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Financial Services State and Local Tax Newsletter

Tracking the significant changes in state taxes for financial services

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In this issue

Hello,

With the fall tax compliance season largely behind us, attention is shifting toward year-end discussions and planning for 2027. This is a good time to step back from filing deadlines and consider how the tax landscape has changed over the past few months.

In this issue, our spotlight article focuses on several significant California developments. We also cover a range of other state tax issues that may affect current-year tax positions and longer-term planning. And a newsletter published in November wouldn't be complete if it didn't mention the upcoming state ballot measures to keep an eye on.

While this publication focuses on financial services companies, I also wanted to share an additional quarterly resource that provides a broader view of the state tax landscape. Our Third quarter state and local income tax developments publication covers a wide range of corporate income, sales and use, and other indirect taxes. Taken together, these publications provide a more comprehensive picture of the state tax issues that may be relevant to your business and investors.

Whether you are navigating the growing complexity of digital and data-related indirect taxes, IRC conformity, or wealth and other taxes affecting your investors, we look forward to discussing these developments with you and helping you identify key considerations as you plan for year-end and 2027.

Best regards,

Joel Bencosme

Spotlight: What California's latest tax developments mean for businesses and investors

The quarter was more active than usual in California for tax developments affecting the financial services industry and their investors. The developments span income tax, sales and use tax, proposed wealth taxation, and unitary business issues, creating near-term planning and compliance considerations.

Nonresident's partnership interest 'hot asset' gain not California source

In its July 24, 2026 opinion in *Appeals of J. Burch, J. Carden, and K. Carden*, the California Office of Tax Appeals (OTA) held that ordinary gain recognized under IRC Section 751(a) from the sale of a partnership interest by nonresident individuals was not California-source income. The OTA concluded that Section 751(a) does not convert the sale of a partnership interest into a deemed sale of the partnership's underlying assets for sourcing purposes. In doing so, the OTA declined to follow FTB Legal Ruling 2022-02, which would have sourced the gain based on the partnership's California apportionment.

The decision, currently pending precedential designation, could have significant implications for nonresident taxpayers who recognized and reported California-source ordinary gain under Section 751(a). Affected taxpayers should evaluate potential refund opportunities for open tax years based on their specific facts and transaction structures, while monitoring the opinion's precedential status, the FTB's response, and potential legislative developments. Read more about this decision here.

Retroactive Section 163(j) change

Last year California updated its IRC conformity date to January 1, 2025 via S.B. 711. Due to a drafting error in the conformity bill, California decoupled from the Section 163(j) interest expense limitation for corporations, however not for individuals (partnerships). Therefore, before the current legislative fix, California conformed to the Section 163(j) provisions in effect under the Tax Cuts and Jobs Act for personal income tax purposes. On September 14, 2026, Governor Gavin Newsom signed SB 145, which extends that decoupling to personal income tax purposes retroactively to January 1, 2025.

Actions to consider: Taxpayers should consider its impact on tax year 2026 estimated payments.

Certain software purchases become taxable in January 2027, and some buyers will owe the tax directly

Beginning January 1, 2027, S.B. 122 (signed June 29, 2026) adds digital products delivered electronically or accessed remotely, including prewritten software and SaaS, to California's sales and use tax base. Custom software remains exempt.

For financial services companies, the change may create significant new tax costs and compliance obligations for software and SaaS purchases. The law also introduces new sourcing rules and, in certain circumstances, may shift responsibility for remitting the tax from the seller to the purchaser, including transactions exceeding $5 million in the aggregate.

Actions to consider: Financial services companies should identify the software, SaaS, and other digital products they purchase that may become taxable and update their accounts payable and use tax accrual systems for this change. Companies should also evaluate available exemptions, including those for custom software, interstate use, and qualifying manufacturing or R&D activities. Pricing and contract terms should be reviewed to determine if they are ready for the change. To learn more about this change, access our previously published Insight.

Billionaire tax would leave little time for valuations if it passes

Proposition 40, on the November 3, 2026 ballot, would impose a one-time tax of 5% of net worth on certain individuals and trusts with net worth of at least $1 billion, generally based on California residency as of January 1, 2026 and asset values as of December 31, 2026. Directly held real estate, pensions and retirement accounts are generally excluded. Proposition 40 prescribes specific valuation methodologies and permits certified appraisals only in certain circumstances, which creates uncertainty for anyone holding private businesses, startup interests, art, or other hard-to-value assets.

Two other November ballot measures could affect Proposition 40. Proposition 41 would add audit and reporting requirements for programs funded by new special taxes and could conflict with Proposition 40's exemption from the constitutional spending limit. Proposition 42 would prohibit new state taxes on the ownership of financial assets and restrict certain retroactive taxes. The Legislative Analyst's Office notes that if either receives more affirmative votes than Proposition 40, a court could find that it prevents some or all of Proposition 40 from taking effect.

Actions to consider: The measure is particularly significant for taxpayers holding private businesses, startup interests, art, and other hard-to-value assets because it prescribes specific valuation methodologies and permits certified appraisals only in certain circumstances, creating potential uncertainty and potentially

significant tax consequences. With little time between the election and the April 2027 due date (taxpayers may elect to pay over five years, at an additional cost), potentially affected taxpayers may want to begin preliminary modeling now to identify assets that may need additional valuation or appraisal work if the measure passes. Access our prior Insight here.

Shared back-office services didn't establish a unitary relationship

In *Appeals of Western Distributing Company, et al.*, a Denver-based S corporation sold the assets of Western Beverage, a division that distributed beverages only in Colorado, and reported about $68.2 million of gain as nonbusiness income sourced to Colorado. The Franchise Tax Board (FTB) treated the division as unitary with the rest of the company, which included a trucking business operating in California, and sought to apportion the gain to California.

The Office of Tax Appeals (OTA) reversed FTB's proposed assessments in a June 18 decision designated 'Pending Precedential.' Although the divisions shared ownership and some administrative functions, including payroll, insurance, and accounting, OTA found that purchasing, sales, and day-to-day management were decentralized and that the few dealings between divisions were at arm's-length prices. OTA also rejected FTB's alternative argument that the tax benefit rule required the company to recapture deductions it had previously claimed as part of a single unitary business, because FTB did not show that those deductions had actually produced a California tax benefit.

Why it matters: For diversified groups, including fund sponsors and holding companies whose portfolio businesses operate largely on their own, the decision may support the position that shared administrative services do not by themselves make a business unitary.

Other state developments of note

Illinois bulletin summarizes budget changes, including PTET expansion

In July, the Department of Revenue published Informational Bulletin FY 2027-01, summarizing the income tax changes enacted in the state's fiscal 2027 budget bill, including a new choice in how partnerships calculate the state's entity-level tax for owners. Taxpayers may either pay on the Illinois-sourced share of every owner's income, or on the full income of Illinois-resident owners plus the Illinois-sourced income of everyone else.

The election applies for tax years ending on or after December 31, 2026. The partnership must select which method of determining the tax base they will use to calculate the PTE tax on the IL-1065.

Actions to consider: Taxpayers should model both methods against the actual mix of resident and non-resident owners. Revisit estimated payments now rather than at filing, as the Department has flagged that the change may affect estimated payments.

Massachusetts provides guidance on PTET relief for high earners subject to 4% surtax

Published in July, the Elective pass-through Entity Excise Tax FAQs was amended to account for the recently enacted extension of the PTET to high earners subject to the 4% surtax on income over $1 million, for tax years beginning on or after January 1, 2026. Pass-through Entity Excise Tax FAQs was amended to account for the recently enacted extension of the PTET to high earners subject to the 4% surtax on income over $1 million, for taxable years beginning on or after January 1, 2026.

The FAQs provide:

- Massachusetts is waiving the first two quarters of 2026 underpayment penalties, but only for entities that elect the new 4% pass-through entity tax. Entities electing only the existing 5% tax are not provided relief.
- Nonresident owners cannot utilize the new 4% PTET credit through a group return filed by the business; they have to claim it on their own Massachusetts non-resident income tax return.

Actions to consider: Since the penalty relief covers only the first half of the year, confirm that catch-up payments are being considered. The election must be made on a timely filed originally filed tax return, including extensions; however, the election may not be revoked once made. Finally, nonresident owners may need to be reminded that they will need to file their own Massachusetts non-resident income tax returns to claim the credit, so the filing burden doesn't surprise them at year end.

Pennsylvania provides guidance on Section 163(j) and GILTI

On July 30, the Pennsylvania Department of Revenue (DOR) revised Corporation Tax Bulletin 2019-03 to limit its IRC Section 163(j) guidance to tax years beginning before January 1, 2025, effectively rescinding prior guidance that eliminated the Pennsylvania separate-company interest expense limitation when the federal consolidated group was not subject to a limitation. The DOR also revised Corporation Tax Bulletin

2019-02 to clarify that references to GILTI and FDII apply to NCTI and FDDEI, respectively, for tax years 2026 and later.

Subsequently, on September 10, the DOR issued Corporation Tax Bulletin 2026-01, clarifying that, for tax years beginning on or after January 1, 2025, taxpayers must calculate their IRC Section 163(j) interest expense deduction under pre-OBBBA rules on a separate-entity basis. Separately, the Philadelphia DOR issued guidance addressing the city's nonconformity with the One Big Beautiful Bill Act (OBBBA), including the treatment of Section 163(j), qualified production property expensing, and research and experimental expenditures for 2025 Business Income and Receipts Tax (BIRT) filers.

Read more of these changes in our prior Insight.

New York City retroactively cuts Unincorporated Business Tax (UBT) credit for high-income residents; prior estimated tax payments may warrant review

Enacted Int. No. 972 retroactively reduced the UBT credit available to city residents with taxable income of $1 million or more. Under prior law, all city resident taxpayers with city taxable income of $142,000 or more received a flat 23% UBT credit regardless of income level. Under the new law, the credit phases down from 23% to 15% for taxpayers with taxable income between $1 million and $1.25 million and is capped at 15% for those with income above $1.25 million. To learn more about these changes, access our Insight.

Actions to consider: The change is retroactively effective to January 1, 2026. Taxpayers subject to the reduced credit may want to update their 2026 income tax projections and revisit estimated payments already made or scheduled for the remainder of the year to reflect the lower credit and resulting increase in projected city tax liability. Where the additional city tax cost is material, affected business owners also may want to consider whether entity choice should be re-evaluated.

Texas provides unauthorized insurance premium tax amnesty for non-admitted captives

Announced in the Comptroller's July 2026 Tax Policy News, the Comptroller of Public Accounts is providing a temporary amnesty program for unlicensed captive insurance companies and their insureds. Captive insurers provide coverage to affiliated companies and, if not licensed under Chapter 964 of the Texas Insurance Code, are subject to the unauthorized insurance premium tax at a rate of 4.85% of gross premiums for insurance covering Texas persons, property, or activities. If the insurer fails to pay the tax, the insured becomes jointly liable.

The amnesty program provides a four-year lookback period covering insurance written from January 1, 2022, through December 31, 2025, with penalties and interest waived. To qualify for amnesty, eligible captive insurers or their insureds must file Forms 25-108 and 25-123, the Texas Annual Unauthorized Insurance Tax Report and its supplement, for tax years 2022 through 2025 by December 31, 2026.

Election 2026 State ballot measures to watch

State	Measure	What it does
California	Proposition 3	Proposition 3 would make permanent the higher income tax rates on high earners first approved by voters in 2012.
California	Proposition 40	Would impose a one-time tax on billionaires who were residents of California on January 1, 2026 equal to 5 percent of their net worth.
California	Proposition 41	Would nullify state taxes enacted after January 1, 2026 that exempt their revenues from voter-approved state spending limit. Would require pre-election and recurring audits of programs funded by new special taxes. This is a measure that would counter the impact of Proposition 40.
California	Proposition 42	Would "[prohibit] any new state tax (1) imposed on the ownership of personal property (all things people own other than real estate), or (2) that applies retroactively based on taxpayer's past activities. Nullifies taxes enacted after January 1, 2026 that conflict with this measure."
California	Proposition 43	Would increase the voter approval threshold for voter-proposed local special taxes from a simple majority (more than 50%) to two-thirds effective January 1, 2027.
Colorado	Amendment 87	Would remove the Colorado constitution's requirement that the income tax rate be a single flat rate and replace the current flat rate with a graduated rate.
Colorado	Proposition 136 (Initiative 232)	Would limit the individual and corporate income tax rates to 4.4%.
North Carolina	S.B. 1080	Would lower the cap on the state income tax rate from 7% to 3.5%.

Washington	Initiative to the People IP 26-645	Would repeal the 9.90% tax on individual income exceeding $1 million and prohibit state and local governments from imposing taxes on individual income or taxes measured by individual income.

Let's talk

For a deeper discussion of how these developments might affect your business, please contact your Financial Services State and Local Tax team member.

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