

State Tax Controversy Trends Related to Global Issues

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Agenda

Common Issues in Federal and State Audits

State Divergence – Departure from Federal Taxable Income

State Policies and Legislative Responses to Taxing Foreign Based Income

Worldwide Combined Reporting

Transfer Pricing

Common Issues in Federal and State Tax Audits

- Intercompany / cross-border debt
- Licensing of intangibles
- Cash management
- States acceptance of finalized IRS audits
 - Impact of negotiated settlement agreements with the IRS upon the states
 - Recent state litigation
 - Can the state reject a Federal Form 870 issued by the IRS that is the final resolution of an issue
- Negotiating federal audit issue with state tax auditors

Common Issues in Federal and State Tax Audits (cont'd)

- Implications of states re-examining issues audited and settled with the IRS
 - What's a taxpayer to do for state audit and RAR reporting purposes?
 - Can the states potential re-examination of settled IRS audit issues contradict the requirement for reporting final federal audit adjustments to the state?

State Divergence – Departure from Federal Taxable Income

Adoption of separate Sec. 482 type rules

- Debt / Equity standards – States could apply varying rules, principles and analysis.
- Application of “sham transaction” analysis to foreign transactions
 - Certain transactions and fact patterns that are not subject to federal tax, under well settled federal tax law, could be analyzed by the state to be tax motivated and / or tax avoidance – and be potentially subject to state taxation (permanent establishment – not effectively connected income).

Application of state nexus standards on foreign transactions

- Federal standard – Permanent Establishment (PE)
- Economic nexus – Application of the nexus standard used by various states in connection with intangible holding companies and credit cards.

States decoupling from international treaties

State Audit Policy and Legislative Responses to Taxing Foreign Based Income

Tax Haven Laws

- General Rule: Corporations must include the income and factors of affiliates formed or engaged in business in “tax havens” in combined tax returns.
- Definition of a tax haven jurisdiction
- States adopting tax haven laws
 - Alaska: Based on foreign country tax rates
 - District of Columbia: Based on apportionment factors
 - Montana: “Blacklist” of tax haven jurisdictions
 - Oregon: “Blacklist” of tax haven jurisdictions
 - West Virginia: Refers to the countries identified by the Organization for Economic Cooperation and Development (OECD) and tax rates
- Potential taxpayer audit controversy & challenges to tax haven laws
 - Inconsistent with IRC treatment: treaties / PE / federal taxable income
 - Unconstitutional: potential Commerce and Due Process Clause violations

State Audit Policy and Legislative Responses to Taxing Foreign Based Income (cont'd)

Maryland

- Expansive view of § 482 state power – see *Comptroller of the Treasury v. Gannett*, 741 A2d 1120 (1999). Maryland subsequently adopted explicit § 482-type provisions.
- Audit policy to examine foreign based affiliates not included in the federal tax return – does this go beyond IRC § 482?

New Jersey

- New Jersey Division of Taxation, TAM-17 6/6/2011 – the DOR is not bound by an advance pricing agreement between a taxpayer and the IRS in evaluating intercompany pricing under New Jersey law.
- New Jersey Division of Taxation, TAM-1 2/6/2012 – the DOR will accept an APA or third-party pricing study – but the DOR reserves the right and authority to challenge the underlying assumptions.

State Audit Policy and Legislative Responses to Taxing Foreign Based Income (cont'd)

Potential Expanded “Addback” Rules

- Reduce the exceptions to the addback rule (i.e., the subject to tax and treaty exceptions). Under most addback rules, an addback of an intercompany expense is not required or is minimized if the payment / deduction is subject to tax in a foreign jurisdiction or is paid to an affiliate in a foreign jurisdiction that has a treaty with the U.S.

World-wide Combined Reporting

- Historically foreign governments and corporations generally opposed WWCR – a roadblock to international business and globalization.
- During the 1980s and 1990s many states adopted water's edge combined reporting.
- States are re-examining WWCR to level the playing field to address tax base and income erosion to foreign jurisdictions.

Transfer Pricing

- Multistate Tax Commission
 - Arm's Length Adjustment Service - Advisory Group – Design a §482 audit program that will have established standards for states and / or the MTC to conduct audits of related party transactions.
 - “ALAS” seeks to provide training, legal analysis and technical support.
- District of Columbia
 - Chainbridge Software LLC cases
- Massachusetts

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