



Recent Multistate Income/Franchise Tax and Sales/Use Tax Developments September-November 2012

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Agenda

Nexus Issues

Tax Base/Modifications

Allocation and Apportionment Issues

Unitary/Combined/Consolidated Issues

Sales/Use Tax Issues

Other Developments

Miscellaneous Cases

Nexus Issues

Nexus

New Jersey

Notice: Intangible Asset Nexus Initiative N.J. Div. of Tax. (9/18/12)

“Recognizing that there are companies that have nexus with New Jersey as a result of having derived income from the use of intangible assets in this State that have not fulfilled their tax filing responsibilities,” the department has announced that it will be offering a limited voluntary disclosure initiative that began on September 15, 2012, and will run through January 15, 2013. Under this program, companies that own intangible assets and derived income from the use of those assets in New Jersey will have the opportunity to come forward and voluntarily comply with their state corporation business tax filing requirements. In addition to New Jersey’s standard procedures and requirements for voluntary disclosure agreements (VDAs) for business taxes, the department states that the following principles will apply with respect to this particular program: (cont.)

Nexus (cont.)

New Jersey

Notice: Intangible Asset Nexus Initiative N.J. Div. of Tax. (9/18/12) (cont.)

- Separate entity state
- Economic nexus
 - In regulations since 1996
 - In statute since 2002
 - Confirmed by NJ Supreme Court in Lanco in 2005
 - Intercompany royalty disallowance (add back) since 2002
 - Certain exception to add back

Nexus (cont.)

New Jersey

Notice: Intangible Asset Nexus Initiative N.J. Div. of Tax. (9/18/12) (cont.)

- Timing to participate open until January 15, 2013
- Lookback period back to 2003
- Terms of Settlement Program
 - Filing of returns and payments of tax, interest and penalties
 - Waiver of certain penalties
 - Throwout sales treatment options
 - Returns subject to audit
- Operating Company refund options

Tax Base/Modifications

Tax Base/Modifications

Michigan

TMW Enterprises Case

- S Corporation taxpayer originally sought to take a casual transaction position in order to exclude from its SBT tax base the capital gain from a large asset sale.
- The initial 2009 Court of Appeals decision in TMW made it clear that an S corporation is a corporation for SBT purposes and thus no casual transaction exclusion was available (statutorily, a casual transaction exclusion is only available for non-corporate SBT taxpayers.) However, the Court's statement that as a corporation, the S corporation must compute business income based on "federal taxable income" opened the door on remand for lower court to determine that federal taxable income for a S Corporation was limited to recognized built in gains and excess passive income.
- Subsequent decision rendered in TMW Enterprises, Inc. v. Department of Treasury, No. 302870 Court of Appeals of Michigan, 2012 Mich. App.

Tax Base/Modifications (cont.)

Michigan

TMW Enterprises Case (cont.)

Potential SBT Refund Opportunity Exists for S Corps with Open SBT Tax Years.

- The de facto “no federal taxable income/no SBT business income” starting point for the SBT tax base of most S corporations under the TMW logic holds other potential SBT implications.
 - The primary SBT tax base additions (e.g. depreciation, interest and royalty expense) may not be required because these are only added to the SBT tax base “to the extent deducted from federal taxable income.”
 - Compensation would still be an add-back, as this definition has no tie-in to taxpayer’s computation of business income.
 - Credits may not be affected, except with the possible (and favorable) exception of the 10/15/20% nonrefundable credit available to S Corporations based on graduated business income amounts.
 - Excess compensation modification to SBT tax base may also be favorably affected.
 - Sales factor should not be altered.
- Unlike the SBT, the MBT definition of business income specifically references S Corporations and provides a methodology similar to how partnerships compute business income; based on income/deductions separately reported to partners

Tax Base/Modifications (cont.)

Tennessee

Intangible expense deduction approval process-Notice 12-16

- Intangible Expense — Add-Back Requirement - Tenn. Code Ann. § 67-4-2006(b)(1)(K) requires all intangible expense paid to an affiliated business entity initially be added to a taxpayer's net earnings or losses on Schedule J of the franchise, excise tax return. These expenses can be subsequently deducted on the same tax returns provided the taxpayer files a Form IE-N or obtains approval for the deduction after filing Form IE-A. Failure to add back intangible expenses paid to an affiliate on the initially filed return will subject the taxpayer to a negligence penalty.

Tax Base/Modifications (cont.)

Tennessee

Intangible expense deduction approval process-Notice 12-16 (cont.)

- Safe Harbor Deductions
- Notice of Deduction
- Application for Approval of Deductions
- Form IE

Allocation and Apportionment Issues

Allocation and Apportionment

California

Mandatory Single Sales Factor Apportionment for most Multistate Taxpayers

- Proposition 30 passed in November election
- Single sales factor and market based sourcing for sales of other than tangible personal property effective for tax years beginning on or after January 1, 2013.
- The election to use a single sales factor formula and the applicable market-based sales sourcing remains intact for the 2011 and 2012 taxable years.

Unitary/Combined/ Consolidated Issues

Unitary/Combined/Consolidated

New York

New York - Proposed NYS Combined Reporting Regs.

On Sept 12, NYS published proposed regulations on combined reporting under Article 9-A.

- 2007 law created mandatory combined reporting where “substantial intercorporate transactions” exist.
 - These can arise from substantial intercorporate receipts, expenditures, or asset transfers.
- Guidance had been issued in TSB-M-08(2)C.
 - Informal policy guidance on new law.
 - Set forth a 10-step process under which combined group is built up among related entities with substantial intercorporate transactions with each other.
 - Defined key terms.

Unitary/Combined/Consolidated (cont.)

New York

New York - Proposed NYS Combined Reporting Regs. (cont.)

- Proposed regulations generally follow TSB-M-08(2)C but contain certain important changes.
 - Substantial Asset Transfers
 - Intercompany Interest
 - Intercompany allocations not treated as intercompany transactions.
 - Some of these answers likely to be changed in final regulation.
 - Combined reporting for members with different fiscal years.
- Combined reporting for members with different fiscal years.
- Ownership test based on voting power, not shares.
- Regulations expected to be effective for 2012 tax year.

Sales/Use Tax Issues

Sales/Use Tax

Alabama

New Administrative Rule Describes Nexus Standards

- New Rule 810-6-2-.90.01, Ala. Dept. of Rev. (eff. 8/24/12).
- Engaged in business guidance and nexus creation via affiliate addressed.

Sales/Use Tax (cont.)

California

Voters Approve Tax Increase

- Voters approved Proposition 30, which temporarily increases both personal income, and sales and use tax rates.
- Proposition 30 increases the state-level sales and use tax rate by a quarter-percent from 7.25% to 7.50% for tax periods beginning on and after January 1, 2013, through December 31, 2016.

Sales/Use Tax (cont.)

Washington

Physical Presence and Economic Nexus Standard Update

- Wash. Dept. of Rev. (11/12) recently updated department guidance regarding substantial nexus
- Provides examples of more than slightest presence include
 - Soliciting sales in this state through employees or other representatives
 - Installing or assembling goods in this state, either by employees or other representatives
 - Maintaining a stock of goods in this state
 - Renting or leasing tangible personal property
 - Providing services

Other Developments

Other Developments

California

California Voters Approve Tax Increase

- Under the new law (Proposition 30), personal income tax rates for single individual filers with taxable income over \$250,000 are as follows:

Taxable Income Over...	But not Over...	Applicable Tax Rate is	Including the Mental Health Tax on Income Over \$1 Million¹⁰
\$250,000	\$300,000	10.3%	
\$300,000	\$500,000	11.3%	
\$500,000		12.3%	13.3%

Other Developments (cont.)

California

California Voters Approve Tax Increase (cont.)

- Under the new law (Proposition 30), personal income tax rates for individuals filing head of household are adjusted as follows:

Taxable Income Over...	But not Over...	Applicable Tax Rate is	Including the Mental Health Tax on Income Over \$1 Million¹⁰
\$340,000	\$408,000	10.3%	
\$408,000	\$680,000	11.3%	
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Other Developments (cont.)

California

California Voters Approve Tax Increase (cont.)

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Other Developments (cont.)

Massachusetts

DOR Issues Draft Administrative Procedure re: Early Mediation Program

- Pilot version expected to be available by the end of October 2012.
- Early Mediation Program would expand “the range of dispute resolution options available to taxpayers and, in appropriate cases, offers an expedited process, potentially avoiding time-consuming and expensive proceedings.”
- Early Mediation does not eliminate or replace existing administrative appeal options, including the taxpayer’s opportunity to request a hearing or settlement consideration with the Office of Appeals if the case is not resolved through the Early Mediation process.”
- The Early Mediation Program pilot program likely will be administered jointly by the department’s audit division, legal division, and the Office of Appeals.

Other Developments (cont.)

Michigan

Pending MBT Technical Clarifications Senate Bill 1037

- Originally began as a clarification of eleven pertinent MBT issues. Michigan Department of Treasury (“Treasury”) resistance has resulted in six of the clarifications being removed from latest version of SB 1037.
- The five remaining clarifications are limited to the following issues:
 - Definition of an Officer
 - Reasonable Return on Capital
 - Income Base NOL Successorship
 - Ultimate Destination for Sales Factor Sourcing purposes
 - Explicit Exclusion from Gross Receipts for CODI
- Any enacted changes would be retroactive to 2008.

Other Developments (cont.)

Michigan

Pending MBT Technical Clarifications Senate Bill 1037 (cont.)

- Most taxpayers are not impacted by items remaining in the Senate Bill.
- Most significant remaining clarification adds an explicit exclusion from gross receipts for COD income. Exclusion tied to federal exclusion under IRC Section 108.
- Latest word is that Treasury wants CODI exclusion struck from Senate Bill as well.

Other Developments (cont.)

Michigan

Pending MBT Technical Clarifications Senate Bill 1037 (cont.)

Clarifications with respect to the following items were previously removed from original version of Senate Bill 1037:

- Self-Constructed Assets
- Addition of term “tangible” to Materials and Supplies definition
- Intercompany Eliminations for Unitary Business Group
- Credit Ordering with regard to unused Single Business Tax Credit carryforwards

Other Developments (cont.)

Michigan

Potential Future Technical Clarifications

Two items to be addressed potentially in the first quarter of 2013:

- ITC Recapture with respect to assets acquired during MBT tax years
- Renaissance Zone Credit

Other Developments (cont.)

Michigan

MBT Audits

- MBT audits, which can be very time consuming, are just beginning to commence.
- Treasury likely to ask for very detailed information (i.e., account detail, invoices, etc.) in the following areas:
 - Gross receipts calculation
 - Purchases deduction
 - Materials and supplies
 - Eliminations

Other Developments (cont.)

Michigan

Clarification of DRE Treatment

- MBT law changes enacted in December 2011 clarify that a Disregarded Entity (“DRE”) for federal purposes is a DRE for MBT purposes.
 - Retroactive to January 1, 2008.
 - Most significant impact is potentially upon foreign DREs.
- Hold harmless clause exists for taxpayers who previously filed 2008-2010 MBT returns treating a DRE as a separate MBT person.
- CIT law has been clarified in similar manner.

Other Developments (cont.)

Michigan

Final MBT Issues for Partnerships

- Flow-through taxpayers with fiscal year-ends must use the “Actual” method for final MBT returns.
- Example — FYE 09/30 Taxpayer
 - Final MBT includes 10/01/11 — 12/31/11 activity
 - Return due 10/31/12 (or 12/31/12 if federal extension filed)
- Consider whether any difference exists if “Annual” (i.e., pro-rated approach) figures are used instead of “Actual”

Other Developments (cont.)

Michigan

Final MBT Extensions

- Final MBT returns were otherwise due 4/30/12
 - 6-month extension would have been available
 - 8-month extension, if federal extension was filed
- For fiscal year taxpayers, will Department consider automatic extension for final MBT returns beyond 10/31/12 or 12/31/12?
- Most critical element was making sure 100% of estimated final MBT liability was paid by 4/30/12.

Other Developments (cont.)

Michigan

CIT Overview

- Levied on corporate taxpayers at a 6% tax rate.
- Levied upon a unitary group of affiliated C Corporations.
- Partnerships, LLCs, and S corps are not be taxed at the entity level.
- No carryover of NOLs generated by an MBT taxpayer for BIT tax base losses generated in 2008 through 2011.
- The sole CIT credit is the small business credit.
- ITC recapture will be required upon the disposition of Michigan sit used assets that previously had been the basis for either SBT or MBT Investment Tax Credit.

Other Developments (cont.)

Michigan

CIT — Ownership in a Flow-Through Entity

- Treatment of activity from an interest in a flow-through entity is dependent upon whether the flow-through is unitary with the taxpayer.
 - Allocation vs. Flow-up of Factors
- Test for “unitary” ownership is consistent with test for unitary ownership between C Corporations.
- Elimination provision exists for sales between C Corp and unitary flow-through entity.

Other Developments (cont.)

Michigan

On-Going Unitary Considerations

Flow of Value Test

- Michigan case law (in the SBT and Individual Income Tax setting) suggests that a unitary flow of value/interdependency may require more than the mere existence of centralized G&A activities.
- Taxpayers should review the substance of intercompany activities between affiliated entities prior to the initial 2012 CIT filing.

Other Developments (cont.)

Michigan

On-Going Unitary Considerations (cont.)

- Control Test
 - Control test may not be as straightforward as Treasury's guidance would suggest.
 - A recent individual income tax decision in Malpass raises questions as to whether indirect control can exist between brother/sister subchapter S corporations.

Other Developments (cont.)

Michigan

Recent Michigan Tax Decision

Reynolds v. Treasury. Michigan Ct Appeals (No. 300001, March 30, 2012)

- In this case, taxpayer sought to exclude from its Single Business Tax base the capital gain it recognized upon the disposition of taxpayer's interest in a foreign joint venture. While no explicit tax base modification existed under the SBT Act, taxpayer claimed that inclusion of the gain violated the unitary business principle.
- Court of Appeals upheld the lower court's determination that the unitary business principle applies to the Single Business Tax and that the taxpayer and its foreign venture did not constitute a unitary business activity.
- Court of Appeals determined that the taxpayer and its foreign venture did not share managerial or operational resources, and that while a technology and service agreement existed between the two parties, the agreements called for payments at fair market value. In addition, taxpayer paid fair market value for the product mined by the foreign venture.
- While not an MBT case, the Court's analysis of unitary principles such as functional integration, centralization of management and economies of scale may potentially provide some insight regarding the manner in which unitary groups may be analyzed for MBT and CIT purposes.

Other Developments (cont.)

Michigan

CIT Reporting Issues

- How will a C-Corporation know if its partnership investment has activity in Michigan?
- Regarding income or apportionment factors, partnerships currently have limited reporting mechanism to either Treasury or those that own partnership interests.

Other Developments (cont.)

Nevada

Nevada State Court Invalidates Proposed Margin Tax Initiative Petition; Appeal Anticipated

- On October 23, 2012, the Carson City District Court (the “District Court”) issued its decision in *Committee to Protect Jobs v. The Education Initiative PAC and Ross Miller, Nevada Secretary of State*, a case involving an initiative petition (the “Petition”) that seeks to amend the Nevada Revenue and Taxation Code to add a new state-level margin tax.
- District Court held that the description of the proposed tax is:
 - Incomplete
 - Deceptive
 - Misleading
 - Invalidates the Petition
- Appeal to Nevada Supreme Court expected.

Miscellaneous Cases

Tax Base/Modifications

Tax Base/Modifications

Alabama

- Taxpayer Asks U.S. Supreme Court to Review Business v. Nonbusiness Income Case
 - Kimberly-Clark Corp. v. Department, U.S. (petition for certiorari filed 9/27/12).

Indiana

- Taxpayer Can Reduce Intangible Expense “Add-back” Calculation by Amounts Paid by LLC
 - Letter of Findings No. 02-20110459, Ind. Dept. of Rev. (9/26/12).

Miscellaneous Cases Allocation and Apportionment Issues

Allocation and Apportionment

Alabama

- New and Revised Rules Implement Double-Weighted Sales Factor Enacted Last Year
 - New Rule 810-27-1-4-.09.01; Amended Rule 810-27-1-4-.17, Ala. Dept. of Rev. (eff. 9/3/12).

Massachusetts

- Book Publisher is a Manufacturing Corp Required to Use Single Sales Factor
 - Random House, Inc. v. Commissioner, Mass. App. Tax Bd. (9/26/2012).

Miscellaneous Cases

Sales/Use Tax Issues

Sales/Use Tax

Arizona

- Retailer Using Private-Label Credit Cards Deemed Ineligible for Bad Debt Deduction
 - Home Depot USA, Inc. v. Department, Ariz. Ct. App. (10/2/12).

Connecticut

- U.S. Supreme Court Denies School Book Club's Request to Review Nexus Case
 - Scholastic Book Clubs, Inc. v. Commissioner, U.S. (cert denied 10/9/12).

Kentucky

- Retailer Using Private-Label Credit Cards is Ineligible for Bad Debt Deduction
 - Home Depot USA, Inc. v. Dep't, Ky. Bd. of Tax App. (10/17/12).

Sales/Use Tax (cont.)

Michigan

- Appellate Court Affirms Remanufacturing Equipment Qualifies for Exemption
 - K&S Industrial Services, Inc. v. Dep't, Mich. Ct. App. (9/27/12).
- Appellate Court Affirms Management Service Provider Qualifies for Resale Exemption
 - Knight Facilities Management, Inc. v. Dep't, Mich. Ct. App. (9/27/12).

Pennsylvania

- Supreme Court affirms sales/use tax exemption
 - Proctor and Gamble Paper Products Co. v. Commonwealth, Pa. (10/16/12).

Sales/Use Tax (cont.)

Tennessee

- Book Club Distributor Ask U.S. Supreme Court to Hear Nexus Case re: Marketing Efforts
 - *Scholastic Books Club Inc. v Commissioner, U.S.*
(petition for cert filed 9/20/2012, cert denied 11/26/2012)

Washington

- Continuing Education Service Provider has B&O Nexus via In-State-3rd Party Reps
 - Tax Determination No. 11-0292, Wash. Dept. of Revenue (9/27/12)

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