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In this issue:

Congressional, White House negotiators drop border-adjustment tax from tax reform principles

Congressional Republican leaders and White House officials announced in a joint statement July 27 that as part of their shared commitment to tax reform, a border-adjustment tax will not be included in any tax code overhaul that moves through Congress this year.
URL: https://www.republicanleader.senate.gov/newsroom/press-releases/joint-statement-on-tax-reform

The statement – which was released by House Speaker Paul Ryan of Wisconsin, Senate Majority Leader Mitch McConnell of Kentucky, House Ways and Means Committee Chairman Kevin Brady of Texas, Senate Finance Committee Orrin Hatch of Utah, Treasury Secretary Steven Mnuchin, and National Economic Council Director Gary Cohn (known informally as the “Big Six”) – outlines a consensus Republican view of the key principles that should animate tax reform.

‘Many unknowns’ on border-adjustment

The statement is drafted in broad strokes and largely avoids specific policy details such as target tax rates for businesses or individuals. On the issue of corporate taxation, however, the drafters express confidence that “without transitioning to a new domestic consumption-based tax system, there is a viable approach for ensuring a level playing field between American and foreign companies and workers, while protecting American jobs and the US tax base.”

“While we have debated the pro-growth benefits of border adjustability, we appreciate that there are many unknowns associated with it and have decided to set this policy aside in order to advance tax reform,” the statement said.

The “Better Way” tax reform blueprint that Ways and Means Chairman Brady and House Speaker Ryan released in June of last year called for a new destination-based cash flow tax with “border adjustments” through an unspecified mechanism that would serve to eliminate US tax on products, services, and intangibles exported abroad (regardless of their production location) and impose a 20 percent US tax on products, services, and intangibles imported into the US (also regardless of production location).

The concept of a border-adjustment tax – which is described only in general terms in the House GOP blueprint and was never fleshed out in a discussion draft or an introduced bill – had divided congressional Republicans and became the focus of an intensive lobbying battle within the business community, with retailers, oil refiners, and other import-dependent industry sectors on one side and export-heavy businesses on the other. It also received only lukewarm support from President Trump.

No alternative put forward

The border-adjustment proposal in the blueprint has been unofficially estimated to raise over $1 trillion dollars to offset the cost of a corporate rate cut. Significantly, the statement does not propose any alternative revenue source for bankrolling a rate reduction.

Other principles in brief

In addition to discussing the border-adjustment issue, the statement from the Big Six also addresses some other significant tax reform priorities for businesses and individuals, albeit obliquely.

Rates: The statement calls for tax reform that “protect[s] American jobs and make[s] taxes simpler, fairer, and lower for hard-working American families” and lowers tax rates for businesses of all sizes “as much as possible.”

Permanence: The statement urges the congressional taxwriting committees to develop legislation that “places a priority on permanence.” This appears to be a call for lawmakers to move forward with comprehensive, revenue-neutral tax reform rather than a tax cut-only bill (which would have to be temporary in order to comply with the budget reconciliation rules, which preclude legislation that increases the deficit outside of the 10-year budget window).

Territoriality: The statement does not include an explicit call to adopt a territorial system for taxing foreign-source income of US multinationals. It does, however, call for tax reform that “creates a system that encourages American companies to bring back jobs and profits trapped overseas.” The House GOP tax reform blueprint advocates a territorial tax system; Treasury Secretary Mnuchin commented at a July 26 Senate Appropriations and General Government Subcommittee hearing that moving to territoriality is a “main priority” of the Trump administration; and Finance Committee Chairman Hatch has been extolling the virtues of a territorial tax system in recent speeches and materials released by his panel.

Cost recovery and limits on interest deductibility: The statement includes a reference to “unprecedented capital expensing” for businesses; however, it does not specify the extent of any proposed change in the expensing rules nor does it mention pairing that proposal with changes to the treatment of interest deductibility.

The House GOP blueprint proposes 100 percent expensing for all assets – tangible and intangible – in year one, but pairs that provision with a call for repealing the deduction for net interest expenses. Small-business owners have argued that eliminating the deduction for net interest expenses could be problematic for businesses that rely on debt financing because they have limited access to capital.

Handoff to the taxwriting committees…

With the release of the statement, the Big Six appeared to shift the tax reform process back to the taxwriting committees, saying, "[o]ur expectation is for this legislation to move through the committees this fall, under regular order, followed by consideration on the House and Senate floors."

Regular order should include passage of the bills through both the Ways and Means and Finance committees before moving to the House and Senate floors, with the opportunity for members of both parties to offer amendments. This does not appear to preclude the use of the reconciliation process, by which Republicans could pass the legislation in the Senate with a simple majority vote rather than the three-fifths majority typically required for nonreconciliation bills to clear procedural hurdles in that chamber.

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Corporate Tax Reform and ASC 606: Implications of the new revenue recognition standard

Accounting departments are diligently working through the intricacies of the Financial Accounting Standards Board's new revenue recognition standard, ASC 606 *Revenue From Contracts with Customers*, as they prepare for the application of the new standard. The standard is effective for annual reporting periods (including interim reporting periods within those periods) beginning after December 15, 2017, for public companies, and for annual reporting periods beginning after December 15, 2018, and interim reporting periods within annual reporting periods beginning after December 15, 2019, for nonpublic companies. The American Institute of Certified Public Accountants formed industry task forces to help develop accounting guidance for how to apply the new revenue recognition standard to specific issues identified in each industry. Certain companies are working with their IT Departments to develop new enterprise resource planning systems to capture the necessary data to analyze their revenue streams.
URL: https://www2.deloitte.com/us/en/pages/audit/topics/revenue-recognition.html?id=us:2em:3na:usic:awa:tax:082117

In other words, adopting ASC 606 is a substantial challenge for many organizations.

The tax law may also be transformed in the near future if the United States Congress overhauls the Internal Revenue Code with corporate tax reform. There is uncertainty around exactly what is the plan for tax reform, but the one thing that has been consistently reiterated is that the proposal will have some type of corporate tax rate reduction from the current rate of 35 percent. If companies plan ahead for tax reform, they may be able to permanently benefit from their cash savings by accelerating deductions into the higher tax rate year or deferring revenue into the lower tax rate year.

As a result of the extensive work companies are already undertaking, the new revenue recognition standard provides the perfect opportunity for companies to concurrently analyze their tax accounting methods for corporate tax reform planning. Companies can leverage their understanding of their revenue items gained from the ASC 606 implementation process to determine whether there may be a more advantageous tax accounting method to defer revenue recognition into the lower tax rate year. Under general US federal income tax principles, an accrual-basis taxpayer reports income in the taxable year in which (1) the right to the revenue becomes fixed and (2) the amount of revenue can be determined with reasonable accuracy. The amount is considered fixed at the earliest of when payment is made, payment is due, or performance has occurred. The amount is determinable with reasonable accuracy when an approximate amount is reasonably ascertainable.
URL: https://www2.deloitte.com/us/en/pages/audit/articles/a-roadmap-to-applying-the-new-revenue-recognition-standard.html?id=us:2em:3na:usic:awa:tax:082117

A few of the tax opportunities companies should consider when analyzing their revenue recognition method include:

- **Variable considerations:** Companies may have benchmarks, milestones, or performance bonus provisions in their contracts with customers that need to be satisfied before they have the right to receive payment for their goods or services. Companies may defer recognition of the variable or contingent revenue for US federal income tax purposes until the provisions within the contracts are met such that the amounts are fixed and determinable.
- **Disputed income:** Companies may have customers that dispute the amounts billed for various reasons such as clerical errors, incorrect quantity, or dissatisfaction with the quality of goods, and short the payment of the invoiced amounts in these circumstances. Companies may exclude the disputed amounts from taxable income in the tax year the sales transaction occurred since they do not have a fixed right to receive that portion of the income. The companies would recognize taxable income in the year they settled the dispute with their customers.
- **Advance payments:** Companies may receive payments in advance of when they perform the services or provide the goods to their customers. Companies may be able to defer to the following taxable year in which they receive the advance payment the portion of their revenue not recognized in their financial statements in the initial year of receipt under Revenue Procedure 2004-34. Alternatively, advance payments for goods may be deferred for two years under Treas. Reg. § 1.451-5.

If companies are not using these methods of accounting for US federal income tax purposes, but want to use them as part of their tax reform planning, they generally have to file a Form 3115, *Application for Change in Accounting Method*, under Revenue Procedures 2015-13 and 2017-30. The change in tax accounting method generally requires companies to calculate a cumulative catch-up adjustment that is equal to the difference between the use of the companies' old and new methods of accounting for the item being changed as of the first day of the taxable year of the change (section 481(a) adjustment). The section 481(a) adjustment would be recognized as follows:

- **Positive section 481(a) adjustment:** It is an increase to taxable income and is recognized ratably over four taxable years (or two for taxpayers under examination by the Internal Revenue Service) beginning with the taxable year of change.
- **Negative section 481(a) adjustment:** It is a decrease in taxable income and the adjustment is recognized entirely in the taxable year of change.

Changes in method of accounting to defer recognizing revenue generally result in negative section 481(a) adjustments that decrease taxable income because companies would have over-recognized revenue under their old method. If companies change their method of accounting before the reduction of corporate tax rates becomes effective, they could potentially be achieving the dual benefit of decreasing their taxable income in the higher tax rate year as a result of section 481(a) adjustment and deferring their revenue recognition into the lower rate tax year. To bring synergy into the work stream, companies can leverage their work in ASC 606 to look for these corporate tax reform planning opportunities.

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Cloud ERP: An opportunity to transform tax operations for greater value

Shifting to "as-a-service" offerings can deliver numerous well-documented benefits, including faster deployment, reduced operating costs, and increased economies of scale. But cloud ERP offerings can also open the door to transforming and elevating the corporate tax practice by finally providing a single source of real-time tax data to the business.

In fact, nearly 40% of 1,929 tax, finance and accounting professionals responding to a poll conducted during a Deloitte Dbriefs webcast on the topic say that, among all the digital initiatives their companies might pursue, putting their ERP system in the cloud would most benefit the tax organization.[1]

"In many cases, cloud ERP systems can enable finance organizations to leverage new database technologies and deploy sophisticated data analytical tools in ways that haven't been possible with legacy enterprise software," says Nathan Andrews, national leader, Tax Management, Deloitte Tax LLP. "Further, new software may also allow the tax function to redesign business processes to be more responsive and efficient," he adds.

A new cloud ERP deployment alone is not a silver bullet. However, tax departments can invest in several changes beyond system implementation to overcome their long-standing data access and reporting challenges.

The call of the cloud

Once upon a time, most companies relied on multiple, poorly integrated homegrown systems to run their businesses. Then came the monolithic ERP suite, which promised to enable data-sharing across these systems. But traditional ERP systems created their own set of issues. Many systems were costly and took years to deploy. They typically required the enterprise to adjust its processes to the system, rather than vice versa. Ultimately, some companies customized their systems so much that they became difficult to maintain. Still other companies never installed a single ERP system.

As vendors have begun offering cloud versions of ERP in recent years, many companies have seen these "as-a-service" alternatives as a chance to mitigate some of the problems introduced by their legacy ERP implementations. According to the Deloitte Dbriefs poll, the biggest drivers for deploying cloud-based systems are lower IT costs (20%) and enhanced reporting and analytical opportunities (18%).

Because of the complexity of legacy ERP systems and the infrastructure on which they operate, most tax professionals spend excessive time gathering and reconciling data before they can begin performing any calculations or analyses. "Those working in companies with different ERP systems or versions are even more encumbered," observes Stephen Metoyer, principal, Deloitte Tax LLP. "Moving ERP systems to the cloud essentially enables many companies to get to a single instance of financial data – which much of the core functionality of ERP systems requires to deliver its full value – for the first time," he notes.

However, cloud-based ERP solutions also present some risk to tax organizations if they are not involved in their implementation. Preconfigured ERP solutions and accelerated rollouts can result in systems that may not meet the needs of the tax function. Tax requirements are country- and organization-specific, and those adopting any new ERP system would do well to consider the complexities of the evolving tax landscape.

A tax-advantaged solution

Moving to a single instance of ERP in the cloud could improve the tax function. The more significant benefits include better shared services strategy, tax data analytics, country-by-country reporting and transfer pricing, according to the Deloitte Dbriefs poll.

The tax function has typically operated in a world of historical information, with very limited ability to analyze large data sets in real time. Transaction processing in traditional ERP suites made reporting and analysis burdensome and time-consuming. Cloud-based ERP provides reporting directly from the source. "Many of the new cloud-based ERP solutions are purpose-built for in-memory computing and new database technologies, but are also accompanied by enhanced reporting and analytical capabilities, creating the opportunity to analyze large volumes of data quickly," suggests John Myers, managing director, Deloitte Tax LLP. "ERP functionality is also evolving. A move to a cloud-based ERP, with an inclusion of direct and indirect tax requirements in the design, may enable a transformation of tax department processes through a reduction of data gathering and reconciliation activities that more fully leverage tax software solutions or can shift some elements of the tax software solution into the ERP environment," he notes.

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[1] Deloitte poll of more than 1,900 attendees of the Dbriefs webinar, "ERP's move to the cloud: Finally, a single real-time source of tax data?"

A single cloud ERP system generally makes it easier for tax organizations to adopt emerging technology capabilities. They might implement cognitive computing systems to increase efficiency or improve fraud detection through profiling. They can adopt robotic process automation in tax processing or compliance monitoring. Ultimately, they might implement blockchain technologies to improve traceability of payments or reduce employee theft.

In the new cloud-based environment, calculations of accounts payable transactions, sales order invoices or client quotes, for example, would no longer have to wait until the end of the month, quarter or year. They could be calculated in the moment at the transaction level and be delivered instantly as part of a customer-facing document. Large multinational corporations that typically handle transfer pricing by manually entering journal entries into their legacy ERP systems country by country could largely automate that process after migrating to ERP in the cloud.

Reimagining the role of tax

The tax organization may spend less time gathering and reconciling data and also gain efficiencies through the associated redesign of inefficient business processes that emerged when ERP suites were first implemented.

The increased visibility into transactional data, coupled with business process improvements, could transform tax operations, enabling dynamic decision-making for tax department management. Tax organizations today are often so consumed with organizing and searching for data that they haven't even considered the value they can add with more advanced quantitative analysis or what-if scenario considerations.

Cloud ERP systems can create the foundation for the tax function to move up the value chain of the organization. Tax departments can improve processes by transforming data into actionable information that describes, predicts and improves timeliness and accuracy in tax functions. The tax function could advance from providing basic descriptive analysis (what happened) to prescriptive analysis (what should happen) and predictive analysis (what will happen). Ultimately, companies could increasingly rely on their tax specialists to provide deep subject matter knowledge, experience and intelligence, either in a center of excellence or embedded in the business.

How to get there from here

Cloud ERP is not a cure-all for what has often failed the corporate tax function. To reap additional benefits from migration, tax and finance leaders would do well to get involved near the beginning of the business case development for cloud ERP to confirm that the solution reflects the tax organization's needs and objectives. This is especially important with cloud solutions that can be rapidly deployed.

In addition, tax leaders can follow these steps to facilitate a successful – and potentially transformative – cloud ERP implementation:

- **Take the time to understand the installed base of ERP systems and business requirements:** When developing road maps for moving to the cloud, balance business imperatives with technical realities.
- **Realize that cloud ERP is not an instant fix to ERP problems:** Cloud ERP can help address some of the issues introduced by traditional ERP, but not without a specific change management program in place.
- **Develop a holistic integration strategy:** Tax and finance leaders can determine that the organization will devote time and money to strategy despite pressure for quick and inexpensive cloud deployment.
- **Invest in organizational changes to successfully support the new ERP environment:** By itself, a shiny new cloud-based system coupled with legacy business processes will not deliver expected value.
- **Incorporate the exponential development of digital technologies into the cloud ERP business case and planning:** Cloud-based ERP can confer certain advantages on its own, but its transformative power lies in additional disruptive technologies that can be adopted.

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State conformity to federal provisions: exploring the variances

To varying degrees, most state income tax regimes rely on the federal income tax regime, including the Internal Revenue Code and the associated Treasury regulations. Potential federal tax reform is on the horizon, and changes to the federal tax base could affect taxpayers from a state income tax perspective. With an eye to the fluid dynamics of what federal tax reform might entail, article reviews state conformity to federal income tax provisions in various settings – focusing on how particular aspects of a state income tax regime can create a state result that varies significantly from the federal result. These differences can arise for various reasons, such as a state's adoption of an earlier version of the IRC, decoupling from specific federal provisions, differences in the treatment of noncorporate entities, or the application of the federal consolidated return regulations.

One classic example highlighting the potential magnitude of a state versus federal income tax variance is an intercompany transaction that creates a gain for federal income tax purposes, yet is deferred under the federal consolidated return regulations. As we will discuss, states that impose tax on a separate legal entity basis generally do not adopt the federal consolidated return regulations. Thus, the gain deferred for federal income tax purposes is generally taxed on a current basis in these separate filing jurisdictions. This example alone highlights the importance of identifying and understanding common federal and state conformity variances because they can have a material impact.

Differences between state tax regimes and the federal determination of taxable income

The state income tax treatment of a transaction typically derives from state law conformity to the federal treatment as modified by state-specific statutes, administrative guidance, and case law interpretations. Although the computation of state taxable income may begin with federal taxable income, differences can be caused by variations in the conformity date, specific decoupling from federal provisions, unique treatment of disregarded entities, and the application of the federal consolidated return regulations or state combined or consolidated return concepts.

State Definitions of Taxable Income: The starting point for a state income tax regime, often termed "taxable" or "business" income, typically derives from explicit statutory references to federal taxable income as reported to the IRS, specific line items from the federal return, gross income as defined by IRC section 61, or taxable income as defined by IRC section 63. In doing so, many states essentially piggyback off the definition or computation of federal taxable income, with statutory modifications. For reasons discussed later, however, the manner and timing of a state's reference to an IRC-derived starting point can differ markedly from state to state.

IRC Conformity Date: Even in a state that conforms to the relevant federal income tax provisions, federal and state differences may exist if the state does not or has not always adopted the current IRC. In states with "static" IRC conformity (that is, conformity as of a specific date), a different state tax result relative to the federal result may be triggered in any instance that an IRC provision affecting the transaction was amended after the state's conformity date. For example, until recently New Hampshire conformed to the IRC in effect as of December 31, 2000.[2]

One unfortunate implication of a state's lagging conformity to the current IRC is the potential inability to apply subsequent federal- level corrective or policy-based amendments. For example, some states' conformity rules have resulted in lagging conformity to IRC section 355(b)(3), enacted federally in 2006 and amended in 2007 (and at other times).[3] Generally speaking, IRC section 355(b)(3) and the subsequent amendments modified the "active trade or

[2] N.H. Rev. Stat. Ann. section 77-A:1.XX.(1). Note that for all taxable periods beginning on or after January 1, 2017, New Hampshire will conform to the IRC in effect on December 31, 2015. N.H. Rev. Stat. Ann. section 77-A:1.XX.(m).
[3] IRC section 355(b)(3). See Tax Increase Prevention and Reconciliation Act of 2005, 109 P.L. 222, 120 Stat. 345, 348 (enacted May 17, 2006); and Tax Technical Corrections Act of 2007. Pub. L. 110-172, section 4(b)(1)-(2).

business" requirement – making it less restrictive to transactions governed by IRC section 355 (that is, spinoffs).[4] IRC section 355(b)(3) permits a corporation to look to members of its "separate affiliated group" – that is, other corporations that would meet the IRC section 1504(a) affiliation requirements if the corporation at issue were treated as the common parent – for purposes of satisfying the active trade or business requirement. At the time of the 2007 amendments to IRC section 355(b)(3), Kentucky conformed to the IRC as of December 31, 2006.[5] Because the effective date of the amendments to IRC section 355(b)(3) occurred after Kentucky's December 31, 2006, fixed conformity date, the federal amendments were not operative for Kentucky corporate income tax purposes until Kentucky updated its conformity date to December 31, 2013, during the 2014 legislative session.[6] This has potential implications for corporations that underwent a restructuring subject to IRC section 355(b)(3) before the 2014 amendment.

Texas also provides a fixed conformity date. Texas conforms to the IRC as of January 1, 2007, and does not automatically adopt IRC amendments that have taken place in the subsequent years.[7] As such, specific amendments to IRC section 355(b)(3) made by the federal Tax Technical Corrections Act of 2007 also may not apply in Texas.

In contrast to a fixed-date conformity to the IRC, many states have automatic or rolling conformity. For example, Massachusetts defines the term "code" as "the Internal Revenue Code of the United States, as amended and in effect for the taxable year…."[8] As a result, in states with rolling conformity dates, some states allow taxpayers to elect the rolling conformity, taxpayers typically avoid federal and state differences resulting from amendments to the IRC.

Specific Decoupling: Even when a state adopts the currently effective version of the IRC, many states decouple from specific federal provisions for fiscal or policy reasons. A common state area of decoupling is the federal bonus depreciation provisions under IRC section 168(k). Other areas of state decoupling include the federal dividends received deduction, the federal deduction of state income taxes, and the federal deduction for income attributable to domestic production activities under IRC section 199.

Decoupling from federal income tax provisions often results in differences in the amount of taxable income currently and the associated tax basis or attributes available in future years. For example, state bonus depreciation decoupling typically increases the state taxable income base in the year of asset acquisition but reduces that base in future years, either through an addback and subsequent subtractions or through an adjustment to basis and depreciation.

Also, when an asset on which federal bonus depreciation was taken is disposed before being fully depreciated, there may be differences in the amount of gain recognized for state income tax purposes. Arizona,[9] California,[10] the District of Columbia,[11] and Virginia[12] – among other states – permit a subtraction modification to reduce the amount of federal gain upon the disposition of an asset when federal bonus depreciation has previously been disallowed. In states without provisions to address federal and state basis differences, it is generally assumed that if the state does not follow IRC section 168(k), the property would generally have a different basis for state income tax purposes. By contrast, Florida[13] and Minnesota[14] are notable examples of states that conform to the federal amount of gain recognized in a disposition, even though they follow a different timeline regarding the bonus depreciation deduction.

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[4] *Id.*
[5] Ky. Rev. Stat. Ann. section 141.010(3) (2007).
[6] Ky. Rev. Stat. Ann. section 141.010(3), amended by H.B. 445, 2014 Reg. Sess. (Ky. 2014). Note that since 2014 Kentucky has updated its IRC conformity date to December 31, 2015, which applies to taxable years beginning on or after April 27, 2016. Ky. Rev. Stat. Ann. section 141.010(3), amended by H.B. 80, 2016 Reg. Sess. (Ky. 2016).
[7] Tex. Tax Code Ann. section 171.0001(9).
[8] Mass. Gen. Laws ch. 63, section 1. In addition to static and rolling conformity dates, some states allow taxpayers to elect the date of conformity. For example, Michigan defines the term "Internal Revenue Code" as the "[IRC] of 1986 in effect on January 1, 2012 or, at the option of the taxpayer, in effect for the tax year." Mich. Comp. Laws section 206.607(6).
[9] Ariz. Rev. Stat. section 43-1122(3).
[10] Cal. Rev. & Tax Code section 24353; and Instructions, Form 100, California Corporation Franchise or Income Tax Return.
[11] D.C. Code Ann. section 47-1803.03(a)(7); and D.C. Code Ann. section 47-1811.04.
[12] Virginia Department of Taxation, Tax Bulletin 16-1, (Feb. 5, 2016).
[13] Fla. Stat. Ann. section 220.13(e)(1); and Florida Tax Information Publication No. 11C01-01. (July 18, 2011).
[14] Minn. Stat. section 290.01(19)(c)(12), (d)(15).

Instead of recognizing any difference in the total amount of federal and state depreciation deductions taken upon the sale of an asset, Florida and Minnesota generally conform to the amount of federal gain/loss recognized.

Another example in which a state may have a federal and state difference in basis is when the state employs a different depreciation method. For federal income tax purposes, depreciation is typically computed under the Modified Accelerated Cost Recovery System (MACRS).[15] California does not fully conform to the IRC, instead incorporating specific IRC sections. Regarding depreciation related to corporate entities, California adopts the depreciation methods employed by IRC section 167 before ACRS (and subsequently MACRS) was enacted.[16] This can lead to differences in both year-over-year depreciation deductions and gain or loss on the disposal of an asset.[17]

Unique Treatment of Disregarded Entities: Although many states tend to follow an entity's classification under federal check-the-box provisions,[18] there are exceptions. For example, New Hampshire's business privilege tax (BPT) is imposed "upon the taxable business profits of every business organization."[19] The term "business organization" is broadly defined to include "any enterprise, whether corporation, partnership, limited liability company, proprietorship, association, business trust, real estate trust or other form of organization…."[20] The definition further provides that "each enterprise under this definition shall be subject to taxation under [the business profits tax] as a separate entity, unless specifically authorized by this chapter to be treated otherwise…."[21] Therefore, if an entity is disregarded for federal income tax purposes and treated as a division of its owner, it is not similarly disregarded for New Hampshire BPT purposes.

In Texas, entities that are disregarded for federal income tax purposes may not be disregarded for Texas franchise tax purposes. The Texas franchise tax is imposed on the taxable margin of a taxable entity subject to tax in Texas.[22] The term "taxable entity" includes not only corporations but also partnerships, limited liability partnerships, and LLCs (including single- member LLCs).[23]

Under Tennessee law, "entities that are disregarded for federal income tax purposes, except for limited liability companies whose single member is a corporation, shall not be disregarded for Tennessee excise tax purposes."[24] Therefore, the general rule of the Tennessee statute is nonconformity with the federal income tax treatment, except when a single-member LLC's single member is a corporation.[25]

These three are examples of states that impose an entity-level income tax[26] on LLCs and other organizations even if they are disregarded for federal income tax purposes.

Differences in Rules Applicable to Separate: One of the most common areas of state nonconformity is relative to the application of the federal consolidated return regulations (Treas. reg. sections 1.1502-1 through -100). At the most basic level, these federal regulations may defer, eliminate, or otherwise modify the treatment provided for under

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[15] 26 USC section 168.
[16] Cal. Rev. & Tax Code section 24349(a).
[17] However, in the case of an S corporation or passthrough entity, MACRS is followed in California. Thus the corporation may have a deduction or gain deducted under MACRS via a K-1 if it has a membership or partnership interest in a passthrough entity. California Franchise Tax Board Form 3885 Instructions, Corporation Depreciation and Amortization.
[18] Treas. reg. section 301.7701-1, -2, -3.
[19] N.H. Rev. Stat. Ann. section 77-A:2.
[20] N.H. Rev. Stat. Ann. section 77-A:1.I
[21] *Id.* The instructions to the New Hampshire BPT return state that "New Hampshire does not disregard limited liability companies…." 2014 Instructions to NH-1120-WE, Combined Business Profits Tax Return (Nov. 2014).
[22] Tex. Tax Code Ann. sections 171.002(a); 171.001(a).
[23] Tex. Tax Code Ann. section 171.0002(a); 34 Tex. Admin. Code section 3.581(c)(6), (d)(1), (e).
[24] Tenn. Code Ann. section 67-4-2007(d).
[25] While the statute does not explicitly cover a situation in which a disregarded SMLLC is owned by another disregarded entity, the Tennessee Department of Revenue has applied a tiered approach in its rulings. *See*, *e.g.*, Rev. Rul. 01-29, Tennessee DOR (Nov. 6, 2001); Letter Rul. 11-46, Tennessee DOR (Sept. 12, 2011); and Letter Rul. 16-10, Tennessee DOR (Nov. 18, 2016).
[26] Non-income taxes, such as franchise taxes, may be imposed on disregarded entities in additional states other than those discussed herein.

the IRC regarding transactions between members of the federal consolidated group. Many state tax regimes do not conform or only partially conform to the federal consolidated return regulations. The ensuing discussion considers how this nonconformity or partial conformity arises and provides examples of significant federal versus state differences that may arise from typical corporate transactions.

- **Conformity to the Consolidated Return Regulations – Separate States:** With limited exceptions, separate company return filing states generally do not follow the federal consolidated return regulations. Instead, separate company return filing states typically begin their computation of state taxable income with pro forma taxable income, as if the corporation were not included in a consolidated federal income tax return. Many states, such as Florida, explicitly require this result by statute or regulation.[27] In other states, it is typically the default result of the nonoperation of federal consolidated return regulations outside of a consolidated return filing. Practitioners should take note, however, of the New Jersey Tax Court's recent decision in *MCI Communication Services Inc.*,[28] in which the New Jersey Division of Taxation argued and the court agreed, that attribute reduction should not be done on a separate company pro forma basis, and instead Treas. reg. section 1.1502-28 (which applies attribute reduction on a consolidated basis) should apply.

- **Conformity to the Consolidated Return Regulations – Combined and Consolidated States:** In combined and consolidated return filing states, the computation of state taxable income spans a spectrum of nonconformity, partial conformity, or general conformity to the federal consolidated return regulations. In many nonconforming or partially conforming states, a statutorily provided elimination concept exists in lieu of conformity to the federal consolidated return regulations. The varying degrees of states' conformity are reflected in the following examples:
    - **Nonconforming State:** New Hampshire administrative regulations generally require business organizations, whether or not filing as part of a New Hampshire combined group, to "determine their gross business profits without applying sections 1501 through 1505 of the IRC and the US Department of the Treasury's Treasury Regulations 1.1501 et seq."[29] Instead, the New Hampshire regulations provide that the gross business profits of each business organization "shall be added together and all intergroup activity eliminated to arrive at the gross business profits of the combined group."[30] In this respect, New Hampshire does not defer the recognition of specific intercompany transactions as required under the federal consolidated return regulations, but instead generally eliminates any gain, income, or loss from transactions between members of a combined group.
    - **Partially Conforming State:** California administrative regulations generally apply Treas. reg. section 1.1502-13 "as amended through April 1, 2012, to the extent possible consistent with combined reporting principles…."[31] The state's regulations also apply portions of Treas. reg. section 1.1502-80.[32] However, California's partial conformity to Treas. reg. section 1.1502-13 and Treas. reg. section 1.1502-80 does not mean that California automatically conforms to any other consolidated return regulations under Treas. reg. section 1.1502- 1 through -100.
    - **Generally Conforming State:** Illinois administrative regulations provide that "the designated agent will determine combined base income by treating all members of the unitary business group (including ineligible members) as if they constituted a federal consolidated group and by applying the federal regulations for determining consolidated taxable income" with limited exceptions and without the application of the federal consolidated net operating loss.[33] In this respect, the state generally

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[27] *See*, *e.g.*, Fla. Stat. section 220.13(2)(f) (providing that: "'Taxable income,' in the case of a corporation which is a member of an affiliated group of corporations filing a consolidated income tax return for the taxable year for federal income tax purposes, means taxable income of such corporation for federal income tax purposes as if such corporation had filed a separate federal income tax return for the taxable year…").
[28] *MCI Communication Services Inc. v. Director, Division of Taxation*, No. 013905-2010 (N. J. Tax Ct. 2015). This decision is being appealed, and it remains to be seen whether this approach could extend to other federal consolidated return regulations or more broadly affect other separate company return filing states.
[29] N.H. Code Admin. R. Ann. 302.09(a), (c).
[30] N.H. Code Admin. R. Ann. 302.09(d).
[31] Cal. Code Regs. tit. 18, section 25106.5-1(a)(2).
[32] *See* Cal. Code Regs. tit. 18, section 25106.5-1(a)(4).
[33] Ill. Admin. Code tit. 86, section 100.5270(a)(1). The exceptions are that "the separate return limitation year provisions and the limitations on consolidation of life and non-life companies in Treas. reg. section 1.1502- 47 shall not apply." *Id.*

conforms to the federal consolidated return regulations where they are otherwise consistent with Illinois law.

Even in a state that generally conforms to the federal consolidated return regulations, a transaction may produce a different result for state income tax purposes if the members of the state combined or consolidated return are not identical to the members of the federal consolidated return. This can occur as the result of the application of a state's unitary business principles, different ownership threshold requirements and standards, inclusion of foreign entities, exclusion of domestic entities with foreign activity, or inclusion or exclusion of specific types of entities (for example, insurance companies).

Differing ownership standards frequently result in member variations between state and federal filing groups. Combined or consolidated return filing states typically require either a "50 percent or greater" or "greater than 50 percent" ownership threshold rather than the 80 percent threshold applicable for federal consolidated return filing under IRC section 1504. States also may use different methods for determining percentage of ownership. States likewise do not always require a common domestic corporate parent, as is required for a federal consolidated group. Thus, a state combined group of two or more corporations commonly owned by a partnership or a foreign corporation may exist where no single consolidated group exists for federal income tax purposes.[34]

As noted, many states do not conform or only partially conform to the federal consolidated return regulations. In the following section, we consider the application of commonly implicated federal consolidated return regulations to two fairly straightforward corporate transactions and the potential implications in states that do not conform to these regulations.

- **Deferral (Treas. reg. section 1.1502-13):** Among other things, Treas. reg. section 1.1502-13 defers specific transactions between members of a consolidated group. The differences between separate reporting, elimination, and deferral can be illustrated by an example. Consider a hypothetical federal consolidated group consisting of Parent (P) and two wholly owned subsidiaries (S1 and S2). In year 1, S1 sells land with a basis of $70 to S2 for $100. In year 3, S2 sells the land to a third party for $110.

  For federal income tax purposes, S1's $30 gain is deferred until year 3, when the property leaves the group. S2 recognizes a $10 gain in year 3 associated with the appreciation of the property in its hands, resulting in an aggregate $40 of gain reflected on the consolidated group's tax return in year 3. In separate reporting states, S1's $30 gain is generally recognized in year 1 because there is no deferral concept. In a combined reporting state that has an intercompany elimination concept, the transaction similarly does not create an immediate gain in year 1. Instead, a gain of $40 is recognized in year 3.[35]

  Suppose, however, that instead of S2 selling the land to a third party in year 3, P sells the stock of S2 to a third party and S2 therefore leaves the federal consolidated group and any combined/ consolidated state groups. For federal income tax purposes, S1's $30 deferred gain is recognized in year 3 under the "acceleration rule" of Treas. reg. section 1.1502-13(d). In a separate reporting state, the gain was recognized in year 1, and there is no further gain recognized on the land in year 3. In a combined reporting state that does not conform to Treas. reg. section 1.1502-13, there is no automatic conformity to the acceleration rule. Absent a statute or regulation similar to Treas. reg. section 1.1502-13 or the existence of state-specific guidance to the same effect,[36] the $30 gain may not be recognized – although there may instead be a federal and state difference in the inside basis of S2's property.

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[34] For a different outcome, relative to the ability of affiliated entities with a common nonincludable parent to be included in a single combined tax return, see *LaBelle Management Inc. v. Michigan Department of Treasury*, 888 N.W.2d 260 (Mich. Ct. App. 2016) addressing indirect ownership for Michigan tax purposes.
[35] In a combined reporting state that does not follow Treas. reg. section 1.1502-13 but tracks separate entity attributes, without further guidance from such a state, it may be unclear in this example which entity recognizes the gain for purposes of determining any attributes that may be tracked on a separate entity basis, such as NOL carryforwards.
[36] *See* Michigan Department of Treasury, Michigan Business Tax Frequently Asked Question U56, which provided "gain or loss on intercompany transactions must be deferred until the time immediately preceding disposition of the property

- **Stock Basis (Treas. reg. section 1.1502-32):** Treas. reg. section 1.1502-32 requires taxpayers to make positive and negative adjustments to the basis of subsidiary stock owned by group members to reflect the subsidiary's taxable income or loss that has been taken into account by the group. Basis is also adjusted for tax-exempt income, noncapital nondeductible amounts, and distributions. These adjustments typically do not apply in separate reporting states or in combined or consolidated filing states applying either an elimination provision or conforming only to Treas. reg. section 1.1502-13 but no other federal consolidated return regulations. Differences in federal and state stock basis as a result of the nonapplication of Treas. reg. section 1.1502-32 may affect the following:
  - The amount of gain or loss on the sale of stock under IRC section 1001 or the worthless stock deduction under IRC section 165;[37]
  - The treatment of a distribution under IRC section 301;
  - The determination of net unrealized built-in gains or losses under IRC section 382; and
  - The reduction of tax attributes under IRC section 1017.

- **Ownership Aggregating Provisions (Treas. reg. section 1.1502-34):** Treas. reg. section 1.1502-34 aggregates stock ownership in determining the application of specific IRC provisions, such as IRC section 332 and IRC section 351. For example, to avoid gain/ loss recognition, a taxpayer contributing property to a corporation must, among other things, own stock possessing at least 80 percent of the combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of each other class of stock of the corporation.[38]

  Suppose Corporation 3 (C3) has a single class of shares and Corporation 1 (C1) and Corporation 2 (C2) each own 50 percent of those shares. In this scenario, a contribution by C1 to C3 does not meet the ownership requirements of IRC section 351 if these corporations are not part of the same federal consolidated return. However, if C1 and C2 are members of a federal consolidated group, a contribution by C1 to C3 can qualify as a tax-free contribution under IRC the ownership aggregating provisions of Treas. reg. section 1.1502-34, provided the contribution otherwise meets the requirements of IRC section 351 by virtue of the ownership aggregating provisions of Treas. reg. section 1.1502-34, provided the contribution otherwise meets the requirements of IRC section 351. These provisions arguably do not apply in separate return reporting states. Whether a nontaxable result may be obtained in a combined reporting state that does not conform to Treas. reg. section 1.1502-34 may depend on how terms such as "intercompany transaction" are defined.

- **Turnoff Provisions (Treas. reg. section 1.1502-80):** Treas. reg. section 1.1502-80, among other things, turns off specific IRC provisions for transactions occurring between members of a federal consolidated group, including IRC sections 357(c), 304, 163(e)(5), 362(e)(2), and 1031.[39] Because these provisions are turned off within a federal consolidated return, the nonapplication of Treas. reg. section 1.1502-80 in separate return filing states and specific combined reporting states may result in unanticipated state consequences if not comprehensively analyzed.

Tax Election Issues: State conformity to federal elections is another area for consideration. While states often follow federal income tax filing elections, some states require a taxpayer to make an affirmative state- specific election when filing the state tax return. For example, although most states automatically conform to a timely filed federal S corporation election, there are notable examples, such as Arkansas,[40] New York,[41] New Jersey,[42] where an affirmative election must be made for state income tax purposes to recognize the federal status.

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in question outside the unitary business group or when either party to the transaction ceases to be a member of the unitary business group."

[37] Further differences may be created in these scenarios by the nonapplication of Treas. reg. section 1.1502-36 as well.

[38] IRC sections 351(a) and 368(c); and Rev. Rul. 59-259, 1959-2 C.B. 115.

[39] Treas. reg. section 1.1502-34(d), (e), (f).

[40] Ark. Code. Ann. section 26-51-409, Form AR1103 Instructions. The separate Arkansas election is no longer required effective for tax years beginning on or after January 1, 2018.

[41] N.Y. Tax Law, section 208.1-A; and N.Y. Tax Law, section 660(a).

[42] N.J. Admin. Code section 18:7-11.16.

Similar considerations exist regarding federal IRC section 338 elections. Under IRC section 338(h)(10), the parties in a taxable stock sale elect to treat the transaction as a sale of the acquired corporation's assets.[43] Under the election, the buyer would then have the ability to take a "step-up" in the basis of the assets. The acquired entity recognizes any gain or loss as though it had sold its assets. California conforms to IRC section 338,[44] however, and a separate state election can be made if none is made for federal income tax purposes.[45] It may be beneficial state election if the federal and state tax profiles of the entities are different. For example, if a selling company does not have net operating losses for federal income tax purposes, but has NOLs for California income tax purposes, a California-only 338(h)(10) election may permit the California gain to be offset by the selling company's California NOLs. The buyer would receive a step-up in basis in the assets, at least for California income tax purposes.

Separate state elections may also be required or permitted if there is a different filing group for state income tax purposes than the federal consolidated filing group. For example, Virginia follows the federal election to forgo the carryback claim to carry back NOLs to earlier tax years.[46] However, if the filing group is different for Virginia income tax purposes, such as in the context of a separate return filer or a nexus consolidated return filing that differs from the federal consolidated filing group, the Virginia taxpayer is required to make its own election to forgo the carryback claim.[47]

Tax Attribute Carryovers: Federal and state differences are also often identified in tax attributes. A tax attribute is a feature of the taxpayer's income tax profile that may provide current or future benefits. Common attributes include NOLs and income tax credits. Regarding tax attributes, states may differ from the federal income tax provisions in the context of whether the state provides the federal attributes, the existence and length of carryforward and carryback periods, and the computation of the attributes themselves.

As noted regarding the starting point in computing state taxable income, many states may begin the computation of NOLs in the same manner as for federal income tax purposes, but then apply their own state-specific requirements. For example, in Maryland an NOL generated in a tax year when the taxpayer was not subject to Maryland income tax may not be allowed as a deduction to offset Maryland income.[48] As a result, the NOL for Maryland income tax purposes will only reflect federal NOLs to the extent that the entity had nexus in Maryland in the loss-generating years. Maryland is not unique in this regard, as there are other states that compute state NOL carryforward balances based on when state income tax returns are filed. State NOL balances may be further altered from their federal counterparts based on the application of apportionment and state modifications (such as bonus depreciation, as previously discussed).

Significant differences also arise between federal and state tax attributes in the context of state limitations and carryforwards. States tend to decouple from the federal NOL carryback provisions. Even states that conform to the federal NOL carryback rules typically decouple from extended carryback rules (for example, the five- year carryback provided under IRC section 172(b)(1)(h) for NOLs generated in 2008 and 2009). The carryforward periods for state NOLs and credits are often based on a state's fiscal considerations mutually exclusive of any federal constructions.

Additional state rules that may affect the computation of state attributes include rules on the transfer of attributes in the case of a merger, acquisition, or reorganization. For example, because New Jersey does not follow IRC section 381,[49] NOLs generated by an entity merged with and into another entity generally do not survive the merger transaction in the state. Montana has a similar limitation.[50] Alternatively, states may not follow the federal limitations under IRC sections 382[51] and 383 on the use of tax attributes after ownership changes. New Jersey does not follow

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[43] The IRC section 338(g) election, which is made by the buyer, may also be elected in California.
[44] Cal. Rev. & Tax Code section 24451.
[45] Cal. Rev. & Tax Code section 23051.5(e).
[46] Va. Code section 58.1-301.
[47] Virginia Administrative Code (VAC) 10-120-325 B 2; Virginia Public Document 05-47 (4/6/2005); Virginia Public Document 93-83 (3/26/1993); and Virginia Public Document 88-106 (5/12/1988).
[48] Md. Code. Regs. 03.04.03.07.A.(5).
[49] N.J. Admin. Code tit. 18, section 7-5.13(b); and *Richard's Auto City Inc., v. Director, Division of Taxation*, 659 A.2d 1360 (N.J. 1995).
[50] Mont. Code Ann. section 15-31-119(8); and Mont. Admin. R. 42.23.804.
[51] Application of IRC section 382 presents various complexities that are outside the scope of this article.

section 381, but it also does not appear to follow IRC section 382.[52] As a result, in states like New Jersey, the NOLs of an acquired entity may be used by that entity without the potential limits for federal income tax purposes (although the states may impose limitations).

Federal income tax credits that may have similar state counterparts – typically by reference to the applicable federal definition of eligible expense – include the research and development credit and some business credits. For example, New Jersey defines its R&D credit in terms of expenses meeting the definition under the federal income tax provisions of IRC section 41; however, the qualifying expenses must be incurred in New Jersey.[53] Thus, the New Jersey R&D credit amount may be different than the R&D credit claimed on a taxpayer's corresponding federal income tax return.

Notwithstanding the federal R&D or other federal tax credits claimed by a taxpayer on its federal return, most states provide state income tax credits based on investment, hiring, or environmental projects within the state.

Nonconformity to IRS Determination: State tax agencies such as the Massachusetts Department of Revenue actively challenge domestic and international intercompany financing transactions. For example, in *National Grid Holdings Inc. v. Commissioner of Revenue*, the Massachusetts Appellate Tax Board on June 4, 2014, upheld assessments denying a domestic taxpayer's interest deductions for payments under deferred subscription agreements (DSAs) with foreign entities on the basis that the DSAs did not qualify as true debt because they lacked an unconditional obligation to repay.[54] The DSAs were instruments intended to be treated as debt for US federal income tax purposes but not for UK tax purposes.[55] As part of the appeal, the taxpayer sought to introduce into evidence a post-audit closing agreement with the IRS that allowed a partial interest deduction related to the DSAs for federal income tax purposes. As provided in the board's findings in the companion case, *National Grid USA Service Company Inc. v. Commissioner of Revenue*, the board held that neither Massachusetts statutes nor applicable case law supported the conclusion that such an agreement with the IRS would require the board to rule that payments made under the DSAs were deductible interest for Massachusetts tax purposes.[56] Both decisions were later upheld on appeal.[57]

Similar to *National Grid*, state challenges to domestic and international intercompany financing transactions generally involve business purpose, economic substance, and debt-to-equity considerations performed by state tax authorities that either do not follow US federal law, or apply those concepts to situations in which federal tax principles have not been traditionally applied. Thus, intercompany debt arrangements that otherwise pass IRS scrutiny may still be disregarded at the state level.

Conclusion

There are many contexts in which the federal and state income tax treatment of financial transactions or the characterization of an entity may differ. A comprehensive understanding of a transaction's state income tax implications requires an appreciation of the federal law and guidance relevant to the transaction, not to mention the extent of state conformity to the federal income tax result factoring in the applicable state's tax filing methods, elections, and other unique rules. These considerations are amplified in an environment where the potential for significant federal tax reform exists.

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[52] N.J. Rev. Stat. section 54:10A-4(k)(6)(D); and N.J. Admin. Code tit. 18, section 7-5.13.
[53] N.J. Rev. Stat. section 54:10A-5.24; and N.J. Admin. Code tit. 18, section 7-3.23.
[54] *National Grid Holdings Inc. v. Commissioner of Revenue*, Mass. App. Tax Bd., No. ATB 2014-357 at 411 (2014).
[55] *Id.* at 366.
[56] *National Grid USA Service Company Inc. v. Commissioner of Revenue*, Mass. App. Tax Bd., No. ATB 2014-630 (2014).
[57] *National Grid Holdings Inc. v. Commissioner of Revenue*, 52 N.E.3d 173 (Mass. App. Ct. 2016); and *National Grid USA Service Company Inc. v. Commissioner of Revenue*, 51 N.E.3d 492 (Mass. App. Ct. 2016).

Calendars to watch

Each edition, be sure to mark your calendars for some of the more important events (recent and upcoming) as well as tax developments making in impact on businesses investing into the United States.

Recent and Upcoming Activities

August 17
On demand

Dbriefs archive: Tax compliance and provision software: Annual tax technology update
Watch
URL: https://www2.deloitte.com/us/en/pages/dbriefs-webcasts/events/august/2017/dbriefs-tax-compliance-and-provision-software-annual-tax-technology-update.html?id=us:2em:3na:usic:awa:tax:082117

August 22
11:00 a.m. ET

Dbriefs webcast: (Special Edition) Hard to value intangibles: What does new BEPS guidance portend?
Register
URL: https://www2.deloitte.com/us/en/pages/dbriefs-webcasts/events/august/2017/dbriefs-hard-to-value-intangibles-what-does-new-beps-guidance-portend.html?id=us:2em:3na:usic:awa:tax:082117

August 29
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Dbriefs webcast: (Special Edition) Centralized audit procedures for partnerships: Proposed regulations
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August 31
2:00 p.m. ET

Dbriefs webcast: Shifting sands: What tax changes may impact inbound investors to the United States?
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URL: https://www2.deloitte.com/us/en/pages/dbriefs-webcasts/events/august/2017/dbriefs-shifting-sands-what-tax-changes-may-impact-inbound-investors-to-united-states.html?id=us:2em:3na:usic:awa:tax:082117

September 12
2:00 p.m. ET

Dbriefs webcast: A primer on IRS advice and guidance processes
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URL: https://www2.deloitte.com/us/en/pages/dbriefs-webcasts/events/september/2017/dbriefs-primer-on-irs-advice-and-guidance-processes.html?id=us:2em:3na:usic:awa:tax:082117

September 13
2:00 p.m. ET

Dbriefs webcast: US tax reform: What is in store for businesses and individual taxpayers?
Register
URL: https://www2.deloitte.com/us/en/pages/dbriefs-webcasts/events/september/2017/dbriefs-september-us-tax-reform-what-is-in-store-for-businesses-and-individual-taxpayers.html?id=us:2em:3na:usic:awa:tax:082117