Accounting for State and Local Taxes

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Learning objectives

• Review of the State and Local Tax income tax provision basics including current and deferred tax provisions, deferred tax balances, effective tax rate and valuation allowances

• Review the practical implications of common state uncertain tax positions including, nexus, combined reporting, tax base and controversies

• Discuss the importance of non-income taxes, such as sales/use tax

• Discuss the state tax provision impact of new state tax developments, including multistate updates and trends, federal tax developments impacting state taxes and tax accounting authority activities
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Agenda

• Tax Accounting Basics
  • Uncertain tax positions and tax contingencies
  • State technical updates
  • Tax accounting authority updates
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ETR = Effective Tax Rate

Federal Piggyback ETR Method

• Tax Effected Cumulative apportioned state income tax rate added to FIT rate

• ASC 740-10-55-25
  – Same operations are taxed in two or more jurisdictions, AND
  – No significant differences between the tax laws of the jurisdictions (or the differences would have no significant effect)
Q&A #3 – Does Statement 109 require separate deferred tax computations for each state or local tax jurisdiction?

If deferred tax assets or liabilities for a state or local tax jurisdiction are significant, Statement 109 requires a separate deferred tax computation when there are significant differences between the tax laws of that and other tax jurisdictions that may apply to the enterprise. In the United States, however, many state or local income taxes are based on U.S. federal taxable income, and aggregate computations of deferred tax assets and liabilities for at least some of those state or local jurisdictions might be acceptable.

WOW! Mom and Dad just said it’s OK if we play with matches!
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Federal Piggyback ETR Method

What you should ask yourself:

• Federal ETR Query – What will make my ETR vary from 35%?
  – and your done

• State ETR Query I – What will make my ETR vary from the Piggyback state statutory rate?

• State ETR Query II – What will make my ETR vary from the currently-recorded state rate?
  – because you likely are not currently at any statutory state rate

• Your Canary in the Coal Mine –
  • What is your Return-to-Provision adjustment?
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Federal Piggyback ETR Method

Why are you not at a statutory state rate?

- Federal/state differences (e.g., Bonus Depreciation – should be looked at cumulatively)
- Varying state apportionment ratios
- Net Operating Losses and those pesky Valuation Allowances
- Affiliated groups - separate entity and combined unitary filings
- Flow-through Entities (e.g., Partnerships and LLCs)
- Alternative tax systems (Texas)
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Federal Piggyback ETR Method

• **Must** adequately account for these items
  – Materiality is not yet a consideration
  – But **should not** (≠) overcomplicate accounting
  – Leads to errors
  – A one-way street – simple to complex

• Provision should generally not use ETR to compute current tax expense
  – Better to use estimated payment data

ETR for current tax expense ≈ risk of significant return-to-provision – ¡muy peligroso!

CTE ETR will typically not be the same as DTE ETR because…
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ASC 740, Accounting for Income Taxes

• ASC 740 – "A deferred tax liability or asset is recognized for the estimated future tax effects attributable to temporary differences and carryforwards"

• The ETR used to compute state-related deferred tax assets or liabilities must consider known future events, legislative changes, etc.

Prediction is very hard, especially about the future - Yogi Berra
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Deferred Taxes and State Apportionment

• Look to the future of state apportionment ratios?
  – Factual projections?
  – Example – entity about to transact an LKE of Texas Assets for PA assets
    • 1.0% tax rate to 9.99% tax rate (or vice-versa)
    • You just moved your tax liability and tax rate
• Alternative Tax Regimes (e.g., Texas) – cannot rely upon federal temporary differences
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Agenda

• Tax accounting basics
• **Uncertain Tax Positions and Tax Contingencies**
• State technical updates
• Tax accounting authority updates
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Uncertain Tax Positions and Tax Contingencies

• Uncertain Tax Positions (UTPs – ASC 740-10 - fka FIN 48) and Contingencies (ASC 450 - fka FAS 5)

• The recognition and measurement of tax positions represents one of the most sensitive and judgmental areas of tax

• ASC 740-10 establishes specific “ground rules” and methodologies for the identification and analysis of income tax positions

• ASC 450 establishes differing “ground rules” and methodologies for the identification and analysis of non-income tax positions

• ASC 450 applies to contingencies in general (e.g., warranties) and not just to non-income taxes
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ASC 740-10 (fka FIN 48) Procedural Steps Refresher

• Identify all years for which the statute of limitations remains open in all jurisdictions in all tax years
  – An inventory of tax returns required to be filed, whether actually filed or not
  – Applies to pass-through entities (e.g., entity-level taxes) and tax-exempt entities (e.g., unrelated business income)
• Identify discrete “Tax Positions” (e.g., fixed asset depreciation or R&E)
• Identify “Units of Account” by Tax Positions (e.g., fixed asset depreciation for 2007, R&E credit for year or project)
• Determine if each Unit of Account is more-likely-than-not (“MLTN”) to be sustained upon examination
• If a Unit of Account does not meet the MLTN standard, do not recognize the full tax benefit
• If the Unit of Account does meet the MLTN standard, record the largest amount of tax benefit with a cumulative greater than 50% likelihood of being realized upon ultimate settlement
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UTP (ASC 740-10) Procedural Steps Refresher

• These steps are to be performed at least annually?
  – Say what??!
• If not, what are the internal controls to compensate?
• Multistate taxation moves pretty fast. If you don't stop and look around once in a while, you could miss it.
• State legislatures are not in gridlock; nor are the Courts. But many State Department of Revenue are temporarily dysfunctional.
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Non-Income Based Tax Contingencies

- ASC 450 applies to non-income based taxes, e.g., sales/use taxes
- ASC 450 should be included in tax provision internal controls and SOX 404 procedures
- ASC 450 is often overlooked by many practitioners – both preparers of provisions and independent auditors
- For companies administering sales/use tax in numerous states, the sales/use tax exposures can often exceed the income tax exposures
- Other potential exposures – employment taxes, ACA penalties, property taxes, franchise taxes, fuel/excise taxes, unclaimed property/escheat, etc. – YOU MUST ASK YOUR SPECIALISTS!
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**ASC 450 Contingent Liabilities**

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<th>Reasonable estimate of potential loss</th>
<th>No reasonable est. of potential loss</th>
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<td>Probable</td>
<td><strong>Accrue contingent obligation</strong> and disclose if necessary to avoid misleading F/S</td>
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<td>Reasonably possible</td>
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<td><strong>Disclose contingent obligation</strong> and est'd range of potential loss</td>
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<td>Remote</td>
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ASC 740-10 vs. ASC 450 Tax Contingencies

• Under ASC 450 (FAS 5), the focus is on the amount of the potential obligation on settlement; Detection risk is considered
  – Under ASC 450, you could have a tax position with a 1 in 3 chance of success – and recognize a liability for 2/3 (66%)

• Under ASC 740-10, focus is on the sustainability of the underlying position based solely on the technical merits
  – Tax position could be less than MLTN for the recognition step and none of the benefit would be recognized

• For positions with a 40% to 60+% chance of success, more likely to end up with an Unrecognized Tax Benefit when applying the ASC 740-10 criteria than the Contingencies criteria
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Common ASC 740-10 Issues

- Nexus determinations
- Unitary/Combined/Consolidated versus separate reporting positions
- Local income/franchise taxes (Don't forget about it!!!)
- Revenue apportionment sourcing methodology
- Reportable transaction penalties/Post-Amnesty Penalties
- Review of intercompany transactions and restructuring; add-back of related party expenses (see MTC ALAS program discussion)
- State statutes of limitations often vary from the respective federal statute
- Reporting of Federal RAR’s/amended returns to states – consider prior periods
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State Income Tax Nexus Considerations

• Knowing the business of the taxpayer (the facts will likely determine any outcome); legal structure and facts can change from year to year

• Public Law 86-272 and the U.S. Supreme Court nexus standard in *Complete Auto Transit*

• State nexus standards – economic, affiliate, agency, independent contractor, **BRIGHT-LINE** (Michigan and Ohio), de minimis (just kidding), etc.

• Consider state law and rules; and state nexus questionnaires

• VDAs and Amnesties; discovery look back periods vary by jurisdiction
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State Income Tax Combined Reporting Issues

- Unitary combined filing groups
  - Special purpose entities
  - Worldwide reporting (California)
  - Unitary questionnaires are tools
  - Instant unity and unity in final period
- Elimination of intercompany transactions will vary based on filing method (80% or 50%)
- Consolidated return adjustments and unitary returns
- Unitary controversies are resource hogs! (worse than nexus controversies)
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State-Federal Tax Base Differences

- Federal conformity (line 28 or line 30)
- Business vs. non-business income
- State based transfer pricing
- Related member expense adjustments (royalty, interest, management fees)
- Bonus Depreciation/Federal Repair Regs/DPAD (Sec. 199)
- Foreign source income and subpart F
- Dividend received deductions
- Net Operating Loss differences
- Treatment of partnership income
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State Income Tax Apportionment

- Factor weighting
- Right to apportion statutes
- Throwback sales and Throw out sales
- Revenue streams included in apportionment
  - gross vs. net
- Apportionment of service revenue
- Sourcing of intangible revenue and sales of intangibles
- Corporate partner flow through of partnership factors
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State Income Tax Allocation/Direct Accounting

• Direct accounting or specific allocation of income from oil and gas producing and related activities
  – e.g., Louisiana, Mississippi, Oklahoma
• In lieu of standard apportionment of income
• Can have an overall loss but in-state income (and vice-versa)
• A taxpayer may have allocable income (i.e., oil and gas) and apportionable income (e.g., transportation or processing)
• Identification of direct costs
• Indirect cost allocation (e.g., G&A and interest expenses)
  – by formula or by cause-and-effect?
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State Income Tax Allocation/Direct Accounting

- Allocation may yield widely-varying tax bases by state
- Consider deferred state income tax accounting methods
  - Federal/state piggyback rate method may not work
  - Ask yourself – "What is the ETR if I sell the properties tomorrow?"
- Is commodity hedging income/loss direct? If not, what is it?
- Is property disposition income direct or indirect?
  - cf sale of an entity; IRC Sec. 338(h)(10) sale – which is it?
  - Sale of a disregarded Limited Liability Company?
- A note on unity of geographically distinct Oil and Gas operations
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Agenda

• Tax accounting basics
• Uncertain tax positions and tax contingencies
• **State Technical Updates**
• Tax accounting authority updates
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Tax Legislative Updates

The effect of legislative changes must be recorded in the period the legislation is enacted or

• You might have an out-of-period adjustment or

• If big enough – the “R” word….restatement

“Legislative” changes include both “Administrative” or “Judicial” changes

• These are tough to keep up with because we need multiple sources of information. More on this later…
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Importance of tracking state tax law changes

- Legislative changes will impact all areas of the tax provision
  - Current tax calculation
  - Deferred tax calculation
  - Effective tax rate
  - Provision-to-accrual adjustments
  - Uncertain tax positions
  - Potential for "netting" consequences
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Market-based sourcing developments

• Several states have recently enacted legislation to adopt or allow taxpayers to elect market-based sourcing
  – Alabama, Arizona, California, Nebraska
• A change to market-based sourcing has important ramifications for tax accounting
• Tax provision implications of a change:
  – Impact on existing tax deferred items. Income statement adjustment may occur as a result
  – Exposure for uncertain tax positions may increase in destination states that used to be cost of performance
  – Ability to collect the correct data from existing systems
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Net operating losses

- State Laws governing NOLs are a patchwork of traps for the unwary
  - e.g., Pennsylvania NOL limitation of greater of $5 million or 30% of taxable income (72 Pa. Cons. Stat. §7401(3)(4)(c)(1))
- NOLs may not survive an acquisition – even a “tax-free” acquisition
  - See NOL limitations in Massachusetts, Montana, New Jersey, North Dakota, Tennessee, Texas and Utah
- Tax accounting for multistate NOLs is generally an opportunity with just a wee bit of a challenge
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Net operating losses

- IRC Sec. 382 limitations on utilization of NOLs
  - May also apply to “tax-free” acquisitions
  - Does IRC Sec. 382 apply in a given state?
  - Some states adopt the limitation (e.g., Alabama, California, Florida, Pennsylvania)
  - Some states do not adopt IRC Sec. 382 (e.g., Arkansas, North Dakota, Utah)
  - Some states impose a separate limitation (e.g., Idaho)
If IRC Sec. 382 is adopted, is the limitation subject to apportionment?

- States requiring apportionment of limitation – e.g., Alabama, Louisiana and Pennsylvania

- But see *AT&T Corporation v. Alabama Department of Revenue*, Alabama Department of Revenue, Administrative Law Division, No. 05-403, June 30, 2006.

- See also *Express Scripts, Inc. v. Commissioner of Revenue*, Minnesota Tax Court, No. 8272 R, August 20, 2012.
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Pass-Through Entity State Income Tax Issues

– Entity-level taxes (e.g., Ohio, Tennessee, Texas, Washington)
– Are these income taxes or non-income taxes?
– The determination, on a state-by-state basis impacts:
  • Tax accounting treatment
  • Deductibility or addback as an income tax
  • Credit for tax paid to another state
  • Sales apportionment throwback rule application
  • P.L. 86-272 protection
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Pass-Through Entity State Income Tax Issues

- Allocation of distributive share or apportionment (flow-through) of distributive share and apportionment factors
- State income tax withholding requirements
  - Most states exclude MLPs from tax withholding requirements
  - Information (partners and distributive share) reporting to state generally required of MLPs
  - Withholding on distributive share (most) or actual distributions (see California and Oklahoma)?
  - For tax accounting purposes, many state withholding and composite return taxes are non-income taxes to the pass-through entity (see FASB ASU 2009-06)
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Pass-Through Entity State Income Tax Issues

• State K-1’s – or deciphering *The Code of Hammurabi*
• Amount of state gain/loss from sale of PTE Ownership Interests
  • Does federal basis necessarily equal state basis?
  • IRC Sec. 708 technical terminations
• Sourcing of state gain/loss from sale of PTE Ownership Interests
• Sourcing of gain/loss from PTE capital transactions
  • The entity approach or the aggregate approach?
• Notes on unity and PTE reporting
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New Federal Partnership Audit Rules

- Multistate – Effect of partnership audit rules under the Bipartisan Budget Act of 2015
- Eff. for tax years beginning in 2018 and thereafter, tax related to partnership IRS audit adjustment assessed and collected at the partnership level
- Think state RAR reporting
- FIT deduction effect?
- Nonresident composite returns and withholding versus in-state residents?
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Multistate Tax Commission Activities

- Multistate – MTC three (3) Factor Apportionment Reporting (or not)
- in front of five (5) State Supreme Courts (and Legislatures)
  - California
  - Michigan
  - Minnesota
  - Oregon
  - Texas
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State Adoption of Federal SOL Provisions

• Oregon - *Hillenga v. Dept. of Rev.*
• Oregon Supreme Court
  – *It ain’t over ‘till it’s over*
• Reminds us of state adoption of FIT Statute of Limitations rules regarding NOLs
• Based upon *Phoenix Electronics v. United States* (1958)
• See also *Springfield St. Railway Co.* (1963) and Rev. Rul. 81-88
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Comments? Questions?
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Closing and THANK YOU!

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