CTO Insights - Issue Spotlight

State and local tax: New challenges, new opportunities

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Never before has the tax department played such an integral role in the success of the business. Chief tax officers (CTOs) are expected to align tax with business goals, drive strategic value, increase transparency, and improve the efficiency of tax operations. KPMG LLP's (KPMG) *CTO Insights* is designed to highlight top-of-mind issues for tax executives and ways CTOs are addressing these opportunities and challenges. We are confident that you will find the information in each issue of *CTO Insights* practical and actionable in demonstrating the value you and your department bring to your organization.

Federal tax reform adds volatility at state level

The inconsistency of state and local tax regulations has long been a challenge for corporate tax functions. Ever-changing rules and shifts in enforcement trends create a great deal of complexity for tax planning and compliance.

Now, U.S. tax reform is adding to the uncertainty. From the highly publicized changes to state and local income tax deductions to new tax incentives for domestic investment, federal tax reform is sure to have a direct effect on the state corporate tax base. But given continued ambiguity and ongoing developments in the new tax law, exactly how federal tax reform will impact state and local taxes is largely still a question mark. Also in question is how individual states and localities will react from a judicial standpoint.

What's clear is that state tax is becoming increasingly important to corporate business strategies and a greater focus in the C-suite. Communicating state-level tax developments to board members and senior executives is a priority among CTOs.

As tax reform pushes certain state tax issues to center stage, and reactionary state laws begin to pass and get enacted, corporate tax functions are reexamining both planning and processes to keep pace with all the change. Some tax functions are also growing the senior team responsible for managing state and local tax collection, filing, and compliance, with the goal of unlocking new tax savings and reducing the company's overall tax burden.

QOZs present a new opportunity for taxpayers

One federal tax initiative that is having an outsized impact on corporations' state tax strategies is Qualified Opportunity Zones (QOZs). QOZs were enacted as part of the 2017 tax law and they encourage impact investing through long-term investment in distressed communities by allowing investors to defer capital gains and reduce tax obligations in thousands of low-income areas nationwide.

Reinvesting capital gains into Qualified Opportunity Funds (QOFs) that hold properties or businesses located within a QOZ creates an opportunity for taxpayers to generate positive social impact while unlocking substantial tax incentives, including:

— Deferral of capital gains tax through 2026, with a 10–15 percent reduction in the capital gain to be recognized through increased basis adjustments at the five- and seven-year holding milestones

— No tax on gain from the investment in a QOF itself, if held for 10 years at time of exit

Given their unique combination of financial and social benefits, QOZs are attracting significant attention from corporate investors. In fact, Treasury Secretary Steven Mnuchin expects QOZs to attract more than $100 billion in capital.[1]

As corporations seek to deploy capital to this new tax-advantaged asset class, state and local tax functions are challenged to deliver the right information to help business leaders select the best investment opportunities and make the right gain deferral decisions. Calculating potential tax benefits is a complex undertaking, especially when organizations are weighing a number of different investment options in a number of different struggling communities.

Tax functions also must ready their systems and processes to comply with key provisions of QOZs. These include rules pertaining to eligibility, investment holding period length, how and when deferral elections can be made, and additional regulatory state income tax filing requirements as a result of the new investment in QOFs, all of which impact the corporation's ultimate ability to achieve the full tax benefits from QOZ investments.

Further complicating matters is that tax incentives depend heavily on timing. To achieve the maximum benefit, capital gains must be deployed to QOZs before 2020, putting the pressure on tax functions to act with urgency. A significant part of that decision requires corporations to anticipate the future 10 years from now to benchmark any applicable gains to be recognized in states that may decouple from the federal QOZ benefits granted under tax reform. This is no easy task in our changing tax landscape, yet it is clear from an industry perspective that a critical area of importance to investors in their decision-making process is the need for a clear understanding of what the ultimate state income tax treatment may be upon the sale of the QOF.

Wayfair shines a spotlight on sales tax

The recent U.S. Supreme Court decision in *South Dakota v. Wayfair*, which allows states to require certain remote sellers to collect sales and use taxes on sales to in-state purchasers, is another federal action with major implications on state and local tax processes.

The *Wayfair* decision overturned decades-old rulings that had previously set the standard for how "nexus," or taxable presence, is defined. Before *Wayfair*, nexus was primarily determined by physical presence. In other words, only companies with some physical presence in a state were required to collect and pay tax on sales in that state. However, the *Wayfair* court ruled that the physical presence standard was unsound, meaning that states may now require businesses that aren't physically present in the state to collect—namely, online sellers.

Almost all states that impose sales and use taxes have already followed in South Dakota's footsteps and passed legislation or adopted rules requiring sellers or marketplaces to collect if they are making a certain threshold amount of sales into the state. While these taxes were legally owed pre-*Wayfair*, having the seller or marketplace collect and remit is administratively easier for the states and many states expect to see additional sales tax revenues as a result of these new laws.

[1] The Hill, "Mnuchin predicts $100B in cap investment from new opportunity zones," September 28, 2018

Corporate tax functions—especially those that conduct business in multiple states—must respond, too. The *Wayfair* decision, and ensuing state actions, could have major repercussions on companies' overall tax footprint, potentially requiring businesses to collect and file tax returns in new states.

Determining what to do next is no easy matter and these rules continue to evolve. But proactive CTOs are anticipating change and preparing for the future by shifting the tax function's focus to a number of key priorities.

— Tracking ongoing state legal developments related to when remote sellers and marketplaces are required to collect and remit state sales and use tax

— Reviewing sales tax collection and filing processes to ensure state-by-state tax compliance

— Determining the impact of sales tax nexus on income tax nexus. If a business registers for sales and use tax collection, the state taxing authority will likely inquire as to whether the business should be filing corporate income tax returns (if they are not already doing so).

Questions to consider

— How does your tax function keep pace with the latest tax developments at the state level?

— Have you calculated the tax advantages of investing in a QOZ?

— Are your tax processes prepared to manage state tax compliance after *Wayfair*?

Explore the resources below for deeper insights on the topics in this edition of *CTO Insights*.

KPMG's Tax Reform website
Browse numerous resources to help stay abreast of the latest developments.

Opportunity Zones: Unlock new opportunities
Discover Qualified Opportunities Zones, a new investment opportunity.

Multistate: More state *Wayfair*-related developments
The *This Week in State Tax (TWIST)* podcast examines state-by-state responses to the *Wayfair* decision.

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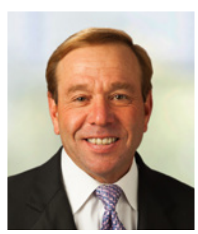

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