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State and Local Tax Current Happenings

SC&H Group's State & Local Tax professionals work to ensure that your tax obligations are accurate and that you are aware of – and take advantage of – all relevant tax saving opportunities.

In this edition of our *State and Local Tax Current Happenings* we cover the following hot topics:

- ITFA and MFA - Sales Tax Alphabet Soup in the U.S. Congress
- What is "Federal Taxable Income" for a Separate Maryland Corporate Return?
- Michigan Phase Out of Personal Property Tax Approved
- Ohio Supreme Court Rejects Contractual Real Estate Purchase Price Allocation

Each of these headlines and happenings are timely, relevant issues that are impacting the state and local tax landscape – and ultimately, your tax obligations.

ITFA and MFA – Sales Tax Alphabet Soup in the U.S. Congress

On September 19, 2014, President Barack Obama signed H.J. Res. 124, the Continuing Appropriations Resolution, 2015 (Public Law 113-164). In addition to continuing the funding for U.S. Government programs and services at the current annual cap, the resolution also extends the Internet Tax Freedom Act (ITFA) through December 11, 2014. There may be additional implications for the Marketplace Fairness Act (MFA).

The ITFA, which was originally passed in 1998 and extended three times, was set to expire on November 1, 2014. The Act places a temporary moratorium on new taxes imposed by state and local governments on internet access or discriminatory taxes on e-commerce. (Recall that the ITFA deals with the Internet itself; it does not change the sales taxability of the products that are ordered via the Internet.) Earlier in the year, bills were presented in both the House and Senate to make this moratorium permanent. The House bill was passed in July; however, the Senate bill has been delayed as Senators attempt to link it to the controversial MFA.

The MFA includes provisions that will allow states to impose a sales/use tax collection requirement on remote sellers who lack the substantial nexus currently needed for a state to impose such a collection requirement, i.e. the physical presence rule articulated by the U.S. Supreme Court in the *Quill* case. In May 2013, the U.S. Senate voted to approve the MFA, but the House of Representatives has not yet voted on the bill.

The short-term extension of the ITFA is intended to allow Congress additional time when they return from recess after the midterm elections on November 4th to pass a bill to further extend the ITFA - or make it permanent. This extension may also result in renewed efforts by the Senate to implement the MFA by addressing one bill that includes both the MFA and additional extension of ITFA. In fact, at the recent Institute for Professionals in Taxation (IPT) Sales Tax Symposium in which SC&H Group participated, attendees shared their anticipation that Congress will address both issues shortly after Thanksgiving.

What is "Federal Taxable Income" for a Separate Maryland Corporate Return?

The Maryland Court of Appeals on August 18 upheld a $2 million income tax assessment against a subsidiary of Nordstrom, Inc. The case is more than another "intangibles holding company" decision as it has been billed by some, and it should be of interest to many corporations that file consolidated federal tax returns. The case also involved, but gives no general guidance for, the issue of when to report, for Maryland purposes, a gain that has been deferred under consolidation principles for federal purposes. Is it 100% in the year of the transaction, or in the later year(s) when it is recognized in federal taxable income?

AN INSUBSTANTIAL HOLDING COMPANY SUBSIDIARY

The now mundane part of the Nordstrom issues with the Maryland Comptroller's Office was the state's assertion of income tax on a company receiving intercompany licensing fees for trademarks. Different from other cases that the Maryland courts have dealt with was the multi-level structure that Nordstrom used in transferring the trademark assets and then the license agreements. Without going into the details here, we'll summarize by simply saying that the courts described the structure as being designed for income shifting purposes "according to a plan labeled the 'anti-Geoffrey strategy' by its tax consultant," referring to the South Carolina case about the intercompany license of the giraffe picture. And the Maryland courts gave the Comptroller yet another win in the now several "intangibles" cases by holding that the subsidiary, NIHC, did not have economic substance separate from its parent, and was therefore taxable in Maryland to the same extent as the parent's Maryland operations.

THE TWIST – A SECTION 311(B) GAIN

However, setting up the multi-tier structure included the transfer of licensing rights, a distribution of appreciated property under section 311(b) of the Internal Revenue Code. The Court of Appeals was left to deal with the question of when the 311(b) gain was taxable in Maryland: 1) in the years in which the company reported the gain on its filed federal income tax returns, i.e. the 15-years of deferred recognition under the federal consolidated return rules, starting in 2002; or, 2) all in the year of the initial transfer of the assets, 1999.

During the litigation proceedings the company cited Maryland law at Tax-General section 10-811, which provides that "each member of an affiliated group of corporations shall file a separate income tax return". The company argued that this statute means that the federal consolidated return rules should be ignored when reporting Maryland income, resulting in the gain being taxable in the year of transfer. Important to the *taxpayer* was that, if the court agreed that the gain was fully taxable in the year of transfer and not in the deferral years, the Comptroller's tax assessment would be voided because the transfer year was outside the statute of limitations.

Conversely, important to the *court* was the fact that the company had reported an amortized portion of the 311(b) gain on filed Maryland income tax returns in the deferral years (indicating the gain as all non-Maryland) and had not amended its Maryland returns to instead report the gain in the 1999 year the assets were transferred - the latter being the position the company was now arguing as correct.

Albeit in a footnote, the Court of Appeals first stated agreement with the lower courts' conclusions that Maryland could tax NIHC based on the subsidiary's lack of economic substance apart from Nordstrom, the parent. The court then discussed procedural matters and that "the only portion of the Tax Court decision that has been preserved for review" was whether the Maryland requirement that related corporations file separate tax returns would prohibit taxation of NIHC's 311(b) income.

The Court of Appeals mentioned that "The Court of Special Appeals stated that it was expressing no opinion on 'the broader issue of whether a corporation's 311(b) gain, which is constitutionally subject to taxation by Maryland, is reportable as Maryland modified income on a deferred basis under Maryland's requirement of separate entity income tax returns, where such deferred gain is reported on the corporation's consolidated federal income tax return.'" In fact, the judges complimented the Court of Special Appeals, saying that "the intermediate appellate court wisely adhered to a maxim of judicial decision-making that counsels against addressing questions abstracted from facts before the court".

THE DECISION

With regard to the timing of taxing the 311(b) gain, the Court of Appeals concluded:

> "There is no question that the income related to Nordstrom's activities in Maryland during 2002 and 2003 tax years was shifted in part to NIHC. The Comptroller assessed tax on that income as NIHC reported it on its tax returns for those years. However, neither NIHC nor its affiliated corporations has amended their returns to reflect another way of reporting that income. Essentially, NIHC asks that, because it mistakenly neglected to report its entire gain and pay the appropriate tax on its 1999 Maryland return, it should be forgiven any tax liability on that income, even though it reported a portion of that income on its 2002 and 2003 returns. On the facts of this case, the separate reporting requirement does not eliminate the tax liability for the income reported, properly subject to tax, and not previously taxed (emphasis added). We hold that, on the record before the Tax Court, NIHC did not carry its burden of showing that the Comptroller's assessment was wrong."

FUTURE IMPLICATIONS?

What, if anything, can be inferred from the case by other taxpayers? How important is the court's phrase "in this case" when it decided that the 311(b) gain was properly taxed in the federally deferred years rather than in the year of the transaction? It is clear that the Court of Appeals intended not to provide general guidance on the issue; the Court of Special Appeals affirmatively stated that they were not doing so.

But, does the court's allowance of NIHC's gain recognition in the deferral years give support to other taxpayers who read the Maryland statute as requiring or allowing it, e.g. because the deferral is part of calculating the federal taxable income of that corporation, in that corporation's separate column, in the federal return? Should the "separate return" rule simply mean that the Maryland return should reflect federal income as recognized in the actual federal return, with the impacts of the consolidated return regulations, but report each corporation separately to Maryland *without consolidating the incomes (or losses) of any of the related corporations*? If so, how does the Maryland return reflect, or not, the various aspects of "separate taxable income" as that phrase has meaning in the federal 1502 regulations?

And/or, does the court's decision give pause to taxpayers who have interpreted the statute's "separate income tax return" to mean something more than an individual return for each individual corporation while using the federal taxable income reported for federal purposes for that individual corporation, e.g., that "separate return" means that federal taxable income must be recalculated by undoing the impact of the federal consolidated return regulations? This is one way of reading the Comptroller's regulations on the topic. Reg. 03.04.03.03B(1) says: "Affiliated corporations which are included in a consolidated federal return shall file separate Maryland returns, and each separate corporation shall report its taxable income without regard to any consolidation for federal income tax purposes." And Reg. 03.04.03.05B says: "Use of federal figures. The starting point for the Maryland return is the taxable income as defined in the Internal Revenue Code and developed on the federal return. Corporations included in a consolidated filing for federal purposes shall file separate Maryland returns and compute separate taxable income." The "without regard to any consolidation" and "compute separate taxable income" are read by most, but not all (including not Nordstrom originally), taxpayers and practitioners to mean that federal taxable income, the starting point for Maryland taxable income, is calculated *as* if the impacts of the federal consolidated return regulations were all undone, or *as* if the company was not part of a federal affiliated group. The question is: does "without regard to any consolidation" mean the same thing as "as if the impacts of the federal consolidated return regulations are undone"?

The Maryland law at section 10-811 simply says: "Each member of an affiliated group of corporations shall file a separate income tax return." Section 10-304 provides that a corporation's calculation of its Maryland income begins with "the corporation's federal taxable income for the taxable year as determined under the Internal Revenue Code and as adjusted under this part II of this subtitle" and there are no pertinent adjustments provided. Additionally, section 10-107 provides "To the extent practicable, the Comptroller shall apply the administrative and judicial interpretations of the federal income tax law to the administration of the income tax laws of this State."

Maryland's tie to the federal statute and administrative and judicial interpretations is for simplicity of design and administration of Maryland's income tax. Interpreting the state statute's "separate income tax return" requirement to mean that the federal return must be deconstructed in order to completely undo the federal consolidated return regulations' accounting requirements certainly results in something other than simplicity – for both the taxpayer preparing the return and the Comptroller's auditing of the return.

In the Nordstrom case, the company had filed the Maryland returns using the interpretation that a separate income tax return form was to be submitted for each individual corporation, and that for NIHC, the separate taxable income calculation included the same deferral of the 311(b) gain as required for the year's federal income tax return. The Court of Appeals determined that "on the facts of this case" this taxation of the gain in the deferral years, rather than in the transaction year, was appropriate.

If there were different facts in a different case, what would the court's holding be? For taxpayers to whom the deferral makes a difference, the NIHC case provides some food for thought, but no clear answer.

NIHC Inc. v. Comptroller of the Treasury, Court of Appeals No. 63, September Term, 2013; August 18, 2014

Michigan Phase Out of Personal Property Tax Approved

In August, Michigan voters gave approval during primary election voting to Proposal 1, a plan to proceed with the phase out of personal property tax for small businesses and Eligible Manufacturing Personal Property (EMPP).

The phase out of the Michigan property tax is not a full exemption. Personal property will continue to be taxable in Michigan unless specifically exempt. One exemption is for Small Businesses with a full cash value of less than $80,000. The exemption requires an affidavit to be filed annually with the local assessor in lieu of filing a personal property return.

The EMPP exemption will begin in 2016 for industrial processing and direct integrated support equipment placed in service after December 31, 2012.

How will Michigan replace the local governments' lost revenues? The plan includes the creation of a special assessment of EMPP, taxing 20% of what would otherwise have been taxable without the EMPP exemption, as well as reallocation of the state's sales/use tax collections.

Ohio Supreme Court Rejects Contractual Real Estate Purchase Price Allocation

In a real property valuation case, the Ohio Supreme Court recently upheld a determination by the Board of Tax Appeals (BTA) that the property values assigned to real estate parcels in a contractual purchase price allocation were not the proper valuations of the properties for property tax purposes.

The taxpayer had sold a large industrial warehouse business in 2010, including several parcels of real estate, and urged the BTA to adopt the allocation of the purchase price to certain properties for the 2008 valuation of the parcels. The BTA rejected the allocation, holding that the allocation documents showed that the sale included some, but not all of, the parcels at issue as well as parcels that were not at issue. The taxpayer had submitted pages of a 2010 Asset Purchase Agreement, a HUD settlement statement form, and two warranty deeds with property descriptions attached.

The BTA's decision had agreed that the best evidence of value was a recent arms'-length sale, but concluded that the taxpayer had presented insufficient evidence of the sale to allow it to be used as a basis for determining value. According to the BTA, it was not clear who had prepared the valuations, and the taxpayer provided no additional evidence beyond the few documents.

In supporting the BTA's conclusion and use of a different valuation, the court said that an owner, who favors the use of an allocated bulk-sale price to reduce the value assigned to real property, must bear the burden of proving the propriety of the allocation. The court noted that "While the Asset Purchase Agreement does contain an allocation, it does not set forth any reasoning as to how that allocation was determined, nor does it even set forth an allocation at the level of individual parcels. Moreover, RNG [the taxpayer] has offered no reasoning in support of the contractual allocation. Although the fact that an allocation was negotiated between the parties is relevant, it is not sufficient by itself, because the motivations behind the allocation are crucial to a determination of its propriety for tax-valuation purposes (citations omitted)."

The case is RNG Properties, Ltd. v. Summit Cty. Bd. of Revision, Slip Opinion No. 2014-Ohio-4036, decided 9/23/2014.

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