

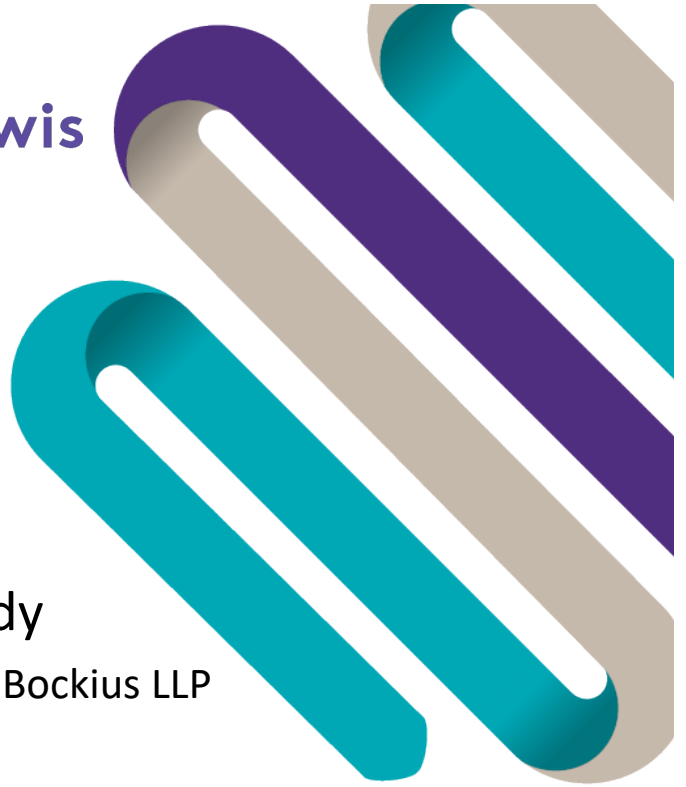


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Domestic & Multistate Update

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Domestic & Multistate Update

- Agenda
 - Significant State Updates: Apportionment, Nexus, and & Other Items
 - Federal Update



Multistate Update 2017

- Apportionment
- Nexus
- Business vs Non-Business Income
- Other Items of Interest
 - Tax Rate Changes
 - Net Operating Loss Limitations



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Apportionment

Significant State Updates



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California – CCR 2017-01

Clarifies sourcing of **sales from non-marketing services** under market-based sourcing

- When taxpayer receives income from subcontracting services that its customers would otherwise be required to perform themselves for ultimate end-user customers, benefit is received by taxpayer's direct customer and not the ultimate customer
- Benefit received by direct customers is release of obligation to perform subcontracted services themselves for ultimate customers



Connecticut – Special Notice 2017(1)

- CT Department of Revenue Services issued guidance on single-sales factor apportionment and **market-based sourcing**
- Under CT law enacted in 2016, gross receipts from services assignable to CT if, and to extent, market for services is in state
- Taxpayer's market for service is in CT to extent service is used at a location in state
- Gross receipts from rental, lease or license of intangible property are assigned to CT to extent property is used in state

Connecticut – Special Notice 2017(1) (cont'd)

- Special Notice includes guidance interpreting statutes, generally specifying that use occurs at location where taxpayer's customer either directly or indirectly receives value from service or intangible property
- Provides procedures and detailed examples illustrating how to source receipts from sales of services or intangible property using newly adopted sourcing methodology
- Must consider specific facts and circumstances of transaction



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Montana – Market Sourcing

- MT enacted legislation revising its Multistate Tax Compact provisions, as recommended by the Multistate Tax Commission, to adopt **market-based sourcing** for sales other than sales of TPP, change definitional terms for "business income" and "sales," and expand alternative apportionment provisions
- Applies to tax years beginning after Dec. 31, 2017



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Oregon – Market Sourcing

- On July 3, 2017, OR enacted legislation adopting **market-based sourcing**, effective for tax years beginning on or after Jan. 1, 2018
- Corporate income from sales of services and intangibles such as software will be subject to market-based sourcing
- Change does not apply to allocation of income for financial organizations, utilities and telecommunications taxpayers



New York - CheckFree

- In *CheckFree Services Corp.*, NY administrative law judge (ALJ) determined taxpayer's receipts from electronic bill payment and presentment transactions constituted **receipts derived from performance of services**
- Highlights difficulties that arose under former NY law when trying to determine whether sales should be classified as services or other business receipts
- Provides interpretation of "services" that accounts for new and emerging technology used in today's markets



Oregon – Apollo Education Group

- In *Apollo Education Group, Inc. v. Department of Revenue*, OR Tax Court applied broadened transactional approach, narrowed cost analysis to source receipts for online university
- For purposes of apportioning income from online courses under the cost of performance (COP) method, "**income-producing activity**" related to the provision of a course section to multiple students, rather than an individual transaction with each student



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Oregon – Apollo Education Group (cont'd)

- Income-producing activity of providing course sections was composed of faculty, curriculum development, and software platform activities, but only the faculty costs were direct costs to be used in the COP calculation
- Application of transactional approach to sourcing income from online university may provide helpful guidance on a how a proper COP study should be constructed for many types of companies earning substantial service-based revenue



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Wisconsin - Microsoft

- In *Microsoft Corp. v. Wisconsin Department of Revenue*, WI Tax Appeals Commission held DOR could not assess additional taxes on royalty income received by Microsoft from licensing its software to out-of-state original equipment manufacturers (OEMs) that ultimately sold computers containing the software to WI purchasers



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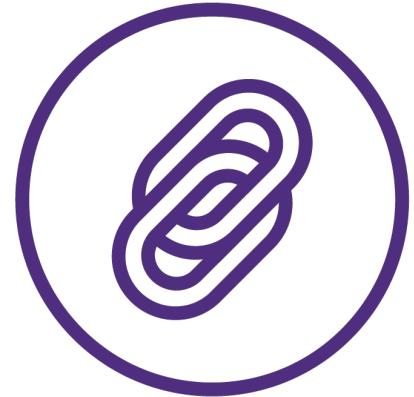
Wisconsin – Microsoft (cont'd)

- Commission rejected DOR's argument that it must look-through the OEM purchasers to the end-users of the software to properly source the royalty receipts
- Limitation on applying look-through analysis potentially could apply to receipts from other forms of intangible property



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Nexus

Significant State Updates



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New Mexico – Aventis Pharmaceuticals

- In *Aventis Pharmaceuticals, Inc.*, NM Taxation and Revenue Department held that subsidiaries of a large multinational pharmaceutical company had nexus with NM because they had activities in the state beyond solicitation of sales and those activities increased their **market and market potential** in the state
- Along with the solicitation of sales, doctors were provided with ongoing education, clinical trials, textbooks, funding for training materials, and classes at the doctors' offices



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Oregon – Capital One Auto Finance

- In *Capital One Auto Finance v. Department of Revenue*, OR Tax Court held two out-of-state financial institution corporations had substantial nexus with OR and were subject to either the corporate income tax or excise tax
- The financial institutions did not have a physical presence in OR, but purposely solicited OR customers, extended credit, loaned money, pursued collections and utilized the court system in OR
- Subjecting the financial institutions to taxation in OR did not violate the Commerce Clause



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Business vs. Non-Business Income

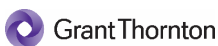
Significant State Updates



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California (Fidelity National)

- In *Fidelity National Information Services v. Franchise Tax Board* (unpublished opinion), CA Court of Appeal held that trial court erred in ruling that taxpayer's capital gains from sale of its stock in a company in which it owned a 29% interest was business income
- Trial court failed to address taxpayer's argument that, even if the stock was an integral part of the taxpayer's business operations at one time, it was a nonbusiness investment long before it was sold
- Whether **sale** of stock was integral is different from whether **stock** itself was integral



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New Jersey (Xylem Dewatering Solutions)

- In *Xylem Dewatering Solutions, Inc. v. Director, Division of Taxation*, NJ Tax Court held gains from deemed asset sale of S corporation under IRC Sec. 338(h)(10) was non-operational income and therefore not subject to apportionment
- Because corporation was a NJ-based S corporation, entire gain was allocated to NJ on nonresident shareholders' gross income tax returns pursuant to NJ corporation business tax rules governing sourcing of non-operational income

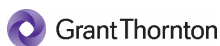


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New Mexico (ConAgra Foods)

- In *ConAgra Foods Food Ingredients Co.*, NM Taxation and Revenue Department held interest income on taxpayer's payment-in-kind (PIK) notes following sale of business constituted nonbusiness income
- Because the taxpayer was not a unitary business with the entity that purchased the business and because the interest income on PIK notes was not integral to taxpayer's line of business, the income was not apportionable to NM consistent with Due Process and Commerce Clauses



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Other Items of Interest

Significant State Updates



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Tax Rate Changes

- District of Columbia – For tax years beginning after Dec 31, 2017, CIT rate reduced to 8.25% (previously 9%) because state met revenue targets.
- New Hampshire – BPT and BET are reduced for tax periods ending on or after Dec. 31, 2019 if state meets revenue targets.
- North Carolina – For tax years beginning on or after Jan. 1, 2019, the CIT rate is reduced from 3% to 2.5%.
- Illinois – Effective July 1, 2017, the CIT rate is increased from 5.25% to 7%.
- Texas – Various cases and rulings clarify qualification for reduced rate.
 - Technology company that primarily provides services was not entitled to the 0.5% tax rate for retailers and wholesalers (Decision, Hearing Nos. 106,718,106,719, Texas Comptroller, June 16, 2017).

Net Operating Losses

- Alabama – Affiliated group of corporations was able to deduct NOLs incurred by one of the corporations in years before the group filed a consolidated return (DOR v. Coca-Cola Refreshments USA, Inc).
- Montana – For tax years beginning after Dec. 31, 2017, an NOL may be carried back 3 years and forward 10. Carryback claims may not exceed \$500,000 per year.
- Pennsylvania – NOL carryover deduction limitation violated Uniformity Clause (Nextel Communications of Mid-Atlantic v. Commonwealth & RB Alden Corp v. Commonwealth)

Net Operating Losses (cont'd)

- Minnesota – Unapportioned IRC 382 limitation should be applied to unapportioned net income (Sinclair Broadcast Group Inc v. Commissioner).
- California – IRC 382 limitations on NOL carryforwards are applied on a pre-apportionment basis (TAM 2017-03).
- Louisiana – NOL utilization tracking changes from FIFO to LIFO for years beginning on or after January 1, 2017.

Domestic Update Agenda

- Status of section 385 regulations.
- Withdrawal of proposed “net value” regulations.
- *Grecian Magnesite* – No effectively income on sale of partnership interest.
- *Greenteam Materials* – Broad interpretation of capital gains for sales of franchises.
- Rulings:
 - CCA 201713010 – Facilitative costs under Reg. § 1.263(a)-5.
 - PLR 201736002 – Intangible under Reg. § 1.263(a)-4.
 - CCA 201724026 – DPGR under Reg. § 1.199-3.
 - PLR 201721014 – Boot in downstream reorganization.

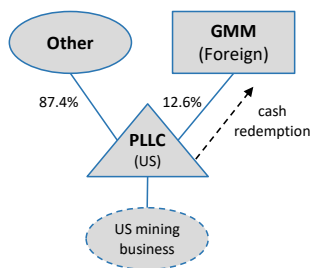
Status of Section 385 Regulations

- Notice 2017-36 – Delays effective date of Reg. § 1.385-2 documentation rules, applicable to interests issued (or deemed issued) on or after January 1, 2019.
- Notice 2017-38 – IRS intends to modify or repeal section 385 regulations, including Reg. § 1.385-3 recharacterization rules.
- Interaction with tax reform?

Withdrawal of 2005 Proposed “Net Value” Regulations – Issues

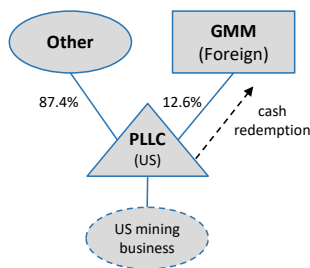
- Section 351 Transfers
 - Must the transferor transfer net value?
 - Must the transferee corporation be solvent after the transfer?
- Section 332 Liquidations
 - Liquidating corporation must distribute assets with respect to each class.
 - Does upstream section 368(a)(1)(C) reorganization override worthless stock deduction for common stock / capital loss on preferred, as provided in *Spaulding Bakeries* and *H.K. Porter*?
- Section 368 Reorganizations
 - Must acquiring corporation be solvent?
 - Compare *Norman Scott* (no) to Rev. Rul. 59-296 (yes).

Grecian Magnesite – Background



- Section 736(b)(1) – payments that GMM received in redemption of its partnership interest are treated as a distribution, which under section 731(a) is treated as gain from the sale or exchange of the partnership interest.
- Section 741 – gain from the sale of a partnership interest generally is treated as gain from the sale or exchange of a capital asset.
- Both reflect entity theory, subject to specific exceptions (e.g., section 897(g), providing for look-thru treatment on U.S. real property interests).
- Rev. Rul. 91-32 – Foreign partner selling an interest in a partnership will be treated as realizing income that is effectively connected with a U.S. trade or business (“ECI”) to the extent the gain is attributable to a U.S. trade or business of the partnership operated through a fixed place of business.
- Foreign partner’s gain on a sale of the partnership interest as ECI to the extent attributable to the partnership’s assets that would generate ECI if sold by the partnership.
- ECI is taxable at graduated rates on a net basis (up to 35% plus a potential 30% branch profits tax for corporations).

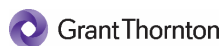
Grecian Magnesite – Tax Court Ruling



- Rejects application of Rev. Rul. 91-32.
- Instead, the court applied the section 865 source rules to the sale of a partnership interest as a single indivisible asset.
- Section 865(e)(3) requires applying the principles of section 864(c)(5) to determine whether gain is attributable to a U.S. office or fixed place of business, which requires that the office or fixed place of business be a material factor in the production of the gain, and that it regularly carries on activities of the type from which the gain is derived.
- An office is not a material factor in producing gain unless it provides a significant contribution to, by being an essential economic element in, the realization of the gain.
- Treating PLLC’s office as material to the deemed sale of GMM’s portion of the assets would be inconsistent with its application of entity theory to the redemption.
- Note, ruling does not affect *allocations* of ECI to foreign partners.

Greenteam Materials – Background

- Petitioners sold its business, which included contractual rights to provide waste-collection services to local governments in California.
- Petitioners treated gains on the sales of the government contracts as capital gains from sales of franchises.
- Commissioner argued that contracts produced ordinary and that nothing in section 1253 specifically prescribes capital gains treatment.
- Tax Court first determined that a contract to provide services for territory in a municipality is a franchise for the purposes of section 1253.
- Section 1253(b)(1) provides that “the term “franchise” includes an agreement which gives one of the parties to the agreement the right to distribute, sell, or provide goods, services, or facilities, within a specified area.”
- Narrower state law definition did not apply.
- Petitioners did not retain any significant rights in the franchises, which would have mandated ordinary treatment under section 1253(a).



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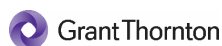
Greenteam Materials – Tax Court Ruling

[S]ection 1253(a) says what doesn’t get capital gains treatment, not specifically what does. The Commissioner says this means section 1253 is inapplicable by its own terms, so the transactions are taxed as ordinary income. A closer look at the whole section resolves this issue though. Section 1253(d) talks about capital accounts. Paragraph (2) says

Any amount paid or incurred on account of a transfer, sale, or other disposition of a franchise, trademark, or trade name to which paragraph (1) does not apply shall be treated as an amount chargeable to capital account. [Emphasis added.]

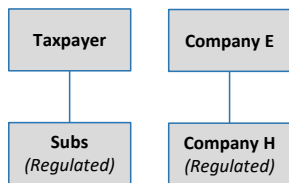
This implies that the sale of a franchise leads to capital gains, unless the transaction is specifically knocked out of section 1253 by section 1253(a).

Our Court has already addressed this issue too. In *Jackson v. Commissioner*, 86 T.C. 492, 520 (1986), *aff’d*, 864 F.2d 1521 (10th Cir. 1989), we held that section 1253 gives a transferor of a franchise capital-gains treatment so long as it doesn’t retain any significant interest in the franchise and the franchise was a capital asset. The Fifth Circuit agrees. It also explained that section 1253(a) says a taxpayer doesn’t get capital-gains treatment when it transfers a franchise if it retains a significant interest in the franchise. *McIngvale v. Commissioner*, 936 F.2d 833, 839 (5th Cir. 1991), *aff’g* T.C. Memo. 1990-340. *McIngvale* also said that section 1253 assumes the inverse too--when a taxpayer transfers a franchise and doesn’t retain a significant interest, the transaction is taxed as the sale or exchange of a capital asset.



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CCA 201713010 – Background



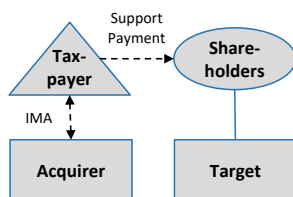
- Taxpayer, a holding company with subsidiaries that include regulated "C" subsidiaries, negotiated a merger with Company E, which held interests that included another regulated "C" company (Company H).
- Proposed merger required approval of the regulatory body.
- The regulatory body approved the merger subject to the following conditions:
 - (1) taxpayer made a capital contribution to Company H to fund a rate credit for each Company H customer;
 - (2) a contribution to a customer investment fund to provide long-term benefits to Company H customers;
 - (3) payments to the interested State party presumably for developments of intangible property; and
 - (4) a commitment to contribute amounts to charitable organizations and traditional local community support within State.

CCA 201713010 – Rulings

- Reg. § 1.263(a)-5(b)(1) clarifies when an amount is paid to facilitate a transaction:

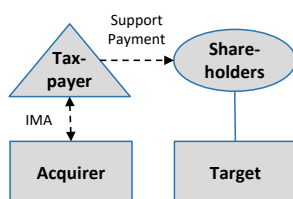
[A]n amount is paid to facilitate a transaction . . . if the amount is paid in the process of investigating or otherwise pursuing the transaction. Whether an amount is paid in the process of investigating or otherwise pursuing the transaction is determined based on all of the facts and circumstances. In determining whether an amount is paid to facilitate a transaction, the fact that the amount would (or would not) have been paid but for the transaction is relevant, but is not determinative.
- The phrase "regulatory approval" should not be read so broadly that it includes any and all costs to address conditions that might be imposed by regulators.
- In this case, the costs at issue appear to be in the nature of annual operating or investment expenses and not analogous to deal costs paid to service providers who assist with financing, investigating, documenting, or otherwise administratively facilitating the transfer of property.
- Three of the four costs are commonly and frequently required by regulators and are annually incurred by regulated Subs as part of their ordinary and recurring business operations.
- Company E previously made annual donations in the same amount as Company E's commitment to make future donations, suggesting a continuation of prior business practice.
- Finally the fourth cost appears to be, at least in part, in exchange for intangible property.

PLR 201736002 – Background



- Taxpayer manages Acquirer pursuant to an investment management agreement (“IMA”), under which Acquirer pays Taxpayer a management fee equal to a percentage of Acquirer’s total assets.
- Acquirer entered into a merger agreement to acquire Target, subject to the approval of Target’s shareholders.
- As a result of the merger, Taxpayer expects that its future fees under the IMA will increase because of Acquirer’s increase in asset size.
- In connection with the merger, in addition to payments per share from Acquirer and Target, Target’s shareholders will receive a payment per share directly from Taxpayer (the “Support Payment”).
- Taxpayer will receive no stock, cash, stock, or other property from Target, Acquirer, or any of their shareholders, employees, or affiliates in consideration for providing the Support Payment to Target’s shareholders.
- Taxpayer is transferring the Support Payment to Target’s shareholders to induce them to approve the merger with Acquirer because Taxpayer expects the merger will result in earning higher fees from Acquirer under the IMA.

PLR 201736002 – Rulings



Support Payment was not Paid to Acquire an Intangible:

- Reg. § 1.263(a)-4 (b)(1) provides that a taxpayer must capitalize amounts paid to acquire, create, or improve an intangible.
- Taxpayer did not pay the Support Payment to acquire any intangible from Target in a purchase or similar transaction. Taxpayer did not receive any stock, cash, stock, or other property from Target, Acquirer, or any of their shareholders, employees, or affiliates in consideration for providing the Support Payment.

Support Payment was not Paid to Enter into an Agreement:

- Reg. § 1.263(a)-4(d)(6)(i)(B) provides that a taxpayer must capitalize amounts paid to another party to create, originate, enter into, renew, or renegotiate with that party an agreement providing the taxpayer the right to provide or receive services.
- Taxpayer is not creating, originating, entering into, renewing, or renegotiating with Target any agreement providing the right to provide or receive services or the right to be compensated for services from Target.
- The IMA is an agreement with Acquirer, not Target, and Taxpayer is receiving nothing in return for paying the Support Payment.

CCA 201724026 – Factual Background

- Taxpayer provides online offerings related to platforms that include websites, user interfacing software applications and non-user interfacing software applications.
- The CCA considers whether Applications A, B, and C (components of Platforms A, B, and C) are computer software that was manufactured, produced, grown, or extracted (“MPGE”) by the Taxpayer in whole or in significant part within the United States for the customers’ direct use while connected to the online software under Reg. § 1.199-3(i)(6)(iii).
- Application A is an optional feature that is accessed by Taxpayer’s customers online only and is subject to a subscription fee.
- Application B is a software tool offered by the Taxpayer at no charge and is downloaded by customers.
- Application C includes software that is downloaded to subscribers’ computers and is subject to a monthly fee.
- Taxpayer identified certain functions of Applications D & E (building and hosting software platforms that are offered for disposition via tangible medium or download on regular and ongoing basis by third parties) as substantially identical to the Taxpayer’s Applications.

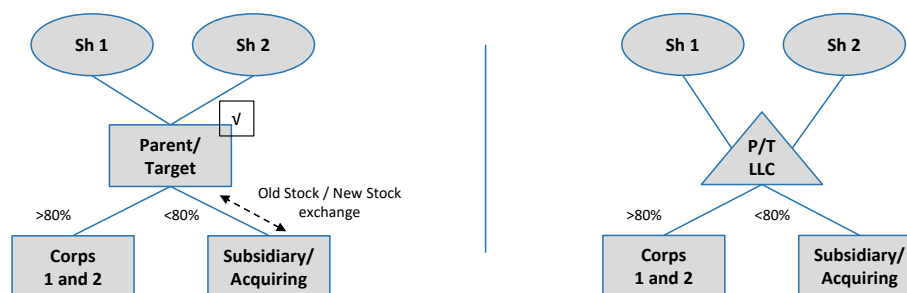
CCA 201724026 – Regulatory Background

- Section 199 defines domestic production gross receipts (“DPGR”) as gross receipts directly derived from the disposition of qualifying production property (“QPP”), including computer software, which was MPGE by the taxpayer in whole or in significant part within the United States.
- Reg. § 1.199-3(i)(6)(ii) provides that gross receipts derived from online services (such as internet access services, online banking services, providing access to online electronic books, newspapers, and journals), and other similar services do not constitute gross receipts derived from a disposition of computer software.
- Section 1.199-3(i)(6)(iii) provides that, notwithstanding Reg. § 1.199-3(i)(6)(ii), if a taxpayer derives gross receipts from providing customers access to computer software produced in whole or significant part by the taxpayer within the United States for the customers’ direct use while connected to the Internet or any other public or private communications network (online software), then such gross receipts will be treated as derived from the disposition of computer software only if Reg. § 1.199-3(i)(6)(iii)(A) or (B) is met.
- Reg. § 1.199-3(i)(6)(iii)(A) (the “Self-Comparable Exception”), requires that a taxpayer also derive, on a regular and ongoing basis in the taxpayer’s business, gross receipts from the disposition to customers that are unrelated persons of computer software that (1) has only minor or immaterial differences from the online software; (2) was MPGE by the taxpayer in whole or in significant part within the United States; and (3) has been provided to such customers affixed to a tangible medium or by allowing them to download the computer software from the Internet.
- Section 1.199-3(i)(6)(iii)(B) (the “Third-Party Comparable Exception”) requires that another person derives, on a regular and ongoing basis in its business, gross receipts from the disposition of substantially identical software (as compared to taxpayer’s online software) to its customers pursuant to an activity described in Reg. § 1.199-3(i)(6)(iii)(A)(3) (i.e., by a tangible medium or download from the Internet).

CCA 201724026 – Rulings

- The CCA states that before applying the either the Self-Comparable Exception or the Third-Party Comparable Exception, a taxpayer must first have gross receipts from the provision of online software rather than the provision of online services and distinguishes between computer software that's being provided for customers' direct use (online software) and computer software being provided to enable a customer to use a taxpayer's services (online services).
- The CCA rules that the Taxpayer's gross receipts from Platforms A, B, and C were derived from the provision of online services rather than for customers' direct use of online computer software because the Taxpayer's computer software enabled customers to participate in the Taxpayer's services.
- Because the Taxpayer's transactions should be characterized as a service, no gross receipts are attributable to any components of the computer software that enables participation in the service and instead must be treated in their entirety as gross receipts derived from online services.
- The CCA also provides that the Taxpayer misapplied the "item" rules in Reg. § 1.199-3(d)(1) since the rules of Reg. § 1.199-3(d)(1)(ii) only apply in cases in which a taxpayer derives gross receipts from property offered in the normal course of business, but the gross receipts from the entire property did not qualify as DPGR.
- Because all of the gross receipts were derived from services, the item rule could not be applied to determine components of property from which the Taxpayer derived gross receipts that could qualify as DPGR).

PLR 201721014 – Background



Background:

- Parent/Target is owned by two individuals, Shareholder 1 and Shareholder 2.
- Parent/Target owns greater than 80 percent of the stock of Corp 1 and Corp 2, each of which is a member of Parent/Target consolidated group.
- Parent/Target also owns less than 80 percent of the stock of Subsidiary/Acquiring.


Proposed Transaction:

- Parent/Target will exchange all of its common stock in Subsidiary (Old Stock) in exchange for voting common stock in Subsidiary (New Stock) (the "Exchange").
- Parent/Target will convert to a limited liability company (P/T LLC); no election will be made for Parent/Target to be taxed as a corporation (the "Conversion").

PLR 201721014 – Rulings



- Provided steps the Exchange and the Conversion qualify as a reorganization under section 368(a)(1), the distribution of Corp 1 and Corp 2 stock (“Boot”) will constitute a distribution of property with respect to the stock of Parent/Target to which section 301 applies.
 - Not section 356 (“boot within gain”) distribution.
 - Section 368(a)(1)(C) or (D) reorganization?
 - Compare Reg. § 1.301-1(l) with Rev. Rul. 71-364 (source of boot vs. shareholder overlap).
- The excess, if any, of the amount distributed with respect to a share of Parent/Target stock over the amount of such distribution treated as a dividend (by reference to Parent/Target’s E&P) will reduce the shareholder’s basis in the share of Parent/Target stock, and any remaining excess will be treated as gain from the sale or exchange of property (section 301(c)(2) and (c)(3)).

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Questions?

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