myStateTaxOffice Quarterly

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MyStateTaxOffice Quarterly is prepared by PwC – Washington National Tax Services SALT team. Our objective is to provide a quick reference to recently issued key developments.

Key State Developments

Recent trends in state transfer pricing controversies

Authored by: Steve Snyder, Director Atlanta, GA (published November 11, 2011)

Numerous headlines have illustrated the issue of state governments struggling to bring in revenues sufficient to cover state budgets. One action that states are increasingly pursuing as a source of inflows is proposing tax assessments related to alleged transfer pricing[1] abuses by corporate taxpayers. CFO.com indicated that 49% of chief financial officers polled find state tax compliance more challenging than federal tax compliance.[2] One potential reason for this response is the increasing focus of state revenue authorities on transfer pricing issues that previously may have been treated as "federal" audit items.

Historically, states have scrutinized the business purpose and economic substance of royalties charged by domestic intellectual property holding companies in low or no tax jurisdictions, but states have since adjusted their laws and policies in this area. Many state tax and revenue authorities now believe that transfer pricing adjustments represent the best opportunity to combat perceived continued tax avoidance stemming from other types of intercompany payments. A few of the more notable regulatory and enforcement trends in the complex topic of state transfer pricing[3] are covered in this article.

Contingency-fee vendors

To compound the state tax compliance issues faced by taxpayers regarding transfer pricing, a new enforcement trend has emerged. At least two firms have gained traction negotiating agreements with multiple state tax and revenue authorities to calculate tax assessments for corporate taxpayers based on the application of the firms' transfer pricing methodology. For their part in calculating the proposed transfer pricing assessments, the firms earn a contingency fee based on a percentage (generally 14-16%) of the tax revenue that the particular state recovers, or a fixed amount in states that don't allow contingency fees.

State contract auditors

Another state transfer pricing trend results from the expansion of issues scrutinized under state tax audits. Faced with limited budget, some states are outsourcing aspects of these tax audits to contractors. One contract auditor is reported to have current or past arrangements, for transfer pricing assistance, with Alabama, the District of Columbia, Kentucky, Louisiana, and New Jersey. In fact, certain states, including Minnesota, have considered legislation that would require the state to engage contract auditors to perform

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[1] Transfer pricing is a term used to describe how a taxpayer prices transactions among its related entities operating in multiple jurisdictions, often with differing income tax rates.
[2] "CFOs Hate the Corporate Rate," *CFO.Com*, May 12, 2011.

[3] Transfer pricing, long a controversial topic on the federal and international levels where multi-million dollar tax payments to settle cross-border disputes are frequent, is increasingly becoming an issue for companies involved in state-to-state intercompany transactions.

analyses "to identify and collect revenues from taxpayers that are using abusive transfer pricing schemes."[4]

It appears that the District of Columbia has been one of the more active jurisdictions and has renewed its contract auditor arrangement at least once. Taxpayers have responded by opposing the District of Columbia's proposed adjustments, and at least one case has been docketed with the Superior Court of the District of Columbia, Tax Division.[5] This case and other early court decisions could have a significant impact on future contract audits.

Other states are following more traditional approaches and have either hired in-house transfer pricing specialists to examine the tax positions of companies filing tax returns in their jurisdiction or engaged outside experts to testify against taxpayers that choose to dispute assessments in that state's judicial system. Over the past decade, states have also pursued regulatory changes,[6] including enacting statutes that disallow intercompany transactions (largely intangible asset licenses and financing arrangements) to attempt and maintain their tax bases.

How should taxpayers prepare for potential scrutiny of state-to-state intercompany transactions?

Although it is unrealistic for taxpayers to prepare separate transfer pricing analyses documenting each state-to-state transaction, it is beneficial if a transfer pricing report covers the primary ones and is followed consistently. In addition, it is helpful if the taxpayer prepares and executes other documents, such as intercompany policies and agreements, that detail the transactions and payment terms and also reference the transfer pricing analyses. Also, if an audit is anticipated, it is helpful if a taxpayer assembles relevant documents and develops defensible positions prior to the start of the audit. However, with the aggressive stance that states are pursuing and the likely disagreement regarding what constitutes arm's length, a new trend of more state tax disputes could result.

Michigan enacts series of corporate income tax amendments

Authored by: Adam Weinreb, WNTS SALT (published October 21, 2011)

Michigan Governor Snyder signed a series of bills that amend provisions of the newly-enacted corporate income tax. The new tax, along with these amendments, takes effect on January 1, 2012. The enacted measures address a variety of subjects, including unitary groups, financial institutions, apportionment, nexus standards, foreign persons, credits, and receipts from flow-through entities. In addition, a bill amending Michigan Business Tax provisions relating to short-year returns and credits was signed by the Governor on October 26, 2011.

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[4] See, e.g., Minnesota H.F. 904, introduced March 7, 2011.
[5] *BP Products North America, Inc. v. District of Columbia*, Tax Docket No. 2011cvt10619, filed June 17, 2011. Other assessments may be appealed to the District's Office of Administrative Hearings (OAH), but these hearings are not public.
[6] Transfer pricing is primarily an issue for taxpayers in separate company return states, but can be an issue in unitary states as well.

- **Tax Year of Unitary Group Members.** House Bill 4946 (enacted 10/14) provides that a person included in a unitary business group that joins or departs a unitary group other than the end of that person's federal tax year must have a tax year that begins with its federal income tax period and ends on the date of joining or departing the group. Another tax year begins on the date immediately after joining or departing the group and ending with its federal income tax period.

- **Financial Institutions.** House Bill 4951 redefines a financial institution to exclude an office of thrift supervision chartered bank or thrift institution, and a savings and loan holding company other than a diversified savings and loan holding company.

- **Foreign Persons Income and Apportionment.** House Bill 4955 (enacted 10/14) provides that the income of a foreign person does not include net income from sales of tangible personal property where title passes outside the United States. Previously, the exclusion was for proceeds from sales where title passes outside the U.S. In addition, for purposes of sales of tangible personal property, the sales factor of a foreign person will include only sales where title passes inside the U.S., and other sales will be apportioned based on the formula for other taxpayers.

- **Credits.** House Bill 4967 (enacted 10/14) provides that any taxpayer that claimed, and failed to comply with the terms of, a credit under the single business tax or Michigan business tax, and that credit included a "clawback provision," the taxpayer must add back all or part of the credit to its corporate income tax liability in the year that the taxpayer failed to satisfy or breached the conditions of the credit. In addition, a taxpayer that claimed a credit under the SBT, Sec. 35A, or the MBT, Sec. 403, for a tangible asset that the taxpayer has sold, transferred out of Michigan, or otherwise disposed of during the current tax year must, to the extent the credit was used, and at the rate at which the credit was used, add back an amount (determined under a statutory formula) to the taxpayer's corporate income tax liability.

- **Financial Institution and Nexus.** The tax regime currently in existence under the MBT for financial institutions will be retained. Financial institutions will be subject to tax based on net capital at a rate of 0.29 percent. Under S.B. 650 (enacted 10/17), a financial institution has substantial nexus if it satisfies any of the following: (1) has a physical presence in the state for a period of more than one day during the tax year; (2) actively solicits sales (as defined for other taxpayers) in the state and has gross receipts of $350,000 or more sourced to the state; or (3) has an ownership interest or beneficial interest in a flow-through entity, directly or indirectly, through one or more other flow-through entities that have substantial nexus (as defined below under S.B. 669) with the state.

- **Actively Solicit Proposal.** Under S.B. 669 (enacted 10/17), language directing the Department to define "actively solicits" is repealed. Under the bill, "actively solicits" means either: (i) speech, conduct, or activity that is purposefully directed at or intended to reach persons within the state and that explicitly or implicitly invites an order for purchase or sale; or (ii) speech, conduct, or activity that is purposefully directed at or intended to reach persons within the state that neither explicitly nor implicitly invites an order for a purchase or sale, but is entirely ancillary to requests for an order for a purchase or sale.

- **Receipts of a Flow-Through Entity and Nexus Threshold.** Under S.B.654 (enacted 10/17), the apportioned or allocated gross receipts of a flow-through entity must be imputed to each of its members based on the same percentage that each member's proportionate share of distributive income is to the total distributive income of the flow-through entity. In addition, if a taxpayer has apportioned or allocated gross receipts for less than a 12 month tax year, the $350,000 receipts/nexus threshold must be multiplied by a fraction, the numerator of which is the number of months on the tax year, and the denominator of which is 12.

- **Apportionment of Flow-Through Entity Income.** S.B. 674 (enacted 10/17) provides apportionment rules for a taxpayer that has an ownership or beneficial interest in a flow-through entity. Under the language of the bill, a taxpayer's business income directly attributable to the business activity of the flow-through entity is apportioned to the state using a single-sales factor based on the activity of the flow-through entity. Previously, the language limited this provision to the ownership or beneficial interest in flow-through entity that has business activity in the state.

- **MBT Amendments/Credits/Part Year Returns.** Under House Bill 4947, (enacted, 10/26/11) for MBT purposes, a taxpayer that has a fiscal tax year ending after December 31, 2011 is deemed to have two separate tax years: the first is for the fractional part of the fiscal year ending before January 1, 2012, and the second is for the fractional part of the fiscal year after December 31, 2011. Returns filed for these short years will both be deemed to be annual returns. The legislation requires these taxpayers to compute their MBT liability under the same method for both fractional periods. In addition, these taxpayers must calculate and claim credits based on actions taken or payments made during the fractional period represented on the return. The legislation also provides that, if a unitary business group elects to keep paying the MBT in order to claim certificated credit or any unused carryforward of that credit, the group return must include all persons in the group regardless of whether that person is incorporated. In addition, the legislation amends provisions for taxpayers claiming a certificated brownfield development credit for multiphase projects. The legislation revises the formula under which the MBT liability is determined for taxpayers that elect to remain subject to the MBT. Specifically, the legislation provides that in making the "greater of" calculation, for a partnership or S corporation, business income includes payments and items of income and expense that are attributable to business activity of the partnership or S corporation and separately reported to the members.

- **Other.** In addition, House Bill 4968 (enacted 10/14) redefines "gross receipts" and House Bill 4953 (enacted 10/14) eliminates the separate definition of business income for a tax-exempt mutual or cooperative electric company.

Illinois governor signs tax package, includes credit extensions and tax tribunal

Authored by Yasmin Dirks, WNTS SALT (published December 15, 2011)

Governor Pat Quinn on December 16 signed legislation (SB 397) that, in addition to extending credits and providing tax incentives to certain taxpayers, grants an Independent Tax Tribunal Board jurisdiction to hear protests in place of the Department of Revenue. [SB 397, signed 12/16/2011]

Illinois Tax Tribunal

SB 397 provides that on July 1, 2013, an Independent Tax Tribunal Board is to assume all rights and powers pertaining to the protest of notices of tax liabilities or deficiencies for all taxes administered by the Department of Revenue. The legislation provides that this tribunal "shall be created by law" and that no state agency shall assume the functions of the tribunal. The tribunal will replace the current formal hearings process before the Department's Office of Administrative Hearings.

Research & Development (R&D) Credit

In addition, SB 397 reinstates and extends the R&D credit for five years (to tax years ending prior to January 1, 2016). The R&D had previously expired effective January 1, 2011. SB 397 further removes the January 1, 2011 expiration for the carryforward of unused R&D credits. The credit is equal to 6 1/2% of qualifying expenditures for increasing research activities in Illinois.

Net Operating Loss

SB 397 reinstates a portion of the net operating loss deduction for tax years ending December 31, 2012 through December 31, 2014. Under the legislation, the amount used as a carryforward shall not exceed $100,000 for such taxable years. Further, the carryforward period is extended for those years in which the NOL deduction would exceed $100,000 but for the limitation.

Federally Regulated Exchanges

The legislation permits federally regulated exchanges an option to source their electronic trades to Illinois using a fixed percentage. Phased in over two years, those federally regulated exchanges that make the election will use a fixed percentage of 63.77% for tax years ending on or after December 31, 2012 but before December 31, 2013, and 27.54% for tax years ending on or after December 31, 2013. Receipts attributable to transactions executed on a physical trading floor in Illinois are sourced to Illinois.

Automatic Sunset Provision

SB 397 also extends by five years any tax credit or deduction scheduled to expire under the statutory automatic sunset provision in 2011, 2012, or 2013.

Estate Tax

SB 397 increases the estate tax exemption from $2 million to $3.5 million beginning January 1, 2012, and then to $4 million beginning January 1, 2013 and thereafter.

Additional Credit Provisions

Further provisions in the legislation address:

- Investment Tax Credit
- Replacement Tax Investment Credit
- Angel Investment Credit
- TECH-PREP Credit
- Veterans Jobs Credit
- Live Theater Production Credit
- Gasohol Tax Benefits
- Affordable Housing Donation Credit
- River Edge Redevelopment Zone
- Sears Economic Development Area (EDA) and Economic Development for a Growing Economy (EDGE) Credit

EITC and Personal Exemption

Another bill sent to Governor Quinn, SB 400, increases the Earned Income Tax Credit (EITC) from 5% of the federal credit to 7.5% for tax years beginning on or after January 1, 2012, and ending prior to December 31, 2013. The EITC will increase to 10% of the federal credit for tax years beginning on or after January 1, 2013.

In addition, SB 400 increases the personal exemption from $2,000 to $2,050 for taxable years ending on or after December 31, 2012 and prior to December 31, 2013. Starting for taxable years ending on or after December 31, 2013, the $2,050 exemption will be subject to a cost-of-living adjustment based on the consumer price index.

PwC Observes

"Taxpayers should note that the effective date of the provisions transferring jurisdiction over tax protests to the Tax Tribunal is July 1, 2013. Obviously, much can happen between now and that date," observes Mike Lovett, State and Local Tax Director with PwC in Chicago. "At a minimum, the effective implementation of a Tax Tribunal will take more that a statute authorizing the creation of said Tribunal. Taxpayers will need to watch for both legislative and administrative actions to transfer the responsibilities of handling tax disputes from the Office of Administrative Hearings within the DOR to an independent Tax Tribunal."

State Tax Practitioner Tip

Your local PwC state tax specialists may assist you with participation in these on-going or up-coming state tax amnesties:

- Ohio

Enacted legislation and issued court decisions and administrative guidance

Note: The parenthetical date is the MySTO published date for the development

Income/Franchise Tax

California

Last call on California market-based sourcing regulation - FTB accepting comments until October 24 (October 14, 2011)

November deadline passes for California I.R.C. conformity; I.R.C. Sec. 355 provisions may be impacted (November 4, 2011)

California Franchise Tax Board approves market-sourcing regulatory proposal, moves forward with DISA, Finnigan, and other measures (December 2, 2011)

Indiana

Indiana tax court finds DOR's combination powers restricted by statute (October 29, 2011)

New Jersey

New Jersey to begin examining intercompany transactions with related foreign affiliates (December 9, 2011)

New York

New York amends rates, reduces tax on qualified manufacturers (December 8, 2011)

South Carolina

South Carolina Supreme Court upholds denial of deduction for expenses related to excluded dividends (December 16, 2011)

Tennessee

Tennessee details compromise program for intangible expenses (December 2, 2011)

Texas

Texas Supreme Court hears oral arguments in Texas franchise tax constitutional challenge (October 29, 2011)

Texas Supreme Court holds franchise tax does not violate constitution's "Bullock Amendment" (December 2, 2011)

Sales & Use Tax

Pennsylvania

Pennsylvania Department of Revenue bulletin declares remote sales tax collection authority (December 9, 2011)

Streamlined sales tax

Streamlined sales tax addresses daily deals, debates federal legislation on remote sales (October 7, 2011)

Other

Michigan

Michigan Business Tax notice requires filing by federally disregarded entities; Deadline extended to December 31, 2011 (October 7, 2011)

Revised Michigan Business Tax notice again extends filing deadline for federally disregarded entities; Deadline extended to July 1, 2012 (November 18, 2011)

Texas

Texas Comptroller to grant extension to combined groups with loss carryforwards (November 4, 2011)

Washington

Washington Court of Appeals: Cash management account proceeds constitute gross income (October 7, 2011)

myStateTaxOffice Quarterly is prepared by PwC – Washington National Tax. We welcome your comments and suggestions – please contact any member of the Washington National Tax Services SALT Team:

Bryan Mayster	*(202) 414-4498*	*bryan.mayster@us.pwc.com*
Denise Dockrey	*(202) 465-5097*	*denise.s.dockrey@us.pwc.com*
Ferdinand Hogroian	*(202) 414-1798*	*ferdinand.hogroian@us.pwc.com*
Jennifer Jensen	*(202) 414-1741*	*jennifer.jensen@us.pwc.com*
Adam Weinreb	*(646) 471-4409*	*adam.weinreb@us.pwc.com*
Elaine Harper	*(202) 414-1013*	*elaine.harper@us.pwc.com*
Amy St Clair	*(702) 691-5445*	*amy.c.st.clair@us.pwc.com*
Kathryn Thurber	*(202) 346-5122*	*kathryn.thurber@us.pwc.com*