EVERSHEDS SUTHERLAND

Top SALT Audit Issues In 2021

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Agenda

- Transfer Pricing
- Alternative Apportionment
- Old Laws, New Technologies
- Credits and Incentives
- Handling Remote Audits

Learning Objectives

- Learn the technical aspects of emerging SALT audit issues in 2021
- Get insights on how state budget pressures may impact ongoing audits
- Learn best practices for making a remote audit go smoothly

Transfer Pricing

Why is Transfer Pricing important?

- Transfer pricing is the pricing of transactions between related entities for goods, intangible assets, services and loans.
  - Designed to prevent tax avoidance among <u>related</u> entities by requiring pricing that places <u>controlled</u> transactions on par with transactions between unrelated parties.
  - Transactions generally must be at <u>arm's length</u>.
  - A tax evasion or avoidance motive is generally <u>not</u> a prerequisite for application of an IRC § 482 adjustment.
- Increased interest in state transfer pricing.
  - Many states with separate entity reporting have expressed interest in expanding their transfer pricing audit capabilities and are looking for test cases.

State Transfer Pricing Developments

Rent-A-Center East Inc. v. Indiana Dep't of State Revenue, 42 N.E.3d 1043 (Ind. Tax Ct. 2015)

– Relying, on part, on R-A-C's IRC § 482 transfer pricing study and the parties' stipulation of valid business purposes, the court rejected combination as an alternative apportionment methodology and rejected the Department's claim that R-A-C's income would be distorted unless it filed a combined return with two affiliates.

Columbia Sportswear USA Corp. v. Indiana Dep't of State Revenue, 45 N.E.3d 888 (Ind. Tax Ct. 2015)

– Concluded that because Columbia's transfer pricing studies demonstrated that its intercompany transactions were conducted at arm's length rates, its Indiana income was fairly reflected for purposes of Indiana's transfer pricing statute.

State Transfer Pricing Developments

Utah State Tax Comm'n v. See's Candies, Inc., 875 Utah Adv. Rep. 26 (Utah Oct. 5, 2018)

- See's Candies deducted IP royalty payments made to an affiliated insurance company.
- The Utah Supreme Court affirmed the trial court's decision finding that the Tax Commission abused its discretion by denying the entire intercompany royalty without considering federal IRC § 482 guidance and the taxpayer's transfer-pricing study.
  - Utah statute, section 59-7-113, granting the Tax Commission discretionary authority, is ambiguous.
  - Due to the striking similarities between section 59-7-113 and IRC § 482, it is appropriate to look at federal IRC § 482 guidance to resolve such ambiguity.
- Subsequently, Utah (H.B. 268) enacted an add back for payments made to a captive insurance company in response to *Utah State Tax Comm'n v. See's Candies, Inc.*, 435 P.3d 147 (Utah Oct. 5, 2018).

State Transfer Pricing Developments

Recently, states have taken an evolved approach to transfer pricing challenges

- A committee of the MTC has developed a transfer-pricing program that would be available to the states - State Intercompany Transactions Advisory Service (SITAS). It is designed to:
  (1) Provide training for state staff to identify distorting intercompany transactions; and
  (2) Provide third-party support to combat transfer-pricing studies provided by taxpayers.
- Increasing scrutiny on transfer pricing studies and application of the arm's-length standard.
- Increased focus on developing technical knowledge under 482.
- Increasing reliance on contingency fee auditors.
- States have began producing in-depth audit reports with respect to intercompany transactions and 482 analysis.

State Transfer Pricing Developments

- States are actually turning to arm's-length principles (e.g., Georgia, Indiana, Rhode Island, North Carolina, South Carolina, Louisiana).
- On July 30, 2020, the North Carolina Department of Revenue announced a voluntary corporate transfer pricing resolution initiative.
- Indiana has created a dedicated transfer pricing group within its audit division to handle the Advanced Pricing Agreement Program relating to transfer pricing issues.

State Transfer Pricing Developments

Trader Joe's East, Inc. v. Comm'r, Ga. Dep't. of Revenue (*petition filed* May 5, 2017)

- Trader Joe's East, Inc. (East), a wholly-owned subsidiary and licensee of Trader Joe's Company (Company), received an assessment from the Department of Revenue. East owns and operates 147 grocery stores in 27 states, including all stores in Georgia.
- East purchased services, including administrative services, and licensed IP from Company.
- East is challenging the Department's disallowance of its expenses made to Company.
- The matter is pending before the Georgia Tax Tribunal.

State Transfer Pricing Developments

Tractor Supply Co. v. S.C. Dep't. of Revenue (*petition filed* Dec. 11, 2019)

– Tractor Supply Co. of Texas, LP ("TSC of Texas") and Tractor Supply Co of Michigan, LLC ("TSC of Michigan") are subsidiaries of Tractor Supply.

– Tractor Supply paid TSC of Texas for purchases of wholesale inventory TSC of Texas made on behalf of Tractor Supply pursuant to an Inventory Procurement Agreement. The compensation as determined based on a 482-study.

– Tractor Supply leased employees to and charged a service fee at a markup to TCS of Michigan pursuant to a Master Shared Services Agreement.

– The Department applied forced combination, combining Tractor Supply, TSC of Texas, and TSC of Michigan.

– The case is pending before the South Carolina Administrative Law Court.

State Transfer Pricing Developments

Altera Corp. v. Commissioner, 926 F.3d 1061 (2019), *cert. denied*, 2020 WL 3405861 (S. Ct. 2020).

– On June 22, 2020, the U.S. Supreme Court denied Altera Corp.'s petition for review of the Ninth Circuit's 2019 decision in *Altera Corp. v. Commissioner*, which upheld the validity of federal regulations that require participants in qualified cost-sharing arrangements to share stock-based compensation costs to achieve an arm's-length result.

– Among the key points of the *Altera* decision is that it affirms the authority of the Treasury and the IRS to interpret the arm's-length standard of Section 482 broadly, based on the fluid history of the standard.

– Applying the reasoning of *Altera* to transfer pricing between affiliated entities in the state context could provide state tax authorities with an argument for additional discretion when challenging transfer pricing arrangements.

– *Altera* may also serve to embolden state departments of revenue to scrutinize controlled transactions and promulgate their own rules.

Alternative Apportionment

Franchise tax win

Comcast, in Mississippi Department of Revenue v. Comcast of Georgia/Virginia Inc. (August 2020)

- Comcast convinced the Mississippi Supreme Court that the company could use an alternative apportionment formula that excluded capital from subsidiaries that didn't engage in any in-state activities
- Comcast's subsidiaries that it excluded from its tax base had no connection to the company's business in Mississippi, and therefore it would be erroneous to include investments in them in the company's franchise tax base, the justices said

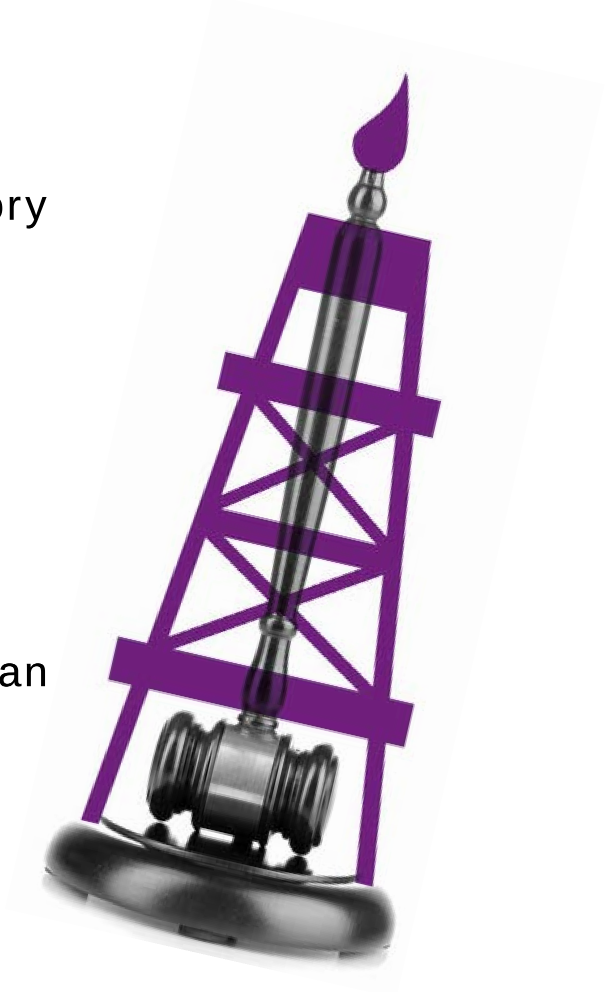
Pizza party

- *State Tax Assessor v. Kraft Foods Group, Inc.* (June 2020).
- The Maine Supreme Judicial Court affirmed a Maine Business and Consumer Court’s ruling that a taxpayer was not entitled to use alternative apportionment in determining its tax on the sale of its frozen pizza business.
- Kraft Foods Group, Inc. manufactured and sold various food products throughout the United States, including Maine, during the periods at issue.
- Over several years, Kraft developed a frozen pizza product line that was manufactured, sold, and distributed through Kraft Pizza Company (KPC), its subsidiary.

Apportion Distortion

- The Court of Appeals reversed the Court of Claims in *Vectren Infrastructure Services Corp. v. Department of Treasury* (March 2020), holding the statutory apportionment formula the Department applied was out of all appropriate proportion to the company’s Michigan business activities.
- The Court remanded the matter to the Department to develop an alternative apportionment method.
- MLI was headquartered in Minnesota and engaged in the business of constructing, maintaining and repairing oil and gas pipelines.
- The company had no Michigan business location nor permanent employees in the state, but was retained to clean up a pipeline spill in Michigan.
- While the project was ongoing, MLI sold all of its assets to Vectren.
- MLI included the gain in its apportionable Michigan income and the denominator of the sales factor.

- The Appellate Court looked to whether the statutory formula was fair.
- It concluded that the value of the business assets was built up over time and was attributable to activity in a number of states.
- Furthermore, much of that activity had no connection to Michigan.
- Applied to MLI, the apportionment formula led to an unconstitutional result. The court declined to set forth an alternative method.



Keep On Truckin’

In re United Parcel Service Inc. (Ohio), No. 19-27 (N.M. Admin. Hearings Office Oct. 25, 2019)

- The New Mexico Administrative Hearings Office determined that UPS may depart from the statutory apportionment method for trucking companies (in-state vs. everywhere mileage), because it produces a result that bears no rational relationship to UPS’s New Mexico business activity.
- The Hearings Office reasoned that the statutory mileage method can cause distortion in large geographic states with small populations because drivers travel farther to reach fewer customers.
- The method was distortive here because it resulted in a 10-fold increase in the sales factor numerator compared to receipts paid by New Mexico customers.
- UPS was allowed to use an alternative method, assigning half of the receipts to the state of origin and half to the state of destination.

Old Laws, New Technologies

Digital Advertising Taxes

- Background
  - Prior attempts by states to tax advertising
  - Constitutional challenges
  - European approaches
- Different Approaches, Same "Problem"?
  - Maryland bill is akin to the approaches taken by France, UK, and Italy
  - A Nebraska bill simply expands the sales tax base to include digital advertisements
- Potential for a "model" digital ad tax?
  - Click-through provisions
  - South Dakota thresholds
  - Streamlined digital goods

DBS and OTT Franchise Fee Lawsuits

- Localities in Arkansas, Indiana, Missouri, Nevada, Ohio, Tennessee, and Texas are pursuing class action lawsuits against DBS and OTT providers to register for franchises and pay franchise fees
- Under the localities' legal theory, the DBS and OTT providers must pay the franchise fees because they provide video programming services through broadband wireline facilities located in public rights-of-way
- Case variations:
  - DBS providers claim Section 602 protection
  - Arkansas, Missouri, Nevada, Ohio, and Tennessee statutes may exempt OTT

Digital Goods

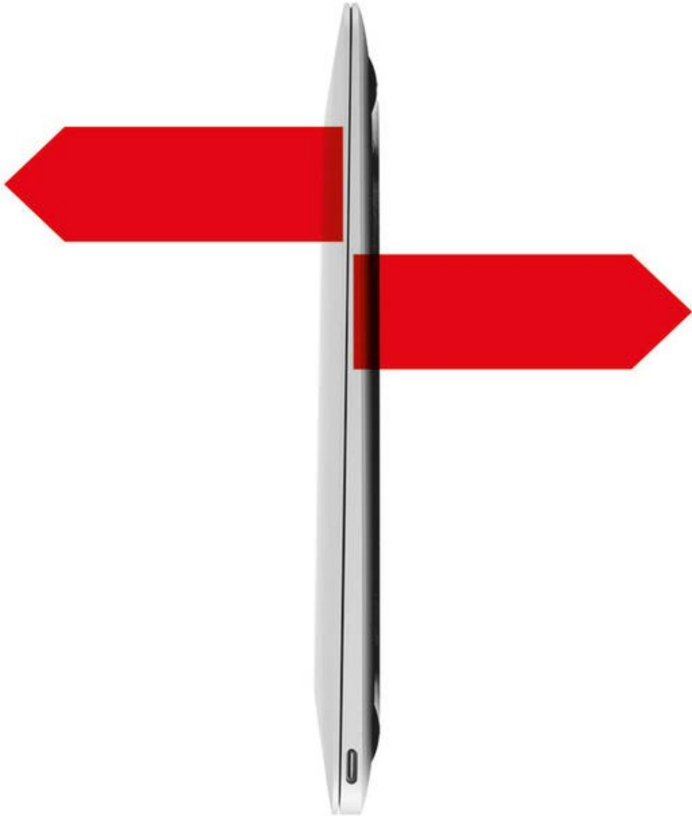
Colorado Code Regs. §39-26-102(15)

- The Colorado Department of Revenue adopted amendments to its tangible personal property rule that will impose sales tax on sales of streaming digital goods.
- The Department considers these amendments to be a “clarification” of Colorado’s statutory definition of “tangible personal property.”
- The regulation provides that the method of delivery does not impact the taxability of a sale—for example, by compact disc, electronic download, or streaming.
- Specifically includes monthly subscription fees that allow customer to select and stream movies and television shows.

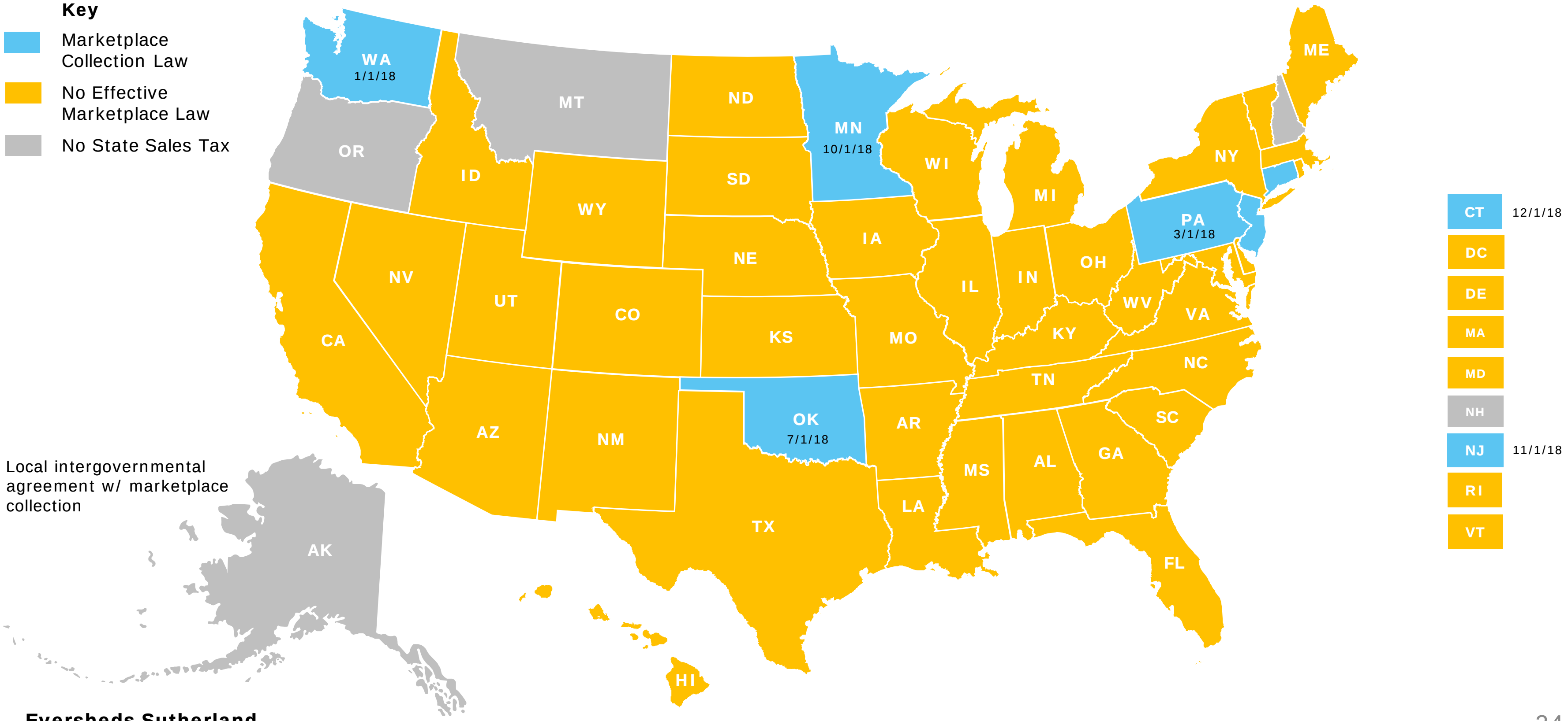
Marketplace Laws

Overview

- Almost all states with a sales and use tax have enacted a marketplace collection law
  - Only 3 states without marketplace collection laws – Florida, Kansas and Missouri
- Generally require marketplaces to collect and remit sales tax on behalf of sellers
- Potential Audit Issues:
  - Who determines taxability?
  - Is marketplace a “retailer”
  - Collection of other applicable taxes and fees
  - Mixed platform sales



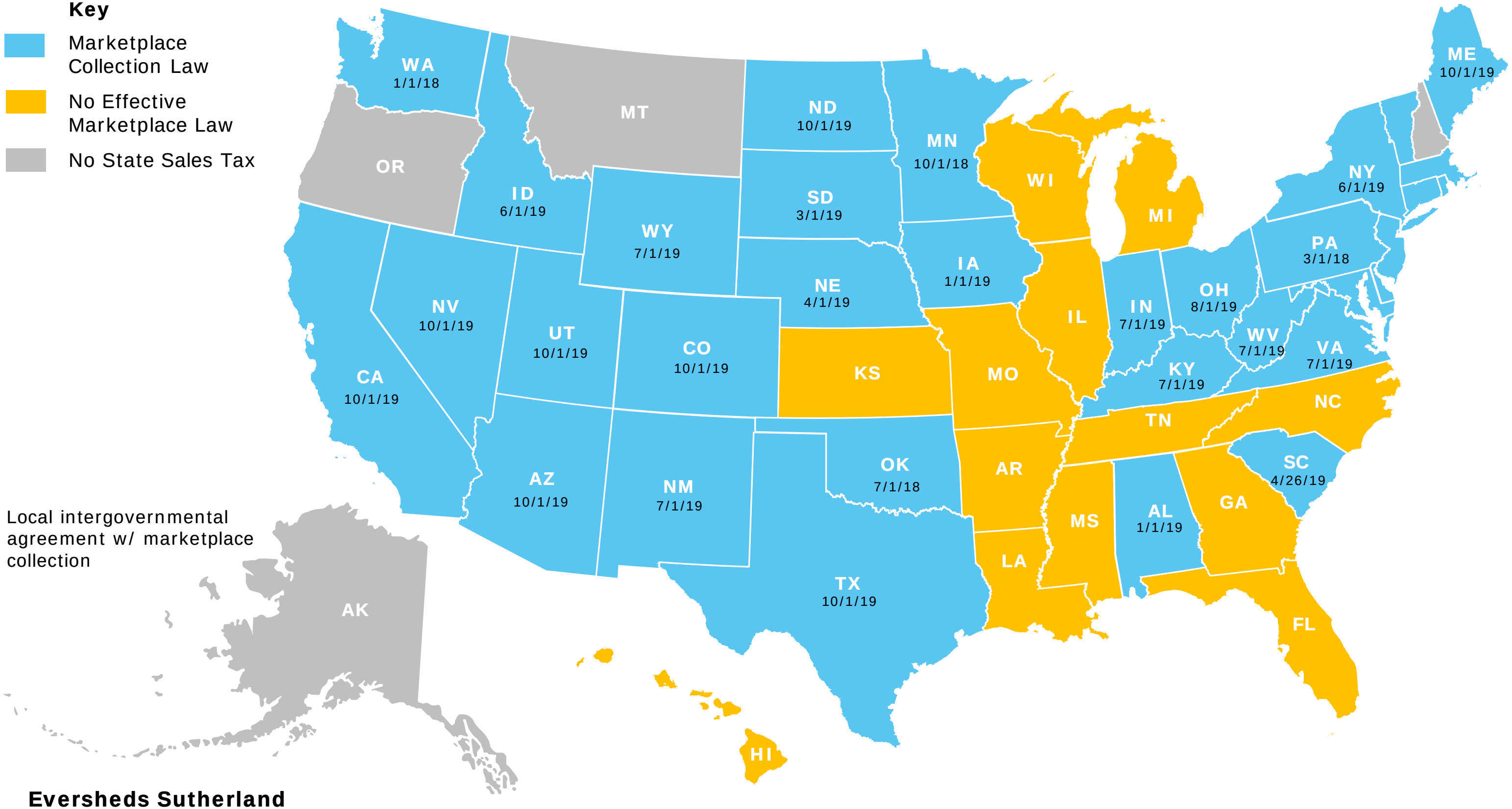
Marketplace Collection Laws & Effective Dates (2018)



Marketplace Collection Laws & Effective Dates (2019)

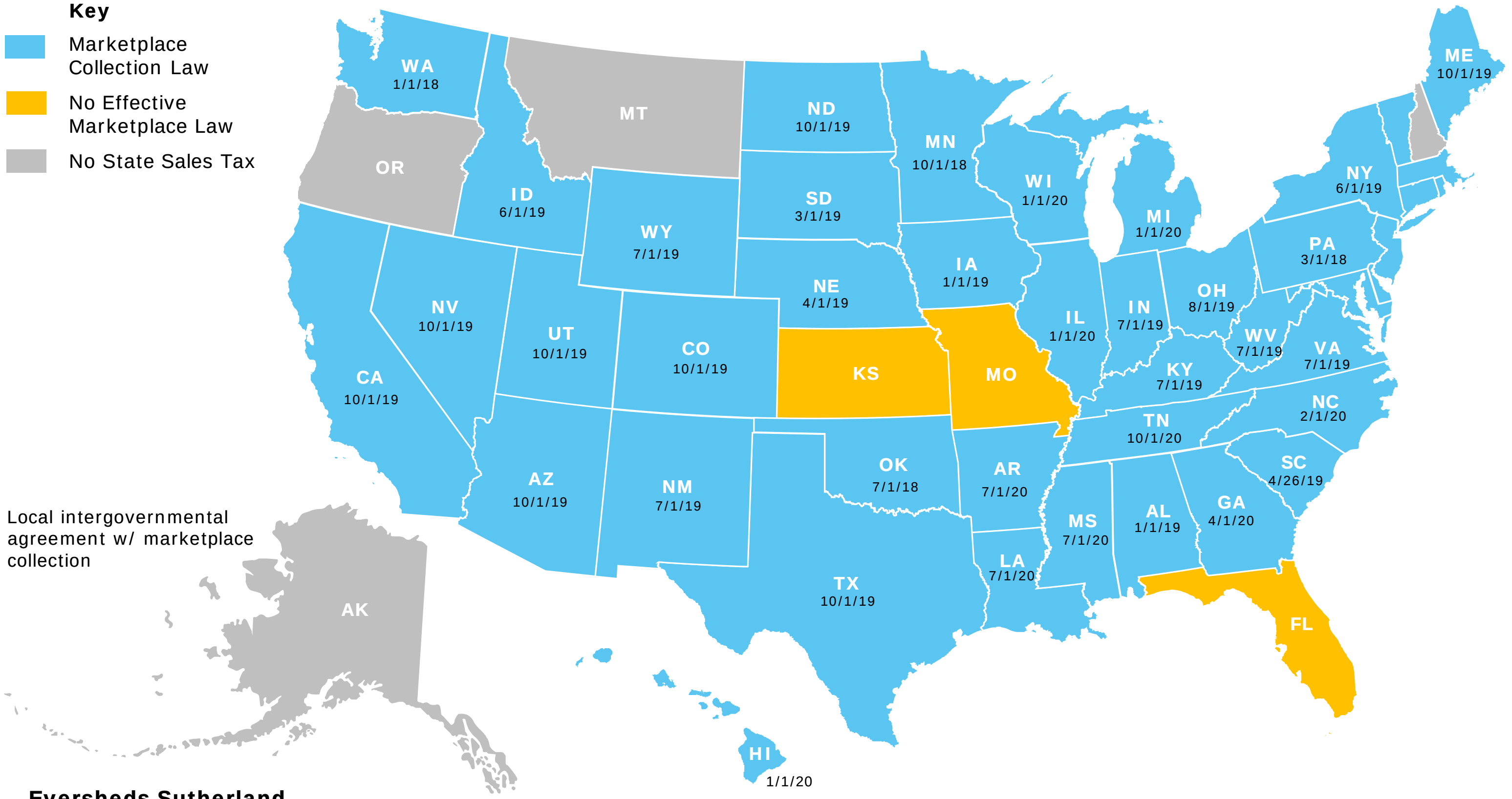
Key

- Marketplace Collection Law
- No Effective Marketplace Law
- No State Sales Tax



CT	12/1/18
DC	4/1/19
DE	10/1/19
MA	10/1/19
MD	10/1/19
NH	
NJ	11/1/18
RI	7/1/19
VT	6/1/19

Marketplace Collection Laws & Effective Dates (2020)



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As of Nov. 10, 2020

Potential Marketplace Audit Issues

- Who is a marketplace?
  - Specific exclusions
- Who determines taxability?
- Is the marketplace a “retailer”?
- Collection of other applicable taxes and fees
- Mixed platform sales

Other Emerging Issues

- Travel intermediaries
- Delivery Charges
- Special fees

Taxability of Services – Texas Litigation

- The Texas Comptroller is pursuing a change in policy that would reclassify payment processing as a taxable data processing service.
- This determination potentially runs contrary to prior Comptroller guidance issued in 1990 and to a decision of the Texas Court of Appeals in *Hegar v. CheckFree Serv. Corp.*, No. 14-15-00027-CV (Tex. App. 14th Dist. 2016).
- In a case currently pending in the Austin Court of Appeals, a payment processor is challenging the Comptroller's assessment of sales and use tax on payment processing services, claiming they constitute taxable data processing.

Credits and Incentives

Changing Terms and Clawbacks

- Louisiana – Industrial Tax Exemption Program
- Local Agreements - Clawbacks
  - Shift to remote workforce
- Other pressures

Duke Energy Corporation v. S.C. Dep’t. of Revenue (Dec. 2020)

- The Department denied Duke Energy’s partial property tax exemption for manufacturing claiming that the company is a utility and not a manufacturer.
- The Administrative Law Court held that Duke Energy is a manufacturer as a matter of law, based on longstanding judicial precedent, and was therefore entitled to the exemption.

North Carolina’s Retroactive Denial of Renewable Energy Credits

- To incent investment in the state, North Carolina enacted law authorizing operating businesses using renewable energy to claim the Renewable Energy Tax Credit equal to 35 percent of the cost to build, buy or lease renewable energy property. The program ended in 2016.
- In 2018, the North Carolina Department of Revenue issued guidance advising taxpayers that a disguised sale determination for federal income tax purposes results in NCDOR not recognizing the credit allocation to members for state income tax purposes.
  - The notice appears to imply that an allocation of state tax credits to a partner which is considered a disguised sale for federal income tax purposes would result in nullifying the allocation, thus resulting in the taxpayer being unable to claim the credit.

Massachusetts's Retroactive Denial of Enterprise Zone Credit

– Massachusetts allows the economic development incentive program credit for capital investment in the state and job creation. Before 2010, the credit was called the economic opportunity area credit.

– Historically, Massachusetts allowed these credits following approval by the Massachusetts Economic Coordinating Council.

– In 2016, Massachusetts amended its statute to also require taxpayers to execute a contract with the Massachusetts Office of Business Development, after obtaining approval by the Massachusetts Economic Coordinating Council. The governor signed the bill on August 10, 2016.

– The language of the amended statute does not specifically address treatment of credits generated prior to 2016 and it does not contain any other specific retroactive provisions. However, a “note” included in a separate section at the end of the bill that enacted the change to the credit statute stated that for credits “claimed” for years beginning on or after January 1, 2016, the taxpayer shall enter into the Business Development contract before December 31, 2016 or the taxpayer shall forfeit such credits.

– On January 3, 2017, the Department issued a publication stating that based on this note to the bill, its position is that if a taxpayer did not enter into a contract with the Office of Business development by December 31, 2016 concerning its credits generated and carried forward prior to 2016, the taxpayer forfeited all such credit carryforward balance.

– Based on this position the Department has recently issued tax assessments denying use of Economic Opportunity Area Credits carried forward from earlier years.

Handling Remote Audits

Handling Remote Audits

- Establishing Remote Rapport
- Using Technology to Your Benefit
  - “Sharing” documents with auditor
- Preparing for a Remote Conference/Hearing
- What “Remote” Practices to Continue Post-Pandemic?

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