Top Ten Nonconformity Issues Between Federal and State

Sixth Annual UW-TEI Tax Forum
February 17, 2017

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Top Ten Nonconformity Issues

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1. Transfer Pricing
Transfer Pricing

Overview

— Federal
  • IRC § 482 permits the IRS to redistribute, reallocate or reapportion certain items of gross income, deductions, credits or allowances among affiliated group members.

— State
  • Nearly every state adopts some statutory regime to adjust prices of intercompany transactions.
    • Many state statutes that are substantially similar to IRC § 482.
    • A few states assert statutory authority broader than IRC § 482.
Transfer Pricing

Limited Historic Use of State Transfer Pricing Authority

— Historically, few states have actively utilized 482-like authority for transfer pricing purposes.

— One reason is that states rely on formulary apportionment for determining where corporate income is earned. By contrast, the U.S. and virtually every other nation in the world rely on transfer pricing for sourcing cross-border income.

— Another reason is that states have limited experience with transfer pricing and few resources trained to apply transfer pricing rules as compared with IRS or foreign taxing authorities.
Transfer Pricing

See’s Candies, Inc. v. Auditing Div. of the Utah State Tax Comm’n, No. 140401556 (Utah Dist. Ct. 2016)

— The court held that the Utah State Tax Commission abused its discretion by denying a taxpayer a full deduction for royalty expenses paid to a related party when the transfer was supported by a transfer pricing study.

— The court found that the Commission’s authority to reallocate income was limited by the regulations under IRC § 482 because the state law is virtually identical to IRC § 482 and there is nothing in the statutory scheme to indicate that guidance comes from anywhere other than the IRC § 482 regulations.

— The state filed its appeal on November 3, 2016.
Transfer Pricing

Rent-A-Center East Inc. v. Indiana Dep't of State Revenue, 42 N.E.3d 1043 (Ind. T.C. 2015)

- The Indiana Tax Court rejected combination as an alternative apportionment methodology.
- The court rejected the Department's claim that R-A-C’s income would be distorted unless it filed a combined return with two affiliates.
- The court relied in part on an IRC § 482 transfer pricing study and the parties’ stipulation of valid business purposes.
- The Indiana Supreme Court denied review on March 2, 2016.
2. Expense Disallowance
Expense Disallowance

Overview

– **Federal**
  - Does not use intercompany expense disallowance.
  - Rely on consolidated reporting and IRC § 482.

– **States**
  - Many states use add-back statutes to disallow otherwise allowable deductions for intangible and interest expenses paid to affiliates.
  - There are generally exceptions to overcome intercompany expense disallowance provisions, but they are often burdensome and confusing for taxpayers to meet.
Expense Disallowance

*Kohl’s Dep’t Stores, Inc. v. Virginia Dep’t of Taxation*, No. CL12-1774 (Va. 13th Jud. Cir. Ct. 2016)

— Royalties paid to related members must be added back to a taxpayer’s federal taxable income unless such payments “are subject to a tax based on or measured by net income or capital.”

— Virginia trial court said that even where royalties are reported by related members to other states, royalty payments do not qualify for the addback exception unless those other states actually tax them.

— The Virginia Supreme Court granted review on October 31, 2016.
**Expense Disallowance**


- Parent corporation took on third-party debt and allocated it to the operating company, Kraft Foods Global.
- The Division asserted that the interest payments made to the parent were subject to addback.
- Kraft Foods Global countered that the debt issued by its parent was essentially Kraft Foods Global’s debt and that the interest payments were a legitimate business expense.
- The New Jersey Tax Court determined that the Division correctly required the taxpayer to add back related party interest payments, holding that the taxpayer did not prove by clear and convincing evidence that addback was unreasonable.
3. Net Operating Losses
Net Operating Losses

Overview

— Computing Federal NOLs
  • IRC § 172 allows taxpayers to carry NOLs back 2 and forward 20 years.
  • In a year when an NOL is generated, no NOL from previous years may be used.

— Computing State NOLs
  • Varies
  • Requires a state by state analysis
Net Operating Losses

State Starting Point

– Does state adopt IRC?

– Line 28 or line 30?
  • Start with Line 28 and determine the NOL using the state rules.
  • Start with Line 30, add back the federal NOL, and compute using the state rules.

– Adoption of IRC §§ 172, 381, 382 and 384?

– Should the IRC § 382 limitation be apportioned?

– Adoption of federal separate return limitation year (SRLY) rules?
Net Operating Losses

State Calculation Issues

- Pre- or post-apportionment?
- Which year’s factor?
- State specific modifications/limitations
- Addition modifications in carryback or carryforward year
- Capped amounts
- Net economic losses
- “Blind conformity” to federal utilization
- Effect of state filing methodology
- Is nexus required in loss year?
Net Operating Losses


— The tribunal held that for general corporation tax (GRT) purposes, the taxpayer may only deduct NOLs from the same source year as its federal NOL deductions.

— The “same source year rule” applies.
4. Return Filing Methods
Return Filing Methods

Overview

- **Federal**
  - Consolidated return filing as provided by the regulations under IRC § 1502.
  - Consolidated return rules can override or modify separate return treatment for federal tax purposes.

- **State**
  - State filing methods vary:
    - Separate Filing
    - Consolidated Filing
    - Combined Filing
    - Unitary Filing (Water’s Edge v. Worldwide)
Return Filing Methods

State Conformity to Treas. Reg. 1.1502

— States can choose to:
  • Adopt the federal consolidated rules
    • E.g., Illinois, Oregon
  • Adopt the federal consolidated rules, with modifications
    • E.g., California, Wisconsin
  • Disconnect from the federal consolidated rules
  • Not specifically adopt the federal consolidated rules
    • Minnesota
Incongruous Results

**NIHC, Inc. v. Comptroller of the Treasury**, 97 A.3d 1092 (Md. 2014)

- The Maryland Court of Appeals held that the Comptroller had the authority to assess Nordstrom’s intellectual property holdco subsidiary, NIHC, Inc., $1.9 million for unpaid taxes, interest and penalties related to its 2002 and 2003 Maryland tax returns.

- Nordstrom and NIHC originally filed in Maryland using federal consolidated rules, which the state does not follow, and subsequently tried to amend their returns to comply with Maryland’s separate filing requirements.

- Nordstrom argued that deferred gain related to a series of transactions shown on NIHC’s Maryland tax return in 2002 and 2003 should have been included on its 1999 return when the deferred gain was recognized—outside the statute of limitation for assessment.

- In rejecting Nordstrom’s argument, the court relied on the Comptroller’s assessment and the use of NIHC’s originally filed 2002 and 2003 returns.
5. Dividends
## Dividends

### Overview

- **Federal**
  - Federal dividends received deduction is provided under IRC §§ 243 and 246 for a certain percentage of dividends received from another corporation to address triple taxation.

- **State**
  - In general, broad conformity with federal dividends received deduction treatment.
  - States may conform, provide their own deduction, or disallow a deduction.
  - REIT dividends currently being targeted (often labeled as "loopholes").
  - Distributions from non-U.S. affiliates are frequently an issue.
Dividends

_Mississippi Dep’t of Revenue v. AT&T Corp.,_ No. 2015-CA-00600-SCT (Miss. 2016)

— The Mississippi Supreme Court affirmed that the Mississippi provision allowing an income tax exemption for dividends received from AT&T’s Mississippi subsidiaries while denying an exemption to similarly situated non-Mississippi subsidiaries was discriminatory in violation of the dormant Commerce Clause.
6. Jurisdiction / Nexus
Overview

— Federal
  • Domestic corporation and foreign corporations with “permanent establishment” in the United States.

— States
  
  Federal Restrictions
  
  Outer limits of a state's authority to tax

  Jurisdiction to Tax
  
  State’s statutory authority to impose tax on a particular entity

  Political Reality
  
  Preference for taxing out-of-state, as opposed to in-state, businesses
State Nexus Requirements

- Constitutional requirements
  - Due Process requirement
  - Commerce Clause requirement—“substantial nexus”

- Federal restrictions
  - P.L. 86-272

- Statutory “doing business” requirements
  - States are expanding the “doing business’ standard
Jurisdiction / Nexus

**Target Brands Inc. v. Dep't of Revenue**, No. 2015CV33831 (Colo. 2nd Dist. Ct. Jan. 27. 2017)

— The court found that despite lacking any physical presence, Target Corporation’s subsidiary that managed Target Corporation’s brands had substantial nexus in Colorado due to its IP licenses used in Colorado.

— However, the Department of Revenue’s use of its alternative apportionment authority to exclude the subsidiary’s substantial property and payroll was unreasonable.
7. Treaty Protection
Treaty Protection

Overview

- **Federal**
  - Foreign corporations in certain countries have treaty protection

- **States**
  - Generally not binding
  - Some states respect treaty immunity.
    - E.g., Florida, Massachusetts, South Carolina, Virginia
  - Other states will exempt only if the treaty excludes the income for state tax purposes.
    - E.g., California
Examples of State Foreign Entity Inclusion Rules

- A foreign corporation may be included if it is subject to federal income tax or required to file a federal income tax return.
- A foreign corporation may be included to the extent of its effectively connected income (ECI).
- A foreign corporation with no ECI may be included to the extent of its U.S. source fixed, determinable, annual or periodic (FDAP) income.
- A foreign corporation may be included to the extent that 20% or more of its activity is within the U.S.
8. Partnerships
Partnerships

Overview

— **Federal**
  • Single level of taxation at the owner/member level with pass-through treatment and the ability to allocate tax items among partners (subject to limitations).

— **States**
  • Most states (like federal) do not tax disregarded entities, partnerships, LLCs or S corporations.
  • States impose withholding on income passed to nonresident partners/members.
  • Challenges with determining nexus for nonresident partners/members
    • Aggregate Theory v. Entity Theory
  • Challenges with allocating and apportionment
State Taxation and the New Federal Partnership Audit Rules

Federal Partnership Audit Reform Basics

- IRS may assess and collect from partnerships at the entity level for 1065 and Schedule K-1 issues.
  - Collection from partnership (not partners) in “year of adjustment” rather than “year of review.”
- After assessment, partnerships (that can’t elect out) can:
  - Modify the proposed entity level assessment by presenting information specific to partners’ taxes; or
  - “Push out” the entity level tax liability by providing Schedule K type reports to partners for their share of the tax imposed at the partnership level—current year.
Partnerships

State Taxation and the New Federal Partnership Audit Rules (cont’d)

— Will state law conform to the new federal changes?
  • Not automatically
    • New federal rules are primarily in IRC §§ 6221 to 6241 (administrative procedures).
    • States use the IRC only to compute taxable income and do not incorporate IRC administrative procedures.

— Without automatic adoption, where does that leaves states?
  • For partnerships assessed by the IRS at the entity level, how will states impose related state tax?
  • How are states to deal with the liability being assessed in “year of adjustment” rather than “year of review”?
  • Most states never conformed to TEFRA.
Partnerships


— Ohio law imposed income tax on capital gain realized by nonresident investor in a pass-through entity if the investor held 20% or greater interest in the entity, with the gain apportioned based on entity’s factors.

— Ohio Supreme Court held law violated Due Process Clause as applied to the nonresident owner because selling an ownership interest did not involve purposeful availment of the state’s protections and benefits, even where the sold entity conducted business in Ohio.
9. Insurance
Insurance

Overview

— Federal
  • No separate regime, but special rules apply to insurance companies, depending on the type of insurance.

— State
  • States generally have a separate tax regime for insurance companies.
  • Types of tax:
    • Premium Tax: imposed upon insurance companies
    • Procurement Tax: imposed upon insureds
    • Surplus Lines Tax: alternatively imposed upon the broker (agent) of nonadmitted insurance contract
    • Income/Franchise Tax: generally exempts insurance companies paying other taxes
  • McCarran-Ferguson Act expressly delegated the regulation of insurance to the states, including taxation.
  • Interstate Commerce Clause does not apply to insurance companies.
10. Foreign Source Income
Foreign Source Income

Overview

— Federal
  • Income that is effectively connected with the conduct of a U.S. trade or business (ECI) is subject to U.S. tax in essentially the same manner as it would be if it were recognized by a U.S. person.
  • Some types of income that are not ECI are subject to a 30% tax if they are from U.S. sources.

— States
  • States do not employ a source-based methodology, but rely on formulary apportionment to divide the taxable income of a unitary business among the states in which it conducts business.
Foreign Source Income

Apportionment

— Issue: Is inclusion of foreign-source dividend, interest and royalty income without appropriate factor relief unconstitutional?

  • No – *NCR Corp. v. Taxation and Revenue Dept. of the State of New Mexico*, 856 P.2d 982, cert. denied 512 U.S. 1245 (1994)
  • No – *NCR Corp. v. Comm’r of Rev.*, 438 N.W. 2d 86 (Minn. 1989)
  • No – *Conoco Inc. v. State of New Mexico Taxation and Revenue Dep’t*, 931 P.2d 730 (NM 1996)
  • No – *E.I. DuPont deNemours v. State Tax Assessor*, 595 A.2d. 1039 (ME 1996), ruling on the “Augusta Formula,” which was devised after the Tambrands case
    • The Augusta Formula allows exclusion of 50% of dividends from foreign subsidiaries, but without factor relief.