





State of the states: Fiscal steadiness through economic headwinds

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With you today



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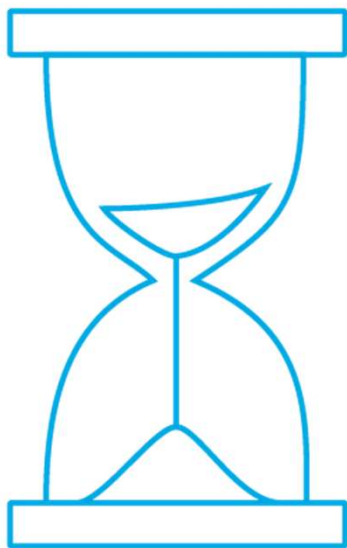
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Agenda

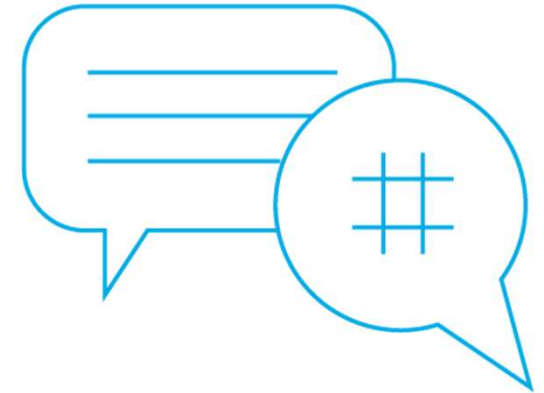


- Election recap and preview
- State of the states
- Legislation
- Litigation

Learning objectives

By the end of this presentation, participants will be able to:

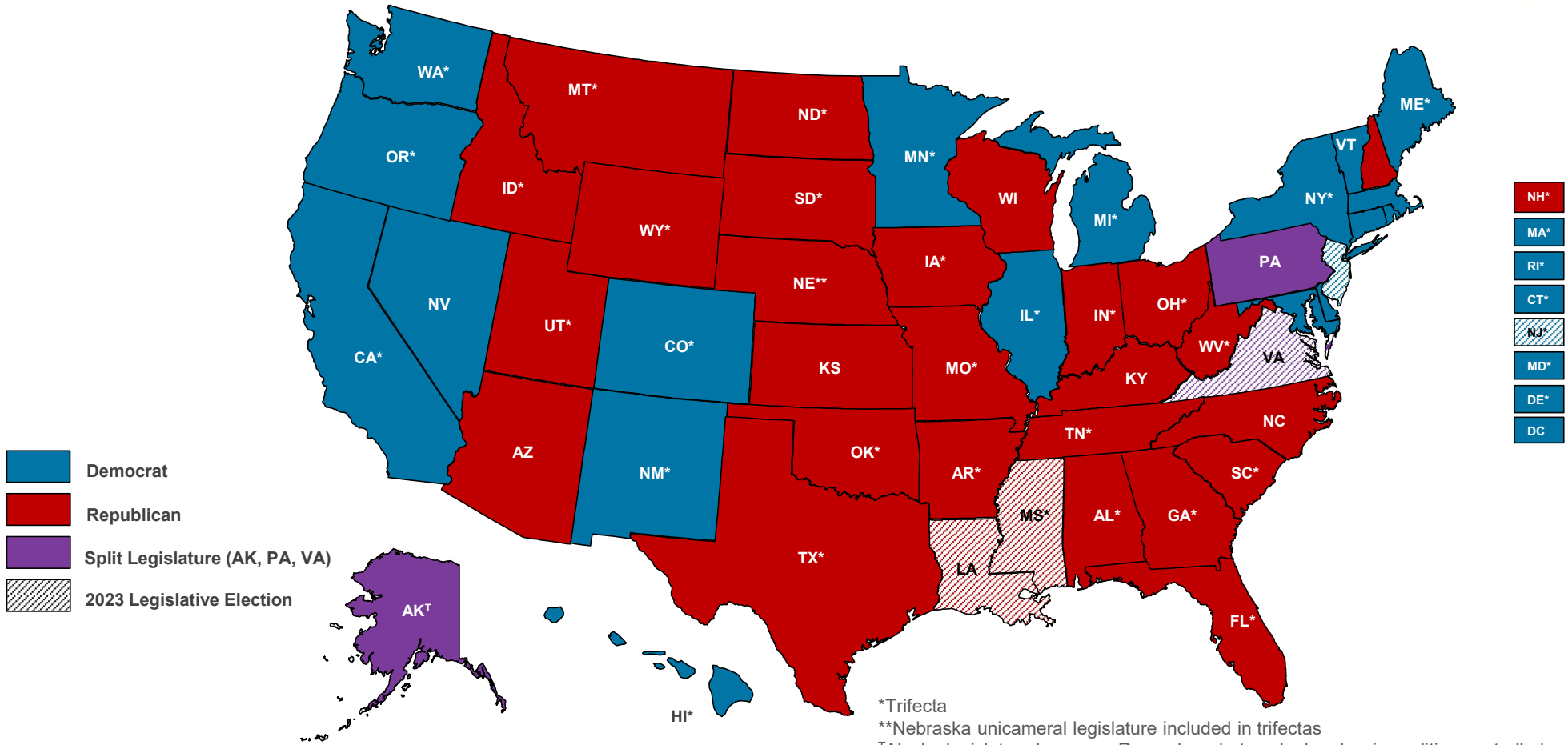
1. Explain the impact of economic headwinds on state taxation
2. Evaluate the implications of recent tax cuts and rebates on state budgets
3. Develop strategies to address uncertainty in state taxation

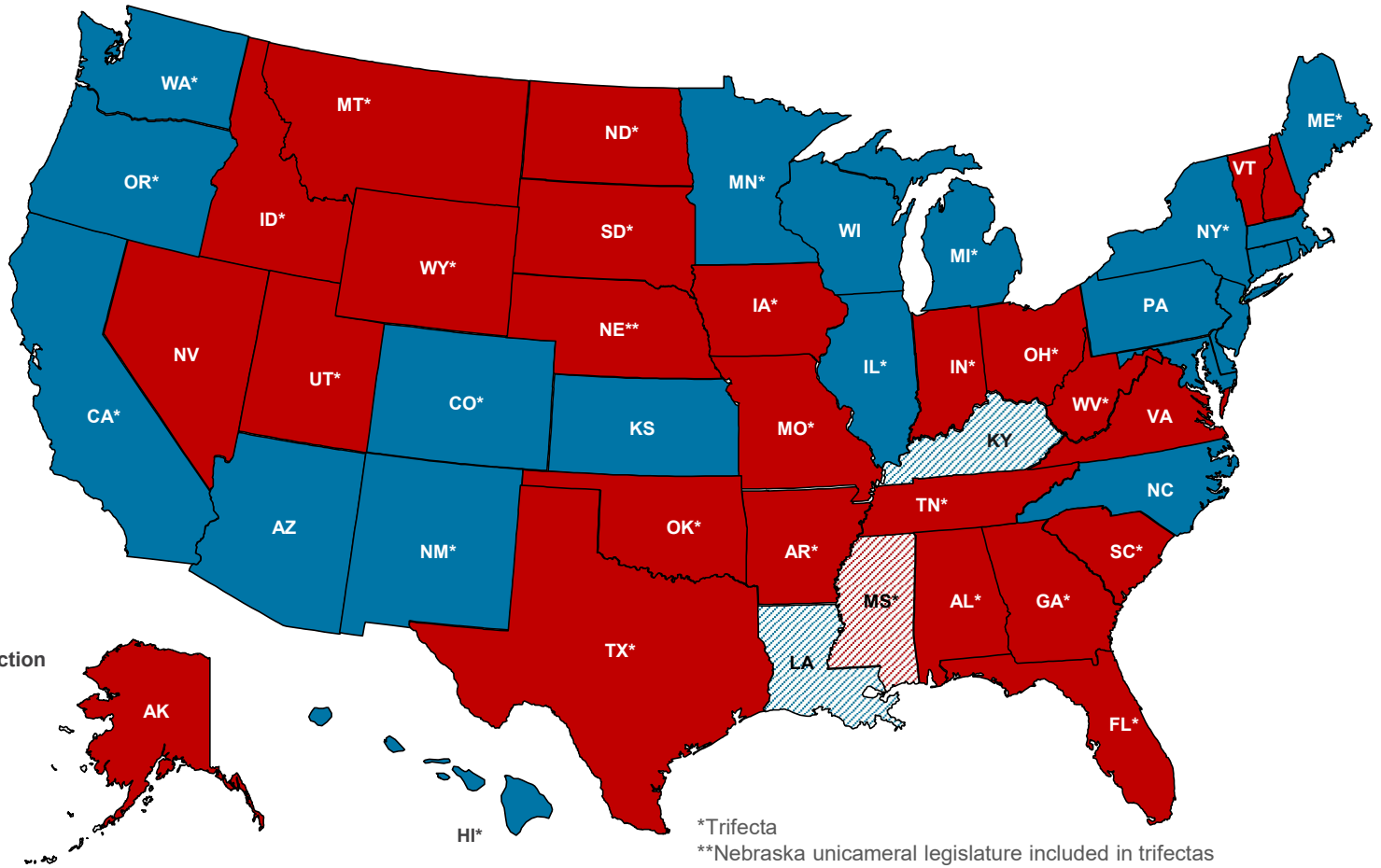


Election recap and preview


Early look at 2023 and beyond







 Democrat
 Republican
 2023 Gubernatorial Election

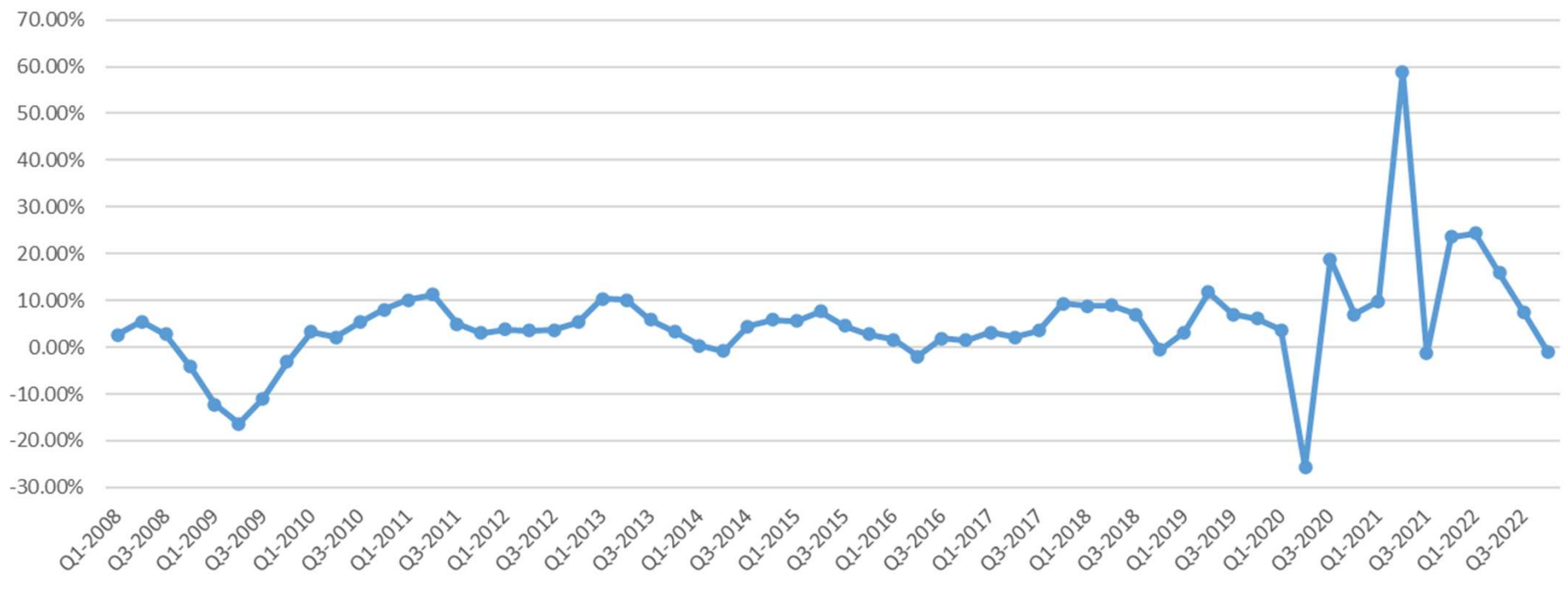
 NH*
 MA*
 RI*
 CT*
 NJ*
 MD*
 DE*
 DC

*Trifecta
 **Nebraska unicameral legislature included in trifectas

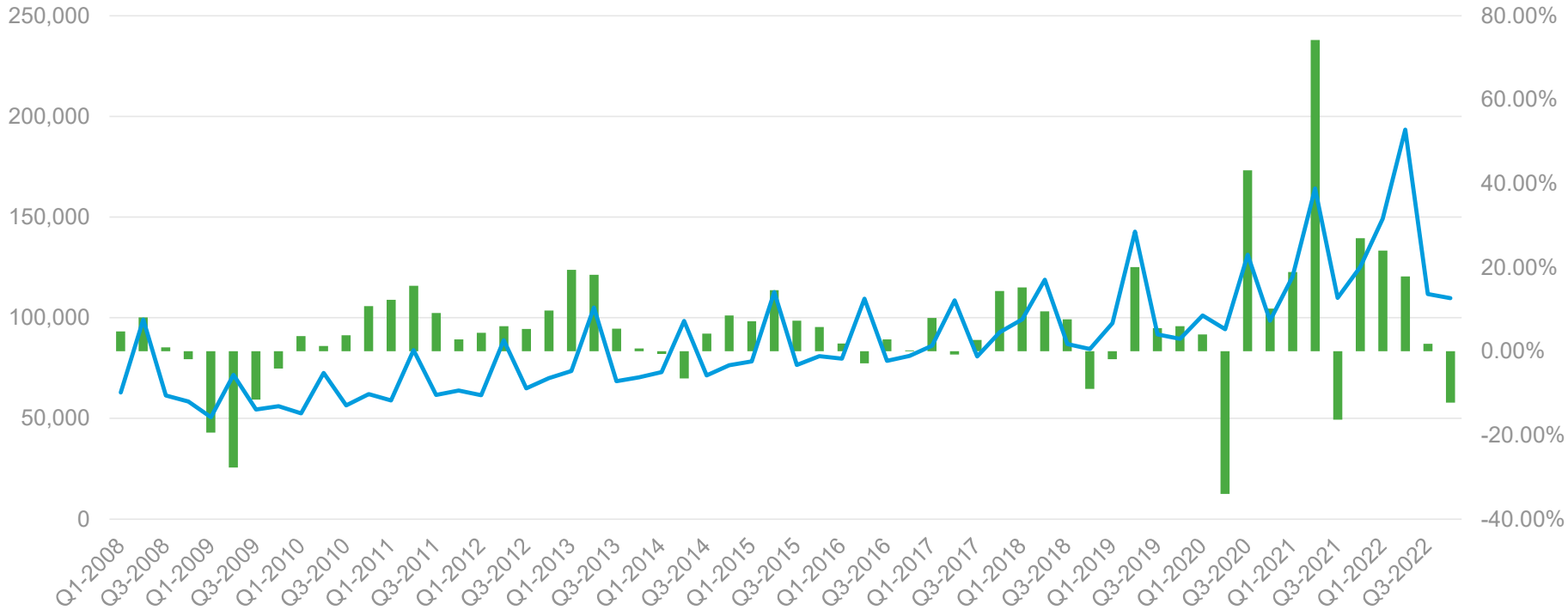
State of the states

Fiscal conditions and what's next

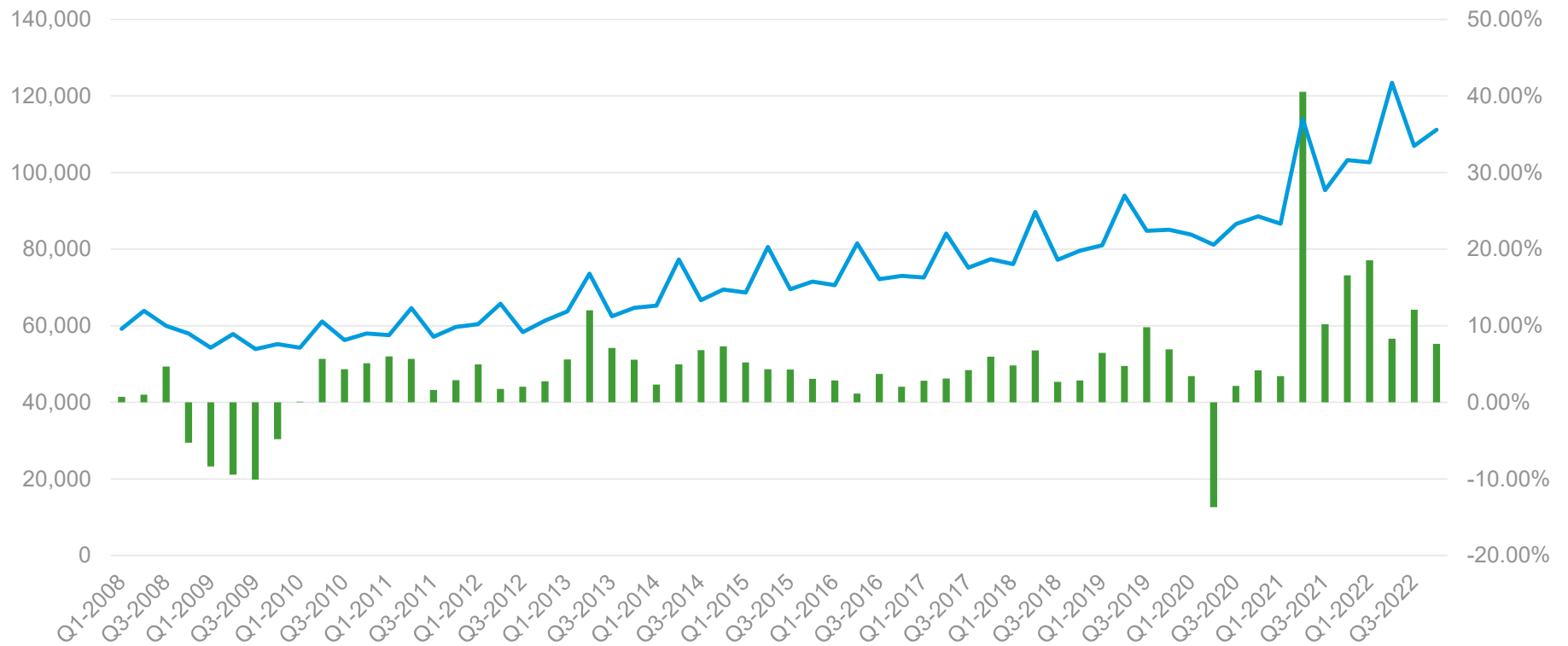
Year-over-year percentage change in total state tax collections -Q1 2008 through Q4 2022



Year-over-year quarterly percentage change of individual income tax collections - Q1 2008 through Q4 2022



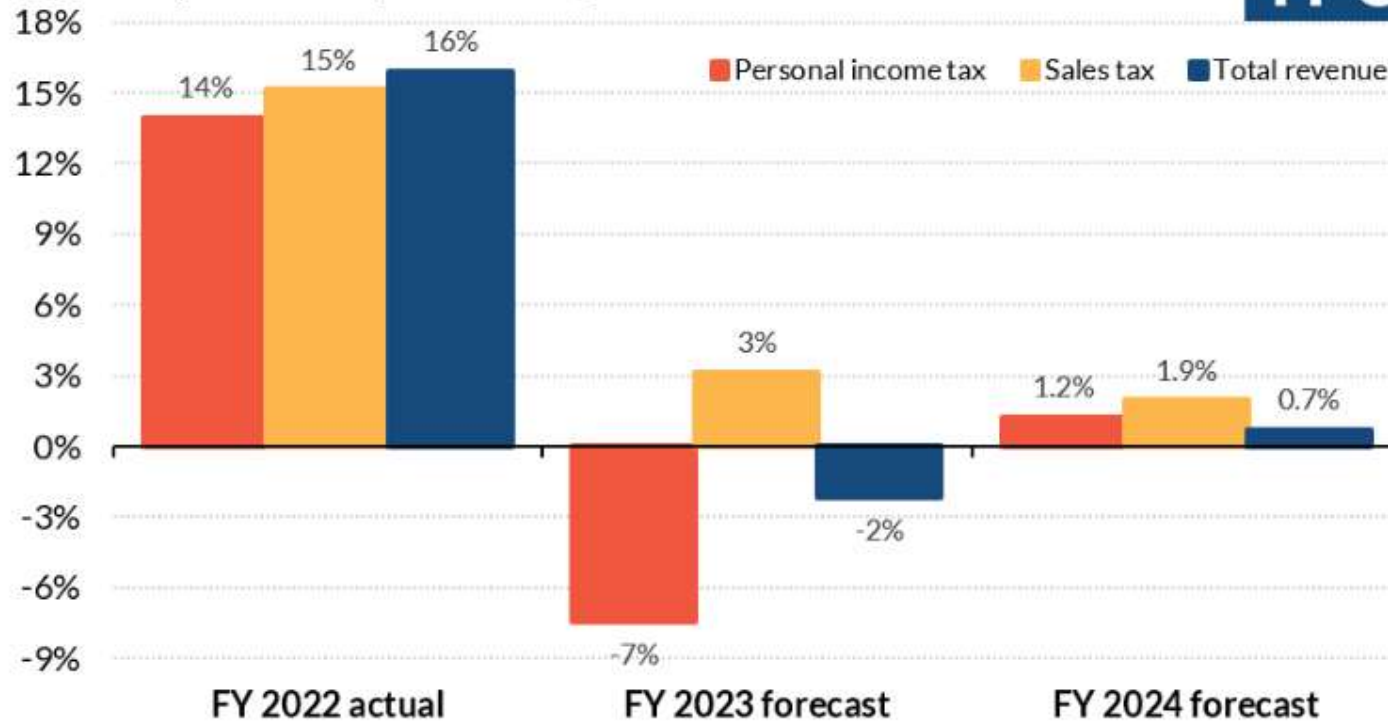
Year-over-year quarterly percentage change in total state sales tax collections – Q1 2008 through Q4 2022



State revenue growth in FY 2022 and forecasts for FYs 2023 and 2024



Year-over-year nominal percent change



Data provided by the Tax Policy Center of the Urban Institute. Please see this site for more information <https://www.taxpolicycenter.org/taxvox/state-revenue-forecasts-look-bleak-revenue-boom-subsides>

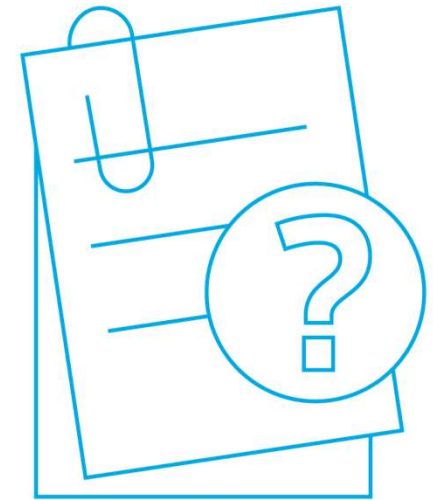
What are the numbers telling us?



- The growth rate for state tax collections slowed beginning in Q3 2022
 - This was expected as prior growth rates were off-the-charts and unsustainable
 - YOY total growth slowing. In Q2 2022 (16%), Q3 (7%) and Q4 2022 (-.9%)
- Factors
 - GDP growth
 - Unemployment rate remains low which provides consistency to individual income taxes
 - Personal consumption continues to be robust
 - In 2022, 18 state sent stimulus checks or rebates
 - Market performance in 2022 and 2023 calendar years could impact individual income taxes
 - Rainy day funds are some of the highest on record, allowing for leeway for the next couple years

Where's the revenue?

- Sales taxes
 - Inflation, *Wayfair*
- Corporate taxes
 - Small piece of the pie, but significantly higher in recent years
- Individual income taxes
 - Primary driver of state tax collections
- Sin taxes
 - Marijuana-related taxation
 - 22 states with tax legislation; Maryland to tax at 9%
 - Sports betting
 - Over two-dozen states, rates as high as 50%
 - Alcohol/cigarette taxes

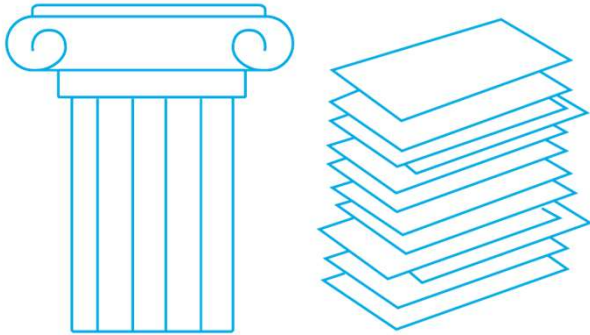


Legislation

States continue to be busy through June



Broad strokes

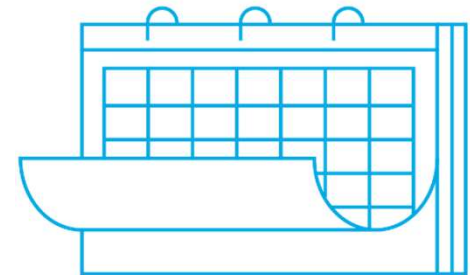


- Individual income tax relief remains popular
- Corporate changes continue piecemeal adoption of apportionment/sourcing
- Targeted expansion of sales tax base
- Direct revenue-raising legislation remains unpopular in state houses

Individual income taxes

- Rate reductions

- Arkansas SB 549 provides reduction of top PIT rate to 4.7% and the corporate tax rate to 5.1%, both a reduction of 2%, effective 2023
- Kentucky HB 37 provides PIT rate reduction to 4% beginning January 1, 2024
- Montana SB 121 provides PIT rate reduction of highest bracket to 5.9% beginning January 1, 2024
- Nebraska provides both PIT and CIT reductions
- Utah HB 54 reduces both personal and corporate income tax rates to 4.65% from 4.85%, effective January 1, 2023
- Proposals in Missouri, Oklahoma and others



Quick hits: Other developments

- Single-sales factor
 - Arkansas election for railroads to use SSF or three-factor with double-weighted sales
 - Montana adopts single-sales factor beginning January 1, 2025
 - Virginia adopts single-sales factor for certain retailer groups beginning January 1, 2023
 - Tennessee single-sales factor phase-in beginning January 1, 2024 for excise/franchise taxes
- Throwback
 - Arkansas scheduled an elimination of throwback by reducing in-state percentages through 2030
 - Louisiana/Oklahoma proposal to eliminate throwback is pending
- Net operating losses
 - Utah allows carry forward of NOLs from tax years beginning on or after January 1, 2008; capped at 80%
- Rolling conformity
 - Virginia adopts rolling conformity beginning January 1, 2023 (previously fixed-date)

Pass-through entity workarounds

- As of today, 36 states/1 city
- Cautions remain—not all PTE owners may benefit
- 2023 PTE elections enacted and proposed (green=enacted blue=proposed)→
- 8+ states amending/correcting provisions in 2023 emphasizes diligence required

Indiana SB 2,
effective 2022

Iowa HF 352,
effective 2022

Kentucky HB
360, effective
2022

Montana SB
554, effective
2023

West Virginia
SB 151,
effective 2022

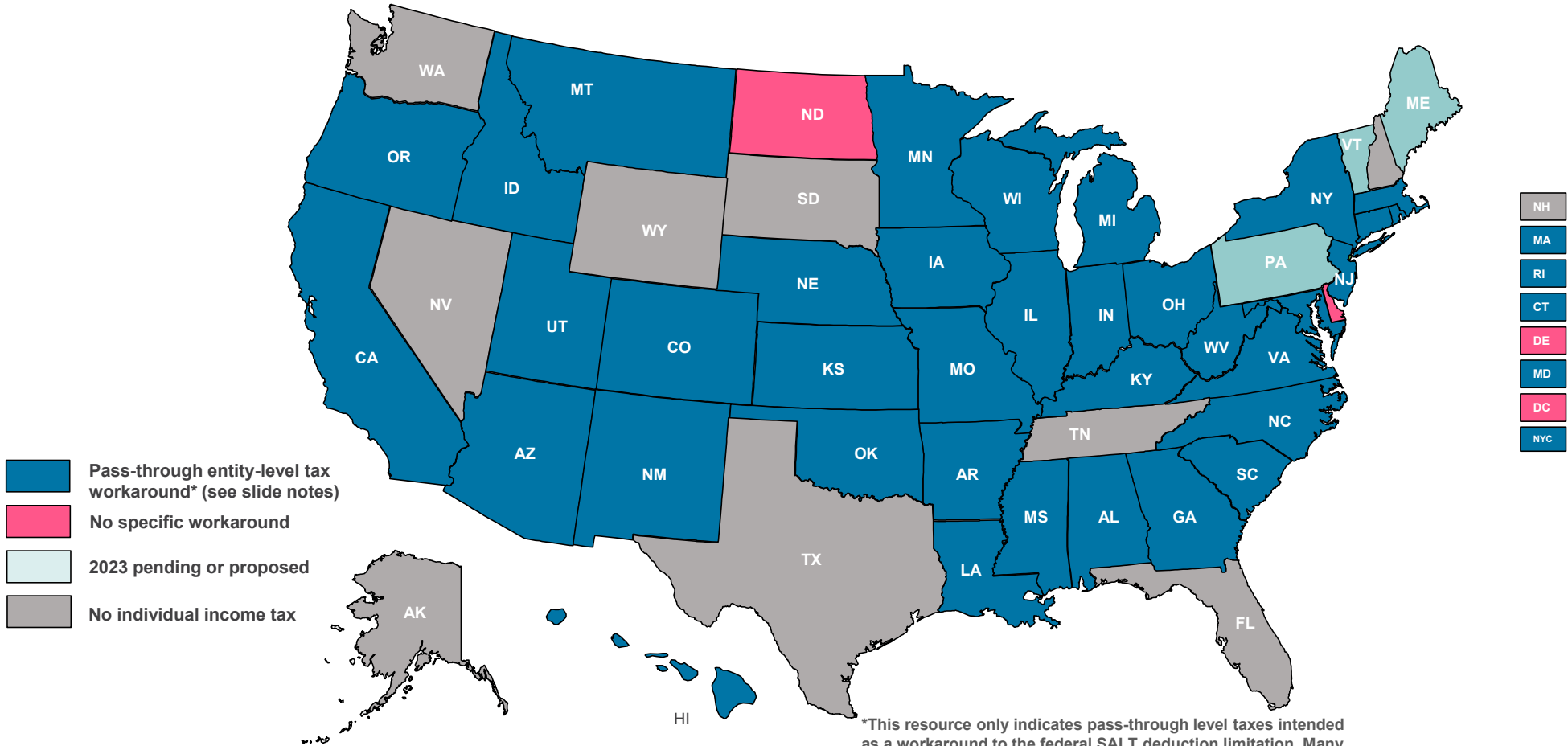
Hawaii SB
1437, effective
2023

Maine LD
1891, effective
2023

Nebraska LB
754, effective
2018
(retroactive)

Pennsylvania
SB 659,
effective 2023

Vermont SB
45, effective
2023



Sales and use tax developments



- Rate reductions
 - South Dakota .3% state sales tax rate decrease until June 30, 2027 (HB 1137)
 - Utah 1.75% sales tax on food elimination will go to voters in 2025
 - Vetoed state sales tax reduction in New Mexico
- Digital goods
 - Georgia to tax digital goods and products
 - Mississippi clarifies that software and software services are subject to tax, provides numerous exclusions and explains that software maintained outside the state and accessible in the state is exempt. PaaS and IaaS are also excluded from computer software.
 - Louisiana and Nevada have proposed to tax digital goods and products
- Delivery fees
 - Colorado amends its fee by raising threshold to \$500,000 and offering option for retailer to pay
 - Minnesota adopts delivery fee effective July 1, 2024



Litigation

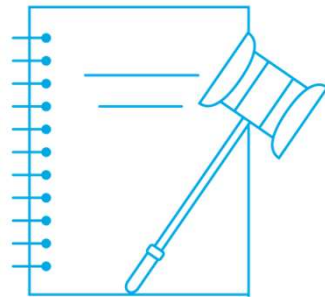


Maryland digital advertising tax lives another day



***Comcast et al. v. Comptroller of the Treasury of Maryland*, No. C-02-cv-21-000509 (Md. S.Ct., May 9, 2023)**

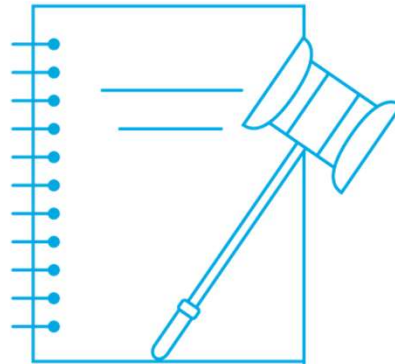
- A Maryland County Circuit Court had held that digital advertising tax violates the Internet Tax Freedom Act, the US Constitution's Dormant Commerce Clause, as well as the First and Fourteenth amendments.
- Maryland Supreme Court found that the taxpayers had not exhausted their administrative remedies in filing the declaratory judgment, thus circuit court did not have jurisdiction



Pennsylvania marketplace inventory

Online Merchants Guild v. Hassell, 282 A.3d 871 (Pa. Commw. Ct. 2022)

- Commonwealth Court of Pennsylvania held that an out of state business does not have sales and use tax or personal income tax nexus simply by virtue of having inventory located within Pennsylvania where the inventory is in an Amazon owned facility and there at the direction of Amazon.



Washington capital gains not an income tax

Quinn v. State of Washington, No. 100769-8 (Wash. 2023)

- On March 24, 2023, the Washington Supreme Court has upheld the state's capital gains tax, ruling that the levy was a lawful excise tax, not an unconstitutional income tax.
- Reversed a lower court decision that determined the Washington capital gains tax was an unconstitutional tax on property. Washington case law establishes income as property, and taxes on property in Washington have strict uniformity and levy limitations that the capital gains tax would violate if it were characterized as such.



Arizona software is the rental of tangible personal property



ADP, LLC v. Ariz. Dep't of Revenue, 1 CA-TX 21-0009 (Ariz. Ct. App. January 31, 2023)

- The Arizona Court of Appeals held that ADP's contract with Maricopa County for the licensing of its Enterprise eTime software was subject to the Transaction Privilege Tax under the tangible personal property rental classification.
- The court likened the software to the sale of jukebox music; which a 1943 Arizona Supreme Court case held was the sale of TPP. The court explained that both jukeboxes and computers produce perceptible effects, for which their users are willing to pay.



Massachusetts cookie nexus crumbles

***U.S. Auto Parts Network, Inc. v. Comm'r of Revenue*, No. SJC-13283 (Mass. December 22, 2022)**

- The Massachusetts Supreme Court held that the Department could not apply *Wayfair* retroactively to impose nexus on a taxpayer whose only contact with the state was through internet cookies. (The taxpayer sold auto parts entirely online and utilized cookies to track customers that visited its website.)
- The court refused to apply *Wayfair*'s holding retroactively because “the regulation, [at issue] by its own terms, limited its reach to nondomiciliary Internet vendors that satisfied the physical presence test set forth in *Quill*.”



South Carolina “BAM” memberships are taxable



Books-A-Million, Inc. vs. South Carolina Department of Revenue, Appellate Case No. 2020-001102, (S.C. Sup. Ct., September 14, 2022)

- Books-a-million offers customers a membership for \$25. Benefits of the membership club include free shipping and discounts on the sales price of tangible personal property, like CDs and books.
- The South Carolina Supreme Court affirmed that the chain’s club membership fees are subject to state sales tax. While the membership itself is an intangible good, members gain a tangible good because they receive discounts on taxable transactions, which makes the sales taxable under state statute.



New York vendor management fees



In the Matter of the Petition of Beeline.com, Inc., DTA No. 829516, (N.Y. Div. Tax App. February 9, 2023)

- The New York Division of Tax Appeals found that a company’s vendor management fees were taxable as the sale of pre-written software. The company offered a web-based application that helps to manage and procure staffing services from requisition through billing.
- The ALJ found the company used the same software for all of its customers; thus, the product was pre-written software – a type of tangible personal property and the primary function test should not apply. The primary function of the sale was a license of software because the software technology and license were “completely intertwined with all the services petitioner offers in the contract.”



U.S. court of appeals for the 9th circuit addresses streaming services



***City of Reno v. Netflix, Inc., et al.*, No. 21-16560 (9th Cir. October 28, 2022)**

- The U.S. court of appeals for the Ninth Circuit held that the City of Reno was not entitled to file a lawsuit against streaming video providers for franchise fee payments. The court held that the law does not create a private right of action for cities to sue for unpaid franchise fees. Reno therefore failed to state a claim against the streaming service providers.
- The court also noted because the city lacks a cause of action under a separate statute, it could not use the state's Declaratory Judgment Act to obtain affirmative relief.



Market-based sourcing developments



- Major litigation addressing state apportionment rules in 2022:
 - Texas – *Sirius XM Radio v. Hegar*: TX Supreme Court clarified that service revenue is sourced to the state where the service is performed for TX franchise tax purposes.
 - Florida – *Target Enterprise, Inc. v. Dept. of Revenue*: FL trial court rules taxpayer’s use of cost-of-performance method to source service revenue for FL corporate income tax purposes was correct.
- Market-based sourcing legislation/administrative guidance:
 - Pennsylvania: legislation applies market-based sourcing to receipts from sales of intangible property/certain financial transactions beginning with 2023 tax year.
 - California: legal ruling addresses application of state’s market-based sourcing rules to certain services provided to business entity customers.



Alaska combined reporting

Dep't of Revenue v. Nabors Intl. Finance, Inc., 514 P.3d 893 (Alaska 2022)

- The Alaska Supreme Court found that Alaska's combined reporting statute requiring taxpayers to include certain foreign affiliates in its income tax return was constitutional
- The court rejected the taxpayer's Commerce Clause challenge, finding that the law was not facially discriminatory because filing a return was not a discriminatory burden, and the law had no discriminatory effect on interstate commerce—which depends on the apportionment formula, which was not challenged. The law was also not arbitrary and irrational under the Due Process Clause, noting that the law was based on the reporting threshold used by the IRS, and simply because a law is characterized as numerically arbitrary does not make it constitutionally arbitrary



Pennsylvania net operating losses



Alcatel-Lucent USA Inc. v. Commonwealth, 290 A.3d 1285 (Pa. Commw. Ct. 2022)

- The Pennsylvania Commonwealth Court held that Alcatel was entitled to refund and that the flat dollar net loss cap should be severed from net loss statute
- The taxpayer was not able to deduct all of its losses due to the state's flat dollar net loss cap of \$4 million. The taxpayer asked the court to apply the decision in *Nextel* retroactively to sever the cap from the statute. The court agreed, noting that *Chevron* test favored retroactive application. Namely, that the decision did not introduce a new principle of law
- Taxpayer was entitled to a refund under uniformity pursuant to Due Process



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