



MEMORANDUM

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

From: Bruce Fort, MTC Counsel

Date: November 21, 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 Income

In its meeting held on July 30, 2012, in Grand Rapids, Michigan, the Income and Franchise Tax Uniformity Subcommittee (the subcommittee) heard a report outlining a possible new project to consider whether a model regulation would be appropriate to allow states to address inappropriate income shifting between related entities under existing “IRC Section 482” statutory authority.

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. Commission staff prepared a “checklist” of possible considerations to encourage focused comments from outside constituencies. A copy of that memo is attached.

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

IRC § 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 have arguably automatically incorporated federal anti-abuse statutes into their statutes, since the federal

provisions are designed to ensure accurate reflection of federal income. *But see: Comptroller of the Treasury v. Gannett Co, Inc.*, 741 A.2d 1130 (Md. 1999)(use of “may” in Section 482 indicates that adjustments under statute are discretionary and it should not be presumed that legislature intended to grant discretionary authority to state tax comptroller). The reasoning employed by the Maryland court is certainly subject to challenge, and the case has not been followed elsewhere. In addition, some fifteen states have adopted separate statutes which parallel the language of IRC §482.¹

IRC §482 authority has the potential of being a very advantageous tool for the states in preventing income distortions, because it addresses fundamental problems arising from the ease in which income can be shifted 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 improperly segregate income from the expenses necessary to generate that income into separate entities. It is difficult for the states to challenge the effects of these transactions. 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 exempt entity.

B. A Regulation Could Provide Guidance on the State’s Use Formulary Apportionment Principles in Implementing §482 Authority.

The principal impediment to the states’ use of §482 authority is a practical one. Taxpayers can be expected to argue that the states 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 Microsoft Corporation v. Office of Tax and Revenue*, D.C. Administrative Hearing Office No. 2010-OTR-00012 (5/1/12)(District could not rely on “comparable profits method” under District’s version of Section 482 without first identifying specific transactions causing distortion of income as required by federal regulations.). The states are generally not well-equipped to make arms-length determinations and adjustments, and the time and expense involved in litigating such adjustments makes it impractical to pursue any but the largest potential liabilities.

A model regulation could remedy 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” 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

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 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.

approach would authorize use of formulary apportionment principles to establish a rebuttable presumption that income is not accurately reflected where gross imbalances exist in the profits and expenses of those entities when measured under apportionment principles.

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 two or more related (and unitary) entities, rather than requiring specific adjustments to income, expenses and deductions.

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 additional due process notice in states contemplating use of authority to correct imbalances of income, expenses and deductions among related entities.

In addition to the outreach question list, attached, I have also prepared a brief power point discussion.

I look forward to answering any questions you or the committee may have on this proposal.

MTC UNIFORMITY COMMITTEE POTENTIAL PROJECT

REGULATION ADDRESSING STATE POWERS AND PROCEDURES FOR IMPLEMENTING SECTION 482 AUTHORITY TO ADJUST INCOME AND EXPENSES AMONG RELATED PARTIES

BACKGROUND

Internal Revenue Code Section 482 provides in pertinent 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. In the case of any transfer (or license) of intangible property (within the meaning of section 936(h)(3)(B)), the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible.

Fourteen states and the District of Columbia have separately adopted some version of this statute into their income tax codes, and arguably, states which have adopted the IRC as the starting point for determining state taxable income have incorporated the provisions of Section 482 into their statutes even without a separate adoption.

The U.S. Treasury has promulgated extensive regulations setting forth the parameters for the use of Section 482 in making adjustments to income. Those regulations generally establish procedures and methodologies for determining the fair market value for transfers among commonly-controlled U.S. and foreign corporations. Most of the regulations are designed to establish an “arms-length price” for such transfers, although the regulations do provide for means by which profits arising from particular transactions can be apportioned among related entities and can include the use of industry-wide profit estimating in the absence of available evidence of arms-length pricing.

At the July 2012 meeting of the MTC’s Income and Franchise Tax Uniformity Subcommittee in Grand Rapids, Michigan, the subcommittee heard a presentation on a proposal to initiate a project to draft one or more regulations establishing guidelines for states to use in making adjustments of income and expenses for state tax purposes, either domestically or internationally, under IRC Section 482 and state versions thereof. The types of methodologies which could be used by the states could be significantly different than federal methodologies, including use of apportionment principles. The subcommittee voted to solicit input from taxpayer groups on the desirability, practicality, or any other thoughts regarding the possible initiation of such a project and the contours any such project might take before proceeding further. In response to the subcommittee’s direction, we have drafted a number of questions for your consideration which we hope will help prompt that input. We encourage you to make additional comments and suggestions as well. We greatly appreciate your interest and efforts in responding to these inquiries.

QUESTIONS

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.