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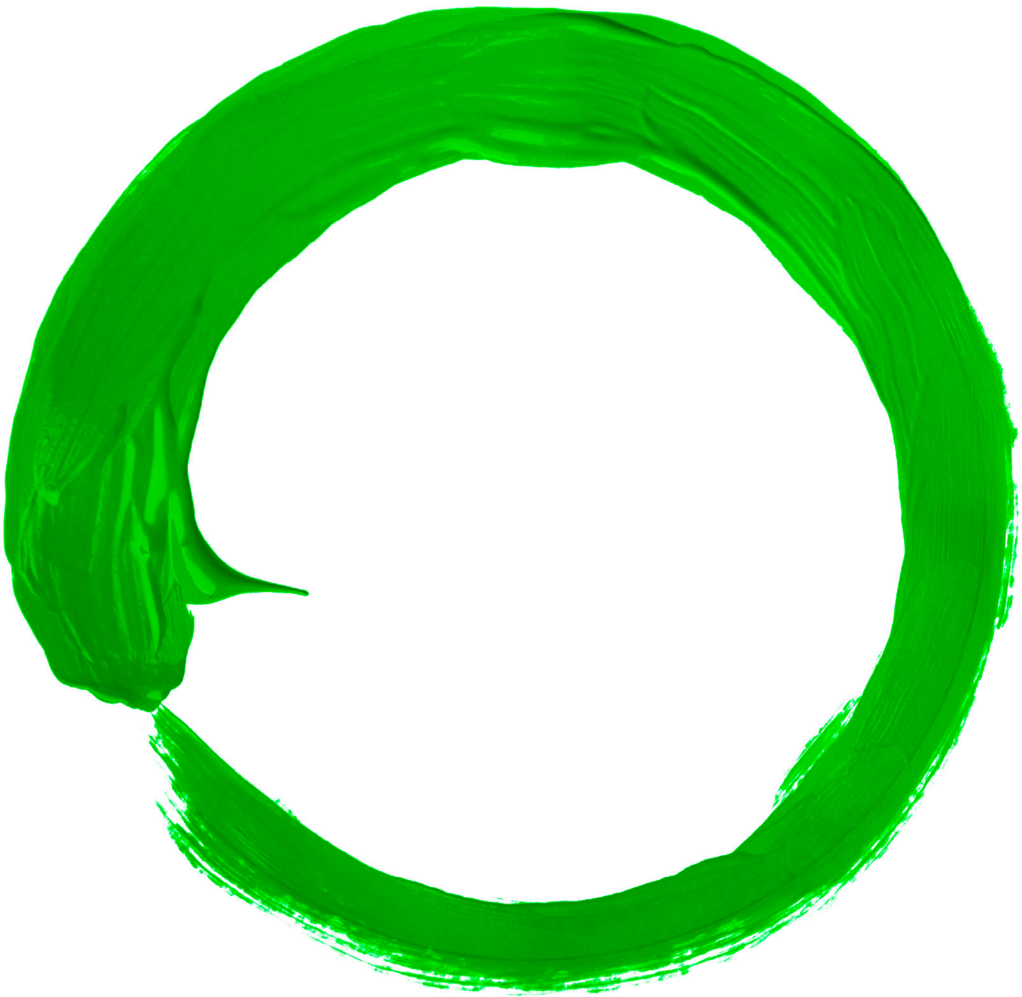

Inside Deloitte

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In this edition of Inside Deloitte, the potential for federal tax reform serves as a backdrop for a discussion of the various degrees in which state income tax regimes conform to or diverge from the federal income tax regime and, consequently, how the state tax implications of a transaction may differ significantly from the federal income tax characterization.

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I. Introduction

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, this 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.

II. 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.

1. 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.

2. 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.[1]

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).[2] Generally speaking, IRC section 355(b)(3) and the subsequent amendments modified the "active trade or business" requirement — making it less restrictive to transactions governed by IRC section 355 (that is, spinoffs).[3] 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.[4] 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.[5] 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.[6] 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 . . . ."[7] As a result, in states with

[1] 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).

[2] 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).

[3] *Id*.

[4] Ky. Rev. Stat. Ann. section 141.010(3) (2007).

[5] 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).

[6] Tex. Tax Code Ann. section 171.0001(9).

[7] 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).

rolling conformity, taxpayers typically avoid federal and state differences resulting from amendments to the IRC.

3. 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,[8] California,[9] the District of Columbia,[10] and Virginia[11] — 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[12] and Minnesota[13] 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. 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).[14] 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.[15] This can lead to differences in both year-over-year depreciation deductions and gain or loss on the disposal of an asset.[16]

4. Unique Treatment of Disregarded Entities

Although many states tend to follow an entity's classification under federal check-the-box provisions,[17] there are exceptions. For example, New Hampshire's business privilege tax (BPT) is imposed "upon the taxable business profits of every business organization."[18] 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 . . . ."[19] The definition further provides that "each

[8] Ariz. Rev. Stat. section 43-1122(3).

[9] Cal. Rev. & Tax Code section 24353; and Instructions, Form 100, California Corporation Franchise or Income Tax Return.

[10] D.C. Code Ann. section 47-1803.03(a)(7); and D.C. Code Ann. section 47-1811.04.

[11] Virginia Department of Taxation, Tax Bulletin 16-1, (Feb. 5, 2016).

[12] Fla. Stat. Ann. section 220.13(e)(1); and Florida Tax Information Publication No. 11C01-01. (July 18, 2011).

[13] Minn. Stat. section 290.01(19)(c)(12), (d)(15).

[14] 26 U.S.C section 168.

[15] Cal. Rev. & Tax Code section 24349(a).

[16] 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.

[17] Treas. reg. section 301.7701-1, -2, -3.

[18] N.H. Rev. Stat. Ann. section 77-A:2.

[19] N.H. Rev. Stat. Ann. section 77-A:1.I.

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 . . . ."[20] 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.[21] The term "taxable entity" includes not only corporations but also partnerships, limited liability partnerships, and LLCs (including single-member LLCs).[22]

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."[23] 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.[24]

These three are examples of states that impose an entity-level income tax[25] on LLCs and other organizations even if they are disregarded for federal income tax purposes.

5. Differences in Rules Applicable to Separate, Combined, and Consolidated Returns

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 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.

a. 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.[26] 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.*,[27] 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.

[20] *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).

[21] Tex. Tax Code Ann. sections 171.002(a); 171.001(a).

[22] Tex. Tax Code Ann. section 171.0002(a); 34 Tex. Admin. Code section 3.581(c)(6), (d)(1), (e).

[23] Tenn. Code Ann. section 67-4-2007(d).

[24] 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).

[25] Non-income taxes, such as franchise taxes, may be imposed on disregarded entities in additional states other than those discussed herein.

[26] *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 . . .").

[27] *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.

b. 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 U.S. Department of the Treasury's Treasury Regulations 1.1501 et seq."[28] 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."[29] 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. . . ."[30] The state's regulations also apply portions of Treas. reg. section 1.1502-80.[31] 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.[32] In this respect, the state generally 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

[28]N.H. Code Admin. R. Ann. 302.09(a), (c).

[29]N.H. Code Admin. R. Ann. 302.09(d).

[30]Cal. Code Regs. tit. 18, section 25106.5-1(a)(2).

[31]*See* Cal. Code Regs. tit. 18, section 25106.5-1(a)(4).

[32]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*.

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.[33]

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.

c. 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.[34]

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,[35] 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.

d. 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;[36]
- the treatment of a distribution under IRC section 301;

[33] 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.

[34] 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.

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

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

- the determination of net unrealized built-in gains or losses under IRC section 382; and
- the reduction of tax attributes under IRC section 1017.

e. 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.[37]

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 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.

f. 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.[38] 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.

6. 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,[39] New York,[40] and New Jersey,[41] where an affirmative election must be made for state income tax purposes to recognize the federal status.

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.[42] 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,[43] however, and a separate state election can be made if none is made for federal income tax purposes.[44] It may be beneficial to make a separate 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

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

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

[39] 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.

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

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

[42] The IRC section 338(g) election, which is made by the buyer, may also be elected in California.

[43] Cal. Rev. & Tax Code section 24451.

[44] Cal. Rev. & Tax Code section 23051.5(e).

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.[45] 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.[46]

7. 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.[47] 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,[48] 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.[49] Alternatively, states may not follow the federal limitations under IRC sections 382[50] and 383 on the use of tax attributes after ownership changes. New Jersey does not follow section 381, but it also does not appear to follow IRC section 382.[51] 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

[45] Va. Code section 58.1-301.

[46] 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).

[47] Md. Code. Regs. 03.04.03.07.A.(5).

[48] 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).

[49] Mont. Code Ann. section 15-31-119(8); and Mont. Admin. R. 42.23.804.

[50] Application of IRC section 382 presents various complexities that are outside the scope of this article.

[51] N.J. Rev. Stat. section 54:10A-4(k)(6)(D); and N.J. Admin. Code tit. 18, section 7-5.13.

definition under the federal income tax provisions of IRC section 41; however, the qualifying expenses must be incurred in New Jersey.[52] 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.

8. 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.[53] The DSAs were instruments intended to be treated as debt for U.S. federal income tax purposes but not for U.K. tax purposes.[54] 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.[55] Both decisions were later upheld on appeal.[56]

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 U.S. 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.

III. 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. ■

[52] N.J. Rev. Stat. section 54:10A-5.24; and N.J. Admin. Code tit. 18, section 7-3.23.

[53] *National Grid Holdings Inc. v. Commissioner of Revenue*, Mass. App. Tax Bd., No. ATB 2014-357 at 411 (2014).

[54] *Id*. at 366.

[55] *National Grid USA Service Company Inc. v. Commissioner of Revenue*, Mass. App. Tax Bd., No. ATB 2014-630 (2014).

[56] *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).