Deloitte.

Multistate Tax

State Tax Matters

5 December 2014

In this issue:

State Corporate Tax and Bankruptcy: Is IRC Conformity Easier? 1
Income/Franchise: District of Columbia: Citing Previous ALJ Ruling that Invalidated Third-Party Contractor's Transfer Pricing Analysis, Franchise Tax Assessments in Three Additional Transfer Pricing Cases are Reversed 2
Income/Franchise: Florida: Department of Revenue Explains How Online Data Company Should Source Certain Streams of Revenue to Market/Customer Location 3
Income/Franchise: Texas: Court of Appeals Holds that Net Loss is Included in Calculating Franchise Tax Apportionment Factor Denominator 4
Multistate Tax Alerts 4

State Corporate Tax and Bankruptcy: Is IRC Conformity Easier?

This article by Brian Sullivan of Deloitte Tax LLP discusses some of the common income tax issues encountered by corporate taxpayers in bankruptcy and out-of-court restructuring transactions, where the blanket adoption of the IRC at the state level creates additional complexity and uncertainty within state income tax regimes.
URL: http://www2.deloitte.com/us/en/pages/tax/articles/state-corporate-tax-and-bankruptcy-is-IRC-conformity-easier.html?id=us:2sm:3tw:mts:awa:tax:120314:deloittetax.htm?id=us:em:na:stm:eng:tax:141205

In the spirit of consistency and ease of administration, most states that impose corporate income taxes begin their computation of taxable income with federal taxable income. One method commonly adopted by many states to accomplish that objective is to require a corporation to use the amount reported on its federal tax return as the starting point for the state tax calculation. Most states, however, have enacted legislation to conform to the Internal Revenue Code[1] in some respect, either through rolling conformity or static conformity.[2] Other

[1] Statutory and regulatory references to the code or IRC section are to the Internal Revenue Code of 1986, as amended, and all regulation section references are to the Treasury regulations thereunder.
[2] Rolling (or moving date) conformity refers to a state conformity statute that automatically adopts any changes to the federal law, while static (or fixed-date) conformity refers to a state

states may not adopt the IRC but rather use the amount reported on Line 28 or Line 30 of the federal Form 1120 as their starting point for determining the amount of state taxable income. It has also been quite common recently for states to opt out of some federal tax provisions that states may view as either unfavorable or inconsistent with their income tax policies (for example, bonus depreciation (IRC section 168(k)), the expensing of depreciable business assets (IRC section 179), the domestic production activities deduction (IRC section 199), and the deferral of some cancellation of debt income (CODI) provided by IRC section 108(i)). Nevertheless, it is possible that the general conformity to the IRC provisions may have other unintended consequences, especially for corporate taxpayers experiencing a bankruptcy or debt restructuring transaction.

Presumably, the goal of general IRC conformity is to make the administration of a state income tax easier by using federal taxable income as a starting point and making only some state modifications that effectuate state tax policies. However, general conformity to the IRC may create situations in which a technical reading of the law produces potentially unintended results not contemplated by state tax policymakers. This article discusses some of the common income tax issues encountered by corporate taxpayers in bankruptcy and out-of-court restructuring transactions, where the blanket adoption of the IRC at the state level creates additional complexity and uncertainty within state income tax regimes.

— Brian Sullivan
Director
Deloitte Tax LLP
briansullivan@deloitte.com

Income/Franchise:
District of Columbia: Citing Previous ALJ Ruling that Invalidated Third-Party Contractor's Transfer Pricing Analysis, Franchise Tax Assessments in Three Additional Transfer Pricing Cases are Reversed

Hess Corp. v. D.C. Office of Tax & Revenue, D.C. Office of Admin. Hrgs. (11/14/14); *Shell Oil Co. v. D.C. Office of Tax & Revenue*, D.C. Office of Admin. Hrgs. (11/14/14); *ExxonMobil Oil Corp. v. D.C. Office of Tax & Revenue*, D.C. Office of Admin. Hrgs. (11/14/14). The District of Columbia Office of Administrative Hearings has reversed franchise tax assessments in three separate transfer pricing suits, holding that non-mutual offensive collateral estoppel precluded the District of Columbia Office of Tax and Revenue (OTR) from proceeding to re-litigate an issue that the OTR had litigated and lost previously in *Microsoft Corp. v. D.C. Office of Tax & Revenue*, D.C. Office of Admin. Hrgs. (5/1/12). In *Microsoft Corp.*, the administrative law judge found that the transfer pricing analysis performed by the OTR's third-party contractor was flawed, arbitrary and unreasonable and thus could not be used to determine whether the taxpayer's intercompany transactions were conducted in accordance with arm's-length standards. In the three respective cases at hand here, the OTR conceded that the franchise tax assessments were based on transfer pricing analyses prepared by the OTR's same third-

---

conformity statute that adopts the federal law on a certain date (for example, January 1, 2011) and does not include any federal law changes enacted after that date.

party contractor, and that the method of analysis utilized by that contractor in these three cases was similar to that used in the *Microsoft Corp.* case.

— Scott Frishman
Principal
Deloitte Tax LLP
sfrishman@deloitte.com

Shona Ponda
Senior Manager
Deloitte Tax LLP
sponda@deloitte.com

Income/Franchise:
Florida: Department of Revenue Explains How Online Data Company Should Source Certain Streams of Revenue to Market/Customer Location

Technical Assistance Advisements, TAA 13C1-007, Fla. Dept. of Rev. (10/25/13). The Florida Department of Revenue (DOR) recently issued a technical assistance advisement (TAA) that explains how a corporation whose predominant business activity consists of earning revenue from providing access to an interactive network, the sale of certain tangible personal property, and the sale of certain services must source its various income streams for state corporate income tax apportionment purposes. With respect to sourcing receipts from providing access to an interactive network, the DOR explains that when a customer located in Florida accesses the corporation's online database, such sales will be sourced to Florida. However, if these same products are delivered to the customer through e-mail, the sale is considered a sale of a service and sourced according to the customer's location – i.e., if the customer is located in Florida, the sale will be included in the numerator of the corporation's sales factor. Where the corporation provides the service of converting data into standard electronic reporting formats for its customers to access online, the transaction and activity is sourced according to where the income producing activity occurs, "which is usually where the customer resides." Where the corporation engages in other related administrative-type services to establish customer eligibility and the collection and maintenance of extensive databases to store critical information, the underlying transactions and activity are generally sourced to where the customer is located "since the actual administration occurs in the administered state;" in this case, such sales should be sourced according to the customer's location. Regarding the corporation's revenues from the licensing of proprietary intangible assets, the DOR explains that such receipts should be treated as Florida-sourced sales if the underlying intangible asset is licensed to a customer located in Florida, "provided that the royalty income is significant." If the corporation's royalty income is not significant, the income must be excluded entirely from the sales factor because it does not clearly reflect the corporation's business activity.
URL: https://revenuelaw.state.fl.us/LawLibraryDocuments/2013/10/TAA-119092_13C1-007%20Redacted%20and%20Summary%20RLL.pdf

— Chris Snider
Director
Deloitte Tax LLP
csnider@deloitte.com

Shona Ponda
Senior Manager
Deloitte Tax LLP
sponda@deloitte.com

Income/Franchise:
Texas: Court of Appeals Holds that Net Loss is Included in Calculating Franchise Tax Apportionment Factor Denominator

Hallmark Mktg. Co. v. Combs, Tex. Ct. App. (11/13/14). A Texas Court of Appeals has affirmed a lower district court's ruling that a taxpayer's gains had to be offset against losses from the sale of investments and capital assets in determining its Texas franchise "margin" tax apportionment factor denominator.
URL: http://www.search.txcourts.gov/SearchMedia.aspx?MediaVersionID=d1caed5a-43fe-4ab6-9325-c99cd2d05266&coa=coa13&DT=Opinion&MediaID=4bf9b630-a4c4-4905-9255-9be245eed81b

— Russell Brown
Partner
Deloitte Tax LLP
rubrown@deloitte.com

Robert Topp
Director
Deloitte Tax LLP
rtopp@deloitte.com

Multistate Tax Alerts

What's new in the States? Our Multistate Tax Alerts highlight selected state tax developments relevant to taxpayers, tax professionals, and other interested persons. Read our more recent alerts below or visit the archive for ones you may have missed.
Archive: http://www2.deloitte.com/us/en/pages/tax/articles/multistate-tax-alert-archive0.html?id=us:em:na:stm:eng:tax

No new alerts were issued this period. Be sure to refer to the archives to ensure that you are up to date on the most recent releases.