Runaway Tax Base

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Agenda

1. Introduction
2. Transfer Pricing Audits
3. Forced Combination
4. Intercompany Expense Disallowance

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Introduction

Corporate Income Tax Audits

- Traditionally, state corporate income taxes have accounted for a small percentage of overall state revenue department collections.
  - According to data compiled by the Tax Foundation, state corporate income taxes historically account for less than 4% of average total state revenue collections.
  - Corporate income taxes account for far less of the average state's overall revenue collections than sales taxes or property taxes.
  - However, corporate income taxes are often subject to lengthy and aggressive state audits.
  - One common theme that comes from these audits: state taxing authorities will often do anything in their power (or outside their power) to increase the corporate income tax base.

The Tax Base Starting Point

- The starting point of the corporate income tax base is defined by statute.
- Many states use federal taxable income (Line 28 or Line 30) as the state corporate income tax starting point.
- However, the state tax base is not necessarily limited to federal taxable income.
- Some states have statutory mechanisms to increase the tax base.
  - E.g.: 482-type powers, forced combination authority, or statutes that require expenses paid to related parties to be added back to the tax base.
- Other states act as if they have such powers, even in the absence of statutory authority.

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Transfer Pricing Audits

State 482-type Powers

- IRC § 482: “In any case of two or more organizations, trades, or businesses . . . owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses. . . .”
- Section 482 and the accompanying Treasury Regulations are designed to reach an “arm’s-length” result.
- Many states also have “482-type” powers.
  - Some statutes “mirror” Section 482 (e.g., Alabama, Maryland, New Jersey).
  - Some statutes afford discretionary adjustment powers that are similar to the “re-allocation” powers afforded under Section 482, but may allow the revenue department to consider factors other than “arm’s-length” pricing (e.g., Colorado, Mississippi).
  - Some states do not have Section 482-type powers at all (but may act as if they do, e.g., Pennsylvania).

Are States Required to Follow Federal 482 Guidance?

- Do states that have 482-type statutes need to follow IRC § 482 and the accompanying Treasury Regulations?
  - Can something be “arm’s-length” for federal purposes but not “arm’s-length” for state purposes?
- Some states (e.g., Maryland, New Jersey, others) are required to look to 482 and the Treasury Regulations and apply 482 “concepts” in applying the state 482-type statute.
- Other states take the position that they are not bound by federal 482 determinations.
  - E.g.: 482-type adjustments based on a lack of “economic substance” rather than the absence of arm’s-length pricing (North Carolina).
- States’ use of contract/contingency fee transfer pricing auditors raises additional concerns.
- What if the taxpayer has prepared a transfer pricing study? Can the state simply disregard it?

See's Candies

- ***See's Candies, Inc. v. Utah State Tax Comm'n***, 435 P.3d 147 (Utah 2018):
  - See's Candies transferred its intellectual property to an affiliate, Columbia Insurance Company, and then paid royalties to Columbia to use that IP.
  - The Utah Tax Commission allocated the royalty payments back to See's taxable income under the state's transfer pricing statute, which is modeled on, but does not adopt, IRC Section 482.
  - The court held that the Commission abused its discretion in failing to consider interpretive guidance under Sec. 482 and improperly ignored transfer-pricing study and other evidence supporting the intercompany transaction.
  - The court determined that See's royalty payment deductions were proper, minus a 10% adjustment determined after an MTC audit.
- **Utah H.B. 268** (enacted March 29, 2019) now requires an addback for payments made to a captive insurance company.

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Forced Combination

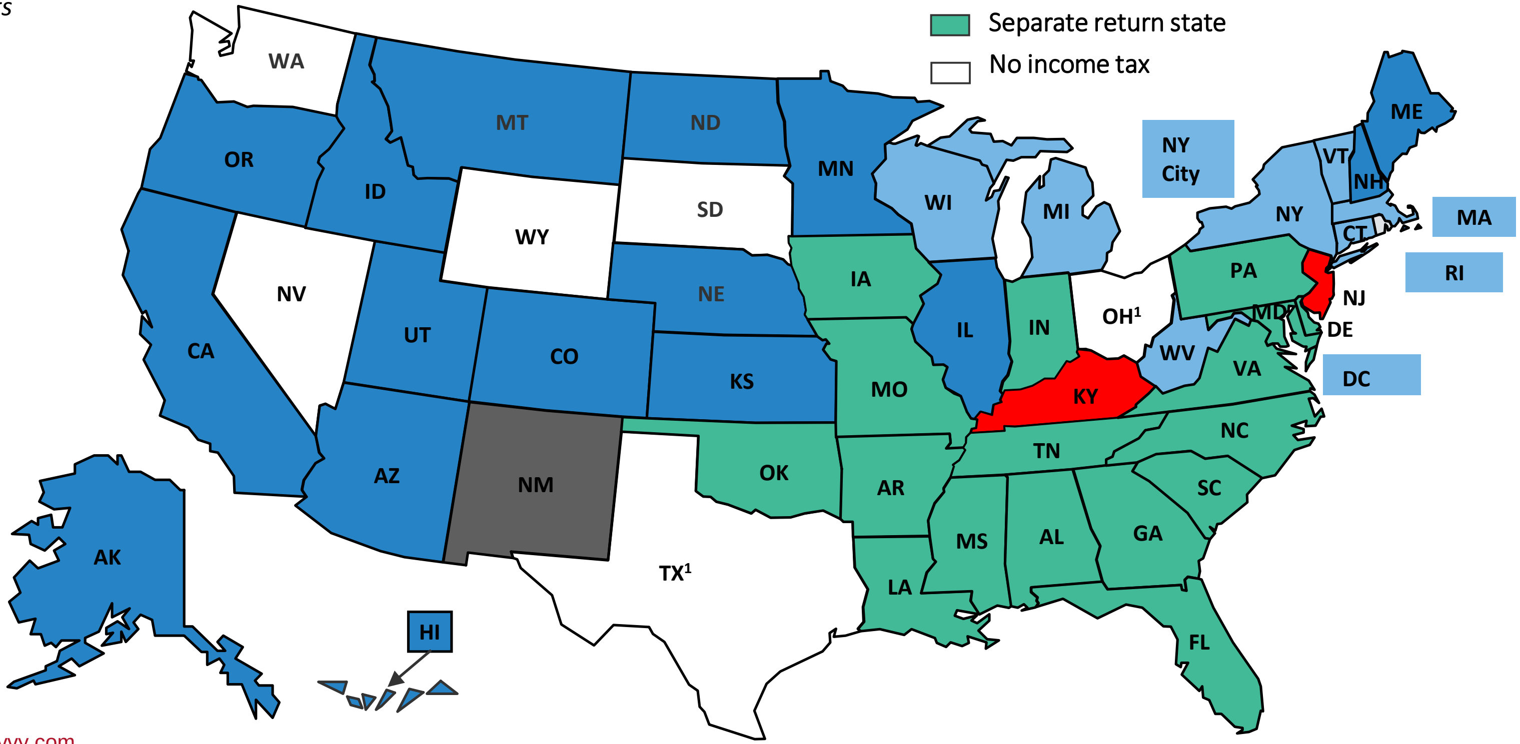
The Basis for Forced Combination

- Another way that states can increase the corporate income tax base is to increase the number of taxpayers reported on the corporate income tax return.
- Enter: combined reporting.
- Over the past 15 years, there has been a marked increase to the number of state that require taxpayer to file mandatory unitary combined returns.

Mandatory Unitary Combined Reporting

- MUCR/consolidated return required prior to 2004
- MUCR adopted for 2004 or later
- MUCR adopted in 2018/2019
- Separate return state
- No income tax

[1] Combined reporting for a tax based on gross receipts



Forced Combination in Separate Return States?

- Even states that do not adopt mandatory unitary combined reporting may force taxpayers to file on a combined basis through "discretionary" combination powers.
- North Carolina, a "separate return" state, has detailed regulations addressing discretionary forced combination.
- The South Carolina Supreme Court has interpreted the general alternative apportionment statute as permitting the filing of a combined return as an "other method" that can fairly reflect a taxpayer's income in South Carolina.   See Media General Communications, Inc. et al. v. South Carolina Dep't of Rev., 694 SE2d 525 (S.C. 2010).
- Even in "combined reporting" states, additional measures can be taken to increase the base – e.g., inclusion of "80/20" companies.
- Combined reporting states may also attempt to expand the base by adding additional members or income of non-members.

Agilent Techs., Inc. v. Dep't of Revenue, 2019 CO 41 (Colo. S.Ct. May 28, 2019); *Oracle Corp. v. Dep't of Revenue*, 2019 CO 42 (Colo. S.Ct. May 28, 2019)

- In both cases, the Colorado Supreme Court held that a subsidiary corporation with no property or payroll could <u>not</u> be included in its corporate parent's Colorado combined report because the subsidiary did not have more than 20% of its property and payroll located in the United States. This was consistent with the Department of Revenue's own regulation that a corporation with no property or payroll cannot be included in a combined report.
- Court rejected the Department's alternative "482" argument that it had the authority to allocate the holding companies' gross income to the affiliates to avoid abuse and to clearly reflect income.
- In response, the Colorado Legislature approved and the Governor signed into law a legislative "fix" (SB 19-233), effectively reversing the Court's decisions.

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Intercompany Expense Disallowance

Intercompany Expense Disallowance

- Several states have enacted “add-back statutes” that disallow federally-allowed deductions for expenses paid to affiliates.
- Generally, expenses must be related to “interest” or “intangibles.”
- All states have one or more statutory exceptions to add-back.
  - Common exceptions:
    - Recipient subject to tax on income in excess of a benchmark rate
    - Recipient is in a foreign country with US income tax treaty
    - Specific industry exceptions
    - Recipient is a conduit for payment to third parties
    - Parties elect to file on a combined basis
    - Unreasonable exception (see New Jersey example on following slide)

BMC Software Inc. v. Dir., Div. of Taxation, No. 000403-2012 (N.J. Tax Ct. 2017)

- Case decided under New Jersey's add-back statute (prior to NJ's move to combined reporting).
- New Jersey Tax Court found that while amounts a wholly-owned subsidiary paid its parent for licensing and distributing software were royalty payments that would be subject to the add-back statute, the "unreasonable" exception applied.
- Regulations: "[A] deduction is allowed if a portion of such expense was paid or received by an unrelated member, and the transaction between the taxpayer and the related member was not for the principal purpose of tax avoidance." NJ Admin. Code 18.7-5.18(b).
- The payments were deemed to be "substantively equivalent" to payments that either the parent or its subsidiary would make to unrelated third parties for similar software license and service contracts.

Questions

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