



State Tax Developments

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Overview

- MTC Compact Litigation Update
 - *Gillette* and related cases around the country
- Transfer Pricing Audits
 - Not Just an international issue
- Unclaimed Property
 - Are states escheating you?



MTC Compact Litigation Update

Background

- Issue
 - May a taxpayer elect to apportion income using the Compact’s 3-factor formula instead of the state’s separate statutory formula?
- Compact Art. III Election
 - “Any taxpayer . . . May elect to apportion and allocate his income in the manner provided by the laws of [the] State . . . Without reference to this compact, or may elect to apportion and allocate in accordance with Article IV.”
 - Article IV provides for a 3-factor formula using property, payroll, & sales
 - Many Compact members states have moved to double-weighted sales or 100% sales factor formulas

Gillette v. FTB

- California apportionment laws
 - enacted Compact in 1974
 - Art. III election
 - Art. IV 3-factor apportionment formula
 - amended Sec. 25128 in 1993
 - “Notwithstanding sec. 38006, all business income shall be apportioned . . .” using a 4-factor formula with double-weighted sales
 - No amendment to Compact provisions in statute
- Taxpayer Litigants
 - Gillette, P&G, Kimberly-Clark, Sigma-Aldrich, RB Holdings, and Jones Apparel
 - Filed original returns using 4-factor formula
 - Filed amended returns electing to use the Compact’s equal weighted 3-factor formula and requesting refunds

Gillette v. FTB

- Trial Court
 - Franchise Tax Board wins
 - 1993 amendment superseded Compact election
- Court of Appeals I (July 2012)
 - Taxpayers win
 - Held: California contractually bound to terms of Compact by virtue of membership in MTC
 - Contract Clause and Compact Clause of U.S. Constitution
 - Court, by its own motion, vacates opinion and grants rehearing
- Court of Appeals II on rehearing (October 2012)
 - Reaffirms taxpayers' right to elect to apportion income using Compact's 3-factor formula

Gillette v. FTB

- California Supreme Court
 - Oral Arguments (October 2015)
 - Packed House
 - Taxpayers’ counsel “swimming uphill”
 - Decision (December 2015)
 - FTB wins
 - unanimous opinion
 - Held:
 - Compact not binding contract among member states
 - Legislature had ability to preclude taxpayers from making Compact election
 - Analysis based on *Northeast Bancorp*, 472 U.S. 159 (1985)
- Taxpayers appealing to U.S. Supreme Court

Fallout from Gillette litigation

- California withdrew from the Compact in 2012 while Court of Appeals case was pending
 - MTC lost its largest dues-paying member
 - Will California return to MTC following Supreme Court decision?
- Several other states followed California's lead in repealing the Compact from their laws to prevent refund litigation

Litigation in Other States

- *IBM* (Michigan Supreme Court 2014)
 - Taxpayer wins; over \$1 billion in potential refunds
 - Michigan adopts legislation retroactively repealing Compact and negating refunds
 - Court of Appeal upholds retroactive legislation against Due Process challenge
 - Taxpayers request review from Michigan Supreme Court
- *Health Net* (Oregon Tax Court)
 - Taxpayer loses; state wins
 - State repeals and reenacts Compact without election
 - Direct appeal to Oregon Supreme Court pending

Litigation in Other States

- *Graphic Packaging* (Texas Court of Appeal)
 - Taxpayer loses; state wins
 - Margin tax is not an “income tax”
 - Appeal to Texas Supreme Court pending
- *Kimberly-Clark* (pending Minnesota Supreme Court)
 - Oral argument in January 2015
 - Appeal from Minnesota Tax Court
 - Summary judgment in state’s favor

Opportunities Remaining?

- Will the U.S. Supreme Court grant cert?
 - Conflicting opinions in different states
 - Inconsistent bases for decisions
 - U.S. Constitutional issues involved
- Protective refund claims
 - In states with pending litigation or without litigation
 - Other Statutory Departures
 - Sales factor sourcing
 - Business income definition
 - Industry Specific Apportionment



Transfer Pricing Audits

The Numbers Don't Add Up

44 (states with corporate income tax)

-24 (states with combined reporting)

- 7 (separate filing states with addback laws)

13 (separate filing states where transfer pricing audits could be a *Major Headache* for your company in 2016)

Usual Suspects: New York, New Jersey, Indiana, Alabama, North Carolina, Connecticut, Florida

States Behaving Badly: (Transfer Pricing Status Quo)

- Discretionary “482-type” Authority
 - Example
 - Colo. Rev. Stat. § 39-22-303(6)
 - Limitations on Authority?
- Questionable Audit Techniques
 - Contract Auditors No More?
 - An Almanac, Seriously?!?!

Dysfunction with a *Capital 'D'*

- Recent litigation in DC highlights some of the issues in transfer pricing audits
 - *Microsoft* (DC OAH '12);
 - *BP Products* (settlement)
 - *Hess Corp., Shell Oil Co., Exxon Mobil Oil Corp.*
 - (pending in DC Court of Appeals)

Alas, The MTC Seeks Uniformity

- Arms-Length Adjustment Service (ALAS)
- A project of states and the MTC to assist states in the identification, audit, and litigation of transfer-pricing issues
- Estimated billions in state revenue are uncollected each year due to improperly valued transactions between related parties
- Economic and related services are too expensive for states to acquire on their own
- States want to share the expense of developing their in-house capacities

ALAS

- The Commission's Executive Committee approved the design document on May 7, 2015
- Development and initial operation of the service will span four years, beginning upon implementation
- \$2 million annual budget
- Gradual roll out – audit adjustments are anticipated primarily in the third and fourth years

ALAS

Two Major Components –

- **Advanced economic and technical expertise**

Analyze taxpayer-provided transfer-pricing studies and, when appropriate, recommend alternatives to taxpayer positions

- **Enhanced state capacity to use the expertise**

Train state staff, establish information exchanges, help states improve their administrative and compliance processes, expand Joint Audit coverage for related party transactions, help states develop and resolve cases, support states in defending their work in litigation, and update states on developments related to transfer pricing

ALAS

- The core staff will consist of a tax manager with expertise in audit processes, an attorney with related-party and transfer-pricing expertise, and a senior economist with transfer pricing experience
- Other staff will include an internal auditor to conduct non-economic audits of transfer pricing studies that do not require the skills of an economist, e.g., examine calculations, selection of comparable prices, and business purpose
- The design plan anticipates hiring additional in-house, transfer-pricing economists at the fifteenth and twenty-fourth months

ALAS

- A one-time voluntary disclosure period is included in the program design in year two
- Taxpayers and states will be encouraged to use the Commission's existing alternative dispute resolution process to resolve issues consistently between a taxpayer and multiple states
- This ADR process also sufficient for working out advance agreements between a taxpayer and states when the program is mature enough to work through such issues

MTC ALAS Project – More Information Available Online

- The ALAS page on the Commission’s website:
<http://www.mtc.gov/The-Commission/Committees/ALAS>
- Previous meeting materials and other reference information are available on this page

Best Practices

- Documentation
- State Transfer Pricing Study
- Audit Defense Coordination
- Strategic Resolutions



Unclaimed Property

What a Nightmare!

- No SOL but not SOL
 - Liability for 30 years (or the life of the company)
- Bounty Hunter Audits
 - Kelmar and others
 - Multiple states at once
- Extrapolation from sampling
 - Abusive techniques coming to an end?
 - *Temple-Inland Inc.*
 - *Select Medical Corp.*
- Targeted Industries / Property-types
 - Life Insurance Companies, Aerospace & Defense
 - Gift Cards, Points Programs

Delaware Reforms Its UP Laws

- SB 11, signed in January 2015, made the following reforms:
 - Limits each bounty hunter to no more than 50% of annual exams
 - Prohibits bounty hunters from entering into contracts longer than 5 years
 - Restricts bounty hunters from hiring senior level state employees for 2 years
 - Eliminates finance secretary's authority to overturn recommendations of independent reviewer
 - Provides for direct appeal from independent reviewer's determination to Court of Chancery
 - Directs finance secretary to establish guidelines for examinations
 - Updates regulations for exam transparency and predictability
- SB 141, signed in July 2015, made the following reforms:
 - Extends the Secretary of State's voluntary disclosure program permanently
 - Requires the Department of Finance to provide holders with the opportunity to enter into the Secretary of State's VDA program before sending audit notice
 - Limits the VDA program lookback period to:
 - 1996 (current VDAs)
 - 19 years (VDAs beginning in 2017)
 - Limits the audit lookback period from 1981 to:
 - 1986 (pending audits)
 - 1991 (audits beginning in 2016)
 - 22 years (audits beginning in 2017)
 - **Reinstates statutory interest on late-filed property**

Defending Against an Audit

- Privilege / *Kovel* Arrangements
- Non-Disclosure Agreements
- Limit the Scope
 - Pension Preemption

Coming Out Of The Woodwork

- Delaware Incorporated or Significant Delaware Operations?
 - VDA Program Extended by UP Reform
 - Are you in compliance?
 - Have you received an audit notice?
 - Determine record retention policy
 - Determine policy and procedures for unclaimed property
- Incorporated or Significant Operations Elsewhere?
 - Determine if amnesty or VDA programs apply
 - Begin compliance in states with no VDA
 - Internal diagnostic
 - Evaluate risk

THANK YOU

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