myStateTaxOffice

A Washington National Tax Services (WNTS) Publication

August 30, 2012

Follow @twitter

Minnesota Tax Court finds that the Department cannot apportion a taxpayer's section 382 limitation and holds that a taxpayer was not unitary with its subsidiary

Authored by: Michael Santoro

In brief

A taxpayer's corporate acquisition triggered an IRC Sec. 382 limitation of the acquired company's net operating loss carryovers equal to approximately $30 million. The Minnesota Department of Revenue apportioned that limitation using the apportionment ratio of the income years, which reduced the amount of available loss to approximately $120,000. The Minnesota Tax Court found that, despite Department guidance to the contrary, there was no statutory authority for the Department's position to apportion the section 382 limitation.

Additionally, the Tax Court found that the taxpayer was not unitary with one of its LLC subsidiaries because the facts did not support a flow of value, nor was there sufficient control over the subsidiary. [*Express Scripts, Inc. v. Commissioner of Revenue*, Minnesota Tax Court, Ramsey County, Docket No. 8272R (8/20/12)]

In detail

Express Scripts, Inc. ("ESI") is a corporation that provides pharmacy benefit management ("PBM") services. ESI acquired all the stock of a corporation, Diversified Pharmaceutical Services, Inc. ("DPS"), on April 1, 1999. DPS had accumulated $370,588,828 of federal NOLs generated during 1995, 1996, and 1997. Due to the ownership change, an IRC Sec. 382 limitation of approximately $30 million was computed.

Minnesota's NOL carryover rules

Minn. Stat. Sec. 290.095, subd. 3(c) provides that "the net operating loss deduction incurred in any taxable year shall be allowed to the extent of the apportionment ratio of the loss year." Minnesota provides a limitation on the NOL deduction, following IRC sec. 382, that serves as a cap on the amount of the deduction that can be claimed in a given year. Minn. Stat. Sec. 290.095, subd. 3(d) provides that the section 382 limitation "shall be applied to net income, before apportionment, in each post change year to which a loss is carried."

While subd. (c) provides that an NOL deduction is apportioned, subd. (d) has no such rule. Sudb. (d) provides that a 382 limitation is applied "*before apportionment."*

Minnesota's section 382 limitation is not subject to apportionment

The Commissioner apportioned the taxpayer's $30 million section 382 limitation by applying the apportionment ratio of the post-change income years. In other words, the Commissioner reduced the section 382 limitation to $120,000 "by applying the post-change year's apportionment percentage to determine the limited amount of apportioned taxable net income eligible for NOL losses being carried forward from pre-change years."

The Commissioner relied on Revenue Notice 99-07 (8/9/99) for support that the section 382 limitation must be reduced by applying the taxpayer's "post-change year's apportionment percentage to determine the limited amount of (apportioned) taxable net income that is eligible for a net operating loss deduction for those losses being carried forward from pre-change years."

The Tax Court agreed with ESI, finding that no apportionment is appropriate because subd.(d) provides that the section 382 limitation is to be determined "before apportionment." The Court found it significant that the legislature included apportionment language in subd.(c) when it intended to require apportionment. The absence of such language in subd.(d) evidenced no such apportionment requirement.

The Tax Court also found that a non-apportioned Minnesota section 382 limitation is consistent with IRC sec. 382 concepts. IRC sec. 382 provides a fixed, unchanging NOL limit that is determinable at the time of corporate change of control. If this limit was subject to post-change apportionment, the 382 limit would change each year resulting in an indeterminable 382 limitation at the time of the change of control. Buyers and sellers would not be able to value NOLs because they would not know the apportionment percentages for future years.

Accordingly, the Tax Court found that the application of an apportioned 382 limitation is not supported by the plain language of the statute and would create an "unnecessary disconnect between Minnesota and federal law."

ESI was not unitary with its LLC subsidiary

ESI and two other unrelated PBM providers formed RxHub LLC to create an electronic prescription and information routing service to facilitate prescription benefit communications. Each member owned a one-third voting interest in RxHub.

RxHub LLC elected to be taxed as a partnership for federal and Minnesota purposes. ESI's treatment of its share of RxHub's income depended on whether it was unitary with RxHub. If they were unitary with each other, then ESI and RxHub would combine their income and apportionment factors. If they were not unitary, RxHub would apportion its Minnesota income and ESI would include its proportionate share of apportioned income in its tax computation.

The Tax Court found that no unitary relationship existed between ESI and RxHub because there was no flow of value between the two entities and ESI did not exert the potential to control or have actual control over RxHub. The Tax Court found that the substantial intercompany transactions between ESI and RxHub did not result in a flow of value because such transactions were at a fair price, equal to the price that third-parties paid. In addition, the Tax Court found that oversight activities by an investor, "which any parent company gives to any subsidiary, does not create unity." Since ESI received no favorable treatment in its transactions with RxHub, there was no flow of value to ESI.

The Commissioner asserted that ESI exerted control of RxHub through its veto power over RxHub's major decisions and because of ESI's financial and technical support. The Court found that actual veto power didn't exist and that the financial and technical support was insufficient to cause a unitary relationship. The Tax Court did not agree that ESI controlled the LLC by financially supporting it through the initial capital contribution that formed the LLC. ESI had only a 1/3 ownership in the LLC. The Tax Court referenced the Minnesota Supreme Court's discussion in *Hercules, Inc. v. Commissioner of Revenue*, 575 N.W.2d 111 (Minn.1998)), which found that taxpayer did not have "sole control over [its subsidiary] because it had to share [that] control."

Actions to think about

In regard to the net operating loss discussion, the Minnesota Tax Court is now applying what the Minnesota Supreme Court has held in its more recent decisions (*Hutchinson Technology, Inc. v. Commissioner of Revenue,* 698 N.W.2d 1 (Minn. 2005) and *HMN Financial, Inc. and Affiliates v. Commissioner of Revenue*, 782 N.W. 558 (Minn. 2010). That is, a court must first look to the **plain language** of the statute. Taxpayers should review apportioned section 382 calculations for opportunities to increase NOL utilization.

Regarding the Tax Court's unitary discussion, taxpayers have long argued that investor oversight and intercompany transactions do not always equate to a unitary finding. This case may provide taxpayers support for this position. Taxpayers should review their unitary filing positions to determine possible opportunities, particularly in relation to their membership/partnership interests.

Let's discuss

If you have any questions regarding the *Express Scripts* decision, please do not hesitate to contact either of the following SALT professionals:

Maureen Pechacek
Partner
(858) 677-2532
maureen.pechacek@us.pwc.com

Gina Ceola
Director
(612) 596-4827
gina.ceola@us.pwc.com