PRESENTATION

SALT Breakfast Briefing

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Multistate Corporate Income Tax Planning Round-up

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Cash Management and Intangibles

- *Kimberly-Clark Corp. v. Comm'r of Revenue*, 981 N.E. 2d 208 (Mass. Ct. App., Jan. 6, 2013), *review denied*, 984 N.E. 2d 296 (Mass., Mar. 1, 2013)
  - 2001-2003 taxable years
  - Centralized cash management system: deductibility of intercompany interest denied
    - Debt formalities followed and used AFR as interest rate
    - Notes contained no security, collateral or default provisions
    - AFR rejected as an arm's length rate; various subsidiaries not proven to be equally credit-worthy
  - 2002 royalty payments: deduction denied under "sham transaction" doctrine
    - KC's IHCO had substantial substance
    - Applied *Sherwin-Williams*: (1) circular flow, and (2) no third party licenses

Kimberly-Clark (con't)

- 2003 rebate payments: deduction denied as "embedded royalty"
  - KC replaced intercompany royalties with supply chain management process (after Mass. enacted add-back statute in 2002)
  - Operating subsidiaries remitted the amount of their cost savings realized from use of patents to a sales company
  - Sales company, in turn, remitted "rebates" to former IHCO
  - Rebate payments treated as payments for "embedded intangibles," because they were tied to the use of patents

- ***Thoughts and Observations***

Economic Presence Nexus – Cracks Forming in the Facade?

- Licensing and use of intangibles in a state and distribution of products by licensees may be insufficient under economic presence theory.
  - *Matter of Scioto Insurance Co.,* 279 P. 3d 782 (Okla. 2012)
    - Trademark sub-licensing arrangement; sub-licensor, but not licensor, derived royalty income from Oklahoma franchisees of Wendy's
  - *Griffith v. Conagra Brands, Inc.,* 728 S.E. 2d 74 (W.Va. 2012)
    - Licensor of trademarks to related/unrelated manufacturers/distributors outside WV who sold trademarked products to WV wholesalers/retailers; licensor did not direct distribution
  - *In re: Washington Mutual, Inc.,* 485 B.R. 510 (U.S. Bankr. 2012)
    - Use of trademarks in Oregon without receipt of royalties or license fees from licensees

Economic Presence Nexus (con't)

- Courts in *Scioto* and *Conagra Brands* emphasized that licensors were not "shell corporations" organized only for tax avoidance.
- ***Thoughts and Observations***
  - See also Tennessee Revenue Ruling # 12-27 (Nov. 14, 2012)

Attributional Nexus

- *Harley-Davidson, Inc. v. Franchise Tax Board,* No. 37-2011-00100846 (San Diego County Super. Ct., May 1, 2013)
  - Financial services affiliate originated loans to customers in CA and other states
  - Contributed the loan receivables to SPEs for securitization; another affiliate serviced the loans
  - "The California Harley-Davidson dealers, . . . , are not clearly completely independent. They are an integral part of Harley-Davidson …."
  - Trial court applied a unitary analysis to a nexus issue ("integral part," "economic interdependence," "functional integration")
  - Court relied on *Reader's Digest Ass'n v. Franchise Tax Board*, 94 Cal. App. 4th 1240 (Cal. App. 2001)
    - Misplaced reliance?

Attributional Nexus

- ***Thoughts and Observations***
  - Why assert taxing jurisdiction over SPEs when HD group was filing a unitary combined report?
  - A flip side: Tennessee Letter Ruling # 12-32 (Dec. 19, 2012)
    - Receivables factoring transactions are not subject to TN intangible expense add-back
    - Other States? Georgia? Indiana? New York? North Carolina?

Business and Nonbusiness Income – Win Some, Lose Some

- *Glatfelter Pulpwood Co. v. Commonwealth,* No. 62 MAP 2011 (Pa. Supreme Ct., Jan. 22, 2013)
  - Sale of Delaware timberland holdings (allocated 100% to DE)
  - Pennsylvania followed the "business liquidation rule" – *Laurel Pipe Line Co. v. Commonwealth,* 642 A. 2d 472 (Pa. 1994)
  - Pennsylvania statutory definition of "business income" amended in 2001
    - Pre-2001: "… acquisition, management, and disposition …"
    - 2001 and current: "… either the acquisition, management, or disposition …"
  - Pennsylvania Supreme Court held that statutory amendment removed the "business liquidation rule" and disposition of assets need not be "integral part of taxpayer's regular trade or business operations …"

- ***Thoughts and Observations***
  - Similar statutory changes in other states (e.g., Illinois and North Carolina)
  - Support for position in traditional UDITPA states?
  - T.C.A. § 67-4-2004(4): "… acquisition, use, management, or disposition …"

Business and Nonbusiness Income (con't)

- Decision of Hearing Officer No. 201100309 (Ariz. DOR, July 30, 2012)
  - Interest and dividends earned on short-term investment account in excess of working capital needs was nonbusiness income
  - Account established to fund purchases/redemptions of taxpayer's retiring/deceased shareholders
  - Decision is short on specifics and does not disclose the taxpayer's "invasion" formula
- ***Thoughts and Observations***
  - Applicability of position for other states? California, Illinois, New Jersey, Oregon, Virginia
  - Tennessee? *Siegel-Robert, Inc. v. Johnson,* No. M2008-02228-COA-R3-CV (Ct. App., Oct. 28, 2009)

Alternative Apportionment

- Background
  - *Microsoft Corp. v. Franchise Tax Board,* 39 Cal. 4th 750 (2006): alternative formula permissible when the activity qualitatively differs from the taxpayer's principal business and quantitatively distorts the standard formula
  - *General Mills, Inc. v. Franchise Tax Board*, 208 Cal. App. 4th 1290 (Cal. App. 2012)
    - **Qualitative**: is the activity conducted for profit? Activity can be qualitatively different even if fundamental or integral to taxpayer's business
    - **Quantitative**: comparison of profit margins (i.e., an activity that generates substantial gross receipts but low margin may quantitatively distort)
  - *Media General Communications, Inc. v. Dept. of Revenue*, 694 S.E. 2d 525 (S.C. 2010): state (or taxpayer, if requesting) must (1) prove that standard formula does not fairly represent the taxpayer's in-state business activity, and (2) that the alternative formula is reasonable.

Alternative Apportionment (con't)

- *Vodafone Americas Holdings, Inc. v. Roberts,* No. 07-1860-IV (Davidson County Chancery Ct., Mar. 19, 2013)
  - Court seemed to focus on disparity in a single factor (sales factor): standard (costs of performance) sourcing resulted in a sales factor 89% less than the Department of Revenue's alternative (market/customer address sourcing)
  - This "unusual factual situation" justified resort to market sourcing
  - Arguably "narrow discretion" to issue a variance, but unlimited discretion in the choice of an alternative
  - The "nowhere income" canard
  - Tennessee service providers
- ***Thoughts and Observations***

Federal Conformity – A Trap or Opportunity?

- FTB Chief Counsel Ruling 2012-06 (Oct. 25, 2012)
  - IRC §§ 332 and 337 – liquidation of 80% or more owned subsidiary does not trigger gain or loss
  - Exception: IRC § 165(g)(3) allows the shareholder a worthless stock deduction if subsidiary is insolvent (equal to shareholder's stock basis)
  - Treas. Reg. § 1.337(d)-2(a)(1): loss disallowed if shareholder and insolvent subsidiary members of the same consolidated return group. For liquidations after Sept. 17, 2008, Treas. Reg. § 1.1502-36 applies.
  - California conforms to subchapter C and § 165, but not with federal consolidated return rules (with certain exceptions not applicable to the ruling)
  - Treas. Reg. § 1.1502-36 allowed worthless stock deduction, but inapplicable to California
  - Q: Did § 1.337(d)-2(a)(1) stand on its own?
  - A: No, FTB Chief Counsel ruled that regulation is itself a federal consolidated return rule and also inapplicable; § 165(g)(3) deduction allowed

Federal Conformity (con't)

- Final Section 336(e) Regulations (Treas. Reg. § 1.336-1, et seq.)
  - Allows seller of "Target" stock, including member(s) of federal consolidated group, to elect to treat as sale of assets by "Target"
  - Federal election required
  - Similar to § 338(h)(10) there is a deemed liquidation fiction for "Target"
  - Regulations effective for a "qualified stock disposition" occurring on or after May 15, 2013
  - Definition of "qualified stock disposition" references "stock meeting the requirements of section 1504(a)(2)"

Federal Conformity (con't)

  - Intra-group stock distributions/sales followed by external stock distribution/sale
    - No § 336(e) election allowed for intra-group transaction
    - Could result in double gain
    - Group will be allowed to make a § 1.1502-13(f)(5) election to treat the deemed liquidation of "Target" as taxable
    - The mechanics/effect of the -13(f)(5) election will generate a stock loss to offset some or all of intragroup gain

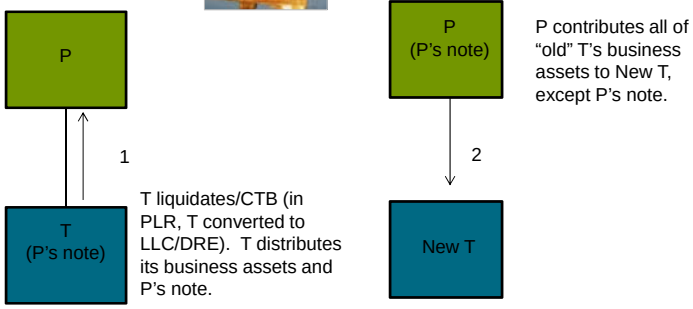
- ***Thoughts and Observations***
  - Will States conform?

The Unwind or Re-Position – Some Useful IRS PLRs on Intragroup Reorganizations

A number of recent IRS rulings illustrate forms to:

- "unwind" prior state tax planning
- eliminate intercompany debt
- distribute appreciated assets
- reposition tax attributes

PLR 201127004
Upstream "C" Reorganization

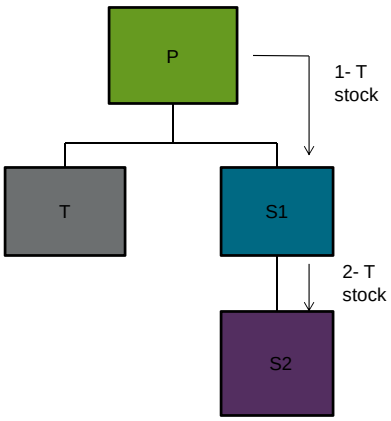


- Ruled: Type "C" reorganization upstream of T, followed by IRC § 351 creation of "New T." New T remains in P's "qualified group" ("COBE" satisfied)
- Treas. Reg. § 1.368-2(k) (note: if the upstream is not a reorganization, then – 2(k) doesn't apply to prevent recharacterization as taxable distribution of the assets remaining in P under liquidation/reincorporation)
- Business purpose was "state tax savings"
- No COD income to P; ruling relied on Rev. Rul. 74-54

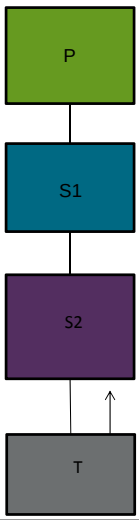
PLR 201220015
Dumbbell D's

- Treated as two Type "D" reorganizations ("dumbbell D's"). T is born to die, but within the same "group."
- "For what are represented to be valid business reasons …."
- Query: Is this the new way to avoid IRC § 311(b)?

PLR 201252002
Double Drop and Die



Ruled: Double IRC § 351 tax-free contributions of T stock and step 3 liquidation of T treated as Type "D" reorganization.



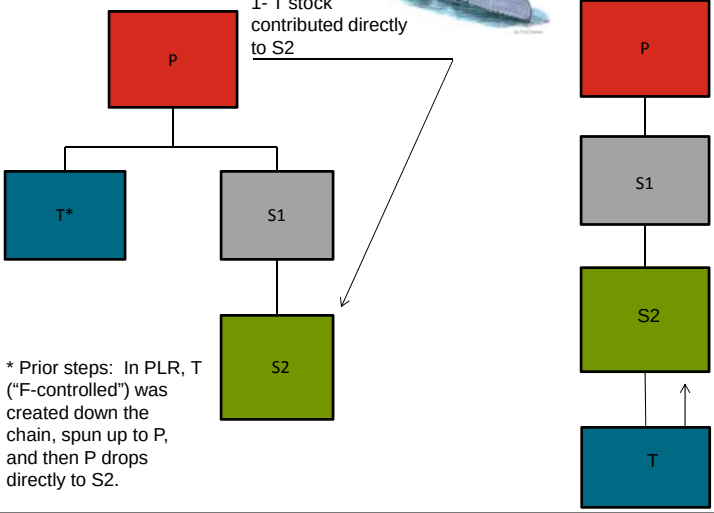
Why not have T liquidate into P (or convert to LLC) and then drop some/all of assets to S1, then to S2?

- Potential liquid/reincorp issues? § 1.368-2(k) may not apply
- Did P not want T's tax attributes?
- Other asset transfer issues?

3- T
liquidates

PLR 201015002

The Submarine



Ruled: Two "D" reorgs (prior step* and the step 2 liquidation - "dumbbell D's"), followed by IRC § 351 contribution of S2 stock that P received in step 1

This makes use of a corporation augmented in a "D" reorg as a "submarine" to carry assets cross chian. Same result if T was newly created.

PLR 201213018

Spin and Die

- T was already in existence and no assets were added to T prior to internal spin, meaning there was no D reorg. Debt owed T by P will be extinguished on liquidation of T without tax effect. Rev. Rul. 74-54.
- Stated business purpose: "state tax savings".
- Ruled: internal IRC § 355 spin and liquidation under IRC § 332.
- Query: is this the new standard way to get rid of intercompany debt?