

Combined Reporting and California Update

2010 Media Industry Tax Conference

Marana, Arizona

May 6, 2010

Bruce Daigh, Partner

PricewaterhouseCoopers LLP
New York, New York
Office (646) 471-5610
Email: bruce.daigh@us.pwc.com

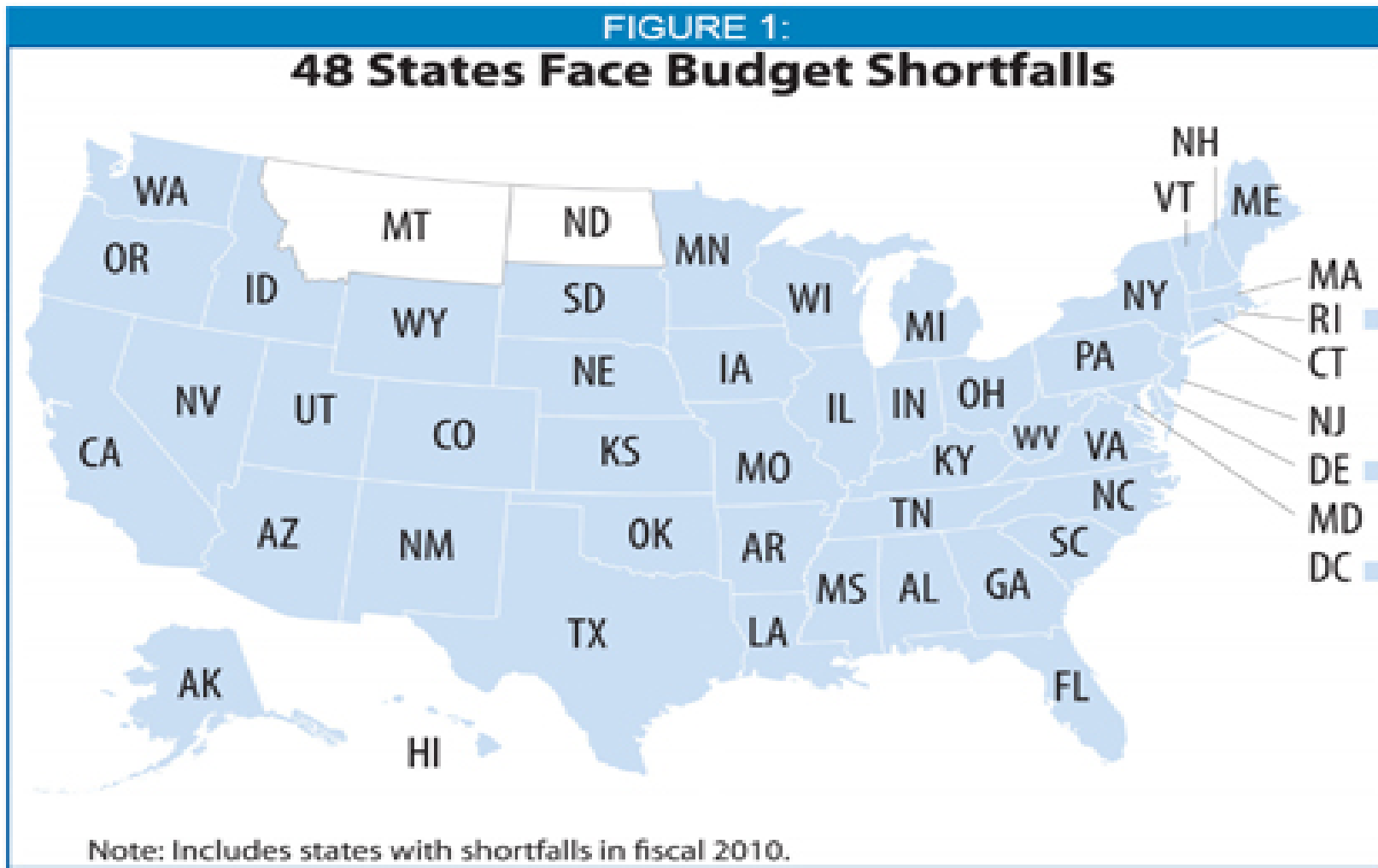
Jeffrey M. Vesely, Partner

Pillsbury Winthrop Shaw Pittman LLP
San Francisco, California
Office (415) 983-1075
Email: jeffrey.vesely@pillsburylaw.com

NOTICE

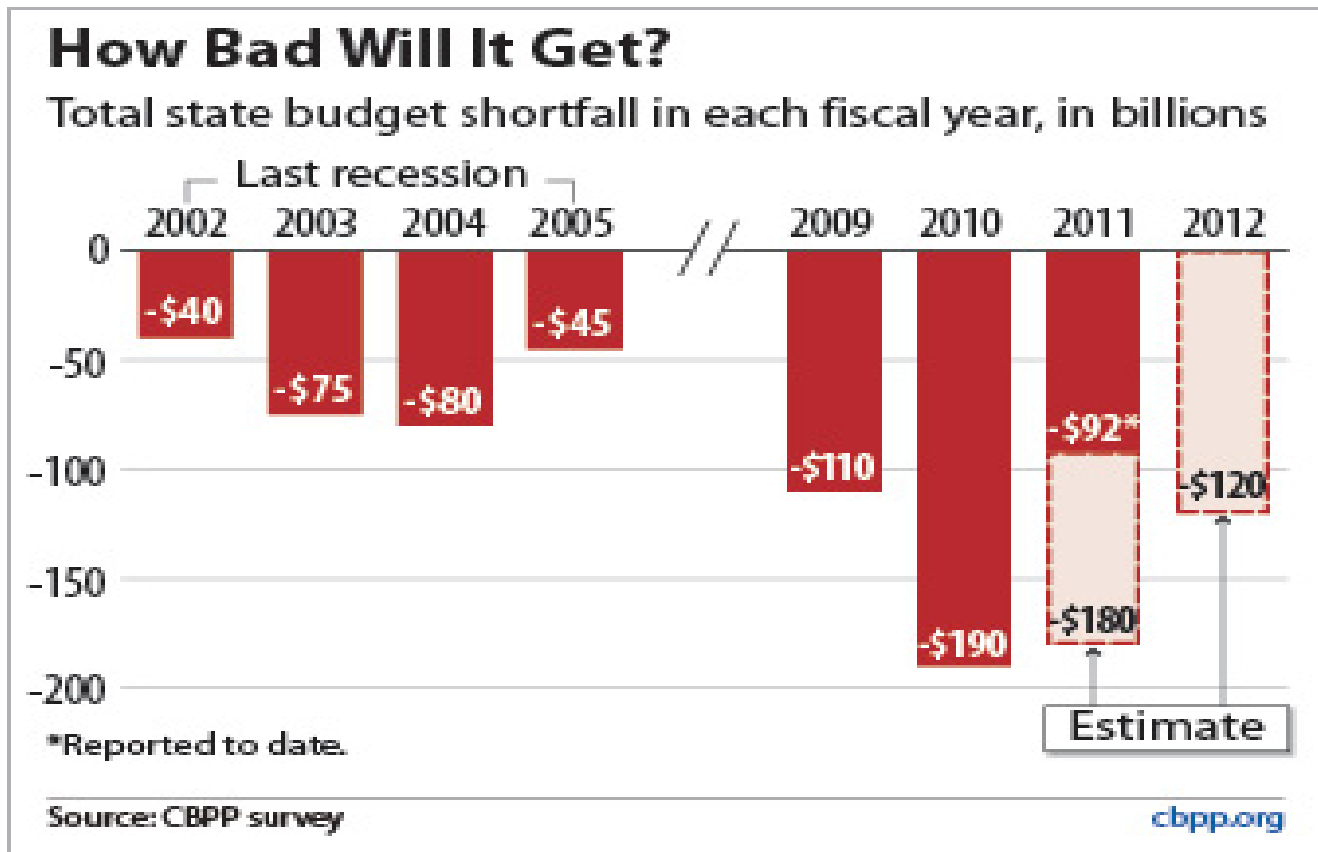
This document is provided by PricewaterhouseCoopers LLP for general guidance only, and does not constitute the provision of legal advice, accounting services, investment advice, written tax advice under Circular 230, or professional advice of any kind. The information provided herein should not be used as a substitute for consultation with professional tax, accounting, legal, or other competent advisers. Before making any decision or taking any action, you should consult with a professional adviser who has been provided with all pertinent facts relevant to your particular situation. The information is provided “as is” with no assurance or guarantee of completeness, accuracy, or timeliness of the information, and without warranty of any kind, express or implied, including but not limited to warranties, or performance, merchantability, and fitness for a particular purpose.

Budget Deficits – Current Year Budget Shortfalls



Source: Center for Budget and Policy Priorities; Policy Points: Recession Still Causing Trouble for States Federal Economic Recovery Funds Providing Some Relief (11/19/09)

Budget Deficits – Projections Show Continued Concerns



Source: Center for Budget and Policy Priorities; Recession Continues to Batter State Budgets; State Responses Could Slow Recovery, McNichol and Johnson, (11/19/09)

State of the States – Responses to Deficits

To cure budget deficits, states are focused on revenue raising measures.

- Numerous states increased tax rates to provide for additional tax revenues, but the rate hikes did not fix the budget deficits.
- States more inclined to seriously consider combined reporting.
- Combined reporting enactment/proposals spark debate over appropriateness of combined reporting from a state budgetary and taxpayer reporting perspective.

Combined Reporting States - 2004

West of Mississippi

Alaska
Arizona
California
Hawaii
Idaho
Kansas
Minnesota
Montana
Nebraska
North Dakota
Oregon
Utah

East of Mississippi

Illinois
Maine
New Hampshire

Combined Reporting States - 2009

West of Mississippi

Alaska
Arizona
California
Hawaii
Idaho
Kansas
Minnesota
Montana
Nebraska
North Dakota
Oregon
TEXAS (2008)
Utah

East of Mississippi

DISTRICT OF COLUMBIA (2011)
Illinois
Maine
MASSACHUSETTS (2009)
MICHIGAN (2007)
New Hampshire
NEW YORK STATE (2007)
NEW YORK CITY (2009)
VERMONT (2006)
WEST VIRGINIA (2009)
WISCONSIN (2009)

State of the States – Responses to Budget Deficits

Maryland

Debate on revenue implications of combined reporting has been aggressively pursued and debated in Maryland.

The Bureau of Revenue Estimates must submit a series of five annual reports on combined reporting. The second report released in March 2010, concluded that:

- 2006 corporate income tax receipts would have increased by approximately \$144M under a *Joyce* method and \$197M under a *Finnigan* method.
 - The first analysis in October 2009, reported increases of approximately \$109M under a *Joyce* method, and \$170M under a *Finnigan* method.
- 2007 corporate income tax receipts would have increased by approximately \$92M under *Joyce*, and \$144M under *Finnigan*.

State of the States – Responses to Budget Deficits

Maryland

- Combined Reporting “Winners” and “Losers”
 - Maryland tax liability likely to increase for groups with more than \$100M in Maryland modified income. Largest increase attributable to combined filers with more than \$1B in Maryland modified income.
 - Maryland tax likely would decrease for taxpayers below the \$100M mark.
- Financial services and retail industry groups would experience greatest increase in taxes.
- Other industries would see more modest increases or a decrease.

State of the States – Responses to Budget Deficits

Maryland

- Estimates were subject to certain assumptions, including:
 - A single-sales factor apportionment is used for manufacturing groups and the NAICS code of the entity with the largest payroll defines the industry of the group.
 - Combined reporting will not change taxpayer behavior.
- Not considered – potential fiscal impact of combined reporting by entities or industries no longer in operation (possibly as a result of the changing economic climate since 2006).
- Contrary reports suggest a shift to combined reporting could actually result in a revenue loss, despite estimates to the contrary.
- 2006 revised estimates are expected to be impacted by net operating loss carrybacks and other changes that cause the filing of an amended 2006 tax return.

State of the States – Responses to Budget Deficits

District of Columbia

- Combined reporting is counted on to generate \$20M for FY 2012
- Permanent combined reporting language became law March 3, 2010:

SUBTITLE U. COMBINED REPORTING REFORM ACT

Sec. 7231. Implementation of combined reporting reform.

The Council shall pass legislation to require, for tax years beginning after December 31, 2010, that all corporations taxable in the District of Columbia shall determine the income apportionable or allocable to the District of Columbia by reference to the income and apportionment factors of all commonly controlled corporations organized within the United States with which they are engaged in a unitary business.

State of the States – Responses to Budget Deficits

District of Columbia

Legislature's Apparent Justifications for Adopting Combined Reporting:

- The \$20M in estimated revenues will help balance the FY 2010 budget(s).
- It will help level the playing field between local companies and large multi-state and -national companies. They'll finally pay their fair share.
- Combined reporting is the next logical step to further DC's efforts to close corporate loopholes.
- There will be no negative fiscal impact from combined reporting.
 - Combined reporting will not change taxpayer behavior.
 - Estimates are based on reliable data.

State of the States – Responses to Budget Deficits

District of Columbia

Close look at The Combined Reporting Reform Act

- A sweeping change to taxation of corporations in DC, yet little consideration given to the details.
- The legislation only mandates that some form of combined reporting legislation will be passed for TY's beginning in 2011, but provides no specifics or guidance.
 - No definition or suggestion as to what will be a unitary business.
 - No clear guidance on whether the reporting will be worldwide combined or water's edge.
 - No timeline for when taxpayers will be provided with the legislative language and, thereafter, regulations implementing the language.
 - No guidance on how combined unitary income will be calculated.
 - Etc., etc., etc.....

State of the States – Responses to Budget Deficits

District of Columbia

DC's recent history of poor tax administration, coupled with the complexity of the expected legislation, guarantees problems at best, disaster at worst.

- Anticipated Pitfalls:
 - MTC's Model Act will be adopted without considering other options.
 - Administrative and financial impacts to taxpayers will be ignored.
 - The Council and OTR will not consider the impact of the add-back legislation on combined reporting.
 - There will be insufficient time to prepare comprehensive regulations.
 - There will be insufficient time for OTR's and taxpayers' planning, training, and implementation.
 - Revenue requirements will force OTR to aggressively audit.

So, is Combined Reporting the Better Return-filing Methodology?

The debate will continue

- Maryland
- Pennsylvania
- New Mexico
- Connecticut
- Iowa
- Tennessee

As part of the debate, the technical, administrative and practical aspects of combined reporting should not get lost in the budgetary debate.

Adoption of Combined Reporting

Items To Consider When Adopting Combined Reporting

- Definition of unity
- Unity of ownership
- Water's edge parameters
- Apportionment methodology
- Coordination with federal consolidated return rules
 - Elimination/deferral of intercompany items
 - Stock basis
 - Earnings and Profits
- *Joyce vs. Finnigan*

Items to consider when adopting combined reporting

- Elimination of dividends
 - From E&P earned in years prior to adoption of combined reporting
 - From E&P earned in pre-unitary years
- NOLs
 - How to handle carryforwards from years prior to adoption of combined reporting and sharing of NOLs
- Capital loss carry overs
- Credits
 - Sharing between members
 - Use of credits from years prior to adoption of combined reporting
- Nonbusiness income/loss
- Affiliate group election

Definition of Unity

Possible approaches to defining a unitary relationship.

- Mutual benefit and flow of value

“...activities of two or more corporations under common ownership that are sufficiently interdependent, integrated or interrelated through their activities so as to provide mutual benefit and produce a significant sharing or exchange of value among them or a significant flow of value between the separate parts.” Mass. Gen. Laws c. 63, Sec. 32B(b)(1).

- Three unities - unity of ownership, operation and use; or an interdependence in their functions.
- “Broadly construed to the extent permitted by the U.S. Constitution.”

Definition of Unity

Pitfalls to defining a unitary relationship:

- Subjective analysis
- Leads to determinations focused on tax results, resulting in fact intensive prolonged audits
- Creates an uncertain tax position from a FIN 48 perspective
- Instant unitary exceptions

Lessons Learned:

- Critical need for an objective affiliated group election
- Affiliated group election should defer to federal consolidated group, taking into account whether multiple federal consolidated groups should be combined
- Election should be binding on taxpayer and the state
- Taxpayer should have right to make election, without need for consent of Commissioner

Water's Edge Parameters - "Intercompany Inclusion"

The parameters of a water's edge election is hotly debated in states that recently enacted combined reporting.

Issues of debate include:

Whether foreign entity should only include U.S. source income.

Whether 80/20 rule should include domestic entities

Proper interpretation of MTC model rule concerning intercompany transactions with members outside the group.

Issues concerning MTC tax haven provision – quasi-worldwide combination?

Water's Edge Parameters - "Intercompany Inclusion"

Model MTC Combined Reporting Proposal

"Any member that earns more than 20% of its income (directly or indirectly) from intangible property or service-related activities, the costs of which generally are deductible for federal income tax purposes, against the business income of other members of the group, but only to the extent of such intercompany income and related apportionment factors."

- Enacted by Massachusetts and West Virginia
- Cropping up in other state proposals

Water's Edge Parameters - "Intercompany Inclusion"

Pitfalls

- Harsh implications, particularly for foreign owned companies required to borrow from foreign affiliates.
- Operates as an addback without exceptions.
- The MTC language leaves open:
 - Whether the 20% threshold is determined on a net income or gross income basis.
 - Standards for determining expenses related to such intercompany transactions.
 - Whether foreign source income is subject to inclusion.

Water's Edge Parameters – Other States

California:

- Income and apportionment factors of unitary CFC included
- An inclusion ratio is used
- Subpart F income over earnings and profits
- Issues arise over whether certain parts of Subpart F regime has been adopted
- Is it federal E&P or California E&P?

Water's Edge Parameters - "Intercompany Inclusion"

Lessons learned:

- Need a federal taxable income limitation.
- Comprehensive and meaningful treaty exception necessary.
- Provision should include net income **or loss**.
- Provision is not needed in states with an addback provision.
- Determination of "related expenses" should defer to federal rules for clarity.

Water's Edge Parameters - 80/20 Test

80/20 Rule

- Taxpayer included in combined group if the more than 20% of its apportionment attributes are within the United States.
- 80/20 calculation may rely on property and payroll, but some states are also including sales into the equation.
- Depending on the state, the 80/20 test may only apply to foreign entities.
- Specific language of 80/20 test could create different results
 - 20% or more within the United States
 - 80% or more outside the United States

Water's Edge Parameters - 80/20 Test

Pitfalls:

- Certain states compute the 80/20 test based on all THREE factors and thus can pull in foreign companies not otherwise included in “traditional” 80/20 states.
- If sales factor is used, then intercompany sales included in 80/20 determination and then eliminated if subject to combination.
- Entity with minimal property or payroll in the U.S. could be subject to inclusion based on its relative sales into the United States.
- 80/20 rule may only apply to foreign entities.

Lessons learned:

- Advocate a property and payroll calculation.
- If sales included, then consider only including third party sales.

Apportionment

Use of single apportionment formula or multiple formulas.

- Single apportionment formula has the benefit of simplicity.
- Use of multiple apportionment formulas, while complex, respects specific rules developed to retain and attract certain industries.

Pitfalls:

- An entity's ability to use specialized apportionment formulas may be disturbed if intercompany transactions are eliminated.
- Combined reporting calculation may minimize the beneficial use of specialized formulas through the apportionment of combined income.

Elimination/Deferral of Intercompany Items

States conformity to IRC 1502 rules within a combined reporting setting.

Pitfalls:

Need to closely review intercompany restructurings and transfers to determine if deferral of gains or losses are respected.

Lesson learned:

States should set clear guidelines on elimination of intercompany transactions.

Stock Basis

Should stock basis be determined on a separate return basis or using a concept similar to the Federal 1502 regs Investment Account Adjustment.

Pitfall:

- If the consolidated return concept is used how do you account for basis adjustments for years prior to the adoption of combined reporting.
- Differences created by combined group members being different from the federal consolidated group.

Lesson learned:

- States should consider a federal basis election for members entering the group.

Earnings & Profits

Question is whether earnings and profits (E&P) is determined on a separate return basis or on the federal consolidated return regulations concept of tiering up

Earnings & Profits

California Deferred Intercompany Stock Balance (DISA) Rules

- Arise where intercompany distribution exceeds distributor's E&P and recipient shareholder's basis in the distributing subsidiary's stock (IRC § 301(c)(3) distribution)
- California does not conform to federal Excess Loss Account rules and treats these amounts not as basis but as deferred income that does not diminish like an excess loss account.
- DISA is not treated as negative basis that can be eliminated in an IRC § 332 liquidation.
- Taxpayer must check proper box on face of corporate return and attach Form 3726
- Amended returns may be required for prior years.

Elimination of Dividends

Pitfalls:

- Dividends paid among members of the group are eliminated only if paid from earnings and profits generated while members of the same combined reporting group.
- Tracking of earnings and profits administratively burdensome.
- Dividends paid by non-nexus entities could generate taxable income, even though their prior year earnings and profits were not subject to tax in the state.

Lesson learned:

- Transitional rules should allow for a pure elimination of dividends paid among members, with no limitations.

Net Operating Losses

States may limit the use of losses to the member that generated the loss.

Pitfall:

- Losses generated by holding companies
 - Holding company apportionment may decrease to 0%
 - As a result, the holding company is not allocated a share of combined group income and therefore cannot utilize its loss carryforwards.

Credits

Credits:

- Like losses, states may limit the use of credits to the member that generated the credit prior to combined reporting, or prior to entering the group.
- Should credits be limited to the entity that generated them or spread among all entities in the unitary group?

Pitfalls:

- Some states limit the credits to the member that generated the credit.
- Elimination of intercompany transactions may change the historic filing methodology and potentially create trapped credits.
- Credits may not apply to the extent of non-unitary business income.

Items to Consider When Adopting Combined Reporting

Procedural Issues:

- Application of Statutes of Limitation
- Claims for Refunds
- Tax Liability – individual or joint and several?
- Audits
- Combination – mandatory, elective, permissive?
- Accounting Methods – how are elections treated?

Who is the Taxpayer?

Question Generates Many Issues

- Substantive
- Procedural

Some Addressed Above

Others

- Joyce vs. Finnigan?
- Non-business gains and losses
 - Is the non-business loss only deductible against the apportioned income of the entity that generated the non-business loss?
- Application of COP
 - How are activities performed “on behalf of” the taxpayer treated?

Wrap Up and Questions

Debate Will Continue

Debate Should Consider

- Budgetary Impact
- Fairness
- Certainty
- Administrative Burdens
 - Taxpayers
 - Tax Administrators
- Constitutional and Federal Law Standards

California Developments

Combined reporting - California

Credit assignment permitted among combined group members (A.B. 1452, Sec. 10)

- Taxpayer may make irrevocable election to assign “eligible credit” to member of its combined reporting group.
- “Eligible credit” generally defined as a credit earned by the taxpayer in a tax year on or after July 1, 2008, or earned in any tax year beginning before July 1, 2008, that is eligible to be carried forward to the taxpayer’s first tax year on or after July 1, 2008.
- Assigned credit can only be applied by the eligible assignee against the "tax" of the eligible assignee in a tax year on or after January 1, 2010.
- Eligible assignee generally treated as if it originally earned the assigned credit.
- S.B. 28X clarifies that 50 percent credit cap applies to credit assignee.
- Effective tax years beginning on or after July 1, 2008.

Combined reporting - California

SBX3 15 – enacted February 20, 2009.

- Unitary group sales: adopts *Finnigan*.
 - For taxable years beginning on or after January 1, 2011, all sales of the combined reporting group properly assigned to the state are included in the numerator of the California sales factor, regardless of whether the member of the combined group making the sale is subject to California tax.
 - The legislation also provides that sales are excluded from the sales factor numerator if the member of the combined reporting group is taxable in the state of the purchaser (i.e. treating the combined reporting group as the “taxpayer” for purposes of throwback.

California Update

- Significant tax changes lie ahead with winners and losers in California
 - Elective single sales factor.
 - Costs of performance sourcing changes to market based sourcing.
 - Treasury proceeds defined in statute.
 - *Finnigan* replaces *Joyce*.
 - Economic nexus /factor presence test adopted
 - Reminder of 2008 changes impacting 2009.
 - 20% Understatement Penalty for \$1M understatements.
 - NOL deduction changes.
 - Credit utilization and assignment.

California Update

SBX3 15 – enacted February 20, 2009

- Elective single sales factor - For tax years beginning on or after January 1, 2011, most taxpayers may make an annual, irrevocable election on a timely-filed original return to use a single sales factor for apportionment. Election cannot be made by businesses that derive more than 50% of their gross receipts from agriculture, extractive business, savings and loans; or bank and financial activities.
- Market sourcing in lieu of cost of performance - For tax years beginning on or after January 1, 2011, to sales of other than tangible personal property will be apportioned using a market sourcing method which sources sales of services to where the purchaser received the benefit of the service. Sales of intangible property are in the state to the extent the property is used in the state, or, in the case of marketable securities, the customer is in the state. The sale, lease, rental, or licensing of real property, or the rental, lease, or licensing of tangible personal property, are in the state if the property is located in the state.

California Update

SBX3 15 – enacted February 20, 2009.

- Exclusion of treasury proceeds from gross receipts. Effective for taxable years beginning on or after January 1, 2011, defines “gross receipts” to exclude amounts received from transactions in intangible assets held in connection with a treasury function of the taxpayer’s unitary business, and the gross receipts and overall net gains from the maturity, redemption, sale, exchange, or other disposition of those intangible assets. The following items are specifically enumerated as excluded from “gross receipts”:
 - Amounts received from hedging transactions involving intangible assets.
 - Repayment, maturity, or redemption of the principal of a loan, bond, mutual fund, certificate of deposit, or similar marketable instrument.
 - The principal amount received under a repurchase agreement or other transaction properly characterized as a loan.
 - Proceeds from issuance of the taxpayer's own stock or from sale of treasury stock.
 - Damages and other amounts received as the result of litigation.

California Update

SBX3 15 – enacted February 20, 2009.

- Other enumerated excluded receipts include”
 - Property acquired by an agent on behalf of another.
 - Tax refunds and other tax benefit recoveries.
 - Pension reversions.
 - Contributions to capital (except for sales of securities by securities dealers).
 - Income from discharge of indebtedness.
 - Amounts realized from exchanges of inventory that are not recognized under the I.R.C.

California Update

SBX3 15 – enacted February 20, 2009.

- Economic nexus/factor presences nexus. Effective for taxable years beginning on or after January 1, 2011, a taxpayer will be deemed to be “doing business” in California where it has one of the following:
 - Annual sales in the state in excess of \$500,000 or 25% of its total sales. Includes sales by an agent or independent contractor.
 - Statute refers to sourcing rules under CRTIC § 25135 and 25136 as modified by regulations under CRTIC § 25137.
 - Real property and tangible personal property in the state exceeding \$50,000 or 25% of the taxpayer’s total real and tangible personal property, or
 - Pays compensation in the state in excess of \$50,000 or 25% of the total compensation paid by the taxpayer.
- Similar to MTC Factor Presence Nexus Standard,
- PL 86-272 should continue to protect out-of-state companies whose activities fall within the federal statute’s scope despite meeting the California statute’s thresholds.
 - Sellers of services/intangibles have no such protection .

California Update

- 2008 changes impacting 2009 - SBX1 28 and A.B. 1452
 - 20 percent penalty imposed on tax understatement in excess of \$1 million for any tax year after 2002. Threshold applies to the aggregate combined group liability, and is in addition to all other applicable penalties and interest applied to late payments. Once assessed, taxpayers may not protest the penalty and there is no reasonable cause exception. Refunds/credit of penalty allowed only where penalty not properly computed. Penalties issued on Notice of Tax Due, rather than Notice of Proposed Assessment.
 - *California Taxpayers' Association v. Franchise Tax Board*
 - California Superior Court on May 21, 2009, rejected a challenge seeking to enjoin enforcement of the 20 percent large corporate understatement penalty. Caltax still fighting the legality of penalty provisions.

California Update

- 2008 changes impacting 2009 - SBX1 28 and A.B. 1452
 - NOL deduction suspended for taxable year beginning on or after January 1, 2008, and before January 1, 2010, for taxpayers with income of \$500,000 or more. Carryover extended by one year for each year that a carryover is barred under statute. California will conform to federal 20-year NOL carryforward for NOLs attributable to tax years beginning on or after January 1, 2008, and the two-year carryback period for NOLs attributable to taxable years beginning on or after January 1, 2011; however, percentage limitation on NOL carryback deductions apply.
 - For taxable years beginning on or after January 1, 2008, and before January 1, 2010, limits to 50 percent of tax liability the amount of business tax credits that can be claimed. Credit limitation is on entity-by-entity basis. Disallowed credit amounts may be carried forward, with the carryover period extended by number of years credit not allowed due to deduction cap.

Conclusion

Questions?

www.pwc.com

© 2010 PricewaterhouseCoopers LLP. All rights reserved. "PricewaterhouseCoopers" refers to PricewaterhouseCoopers LLP (a Delaware limited liability partnership) or, as the context requires, other member firms of PricewaterhouseCoopers International Ltd., each of which is a separate and independent legal entity.
*connectedthinking is a trademark of PricewaterhouseCoopers LLP.