

## Income Tax Developments

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Atlanta, Georgia



### Your presenters

- ▶ Joe Garrett
  - ▶ Tax Policy Administrator
  - ▶ Alabama Department of Revenue
  - ▶ Joe.Garrett@revenue.alabama.gov
  
- ▶ Frank O'Connell
  - ▶ Director of Tax Law & Policy
  - ▶ Georgia Department of Revenue
  - ▶ Frank.O'Connell@DOR.GA.GOV
  
- ▶ Philip Tatarowicz
  - ▶ Partner
  - ▶ Ernst & Young LLP
  - ▶ philip.tatarowica@ey.com

## Agenda

- ▶ Nexus
- ▶ Filing options
- ▶ Computation of tax base
- ▶ Allocation and apportionment
- ▶ Financial services
- ▶ Pass-through entities and members
- ▶ States' discretionary authority to adjust income

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## Nexus



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## Economic nexus overview

- ▶ Enacted/approved
  - ▶ California (effective 2011)
  - ▶ Connecticut (effective 2010)
  - ▶ Colorado (Bright line nexus regulation, effective 2010)
  - ▶ New York (limited to credit card banks, effective 2008)
  - ▶ New York City (limited to credit card banks, effective 2011)
  - ▶ Oregon (effective 5 May 2008)
  - ▶ Washington (B&O tax, effective 2010)
  - ▶ Wisconsin (effective 2009)
- ▶ Considered
  - ▶ Federal – BAT bill still being considered
  - ▶ Hawaii – Governor vetoed bill that would have adopted economic nexus standard

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## Regulatory developments

- ▶ Colorado – Amended Reg. 39-22-301.1 (eff. 30 April 2010)
  - ▶ Adopts a factor presence nexus standard (\$50,000 of property, or; \$50,000 of payroll, or; \$500,000 of sales, or; 25% of total property, total payroll or total sales ).

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## Administrative developments

- ▶ Florida – TAA Nos. 10C1-001 and 10C1-002 (Feb. 2010)
  - ▶ An out-of-state manufacturer of tools that through its dealer network offers products, training, service and support has nexus because the activities are not protected under Pub. Law 86-272.
  - ▶ Unrelated, independent contractors that distribute goods for an out-of-state company that has no property or payroll in Florida create nexus for the company because the distributors exceed the pure solicitation of sales of Pub. Law 86-272.
  
- ▶ West Virginia – Administrative Decision S 06-544 N (Jan. 2010)
  - ▶ Out-of-state taxpayer that licenses trademarks and trade names to unrelated entities and affiliated companies which in turn sell trademarked and trade-named products to customers in West Virginia, has sufficient contacts with the state to establish nexus.

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## Judicial developments

- ▶ Nexus premised on use of intangibles
  - ▶ *AccuZip, Inc. and Quark Inc.* – New Jersey
    - ▶ Nexus with the state will not be established for out-of-state companies if their only connection to New Jersey is the in-state presence of licensed copyrighted computer software programs to which it retains title.
  - ▶ *Praxair Technology* – New Jersey
    - ▶ An out-of-state intangible holding company that conducted all business, and whose offices were located, outside New Jersey had nexus in years prior to adoption of an amendment to the doing business regulation that added an out-of-state intangible holding company example

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## Judicial developments

- ▶ Nexus based on affiliate's activities in-state
  - ▶ *The Classics Chicago Inc.* – Maryland
    - ▶ An intangible holding company subsidiary lacked economic substance and had nexus with the state through the activities of its parent corporation
- ▶ Other
  - ▶ *Telebright Corp.* – New Jersey
    - ▶ An out-of-state software company that does not maintain an office or financial accounts in New Jersey or solicit sales in the state has a taxable nexus with the state because of an employee who telecommutes each business day from her New Jersey home.

## Filing options



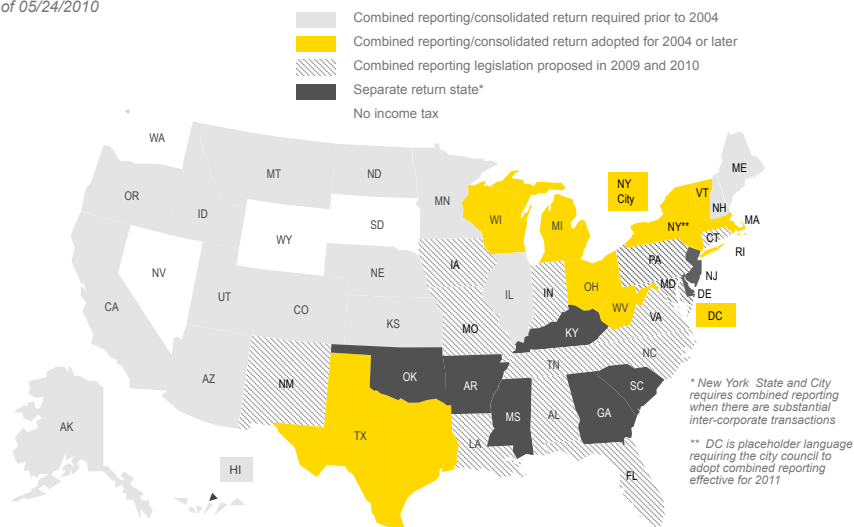
## Expansion of combined reporting

- ▶ 16 states required combined reporting prior to 2004
- ▶ Since 2004, combined reporting adopted in:
  - ▶ Effective 2006 – Vermont and Ohio
  - ▶ Effective 2007 – New York
  - ▶ Effective 2008 – Michigan and Texas
  - ▶ Effective 2009 – Massachusetts, New York City, West Virginia, and Wisconsin
  - ▶ Effective 2011 – District of Columbia
    - ▶ Note DC Council still has to adopt combined reporting language
- ▶ Considered by an additional 14 states in 2009 and 2010
  - ▶ Still pending in Pennsylvania and Rhode Island

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## Expansion of combined reporting

As of 05/24/2010



## Combined reporting states enacting or expanding intercompany addback provisions

- ▶ Trend in combined reporting states is to retain and/or adopt intercompany addback provisions (i.e., IL, NY, MA, WI)
  - ▶ Make provisions broad enough to reach as many taxpayers as possible, including some foreign
    - ▶ See MTC Model Statute
  
- ▶ Enacted/approved in 2009
  - ▶ Oregon
  - ▶ West Virginia
  - ▶ Wisconsin

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## Judicial developments

- ▶ *RR Donnelley* – Arizona Court of Appeals
  - ▶ A printing business was not required to file a combined report with two subsidiaries that provide management services, but was required to file a combined report with a trademark-holding subsidiary.
- ▶ *Hormel Foods* – Wisconsin Tax Appeals Commission
  - ▶ Intercompany royalty and interest-expense adjustments were disallowed, because the transactions transferring the intellectual property to the subsidiary and subsequent license back to parent lacked a valid non-tax business purpose and economic substance.
- ▶ *Publishers Printing* – Kentucky Tax Board
  - ▶ A publishing company and its five subsidiaries that filed a unitary tax return for 1988-1991 were not entitled to a refund of tax because use of a unitary return distorted the entities business activity in Kentucky

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## Computation of tax base



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► To be added

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## Allocation and apportionment



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## Allocation and apportionment

- ▶ UDITPA Revision
- ▶ ULC abandons project after much sound and fury.
  - ▶ Is uniformity obtainable?
  - ▶ Is uniformity desirable?
- ▶ MTC picks up UDITPA Revision as a uniformity project.
  - ▶ Proposed model Section 17 language is on the MTC Uniformity Committee's July meeting agenda.
  - ▶ Drafting revisions to other UDITPA Sections underway – Ex. = Definition of Receipts.
- ▶ Section 17's Flawed Income Producing Activity / Cost of Performance rule is driving state action.
  - ▶ IPA / COP rules are neither administrable nor reflective of the market.
  - ▶ States (Ex = CA) are moving away from Section 17 without a model.

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## Allocation and apportionment

- ▶ Business v. NonBusiness
- ▶ Continued disputes over the scope of the UDITPA definition of business income applied to asset dispositions.
  - ▶ *Gannett* (Montana)
  - ▶ *Kimberly-Clark* (Alabama)
    - ▶ Paper company's sale of Alabama pulp mill and timberland generated non-business allocable income.
    - ▶ Original audit dispute over the inclusion of the receipts from the transaction in the sales factor.
- ▶ Expanded state definitions of business income bump against the borders of constitutionally apportionable unitary income.
  - ▶ *Tate and Lyle* (Alabama)
  - ▶ *Blue Bell and Siegel – Robert Inc.* (Tennessee)
- ▶ Inconsistent Reporting
  - ▶ *Oracle* (Oregon)

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## Allocation and apportionment

- ▶ Sales Factor Over Weighting
- ▶ The trend toward an over weighted or even single sales factor apportionment formula is accelerating.
  - ▶ The following states have recently moved or are moving to an over weighted or single sales formula:
    - ▶ CA, CO, GA, DE, IN,KS, LA, MN,SC, UT and VA.
- ▶ Issues associated with overweighting sales factor:
  - ▶ Economic development versus tax policy
  - ▶ Different rules for different industries
  - ▶ Elections?
  - ▶ Increased pressure on nexus and Section 17 issues
  - ▶ Constitutional issue reconsidered? *Moorman* (Iowa)

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## Allocation and apportionment

- ▶ Sourcing of Receipts from Sales of Other Than Tangible Personal Property
  - ▶ *AT&T* (Massachusetts)
  - ▶ *The Interface Group* (Massachusetts)
  - ▶ CA, IL, WI moving to market based sourcing
  - ▶ Questions, at least one of which, I usually cant answer:
    - ▶ What is the activity that produced the income?
    - ▶ What costs were incurred in the production of the income?
    - ▶ Where were those costs incurred?
- ▶ Inclusion of Gross Receipts Derived from the Sale of Short-Term Investments
  - ▶ *General Mills* (California)

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## Financial services



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## Financial services

- ▶ Credit Card Companies and Economic Nexus
  - ▶ *MBNA* (Indiana)
  - ▶ *Capital One* (Massachusetts)
  - ▶ Legislation in New York establishing economic nexus thresholds
  
- ▶ What does the states' success with economic nexus challenges in the credit card arena mean for other industries?

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## Financial services

- ▶ *HMN Financial* (Minnesota)
  - ▶ Minnesota Supreme Court reverses lower court's decision that denied bank's state income tax benefits associated with a captive REIT.
  - ▶ Did economic substance and business purpose mean anything?

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## Pass-through entities and members



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▶ To be added

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## States' discretionary authority to adjust income



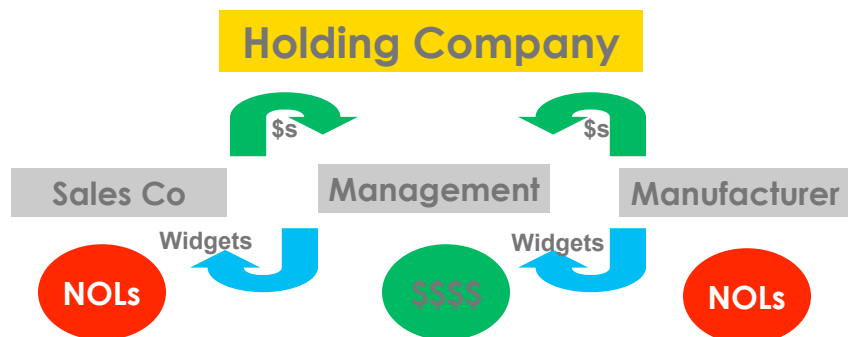
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## States' discretionary authority to adjust income

- ▶ Codified Economic Substance and Business Purpose Rules
- ▶ New IRC Section 7701(o) was created by the Health Care and Education Reconciliation Act of 2010 (H.R. 4872).
- ▶ Taxpayers must show that the transaction resulted in a meaningful change in economic position and that they had a substantial purpose for the transaction.
- ▶ A state tax savings purpose does not satisfy the test. IRC Section 7701(o)(3).
- ▶ State Income Tax Impact?
  - ▶ Does a state's tie to federal taxable income as a starting point tie the state to the federal codification of the economic substance and business purpose rule?
  - ▶ Will a state be free to adjust separate company transactions ignored by the IRS?

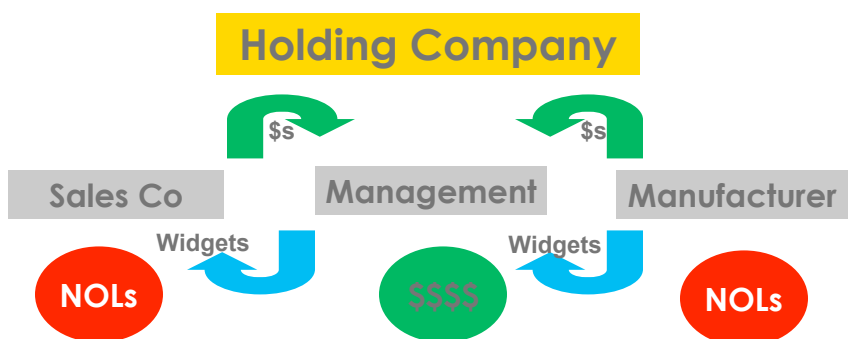
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## States' discretionary authority to adjust income



- ▶ Very profitable widget manufacturing group has two separate entity taxpayers in your state: Manufacturer and Sales Co.
- ▶ Manufacturer sells to Management that instantly sells to Sales Co who sells to instate customers.
- ▶ Sales Co and Manufacturer pay Management a fee for “management services.”
- ▶ Sales Co and Manufacturer break even or loose money.

## States' discretionary authority to adjust income



- ▶ Is this structure subject to a state's discretionary authority to adjust?
  - ▶ Transfer pricing adjustment? Deduction denial? Forced Combination? Nexus?
- ▶ What are the factual issues to consider?
  - ▶ Transfer pricing report? Intangibles? Documented separation? Operational separation? Management's operations?

## Questions?



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**Thank you for your  
participation!**

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