



McKesson Corporation 8th Annual Corporate Tax Conference May 24 – 25, 2010

State Taxation—Updates and Current Issues

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Agenda

- Income Tax Developments
 - CA Legislative Proposals
 - Nexus
 - Combined Reporting
 - Add-Back Provisions
 - Treatment of Dividends
 - Apportionment
 - Tax Credits
 - Remedy
 - Penalties

Income Tax – CA Legislative Proposals

- Various proposed revenue raisers
 - Repeal of recent business incentives (elective single sales factor; tax credit assignments; NOL carrybacks)
- Public disclosure of names of businesses receiving state tax incentives
- Tax havens legislation (AB 1178 – pending)
 - Inclusion of tax haven foreign subs in water's edge combined report
- State Board of Equalization (SB 1113 – pending)
 - Would allow FTB to appeal adverse SBE decisions in state court (trial de novo, but FTB presumed correct)
- Status of proposed Business Net Receipts Tax

Income Tax - Nexus

- Physical Presence and Beyond—Is **Quill** Controlling in Income Tax Cases?
- The credit card cases:
 - **Quill** physical presence controls
 - **J.C. Penney Nat'l Bank v. Johnson**, 19 S.W.3d 831 (Tenn. Ct. App. 1999)
 - **Quill** is limited to sales/use taxes
 - **Tax Comm'r of W.Va. v. MBNA**, 640 S.E.2d 226 (W. Va. 2006)
 - **MBNA America Bank v. Dep't. of Revenue**, 895 N.E.2d 140 (Ind. Tax Ct. 2008)
 - **Capital One Bank v. Comm'r of Rev.**, 899 N.E.2d 76 (Mass. 2009)

Income Tax - Nexus

- Economic Nexus—Gaining Momentum
- Franchise and Royalty Agreements
 - **KFC Corporation v. Dept. of Revenue**, Dkt. No. 07DORFC016 (Iowa Admin. Hearing Div. Aug. 8, 2008)
 - KFC had third-party franchise agreements and derived royalty and license income from such agreements.
 - The Board found that KFC's franchise agreements were an integral part of its business activity occurring regularly in Iowa.
 - Physical presence not necessary, where KFC has intangible property from which it derives income within Iowa.
 - **In the Matter of [Redacted]**, Case No. 200700083-C (Ariz. Admin. Hearing, March 27, 2008).
 - Hearing officer rejected taxpayer's argument that franchisor/franchisee relationship fundamentally differs from parent/sub relationship due to lack of control in the former.

Income Tax - Nexus

■ Maryland Cases - Intangible Holding Companies

- **The Classic Chicago, Inc. v. Comptroller and The Talbots, Inc. v. Comptroller**, Md. Tax Ct., Nos. 06-IN-OO-0226, 06-IN-OO-0227 (April 11, 2008)
 - Wholly-owned subsidiary licensed trademarks to parent in exchange for a royalty. The Maryland Tax Court affirmed assessments issued by the Comptroller against the parent and its subsidiary finding that the subsidiary lacked economic substance.
 - The court noted that the subsidiary had minimal operating expenses and little or no expenses for compensation for officers, salary, wages and cost of labor and minimum expenditures for travel, maintenance, professional services, service charges, directors' fees and rent.
 - The subsidiary generated no other income and the royalty payments to the subsidiary were returned to the parent in the form of a dividend.
 - Court held that the subsidiary lacked economic substance as a separate business entity and had nexus with Maryland through the activities of its operating parent.
 - Affirmed on appeal. 985 A.2d 593 (Md. App. Ct. 2010).
- **Nordstrom, Inc. v. Comptroller**, Md. Tax Ct., No. 07-IN-00-0317 (Oct. 24, 2008)
 - Tax Court looked at whether subsidiaries were sufficiently independent from parent. Finding they were not sufficiently independent, the Tax Court held the subsidiaries had nexus with Maryland.

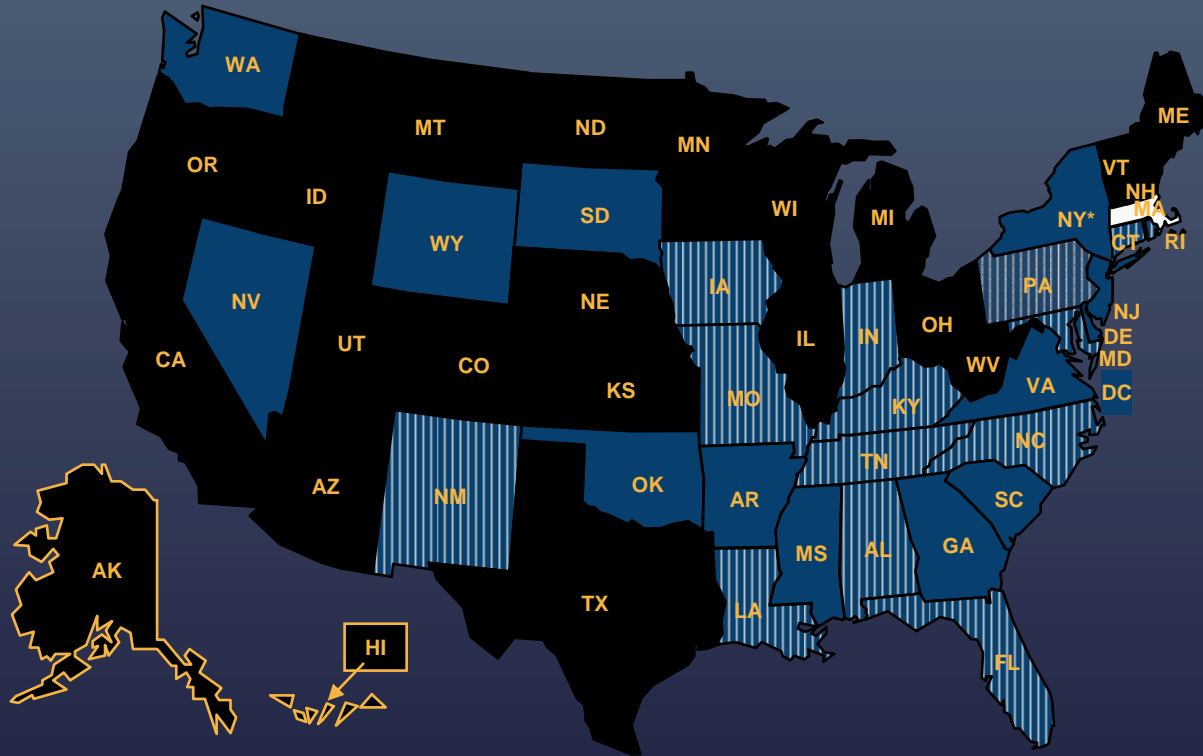
Income Tax - Nexus

- Recent “Economic Nexus” Statutes
 - California (AB X3 15): “Doing business” in CA defined as any one of the following:
 - Taxpayer organized or commercially domiciled in CA
 - Taxpayer’s sales in CA exceed \$500,000 or 25% of its total sales
 - Taxpayer’s real and tangible personal property in CA exceeds \$50,000 or 25% of its total real/tangible personal property
 - Taxpayer’s payroll in CA exceeds \$50,000 or 25% of its total payroll
 - Other states enacting similar economic nexus standards: Wisconsin, Connecticut, Colorado (proposed regs)




Income Tax - Nexus

- Other extensions of nexus beyond physical presence
 - Affiliate nexus
 - Agency/third party nexus (Scripto)
 - “Amazon” nexus
 - Website linking arrangements

Overview of Combined Reporting



**New York requires related corporations to file a combined report upon the existence of substantial intercorporate transactions*

-  Combined Reporting Proposals Considered Recently, Currently Proposed
-  Unitary/Combined States (now including the Ohio CAT, Texas Margin Tax and Michigan Business Tax)
-  Remaining Separate Entity or Elective Consolidated Reporting/Other

Income Tax – Combined Reporting

- Issues to Consider in Combined Reporting States
 - 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

Income Tax – Combined Reporting

- Issues To Consider in Combined Reporting States
 - 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 carryovers
 - Credits
 - Sharing between members
 - Use of credits from years prior to adoption of combined reporting
 - Nonbusiness income/loss
 - Affiliate group election

Income Tax – Combined Reporting

Forced Combination—North Carolina

- **Delhaize America, Inc. v. Hinton**, No. 07 CVS 020801 (Wake County N.C. Superior Ct.)
 - NC DOR combined taxpayer's NC and FL entities with intercompany payments in order to “reflect true net earnings.”

- **Wal-Mart Stores East, Inc., v. Hinton**, 676 S.E.2d 634 (N.C. Ct. App. 2009)
 - Court unanimously upheld Secretary of Revenue's decision to require a Wal-Mart operating subsidiary to file a combined report with other select subsidiaries.

 - Court addressed statutory and constitutional issues raised by that taxpayer, finding that the State's combined reporting statute should be construed broadly, and that the Secretary may mandate combined reporting if he finds that the corporation has not disclosed its true earnings.

Income Tax – Add-back

- Since 2000, approximately 20 states have enacted add-back rules
- Add-back is designed to curb perceived taxpayer abuse on use of interest and intangible-related expenses between related parties
- Add-back provisions generally require the payer of related-party interest, royalties, license fees and similar charges to add back those expenses
- Various exceptions may apply

Income Tax – Add-back

- **VFJ Ventures, Inc. v. Surtees**, 8 So. 3d 983 (Ala. 2008)
 - Alabama trial court held for VFJ in a 2007 ruling that royalty payments made to a related intangible holding company satisfied the “unreasonable exception” to add-back because the intangible holding company had substance and was not a sham.
 - Alabama Court of Civil Appeals reversed the trial court and held that the unreasonable exception only applies when add-back results in a distortion of the taxpayer’s income or when it results in the payment of tax that is “out of proportion” to the taxpayer’s Alabama activities.
 - Alabama Supreme Court’s decision affirmed and adopted in its entirety the opinion of the Court of Civil Appeals that Alabama’s intangible and interest expense add-back statute did not violate the Commerce and Due Process Clauses of the U.S. Constitution.
 - The U.S. Supreme Court denied VFJ’s petition for a writ of certiorari.

Income Tax – Add-back

- **Beneficial New Jersey, Inc. v. Director, Div. of Taxation, N.J. Tax Ct., Docket No. 009886-2007 (pending)**
 - In 2004, New Jersey, a separate company state, enacted a wide range of taxpayer-unfriendly statutes. One of the most controversial is the disallowance of the deduction for intercompany interest expenses.
 - The law goes beyond disallowing deductions related to intangible holding companies and affects taxpayers who engage in arm's-length intercompany transactions in the regular course of their trade or business operations.
 - Beneficial New Jersey (“BNJ”) is a subsidiary of Household Finance Corporation (“HFC”). HFC borrows from non-affiliated lenders and loans funds to its subsidiaries. The subsidiaries then turn around and loan them to their customers.
 - The deduction for intercompany interest expense paid by BNJ to HFC was disallowed by the Division of Taxation.
 - BNJ filed a complaint in the New Jersey Tax Court challenging the disallowance of the deductions. The arguments raised include whether BNJ meets any of the statutory exceptions to the add-back of interest expense and whether the add-back has violated the Due Process of Commerce Clauses.
 - This is the lead case in New Jersey regarding the add-back of interest expenses.
 - Oral argument on cross motions for summary judgment May 25, 2010.

Income Tax – Treatment of Dividends

- **Apple Inc. v. FTB**, San Francisco Sup. Ct. No. 471129 (2010) (on appeal)
 - Case involves issue whether dividends paid by foreign corporations in a water's edge setting should be eliminated under RTC §25106 or deducted under RTC §24402
 - FTB applied a LIFO proration approach and prorates the dividends between RTC §25106 and §24402
 - Apple contends that a preferential ordering approach is mandated under RTC §25106 and *Fujitsu IT Holdings, Inc. v. FTB*, 120 Cal. App. 4th 459 (2004), and that all dividends should be eliminated
 - Case also involves the issue whether interest expense deductions should be disallowed under RTC §24425, i.e., was Apple's dominant purpose in borrowing funds to provide funds to the foreign dividend payors
 - Trial court issued a final decision on January 26, 2010, holding in favor of the taxpayer on the interest expense issue and in favor of the FTB on the dividend ordering issue
 - Case may have direct relevance as to the proper application of the foreign investment interest offset provisions under RTC § 24344 and the dividends received deduction provisions under RTC § 24411
 - Case is on appeal by both parties

Income Tax – Treatment of Dividends

Issues That May Arise:

- Were the dividends paid from non- or pre-unitary E&P? (Willamette)
 - Dividends paid by recently acquired subsidiaries
 - Dividends paid by subsidiaries outside the combined reporting group
- Are the distributions even dividends for California purposes?
 - California v. federal E&P
 - Inclusion in California E&P as distributions pass through tiers of subsidiaries. (See, e.g., FTB Chief Counsel Ruling 2005-5)
- Do non-dividend distributions in excess of basis give rise to currently recognized gain?
 - FTB's deferred intercompany stock account (DISA) rules under Regulation 25106.5-1
 - Reporting of DISA balances

Income Tax – Apportionment

California – Treasury Function Gross Receipts

General Mills, Inc. v. FTB, 172 Cal. App. 4th 1535 (2009)

- Trial court concluded that commodity hedging transactions did not generate “gross receipts” for sales factor purposes
- Trial court did not reach the issue whether inclusion of such receipts would be distortive under RTC §25137 (i.e., UDITPA §18)
- Court of Appeal reversed the trial court’s decision
 - Full sales price of commodity futures contracts are “gross receipts” includible in the sales factor
 - Court noted that hedging activity was an integral part of the taxpayer’s business activity
 - Case remanded to trial court to address the distortion issue
- Petition for review denied
- Case on remand in the trial court on the distortion issue

Income Tax – Apportionment

California – Treasury Function Gross Receipts

- Statutory amendment to RTC §25120 effective Jan. 1, 2011 that “gross receipts” do not include amounts from certain transactions in connection with treasury function activities.
- See also FTB Reg. 25137(c)(1)(D) which is applicable to tax years beginning on or after January 1, 2007.
- In 2008, the FTB put forth a general proposal for settling pending treasury function cases.
 - The FTB’s proposed concession is based on a sliding scale that ranges from 5% to 75% of the tax amount depending on the percentage of gross receipts from treasury activities in the sales factor.

Income Tax – Apportionment

New Jersey Throwout Rule

Pfizer, Inc. v. Division of Taxation, 23 N.J. Tax 515 (NJ Tax Ct. 2008), remanded by 960 A.2d 388 (N.J. 2008)

- Case represents consolidated challenge (Pfizer, GE, Federated Brands and Whirlpool) to constitutionality of New Jersey's throwout rule. Taxpayers' filed summary judgment motions requesting that the throwout rule be declared facially unconstitutional – must establish that no set of circumstances exists under which throwout would be valid.
- Court held that under the Due Process and Commerce Clauses, the throwout rule is constitutional on its face because, in at least some circumstances, it can operate in a constitutional manner. The Court also held that because the throwout rule is not a tax, the use of a throwout procedure in multiple states would not produce multiple taxation and hence does not violate internal consistency.
- Finally, the Court held that throwout rule does not violate the Supremacy Clause because the rule does not impose a tax, which would be prohibited by P.L. 86-272, but merely is a part of the calculation to determine what portion of a corporation's total income will be taxed in New Jersey.
- New Jersey Supreme Court remanded an interlocutory appeal back to the appellate court to address whether the throwout rule is facially unconstitutional.

Income Tax – Tax Credits

Dicon Fiberoptics, Inc. v. FTB, Cal. Ct. App., No. B202997 (May 7, 2009)

- Taxpayer filed a suit for refund challenging the FTB’s authority to look behind its Enterprise Zone hiring credit vouchers
- The trial court sustained the FTB’s demurrer and the taxpayer appealed
- The Court of Appeal held that while the FTB has the authority to audit vouchers, the vouchers are prima facie proof a worker is a qualified employee
- The Court also held that in auditing the vouchers, the FTB bears the burden of proving the worker did not meet the criteria to be a “qualified employee”
- In meeting its burden of proof, the FTB may not rely on the employer’s failure to produce during the audit documents establishing a worker’s eligibility
- The FTB filed a petition for review, which was granted
- Case is pending before the California Supreme Court

Income Tax – Tax Credits

- Assignment of Tax Credits
- California allows the assignment of certain credits among members of the same combined reporting group (RTC §23663)
- For credits earned in a tax year on or after July 1, 2008 or that are eligible to be carried forward to the taxpayer's first taxable year beginning on or after July 1, 2008
- The election to assign is irrevocable and must be made on the taxpayer's original return for the tax year in which the assignment is made
- FTB has issued FAQs and Form 3544 concerning these credit assignment provisions

Income Tax – Remedy

Abbott Laboratories, Inc. v. FTB, 175 Cal. App. 4th 1346 (2009)

- RTC §24402 provides a dividends received deduction for dividends paid from income subject to tax in California
- Court in *Farmer Bros. Corp. v. FTB*, 108 Cal. App. 4th 976 (2003), held that “subject to tax in California” requirement was unconstitutional
- For tax years after 1998, FTB’s remedy was to deny all RTC §24402 DRDs
- Court invalidated RTC §24402 in its entirety:
 - Court did not sever the invalid portion of RTC §24402 under statutory severance clause (RTC §23057)
 - Court declined to reform RTC §24402 as inconsistent with legislative intent
- Other similar cases pending at Court of Appeal

Income Tax – Remedy

Tax v. Fee – California LLC “Fee”

Northwest Energetic Services, LLC v. FTB, 159 Cal. App. 4th 841 (2008), review denied (June 11, 2008)

Ventas Finance I, LLC v. FTB, 165 Cal. App. 4th 1207 (2008), review denied (2008), cert. denied (April 6, 2009)

- Both decisions held that the fee was actually a tax.
- Tax held to violate Commerce Clause under Complete Auto (430 U.S. 273) because tax fails both the internal and external consistency tests.
- Ventas court held that that the LLC “fee” statute could not be judicially reformed because the Legislature rejected apportionment.
- Court also held that Ventas was not entitled to a full refund under McKesson (496 U.S. 18); refund limited to the amount of the tax (or fee) not based on fair apportionment.
- FTB issued Notice 2009-04 (May 22, 2009): LLC can use (1) default option using % of CA sales versus everywhere (schedule R) or (2) actual income (must provide info by August 20, 2009).

Penalties

California's 20% Understatement Penalty

- Cal. Rev. & Tax. Code §19138 imposes 20% strict liability penalty on understatements of corporate franchise/income tax exceeding \$1million for tax years after 2002
- Cal-Tax filed lawsuit arguing the penalty is invalid because:
 - Penalty is a tax that was not passed by 2/3 vote of Legislature (Prop 13)
 - Legislature violated procedural rules in enacting RTC 19138 at 11th hour
 - Penalty is retroactive in violation of substantive Due Process
 - RTC §19138 violates procedural Due Process by failing to provide adequate remedy to challenge FTB's imposition of the penalty
 - Penalty violates Equal Protection, Commerce Clause and Excessive Fines Clause
- Superior court sustained validity of the penalty
- Case is pending on appeal

Penalties

- New Era of Strict Liability Penalties
- From “Carrot” to “Stick”: Strict Liability Penalties with No Amnesty
- Tax v. Penalty—Are strict liability penalties intended to raise revenue (i.e., a tax) or punish tax delinquents and increase compliance (i.e., a penalty)?
- Addressing Federal Audit Changes

Questions