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Advanced State and Local Tax 2017

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Advanced State and Local Tax 2017

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Peter L. Faber

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Prepared for distribution at the
ADVANCED STATE AND LOCAL TAX 2017
Program
New York City, March 21, 2017

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Program Attorney: Stacey L. Greenblatt

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Advanced State and Local Tax 2017
New York City and Live Webcast, www.pli.edu,
March 21, 2017, 1:50 p.m. – 5:00 p.m.
Atlanta, Boston, Cincinnati and Nashville Groupcast
Locations, March 21, 2017, 1:50 p.m. – 5:00 p.m.

Program Schedule
1:50 p.m. – 5:00 p.m.

1:50 **Introduction and Opening Remarks**
Peter L. Faber

2:00 **State and Local Taxation of International Business and Mergers & Acquisitions**

- State and local taxation of international business
  - Nexus and tax residency
  - Unitary taxation
  - Business apportionment
  - MTC State Intercompany Transactions Advisory Service (SITAS)
  - Tax haven legislation
- Mergers and acquisitions
  - Calculation and characterization of gain or loss
  - Section 338(h)(10) transactions
  - Tax-free reorganizations and spin-offs
  - Special state limitations on NOLs

Peter L. Faber, Richard W. Genetelli, Jack L. Harper, Kenneth T. Zemsky

3:45 *Networking Break*

4:00 **E-commerce Income Tax and Sales Tax Issues**

- Defining the transaction: license of software, service, something else?
- Nexus issues
- Apportioning income

Jack Trachtenberg, Margaret C. Wilson

5:00 **Adjourn**

Chair:

Peter L. Faber
McDermott Will & Emery LLP
New York City

Faculty:

Richard W. Genetelli
The Genetelli Consulting Group
New York City

Jack L. Harper
Vice President, Corporate Tax
Discover Financial Services
Riverwoods, Illinois

Jack Trachtenberg
Reed Smith LLP
New York City

Margaret C. Wilson
Wilson Agosto LLP
Somerville, New Jersey

Kenneth T. Zemsky
AndersenTax
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Program Attorney: Stacey L. Greenblatt

Faculty Bios

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Peter L. Faber is a partner in the New York office of the law firm of McDermott, Will & Emery LLP. He specializes in state and local tax matters, including planning, administrative proceedings, and litigation.

Mr. Faber's state and local tax practice has included tax planning for corporate acquisitions, divestitures, and restructurings; combined report planning; electronic commerce and nexus issues; cloud computing issues; residence matters; alternative apportionment issues; and a variety of other matters. He has litigated many cases before state and local administrative agencies and courts and has represented taxpayers at all levels of the administrative controversy and ruling process, including Attorney General investigations and False Claims Act proceedings. He has also represented companies and industry groups in legislative and regulatory matters. His clients include Goldman Sachs, Morgan Stanley, MetLife, Aetna, The New York Times Company, and Starbucks. He is a member of the Firm's State and Local Tax Practice Group, that includes SALT specialists around the Country and that, among other matters, successfully represented the taxpayers in the landmark *Quill*, *ASARCO*, and *Woolworth* cases before the United States Supreme Court.

Mr. Faber has served as Chairman of the American Bar Association Section of Taxation and is a member of the Section's Committee on State and Local Taxes. He is a former Chairman of the New York State Bar Association Tax Section. Mr. Faber has served as a member of the Governor's Council on Fiscal and Economic Priorities and as Chairman of the New York City Partnership's Committee on Taxation and Public Revenue. He served on the Board of Directors of the Partnership.

He has served on the New York State Tax Reform Commission, the Governor's Temporary Commission to Review the New York Sales and Use Tax Laws, and the New York State Legislature's Tax Study Commission's Policy Advisory Group. He currently serves as a member of the Advisory Committees of the New York State Tax Appeals Tribunal, the New York City Tax Appeals Tribunal, the New York State Department of Taxation and Finance, and the New York City Department of Finance.

Mr. Faber has lectured on state and local taxation at the Georgetown University Institute on State and Local Taxation, the National Institute on State and Local Taxation, the Committee on State Taxation (COST), the Hartman State and Local Tax Forum, the National Tax Association, The NYU Annual Institute on State and Local Taxation, the National Conference of State Tax Judges, the Multistate Tax Commission, and before many other professional groups. He is a member of the Advisory Committees of the Georgetown and NYU Institutes. He is the author of many articles on state and local taxation.

Mr. Faber graduated from Swarthmore College with high honors and from Harvard Law School, cum laude.

Richard W. Genetelli

Richard W. Genetelli is the founder of the state and local tax consulting firm The Genetelli Consulting Group. Richard was previously with Coopers & Lybrand (now PwC) for twenty years, having been a partner for ten of those years. Richard was at the forefront of the state and local tax practice at Coopers & Lybrand, having served as the national and regional leader, before leaving to form Genetelli in 1991.

Richard is a member of both the New York State Society and American Institute of Certified Public Accountants. Richard is also a member of the New York Chamber of Commerce, Wall Street Tax Association, and Interstate Tax and State and Local Tax Committees of the New York State Society of Certified Public Accountants. In addition, Richard is on the Advisory Boards of New York University, Bloomberg BNA Tax Management Inc. Multistate Tax Portfolio Series, Multistate Tax Analyst and the Journal of State Taxation.

Richard has received the Outstanding Achievement in State and Local Taxation Award from New York University (2011), the Franklin C. Latcham Award for Distinguished Service in State and Local Tax from BNA Tax & Accounting (2010), the 25 Year Service Award from Pace University (2010), the Certificate of Excellence Award from BNA Tax Management (2002), the Distinguished Faculty Award from the Foundation for Accounting Education (multiple periods), and the Outstanding Discussion Leader Award from the New York State Society of Certified Public Accountants (multiple periods). Richard regularly co-chairs the New York University School of Continuing and Professional Studies Institute on State and Local Taxation (2015, 2014, 2012, 2010, 2008 and 2006).

Richard has authored numerous articles regarding state and local taxes, including Combined Reporting Developments and Controversies in New York (New York University Institute on State and Local Taxation), Intercompany Transactions Remain Front and Center for State Tax Developments (Bloomberg BNA Tax Management Weekly State Tax Report), New York State Tax Appeals Tribunal Furnishes Extensive Unitary Business Analysis in ‘SunGard’ Reversal (Bloomberg BNA Tax Management Weekly State Tax Report), Inconsistent Decisions Based on Identical Facts Should Concern Companies About Nexus and Nonfiling Exposure (Bloomberg BNA Tax Management Weekly State Tax Report), New York’s Related Member Royalty Payment Legislation: The Old, the New, and What the Amendments Mean to You (Bloomberg BNA Tax Management Weekly State Tax Report), New York State Residency Audits: Hot Issues and What Auditors Look for in Determining a Taxpayer’s New York Residency Status (Bloomberg BNA Tax Management Weekly State Tax Report), With States on the Attack, Investment by Companies in State Tax Resources Can Have Positive Effect on Earnings (Bloomberg BNA Tax Management Weekly State Tax Report), Local Tax Considerations in Today’s Economic Climate: Cities Offering Solutions for Mitigating Nonfiling Exposure (BNA Tax Management Weekly State Tax Report), State Tax Planning in an Era of Aggressive Enforcement: Effective Strategies to Reduce Taxes and Minimize Exposure (BNA Tax Management Weekly State Tax Report), During a Turbulent Economy, Intercompany Transactions Become Focal Point of State Tax Planning, Audit Activity (BNA Tax Management Multistate Tax Report), Planning Strategies to Reduce State and Local Income/Franchise Taxes and Improve Profitability (Journal of State Taxation), Strategies to Minimize State Unemployment Taxes (Payroll Exchange), Analysis and Planning of Section 482-Type Audits at State and Local Levels (Journal of State Taxation), Minimizing State and Local Taxes with Combined (Unitary) Reporting (Journal of State Taxation), Clarification of Tax Treatment of Repurchase Agreements Makes Life Easier (The Journal of New York Taxation), Mergers and Acquisitions: Reducing the Local Taxman's Bite (Journal of State Taxation), How State Income Taxes Can Be Minimized (Boardroom Reports), Corporate Multistate Tax Saving Strategies (American Institute of Certified Public Accountants), and Controlling Property Taxes (Financial Executive).

Richard is qualified as an expert witness and testifies on behalf of taxpayers litigating state and local tax issues throughout the country. Richard is a professor of graduate and undergraduate courses at the Lubin School of Business, Pace University, and a frequent lecturer on state and local taxes throughout the country. The organizations that Richard regularly speaks before include the Tax Executives Institute, Committee on State Taxation, New York State Society of Certified Public Accountants, American Institute of Certified Public Accountants, New York University and New York State Business Council.

Jack L. Harper, Esq., CPA
Vice President, Corporate Tax
Discover Financial Services
Riverwoods, Illinois

Jack Harper is Vice President, Corporate Tax at Discover Financial Services (Discover Card) in Riverwoods, Illinois. He heads the Company's Tax Department. He is formerly a Senior Director with Walmart Stores Inc., where he was responsible for Tax Planning for the Company's U.S. Operations and for the Company's Global Tax Controversy function aimed at mitigating world-wide tax audit risks and exposures. He was previously Senior Vice President at Wells Fargo/Wachovia Corporation where he managed the federal and state income tax examinations and administrative tax appeals for Wachovia Bank, NA. He began his career in Raleigh, North Carolina with the accounting firm that is now Ernst and Young, advising federal tax clients in the insurance and financial services industries. He performed his public service work at the North Carolina Department of Revenue as Assistant Secretary for Tax Administration and Director of the Corporate, Excise and Insurance Tax Division. There, he was the Chief Administrative Tax Policy Official for the State of North Carolina. Through those capacities, he served on several committees of the Multi-State Tax Commission including its Executive Committee. Upon returning to public accounting from the Department of Revenue, he led PriceWaterhouseCoopers's North and South Carolina state tax controversy practice.

He received his Bachelor of Science degree in Accounting from North Carolina Central University in Durham, North Carolina; Masters of Science in Taxation from Colorado State University, Fort Collins, Colorado; and Juris Doctorate, with honors, from the School of Law at North Carolina Central University. He is a Certified Public Accountant and Licensed Attorney. He is a past Chairman of the Tax Section of the North Carolina Bar Association. He currently serves on the Advisory Boards of New York University's State and Local Tax Institute and Vanderbilt University's Hartman State and Local Tax Forum. He was named to North Carolina's 2008 Legal Elite, one of North Carolina's best lawyers as identified by fellow attorneys in the State. He annually speaks at numerous state tax seminars and conferences throughout the county, and has presented papers on various tax topics.

The business of relationships.

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Education

State University of New York at Buffalo Law School, 2002, J.D., *magna cum laude*, Best Brief, Mugel Moot Court Competition, Assistant Executive Editor, *Buffalo Law Review*

Case Western Reserve University, 1999, M.A., Political Science,

Case Western Reserve University, 1999, B.A., Phi Beta Kappa

Professional Admissions

New York

Jack advises clients on all aspects of state and local tax from planning and compliance to controversy and litigation before administrative bodies and trial and appellate courts across the country.

Jack has extensive experience advising clients on New York State and New York City tax matters, having successfully litigated cases before the New York State Division of Tax Appeals, the New York State Tax Appeals Tribunal and the New York State Supreme Courts. Jack's practice focuses on corporate income, franchise, gross receipts, sales and use, and personal income taxes. Jack also advises and represents clients regarding the application of state False Claims Act statutes in tax cases.

In 2009, Jack temporarily left private practice when he was appointed by the Governor of New York to serve as the first Deputy Commissioner and Taxpayer Rights Advocate at the New York State Department of Taxation and Finance. In this role, Jack created and implemented the state's Office of the Taxpayer Rights Advocate, which intervened on behalf of taxpayers facing intractable tax disputes. In its first two years, the office managed nearly 4,000 cases and obtained relief for taxpayers nearly 70% of the time. As the Taxpayer Rights Advocate, Jack worked to identify systemic problems that burdened large segments of the taxpayer community. Because of his efforts, important tax reform legislation was passed and key changes were made to department processes and procedures.

Jack is a frequent speaker on state tax issues and has spoken at conferences sponsored by the Council on State Taxation (COST), the Tax Executives Institute (TEI), the Institute for Professionals in Taxation (IPT), the New York State Society of CPAs, the Business Council of New York State, the New York State Bar Association, and the American Bar Association, among others. Jack is also an author, editor, co-author or publisher of many publications, including the "Multistate Corporate Tax Guide," the "Multistate Guide to Sales and Use Tax," the "New York State Sales and Use Tax Answer Book," and the LexisNexis "Tax Practice Insights: New York." He is also a frequent contributor to tax and accounting publications, such as State Tax Notes and The CPA Journal, and has taught State and Local Tax courses at Albany Law School.

Representative Matters

- Favorably resolved a large New York State corporate income tax assessment against a multinational consumer products company by challenging, on statutory and constitutional grounds, the state's application of its royalty income exclusion and royalty expense addback provisions.
- Represented a big-box retailer in a Massachusetts corporate excise tax matter involving section 482 type adjustments and application of the state's interest expense addback provisions.
- Represented an online travel company in a New York State corporate income tax matter involving the state's attempt to use market-based sourcing instead of cost-of-performance to source service receipts.
- Represented a multinational retail corporation in a business license tax dispute involving a locality in California that was seeking to impose tax on 100% of the taxpayer's unapportioned gross receipts.
- Prevailed against and assessment of income tax (and obtained a refund) before the New York State Division of Tax Appeals and on appeal before the New York State Tax Appeals Tribunal, arguing successfully that the sale of a company in which a Section 338(h)(10) election had been made should be treated as a nontaxable disposition of stock for purposes of New York's sourcing rules.
- Successfully challenged a claim of New York City residency before the New York State Division of Tax Appeals, obtaining a favorable finding of domicile for clients in future years.

- Successfully represented a national retail clothing store before the New York State Division of Tax Appeals against an assessment of sales and use tax on chemicals used to dry-clean garments prior to rental or sale.
- Represented a corporate executive as an amicus before the New York State Tax Appeals Tribunal, successfully convincing the Tribunal to adopt a rationale that led to the invalidation of a long-standing policy regarding the taxation of stock option income.
- Represented a company in a declaratory judgment action filed in New York State Supreme Court, ultimately resulting in a reduction of the sales and use tax assessment to $19.05, as well as an award of approximately $160,000 in attorneys fees against the state.
- Favorably resolved a large sales and use tax assessment against a national real estate data and valuation company after filing a declaratory judgment action in New York State Supreme Court challenging the state's claim that the company was engaged in the sales of a taxable information service.
- Favorably resolved a sales and use tax assessment issued against a global electronics industry leader by arguing that the company's "demo" equipment remained in inventory for resale and had not be put to a taxable use.
- Represented a global financial services firm in obtaining a favorable settlement of a multi-million dollar New York State withholding tax audit.
- Represented a national energy company in obtaining a favorable resolution of a sales and use tax assessment by arguing that the company had no nexus and transferred title to its product outside the state.
- Obtained a temporary restraining order in an Article 78 proceeding brought in New York State Supreme Court, prohibiting the New York State Department of Taxation and Finance from collecting a tax debt that was later cancelled in its entirety and converted into a refund of monies seized from the taxpayer.

Publications

- "Sprint FCA Case Denied Certiorari by U.S. Supreme Court," *Reed Smith Client Alerts*, 31 May 2016
Co-Author(s): Adam P. Beckerink, Jennifer S. White, Douglas A. Wick, Jason Feingertz, Jonathan E. Maddison
- "Three New Qui Tam Lawsuits Likely to Move Forward in New York," *Bloomberg BNA*, 27 January 2016
- "The State Tax Impact Of NBA Offseason Decisions," *SportsAgentBlog*, 29 October 2015
Co-Author(s): Jason Feingertz
- "Establishing Residency for Professional Athletes," *Tax Analysts*, 14 September 2015
Co-Author(s): Jason Feingertz
- "ALJ Strikes Down Aggressive Attempt by New York State Department of Taxation and Finance to Tax Nonresident Attorney," *Reed Smith Client Alerts*, 5 August 2015
Co-Author(s): Jennifer S. White, Jason Feingertz
- "Reed Smith Files Amicus Brief on Behalf of the Institute for Professionals in Taxation in Sprint False Claims Act Appeal," *Reed Smith Client Alerts*, 31 July 2015
Co-Author(s): Adam P. Beckerink, Jennifer S. White, Douglas A. Wick, Jason Feingertz
- "New York's Unitary Combined Reporting Rules: Guidance Is Needed," *New York Law Journal*, 6 July 2015
Co-Author(s): Jennifer S. White, Jason Feingertz
- "Consumer Class Action Suit Alleging Sales Tax Misconduct is Partially Dismissed," *Reed Smith Client Alerts*, 19 June 2015
Co-Author(s): Adam P. Beckerink, Douglas A. Wick, James L. Rockney
- "Combined Reporting in New York: The Coming Battles Over the Unitary Business Principle," *Bloomberg BNA Tax Management Weekly State Tax Report*, 5 June 2015
Co-Author(s): Jennifer S. White
- "What a Sham: Massachusetts's Power to Attack Legitimate Tax Planning," *TaxAnalysts*, 5 May 2015
Co-Author(s): Michael A. Jacobs, Robert E. Weyman, Brent K. Beissel
- "Class Action Lawsuit Filed Against BJ's Wholesale Club Alleges Improper Sales Tax Collection in Florida – The Continuation of a Disturbing Trend," *Reed Smith Client Alerts*, 10 April 2015
Co-Author(s): Adam P. Beckerink, Douglas A. Wick
- "New York State Legislature Passes 2015-2016 Budget Bill with Significant Changes from Governor's Proposal," *Reed Smith Client Alerts*, 2 April 2015
Co-Author(s): Jennifer S. White, Aaron M. Young
- "Reed Smith LLP Advises Multistate Tax Commission Work Group on Class Action and False Claims Act Model Statutes," *Reed Smith Client Alerts*, 17 March 2015
Co-Author(s): Adam P. Beckerink
- "New York Residency Audits: Defending Foreign Domicile Changes," *Tax Stringer*, March 2015
Co-Author(s): Jennifer S. White
- "New York State Division of Tax Appeals Renders Long-Awaited Decision Regarding Corporate Franchise Tax Sourcing of Services and 'Other Business Receipts'," *Reed Smith Client Alerts*, 17 February 2015
Co-Author(s): Aaron M. Young

- "Georgia's Improper Application of Its Transfer Pricing Authority," *Tax Analysts*, 10 February 2015
  Co-Author(s): Brent K. Beissel, Kenneth R. Levine
- "A Disturbing Trend: Applying False Claims Acts to Tax Matters," *Corporate Disputes*, October-December 2014
  Co-Author(s): Adam P. Beckerink, Jennifer C. Waryjas
- "To Blacklist or Not to Blacklist -- The Trend Toward State Tax Haven Laws," *State Tax Notes*, 8 September 2014
  Co-Author(s): Michael A. Jacobs, Michael I. Lurie
- "Opportunities for Interest Abatement in Maryland," *State Tax Notes*, 12 May 2014
  Co-Author(s): Stephen J. Blazick
- "New York's Highest Court Unanimously Rejects Tax Appeals Tribunal's Interpretation of Statutory Residency Test," *Reed Smith Client Alert*, 19 February 2014
  Co-Author(s): Aaron M. Young, Jennifer S. White
- "Source It Here, Source It There - The Pennsylvania Sales Factor," *Tax Analysts*, 10 February 2014
  Co-Author(s): Kyle O. Sollie, Paul E. Melniczak
- "NY Governor Cuomo Proposes Sweeping Tax Reform," *Reed Smith Client Alert*, 10 February 2014
  Co-Author(s): Aaron M. Young, Jennifer S. White
- "Defending New York Residency Audits that Target Capital Gains," *Tax Stringer*, February 2014
- "Taxpayer Wins New York Bank Tax Case: Division of Tax Appeals Determines that Department Violated its Own Published Guidance," *Reed Smith Client Alert*, 15 November 2013
  Co-Author(s): Aaron M. Young, Jennifer S. White
- "This Is Why We Fight: A Survey of New York Tax Issues," *State Tax Notes*, 14 October 2013
  Co-Author(s): Aaron M. Young, Jennifer S. White
- "Between a Rock and a Hard Place: Third-Party Enforcement Actions," *A Pinch of SALT, State Tax Notes*, 1 October 2012
- "Applying False Claims Acts in State Taxation," *A Pinch of SALT, State Tax Notes*, 7 May 2012
- "New York State Taxpayer Rights Advocate Outlines Services," *Tax Stringer*, 1 February 2012
- "New York State Sales and Use Tax Answer Book," 1 January 2012
- "An Update from the New York State Taxpayer Rights Advocate," *Tax Stringer*, 1 March 2011
- "New York State Does the 'Right' Thing:The State's First Taxpayer Rights Advocate," *Journal of Multistate Taxation & Incentives*, 1 October 2010
- "My Role as New York's Taxpayer Rights Advocate," *New York State Society of CPAs, Guest Column*, 1 August 2010
- "Is New York's Special Investigations Unit Targeting You or Your Client: Avoiding and Responding to New York Criminal Tax Investigations," *The CPA Journal*, 1 October 2009
- "An End to the Temporary Stay Test in New York?," *State Tax Notes*, 12 November 2008
- "Industrial Development Agencies Provide Sales Tax Benefits," *Construction Accounting and Taxation Journal*, 1 November 2008
- "New York's Less Kind and Gentle Tax Department-Preparing for Criminal Investigations," *State Tax Notes*, 31 March 2008
- "Stock Options - The New York Tax Department's Effort to Undermine Stuckless," *State Tax Notes*, 1 April 2007
- "New York State Sales Tax Issues for the Construction Contractor," *Construction Accounting and Taxation Journal*, 1 July 2006
- "The Imposition of Unlimited Liability on Limited Partners and Members of LLCs in New York," *State Tax Notes*, 5 December 2005
- "Matter of Randall Stuckless and Jennifer Olson: New York Tax Appeals Tribunal Issues Stock Option Decision," *State Tax Notes*, 4 July 2005
- "Corporate Fiduciaries, Advisors, and Other Co-Trustees - Perhaps Your Trust Isn't Exempt From New York State Income Tax," *Trusts and Estates Law Section Newsletter*, 1 April 2005
- "Doing Business in the United States: U.S. Tax Issues for Expanding Canadian Businesses," *2004 Ontario Tax Conference Report*, 1 January 2004

Speaking Engagements

- 13-16 November 2016 IPT's Income Tax Symposium, Tucson, Arizona
  "National Update - The Year in Review" "Understanding the Unitary Business Concept in 2016"
- 8 November 2016 New York State Taxation Conference, New York, New York
  "NYS Residency Update"
- 18-21 October 2016 COST's 47th Annual Meeting, Las Vegas, Nevada
  "Enough About Tax Reform. What Else Do I Need to Know About New York?"
- 8 June 2016 2016 Annual Conference on State Taxation, Albany, New York

- 22-25 February 2016 2016 COST Sales Tax Conference and Audit Session, San Diego, California
  "False Claim Act and Class Action Lawsuits in Sales Tax - Audited Through the Courts"
- 18 February 2016 COST California & Pacific Southwest Regional State Tax Seminar, Irvine, California
  "National Judicial Update and Discussion of State Tax Cases" "Special Report – New York & Pennsylvania Issues in Litigation"
- 26 January 2016 NYSBA Tax Section Annual Meeting, Recent Developments in N.Y. Corporate Tax Reform, New York, New York
  "Recent Developments in N.Y. Corporate Tax Reform"
- 1st - 4th November Income Tax Symposium - Federal Conformity and Tangible Personal Property Regulations, Austin, Texas
- 10 - 11 June 2015 Business Council of New York State Annual Conference on State Taxation - Living with NYS Corporate Tax Reform Part A: 2014 Key Compliance Issue, Albany, New York
  "Living with NYS Corporate Tax Reform Part A: 2014 Key Compliance Issue"
- 22 April 2015 COST 2015 Spring Audit Session/Income Tax Conference, Memphis, Tennessee
  "New York Update – The Devil's In The Details"
- 5 May 2014 COST Mid-West Regional Seminar, Rolling Meadows, Illinois
  "Judicial Update on State Tax Developments"
- 29 April 2014 New York State Bar Association Eighteenth Annual New York State and City Tax Institute, New York, New York
  "Corporate Tax Legislative Changes"
- 28 April 2014 COST Income Tax Conference, Colorado Springs, Colorado
  "Lessons Learned After Two Decades of Intangible Expense Disallowance and the Strategies for Challenging Those Statutes"
- 28 January 2014 Application of New York False Claims Act to Taxes, New York City, New York
- 23 January 2014 - 25 January 2014 Private Enforcement of State Tax Laws: False Claims Acts and the Transaction Tax Overpayment Model Act, Phoenix, Arizona
- 17 December 2013 New York State Tax Update, Mineola, New York
- 10 December 2013 Tax Aspects for Early Stage Companies in New York City: Credits and Incentives Opportunities, New York City, New York
- 30 June 2013 NYSSA Tax Section Summer Meeting
  "A More Perfect Union? How States are Struggling to Adapt their Tax Codes to the Digital Economy"
- 25 April 2013 The Business Council for New York State: 2013 Annual Conference on State Taxation
  "Corporate Tax Reform/Key Policy Issues in Income and Sales Tax"
- 20 March 2013 ABA/IPT Sales Tax Seminar
  "Between a Rock and a Hard Place: Third-Party Enforcement Actions"
- 20 March 2013 TEI 63rd Midyear Conference
  "Class Action Lawsuits and False Claims Act Suits: Protecting Your Company"
- 27 February 2013 COST Sales Tax Conference and Audit Session
  "Class Action and Qui Tam: Look Who's Suing You Now"
- 24-26 January 2013 ABA Section of Taxation 2013 Midyear Meeting
  "Transparency Issues in State Tax Administration"
- 16 January 2013 Foundation for Accounting Education 2013 Tri-State Taxation Conference
  "Candid Views on Tax Administration and Policy"
- 30 August 2012 COST Pacific Northwest Regional State Tax Seminar
  "Hot Topics in New York State Tax"
- 20 August 2012 Bloomberg Law Podcast
  "Whistleblower Tax Suits on the Rise"
- 26 July 2012 State and Local Tax Roundtable
  "Hot Topics in New York State Tax"
- 12 July 2012 COST South West Regional State Tax Seminar
  "Settlement Expectation: When to Hold and When to Fold"
- 18 June 2012 Federation of Tax Administrators Annual Meeting
  "Application of False Claims Act to Tax Enforcement"
- 8 May 2012 TEI New York State and Local Tax Chapter Meeting
  "New York State Tax Issues You Must Litigate"
- 1 May 2012 TEI Tri-Chapter Conference
  "Waive or Walk"

- 26 April 2012 The Business Council of New York State 2012 Annual Conference on State Taxation
  "Business Tax Reform - Beyond 9A/32 Integration"
- 19 April 2012 New York State and City Tax Institute
  "Hot-Breaking State and Local Tax Issues"
- 6 March 2012 The District of Columbia Bar
  "Reflections from NYS's First Taxpayer Rights Advocate"
- 18 August 2010 Tax Foundation Podcast
  "New York's Taxpayer Rights Advocate Jack Trachtenberg: Improving the Tax Department"
- 1 May 2009 LexisNexis Tax Law Center
  "New York State Tax Compliance and Collection Enforcement"

Notable Quotes

- 18 October 2016 "New York Corporate Tax Revenue Declines After 2014 Overhaul of Business Taxes" *Bloomberg BNA*
- 27 July 2016 "New York ALJ Says Company Should Have Filed Combined Return, Not Added Back Royalty Payments" *Tax Analysts*
- 20 April 2015 "5 Ways Retailers Can Avoid The Sales Tax Litigation Blitz" *Law 360*
- 13 March 2015 "MTC Uniformity Committee Leaning Toward IRS Whistleblower Model" *State Tax Today*
- 10 March 2015 "NY Tax Preparer Rules Give Glimpse Of Future Regulation" *Law 360*
- 10 February 2015 "Online Marketing Services Not Taxable Under Advertising Exclusion, New York Finds" *Bloomberg BNA*
- 24 February 2014 "New York High Court Overturns Definition of Statutory Resident" *State Tax News and Analysis*
- 20 February 2014 "Lower Taxes Seen for Nonresidents Who Own Property in New York" *The Wall Street Journal*

Professional and Community Affiliations

- Member, Executive Committee, Tax Section of New York State Bar Association
- Member, Executive Committee, State and Local Tax Committee of American Bar Association
- Member, State and Local Tax Committee, New York City Bar Association
- Member, Personal Income Tax Committee, New York City Bar Association
- Secretary, The Tax Review

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State and Local Tax Services
Advisory & Planning
Audit & Compliance Strategy
Controversy/Litigation

Education
University of Michigan Law School,
J.D. with honors
New York University School of Law,
LL.M. in Taxation
University of Michigan,
B.A. with honors

Admitted to Practice
New Jersey
New York
Pennsylvania

Margaret Wilson is a founding partner of Wilson Agosto LLP, resident in its central New Jersey office. Ms. Wilson's practice focuses on state and local taxation, including state and local tax controversies across the country and multistate tax planning. She has previously been a partner with two national law firms and Associate General Counsel for Verizon Communications in charge of state and local taxation.

Ms. Wilson frequently lectures and writes on state and local taxation topics, with articles in publications including *State Tax Notes*, the *Journal of Multistate Taxation and Incentives* (for which she also previously served on the Editorial Board), the ABA *State and Local Tax Lawyer*, the ABA *Tax Lawyer*, and the T.E.I. *Tax Executive*. She also authors the Corporation Business Tax and Sales and Use Tax chapters of the New Jersey Tax Handbook (American Lawyer Media).

Ms. Wilson previously served as the President of the Institute for Professionals in Taxation (2015-16), as the Chair of the Taxation Section of the New Jersey State Bar Association and as a Vice Chair of the American Bar Association State and Local Tax Committee. She serves on the New Jersey Supreme Court Committee on the Tax Court and the advisory board of the Paul J. Hartman State and Local Tax Forum.

WILSON AGOSTO LLP
STATE AND LOCAL TAX ATTORNEYS

MARGARET WILSON

Representative Experience

- Nationwide sales tax refund work for AT&T Mobility, litigation pending in multiple states
    - Won partial summary judgment in the New Jersey Tax Court for New Cingular Wireless on its $32 million sales tax refund claim. Chief Judge DeAlmeida agreed with WALLP's arguments, rejecting each of the Division of Taxation's multiple procedural grounds for denial as unreasonable in light of New Jersey sales tax refund law.
    - Represented AT&T Mobility in overcoming numerous procedural defenses to prevail in an Alabama sales tax refund claim trial. Chief Judge Thompson of the Alabama Tax Appeals Tribunal agreed with our arguments, witness testimony and documentary evidence on agency, the federal Tax Injunction Act (28 U.S.C. §1341), and numerous other issues intersecting contract and tax law.
- Income tax audit/litigation in six states for a Fortune 500 health services provider
- NY and NYC combined reporting challenges for international communications technology company and an international software company
- National advice to Internet retailer on sales tax nexus impact of provider relationships
- Obtained voluntary disclosure agreements on corporate income tax, sales tax, and personal income tax issues in FL, MA, NJ and NY.

Representative Recent Publications

- Author/Editor - New Jersey Tax Guide (American Lawyer Media, 2003 - present): Corporation Business Tax and Sales and Use Tax chapters
- IPT Income Tax Guide, Author - M&A and Tax Planning Chapter, Overall Editor
- The Beast of the Burden of Proof, IPT May 2012 State Tax Report
- State and Local Tax Snafus in "No Tax" Deals, MWE Inside M&A (May/June 2010)
- The Shifting Landscape of the Work Product Doctrine, IPT Membership Newsletter, Fall 2010
- Assistant Editor, ABA Sales and Use Tax Deskbook (2010-11, 2005-06)
- Apportionment in Gross Receipts Taxes: A Brief Analysis of Constitutional Questions About Methods and Standards, BNA Tax Management Multistate Tax Report (March 23, 2007)

- The Trend Toward Alternative Taxes and How They Are (or Must Be?) Apportioned, State Tax Notes (July 3, 2006)
- Apportionment Apoplexy: Throw Back, Throw Out, or Just Throw Up Your Hands, The Tax Executive (July/August 2005)

Representative Recent Speeches

- Nexus Issues for Passthrough Entities, Hartman State & Local Tax Forum (Oct 2015)
- Refund Roadblocks and How to Get Past Them, IPT Sales Tax Symposium (Sept 2015)
- Passthrough Entities, Georgetown Advanced State and Local Tax Institute (Aug 2015)
- East Coast/NJ and NY SALT Update, IPT Annual Meeting (June 2015)
- Why CEOs Should Include SALT in Their Plans – and How You Can Convince Them to Do It, IPT Annual Meeting (June 2015)
- Passthrough Entities, IPT Advanced State Income Tax School (June 2015)
- Taxation of Foreign Affiliates, IPT Advanced State Income Tax School (June 2015)
- Passthrough Entities, COST Income Tax Conference (April 2015)
- Ethical Dilemmas in a Cost-Cutting Environment, ABA-IPT Sales/Income Tax Symposium (Mar 2015)
- New Technologies and Associated Sales Tax Issues, COST Sales Tax Conference (Feb 2015)
- Apportionment Issues, NYU Institute on State and Local Taxation (Dec 2014)
- Multistate Issues for Passthrough Entities, NJSCPA Multistate Tax Conference (Nov 2014)
- Where Passthroughs and Combined Reporting Collide, Hartman State & Local Tax Forum (Oct 2014)
- Avoiding the Family Feud: Intercompany Transactions and Taxes, IPT Sales & Use Tax Symposium (Sept 2014)
- Passthrough Entities, IPT Advanced State Income Tax School (June 2014)
- Tax Planning, IPT Advanced State Income Tax School (June 2014)
- Refund Barriers and How to Jump Them, Telestrategies (May 2014)
- Handling State Tax Controversies, Denver TEI (May 2014)
- The Intersection of Unitary, International and Combined Reporting Issues, ABA/IPT Advanced Income Tax Seminar (April 2014)
- Sales and Use Tax Planning for Complexities of Software and Cloud Transactions, ABA/IPT Advanced Sales Tax Seminar (April 2014)
- Too Many Forks in the Road to Refunds, Council on State Taxation-Sales Tax Seminar (Feb 2014)

Community Service

- Special Needs Advocate for Parents - Past Board Member
- Commissioner, Somerset County Board of Taxation (2006 - 2010)

Recognition

- State Tax Notes – State Tax Spotlight on Margaret C. Wilson, June 1, 2015
- IPT Distinguished Service Award, 2011

ANDERSEN TAX

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Kenneth T. Zemsky
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Kenneth Zemsky specializes in multistate corporate and personal income taxes with a concentration in New York State and New York City tax law. He has over 33 years of experience and primarily works with multistate corporate taxpayers with presence in the tri-state area, high net worth individuals, alternative investment funds and owner- operated businesses.

Ken has served on several boards, including the New York State and New York City Commissioner Tax Advisory Boards, New York State and New York City Tax Appeals Tribunal Advisory Boards, Interstate Tax Press Board of Advisors, as well as Chairman of the State and Local Tax Committee of the New York State Society of CPAs.

Ken also has authored numerous articles that were published in the Journal of Multistate Taxation, State Tax Notes and other industry publications.

He is a frequent speaker and has spoken at several symposia, including the New York University State and Local Tax Institute; Georgetown State and Local Tax Institute; New York State Bar Association Tax Section; and New York State Society of CPAs State Tax Updates.

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- American Institute of CPAs

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State and Local Taxation of International Business (December 19, 2016)

Richard W. Genetelli

The Genetelli Consulting Group

December 19, 2016

If you find this article helpful, you can learn more about the subject by going to www.pli.edu to view the on demand program or segment for which it was written.

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- Intercompany Transactions Remain Front and Center for State Tax Developments, Bloomberg BNA Tax Management Weekly State Tax Report, May 6, 2016
- New York State Tax Appeals Tribunal Furnishes Extensive Unitary Business Analysis in 'SunGard' Reversal, Bloomberg BNA Tax Management Weekly State Tax Report, July 10, 2015
- Inconsistent Decisions Based on Identical Facts Should Concern Companies About Nexus and Nonfiling Exposure, Bloomberg BNA Tax Management Weekly State Tax Report, May 8, 2015
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- New York State Residency Audits: Hot Issues and What Auditors Look for in Determining a Taxpayer's New York Residency Status, Bloomberg BNA Tax Management Weekly State Tax Report, January 18, 2013
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State Section 482-Type Audits

I. GENERAL CONCEPTS

A. The Internal Revenue Service places a great emphasis on transfer pricing as a source of revenue for the federal government.

B. Similarly, many states directly audit intercompany transactions to reattribute income and expenses among related entities.

C. Many states have obtained authority to adjust the pricing of inter-company transactions by enacting statutes or regulations similar to Internal Revenue Code Section 482.

D. Alternative authority to perform, in effect, a federal audit at the state level is derived from the fact that some states that use federal taxable income as the starting point for computing state taxable income presume that the correct measure of the state tax base is income required to be reported to the federal government.

   1. Under such a presumption, the state takes the position that an audit of the federal base is appropriate.

II. PLANNING FOR STATE SECTION 482-TYPE AUDITS

A. Monitor the applicable statutes, regulations, rulings and cases in the various states with respect to section 482 authority.

   1. In certain instances the adjustments proposed by a state have gone beyond the scope of adjustments permitted at the federal level under Internal Revenue Code Section 482.

   2. In other instances a state's proposed adjustments are within the scope of Internal Revenue Code Section 482, but the state grant of authority is not as broad as permitted under the federal statute.

B. Properly prepared taxpayers can successfully contest the validity of a state section 482-type adjustment.

   1. As a preliminary matter each participant in an intercompany transaction must be a separate, viable entity and not simply a shell or paper entity.

      a. Each participant should be established for specific business and legal purposes to support its formation and existence.

b. These business and legal purposes should be documented prior to formation.

2. Furthermore, intercompany transactions must be performed on an arm's-length basis.

   a. Where appropriate and economically feasible appraisals and/or arm's-length pricing studies should be utilized to document and support the pricing of intercompany transactions.

   b. Ideally such appraisals/studies should be undertaken prior to engaging in the transactions to best substantiate the arm's-length conduct of the participants.

   c. In the absence of an appraisal/study a federal closing agreement under Internal Revenue Code Section 482 can substantiate arm's-length pricing, although the states are not generally bound to accept the federal findings.

III. MULTISTATE TAX COMMISSION TRANSFER PRICING INITIATIVE

A. In a coordinated effort to share resources and expertise the states began working with the Multistate Tax Commission a few years ago on developing a design for an arm's-length adjustment service.

B. A stated mission of the Multistate Tax Commission initiative was to provide states with timely, cost-effective services and opportunities for interstate cooperation to help attain equitable compliance from corporate taxpayers with state business taxes in circumstances where improper related-party transactions undermine equity in taxation.

C. The design for the Multistate Tax Commission initiative originally entailed two broad components.

1. The first component involved using advanced economic and technical expertise to produce analyses of taxpayer-provided transfer pricing studies and where appropriate to recommend alternatives to taxpayer positions taken based on those studies.

2. The second component involved enhancing the ability of states to use this expertise and the resulting analyses effectively in addressing cases of income shifting through related-party transactions.

   a. This second component contemplated training state staff, establishing information exchanges, helping states improve their tax administrative and compliance processes, expanding audit coverage for related-party transactions in the Multistate Tax Commission Audit Program, providing assistance to states in developing and resolving cases, and supporting states in defending their work in litigation.

D. Implementation of the Multistate Tax Commission initiative (formerly known as the "Arm's-Length Adjustment Service") was initially targeted for July 1, 2015.

E. States wishing to participate in the Arm's-Length Adjustment Service were asked to make a four-year commitment.

   1. The anticipated budget for the Arm's-Length Adjustment Service over the first four years was approximately $2 million annually or an average of approximately $200,000 per state per year based on ten participating states (actual state costs would vary based on state size and usage of services).

F. In light of an insufficient number of state commitments to the Arm's-Length Adjustment Service (generally based on state concerns over costs in relation to potential monetary benefits) implementation of the Multistate Tax Commission initiative was delayed while state recruitment continued.

G. Alternatives were considered to make the Multistate Tax Commission initiative less resource-intensive in order to move the project forward.

   1. Certain activities were identified for undertaking prior to obtaining sufficient state commitments to formally launch the Multistate Tax Commission initiative including training for state staff, exchanges of taxpayer information, and interstate discussions of pending taxpayer cases involving important arm's-length issues.

H. The name of the Multistate Tax Commission initiative was changed to the "State Intercompany Transactions Advisory Service" in the summer of 2016.

Tax Haven Legislation

I. GENERAL CONCEPTS

A. In the context of forced combination many states have considered adding tax haven company provisions to their combined reporting laws.

B. Tax haven legislation generally requires the inclusion in a combined filing of income from foreign affiliates incorporated or doing business in tax haven jurisdictions.

C. States looking at combining tax haven companies must evaluate:

1. the criteria for determining tax haven jurisdiction status and whether to specifically name tax haven jurisdictions;

2. potential constitutional challenges that may arise; and

3. the risk of loss of business investment and jobs that may ensue.

II. RECENT EXAMPLE IN CONNECTICUT

A. Unitary legislation (effective for income years beginning on or after January 1, 2016) provides that a combined group filing on a water's edge or affiliated group basis must include commonly owned unitary companies incorporated in a tax haven.

B. A tax haven company may be excluded from the combined group if the company can establish that it was incorporated in the tax haven for a legitimate business purpose.

C. The legislation sets forth five factors that define a tax haven, and states that irrespective of the five factors, a tax haven does not include a jurisdiction that has entered into a qualifying comprehensive income tax treaty with the United States.

D. The five factors define a tax haven as a jurisdiction that:

1. has laws or practices that prevent effective exchange of information for tax purposes with other governments on taxpayers benefitting from the tax regime;

2. has a tax regime which lacks transparency;

3. facilitates the establishment of foreign-owned entities without the need for a local substantive presence or prohibits these entities from having any commercial impact on the local economy;

4. explicitly or implicitly excludes the jurisdiction's resident taxpayers from taking advantage of the tax regime benefits or prohibits enterprises that benefit from the regime from operating in the jurisdiction's domestic market; or

5. has created a tax regime which is favorable for tax avoidance, based upon an overall assessment of relevant factors, including whether the jurisdiction has a significant untaxed offshore financial or services sector relative to its overall economy.

E. A requirement that the Connecticut Commissioner of Revenue Services publish a list of jurisdictions considered to be tax havens was eliminated.

Nexus

I. GENERAL CONCEPTS

A. Nexus is the contact necessary to subject an entity to a state's taxing authority.

B. Generally, an entity will have income tax nexus if it has a physical presence in a state (i.e., maintains real or tangible personal property, stores inventory and raw materials, or establishes an office in a state) or performs services in a state.

C. State authority to subject an entity to tax is limited by federal law, principles of the United States Constitution and decisions of the United States Supreme Court.

1. Public Law 86-272.

a. Prevents a state from imposing its income tax on a taxpayer whose only activity within the state is soliciting orders for the sale of tangible personal property provided these orders are sent outside the state for approval and, if approved, are filled and delivered from a stock of goods located outside the state.

b. Applies only to the imposition of state income taxes and to entities that derive their income from the sale of tangible personal property rather than intangible property or services.

c. The states offer varying interpretations of Public Law 86-272 with some states applying the protections to transactions in foreign commerce and others limiting the application to transactions in interstate commerce only.

2. Commerce Clause.

a. Forbids the states to levy taxes that discriminate against interstate commerce or that burden it by subjecting activities to multiple or unfairly apportioned taxation.

b. A state tax must (1) be applied to an activity that has a substantial nexus with the taxing state, (2) be fairly apportioned, (3) not discriminate against interstate commerce, and (4) be fairly related to services provided by the state. Complete Auto Transit, Inc. v. Brady, 430 U.S. 285 (1977).

c. A state tax affecting foreign commerce must also (1) not create multiple international taxation, and (2) not impair federal uniformity in an area where federal uniformity is essential. Japan Line, Ltd. v. County of Los Angeles, 441 U.S. 434 (1979).

3. Due Process Clause.

a. Limits the territorial reach of state taxing powers by requiring some minimum connection between a state and the person, property or transaction that the state seeks to tax, and a rational relationship between the tax and the values connected with the taxing state.

b. Due process is satisfied when (1) a nonresident purposefully avails itself of the benefits of an economic market in a taxing state, (2) the nonresident's contacts with the state are not so minimal that subjecting it to tax would offend traditional notions of fair play and substantial justice, and (3) the tax is related to the benefits that the nonresident receives from access to the state. Quill Corp. v. North Dakota, 504 U.S. 298 (1992).

II. ECONOMIC NEXUS

A. In order to address current business practices and the increasing utilization of electronic commerce, the states are modernizing their nexus requirements and expanding the types of activities that trigger nexus and subject businesses to tax.

B. Based on economic nexus principles, a business can be deemed taxable by a state with only sales taking place in the state and no physical presence there.

   1. For example, New York recently enacted legislation (effective for tax years beginning on or after January 1, 2015) that added an economic nexus standard (i.e., deriving receipts from activity in New York) with a de minimis threshold of $1 million.

   2. In California (effective for tax years beginning on or after January 1, 2011) a taxpayer is doing business in the state if any of the following "factor presence" conditions (adjusted annually for inflation) are satisfied:

      a. Sales of the taxpayer in California (including sales by the taxpayer's agents and independent contractors) exceed the lesser of $500,000 or 25 percent of the taxpayer's total sales;

      b. Real and tangible personal property of the taxpayer in California exceed the lesser of $50,000 or 25 percent of the taxpayer's total real and tangible personal property; or

      c. The amount paid in California by the taxpayer for compensation exceeds the lesser of $50,000 or 25 percent of the total compensation paid by the taxpayer.

C. Economic nexus provisions can potentially have a significant impact on out-of-state entities that generate revenue from services and/or the use of intangibles depending on whether the sales condition is implemented utilizing a market-based approach.

D. If economic nexus subjects a business to tax, other state provisions (including those involving the computation of the apportionment factor and the interplay of economic nexus with Public Law 86-272, effectively connected income and tax treaties) will greatly influence the tax liability.

E. Other theories utilized by the states to subject taxpayers with no physical presence to tax include attributional nexus (attributing the in-state presence of others to the taxpayer) and affiliate nexus (attributing the in-state presence of affiliates to the taxpayer).

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State and Local Taxation (December 22, 2016)

Kenneth T. Zemsky

AndersenTax

December 22, 2016

If you find this article helpful, you can learn more about the subject by going to www.pli.edu to view the on demand program or segment for which it was written.

Kenneth T. Zemsky, "Understanding the New Developments Regarding Combined Filing in New York", Journal of Multistate Taxation and Incentives, Vol. 18, No. 1

Kenneth T. Zemsky and Marji Gordon-Brown, "Executive Privilege as Absolute Curse", 16 Journal of State Taxation 15

Kenneth T. Zemsky and Raymond J. Freda, "Proposed Combined Reporting Regs: The Same old Story?", 66 State Tax Notes 209

And for something a little different, the following novels (available on Amazon or through the author's web site –kennethtzemsky.com)

KNIGHT TO KING 4 (chess greats Bobby Fischer and Gary Kasparov challenge each other in this Cold War-era fictitious match)

THE NATION'S HOPE (a pioneering woman journalist covers the iconoclastic 1965 NYC mayoralty campaign and the birth of modern conservatism)

TO THE CLOSE OF THE AGE (a husband and wife team of scientists invents a time machine and travels to 33 AD to discover if Jesus really rose from the dead)

I. RESIDENCY: DUAL TEST—DOMICILE AND STATUTORY

A. Domicile

1. Domicile is a legal term. Defined as the place of true, fixed home. Requires intent plus presence. *18 Cal. Code of Regs Sec.17017(c)*.
2. May only have one domicile at a time.
3. Domicile change requires abandonment.
4. Rare exceptions do exist.
5. Indicia of domicile.
6. For tax purposes, a days test is often combined with domicile.

B. Statutory

1. Permanent place of abode
2. Also combined with a days test

C. Legal requirement of "day."

1. "Day" defined
2. Exceptions (e.g., Stranahan).
3. Requisite number of days.
4. Risk of multiple taxation.
5. Evidentiary problems.

D. Major cases

1. Hot audit topics
2. Ways to cleanse

E. Division of tax base: apportionment and credit mechanism

F. Nonresident taxation

II. ALLOCATION OF INCOME OF MULTISTATE CORPORATIONS

A. Apportionment of the income of a multi-state taxpayer is necessary to ensure that a state taxes only its fair share of a corporation's income and to avoid multiple taxation.

1. The second prong of the *Complete Auto* four-prong test requires "fair apportionment." *Complete Auto Transit. Inc. v. Brady,* 430 U.S. 274 (1977).

2. There are two components to the "fairness" requirement: under "internal consistency," if the formula were applied by every state, it must result in no more than all of the unitary business's income being subject to tax; and under "external consistency," the factors "must actually reflect a reasonable sense of how income in generated." *Container Corp. of Am. V. Franchise Tax Bd., 463 U.S. 159, 169* (1983).

B. While early state tax apportionment methods were based on the use of a single factor (common property), by the 1930's here was fairly widespread use of the three-factor formula (often called the "Massachusetts formula," based on property, payroll and sales.

1. In 1957, the Uniform Division of Income for Tax Purposes Act ("UDITPA") was adopted, setting forth a uniform three-factor rule. By 1966, only eight states had adopted it. In 1965, The Willis Committee formed by Congress recommended federal legislation to address businesses' concerns about the lack of uniformity among the states. To fend off federal legislation, more states begin adopting UDITPA, in whole or in part, and in 1966-67 the Multistate Tax Compact was created, administered by a Multistate Tax Commission. Today, a majority of states have adopted some variation of the MTC formula, although many states have abandoned the three-factor formula in favor of a single-factor method.

C. Basic rules for sourcing income under UDITPA:

1. Business income is apportioned by the three-factor formula.

2. Nonbusiness income is allocated either to where the income-producing property is located or to the corporation's commercial domicile.

3. UDITPA Section 18 allows deviation from the standard appointment factors when necessary to fairly represent the taxpayer's business activity in the state, and many states have adopted variations of this statue. The taxpayer may require separate accounting, exclusion or inclusion of factors, or "any other method" needed to arrive at an equitable allocation. Generally, the party seeking to depart from the statutory formula bears

the burden of proof. *See, e.g., CarMax Auto Superstores West Coast, Inc. v. S.C. Dep't of Revenue, 725 S.E. 2d 711* (S.C. Ct. APP., Mar. 14, 2012).

a. An alternative apportionment statute has also been deemed to authorize combined reporting. *Media General, Inc. et al v. S.C. Dep't of Revenue,* 694 S.E.2nd 525 (S.C. 2010).

4. Repeated attempts to update UDIPTA have not been successful to date.

D. The sales factor is often the most highly debated and has resulted in most of the litigation in this area.

1. Sales of tangible personal property are generally sourced to the state where the property where the property is delivered to the purchaser.

a. Receipts from sales of capital assets are generally included if they result in business income. Under UDITPA, sales of capital assets are business income if "[t]he acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations." Section 1(a).

b. Rentals of tangible personal property are generally sourced to the location of the property rented. *See, e.g.,* New York Tax Law Section 201(3)(a)(2)(C).

E. Receipts from sales of services traditionally were sourced to a state if the income-producing activity occurred in that state, based on the cost of performance. Some states use an "all or nothing" rule (apportioning no sales to a state unless more than 50% of the income-producing activity occurred in that state, and in that state, and in that case apportioning 100%), and others used a proportional rule to a state. The "income producing activity" can be difficult to determine:

1. In *AT&T Corp. v. Commissioner of Revenue,* 82 Mass. App. Ct. 1106 (Mass. Ct of App. 2012), the appeals court affirmed the decision of the Appellate Tax Board that AT& T's income-producing activity was the provision of a national, integrated telecommunications network, from its headquarters in New Jersey, and not the provision of separate telephone calls that may have originated or terminated in Massachusetts.

2. However, a different result was reached in Oregon, on substantially the same facts and under a similar law. *AT&T Corp.*

and Includible Subsidiaries v. Dep't of Revenue, TC 4814 (Or. Tax Ct. June 28, 2011).

3. Boston Prof'l Hockey Ass'n v. Commissioner of Revenue, 443 Mass. 276 (2005). The court held that the income-producing activity was the operation of the NHL franchise, not the playing of individual home or away game, and focused on the activities conducted at the franchise's Massachusetts headquarters.

F. Many states have adopted "market-based" sourcing for sales of services. See, e.g., Cal. Rev. & Tax Codes § 25136(b); Ill. Camp. State § 5304(a)(3)(C-S)(iv); Wis. Stat. § 71.25(9).

G. Many states have adopted single-factor sales factor formulas, at the behest of local businesses. More than 30 years ago, the Supreme Court found that a single-factor formula was not constitutionally prohibited. *Moorman Mfg.* co. *v. Bair,* 437 U.S. 267 (1978).

H. In *Gillette* Co. *v. Franchise Tx Bd.,* 290 Call. App. 4th (Cal. Ct. App. 2012), *review granted* (Cal. Sup. Ct. Jan 16, 2013), the California Court of Appeals held that the Multistate Tax Company is a valid, binding compact, and that multistate taxpayers are entitled to the option of using either of the Compact's equally weighted three-factor formula, or the state's own alternative apportionment formula, unless and until the state formally withdraws from the Compact. The Michigan Court of Appeals has reached the opposite result. *IBM Corp. v. Dep't of Treasury,* No 306618 (Mich. Ct. App., Nov. 20, 2012), *leave to appeal requested.*

I. Whether income from intangibles (sales of securities, foreign exchange contracts, etc.) should be included in the receipt factor has been the subject of considerable debate, particularly in California. *See, e.g., General Mills v. Franchise Tax Bd.,* 208 Cal. App. 4th 1290 (Cal. Ct. of App., 2012); *Microsoft Corp. v. Franchise Tax Board,* 139 P.3f 1169 (2006); *Appeals of Pacific Telephone and Telegraph* Co., 78-SBE-028 (Cal. State Bd. Of Equal., May 4, 1978). The California statute was amended for tax years beginning January 1, 2011. *Revenue and Taxation Code Section 2512(f)(2).*

J. New York in 2014 amended the law, retaining the single sales factor first enacted in 2007. It retained the sourcing rules for sales and rentals of TPP, gains of sales of property, and royalty/intangible income. Market based sourcing will be applied for all other receipts for which there is not a specific sourcing rule. Major specific sourcing items include: qualified financial instruments (mark to market per IRC sections 475 and 1256, subject to a taxpayer opt out in favor of customer based sourcing); credit card revenues (authorization processing, clearing and settling receipts are sourced to where the customer accesses the processor's network; all other credit card processing receipts are sourced using the average of 8% and the percentage of New York access points); services are sourced to where the benefit of the services was received; digital goods are sourced based on primary use. Note, in a number of areas a hierarchy of sourcing rules is provided.

III. WHEN ARE COMBINED RETURNS ALLOWED OR REQUIRED?

A. Constitutional prerequisites for unitary filing include common ownership and intercompany flow of value (as per Supreme Court in *Container Corp.)*. Depending on the state, the tests vary, but must meet the constitutional minimum.

B. Various iterations of unitary taxation include: California's three unities test. Florida's hybrid formulation (i.e., if parent has nexus to Florida, affiliated group can elect combined filing); worldwide unitary (quasi-elective since the mid-1980's).

C. Tax fiction in combined filing is that the discrete affiliates lose their separate status. *(See Bausch* & *Lomb* case in NY).

D. Unitary taxation can at times be desirables, as where taxpayers wish to import losses to water down territorial income, or where factor dilution is an element of planning.

E. Several significant developments occurred in 2014. One was a matter of case law, and the other was statutory. We begin with the judicial development. In order to appreciate that, some background is in order.

    1. Background of NY historical combined reporting. There was a three part test. The three elements were: ownership, unitary operations and "distortion." The latter term was defined by reference to a substantial intercorporate transactions test or in the alternate a distortion analysis. Thus "distortion" was defined by a rather nebulous concept of "distortion" which understandably generated significant controversy and litigation.

    2. In large part to remove the uncertainty and reduce litigation, in 2007 then Governor Spitzer introduced legislation to amend the unitary methodology. Whereas that matter had by and large

been left to the regulations, now the issue was dealt with more concretely in the law, specifically section 211.4.

3. The amended statute provided that combination was mandatory where the ownership test was met and where there were “significant intercorporate transactions.” The latter term historically defined by a greater-than-50% receipts or expenses test. So-called distortion seemingly was jettisoned by the law change.

4. The Department of Taxation and Finance (DTF) issued two pronouncements (TSBM’s) providing explanatory detail. The two TSBM’s are substantially identical, with the second providing some additional illustrative material and including an intercorporate asset transfer test. While useful as guidance regarding DTF’s interpretation of the law, TSBM’s do not have the weight of regulations. Moreover, taxpayers face a quandary where there were old regulatory and new statutory provisions that agreed in part and diverged in part. This confused state remained for five years.

5. Finally in late 2012 revised regulations were promulgated. In large part they parroted the TSBM approach. Key points include: the inartfully named “10-step analysis”; the asset transfer component of the intercorporate transactions test; the seeming reinstatement of soft distortion; removal of intercorporate allocations from the substantial intercorporate transactions test.

6. Rather than filling in gaps, the revised regulations raised many questions. The provisions dealing with intercorporate allocations and tax motivated transactions in particular are likely to generate significant controversy, thus undercutting much of the reason for the law change in the first place. Coupled with this DTF of late seems to be engaged in an orchestrated effort to de-combined taxpayers, running afoul of the case law DTF fought for over the last two decades as well as much of the new law.

7. Reliance for interpretation of the relevant legal provisions will have to be on the Tax Appeals Tribunal, the highest administrative review body for tax matters in New York. The Tribunal is a three-person panel, though currently there is vacancy. Tribunal decisions mark the end of the administrative review process, at which time recourse can be had to judicial review.

8. The first case decided under the 2007 law was issued by the Tax Appeals Tribunal in 2014. That case, Knowledge Learning Corporation {KLC), resolved that distortion could be proven even in the absence of substantial intercorporate transactions. Moreover, the Tribunal ruled that transfer of employees to an affiliate coupled with charge-backs for services rendered to the transferor corporation qualified as valid expenses/receipts for purposes of the substantial intercorporate transactions test. Third, the Tribunal held that testimonial evidence, in addition to corroborating documentary evidence, was a valid way to prove the fact of the intercompany transactions. This is considered a landmark decision inasmuch as it was the first of its kind and in that it settled the major questions that had existed in the aftermath of the 2007 law change.

9. In 2014, the law was again amended. The revised provision approximates the California tests. Thus if taxpayers are engaged in a "unitary" business and there is greater than 50% ownership or control of capital, combined filing is mandatory~ Moreover, even in the absence of a unitary relationship, combination can be elected by the taxpayers so long as the greater-than-50% ownership test is met. The election is irrevocable for seven years. Banks can be included with non-bank corporations, though certain other types of taxpayers (alien, insurance, etc. corporations) cannot.

10. Given the time lag of the audit cycles, practitioners and taxpayers will have to work with both sets of laws (the 2007 and the 2014 versions) for a considerable period of time.

NOTES

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State and Local Income and Franchise Tax Aspects of Corporate Acquisitions (December 21, 2016)

Peter L. Faber

McDermott Will & Emery LLP

December 21, 2016

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I. INTRODUCTION

A. State and local tax consequences are often ignored, or are addressed too late, in planning corporate acquisitions.

B. Form can be important in determining the state and local tax consequences of an acquisition. In many states, the principle that substance prevails over form is less well developed than it is under federal tax laws.

II. GENERAL CONSIDERATIONS

A. Effect of an acquisition on jurisdiction to tax.

1. If a purchasing corporation (P) that is not subject to a state's taxing jurisdiction buys the assets of a target corporation (T) that is doing business in the state, P will become taxable in the state and the state's apportionment formula may become applicable to P's worldwide operations. See, e.g., Reuters Ltd. v. Tax Appeals Tribunal, 180 A.D.2d 270, 584 N.Y.S.2d 932 (3d Dep't 1992), aff'd, 82 N.Y.2d 112, 603 N.Y.S.2d 795 (1993), cert. denied, 512 U.S. 1235 (1994) (corporation organized in the United Kingdom required to file a New York State corporate franchise tax return reporting its worldwide income); Schlumberger Limited, N.Y.S. Division of Tax Appeals (2000), CCH New York State Tax Reporter ¶ 403-642 (statutory argument to the contrary rejected).

2. If the acquired business is not part of a unitary business conducted by P in the taxing state, P's income cannot constitutionally be subject to the taxing state's apportionment formula even if the statute purports to do so. Central National-Gottesman, Inc. v. Director, Division of Taxation, 14 N.J. Tax 545 (1995), CCH New Jersey State Tax Reporter, ¶ 400-374, aff'd, 291 N.J. Super. 277 (1996), CCH New Jersey State Tax Reporter ¶ 400-455; Movie Service Functions, Inc., N.Y.S. Division of Tax Appeals (1988), CCH New York State Tax Reporter ¶ 252-143; Just Born, Inc., TAT(H) 93-456(GC) (N.Y.C. Tax Appeals Tribunal 1998) CCH New York State Tax Reporter ¶ 600-326; Emigrant Savings Bank, TAT(H) 94-130(BT) (N.Y.C. Administrative Law Judge Division 1997), CCH New York State Tax Reporter ¶ 600-294, rev'd, N.Y.C. Tax Appeals Tribunal (September 18, 1998) (on grounds that taxpayer had

failed to make enough of a showing that there was no unitary business to justify summary judgement), CCH New York State Tax Reporter ¶ 600-345; Siegel-Robert, Inc. v. Johnson, 2009 Tenn. App. LEXIS 722 (Tenn. Ct. App. 2009).

3. Effect on status under Public Law 86-272, 15 U.S.C. § 381(a)(1).

   a. P.L. 86-272, a federal statute, provides generally that a corporation that is engaged in the business of selling goods cannot be subject to a state net income tax if its only business activities within the state consist of the solicitation of orders that are sent outside the state for approval or rejection and, if approved, are filled by shipment or delivery from outside the state.

   b. If P acquires T's assets and T was protected by P.L. 86-272 from being taxed in a state, that protection can be lost if P's activities in the state go beyond solicitation. This problem can be avoided if P buy's T's stock so that T's operations and P's are not combined in the same corporate entity.

B. Effect of an acquisition on combined and consolidated reporting.

1. States ordinarily require corporations to be engaged in a unitary business for them to be permitted or required to file combined or consolidated reports.

2. The injection of a new member into a vertical corporate chain can fill a gap and create a unitary business where none previously existed.

3. In a particular case, it may be argued (by either the taxpayer or the taxing authorities) that unitary status should begin only after a period of time necessary to integrate the operations of the two corporations. Compare, Appeal of Allied Signal Company, Inc., CCH California State Tax Reporter ¶ 401-798 (S.B.E. 1990) (no immediate unitary business), with Appeal of Atlas Hotels, Inc., CCH California State Tax Reporter ¶ 401-014 (S.B.E. 1985, and Appeal of Paradise Systems, Inc., (Ca. S.B.E. 1997, 1997 Cal. Tax LEXIS 125) (unitary status immediately after acquisition). Generally, instant unity will be found only if the companies were engaged in a unitary business before the acquisition.

C. Effect of an acquisition on apportionment and allocation of income.

1. If P acquires T's assets and business, T's assets and business will become P's and will be taken into account in computing P's apportionment factors.

2. If P buys T's stock and not its assets, T's apportionment factor items (i.e., its property, payroll, and sales) will be trapped in T's corporate entity and will not affect P's as long as the two corporations do not file combined or consolidated reports.

III. TAXABLE ACQUISITIONS

A. Treatment of the seller.

1. General principles of gain calculation and recognition.

a. The sale of a business is generally treated as is the sale of any other asset. Gain is recognized unless a specific provision exempts or defers it.

b. Under federal tax law, the sale of a corporate business will be tax-free if the consideration consists substantially of P stock (or stock of P's parent). The technical requirements for tax-free treatment vary depending on the form of the transaction. I.R.C. § 368. Gain will be taxable to the extent of non-stock consideration. I.R.C. §§ 354, 356.

c. Calculation of gain.

(1) The gain on the sale of T's assets or stock is often the same for state and local purposes as it is for federal purposes. Many jurisdictions have no special basis rules and the federal gain is automatically incorporated into the tax base.

(2) Some states have different depreciation rules than the federal rules, sometimes reflecting a conscious decision not to adopt the tax subsidy inherent in the federal accelerated depreciation system. See, e.g., Cal. Rev. & Tax Code § 24349. Typically, these states adjust gain or loss on sale to reflect the different depreciation rules. See, e.g., Tenn. Code Ann. § 67-4-2006(b)(1)(G), (H); Kan. Stat. Ann.

§§ 79-32,117(c)(iii) and 79-32,138(c)(i); Wis. Stat. § 71.26(2)(a).

(3) Another area of possibly nonconforming basis involves the filing of consolidated and combined returns by related corporations.

(a) Corporations linked by 80% or more common ownership with a corporation at the top of the chain may, but cannot be required to, file consolidated federal returns. The typical pattern in the states is for consolidated or combined returns to be allowed only if, in addition to common ownership, the corporations are engaged in a unitary business. Moreover, corporations that are linked by common ownership and that are engaged in a unitary business can be compelled to file combined or consolidated returns against their will. Thus, often corporations that file consolidated federal returns file separate state returns, and vice versa.

(b) Under federal regulations, the basis of a parent in a subsidiary's stock when the corporations file consolidated returns is adjusted for a variety of factors, including the subsidiary's income and loss, distributions, and other items. Regs. § 1.1502-32. The states typically do not have special basis adjustment rules nor do they change federal basis to reflect differences between federal and state filing status. Thus, discontinuities can arise when corporations file consolidated returns in one jurisdiction and separate returns in another and federal basis adjustments (or the lack thereof) are automatically reflected in state basis.

(i) Taxpayers in particular situations may urge the taxing authorities in their states to exercise discretionary powers to adjust basis to reflect the state filing method. See <u>Walsh v. State of New Jersey,</u>

Department of the Treasury, Division of Taxation, 10 N.J. Tax 447 (N.J. Tax Ct. 1989), aff'd per curiam, 240 N.J. Super. 42, 572 A.2d 222 (App. Div. 1990) (shareholders of S corporation not required to use federal basis on sale of their stock where state did not recognize subchapter S and federal basis adjustments would produce an "anomalous result"); Koch v. Director, Division of Taxation, 157 NJ 1, 722 A.2d 918 (1999) (partner need not reduce basis in partnership interest by losses that he could not deduct for New Jersey purposes); The Bank of Baltimore v. State Department of Assessments and Taxation, Maryland Tax Court (1995), CCH Maryland State Tax Reporter ¶ 201-518 (recapture of federal bad debt reserve not taxable by Maryland when bank had not used bad debt reserve method for Maryland tax purposes). One the other hand, the Maryland Court of Appeals in NIHC, Inc. v. Comptroller (2014) did not allow a separately filing subsidiary to recognize gain on a distribution to its parent under I.R.C. section 311(b) because the gain was deferred for federal income tax purposes (the corporations filed consolidated federal income tax returns).

(ii) Some states have insisted on conformity with federal rules absent a specific modification provision. Taxpayer filing California combined returns on a worldwide unitary basis was not allowed to increase the basis of a subsidiary's stock by the subsidiary's undistributed earnings and profits. California had not adopted a statute or regulations comparable to the federal investment adjustment regulations and statute allowing adjustments for items "properly chargeable to capital account" was inapplicable. Appeal of Rapid-American Corporation (SBE 1996), CCH California State Tax Reporter ¶ 402-893, replaced by new opinion (SBE 1997), CCH California State Tax Reporter ¶ 402-934. S corporation shareholders were allowed to use the federal tax basis of their stock even though the S election was not recognized for North Dakota tax purposes in Erdle v. Dorgan, 300 N.W.2d 834 (N.D. 1980). An Alabama case required a taxpayer to reduce the basis of real property for depreciation deducted on his federal tax returns during years in which he did not live in Alabama and did not file Alabama tax returns. Alabama Dep't of Revenue v. Robertson, 733 So.2d 397 (Ala. Civ. App. 1998), cert. denied, 120 S.Ct. 183 (1999). Massachusetts has gone both ways. In one case, a distribution to a parent corporation that did not result in federal tax because it was a "deferred intercompany transaction" under the federal consolidated return regulations did not result in Massachusetts tax even though the parent and subsidiary did not file combined Massachusetts returns. R.J. Reynolds Tobacco Co. v. Commissioner, 21 Mass. App. Tax Bd Rep. 23 (1997). In another case, however, federal income from the recapture of losses from futures contracts that had been deducted for federal but not state purposes was held not taxable by Massachusetts. Weston Marketing Corp. v. Commissioner, 16 Mass. App. Tax Bd Rep. 76 (1994), aff'd, 40 Mass. App. Ct. 1108, 662

N.E.2d 249 (1996). In T.H.E. Investment Corp. v. Commissioner, 8 Mass. App. Tax Bd Rep. 12 (1986), a recaptured federal excess loss account was not taxable because the deductions that created the ELA had not been claimed for Massachusetts purposes. A Connecticut court required a shareholder of an S corporation to reduce the basis of his stock by corporate losses that reduced his federal basis in years in which Connecticut did not have an income tax. Berkley v. Commissioner of Revenue Services (Superior Court 1998), CCH Connecticut State Tax Reporter ¶ 400-288.

(iii) Taxpayers may be able to bring about appropriate basis adjustments by engaging in actual intercorporate transactions that mirror the transactions that are deemed to occur for state tax purposes.

(iv) For a general discussion of departures from federal conformity, see Peter L. Faber, "Logic v. the Statute: When Federal Conformity Makes no Sense," State Tax Notes, March 16, 2015.

2. Sale of assets by T.

a. Federal tax treatment.

(1) T is taxed on any gain and can deduct any loss.

(2) If T is liquidated and T is not a subsidiary of another corporation, T's shareholders are taxed on any gain on the liquidation. I.R.C. § 331. Thus, the same economic gain can be subject to a double tax. If T is a subsidiary of another corporation, T's shareholder is not taxed on the liquidation. I.R.C. § 332.

(3) The shareholder-level gain can be deferred if T is not liquidated and is kept in existence as a holding company that invests the sale proceeds.

b. Recognition of gain or loss.

(1) The recognition of gain or loss for state and local purposes will generally conform to the recognition of gain or loss for federal purposes.

(2) If an asset has a different basis for state and local purposes than it does for federal purposes, the amount of gain may differ and some states require that the federal gain or loss be modified to reflect the difference. See, e.g., Wis. Stat. § 71.26(2)(a).

c. Allocation of sale price among assets.

(1) Allocation of the sale price among different assets can affect the nature of the gain as business or nonbusiness and, hence, can affect each state's share of the gain.

(a) Gains that are treated as business income are apportioned under the normal apportionment methods. UDITPA §§ 1(a) and 9.

(b) Gains and losses from the sale of nonbusiness property are allocated based on the nature of the property. UDITPA § 6.

(i) Gains and losses from the sale of real property are ordinarily allocated to the state in which the property is located.

(ii) Gains and losses from the sale of tangible personal property are ordinarily allocated to the state in which the property is located or, if the corporation is not taxable in that state, to the state of the taxpayer's commercial domicile.

(iii) Gains and losses from the sale of intangible property are ordinarily allocated to the state of the taxpayer's commercial domicile.

(2) The allocation of the sale price for federal tax purposes is subject to the requirements of section 1060 of the Internal Revenue Code.

(a) In general, section 1060 requires the price to be allocated to different classes of assets to the extent of the fair market value of the assets falling within each class. Any excess price is allocated to good will.

(b) Section 1060 applies only if the assets sold comprise a business.

(c) The parties are required to report certain information about the allocation to the Internal Revenue Service.

d. Characterization of income.

(1) The states generally apply two tests (or variations) in determining whether gain on the sale of a corporation's assets is business income or nonbusiness income: the transactional test and the functional test. See Faber, "When does the Sale of Corporate Assets Produce Business Income for State Corporate Franchise Tax Purposes," The Tax Executive (May/June 1995).

(2) The Uniform Division of Income for Tax Purposes Act (UDITPA) defines "business income" as:

> "Income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations." § 1(a).

(3) The transactional test.

(a) Gain is treated as business income if the taxpayer regularly engages in the type of transaction producing the gain.

(b) The sale of an entire business would ordinarily produce nonbusiness income under this test.

(i) See, e.g., Union Carbide Corporation v. Huddleston, 854 S.W.2d 87 (Tenn. 1993) CCH Tennessee State Tax Reporter ¶ 400-332; Federated Stores Realty, Inc. v. Huddleston, 852 S.W.2d 206

(Tenn. 1992), CCH Tennessee State Tax Reporter ¶ 400-296, petition for rehearing denied (May 3, 1993), CCH Tennessee State Tax Reporter ¶ 400-331. (The Tennessee Legislature later amended the statute to adopt the functional test, effective for taxable years ending after July 14, 1993.) Western Natural Gas Co. v. McDonald, 202 Kan. 98, 446 P.2d 781 (1968); McVean & Barlow, Inc. v. New Mexico Bureau of Revenue, 88 N.M. 521, 543 P.2d 489 (1975), cert. den., 89 N.M. 6, 546 P.2d 71 (1975).

(ii) But the sale of a business has been held to produce business income under the transactional test when the taxpayer regularly bought and sold businesses. PPG Industries, Inc. v. Illinois Department of Revenue (Ill. App. Ct. 2002).

(c) Factors considered in applying the transactional test.

(i) Whether sale of the property was the taxpayer's principal business activity. McVean & Barlow, Inc. v. New Mexico Bureau of Revenue, supra.

(ii) Whether sales of similar property were common, even if not the taxpayer's normal business activity. Atlantic Richfield Company v. The State of Colorado, 198 Col. 413, 601 P.2d 628 (1979) (taxpayer often sold entire businesses). See, Welded Tube Co. of America v. Commonwealth of Pennsylvania, 101 Pa. Commw. 32, 515 A.2d 988 (Pa. Commw. 1986) (gain on sale of plant and equipment was business income because a normal incident of business even though only two sales of real estate in 30 years); BP Products North America, Inc. v. Bridges (La. Ct. App. 2011) (gain on sale of oil refinery was apportionable business income, as taxpayer requested, because taxpayer often sold refineries and this was in the ordinary course of its business).

(iii) Frequency of sales. Ross-Araco Corp. v. Commonwealth of Pennsylvania, 165 Pa. Commw. 49, 644 A.2d 235 (Pa. Cmwlth. 1994), aff'd, 544 Pa. 74, 674 A.2d 691 (1996), CCH Pennsylvania State Tax Reporter ¶ 202-651 (sale of undeveloped land by company in the construction business held nonbusiness income).

(iv) Whether sale proceeds are distributed in liquidation and not reinvested in the business. Union Carbide Corporation v. Huddleston, supra.

(v) Whether the sale was prompted by extraordinary circumstances. Phillips Petroleum Company v. Iowa Department of Revenue and Finance, 511 N.W.2d 608 (Ia. 1993); Union Carbide Corporation v. Huddleston, supra (sales incurred to raise money to pay massive tort liabilities and to buy back stock to resist hostile takeover attempt); Kroger Co., Kan. Board of Tax Appeals 1997, CCH Kansas State Tax Reporter ¶ 200-746 (sale of leasehold interests as part of the discontinuance of a business pursuant to a restructuring).

(vi) Size of the transaction. Phillips Petroleum Company v. Iowa Department of Revenue and Finance, supra.

(4) The functional test.

(a) Gain is treated as business income if the assets were used to generate business income, even if their sale is not a regular incident of the business.

(b) The Multistate Tax Commission regulations incorporate a strong presumption in favor of business income. The general definition of business and nonbusiness income provides:

> "[A]ll income which arises from the conduct of trade or business operations of a taxpayer is business income. For purposes of administration of Article IV, the income of the taxpayer is business income unless clearly classifiable as nonbusiness income. . . . In general all transactions and activities of the taxpayer which are dependent upon or contribute to the operations of the taxpayer's economic enterprise as a whole constitute the taxpayer's trade or business and will be transactions and activity arising in the regular course of, and will constitute integral parts of, a trade or a business." § IV.1.(a).

The regulation specifically dealing with gain from the sale of property clearly adopts the functional test:

> "Gain or loss from the sale, exchange or other disposition of real or tangible personal property constitutes business income if the property while owned by the taxpayer was used in the taxpayer's trade or business." § IV.1.(c)(2).

(c) The theory of the functional test is that the second clause of the UDITPA definition contains a separate and independent test. States adopting this interpretation hold that income will be business income if it meets either the transactional or the functional test.

(d) Under this approach, gain from the sale of the assets of a business will ordinarily be treated as business income. Gannett Satellite Information Network Inc. v. Montana Department of Revenue, 348 Mont. 333 (2009); National Realty and Investment Co. v. Department of Revenue, 144 Ill. App.3d 541, 494 N.E.2d 924 (1986); Texaco-Cities Service

Pipeline Company v. Department of Revenue (Cir. Ct. Cook County, Ill. 1995), CCH Illinois State Tax Reporter ¶400-723, aff'd, 286 Ill. App.3d 529, 675 N.E. 2d 1004 (1997), aff'd, 182 Ill.2d 262, 695 N.E.2d 481 (1998), CCH Illinois State Tax Reporter ¶ 400-925 (distinguishing cases applying transactional test because functional test is followed in Illinois); Kroger Co. v. Department of Revenue 284 Ill. App. 3d 473, 673 N.E. 2d 710 (1996), CCH Illinois State Tax Reporter ¶ 400-790; Welded Tube Co. v. Commonwealth, 101 Pa. Commw. 32, 515 A.2d 988 (1986); Pledger v. Getty Oil Exploration Co., 309 Ark. 257, 831 S.W.2d 121 (1992); District of Columbia v. Pierce Associates, Inc., 462 A.2d 1129 (D.C. 1983); L.A.F. Delaware Co. v. Missouri Director of Revenue, CCH Missouri State Tax Reporter ¶ 201-077 (Mo. Admin. Hearing Comm'n 1987) (gain from the sale of all of the assets of a business was business income); Appeal of Triangle Publications, CCH California State Tax Reporter ¶ 400-905 (SBE 1984) (gain from the sale of two divisions and part of a third division was business income); Virginia Department of Taxation Ruling PD 95-60 (gain from sale of former headquarters building leased to former division was business income).

(e) There may be an exception to business income treatment under the functional test for sales in liquidation of a business.

(i) The Pennsylvania Supreme Court has held that gain is nonbusiness income under the functional test when the sale is pursuant to a complete or partial liquidation of a business, even if the assets were used in the business. The Court reasoned that the sale was not an integral part of the business's operations. Laurel

Pipe Line Company v. Commonwealth of Pennsylvania, 537 Pa. 205, 642 A.2d 472 (1994). (In a statement of policy adopted on November 12, 1994, the Pennsylvania tax authorities said that they would interpret Laurel Pipe narrowly. For example, the Department said that it viewed the case as being limited to situations in which the property had not recently been used in the business (the assets in Laurel Pipe Line had been idle for three years) and in which the sale proceeds were distributed to shareholders and were not reinvested in the business. CCH Pennsylvania State Tax Reporter ¶ 14-801.) The Department's reading of Laurel Pipe Line is overly restrictive. Although the assets had been idle before their sale, the Court did not regard that as controlling. It relied on McVean & Barlow, which it said was factually similar and which involved assets that were used in the business until their sale. See, MTC Regs. § IV.1.(c), Ex. (iii) (business income when property was put up for sale when business use ended and sold 18 months later).

(ii) The North Carolina Court of Appeals held in Lenox, Inc. v. Offerman that a sale in liquidation of one of a corporation's operating divisions produced nonbusiness income under the functional test. It said that "when the asset is sold pursuant to a complete or partial liquidation, courts focus on more than whether or not the asset is integral to the corporation's business. Instead, they concentrate on the totality of the circumstances, including the nature of the transaction and how the proceeds are used. In this regard, whether the liquidation results in a complete cessation of the company's involvement in that line of business is particularly relevant." (N.C. Ct. App. 2000) CCH North Carolina State Tax Reporter ¶ 202-116. The decision was affirmed by the North Carolina Supreme Court. Lenox, Inc. v. Tolson, 353 NC. 659, 548 S.E.2d 513 (2001), CCH North Carolina State Tax Reporter ¶ 202-130. The Department of Revenue has announced that it will follow Lenox. Directive No. CD-01-1 (Nov. 20, 2001). See Polaroid Corp. v. Offerman, 349 N.C. 290, 306, 507 S.E.2d 284, 296 (1998), cert. denied, 526 U.S. 1098 (1999). Cf., Union Carbide Corporation v. Offerman, (N.C. Ct. App. 1999) (reversion of pension plan funds nonbusiness income because an extraordinary event and not an integral part of the business (no mention of tax benefit rule)), CCH North Carolina State Tax Reporter ¶ 202-053.

(iii) Other cases holding that a sale in liquidation produces nonbusiness income under the functional test even though the assets were used in the business are Kemppel v. Zaino, Tax Comm'r, 91 Ohio St.3d 420, 746 N.E.2d 1073 (2001); Blessing/White, Inc. v. Zehnder, 329 Ill. App.3d 714, 768 N.E.2d 332 (Ill. App. Ct. 2002); National Holdings, Inc. Zehnder, 369 Ill. App.3d 977 (App. Ct.Ill, 4th Dist. 2007) (after distribution to parent, proceeds contributed to another subsidiary but not reinvested in business). In The Mead Corp. v. Illinois Dept. of Revenue, 371 Ill. App.3d 108 (1st Dist., 4th Div. 2007), cert granted on other grounds (Sep. 25, 2007), the court held that the sale in liquidation of a business produced business income because the sale proceeds were not distributed to the shareholders, distinguishing Blessing/White.

(iv) In rejecting the existence of a functional test, the Supreme Court of Alabama said that even if there were a functional test sales in liquidation of a business would produce nonbusiness income. Uniroyal Tire Co. v. State Department of Revenue, 779 So.2d 227 (Ala. Sup. Ct. 2000). The Court commented that "the Department [of Revenue] has not directed us to *any* case holding that gains realized from a complete liquidation and cessation of business operations produced business income." The court recently reaffirmed this holding. Kimberly-Clark Corp. v. Ala. Dep't of Revenue (Ala. Sup. Ct. 2010).

(v) Some courts have held that there was no liquidation exception to the functional test. Jim Beam Brands Co. v. Franchise Tax Bd., 34 Cal.3d 874 (2005); Crystal Communications, Inc. v. Oregon Dep't of Revenue, 353 Ore. 300, 297 P.3d 1256 (2013); First Data Corp. v. Arizona Department of Revenue, 233 Ariz. 405, 313 P.3d 548 (Az. Ct. App. 2013); Harris Corp. v. Arizona Department of Revenue, 233 Ariz. 377, 313 P.3d 1143 (Az. Ct. App. 2013).

(vi) A Pennsylvania case held that a "liquidation" means the cessation of a substantial business operation. It is not enough that the sale proceeds are distributed to the shareholders. Glatfelter Pulpwood Co. v. Commonwealth, 19 A. 3d 572 (Comm'w Ct. 2011), aff'd on other grounds, 61 A.3d 993 (Pa. Sup. Ct. 2013).

(vii) Will a deemed sale of assets and liquidation under Internal Revenue Code section 338(h)(10) be treated as a sale and actual liquidation, resulting in non-business income? The Pennsylvania Com monwealth Court held that it should in Canteen Corp. v. Commonwealth, 818 A.2d 594 (2003), aff'd, 854 A.2d 440 (Pa.Sup.Ct. 2004). Accord, American States Insurance Company v. Hamer, 352 Ill. App.3d 521, 816 N.E.2d 659 (Ill. App. 2004), leave to appeal den., Ill. Sup. Ct. (January 26, 2005); Nicor v. Illinois Department of Revenue, Ill. App. Ct.,1st Dist (2008); ABB C-E Nuclear Power Inc. v. Missouri Dir. of Rev., 215 S.W.3d. 85 (Mo. 2007); McKesson Water Products Co. v. Director, Division of Taxation, 23 N.J. Tax 449 (N.J. Tax Ct. 2007) (describing the issue under the UDITPA language as being whether the taxpayer's income was "operational"). In a case involving a non-UDITPA statute, the Minnesota Tax Court held that an S corporation's gain in a deemed sale of its assets was investment income and was not apportionable, Nadler v. Commissioner of Revenue, 2006 Minn. Tax LEXIS 12 (Mn. Tax Ct. 2006); contra, Newell Window Furnishing Inc. v. Johnson, 311 S.W.3d 441 (Tenn. Ct. App. 2008).

(A) Nevertheless, a BNA survey reported that many state tax departments take the position that the gain must be business income. The North Carolina Department of Revenue treats the gain as business income even though gain from an actual sale of assets and liquidation would be non-business income. Directive CD-02-3 (2002). The South Carolina Department of Revenue treats the gain as apportionable business income but allows gain on the deemed sale of real estate to be allocated to the situs state except to the extent that it results from depreciation recapture. Revenue Ruling 09-4. (The Massachusetts Appellate Tax Board has held that the gain in a section 338(h)(10) transaction was apportionable, but the Massachusetts statute makes all income apportionable, whether business income or nonbusiness income, so the case is not authority as to the classification of the gain. General Mills, Inc. v. Commissioner, Appellate Tax Board (2001), CCH Massachusetts State Tax Reporter ¶ 400-718), aff'd, 440 Mass. 154, 795 N.E.2d 552 (2003), cert. den., 541 U.S. 973 (2004) (taxpayer's constitutional argument rejected).

(B) In First Data Corp. v. Arizona Department of Revenue, 233 Ariz. 405, 313 P.3d 548 (Az. Ct. App. 2013), the Court held that there was no liquidation exception to the functional test and, hence that gain in a section 338(h)(10) transaction was business income.

(C) In CenturyTel, Inc. v. Dep't of Revenue, the Oregon Tax Court did not acknowledge that there was a liquidation exception to the functional test but it said that if there was it would not apply to the facts before it because the selling parent used the sale proceeds in a business that was unitary with the business conducted by the subsidiary the stock of which was sold. Oregon Tax Ct. 2010. This is the only case that has focused on the use of the sale proceeds by the seller. See Peter L. Faber, "Oregon Court Adds New Test for Nonbusiness Income in Liquidating Sale," State Tax Notes (September 13, 2010).

(f) The Indiana Tax Court has held that gain from the sale of the assets of a division of T that did not amount to a liquidation was not business income because it was not "integral" to T's business. May Department Stores Co. v. Indiana Department of State Revenue (May 7, 2001). The New Jersey Appellate Division held that gain was not "operational income" and, hence, was not apportionable and should be allocated to the taxpayer's commercial domicile. McKesson Water Products Co. v. Division of Taxation, 408 N.J. Super. 213, 974 A.2d 443 (N.J. App. Div. 2009), certif. denied, Nov. 17, 2009). The New Jersey Tax Court distinguished McKesson in Elan Pharmaceuticals, Inc. v. Director, Division of Taxation (N.J. Tax Ct. 2014), holding that gain on the sale of part of the business was operational because the taxpayer sold only part of its pharmaceutical business, kept some rights to use the drug that was sold, and did not distribute the sale proceeds.

(g) The functional test has been applied to a sale of a subsidiary's stock. Indiana Department of Revenue Admin. Decision 94-070

(h) 9 ITC (1996) (sale by gasoline station owner of stock of gasoline producer from which it purchased gasoline).

(i) Is the functional test a valid interpretation of the statute?

(i) Yes.

(A) The UDITPA language is based on prior California case law.

(I) The California cases held that income from property the acquisition, management, and disposition of which was an integral part of the taxpayer's business was business income. Houghton Mifflin Co. (SBOE 1946); International Business Machines Corp. (SBOE 1954); National Cylinder Gas Co. (SBOE 1957).

(II) Applying this test, several cases held that the fact that property was used in the business was sufficient to make gain on its sale business income. See, e.g., American Airlines, Inc. (SBOE 1952) (sale of aircraft); American President Lines, Inc. (SBOE 1961) (sale of charter boat); Velsicol Chemical Corp. (SBOE 1961) (sale of patents, specifically referring to the "acquisition, management, and disposition" standard); Voit Rubber Corp. (SBOE 1964) (sale of all of the assets of a business).

(B) Later cases have cited this background in holding that UDITPA incorporates the functional test. See e.g., Borden, Inc. (CA SBOE 1977); Appeal of Chief Industries, Inc., 255 Kan. 640, 875 P.2d 278 (1994) (dissent).

(ii) No.

(A) The argument against the functional test is based on a literal reading of the statutory language.

(I) The use of the word "and" before the word "disposition" indicates that the disposition of the property and not just its use must be an integral part of the taxpayer's business.

(II) See the analysis of the court in General Care Corporation v. Olsen, 705 S. W.2d 642 (Tenn. 1986); The Kroger Co. v. Department of Revenue (Cir. Ct. Cook County, Ill. 1995), CCH Illinois State Tax Reporter ¶400-716. See, also, Western Natural Gas Co. v. McDonald, supra; McVean & Barlow, Inc. v. New Mexico Bureau of Revenue, supra; Appeal of Chief Industries, Inc., 255

Kan. 640, 875 P.2d 278 (1994).

(B) Opponents of the functional test concede the presence of the legislative history in California and often concede that the functional test is appropriate from a tax policy standpoint, but they argue that these considerations must yield to the clear language of the statute. See Uniroyal Tire Company v. State Department of Revenue, 779 So.2d 227 (Ala. Sup. Ct. 2000), CCH Alabama State Tax Reporter ¶ 200-786 (functional test supported by tax policy but not by statutory language, citing Faber, supra, at III.A.4.d(1)). The court recently reaffirmed this holding. Kimberly-Clark Corp. v. Ala. Dep't of Revenue (Ala. Sup. Ct. 2010).

(C) An argument can be made that even if there is a separate functional test the statutory language requires that a sale of property produces nonbusiness income unless the property's disposition is an integral part of the seller's regular business operations.

(j) Some states have adopted statutory language that clearly incorporates the functional test (by replacing the word "and" before "disposition" with the word "or"). See, e.g., Ala. Code § 40-27-1.1; Idaho Code § 63-3027(a)(1); Tenn. Code Ann. §67-4-2004(3) (see Blue Bell Creameries LP v. Roberts, _____ Tenn. _____ (2011), applying the functional test under the revised statute to find gain from a stock redemption to be business income); N.C.

Gen. Stat. § 105-130.4(e); Kan. Stat. Ann § 79-3271(a) (taxpayer may elect the application of the functional test); Ia. Code § 422.32.2 (business income includes gain from the sale of property that is "operationally related" to the taxpayer's business); N.M. Stat. Ann. § 7-4-2(A) (business income includes income from the "disposition or liquidation of a business or segment of a business").

(k) Some states have attempted to avoid the controversy by repealing the UDITPA definition.

(i) In some states, all income that can be apportioned under the Constitution is business income. See, e.g., 72 Pa. Cons. Stat. § 7401 (3)(2)(a)(1)(A).

(ii) In Minnesota, only income "not derived from the conduct of a trade or business" may be allocated and not apportioned. Minn. Stat. § 290.17.

(5) The Oregon Tax Court has held that a taxpayer that treated a gain as business income in another state was not barred from arguing that the gain was nonbusiness income under Oregon law despite a similarity in statutory language. Oracle Corp. v. Dep't of Revenue (Ore.Tax Ct. 2010).

(6) The U.S. Supreme Court in MeadWestvaco Corp. v. Illinois Department of Revenue, 553 U.S. 16 (2008), made clear that under the Constitution an asset must be part of a unitary business being conducted in a state for gain or loss on its sale to be apportionable.

(7) The North Carolina Department of Revenue's Office of Administrative Hearings held that gain on the sale of a limited partnership interest was not apportionable because the taxpayer was a passive investor in the partnership and was not unitary with it, even though the partnership was closely held and operated a series of related businesses. The fact that the taxpayer had reported income

from the partnership as apportionable business income was irrelevant. Final Agency Decision No. 09 REV 5669 (2011).

e. Gain from the sale of out-of-state real property may be separately accounted for if including it in the apportionment formula would distort income. See People ex rel. Sheraton Buildings, Inc. v. New York State Tax Commission, 15 A.D.2d 142 (3d Dep't 1961) aff'd without opinion (1963) (separate accounting allowed); British Land (Maryland), Inc. v. Tax Appeals Tribunal, 85 N.Y.2d 139 (1995), reversing 202 A.D.2d 867 (3d Dep't 1994), CCH New York State Tax Reporter ¶ 401-456 (separate accounting allowed where income would have been distorted and appreciation occurred before taxpayer was doing business in New York, despite presence of unitary business).

f. Depreciation recapture was held to be apportionable even though capital gain would be allocable to the state where sold property was located in CNA Holdings, Inc. v. Delaware Director of Revenue (Del. Sup. Ct., New Castle County, 2002).

g. Liquidation of T.

(1) If T distributes assets in kind to its shareholders, it will be treated as if it sold them to its shareholders for their fair market values. Gain (and perhaps loss) will be recognized unless T is an 80% or more subsidiary of another corporation. I.R.C. §§ 336, 337.

(2) T's gain on the distribution of appreciated assets will ordinarily be treated as business or nonbusiness income under whichever of the functional or the transactional test as is normally applied in the taxing state.

(3) If a T shareholder receiving a distribution in liquidation of T is a corporation, its gain or loss will be classified as business or nonbusiness as if it had sold its T stock.

h. If T's assets are sold in an installment sale with the price (and gain) being spread over a period of years, a question arises as to what year's apportionment factors are used in apportioning business gain. See Tenneco West, Inc. v. Franchise Tax Board, 234 Cal. App. 3d 1510 (1991) (factors for the year of the sale are used, rather than for the year in which payment is received, on the theory that this more accurately reflects the activities that produced the income).

3. Sale of subsidiary stock.

a. Federal tax treatment.

(1) The sale of stock of a subsidiary is ordinarily taxable as is the sale of any other asset.

(2) The parent's gain or loss is ordinarily capital.

(3) The basis of the subsidiary's assets does not change unless a special election is made. I.R.C. § 338.

b. State taxation of gain or loss.

(1) Ordinarily, gain from the sale of a subsidiary's stock is taxable, mirroring the federal treatment.

(2) The use of an intermediate holding company in another state may not divert gain from the parent. See, e.g., Trans-Lux Corp. v. Meehan, 43 Conn. Sup. 314, 652 A.2d 539 (Ct. Super. Ct. 1993), CCH Connecticut State Tax Reporter ¶ 400-056, in which an intermediate holding company's gain on the sale of its subsidiaries' stock was allocated to its parent in order clearly to reflect income despite uncontroverted evidence that the holding company was formed and held the subsidiaries' stock for non-tax business purposes.

c. Apportionment or allocation of gain.

(1) The characterization of the parent's gain or loss as business or nonbusiness income can be important. Business income is typically apportioned among the states in which the taxpayer does business, usually based on the relative amounts of the taxpayer's property, payroll, and sales in each state.

Nonbusiness income is usually allocated entirely to the state of the taxpayer's commercial domicile.

(2) The Uniform Division of Income for Tax Purposes Act (UDITPA) defines business income to include income from intangible property (presumably including gains from the sale of subsidiary stock) "if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations." UDITPA § 1(a).

(3) Gain from the sale of a subsidiary's stock will be business income if the subsidiary and the selling parent were engaged in a unitary business. See, e.g., Allied-Signal, Inc. v. Director, Div. of Taxation, 504 U.S. 768 (1992); Dep't of Revenue v. Tate & Lyle Ingredients Americas Inc. (Montgomery County, Alabama, Cir. Ct. 2009).

(4) The Supreme Court has held that income from a subsidiary that is not engaged in a unitary business with the parent cannot constitutionally be treated as business income subject to apportionment under the Due Process Clause. ASARCO, Inc. v. Idaho State Tax Commission, 458 U.S. 307 (1982); F.W. Woolworth Co. v Taxation and Revenue Department, 458 U.S. 354 (1982). The Court reaffirmed this principle, after specifically requesting argument on the point, in Allied-Signal, Inc. v. Director, Division of Taxation, 504 U.S. 768 (1992).

  (a) Cases holding that gain on the sale of a corporation's stock was apportionable business income because of the presence of a unitary relationship include Super Valu Stores, Inc. v. Iowa Dep't of Revenue and Finance, 479 N.W. 2d 255 (La. 1991) cert. den., 505 U.S. 1213 (1992); Borden, Inc. v. Illinois Dep't of Revenue, 295 Ill. App. 3d 1001, 692 N.E. 2d 1335 (1998).

  (b) Cases holding that gain on the sale of a subsidiary's stock was not apportionable business income because of the lack of a unitary relationship include In re Appeal of VSI Corporation (Calif. SBE 1991); In re Hercules, Inc. (Kansas Bd. Tax App. 2000).

(c) The California Franchise Tax Board has ruled that the mere intent when stock is acquired to establish a unitary or business relationship later does not make the stock a business asset if it is sold before the unitary relationship is established. Legal Ruling No. 2012-01.

(5) The Supreme Court in Allied-Signal did, however, state that income from the sale of stock could be treated as business income if it served an "operational" rather than an investment function.

(a) Income from the sale of stock of a 20%-owned corporation was business income under this exception where the seller acquired and later sold stock of a corporation that did contract manufacturing for it in a new market area. CTS Keene, Inc. (SBE 1993), CCH California State Tax Reporter ¶ 402-589, petition for rehearing denied, June 23, 1993.

(b) Stock of a 50%-owned corporation was not an operational asset even though the taxpayer provided services to the corporation and purchased goods from it. Hercules, Inc. v. Comptroller of the Treasury, Maryland Tax Court (1995), CCH Maryland State Tax Reporter ¶ 201-521, aff'd, 351 Md 101, 716 A.2d 276 (1998); Hercules, Inc. v. Commissioner of Revenue, 575 N.W.2d 111 (Mn. 1998), CCH Minnesota State Tax Reporter ¶ 202-792, rev'g decision of Minnesota Tax Court, CCH Minnesota State Tax Reporter ¶ 202-716 (1997); Appeal of Hercules, Inc., Kans. Bd. of Tax App. (1999). CCH Kansas State Tax Reporter ¶ 200-841, aff'd on reconsideration (2000), CCH Kansas State Tax Reporter ¶ 200-842; Hercules, Inc. v. Illinois Department of Revenue (Ill. App. Ct., 1st Dist. 2001), CCH Illinois State Tax Reporter ¶ 401-273.

(c) In MeadWestvaco Corp. v. Illinois Department of Revenue, 553 U.S. 16 (2008), the Supreme Court explained that the operational function reference in Allied Signal was not intended to add an additional ground for apportionability. It only meant that an asset that served an operational function could be part of a taxpayer's unitary business even if there was no unitary relationship between the payor and the payee.

(6) In Oracle Corp. v. Dep't of Rev., the Oregon Tax Court held that the DOR could not exclude gain on the sale of stock from the denominator of the receipts fraction. The gain was business income and was incurred in the regular course of Oracle's business. (Ore. Tax Ct, 2012)..

d. Basis of target assets.

(1) Ordinarily, the basis of T's assets does not change when its stock is sold.

(2) Under federal law, an election to change the basis of T's assets to reflect the purchase price of its stock is available under certain circumstances. I.R.C. § 338.

(a) General requirements of section 338.

(i) The buyer must be a corporation.

(ii) P must acquire at least 80% of T's stock.

(iii) The acquisition of T's stock must be in a taxable transaction.

(b) The general pattern of a section 338 transaction is that T is treated as if it sold its assets to itself. The assets get a new basis but T must recognize gain. Since the T shareholders also recognize gain on the sale of their stock, the double tax generally makes section 338 unattractive unless T has net operating losses that can shelter the gain.

(c) If T is a subsidiary of another corporation or is an S corporation, section 338(h)(10) of the Code offers a viable alternative.

(i) If both P and T's parent (or shareholders, if T is an S corporation) elect, the transaction is treated as if T sold its assets in a taxable transaction and liquidated into its parent tax-free under section 332 of the Code. The sale of T stock by its parent is ignored for tax purposes.

(ii) Under section 338(h)(10), only a single tax is imposed, on the deemed sale by T of its assets.

(iii) T's tax attributes, including net operating loss carryovers, pass to T's selling parent.

(d) The states have taken different approaches to section 338(h)(10).

(i) New York State now respects the section 338(h)(10) construct, although it has not formally announced its position. Advisory Opinion TSB-A-99(22)C. Under its prior approach, T had to file two reports: one for the short year ending with and including the day on which the deemed sale occurs, and one for the rest of the year. The gain was included in the selling parent's combined report with T if combined reports were filed. The sale of T stock by the parent was not ignored, but it was ordinarily not taxed because gains from the sale of subsidiary stock are not taxable in New York. TSB-M-91 (4)(C) (April 17, 1991); Regs. §§ 3-2.2, 6-2.7, 18-2.2, 21-2.7. New York City took the same position.

Ruling No. X-2-006-001 (September 24, 1990) (the City has not announced a change in its position to conform to the new State approach). If T is an S corporation, however, New York has followed the federal characterization of a section 338(h)(10) transaction and the sale of T stock by its shareholders is ignored. Advisory Opinion TSB-A-97 (2)I.

(ii) However, the New York State Tax Appeals Tribunal has held that section 338(h)(10) does not apply to a sale of an S corporation's stock, relying on a statute that provides that an S corporation's income is calculated as if it were a C corporation (a C corporation owned by individuals could not be sold in a 338(h)(10) transaction). Petition of Baum, N.Y.S. Tax Appeals Tribunal (2009). The Georgia Supreme Court held that a federal section 338(h)(10) election with respect to an S corporation was ineffective for Georgia tax purposes because Georgia law recognized only elections made by corporations and the election before it was made by the S corporation's individual shareholders. Trawick Construction Co., Inc. v. Dep't of Revenue, 690 S.E.2d 601 (Ga. Sup. Ct. 2010). In contrast, the Alabama Court of Appeals held that a nonresident S corporation shareholder was taxable on his share of the corporation's gain on the deemed sale of its assets, rejecting the taxpayer's constitutional arguments. Prince v. Dep't of Revenue, Docket 2080634 (Ala. Ct. App. 2010).

(iii) California allows the corporations to elect section 338(h)(10) treatment or not, regardless of whether they have elected section 338(h)(10) treatment for federal purposes, if T is a subsidiary of another corporation. Cal. Rev. & Tax. Code § 23051.5(e). FTB Chief Counsel Ruling C1-88-254 (November 15, 1988); FTB Information Letter (October 28, 2003). The choice may depend on the relative bases of T in its assets and of T's parent in T's stock and whether it would be preferable to have the gain treated as business or nonbusiness income. If T is an S corporation, the parties do not have a choice. The federal election (or lack of one) controls. Cal. Rev. & Tax. Code § 23806.

Wisconsin also gives taxpayers a choice, regardless of whether a section 338(h)(10) election is made for federal tax purposes.

(iv) Some states automatically accept the section 338(h)(10) election if it is made for federal purposes. See, e.g., Arizona Corporate Tax Ruling CTR 98-2, CCH Arizona State Tax Reporter ¶ 300-269 (1998) (noting that normal rules for determining business or nonbusiness character of gain apply); Ga. Code § 48-7-21(b)(7)(containing special rules for S corporations); Michigan, Revenue Administrative Bulletin 1994-12, CCH Michigan State Tax Reporter ¶ 319-253; Virginia, Ruling of Commissioner P.D. 91-317 (1991), reported at CCH Virginia State Tax Reporter ¶ 202-115; West Virginia Department of Taxation and Revenue, Technical Assistance

Advisory 95-003; Illinois Private Letter Rulings 89-0306 and 89-0222.

(v) New Jersey recognizes section 338(h)(10) with respect to sales of stock of corporate subsidiaries occurring after January 13, 1992. New Jersey State Tax News, Summer 1995. N.J. Admin. Code §§ 18:7-5.8. See also letter ruling of July 10, 1995, in which section 338(h)(10) was held to be available with respect to the sale of an S corporation. Before then, the Division of Taxation did not allow section 338(h)(10) treatment, thus imposing a double tax as if a regular section 338 election had been made. See, e.g., prior N.J. Regs. §§ 18:7-11.12, 18:7-11.15, 18:7-12.1, and 18:7-12.3; General Building Products Corp. v. State of New Jersey, Division of Taxation, 14 N.J. Tax 232 (N.J. Tax Court (1994)), CCH New Jersey State Tax Reporter ¶ 400-320, aff'd, 15 N.J. Tax 213 (N.J. Sup. Ct. App. Div. 1995), CCH New Jersey State Tax Reporter ¶ 400-390 (taxpayer's argument that it should not be bound by its regular section 338 election because of the unavailability of section 338(h)(10) rejected). With respect to S corporations, the New Jersey courts have rejected the section 338(h)(10) fiction and have treated the transaction as a sale of stock by the shareholders. Miller v. State of New Jersey, Division of Taxation, 352 N.J. Super. 98, 799 A.2d 660 (N.J. Sup. Ct. App. Div. 2002); Mandelbaum v. State of New Jersey, Division of Taxation, 20 N.J. Tax 141 (N.J. Tax Court (2002)).

(vi) Some states do not recognize section 338 (h)(10). See, e.g., Or. Admin. R. § 150-317.329(5) (if T and its parent are not engaged in a unitary business or do not file a consolidated Oregon return).

(e) Even if a state purports to recognize section 338(h)(10), if it does not allow the selling parent and T to file combined reports the tax liability with respect to the deemed sale will be T's and the burden will pass to P unless the parent agrees by contract to assume it. See Illinois Dep't of Revenue Letter Ruling IT-89-306 (1989), CCH Illinois State Tax Reporter ¶ 11-101.40; Newell Window Furnishing, Inc. v. Johnson, 311 S.W.3d 441 (Tenn. Ct. App. 2008). This is particularly a problem in states that do not permit combined reports under any circumstances.

(f) If the buyer does not want some of the target's assets, the target may distribute them to its selling parent before the sale of the target's stock. The actual distribution of assets is treated as part of a liquidation for federal income tax purposes. Temp. Regs. § 1.338(h)(10)-IT(e), Example (2). It is likely that the states will take the same position. See, e.g., New York State Advisory Opinion TSB-A-02(1)(C) (April 2, 2002); Virginia Ruling P.D. 01-192 (November 30, 2001); Illinois Priv. Ltr. Rul. IT 94-0012 (March 9, 1994). We have obtained unpublished private letter rulings from the tax authorities in a number of states to the same effect.

(g) In one Illinois case, T was required to increase its paid-in capital for purposes of the capital-based franchise tax by the amount of the increase in tax basis. E&E Hauling, Inc. v. Ryan, 306 Ill. App.3d 131, 731 N.E.2d 178 (Ill. App. Ct., 1st Dist., 4th Div. (1999)).

(h) Are the proceeds of the deemed sale included in the receipts factor of the apportionment formula?

(i) A section 338(h)(10) transaction is an extraordinary event and arguably should be excluded from the receipts factor. See MTC Regs. § IV.18(c)(1) (receipts factor does not include "substantial amounts of gross receipts…from an incidental or occasional sale of a fixed asset used in the regular course of a taxpayer's trade or business")

(ii) The California Franchise Tax Board discussed apportionment issues generally in Legal Ruling No. 2006-03. The deemed sale receipts will be excluded if they are "substantial."

(iii) The resolution of the question may depend on the extent to which the gain on the deemed sale is considered distortive. Compare Florida Department of Revenue Technical Assistance Advisements 97(C)1-007 (1997) (receipts excluded) and 00(C)1-012 (2000) (receipts not excluded).

(iv) The Connecticut Department of Revenue Services has ruled that the income is T's, arising from a sale of assets, and that the income is included in T's receipts factor. Ruling No. 2003-3 (July 14, 2003), CCH Connecticut State Tax Reporter ¶400-838.

(v) The income is included in the receipts factor in New Jersey. Regulations sections 18:7-8.10 and 8.12.

(vi) The Massachusetts Appellate Tax Board has held that the sale proceeds were not included in the receipts factor because the transaction was actually a sale of stock and the statute specifically excluded receipts from sales of securities. Combustion Engineering, Inc. v. Commissioner, Appellate Tax Board (2000), CCH Massachusetts State Tax Reporter ¶ 400-612; General Mills, Inc. v. Commissioner, Appellate Tax Board (2001), CCH Massachusetts State Tax Reporter ¶ 400-718, aff'd, 440 Mass. 154, 795 N.E.2d 552 (2003), cert. den., 541 U.S. 973 (2004).

(i) The Ohio Department of Taxation takes the position that T keeps its net operating losses and other tax attributes (even though they pass to its selling parent for federal income tax purposes). Information Release CFT 2004-02 (2004); unpublished letter to the writer dated April 4, 2001.

(j) The New York State Department of Taxation and Finance Counsel has opined that T should not be treated as a new corporation for purposes of a credit that was intended to encourage new businesses. TSB-M-03(1)C (January 28, 2003).

(k) The New York State Tax Appeals Tribunal has held that T's investment tax credits are recaptured. AIL Systems (2006).

(l) A nonresident shareholder was taxed on his gain from an S corporation's section 338 (h)(10) transaction. He elected to treat the sale as being of the corporation's assets and not as a sale of intangible property (i.e., his stock). General Accessory Mfg. Co. v. Oklahoma Tax Commission, 122 P.3d 476 (Ok. Civ. App. 2005); Accord, Nadler v. Commissioner of Revenue, 2006 Minn. Tax LEXUS 12 (Mn. Tax Ct. 2006).

(3) Significance of basis for state and local purposes.

(a) Calculation of gain on later sale of assets.

(b) Depreciation.

(c) Apportionment of income if property factor is based on income tax basis.

4. Sale of T stock by individual shareholders.

a. Selling T shareholders are generally taxed on any gain by their state of residence.

b. Shareholders contemplating a sale of their stock may move to a state with lower tax rates before the sale. A change in domicile must be genuine to be respected for tax purposes and there is a strong presumption against a change of domicile. See, e.g., N.Y. Tax Law § 689(e). In the Matter of Newcomb, 192 N.Y. 238 (1908).

c. Selling stock in an installment sale and then moving to a low-tax state will ordinarily not shift the incidence of taxation. Appeal of Gordon (SBE 1983), CCH California State Tax Reporter ¶ 400-631; N.Y. Tax Law § 639 (gain accelerated into last resident return).

d. Giving stock to a relative before the sale will transfer the gain to the donee, but not if the gift is made after the sale has been negotiated and not if the donor retains control of the stock and the sale proceeds. David M. Siegel, N.Y.S. Div. of Tax App., DTA 823107 (2011).

e. Nonresident shareholders of an Oklahoma S corporation were taxable on their shares of the corporation's gain on the deemed sale of its assets in a §338(h)(10) transaction in General Accessory Mfg. Co. v. Oklahoma Tax Comm., 122 P.3d 476 (OK.Civ.App. 2005). The court rejected the argument that the transaction was a stock sale that was not taxable to nonresidents.

B. Treatment of the buyer.

1. Basis of purchased assets.

a. Allocation of purchase price.

(1) P will generally want to allocate as much of the price as possible to assets that produce an early tax benefit (e.g., inventory, short-lived depreciable property).

(2) If T has separate businesses that are not part of a unitary business, P will want to allocate as much of the price as possible to depreciable assets of the business that is conducted in high-tax states.

(3) The allocation of purchase price can affect the property factor of the apportionment formula.

(4) See III.A.4.c.(2) for a discussion of allocation principles.

b. Election to adjust the basis of T's assets when P buys T's stock.

(1) For a discussion of the requirements for P to make a section 338 election, see III.A.2.d.

(2) The states generally respect an election to adjust basis under section 338. This is true even for states that, in taxing the seller side of the transaction, do not conform to the federal treatment of a section 338(h)(10) election.

(3) The allocation of basis under section 338 generally is similar to the allocation of basis in an asset purchase under I.R.C. section 1060.

2. Purchase of intangible assets.

a. The buyer should consider forming a separate subsidiary ("passive holding company," or "PHC") to purchase T's intangible assets and license them to the operating corporations that will use them. A separate purchase of the T intangibles by an unrelated buyer is more likely to withstand scrutiny than is a sale-licenseback after the acquisition.

b. If the corporation's operations are conducted in a jurisdiction that does not impose tax on income from owning intangible assets (such as Delaware or Nevada) or in a state that would effectively tax the corporation's income through unitary combined reporting, significant state and local tax savings can result. The operating companies can deduct royalties paid to the PHC in the states in which they do business to the extent that those states do not require unitary combined reporting. The tax economics are affected by the extent to which the cost of the intangibles can be recovered by depreciation deductions under I.R.C. section 197.

c. A PHC should have substance to be respected for business and tax purposes. See, Faber, "Planning for the Use of Intangibles Holding Companies," State Tax Notes (June 15, 1998).

3. Deduction of interest.

a. Interest is generally deductible by corporations.

b. Express limits on deduction of interest.

(1) Federal limits.

(a) Under I.R.C. § 279, interest in excess of $5,000,000 is not deductible if it is incurred to acquire another corporation, the debt has certain equity-type features, and the borrower is highly-leveraged.

(b) Under I.R.C. § 163(e)(5), original issue discount on certain high yield obligations is not deductible and, to some extent, may be treated as equity.

(c) Under I.R.C. § 163(j), interest paid to tax-exempt or nontaxable related parties (e.g., a foreign parent that is subject to a reduced tax on interest income under a tax treaty) by certain highly-leveraged taxpayers is not deductible.

(2) New York limits the deduction of interest when a corporate acquisition is made by a corporation whose leverage is significantly increased, even if the acquisition itself is not financed by debt. See Faber, "New York State Antitakeover Bill: First Step Down a Rocky Road," Tax Notes (June 5, 1989). N.Y. Tax Law § 208.9(b)(6-a). Repealed for New York State but not for New York City, effective January 1, 2000.

c. Limitations on deducting interest attributable to subsidiaries.

(1) Many states exempt from tax all or part of dividends from subsidiaries. See, e.g., Ala. Code § 40-18-35(a)(7), (b)(8) (dividends from 20%-owned subsidiaries excluded); Ark. Code Ann. § 26-51-404(b)(8) (dividends from 80%-owned subsidiaries excluded); Ky. Rev. Stat. Ann. § 141.010(12)(b) (all dividends excluded); N.J. Stat. Ann. § 54:10A-4(k)(5) (100% of dividends from 80%-owned corporations excluded and 50% of dividends from 50%-owned corporations excluded); Tenn. Code Ann. § 67-4-2006(b)(2)(A) (80% deduction for dividends from 80%-owned subsidiaries); Va. Code Ann. § 58.1-402(C)(10) (dividends from 50%-owned subsidiaries excluded); Wis. Stat. § 71.26(3)(j) (dividends from 70%-owned subsidiaries excluded).

(a) Some of these states do not expressly disallow expenses relating to subsidiary stock, presumably indicating that they are deductible. See, e.g., the Laws of Alabama, Arkansas, New Jersey and Virginia. In Tennessee, an attempt by the tax authorities to disallow expenses relating to tax-exempt dividends from subsidiaries was rejected because of the lack of statutory authority for such a position. Kellogg Co. v. Olsen, 675 S.W.2d 707 (Tenn. 1984); see, also, Director of Revenue v. First Federal Savings & Loan Association of New Castle County, Delaware Superior Court (1972), cited at CCH Multistate Corporate Income Tax Guide ¶ 338.46.

(b) Other states expressly disallow expenses relating to the production of tax-free income, including exempt dividends from subsidiaries. See, e.g., Ky. Rev. Stat. Ann. § 141.010(13)(d); Wis. Stat. §§ 71.26(2)(a), 71.26(3)(l). If a corporation does not borrow expressly for the purpose of buying a subsidiary's stock but has loans outstanding at a time that it makes an acquisition for cash, the tax authorities may allocate part of its debt to the acquisition on the theory that the debt should be allocated among all of its assets. See, e.g., Kentucky Revenue Policy 41P150, cited at CCH Kentucky State Tax Reporter ¶ 16-024. This can present a major problem for holding companies.

d. Interest deductions will be disallowed if the debt is reclassified as equity.

4. New York State investment income designation.

a. Under legislation effective January 1, 2015, a corporation's investment in corporate stock will not produce tax-exempt investment income unless the corporation identifies the stock as being held for investment on the day of purchase in a manner similar to Internal Revenue Code section 1236. N.Y.S. Tax Law §208.5.

b. If a corporation's stock is purchased in an I.R.C. section 338 (h)(10) transaction, it is treated as a new corporation for most income tax purposes. If such a corporation has previously made an identification under this provision, it is not clear whether it is treated as a new corporation that must make a new identification. It is also unclear whether the surviving corporation in a merger must make a new identification with respect to stocks that had been owned by the merged corporation and had been identified by it as having been held for investment.

IV. TAX-FREE REORGANIZATIONS

A. Under federal law, the acquisition of a corporate business can be made on a tax-free basis if the consideration largely consists of stock of the buyer or its parent. The technical requirements for tax-free treatment, including the extent to which nonstock consideration is permitted, vary depending on the form of the transaction. I.R.C. § 368.

B. State rules on tax-free reorganizations.

1. The states have generally not tried to define tax-free reorganizations, relying on their general conformity provisions to provide parity. See, e.g., Florida Department of Revenue, Technical Assistance Advisement No. 94(C)1-005, CCH Florida State Tax Reporter ¶ 202-737.

2. Alabama specifically incorporates the federal reorganization provisions by reference. Ala. Code § 40-18-8. California incorporates by a general reference those Internal Revenue Code provisions that deal with relations between corporations and shareholders without referring to Code sections. Cal. Rev. & Tax Code § 17321.

3. State tax attributes may pass to the acquiring corporation in a reorganization even if they are not referred to in I.R.C. § 381. See, e.g., International Paper Company v. Broadhead, 662 So.2d 277 (Ala. Civ. App. 1995) (credit for foreign corporations doing business in state).

4. Liabilities of a merged corporation were held to be not deductible by the surviving corporation when they related to non-City activities. Canadian Imperial Holdings, Inc., TAT (H) 98-48 (BT) (N.Y.C. Tax App. Trib., A.L.J. Div. 2002).

5. The liquidation and merger of a subsidiary into its parent was held not to be a "disposition" that would trigger recapture of the Massachusetts investment tax credit in Comm'r of Revenue v. Gillette Co., 454 Mass. 72 (2009).

V. SPINOFFS

A. A spinoff that is tax-free under section 355 of the Internal Revenue Code will generally be tax-free for state and local income tax purposes. Mississippi, while exempting the shareholders from tax on the receipt of the distribution, used to tax the distributing corporation on any gain in the stock that is distributed. Regs. § 801(f). This rule was repealed, effective as of January 1, 2012.

B. A spinoff can change the tax profiles of the distributing and the distributed corporations.

1. An analysis should be done before the transaction of what the corporations will look like afterward.

2. Distributing a division to shareholders can remove the distributing corporation from the taxing jurisdiction of states in which the division does business (or create the possibility of avoiding nexus by further adjustments).

3. The corporate readjustment can create new opportunities for filing (or avoiding) combined reports.

C. Effective May 17, 2006, section 355(b)(3) was added to the Internal Revenue Code, providing that the active trade or business ("ATOB") test will be met with respect to the distributing or distributed corporation if any member of the corporation's federal affiliated group is engaged in an ATOB. Spin-offs that are structured to take advantage of this new rule and in which either corporation is not itself engaged in an ATOB will fail to qualify for tax-free treatment in states that conform to the Internal Revenue Code as it existed as of a date before May 17, 2006. See California Franchise Tax Board Chief Counsel Rulings 2007-3 and 2008-1, confirming that California did not follow section 355(b)(3). The statute was amended to conform to section 355(b)(3), but only as of January 1, 2010, so transactions closing before that date were not able to meet the ATOB test on an affiliated group basis. Moreover, as a result of Proposition 26, adopted in 2010, it appears that the updated conformity bill became void on November 3, 2011, at which time section 355(b)(3) no longer applied in California. This is still a problem in New Hampshire, which conforms to the Code as it existed on December 31, 2000.

D. Are state qualification issues presented if saving state taxes is the business purpose justifying tax-free treatment at the federal level? See California Franchise Tax Board Chief Counsel Ruling 2007-3, in which the taxpayer had to represent that saving California taxes was not its purpose.

E. For a general discussion, see Faber, "State and Local Tax Aspects of Corporate Spinoffs," State Tax Notes (February 27, 2012).

VI. NET OPERATING LOSS CARRYOVERS

A. General state rules governing NOLs.

1. Periods of NOL carryforwards and carrybacks.

a. The federal rules allow NOLs to be carried back 2 years and forward 20 years.

b. States, such as New York, that incorporate the federal rules automatically under their conformity provisions now have the 2-year carryback and 20-year carryforward periods.

c. Some states allow the federal carryforward but allow no carryback.

d. Some states have a shorter carryforward period and no carryback.

e. Some states allow shorter carryforward periods.

2. Amounts of NOL carryforwards and carrybacks.

a. Most states have some mechanism for limiting carryforwards and carrybacks to NOLs attributable to the state.

(1) The most common approach is to apply the state's apportionment formula to taxable income, determined by taking the NOL into account.

See, e.g., Colo. Rev. Stat. § 39-22-504(1). Colorado does not allow an NOL to be carried to a year in which a different apportionment method is used from that used in the year in which the loss was sustained. Colo. Rev. Stat. § 39-22-504(5). The Department of Revenue will allow a NOL sustained in a two-factor year to be carried forward to any other two-factor year in the carryforward period regardless of the number of intervening years. Letter of September 17, 1988, cited in CCH Colorado Tax Reporter at ¶ 10-440.55.

(2) Some states limit NOL carryforwards to losses actually sustained in the state.

See, e.g., Sesek & Associates v. Arizona Department of Revenue, 2004 Ariz. Tax LEXIS 9 (Ariz. Bd. of Tax App. 2004); Miss. Regs. § 506.

(3) Some states require the corporation to have been a taxpayer in the state for the year in which the loss was sustained.

See, e.g., Ga. Code Ann. § 48-7-21(b)(3); Idaho Code Ann. § 63-3022(c)(2); 48-030-001 Miss. Code R. § 506 (loss must have been reported on a return);

Mo. Code Regs. Ann. tit. 12, § 10-2.165(3) (declared invalid in Cooper Industries Inc. v. Director of Revenue, which held that it had no statutory basis (Admin. Hearing Comm. 2000)), CCH Missouri State Tax Reporter ¶ 202-355); R.I. Gen. Laws § 44-11-11(b); Wis. Stat. § 71.26(4).

b. Some states place a percentage or dollar limit on carryforwards or carrybacks.

(1) New Hampshire limits the amount of net operating loss that may be generated and then carried forward to $1,000,000. N.H. Rev. Stat. Ann. § 77-A:4(XIII).

(2) Some states limit carrybacks or refunds from carrybacks.

See, e.g., Idaho Code Ann. § 63-3022(c)(1) (maximum of $100,000 from any taxable year); N.Y. Tax Law § 208. (9)(f)(5) (maximum of $10,000 from any taxable year).

(3) Colorado limits the NOL deduction in any year to $250,000 (applicable to years starting after 2010 and before 2014). H.B. 1199.

c. In recent years, some states have restricted the use of net operating loss carryovers in order to raise revenue. See, e.g., Cal. Rev. & Tax Code § 24416.3 (no losses allowed for the 2002 and 2003 tax years); 72 Pa. Cons. Stat. § 7401(3)(4) (repeal of use of carryovers for years starting after 1990; NOLs restored beginning in 1995, but now only to the extent of $2,000,000 per year).

d. An argument can be made that an NOL that is used in a year for federal tax purposes should not be reduced in that year for state tax purposes if it produces no state tax benefit because the corporation pays tax in that year on a base other than net income (such as capital). See, TD Holdings II Inc., N.Y.S. Div. Tax App., ALJ Div., DTA No. 825329 (2015). See Peter L. Faber, "Logic v. the Statute: When Federal Conformity Makes no Sense," State Tax Notes, March 16, 2015.

B. State rules governing NOLs in acquisitions.

1. Transfer of NOL carryforwards in acquisitions (federal provision: I.R.C. § 381).

a. Some states allow the transfer of NOLs in the same manner as under § 381 of the Internal Revenue Code.

(1) Some statutes expressly adopt § 381.

See, e.g., Ala. Code § 40-18-35.1(6); Cal. Rev. & Tax Code § 24471 (as modified); 35 Ill. Comp .Stat. § 5/405(a); Minn. Stat. § 290.095(3)(d); Wis. Stat. § 71.26(3)(n) (as modified).

(2) Some states adopt § 381 because of a failure to vary from federal law.

See, e.g., Delaware, Kansas, New York; see analysis in Virginia Rulings P.D. 96-38, CCH Virginia State Tax Reporter ¶ 202-922 (1996), and P.D. 97-193, CCH Virginia State Tax Reporter ¶ 203-446 (1997)

(3) Idaho allows NOLs to move to the acquiring corporation in a merger but not in a section 368(a)(1)(C) reorganization or a section 332 liquidation of a subsidiary not accomplished by a merger. Id. Code §63-3021(c).

(4) Even if a state allows the transfer of NOLs under §381, the computational proration rule of §381(c) may not apply. Illinois General Information Letter IT-09-0032-GIL (2009).

b. Some states limit the circumstances in which T's losses can pass to P.

(1) Continuity of business.

(a) Several states have no provision for the passage of NOLs from one corporation to another in a merger. Litigation in those states has focused on the question of whether the surviving corporation is the same "taxpayer" as the merged corporation. They have often cited federal cases that addressed the same issue under the law that preceded the enactment of section 381. See, e.g., Libson Shops, Inc. v. Koehler, 353 U.S. 382. reh. denied, 354 U.S. 943 (1957), and other cases that generally established the principle that pre-merger losses could be carried over only to offset post-merger income that was generated by the same assets. See, Faber, "State Tax Treatment of Net Operating Loss Carryovers in Corporate Acquisitions," The Tax Executive (July/August 1996).

(b) In Arizona, there is no statutory provision but case law holds that T's NOLs can be used after a merger of T into P only to the extent of P's post-merger income from the old T business that sustained the losses. Oliver's Laundry & Dry Cleaning Co. v. Arizona State Tax Commission, 19 Ariz. App. 442, 508 P.2d 107 (1973); Case No. 200600161-C (Ariz. Dept of Revenue Hearing Officer Decision 2007). NOL carryovers in a combined report must be calculated on a combined group basis. Dial Industries Inc. v. Department of Revenue, 1995 Ariz. Tax LEXIS 31 (1995), CCH Arizona State Tax Reporter ¶400-217.

(c) North Carolina.

(i) The North Carolina Department of Revenue took the position that T's NOLs are destroyed unless surviving P is substantially the same corporation as pre-merger T. The statute provides that pre-merger losses can be used only against post-merger profits produced by the assets that generated the losses. 17 N.C. Admin. Code § 5C.1507. In one case, T's losses could not be used after a merger of T into P where P after the merger was much larger and had more extensive businesses than T before the merger. Good Will Distributors (Northern), Inc. v. Shaw, 247 N.C. 157, 100 S.E.2d 334 (1957). The Corporate Income and Franchise Tax Division interpreted this case restrictively and allowed T's loss to pass to P in a merger only if P was an empty shell before the merger. Letter of November 9, 1964, cited at CCH North Carolina State Tax Reporter at ¶ 10-320.51. In another case, T's losses could not be used by P after a merger when T's old business continued to produce losses. Fieldcrest Mills, Inc. v. Coble, 290 N.C. 586, 227 S.E.2d 562 (1976). On the other hand, a corporation (apparently a new "shell" corporation) into which three corporations were merged was allowed to use the merged corporations' pre-merger NOLs where one person owned all of the stock of all of the corporations and the survivor continued the businesses of the merged corporations. Benton Woods, Inc. (Tax Rev. Bd. 1993), CCH North Carolina State Tax Reporter ¶ 201-771. The Department of Revenue does not acquiesce. Id. ¶ 201-772. A more generous approach was followed in Bellsouth Telecommunications, Inc, v. N.C. Department of Revenue, 95-CVS-1982 (Mecklenburg County Superior Court 1996), CCH North Carolina State Tax Reporter ¶ 201-912, in which P was allowed to apply T's pre-merger NOLs against P's post-merger income even though it failed to show that T's assets generated a profit after the merger. The court noted that P had been forced to create T by an FCC ruling; but for this it would have conducted T's operations, and sustained its losses, directly. The North Carolina Court of Appeals reversed, holding that the taxpayer had

failed to show a continuity of business, citing Fieldcrest. 126 N.C.App. 409, 485 S.E.2d 333 (1997), CCH North Carolina State Tax Reporter ¶ 201-952.

(ii) The Department has now announced that it will take a more liberal approach, indicating that it will allow pre-merger losses of T to be applied against post-merger profits of P to the extent that the group of assets that generated the loss generate profits after the merger, Amendment to Department's position on NOL carryovers, http://www.dor.state.nc.us/taxes/corporate/loss.html (February 22, 2001).

(d) The Connecticut courts have shown some flexibility.

(i) The general rule is that NOLs of the merged corporation do not survive a merger. Golf Digest/Tennis, Inc. v. Dubno, 203 Conn. 455, 525 A.2d 106 (1987).

(ii) But in Thermatool Corporation v. Department of Revenue Services, 43 Conn. Sup. 260, 651 A.2d 763 (1994), the court held that, although T's NOLs could not be used by P after a merger, they could be used by a new corporation to which P later transferred the old T business and the stock of which it distributed to P's shareholder because there was a continuity of business.

(iii) In Grade A Market Inc. v. Commissioner of Revenue Services, 44 Conn. Sup. 377, 688 A.2d 1364 (1996), CCH Connecticut State Tax Reporter ¶ 400-140, the pre-merger NOLs of two corporations were allowed to be used against the post-merger income of a third corporation into which they were merged when the three corporations were effectively operated as one before the merger, with common employees and functions. It was unclear whether the post-merger income was generated by the same assets that had generated the NOLs.

(iv) The Department of Revenue has applied continuity of business principles in allowing a parent corporation's NOLs to pass to a newly-organized "shell" subsidiary into which the parent merged where the following factors were present:

(A) the merger was a statutory merger that qualified as a reorganization under I.R.C. § 368(a)(1)(F);

(B) the ownership of the subsidiary after the merger was the same as that of the parent before it;

(C) the primary purpose of the merger was not tax avoidance;

(D) the subsidiary continued the parent's business after the merger;

(E) the parent's old business was operated by the subsidiary as a separate division or its assets were separately accounted for; and

(F) the only income against which the parent's NOLs were applied after the merger was generated by the parent's old business. Ltr. Rul. No. 97-3, CCH Connecticut State Tax Reporter ¶ 360-535.

(v) In Cunningham Group, Inc. v. Commissioner of the Department of Revenue Service (Superior Court, 1997), CCH Connecticut State Tax Reporter ¶ 400-256, NOLs of the merged corporation were allowed to be used against post-merger income of the surviving corporation where the business that generated losses was continued, even though there was no showing that it generated income after the merger.

(e) A Tennessee appellate court has denied the use of pre-merger NOLs against post-merger income of the acquired assets that had generated the losses. Little Six Corporation v. Johnson (Tenn. Ct. App., 1999), CCH Tennessee State Tax Reporter ¶ 400-669. This result has now become codified. Tenn. Code Ann. § 67-4-2006(c)(2). The Tennessee Department of Revenue has ruled that the NOL is extinguished in a tax-free liquidation or merger of a subsidiary into its parent corporation even if the corporations were engaged in a unitary business Ruling No. 07-14 (2007).

(f) A reincorporation into another state was held to result in a loss of pre-merger NOLs in Caterpillar Inc. v. Department of Revenue CCH Wisconsin State Tax Reporter ¶ 400-416 (Wis. Tax App. Comm. 1999) (involving pre-1987 year-Legislature adopted § 381 for later years); Cf McDermott Will & Emery, TSB-A-07(1)C (N.Y.S. Dept of Tax. And Fin. Advisory Opinion 2007) (grandfathered Article 9-A status lost when corporation reincorporated in another state).

(g) The NOLs of a defunct corporation were not allowed to pass to its parent in Appeal of Realprom Holding Corp. (CA SBE 1999) in a merger that the Board viewed as coming within I.R.C. § 332 because of a lack of business purpose and continuity of business enterprise. The Board cited U.S. Treasury Regs. § 1.368-1(d). California has incorporated I.R.C. § 381 by reference.

(h) NOLs may disappear in a merger of different kinds of corporations. The NOLs of a regular business corporation did not pass to a bank in Colonial BancGroup v. Alabama Department of Revenue (Ala. ALJ Division, January 5, 2001).

(2) Common ownership.

See, e.g., Ark. Code Ann. § 26-51-427(3), allowing the transfer of T's NOLs if P acquires T's assets but only if T and P had common ownership of at least 80% and only to the extent of P's post-acquisition income from the old T assets. (The statute literally applies to taxable asset purchases. It does not indicate what proportion of T's assets must be acquired by P.)

(3) Ohio law provides that T's NOLs survive a merger into P only if T was an Ohio taxpayer when the losses were sustained. Litton Industrial Products, Inc. v. Limbach, BTA No. 87-G-187 (1990), CCH Ohio State Tax Reporter ¶ 400-506.

c. In some states T's NOLs disappear in a merger into P.

(1) Mont. Admin. R. 42.23.415; N.J. Admin. Code. § 18:7-5.13(b) expressly provide that there is no exception for a mere change in state of incorporation; the Regulation was upheld and T's NOLs were not allowed to pass to P in a merger in A.H. Robins Co., Inc. v. Director, Division of Taxation, 365 N.J. Super. 472, 839 A.2d 914 (2004), aff'd per curiam, 2004 N.J. LEXIS 1404 (N.J. Sup.Ct. 2004), and Richard's Auto City, Inc. v. Director, Division of Taxation, 140 N.J. 523, 659 A.2d 1360 (1995), CCH New Jersey State Tax Reporter ¶ 400-378, rev'g 270 N.J. Super. 92 (App. Div. 1994); AT&T Corp. v. Johnson, 2004 Tenn. App. LEXIS 214 (Tenn. Ct. App. 2004) (no discussion of continuity of business), appeal denied (Tenn. Sup. Ct. 2004); Tennessee (Rule § 1320-6-1-.21(2)(d)); Texas, Ruling of Comptroller of Public Accounts, Microfiche No. 9406L1315B04 (1994); Texas,

Comptroller of Public Accounts hearings Nos. 36,030 (1996), 37,978 (2000); 34 Texas Administrative Code § 3.555(g)(3); Sergent Enterprises, Inc. v. Strayhorn (Tex. Ct. App. 3d Dist., Austin 2003); (codified by S.B. 1689, amending Tax Code § 171.110(e), signed by the Governor on June 15, 2001); Utah (Code Ann. § 59-7-110(5)(a); NOLs do pass to P in a merger that effects a mere change in state of incorporation).

(2) Massachusetts generally follows the same approach Regs. § 63.30.2(11)(a); Macy's East, Inc. v. Commissioner, 441 Mass. 797, 808 N.E.2d 1244 (2004), cert. den., 125 S.Ct. 454 (2004) (an "F" reorganization, no discussion of continuity of business). But NOLs will survive if the merger qualifies as a mere change in form under I.R.C. § 368(a)(1)(F). Letter Ruling 95-4, CCH Massachusetts State Tax Reporter ¶ 400-209.

(3) Some state statutes prohibit a transfer of NOLs from one corporation to another. New Jersey (N.J. Stat. Ann. . §54:10A-4.5); Texas (Tex. Code Ann. §171.110(e)); Tennessee (Tenn. Code Ann. §67-4-2006(c)(2)).

(4) In an apparent misapplication of federal law, the Idaho Tax Commission ruled that the NOLs of a wholly-owned subsidiary did not pass to the parent when the subsidiary merged into the parent because the subsidiary's business was discontinued after the merger, citing section 382 of the Internal Revenue Code. Docket No. 25749. The stated reasoning is wrong. Section 382 does not apply to a merger of a subsidiary into a parent because of the constructive ownership rules. Moreover, section 382 does not prevent an NOL from moving to the surviving corporation in a merger, it merely limits its use by the surviving corporation after the merger.

2. Curtailment of NOLs because of a change in stock ownership (federal provision: I.R.C. § 382).

a. Some states apply the § 382 limitations in the same manner as under the Internal Revenue Code.

(1) Some statutes expressly adopt § 382.

See, e.g., Ala. Code § 40-18-35.1(6); Ore. Rev. Stat. § 317.478; Wis. Stat. § 71.26(3)(n).

(2) Some states adopt § 382 because of a failure to vary from federal law.

See, e.g., California, Delaware, Kansas, New York.

(3) Illinois expressly rejects § 382 in cases of acquisitions subject to § 381 but, apparently, not in other acquisitions. 35 Ill. Comp .Stat. §§ 5/405(a), (b-5).

b. Some states have no provision comparable to § 382 and reject the concept.

See, e.g., Ruling 93-23 (Connecticut Department of Revenue Services 1993), CCH Connecticut State Tax Reporter ¶ 360-489.

c. New Jersey has its own rules limiting the use of NOLs when there is a change in stock ownership.

(1) New Jersey's statute is similar to I.R.C. § 382 before amendment by the Tax Reform Act of 1986. N.J. Stat. Ann. § 54:10A-4(k)(6)(D).

(2) T's NOLs are destroyed if:

(a) There is a 50% or more ownership change (N.J. Admin. Code. § 18:7-5.14(a) indicates that this refers to cumulative changes since June 30, 1984); and

(b) The corporation changes the business giving rise to the loss. (N.J. Admin. Code. § 18:7-5.14(c) indicates that a change does not occur even if all of the old product lines are replaced by new product lines, the corporation's name changes, and new employees are hired.)

(3) T's NOLs are also destroyed if there is a 50% or more ownership change and P's primary purpose in making the acquisition was to get the benefit of T's NOLs (similar to I.R.C. § 269).

(4) The New Jersey Division of Taxation holds that T's NOLs cannot be used by P after T merges into P because there is no provision in the statute for a transfer of the NOLs from T to P. Regs. § 18:7-5.13(b). This position was upheld in Richard's Auto City, Inc. v. Director, Division of Taxation, 140 N.J. 523, 659 A.2d 1360 (1995), CCH New Jersey State Tax Reporter ¶400-378, rev'g 270 N.J. Super. 92 (App. Div. 1994).

d. The allocation of §382 limits among related corporations is unclear when some members of a federal consolidated return group file separate state returns.

3. Use of NOLs in a consolidated or combined return after an acquisition.

a. The states generally do not limit the use of NOLs, although general limitations on the use of out-of-state losses apply.

b. New York applies the SRLY concept. Regs. § 3-8.7(a). See also Alabama Department of Revenue Proposed Rule § 810-3-35.1-.03. But SRLY rules were held inapplicable when the corporations were affiliated but filed separate returns when the losses were sustained. Weyerhaeuser USA v. Ala. Dep't of Revenue, Ala. Dep't of Revenue, Administrative Law Judge Division, Docket No. Corp. 04-511 (2005).

c. South Carolina expressly rejects the use of SRLY concepts. TAM # 89-22(1989), CCH South Carolina State Tax Reporter ¶ 200-377 (basing its holding on a policy of conforming to federal rules but not referring to the SRLY rules in the federal consolidated return regulations).

d. An attempt by the Florida Department of Revenue to apply SRLY principles was contrary to the statute and invalid. Golden West Financial Corp. v. Florida Department of Revenue (FL D. Ct. of App. 2008).

e. Arizona's Department of Revenue limits the use of a loss on a combined return to the income of the business that produced the loss. Corporate Tax Ruling No. CTR

91-2 (April 2, 1991), CCH Arizona State Tax Reporter ¶ 201-004.

f. The Utah State Tax Commission unsuccessfully attempted to prevent an acquired subsidiary from deducting its own losses against its own income on the buyer's consolidated return. Savage Industries, Inc. v. Utah State Tax Commission, 160 Utah Adv. Rep. 5, 811 P.2d 664 (Utah 1991).

g. In New York, the NOL deduction cannot exceed the federal NOL deduction. Tax Law ¶ 208.9(f)(3). If a corporation's federal NOL is applied against the income of other corporations with which it files a federal consolidated return, it will not be available to be carried forward for New York purposes, even if the corporation filed a separate New York return for that year and the related corporations were not New York taxpayers for that year. See, Royal Indemnity Co. v. Tax Appeals Tribunal, 75 N.Y. 2d 75, 550 N.Y.S. 2d 610 (1989) (NOLs carried back and exhausted for federal purposes could not be carried forward for New York State purposes even though corporation was not a New York taxpayer during the carryback years).

h. In Massachusetts, NOLs can be applied only against the income of the corporation that sustained them. Carryforwards cannot be applied against the income of other corporations in the combined report group, even though the corporations were affiliated when the losses were sustained. Farrell Enterprises, Inc. v. Commissioner of Revenue (Mass. Ct. App. 1999), CCH Massachusetts State Tax Reporter ¶ 400-538; 830 CMR § 63:32B.1(9)(a).

4. The Oregon Tax Court has held that the NOL of a parent corporation spinning off a subsidiary for the year of the spin-off can be used by the subsidiary only to the extent of a pro rata portion based on the number of days in the year before the spin-off (when the corporations had a unitary relationship). US West Inc. v. Dep't of Rev. (2011).

NOTES

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Mergers and Acquisitions State and Local Tax Aspects (PowerPoint slides)

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Mergers and Acquisitions State and Local Tax Aspects

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PRELIMINARY CONSIDERATIONS

1. Get SALT people involved at the outset.
2. The application of state tax laws to corporate transactions is often unclear.
   - Many states do not have the equivalent of the Joint Committee on Taxation staff.
3. Corporations that file consolidated federal income tax returns often file separate returns in one or more states or file on a combined basis with different group members.
   - This can result in dramatic differences between the federal and state taxation of transactions.
   - It can also mean that the target has joint and several liability for taxes of other entities that are not involved in the transaction.

INCOME TAX ISSUES

- Nexus Issues
- Business v. nonbusiness income.
  - Asset acquisitions.
  - Stock acquisitions.
- 338(h)(10) transactions.
- Acquisitive reorganizations under section 368.
- Spin-offs and restructurings.
- Net operating loss carryovers in acquisitions.
- Ongoing planning.

INCOME TAX NEXUS BY ACQUISITION TARGET

- Acquiring target's <u>assets</u> located in a jurisdiction where acquirer is not taxable will often cause acquirer to become taxable in that jurisdiction.
- Acquiring target's <u>stock</u> may result in acquirer and target having to file state combined returns if engaged in a unitary business.
  - A unitary relationship may not be established immediately unless the corporations have a prior business relationship.
- Effect of acquisition on acquirer's income apportionment factors.
- Economic or attributional nexus.

BUSINESS v. NONBUSINESS INCOME

SIGNIFICANCE:

- Most states tax business income differently than nonbusiness income.
- Business income is typically apportioned among all the states in which a company does business under a formula (often based on a combination of the location of property, payroll, and sales, although use of sales-only formulas is increasing).
- Nonbusiness income is typically allocated to one state only.
  - The state of physical location, in case of tangible property.
  - The state of commercial domicile in case of good will and other intangible property.
- Corporations usually prefer gain on the sale of a business to be nonbusiness income, but this is not always the case.

BUSINESS v. NONBUSINESS INCOME: ASSET SALES

- UNIFORM DIVISION OF INCOME FOR TAX PURPOSES ACT ("UDITPA"):
  - Business income is: "Income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations." Section 1(a).

BUSINESS v. NONBUSINESS INCOME: ASSET SALES

Two tests for business income have been developed by the courts

All courts agree that gain on the sale of property (e.g., inventory) that is sold in the regular course of business produces business income, even if sold in bulk in an extraordinary transaction (the "transactional test").

– The courts have divided on whether gain on the sale of property that is used to produce business income (e.g., a factory) is business income (the "functional test").
– Cases holding that there is a functional test include Gannett Satellite Information Network Inc. v. Montana Dep't of Rev., 348 Mont. 333 (2009); Welded Tube Co. v. Commonwealth, 101 Pa. Commw. 32, 515 A.2d 988 (1986).
– Cases holding that there is no functional test include Western National Gas Co. v. McDonald, 202 Kan. 98, 446 P.2d 781 (1968); McVean & Barlow, Inc. v. N.M. Bur. Of Rev., 88 N.M. 521, 543 P.2d 489 (1975).

BUSINESS v. NONBUSINESS INCOME: ASSET SALES

Should there be a functional test?

YES: Tax Policy. The value of an asset that is used in the business is attributable to its ability to produce future business income and gain on its sale should be business income.

NO: Statutory Language. The statute says “and,” not “or.” Gain on the sale of an asset is nonbusiness income unless the disposition of the asset is a regular incident of the taxpayer's business.

BUSINESS v. NONBUSINESS INCOME: ASSET SALES

LIQUIDATING SALES

- Some courts that follow the functional test have held that gain on the sale of business assets that would ordinarily be business income is nonbusiness income if the sale proceeds are distributed to the shareholders and not reinvested in the seller's business. See, e.g., Laurel Pipe Line Co. v. Comm'w of Pa., 537 Pa. 205,642 A. 2d 472 (1994); Lenox, Inc. v. Tolson, 353 N.C. 659, 548 S.E.2d 513 (2001).
- The same principle may be applied to a corporation that is deemed to have sold its assets and liquidated under section 338(h)(10) of the Internal Revenue Code. See, e.g., Canteen Corp. v. Comm'w of Pa., 818 A.2d 594 (2003), aff'd, 854 A.2d 440 (Pa. Sup. Ct. 2004); ABB C-E Nuclear Power Inc. v. Mo. Dir. of Rev., 215 S.W.3d 85 (Mo. 2007).

BUSINESS v. NONBUSINESS INCOME: ASSET SALES

LIQUIDATING SALES

- What is a liquidation?
  - A distribution of the sale proceeds to the shareholders?
  - The sale of a business? See Glatfelter Pulpwood Co. v. Comm'n of Pa, 19 A.3d 572 (Pa. Comm. Ct. 2011).
  - No liquidation when sale was of only some of the assets of a worldwide business and sale proceeds were not distributed to shareholder. Elan Pharmaceuticals, Inc. v. Director, Div. of Tax. (N.J. Tax Ct. 2014)
- Reinvestment of proceeds in a unitary business may prevent a "liquidation" for this purpose. Century Tel, Inc. v. Dep't of Revenue (Ore. Tax Ct. 2010).

LIQUIDATING SALES

- Some courts have held that there is no liquidation exception to the functional test. Jim Beam Brands Co. v. Franchise Tax Bd., 34 Cal.3d 874 (2005); Crystal Communications, Inc. v. Oregon Dep't of Revenue, 353 Ore. 300, 297 P.3d 1256 (2013); First Data Corp. v. Arizona Department of Revenue, 233 Ariz. 405, 313 P.3d 548 (AZ. Ct. App. 2013); Harris Corp. v. Arizona Department of Revenue, 233 Ariz. 377, 313 P.3d 1143 (AZ. Ct. App. 2013).

BUSINESS v. NONBUSINESS INCOME: ASSET SALES

CONCLUSIONS.

- The law is unclear as to whether there is a functional test. Taxpayers should not hesitate to dispute department of revenue determinations.
- Taxpayers can take inconsistent positions in different states. Oracle Corp. v. Ore. Dep't of Rev. (Ore. Tax Ct. 2010).

BUSINESS v. NONBUSINESS INCOME: STOCK SALES

- Gains from the sale of a subsidiary's stock will generally be business income only if the parent and the subsidiary were engaged in a unitary business. Allied-Signal, Inc. v. Director, Div. of Taxation, 504 U.S. 768 (1992).
- The mere intent to create a unitary relationship does not convert a subsidiary's stock to a business asset if it is sold before the relationship is created. Calif. F.T.B. Legal Ruling No. 2012-01.

338(h)(10) TRANSACTIONS

- Under section 338(h)(10) of the Internal Revenue Code, a sale of the stock of a corporate subsidiary or an S corporation is treated as if the corporation had sold its assets and distributed the sale proceeds to its shareholders in liquidation. The actual sale of stock is ignored.
- The incident of tax is the deemed sale of the corporation's assets by the target corporation.
- The buyer and the seller must elect to have section 338(h)(10) apply.
- The provision's purpose is to allow the buyer of a corporation's stock to step up the basis of the corporation's assets to reflect the purchase price, as it would if it bought the assets directly.

338(h)(10) TRANSACTIONS

- The states generally follow section 338(h)(10) in that they allow the basis step-up of the target corporation's assets and otherwise respect the fiction of the deemed sale and liquidation.
- Whether 338(h)(10) treatment is available can affect pricing.
- California and Wisconsin allow taxpayers to elect into or out of section 338(h)(10) regardless of whether they elect it for federal tax purposes.
- Treatment of deemed sale proceeds in receipts factor can be an important issue.

338(h)(10) TRANSACTIONS

TRAP:

- In the typical 338(h)(10) transaction, the selling parent and the target file consolidated federal income tax returns and the target's gain on the deemed sale of its assets is taxed on the parent's return that includes the target.

- If the parent and the target file separate state returns, there is no mechanism for including the target's gain on the deemed sale of its assets on a parent tax return. The tax on the gain is a liability of the target and the economic burden of the tax will be borne by the buyer. Newell Window Furnishing, Inc. v. Comm'r of Rev., 311 S.W.3d 441 (Tenn. Ct. App. 2008).

- Solution: Reduce the purchase price to transfer the economic burden of the tax to the seller.

338(h)(10) TRANSACTIONS

- NYS Tax Reform Legislation: need to identify stock <u>on the day of purchase</u> as being held for investment for income from that stock to be tax-free investment income.
- Is the target treated as a new corporation for this purpose so that it must make a new identification on the closing date, even though it may have made a prior identification?

TAX-FREE REORGANIZATIONS

- State income taxes generally conform to the federal reorganization provisions and a transaction that is a tax-free reorganization under IRC section 368 will be tax-free for state income tax purposes.
- WARNING: a transaction that is not subject to federal, state, and local income taxes may be subject to state and local gross receipts, sales, and real property transfer taxes.

NYS INVESTMENT INCOME IDENTIFICATION

- NYS Tax Reform Legislation: need to identify stock on the day of purchase as being held for investment for income from that stock to be tax-free investment income.
- The acquiring corporation in a merger should make a new identification on the closing date. There is no authority suggesting that an identification made by the merged corporation carries over.

SPIN-OFFS AND RESTRUCTURINGS

- The distribution of the stock of a subsidiary corporation will generally be tax-free to the distributing parent and the parent’s shareholders if the corporations are each engaged in an active business, there is a non-tax business purpose for the distribution, and the distribution is not a device to distribute the parent’s earnings and profits. IRC section 355.
- The states generally follow the federal treatment of spin-offs. A spin-off that qualifies under section 355 will generally be tax-free for state income tax purposes.

SPIN-OFFS AND RESTRUCTURINGS

AREAS OF NONCONFORMITY WITH FEDERAL RULES

- New Hampshire does not follow the federal rule that qualification under the active business test is determined on an affiliated group (and not a separate corporation) basis because it conforms to the Internal Revenue Code as in effect before the effective date of IRC section 355(b)(3).
- California statute conformed to section 355(b)(3) as of January 1, 2010, but, because the bill of which it was a part was not adopted by the 2/3 vote required for tax increases, it may have been invalid. It is understood that the FTB was applying it as if it were in force. This has apparently been corrected by legislation enacted in 2015.

SPIN-OFFS AND RESTRUCTURINGS

- Internal restructurings typically involve asset transfers that can have tax consequences.
- The distribution of assets from a subsidiary corporation to a corporate shareholder can result in the recognition of gain to the subsidiary under I.R.C. section 311(b).
  - The gain may be deferred for federal tax purposes if the corporations are filing consolidated returns, but it will be taxed immediately for state tax purposes in states in which the corporations are filing separate state returns.
- Transfers within a corporate group may result in sales or other transfer taxes.

NET OPERATING LOSS CARRYOVERS

- The states often have special rules for net operating loss carryovers (NOLs) that do not track the federal rules.
- Taxpayers should not assume that NOLs that are available for federal tax purposes will be available for state tax purposes.

NET OPERATING LOSS CARRYOVERS

- States often have shorter carryforward periods than the federal 20-year period.
  - NOLs that are still available for federal tax purposes may have expired in one or more states.
  - NOLs may be suspended, sometimes for state budgetary reasons.
- Some states allow NOLs only to the extent that they are attributable to in-state activities.
- Use of NOLs may vary if state combined group is different from federal consolidated group.
- Apportionment of NOLs may vary, affecting availability of NOLs in different states.

NET OPERATING LOSS CARRYOVERS

- Some states do not have a provision allowing NOLs or unused credits to move from the target corporation to the buyer in a tax-free reorganization comparable to IRC section 381.
- In those states, the NOLs may be extinguished in the transaction. See A.H. Robins Co., Inc. v. Director, 182 N.J. 77 (2004).
- Case law in some states has held that the target's NOLs nevertheless survive the transaction if the buyer after the transaction continues the target's business that generated the NOLs, *See*, *e.g.,* Oliver's Laundry & Dry Cleaning Co. v. Ariz. State Tax Comm., 19 Ariz. App. 442, 508 P2d 107 (1973); Thermatool Corp. v. Dep't of Rev. Services, 43 Conn. Sup 260, 651 A2d 763 (1994).
- WARNING: This is a potential problem when a corporation with NOLs is reincorporated in another state by merging into a new "shell" corporation.

NET OPERATING LOSS CARRYOVERS

- Idaho statute: NOL passes in a merger but not in a “C” reorganization or in a section 332 liquidation.
- Idaho Decision 25749 (2014) incorrectly holds that a wholly-owned subsidiary’s NOLs do not pass to its parent when it merges into the parent, citing IRC section 382. The Commission’s mistakes: (1) section 382 does not apply to a merger of a subsidiary into a parent, and (2) section 382 limits the use of the NOL but does not prevent it from passing to the parent.

SALES TAX ISSUES

- “Sale” is broadly defined to include all transfers of title or possession of goods for consideration “unless otherwise excepted”. Consideration is considered both cash and the assumption of liabilities.
- Exceptions –Sales of businesses must be specifically exempted in order to escape the sales tax.
  - Not a transaction occurring in the ordinary course of business - <u>Isolated, Casual or Occasional sales</u>.
  - Reorganization Exemption specifically provided by statute.

SALES TAX ISSUES

- Sales Tax Exemptions for Transfers in Incorporations, Mergers, Acquisitions, & Liquidations
  - Strict compliance with statutory language and/or regulations is mandatory or the exemption will be forfeited.
  - State sales tax analysis must be done before structuring the transaction based solely on federal income tax consequences, or significant sales taxes could be due.

Sales Tax Problem Areas

- Creation of new subsidiaries and drop down assets with parent receiving consideration in the form of stock and securities in the subsidiaries. Tennessee held a taxable sale occurred. In <u>D. Canalle & Co.</u> (Tenn. Jan. 17, 1989).
- Some states exempt transfers in exchange for an equity interest that occurs "at the time of organization of the entity". New York, New Jersey and Vermont.
  - Later transfers may be taxable. <u>Noar Trucking C. Inc., v. State Tax Commission</u> 138 A.D. 2d 869 (3d Dept. 1988).

Sales Tax Problem Areas

- Section 351 incorporation transactions may be subject to sales taxes, although many states have partial exemptions.
  - Liabilities that are assumed or taken subject to may be treated as cash that is not eligible for exemption. Beatrice Co. v. SBE, 6 Cal. 4th 767, 863 P.2d 683 (1993).
  - New York's exemption applies only to transfers upon the organization of the transferee corporation.
    - The economically meaningless issuance of new stock to a 100% shareholder can result in sales tax even though a capital contribution of unencumbered assets for no new stock would be exempt. Petition of Weichbrodt, N.Y.S. Tax App. Trib. (2002).
    - A transfer to a dormant "shell" corporation is taxable. P-H Fine Arts Ltd. v. N.Y.S. Tax App. Trib., 227 App. Div. 2d 683 (3d Dep't 1996); Petition of Mohonk Oil Co., Inc., Tax App. Trib. (2009).

Sales Tax Problem Areas

SMLLC

- Transfer assets to SMLLC followed by the sale of the SMLLC interest.
  - New York– no sales tax due.
  - Washington State and California – sales tax will be due.

Sec. 338(h)(10)

- Application of Sec. 338(h)(10) to Sales Tax. Generally, for sales tax purposes the deemed asset sale is not treated as an actual sale, and the sales tax normally would not apply.

BULK SALES/SUCCESSOR LIABILITY ISSUES

- In order to protect their tax revenues, most states have one or more bulk sale or successor liability provisions in their tax laws.
  - These provisions generally require the seller and/or purchaser of the assets of a business to notify the appropriate taxing authorities of the sale within a certain number of days before the transaction.
  - The purpose of the request is to either:
  1. obtain a clearance certificate from the authorities stating that the seller has no outstanding tax liabilities; or
  2. be instructed by the authorities as to the amount that should be withheld by the purchaser from the purchase price to cover the outstanding tax liabilities of the seller.

DUE DILIGENCE

- Develop check-list of SALT issues.
- Vary the check-list for industry-specific and company-specific issues.
- Watch out for aggressive tax planning strategies.
- Focus on key states if time and budget do not allow you to survey all states.

Other State Tax Issues

- Sec. 409A
- State Income Tax Withholding
- Employee v. Independent Contractor Classifications
- State Unemployment Taxes
  - "Successor Employer"
  - Experience Rating Transfers

NOTES

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5

E-Commerce Income Tax and Sales Tax Issues

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If you find this article helpful, you can learn more about the subject by going to www.pli.edu to view the on demand program or segment for which it was written.

1. INTRODUCTION

a. Advances in a number of related technologies, including sensors, analytics, network, cloud, security, and M2M management platforms, are allowing companies across industries to illuminate their “dark” assets.

b. These companies can collect, analyze, share and act on the data to drive operational efficiencies or new growth models in new ways.

c. Technology Innovation

   i. Smart Devices

      1. Examples: Smart home devices, wearable tech.

      2. Devices are becoming miniaturized and more affordable.

      3. The trend is away from “all-in-one” devices to those that meet specific needs.

      4. The focus is now on more “personal” applications.

   ii. Mobility

      1. More devices are enabled with both portability and connectivity.

      2. The mobile device is finding application as the controller of other devices.

      3. With “Bring-Your-Own-Device” (“BYOD”) trends, the focus is on device management to app management.

   iii. Cloud Computing

      1. Over 50% of IT spending over next 2 years is on cloud.

      2. Cloud is being used to help drive business agility and speed to market.

      3. Cloud provides a common innovation platform for Mobile, Social, and Big Data.

      4. Cloud enables the analysis/dissemination of data for IOT.

   iv. Analytics

      1. Data visualization and dashboards are making analytics more accessible and driving adoption.

2. Data from smart devices is now being collected and monetized.

3. Predictive analytics is helping businesses be more proactive in driving decision-making.

v. Data Security

1. Security investments are dramatically increasing, driven by increased regulation and increased focus on privacy/ controls.

2. Security as a Service is being driven by more users accessing cloud services from mobile.

3. Hybrid cloud model is helping meet more stringent SLAs.

d. Cloud Metrics

i. $77 billion: Revenue expected to be generated by mobile apps by 2017.

ii. 1.34 billion: Digital music tracks sold online in 2013.

iii. 82 billion: Digital apps downloaded worldwide in 2013, expected to exceed 200 billion by 2017.

iv. 1 million+: number of e-books available from Amazon's online store.

2. DEFINING THE TRANSACTION: LICENSE OF SOFTWARE, SERVICE, OR SOMETHING ELSE?

a. How do we Characterize the Transaction?

i. Customer's "true object", "primary purpose"?

ii. Which of the various elements of the service was "predominant"?

iii. What ownership rights (to what is being purchased) are transferred?

iv. What does the purchase agreement say?

v. What do the marketing materials say?

vi. Is there a software license agreement?

b. Animal, Vegetable, or Mineral?

i. States struggle to characterize transactions in the cloud:

1. Is it taxable software?

a. All internet-based platforms necessarily utilize software.

b. But that doesn't mean software is the "true object" of the transaction.

2. Is it a taxable information service?

a. Internet-based services may draw upon a database of information.

b. But that doesn't mean the "true object" of the transaction is the information.

3. Is it a taxable communications service?

a. When, if ever, does a cloud based service that "routes" messages or information constitute a communications service itself?

b. Who supplies the telecommunications transport?

c. Example

i. Vendor = Platform where businesses can compare, match analytics

1. Is it information?

a. "Trading" personal information.

2. Is it telecommunications?

a. Does "route" to correct recipient, but each customer uses outside telecommunications to get to the platform.

3. Is it software?

a. Not really providing functionality, just access.

3. NEXUS ISSUES

a. Emerging digital products and services can create sales tax liability for those who never had it before.

b. Example

i. Financial Services in New York

1. Investment research/reports

2. “Soft dollar” arrangements

3. For further discussion, see Timothy P. Noonan and Elizabeth Pascal, *State of Confusion: Sourcing Financial Services Receipts* (http://www.hodgsonruss.com/media/publication/512_Sourcing%20Financial%20Services%20Receipts.pdf).

c. Income Tax

i. Economic Nexus

d. Streamlined Sales and Use Tax Agreement

i. “Prewritten computer software”

1. Tangible personal property, but states can choose to exempt it altogether or based on how it is delivered.

ii. “Specified Digital Products” and Products “Transferred Electronically”

1. Separately defined from computer software, ancillary services, telecommunication services and tangible personal property.

2. Sources the sale/purchase of such products to where the products are “received” by the purchaser.

iii. “Receipt/Receive”

1. Taking possession of tangible personal property, making first use of services or taking possession or making first use of digital goods, whichever comes first.

e. Internet Tax Freedom From Discrimination

i. Internet Tax Freedom Act (ITFA)

1. Bans state and local taxation of internet access.

2. Forbids multiple or discriminatory taxes on electronic commerce (does not ban taxation of sales made over the internet).

3. Became permanent on February 24, 2016.

ii. What is a discriminatory tax?

1. If the "brick and mortar" version of goods or services isn't taxable, then the same goods delivered or services performed via the internet cannot be taxed.

2. Taxing the internet-based commerce at a different rate.

3. Imposing a tax collection or payment obligation on a different party than in the case of "brick and mortar" transactions.

f. E-Commerce Discrimination

i. *Performance Marketing Ass'n v. Hamer*, Ill. S.Ct. No. 114496 (10/18/13)

1. The Illinois Supreme Court applied the ITFA to strike down a discriminatory tax burden imposed on e-commerce.

2. Illinois "click through" nexus statute required out-of-state vendors to collect Illinois use tax based on using in-state internet-based marketers.

a. Collection obligation triggered if more than $10,000 in sales were made through the link.

3. Illinois Supreme Court noted that performance marketing by out-of-state retailer which appears in print or on over-the-air broadcasting in Illinois, and which reaches the same dollar threshold, did <u>not</u> trigger an Illinois use tax collection obligation.

4. Court struck the Illinois statute for violating ITFA's bar against imposing a discriminatory tax on electronic commerce.

How closely must the "brick & mortar" good/service parallel the cloud-based good/service for there to be discrimination?	
Brick & Mortar	Cloud
Hardcover or paperback book	E-Books
Career consulting service operated "in-person" out of an office	On-line career consulting service with access to a database of jobs
Tax preparation performed "in-person" out of an office	On-line access to tax preparation software

g. Example

i. "On-line" Personal Training Services

1. "Brick and mortar" gym training not taxable.

2. What about on-line training?

a. Any interaction with "human" trainer?

b. Or do you just put in your personal information and a training program is developed for you?

c. Or is it something in between?

4. APPORTIONING INCOME

a. Sourcing Issues

i. How the product/service is delivered to the customer does matter in determining taxability and sourcing of the sale.

ii. Does the purchase agreement specify what is being sold?

1. Auditors and courts rely heavily on the contractual language in characterizing the item being purchased.

a. If a software license agreement is executed, it will be difficult to argue that you are not licensing software.

2. Invoice and marketing materials may also be relied on.

iii. Services: Place of benefit, use, performance?

iv. Does the state have "digital goods" rules?

v. Does server location matter? See, e.g., Alabama's server location.

b. States are moving toward market sourcing.

i. Market based sourcing is used in 23, in addition to North Carolina's legislature directing the Department to draft rules to implement market sourcing.

ii. Washington and Ohio do not impose an income-based tax, but have market-based sourcing rules for their business tax.

c. "Delivery" v. "Where the benefit of the services are received"

i. Defining the "market" under the "benefit of the services are received" test may be difficult.

1. States using “benefit of the services received”:
    a. CA, GA, IA, NY, OH, RI, UT, WA, WI
        i. See, e.g., NY Art. 9-A Sec. 210-A(10)(b), http://law.justia.com/codes/new-york/2014/tax/article-9-a/210-a.
2. States using “market”:
    a. AL, CT, LA, MA, PA, TN
        i. See, e.g., CT S.B. 502, 2016 § 203 (Conn. 2016), https://www.cga.ct.gov/2016/TOB/s/pdf/2016SB-00502-R00-SB.pdf.

5. BEST PRACTICES

a. Require electronic delivery.

b. Contract terms must address:
    i. Delivery;
    ii. Characterization;
    iii. Sourcing; and
    iv. Responsibility for tax.

c. Consider incentives.

d. Get exemption/resale certificates.

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