

State Tax Quarterly Insights



Highlighting legislative proposals and nexus decisions

With legislative sessions in full swing, it is not surprising that state budget and other legislative proposals dominate this quarter's developments. PwC Insights over the last three months summarize nearly twenty proposals, including state efforts to reduce income and sales tax rates, broaden tax bases, expand sales tax nexus, move to market-based sourcing, and even impose mandatory worldwide reporting. In this quarterly publication, we highlight California's attempt to reform the state's Enterprise Zone program.

Also summarized below is one successful proposal. Delaware enacted incentives for companies to participate in the Secretary of State's Voluntary Disclosure Agreement initiative for Abandoned and Unclaimed Property.

Four major nexus or doing business court decisions were decided last quarter, and we detail one of them below - the Maryland Court of Special Appeals' *Gore* decision, which held that the Comptroller may tax a company that lacks physical presence in Maryland based on its unitary relationship with an affiliate operating in the state.

Every item in the *developments* section, starting on page 7, links to a PwC Insight that provides analysis and observations regarding the development. Insights this quarter examine the Multistate Tax Compact apportionment election, business/nonbusiness income decisions, state adjustment powers, and other significant state and local tax matters.

Key state developments

Budget proposal and other changes impact California's Enterprise Zone program

On January 10, 2013, California Governor Jerry Brown released his proposed 2013-2014 Budget Summary. The budget includes proposed savings from 'Enterprise Zone Regulatory Reform.'

The California Enterprise Zone (EZ) program can produce substantial tax benefits that can be used to offset California income taxes, potentially providing \$1 million of tax credit for every 25 qualified employees. There are additional benefits measured by sales taxes paid on qualified equipment placed in service in the EZ. Moreover, documented credits can be carried forward indefinitely.

One key proposed 'reform' is that voucher applications documenting Hiring Credits would have to be submitted for approval within one year of the date of hire. This would be a significant change since currently employees can be vouchered and claimed as long as the statute of limitations is open for income tax purposes (which allows taxpayers to voucher retroactively for extended periods). [[2013-14 Governor's Budget Summary](#) (1/10/13)]

Following release of the governor's Budget Summary, the California Department of Housing and Community Development issued proposed regulations to amend California's Enterprise Zone program, which incorporate many of the governor's proposals. [[Enterprise Zone Reform Web Page](#), California Department of Housing and Community Development, proposed regulations posted 1/11/13]

Several hearings have been held regarding the proposed regulations. [Click here](#) for our summary of a recent hearing.

Other recent California changes impact the EZ program. Proposition 39 establishes single sales factor apportionment for most taxpayers effective for the 2013 tax year. As a result, certain companies within a combined group may not be able to utilize EZ credits if they don't have third-party sales. Also, the California Supreme Court's *Dicon* decision has empowered the FTB to request documentation supporting EZ voucher certificates, so it continues to be very important for companies to collect and retain good supporting documentation. Finally, taxpayers should consider how San Francisco's new Gross Receipts Tax may have an impact on EZ credits.

In detail

The governor's 2013-14 Budget Summary includes a section titled '**Enterprise Zone Regulatory Reform**,' which provides that:

"The Budget includes savings relating to new regulations for the Enterprise Zone program. The proposed regulations will accomplish the following reforms:

- Limit retrovouchering by requiring all voucher applications to be made within one year of the date of hire.
- Require third party verification of employee residence within a Targeted Employment Area.
- Streamline the vouchering process for hiring veterans and recipients of public assistance.
- Create stricter zone audit procedures and audit failure procedures."

Timing of proposed changes

Limitations on the retroactive vouchering of employees for Hiring Credit purposes have been considered for quite some time. The Budget Summary is the strongest indication to date that this change will occur in the near future. Significantly, the proposed change as described in the Budget Summary is projected to "increase General Fund revenue by \$10 million in 2012-13 and \$50 million in 2013-14." This suggests an intention to issue new regulations soon and have them take effect quickly since the proposed reforms are projected to impact this year's revenue. However, the

new regulations would have to comply with the rulemaking process, which could cause delays.

Tax benefits of EZ credits

Companies that operate in Enterprise Zones are eligible for substantial tax credits and benefits including:

- Hiring Credits of approximately \$38,000 per employee (taken over 5 years); and
- Income tax credits based upon sales/use taxes paid on purchases of up to \$20 million (for corporations, others have a \$1 million limit) of qualified equipment.

Potential traps based upon income tax rules

There are limitations on the utilization of EZ credits that arise because of California income/franchise tax rules, including the following:

- Credit utilization is limited based on the separate tax liability of each corporation determined through intrastate apportionment
- EZ credit utilization is further limited to the tax liability attributable to a taxpayer's activities in a zone
- Credit utilization is limited to the company earning the credit absent assignment to an affiliate
- Limited opportunities to assign EZ credits to unitary affiliates
- Special rules regarding disregarded entities (DREs) including limiting the credit related to a DRE to the income tax attributable to the DRE on a stand-alone basis.

The limitations can be especially challenging for companies that do business through multiple separate legal entities. The recent enactment of a mandatory single sales factor for income tax apportionment purposes under Proposition 39 (effective for tax years beginning on or after January 1, 2013 for most businesses) results in companies having California income tax assigned to them only if they have third-party sales. To the extent an affiliated group of companies has a sales entity and another entity with activity that generates the credit with no third-party sales, the credit could become trapped. Making a protective claim to elect an equally weighted three-factor formula based upon the recent decision in *Gillette* and FTB Notice 2012-1 may be one consideration for such companies.

The risk of audit

Additionally, the California Supreme Court in *Dicon Fiberoptics* held that the FTB is not required to accept a voucher certificate issued by a zone coordinator as conclusive evidence that an employee is qualified. In light of this ruling, the FTB is aggressively auditing previously conducted EZ studies to ensure that they agree with the supporting *documentation* underlying the voucher.

Additional changes in the works

The Budget Summary also notes that the Administration will be pursuing further Enterprise Zone reform through legislation. Currently, EZ credits may be carried forward indefinitely, and it is possible that the Administration will seek to limit the carryforward period, or propose other changes that will negatively impact the value of the EZ credits.

San Francisco Payroll and Gross Receipts Taxes

EZ Credits can in certain cases also be used to offset the current San Francisco Payroll Tax and also the new San Francisco Gross Receipts tax. The San Francisco Gross Receipts tax, approved by voters in November 2012, is being phased in over a period of five years beginning in 2014.

The takeaway

For companies that have not taken full advantage of the EZ program, time may be running out. There are a number of reasons companies may have not fully captured their potential EZ benefits in the past. For example, sometimes companies do limited

scope projects, documenting employees who work and live in EZs, but not increasing the EZ credits by obtaining information, through a short interview process, to document the various socio-economic factors that also support that EZ credit. Another example involves companies that are marginally profitable, or that have excess EZ credits, that perform only a limited scope documentation of available credits. In these cases, the companies historically have had the luxury of being able to retroactively voucher additional employees as additional credits are needed. However, given the proposed reforms to limit retroactive vouchering, there may be a limited window in which to document additional credits. Since under current rules EZ credits may be carried forward indefinitely, it may be worthwhile to consider increasing EZ credits now.

Let's talk

State and local tax services

Matthew Mandel
Partner, *San Francisco*
+1 (415) 498-7699
matthew.a.mandel@us.pwc.com

Erin Bradley
Director, *San Francisco*
+1 (415) 498-5715
erin.r.bradley@us.pwc.com

Makoto Takahashi
Director, *San Francisco*
(415) 498-6239
makoto.t@us.pwc.com

Mary Crane
Director, *San Francisco*
+1 (415) 498-5025
mary.crane@us.pwc.com

Michael Santoro
Director, *Chicago*
+1 (312) 298-2917
michael.v.santoro@us.pwc.com

Credits and incentives

Mike Harris, Credits and Incentives Leader
Partner, *Kansas City*
+1 (816) 218-1667
michael.a.harris@us.pwc.com

Delaware provides incentives to participate in the new voluntary disclosure initiative

Incentives are available to participate in the Delaware Secretary of State's new voluntary disclosure initiative. On January 10, 2013, House Bill 2 (HB 2) was introduced to create additional incentives for holders of abandoned property under the new program. The bill expands the timeframe to make payment or enter into a payment plan and allows holders to enter into new VDA agreements for related parties or for property not previously included in a VDA. The governor signed HB 2 on January 30, 2013.

In detail

In an effort to expand the scope of companies reporting unclaimed property to Delaware, on July 11, 2012 [SB 258](#) was enacted to establish a new voluntary self-disclosure initiative that would be run by the Secretary of State. The new program allowed holders to take advantage of a limited lookback period if a notice of intent to file a voluntary self-disclosure agreement (VDA) was submitted on or before June 30, 2013 and payment made (or a payment plan developed) on or before June 30, 2014. (For a detailed summary of the new voluntary disclosure program please see [Delaware legislature passes VDA incentives, awaits governor's signature](#).) To provide additional incentives, last week the Delaware legislature proposed HB 2, which was reported out of the House Administration Committee and is expected to have a full House vote on January 17, 2013.

HB 2 extends the date that payment or a payment plan must be made under the new VDA from June 30, 2014 until June 30, 2015, allowing holders an additional year to either make a payment or enter a payment plan. The legislation also provides that a holder that has previously entered into a VDA prior to June 30, 2012, may enter into the new voluntary disclosure program with respect to any related party that was not included in an earlier voluntary self-disclosure or with respect to property types and/or periods that were not included in a prior voluntary self-disclosure agreement.

Finally, the legislation also expands the duty of the State Escheator to protect confidential information. Currently, the State Escheator is only required to protect confidential information with regard to Subchapter 1141, which addresses public records that must be maintained. HB 2 expands the confidential information limitation to include Chapter 11, the entire chapter on unclaimed property.

The takeaway

Holders of unclaimed property who enter into a VDA on or before June 30, 2013, will have the benefit of a limited lookback period to 1996; those who enter into a VDA on or before June 30, 2014, will only have the lookback period limited to 1993. Therefore, in addition to the additional incentives offered by HB 2, holders will receive the most benefit by entering the VDA by the June 30, 2013, deadline.

Under HB 2, the additional time to make payment or enter a payment plan with regard to the new VDA program is a welcome relief for affected holders. The expansion of eligible property and holders in the program demonstrates a willingness on the part of Delaware lawmakers to increase compliance and ease the burden for holders of unclaimed property. Those considering entering a VDA should do so before June 30, 2013 so that they may take the greatest advantage of the VDA initiative, which would include the shorter lookback period.

Let's talk

Abandoned and Unclaimed Property

Janet Gagliano, National Practice Leader-
Abandoned and Unclaimed Property
Partner, *Atlanta*
+1 (678) 419-1068
janet.c.gagliano@us.pwc.com

Maryland - Nexus established through unitary relationship

The Maryland Court of Special Appeals held that the Comptroller may tax a company that lacks physical presence in Maryland based on its unitary relationship with an affiliate operating in the state. Out-of-state taxpayers with in-state affiliates should be concerned with the Court's application of unitary and accounting principles to establish nexus with the state. [[*Comptroller of the Treasury v. Gore Enterprise Holdings, Inc., et.al.*](#), Maryland Court of Special Appeals, Nos. 1696, 1697, September Term, 2011, (1/24/13)]

In detail

Facts and procedural history

During the years at issue, W.L. Gore & Associates, Inc. (Gore), a Delaware corporation, patented materials used in the manufacture of several products. Gore filed Maryland corporate income tax returns, and attributed income to Maryland based on its local product sales and on its Maryland manufacturing facilities, which employed over 2,000 people.

Gore formed Gore Enterprise Holdings, Inc. (GEH), a wholly-owned subsidiary to operate in Delaware and to hold all Gore patents. GEH was governed by a board of directors comprised of Gore employees and all GEH activities were ultimately directed by the board. Additionally, Gore provided various administrative services to GEH, including accounting, payroll, employee benefits, and 'general services.' Upon its formation, GEH granted Gore an exclusive license to use all US patents presently

owned or thereafter acquired. In exchange, Gore paid GEH a 'reasonable fee,' which was deducted from its taxable income. GEH recognized these royalty payments as taxable income.

Gore also formed Future Value, Inc. (FVI), a wholly-owned subsidiary to hold all Gore financial assets. FVI was funded entirely by contributions from Gore and GEH, and by reinvesting its investment income. FVI also made loans to Gore. Gore deducted from its taxable income interest payments to FVI and FVI recognized these payments as taxable income. GEH and FVI are hereinafter referred to as 'the subsidiaries.'

Neither of the subsidiaries filed Maryland corporate income tax returns. An audit by the Comptroller determined that the subsidiaries were subject to tax and were required to apportion income to Maryland. The assessments were affirmed by the Maryland Tax Court. On appeal to the Circuit Court of Cecil County, the Maryland Tax Court opinion was reversed and the Comptroller's assessments were cancelled. The Comptroller filed this appeal before the Court of Special Appeals (Court).

Subsidiaries have nexus with Maryland through unitary relationship with Gore

At issue in this case was a Maryland statute that imposes a tax on a corporation's income "derived from or reasonably attributable to its trade or business" in the state. Because Gore had nexus with Maryland due to its in-state activities, the Court found that if the subsidiaries partake in Gore's unitary business, then they inherit Gore's nexus with Maryland.

The Court recognized that a nexus sufficient to justify taxation arises from the economic reality that a parent's in-state business produces a subsidiary's income. Accordingly, the Court found that "Gore generated income in Maryland and deducted payments to GEH and FVI, which recognized those payments as their income - an accounting identity that reflects their unified business." The Court noted that, as a practical matter, Gore's expenses paid to the subsidiaries result in "gains to assets on its own balance sheet" and that it would "defy logic" to argue that the subsidiaries' gains are somehow not realized in Maryland as part of a unitary business.

The Court also found that the entities demonstrated the 'hallmarks' of a unitary business relationship: (1) functional integration, (2) centralized management, and (3) economies of scale. For example, the subsidiaries were dependent upon Gore for their core business functions, including various administrative services Gore provided and Gore and its subsidiaries had common directors, executives and employees. Further, the subsidiaries remained under Gore's complete control and advanced its interest in whole. While the Court noted that control is not dispositive of a unitary business, in this case it was sufficient because Gore's deductible expense in Maryland is its subsidiaries' income.

Gore's Maryland apportionment factors used

The Tax Court applied Gore's Maryland apportionment factor, including property, payroll and sales, to the subsidiaries' incomes to calculate their Maryland tax obligations. The Court of Special Appeals agreed that this was a reasonable methodology. The Court reasoned that if Gore's apportionment reasonably reflects its expenses in Maryland, and those expenses are the subsidiaries' income, then the same apportionment factor reasonably reflects the proportion of income generated in Maryland as part of Gore's unitary business.

The takeaway

This decision expands on Maryland's previous *SYL* decision, which focused its analysis on overall business purpose in addition to unitary considerations. In essence, the *Gore* Court provides that the Comptroller can tax an entity without its own Maryland presence if it operates as part of a unitary business with an affiliate operating in Maryland. Despite Maryland being a separate return filing state for corporate income tax purposes, the Court effectively allows taxation on a combined reporting basis in this decision. Taxpayers should be cautioned that, rather than applying traditional constitutional nexus principles, the Court essentially substitutes unitary concepts as a surrogate for nexus. The Court explains that the "distinction

that appellees draw between the 'constitutional nexus' and the 'unitary business principle' is relevant where there is some question as to whether *any* part of a unitary business has a sufficient nexus with the taxing state. But where, as here, a parent company undoubtedly has a requisite nexus, the only question is whether the subsidiary partakes in the parent's unitary business; if so, it inherits the parent's nexus and the tests are effectively merged."

In addition, the Court agreed that the Comptroller can exercise its right to use an "alternate apportionment when the statutory formulas do not 'reflect clearly the income allocable to Maryland'" to tax an out of state company using the apportionment of the affiliate operating in Maryland versus the separate entity's own apportionment factors.

In describing the entities' unitary relationship, the Court appears to put great emphasis on Gore's expenses and the subsidiaries' income. It is unclear whether the Court views this 'accounting identity' as an *element* of the traditional 'hallmarks' of a unitary relationship, or as *independent* support for a unitary relationship. It would be troubling, and constitutionally suspect, for mere accounting entries to raise a business relationship to the level of creating nexus for out-of-state companies.

The Court of Special Appeals is the intermediate appellate court in Maryland. It is not yet known whether the decision will be appealed to the Maryland Court of Appeals, the highest court in Maryland.

Let's talk

For a deeper discussion of how these issues might affect your business, please contact:

Steve Arluna
Partner, *McLean, Virginia*
+1 (703) 918-1521
steve.arluna@us.pwc.com

Renee Padousis
Director, *McLean, Virginia*
+1 (703) 610-7455
renee.p.padousis@us.pwc.com

Michael Santoro
Director, *Chicago*
+1 (312) 298-2917
michael.v.santoro@us.pwc.com

Practitioner's tip

*Ohio Use Tax
Amnesty ends May 1,
2013*

Other state tax development insights

The parenthetical indicates the development's PwC Insight published date

Time sensitive

Credits

[Retroactive Work Opportunity Tax Credit opportunity - transition relief provides taxpayers until April 29 to file certain Form 8850s](#) (Mar. 11, 2013)

California

[California to start issuing assessment notices in April for invalid qualified small business stock gain exclusions and deferrals](#) (Mar. 7, 2013)

State budget and legislative proposals

Multi-state

[2013 begins with a flurry of sales tax nexus expansion proposals](#) (Mar. 1, 2013)

Arizona

[Arizona proposes transaction privilege tax changes](#) (Feb. 14, 2013)

California

[California bill would modify what triggers a real property tax reassessment and would add new property tax filing requirements](#) (Feb. 18, 2013)

[California proposes that a legal entity 'change in control' would trigger real estate transfer tax](#) (Mar. 8, 2013)

[First public hearing held relating to California Enterprise Zone proposed regulations](#) (Feb. 15, 2013)

Colorado

[Colorado General Assembly to consider mobile workforce legislation](#) (Feb. 14, 2013)

Illinois

[Illinois proposes repealing dividend deductions, decoupling from domestic production activities deduction, and repealing non-combination rule](#) (Mar. 8, 2013)

Massachusetts

[Massachusetts budget proposes significant law changes](#) (Jan. 25, 2013)

Minnesota

[Minnesota - Governor releases FY 14-15 budget, includes significant tax reform proposals](#) (Jan. 25, 2013)

[Minnesota Supreme Court - Tax Court's decision to stay its order does not extend the statutory time to appeal](#) (Jan. 25, 2013)

[Minnesota bill proposes significant corporate income, sales and use, and other tax changes](#) (Feb. 20, 2013)

[Minnesota governor's revised budget](#) (Mar. 22, 2013)

Montana

[Montana bill proposes mandatory worldwide reporting](#) (Feb. 8, 2013)

New York

[New York Senate calls for phase-out of tax on manufacturers](#) (Mar. 14, 2013)

[Proposed New York budget proposes related party royalty addback and other tax changes](#) (Jan. 24, 2013)

[New York budget bill passes legislature](#) (Mar. 29, 2013)

Ohio

[Ohio proposes sales tax, personal income tax, and severance tax changes](#) (Feb. 14, 2013)

[Ohio bill proposes changes to Uniform Municipal Tax Code](#) (Mar. 1, 2013)

Oregon

[Oregon bills propose corporate income tax changes](#) (Feb. 8, 2013)

Texas

[Texas - Proposed rule change addresses COGS deduction for labor and service costs, reflects election policy change](#) (Mar. 20, 2013)

Nexus and doing business

New Mexico

[New Mexico - In-state subscribers subject out-of-state web-based solutions provider to gross receipts tax](#) (Mar. 1, 2013)

Oregon

[Oregon - Bankruptcy court, no nexus due to intangible presence](#) (Jan. 18, 2013)

Tennessee

[Tennessee - Patent licensor not doing business in the state](#) (Jan. 17, 2013)

Business/nonbusiness income

Missouri

[Missouri - Income from trust is nonbusiness income](#) (Mar. 19, 2013)

Oregon

[Oregon - Telecommunication company's gain from sale of assets is apportionable business income](#) (Mar. 22, 2013)

Multistate Tax Compact election

Multi-state

[States weighing considerations for continued Multistate Tax Compact membership](#) (Mar. 8, 2013)

[MTC Update – Did you miss the meeting invitation to discuss the formation of the Multistate Tax Compact?](#) (Mar. 22, 2013)

Michigan

[Michigan - 2011 tax year refund based on MTC election due April 1](#) (Mar. 8, 2013)

State adjustment powers

New York

[New York ALJ - Corporations properly filed combined returns, defeated department attempt to force separate filing](#) (Jan. 11, 2013)

North Carolina

[North Carolina rules regarding Secretary's authority to adjust income or require combined returns](#) (Jan. 10, 2013)

Tennessee

[Tennessee - Alternative apportionment and nexus upheld](#) (Mar. 28, 2013)

Other income tax developments

Illinois

[Illinois Appellate Court - Department improperly used math error procedure to change taxpayer's apportionment factor](#) (Jan. 4, 2013)

[Illinois - Taxpayer timely filed refund claim for payment made under amnesty based upon good-faith estimate of liability resulting from a federal audit](#) (Feb. 15, 2013)

Louisiana

[Louisiana Supreme Court – When tax collector fails to act on refund claim, taxpayer is not compelled to pay under protest and there is no time limitation for refund claim review](#) (Mar. 29, 2013)

Maryland

[Maryland - Failure to provide a credit to local portion of personal income tax for out-of-state income is unconstitutional](#) (Feb. 1, 2013)

Massachusetts

[Massachusetts Appellate Court disallows interest expense, royalty expenses, and rebate payments](#) (Jan. 17, 2013)

Michigan

[Michigan provides guidance regarding Corporate Income Tax unitary business group control test and relationship tests](#) (Jan. 18, 2013)

Ohio

[Ohio proposes sales tax, personal income tax, and severance tax changes](#) (Feb. 14, 2013)

Oklahoma

[Oklahoma Appeals Court - Capital gains deduction provision is unconstitutional](#) (Feb. 1, 2013)

Other sales & use tax developments

Multi-state

[Federal Marketplace Fairness legislation introduced](#) (Feb. 15, 2013)

Massachusetts

[Massachusetts budget proposes significant law changes](#) (Jan. 25, 2013)

Minnesota

[Minnesota - Governor releases FY 14-15 budget, includes significant tax reform proposals](#) (Jan. 25, 2013)

[Minnesota bill proposes significant corporate income, sales and use, and other tax changes](#) (Feb. 20, 2013)

Ohio

[Ohio proposes sales tax, personal income tax, and severance tax changes](#) (Feb. 14, 2013)

Utah

[Utah - 18% collection allowance for remote sellers](#) (Mar. 28, 2013)

Washington

[Washington issues new regulations on software and digital products](#) (Mar. 8, 2013)

Let's talk

For a deeper discussion of how these issues might affect your business, please contact:

Bryan Mayster
Managing Director, *Chicago*
+1 (312) 298-4499
bryan.mayster@us.pwc.com

Jennifer Jensen
Director, *Washington, DC*
+1 (202) 414-1741
jennifer.jensen@us.pwc.com

Adam Weinreb
Director, *New York, NY*
+1 (646) 471-4409
adam.weinreb@us.pwc.com

Elaine Harper
Sr. Associate, *Seattle*
+1 (202) 414-1013
elaine.harper@us.pwc.com

Denise Dockrey
Director, *Washington, DC*
+1 (202) 465-5097
denise.s.dockrey@us.pwc.com

Michael Santoro
Director, *Chicago*
+1 (312) 298-2917
michael.v.santoro@us.pwc.com

Amy St Clair
Manager, *Las Vegas*
+1 (702) 691-5445
amy.c.st.clair@us.pwc.com

Kathryn Thurber
Sr. Associate, *Washington, DC*
+1 (202) 346-5122
kathryn.thurber@us.pwc.com