MULTISTATE TAX COMMISSION
Maximizing the synergies of multi-state tax cooperation

To: **MTC Uniformity Committee**

From: **Sheldon H. Laskin, Counsel**

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Subject: **Conformity With Federal Tax Regulations**

The purpose of this memo is to summarize a number of cases that have considered when, and to what extent, courts have found it appropriate to rely on a federal tax regulation to construe a state tax statute. This issue has taken on some prominence in recent years, for example, where the federal regulations at issue involve questions of how to treat related-party transactions. In those cases, taxpayers have relied on transfer pricing studies, as allowed by federal regulation, to value the transfer of intangible assets between related affiliates in separate entity states or when a combined reporting state cannot combine the transferor and transferee of the assets.

Some General Observations

The case law in this area is not based on a rigid jurisprudential framework. Rather, the cases tend to approach the issue of conformity pragmatically. The opinions examine the applicable federal regulation (1) in view of the extent to which the state statute has committed the state to follow federal regulations, (2) after first examining the purpose of the state tax policy in question, and (3) finally analyzing the federal regulation to determine whether the purpose behind that regulation is consistent with the purpose behind the state tax policy in question.

Several of these cases are very relevant to the Section 482 issue raised in *See's Candies v. Utah State Tax Commission,* Case No. 140401556 (Utah 4th Judicial

District Court (October 7, 2016). This case illustrates the kind of questions that may arise and how federal regulations may come into play.

See's Candies is a wholly-owned subsidiary of Berkshire-Hathaway. In 1997 Columbia Insurance Company, also a Berkshire Hathaway wholly-owned subsidiary, purchased See's trademarks and other intellectual property, in return for Columbia stock. In valuing the IP and the royalty payments See's paid for the use of the marks, Berkshire hired Deloitte Touche to conduct a transfer pricing study to assure that the transaction satisfied the "arm's length standard" required under IRC Section 482.

Utah is a combined reporting state but does not include insurance companies that are subject to the state's premium tax in the combined group. See's claimed a deduction from its income subject to the franchise tax for the royalty payments it made to Columbia. The State Tax Commission disallowed the deduction pursuant to Utah Code Annotated Section 59-7-113, which authorizes the Commission to reallocate income and expenses among related corporations in order to properly reflect income. The statute is nearly identical to IRC Section 482 (as that statute was written prior to 1986). The Commission concluded that reallocation was authorized because the transfer between these two related entities was not at arm's length and had created a distortion of See's income. Although the federal statute makes no mention of how the "proper" reflection of income should be measured, long-standing federal regulations establish a comprehensive methodology for determining whether particular transactions resulted in distortion and the degree to which the "transfer price" for those transactions can be adjusted. Those measures include examining uncontrolled prices charged in similar transactions where available, resorting to profit split methodologies, industry average profitability and other methodologies where adequate information on comparable uncontrolled transactions is unavailable. The federal regulations generally do not contemplate use of formulary apportionment principles or combined reporting as a means to more properly reflect income among related parties.

Concluding that federal regulations interpreting Section 482 govern the proper interpretation of Section 59-7-113, the district court reversed the findings of the Tax Commission. The district court held that given the close similarity between the federal and state statutes, it was appropriate to use federal arms-length accounting principles in evaluating whether the Commission exceeded its discretion. Because the taxpayer had submitted a transfer pricing report establishing the reasonableness of the intercompany royalty rate, and in the absence of contrary evidence regarding the valuation of the IP and the royalties, the Court held that Utah's Tax Commission lacked authority under the federal regulations to disallow the taxpayer's royalty expense deduction.

A similar result was reached in the case of *In re Microsoft*, District of Columbia Office of Administrative Appeals No. 2010-OTR-00012 (2012), where the administrative law judge rejected the tax agency's evidence of improper reflection of income. The taxpayer maintained, and the ALJ agreed, that under regulation 26 C.F.R. Sec. 1.482-5, before a tax agency can use the comparable profits methodology, it must first identify the particular controlled transactions which were not in accordance with uncontrolled transaction prices, if available. The tax agency maintained that it had met the federal requirements but were not bound by them. http://oah.dc.gov/sites/default/files/dc/sites/oah/publication/attachments/2010-OTR-00012_Redacted_Final_Order_Microsoft.pdf.

Survey of Cases

The following list is not meant to be exhaustive. It is instead illustrative of the way courts have dealt with the conformity issue, looking at cases where either the taxpayer or the state relied on the regulation.

1. Cases that address Section 482 adjustments

- *Bunge Corporation v. Dep't. of Revenue & Taxation,* 419 So. 2d 1288 (C.A. LA 1982) (declined to follow federal regulation)

Issue: Whether taxpayer was allowed to defer recognition of income received from domestic international sales corporation (DISC).

The taxpayer argued that the state was required to apply the federal accounting rule allowing taxpayers to defer recognition of income received from a related DISC because Louisiana's distortion statute is modeled on IRC 482. The taxpayer asserted that conformity principles therefore required the state to accept the federal tax treatment of DISC income and allow the deferral.

The court held that the state was not obligated to accept federal tax treatment of DISC income. Nothing in the IRC or in the Louisiana distortion statute supports a conclusion that Louisiana is required to adopt the federal tax treatment of DISC income. The IRC contains many deductions and exclusions or "shelters" (sic) applicable to federal tax. The state is not obligated to accept these federal provisions merely because its distortion statute is modeled on Section 482.

- *Wisconsin Dep't of Revenue v. Sentry Financial Services Corporation,* 469 NW 2d 235 (CA WIS 1991) (Followed federal regulation)

Issue: Whether state could reallocate a gain on the bargain sale of an airplane from a corporation to its parent when the IRC and federal regulations provide for nonrecognition of gain on a bargain sale of property between related entities.

The taxpayer argued that conformity principles required the state to accept the federal nonrecognition of gain on bargain sales. First, the state statute clearly would have required the non-recognition of gain on the transfer of stock. The state treated the transfer of the airplane as a constructive dividend and therefore the airplane sale was equivalent to a distribution with respect to the transferor's stock. Furthermore, the federal bargain sale regulations specifically treat a bargain sale as if it were a distribution of stock. Since the Wisconsin non-recognition statute is modeled after the federal statute, conformity required that the state accept the taxpayer's non-recognition of gain on the bargain sale.

The court ruled in favor of the taxpayer and disallowed the state's reallocation of gain.

- *Comptroller of the Treasury v. Gannett Co., Inc.,* 741 A.2d 1130 (MD 1999) (both parties rely on conformity, but at different levels of generality/specificity)

Issue: Whether state could impute interest income on intercorporate debt under IRC Section 482.

At the time, Maryland did not have a distortion statute. The state therefore relied directly on IRC Section 482 to impute income on intercorporate debt so as to eliminate the distortion of income that would otherwise result. Gannett had filed a consolidated federal return, so there was no occasion for the IRS to apply Section 482 and the Service accepted the return as filed.

The state maintained that conformity allowed it to rely on Section 482 because the calculation of Maryland income begins with federal taxable income. As the IRS **could have** made adjustments to federal taxable income under Section 482, the state asserted it had coextensive authority to do the same. Gannett maintained that, in the absence of a state statute addressing distortions of income, 482 did not give the Comptroller independent authority to make the adjustments if the IRS had accepted the return as filed and the adjustments at issue would be above the line adjustments. The court agreed.[1]

The Maryland General Assembly enacted a distortion statute as a result of the case.

2. Conformity in contexts other than Section 482 adjustments

- *Gulf Oil Corporation v. Alaska Dep't of Revenue,* 755 P.2d 372 (AK 1988) (Did not follow federal rule)

Issue: Whether taxpayer could reduce its apportionable tax base by subtracting foreign income taxes paid.

The taxpayer argued that conformity principles required the state to accept its reduction of the apportionable tax base by the amount of foreign income taxes paid because federal tax regulations allow a credit for foreign income taxes paid.

[1] The Court also ruled that the Comptroller would have authority to impute income under IRC Section 7872, even if the IRS had not done so, because Section 7872, unlike Section 482, **requires** the imputation of income in all cases to which it is applicable. However, the Court also noted that under the Section 7872 regulations, it was clear that Section 7872 was not applicable in this case as the taxpayer had filed a consolidated federal return. Therefore there would be no significant federal tax consequences if income were to be imputed. As the adjustments the Comptroller was proposing would be adjustments to federal taxable income, he did not have 7872 authority in this case to make those adjustments.

The court held that the state was not required to accept the federal regulations for purposes of reducing the apportionable tax base. First, state law allowed such a reduction only for foreign taxes paid other than an income tax. Conformity is inappropriate when the purposes and incentives of federal and state tax law are directly contrary to each other. Furthermore, the state conformity statute authorized the state to "except to or modify" the applicable federal rule. The court held that disallowing the reduction of the tax base for foreign income tax paid is such an exception.

- *Wien Air Alaska, Inc. v. Alaska Dep't of Revenue,* 647 P. 2d 1087 (1982) (Majority did not follow federal rule)

Issue: Whether a retroactive limitation on a state investment tax credit is subject to the federal binding contract rule, such that the state could not apply the limitation to otherwise qualifying contracts that became binding prior to the effective date of the limitation.

The taxpayer argued that the federal binding contract rule was incorporated in state law because the state statute incorporated by implication all of the applicable federal investment tax credit statues and regulations.

A majority of the court ruled that the state was not bound by the federal binding contract rule. First, the legislative history of the limitation made clear that it was designed to reduce the ouflow of state tax revenues to other states as a result of large multistate corporations claiming the credit. Applying the federal binding contract rule would defeat that purpose. Secondly, the fact that the legislature made the limitation retroactive is clearly inconsistent with the purpose of the federal binding contract rule. Since that federal rule is based on the effective date of the statute that eliminated or reduced the tax benefit, applying the rule to a retroactive limitation would produce anomalous results. A binding contract entered into prior to the effective date of the retroactive state limitations statute would not be subject to that limitation. But an equally binding contract entered into after the retroactive effective date of the statute but before the later date of enactment would be subject to the limitation. (The effective date of the limitation in this case was January 1, 1975. But the statute was not enacted until June 1975.)

Two justices dissented.

- *Standard Oil Company of New Jersey v. Collector of Revenue,* 27 So. 2d 428 (LA 1946) (Followed federal rule)

Issue: Was taxpayer entitled to expense oil drilling expenditures, or could state require it to capitalize the expenses?

The taxpayer argued that conformity principles required the state to allow it to expense its oil drilling expenditures.

The court ruled in favor of the taxpayer. The applicable federal regulations clearly allowed the taxpayer to choose a current deduction instead of capitalizing the expenses. As the state and federal statutes governing expense deductions, depletion and depreciation were identical, the state was required to accept the federal regulations and allow the taxpayer to elect to expense the costs.

- *Taiheiyo Cement USA, Inc. v. Franchise Tax Board,* 138 Cal.Rptr.3d 536 (CA 2012) (Federal regulation applied)

Issue: Whether enterprise zone sales and use tax credit applied to the purchase of assets that the taxpayer expensed?

The state argued that the credit was only authorized where the taxpayer capitalized its purchases and not when the purchases were expensed.

The court ruled in favor of the state. The state statute authorizing the credit also provides for when the qualified property is considered to be "placed in service." The court found that under federal tax regulations, the phrase "placed in service" is a term of art that is only used with reference to capitalized property. Similarly, the state statute refers to the "basis" of qualified property. Again, "basis" is a term that is commonly used in the IRC with reference to capitalized property.

- *Kmart Michigan Property Services, LLC v. Dep't. of Treasury,* 770 NW2d 915 (CA MI 2009) (Federal rule not applied)

Issue: Whether an LLC is barred from filing as a separate entity for state SBT purposes when it had elected to be a disregarded entity for federal income tax purposes.

The state argued that the taxpayer's election to file as a disregarded entity for federal income tax purposes barred it from filing a separate SBT return.

The court ruled in favor of the taxpayer. The court noted that the federal regulations explicitly state that the "check the box" rules are governed by federal law and do not depend on whether state law recognizes an LLC as a separate entity. Also, the court viewed conformity as only requiring the state to apply federal tax *definitions* in comparable state tax contexts. There was no issue in this case as to the meaning of the terms "LLC," "disregarded entity" or "separate entity." The only issue was whether an election for federal tax purposes was binding on the taxpayer for state tax purposes.

- *Mlady v. Director of Revenue, 108 SW 3d 12 (MO CA 2003)* (Federal regulation does not apply)

Issue: Does federal tax definition of domicile govern in a state tax case regarding residency?

The taxpayer argued that conformity required that the federal definition of "domicile" be used to determine state residency.

The court ruled that the federal definition was inapplicable. First, the purpose of the federal rule-- to determine when an individual was domiciled *in the United States for estate tax purposes*—is not comparable to the purpose in state tax cases, which is to determine state residency. Missouri caselaw had previously construed the term "domicile" under the state statute governing residency.

- *Marx v. Bragalini*, 6 NY2d 322 (CANY 1959) (Followed federal regulation)

Issue: Whether a distribution in cash to a shareholder from unrealized appreciation of the assets of an apartment house corporation constituted taxable income to the extent the distribution did not exceed the shareholder's basis.

The taxpayer argued that the federal regulation dealing with distributions from appreciated assets supported its position that the distribution was not taxable.

The court agreed, noting that the state legislature explicitly modeled the New York definitions of gross income and dividends after the preexisting federal definitions.

- *Delese v. Tax Appeals Tribunal,* 771NYS 2d 191 (NY App Div 2004) (Followed federal regulation)

Issue: Whether the value of a retained life estate should be subtracted from the appraised value of a residence to determine the amount of a gift of real property subject to gift tax.

The state argued that the federal regulation valuing a retained life estate at zero for gift tax purposes supported its position that no valuation should be allowed for the retained life estate.

The court agreed, finding that the New York tax statute explicitly adopted the relevant provision of the Internal Revenue Code, notwithstanding that the state had never promulgated the federal regulation as a state regulation.

- *In re Norma Bagdan,* 2004 WL 1038114 (NY Div. Tax. App. 2004) (Followed federal regulation)

Issue: Whether successive creations of mortgage interests in favor of the donee of a gift of real property constitute a transfer of those proportionate shares of the real property such that each successive mortgage constitutes a tax-exempt gift.

The state argued that the IRC, federal regulations and federal case law supported its position that there was no gift until title to the property was transferred by deed.

The court ruled in favor of the state, noting that the New York gift tax statute specifically cites to sections of the IRC that govern when transfers of property are subject to gift tax. In the case of real property, the taxable transfer occurs when the deed to the property is delivered.

- *In re Ronald Brenhouse*, 2008 WL 4196633 (NY Tax. App. Trib. 2008) (Followed federal regulation)

Issue: What was the correct statute of limitations for a refund claim when the taxpayer failed to file timely returns and the resulting assessment for underpayment of tax was final and collected?

The taxpayer argued that he had three years from the date the return was ultimately filed to file his refund claim, notwithstanding that the payment on the assessment was made more than three years before he filed the refund claim. He relied on the IRC and federal case law to support his position. [NOTE: the refund claim was for 1994 and the tax return for that year was filed on June 27, 2001. The Division of Taxation determined he had overpaid tax for 1994 in the amount of $306,350, which had been based on estimated assessments. The Division had previously executed on the assessments which subsequently generated the refund claim, more than three years after the Division received payment via various tax levies.]

The Tax Appeal Tribunal ruled in favor of the taxpayer, partly because the state tax statute specifically required that the meaning of terms under the New York income tax laws should have the same meaning as terms that are used under federal tax law in a comparable context, unless a different meaning is clearly required under the state law. The IRC and federal case law, especially from the Second Circuit, made clear that a timely filed return is not a prerequisite for a timely refund claim.

- *Astoria Financial Corporation v. Tax Appeals Tribunal,* 880 NYS2d 389 (NY App Div 2009) (Did not follow federal regulation)

Issue: Whether Astoria was entitled to a tax credit for mortgage origination when it used the property subject to the mortgage to manage its own mortgage portfolio and not in its trade or business as a broker or dealer in securities.

Astoria relied on the IRC definition of “security” which would include mortgage origination for property used to manage the taxpayer’s own mortgage portfolio.

The court rejected the taxpayer's reliance on the IRC definition, notwithstanding the general rule of conformity with substantially similar federal tax provisions as articulated in *Bragalini* and *Delese.* The federal definition governed which entities must comply with "mark to market" accounting rules and was not intended to govern investment tax credits. In this context, Astoria's reliance on the federal definition was not reasonable.

- *Gaupp v. Tarver,* 691 So.2d 107 (CA LA 1997) (Did not follow federal regulation)

Issue: Whether United States savings bonds that are registered in the name of a beneficiary are made in contemplation of death and subject to Louisiana inheritance tax.

The taxpayer asserted that the state statute was preempted by the federal regulations governing savings bonds.

The court rejected the argument. Notwithstanding that Louisiana courts have recognized that the applicable Treasury Regulations that govern transmission and disposition of the bonds are superimposed upon Louisiana law governing inter vivos gifts and gifts in contemplation of death, the court found no conflict here. The federal regulations govern ownership of the bonds, not the state tax consequences of holding the bonds in a particular form. The court noted that the applicable federal regulations specifically allow for state taxation of the proceeds of the bonds.

- *Kidde America v. Director of Revenue,* 198 SW 3d 153 (MO 2006) (Followed federal regulation)

Issue: Whether the taxpayer could claim a good faith exception to the deadline for making an election to file a consolidated return.

The taxpayer relied on a federal regulation which allows for a good faith exception to regulatory filing deadlines, if the taxpayer acted reasonably.

The court ruled in favor of the taxpayer. Although the corresponding Missouri statute did not allow for a good faith exception to the election deadline, the Missouri statute did provide that state rules and regulations should follow as nearly as practicable federal tax rules and regulations. Because the state had adopted the deadline portion of the corresponding federal regulations while omitting the good faith exception, the state did not follow the statutory mandate to follow the federal regulations "as nearly as practicable."

- *Express Scripts, Inc. v. Director of Revenue,* 2014 WL 6772753 (Mo.Admin.Hrg. Com.2014) (Did not follow federal regulation)

Issue: Whether a consolidated group of corporations may carry forward into the consolidated return NOLs previously incurred when the corporations filed on a separate return basis.

The taxpayer relied on a federal regulation that would have allowed it to carry forward the prior separate entity NOLs.

The Administrative Hearings Commission rejected the taxpayer's reliance on the federal regulation, for three reasons:

First, the Commission rejected the taxpayer's assertion that the Missouri conformity statute mandated the state promulgate the federal rule as a Missouri rule.

Second, the Commission rejected the taxpayer's reading of *Kidde America* as mandating the state promulgate the federal rule. All that *Kidde America* held is that, assuming the state had partially adopted a federal rule, it would ordinarily be required to apply the omitted portion of that rule, if doing so was practicable.

Third, the Commission noted that *Kidde America* explicitly ruled that a federal regulation cannot change Missouri substantive law. Since the NOL deductions at issue in *Express Scripts* are provided by statute and not by regulation, the statutory requirement to follow federal regulations as nearly as practicable is irrelevant.

Nevertheless, the Commission noted that the parallels to *Kidde America* were striking. Had the taxpayer argued that the failure to promulgate a rule that is comparable to the federal rule required the state to apply the federal rule – as opposed to formally promulgate the rule as a state rule – the result of the case might have been different. But the taxpayer disclaimed that argument and the Commission did not consider it.

- *King v. Comptroller of the Treasury,* 425 Md. 171 (MD 2012) (Followed federal regulation)

Issue: How is the statute of limitations for refund claims to be computed when a limited partner files a refund claim based on adjustments to the partnership return, when the partner signed a settlement agreement as to those partnership adjustments?

The case turned on a determination of when an IRC partnership adjustment is "final." The taxpayer argued that a partnership adjustment is not final until the dates for all applicable appeals have lapsed.

Relying on the IRC, the court held that a partnership adjustment is final on the date the adjustment report was issued, as applied to all partners who consented to the adjustment. Only non-consenting partners would be entitled to the longer limitations period that is measured from the date of a final decision of the highest court to which an appeal was taken.

The court distinguished statutes from Kentucky and Texas that appeared to measure the limitations period from the date any applicable appeals would be final as Ms. King did not contest the adjustments.

<u>3. You've hit the trifecta – tax conformity, the False Claims Act and removal to federal court</u>

- *Eric Rasmusen v. Citigroup, Inc.,* United States District Court for the Southern District of New York, Case No. 15-cv-07826 (December 2, 2016)

I close, Constant Reader, with this nightmare of a case that could only have come from the fevered imagination of Stephen King, had he gotten an LL.M in Taxation while recovering from the auto accident in 1999.

Rasmusen is a False Claims Act case. Mr. Rasmusen alleges that Citigroup improperly deducted net operating losses in New York. Citigroup's calculations of the NOLs was consistent with IRS guidance for the implementation of the Troubled Asset Relief Program (TARP) pursuant to which the Treasury Department had purchased a significant ownership interest in Citigroup, which it later sold at a significant profit. New York law does not allow taxpayers similar favorable treatment for NOLs.

Mr. Rasmusen filed his action in state court. The state declined to intervene. Citigroup removed the action to federal court. The federal court has now remanded to state court, finding there is no substantial federal question in the case.

So-o-o now the issue of the proper treatment of NOLs amounting to probably billions of dollars will be litigated in state court, without direct participation by the state, and between clearly self-interested parties. Citigroup is in the position of championing tax conformity while Mr. Rasmusen presumably will argue it does not apply. Stay tuned.