



MEMORANDUM

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

From: Bruce Fort, MTC Counsel

Date: July 19, 2012

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 Incomes

This memo outlines issues for the income and franchise tax uniformity subcommittee to consider in deciding whether a model regulation would be appropriate to allow states to address inappropriate income shifting between related domestic entities under existing statutory authority. The states have authority to adjust income and expenses among related entities arising from several statutory provisions and presumably under common law authority, such as the “sham transaction” doctrine. But states are not always able to use the full range of their authority for a variety of reasons, including uncertainty over how to apply state anti-abuse laws in the context of formulary apportionment systems. This memo addresses a possible model that would fill that gap by providing regulatory guidance for applying one existing statutory source of state anti-abuse authority in the context of formulary apportionment.

A. Existing State and Federal §482 Authority to Allocate Income, Expenses and Deductions.

The broadest and most explicit anti-abuse provision available to the states is Section 482 of the Internal Revenue Code (“IRC”). IRC Section 482 states in part:

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.

All states which use federal taxable income as their starting point also have arguably automatically incorporated federal anti-abuse statutes into their statutes, since the federal provisions are designed to ensure accurate reflection of federal income. (It must be noted that one court has concluded that its legislature did not intend to incorporate federal §482 powers. See *Comptroller of the Treasury v. Gannett Co, Inc.*, 741 A.2d 1130 (Md. 1999).) In addition, some fifteen states have adopted separate statutes which parallel the language of IRC §482.¹

IRC §482 authority has the potential to address problems arising from income shifting to related entities in low tax states. 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 have the effect of separating income from the expenses necessary to generate that income into separate entities. Thus, expenses may be sourced to one jurisdiction while income is shifted to another. It is difficult for the states to challenge the effects of these transactions, especially since they may arguably have a legitimate business purpose. Asserting nexus over the income transferee is not always an option. And, income may be transferred to a captive insurance company or other exempt entity.

B. A Regulation Could Establish the Ability to Use Formulary Apportionment Principles in Implementing §482 Authority.

The principal impediment to the states’ use of §482 authority is a practical one. Taxpayers have argued that the state must use the substantive and procedural rules established under federal regulations, especially the application of arms-length accounting principles, in demonstrating how income has been improperly reflected. See, e.g., *Microsoft Corporation v. Office of Taxation and Revenue (District of Columbia)*, Case No. 2010-OTR-00012, http://oah.dc.gov/sites/default/files/dc/sites/oah/publication/attachments/2010-OTR-00012_Redacted_Final_Order_Microsoft.pdf. But the time and expense involved in arms-length determinations and adjustments make it impractical to pursue any but the largest taxpayers and most obvious abuses.

A model regulation could help address that problem by authorizing states to gauge whether a return “clearly reflects income” among related entities by application of the “distortion” concept which has arisen in some “forced combination” cases and equitable apportionment cases. See, e.g., *Microsoft v. Franchise Tax Board*, 47 Cal. Rptr. 3d 216, 139 P.3d 1169 (2006); *Wal-Mart Stores East, Inc. v. Hinton*, 676 S.E.2d 634 (N.C. App. 2009). Rather than attempting to establish an accurate transfer price for goods, services and intangibles passed between related entities, this approach would authorize use of formulary apportionment principles to establish a rebuttable presumption that income is not accurately reflected if gross imbalances exist in the

¹ 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 Sta. 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.

profits and expenses of interdependent entities when those imbalances arise from non-recognition transactions. There are other criteria which could be applied in establishing when §482 powers should be invoked, including modification of the provisions currently used in the MTC's model combined reporting statute for inclusion of certain entities in the water's edge combined return in order to prevent income-sifting. See also, Ak. St. § 43.20.073(a)(1)(b)(inclusion of companies doing less than 20% of business in U.S. on water's edge return if the companies lack substantial business operations.)

For the practical reasons discussed above, the model regulation might provide that the appropriate remedy when income is not accurately reflected is the combination of income and apportionment factors of those related entities, rather than requiring specific adjustments to income, expenses and deductions.

As an example of how such a model regulation would operate, consider the case of a bank which transfers its loan portfolio to a Delaware subsidiary in a §351 transaction. The bank will continue to incur interest expense on the money it borrowed from the Federal Reserve or other sources. The subsidiary would collect the loan payments but would have minimal apportionment factors, resulting in a very high taxable income to expense ratio which could be expected to continue on a long-term basis. The bank, on the other hand, would have substantial expenses (apportionment factors) but little taxable income.

Use of Section 482 authority would be appropriate to align income and expenses between these related entities in this example, and in addition to considering systematic imbalances between income and expenses, use of apportionment principles would be appropriate to demonstrate that the bank's earnings were understated in relation to the subsidiary's earnings. The bank could attempt to establish that the high income to expense (apportionment factors) ratio of its subsidiary in comparison to the bank was appropriate, perhaps because of differences in efficiencies in factors of production.

Other existing state remedies would be problematic in combating this income-shifting technique. Since the loan transfer was accomplished under §351 in exchange for the subsidiary's stock of equal value, the bank would argue that the transaction was at "arms-length" for traditional §482 purposes. The bank would presumably be ready to make a case that the transaction had economic substance. And it would be difficult for a non-domiciliary state to assert nexus over the subsidiary. Add-back statutes would also be unavailing since neither party would need to make interest payments to the other.

Under this proposal for a model regulation, combination of the two entities would be authorized as a remedy under state application of IRC§482 principles and parallel state statutes. The taxpayer would still be entitled to rebut that application of the statute by asserting that the results under formulary apportionment failed to accurately reflect its in-state income.

A model regulation could also help establish state authority to utilize §482 remedies where the state has not adopted a separate §482-equivalent statute. A regulation clarifying the right of states to use §482 authority and establishing procedures and guidelines for its implementation

would assure taxpayers of due process for states wishing to re-asserted their long-dormant authority to correct imbalances of income, expenses and deductions among related entities.