Conformity, "Conscious Coupling/Decoupling," and Inadvertent Disconnects:

State Issues from Federal Taxes

Speakers

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Agenda

- Federal vs. State Filing Methodologies
  - State Filing Methodologies vs. Federal Consolidated Return Rules ("CRR")
  - State Adoption of Federal Taxable Income
- Transactional Examples
  - Distributions
  - Stock ownership attribution for control
  - State/Federal Basis Differences
- Special Issues for Nonconforming States

Federal vs. State Filing Methodologies

Federal Consolidated Return

- In general, while the goal of the federal consolidated return regime is to treat a consolidated group as if they were divisions of a single corporation, the post-1995 regulations do not completely embrace the single-entity model.
- Each member does have a "separate taxable income" (Treas. Reg. § 1.1502-12):
    - Taxable income determined as if the member filed a separate return, plus consolidated adjustments such as excluding income from intercompany transactions
- Consolidated Taxable Income (Treas. Reg. § 1.1502-11):
    - Total of separate taxable income of members plus items computed on a consolidated basis, such as NOLs, capital gains/losses, section 163(j) limitations, etc.

State Filing Methodologies

Unitary with Federal Consolidated Conformity ("**Full Fed Conformity**") (Illinois)	Unitary with Partial Consolidated Conformity **("Partial Fed Conformity")** (California/Massachusetts)	Unitary w/ Separate Entity Identity and Eliminations ("**Elimination State**") (Michigan/Texas)	Separate Filing ("**Separate**") (Pennsylvania)
• Treats all members of the combined unitary group as if they were members of a consolidated group	• Uses unitary rules to determine group • Conforms to certain CRR, (often Treas. Reg. § 1.1502-13) but not all • May have separate member character, especially when it comes to attributes	• Each member of the group calculates its separate company federal income • Any intercompany transactions are permanently eliminated with no corresponding basis adjustments	• Does not follow the CRR • Would also include post-apportionment combination states

State Filing Methodologies (cont'd)

Full Fed Conformity

Illinois (86 ILAC 100.5270)

The designated agent will determine combined base income by treating all members of the unitary business group… ***as if they constituted a federal consolidated group and by applying the federal regulations for determining consolidated taxable income***…

Partial Fed Conformity

Mass (830 CMR 63.32B.2(6))

(c)(2) Except as otherwise provided, the total income of the combined group is the ***sum of the incomes, separately determined***, of each member of the combined group…

(c)(5) Income from an intercompany transaction between members of the same combined group… shall be deferred in a manner ***similar to that provided in U.S. Treas. Reg. § 1.1502-13.***

Elimination States

Michigan (MCL § 206.691)

Each United States person included in a unitary business group or included in a combined return shall be treated as a ***single person***, and ***all transactions between those persons included in the unitary business group shall be eliminated*** from the corporate income tax base..."

Separates

Pennsylvania (72 P.S. §7401)

The starting point for a corporation included in a federal consolidated report is federal taxable income computed ***as though a separate federal return had been filed***

State Filing Methodologies (cont'd)

States may have a lack of clear guidance

Kan. Admin. Regs. § 92-12-110

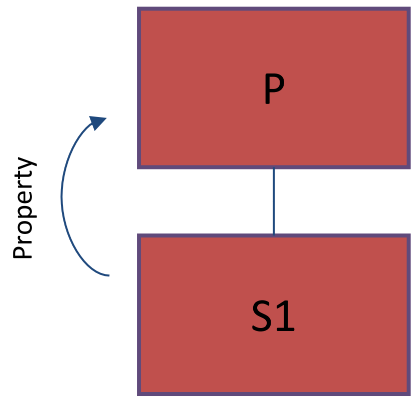
- *Each corporation filing a Kansas income tax return using the combined income method of reporting with more than one entity of the combined group doing business in Kansas,* ***may report the total Kansas combined income and pay the tax due by filing one Kansas income tax return.*** *When a corporation uses this method for a taxable year, the corporation shall continue to use this method for all future years or as long as the Kansas combined return is utilized.*

Transactional Examples

Distributions

IRC § 301	• Treats a distribution by a corporation to its shareholder as (1) a dividend to the extent of E&P, then (2) a return of available basis, then (3) capital gain.
IRC § 311(b)	• Distributing corporation realizes gain (but not loss) to the extent FMV of assets distributed > Basis
Treas. Reg. §§ 1.1502-13(f) and 1.1502-32	• Treas. Reg. § 1.1502-13(f)(2) excludes from gross income an intercompany distribution by a corporation to another consolidated group member but only to the extent there is a corresponding negative adjustment reflected under § 1.1502-32 in the stock of the distributing member
Treas. Reg. § 1.1502-19	• To the extent one corporation distributes in excess of basis to another consolidated group member it creates an excess loss account (“ELA”)

Example: Intercompany Distribution



Background

- P and S1 file a federal consolidated return
- S1 was acquired in the past year and makes a significant distribution of valuable IP
  - Value of IP is made up of multiple year's worth of S1's E&P
  - Value of IP is in excess of S1's basis

Items to Consider – Examples (not all inclusive)

- Basis of Asset being distributed vs FMV
- E&P in S1 vs value of amount being distributed
- Whether gain is deferred an impact on E&P for distribution
- E&P at S1
  - Separate company vs consolidated
  - Impact of non-conformity to items such as 965, SubF & GILTI

Example: Intercompany Distribution

Full Fed Conformity	Partial Fed Conformity	Elimination States	Separates
• Dividend is excluded from income of P • Section 311(b) gain is deferred • P reduces its basis in stock of S1	• If state does not conform to Treas. Reg. § § 1.1502-13(f) and/or 1502-32, dividend would be taxable unless a state DRD or elimination applies for pre-unitary E&P • California doesn't conform to Treas. Reg. § 1.1502-19, potential for DISA	• In general, the income would be eliminated. • **Question** – what is the impact on the corresponding gain / basis adjustment?	• Dividend could be taxable unless a state DRD or Section 243(b) applies • Any capital gain under section 301(c) would be recognized currently by P • Section 311(b) gain is recognized currently by S1

Stock ownership attribution for control

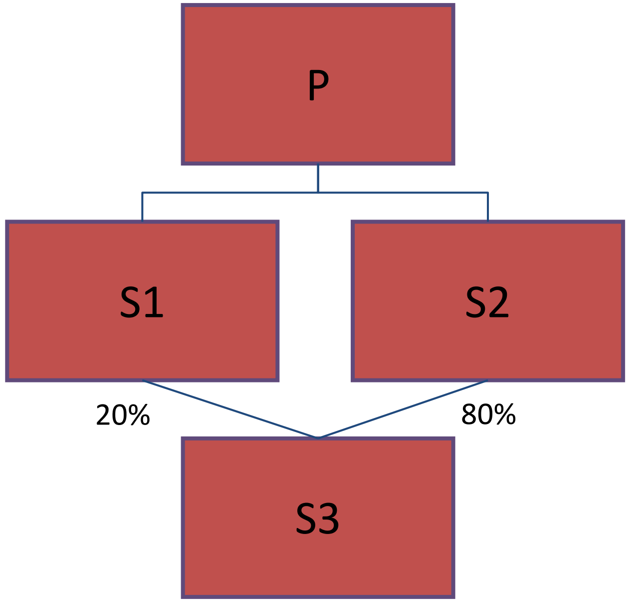
IRC §§ 332 & 337, 351 and 368

- IRC provisions allowing tax-free liquidations, contributions, and reorgs all generally require 80% control

Treas. Reg. § 1.1502-34

- Attributes stock ownership of one member of the federal consolidated group to all other group members

Example: Liquidation with Split Ownership



Background

- P, S1, S2, and S3 file a federal consolidated return
- S3 is solvent and liquidates into S1 and S2 distributing appreciated property

Federal Consolidated Treatment

- No gain or loss is recognized under Section 332 for federal tax purposes since S1 can aggregate its < 80% ownership with S2

State Tax Non-Conformity

- In states that do not conform to Treas. Reg. § 1.1502-34, S1 would recognize gain under Section 331 and S3 under 336

Example: Liquidation with Split Ownership

Full Fed Conformity	Partial Fed Conformity	Elimination States	Separates
• No gain or loss recognized because S1 gets attribution of ownership	• If state does not conform to Treas. Reg. § 1.1502-34, but does conform to Treas. Reg. § 1.1502-13 – (e.g., California) would **<u>not</u>** have a deferred gain	• If state does not conform to Treas. Reg. § § 1.1502-13 and 1.1502-34, could have a gain recognized. • Question would it then eliminated?	• Would have current gain recognized upon liquidation

Liquidations, Contributions, and Reorgs

IRC § 357(c)	• Attributes stock ownership of one member of the federal consolidated group to all other group members
IRC § 362(e)	• Limitation on transfer of built-in losses
Treas. Reg. § 1.1502-80	• “Shuts off” certain IRC provisions on transactions between consolidated group members, including section 304, section 357(c) and 362(e)

State/Federal Basis Differences

Treas. Reg. § 1.1502-32

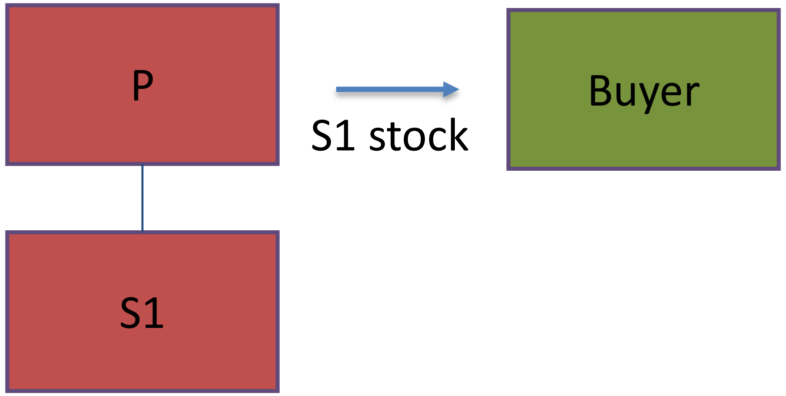
- Investment adjustments to basis are required for consolidated group subsidiaries, including:
  - Income/Loss recognized
  - Exempt Income
  - Adjustments required by Treas. Reg. 1.1502-13 for intercompany transactions
  - Adjustments required because of COD income

State/Federal Basis Differences (cont'd)

State Conformity to Treas. Reg. § 1.1502-32

Full Fed Conformity	Partial Fed Conformity	Elimination States	Separates
• Yes	• Depends on the state, for example California does not conform but Massachusetts does • Many states are silent, requiring decisions, e.g., if the state follows -13 is it likely that they follow -32?	• Generally, no	• No

Example: Sale of a Subsidiary



Background

- P bought S1 stock for $100M
- While owned by P and consolidated, S1 earned $40M of E&P made a $20M taxable loss and made a distribution of IP worth $60M
- P sells stock of S1 to Buyer for $300M

Sale with Treas. Reg. 1.1502-32	Sale without Treas. Reg. 1.1502-32
$100M original cost - $20M taxable loss - $60M distribution = $20M basis Gain = $300M - $20M = **$280M**	$100M original cost -$20M §301(c)(2) distribution = $80M basis Gain = $300M - $80M = **$220M**

Special Issues for Nonconforming States

Special Issues for Nonconforming States

	Federal Consolidated	Michigan Unitary
Section 163(j)	• § 163(j) limitation is computed based on consolidated adjusted taxable income ("ATI") and interest income	• § 163(j) limitation is computed based on separate company ATI and interest income and applied to separate company expense • § 163(j) carryover or excess ATI may not be shared with other group members
Capital Losses	• Capital losses are carried over and netted against capital gain on a consolidated basis	• Capital losses are carried over and netted against capital gain at a separate entity level and cannot be shared among group members

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