MULTISTATE TAX COMMISSION

MEMORANDUM

To: Robynn Wilson, Chairperson,
Income and Franchise Tax Uniformity Subcommittee

From: Bruce Fort, MTC Counsel

Date: January 29, 2013

Re: Possible Uniformity Project: Regulation Regarding Use of Formulary Apportionment Principles in Applying State "IRC §482" Authority to Adjust Income and Expenses of Related Parties to Clearly Reflect Income

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The Income and Franchise Tax Uniformity Subcommittee (the subcommittee) continues to solicit public comment on whether the subcommittee should undertake a project to draft model regulations governing the use of state statutory authority to adjust income and expenses between related parties. The federal tax code grants the Commissioner of the IRS authority to make such adjustments in IRC § 482, set forth below.[1] Some 14 states have adopted similar versions of Section 482 in their income tax codes,[2] although arguably, all states have such authority by virtue of the federal Code to determine state "base" income amounts. Despite the widespread availability of "Section 482" authority, only a handful of states use Section 482 with any regularity to respond to income shifting; in some of those states, including Arizona, Indiana, and North Carolina, the ability to require a combined return is based on Section 482's "clearly reflect

> [1] In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses.

[2] *See* Ala. Code § 40-2A-17; Ark. Code Ann. § 26-51-805; Conn. Gen. Stat. § 12-226a; Del. Code Ann. tit. 30, § 6403; Fla. Stat. § 220.44; Ga. Code Ann. § 48-7-58; Ind. Code § 6-3-2-2(m); Iowa Code § 422.33; La. Rev. Stat. Ann. § 47:95; Md. Code Ann., Tax-Gen. § 10-109; Montana Stat. Ann. § 15-31-505; N.J. Stat. Ann. § 54:1A-10; N.C. Gen. Stat. Ann. § 105-130.6; Tenn. Code Ann. § 67-4-2014; and Va. Code Ann. § 58.1-421.

income" standard.See generally, J. Snethen & K. Erbeznik, *Playing the Price is Right With State Transfer Pricing Studies,* State Tax Notes, p. 31, January 2, 2011.

One reason states do not invoke their "Section 482" authority more frequently may be a belief that the states would also be bound to follow IRS regulations governing when and how IRC § 482 authority may be used in the federal system. See 26 CFR 1-482.1-6. According to the 1996 regulations promulgated by the IRS, "in determining the true taxable income of a controlled taxpayer, the standard to be applied in every case is that of a taxpayer dealing at arm's length with an uncontrolled taxpayer." 26 CFR 1.482-1(b)(1). Many states are reluctant to use "arms-length accounting" standards to make adjustments to state reported income since the states use formulary apportionment as the best and most predictable means to determine the amount of income earned within a jurisdiction, and the states are often ill-equipped to determine accurate transfer prices between related entities.

While federal tax authorities have concluded that "arms-length pricing" is the best means of implementing § 482 at the federal level, there are good reasons to assume that state legislatures did not intend to so limit state taxing authorities to the arms-length methodology, which appears nowhere in the language of § 482, given the universal acceptance of formulary apportionment as the primary means to determine in-state earnings. The case against the use of arms-length accounting standards in making state "Section 482" adjustments is especially strong where the states have adopted stand-alone 482-like statutes. The adoption of one or more model regulations governing the use of state § 482 authority could have the following salutatory effects:

(a) the regulation could provide valuable guidance to taxpayers as to the circumstances in which § 482 authority could be implemented and the possible remedies available to the tax commissioner in the event that authority was implemented;

(b) states would be more likely to use their implicit or explicit § 482 authority instead of foregoing revenue lost to income-shifting, or instead of relying on means which may be less appropriate under the circumstances, such as assertions of nexus, sham transaction theory or litigation regarding inclusion in a combined report;

(c) in states which currently rely on arms-length accounting methodologies to prevent income-shifting, states and taxpayers could save resources, eliminating the need to prepare transfer pricing reports or to hire economists to establish reasonable transfer pricing.

In earlier memos to the Committee, staff has listed a number of factors to consider for implementation of Section 482 authority and possible remedies available to state tax commissioners. One possible "trigger" is the presence of a gross imbalance between reported income and expenses (the latter gauged either by federal deductions on lines 11-26 of the federal 1120 or by the quantity of apportionment factors) among related parties arising, either directly or indirectly, from transactions between those parties. A second possible "trigger" would be evidence of significant transfer of property between related parties in non-recognition transfers, the most common means used by taxpayers in state income tax shifting.[3] The "gross imbalance" standard would discourage use of Section 482 authority in routine situations where one component of a taxpayer's business conducted outside the state's jurisdiction appears more profitable compared to the in-state components of the same business.

With respect to potential state remedies in the absence of transfer pricing adjustments, those remedies could include elimination of an in-state taxpayer's current and "historic" costs associated with a particular unitary asset held by a subsidiary, or forced combination of two or more subsidiaries.

The proposal generated a great amount of discussion and the committee voted narrowly to take comments from the practitioner community and others before deciding whether to initiate the project. That "outreach" effort is now under way. A list of proposed areas for comment is attached.

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[3] Many state tax planning strategies use IRC §351 "non-recognition" transactions between related domestic companies to move ownership of income-producing assets to low-tax states. These transfers improperly segregate income into separate entities while retaining the expenses necessary to generate that income in the nexus companies. It is difficult for the states to challenge the effects of these transactions, even as a matter of arms-length pricing adjustment, since (non-income generating) stock is received in exchange for the assets. Asserting nexus over the transferee is not always an option, especially as tax planning transactions have become more complex. Income may also be improperly transferred to a captive insurance company or other entity exempt from inclusion on combined reports.

<u>QUESTIONS</u>

Procedural:

- Do you believe that the states currently lack uniformity in applying Section 482 standards and authority?
- Do you believe uniformity in applying Section 482 standards and authority would be beneficial to the public?
- Do you believe state use of Section 482 authority is or may become a matter of concern for you or your clients?
- Do you feel this project may make it more likely that states will increase their utilization of whatever Section 482 authority they may have?
- Do you think an MTC project on this topic could be successful? Why or why not?
- Do you think states would adopt a model regulation or regulations on this topic if the MTC approved them? Might your organization support states in pursuing adoption?
- Are there other interested parties you suggest we consult in determining the procedural and substantive aspects of this project?
- What timeline would you recommend for such a project?

Substantive – we would also welcome any thoughts you have, and would like to share at this time, on the following questions:

- Do you believe a regulation on this topic should address whether states have the authority to use Section 482 authority if the states have not adopted state-equivalents to Section 482?
- Do you believe the states should be bound to use existing federal regulations in implementing Section 482, including preferences for use of particular methodologies and evidence?
- Do you believe the states should be permitted to use formulary apportionment principles in implementing Section 482?
- Do you believe state remedies for failure to clearly reflect income or prevent evasion of taxes include the use of combined reporting of incomes?
- If combined reporting is considered as an available option, do you believe it should be given a lower preference than other remedies?
- If combined reporting is considered to be an available option, do you believe the scope of permissible combination should be limited in any way, such as, to exclude insurance or financial entities?
- Do you believe a regulation on this topic should address burdens of proof and safe harbors?

Other Comments and Suggestions?

We recognize that this list of questions covers only a limited range of topics and considerations. We welcome your input and advice on all aspects of this proposed project.