating the income are matched against the income as a deduction in South Carolina. If income is not taxable in South Carolina, the expense incurred in generating that income may not be matched against it as a deduction in South Carolina.

In this case, the taxpayer was not allowed a deduction because the income was taxable by Missouri, not South Carolina. The taxpayer challenged this provision, arguing that as applied, it discriminates against non-resident taxpayers in violation of the Commerce Clause. Disagreeing with the taxpayer, the South Carolina Supreme Court found that the taxpayer failed to prove that the provision at issue was discriminatory. Rather, the disparate tax consequences the taxpayer claimed were caused not by the application of South Carolina law, but rather are the product of the laws of its home state – Missouri. The court "reject[ed] the implication that the constitutionality of one state's allocation statute turns on the allowance of certain deductions in another state."

<sup>4</sup>*Emerson Electric Co. v. South Carolina Department of Revenue*, No. 27072 (S.C. Sup. Ct. 12 December 2011).



## Texas

In *Allcat Claims Services*<sup>5</sup> the Texas Supreme Court held that the revised franchise tax does not violate the Bullock Amendment's requirement that the imposition of an individual income tax be approved by voters because the tax is not a tax imposed on the net income of individual partners. In reaching this conclusion, the court explained that the state follows the entity theory of partnership law (i.e., a partnership is an entity separate and distinct from its partners), and not the aggregate theory of partnership law (i.e., a partnership is not an entity separate and distinct from its individual partners). Further, the Texas Revised Uniform Partnership Act provides that "partners have creditors' rights in regard to distributions of partnership profits, but it does not provide that allocations of partnership profits are property of, subject to the control of, or income to the separate partners...Thus, under Texas law the allocation of partnership income or profits to a partner does not convert the amounts allocated into property of or income to the partner..."

The court also rejected the taxpayer's argument that the Bullock Amendment extends to situations in which an individual's partnership income is taxed indirectly. Lastly, the court found that it lacked jurisdiction to consider the taxpayer's equal and uniform challenges to the revised franchise tax.

## Virginia

In a letter ruling, the Virginia Department of Taxation determined that a taxpayer filing a federal consolidated corporate income tax return with its subsidiaries but filed separate returns for Virginia corporate income tax purposes is allowed to claim its proportional share of the IRC §199 production deduction for Virginia tax purposes. For federal purposes, an expanded affiliated group (i.e., a group of consolidated and non-consolidated members that meets certain ownership requirements) is treated as a single corporation for purposes of the 199 deduction. The deduction is allocated among the members of the group in proportion to each member's respective amount of qualified production activities income.

Prior to 2010 Virginia conformed to the 199 deduction. Thereafter, taxpayers are allowed only 2/3 of the deduction. Under Virginia law, taxpayers that filed federal consolidated returns and separate Virginia returns compute the federal taxable income of each group member as if separate federal returns had been filed. Further, such taxpayers can claim their proportional share of the 199 deduction for Virginia income tax purposes "because this amount would be the same had it filed separate federal returns." Va. Dept. of Taxn., Rulings of Tax Commissioner PD 11-181 (1 November 2011).

<sup>5</sup>In *Re Allcat Claims Services, L.P. and John Weakly*, No. 11-0589 (Tex. Sup. Ct. 28 November 2011).



## Income tax accounting considerations

Affected companies should consider the income tax accounting implications, if any, of the developments discussed above. Under Accounting Standards Codification topic 740, the effects of changes in tax laws and rates on current and deferred tax balances (including any related valuation allowance effects) are recognized in the period the new legislation is enacted.

For interim reporting purposes, the effects of a change in tax laws or rates on taxes currently payable or refundable for the current year should be reflected in the computation of the estimated annual effective tax rate beginning as of the first interim period that includes the enactment date of the new legislation. The effect of a change in tax laws or rates on deferred tax assets or liabilities should be recognized as a discrete event as of the enactment date and should not be allocated to subsequent interim periods by an adjustment of the estimated annual effective tax rate.

In addition, certain judicial or state tax authority administrative or private letter rulings may constitute new information resulting in a potential change in judgment as to recognition or measurement of an uncertain tax position for the current or prior years. Therefore, the aforementioned developments should be reviewed for any such potential implications.

## Year in review – Q1 through Q3

- ▶ Arizona law phases in single sales factor, reduced corporate income tax rate (1st quarter newsletter)
- ▶ Illinois temporarily increases corporate and individual income tax rates, suspends net loss utilization (1st quarter newsletter)
- ▶ State tax implications of the federal bonus depreciation provision (1st quarter newsletter)
- ▶ California FTB provides guidance on scope of SBE ruling that the Enterprise Zone Hiring Credit can offset the Alternative Minimum Tax (1st quarter newsletter)
- ▶ New Jersey Division of Taxation issues guidance on related member interest add-back exceptions (1st quarter newsletter)
- ▶ North Carolina Superior Court upholds forced combination, voids penalty (1st quarter newsletter)
- ▶ Michigan repeals Michigan Business Tax, replaces it with a corporate income tax (2nd quarter newsletter)
- ▶ Wisconsin amends combined reporting provisions, adopts production credit and capital gain subtraction (2nd quarter newsletter)
- ▶ North Carolina law provides guidance on when combined reporting will be required (2nd quarter newsletter)
- ▶ Discussion of multistate trends related to net operating losses (NOLs), sales factor, and rate changes (2nd quarter newsletter)
- ▶ Indiana tax court finds Department of Revenue could not compel a taxpayer to file a combined income tax return (2nd quarter newsletter)
- ▶ New Jersey Supreme Court finds parts of “throwout rule” facially constitutional (3rd quarter newsletter)
- ▶ Louisiana and New Jersey courts opine on whether holding a limited partnership interest creates nexus (3rd quarter newsletter)
- ▶ District of Columbia enacts mandatory combined reporting provisions, moves to a double-weighted sales factor formula (3rd quarter newsletter)
- ▶ California FTB announces its position regarding the carryover periods for NOLs that could not be claimed due to NOL suspension (3rd quarter newsletter)
- ▶ New Jersey modifies the state’s nexus rules to make explicit the responsibilities to file and pay tax for foreign taxpayers receiving income from in-state sources after 2002 law changed (3rd quarter newsletter)

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