



INSIGHTS FROM THE BDO FINANCIAL INSTITUTIONS & SPECIALTY FINANCE PRACTICE

# STATE TAX EXPOSURE FOR FINANCIAL INSTITUTIONS: WHAT YOU NEED TO KNOW

As a result of federal tax reform and the lowering of federal corporate and individual rates, state income tax has proportionally become a more significant part of a financial institution's overall effective tax rate. Thus, multistate tax developments have likewise become a more material aspect of the tax burden.

Financial institutions generally have economic nexus with numerous states because they generate gross receipts (typically interest) from customers located throughout the country. As a result, financial institutions must be aware of tax developments in all states, since most are adopting economic presence nexus. Interestingly, most state tax reform has a general application to all corporate taxpayers.

A financial institution must closely consider each state's tax laws and changes where it has assets, depositors and customers,

and evaluate the impact these changes will have on its state tax obligations. In addition, financial institutions generally need to account for the impact of state tax reform in their financial reporting and tax provisions when the reform is enacted into law, even if the effective date is prospective.

The following is intended to briefly cover selected state tax issues that impact a financial institution's state tax liabilities and economic bottom line. Specifically, this article will address how financial institutions may be impacted by:

- ▶ The U.S. Supreme Court's *Wayfair* decision
- ▶ New Jersey's newly enacted combined reporting requirements
- ▶ New York City's provisions for reporting Global Intangible Low Taxed Income (GILTI)
- ▶ Sales and use tax refund opportunities with respect to the purchase of software licenses and information services

## WAYFAIR DECISION AND ECONOMIC NEXUS

On June 21, 2018, in *South Dakota v. Wayfair*, the U.S. Supreme Court overturned the longstanding physical presence nexus requirement and upheld the application of economic presence.<sup>1</sup> Although *Wayfair* involved sales and use taxes, the decision is not limited to those taxes and applies equally to income taxes and other state taxes, such as gross receipts taxes. Therefore, the decision confirms what most state tax practitioners have long acknowledged with respect to income tax and gross receipts tax: States can generally enforce economic presence nexus provisions on taxpayers, including financial institutions. Indeed, a number of state court decisions prior to *Wayfair* that sustained state economic presence nexus in the income tax context involved financial institutions.

States that adhere to an economic presence nexus standard consider nexus to be triggered merely by making sales into the state or generating revenue from transactions occurring in the state. Although many states have a broad definition for when economic nexus exists, several states have “bright-line” sales thresholds (typically \$500,000 or more) to determine when economic nexus is triggered. In 2019, Hawaii, Massachusetts and Pennsylvania enacted bright-line economic presence nexus provisions. Effective January 1, 2020, Pennsylvania will assert economic nexus for corporate income tax purposes when an out-of-state company or financial institution generates \$500,000 or more of gross receipts from sources in Pennsylvania. Likewise, Massachusetts amended its corporate income tax nexus regulation to incorporate a \$500,000 sales threshold, but the regulation appears retroactively effective to January 1, 2019. Hawaii adopted the *Wayfair* standard of \$100,000 of Hawaii-sourced sales or 200 separate sales transactions with Hawaii customers as a threshold, also effective for tax years beginning in 2020. Effective for tax years beginning on or after January 1, 2019, Indiana enacted a broader economic presence nexus statute without any minimum sales threshold. Further, Oregon enacted a new Corporate Activity Tax (CAT) based on gross receipts and will assert economic presence nexus when the taxpayer's Oregon sourced receipts exceed \$1 million (or \$750,000 for a unitary combined group).<sup>2</sup> The Oregon CAT is effective starting in 2020. Lastly, Texas has issued a proposed rule whereby starting in 2020, the Texas franchise tax will be imposed on taxpayers having \$500,000 of Texas-sourced gross receipts.

It should be noted that these recent developments are not only in addition to pre-existing state case law sustaining economic presence nexus on out-of-state financial institutions, but also in addition to those states that have historically imposed economic

presence nexus by statute on financial institutions (Indiana, Minnesota, Tennessee and West Virginia.)

## NEW JERSEY TAX REFORM AND COMBINED REPORTING

New Jersey enacted sweeping changes to the New Jersey Corporation Business Tax (CBT) law during 2018, including the technical corrections enacted in October.<sup>3</sup> New Jersey's tax reform is comprehensive and impacts all corporate taxpayers, but financial institutions should take special note of the state's new mandatory combined reporting rules.

For tax years ending on or after July 31, 2019, banking corporations and financial corporations are generally subject to New Jersey's mandatory combined reporting rules when the entities share common-ownership and are engaged in a unitary business. Note, however, that financial institutions may share common-ownership and be engaged in unitary business with entities that New Jersey currently requires to file on a separate-entity basis: real estate investment trusts, regulated investment companies, and investment companies.

New Jersey issued specific guidance to assist banking corporations that historically filed income tax returns on a calendar year privilege period pursuant to N.J.S.A. 54:10A-34, but that will now be required to report income on a combined return that has a fiscal tax period. In Technical Bulletin 89(R), New Jersey explains that a banking corporation can join a combined group's fiscal privilege period by reporting its 2018 calendar year on Form BFC-1, and then filing a short period return (BFC-1-F) covering January 1, 2019, through the end of the month of the combined group's group privilege period.

## NEW YORK CITY & GILTI

Financial institutions that have Controlled Foreign Corporations (CFCs) and report GILTI for federal income tax purposes should be aware that New York City's treatment of GILTI diverges from New York State's. Note, however, that it appears that there are state constitutional and statutory issues regarding New York City's ability to do so.

By way of background, in June 2019, the state of New York enacted legislation amending its GILTI treatment for general corporation tax purposes. The legislation amended New York State's definition of a corporation's “exempt CFC income” to include 95% of a corporation's gross GILTI, or, in other words, effectively exempting 95% of GILTI from New York State corporation tax. The amendment is a significant departure

<sup>1</sup> For additional details, see: <https://www.bdo.com/wayfair>.

<sup>2</sup> For additional details, see: <https://www.bdo.com/insights/tax/state-and-local-tax/oregon-enacts-the-corporate-activity-tax,-a-gross>.

<sup>3</sup> For additional details, see: <https://www.bdo.com/insights/tax/state-and-local-tax/new-jersey-enacts-technical-corrections-and-substa>.

from New York State's previous treatment, which effectively conformed to the federal income tax treatment and included 50% of a corporation's GILTI in the tax base. However, the state's GILTI subtraction is effective for tax years beginning on or after January 1, 2019.

In contrast to New York State's recent amendment, New York City has not followed suit and, instead, left its prior treatment of GILTI unchanged, which conformed to New York State's original legislation and included 50% of GILTI in the tax base. New York City officials have publicly commented that the city decided to conform to the federal income tax treatment of GILTI, instead of New York State's approach.

Taxpayers should be aware that the New York Court of Appeals, which is New York State's highest court, has previously ruled in *Castle Oil Corp. v. City of New York* that "municipalities such as the City of New York have no inherent taxing power, but only that which is delegated by the State." Accordingly, the court held that, in the absence of express authorization, New York City's general corporation tax must "substantially" follow and conform to New York State's. There is nothing in New York State's legislation amending its GILTI provisions that appears to grant New York City express authority to deviate from New York State's treatment of GILTI. Accordingly, taxpayers may have a position to question the validity of New York City's GILTI provisions.

## **SALES/USE TAX REFUND OPPORTUNITIES: SOFTWARE LICENSES AND INFORMATION SERVICES**

Software licenses and information services are generally two material purchases for taxpayers in the financial service industry. There is a risk that taxpayers, including financial institutions,

erroneously overpay sales/use tax on these purchases as a result of not properly sourcing the transaction to the state where the product is used.

Software licenses and remotely accessed information services are generally sourced to where the users of the license or information are located. However, taxpayers often source such transactions for sales/use tax purposes based on where the software code is "sitting," or where the vendor's server is located, or the ship to/bill to location listed on the invoices. Purchasers of such products should inform the vendors of where the users are located so that the appropriate sales tax could be charged or use tax self-assessed. If the vendors are not informed of the user locations, vendors generally charge sales tax based on the ship to/bill to location stated on the invoice, which could be materially different from where the users are located. In addition, many vendors' internal billing systems do not have the capabilities to charge sales tax to multiple tax jurisdictions on one invoice; therefore, vendors generally charge sales tax on the entire invoice amount based on the location indicated on the invoice.

In general, purchasers are entitled to file refund claims with a state for the sales/use tax erroneously paid with respect to the users located outside the state. Note, however, that taxpayers may need to self-assess and report use tax to other states where the vendor did not charge sales tax. Thus, the taxpayer's tax savings could be the entire tax paid to a particular state, or the delta between the tax rates of different jurisdictions.

In conclusion, a spate of recent tax law changes at the state level means the time is now for leaders at financial institutions to evaluate their exposure and develop strategies to manage their tax burden.

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**Learn more about how your organization can navigate your state tax exposure by reaching out:**

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