State and Local Tax Considerations in Light of COVID-19

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The first order of business for many state tax authorities in response to COVID-19 was deciding whether to extend their respective income tax filing and payment deadlines for the 2019 tax year, either automatically by following the Internal Revenue Service's extended deadlines or through separate action. Now that many states have reached a decision on that matter, they face a range of additional tax concerns arising out of the pandemic.

State Conformity With the CARES Act

The federal government enacted the Coronavirus Aid, Relief, and Economic Security Act (CARES Act) on March 27, 2020, in response to the pandemic, as discussed in our client alert "CARES Act Provides Much-Needed Stimulus for U.S. Businesses, Individuals." The act included numerous key tax relief provisions intended to ease the financial burden on many companies affected by COVID-19 (see our client alert "CARES Act Tax Considerations"). However, the act raises questions regarding whether states will conform to federal changes that could impact state tax liability and reporting.

Of particular importance are the CARES Act provisions related to net operating loss carrybacks (NOLs) and interest deductibility limitations under Section 163(j).[1] Under the new law, taxpayers are generally permitted to carry back NOLs arising in taxable years beginning after December 31, 2017, and before January 1, 2021, for up to five years. As of today, a majority of states do not permit taxpayers to carry back NOLs. For those states that do, conformity with the new federal NOL provisions will generally require an act of a state's legislature since most states do not automatically conform with the federal NOL provisions.

Section 163(j), which was put into place through the Tax Cuts and Jobs Act (TCJA) of 2017, sharply limits the ability of businesses to deduct interest payments when calculating their taxable income. Under the limitation, a taxpayer's allowable deduction for interest expense in a particular tax year generally is limited to the sum of 30% of "adjusted taxable income" plus its business interest income, with any excess carried forward to future years. The CARES Act temporarily increases, for tax years beginning in 2019 or 2020, the threshold from 30% to 50%. Whether those states that conform to Section 163(j) will adopt the changes made by the CARES Act remains to be seen, though. Because federal taxable income is the starting point for most states

[1] Unless otherwise specified, all "section" references herein are to sections of the U.S. Internal Revenue Code of 1986, as amended.

in the calculation of state income tax, many states likely will automatically adopt the modifications to Section 163(j), unless a state legislature enacts legislation expressly decoupling from the CARES Act modifications. Relatedly, at the time the TCJA was enacted, some states, such as Connecticut[2], Indiana[3] and Georgia[4], enacted legislation expressly decoupling from the TCJA Section 163(j) provisions. Therefore, in those jurisdictions, the CARES Act modifications to Section 163(j) are not likely to have any effect.

State Tax Impact of Telecommuting

In response to COVID-19, states across the country have issued "stay-at-home" or "shelter-in-place" orders requiring the closure of "non-essential businesses," encouraging many businesses to ask employees to work remotely. These work-from-home recommendations, although strongly encouraged by state and local governments, could potentially result in additional state tax exposure and withholding obligations for those businesses.

- **Nexus.** State policymakers should consider whether the presence of remote workers will continue to qualify as a nexus creating activity for businesses during this time. To date, two states — New Jersey[5] and Mississippi[6] — have issued formal guidance on this matter stating that remote work in response to COVID-19 will not be cited to trigger nexus in their states. In addition, officials from two other jurisdictions — the District of Columbia and Pennsylvania — have informally indicated that remote workers will not create nexus for companies responding to COVID-19.
- **Apportionment.** State policymakers should consider whether a change in employee location or company property in response to COVID-19 stay-at-home orders will be considered in state apportionment formulas. For those states that rely on property or payroll factors in their apportionment formula, an employee's change in location due to remote work or movement of company property could result in a change to the apportionment of business income. In addition, for those states that use the cost-of-performance method to determine sales sourcing, a change in the location of an employee's activities could impact apportionment for those states.
- **Individual Residency.** Not all individuals complying with stay-at-home orders are doing so in their state of tax residency. State policymakers should consider whether an individual's physical location for the duration of government stay-at-home orders should affect the individual's state residency status. The ability to work remotely means that some employees will choose or be forced to work from a location different than their existing tax residency. Those individuals should be mindful of the state's residency requirements and whether their time in the state will trigger any additional filing obligations.
- **Payroll Withholding.** State policymakers should consider whether an individual's personal change in domicile for the duration of stay-at-home orders will affect employers' payroll tax withholding obligations. Because employees may choose to work from locations outside their home state, employers may be required to withhold additional payroll taxes in those states.

Credits and Incentives

Federal and state governments are rapidly working to establish programs or policies to assist businesses impacted by COVID-19. Some struggling businesses already may have been participants in existing credit or incentive programs administered by state or local governments before the onset of COVID-19. In most cases, when a business opts to participate in a tax credit or incentive program, the business agrees to satisfy certain employment, investment or growth thresholds in exchange for tax credits or other tax incentives. When a business is unable to satisfy those requirements, it may become ineligible for future credits, and any prior credits may be subject to clawback claims. State and local policymakers will need to consider whether they will strictly enforce program requirements and, if they do not, the appropriate criteria and process for amending them.

[2] 2018 Conn. Pub. Acts 18-49.

[3] 2018 Ind. Acts 1316(ss).

[4] 2019-2020 Ga. Laws 419.

[5] See here for New Jersey's guidance.

[6] See here for Mississippi's guidance.