

The Impact of “Loophole” Closing Legislation

Federation of Tax Administrators
Annual Meeting

June 16-18

Panel Participants

Moderator

Jeff Friedman, KPMG LLP

Taxpayers

- Mr. John Pydyszewski
 - Johnson & Johnson
- Ms. Merle Buff
 - American Express
- Mr. Robert Montellione
 - Prudential

Tax Administrators

- Mr. Richard Nicholson
 - Connecticut
Department of Revenue
- Mr. Tom Zaino
 - Ohio Department of
Revenue



Agenda

- How Did We Get Here?
 - Tax loopholes
 - State challenges
- States' Goals and Concerns
 - *Carpenter* Case Study
- Taxpayer Issues and Concerns
 - Unintended impact on business
 - Arbitrary and inconsistent
 - Examples



Definition of a Loophole

According to Webster:

Loophole – an ambiguity or omission
in the text through which the intent of a statute, contract, or
obligation may be
evaded (emphasis added)



Is “Loophole” Closing Legislation Necessary?

- Expansion of Nexus (e.g., *Geoffrey* in SC and *KPI* in NM)
 - Economic
 - Agency and attribution
 - Affiliate
- Business Purpose & Economic Substance (e.g., *Sherwin Williams* in MA, NY and *Syms* in MA, MD)
- Forced Combination (e.g., *Tropicana* in NY)



Related Party Transactions

- | | | |
|---|--|--|
| ■ Current Expense Disallowance States | ■ Proposed Expense Disallowance States | ■ No Expense Disallowance States* |
| <ul style="list-style-type: none">- Alabama- Arkansas- Connecticut- Massachusetts- Michigan- Mississippi- New Jersey- New York- North Carolina- Ohio | <ul style="list-style-type: none">- District of Columbia- Maryland- Missouri- Pennsylvania- Rhode Island- Tennessee- Texas | <ul style="list-style-type: none">- Delaware- Georgia- Florida- Indiana- Iowa- Kentucky- Louisiana- New Mexico- Oklahoma- South Carolina- Virginia- Vermont- Wisconsin- West Virginia |

* Does not include unitary combination states



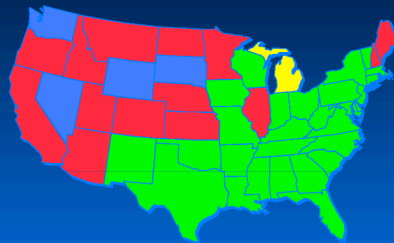
Expense Disallowance

| | AL | AR | CT | MA | MS | NJ | NY | NC | OH |
|---|----|----|----|----|----|----|----|----|----|
| Disallows Intercompany Expenses Related to Intangible Property | X | X | X | X | X | X | X | X | X |
| Explicitly Disallows Intercompany Interest Expense | X | | X | X | X | X | X | X | X |
| "Business Purpose" or Non-Tax Avoidance Type Exception | X | X | X | X | X | X | X | | |
| Related Party Subject to Tax on Income (or rate differential) Exception | X | X | X | X | | X | | X | |
| "Arm's Length" Terms Exception | X | X | | X | | | X | | |
| Substantial Non-PIC Operations Exception | X | X | | | X | | | | X |
| Throw-out Apportionment Rule | | | | | | X | | | |

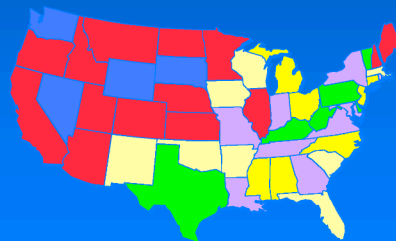
KPMG

Related Party Transaction Landscape

Before



After



- Unitary
- Add Back of Royalty
- No Income Tax
- Economic Nexus
- States Attacking on Audit
- States Where Benefits or Partial Benefits Remain

KPMG

Carpenter Expands Internationally and Forms CII

- Carpenter expanded its business into foreign countries through the acquisition of foreign subsidiary corporations
- Carpenter asserted that it was concerned about exposing domestic assets to liability when selling its products in foreign markets
- Carpenter incorporated CII as a wholly-owned domestic subsidiary
- It was intended that it would become the parent of the foreign subsidiary corporations



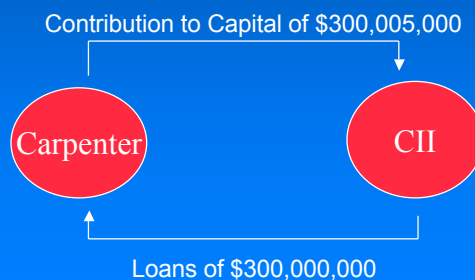
Carpenter's capitalization of CII and Circular Flow of Funds

| <u>Carpenter Contributions</u> | <u>CII Loans</u> |
|--------------------------------|---------------------|
| \$60,005,000 | \$60,000,000 |
| \$70,000,000 | \$70,000,000 |
| \$70,000,000 | \$70,000,000 |
| \$50,000,000 | \$50,000,000 |
| <u>\$50,000,000</u> | <u>\$50,000,000</u> |
| Total \$300,005,000 | \$300,000,000 |



Carpenter's Capitalization of CII and Circular Flow of Funds

- Three days after each of the contributions, CII loaned back to Carpenter the same funds that it had just received
- Carpenter executed a revolving unsecured promissory note to CII for each "loan" of funds received from CII, at an interest rate of 2% over prime for corporate loans from large US commercial banks



KPMG

Carpenter's Interest Payments and the Court Case

- The interest payment for the 1991 tax year was **\$40,167,993.16**. (There was no record of the 1990 payment)
- The DRS claimed that the taxpayer received **\$214,679** in CT tax savings from this plan
- Tax Court determined that the loans from CII to Carpenter had economic substance and business purpose
- Carpenter Committee (comprised of private and public sector reps.) formed by Commissioner to respond legislatively to Carpenter decision

KPMG

Carpenter Committee

- Carpenter Committee reviewed 3 possible approaches:
 1. Adopt detailed regulations re Commissioner's discretionary authority to make adjustments
 2. Add back intercompany interest expenses
 3. Rebuttable presumption that a related loan creates an inaccurate reflection of net income subject to exceptions.
Can be rebutted by clear & convincing evidence that transaction had substantial economic substance

No consensus could be achieved on the three approaches



Carpenter Legislation

- Legislation was passed that:
 1. Confirmed Commissioner's discretion to make adjustments to net income unless arbitrary, capricious or unreasonable
 2. "The General Assembly hereby affirms that the facts, circumstances and transactions at issue in Carpenter Technology Corp. v. Commissioner, 256 Conn. 455 (2001), amply satisfy the improper or inaccurate reflection of net income standard adopted by the General Assembly in the enactment of section 12-226a of the general statutes and were properly the subject of an adjustment by the Commissioner of Revenue Services pursuant to said section 12-226a"



Taxpayer Concerns

- Overbroad legislation
 - Penalizes taxpayers conducting legitimate business transactions (e.g., regulatory – required intercompany transactions)
 - Suspending NOLs are short term “revenue grabs”, but are not always timing differences for the taxpayer (e.g., NOL expiration)
- Arbitrary and inconsistent provisions??
 - Inconsistencies and undefined terms among states invites future litigation (e.g., “preponderance”, “clear and convincing”, etc.)
 - Some arbitrary safe harbors raise constitutional questions (e.g., rate differentials, throw-out rule, extraterritorial taxation)



Example 1- Expense Related to Intangible

- **Facts:**
 - Card companies required to pay merchants prior to receiving money from card holders
 - Efficient borrowing necessary to stay competitive (cost of funds)
 - Finance subsidiaries with non-operational assets have more borrowing power than operating companies
 - Card companies fund themselves by selling card receivables to a related finance company
- **Result:**
 - Expense paid to related finance company could be disallowed in several states as an expense related to an intangible



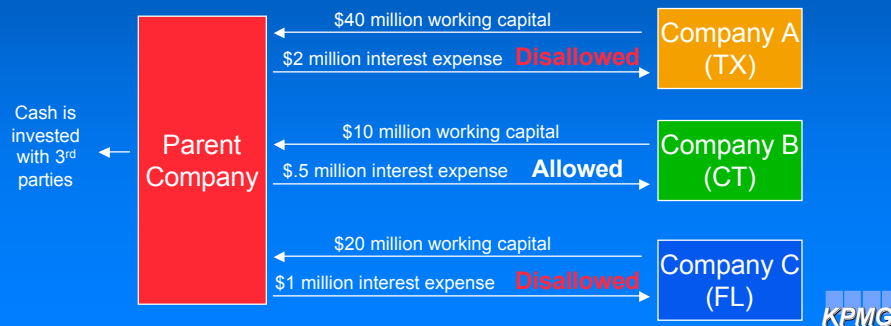
Example 2- Interest Expense

3% Exception

■ **Facts:**

- Parent Company, a diversified holding company, does business in a few states
- Regional operating companies (A, B, and C) generate revenue (and cash)
- Excess cash is swept to Parent to fund headquarter expenses; cash is aggregated at Parent for more efficient treasury function; interest is charged at arm's length

■ **Result:** Portion of interest expense disallowed based on arbitrary state rate differential



Example 3 – Royalty Expense

■ **Facts:**

- Company A and Company B are unrelated entities
- Company A pays a royalty to Company B for the use of a trademark
- An affiliate of Company A acquires the stock of Company B
- The original licensing arrangement remains largely unchanged

■ **Result:**

- Company A's royalty expense is disallowed once it becomes related to Company B even though the underlying business relationship between the two entities is unchanged

Example 4 – NOL Suspension

■ Facts:

- A new entity loses money in years 1 and 2, but becomes equally profitable in years 3 and 4
- State suspends use of NOLs for years 3 and 4
- Entity merges out of existence in year 5

■ Result:

- Unexpected financial statement result undermines rationale of carryforwards

| <u>Year</u> | <u>Income (loss)</u> | <u>Cash Tax Expense*</u> | <u>GAAP Tax Expense (Profit)*</u> |
|-------------|----------------------|--------------------------|-----------------------------------|
| 1 | (\$50,000,000) | -0- | (\$3,000,000) |
| 2 | (\$20,000,000) | -0- | (\$1,200,000) |
| 3 | \$30,000,000 | \$1,800,000 | -0- |
| 4 | \$40,000,000 | \$2,400,000 | -0- |
| 5 | N/A | N/A | \$4,200,000 |

*Assumes 6% effective tax rate



Other Taxpayer Issues

■ Throw-out Rule

- Effectively taxes income earned outside states' borders

■ No Method to the Madness

- If genuinely concerned about intercompany transactions, why not consider combined reporting?

