A Panel Discussion of Recent Developments in State Tax Reform

By: Leonel Renteria

There have been interesting current developments in the area of state tax reform. The presentation, "State Tax Reform—Tax Havens, Transfer Pricing, and More," at the 31st Annual TEI-SJSU High Tech Tax Institute addressed recent state legislation on tax havens and transfer pricing. Brian Pederson, Managing Director with Alvarez & Marsal Tax; Rob Weyman, Senior Associate with Reed Smith; and Annette Nellen, Professor and Director of San José State University's graduate tax program led the panel discussion.

Brian Pederson began the presentation with a discussion on "tax haven" legislation. Several states and the District of Columbia have recently passed laws targeting corporations with tax haven affiliates.[72] These states are targeting after multi-national corporations by expanding the combined filing group requirements to include entities incorporated in jurisdictions with minimal or no taxes. By expanding the unitary group for tax filings purposes, these states are seeking to reach beyond the water's edge and broaden the income base and apportionment factors. These new rules generally take two approaches: the "Blacklist" approach or the Multistate Tax Commission (MTC) approach.[73]

Under the "Blacklist" approach, states identify a list of "tax haven" jurisdictions. For example, Oregon includes 44 jurisdictions in its "Blacklist," including favored tax planning jurisdictions such as the Cayman Islands and Bermuda. Generally, these rules will look to a multinational's jurisdiction of incorporation and that of its affiliates and subsidiaries. A corporation deemed to be doing business in a "Blacklist" jurisdiction must include the income and apportionment factors of these affiliates or subsidiaries in its state consolidated water's edge return.

Under the MTC approach, similar to that of the Blacklist regime, its purpose is to expand a unitary business combined group for state tax reporting, similar to that of the Blacklist regime. However, this method relies on the "tax haven" definition outlined in the Multistate Tax Compact rather than a list of jurisdictions. The MTC defines a "tax haven" as a jurisdiction that has no or nominal effective tax or relevant income *and*:

I. has laws or practices that prevent effective exchange of information for tax purposes with other governments on taxpayers benefiting from the tax regime;
II. has a tax regime which lacks transparency;
III. facilitates the establishment of foreign-owned entities without the need for a local substantive presence or prohibits these entities from having any commercial impact on the local economy;

[72] Enacted legislation: AK, CT, MT, OR, RI, WV, DC; proposed legislation: AB, KY, MA, NH

[73] Pederson, Brian. "State Tax Reform—Tax Havens, Transfer Pricing, and More." 31st Annual TEI-SJSU High Tech Tax Institute. Crown Plaza Hotel, Palo Alto, CA. 10 Nov. 2015. Conference Presentation.

IV. explicitly or implicitly excludes the jurisdiction's resident taxpayers from taking advantage of the tax regime benefits or prohibits enterprises that benefit from the regime from operating in the jurisdiction's domestic market; or

V. has created a tax regime which is favorable for tax avoidance, based upon an overall assessment of relevant factors, including whether the jurisdiction has a significant untaxed offshore financial or services sector relative to its overall economy.[74]

A taxpayer who is a member of any unitary group doing business in a locality that meets the definition of tax haven jurisdiction will be subject to these statutes.

This category of legislation is not new; Montana passed similar laws about a decade ago. However, these laws have been receiving increased attention from multiple stakeholders due to their aggressive stance considered by many to be adverse tax treatment of multinational corporations. Whereas some view these laws necessary to recoup lost revenue due to corporations stashing profits in low tax jurisdictions, others see it as an attack on businesses and poor tax policy. As Mr. Peterson commented, many questions, for instance on the constitutionality and commerce clause implications, linger and might have to be addressed by the courts.

Some states have also shifted focus to transfer pricing taxation. Presenter Rob Weyman with law firm Reed Smith in Philadelphia continued with a brief discussion on the transfer pricing ("TP") environment. For multi-jurisdictional corporations and entities, transfer pricing is a settled tax issue at the federal level under I.R.C. §482. However, at the state level, the development and application of transfer pricing taxation appears to be in its rudimentary stage. As Mr. Weyman commented, states are looking for money without raising taxes. Since states have §482-like powers they are increasing scrutiny primarily by increasing the number of audits and expanding categories of transactions subject to examination. Nevertheless, states are challenged due to the difficulty in developing and implementing sound transfer pricing tax policy and lack of resources at the state level for this purpose.

To illustrate his point, Mr. Weyman provided several examples in state transfer pricing controversies that did not bode well for the states. In New Jersey, the Director of Taxation terminated a multi-million dollar contract that involved performing transfer pricing analysis citing taxpayer resistance. Kentucky's Department of Revenue declined to renew its third-party contract for transfer pricing audit assistance even though no assessments were issued and no taxes had been collected. This was in great part due to the controversy and apparent conflict-of-interest of using third-party auditors contracted on contingency fee basis.

In the District of Columbia, the transfer pricing case *Microsoft Corp. v. Office of Tax and Revenue* is illustrative of the inherent problems with states adjudicating transfer pricing transactions absent sound policy.[75] In

[74] *Ibid pg. 4-10.*

[75] *Microsoft Corp. v. Office of Tax and Revenue*, District of Columbia Office of Administrative Hearings, No. 2010-OTR-00012, May 1, 2012.

this case, Microsoft's deficiency notice by the Office of Tax and Revenue ("OTR") was reversed. OTR contracted a third party, Chainbridge Software, to conduct a transfer pricing audit. The taxpayer filed for summary judgment arguing the Chainbridge method: (1) violated federal §482 regulations and (2) failed to properly reconcile tax accounting with financial accounting.[76] The District of Columbia Office of Administrative Hearings (OAH) found that the third party's transfer pricing study was arbitrary and wholly unreasonable. Given the overwhelming rejection of state's use of third-party contractors, it is not farfetched to think several transfer pricing cases on appeal with the D.C. OAH will be ruled on in the same manner.

Mr. Weyman emphasized that there are some inherent problems in states going after transfer pricing adjustments. Many, if not most, do not have the resources, the professional expertise or an assigned and dedicated staffed department for studying these specific types of transactions. The Microsoft case highlighted some of the challenges state tax authorities must grapple with when delving into a new tax territory.

Professor and Director of San José State University's graduate tax program, Annette Nellen, finished the panel presentation with an update on other state tax reform topics. She listed and commented on several bills in Congress on state tax reform topics including: broadening the sales tax base, lowering income taxes and increasing sales tax, accountability measures and evaluating incentives, worker classification clarification and enforcement, getting ready for possible enactment of Marketplace Fairness, and taxing marijuana. Another state tax reform concern is whether the Supreme Court will revisit its decision in *Quill Corp. v. North Dakota*.[77] In this case, the Supreme Court ruled that a taxpayer must have a physical presence in a state in order to require collection of sales or use tax for purchases made by in-state customers.[78] Given the rise of technology, internet sales and ecommerce, it has been posited that the decision in *Quill* will be revisited soon. Certainly, in the arena of state tax policy the implications would be significant.

Many state legislatures are adopting more active and defensive tax policies against multi-national corporations. This will continue to have an effect on state tax planning and compliance issues. As highlighted in the presentation, "State Tax Reform—Tax Havens, Transfer Pricing, and More" tax policies at the state level will continue to enter new realms and will require further study and analysis. The High Tech Tax Institute offers the opportunity for professionals with expert knowledge in their respective areas to contribute to the understanding of the state tax realm.

[76] Weyman, Rob. "State Tax Reform—Tax Havens, Transfer Pricing, and More." 31st Annual TEI-SJSU High Tech Tax Institute. Crown Plaza Hotel, Palo Alto, CA. 10 Nov. 2015. Conference Presentation.

[77] *Quill Corp. v. North Dakota* (91-0194), 504 U.S. 298 (1992)

[78] Atkins, Chris. "Important Tax Cases: Quill Corp. v. North Dakota and the Physical Presence Rule for Sales Tax Collection." Taxfoundation.org. Tax Foundation. 19 July 2005. Web. 21 Nov 2015.