Special Report

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2015 STATE TAX OUTLOOK

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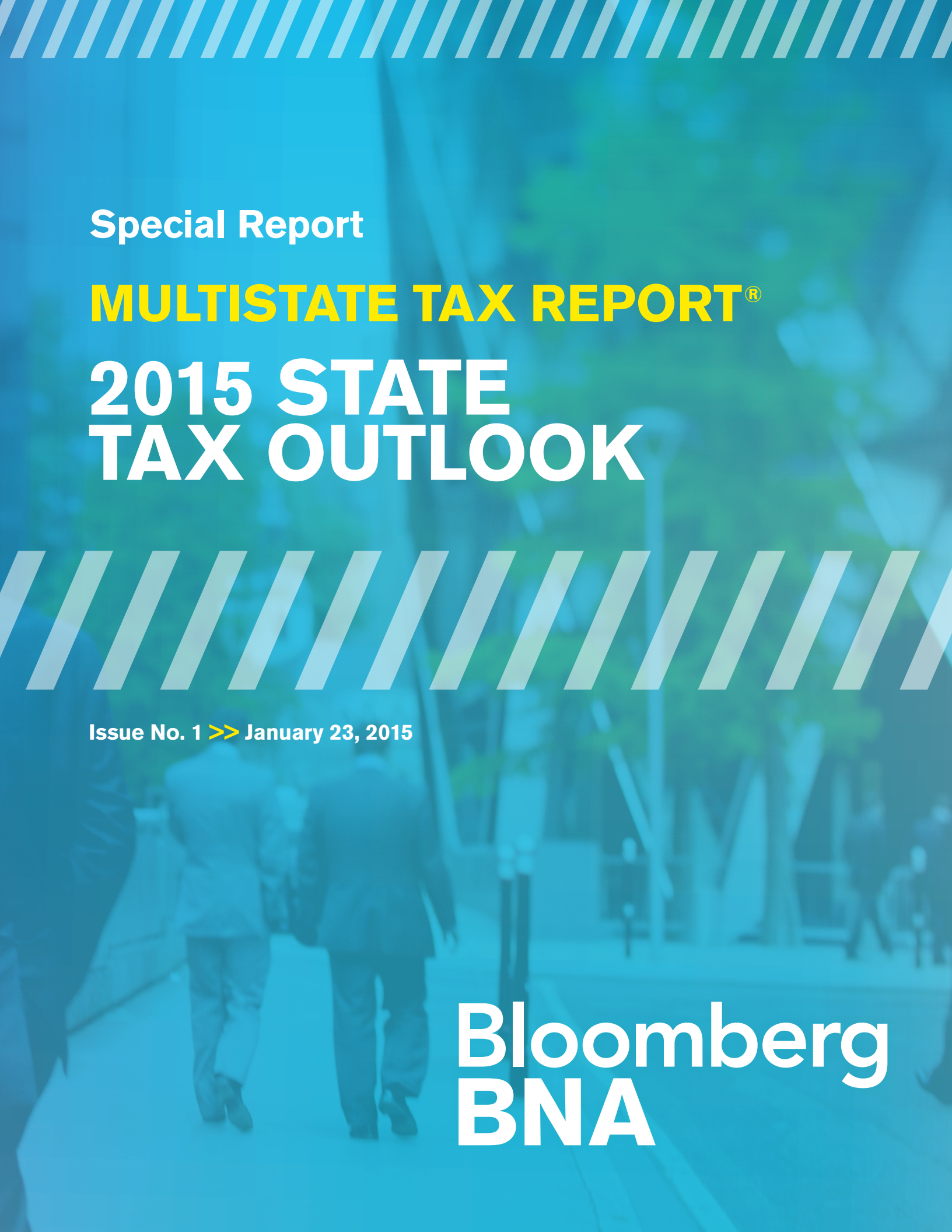

Bloomberg BNA

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Fiscal Outlook

Revenue

In 2015, as many states continue to emerge from the lingering financial hardships of the Great Recession, the fiscal forecast is cautiously optimistic. As states set the budget for the next biennium they will grapple with balancing the need for increased spending on public initiatives, such as education, Medicaid and infrastructure projects, against pressure to provide tax relief. The 2014 election results do not signal major tax policy changes ahead. But many states will be watching Kansas and North Carolina before enacting tax cuts to spur economic growth.

Key Issues: 2015 Fiscal Outlook, Impact of Election, Budgetary Challenges and Prospects for Tax Reform

BY RADHA MOHAN (RMOHAN@BNA.COM)

As states ring in the New Year, there is hope that the slow progress that characterized the states' fiscal health in 2014 will continue in 2015. ''2015 will be ok; not great, but ok,'' said Scott Pattison, Executive Director of the National Association of State Budget Overseers (NASBO), in a Dec. 19, 2014, phone interview with Bloomberg BNA.

It is not 'Happy Days Are Here Again'; but maybe it is 'Pleasant Days Are Here Again'— at least for a short while.

DONALD J. BOYD, SENIOR FELLOW, ROCKEFELLER INSTITUTE OF GOVERNMENT

Although the fiscal climate for the states greatly improved, cautious optimism remains the hallmark of all fiscal and revenue forecasts for 2015. ''It is not 'Happy Days Are Here Again'; but maybe it is 'Pleasant Days Are Here Again'— at least for a short while,'' said Donald J. Boyd, a Senior Fellow at the Rockefeller Institute of Government, in a Jan. 12 e-mail to Bloomberg BNA.

As state tax revenues gradually recover, most states will continue to approach budget decisions with caution, with the exception of certain states that enacted substantial tax cuts, such as Kansas. In 2015, there seems to be little appetite to raise taxes, with the exception of a few targeted increases in certain taxes, such as the gas tax and cigarette tax. The results of the 2014 elections indicate that most states, including those that slashed taxes, will continue their current approach in the New Year.

The results of these budgetary decisions will become apparent when states meet in June to set the budget for the next biennium. States will have to continue to balance the pressure to provide tax relief against the demand for additional spending on public initiatives.

With limited resources, 2015 will be marked by the need for states to increase spending on public programs, such as education, Medicaid, transportation and other infrastructure needs, while balancing pressure from taxpayers to provide tax relief. ''How state revenue departments and politicians respond to these pressures will largely determine the fiscal health of the states in the New Year,'' said Laura Porter, Managing Director of Fitch Rating's State Ratings Group, in a Dec. 18, 2014, phone interview with Bloomberg BNA.

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LAURA PORTER, MANAGING DIRECTOR, FITCH RATING'S STATE RATINGS GROUP

To summarize the states' fiscal position in 2014, Pattison used the analogy of a family recovering from the Great Recession. ''Both parents are back in the workforce, and they received unexpected raises from their jobs, but they will not necessarily be able to immediately repay the money they withdrew from the college funds, and they will still have to make monthly pay-

ments on the home equity loan they took out instead of paying it all off.''

While the relative stability that defined 2014 will continue in 2015, the family seems to be growing; the kids need new shoes and the house has fallen into disrepair. However, there is serious doubt as to whether mom and dad will be able to meet much more than the family's basic needs.

While the relative stability that defined 2014 will continue in 2015, the family seems to be growing; the kids need new shoes and the house has fallen into disrepair. However, there is serious doubt as to whether mom and dad will be able to meet much more than the family's basic needs.

Not Quite 'Happy Days Are Here Again.' June 2015 will mark the seven-year anniversary of the start of the Great Recession. The states are experiencing modest growth, but the recovery is far from complete. Assuming the economic recovery is not derailed, states are still experiencing slow tax revenue growth, said Boyd.

''The Great Recession was a historic one; the worst since the Great Depression,'' said Michael Leachman, Director of State Fiscal Research at the Center on Budget and Policy Priorities, in a Jan. 5 phone conversation with Bloomberg BNA. ''State finances and revenues are just barely back to where they were before the recession. In the meantime, costs have risen sharply; we have 485,000 more kids in public schools and a rise in the number of people requiring services in general. The states have a long way to go before they recover.''

Last year was marked by relative stability as the states balanced election pressures against unexpected drops in revenue in the first half of the year. Since the economy is a strong indicator of state fiscal health, the effects of a sluggish growth are mirrored in state revenue performance.

''State tax revenues generally respond very quickly to the economy,'' said Porter. ''Their budget fortunes will rise and fall based on the economy. Whatever is going on with the economy shows up in those revenues.''

''Since economic trends are all on the upside, the states should mirror the modest progress the economy is making,'' added Pattison.

Tax Outlook for 2015. As state economic fortunes recover, tax revenue has remained tepid. After 17 consecutive quarters of tax revenue growth, with a jump in income taxes in the first half of 2013, state revenues were flat in the first half of 2014, according to the 2015 Outlook released by Fitch Ratings. Total second-quarter tax revenues declined in 33 states compared with the same period last year, according to the State and Local Finance Initiative's State Economic Monitor.

Some states, like Alaska, Ohio and Wisconsin, have been hit particularly hard. Alaska saw a 15.2 percent reduction in total tax revenue in the first half of 2014; Ohio and Wisconsin saw reductions over 10.5 percent of tax revenue. This trend may continue into 2015 as a result of tax cuts and falling oil rates. Additionally, ''financial markets are always a wildcard, especially for the personal income tax,'' said Boyd. ''While this was a positive factor for the 2014-2015 fiscal year, do not expect a repeat for the 2015-2016 fiscal year''

Going into 2015, while experts predict continued growth, revenue growth was less in fiscal 2014 and 2015 than fiscal 2013, according to Pattison. ''Historically, year over year growth is 5.5 percent. But, for fiscal year 2015, it is expected to be 3.1 percent.''

''It is enough; but not enough to celebrate,'' Boyd said.

However, this decline may be temporary. ''With the recent drop in oil prices, most states will see a bump in tax collections as consumers spend more on taxable goods and less on fuel,'' said Ronald Alt, Senior Research Associate for the Federation of Tax Administrators (FTA), in a Jan. 6 e-mail to Bloomberg BNA. ''We are also seeing stronger growth in sales taxes in most states.''

Predictions for the fiscal outlook in 2015 are generally positive, but there is still some debate as to how to interpret indicators. For example, there is some disagreement as to what the recent drop in oil prices may portend. ''There are still a lot of economic risks,'' said Boyd. ''There is a slowdown in much of the world. While oil price declines are generally a good thing, they have been bad recently for the financial markets. They could be bad for selected economies. Additionally, low inflation, disinflation and even some deflation risks are all negative factors for tax revenues.''

Financial markets are always a wildcard, especially for the personal income tax. While this was a positive factor for the 2014-2015 fiscal year, do not expect a repeat for the 2015-2016 fiscal year.

DONALD J. BOYD, SENIOR FELLOW, ROCKEFELLER INSTITUTE OF GOVERNMENT

Other factors that are strong indicators of state fiscal health include the employment rate and state budget spending. Through October 2014, only 22 states had fully recovered to their pre-recession employment peaks, with certain states, like North Dakota, performing better than others, according to the 2015 Outlook released by Fitch Ratings.

Overall, as the economy steadily improves, state revenue forecasts will improve as well. ''The states are in a better position than they were a few years ago,'' said Porter. ''While there may not be huge bursts in spending and budgets are still experiencing below average growth, we will still go into fiscal year 2016 this spring with things looking better,'' added Pattison.

Election Results Indicate No Major Shifts in Tax Policy. After the drama of the mid-term elections in November, taxpayers are looking forward to the New Year and continuing on the road to recovery. As newly elected officials take office, many of them are starting to set the tone for the next four years. Taxpayers will get a view

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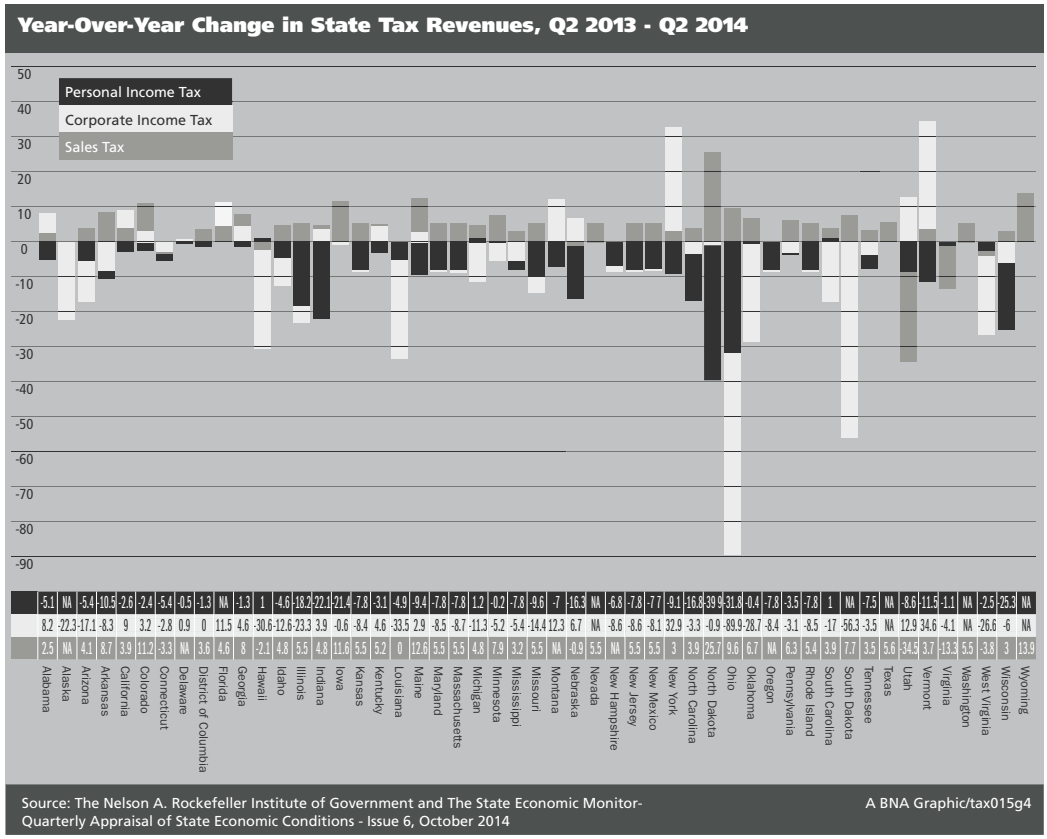

of the newly elected legislatures' agendas in the spring budget.

In 2015, in setting new budgets, states will have to balance budgetary constraints against the increasing costs of healthcare, education and infrastructure projects, while taxpayers clamor for tax relief. ''It will be very important to see how this will play out,'' said Porter. ''It will be a major indicator of the direction states are headed for the next biennium.''

Generally, the 2014 election results seem to indicate that the states will continue on their current trajectory.

In November, there were 36 gubernatorial races and 36 Senate elections held throughout the country. The Democrats lost three seats and the Republicans gained two seats in the governors' races. Ten state legislatures changed hands to the Republicans; 30 legislatures are now in Republican control. Eleven states and seven governorships are in Democratic control. In the Senate, Democrats lost nine seats and Republicans gained nine seats. ''With a few notable exceptions, most incumbent governors were re-elected,'' said Jamie Yesnowitz, a Principal at Grant Thornton, in a Jan. 12 e-mail to Bloomberg BNA.

''These results seem to indicate that most states will continue their current approach to budgeting. It is unlikely that we will see major shifts in policy in the coming year,'' said Leachman.

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However, the election results yielded shifts in power in Congress, with power shifting in the Senate from a Democratic majority to a Republican one. After the 2014 elections on the state level, there are fewer states where the governor and both houses of the legislature are controlled by the same party. ''I don't think the election results as a whole are likely to substantially alter the historic SALT proposals that will come in front of Congress the next two years,'' said Yesnowitz. ''I do think that where there have been shifts in power in particular states, more distinctive state tax legislation in those states is likely to follow,'' he added.

In November, voters also weighed in on 158 ballot measures, according to the 2015 Outlook released by Fitch Ratings. ''The results of the ballot measures reflected increased voter support for funding initiatives,'' said Porter. ''However, voters did not seem to share the same enthusiasm for new tax measures.''

For example, voters in Kansas re-elected Governor Brownback (R), despite his policy of tax cuts that led Kansas to dire fiscal straits and major cuts to education funding. The recent budget cuts led to the recent Kansas Supreme Court decision holding that the inadequate funding for public education was unconstitutional. While voters in Kansas are unhappy about cuts to spending for public programs, it remains to be seen whether they will support tax increases in the near future.

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LAURA PORTER, MANAGING DIRECTOR, FITCH RATING'S STATE RATINGS GROUP

Kansas Faces the Music. As the dust settles after the elections, taxpayers are starting to get a better picture of the current fiscal situation. In states like Kansas, where economics and tax policy were major issues, tax experts were watching the elections closely.

Prior to the election, Kansas faced serious budgetary issues as the state general fund profile indicated a steady decline in available funds. Between fiscal year 2014 and fiscal year 2015, the state general fund availability went from $709.3 million to $379.8 million, according to J.G. Scott, Chief Fiscal Analyst for the Kansas Legislative Research Department, in an Oct. 29, 2014, phone interview with Bloomberg BNA. Currently, there is $29.4 million available in the general fund and projected receipts in excess of approved expenditures is estimated to be about $350.4 million.

The fiscal situation in Kansas remains dire. ''Kansas tax revenue dropped very dramatically in fiscal year 2014 as a result of tax cuts,'' said Duane Goossen, the former Kansas Budget Director for 12 years under three different administrations in a Jan. 9 e-mail to Bloomberg BNA. ''So far in fiscal year 2015 revenue has not been growing, and the official forecast for fiscal year 2016 and fiscal year 2017 shows revenue basically flat as even more tax reductions are scheduled to take effect.''

Although voters re-elected Gov. Brownback, experts believe that that his narrow victory is a sign of voter displeasure. ''Although Gov. Brownback was narrowly re-elected in November, I believe the closeness of the election signals strong concern from Kansas citizens about the direction of the state's tax policy,'' said Goossen.

Furthermore, the depth of the fiscal crisis in Kansas only became clear after the election. ''A week after the election, the fiscal year 2015 revenue forecast was revised sharply downward, further highlighting the reality of the very difficult budget situation that Kansas now faces as a result of tax cuts,'' said Goossen.

''The extent of the damage caused by the tax cuts only became clear after the election. They were drawing on reserves to avoid making deeper cuts prior to the election,'' added Leachman.

After the consensus estimating group met on Nov. 10, 2014, consensus revenue estimates for fiscal year 2015 were decreased by $205.9 million from the fiscal year 2015 approved budget, according to a letter dated Dec. 9, 2014, from Shawn Sullivan, the Kansas Director of the Budget, to Gov. Sam Brownback. As a result, in order to balance the budget, Gov. Brownback will have to cut approximately $280 million from the budget before June 30, 2015.

These cuts only temporarily plug the budget hole. In fiscal year 2016, lawmakers will need to cut approximately $669 million from the budget just to keep the general fund solvent, according to a blog post on kansasbudget.com by Goossen.

As a result of the budget problems, politicians in Kansas may be forced to consider a change in tax policy. ''Some lawmakers have expressed a willingness to reconsider some portions of the new tax policy or to potentially halt the implementation of tax rate reductions scheduled for the future, and the governor has announced that 'everything' is now on the table,'' said Goossen.

Paying the Piper. Policy experts and the media have disparaged the effectiveness of the policy to aggressively cut taxes to grow the economy. However, the governors who instituted these policies were generally re-elected to office. In Florida, Kansas, Ohio and Michigan, governors who cut taxes won; while in states like Illinois and Maryland, politicians who increased taxes were ousted. Given the results of the election, it is more likely that states will push for tax cuts, with a few states instituting small targeted tax increases in certain areas only, a prominent state and local tax policy expert noted.

Politicians who implemented large-scale tax cuts may have short-lived victories as states watch the effect of large tax cuts unfold in many states. This issue will be hotly debated in 2015. ''The question of whether tax cuts really work to grow the economy will be the forefront of tax policy debate,'' said Leachman. ''The fiscal disaster that is Kansas will continue to play out and this will be an issue of significant importance in other states.''

States that enacted large tax cuts in the past are now having to pay for them.

MICHAEL LEACHMAN, DIRECTOR OF STATE FISCAL RESEARCH, CENTER ON BUDGET AND POLICY PRIORITIES

As Kansas comes to grips with the magnitude of its fiscal crisis, largely spurred by huge tax cuts, other states may view this as a cautionary tale. Of all the states, Kansas enacted tax cuts on the largest scale; but the other states that followed suit and enacted major cuts are slowly beginning to see the effects as they are phased in. ''States that enacted large tax cuts in the past

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are now having to pay for them,'' said Leachman. ''Kansas is a very good example of a state with very large budget shortfalls due to its implementation of large tax cuts. Other examples include Arizona, North Carolina and Wisconsin.''

Despite Brownback's win in November, as evidenced by his narrow victory, it is clear that many voters do not necessarily support the policy of large tax cuts. ''Voters in Kansas may like the tax cuts now, but they have not yet had to pay for them'' said Boyd. ''After they face spending cuts in programs or increases in other taxes, we will have a better sense of whether the voters really wanted tax cuts this big. I suspect they will not like what it would take to keep the cuts fully in place.''

In states that also recently enacted tax cuts, such as North Carolina, policymakers are eager to distance themselves from Kansas. North Carolina continues to distinguish itself from Kansas, citing to the fact that it has the 9th largest GDP, as compared to Kansas, which is 31st, according to Stats America's States in Profile report. Furthermore, the tax cuts in North Carolina only represent 3 percent of North Carolina's general fund, while tax cuts in Kansas were 13 percent of the general fund, according to an Oct. 28, 2014 phone interview with Lee Roberts, North Carolina's Budget Director.

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DONALD J. BOYD, SENIOR FELLOW, ROCKEFELLER INSTITUTE OF GOVERNMENT

North Carolina also highlights its more robust economy after implementing large-scale tax reform, including the tax cuts. ''The North Carolina General Assembly enacted comprehensive tax reform during the 2014 legislative session, which has significantly increased the competitiveness and improved the business climate of our state,'' said Roberts, North Carolina's Budget Director in a Dec. 29, 2014 e-mail to Bloomberg BNA. ''We anticipate that the pace of economic growth will remain on a steady upward trajectory in 2015.''

However, revenue predictions for 2015 are not as certain. ''Through November, collections were slightly below forecast, however it is still too early to determine whether or not we will have a shortfall,'' said Roberts. ''We will have a clearer revenue picture after seeing November and December sales tax figures and personal income tax collections from February, March and April.''

Data suggests that tax cuts implemented by North Carolina Governor Pat McCrory (R) are beginning to affect revenues in the state. A recent report issued by the North Carolina Controller on Oct. 31, 2014, indicates that tax revenues are down by about 6 percent from the same time last year.

The recent dip in revenue may indicate that while the tax cuts instituted in Kansas and North Carolina were different in many ways, there are many similarities between the cuts instituted by both states. ''Both states instituted significant cuts that focused primarily on income taxes that disproportionately went to the wealthy and raised taxes at the bottom,'' said Leachman. ''In both states, the cuts were very expensive and they will find it difficult to rebuild and not lose further ground. In both states, the cost of the tax cuts has turned out to be much higher than originally projected.''

While other states may learn from Kansas's mistakes, the election results in November may indicate that taxpayers do not respond well to major tax increases either. ''In Maryland, tax increases may have played a significant role in Governor Larry Hogan's (R) win,'' said Boyd. ''People don't like spending cuts, but they don't like tax increases even more—especially when real incomes are stagnant, so it is painful to pay higher taxes.''

When there is an increase in taxes, voters need to see a tangible return on their investment. For example, several years ago, when California implemented major tax increases, taxpayers got a state university system in return, Dr. Elliott Dubin, the Director of Policy Research for the Multistate Tax Commission (MTC) told Bloomberg BNA in a Dec. 19, 2014, phone interview. ''However, in Maryland, despite tax increases, there were no significant additions to services,'' he added.

Given the recent economic and tax climate, it is unlikely that many states will follow Maryland's example. ''If you are going to raise taxes it has to be a unique event,'' added Pattison. ''Voters want to see balance. If there is a perception that taxes are increased too much, they are uncomfortable with this.''

For example, in Michigan, Governor Rick Snyder (R) who previously made large tax cuts may be considering a targeted increase in taxes. ''Voters yearn for fiscal responsibility,'' said Kurt Weiss, a spokesperson for the Michigan State Budget Office in a Dec. 18, 2014, e-mail to Bloomberg BNA. ''The governor and the legislature recently worked to pass a transportation package that will call on the voters to approve a 1 percent sales tax hike in May in order to raise $1.2 billion for Michigan roads. Our crumbling infrastructure is an example of something that requires additional investment and additional revenue. The vote in May will speak loudly to whether citizens have the desire for raising taxes for something that they have been vocal about wanting.''

This type of targeted increase may be a trend for 2015 throughout the country. ''There may be support for very targeted tax increases, such as cigarette taxes, or increases tied very closely to programs that people

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However, it seems unlikely that many states will institute larger tax hikes. ''If the economy roars, people may find tax increases more palatable; but not now,'' said Boyd.

Instead, it is more likely that states will make modest tax cuts. ''Following the elections, there should be more of a push for tax cuts, particularly income and business taxes, which Republicans tend to favor,'' said Alt. ''I would expect some states to drop the revenue neutral provisions and push for plain income tax cuts if the revenue growth trend continues.'' For example, seven states and the District of Columbia have already lowered their corporate income tax rate in 2015, as a result of statutorily scheduled decreases.

In 2015, this debate will continue to play out as the effects of these tax cuts continue to unfold and some states shift gears and institute targeted increases.

Shaping the Conversation in 2015. As policymakers look forward to setting the budget for fiscal year 2016 this spring, it remains to be seen how they will balance the need for increased spending against the pressure to cut taxes and balance the budget.

There is a lot of overdue maintenance. It has been a long time since most states have raised gas taxes.

MICHAEL LEACHMAN, DIRECTOR OF STATE FISCAL RESEARCH, CENTER ON BUDGET AND POLICY PRIORITIES

In setting the budget, many states will focus on a few key issues around which conversations about tax policy will be framed this year. ''Education, healthcare and funding transportation and other infrastructure projects will be major issues this year,'' said Pattison.

State budgets and finances are expected to continue to improve in 2015. ''In 2015, general fund expenditures are expected to increase by about 3.1 percent,'' said Pattison. While this number is far below the estimated 5 percent increase in 2014, executive budgets show general fund spending increases from $728.8 billion in fiscal 2014 to $751.6 billion in fiscal 2015, according to the NASBO Fall 2015 Fiscal Survey of the States.

Legislators in 43 states enacted a larger budget for fiscal 2015, as compared to fiscal 2014, noted Pattison. ''The slight improvement in state revenues will be evidenced in modest spending increases in K-12 education and other parts of the budget,'' added Leachman. States increased general fund appropriations by about $11.1 billion for K-12 education, $8.5 billion for Medicaid and $1.4 billion for transportation, according to the NASBO survey.

Despite increases in K-12 education funding, many states are still in dire straits in terms of providing adequate funding for education. State courts in four states have ruled that funding for public education is constitutionally inadequate. Despite voters showing enthusiasm to enact targeted tax increases to fund public education, pre-existing funding gaps are major obstacles in many states. For example, Washington recently voted on Initiative §1351 to reduce class size in grade K-12 classrooms, said Dr. Kriss Sjoblom, an economist and Vice President of the Washington Research Council, in a Dec. 2, 2014, phone interview with Bloomberg BNA. However, due to the $4.5 billion budget gap that needs to be filled in the next two years, it remains unclear whether there will be adequate funds to execute the initiative.

In addition to education funding, in the aftermath of the recession, many states were not able to invest in infrastructure projects. ''There is a lot of overdue maintenance,'' said Leachman. ''It has been a long time since most states have raised gas taxes. About a dozen states seriously debated transportation revenue last year. We will see this issue resurface in both red and blue states.''

In states like Florida, Georgia, Illinois, Michigan, and Washington, transportation funding will be a major issue. ''Road funding is our top priority in Michigan, it is just a question of finding the revenue,'' said Tricia Kinley, Senior Director of Tax and Regulatory Reform for the Michigan Chamber of Commerce, in a Dec. 4, 2014, phone interview with Bloomberg BNA.

In Georgia, the state's transportation infrastructure is facing a $1.5 billion dollar shortfall. Georgia Governor Nathan Deal (R) recently announced in his Jan. 14 state of the state address, that in order to just maintain the state's roads and infrastructure, taxes on motor fuel need to be reformed. Gov. Deal noted that the excise tax, which is a per gallon flat fee, has remained the same since 1971. ''In 2014 dollars, we collected approximately 17 percent less in state motor fuel funds per capita for transportation than we did a quarter of a century ago, in part because of greater fuel efficiency,'' said Deal.

In Georgia and other states, as legislatures set their budgets this spring, finding the funds for public works projects, without large tax increases will be a major theme. In South Carolina, Representative J. Gary Simrill (R) has drafted legislation that would lower the gas tax paid by consumers, while applying a 6 percent sales tax to the wholesale price of fuel, which is currently exempt from the sales tax. If voters approved the bill, it would create additional revenue.

In Michigan, lawmakers are also debating proposals to raise revenue to improve infrastructure. ''Michigan's current $52 billion budget provides strategic investments in key areas like education and public safety,'' said Weiss. ''While an improving economy will continue to help the state's revenue picture, the state is now in need of providing additional investment into infrastructure and roads. The only way to meet that need without impacting other vital services is by raising additional revenue through a tax increase.''

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Shifting the Burden to Municipalities. In many states, if the revenue shortage to fund infrastructure projects persists, localities will take matters into their own hands.

An increasing number of localities are looking for additional revenue, especially since they are not getting as much funding from the state.

DEBRA REASON, MASTER COMMISSIONER OF REVENUE OF HOPEWELL, VIRGINIA

In 2015, experts believe that a growing number of municipalities will enact new taxes and step up enforcement to drive economic development goals. ''An increasing number of localities are looking for additional revenue, especially since they are not getting as much funding from the state. Localities are looking for money anywhere they can,'' said Debra Reason, Master Commissioner of Revenue of Hopewell, Virginia, in a Jan. 13 e-mail to Bloomberg BNA.

Many localities are also taking advantage of state incentives to bring in business, noted Reason. For example, in Virginia, The Enterprise Zone program is a partnership between state and local governments that helps generate employment creation and private investment.

''Business leaders in many cities, like Topeka, Nashville, Oklahoma City and Glenwood Springs are driving economic growth'', said Mick Fleming, the President and CEO of the Association of Chamber of Commerce Executives (ACCE) in a Jan. 12 e-mail to Bloomberg BNA. ''Many economic development organizations and chambers of commerce host delegations from other cities as a way to share best practices that enable the private sector and government to come together to create a positive climate for jobs and investment.''

Fleming went on to describe a public-sector fund created in Glenwood Springs, Colorado, that has been created and maintained to bolster pro-growth investments. ''Similar local initiatives, whether publicly or privately funded, are increasingly recognized as critical to future prosperity.''

In 2015, it is likely that we will see more public-private partnerships, added Pattison. ''This issue will be widely discussed, but the success of these efforts is uncertain. We will have to wait and see what ultimately happens.''

Many experts echoed Pattison's view on local funding if states cannot procure adequate revenue. ''In tight budget environments, it is natural to revisit the distribution of state and local government responsibilities,'' said Roberts. ''Some municipalities will likely seek opportunities to conduct infrastructure projects independently of states, however statutory and fiscal restraints will affect these efforts.''

While localities may try to bridge the gap and raise revenue to fund infrastructure projects, they are unlikely to have adequate resources, added Boyd.

Policy Reform to Avoid Budgetary Shortfalls. In 2015 as states set their budgets for fiscal year 2016, the struggle to find adequate funding for public works projects and growing education needs will continue. In many states, due to the economic ups and downs of the decade, state revenue has been volatile, which directly influences the size of budget shortfalls, according to the Fiscal 50: State Trends and Analysis tool by Pew Charitable Trusts (Pew).

For some states, due to their dependence on oil and gas severance taxes, which are heavily dependent on the global energy market, the overall volatility of tax revenues is very high. For example, Alaska, North Dakota and Wyoming are the three most volatile states, with volatility rates of 34.4 percent, 11.6 percent and 12.1 percent respectively, according to Pew.

This volatility can be largely attributed to their reliance on severance taxes. ''If you live by the oil rig, then you die by the oil rig,'' explained Dubin. For example, in Alaska, severance taxes made up 78.3 percent of tax revenue; they account for 46.4 percent of revenue in North Dakota.

If you live by the oil rig, then you die by the oil rig.

DR. ELLIOTT DUBIN, DIRECTOR OF POLICY RESEARCH, MULTISTATE TAX COMMISSION

In order to meet rising budgetary demands, states can work toward reducing volatility and implementing other measures to ensure more steady revenue growth and manage uncertainty in the budget.

Due to heavy reliance of state tax revenues on a cyclical economy, in order to avoid sharp revenue downturns during slow periods of economic growth, in 2015 policymakers should refine budget policies that run counter to economic cycles and save money during growth periods for use in down times, according to Pew.

Part of the problem may be how many states respond to economic downturns. ''During 'boom' times, state and local governments tend to increase expenditures by performing deferred maintenance, implementing desirable (in their view) programs, granting deferred raises, replenishing 'rainy day' funds, and cutting taxes,'' said Dubin. ''That is, most states are reluctant to keeping expanding the 'rainy day' funds beyond what policy makers consider prudent limits. During recessions, because states and local governments face legally binding balanced budget constraints, they cut spending and lastly raise taxes and fees.''

Many states have developed safety measures to help combat volatility. For example, Massachusetts introduced a mechanism to limit capital gains related tax revenue in the budget and limit its use to one-time judgment and settlement payment had helped reduce the risk of overspending in the budget. ''Adopting Massachusetts-like rules that sequester 'one time' or atypical revenue so that it cannot easily be spent on recurring programs'' is a good way to manage volatility, said Boyd.

Going forward in 2015, as economic recovery continues, states should also ''continue to build up rainy day funds, explicitly impose rules on themselves so that they spend less than all of the revenue they forecast and forecast conservatively,'' said Boyd.

By enacting these measures, states may be able to avoid some of the mistakes made during recession

years by reducing volatility and creating more stable revenue streams. This will help alleviate the pressure to cut spending and increase taxes, which will help keep the states on track during the New Year.

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Constitutional Issues

Constitutional Issues

In 2015, the U.S. Supreme Court will decide three important cases that could have profound impacts for state taxes. *Wynne* and *CSX* will contribute to our understanding of commerce clause jurisprudence, while *DMA* will answer the question of whether the Tax Injunction Act bars a state's use tax reporting requirement from being challenged in federal court.

Key Issues: High Court to Rule on 'Credit for Taxes Paid,' Discriminatory Sales Taxes and Scope of Tax Injunction Act

BY MICHAEL KERMAN (MKERMAN@BNA.COM) AND RISHI AGRAWAL (RAGRAWAL@BNA.COM)

The U.S. Supreme Court heard oral arguments in three state tax cases, and perhaps the one with the furthest reaching implications is *Maryland Comp. of the Treas. v. Wynne*.

The Wynnes, who are Maryland residents, are challenging the Maryland tax regime, which provides a state tax credit for taxes paid to other states but does not provide a credit against its county taxes.

Maryland argues that it has a right to tax its residents and has no obligation to provide a credit, even if that income is taxed elsewhere. The Wynnes argue that the tax, without the credit, amounts to double taxation because they pay taxes twice on the same income, to the Maryland county and to the state where the income is earned.

Tax practitioners are keeping a close eye on the court's decision in *Wynne*. ''We are all watching the outcome of this case not because of how it will affect taxpayers like the Wynnes, but [because of] what it says about the court's current view of the dormant commerce clause doctrine,'' said Helen Hecht, general counsel for the Multistate Tax Commission, in a Dec. 17, 2014, e-mail.

Dormant Commerce Clause. The outcome of the *Wynne* case will be the first true indicator of where this court stands on the issue of the dormant commerce clause. Abandoning the dormant commerce clause would not sit well with some. ''Is it fair that someone who works in another state should have to pay higher income taxes than someone who works entirely at home? No, that's not fair and that's something that the dormant commerce clause is supposed to guard against. That's what the internal consistency doctrine would guard against,'' Professor Richard Pomp, Professor of Law at the University of Connecticut, told Bloomberg BNA in a Dec. 17, 2014, phone interview. ''But if the court is willing to abandon those doctrines, then it really has abandoned any notion of fairness,'' he added.

Also unclear is how the court will address its own precedence on the dormant commerce clause. ''If the court manages to get through this opinion without citing *Complete Auto*, then I'd say we know for sure it's passe,'' Shirley K. Sicilian, national director of state and local tax controversy at KPMG LLP, said via e-mail Dec. 18, 2014. A four-prong test to determine whether a state tax is constitutional was laid out in *Complete Auto Transit Inc. v. Brady*, 430 U.S. 274 (1977), *reh'g denied*, 430 U.S. 976 (1977).

A State Victory. In addition to the dormant commerce clause challenge, the implications of a state victory may not bode well for taxpayers across the country. If the court rules in favor of Maryland, ''that would be traumatic,'' Pomp said. ''Right away, there will be states like Connecticut that have a real dog in this fight—maybe more so than most states because the state has a lot of high net worth individuals commuting to New York,'' he added

Is it fair that someone who works in another state should have to pay higher income taxes than someone who works entirely at home? No, that's not fair and that's something that the dormant commerce clause is supposed to guard against.

RICHARD POMP, PROFESSOR OF LAW, UNIVERSITY OF CONNECTICUT

''Every state will look at its tax system and ask the question: what could it be doing differently that it previously thought was constitutionally required? It will

send real ripple effects through the state tax field. It is a radical position to claim that there is no dormant commerce clause relief for individuals,'' Pomp said.

If the court denies dormant commerce clause protection for individuals, it will essentially be making a distinction between interstate commerce conducted by individuals through pass-through entities and interstate commerce conducted by other business formations. ''That would be a major development,'' Sicilian said. ''It would be a departure from the view that the commerce clause protects interstate commerce from state economic protectionism generally,'' she added.

The court ''could issue a decision so broad in scope that it would bleed over to corporate income taxation,'' Pomp said. ''And I would hope the court would be wiser and more limiting in its opinion and realize this is really a Pandora's box,'' he added.

Other State Tax Cases. In addition to the *Wynne* case, in December, the U.S. Supreme Court heard oral arguments in two state tax cases that could have major importance in 2015 and beyond.

In *Direct Mktg. Ass'n v. Brohl*, No. 13-1032, the court addressed the question of whether Colorado's requirement that remote sellers provide information about in-state buyers' use tax obligations amounts to ''tax collection'' for purposes of the Tax Injunction Act. That law bars federal courts from hearing disputes over state tax assessment and collection.

Companies would have to report to Big Brother what customers purchased, not just the amount of tax owed. I don't think anyone would advocate turning over that much information to the government.

STEPHEN KRANZ, PARTNER, MCDERMOTT WILL & EMERY

The court's decision could have downstream effects outside of the sales tax realm, Pomp told Bloomberg BNA in a Dec. 21, 2014, phone interview. Specifically, other taxes that rely on elaborate reporting schemes, like motor fuels, cigarette and alcohol taxes, may be in danger. If Colorado loses before the U.S. Supreme Court, then taxpayers challenging reporting requirements for other taxes may also have an easier route to federal court, Pomp said.

Under the *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992) standard, remote vendors with no physical presence are not required to collect tax, but what is less clear is whether *Quill* also prohibits the reporting requirement at issue here. In an amicus brief filed with the court, Joe Huddleston of the MTC argued that because Colorado's collection rate is so low absent any reporting requirement, the requirement essentially becomes ''collection'' if it's the only practical way for the state to collect.

State Versus Federal Jurisdiction. One unusual aspect of the case is that the issue of the TIA's effect on state versus federal jurisdiction was raised by the 10th Circuit itself, rather than by either party. However, whether the merits are ultimately heard in federal or state court will not have a major impact on the case, Pomp said. ''Most taxpayers think they will get a fairer shake in federal court. But there is no inherent bias in state court judges just because they are paid from state revenue,'' Pomp said.

Further, it's possible that Colorado acted strategically in not raising the issue, because the state did not want to characterize their use tax reporting requirement as a tax, Pomp said. For the TIA to be triggered, the requirement would have to be considered a tax. ''The state did not want to argue *Quill*—instead they wanted to call it a regulation and argue for a broader balancing test under *Pike*,'' Pomp said, referring to *Pike v. Bruce Church Inc.*, 397 U.S. 137 (1970).

Regardless of the court's holding in *DMA*, a clear result will not be seen for some time after. ''If Colorado loses, it's a procedural issue only, not on the merits,'' Pomp said. Because the 10th Circuit did not reach the merits, the case will return to state court for a decision on the merits. ''If the state loses on the merits, they're back in the same position as any other state and that may mean putting a line on their income tax return for use tax, or using assumptions for out-of-state purchases based on certain levels of adjusted gross income.''

Regarding the practicality of the use tax reporting requirement, Justice Scalia unfairly portrayed Colorado's innovation, Pomp said. ''Justice Scalia turned the state's creativity against it, saying if the reporting requirement was such a critical tool to the collection of the use tax, how come no other state has also adopted it. Under that logic, the innovator could never prevail,'' Pomp said.

State Self-Help. But others see the reporting requirement as a state self-help remedy that really seeks to coerce remote vendors subject to the requirement to start collecting instead. ''The states are trying to force someone to litigate because most remote vendors would rather just collect than litigate, unless you have the time and the money,'' Stephen Kranz of McDermott Will & Emery told BNA Jan. 5.

The use tax reporting requirement imposes great burdens on remote vendors, primarily due to the lack of software and systems. ''There is software for sales tax collection available today, but building a whole new infrastructure to get data on all sales—that doesn't exist,'' said Kranz. Without a federal framework for sales tax collection by remote vendors, use tax enforcement will remain an inefficient and impractical task for states, Kranz said.

Another issue with the reporting requirements separate from the tax issues is customer privacy. ''Companies would have to report to Big Brother what customers purchased, not just the amount of tax owed,'' Kranz said. ''I don't think anyone would advocate turning over that much information to the government.''

Railroad Discrimination. The other important case heard by the U.S. Supreme Court is *CSX v. Alabama Dept. of Rev.*, No. 13-553, regarding whether Alabama discriminates against rail carriers by subjecting them to sales tax on fuel, while exempting truckers, who are instead subject to a per-gallon excise tax.

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''*CSX* has the potential for contributing to our understanding of how discrimination is evaluated, even though the discrimination in this case arises in the context of a federal statute—the 4R Act,'' Pomp said. The court's ''discrimination'' discussion could in turn have much wider application to commerce clause jurisprudence or other federal statutes.

The court could limit its discussion of discrimination to the 4R Act alone, but this is unlikely, Pomp said. ''If that happens it does not become a very significant case outside the 4R Act. At oral arguments there did not seem to be much interest in that approach,'' Pomp said, adding that Justice Ginsburg, an advocate of that approach before the U.S. Supreme Court remanded it in 2011, was ''unusually quiet with respect to that approach'' this time around.

Complicated Tax Calculations. The court shouldn't find discrimination here, Pomp opined, because whether the percentage sales tax or per-gallon excise tax is more favorable depends on the current price of fuel, and may change over time.

An important aspect of this case is that it will be difficult for the court to find discrimination, because rail carriers and truckers use different apportionment methods and different valuation methods, Jeffrey Friedman, a partner with Sutherland Asbill & Brennan LLP in Washington, said at New York University's 33rd Institute on State and Local Taxation Dec. 8, 2014, in New York City. ''You will never find discrimination because it's too complicated to even assess whether there's discrimination,'' Friedman said.

Depending on the price of fuel and how many miles a railroad can cover per quantity of fuel, the railroad may actually be better off than truckers in some years, Pomp said. But an overly formalistic approach that simply says the railroads pay sales tax and the truckers do not is overly formal and simplistic, Pomp said, because it deprives the state of explaining why there is no discrimination despite one class being subject to a sales tax and another subject to an excise tax.

You will never find discrimination because it's too complicated to even assess whether there's discrimination.

JEFFREY FRIEDMAN, PARTNER, SUTHERLAND ASBILL & BRENNAN

However, although he believes the state has a strong argument for its treatment of truckers, Pomp finds it problematic that companies that transport items via barges don't pay the sales tax or the excise tax. ''Alabama doesn't have a good story to tell with the bargers—they are the 900-pound gorilla in the room.''

Due Process. While this year's U.S. Supreme Court cases will focus largely on the commerce clause, due process issues remain a concern for state tax practitioners. Taxpayers have faced unpleasant surprises even when a state's laws seemed clear. Craig Fields, of Morrison & Foerster LLP in New York, cited as an example the *Equifax v. Mississippi Dept. of Rev.*, 125 So.3d 36 (Miss. 2013), *cert. denied*, No. 13-1006 (U.S. 2014) in which a taxpayer apportioned its income based on costs of performance per tax agency guidance, but was then hit with penalties for failing to use a market-based approach to source its receipts. However, Fields sees taxpayer willingness to seek redress from state legislatures after unfavorable court decisions as a silver lining, such as in Mississippi after the *Equifax* ruling. ''If you can't get a win in the courts, there are other avenues,'' Fields said. Mississippi amended its alternative apportionment statute on a prospective basis to prevent similar results.

Independent Tribunals. The scales of justice are beginning to tilt more in taxpayers' favor though as more states are adopting tax tribunals that operate independently from the jurisdiction's tax agency. Alabama recently established an independent tribunal after a 15-year process. Independent tax tribunals provide for appeals to be heard by bodies with tax experience, and also give the taxpayer a better perception of the tribunal's independence compared to reviews done by the department itself, said Judge William Thompson, the Chief Tax Tribunal Judge of Alabama's Tax Tribunal.

With Alabama, now approximately two-thirds of the states have independent tax tribunals. This is important because the U.S. is one of the few countries with both a robust national tax system and a robust sub-national tax system, said Karl Frieden, Vice President and General Counsel of the Council On State Taxation (COST).

The presence of an independent tax tribunal is one criterion included in COST's state tax administration scorecard, along with even-handed statutes of limitations for assessments and refunds, reasonable protest times, fair interest rates and transparency in decision making. ''More than half the states still fail the mark,'' said Frieden, noting that interest rates is one area where states have much room for improvement.

For example, the District of Columbia assesses 12 percent interest on assessments, but provides only 3 percent interest on refunds, Frieden explained. Similarly, Frieden said Maryland is ''hedging its bets'' in case of a loss in the *Wynne* case by providing for only 3 percent interest on certain refunds instead of the usual 13 percent. But states, like Alabama, are showing a willingness to make improvements based on COST's standards. ''I thought I was done with grades after law school, but you can't believe how many commissioners are concerned about their grades,'' Frieden joked.

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Federal Legislation

Federal Legislation

Congress concluded 2014 by temporarily extending the Internet Tax Freedom Act and leaving the Marketplace Fairness Act stalled in the House of Representatives. Both of these measures are likely to reemerge in 2015, along with other state-tax related legislation, such as the Business Activity Tax Simplification Act and the Mobile Workforce State Income Tax Simplification Act.

Key Issues: Imposing Sales Tax on E-Commerce, Continuing The Tax Ban on Internet Access and Taxing the Mobile Workforce

BY CHRISTINE BOECKEL (CBOECKEL@BNA.COM), MICHAEL KERMAN (MKERMAN@BNA.COM), ERICA PARRA (EPARRA@BNA.COM) AND CASEY WOOTEN (CWOOTEN@BNA.COM)

THE ITFA: A VEHICLE TO ENCOURAGE PASSAGE OF THE MFA?

The Marketplace Fairness Act (S. 743) remained stalled in the House through the end of 2014. Bills similar to the MFA seem to come up every year but fail to be enacted. Following its passage in the Senate 69-27, on May 6, 2013, it became the subject of significant debate and proposed revisions.

The MFA's purpose is fairly straightforward, as reflected by the bill's full title: ''[t]o restore States' sovereign rights to enforce State and local sales and use tax laws.'' But sales and use taxes are complicated and many businesses that are not otherwise subject to collection requirements are not eager to take on the task.

Since the U.S. Supreme Court established the physical presence nexus standard in *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992), states have been battling to maintain a reliable system for collecting their sales and use taxes. With the economy shifting toward an Internet-based market, it has been more challenging for states to assert that retailers have a physical presence within their borders sufficient to burden those retailers with tax collection responsibility.

The major problem is that even those that generally agree that the MFA should be passed in some form cannot reach a consensus on the necessary details. The version of the MFA that passed the Senate drew questions from state tax practitioners, who noted ambiguity in some of the provisions or complete silence on critical terms.

Some practitioners think that other approaches that are being considered as alternatives to the MFA would be problematic. ''Alternatives to the MFA, like origin sourcing, would be radical and antithetical to a consumption-based tax,'' said Stephen Kranz of McDermott Will & Emery in Washington by phone Jan. 5.

However, as the year drew on, attention in Washington shifted toward other priorities, including campaigns for mid-term elections that shook up the composition of the House and Senate.

Referring to his testimony at a March 2014 U.S. House Judiciary Committee hearing on such alternatives, Kranz said, ''I was discouraging those radical ideas, and have long been an advocate for a sales tax system that uses uniformity and technology. Overturning *Quill* under a simplified, destination-based regime would not be a radical departure from *Quill*,'' Kranz said. ''Congress would be doing what *Quill* told them they should.''

Despite its shortcomings, many believed the MFA had solid momentum and was getting the attention it needed to be revised into something that both the House and the Senate could agree upon. However, as the year drew on, attention in Washington shifted toward other priorities, including campaigns for mid-term elections that shook up the composition of the House and Senate. The MFA also faced a challenge in passage due it its portrayal by some during campaigns for the 2014 elections as an additional sales tax—or even a national sales tax.

But this is nothing new—since 1992, more than 25 bills have been introduced to repeal the *Quill* physical presence standard, according to Kranz. ''This bill has progressed further than ever before,'' Kranz said. Ulti-

mately, Kranz declined to predict whether 2015 will be the year in which Congress will finally solve the issue. ''I stopped wagering on the MFA's passage long ago,'' Kranz joked.

Heading toward the end of the year, the MFA had a second shot as it was pulled into the spotlight with the ITFA, under the guise of a combined measure.

Internet Tax Freedom Act Extension. The Internet Tax Freedom Act limits states from relying on a remote seller's out-of-state computer server as the sole basis for the assertion of nexus and prohibits states from imposing tax on Internet access. Originally enacted in 1998 and extended numerous times to prevent its expiration, the ITFA was set to expire—yet again—on Dec. 12, 2014, when it was finally extended for another year. On Dec. 16, 2014, President Obama signed H.R. 83, the ''Consolidated and Further Appropriations Act, 2015,'' which contained a provision to extend the ITFA through Oct. 1, 2015.

The significance of the ITFA cannot be understated because there is a lot of money at issue—for those states that are grandfathered in and currently impose tax on Internet access, as well as those that would seek to tax Internet access if not prohibited by the ITFA. Eight states remain grandfathered under the ITFA, but a permanent extension may entirely cut off their ability to tax Internet access. There may have been some debate on whether to extend, make permanent, or let it expire, but ultimately there was little surprise that the ITFA was merely extended for another year.

A permanent ban on Internet access taxes is the crucial next step, and the introduction of the bipartisan Permanent Internet Tax Freedom Act reopens the debate in the new Congress.

REP. ANNA ESHOO (D-CALIF.)

A permanent version, the Permanent Internet Tax Freedom Act (H.R. 235), was introduced Jan. 9, sponsored by a bipartisan group of House lawmakers including House Judiciary Committee Chairman Robert Goodlatte (R-Va.), Rep. Anna Eshoo (D-Calif.), Rep. Tom Marino (R-Pa.), Rep. Steve Chabot (R-Ohio) and Rep. Steve Cohen (D-Tenn.). A similar, permanent ban on state and municipal taxes on Internet access failed in the previous Congress.

''A permanent ban on Internet access taxes is the crucial next step, and the introduction of the bipartisan Permanent Internet Tax Freedom Act reopens the debate in the new Congress,'' Eshoo said in a statement announcing the bill's introduction. ''Passage of this bill would ensure that millions of consumers will not be burdened with an increase to their monthly Internet bills due to new state and local access taxes.''

Some who support a permanent version point to consistency and certainty as major considerations. ''Although one could argue that the temporary nature of the previous moratoria put the world on notice that the nontaxability of access charges might not last forever, I believe that as a practical matter, settled expectations would be upset by a change and permitting taxability would create some major uncertainties,'' said Arthur Rosen of McDermott Will & Emery in a Jan. 12 e-mail to Bloomberg BNA.

One specific industry that might be particularly affected by uncertainty in the definition of nondiscrimination is the telecommunications industry, Rosen said. ''Maintaining this principle is important as state and local governments have a tendency to discriminate tremendously when taxing anything related to telecommunications, and I believe that such discrimination is bad tax policy,'' Rosen said.

The permanent bill would remove the October 2015 sunset date from the current version of the ITFA, but does not make any changes regarding the language that grandfathers in those states that had taxes on Internet access when the original ITFA was passed in October 1998.

One surprise, however, was the popularity of a measure that attempted to combine the MFA and the ITFA.

MFA & ITFA Combination. By putting forth S. 2609, a measure that combined the MFA and the ITFA, Harry Reid (D-Nev.) attempted to use the ITFA as a vehicle for passing the MFA, on the basis that the ITFA was likely to be passed as it had been in prior years, and the MFA could be carried with it. However, the combined measure has drawn opposition from lawmakers in nonincome tax states, including Senate Finance Committee ranking member Ron Wyden (D-Ore.), who helped write the original ITFA and doesn't want it paired with the MFA.

Others, like Goodlatte (R-Va.) supported H.R. 3086, a measure that would make permanent the ITFA and not tie its fate to the MFA.

''Combining the MFA and ITFA makes sense as both of them deal with transaction taxes and are focused on the Internet economy,'' Kranz said. ''Ultimately this is a political question and not a substantive one, because the two bills accomplish very different objectives.''

Some practitioners think that combining the two bills would make political sense. ''Many of the state and local tax initiatives that were introduced in the last Congress should be combined for both political and substantive reasons,'' Rosen said. ''Combining them would create several 'offsets' so all parties would win a little and lose a little.''

As the October sunset date approaches, Congress will likely explore the option of combining the two measures. ''It is clear that the recent extension of the ITFA was short term to allow for a more full exploration of the potential that the two issues should be combined,'' Kranz said.

Whether the two will ultimately be combined will depend on the strength of support for the MFA in the new, Republican-controlled Congress, Rosen said.

A GOOD YEAR TO TRAVEL FOR WORK?

Another state tax bill proposed by Congress that has received opposition from states is the Mobile Workforce State Income Tax Simplification Act (H.R. 1129). H.R. 1129 is legislation that would set a standard across states for requirements regarding tax filing and tax withholding for employees working temporarily in another state.

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The Council On State Taxation (COST) believes a national standard ''should be set by Congress to protect nonresident workers and their employers from personal income tax liability when employees travel for short periods of time to work in other states,'' Maureen Riehl, the Vice President of Government Affairs at COST wrote to Bloomberg BNA in a Jan. 6 e-mail. ''The Mobile Workforce bill supported by COST and more than 250 coalition members would establish a 30-day standard or 'safe harbor,' after which an employer would then be liable for withholding tax, and the employee would be liable for filing a nonresident return.'' Currently, many states require taxation of temporary employees that work in the taxing state for only one day.

While legislation for the Mobile Workforce State Income Tax Simplification Act has failed to progress in past Congressional sessions, Rosen told Bloomberg BNA in a Jan. 5 e-mail that he believes that ''members of Congress realize that enactment is necessary to remove an undue burden on interstate commerce,'' and believes there is a very good chance of seeing another version this year. The bill has bipartisan Congressional support but faces strong opposition from state governments, who view it as potentially harming state tax sovereignty.

NATIONAL NEXUS STANDARD FOR STATE BUSINESS TAXES

Congressional legislation impacting state taxation often places states at odds with the federal government. One of the proposed bills, the Business Activity Tax Simplification Act (BATSA), H.R. 2992, was originally introduced by Congressman Jim Sensenbrenner (R-Wis.) in August of 2013. The act would mandate the use of a physical presence standard across all states for determining whether an entity can be taxed. Currently most states require an economic presence standard, which has a lower threshold for requiring taxation by entities doing business or earning income within a state. The bill would expand the protections of Pub. L. No. 86-272 to prohibit taxation of businesses whose activities in the taxing state consist of solicitation of orders or customers for the sale of tangible personal property and all other forms of property, services and other transactions.

Although BATSA has not had much momentum since it was introduced, Arthur R. Rosen a partner with McDermott Will & Emery LLP stated in a Jan. 5 e-mail to Bloomberg BNA that we will see movement with BATSA in 2015 because of ''the change in the composition of the Senate . . . the pressure being put on Congress regarding several other state and local tax bills, [and]. . .the concept has been vetted long enough that all the parties should be comfortable with it by now.''

''The Chairman of the House Judiciary Committee, which has jurisdiction over the bill, has indicated that he intends to move various state tax bills, including BATSA, this year,'' said Maggi Lazarus, an attorney at the Law Offices of John O'Rourke and a proponent of BATSA, in a Jan. 5 e-mail to Bloomberg BNA. Lazarus, whose firm represents the Coalition for Interstate Tax Fairness & Job Growth, said ''progress on BATSA and other state tax bills was delayed because of unresolved concerns relating to the Internet sales tax issue,'' Lazarus said, adding that she does not believe the Internet sales tax issue will hinder movement of BATSA in the current Congress.

It is grossly unfair to force an out-of-state business to pay a direct tax to a state where it has no physical presence and from which it, therefore, receives no meaningful benefits or protections.

MAGGI LAZARUS, ATTORNEY, LAW OFFICES OF JOHN O'ROURKE

Many BATSA opponents believe that if enacted, it will encourage tax evasion and avoidance by creating opportunities for companies to structure corporate transactions and affiliates to avoid paying state taxes, as well as interfere with state sovereignty and undermine the states' ability to create revenue. Opponents also believe it will favor large multi-state corporations to the detriment of smaller businesses that may not have the resources to compete with companies that are selling from out of state but not being taxed by the state to which they are selling.

Proponents of the bill believe that its enactment will level the playing field and is ''the best solution to the problem of confusing, inconsistent and unfair state nexus standards,'' said Lazarus. ''It is grossly unfair to force an out-of-state business to pay a direct tax to a state where it has no physical presence and from which it, therefore, receives no meaningful benefits or protections, e.g., schools, police, fire, transportation, etc. BATSA's physical presence nexus standard would allow for equitable distribution of tax revenue to those jurisdictions where the business taxpayer receives significant government benefits or protections.''

Rosen encourages businesses to ''become actively involved in the legislative process to make sure that they are not taxed by states in which they have no part in the local society.''

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Sales and Use Tax

Sales and Use Tax

In 2015, states are likely to continue to respond to federal inaction by legislating self-help bills that will inevitably create compliance confusion for companies until Congress brings clarity. States are also likely to consider broadening the sales tax base to include services that are presently not subject to sales taxes.

Key Issues: Click-Through Nexus, Hybrid-Origin Sourcing and Broadening the Sales Tax Base

BY MICHAEL KERMAN (MKERMAN@BNA.COM) AND RADHA MOHAN (RMOHAN@BNA.COM)

CLICK-THROUGH LAWS: A PATCHWORK OF STATE SELF-HELP ATTEMPTS?

Unless the Marketplace Fairness Act is enacted in 2015, click-through nexus laws will likely continue to play an important role in the sales tax world this year. Without a federal framework for sales tax collection by remote vendors, states will continue to use self-help remedies, like click-through nexus laws, to counteract federal inaction, Stephen Kranz of McDermott Will & Emery in Washington told Bloomberg BNA in a Jan. 5 phone interview.

Without a federal framework for sales tax collection by remote vendors, states will continue to use self-help remedies, like click-through nexus laws, to counteract federal inaction.

STEPHEN KRANZ, PARTNER, MCDERMOTT WILL & EMERY

Click-through laws are modeled after New York's ''Amazon law,'' which was enacted in 2008 and creates a rebuttable presumption of nexus for out-of-state sellers that compensates state residents for sales made through links on their websites.

The New York Court of Appeals—the state's highest court—upheld the law and in December 2013 the U.S. Supreme Court denied cert. (*Overstock.com LLC v. New York Dept. of Taxn. and Fin.*, No. 13-252, and *Amazon.com LLC v. New York Dept. of Taxn. and Fin.*, No. 13-259). The U.S. Supreme Court's cert. denial should send a clear message that the court is looking to Congress to provide an answer, Kranz said in testimony before the U.S. House of Representatives in March.

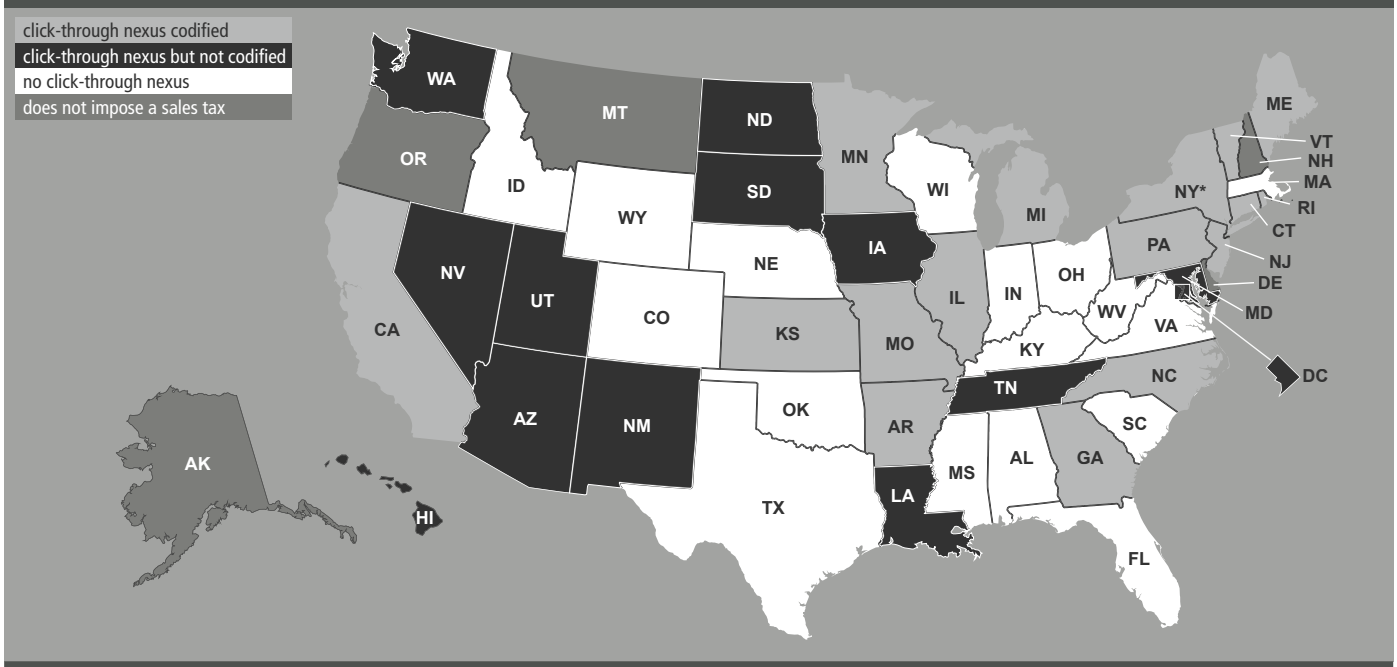
Although the Illinois Supreme Court struck down the state's click-through nexus law in October 2013, holding that it was preempted by the federal Internet Tax Freedom Act, (*Performance Mktg. Ass'n v. Hamer*, 998 N.E.2d 54 (Ill. 2013)), the state enacted another click-through law in 2014 (S.B. 352, enacted 8/26/14), which took effect Jan. 1, 2015, and seeks to remedy the issues the Illinois court found with the state's prior enactment.

Specifically, the court found that Illinois' original click-through nexus law discriminated against e-commerce because it applied only to retailers with Internet marketing affiliates. The new law takes a more expansive approach, including marketing arrangements involving mail, radio and broadcast media.

With Illinois back in the mix, 16 states have now adopted click-through nexus laws, with Michigan adopting S.B. 658 and S.B. 659 Jan. 15 and New Jersey adopting A.B. 3486 in June 2014. But Bloomberg BNA's 2014 Survey of State Tax Departments (April 25, 2014) found that 12 more states, including Arizona, Maryland and Washington, along with the District of Columbia, responded that they consider remote vendors with in-state affiliates to have nexus despite having no click-through laws officially on the books or any administrative pronouncements authorizing them to do so. The total now reaches more than half of the states.

Click-Through Nexus Laws

As of Jan. 15, 2015



Source: Bloomberg BNA 2014 Survey of State Tax Departments, Vol. 21, No. 4, April 25, 2014. A BNA Graphic/tax015g1

State-by-State Click-Through Nexus Laws

Arkansas	California	Connecticut	Georgia
(rebuttable presumption) **Effective:** Oct. 24, 2011 **Threshold:** More than $10,000 **Statute:** Ark. Code Ann. § 26-52-117	(rebuttable presumption) **Effective:** Sept. 15, 2012 **Threshold:** More than $10,000 (and more than $1 million in annual in-state sales) **Statute:** Cal. Rev. & Tax. § 6203(c)	(irrebuttable presumption) **Effective:** July 1, 2011 **Threshold:** More than $2,000 **Statute:** Conn. Gen. Stat. § 12-407(a)(12)(L)	(rebuttable presumption) **Effective:** Oct. 1, 2012 **Threshold:** More than $50,000 **Statute:** Ga. Stat. Ann. § 48-8-2(8)(M)
Illinois	**Kansas**	**Maine**	**Michigan**
(rebuttable presumption); current statute enacted after repeal of former irrebuttable presumption upheld by *Performance Mktg. Ass'n v. Hamer*, 998 N.E.2d 54 (Ill. 2013) **Effective:** July 1, 2011 **Threshold:** More than $10,000 **Statute:** 35 ILCS 105/2, 35 ILSC 110/2, *as amended by* 2014 Ill. S.B. 352	(rebuttable presumption) **Effective:** July 1, 2013 **Threshold:** More than $10,000 **Statute:** Kan. Stat. Ann. § 79-3702(h)(2)(C)	(rebuttable presumption) **Effective:** Oct. 9, 2013 **Threshold:** More than $10,000 **Statute:** Me. Rev. Stat. Ann. § 1754-B(1-A)(C)	(rebuttable presumption) **Effective:** Oct. 1, 2015 **Threshold:** More than $10,000 to in-state purchasers through affiliates (and more than $50,000 gross receipts from sales to in-state purchasers **Statute:** S.B. 658 and S.B. 659
Minnesota	**Missouri**	**New Jersey**	**New York**
(rebuttable presumption) **Effective:** July 1, 2013 **Threshold:** More than $10,000 **Statute:** Minn. Stat. § 297A.66(4a)	(rebuttable presumption) **Effective:** Aug. 28, 2013 **Threshold:** More than $10,000 **Statute:** Mo. Rev. Stat. § 144.605(2)(e)	(rebuttable presumption) **Effective:** July 1, 2014 **Threshold:** More than $10,000 **Statute:** N.J. Rev. Stat. § 54:32B-2(i)(1)(C), *as amended by* P.L. 2014, c. 13	(rebuttable presumption) **Effective:** June 1, 2008 **Threshold:** More than $10,000 **Statute:** N.Y. Tax Law § 1101(b)(8)(vi)
North Carolina	**Pennsylvania**	**Rhode Island**	**Vermont**
(rebuttable presumption) **Effective:** Aug. 7, 2009 **Threshold:** More than $10,000 **Statute:** N.C. Gen. Stat. § 105-164.8	**Effective:** Sept. 1, 2012 **Threshold:** None specified **Statute:** Pennsylvania Sales Tax Bulletin No. SUT 2011-01 (Dec. 1, 2011); proposed legislation in 2013 (H.B. 1043)	(rebuttable presumption) **Effective:** July 1, 2009 **Threshold:** More than $5,000 **Statute:** R.I. Gen. Laws § 44-18-15	(rebuttable presumption) **Effective:** When adopted in 15 other states **Threshold:** More than $10,000 **Statute:** Vt. Stat. Ann. tit. 32, § 9701(9)(I) (H.B. 436)

Source: Bloomberg BNA 2014 Survey of State Tax Departments, Vol. 21, No. 4, April 25, 2014. A BNA Graphic/tax015g6

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This is problematic because rather than solving the problem, it creates an inconsistent patchwork of state laws that burden companies trying to comply, Kranz told Bloomberg BNA. But states see click-through nexus as a way to recoup lost tax revenue from Internet purchases made by residents. For example, the New Jersey Department of Treasury estimated that its click-through nexus law would generate $25 million in revenue in 2015.

And more states will likely consider enacting click-through nexus statutes in the future because of the general success that states have had in enforcing them, Susan Haffield, partner with PricewaterhouseCoopers LLP in Minneapolis, said Dec. 8, 2014, at the NYU Institute on State and Local Taxation.

''We've seen a lot more attention to this issue on Capitol Hill, in state legislatures and in board rooms of large retailers over the past three or four years,'' Kranz said, attributing some of that growing awareness to large retailers going out of business in part because of the difficulty of competing with online retailers that were not collecting sales tax.

The problem is that because taxability would depend on the seller's location, sellers would be incentivized to relocate to states with low or no sales taxes.

Also in 2014, Amazon agreed to begin collecting sales tax on purchases made by Florida customers, despite the state having no click-through legislation. Amazon's website as of Jan. 6 indicates that sales into 23 states are now subject to sales tax.

The year 2015 will bring an onslaught of state legislature attacks against the e-commerce world, through continued use of click-through legislation, use tax reporting requirements and other varieties of state self-help remedies, Kranz predicts. ''The fact that the MFA passed the Senate but stalled in the House has only increased state frustrations with Congress.''

HYBRID-ORIGIN-SOURCING: THE 'NUCLEAR BOMB' OPTION

While the MFA is stalled in the House Judiciary Committee, another approach that is gaining traction for some legislators is origin-based sourcing. Under that approach, an online retailer would collect sales tax based on its own location rather than where the customer is located.

While this concept sounds simple, it has serious drawbacks, so much so that Kranz referred to it as ''the nuclear bomb version of tax competition,'' when he testified at the committee's hearing in March on alternatives to the Senate's version of the MFA. The problem is that because taxability would depend on the seller's location, sellers would be incentivized to relocate to states with low or no sales taxes.

This would essentially be a federal mandate to eliminate sales and use taxes, Kranz said, because businesses located in states that impose a sales tax will demand that such taxes be eliminated. States would also be more likely to increase property and income taxes as a result.

Even with the likelihood of businesses relocating to states without sales taxes should an origin-based system be adopted, some in those states are still not keen on switching to that approach. Consumers in states that don't impose a sales tax would be required to pay sales tax on purchases under an origin-based system if the seller's state imposes such a tax, said Bruce Starr, an Oregon state senator and President of the National Conference on State Legislatures, in an April 2014 letter to House Judiciary Chairman Robert Goodlatte (R-Va.). This undermines a state's sovereignty in determining what taxes its residents should be subject to, Starr wrote.

Echoing the same concerns over state sovereignty, Kranz added that origin sourcing removes the choice of how to tax a transaction from the very state benefitting from the transaction. ''It is the equivalent of letting France unilaterally decide whether the U.S. will get tax revenue from a phone call between a woman in Ohio and her friend in Paris,'' Kranz said.

Origin sourcing could also raise due process concerns, Kranz added, because a purchaser would not necessarily have minimum contacts with the seller's state. ''The purchaser would merely be ordering something with no knowledge or interest in what state the product would originate.''

A modified version called hybrid-origin sourcing has also been advocated, under which origin-based collection would be combined with a system for redistributing funds collected, similar to the process under the International Fuel Tax Agreement (IFTA). However, rather than simplify the situation, this proposal merely combines the problems associated with both origin sourcing and the IFTA into one, Kranz said.

Goodlatte circulated a draft proposal, titled the Online Sales Simplification Act, Jan. 13 to adopt hybrid-origin sourcing, but is open to alternatives to that approach. One noted critic is Rep. Jason Chaffetz (R-Utah), who said a shift to hybrid-origin sourcing would create more problems than it solves. Chaffetz's district is home to Overstock.com.

Further, because the hybrid approach would apply only to remote sales, customers would be left in a difficult situation, Kranz said. For example, if the seller has a physical presence in the customer's state, then the seller would collect based on the customer's location under traditional destination-based rules. But if the seller does not have a physical presence in the customer's state, the seller would collect based on its own location.

Whether a seller has a physical presence is not always a clear determination, and leaving that determination to the customer is problematic, said Kranz.

In stark contrast to the origin-based sourcing proposals before Congress, the European Union just adopted destination-based sourcing rules effective Jan. 1 for VAT on business to consumer sales of telecommunications, broadcasting and electronic services.

Destination-based sourcing has its own complexities, including determining where a customer is truly located, Annette Nellen, a tax professor with San Jose State University, noted in a Nov. 21, 2014, article in the Bloomberg BNA Weekly State Tax Report. For example, a customer might purchase an e-book while

waiting at an airport in one location, but ultimately use it in another.

It is the equivalent of letting France unilaterally decide whether the U.S. will get tax revenue from a phone call between a woman in Ohio and her friend in Paris.

STEPHEN KRANZ, PARTNER, MCDERMOTT WILL & EMERY

Sales tax rules generally assume that the location of delivery is the place of consumption, and there is no reason to not apply the same assumption to electronically delivered goods, Nellen argues. The E.U.'s destination-based system would inevitably require some of the same assumptions, but the E.U. allows for uniform sourcing rules for sales in E.U. countries, Nellen explained.

Hybrid-origin sourcing has one substantial benefit—simplicity, Rachelle Bernstein, Vice President and Tax Counsel of the National Retail Federation, said in a statement presented at an NCSL hearing on state and local taxation Jan. 9. But that is not enough to make the proposal attractive in practice, Bernstein said. ''The competitive problem that brick and mortar retailers face would never be solved by this proposal,'' agreeing with Kranz's prediction that Internet retailers would relocate to states with no sales tax if origin sourcing were adopted.

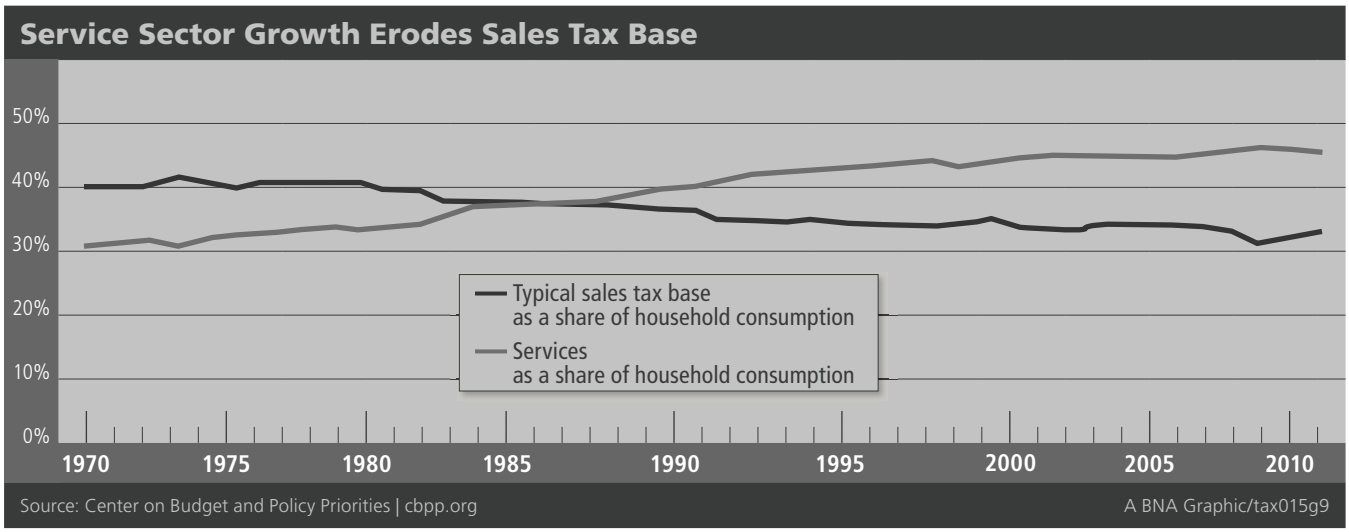
Destination sourcing would level the playing field between Internet retailers and brick-and-mortar stores, because all goods consumed in a state would be taxed the same, Bernstein said. ''The way that locally-elected legislators determined they should be taxed.''

The E.U.'s new VAT rules provide a model for Congress, and also signify falling further behind the times if a destination-based system is ignored. ''If the U.S. adopted hybrid-origin sourcing, we would be the only country in the world that taxed consumption on an origin basis,'' Kranz said by e-mail Jan. 7.

A 20TH CENTURY SALES TAX IN THE 21ST CENTURY

As states emerge from the recession, the struggle to expand budgets and find the necessary revenue to increase spending on key public initiatives, such as education and transportation networks, continues. In 2015, as the economy becomes increasingly service-based and moves away from manufacturing, one way to raise the necessary funds is to modernize the sales tax system, noted one prominent state and local tax policy expert.

As the economy evolves and becomes increasingly service-based, current sales tax systems are too antiquated to keep up. ''In most states, sales tax systems were designed a long time ago, when our economy was much less based on services than it is today,'' Michael Leachman, Director of State Fiscal Research at the Center on Budget and Policy Priorities (CBPP), told Bloomberg BNA in a Jan. 5 phone interview. ''Today, so much of our economy is service-based and these services are exempt from taxation.''



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Sales taxes account for nearly a third of tax revenue that the states collect, according to the CBPP. If states do not modernize the current system, many of them will have to raise their rates in order to maintain current revenues. ''Income and sales taxes are significant sources of state tax revenues,'' said Leachman. ''But, in terms of growth over time, income taxes tend to grow faster. Without modernizing the current system, states have to keep raising the rate if they want revenues to increase.''

Many states recognize the antiquity of the sales tax system as a growing problem. ''In 2015 states will continue to examine this issue and attempt to broaden the base,'' said Leachman. ''However, many states may not be successful; the challenge is that the industries that provide those services will not want to see their services taxed.''

In recent years, many states have attempted to broaden the base of their sales and use taxes with limited success. ''In 2013, Ohio, Minnesota, Nebraska and Louisiana tried to broaden the sales tax base to include a wide range of services. But, their attempts were not successful,'' said Karl Frieden, Vice President and General Counsel for the Council On State Taxation (COST), in a Jan. 13 e-mail to Bloomberg BNA. As more states continue to examine proposals to broaden the sales and use tax base, there are important lessons to be learned from the experiences of these states.

One major issue with proposals to broaden the base is the manner in which these statutes are drafted. ''Part of the problem is that there is a major design flaw in sales tax base broadening efforts,'' said Frieden. ''Sales taxes should be applied to retail consumption (business-to-consumer transactions), not to intermediate purchases (business-to-business transactions). In the 2013 legislation, no exemptions were provided for business purchases resulting in about 80 percent of the additional taxes being imposed on intermediate inputs and not on final retail consumption.''

This design flaw ultimately creates a pyramiding effect. A pyramiding effect results when sales taxes are imposed multiple times on the same value at different stages in the production and distribution process, according to a report by COST, titled ''What's Wrong With Taxing Business Services.'' ''Ultimately, this causes the 'effective' sales tax rate to exceed the statutory rate, which leads many businesses to oppose broadening the sales tax base—even if it's coupled with a lowering of income tax rates,'' said Frieden.

Part of the problem is that there is a major design flaw in sales tax base broadening efforts...

KARL FRIEDEN, VICE PRESIDENT AND GENERAL COUNSEL, COUNCIL ON STATE TAXATION (COST)

In 2015, as states continue to debate broadening the base to increase revenues without raising the rate, many may consider taking a closer look at the mistakes made in previous legislation to help make the new proposals more palatable to the business community.

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Corporate Income Tax

Corporate Tax

States will likely continue to take aggressive positions with respect to nexus in 2015, especially in cases involving corporate affiliates and intangible property. Apportionment methods and the sourcing of income are also likely to remain in focus as more states shift toward a market-based sourcing approach that reflects sales made to customers within their borders. Meanwhile, the California high court is likely to render its decision this year on the controversy surrounding a taxpayer's right to elect the three-factor apportionment formula under the Multistate Tax Compact. The states will press on with efforts to preserve their tax base by implementing policies aimed at preventing income shifting.

Key Issues: Economic Nexus, Apportionment, Market-Based Sourcing, the MTC Election Controversy and Tax Base Erosion

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MORE ECONOMIC NEXUS, AGGRESSIVE ACTION BY STATE TAX DEPARTMENTS

The last year did not bring about significant changes in nexus standards for corporate income tax purposes, with the vast majority of states continuing to employ an economic presence nexus standard. However, 2014 saw state tax departments taking more aggressive positions when making nexus determinations based on an affiliate's in-state activities and lowered thresholds for what constitutes a de minimis level of activity within the state. For 2015, taxpayers should expect these trends to continue.

Expect the states that have not adopted economic nexus yet to do so, either through formal legislation or through administrative action.

JEFF FRIEDMAN, PARTNER, SUTHERLAND, ASBILL & BRENNAN LLP

''There is only a small handful of states that do not assert economic nexus at this point, if you consider those that have factor presence statutes, economic nexus statutes, or no such statutes, but assert economic nexus through administrative guidance,'' Jeff Friedman and Leah Robinson, partners at Sutherland, Asbill & Brennan LLP in Washington, D.C. and New York, respectively, said in a joint Jan. 5 e-mail to Bloomberg BNA. Friedman and Robinson told Bloomberg BNA to ''expect the states that have not adopted economic nexus yet to do so, either through formal legislation or through administrative action.'' ''States that have only administrative guidance asserting economic nexus are likely to push for legislation'' in 2015, they also predicted.

Just because a lot of states have an economic nexus standard does not mean it is constitutional.

JEFF FRIEDMAN AND LEAH ROBINSON, PARTNERS, SUTHERLAND, ASBILL & BRENNAN LLP

Despite the trend favoring economic nexus standards, Fred Nicely, Tax Counsel for the Council on State Taxation (COST) in Washington, D.C., told Bloomberg BNA in a Jan. 6 e-mail that ''COST will continue to advocate that out-of-state businesses should only be subject to a state's taxing jurisdiction when such business receives meaningful benefits and protections from the state.'' He then explained that this generally means a taxpayer needs to be physically present in the state.

As part of its recent corporate tax reform, New York, which Friedman and Robinson described as ''perhaps the largest physical presence jurisdiction left in 2014,''

added a factor-based nexus standard to a list of nexus-creating activities beginning in 2015.[1] Friedman and Robinson told Bloomberg BNA they expect additional states will follow New York and California (which added factor-based nexus beginning in 2011) and implement a factor-based nexus standard either in place of or in addition to their current nexus standard.

''Just because a lot of states have an economic nexus standard does not mean it is constitutional,'' they then noted. Nicely agreed, saying that ''even when a taxpayer exceeds a factor threshold, the mere use of a litmus test to determine whether a taxpayer has substantial nexus is constitutionally deficient.''

Friedman, Robinson and Nicely all pointed to the lack of recent guidance from the U.S. Supreme Court as one way in which states justify the use of economic nexus standards. ''Even though the United States Supreme Court has never affirmed economic nexus, its unwillingness to review economic nexus cases has bolstered state legislatures' and tax departments' confidence in the approach,'' Friedman and Robinson said. ''Unfortunately, especially with the U.S. Supreme Court not having granted review of an economic nexus case post-*Quill* (1992), some state tax agencies feel they have unbridled discretion to assert substantial nexus when a taxpayer lacks any physical presence in the state,'' Nicely said when expressing similar sentiments.

Documenting activities now is the best way to protect your company in the future.

JEFF FRIEDMAN AND LEAH ROBINSON, PARTNERS, SUTHERLAND, ASBILL & BRENNAN LLP

However, in light of recent precedent set by the U.S. Supreme Court interpreting the due process clause when addressing personal jurisdiction in non-tax cases, such as *J. McIntyre Mach. Ltd. v. Nicastro,* 131 S. Ct. 2780, 2011 BL 168067 (2011); *Goodyear Dunlop Tires Operations S.A. v. Brown,* 131 S. Ct. 2846, 2011 BL 168062 (2011); *Daimler AG v. Bauman,* 134 S. Ct. 746, 2014 BL 9151 (2014); and *Walden v. Fiore*, 134 S. Ct. 1115, 2014 BL 49900 (2014), Nicely ''hope[s] that tax administrators become more reserved/cautious on what they pronounce as a nexus creating activity in the future.'' ''While the U.S. Supreme Court has been reluctant on taking a commerce clause nexus case, it may not have the same reluctance with the due process clause,'' he also said.

States' Positions on Nexus Determinations. Another nexus-related trend that taxpayers will likely see again in 2015, perhaps bolstered by the U. S. Supreme Court's recent silence on economic nexus issues, is state tax departments taking a more aggressive stance when determining whether a taxpayer has sufficient nexus with the state.

Friedman and Robinson predict that state tax departments will do so by ''asserting nexus based on the instate use of intangible property'' and ''aggressively pursu[ing] attribution nexus assertions on companies who have affiliates providing some services'' in the state. Additionally, ''state tax departments are likely to ask for more information regarding telecommuting and traveling employees,'' they said. ''To the extent that states still have a physical presence standard, telecommuting and traveling employees (and the property they carry with them) could exceed a de minimis presence,'' Friedman and Robinson went on to explain.

Generally, taxpayers may rely on Pub. L. No. 86-272 to protect them from creating nexus with a state simply by soliciting sales of tangible personal property in the state. As state tax departments take more aggressive positions and the economy continues to shift away from sales of tangible personal property and towards sales of services and digital goods, taxpayers in 2015 may question the value of these protections and the role they will play in the taxpayer's attempts to avoid nexus with a state.

Nicely, Friedman and Robinson all told Bloomberg BNA that Pub. L. No. 86-272 will continue to be important in 2015, but recognized its changing role in today's economy. ''P.L. 86-272 does, however, need to be modernized,'' Nicely said, adding that ''since its passage in 1959, interstate commerce has only increased. This includes more interstate services transactions which are not expressly covered under P.L. 86-272.''

COST is hopeful the new 114th Congress will use its authority under the commerce clause to legislatively affirm physical presence as the substantial nexus requirement for all business activity taxes.

FRED NICELY, TAX COUNSEL, COUNCIL ON STATE TAXATION (COST)

Friedman and Robinson acknowledged that ''the digital economy raises a lot of issues'' for Pub. L. No. 86-272. For them, one issue is whether any digital goods and products (including services delivered electronically) are properly treated as tangible personal property for income tax purposes. ''We see states assert that many digital goods and products are tangible property for sales tax purposes,'' they said, before questioning whether states should ''be required to take consistent positions for income tax and therefore for 86-272 protection.'' Taxpayers can expect more litigation surrounding this issue, Friedman and Robinson told Bloomberg BNA.

Companies that are not affected by today's digital economy must also be mindful of its reliance on Pub. L. No. 86-272, particularly given states' increasingly aggressive positions on nexus. ''As states adopt 'Finnigan' rules for apportionment—as New York formally did for 2015—an affiliate's nexus with [the state] could have

[1] *See* N.Y. Tax Law §§209(1)(a) and (b), *as amended by* N.Y. 2014 A.B. 8559/S.B. 6359, *effective* Jan. 1, 2015 (imposing the corporation franchise tax on all domestic and foreign corporations for the privilege of exercising its corporate franchise, doing business, employing capital, owning or leasing property or maintaining an office in New York or including receipts of $1 million or more in the numerator of its New York apportionment formula).

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the effect of voiding a company's 86-272 protection,'' Friedman and Robinson said.

Friedman and Robinson suggest that, in order to prepare themselves for these coming trends, taxpayers should maintain detailed records, not only of whether its employees or property enter a state, but also of what is being done in a state. Taxpayers must continuously review their activities and those of their affiliates, including by having their tax departments ''be vigilant in checking in with the business and operations folks to know what the company is doing and where,'' they said. According to Friedman and Robinson, ''documenting activities now is the best way to protect your company in the future.''

For Nicely, federal action is needed to protect taxpayers from the negative effects of these trends. Nicely would like to see Congress ''address this important issue and pass legislation to impose uniform and consistent requirements on when a state or local government can impose their tax on out-of-state businesses.'' ''COST is hopeful the new 114th Congress will use its authority under the commerce clause to legislatively affirm physical presence as the substantial nexus requirement for all business activity taxes,'' he also said.

IN 2015, CONTINUED FOCUS ON APPORTIONMENT, SOURCING ISSUES

State Adoption of UDITPA Amendments. The need for revisions to Article IV were first addressed in 2009, but the draft amendments were not approved for public comment until December 2012. Over a year passed before the Executive Committee approved the recommend amendments voted on by the member states. Finally, the Multistate Tax Compact member states voted to adopt market-based sourcing provisions and other long-awaited revisions to the compact during this year's annual business meeting on July 30 in Albuquerque, New Mexico.

The amendments, which passed with an 81 percent vote and without discussion or opposition by those present, change UDITPA's apportionment and sourcing provisions by:

- moving from cost-of-performance to market-based sourcing for services and intangibles;
- giving states the option to choose their own factor weighting, but including a recommendation that states double-weight the sales factor;
- expanding the definition and scope of ''business income'' to all income that is apportionable under the U.S. Constitution; and
- narrowing the definition of sales to exclude hedging transactions and treasury receipts from the sales factor.

Although MTC members approved the compact amendments, taxpayers must now wait and see if member (or even non-member) states will enact legislation conforming their sourcing and apportionment provisions to these amendments in 2015. Whether they do ''will not be driven by member or non-member status,'' Joe Huddleston, Executive Director for the Multistate Tax Commission in Washington, D.C., told Bloomberg BNA in a phone interview on Dec. 30, 2014; ''it will be driven by how taxpayers do business in the state,'' he said. When issues relating to the amendments arise, both member and non-member states will look to the model language provided by the MTC, Huddleston added. ''The amendments provide a template for the states that do not follow the Compact,'' Jamie Yesnowitz, a State and Local Tax Principal at Grant Thornton LLP in Washington D.C., also told Bloomberg BNA in a Dec. 31, 2014, e-mail.

2015 Legislation. Huddleston does not believe there will be significant movement by the states to adopt the model language in 2015. ''It is almost always slow moving with the states,'' he said, before explaining that this was largely due to the fact that states moved based on the businesses and economy in their jurisdictions. Unlike Huddleston, Yesnowitz said he ''think[s] the MTC's adoption of market-based sourcing for services and intangibles pursuant to the revisions made in the Compact will be considered in several of the state legislative sessions commencing early in 2015, with the possibility of two or three of the western states that traditionally have been closely aligned with the MTC's efforts making these changes in 2015.''

It is almost always slow moving with the states.

JOE HUDDLESTON, EXECUTIVE DIRECTOR, MULTISTATE TAX COMMISSION

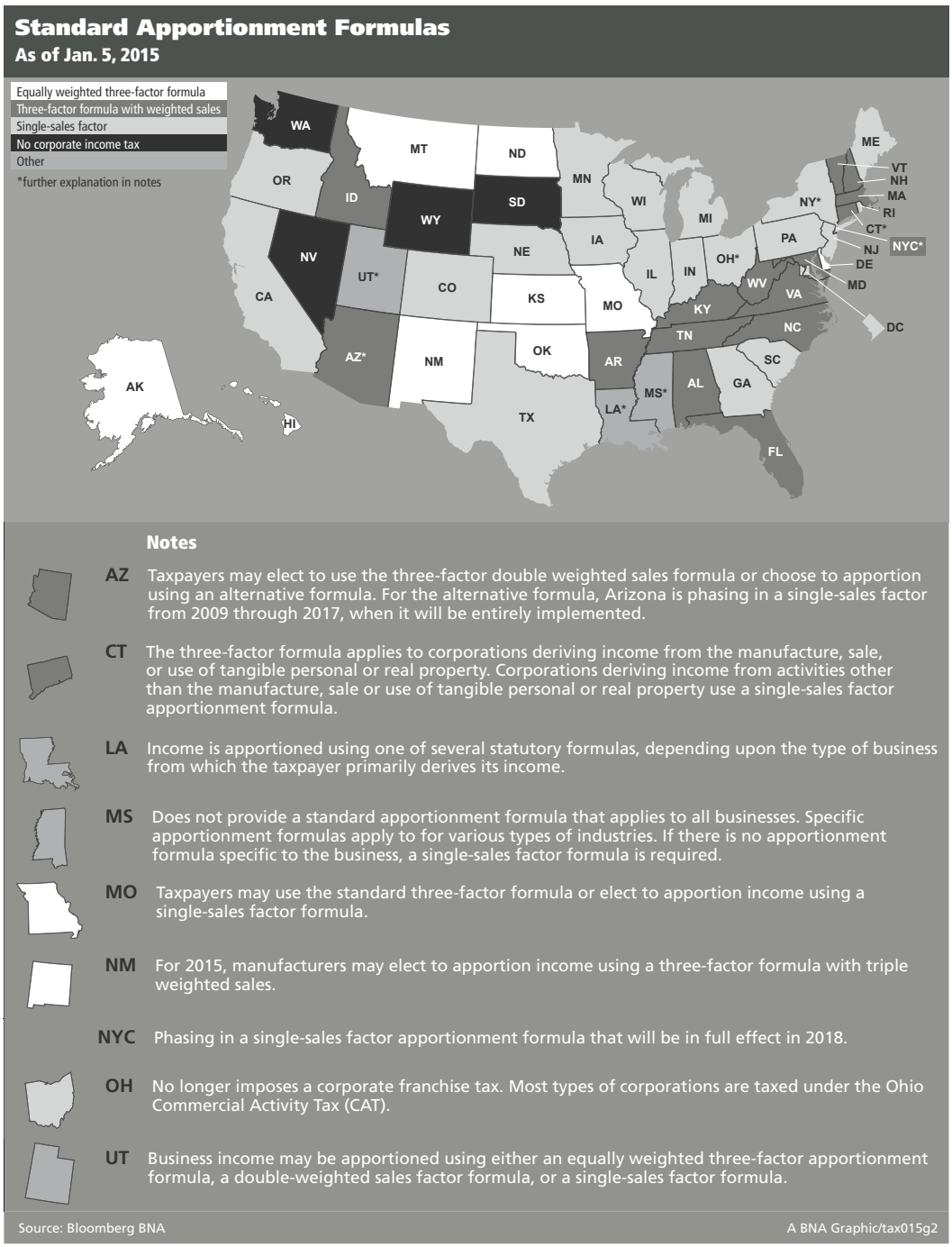
Although Yesnowitz said states will follow the MTC's adoption of market-based sourcing, he told Bloomberg BNA ''the factor weighting recommendation of double-weighted sales is unlikely to be heeded by states, which have shown that they want complete autonomy in setting the parameters of their apportionment formula.'' But ''as the sales factor becomes even more important in the determination of corporate income tax liability, one would hope to see more guidance published by state tax departments,'' he said.

According to Yesnowitz, issues on which guidance is needed include when the size of an apportionable receipt distorts the apportionment formula to the extent that exclusion from the apportionment factor or an alternative apportionment formula is necessary, how taxpayers in the remaining cost-of-performance states measure their costs of performance and whether a taxpayer must source every transaction in a revenue stream or if it may source via a grouping method.

While they await the adoption of the MTC Compact amendments by the states, there is not much that taxpayers can do to prepare for the change. As the economy continues to change, taxpayers are in an ''unenviable and somewhat uncomfortable position right now,'' Huddleston told Bloomberg BNA, adding that, as a result, they are already adjusting to reflect the changing economy. When legislation adopting the amendments is enacted, Huddleston recognizes that taxpayers will need to adopt different reporting methods and said they must do so. ''The amendments were largely driven by how businesses do business, so the change in reporting won't be that big of a problem for taxpayers,'' he added, using large multinational taxpayers already used to reporting a variety of ways as an example.

Increased Use of Single-Sales Factor Formula. The states are likely to continue the trend of measuring corporate income based on a taxpayer's sales within their borders and place less emphasis on the amount of property or payroll within their jurisdiction. The rationale behind this is to attract out-of-state businesses to develop deeper contacts with the state by removing payroll and property factors from the apportionment formula.

New York, Rhode Island and the District of Columbia are all moving to a single-sales factor system in 2015. Minnesota completed its phase-in of the single-sales factor in 2014. California has required single-sales factor apportionment for multistate businesses since 2013, Michigan since 2012, Indiana since 2011, Colorado since 2009, Georgia since 2008, and Maine since 2007. This is a larger, more slow-moving trend, but many states are changing to this over the three-factor apportionment formula in the hopes it will attract investment from larger multistate businesses.



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However, critics have argued that single-sales factor formulas have not brought business and jobs to the states that have made the switch. In Florida, single-sales factor apportionment has been available since 2013 as an elective measure for taxpayers with a minimum of $250 million in qualified capital expenditures in state within a two-year time frame. When asked about the effectiveness of single-sales factor apportionment in Florida, former state legislator and current Pasco County Tax Collector Mike Fasano said in a Jan. 7 phone interview with Bloomberg BNA that there has been no record of new jobs created in the state as a result of this tax break and no record of any corporations coming to the state to take advantage. Fasano noted that the requirement for $250 million in capital expenditures made it very difficult for companies to qualify, and noted that even companies who qualify, such as Publix Super Markets, have said that the incentive did not affect their actions when it came to investing within the state.

I am also waiting for a constitutional challenge, since single-sales factor fails the Supreme Court requirement that the formula match the taxpayer's activities.

ARTHUR ROSEN, PARTNER,
MCDERMOTT WILL & EMERY LLP

When asked about these policies, Arthur Rosen, a partner at McDermott Will & Emery LLP, said in a Dec. 30, 2014 e-mail to Bloomberg BNA, ''While I am not an economist, I do know that state tax does, indeed, play a significant role in corporate decision making.'' Rosen then noted that further court battles on the subject are likely, saying ''I am also waiting for a constitutional challenge, since single-sales factor fails the Supreme Court requirement that the formula match the taxpayer's activities.''

Shift Towards Market-Based Sourcing. Although most states continue to adhere to the cost-of-performance sourcing rule when calculating the sales factor of a multistate taxpayer's apportionment formula, the number of states using a market-based sourcing approach is growing steadily.

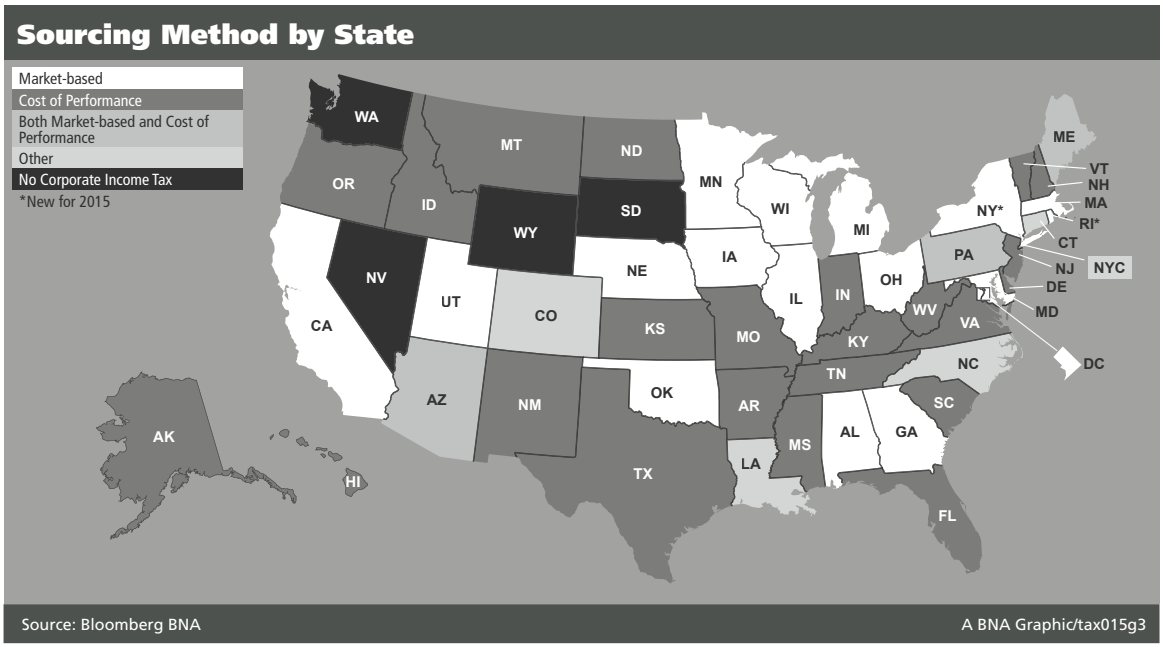
I don't see those states immediately shifting to market-based sourcing but it's something that they may consider.

JAMIE YESNOWITZ, PRINCIPAL,
GRANT THORNTON LLP

Under the cost-of-performance approach, receipts are generally sourced to a state if the income-producing activity is performed entirely in that state or, when the income-producing activity is performed in multiple states, if the income-producing activity is performed more in that state than in any other state, based on costs of performance. Unlike the cost-of-performance approach, the market-based sourcing approach sources receipts to states based on the location of the taxpayer's market for the receipt. Even though this approach is increasingly gaining popularity, its implementation varies greatly among the states and takes into consideration a number of different factors when determining where the taxpayers market is located.

The market-based sourcing approach gained several additional followers in 2014. This method was implemented for the first time in 2014 for taxpayers in the District of Columbia, Massachusetts, Nebraska and Pennsylvania. Market-based sourcing was also adopted, but not implemented, in 2014 by New York, Rhode Island and the Multistate Tax Commission (MTC).

We will continue to see ''a movement of states towards market-based sourcing'' in 2015, Huddleston predicted, in a Dec. 30, 2014, phone interview. Yesnowitz also told Bloomberg BNA in a Dec. 31, 2014, e-mail that more states are likely to will adopt market-based sourcing for services and intangibles in the coming year. However, ''there are several non-UDITPA states



that remain tied to different methods of cost of performance,'' he said. ''I don't see those states immediately shifting to market-based sourcing but it's something that they may consider,'' Yesnowitz added.

Regulatory Guidance. 2015 will not only bring about the use of market-based sourcing for taxpayers in New York, Rhode Island, and possibly others, but it will also see the introduction of regulations providing additional guidance on the approach by Massachusetts, which adopted its regulations on Jan. 2, and the MTC, which is currently in the process of developing these regulations using those issued by Massachusetts as its starting point.

Huddleston is also optimistic about the prospect of publishing the MTC's model regulations on market-based sourcing, despite the lengthy amendment process culminating in the adoption of market-based sourcing in Article IV, Section 17 of the Multistate Tax Compact. ''There was a lot of industry opposition in the beginning, but you will see us moving much quicker in the next year or so regarding the regulations,'' Huddleston told Bloomberg BNA.

According to Yesnowitz, the MTC's sourcing regulations will be interesting for states that have recently adopted market-based sourcing and may serve as a template that could be followed more closely by tax departments in states that follow the approach adopted by the MTC. States that did not follow the statutory template used in the changes to the compact ''are unlikely to be able to completely follow the prospective regulatory changes proposed by the MTC unless these states act to modify their statutes accordingly,'' he said.

There was a lot of industry opposition in the beginning, but you will see us moving much quicker in the next year or so regarding the regulations.

JOE HUDDLESTON, EXECUTIVE DIRECTOR, MULTISTATE TAX COMMISSION

Sourcing Rules Adopt to Digital Economy. As the trend towards a digital economy continues, taxpayers have watched as the states adjust their varying tax schemes to reflect this change. Over the past year, state tax departments have increasingly addressed the issue of how to appropriately source receipts from sales of digital goods or services, including receipts from cloud computing and software as a service transactions—generally, by applying market-based sourcing principles governing receipts from intangibles or services.

Some states, such as Illinois and Florida, have done so by issuing administrative rulings sourcing such receipts based on the location of the customer.[2] Other

[2] *See* Illinois Private Letter Ruling IT-14-003-PLR (April 24, 2014) (ruling that receipts from dedicated and public clouding computing transactions should be treated as receipts from the sale of services and sourced based on the location of the cus-

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states, including Massachusetts, Nebraska and New York, have included specific sourcing provisions within their market-based sourcing rules addressing specific digital-related goods or services.[3]

''Specific sourcing rules for particular types of sales, like those adopted by Massachusetts, Nebraska and New York, are definitely in vogue and stand in stark contrast to the historic uniform UDITPA approach to all sales of items, other than tangible personal property,'' Yesnowitz told Bloomberg BNA.

For Yesnowitz, the question then becomes whether states can create sourcing rules for every type of sale imaginable that remain understandable to taxpayers, follow sound tax policy, are consistent between the different industries and do not become obsolete as technology continues to change. ''I think it's going to be a challenge, but given the increased importance of the sales factor, consideration of these issues is a necessity,'' he said.

CHANGES TO ALTERNATIVE APPORTIONMENT

Another issue likely to see significant developments in 2015 is alternative apportionment of corporate income, as 2014 saw several significant developments in alternative apportionment in different state courts.

Alternative apportionment is a solution to situations in which the taxpayer corporation has a unique situation that causes the standard statutory formula of apportionment to not accurately reflect the taxpayer's income, in relation to the level of business contact that the taxpayer has to the state. Most states have systems in place in which either the taxpayer or the state department of revenue can request the use of a different formula that more accurately reflects the taxpayer's income in proportion to its activity in the state.

In November, the Tennessee Supreme Court agreed to hear the appeal of the decision in *Vodafone Americas Holdings Inc. v. Roberts*, Tennessee Ct. of Appeals, No. M2013-00947-COA-R3-CV (June 23, 2014). In *Vodafone*, a telecommunications company tried to apportion its income based on the standard statutory cost-of-performance method of sourcing receipts. The Tennessee Department of Revenue required Vodafone to use an alternative, market-based method of sourcing to apportion its income, resulting in a larger tax liability.

tomer); Florida Technical Assistance Advisement 13C1-007 (Oct. 25, 2013, released Nov. 25, 2014) (concluding that receipts from products and services delivered or submitted over the Internet to the taxpayer's online database or interactive network, the conversion of data, the administration of premium plans and the licensing of proprietary intangible assets are sourced based on the location of the customer).

[3] *See* Mass. Regs. Code tit. 830, §63.38.1(9)(d)(4), *as amended*, Jan. 2, 2015 (differentiating the sourcing of receipts for services delivered electronically from those not delivered electronically); Mass. Regs. Code tit. 830, §63.38.1(9)(d)(7), *as amended* Jan. 2, 2015 (providing special sourcing rules for software transactions and sales or licenses of digital goods or services); Neb. Rev. Stat. §77-2734.14(3)(b) (providing sourcing rules for receipts from application services); N.Y. Tax Law §210-A(4), *as enacted by* N.Y. 2014 A.B. 8559/S.B. 6359, *effective* Jan. 1, 2015.

Thus, using alternative apportionment to turn cost-of-performance sourcing, as the legislature mandated, into market-based sourcing is just wrong.

ARTHUR ROSEN, PARTNER,
MCDERMOTT WILL & EMERY LLP

Upon judicial review of this decision, the Tennessee Court of Appeals ruled in favor of the department, stating that they satisfied the burden of showing by clear and cogent evidence that Vodafone's circumstances were unusual and the standard statutory formula did not accurately reflect its level of business contacts with the state. Vodafone filed an application to appeal, and the Supreme Court of Tennessee agreed to hear the appeal on Nov. 20, 2014.

The case has strong implications for the future of alternative apportionment in Tennessee. The court must address whether the department acted within the scope of their discretion, whether the Tennessee Court of Appeals properly assigned the burden of proof and whether the alternative method of apportionment imposed by the department accurately reflects the taxpayer's Tennessee income.

When asked about the case and its potential outcome, Arthur Rosen, a partner at McDermott Will & Emery LLP, responded, ''I am hoping that the court will understand its proper role in ensuring that legislative intent, if constitutional in its implementation, should control, and, accordingly, decide in favor of the taxpayer. The legislature clearly adopted the policy position that a service business should be taxed by the jurisdiction that provides the wherewithal for the business' operations; in other words, the jurisdiction in which the taxpayer expends its resources should be the jurisdiction to collect revenue from that taxpayer's operations. Alternative apportionment is a tool that should be used by a revenue agency to substitute other quantities or factors to meet that legislative goal when the standard quantities or factors do not achieve the legislative goal.''

I think that the court's insistence on real proof on the first issue is worthy of an award.

ARTHUR ROSEN, PARTNER,
MCDERMOTT WILL & EMERY LLP

''Thus, using alternative apportionment to turn cost-of-performance sourcing, as the legislature mandated, into market-based sourcing is just wrong. However, I am not overly optimistic based on the court's history in this area,'' Rosen finished.

Most recently, the Supreme Court of South Carolina released its opinion in *Carmax Auto Superstores West Coast, Inc. v. South Carolina Dept. of Rev.*, S.C., No. 27474, Dec. 23, 2014. Similar to *Vodafone*, the depart-

ment imposed alternative apportionment on the taxpayer, seeking to reach more of Carmax's income by altering the formula.

The Supreme Court of South Carolina determined that the department had failed to prove by a preponderance of the evidence that the standard apportionment formula did not fairly represent the taxpayer's business activity in South Carolina. The court ruled that this was a threshold issue for alternative apportionment within the state.

When asked about the court's ruling on this threshold issue, Rosen replied, ''I think that the court's insistence on real proof on the first issue is worthy of an award. The court's approval of the idea that the party that wants to deviate from the standard statutory formula bears the burden of proof is also noteworthy. Finally, I also think that the standard of 'preponderance of evidence,' in contrast to 'clear and convincing evidence,' makes South Carolina a great place.''

The MTC appears to be moving toward further revising its rules for alternative apportionment in Section 18 of the Uniform Division of Income for Tax Purposes Act (UDITPA). In 2014, the MTC adopted a number of changes to UDITPA, but the member states did not vote on several proposed amendments to Section 18. The Commission did pass an amendment allowing state departments of revenue to create specific alternative apportionment rules for particular business activities or industries to be applied uniformly within the state. Notably, one of the proposed changes is to place the burden of proof on the party seeking to use or impose an alternative apportionment formula.

When asked about the proposed changes to UDITPA and their effects, Rosen said, ''I am guessing that the major effect will be in states being forced to give more 'respect' to the standard statutory formula; they will have to think longer and harder before going down that route than they did before.''

MTC COMPACT ELECTION CONTROVERSY

A widely anticipated decision from the California Supreme Court in 2015 on the availability of the Multistate Tax Compact's three-factor apportionment election will likely not end protracted litigation and uncertainty for both taxpayers and MTC member states. The California Supreme Court is finally expected to hear oral arguments early in the year in *Gillette Co. v. California Fran. Tax Bd.*, 147 Cal. Rptr. 3d 603 (Cal. Ct. App. 2012); petition for review granted, 291 P.3d 327 (Cal. 2013).

In *Gillette,* the taxpayer elected to employ the three-factor election, available under Article III of the compact, in a tax year in which California had implemented a double-weighted sales factor formula. The California Court of Appeal upheld the taxpayer's right to use the three-factor election by holding that the compact was a valid, multistate compact which California was precluded from unilaterally modifying.

In response to the decision, the California legislature repealed the compact retroactively to 1993. The California high court will likely rule on two issues: one, whether the Multistate Tax Compact was a binding compact that California was prohibited from amending; and two, whether retroactive repeal of the compact by California was constitutional.

Similar cases are pending in other states. Taxpayers' celebrations of the Michigan Supreme Court's decision in *Int'l Bus. Mach. Corp. v. Michigan Dept. of Treas.*, 496 Mich. 642 (Mich. 2014) (''IBM'') proved short-lived after the Michigan Court of Claims' recent and sweeping dismissal of most of the compact election cases. In *Yaskawa America, Inc. v. Michigan Dept. of Treas.*, No. 11-000077-MT (Mich. Ct. Cl. Dec. 19, 2014) the court ruled that the compact was merely an advisory compact, not binding on the state, and that the Michigan legislature's retroactive repeal of the compact back to 2008 did not offend federal or state due process clauses. Importantly, the three Michigan Supreme Court justices who addressed this specific question in the *IBM* decision reached the same conclusion as the Court of Claims. As a result, the prospects of taxpayer success on the compact election issue may have substantially dimmed in Michigan heading into 2015.

The Texas Comptroller also determined that the three-factor election was not available for the Franchise ''Margin'' Tax and early decisions from a trial court in Texas in *Graphic Packaging Corp. v. Texas Comp. of Pub. Accts.*, Dkt. No. D-1-GN-12-003038 (353rd Jud. Distr. Ct. Jan. 15, 2014), appealed, Tex. App., No. 03-14-00197-CV, 4/2/2014, have upheld this determination. In addition, there is active litigation on the compact election in Oregon and Minnesota. With California and Michigan's withdrawal from the Multistate Tax Compact, the significance of this issue will likely dwindle as no major market states remain full compact members apart from Texas.

Even though the MTC apportionment election is now largely a historical issue, taxpayers will need to consider whether any positions for open tax years should be taken in MTC states other than California or Michigan. The Texas and Alabama legislatures have not explicitly withdrawn from the compact but have altered apportionment formulas and sourcing rules with subsequent legislation. If these changes to the compact's apportionment provisions are ultimately found to be ineffective, taxpayers will benefit by filing protective refund claims now. Further, taxpayers filing in states who recently withdrew from the compact, such as Utah or Minnesota, may have still have tax years open in which to file amended returns that utilize the compact's three-factor election.

The resolution of the compact election controversy in California, Michigan and Texas could have a substantial impact on each of these states' fiscal health. In a motion before their state's supreme court for reconsideration of the *IBM* decision, the Michigan Governor and Attorney General stated that the estimated budgetary impact of allowing corporate taxpayers to elect three-factor apportionment for tax years under the Michigan Business Tax was greater than $1 billion plus interest. Previous estimates of the impact of *Gillette* on California's treasury have exceeded $500 million.

How California resolves the *Gillette* case could be strongly determinative of the ultimate outcome of this controversy in other MTC states. It could be that two or more state high courts reach different conclusions on the nature of the compact in the next few years. With billions of dollars of state tax revenue potentially at stake, appeals to the U.S. Supreme Court seem a certainty.

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Between 1983 and 2003, only 29 companies inverted; between 2004 and 2014, 47 companies engaged in inversion transactions, with most inversions taking place after 2009.

CONGRESSIONAL RESEARCH SERVICE (CRS)

COMBATTING INCOME SHIFTING AND BASE EROSION

Income-Shifting Tactics. There has been a surge in corporate inversions in the past 10 years—between 1983 and 2003, only 29 companies inverted; between 2004 and 2014, 47 companies engaged in inversion transactions, with most inversions taking place after 2009, according to the Congressional Research Service (CRS). Estimates show that legislation to tighten rules to limit inversions could save taxpayers nearly $20 billion over ten years, according to the House Ways and Means Committee. As the economy continues to slowly recover from the effects of the great recession, this amount could have a significant impact on the budget.

Inversion transactions are only the tip of the iceberg, as corporations use a variety of mechanisms to shift income abroad, leaving the states and the federal government with a dwindling tax base. As inversions and other income-shifting tactics have evolved, federal legislation has not caught up to stop the erosion of the tax base that results from these transactions. While Notice 2014-52 issued by the U.S. Treasury on Sept. 22, 2014 was a starting point to curb inversion transactions, it does not fully address the wide array of corporate income shifting strategies that contribute to the erosion of the tax base.

In 2015, in the aftermath of the Burger King-Tim Horton's merger, the issue of corporate income shifting and base erosion will continue to be a major issue. On the federal level, in September 2014, the Treasury released guidance on the issue. On the state level, states are likely to continue to introduce legislation to make it more difficult to shift income to tax havens or complete corporate inversions in 2015. States are currently using tools like the MTC transfer pricing initiative, mandatory combined reporting and tax haven legislating to address this problem.

MTC Transfer Pricing Initiatives. Transfer pricing has become a major tax planning strategy employed by companies to shift profits to offshore subsidiaries. The MTC transfer pricing initiative is an attempt to address corporate tax avoidance by strengthening current regulations.

In June 2014, the MTC organized the Arm's-Length Adjustment Service (ALAS) to develop a program to assist states in addressing transfer pricing issues as they conduct corporate audits. At meetings held in October, the ALAS identified two major hurdles states must overcome in order to effectively evaluate transactions between related corporations: the lack of economic and technical expertise within state tax departments and states' concerns with the potential expense of the program.

A document prepared for the October meetings, which is titled ''Draft Design for an MTC Arm's-Length Adjustment Service'' and is available on the MTC's website, served as the focus of discussion. Dan Bucks, former commissioner of the Montana Department of Revenue, authored the draft design, detailing both a proposed structure and implementation schedule of the ALAS program. Bucks proposed an initial charter period of four years, with the first taxpayer audits commencing during 2015, and recommended that the MTC hire three new ALAS staff members to manage the program and coordinate with third-party economic consulting firms. The draft calls for outside consultants to perform all substantive transfer pricing analysis at the outset, but would also have those consultants train MTC staff so that staff can become more involved in taxpayer audits over the course of the charter period.

As outlined in the draft design, the ALAS program will provide a variety of services to states, including:

- audit selection procedures;
- planning audits of related party transactions;
- understanding how to integrate economic analysis into the audit process;
- conducting technical audits prior to economic analyses; and
- developing defensible transfer pricing adjustments.

A key strategy of the draft design is to expand the capacity of the states and the MTC to address related party transfer pricing issues in order to reduce costs. The goal would be to develop state staff well versed in transfer pricing compliance issues who could work across state lines and share knowledge and experience to solve compliance problems. By strengthening capacity, states would be able to rely less on economics expertise from outside firms.

To compensate for a lack of in-house resources and technical expertise, some states have hired outside contractors to assist with transfer pricing analysis and have had mixed results. In *Microsoft Corp. Inc. v. D.C. Office of Tax and Revenue*, No. 2010-OTR-0012 (D.C.O.A.H. May 1, 2012), a D.C. administrative law judge found the analysis prepared by the District's expert to be ''useless in determining whether Microsoft's controlled transactions were conducted in accordance with the arm's length standard.'' In granting Microsoft's motion for summary judgment, the judge struck down a $2.75 million assessment against the taxpayer.

More recently, a different D.C. administrative law judge overturned franchise tax assessments against three major oil companies because they were based on the same transfer pricing analyses ruled invalid in the *Microsoft* case.[4] Other states, including Massachusetts,

[4] *See Hess Corp. v. D.C. Office of Tax and Rev.*, No. 2012-OTR-0027; *Shell Oil Co. v. D.C. Office of Tax and Rev.*, No. 2011-OTR-0047; and *Exxon Mobil Oil Corp. v. D.C. Office of Tax and Rev.*, (D.C.O.A.H., final orders Nov. 14, 2014). The judge ruled that the District is bound by the decision in *Microsoft*, which the Office of Tax and Revenue declined to appeal. As a result, the three oil companies obtained relief from proposed deficiencies totaling more than $3.8 million. Four other cases are still pending before the Office of Administrative Hearings.

Nebraska and New York, have included specific sourcing provisions within their market-based sourcing rules addressing specific digital-related goods or services.[5]

The states are much better equipped to deal with the issue since they have had to deal with multijurisdictional tax issues since the aftermath of World War II, when under the Marshall Plan we started rebuilding Europe.

RICHARD POMP, PROFESSOR OF LAW, UNIVERSITY OF CONNECTICUT

The ALAS program will represent a significant commitment of states' resources with the hope of raising substantial revenue by developing state expertise in transfer pricing issues. It remains to be seen whether the program will obtain a critical mass of participating states to provide sufficient funding for the endeavor.

Tax Haven Legislation. While the MTC transfer pricing initiative may help curb corporate income-shifting, there are still many tax provisions that corporations can use to shift income offshore. Due to limited federal action last fall, many states are taking matters into their own hands. ''The states are much better equipped to deal with the issue since they have had to deal with multijurisdictional tax issues since the aftermath of World War II, when under the Marshall Plan we started rebuilding Europe'' said Professor Richard Pomp of the University of Connecticut School of Law in a Jan. 12 e-mail to Bloomberg BNA.

In Alaska, the District of Columbia, Montana, Oregon and West Virginia, the legislature has enacted bills that identify by name or by reference to a specific set of criteria, jurisdictions that appear to be tax havens. Corporations incorporated in and profits attributable to these countries must be included in the water's edge group income. For example, effective for tax years beginning on or after Jan. 1, 2014, Oregon provides a statutory definition of tax haven in the form of a list of 39 countries, despite the difficulty of keeping a list current. In Oregon, these measures are expected to generate an additional $42 million in the 2015-2017 biennium.

This fall, both Michigan and New Jersey have introduced pending legislation to curb corporate inversions. Sen. Shirley Turner (D- NJ) introduced a bill to deny state benefits to companies that have participated in a corporate inversion. Similarly, in Michigan, Representative Andy Schor (D) introduced legislation that denies state economic development incentives for certain corporations that have inverted within ten years of applying for assistance.

In Massachusetts (budget amendment 1142), Minnesota (H.F. 1440), West Virginia (H.B. 4586) and Wisconsin (A.B. 844), tax haven measures were also introduced during the year. However, the legislation did not pass. The Massachusetts budget amendment was withdrawn from consideration on April 28, 2014. In the other states, the proposals did not move from committee before the legislature adjourned for the year.

The basic problem is having notions of 'domestic' and 'foreign' corporations in the tax law. All corporations should be taxed the same regardless of their place of residence.

HERMAN BOUMA, SENIOR TAX COUNSEL, BUCHANAN, INGERSOLL & ROONEY PC

Tax haven legislation, as a tool for combatting corporate inversions and other tax planning strategies, may be the beginning of a new trend, as similar legislation was recently considered in several states, including Maine and Massachusetts. However, even its supporters voice concern. ''While the legislation is something that a number of states have considered, I am a bit leery of that legislation because it requires somewhat of a subjective determination on the part of the states,'' said Huddleston in a Jan. 12 e-mail to Bloomberg BNA. ''But, I certainly understand why states enact tax haven statutes.''

Pomp agreed with Huddleston, noting that this type of legislation is only a partial solution, not as good as worldwide combined reporting, but a step in the right direction.

On the other end of the spectrum, anti-corporate inversion legislation has many detractors. The recent surge in inversions may be symptomatic of a larger problem with the U.S. corporate income tax system that is no longer competitive in a global economy, particularly due to the high tax rate. ''As other industrialized nations lowered their tax rate, the U.S. stagnated and fell behind the rest of the world,'' said Todd Behrend of Ryan in an Oct. 6, 2014, phone call with Bloomberg BNA.

Corporate inversions are a direct result of the disparate treatment foreign and domestic corporations receive under U.S. tax law. ''I'm against all anti-inversion legislation because inverted companies are just trying to be more competitive,'' said Herman Bouma, Senior Tax Counsel with Buchanan, Ingersoll & Rooney PC, in a Dec. 19, 2014 e-mail to Bloomberg BNA. ''The basic problem is having notions of 'domestic' and 'foreign' corporations in the tax law. All corporations should be taxed the same regardless of their place of 'residence.' ''

[5] *See* Mass. Regs. Code tit. 830, §63.38.1(9)(d)(4), *as amended* Jan. 2, 2015 (differentiating the sourcing of receipts for services delivered electronically from those not delivered electronically); Mass. Regs. Code tit. 830, §63.38.1(9)(d)(7), *as amended* Jan. 2, 2015 (providing special sourcing rules for software transactions and sales or licenses of digital goods or services); Neb. Rev. Stat. §77-2734.14(3)(b) (providing sourcing rules for receipts from application services); N.Y. Tax Law §210-A(4), *as enacted by* N.Y. 2014 A.B. 8559/S.B. 6359, *effective* Jan. 1, 2015.

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While I do not believe that these measures will be an effective deterrence to corporations to invert, it is difficult to predict whether they will have an economic impact.

JEFF FRIEDMAN, PARTNER,
SUTHERLAND, ASBILL & BRENNAN

Tax haven legislation and other legislation that discourages corporate tax planning are seen as a ''Band-Aid solution'' to a larger problem, since corporations often invert for a host of non-tax related reasons. ''Companies do not invert to save state taxes,'' said Friedman in a Dec. 18, 2014 e-mail to Bloomberg BNA. ''Rather, corporate inversions are a byproduct of a federal tax system that favors corporations domiciled outside of the United States.''

Furthermore, the legislation passed by New Jersey and Michigan may not be effective at all and may have a negative impact on the states. ''While I do not believe that these measures will be an effective deterrence to corporations to invert, it is difficult to predict whether they will have an economic impact,'' said Friedman. It is possible that companies that seek to sell goods and services to states will lose out on potential sales. At the same time, it is possible that states will end up suffering from these provisions by not being able to choose the most cost effective or best suited seller in the marketplace.''

In 2015 it remains to be seen whether the federal government will take the initiative to enact significant reform. In the meantime, there is a clear divide between those who firmly believe that states should continue to legislate in this area and those who believe that this is solely the purview of the federal government.

Combined Reporting. In contrast to tax haven legislation, many states have established combined reporting regimes for unitary groups. For example, in 2014, Rhode Island also joined a small number of states that are using combined returns to address the problem of companies using offshore tax havens to dodge state taxes. For tax years beginning on or after Jan. 1, 2015, each C corporation that is part of a unitary business with one or more other corporations must file a Rhode Island combined group return. A non-U.S. corporation with 80 percent or more of its sales outside the U.S. generally is not included in the combined group. Even if a non-U.S. corporation is included in a combined return *(i.e.*, because more than 20 percent of its sales occur within the U.S.), income and associated expenses and apportionment factors are excluded to the extent those items are protected by a federal income tax treaty.

A corporation must report treaty-protected attributes on a Rhode Island return, however, if the treaty is between the U.S. and a tax haven country. Rather than provide a list of countries considered to be tax havens, Rhode Island defines a tax haven as a jurisdiction that, during the tax year in question, has no or nominal effective tax on the relevant income and may be described as having laws or practices that prevent effective exchange of tax information, a tax regime that lacks transparency or one that is favorable for tax avoidance.

Corporate Tax Reform. Without addressing the taxation of income derived from tax havens, New York adopted mandatory combined reporting, effective for tax years beginning on or after Jan. 1, 2015, for all unitary corporations that meet certain ownership requirements. A corporate taxpayer that is engaged in a unitary business with a ''related corporation'' must make a combined report with that related corporation. Two corporations are related if:

- one corporation owns or controls, directly or indirectly, more than 50 percent of the voting power of the capital stock of the other corporation; or
- more than 50 percent of the voting power of the capital stock of both corporations is owned or controlled, directly or indirectly, by the same interests.

In addition, a New York unitary combined group includes a non-U.S. corporation that has effectively connected income for the tax year. The group must determine the foreign corporation's effectively connected income regardless of any treaty protections, provided the treaty does not prohibit state taxation of the income. As a consequence, a non-U.S. corporation may have effectively connected income for New York corporate tax purposes, but not for federal income tax purposes.

As noted in Bloomberg BNA's 2014 Survey of State Tax Departments (April 25, 2014), a slight majority of states that impose a corporate income tax require corporate parents to file a single return that includes the tax attributes of their subsidiaries. Pennsylvania may become the next state to mandate combined corporate tax returns. A bill to that effect (S.B. 882) was introduced and referred to the Finance Committee on April 24, 2013, but made no further progress. During the 2014 gubernatorial campaign, however, both Gov.-elect Tom Wolf (D) and incumbent Gov. Tom Corbett (R) expressed support of expanding the reach of the corporate net income tax by requiring combined reporting by a unitary group of corporations.

Finnigan Method. New York's corporate tax reform legislation also retains the Finnigan method for the computation of income and factors for the members of a unitary combined reporting group. In 2008, New York's highest court held in *Disney Enterprises, Inc. v. New York Tax App. Trib.*, 10 N.Y.3d 92, 888 N.E.2d 1029 (2008) that inclusion of destination sales of subsidiaries without nexus to New York in the numerator of a combined group's sales factor did not violate the restrictions of Pub. L. No. 86-272. The Finnigan method is now codified in N.Y. Tax Law §210-C(5), which requires the income and factors for all members of the combined group to be aggregated to arrive at a single business income and apportionment percentage attributable to New York.

UNFAIR INTRUSION OF PRIVACY OR NECESSARY FOR REFORM IN 2015?

Over the years, states have discussed the merits of requiring corporations to disclose tax information submitted to other state tax revenue departments in order

to assess taxpayer compliance and unveil any loopholes corporations are using to avoid taxation in the state. An example often used by proponents of the bill to show the necessity of disclosure is *Geoffrey, Inc. v. South Carolina Tax Commission*, 437 S.E.2d 13 (S.C. 1993). In the case, Geoffrey, a multistate corporation, shifted its taxable income from high tax states to 'passive income' subsidiaries located in states with a low or zero corporate income tax, thus avoiding tax liability.

Corporations routinely lobby state lawmakers for new tax breaks. It's absurd that lawmakers must often decide whether to provide new corporate tax breaks without knowing whether companies are paying the income tax to begin with.

MATT GARDNER, EXECUTIVE DIRECTOR,
INSTITUTE ON TAXATION AND ECONOMIC POLICY

Proponents of corporate disclosure, such as Peter Franchot, the Comptroller of Maryland, believe that it would help show policymakers whether the state corporate income tax is structured in a way that ensures all corporations doing business within the state are paying their fair share of the tax burden. They also believe that it would shed light on effectiveness of tax policies and thus make for easier tax reform. Opponents, such as the Council on State Taxation (COST), take the position that taxpayers have a right to privacy with regard to taxes they pay and releasing specific business tax returns or information does not serve a policy purpose like proponents of disclosure assert.

Yesnowitz wrote in a Jan. 5 e-mail to Bloomberg BNA that he thinks having public disclosure requirements for all corporations is problematic for the following reasons:

■ *Privacy*. Requiring public disclosure violates the expectation that a taxpayer's information remains known only to its own personnel, authorized representative/tax preparer and the state tax authority, which appears to contrast with the general federal income tax rule as stated in I.R.C. §6103 (dealing with confidentiality and disclosures of returns and return information).

■ *Data may not paint the full picture*. Often, disclosure is requested as a means to prove tax avoidance for profitable corporations that have little or no taxable income in the taxing state. This often is a misleading implication. For example, a taxpayer may not show corporate income tax liability to particular states because of the proper utilization of a net operating loss. In addition, a taxpayer's lack of state corporate income tax liability does not take into account the sales tax and property tax liability incurred by that taxpayer.

■ *Competitive intelligence*. Information on the returns that is made public could be valuable to other competitors.

■ *Burden*. The disclosure request adds to the taxpayer's overall reporting burden, may go beyond the four corners of the tax return and may involve significant time and effort to complete, or in an extreme case, even try to reach out to non-taxpayers. For example, in 2013 Illinois proposed H.B. 3627, which would have required corporations not required to file a tax return in Illinois to disclose the information as if a return was required or file a statement explaining why the corporation did not have to file a return, among other information.

Matt Gardner, Executive Director of the Institute on Taxation and Economic Policy (ITEP) told Bloomberg BNA in a Jan. 12 e-mail that ''ITEP published a report in 2014 that suggests the need for state-by-state corporate tax disclosure. The report, ''90 Reasons We Need State Corporate Tax Reform,'' identifies 90 profitable Fortune 500 corporations that found a way, at least once in the past five years, to pay zero state corporate income taxes nationwide despite being profitable in all five years.'' Gardner said that more disclosure is necessary, especially for state lawmakers to make informed decisions. ''[C]orporations routinely lobby state lawmakers for new tax breaks. It's absurd that lawmakers must often decide whether to provide new corporate tax breaks without knowing whether companies are paying the income tax to begin with.''

It's just not on the radar of lawmakers who, right now, are just trying to balance the rest of this year's budget.

MATT GARDNER, EXECUTIVE DIRECTOR,
INSTITUTE ON TAXATION AND ECONOMIC POLICY

Yesnowitz said that in 2015 Illinois and California are likely to consider whether corporate taxpayers should be required to publicly disclose their state income tax information. Meanwhile, Gardner said ''it's just not on the radar of lawmakers who, right now, are just trying to balance the rest of this year's budget[,]'' causing possible problems in the long run while taking care of bigger ticket items in the short run.

CAPITAL STOCK TAX PHASE-OUTS DUE TO BUDGET SHORTFALLS

Business advocates will find strong resistance to the elimination of capital stock taxes in the coming year as state revenues continue to lag behind expenditures. Less than a third of states still impose a capital stock tax on general business corporations, while other states impose a capital stock tax on financial institutions in lieu of a corporate income tax. Corporate taxpayers have aggressively targeted their repeal over the past decade as the taxes are considered unresponsive to declines in income and cash flow typical of the recent recessions.

As the legislature convenes in Pennsylvania, the state is facing another budget deficit, estimated to be over $2 billion for the 2015-2016 fiscal year. The Pennsylvania Capital Stock tax was scheduled to be phased out by 2014 but was extended for an additional two years in 2013. The prospects of the capital stock being extended in the state are high despite repeated legislative promises to finish the phase-out that begin more than a decade ago.

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2015 will also be the last year for several other capital stock taxes. The Missouri Corporation Franchise Tax will be completely phased-out beginning in 2016. Other states whose repeal or phase-out of these taxes will occur or conclude in 2015 include Kansas, Ohio, Rhode Island and West Virginia. Legislators in Kansas, Pennsylvania and Rhode Island will likely be particularly averse to raising revenue through business taxes, even though aggressive tax cuts and declining income tax revenues over the past few years have left the states facing substantial budget deficits.

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Individual Income Tax

Individual & Estate Taxation

Same-sex couples are likely to continue facing uncertainty as to their state income tax filing status in 2015. While states are increasingly recognizing same-sex marriages and allowing these couples to file joint returns, several jurisdictions are still refusing to grant legal recognition to these unions. Meanwhile, small business owners are awaiting a potentially groundbreaking U.S. Supreme Court decision regarding the constitutionality of a Maryland statute that gives less than full credit for amounts representing taxes paid to other states. The upcoming year is also likely to see states continuing the trend of disputing the classification of workers as independent contractors. In addition, while trustees and settlors of trusts with a presence in multiple states remain in need of a resolution for the issue of double taxation, estate taxes are becoming less of a burden for those with sizeable estates.

Key Issues: Same-Sex Married Couples, the 'Wynne' Case, Worker Classification and the Tax Treatment of Trusts

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SAME-SEX COUPLES CONTINUE TO FACE FILING UNCERTAINTIES

Although the last two years have brought significant clarity at the state level regarding married, same-sex couples' filing status, many same-sex couples will still be unable to file joint state returns in 2015, leaving them restricted to filing separately or unsure as to their appropriate filing status.

''It's very hard to plan—that's the hardest part for same-sex couples not knowing how to plan what their tax liability will be,'' Janis Cowhey, partner at the New York City office of Marcum LLP told Bloomberg BNA in a Dec. 19, 2014, phone interview.

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Janis Cowhey, Partner, Marcum LLP

Following the U.S. Supreme Court's decision in *United States v. Windsor*, 570 U.S. 12 (2013), the Internal Revenue Service issued IRS Rev. Rul. 2013-17, announcing that married, same-sex taxpayers could now elect to file their federal returns with a status of married filing jointly. Subsequently, seven states allowed same-sex couples the election of a joint filing status on state returns in 2013.

Fast forward one year later, 2014 also brought significant developments with regard to state recognition of same-sex marriage for tax purposes. Fourteen states began allowing married, same-sex taxpayers to file a joint state return, often requiring that they match their filing status to their federal return.

Court Rulings. This increase in recognition, however, has not been consistent. Same-sex marriage bans in Kentucky, Michigan, Ohio and Tennessee were upheld by the U.S. Court of Appeals for the Sixth Circuit in *DeBoer v. Snyder*, No. 14-1341 (6th Cir., Nov. 6, 2014). Further, this ruling upheld the states' authority to refuse to officially recognize same-sex marriages performed in other states, thus denying legally married, same-sex taxpayers the ability to file a joint state return.

The Sixth Circuit's holding certainly changed the landscape over the last two years of states increasingly moving toward recognition of same-sex marriage. This holding also ''created controversy, something that was originally lacking amongst the states with regard to the removal of bans against same-sex marriage,'' Cowhey said. This lack of controversy ''is likely why the U.S. Supreme Court would not hear these cases'' previously, she added.

However, now that there is a circuit split, the U.S. Supreme Court granted *certiorari* in *DeBoer*, No. 14-571 (U.S., Jan. 16, 2015), consolidating the case with *Bourke v. Beshear*, No. 14-574 (U.S., Jan. 16, 2015), *Obergefell v. Hodges*, No. 14-556 (U.S., Jan. 16, 2015) and *Tanco v. Haslam*, No. 14-562 (U.S., Jan. 16, 2015).

In direct contrast to the Sixth Circuit yet closer in line with similarly situated states in the Ninth Circuit, Montana's ban on same-sex marriage was held unconstitutional in *Rolando v. Fox*, No. cv-14-40-GF-BMM (D. Mont., Nov. 19, 2014), making it the 35th state to recognize same-sex marriage at that time. An appeal in the *Rolando* case is currently pending before the U.S. Court of Appeals for the Ninth Circuit.

Arkansas added to the controversy in *Jernigan v. Crane*, No. 4:13-cv-00410 (E.D. Ark., Nov. 25, 2014), in holding that Arkansas' same-sex marriage ban was unconstitutional. Arkansas' attorney general appealed the decision to the U.S. Court of Appeals for the Eighth Circuit on Dec. 23, 2014.

In addition, South Dakota's same-sex marriage ban was struck down as unconstitutional on Jan. 12 in *Rosenbrahn v. Daugaard*, No. 4:14–cv-04081–KES (D. S.D., Jan. 12, 2015). The decision is stayed pending an appeal.

On the same day, however, the U.S. Supreme Court denied certiorari in *Robicheaux v. Caldwell* (now *Robicheaux v. George*), 2 F. Supp. 3d 910 (E.D. La., Sept. 3, 2014), which held that Louisiana's same-sex marriage ban is constitutional.

Current Bans. Same-sex marriage bans remain in place in Alabama, Arkansas, Georgia, Kentucky, Louisiana, Michigan, Mississippi, Missouri, Nebraska, North Dakota, Ohio, Tennessee and Texas. These bans and court rulings, along with often-changing guidance from state departments of revenue regarding same-sex marriage, render same-sex couples uncertain as to their filing status.

''There are fifty states with fifty rules; you have to know them,'' Cowhey said.

Filing uncertainty may be dissipating as more states have increasingly recognized same-sex marriage for tax purposes, but complications and disparity between states remain. The only thing promised in 2015 is that we can continue to expect more state developments and will soon see a U.S. Supreme Court ruling pertaining to same-sex marriage.

TAX EXPERTS AWAIT OUTCOME OF 'WYNNE' CASE

The U.S. Supreme Court heard three state tax cases last November, and perhaps the one with the furthest reaching implications is *Maryland Comp. of the Treas. v. Wynne*. ''States should be watching this case,'' Shirley K. Sicilian, national director of state and local tax controversy at KPMG LLP, said via e-mail Dec. 18, 2014.

Background. The Wynnes, who are residents of Maryland, own an S corporation that earns income in nearly every state and pays income tax to those states based on the portion of income that is sourced to each state. Although Maryland provides a credit for taxes paid to other states at the state level, it does not provide a credit against its county taxes.

The state of Maryland argues its tax scheme is fair because a state has the right to tax its residents since they take advantage of services, such as schools and utilities, provided by the state. Furthermore, Maryland contends it is under no obligation to provide a credit if that income is taxed elsewhere.

However, the Wynnes argue that the tax, without the credit, amounts to double taxation, as the Wynnes pay taxes both to Howard County and the state where the income is earned.

Residency-Based Versus Source-Based Taxation. Regardless of how the court rules, however, there could be major changes to state law. If the U.S. Supreme Court were to rule in favor of the Wynnes, it's difficult to say what the impact would be.

''Of course, the impact of the case will depend on the court's rationale,'' Sicilian said. ''If the court were simply to find that the Maryland tax structure violates internal consistency by mixing source-based and residency-based taxation, then Maryland may have to choose between the two and either allow the credit against both state and county tax or stop taxing income of nonresidents,'' she added.

On the other hand, ''if the court were to find that a state cannot choose to tax all income—or all of a certain type of income—on a residency basis, then there could be a huge impact. The court would essentially be requiring source-based, as opposed to residency-based, taxation,'' Sicilian said.

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If the court were simply to find that the Maryland tax structure violates internal consistency by mixing source-based and residency-based taxation, then Maryland may have to choose between the two and either allow the credit against both state and county tax or stop taxing income of nonresidents.

SHIRLEY K. SICILIAN, MANAGING DIRECTOR, KPMG (STATE AND LOCAL TAX CONTROVERSY)

Credit for Taxes Paid. A victory for the Wynnes would also require some analysis on behalf of a state regarding its credit for taxes paid. ''States will have to evaluate, based on the court's decision, when income is the 'same income' taxed in another state, and when a tax is the 'same tax' as the tax imposed in another state,'' Helen Hecht, general counsel for the Multistate Tax Commission, said via e-mail Dec. 17, 2014.

''It's hard to see where that line will be drawn given that you have cases like this one where income is earned by an entity but, because of the owner's election, is imputed to the owner,'' Hecht added.

However, not everyone agrees that a ruling in favor of the Wynnes would have such a ripple effect on state taxation. ''If the court rules in favor of the Wynnes, it will have virtually no effect on state tax because the overwhelming majority position is exactly what the Wynnes are claiming: that they are entitled to a credit for taxes paid to other states,'' Professor Richard Pomp, the Alva P. Loiselle Professor of Law at the University of Connecticut, told Bloomberg BNA in a Dec. 17, 2014, phone interview.

If Maryland wins, some states might see the decision as an opportunity to restructure their tax scheme. ''It is entirely possible that there will be a debate in [Connecticut], especially if we're running a deficit, . . . about closing that deficit by shaving the credit,'' Pomp said. ''Maybe not eliminating it outright, but phasing out some of it,'' he added.

Unsurprisingly, others believe a decision in favor of Maryland will not be an extreme departure from current law. ''All states either give some form of credit for state income tax paid by the same taxpayer on the same income, or they agree that the state of residence will tax the income,'' Hecht said. ''So, in practical effect, it will have no impact unless you assume the state will decide to remove those credits. Given that the benefit of the credits goes to the states' citizens, that's highly unlikely,'' she added.

Corporate Tax Implications. Regardless of the outcome, the case's impact may go beyond individual income tax. ''If the court prohibits residency-based taxation, then virtually all states with a corporate income tax will want to rethink how they allocate nonbusiness income,'' Sicilian said. ''If the court restricts the way a state taxes commerce, that restriction should apply, to the extent it's relevant, across all tax types,'' she added.

WORKER MISCLASSIFICATION IN 2014 AND BEYOND

In 2015, businesses will likely continue the recent trend of hiring independent contractors instead of employees in an attempt to lower their unemployment taxes and reduce their withholding obligations. In 2015, states will also continue their trend of scrutinizing these classifications of workers as independent contractors, because the state definition of an employee is often at odds with an employer's definition of an employee, potentially leading to financial consequences to the employer.

''[T]he vast majority of worker classification issues start at the state level,'' Kevin Shimkus, director at Deloitte Tax LLP specializing in employment taxes told Bloomberg BNA in a Dec. 17, 2014, phone interview. ''[W]e're seeing more activity in that area,'' he added.

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KEVIN SHIMKUS, DIRECTOR, DELOITTE TAX LLP

Unemployment Taxes. Traditionally, audits into worker classification issues are ''a result of an individual going down to file a state unemployment claim,'' Shimkus said. States generally have strict reporting requirements in connection with unemployment taxes, but because independent contractors are ineligible for unemployment benefits, businesses usually are not required to pay unemployment taxes for, nor report on, their contractors.

When an individual is treated as an independent contractor, not as an employee of the employer or a third-party contractor, and seeks unemployment benefits, the result is ''at least an inquiry and often times a full blown audit of a particular company,'' Shimkus said.

Government Activity. Several states have entered into Memorandums of Understanding (MOUs) with the U.S. Department of Labor and Internal Revenue Service. These MOUs allow the federal government to share information regarding employment tax audits with the state—primarily the state's tax and labor agencies. Eighteen states have at one point entered into an MOU with the federal government, two of which expired in 2014 and have yet to be renewed, according to the Department of Labor.

In 2014, Rhode Island also took steps to better identify worker misclassification within the state. Rhode Island established a tip line allowing individuals to anonymously alert the state to worker misclassification and fraud.

Key Cases. Two decisions issued last year by the Ninth Circuit specifically dealt with the issue of employee classification: *Alexander v. FedEx Ground Package Sys. Inc.*, 765 F.3d 981 (9th Cir. Aug. 27, 2014) and

Slayman v. FedEx Ground Package Sys. Inc., 765 F.3d 1033 (9th Cir. Aug. 27, 2014). These cases illustrated that employee classification, and all the responsibilities it conveys to the employer, are determined through the actual employment relationship and not the employment contract.

In *Alexander* and *Slayman*, the court ruled that classes of FedEx delivery drivers were in fact FedEx employees, despite their classification as independent contractors in the FedEx operating agreement. The court's opinions were based on its determination that FedEx exercised sufficient control over the drivers to deem them employees under state law.

Why Is Worker Classification Important? A misclassification of workers can have significant tax implications. From the federal perspective, employers are not required to withhold income or social security taxes for independent contractors, so ''there is a potential cost there as a result of a reclassification,'' Shimkus said.

''The same with the stateside from a tax perspective. It is typically the unemployment tax that you haven't paid, plus interest and penalties that you would be assessed on a worker reclassification,'' Shimkus added.

To complicate matters, the tax implications are only one piece of the reclassification puzzle. Employers also have to worry about providing misclassified employees with any benefits that they would have received if they had been properly classified. For example, in *Vizcaino v. Microsoft Corp.*, 120 F.3d 1006 (9th Cir. July 24, 1999), the court determined that a class of Microsoft workers were employees and as such were entitled to the benefits Microsoft offered other similarly situated employees.

''[I]f there is a wholesale reclassification of a class of workers, you run the risk of that class of workers saying that they should have gotten some type of benefit—whether it be stock options, which was the case in *Microsoft*, or health care, or whatever it happens to be that they weren't getting, but the employees were getting,'' Shimkus said.

There are further implications for the workers themselves. Aside from being denied certain benefits, independent contractors are prohibited from many work-related activities that employees enjoy, such as being paid overtime wages or being eligible to join a union.

Looking Ahead. In addition to the other issues surrounding worker classification, the federal Patient Protection and Affordable Care Act (ACA), ''is going to start to rear its head more and more in the future,'' Shimkus said.

[The federal Patient Protection and Affordable Care Act] is going to start to rear its head more and more in the future.

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Under the ACA, employers ''may not have the same safe harbor protection,'' as they would have had under an IRS challenge to the classification of their workforce, Shimkus said. ''As we roll into 2015 and we start to see the potential of employer penalties, there are a lot of companies that have historically realized that they may have some exposure out there,'' he added.

Although penalties for denying benefits to misclassified employees is primarily a federal issue, there is the possibility of state implications as well. In ''states like Massachusetts that have universal health care coverage . . . there could be, again, an expense to the employer for not covering these individuals,'' Shimkus said.

Recommendations. Given what is at stake for employers, and the current trend of heightened enforcement among the states, businesses have a lot to lose by not being mindful of how they classify their workforce.

Businesses should ''take a look not only at their current staff of 1099 workers [independent contractors] but also take a step back and look at the processes of onboarding a 1099 worker,'' Shimkus said.

CHANGES IN 2015 FOR TRUSTS AND ESTATES

Trust Taxation and Residency. The upcoming year brings continuing trust residency issues in need of resolution. ''The hodgepodge of residency rules [across the states] creates certain difficulties,'' said Michael D'Addio, principal at Marcum LLP, in a Jan. 5. phone interview.

Bloomberg BNA's 2014 Trust Nexus Survey (Sept. 26, 2014) illustrates how double taxation arises from the lack of a uniform trust residency law across the states. Factors used by states to determine a trust's residency may include: where the trust is administered, the location of the trust's assets or the residency or domicile of trustors, trustees or beneficiaries.

''It is a different world than it was when settlors who established trusts lived in the same place as their trustees and beneficiaries. Individuals and capital were not as mobile,'' Amy E. Heller, partner at McDermott Will & Emery LLP, told Bloomberg BNA in a Jan. 2 phone interview. ''Now there are more trusts that touch multiple jurisdictions and end up being potentially subject to taxation in many states,'' she said.

When a trust is a resident trust under a state's law, the state may tax the trust's entire income. Double taxation becomes a concern because trust residency laws vary so much among the states that a trust may be considered a resident trust in more than one state, and thus, taxable on its entire income in multiple states.

''If a person is subject to income tax in multiple states, there's a system of credits among the states, so in theory, the person is not supposed to be taxed twice,'' Heller said. The system of credits that applies to individuals does not apply to trusts as simply. ''Because of the way different states define resident trusts, and because states impose tax on trusts on different bases, I've had situations where the credit system may not work out properly in the case of trusts,'' Heller explained.

In March 2014, the Uniformity Committee of the Multistate Tax Commission (MTC) proposed formulating a model uniform trust residency law, which would settle some of these double taxation issues. However, the MTC's project was put on hold in December 2014,

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and it is undetermined whether the committee will pick it back up again in 2015.

With the MTC's trust uniformity project on the back burner for the foreseeable future, states may begin acting on their own to mitigate double taxation issues. California's trust income tax regime offers a model for other states to adopt. California's residence rules apportion taxes based on the residency of beneficiaries, which ''more accurately reflects trusts' multistate presence,'' Lila Disque, an attorney at the MTC who led the Trust Work Group, told Bloomberg BNA via e-mail Oct. 2, 2014.

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AMY E. HELLER, PARTNER, MCDERMOTT WILL & EMERY LLP

Incomplete Gift Non-Grantor Trusts. Some taxpayers attempt to avoid state income taxes imposed on trusts by setting up Incomplete Gift Non-Grantor trusts (IGNGs) in states such as Delaware and Nevada, which are commonly referred to as DINGs or NINGs respectively. IGNGs are carefully drafted trust documents that allow the grantor to retain enough control that any transfer is not deemed a gift, but the grantor must give up enough control that he or she is no longer considered owner of the trust assets so that the tax on retained income is taxable to the trust, which is located in a state that does not tax the trust's income.

However, the federal net investment income tax frustrates the purpose of creating IGNG trusts, so they are falling out of favor as state tax-saving instruments. Individuals who create IGNG trusts are ''primarily motivated by the state income tax savings,'' D'Addio said. ''If you are going to structure a trust that is suddenly going to incur the additional federal net investment income tax, it offsets the tax savings expected from reducing the state tax incurred, which is one of the reasons people will not pursue [IGNGs] as much as they want,'' he added.

Estate Tax Changes. In addition to continued trust taxation and residency issues, there will be changes in the taxation of estates in 2015. ''There has been movement in 2014 where several states either reduced or eliminated estate taxes and, when a state does that, it [is because the state sees] potential for the flight of their population into states where there is no estate tax regime,'' D'Addio said.

''Clients are much more attuned to state taxes now as a practical matter because they have become significantly higher,'' D'Addio said. ''Years ago, state taxes were a much smaller piece of the overall pie, but now with federal rates coming down, the portion of taxes attributable to state taxes has increased.'' This realization has caused, and will continue to cause, states to act.

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MICHAEL D'ADDIO, PRINCIPAL, MARCUM LLP

''We have seen a number of states recently repeal their estate taxes altogether, and others, like New York, increase the relevant exemption thresholds,'' Heller said. ''It was somewhat surprising to see states move to eliminate their state estate taxes, given that states do need revenue,'' she added.

In 2015, Maryland and New York's estate tax exemption amounts will begin to increase gradually until they match the federal exemption amount. Also, Tennessee will impose its inheritance tax, which operates like an estate tax, for its final year in 2015.

There is a dynamic among states where, on the one hand, they need revenue, but there's also a sense of jurisdictional competition among states.

AMY E. HELLER, PARTNER, MCDERMOTT WILL & EMERY LLP

''There is a dynamic among states where, on the one hand, they need revenue, but there's also a sense of jurisdictional competition among states,'' Heller said.

''While it's hard to predict what any given legislature is going to do, if one state makes a particular move, it's logical and rational to expect that a similar law or reform might get enacted in another state because people and capital are mobile,'' Heller added.

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Excise Tax

Excise Tax

A perfect storm of conditions—low energy prices, underfunded transportation coffers and deteriorating highways—could set the stage for gas tax reform at the federal and state levels. Meanwhile, the battle rages on over the amount of taxes online travel companies are required to remit. The states will also grapple over whether or not to legalize marijuana (and tax it) and how best to regulate (and tax) e-cigarettes. Captive insurance is likely to emerge as an issue in some states.

Key Issues: Gas Tax Reform, Hotel Occupancy Taxes, Marijuana Legalization, E-Cigarettes and Captive Insurance

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LACK OF REVENUE, LOW GAS PRICES MAY SPUR 2015 GAS TAX REFORMS

Will 2015 be the year of major gas tax reform? One gas tax policy expert said momentum for changes to gas tax laws has been building in a bipartisan way, and current low gas prices might give reformers the push they need to get their work done. However, the traditional obstacles still remain—like a potential lack of popular support for gas tax reform.

In 2015 and beyond, these issues that perpetually keep transportation projects underfunded could cause states to continue to search for other forms of transportation funding, such as tolls and per-mile usage charges, each of which garnered some attention in 2014.

Building Momentum for Gas Tax Reform. The gas tax has traditionally been a tax per gallon of gasoline sold, and that money has generally been earmarked for transportation improvement projects. But motorists driving more fuel-efficient cars, paired with often flat gas tax rates, has been chipping away at transportation funding for decades.

States have varying gas tax rate structures, which can be boiled down to one of two general forms: a fixed-rate tax or a variable-rate tax. Flat-rate gas taxes collect a certain number of cents per gallon of gas purchased. Meanwhile, variable-rate taxes are calculated one of several ways: based on the price of gas (similar to a traditional sales tax), based on a broader measure of the economy's inflation, or based on a hybrid of both the price of gas and an inflation measure, according to a May 2014 policy brief from the Institute on Taxation and Economic Policy (ITEP).

While the states have sometimes been slow to react to transportation funding shortfalls, at least lawmakers seem to be beginning to understand the reasons for gas tax reform, said Matthew Gardner, executive director of the non-profit, non-partisan ITEP, in a Dec. 19, 2014 phone interview with Bloomberg BNA. . Gas tax reform was something that many lawmakers weren't willing to talk about a year ago, he said.

''The only way they can expect the gas tax to keep up with their funding needs is to increase it,'' Gardner said. He said that people are realizing, in a bipartisan way, that they have to do something. ''It's going to seem more attainable,'' Gardner said about reform, because politicians are admitting the problem publicly now.

The only way they can expect the gas tax to keep up with their funding needs is to increase it.

Matthew Gardner, Executive Director, Institute on Taxation and Economic Policy

For example, Iowa Gov. Terry Branstad (R) has put gas tax reform on the table for his state this year, Gardner said.

''This isn't a guy who's known for his advocacy for raising taxes,'' Gardner said. But he also said that ''it's not a partisan thing'' to recognize the basic imbalance between transportation revenue and spending.

Other states, including Michigan and New Jersey, are also considering higher taxes at the pump, according to Bloomberg BNA's Daily Tax Report.

Awareness of the issue has not always translated into action. Gardner said that close to two-thirds of states have not engaged in meaningful gas tax reform by modernizing the gas tax. With gas prices continuing to decrease, now might be the time. On a political level, Gardner said a large source of gas tax frustration is the disconnect between services and a willingness to increase the price.

''It sure seems like a corner is being turned,'' Gardner said, and at least in some states, legislators understand the importance of the gas tax.

Capitalizing on Low Gas Prices. Gas prices are the lowest they have been in years, and Gardner said those falling prices are part of the reason gas tax reform can happen now—even though gas taxes have very little to do with the price of gas.

As of early January, the price of gas had been sliding for more than 100 days, according to a release from AAA, a not-for-profit federation of affiliated motor clubs. As of Jan. 5, the average price of $2.20 per gallon is the lowest average price since May 2009.

Indeed, the U.S. Energy Information Administration announced in December that the average U.S. household is expected to spend approximately $550 less on gasoline in 2015 compared with 2014. That means gas prices are on track to be the lowest they have been in 11 years.

Federal Gas Tax Reform. Reform efforts are in the works at the federal level, too. In mid-2014, U.S. Sen. Bob Corker (R-Tenn.) and U.S. Sen. Chris Murphy (D-Conn.) announced a bipartisan proposal to increase the federal gasoline and diesel tax by $0.06 in each of two years, for a total $0.12 increase. They proposed indexing the federal gas tax to inflation using the Consumer Price Index so that the tax rate wouldn't lose buying power year after year, and they want to offset the gas tax increase by reducing tax somewhere else, according to the proposal.

The federal gas tax, which is a flat $0.184 per gallon, has remained unchanged since 1993. That means the purchasing power of the gas tax is about 63 percent of what it was in 1993, according to a release issued by Murphy's office.

However, just because tolls are seen by many as ''voluntary'' because people could presumably use other roads or bridges to avoid them, does not mean that they are actually voluntary.

MATTHEW GARDNER, EXECUTIVE DIRECTOR, INSTITUTE ON TAXATION AND ECONOMIC POLICY

Major media outlets showed renewed interest in the proposal in early January after Corker discussed what he called the ''gasoline tax user fee'' on Fox News Sunday.

Still, at any level, reform-minded politicians must gauge the interest of constituents in their plans, or risk setbacks like Massachusetts faced in 2014. In November, voters there repealed the state's annual gas tax inflation-index provision, causing the state to revert back to imposing a flat gas tax.

2015 Gas Tax Changes. The new year has brought gas tax rate changes in 10 states, with states evenly split between gas tax increases and gas tax decreases, according to ITEP. Pennsylvania, Virginia, Maryland, North Carolina and Florida are all hiking their gas taxes, while Kentucky, West Virginia, Vermont, Nebraska and New York will all see gas tax decreases.

Gas Tax Rate Changes

State	Rate Change
Florida	+ 0.3 cents
Kentucky	- 4.3 cents
Maryland	+ 2.9 cents
Nebraska	- 0.8 cents
New York	- 0.6 cents
North Carolina	+ 1 cent
Pennsylvania	+ 9.8 cents
Vermont	- 0.83 cents
Virginia	+ 5.1 cents
West Virginia	- 0.9 cents
Source: Institute on Taxation and Economic Policy	

In all of the jurisdictions that are seeing price declines, the lost revenue stems from their gas taxes being indexed to inflation at a time when gas prices are decreasing, according to ITEP.

Tolls and Fees. While a big story about the gas tax over the past few decades has been one largely of inaction, Gardner said there has been a steady stream of user fees imposed in the transportation arena over time.

Toll roads already make up many parts of the Northeast's and Mid-Atlantic's Interstate arteries and are scattered around other parts of the country, too. In the Washington, D.C. area, some tolls have more recently been increased to pay for transportation projects (such as an expansion of the subway system to Dulles International Airport) or ease congestion (Northern Virginia's Interstate 495 or Interstate 95 Express Lane tolls).

However, just because tolls are seen by many as ''voluntary'' because people could presumably use other roads or bridges to avoid them, does not mean that they are actually voluntary, Gardner said.

He said the issues highlighted by the stagnation of the gas tax compared to continually increasing ''user fees'' mirrors a broader trend of increasing costs through the ''backdoor.''

There is generally less oversight on user fees, because they are generally implemented by regulatory agencies rather than legislatures. However, Gardner said the net effect is the same—the nickel and diming adds up.

''It can actually be a fairly pernicious thing,'' Gardner said, because of two reasons:

- there is generally lower visibility and less oversight of alternative revenue sources; and

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■ to fund transportation projects, policymakers are borrowing money from other sources.

For example, when the U.S. Congress plugged the federal Highway Trust Fund this summer via H.R. 5021, Bloomberg BNA's Daily Labor Report reported that Congress came up with transportation funding in part by pension ''smoothing,'' or allowing companies to reduce the amount that they contribute to pension funds now and make up for it in later years. That means plan sponsors would pay more tax now because their taxable income would increase.

''That's not fooling anybody,'' Gardner said about governments' temporary fixes. ''It's moving money around, rather than finding new money.'' Gardner called this a very unprincipled choice, because it is making a judgment that transportation funding is more important than wherever else the money was taken from.

''Some of these fixes are so ludicrous that you could not expect a legislator to go home and explain to constituents with a straight face,'' Gardner said.

Per-Mile Charges as Gas Tax Alternative. In light of gas tax revenue shortfalls, will other states follow Oregon's lead and start programs that charge motorists based on the miles they drive rather than the gallons of gas they use?

After years of discussion and several pilot programs, Oregon's voluntary program to pay per-mile charges and receive gas tax rebates will start this summer.

California may be close on its heels, having started down that road in 2014 by passing S.B. 1077, which lays the groundwork for a ''road usage charge'' pilot program. The program would impose taxes on drivers based on their miles traveled on the state's roads and highways instead of the current per-gallon tax paid at the pump.

Gardner said he thinks in the long-term, other states will use this kind of approach as well because vehicles are becoming more fuel efficient, which is one of the reasons the gas tax does not bring in as much money as it used to. Gardner said that people might still be driving less, but per-mile charges could still capture the growth in alternative forms of transportation.

However, Gardner said that moving to a mileage tax does not have to be a cure-all, because policymakers could still set the tax at unsustainable levels.

''It's not obvious that the mileage tax is immune to the same issues facing the gas tax,'' Gardner said. He also said that users might find the charges intrusive (because in many cases people would have to be tracked via GPS to determine how much they drive on a state's roads). Still, he said it is a very strong example of thinking sustainably about the tax system.

It's not obvious that the mileage tax is immune to the same issues facing the gas tax.

MATTHEW GARDNER, EXECUTIVE DIRECTOR, INSTITUTE ON TAXATION AND ECONOMIC POLICY

Severance Tax. Pennsylvania and Ohio are the states to watch in 2015 for tough severance tax debates, as governments and industry leaders try to figure out just how high or low the tax burden should be on those who harvest natural resources from the earth.

In Pennsylvania, the debate is heating up after a state senator announced in December that he will propose a 5 percent severance tax on shale gas extraction, with the proceeds benefiting public schools.

After much debate, Ohio failed in 2014 to change its severance tax rate—but the issue will likely come up again in 2015.

Meanwhile, in December, New York issued a ban on hydraulic fracturing, also known as fracking, citing health concerns—shutting down discussion of any potential severance taxes on natural gas there. Hydraulic fracturing is a process through which fluids and other substances are injected into wells under pressure to fracture the rock and free the hydrocarbons stored there, according to Bloomberg BNA's Water Pollution Control Guide.

Looming Severance Tax Debates. In mid-December, Pennsylvania State Sen. Jim Brewster (D) announced that he will introduce a plan to tax shale gas extraction and, at the same time, keep the state's current well impact fees.

In his announcement, Brewster said that a 5 percent levy would generate between $700 million and $1 billion. Based on the plan so far, shale drillers would be able to credit current impact fee expenses against their severance tax liability.

''It is important that energy companies pay a reasonable tax for a Pennsylvania resource, but we also need to balance well fees and market competitiveness so we don't harm the industry,'' Brewster said in his announcement.

Pennsylvania's Gov.-elect Tom Wolf (D) campaigned on using a robust shale tax to fund education, according to the announcement. He is no stranger to tax issues, having previously served as secretary of the Pennsylvania Department of Revenue.

However, a new severance tax will not be imposed without resistance from the natural gas industry. In

Pennsylvania, industry advocates include the Marcellus Shale Coalition. The coalition steadfastly opposes a new severance tax, arguing in part that it would not raise the money promised and it would discourage additional production and investment.

Right now, Pennsylvania producers pay a flat impact fee on wells annually, with the fee amount based on the average annual price of natural gas, and declining over 15 years.

''The impact fee is working,'' said Patrick Creighton, spokesman for the Marcellus Shale Coalition, in a phone interview on Jan. 8. He said adding a severance tax now may cause some rigs to cut their capital investments—running the risk of lost revenue at secondary businesses that also benefit from the natural gas boom, such as local hotels, restaurants, etc.

In Ohio, Gov. John Kasich's (R) budget proposal is scheduled to be released in the first week of February, but there are early indications that he will again propose severance taxes that are higher than the natural gas industry there wants to pay.

''The governor has been steadfast in his commitment to modernize Ohio's outdated severance tax to help drive down the state's income tax,'' Jim Lynch, the governor's special advisor for communications, said in a Jan. 7 e-mail. ''Under Ohio's current severance tax system, oil companies pay just 20 cents on a barrel of oil and 3 cents on a MFC unit of natural gas.''

Under Ohio's current severance tax system, oil companies pay just 20 cents on a barrel of oil and 3 cents on a MFC unit of natural gas.

JIM LYNCH, SPECIAL ADVISOR FOR COMMUNICATIONS, OFFICE OF GOV. JOHN KASICH (OH- R)

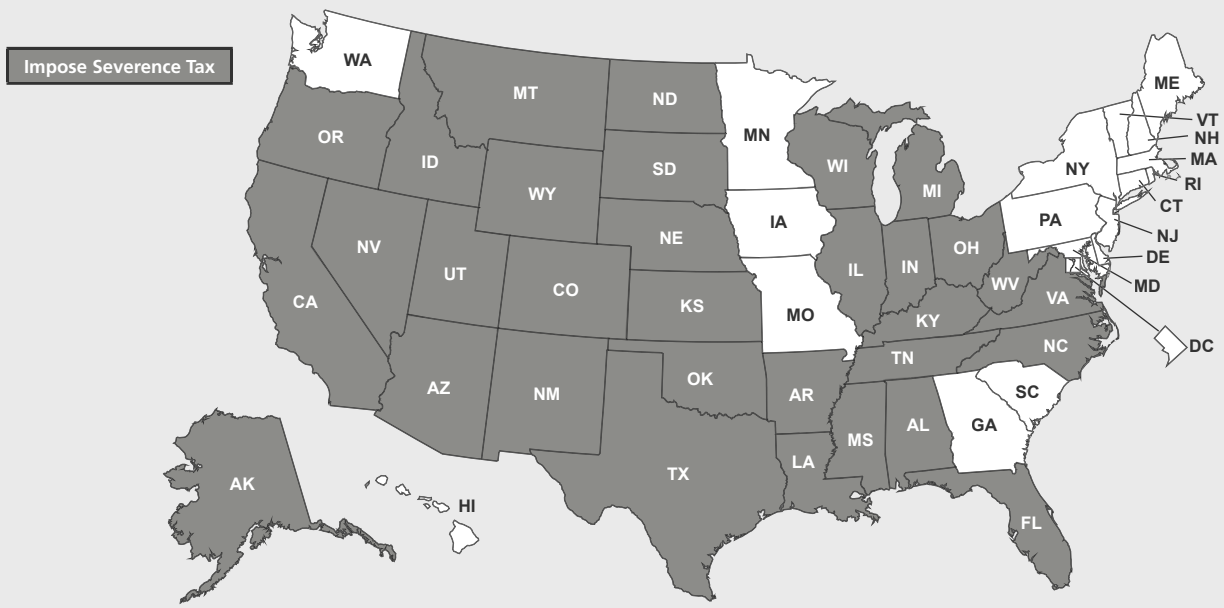
As in previous years, the oil and gas industry is monitoring the debate.

The Ohio Oil and Gas Association (OOGA) has not seen the governor's budget proposal yet, but Shawn Bennett, the OOGA's executive vice president, said in a Jan. 8 phone interview that given the current market conditions it is going to be a very different conversation than previous years.

''We have seen more than a couple shale operators cutting their capital budget here [in Ohio's Utica region],'' Bennett said, based on declining prices in the natural gas market.

And as for any potential severance tax rate changes, ''that is a conversation that we, among our members, will have to have,'' Bennett said. ''We have to make sure that it's a rate that still promotes investment and devel-

States That Impose Severance Tax on Oil and/or Gas



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opment. We always welcome the exchange of ideas with the governor and the legislature.''

Tapping Resources With Better Technology. Much of Pennsylvania lies in the Marcellus Region, a rock formation that holds large amounts of natural gas. Both the Marcellus Region and eastern Ohio's Utica Region are among the seven most productive shale areas in the country, according to the U.S. Energy Information Administration (EIA).

Production even within the last few years has increased drastically because of technological improvements. The biggest increases in natural gas per rig are in the Marcellus Region. New drilling rigs in that region in October 2014 were estimated to produce nearly 7.5 million cubic feet more of natural gas per rig each day than rigs drilling in the same region in October 2007, according to the EIA.

In the EIA's Short-Term Energy Outlook, the agency forecasts natural gas production will continue to increase through 2015 and more than offset the long-term trend of declining Gulf of Mexico production. In previous years, more production has many times meant increasing state tax revenue. But now, as production has boomed and prices have declined, that may not be true for 2015.

Declining Prices, Declining Taxes? While most states have fairly diversified tax and revenue schemes, some states like Alaska and North Dakota get a large amount of their total revenue streams from severance taxes. For example, in 2013, severance tax in Alaska accounted for 78.3 percent and in North Dakota accounted for 46.4 percent of total tax collections, according to the U.S. Census' 2013 State Government Tax Collections Summary Report (the most recent available).

In North Dakota, increases in tax revenue overall in 2013—27.8 percent more than it was in fiscal year 2012—were largely due to increases in severance tax revenue, according to the U.S. Census' report.

Even before the price declines, Alaskans were dealing with the possibility that their oil and gas resources are finite. Faced with declining production, the state held a bitterly divisive election in August. In it, voters narrowly defeated a referendum to repeal Alaska's new (enacted in 2013) tax regime that reduced tax rates on oil production.

Now, based on declining oil prices, Alaska is cutting new spending on capital projects and may raid almost half of the state's savings, according to a Jan. 7 Bloomberg News article.

Accordingly, severance tax revenue streams there and in other states may slow this year if oil and gas prices continue to decline.

OTCS AND GOVERNMENTS IN HIGH STAKES BATTLE OVER HOTEL TAXES.

The bruising battle between online travel companies (OTCs) and state and local governments over the proper tax base for hotel occupancy taxes will continue into 2015 and shows little sign of abating. States want the taxes to be collected on the full price paid by the consumer to OTCs, while OTCs assert that a portion of the price paid is a service fee on which no hotel occupancy tax is due.

Hotel Occupancy Taxes. Hotel occupancy tax, called transient occupancy tax, room occupancy tax, and even tourist development tax in some jurisdictions, is imposed in most states at either the state or local level. Generally, this is a tax on the rent paid for a hotel room. The customer pays the tax at the point of sale and the hotel remits the tax to the appropriate jurisdiction. On the surface, this taxing methodology seems fairly simple to understand and implement—and presumably it was until the emergence of online travel companies.

Online travel companies (OTCs) fashion themselves as middle men between hotels and consumers. They help promote travel to every corner of the world and are often one of the few ways that independently-owned and local hotels, B&Bs and inns reach a national, or even international audience, Philip Minardi, director of communications and public affairs at Travel Technology Association, told Bloomberg BNA via e-mail on Dec. 23, 2014. In addition, OTCs provide consumers the ability to search a myriad of choices, compare them and book their itineraries. They charge the consumer a service fee for providing that capability, said Minardi.

The advent of OTCs has complicated the process of collecting hotel occupancy taxes. Many states and local jurisdictions are unwilling to accept the merchant model principle that the proper tax base is the wholesale room rate negotiated and paid to hotels. ''Under the merchant model, the website operator is not responsible for tax on the delta that they earn between what they pay to the hotel and what the customer pays to them,'' said Richard Nielsen, senior counsel at Pillsbury Winthrop Shaw Pittman, in a Dec. 19, 2014 phone interview with Bloomberg BNA. However, some governments argue that the tax base should be nothing less than the full price paid by consumers when booking a room, regardless of whether it is done through OTCs or through hotels directly.

Many hotel occupancy tax ordinances were drafted 30 or 40 years ago, Nielsen said, years before the emergence of OTCs. In fact, ''hotel tax statutes were written very carefully, to make sure the tax wasn't imposed on activities beyond amounts paid to the hotel for the room,'' Joseph Henchman, vice president of legal and state projects at the Tax Foundation, told Bloomberg BNA in a Dec. 19 e-mail.

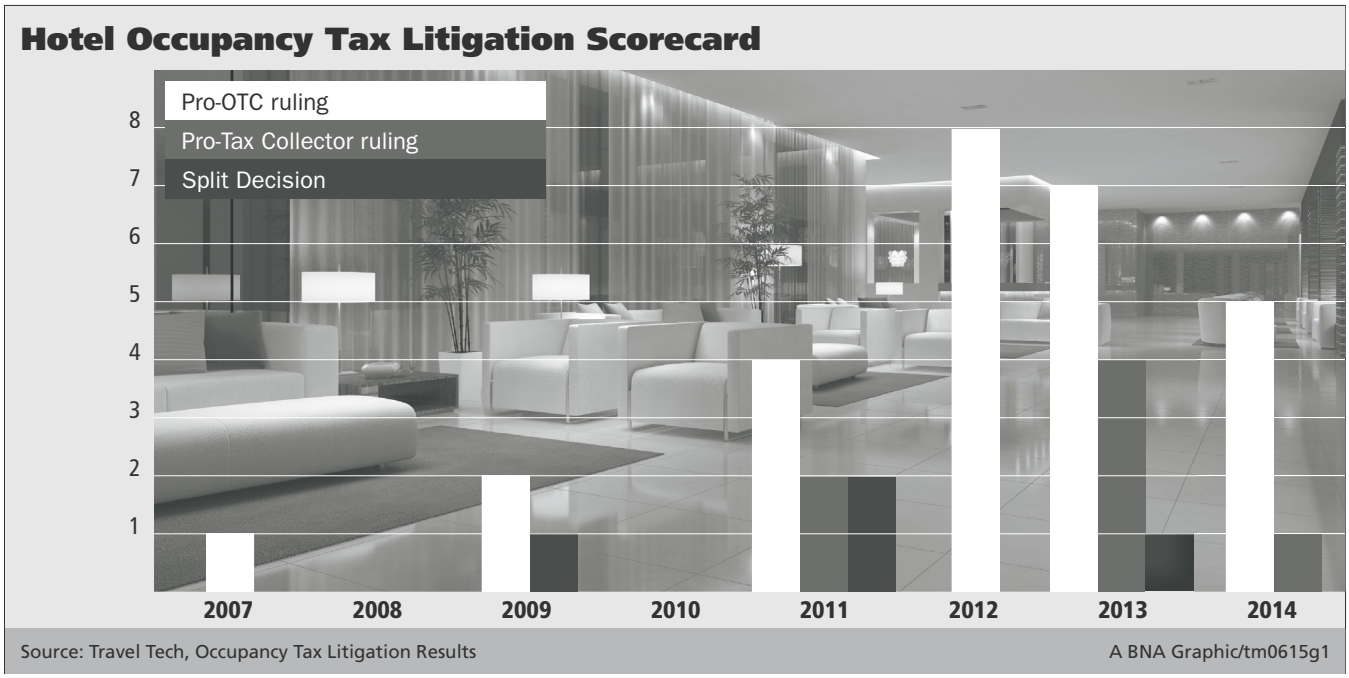
Hotel tax statutes were written very carefully, to make sure the tax wasn't imposed on activities beyond amounts paid to the hotel for the room.

JOE HENCHMAN, ATTORNEY AND POLICY ANALYST, TAX FOUNDATION

For example, in San Diego, the municipal code states that the transient must pay a tax of 6 percent of the rent charged by the operator. In Florida, where counties are authorized under state law to impose a tax on the rental or lease of accommodations in hotels, motels, apartments, etc., the statute stipulates that the tax will be due on the consideration paid for occupancy in the county. The municipal code of San Antonio states that the hotel occupancy tax is levied on the price paid for a sleeping room or sleeping facility furnished by any hotel, including all goods and services provided by the hotel that are not ordinarily subject to sales tax.

Each of these statutes emphasizes the price paid for the room, but governments in San Diego, San Antonio and Florida still filed suit against OTCs with varying degrees of success.

Online Travel Companies Win Most, Lose Some. In 2014, states and localities from coast to coast continued to battle in the courtroom over the issue of whether hotel occupancy tax is due on the wholesale rate negotiated and paid by online travel companies to hotels or on the full amount paid by consumers when booking on travel company websites. Dozens of courts throughout the country have affirmed that online travel companies do not owe hotel occupancy taxes on their service fees, Minardi said.



In *In re Transient Occupancy Tax Cases*, 225 Cal. App. 4th 56 (Cal. Ct. App. 2014), the California Court of Appeals upheld the trial court's decision, ruling that under the plain language of San Diego's ordinance, OTCs have no transient occupancy tax obligations or liability. Specifically, the court held that because the city's ordinance imposes tax only on the rent charged by an operator—which it identified as the wholesale price charged by the hotel in merchant model transactions—it does not reach amounts charged by OTCs for their services. However, on July 30, the California Supreme Court granted review of this decision, giving San Diego and jurisdictions throughout the state new life and setting the parties up for another face-off in 2015.

In Hawaii, online travel companies continue to battle the state over their liability for the general excise tax and the transient accommodations tax. The general excise tax is an annual privilege tax imposed on persons doing business within the state. The transient accommodations tax is the state's version of hotel occupancy tax, and is imposed on the operator on the gross rental or gross rental proceeds from providing transient accommodations.

The Hawaii Tax Appeal Court found that OTCs are not liable for transient accommodations tax but found they are liable for the general excise tax. Both sides appealed and the cases have been combined and are currently pending before the Hawaii Supreme Court. There is over $1 billion at stake, Steven D. Wolens, principal at McKool Smith in Dallas and one of the attorneys representing the state of Hawaii in this litigation, told Bloomberg BNA in a Dec. 23, 2014 phone interview.

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The Hawaii case is quite different from litigation seen in other states, as Hawaii has a general excise tax that is explicitly applicable to services in addition to their occupancy tax. If the court rules in favor of the state, online travel companies ''would have to pay years of retroactive sales taxes without the ability to pass them on to consumers . . . but the Hawaii case is not about a special tax at a punitive rate,'' Henchman said.

One of the biggest losses suffered by OTCs thus far was in *City of San Antonio v. Hotels.com*, No. 5:06-cv-00381-OLG (W.D. Tex. 2013), a class action joined by 172 other Texas cities, despite the statute seeming to favor the travel companies. However, ''there is a lot of strong evidence about the amount of control that the online travel companies exercise in a merchant model transaction,'' Wolens said, and this case rested on the finding by a jury that online travel companies controlled hotels.

There is a lot of strong evidence about the amount of control that the online travel companies exercise in a merchant model transaction.

STEVEN D. WOLENS, PRINCIPAL, MCKOOL SMITH

The online travel companies were denied in their bid for a new trial in 2014 and are facing a $55 million tax bill consisting of underpaid tax, penalties and interest. Among other issues, the companies unsuccessfully argued that the judge should be guided by a trial court's dismissal of identical claims by the City of Houston, which was subsequently upheld by a Texas appeals court.

In April, county governments in Florida, one of the most popular U.S. states for tourism, urged the state Supreme Court to overturn the appellate court ruling in *Alachua County v. Expedia, Inc.*, 110 So. 3d 941 (Fla. Dist. Ct. App. 2013). That court affirmed a trial court's ruling, holding that the state's tourist development tax does not apply to the portion of room reservation payments that OTCs retain as a fee for facilitating the transaction. In its analysis, the court discussed control but determined that OTCs do not control hotel property and thus, could not be deemed to rent, lease or let hotels under the meaning of Florida's statute. Given this, the consideration received for the lease or rental of a room is the amount paid to hotels by OTCs and does not include the mark-up profit retained by OTCs.

In North Carolina, the state Court of Appeals held that online travel companies are not operators of hotels and thusly, their gross receipts are not subject to tax. The court also rejected the claims that OTCs had collected taxes from online customers that it did not remit.

This victory may have felt somewhat hollow, however, because in 2011, the North Carolina Legislature amended the state's tax law so that the service fees charged by online travel companies are now subject to both the state sales tax and the room occupancy tax imposed by counties. The online travel companies filed a lawsuit challenging the constitutionality of the legislative amendments, but the parties ultimately reached a confidential settlement in 2014.

Forecast for 2015. Last year, not one state enacted new occupancy taxes, Minardi noted. ''States should be working with these online travel innovators to promote travel to their communities, not place additional taxes on an industry that brings immense value to local economies,'' he said.

Their economic value to local economies notwithstanding, governments want tax dollars from online travel companies as well and there are significant pending decisions that could jolt the industry. The Hawaii Supreme Court decision regarding the online travel companies' liability for general excise tax and transient accommodation tax is expected in the first quarter of 2015, according to Wolens. Also, the California Supreme Court could render a decision in the San Diego litigation; however, that case could also extend to the early part of 2016. A decision is also expected from the Florida Supreme Court on whether that state's tourist development tax applies to more than the amount the property owner receives for the rental of accommodations.

Online travel companies and governments have been fighting the same battle for almost a decade. States need to step in and codify some uniform terminology rather than having 50 jurisdictions out there with different ordinances, Nielsen said, and perhaps that would alleviate the uncertainty.

SUPPORT FOR MARIJUANA LEGALIZATION RAMPS UP

Support for the legalization and taxation of marijuana will continue in 2015.

Colorado and Washington will see a full year of recreational marijuana sales this year, and Alaska could possibly begin recreational marijuana sales as soon as this summer. Legalization activity will ramp up in several other states, and Nevada, Rhode Island and Vermont could be the next jurisdictions to legalize recreational marijuana sales, Mason Tvert, Director of Communications for the Marijuana Policy Project (MPP), told Bloomberg BNA in a Dec. 29, 2014 e-mail. He said ''2014 turned out to be yet another historic election year for the movement to end marijuana prohibition'' and has ''set the stage for 2016.''

2014 turned out to be yet another historic election year for the movement to end marijuana prohibition [and has] set the stage for 2016.

MASON TVERT, DIRECTOR OF COMMUNICATIONS, MARIJUANA POLICY PROJECT

However, regardless of the number of states with legalized forms of marijuana, conflicts between state and federal law, as well as state and federal tax reporting requirements, will continue to cause issues for financial institutions and marijuana-related businesses as long as marijuana remains illegal at the federal level.

Marijuana Taxes in Colorado and Washington. ''The next 12-month period is going to be significantly different than the past 12 months,'' said Tvert, regarding tax revenues generated by legalization.

Revenues in Colorado were lower than expected for 2014, but rose throughout the year. The state levies a 15 percent excise tax on the average market rate of wholesale marijuana and a 10 percent excise tax on retail marijuana sales, in addition to state and local sales taxes.

Colorado generated approximately $71.4 million during the first year of recreational marijuana sales, based on data reported through November, according to data from the Colorado Department of Revenue. That number includes the state sales tax, retail marijuana sales tax and retail marijuana excise tax, as well as marijuana business license and application fees.

Marijuana revenues will continue to fluctuate as localities make adjustments, according to Tvert. Many Colorado localities did not begin issuing licenses until several months into the year, and stores in some cities, such as Aurora, which is the third most populous city in the state, were not open to the public until late in the year, according to Tvert. The same was true of businesses in Denver.

Revenues in Washington were higher than expected, according to the Washington Economic and Revenue Forecast Council. Washington levies a 25 percent excise tax on producer, processor and retailer sales, in addition to state and local sales taxes.

After Washington began recreational sales in July, the 25 percent excise tax generated $15.9 in revenue, according to information from the Washington State Liquor Control Board, which administers the recreational marijuana program. Other tax collections for medical and recreational marijuana from January to October totaled approximately $13.6 million, according to information provided by the Washington Department of Revenue. These other taxes include state sales tax and penalties, along with business and occupation taxes. Through the middle of 2015, marijuana excise, sales and business taxes in Washington should generate about $43 million, according to the Economic and Revenue Forecast Council.

The Economic and Revenue Forecast Council also expects marijuana to bring in more than $694 million in revenue through the middle of 2019, higher than earlier estimates of $636 million.

Marijuana Taxes Coming to Alaska and Oregon. Marijuana legalization implementation is underway in Alaska and Oregon, where voters passed ballot initiatives during the November election legalizing recreational marijuana sales.

Alaska's Measure 2 requires that every marijuana cultivation facility pay a $50 per-ounce excise tax on marijuana sold or transferred to a retail marijuana store or marijuana product manufacturing facility. Although the state did not release an official estimate of revenues that the tax could generate, the Marijuana Policy Group, which does not take a stance for or against legalization, estimated that sales could generate approximately $7 million in additional excise tax revenue for Alaska during the first year, rising to over $23 million by 2020.

Alaska's Alcoholic Beverage Control (ABC) Board has nine months to implement Measure 2 and adopt regulations to govern marijuana businesses. Regulations will include information regarding marijuana establishment licensing and registration, along with penalties for violations. The Alaska Legislature can also create a Marijuana Control Board within the Department of Commerce, Community and Economic Development (DCCED) to assist with implementation. The DCCED estimates that once the regulatory framework is in place in mid-June 2015, retail sales could begin.

Oregon's Measure 91 will implement a $35 per-ounce excise tax on marijuana flowers, a $10 per-ounce tax on marijuana leaves and a $5 tax per immature marijuana plant. The Oregon Liquor Control Commission (OLLC), which will license and regulate marijuana, estimates that revenues from legalization could range between $17 and $40 million annually.

Measure 91 in Oregon allows more time for the state to implement legalization. The OLLC has until Jan. 1, 2016, to adopt rules and regulations to implement marijuana legalization, and has until Jan. 4, 2016, to begin accepting license applications for marijuana facilities.

Summary of Marijuana Taxes in the U.S.

State	Applicable Marijuana Taxes
Alaska	$50 per-ounce excise tax on marijuana sold or transferred to a retail marijuana store or marijuana product manufacturing facility
Colorado	■ 15 percent excise tax on the average market rate of wholesale marijuana ■ 10 percent excise tax on retail marijuana sales ■ 2.9 percent state sales tax (for medical and retail marijuana) ■ local sales taxes (rates vary by locality)
Delaware	gross receipts tax (rate varies)
Illinois	■ 7 percent cultivation privilege tax ■ 1 percent retailer's occupation tax on medical cannabis and cannabis infused products ■ 6.25 percent retailer's occupation tax on cannabis paraphernalia
New Mexico	5.125 percent gross receipts tax

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State	Applicable Marijuana Taxes
New York	7 percent excise tax on medical marijuana
Oregon	■ $35 excise tax per ounce on all marijuana flowers ■ $10 excise tax per ounce on all marijuana leaves ■ $5 excise tax per immature marijuana plant
Rhode Island	4 percent compassion center surcharge
Washington	■ 25 percent excise tax on producer sales to processors ■ 25 percent excise tax processor sales to retailers ■ 25 percent excise tax retailer sales to customers ■ 6.5 percent state sales tax ■ local sales taxes (rates vary by locality) ■ business and occupation taxes

Next Jurisdictions to Legalize and Tax. Expansion should continue throughout 2015 for both recreational and medical marijuana programs, and the stage is set for ballot initiatives in at least five states in 2016, said Tvert. Three states already have bills ready for consideration.

In Arizona, H.B. 2007, a bill that would legalize and impose a $50 per ounce excise tax on the sale or transfer of marijuana from a cultivation facility to a retail marijuana store or manufacturing facility, was pre-filed on Dec. 29, 2014. Legalization was estimated to increase state revenue by $48.3 million, according to an Arizona Joint Legislative Budget Committee Staff Memorandum prepared in response to H.B. 2558, a legalization bill considered in 2014 that ultimately died in committee. That number only related to direct revenue generation and did not account for other costs associated with implementation or regulation.

This year, Nevada will consider a legalization measure after a petition drive garnered enough signatures to be submitted to the legislature. The measure will levy a 15 percent excise tax on the fair market value at wholesale of marijuana, payable by marijuana cultivation facilities. If the legislature passes it and the governor signs it into law, marijuana legalization will go into effect Oct. 1. If the legislature does not act on the measure, it will be placed on the November 2016 ballot.

Additionally, even though New York is not predicted to legalize recreational marijuana within the next few years, S.B. 1747, which would legalize, regulate and tax marijuana, was introduced to the State Assembly on Jan. 14. The bill would impose a 15 percent excise tax on the price at transfer of marijuana sold or transferred from a processor to a retail store, $35 per ounce on marijuana flowers, $10 per ounce on marijuana leaves, and $5 per immature marijuana plant. And New York City has been looking at projected revenues that could come if recreational marijuana were legalized in the state. In a November report, New York City's Independent Budget Office predicted that the city could see an additional $25 million in city sales tax revenue. This prediction was based on New York only collecting its existing 4.5 percent sales tax on retail sales, above state sales and excise taxes applying to marijuana. New York enacted medical marijuana program legislation in July 2014, but sales have not begun yet.

The Marijuana Policy Project will also begin petition drives in Arizona, California, Maine and Massachusetts throughout the course of 2015, Tvert said. Activists in Missouri and Ohio are also supporting similar measures that could be on the 2016 ballot, although the outcomes of these efforts are less certain, he said.

Aside from ballot initiatives, the state legislatures of Delaware, Hawaii, Maryland, New Hampshire, Rhode Island and Vermont could consider legislative proposals some time during the next few years, said Tvert.

In response to the push for legalization in Vermont, the RAND Corporation released a study this month regarding the state's options if it wanted to pursue legalization. The report predicted that tax revenues from sales could possibly be between $20 million and $75 million annually.

It could be possible that if marijuana were legal and taxed in all 50 states and in D.C., sales could generate over $3 billion in additional tax revenue for the states, according to an estimate done by NerdWallet, a financial analysis website. The estimate assumed a 15 percent excise tax on marijuana, similar to Colorado's current tax.

Legalization Efforts in D.C. The District of Columbia may be close to marijuana legalization also, as voters passed Initiative 71 in November, which legalizes the possession of marijuana (not sales). Also, B21-0023, a marijuana legalization bill, was introduced to the D.C. Council on Jan. 6, which would impose a 15 percent excise tax on the first sale or transfer of unprocessed retail marijuana by a cultivation facility to a manufacturing facility, retail store or other cultivation facility, as well as a 10 percent sales tax on marijuana or marijuana products.

However, a provision in the omnibus spending bill passed by Congress in December blocks D.C. from spending tax dollars to enact the initiative and could block future attempts by D.C. to legalize sales of marijuana. Specifically, D.C. is prohibited from using ''both federal and local funds . . . to implement a referendum legalizing recreational marijuana use in the District,'' according to a House Appropriations Committee summary of the bill.

Despite this setback, D.C. officials plan to move forward with legalization efforts. D.C. Council Chairman Phil Mendelson submitted Initiative 71 to Congress on Jan. 13. It is projected to become law on Feb. 26 if approved. At the swearing in ceremony for new D.C. officials on Jan. 2, Attorney General Karl Racine said he ''will be fierce and unyielding in defending the will of the people, including Initiative 71.'' Committee hearings for B21-0023 may begin in early February.

When asked about initiative, Tvert said, ''Public support is growing quickly, and members of Congress are recognizing it. If Republicans want to make it a priority to prevent implementation, I think they will encounter

a big political battle that will not score them any points with most voters. If they're smart, they will respect the will of District voters.''

If they're smart, they will respect the will of District voters.

MASON TVERT, DIRECTOR OF COMMUNICATIONS, MARIJUANA POLICY PROJECT

Conflict with Federal Law. The path to legalization has been overshadowed with the constant struggle against marijuana's illegality at the federal level. Marijuana remains a Schedule 1 substance under the Controlled Substances Act (CSA) and is illegal. Even in states that have legalized recreational and medical marijuana, marijuana-related activity is illegal at the federal level.

Lawsuits are attacking the validity of marijuana legalization itself. In December, the Attorneys General of Nebraska and Oklahoma filed suit against Colorado in an original action in the U.S. Supreme Court, alleging that Colorado is violating federal law by legalizing marijuana and allowing the manufacture, distribution and sale of marijuana in violation of the Controlled Substances Act, among other claims. Oklahoma and Nebraska have seen increased law enforcement action in their states because individuals travel from Colorado into neighboring states, where marijuana remains illegal.

In a statement about the lawsuit, Colorado Attorney General John W. Suthers (R) says the suit is ''without merit.'' He went on to say, ''[I]t appears the plaintiffs' primary grievance stems from non-enforcement of federal laws regarding marijuana, as opposed to choices made by the voters of Colorado'' and that Colorado ''will vigorously defend against it in the U.S. Supreme Court.''

Not all Oklahoma legislators agree that suing Colorado is the best course of action to address the difficulties caused by marijuana legalization. On Jan. 7, several Oklahoma legislators wrote a letter to Oklahoma Attorney General Scott Pruitt (R), saying ''we share your concerns about the growing amounts of marijuana apparently coming into our state from Colorado.'' The letter continues, ''However, we believe this lawsuit against Colorado is the wrong way to deal with the issue . . . .'' The legislators then suggested dropping the suit against Colorado because if the suit were successful in the Supreme Court, the suit could ''undermine . . . efforts to protect our own state's right to govern itself.''

Federal guidance relating to doing business with marijuana-related businesses is also unclear.

Doing business with known marijuana entities is unlawful under federal money laundering laws. Guidance provided by the Department of Justice and the Financial Crimes Enforcement Network (FinCEN) requires that financial institutions comply with reporting requirements about marijuana-related activities. Even though these guidelines were meant to enhance the availability of financial services for and transparency of marijuana-related businesses, financial institutions have remained reluctant to do business with marijuana-related businesses. The guidelines are merely a guide to the exercise of investigative and prosecutorial discretion, not an exemption from legal action. They include following a rigorous due diligence process for every marijuana-related business client and filing a variety of suspicious activity reports for every transaction associated with marijuana business clients. Even after following the guidelines, financial institutions may still be subject to prosecution for participating in illegal activity.

The difficulty complying with these guidelines has caused bank account closures in at least one state. Credit unions in New Mexico sent letters to marijuana-related businesses in that state last September, closing their accounts, citing compliance difficulties as the reason for the closures.

However, marijuana-related businesses in Colorado may soon have a solution to their banking difficulties. Colorado granted a state charter to Fourth Corner Credit Union in November, a financial institution strictly for businesses and individuals involved in the marijuana industry, which may be able to open as soon this month, once it receives a master account from the Federal Reserve System. Membership in the credit union is only available to marijuana businesses, associated companies and individuals that are members of pro-marijuana legalization groups. Once it receives a master account, the credit union may open even while it is awaiting deposit insurance from the National Credit Union Association.

Colorado also passed legislation in 2014 that authorizes financial cooperatives to serve the marijuana industry, but no cooperatives have opened yet.

Other Issues. Lack of access to the banking system has had other consequences for marijuana-related businesses. Many businesses have to operate on a cash-only basis because they cannot obtain an account with a bank. Without an account, marijuana-related businesses are forced to pay taxes in cash, increasing the security risk for these businesses because of the large amounts of cash kept on hand. There is also a lack of transparency for revenue departments looking to track revenues and ensure accurate payment.

Published guidance should promptly clarify that a tax professional will not be considered unethical, will not be targeted for audit, and will not be in violation of Treasury Circular 230 solely for representing or preparing a return for a business that is illegal under federal law but legal at the state level under state law.

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Paying taxes in cash also comes with additional work for marijuana-related businesses. In Washington, marijuana-related businesses without a bank account and unable to pay by electronic transfer must obtain a waiver from the state revenue department and pay tax at department field office locations. If the amount of tax

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due is over $20,000, the business must make an appointment with the office before the due date to ensure timely payment. Cash payments of marijuana excise tax due to the Washington State Liquor Control Board can only be made at the Liquor Control Board's Olympia headquarters office. Marijuana businesses in Colorado can only make cash payments at the state revenue department's Denver office.

Penalties for paying taxes in cash can also be an issue for marijuana-related businesses. For instance, the I.R.S imposes a 10 percent penalty for failure to pay federal employee withholding taxes electronically as required. Businesses unable to obtain bank accounts are unable to comply with that requirement.

At least one case has been filed regarding these cash payment penalties. Allgreens LLC, a marijuana dispensary in Colorado, filed suit against the IRS in the U.S. Tax Court in 2014 after being fined more than $20,000 in penalties for failing to comply with requirements to file quarterly tax payments by bank wire from December 2012 to December 2013.

Some marijuana-related businesses are also prohibited from taking deductions or credits for business activities relating to marijuana. Under I.R.C. §280E, marijuana-related businesses, including producers, manufacturers, distributors and dispensaries cannot take deductions or credits for ''any amount paid or incurred during the taxable year in carrying on any trade or business if such trade or business . . . consists of trafficking in controlled substances'' that are prohibited under federal or state law. Section 280E was enacted to punish drug dealers, but now that marijuana is being legalized at the state level, it is applying to ''legal'' activity as well. It applies to medical and recreational marijuana-related businesses equally.

The federal tax situation could ultimately drive some marijuana-related businesses out of business. During a November 2014 American Bar Association webinar presenters discussed the difficulties that §280E poses for marijuana dispensaries in states where medical or recreational marijuana has been legalized. The speakers agreed that §280E is ''at the center of the conflict between federal and state laws'' with respect to marijuana businesses and results in marijuana-related businesses paying much higher taxes than other entities.

Yet there is some guidance on this issue. In *Californians Helping to Alleviate Medical Problems v. Commissioner*, 128 T.C. 173 (2007), the court held that §280E does not preclude businesses from taking deductions for expenses that are attributable to a trade or business other than illegal trafficking in controlled substances even if the business is involved in trafficking in controlled substances. Essentially, a business can deduct expenses for expenses unrelated to services involving the sale of marijuana, if the other services stand on their own merits.

However, if all revenue comes from the sale of marijuana, which is considered trafficking in controlled substances, §280E will preclude deduction of business expenses, as happened in *Olive v. Commissioner*, 139 T.C. 19 (2012).

Because of compliance struggles, the IRS and the Office of Professional Responsibility are working on an advisory guide for marijuana businesses to use when preparing and filing federal taxes for 2014. According to the 2014 Office of Professional Responsibility Report, ''Published guidance should promptly clarify that a tax professional will not be considered unethical, will not be targeted for audit, and will not be in violation of Treasury Circular 230 solely for representing or preparing a return for a business that is illegal under federal law but legal at the state level under state law.''

The Future of Legalization. Marijuana legalization is spreading throughout the U.S. ''With marijuana being successfully regulated and taxed in Colorado and Washington, and with two more states now moving forward with similar systems, it is now clear that there is a viable—and preferable—alternative to prohibition,'' Tvert said.

More and more states are moving forward with a new, more sensible approach to marijuana policy, and it's really just a question of how quickly the rest will follow.

MASON TVERT, DIRECTOR OF COMMUNICATIONS, MARIJUANA POLICY PROJECT

Even Congress has taken an unprecedented step and approved an amendment in the omnibus spending bill in December that prohibits the Department of Justice from interfering with the implementation of state medical marijuana laws, which will save hundreds of millions of taxpayer dollars on law enforcement costs, according to Americans for Safe Access.

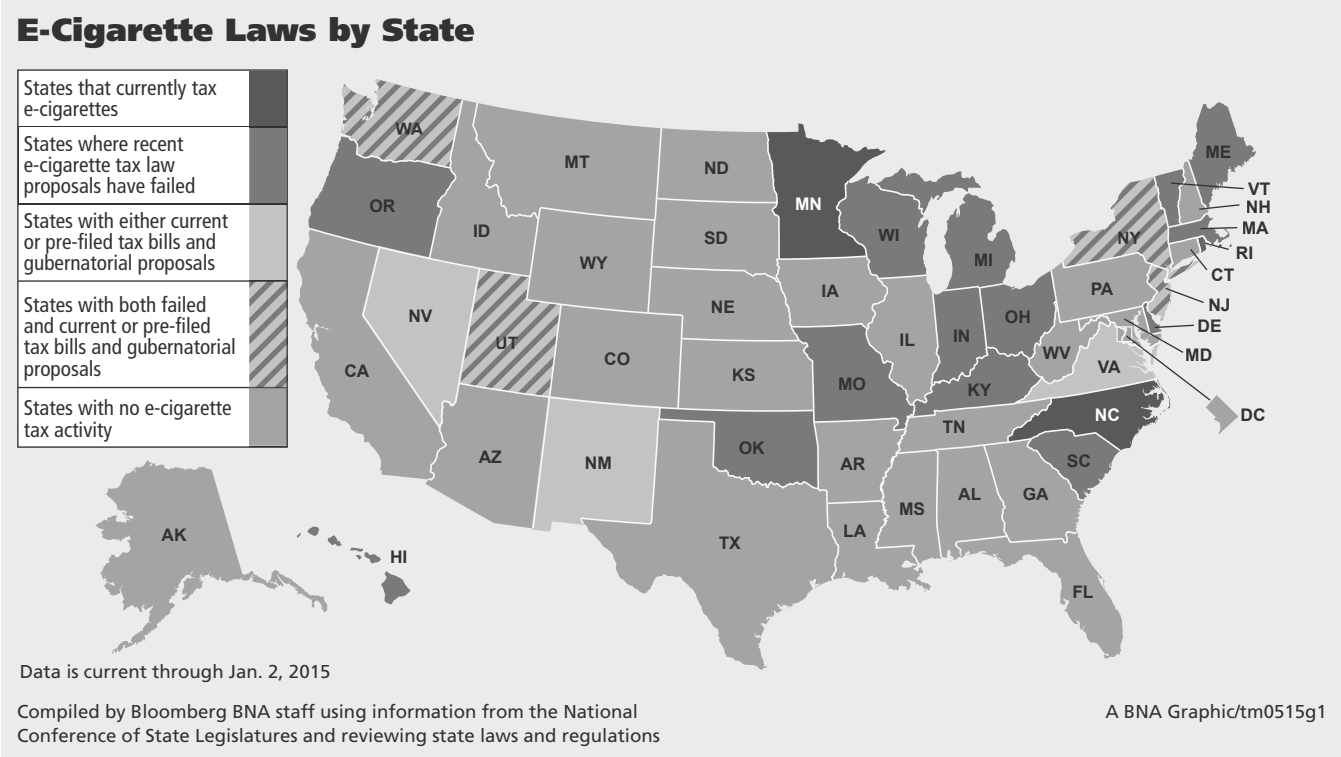
''More and more states are moving forward with a new, more sensible approach to marijuana policy, and it's really just a question of how quickly the rest will follow,'' said Tvert.

E-CIGARETTE TAX LEGISLATION IS STILL SMOKING

Taxing electronic cigarettes (e-cigarettes) will likely be a hot topic in 2015. These battery-powered devices resembling cigarettes that provide users with vaporized nicotine ''e-liquid'' have recently been in the crosshairs of numerous state legislators.

Motivating the push for taxation is debate over potential public health risks from e-cigarettes. While e-cigarette enthusiasts see the products as healthier alternatives to smoking, tax advocates see imposing excise taxes as a useful way to deter nicotine addiction. Jaime Smith, a spokesperson for Gov. Inslee (Wa.- D), told Bloomberg BNA Dec. 23, 2014 that ''of all tools available to policymakers for curbing tobacco use, price increases are demonstrably the most effective.''

Last year in particular was a busy year for e-cigarettes. Indeed, the FDA released a proposed rule in April that would classify e-vapor products as tobacco products in federal definitions, and thus bringing them under FDA regulation. There were also tax bills in several state legislatures. While only one bill emerged victorious in legislative battle, the war to impose excise taxes on e-cigarettes continues in the new year.



2014 Legislation in Review. Last year saw one legislative win for e-cigarette taxation when North Carolina enacted new legislation taxing e-cigarettes. Now there are two states taxing the product. Before North Carolina's tax bill became law in May, the only state with an e-cigarette excise tax was Minnesota. However, the structure of the tax used in Minnesota is significantly different than the one being used in North Carolina, Tax Foundation economist Scott Drenkard told Bloomberg BNA in a Dec. 19, 2014 interview.

Minnesota has been taxing e-cigarettes as tobacco products since 2012. This treatment began as the result of a state revenue department procedure. Minnesota taxes the entire e-cigarette, not just the e-liquid, at 95 percent of the wholesale price; the tax falls on just the e-liquid only if the wholesaler sells the cartridge separately.

Excise taxes are usually based on a specific weight or volume, so placing an ad valorem tax on the wholesale price was unusual, Drenkard said. The North Carolina tax is $0.05 per milliliter of the e-liquid, which is more reflective of e-cigarettes being a ''novel product,'' said Drenkard.

Minnesota and North Carolina, by virtue of being the only states with these taxes, have become the two standards between which lawmakers are choosing. They reflect different approaches to excise taxation. Drenkard listed three methods for taxes. Policymakers can try quantifying externalities [identifying costs that third parties bear from a particular activity], which he said is ''not the argument I'm seeing.'' They can tax riskier products more, which he says ''fits more here,'' or they can decide a product must be taxed because it is undesirable. That the North Carolina tax is lower he finds as reflective of a lesser risk in using the product.

The other state bills and gubernatorial budget proposals of 2014 did not pass. Many were either defeated in the legislature while some died in committee. One of these, Ohio's mid-biennium review bill H.B. 472, which included e-cigarettes in the state definition of tobacco products and imposed a 41 percent tax, expired when the legislative session closed at the end of 2014.

Similarly, Michigan's tax legislation S.B. 1018, considering e-cigarettes ''smokeless tobacco'' and imposing a tax of $0.15 per milliliter, expired when the legislature adjourned in December.

Vapors Over Vaping. Much of the debate stemming from e-cigarettes is over the potential public health consequences. E-cigarettes are fairly new products that have only been in the U.S. for about a decade. As a result, there has been less research on their effect on users' health.

Vaping proponents oppose excise taxes because of the potential effect on consumer behavior. Many see e-cigarettes as a healthier alternative to regular cigarettes as some studies indicate that they are less addictive.

Because the delivery system vaporizes the e-liquid, e-cigarette users do not inhale the tar that tobacco produces. Numerous users say that using e-cigarettes and other vapor products has helped them either reduce or quit smoking tobacco.

Not everyone is convinced by these endorsements, however. Many tax advocates are concerned with possible negative long-term health problems that research may not have uncovered yet.

''[W]hile the health impacts of vapor products are still being studied, studies have found that many vapor products contain carcinogens and toxic chemicals, in-

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cluding cadmium, formaldehyde and lead,'' Smith said. ''[E]-cigarettes may not be helpful to quit smoking. There is no scientific evidence that vapor products are an effective long-term smoking cessation aid.''

The Indiana Attorney General issued a press release noting discrepancies with quality control in manufacturing e-cigarettes as well as the ability to use the cartridges to vape liquid forms of drugs.

Additionally, there have been many expressed worries over minors becoming addicted to e-cigarettes, and these concerns have prompted many states to ban sales of e-cigarettes to minors. The National Institute of Drug Abuse's recent survey has found that more teenagers are using e-cigarettes, and this consumption is greater than the number of teenagers smoking normal cigarettes.

Looking Forward to 2015. While most tax efforts were quashed in 2014, some state legislatures and governors' offices are girding, and in some instances, re-girding their loins.

In Virginia, Del. Robert Krupicka (D) pre-filed a bill, H.B. 1310, that would place a $0.40 tax on each milliliter of vapor products' e-liquid. The tax is imposed when the product is imported, made in-state, or shipped within Virginia to retailers. The revenue from the tax will support pre-K programs and health care costs. Drenkard said that in comparison to North Carolina, this tax is ''heftier'' and ''closer to Minnesota.''

Pre-filed for New Mexico's 2015 legislative session are two e-cigarette bills. One of them, H.B. 42, prohibits sales to minors. The other, S.B. 65, does not classify e-cigarettes as tobacco products. Instead, it classifies e-liquid as a nicotine product and imposes a $0.04 excise tax on each milligram of nicotine. In addition, S.B. 65 requires businesses to register with the state to sell nicotine products.

In New York, which saw e-cigarette tax efforts in 2014, A.B. 296 has been pre-filed. This bill would consider e-cigarettes as tobacco products for state tax purposes. A bill with the same content, S.B. 722, has been pre-filed in the senate. Currently, the state tax rate for non-cigarette tax products, other than little cigars and snuff, is 75 percent of the wholesale price.

Though New Jersey Gov. Chris Christie (R) included an unsuccessful 75 percent wholesale sales tax provision in his budget proposal, the state is still considering e-cigarette taxes from a different source. S.B. 1867, which would impose the same tax rate, was introduced in March and is pending in the state senate.

[T]he current cigarette tax is a per unit excise tax. That is more difficult to apply to the various vape and e-cig products, so the 95 percent OTP [other tobacco products] tax made more sense.

JAIME SMITH, SPOKESPERSON, OFFICE OF WASHINGTON GOV. INSLEE (D)

In 2014, a Washington Senate e-cigarette tax bill, S.B. 6569, was introduced in the state legislature and ultimately failed. However, the state's Gov. Jay Inslee (D) recommended a 95 percent tax in his budget proposal, which he released in late December. This tax would be imposed on the wholesale price of all vaping products, including those without nicotine. The proposal indicates that 6,700 taxpayers would be affected, yielding $4.53 million in revenue for fiscal year 2016 and as much as $78.4 million by the 2017-2019 biennium.

Washington's proposed excise tax ''will fund enforcement, tobacco control and prevention and public health efforts,'' said Smith. In particular, the tax is meant to aid and fund the governor's ''Healthiest Next Generation Initiative.'' The program aims to prevent underage nicotine addiction, and in addition to the tax, online e-cigarette sales will be prohibited to limit access to them.

When proposing the tax, the governor's office looked to the North Carolina and Minnesota taxes as examples, as well as experts' advice and other states' tax proposals, said Smith. However, ''[t]he current cigarette tax is a per unit excise tax. That is more difficult to apply to the various vape and e-cig products, so the 95 percent OTP [other tobacco products] tax made more sense.''

Washington is not the only state with a gubernatorial proposal taxing e-cigarettes. Utah Gov. Gary Herbert (R) also released a budget proposal in late 2014 touching on the subject. His proposal mentions e-cigarettes only in a footnote, projecting revenue of $10 million. The tax would be similar to the state OTP tax, which is a percentage of the wholesale price, said Phil Dean, an analyst for the Governor's Office of Management and Budget, in a phone interview with Bloomberg BNA on Jan. 6.

The Indiana Attorney General's office issued a press release on Jan. 2, announcing that Atty. Gen. Greg Zoeller (R) and state lawmakers introduced a proposal to stop minors from using e-cigarettes. This proposal includes a tax on e-cigarettes similar to the state's tobacco products tax. While the press release did not identify the rate, the current Indiana excise tax rate on tobacco products, other than moist snuff, is 24 percent on the wholesale price. Two state representatives, Rep. Ed Clere (R) and Rep. Charlie Brown (D), have agreed to write the bill, making this a bipartisan effort.

While no bill has been filed yet, the Arizona Legislature has been considering taxing e-cigarettes. The legislature's Joint Budget Committee released a fiscal impact statement in November which analyzed different methods of taxing the product and projected revenue yields. Among the options were tax rates akin to both Minnesota and North Carolina. The committee also studied other states' tax proposals for this report. Taking into consideration a 40 percent tax avoidance rate, the committee determined that the highest revenue yield would be $13.5 million from a 95 percent tax on the retail price.

At the federal level, the comment period for the proposed FDA rule ''deeming'' e-cigarettes to be tobacco products ended in August. The agency has not yet issued a final rule but may continue to make other advances in regulating e-cigarettes in 2015.

Revenue Is Reality. One thing to note is that regardless of the health concerns or risk involved in using e-cigarettes, they will continue to be attractive to legislators as a possible revenue source.

Virginia's e-cigarette bill is specifically meant to fund Pre-K and healthcare. And Arizona is keeping a very detailed eye on which tax methods could bring them the most funding.

State governments need revenue and in 2015, a number of legislatures will be making decisions about whether e-cigarettes will help deliver it.

STATES ATTRACT CAPTIVE INSURANCE AND EXPAND TAX REVENUES

The number of captive insurance companies in the U.S. has swelled after passage of the federal Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) and the Non-admitted and Reinsurance Reform Act (NRRA) contained within it. The language of Dodd-Frank and the NRRA limits taxation and regulatory authority over non-admitted insurers, such as captive insurers, to the ''home state'' of the insured, and its provisions apply even if a portion of the risk or premium is located in other states. Thus, states now have the ability to retain the tax on 100 percent of premiums paid to a captive insurance company.

States wanting to take advantage of this ability have been enacting new laws or expanding existing laws to generate additional tax revenue for the state.

In 2015, states will continue to refine tax mechanisms on captives to entice companies to form captives in their states. Guidance may also be coming from the federal legislature that could have a significant impact on states' abilities to retain 100 percent of tax on premiums paid to captives under Dodd-Frank and the NRRA. Additionally, heightened interest in captive insurance companies by the National Association of Insurance Commissioners (NAIC) may result in new regulations applicable to captive insurance companies.

The Effect of Dodd-Frank and the NRRA. Dodd-Frank became effective in 2010 and provisions of the NRRA became effective July 21, 2011. The NRRA limits taxation and regulatory authority over non-admitted insurance to the ''home state'' of the insured, which is ''the state in which an insured maintains its principal place of business or, in the case of an individual, the individual's primary residence.''

The NRRA provides that no state other than the home state of an insured can require payment of direct placement, also called direct procurement, taxes to a non-admitted insurer (e.g., a captive in another state). Basically, home states can retain the tax on 100 percent of multi-state captive self-insurance program premiums. If 100 percent of the insured risk is located out of the state as set forth in the statute, then, the law defaults ''to the state with the greatest allocation of premium.''

States are also authorized under the NRRA to enter into interstate compacts or other processes to allocate or share taxes on non-admitted insurance, and some states have elected to enter into these tax-sharing arrangements. The Non-Admitted Insurance Multi-State Agreement (NIMA) and Surplus Lines Insurance Multi-State Compliance Compact (SLIMPACT) are two such arrangements currently in place. NIMA has six full members and two associate members. SLIMPACT has nine members, but remains inactive until a tenth member joins the compact.

Taxes on captive insurance are affected by the NRRA because there is ambiguity about whether the NRRA was meant to apply to captive insurance companies. It does not specifically mention application to captive insurance companies. Because of this ambiguity, states have been taking advantage of their ability to gain additional tax revenue by imposing direct procurement or other taxes on captive insurers.

Taxation of Captives in the U.S. The number of captive insurance domiciles in the U.S. has increased in recent years. After Ohio enacted captive legislation in 2014, 35 jurisdictions within the U.S. now have captive-enabling laws, meaning that captive insurance companies may be formed in their jurisdiction.

Vermont is the leading U.S. domicile for captive insurance companies, with over 500 licensed captives within the state, according to a March 2014 survey by *Business Insurance*. Utah and Delaware join Vermont to round out the top three captive domiciles in the U.S. Arizona, the District of Columbia, Hawaii, Kentucky, Montana, Nevada and South Carolina also have over 100 captive insurance companies within their state, according to the survey.

After Ohio enacted captive legislation in 2014, 35 jurisdictions within the U.S. now have captive-enabling laws, meaning that captive insurance companies may be formed in their jurisdiction.

Generally, states impose taxes on captive insurance either by taxing premiums or income. Tax revenues come from one of the following:

- direct procurement or industrial insured taxes, which are taxes on the insured parent company that pays a premium to a captive in another state. Typically, direct procurement taxes range between 3 and 5 percent of direct premiums paid by the insured.
- a premium tax imposed by the domiciliary state in which the captive is formed. Premium taxes are typically a fraction of a percentage point with a cap or total annual tax based on direct or reinsurance premiums paid to the captive.
- a tax on the income of the captive (underwriting and investment income).

Many states prefer using direct procurement taxes because the state can keep 100 percent of the tax imposed on a company, instead of having the tax allocated among several states.

However, there is potential for double taxation to occur. In cases where the insured's home state imposes a direct procurement tax on premiums paid to an out of state captive, and the captive is domiciled in a state that imposes a premiums tax on unauthorized insurance, the same transaction could be subject to tax twice, according to information provided by speakers at Bloomberg BNA's Fall 2014 Captive Insurance Tax Summit. Companies can potentially avoid double taxation by relocating a captive to a home state, which may also lower a company's overall tax burden.

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New Tax on Captives in Illinois. For several years, Illinois has imposed an income tax on out-of-state captives with an Illinois nexus with respect to risk in Illinois. This was an advantageous situation for parent companies because there was no home state tax imposed, even after Dodd-Frank was enacted.

Currently, only 10 states, including Illinois, impose an income tax on insurers. They include the following:

- Florida,
- Illinois,
- Louisiana,
- Maine,
- Michigan,
- Mississippi,
- Nebraska,
- New Hampshire,
- Oregon, and
- Wisconsin.

But in 2014, the Illinois Legislature enacted S.B. 3324, which imposes a 3.5 percent direct procurement tax, effective beginning Jan. 1 of this year. The tax applies to industrial insureds, but it will also apply to premiums paid to out-of-state captives. This means companies located in Illinois with out-of-state captives will be paying additional taxes.

When S.B. 3324 was presented to the legislature, the fact sheet on the bill did not mention that a new tax was part of the legislation, according to information posted on Illinois Rep. Barbara Wheeler's (R) website. The tax was discovered after the bill had moved through the legislature and was presented to the governor for his signature, according to a letter written by Illinois Rep. Bob Pritchard (R) about the strong opposition to the new tax. There was opposition because of its negative effect on businesses in Illinois, according to speakers at the Tax Summit. The 3.5 percent tax is expected to raise taxes on Illinois companies by an additional $100 million, according to Pritchard's letter. Even though legislators made efforts to prevent the bill from becoming law, the governor signed it in August.

In an effort to repeal the bill, state representatives filed H.B. 6302, which would have restored language deleted by S.B. 3324 and deleted language added by the bill. There were 47 sponsors for the bill, which did not pass before the end of the legislative session.

Federal Activity. Congress has taken steps to correct the ''unintended consequences'' of the NRRA, specifically, the ambiguity relating to its application to captive insurance.

In July 2014, Sen. Patrick Leahy (D-Vt.) and Sen. Lindsey Graham (R-S.C.) introduced the Captive Insurers Clarification Act, S. 2726, 113th Cong. (2014), which clarifies the definition of a non-admitted insurer under Dodd-Frank and the NRRA to exempt captives. When introducing the bill, Sen. Leahy said, ''due to the ambiguity of the NRRA, captive insurers are concerned that both the [insured's home state], and the state in which the captive is domiciled, may claim the premium tax,'' referencing the potential for double taxation. ''The Captive Insurers Clarification Act would simply clarify that [captives] were never intended to be included under the Non-admitted and Reinsurance Reform Act,'' he continued. But the legislation failed to pass before the end of the 2014 legislative session.

If similar legislation passes during Congress' new session and the NRRA does not apply to captives, states will lose their ability to retain the tax on 100 percent of premiums paid to a captive, even if they are the parent company's home state. Essentially, the tax situation will return to pre-Dodd-Frank, where taxes were allocated among all the states where risk is located.

The IRS has also expressed concern about captive insurance companies, and has put captives in its 2014-2015 Priority Guidance Plan (PGP). The plan indicates that the IRS will issue ''Guidance relating to captive insurance companies,'' even though the plan does not provide an explanation of what that guidance may be.

Nevertheless, until legislation is passed or other federal guidance is released, states will continue to operate under the assumption that the NRRA does apply to captives and take advantage of the ability to retain 100 percent of the tax on multistate captive self-insurance program premiums.

Concern About Captive Reinsurance. The U.S. Department of Treasury's Office of Financial Research listed the use of captive reinsurance companies as a potential threat to financial stability in its 2014 Annual Report published in December. The use of captive reinsurance companies by life insurers has increased within the past decade or so, according to the report. By using a captive reinsurance company, life insurers are able to cede some of their risk to the captive, thereby reducing the life insurers' reserve and capital requirements. The report cites concern about the solvency of captives and the potential for losses of captives to affect their holding companies because these transactions are less tightly regulated than traditional insurance. The report notes that regulators and market participants need additional information about captive reinsurance to evaluate risk mitigation. The Treasury Department's Financial Stability Oversight Council's 2014 Annual Report also discusses similar concerns.

New York has been concerned about captive reinsurance transactions since 2013, when Benjamin Lawsky, New York State's Superintendent of Financial Services, issued a report about ''shadow insurance,'' which the report calls a ''little-known loophole that puts insurance policyholders and taxpayers at greater risk.'' Reinsurance transactions can provide federal tax benefits because reductions in reserves are taxable income, but when the reserves are ceded to a captive reinsurer, the obligations remain within the same corporate family, so no tax liability is incurred. Reserves are also tax deductible as an ordinary business expense.

In response to concerns about these types of reinsurance transactions, the National Association of Insurance Commissioners (NAIC) prepared a 2013 white paper for regulators regarding the use of captives and special purpose vehicles, recommending that the NAIC prepare additional guidance for states to assist them with reviewing captive and special purpose vehicle reinsurance transactions.

Lawsky declared a moratorium on these types of reinsurance transactions in New York after he issued his 2013 report. But these transactions can still be performed using captives in other states. In a November 2014 letter to Treasury Secretary Jacob J. Lew, Lawsky asked the IRS to investigate the use of these transactions nationwide.

The American Council of Life Insurers (ACLI) posted a statement on its website in December regarding the use of reinsurance subsidiaries, saying that the use of affiliated reinsurance subsidiaries, including captives, ''[is] an important component of risk management.'' In a July study commissioned by ACLI regarding a NAIC white paper, ACLI said, ''There is likewise no credible evidence [in the white paper] that the arrangements have been overlooked by regulators and rating agencies or that they significantly increase insolvency risk.''

There is likewise no credible evidence [in the white paper] that the arrangements have been overlooked by regulators and rating agencies or that they significantly increase insolvency risk.

AMERICAN COUNCIL OF LIFE INSURERS (ACLI)

Other Regulatory Considerations. The NAIC has taken a greater regulatory interest in captives recently and this trend will continue in 2015.

The NAIC adopted Actuarial Guideline 48 (AG48) in December, relating to new national standards for XXX/AXXX reserve financing arrangements, which went into effect on Jan. 1. The purpose of AG48 is ''to establish uniform, national standards governing XXX or AXXX reserve financing arrangements and, in connection with such arrangements, to ensure that Primary Security . . . is held by or on behalf of the ceding insurer.'' The guidelines do not apply to policies issued prior to Jan. 1 if the policies were included in reserve financing arrangements as of Dec. 31, 2014. These new standards will help address some of the concerns about life insurer use of captive reinsurance, discussed above.

Also, in March 2014, the NAIC proposed revisions to the definition of ''multi-state'' reinsurers to include captive insurers. The proposed revisions met with strong opposition from industry stakeholders and have not been finalized yet, but that may occur in 2015.

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Property Tax

Property Tax

The dual pressures of increasing education funding while providing property tax relief to taxpayers will be two conflicting themes that will play out in 2015. Funding for public education has decreased in states throughout the country. One result has been state courts in Kansas, South Carolina and Texas ruling that current state education funding is inadequate and unconstitutional.

Key Issues: Prospects for Property Tax Reform, Budgetary Battles Over Funding Public Education

BY GEORGE LYNCH (GLYNCH@BNA.COM)

The funding of public education, which is largely funded by property taxes, has seen a lot of action in 2014, and will continue to see movement into 2015. Property tax cuts and public education funding has been a top issue in several large states, such as Texas, Illinois and New York. Several states, such as Texas, South Carolina and Kansas, have had their education funding mechanisms ruled unconstitutional by state courts, and other states have had lawsuits filed against them based on education funding laws.

At least 30 states are providing less funding per-student than they did prior to the recession, with at least 14 states having cut funding by more than 10 percent.

2014 STUDY BY THE CENTER ON BUDGET AND POLICY PRIORITIES (CBPP)

Lingering effects of the Great Recession of 2007-09 continue to have an impact on education funding and the property taxes that support most public education. A 2014 study by the Center on Budget and Policy Priorities (CBPP) found that at least 30 states are providing less funding per-student than they did prior to the recession, with at least 14 states having cut funding by more than 10 percent.

The drastic drop in property values after the recession made it extremely difficult for school districts to raise revenue through property tax increases, and often times led to rate increases. State budgets, which were hit particularly hard, filled the vast majority of their budget holes with spending cuts and federal assistance, which expired at the end of 2011. This lack of available resources for education from local school districts, state governments and the federal government has been the main contributing factor to many of the property tax developments we are seeing in 2014 and will see in 2015.

While property values have improved since the recession, they are still under their pre-recession levels. Additionally, most states have yet to realize the revenue from the increased values, which takes about three years to materialize in state coffers, according to research cited in the CBPP study. This interplay between property tax relief and a more equitable funding for education is the critical background needed to understand the decisions that state and local lawmakers will make in 2015.

Reform. Along with sagging public education funding, the major reform theme among the states and local taxing jurisdictions is a desire to lower property taxes. The dual pressures of increasing education funding while providing property tax relief to taxpayers will be two conflicting themes that will play out in 2015. The withdrawal of state and federal education funding to local school districts over the last few years has resulted in an increase in property taxes, yet continued underfunding of public education. This has put pressure on state legislators to promise relief to voters, ''but with the same understanding that a lot of the taxes are used to fund public education, so there are concerns with how you address both those issues,'' Senior Tax Counsel for the Council On State Taxation, Fred Nicely, in a Jan. 7 telephone interview with Bloomberg BNA.

Governor Mario Cuomo (D) has thus far proposed the most significant property tax reform plan of 2015. He announced a new $1.66 billion property tax credit program on Jan. 15, that is aimed at low and middle-income homeowners and renters. Once the program, which is part of Cuomo's 2015 Opportunity Agenda, is

Lowest Ranked U.S. State Jurisdiction on COST/IPTI Scorecard	
Pennsylvania	D
Connecticut	D+
Delaware	D+
Hawaii	D+
Nevada	D+
Rhode Island	D+
Highest Ranked U.S. State Jurisdiction on COST/IPTI Scorecard	
Indiana	B
Colorado	B-
District of Columbia	B-
Idaho	B-
Maine	B-
Maryland	B-
Montana	B-
Oregon	B-
Texas	B-

Information from Joint Report, Council on State Taxation and International Property Tax Institute, "The Best and Worst of International Property Tax Administration: COST-IPTI Scorecard on State and International Property Tax Administrative Practices" (2014), http://cost.org/WorkArea/DownloadAsset.aspx?id=88125

A BNA Graphic/tax015g5

phased in over 4 years, is expected to provide tax credits to more than 1 million renters and homeowners.

The program is targeted at homeowners with incomes under $250,000, and would apply to 50 percent of the amount that a homeowner's property taxes exceed 6 percent of their income. A credit for renters would be based on the estimated 13.75 percent of annual gross rent that is attributed to property taxes, providing property tax relief to renters with income up to $150,000 when the amount of rent going to property taxes exceeds 6 percent of the renter's income. State officials estimate that once the program is fully phased in, it will provide an average tax credit of $950 to 1.3 million New York taxpayers.

Property taxes played a major role in the 2014 Texas election, with reforms being pushed by candidates for both parties. Lieutenant Governor-elect Dan Patrick (R) and state Senator-elect Paul Bettencourt (R-Houston), specifically, made property tax reduction a key plank of their campaigns. With a decision by a Texas district court, finding Texas' education funding mechanism to be in violation of the Texas Constitution, and an appeal to the Texas Supreme Court both hanging in the air of the campaign, the tension between property tax relief and education funding was especially visible in Texas.

With the Texas Supreme Court case on education financing pending, major reform is unlikely to happen in this legislative session, but that has not stopped lawmakers from introducing a variety of property tax bills. Patrick and Bettencourt have each expressed their belief that any budget that is passed will contain property tax relief. ''The fundamental problem with property taxes in Texas is that as values go up, tax rates never go down,'' Bettencourt told Bloomberg BNA's Weekly State Tax Report in an interview published on Jan. 9, noting that ''[m]any jurisdictions are seeing double-digit growth in property tax revenue in one year alone.''

There were some proposals in the 2014 legislative session, for example, that would have reformed the appraisal appeals process, through which wealthy property owners, such as large corporations, are often able to cost the state significant revenue by continually contesting appraisals through the appeals process. Bettencourt has also pre-filed a bill, S.B. 182, that would lower the rollback rate that would trigger a public referendum on property tax raises. Current law mandates a special rollback election if city, county or special district revenues grow by 8 percent. Bettencourt's bill would halve the limit and trigger an election if tax revenues grow by 4 percent, which ''would put more pressure on taxing jurisdictions to lower the tax rates as tax bills rise,'' according to Bettencourt.

The action most likely to take place before the Texas Supreme Court's ruling is to raise the homestead exemption, John Kennedy, a Senior Analyst at the Texas Taxpayers and Research Association, told Bloomberg BNA in a Jan. 7 phone interview. State Senator Kirk Watson (D-Austin) has also pre-filed a spate of bills to overhaul the system in the next legislative session, including a proposed $10,000 increase in the homestead exemption, from the current $15,000 to $25,000, which has not been increased since 1997 among much lower home prices. Lawmakers on both sides of the aisle have also made property tax relief a priority, so the big question is how they will manage to reduce the inequities in education funding while providing taxpayers the relief that legislators have promised. For the most part, however, action on property taxes will probably be in a holding pattern until the Texas Supreme Court makes a ruling on the school financing case.

Two of the states that have instituted aggressive tax cuts over the last few years both plan on further reducing property taxes this year. Wisconsin made more than $500 million in property tax cuts in 2014, and North Dakota has reduced overall taxes by $4.3 billion since 2009.

In December, the Wisconsin state government released the Wisconsin Tax Relief and Reform report, which consisted of a year's worth of meetings with various groups of Wisconsinites. The Wisconsin government concluded through the report that ''the most common concern was the property tax burden faced by all of our working families and small businesses.'' Governor Scott Walker (R) has made further property tax reductions a centerpiece of his 2015 agenda, and this report suggests he will make a serious push.

Many jurisdictions [in Texas] are seeing double-digit growth in property tax revenue in one year alone.

PAUL BETTENCOURT (R-HOUSTON), TEXAS STATE SENATOR-ELECT

In North Dakota, Governor Jack Dalrymple (R) made property tax cuts a priority and has made clear he will do so again in 2015, as have Democrats in the legisla-

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ture. In his 2015 state of the state address, Dalrymple said that ''[t]his year, the legislature will have an opportunity to pass a property tax reform bill that provides for more spending discipline, and makes it easier for taxpayers to understand how their tax dollars are used in comparison to other political subdivisions.''

With Michigan going forward with the 15-year phase-out, Indiana is now one of the few of its neighboring Midwestern states that retains personal property taxes (Ohio and Illinois have already eliminated them). Cutting or eliminating the business personal property tax had been on the 2014 agenda of Indiana legislators, who created a study committee to analyze the tax code and look at its impact on local governments. The chair of the study committee, state Senator Brandt Hershman (R-Buck Creek), introduced a bill that would allow local governments the option of eliminating the business personal property tax. He has also stated a preference for expanding the bill in the 2015 session.

Given the absence of a personal property tax in other Midwestern states, there are now ''some pressures to reduce or eliminate'' them, said Nicely. While personal property taxes in Indiana are comparatively low to states that retain them, and Indiana ranked first on COST's property tax scorecard, there is concern that businesses could move to neighboring states that have eliminated the personal property tax altogether. As a result, 2015 will ''see some states looking at what they could do to stay competitive, said Nicely.

With farmers and agricultural land bearing a large amount of property taxes, property tax reform is emerging as a leading issue for Nebraska in 2015. With farmers and ranchers comprising 3 percent of Nebraska's population, yet paying 26 percent of total statewide property taxes, the Nebraska Farm Bureau has announced that property tax relief is its number one priority in the 2015 legislative session. Agricultural land in Nebraska has increased by more than 10 percent since 2008 and by 116 percent between 2003 and 2012. Agricultural land is taxed at 75 percent, second only to North Dakota among neighboring states. According to the Open Sky Policy Institute, a non-partisan fiscal research organization in Nebraska, rural Nebraskans pay significantly higher property taxes on both a per-capita basis and as a share of income than urban Nebraskans. Like other states, Nebraska already faces a fiscal imbalance, according the Executive Director of the Open Sky Policy Institute, and this has caused rural Nebraskans to bear a greater share of K-12 education funding.

Some lawmakers, such as state Senator Kirk Watson (D-Austin), insist that the state cannot afford to wait for the Texas Supreme Court ruling to begin reforming education funding.

Education Reform. With a Texas Supreme Court case on education financing pending (discussed below) major reform is unlikely to happen in this legislative session, but that has not stopped lawmakers from introducing a variety of property tax bills. The general consensus is that the Texas Supreme Court will not decide the case until the end of the year, and that significant reform will not occur until then.

Some lawmakers, such as state Senator Kirk Watson (D-Austin), insist that the state cannot afford to wait for the Texas Supreme Court ruling to begin reforming education funding. Nevertheless, Bettencourt does not see any sweeping changes during the upcoming legislative session, ''because in the last session, the legislature restored $3.7 billion worth of funding from the $5.4 billion cut [from 2011].'' Bettencourt argues that the education cuts that led to the lawsuit are not as severe as critics say. The quick rise in property values have given taxing jurisdictions more local money than before, which off-set at least some of the cuts to state education funding, according to Bettencourt's interview with Bloomberg BNA.

The Illinois Senate made a concerted effort in 2014 to rebalance the education finance funding formula. The senate passed S.B. 16 with the aim of providing more funding to low-income public schools in the state, with state aid focused on need-based distribution, but the lower chamber failed to consider it before the legislative session ended. State Senator Andy Manar (D-Bunker Hill), who introduced S.B. 16 in the 2014 session, plans to amend the bill, while keeping the core of it intact, and reintroduce the bill in the upcoming legislative session.

In 2014, New York Governor Andrew Cuomo (D) made an aggressive push to cut school costs and keep property taxes down by using potential property tax freezes to incentivize school districts to consolidate. Cuomo intends to continue his consolidation push into 2015, although the extent of its success will depend on voters in each district who must approve any consolidations.

In addition, recently re-elected Nevada Governor Brian Sandoval (R) has said that improving education in his state is his top priority for the 2015 legislative session. Sandoval has said that the funding formula, which was set in 1968, must take into account demographic factors such as the population of non-native English speakers in each district and the amount of at-risk youth in the district. With the overwhelming defeat of Question 3 in the previous election, which would have imposed a business margins tax to raise money for education, it is unclear where further education funding could come from. Higher property taxes or a corporate profits tax have both been discussed as options.

Property taxes and education funding became a big issue in Vermont's gubernatorial race for the opposite reason as most states. Both candidates cited high property taxes as a major burden on Vermonters, but they also both believe that education funding in the state is too high as student numbers have decreased 20 percent over the past 15 years. Property taxes rose by two percent last year, which is less than previous years.

House Speaker, Shap Smith (D), organized a group of legislators and policy experts, known as the Education Finance Working Group, to develop a plan to overhaul the entire education funding structure. The group released its report in December 2014, ahead of the approaching legislative session, laying out three different options on how to overhaul education financing.

Unconstitutional Education Financing. Along with voluntary education funding reforms, there were a string of states in 2014 that had their education funding ruled unconstitutional by state courts, and other states that

are still grappling with rulings on the unconstitutionality of their education funding from previous years, and other states that had lawsuits brought against them in 2014 for inadequate education financing.

This decision holds the system unconstitutional on more grounds than ever before.

WAYNE PIERCE, EXECUTIVE DIRECTOR OF THE EQUITY CENTER

In August 2014, a Texas district court ruled that the state's education finance system violated the Texas Constitution because it failed to adequately fund and equally distribute funding to Texas students, and the the restrictions the legislature placed on local property taxes created a de facto state-level property tax, which is prohibited by the Texas Constitution (*Texas Taxpayer & Student Fairness Coalition v. Williams*, No. D-1-GN-11-003130 (Tex. Dist. Ct. Aug. 28, 2014)). Texas is appealing the ruling to the Texas Supreme Court, and Texas legislators are unlikely to address the issue until the Supreme Court issues a final ruling, Wayne Pierce of the Texas Taxpayer & Student Fairness Coalition, and Thomas Ratliff, a Member of the Texas State Board of Education, told Bloomberg BNA in August.

''This decision holds the system unconstitutional on more grounds than ever before,'' Wayne Pierce, Executive Director of the Equity Center, a plaintiff in this case, told Bloomberg BNA in a Sept. 8, 2014, e-mail, shortly after the ruling. The court found that Texas' education finance system violated all three prongs of the Texas Constitution's requirements of adequacy, suitability and equity in school funding. State Board of Education Member for District 9, Thomas Ratliff, told Bloomberg BNA that he is confident that the funding formula itself is not the problem, but the legislature's unwillingness to adequately fund the system while placing more rigorous, but unfunded, mandates on public schools.

South Carolina legislators are considering drastic changes to their education funding in the wake of a November 2014 state Supreme Court ruling that held that South Carolina failed to provide poorer school districts with ''minimally adequate'' education, in violation of the state constitution (*Abbeville County School District v. South Carolina*, No. 27466 (S.C. Nov. 12, 2014)). The court ordered state legislators and school districts to work together to come up with a plan to be presented to the justices ''within a reasonable amount of time.''

South Carolina's current Education Finance Act was passed when industrial areas were spread throughout districts of the state, but large industrial areas are now concentrated in a few counties, making it harder for poor and rural areas to sufficiently fund their schools. State Representative Jenny Horne (R-Dorchester) introduced the South Carolina Jobs, Education and Tax Act in the 2014 that would establish a state-wide property tax and give school districts more flexibility in spending funds and raising local taxes. The bill died in committee last session, but is supported by major South Carolina education groups and the incoming State Schools Superintendant Molly Spearman. Horne intends to prefile the bill for the upcoming 2015 legislative session.

Kansas is the latest state to have its education funding mechanism found to be in violation of its state constitution (*Gannon v. Kansas*, No. 109,335 (Kan. Dec. 30, 2014)). The Kansas Supreme Court found unconstitutional inequities in state funding to districts in a March 2014 opinion but sent the case back to the district court to address whether overall education funding was constitutionally inadequate (*Gannon v. Kansas*, No. 2010CV1569 (Kan. March, 7, 2014)). The state supreme court also issued an order that educational outcomes must be considered in addition to total funding when deciding its adequacy. The district court announced its decision in December and found education funding for Kansas schools to be inadequate.

In addition to these states that had their education financing found unconstitutional this year, there are other states that are still grappling with court rulings on school financing schemes from previous years. Washington, for example, was ordered by its state supreme court, in *McCleary v. State of Washington*, to rely less on local levies for education funding due to the inequities that ultimately result (*McCleary v. Washington*, No. 84362-7 (Wash. 2012)). The court held the Washington Legislature in contempt in 2014 and threatened further sanctions, if lawmakers did not make significant progress on reformulating school funding. Governor Jay Inslee (D) left the issue of levy equalization out of his 2015 budget proposal, so it will be interesting to see whether it's the legislature or the courts that make the next move.

Lawsuits on the constitutionality of school funding have also been filed in Mississippi and Pennsylvania. In Mississippi, legislators have ignored the state education funding law and have underfunded Mississippi schools since 2008. As a result, 80 percent of Mississippi's 146 school districts have raised property taxes since 2008, and some districts no longer have the legal ability to raise property taxes any further. According to estimates released at the end of 2014, the 2016 budget could fall $280 million short of its statutorily mandated funding level.

AP found that the wealthier half of districts spend on average $1,800 more per student than the poorest half of districts.

Five school districts in Pennsylvania have also recently filed a lawsuit challenging the state's education funding. With the Pennsylvania state government playing a smaller role in education funding than most states, and cuts the state has made to education in recent years, an Associated Press (AP) analysis of state data on spending, income and attendance found that the gap between rich and poor schools had doubled since the 2010-2011 school year. AP found that the wealthier half of districts spend on average $1,800 more per student than the poorest half of districts. The report also found that wealthier districts largely weathered the budget cuts, while the poorer districts, which do not have the ability to raise local property taxes, saw their budgets frozen or decline.

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The incoming governor, Tom Wolf (D), has pledged to make restoring cuts to education his priority, which should have an impact on property tax decisions throughout the state.

Conclusion. Reconciling the major issues of adequately and equitably funding public education and providing property tax relief to taxpayers who have been bearing an increasingly heavy burden for education funding in the face of decreasing state and federal aid will hopefully make 2015 an exciting and eventful year in the world of property tax.

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Unclaimed Property

Unclaimed Property

Several key developments in state unclaimed property law are on the horizon for 2015, including a new draft of the Uniformed Unclaimed Property Act and a U.S. Court of Federal Claims case on federal savings bonds. Additionally, Delaware is considering revising its unclaimed property law.

Key Issues: New Draft of UUPA, Ruling on Escheat Of Federal Bonds and Further Reforms Expected in 2015

BY ALEX DOWD (ADOWD@BNA.COM)

Unclaimed property is likely to see a number of developments in 2015 that will have significant impact on future claims.

In November of 2014, the Uniform Law Commission's (ULC) Drafting Committee met for the second time to continue in the rewriting of the 1995 Uniform Unclaimed Property Act (UUPA). The Drafting Committee is poised to release the first draft of its new version of UUPA for debate in February. The target for releasing the completed new version of UUPA is 2016.

The first draft has received positive feedback. ''I believe that the first draft will be a very substantive and comprehensive effort to address each existing provision of the 1995 Uniform Unclaimed Property Act, as well as the 'new' or undeveloped issues that have been identified for inclusion in this new uniform act by various stakeholders that represent interests of the states, holders and owners,'' said Kendall Houghton, a partner at Alston & Bird LLP, in a Jan. 5 e-mail to Bloomberg BNA. ''Reporter Trost has received well over 1,500 pages of commentary and draft statutory language in the past year, as well as proposed Commissioners' commentary to the statutory provisions; he plans to digest this material and cast it into a straw-man first draft for the participants' careful review and additional commentary.''

I believe that the first draft will be a very substantive and comprehensive effort to address each existing provision of the 1995 Uniform Unclaimed Property Act...

KENDALL HOUGHTON, PARTNER, ALSTON & BIRD LLP

''Assuming that the straw-man draft act is promulgated in advance of the February meeting, I anticipate that meeting will generate a discussion that is both lively and more nuanced; I also think that advocates will begin to focus their comments to the ULC Drafting Committee on their respective high-priority issues,'' Houghton added.

It remains to be seen how the ULC will treat several controversial issues. These include the treatment of gift and stored value cards as well as potential rules for life insurance proceeds.

When asked about issues related to gift and stored value cards, Houghton said, ''The ULC has been asked to incorporate the Derivative Rights Doctrine into this

new uniform act and to declare that if such instruments are redeemable solely for merchandise or services, and not for cash, then by virtue of the states' derivative interest in and rights to an unclaimed gift or stored value card, the states may not assert a right to payment of the cash value of such unredeemed gift card. Holders and other advisors (including the ABA) have noted that this position would also conform to the current majority position of states, which have largely exempted gift and stored value card balances from escheat requirements (often premised upon the card issuer's satisfaction of consumer protection requirements such as the absence of an expiration date or the non-imposition of dormancy or other administrative fees).''

''On the other hand,'' Houghton noted, ''certain state representatives have argued that the ULC should neither recognize and adopt the derivative rights doctrine (though it has been articulated and applied by many of these state administrators' courts of law), nor create a statutory exemption as a matter of uniform law. Therefore, this property type will undoubtedly attract continued attention and advocacy by all affected parties.''

On the other hand, certain state representatives have argued that the ULC should neither recognize and adopt the derivative rights doctrine...

KENDALL HOUGHTON, PARTNER, ALSTON & BIRD LLP

In addition to a new version of UUPA on the horizon, a significant court development may be on the way in 2015 as well. In *Estes v. USA*, No. 1:13-cv-010110-EDK (Fed. Cl. filed Dec. 20, 2013), the Kansas State Treasurer, Ron Estes, is suing the U.S. Treasury in the U.S. Court of Federal Claims for the proceeds of unclaimed federal savings bonds whose original owners had their last known addresses in the state of Kansas.

The U.S. Treasury in October 2013 allowed Kansas to take the proceeds from unclaimed federal bonds for which the state had the physical paper copy of the bond, taken from unclaimed safety deposit boxes. However, this amount was about $862,000, and Kansas is currently seeking the redemption of $151 million worth of bonds in their current case against the U.S. Treasury.

Kansas is among several states, including Missouri, Kentucky and Louisiana, that now have escheat laws for federal savings bonds that dictate the bonds escheat in title to the state after some period of time after becoming unclaimed property. The distinction is notable because the Third Circuit Court of Appeals has ruled in *Treasurer of the State of New Jersey v. U.S. Department of the Treasury*, 684 F.3d 382 (3rd Cir. 2012) that state escheat of custody rules that pertain to federal savings bonds are preempted by federal law. However, the court did not explicitly rule on state escheat of title laws.

This case will have a significant effect on several states who are seeking to gain access to the proceeds of unclaimed federal bonds. The ruling will determine whether the previous ruling that escheat of custody statutes for federal bonds are preempted by federal law can be extended to escheat of title statutes. Additionally, a significant quantity of money is at stake should every state with laws similar to Kansas seek the redemption of unclaimed federal bonds for which they do not have the paper document.

Meanwhile, the Delaware legislature is considering reforms to the state's unclaimed property program after establishing the Unclaimed Property Task Force. On Dec. 23, 2014, the task force released a draft for a set of recommendations. Recommended changes include the creation of a best practices manual by the Delaware Department of Finance, modification of the appeals process to greater emphasize third-party review and adjustment of the look-back period and statute of limitations in unclaimed property audits. Whether the legislature will institute reforms to Delaware's unclaimed property law in response to these suggestions in 2015 remains to be seen.

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