Multistate Tax Update: December 17, 2015

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ILLINOIS: AIRBNB EXPANDS TAX COLLECTION INITIATIVE

On Dec. 10, 2015, Airbnb, the self-described "trusted community marketplace for people to list, discover, and book unique accommodations around the world," was excited to announce that starting on Jan. 15, 2016, it will be paying its fair share of taxes in Illinois. The state imposes a Hotel Operators' Occupation tax at the rate of 5 percent of 94 percent of the gross rental receipts.

Airbnb's announcement follows its mid-November pledge to "work with cities to help ensure the efficient collection of tourist and hotel taxes." We addressed this community compact in our **Nov. 19, 2015**, *Multistate Tax Update*.

The company's commitment to the entire state of Illinois follows its tax collection and remittance efforts in Chicago, pursuant to which Airbnb expects to contribute approximately $2.5 million in tax revenue to the Windy City by February 2016. Chicago imposes a 4.5 percent hotel accommodations tax.

Airbnb explains itself as follows:

> We're happy to be taking this important step that helps our host community and makes Illinois stronger. Home sharing allows people to turn what is generally one of their greatest expenses, housing, into a tool to help make ends meet. Most Airbnb hosts are middle class residents who share their homes to pay the bills. Meanwhile, Airbnb guests generate sustainable, local economic activity that supports small businesses who previously haven't benefitted from tourism…based on data from July 2014 to June 2015, found that Airbnb generated $209 million in economic activity in Chicago.

Airbnb collects and remits hotel and tourist taxes from guests on behalf of hosts in Amsterdam, Chicago, Malibu, North Carolina, Oakland, Oregon, Palo Alto, Paris, Philadelphia, Phoenix, Portland, Rhode Island, San Diego, San Francisco, San Jose, Florida, and Washington D.C., and is collaborating with policymakers on similar initiatives around the globe.

DELAWARE: BUSINESS-FRIENDLY CLIMATE LEADS TO LOSS OF BILLIONS IN REVENUES FOR OTHER STATES

In a December 2015 report by the Institute on Taxation and Economic Policy (ITEP), the authors call out Delaware as an onshore tax haven that costs other states billions in tax revenues, not unlike "notorious zero-tax Caribbean islands like the Cayman Islands and Bermuda." As a consequence, there is a total tax gap of $450 billion. The IRS defines a tax gap as the amount of true tax liability faced by taxpayers that is not paid on time. About $376 billion of this gap is the result of underreported income, according to an IRS Estimate of 2006 liabilities, the latest year for which figures are available.

The report points out that Delaware now has more companies than people. With just 935,000 residents, it has the fourth smallest state population, but as of 2014, more than 1.1 million companies. 65 percent of Fortune 500 companies are incorporated there. This figure dwarfs the number of subsidiaries in the two states that contribute the most to the U.S. gross domestic product, California and Texas, which have only 1,160 and 1,540 Fortune 500 subsidiaries, respectively.

Also based on 2014 statistics:

- 85 percent of Fortune 500 companies reported having at least one subsidiary in Delaware
- These companies reported having more than 19,000 Delaware subsidiaries
- 58 percent of all reported U.S. subsidiaries, and 30 percent of total reported subsidiaries, are located in Delaware

WHAT MAKES A "TAX HAVEN?"

The report cites the Organization for Economic Cooperation and Development's identification of four key features of a tax haven:

1. Minimal or no taxes on specific types of income.
2. Laws that encourage financial secrecy and inhibit the provision of information to tax and law enforcement authorities.
3. Lack of transparency in legislative, legal, or administrative practices.
4. No requirements that activities in the state be "substantial," suggesting that a jurisdiction is trying to attract investment or transactions that are driven primarily by tax considerations.

Focusing on the first three of these, the report discusses how they work and what can be done to remedy the losses.

THE "DELAWARE LOOPHOLE"

Characterized as "glaring," the so-called Delaware tax loophole enables companies to pay zero tax on income relating to intangible assets held by a Delaware holding company or a passive investment company. Such income includes interest and investment income, as well as that related to intellectual property, like trademarks and patents.

This loophole allows corporations to set up Delaware-based holding companies and pay the holding companies for the use of the intellectual property, without incurring income tax liability on the earnings of the intellectual property. In addition, corporations are allowed to deduct those payments as legitimate business expenses, which reduces their income tax liabilities in their home states. This practice has cost states $9.5 billion over a decade in lost revenues, declared the report, quoting a 2012 *New York Times* estimate. Individual firms were able to reduce their state income tax liability by 15 to 24 percent, saving on average $3.2 to $4.2 million annually.

The retailer Toys"R"Us, Inc. offers a good example of how companies leverage the Delaware loophole. There are 865 Toys"R"Us and Babies"R"Us stores in the United States and Puerto Rico, and more than that number of international and licensed stores. The toy and baby products giant is headquartered in Wayne, New Jersey, but has a Delaware-based subsidiary, Geoffrey LLC.

The retail stores in each state pay Geoffrey LLC for use of the company's trademarks and trade names, like its mascot, Geoffrey the Giraffe, income for which Geoffrey LLC does not pay Delaware taxes. In addition, the stores deduct those payments on their state tax returns. This arrangement allowed Toys"R"Us to avoid approximately $2.75 million of state taxes, while Geoffrey LLC gained $55 million in untaxed royalty income.

Another scheme involves the combination of Passive Investment Companies (PIC) with Real Estate Investment Trusts (REITs), under which a firm moves all of its real estate assets into a Delaware-based PIC. For retailers with large amounts of real estate, like big box retailers, there is potential to save millions in taxes. Wal-Mart, which has more than 5,000 stores in the United States, saved about $350 million in state taxes between 1998 and 2001.

FINANCIAL SECRECY, LACK OF TRANSPARENCY

The report argues that another reason for Delaware's tax haven status is "the ease with which an anonymous company can be created." Anonymity works by making it difficult, or impossible, for authorities to trace taxable income from legal activities, or laundered income from illegal activities, to the beneficial owners. Indeed, the report points out that "setting up a company in Delaware requires less information than signing up for a library card," making it "one of the easiest jurisdictions in the world to set up an untraceable shell company." Ultimately, these laws prevent authorities from prosecuting those that use anonymous shell companies to evade taxes and/or launder money.

Although Delaware lawmakers have passed laws in an attempt to reduce this secrecy, key information is still unavailable to the public, is otherwise difficult to access, and allows owners to skirt the process.

WHAT CAN BE DONE?

Beyond the tax loophole and secrecy/lack of transparency, the report points out that Delaware's business friendly climate contributes significantly to its success as a tax haven. Its dedicated corporate court system has produced legal precedent that favors management over shareholders, and it is easy and fast to form business entities there.

Of course, Delaware lawmakers could pass laws to make it much harder for corporations to evade their tax liabilities, but they have not. Instead, lawmakers outside of Delaware have taken action. One step is the adoption of an "addback rule" that requires businesses to add payments made to related companies for interest or intangible assets back into their taxable income. However, most jurisdictions have crafted exceptions to the rule. In addition, there is a lot of variation in these measures from one state to another. Both of these circumstances make it easy to shift income to states where it will face the least amount of tax.

A better solution, which about half of states have implemented, requires companies to report the income and expenses of all of their out-of-state subsidiaries for the purpose of determining corporate income tax. Known as "combined reporting," the report declares this to be the most effective way to prevent tax avoidance.

Finally, ITEP would like to see Congress pass a law mandating that states require beneficial ownership information from businesses. The Incorporation Transparency and Law Enforcement Act would make it easier to investigate tax evasion and illicit financial flow. It has bipartisan support federally, but Democratic Delaware senators oppose it; the state receives approximately 25 percent of its revenues from franchise taxes and other business fees, so has an interest in maintaining the status quo. Despite this, 31 state lawmakers have signed a letter encouraging the act's passage.

Until something changes, those 31 lawmakers are stuck with Delaware's "reputation for attracting shady businesses."

SOUTH CAROLINA: DEPARTMENT OF REVENUE ANNOUNCES EXPIRATION OF CERTAIN TAX PROVISIONS

A law enacted in 2011, codified under section **12-36-2691** of South Carolina's code, allowed businesses to disregard the ownership, lease, or utilization of a distribution facility in the state, including those of a third-party or affiliate, when determining whether that firm had sufficient nexus—or physical presence in the state—to be subject to sales and use taxes.

In Information Letter #15-19, the South Carolina Department of Revenue (SCDOR) announced the expiration of this distribution facility "safe harbor" for nexus purposes. Accordingly, Code Section 12-36-2691 no longer applies on the earlier of either:

- Jan. 1, 2016;
- the effective date of any law enacted by Congress that allows a state to require that its sales tax be collected and remitted even if the taxpayer does not have substantial nexus with that state; or
- when the person fails to meet the following requirements:
  - Placing a distribution facility in service after Dec. 31, 2010, and before Jan. 1, 2013.
  - Making a capital investment of at least $125 million after Dec. 31, 2010, and before Dec. 31, 2013.
  - Creating at least 2,000 full-time jobs, with a comprehensive health plan, for those employees after Dec. 31, 2010, and before Dec. 31, 2013, and then maintaining at least 1,500 full-time jobs and with a comprehensive health plan for those employees until Jan. 1, 2016.

The result of the expiration of this provision means that owning, leasing, or utilizing a distribution facility, including a distribution facility of a third-party or an affiliate, within South Carolina is considered in determining nexus for South Carolina sales and use tax purposes.

Separately, in Information Letter #15-18, the SCDOR announced that the time to file an eligibility notice for certain sales and use tax exemptions has expired. This applies to the following exemptions:

- **Computer equipment:** When used in connection with a manufacturing facility when both of the following occur:
  - The taxpayer invests at least $750 million in real or personal property or both comprising or located at the facility over a seven-year period.
  - The taxpayer creates at least 3,800 full-time new jobs at the facility during that seven-year period.
- **Construction materials:** When used in the construction of a new or expanded single manufacturing or distribution facility (or one that serves both purposes) when both of the following occur:
  - The taxpayer invests at least $750 million in real or personal property or both comprising or located at the facility over a seven-year period.
  - The taxpayer creates at least 3,800 full-time new jobs at the facility during that seven-year period.

The exemption for construction material used in the construction of a new or expanded single manufacturing or distribution facility with a capital investment of at least $100 million is still available.

- **Fuel used for test flights and certain transportation of aircraft:** When the fuel is used for test flights of aircraft by the manufacturer of the aircraft, or used in the transportation of an aircraft prior to its completion from one facility of the manufacturer to another facility of the manufacturer, not including the transportation of major component parts for construction or assembly or transportation of personnel, when both of the following occur:
  - The taxpayer invests at least $750 million in real or personal property or both comprising or located at the facility over a seven-year period.
  - The taxpayer creates at least 3,800 full-time new jobs at the facility during that seven-year period.

These exemptions continue to be available to eligible taxpayers who notified the SCDOR before Oct. 31, 2015.

NEW JERSEY: LAWMAKERS CONSIDERING LEGISLATION THAT PUNISHES CORPORATE INVERTERS

Late last month, the pharmaceutical behemoths Pfizer and Allergan announced the completion of their $160 billion merger plan "to form the world's biggest drug company by sales, in a deal that is mostly, if not exclusively, about tax," reported *Fortune Magazine*. An Allergan press release disclosed that under the terms of the deal, the businesses will be combined and renamed "Pfizer plc," and will trade on the New York Stock Exchange using the PFE ticker. The new company will maintain Allergan's legal domicile in Ireland, locate its principal executive offices in Dublin, but base its global operations in New York.

Noting that the portfolio of drugs include the well-known Botox and Viagra, along with a pneumonia vaccine and treatments for Alzheimer's and rheumatoid arthritis, *Fortune* characterized the merger as "the largest so-called inversion deal ever." The deal allows U.S.-based Pfizer to reincorporate overseas and avoid U.S. tax liability while remaining, for all other intents and purposes, an American company.

Allergan operates its administrative headquarters out of Parsippany, New Jersey. Incensed by "handouts to wealthy corporations that avoid tax obligations," New Jersey Sen. Shirley Turner has been working to prevent taxpayer funds from being used to subsidize companies that engage in tax-avoidance schemes, like inversions.In a mid-September press release, the senator quoted a study by the U.S. Public Interest Research Group revealing that states lost more than $39 billion in tax revenue in 2011, and that New Jersey was among the top five losers.

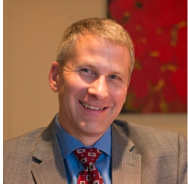
To stop this, the senator introduced **S-2361**, most recently amended on Dec. 7, 2015. This act would render an inverted domestic corporation ineligible for various types of financial aid, like state economic development grants and reimbursement of taxpayer-subsidized programs, such as Medicaid.

In addition, the legislative language now precludes inverters from receiving development contracts. To this end, it requires any applicant for a development subsidy to provide a standing certificate attesting to the legal status of the applicant, among other things. The language also now obliges any corporate recipient of a development subsidy that becomes an inverted domestic corporation during the term of a development subsidy to pay back the total value of the development subsidy.

Sen. Turner has also introduced legislation to prohibit the state's pension board from investing in companies that have exploited the inversion tax loophole.

In reporting on the merger, Bloomberg recognized that New Jersey may be the first state to punish inverters. However, Gov. Chris Christie and other state Republicans oppose such prohibitions, preferring to deter overseas moves by lowering taxes. This is a position at odds with the Democratic controlled Senate that could result in a show down. Bloomberg notes that Dublin's corporate tax rate is 12.5 percent, versus the 35 percent tax rate in the U.S.

New Jersey has awarded Pfizer with $48.28 million in various incentives, according to Sen. Turner. Bloomberg quoted her as wanting to "send a strong message to Pfizer as well as any other corporate deserters looking to do the same thing…They are parasites living off of our taxpayers, and it's not like they're going bankrupt by any means."



DAVID KALL

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