MOSSADAMS

WHITE PAPER

# Comply with State Laws Using State-by-State Apportionment Schedules

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Determining the appropriate sales factor numerator and denominator requires navigating multiple, often contradictory state tax rules—especially for a taxpayer with several sources of revenue, complex operations, and a potentially global reach. The increasingly common practice of conducting business through pass-through entities (PTEs), such as limited liability companies (LLCs), adds another dimension to the analysis.

When a taxpayer disposes of its investment in a business contained in a PTE, either through selling the assets or selling the interest in the PTE, various state rules—either statutory or developed through case law—may apply. The taxpayer may need to analyze whether, and how, the transaction should be reflected in the sales factor and documented in the apportionment schedules.

Taxpayers should also consider new, potentially significant changes resulting from tax reform, commonly known as the Tax Cuts and Jobs Act (TCJA). One such addition is the new class of Subpart F Income, which is effective for tax years ending on December 31, 2017.

# APPORTIONMENT SCHEDULES BY STATE

Each state can have its own set of rules for apportionment—such as income from a PTE, income from dividends, and income realized on the disposition of a PTE. The rules affect not just the computation of a given state's numerator, but also whether the income should be reflected in the sales factor at all.

In order to document and support its apportionment positions, a taxpayer may have to build separate sales factor apportionment schedules for each state in which it does business—each schedule plotting a different path for the particular state laws.

As a strategy, state auditors often demand that businesses supply their multistate apportionment schedules during the audit. However, displaying the numerators and denominators on a single spreadsheet according to each state's rules is a multidimensional problem that's extremely cumbersome—if not impossible—to solve.

The following analysis will review the process of preparing sales factor apportionment schedules for operations transacted through PTEs, and transactions involving PTEs, through the rules of five specific states: California, Colorado, Idaho, New Mexico, and Oregon. The analysis will illustrate the need for several sales factor calculations that present the multistate numerators and denominators according to a specific set of rules.

# PASS-THROUGH ENTITY APPORTIONMENT CONSIDERATIONS: CURRENT OPERATIONS AND TRANSACTIONS

When the Internal Revenue Service (IRS) ruled that a Wyoming LLC could be taxed as a partnership rather than a corporate entity,[1] it opened the door to additional states authorizing LLC formation. Since that time, the share of taxable income earned by PTEs has markedly increased. A linear regression in one analytical model shows that corporations' share of taxable income decreased from 50% to 30% from 1993 to 2013.[2] This means taxpayers have managed compliance with state apportionment rules and their application to PTEs for some time.

## CURRENT OPERATIONS

Many tax departments have experience with preparing their sales factor numerators and denominators from ongoing operations conducted through a PTE. To do so, tax departments must answer the following questions.

*Does the state adopt federal entity classifications? Is a separate election required and, if so, has it been met?*

Tennessee, for example, will follow the classification for a single-member LLC owned by a corporation. However, a multimember LLC that's filing for federal purposes as a partnership will file as a separate entity and pay Tennessee tax on its apportioned business income separately from its members.[3]

*Does the state provide for inclusion of a PTE's income or loss at the partner level or partnership level?*

A taxpayer that's computing apportionment factor numerators and denominators must determine whether a state treats the PTE as a division of the taxpayer. If it does, the taxpayer's distributive shares of the PTE's apportionment factors—including property, payroll, and sales—will be included with the member entity's standalone factors. If it doesn't, the member may be required to include the results of the PTE's operations as an allocated item.

### Oregon & New Mexico Taxpayers

For example, Oregon requires a taxpayer to include its distributive shares of the PTE's Oregon sales and total sales in its own factor.[4] This is often referred to as determining the factor at the partner level.

Although this process is straightforward in theory, it's easy to forget the importance of having a corporate LLC member obtain apportionment information during compliance. This information is often omitted from the state K-1 and may not be readily available if the member isn't the tax matters partner.

On the other hand, New Mexico requires that the member's income include its distributive share of income from the PTE, apportioned to New Mexico using the factors of the PTE. This is often referred to as determining the factors at the partnership level. To provide additional motivation, New Mexico's laws state that if the entity fails to provide the business with adequate information, the member must treat its entire distributive share as apportioned to New Mexico.[5]

A taxpayer that owns a PTE operating in New Mexico and Oregon must include apportioned New Mexico income from the entity when preparing its New Mexico returns. It must also include its distributive share of pre-apportioned income and apportionment factors when preparing the Oregon return. In responding to audit requests, this taxpayer may find it simplest to prepare two multistate apportionment schedules: one reflecting the numerators and denominators computed using New Mexico rules and one reflecting Oregon rules.

### Unitary Considerations

Taxpayers should also address unitary considerations. While the term unitary is often used to analyze the operations of an enterprise with several legal entities, it's useful to consider that the unitary principle was originally developed in connection with valuing the property *as a unit* of a single legal entity and assigning a portion of the value to each state.[6] Applying an apportionment factor to a business operation presumes that the operation comprises one unitary trade or business.[7]

Several states make this distinction explicit. California, for example, instructs a taxpayer to first determine whether the partnership's activities and the taxpayer's activities "constitute a unitary business" before combining the factors.[8] Oregon regulations refer to combining factors of a PTE that's "part of the corporation's overall business operations."[9]

While other states may not include similar qualifications in their apportionment provisions, unitary principles still apply. A taxpayer would likely have to assume a significant burden of proof if the operations of a PTE are not unitary with the member or owner's business—especially if the business is a single-member LLC that's disregarded for federal tax purposes. However, the taxpayer may be able to defend separately allocating the PTE's results if the facts support the position.

## SELLING AN INVESTMENT

Selling an investment in a PTE adds another dimension to determining the appropriate apportionment formula. A member may sell a full or partial interest in an entity outright, or it may employ various transaction structures. However, the potential state tax consequences are less clear—taxpayers should analyze them to avoid unanticipated consequences.

For instance, a business that owns a single-member LLC may bring in additional partners in several different ways. Revenue Ruling 99-5 describes two situations, discussed below.

#### SITUATION ONE

An unrelated entity (Purchaser) buys 50% of the owner's (Seller) interest. Seller doesn't contribute any portion of the purchase price to the LLC, which continues to operate as a partnership with two members. In this situation, Purchaser is treated as purchasing a 50% interest in each of the LLC's assets, and Seller "recognizes gain or loss from the deemed sale of the 50% interest in each asset of the LLC" to Purchaser.[10]

#### SITUATION TWO

An unrelated entity (Purchaser) contributes funds to the LLC in exchange for an ownership interest in the LLC, owned by Seller. The LLC uses all of the contributed cash in its business and continues to operate as a partnership with two members. In this situation, Purchaser's "contribution is treated as a contribution to the partnership in exchange for an ownership interest in the partnership." The Seller "is treated as contributing all of the assets of the LLC to the partnership in exchange for a partnership interest."

#### TAKEAWAY

The distinction between these situations has important ramifications for state tax apportionment purposes. If the restructuring conforms to the facts described in situation one, the Seller is treated as receiving a distribution of assets from its single-member LLC and realizing a gain on the sale of these assets. The Seller will report the transaction on the appropriate sections of its federal tax return. A state that adopts the relevant federal code sections would also view the owner as receiving cash in exchange for assets of the business, rather than cash for the sale of an intangible investment interest.

This analysis will focus on sales that are treated for federal purposes as sales of assets, rather than sales of interests. When selling an interest, it's also very important to review specific state rules, as they can differ from rules for selling interests in entities that aren't PTEs.[11]

Colorado, Idaho, New Mexico, and Oregon, for instance, conform to federal entity classification law and to federal taxable income as the starting point for determining state apportionable income.[12] California also adopts the federal choice-of-entity rules.[13]

Although these five states would likely treat the Seller as receiving proceeds from the sale of business assets, a comparison of each state's rules reveals significant differences in how the transaction's results would be reflected in the sales factor numerator and denominator for each state—highlighting the importance of a full, multistate analysis in the year of a transaction.

### CONDUCTING A MULTISTATE ANALYSIS

When conducting the analysis, taxpayers should consider the following questions:[14]

- Does the state consider results from these transactions in the calculation of the sales factor?
- If so, does the state exclude receipts that are substantial and occasional?
- If so, does the state consider receipts from the sale of goodwill to be subject to the substantial and occasional exclusion?
- How does the state source the receipts?

## INCLUDING TRANSACTIONS WHEN CALCULATING THE SALES FACTOR: BASE RULES

Adopting the transaction's federal categorization as an asset sale doesn't mean the transaction is reflected in the sales factor. California, Colorado, Idaho, and New Mexico define sales as, "all gross receipts of the taxpayer not allocated," including the amounts received from the sale or exchange of property.[15] For years beginning before January 1, 2018, Oregon defines sales as, "total sales."[16]

These states seem to include gross receipts from an asset transaction, but a state's adoption of the Multistate Tax Commission (MTC) revisions to the definition of receipts could change this result. Article IV of the previous model law used an expansive definition of sales, similar to the definition of sales used by California, Colorado, Idaho, New Mexico, and Oregon. Sales were defined as, "all gross receipts of the taxpayer not allocated."[17] The MTC amended the model law in May 2014. Receipts are now only those amounts "received from transactions and activity in the regular course of the taxpayer's trade or business."[18]

The revisions also further restrict receipts from intangibles. Only receipts from certain listed types of intangible property are included in the factor. Property that's "rented, leased, or licensed,"[19] which constitutes a "contract right, government license, or similar intangible property that authorizes the holder" to perform certain actions, or that yields receipts "contingent on the productivity, use, or disposition of the property," may be included.[2]0 All other intangible receipts are to be excluded.[21]

The MTC finalized model regulations and implemented the revised model law in February 2017. If a state adopts the model law or regulation, in whole or in part, it's possible that receipts from an asset sale, if the sale isn't from "transactions and activity in the regular course" of the business, will be excluded from consideration in the factor—although the net gain or loss is included in apportionable income.

# INCLUDING TRANSACTIONS WHEN CALCULATING THE SALES FACTOR: EXCLUSION FOR SUBSTANTIAL RECEIPTS FROM OCCASIONAL SALES

Before the amendment, the states and the Model Compact Article IV (Compact) base rules required taxpayers to include the transaction in the sales factor. However, because large asset sales could distort the apportionment factor, the MTC provided an exclusion in these circumstances in Section IV.18.(c) of its regulations. Many states have either adopted these exclusions, modified them, or inserted their own provisions.

## CALIFORNIA

A California taxpayer must exclude gross receipts from occasional sales of property—defined as fixed assets or other property—from the sales factor if they're substantial. A sale is considered occasional if the transaction is outside of the taxpayer's normal course of business and occurs infrequently. A sale is substantial if excluding the proceeds would decrease the sales factor denominator by at least 5%. If the taxpayer is part of a unitary group, the standard is the denominator of the group.[22]

If the facts support it, a California taxpayer can overcome this apparent bright-line test by demonstrating that the transaction isn't occasional, or by demonstrating that applying the special rule excluding the receipts from the factor would distort California taxable income.

In *Appeal of Emmis Communications*, the California State Board of Equalization (BOE) found that the Franchise Tax Board's (FTB's) exclusion of over $930 million in receipts from the sales of 13 television stations from Emmis' sales factor denominator "would not fairly represent the extent of appellant's business activities in California," although the sales appeared to be infrequent.[23]

## NEW MEXICO, OREGON & IDAHO

New Mexico and Oregon also allow or require the exclusion of substantial receipts from "an incidental or occasional sale" of a fixed asset, although they don't provide a bright-line test such as California's.[24] Idaho doesn't have a specific exclusion.

## COLORADO

Colorado's treatment merits additional discussion as its regulations overlap and appear to conflict. What's clear is that Colorado has several tools for excluding receipts from transactions.

Colorado's general apportionment regulation states that in some cases, "certain gross receipts should be disregarded" so that the "apportionment formula will operate fairly."[25] The statutes direct the Department of Revenue (the Department) to "promulgate rules" for "certain industries where unusual factual situations produce inequitable results" and also allow a taxpayer to petition for, or the Department to require, alternative apportionment—including using "any other method" to determine a taxpayer's Colorado income.[26]

Colorado's associated regulation states that the statutes *permit a departure* from Colorado's apportionment provisions "only in limited and specific cases," and they are to be invoked only "where unusual fact situations (which ordinarily will be unique and nonrecurring) produce incongruous results."[27]

Further, the Department may provide apportionment rules for special industries and may also adjust Colorado income through the mechanism of Internal Revenue Code (IRC) Section 482.[28] This regulation also includes *special rules*, which include the exclusion for incidental or occasional sales.[29]

It's unclear whether a single incidental or occasional sale constitutes a limited, specific case, involving a unique and nonrecurring fact situation. The following recent private letter rulings provide some instructions.

### RULING ONE

In 2016, a corporate partner requested guidance regarding the computation of its apportionment factors, particularly whether it should include its gain from the sale of a partnership interest in its apportionment factor. The Department concluded that the transaction shouldn't be included in the apportionment factor because the inclusion would produce inequitable apportionment—citing both regulations as authority for its action.[30]

The Department found several specific facts relevant in its analysis, including the fact that the partnership didn't operate in Colorado, that it reported 100% of the gain in numerators where it did operate, and that the partner's commercial domicile was in Colorado. Including the transaction in the factor under Colorado's rules for determining the sales factor numerator would have resulted in increased income reported to Colorado. This means the Department's conclusion was favorable to the taxpayer.

RULING TWO

The Department considered another request in 2017. This taxpayer realized a gain on a sale of its PTE interest. The Department again applied alternative apportionment and found that the taxpayer shouldn't include the gain in its sales factor.[31] As the taxpayer was arguably domiciled in Colorado, this decision was favorable.

TAKEAWAY

Both examples are tempered by the fact that an unfavorable decision would have resulted in double apportionment. In the first situation, the gain would have been sourced to Colorado and other states. In the second situation, the gain would have been sourced to Colorado, but it would have been excluded from other states' denominators. Both situations would have resulted in the gain being effectively taxed more than once. If the outcome of a favorable decision would have resulted in nowhere income, it's possible the Department would have come to a different conclusion.

A taxpayer recognizing receipts or gains from such transactions should be prepared to support its position for either including or excluding the receipts—and may be well—advised to request a private letter ruling.

# ANALYSIS OF THE EXCLUSION OF SUBSTANTIAL RECEIPTS FROM OCCASIONAL SALES: TREATMENT OF GOODWILL AND OTHER INTANGIBLE ASSETS

Many PTE asset sales include value attributable to goodwill and other intangibles, such as workforce in place, customer relationships, and developed technology. In fact, the value of an intangible often exceeds the fixed assets' value.

Article IV and several states refer to excluding substantial receipts from occasional sales as receipts from the sale of a fixed asset. While goodwill and other intangibles would seem to fall outside the scope of this exclusion, both the MTC regulations and state interpretations address these assets by including them within the definition of assets—either by regulation or case law.

## INTANGIBLES ACCORDING TO MTC REGULATION IV.18.(C)(3)

MTC Regulation IV.18.(c)(3) discusses intangibles in the context of income-producing activities. Before its current amendment, the regulation assigned income to state numerators based on where the taxpayer conducted the activities that generated income—known as the income-producing activities. Receipts, other than those from the sale of tangible personal property, were assigned to the state in which the taxpayer conducted the income-producing activity.

If the taxpayer performed the activity in more than one state, the receipts were assigned to the state in which the greater portion of the activity was performed, measured by the costs to perform that activity.[32] The term income-producing activity includes the "sale, licensing, or other use of intangible personal property," although the *mere holding* of intangible property "is not, *of itself*," an income-producing activity.[33]

If income from intangible property can't be tied to a particular income-producing activity, the taxpayer is, by definition, unable to assign it to any particular state numerator. In this case, the receipts are excluded from the factor altogether.[34]

If the taxpayer can identify a relevant income-producing activity, the receipts from the intangible should be included in the apportionment factor of a state that incorporates this model language, unless the state has barred its application in relevant litigation or through other guidance.

## THE PURPOSE OF AMENDMENTS TO COMPACT ARTICLE IV

The amendments to Compact Article IV serve to exclude sales of goodwill and similar intangible assets from the factor. States may also address these transactions in their own statutes, regulations, or through case law or other decisions.

# STATE SOURCING OF RECEIPTS

States' rules for the inclusion of proceeds from the sale of intangible assets in the sales factor are discussed below.

### CALIFORNIA

As noted above, California's exclusion for substantial receipts refers to "fixed asset(s) or other property" and specifies, among other items, patents and stock in affiliates.[35] The BOE has also addressed the exclusion of goodwill from the sales factor, most recently in *Matter of the Appeal of Imperial, Inc.* Imperial, a Wisconsin corporation with a valid Subchapter S election, entered into an acquisition agreement involving an IRC Section 338(h)(10) election.

The transaction yielded over $38 million in goodwill, which Imperial argued should be included in its California sales factor denominator.[36] The BOE found the receipts were excludable because they resulted from an "infrequent, occasional sale of property" and were otherwise so inseparable from overall business activities that there couldn't be any assignment of goodwill to any state's numerator.[37]

A taxpayer with facts indicating the sale wasn't occasional would presumably include goodwill in the apportionment factor. California's market sourcing regulations for transactions occurring in tax years beginning after December 31, 2010, provide specific guidance for sourcing these sales.

### COLORADO

As discussed above, Colorado's general sales factor regulation provides for the exclusion of gross receipts where necessary to ensure that the "apportionment formula will operate fairly." Specifically, the special rules require the exclusion of income from intangible property when it "cannot readily be attributed to any particular income-producing activity of the taxpayer, and such income cannot be assigned to the numerator of the sales factor for any state."38 However, if the income can be identified and assigned to a state, it's included in the factor.[39] If the transaction is included in the factor, net gains, rather than gross proceeds, are included.[40]

The standard for excluding receipts from the sale of an intangible turns on a taxpayer's inability to assign a receipt to a state numerator. This contrasts with the standard for excluding receipts from the sale of a fixed asset, which hinges on its characterization as (a) significant, and (b) incidental or occasional. If a transaction meets the description in Revenue Ruling 99-5. it could result in excluded receipts from fixed assets and included receipts from intangibles. Any inclusion of intangible receipts would still need to satisfy Regulation 39-22.303.5.4(a)(2)'s requirements for fair operation of the formula.

### IDAHO

Idaho also addresses receipts from intangibles, assigning receipts to numerators in accordance with the income-producing activity associated with the business income from the property.[41] Mirroring the MTC regulation before its amendment, receipts such as dividends, royalties, and interest resulting from the "mere holding of the intangible property," can't be linked to an income-producing activity and are excluded from the factor.[42]

### NEW MEXICO

New Mexico enshrined the MTC model laws, including Article IV, in its laws in 1978.[43] Subject to the constraints of MTC Regulation IV.18(c)(3), as stated on July 29, 2010, a taxpayer would recognize proceeds from the sale of intangibles—including goodwill—in its apportionment factor. If the business can identify the income-producing activity associated with the sale for the New Mexico apportionment schedule, it would reflect proceeds from the sale in the factor.[44]

This could lead to an incongruous result. If a business can support an income-producing activity occurring outside New Mexico with respect to the sale of the intangibles, its New Mexico denominator would include the proceeds, but its New Mexico numerator wouldn't—even if its distributable income from the PTE was fully allocable to New Mexico. Conversely, a New Mexico-based business could have a high numerator inclusion even if the PTE operated wholly outside New Mexico.

### OREGON

Through December 31, 2017, Oregon also uses the income-producing activity standard for assigning receipts from sales other than from tangible property.[45] Receipts that can't be associated with a particular income-producing activity are excluded from the factor, although Oregon acknowledges in a regulation that, "usually the income-producing activity can be readily identified" in transactions involving the sale of intangible personal property.[46]

If the receipts can be identified with an income-producing activity, an Oregon taxpayer must apply a cascading set of rules, as shown in the following examples:

EXAMPLE ONE

In 2000, the Department of Revenue lost its argument that a taxpayer improperly distorted its Oregon sales factor by including the receipts from treasury transactions.[47] This loss drove the Oregon Legislature to amend the apportionment statutes. The amendment, meant to address what the Legislature saw as the treasury function problem, introduced a two-prong analysis to the inclusion of intangibles receipts.

Under the revised statute, gross receipts from intangibles are excluded from the factor, "unless those receipts are derived from the taxpayer's primary business activity."[48] However, if the receipts are not derived from the taxpayer's primary business activity, the transaction isn't disregarded. Instead, net gains, rather than gross receipts, are included in the factor.[49]

EXAMPLE TWO

In 2013, the Oregon Supreme Court considered several facets of Oregon's laws and regulations regarding the inclusion of goodwill in the sales factor for an Oregon-based company. The state high court upheld a lower court's decision, but on different grounds. The court also identified a future avenue for argument that could lead to a different result.

The company, Tektronix, sold the assets of its printer division, realizing a substantial gain that was attributable to goodwill. Tektronix was an Oregon-domiciled entity, so inclusion of goodwill proceeds in the factor would have resulted in a higher Oregon numerator.

TAKEAWAY

A detailed discussion of the tax court and state high court decisions is beyond the scope of this analysis. However, they provide instructions for taxpayers with business operations in Oregon. Footnotes to the Oregon Supreme Court decision acknowledge Oregon's two-part test, but explain that the Oregon Department of Revenue abandoned its second line of argument—which might have included the net gain from the sales of intangibles in the factor—from the support for the adjustment.

The Oregon Department of Revenue may have been responding to this decision when it amended its regulations to include intangibles in the scope of the rules for incidental and occasional sales for tax years beginning on or after January 1, 2014, and before January 1, 2018. The amended regulation states that the treatment "for an incidental or occasional sale of a fixed asset used in the regular course of the taxpayer's trade or business applies to any intangible assets associated with that sale including, but not limited to, goodwill."[50] It's unclear whether this interpretation would apply for a sale that didn't involve substantial receipts from the sale of fixed assets—such as the sale of an entity involved in intangible activities.

A taxpayer that can document an income-producing activity associated with the sale of the intangible may have a strong position for including the net gain in the factor—which, for many intangibles, may equal the proceeds.

## CONCLUSION FOR INTANGIBLE ASSETS BY STATE

Aside from Oregon statutes applicable to 2018 and future tax years, each state's default rules allow for the inclusion of proceeds from the sale of intangible assets in the sales factor—provided the taxpayer can identify an income-producing activity, associate that activity with a location, and defend against a state's attempt to categorize the transaction as excludible under the substantial and occasional principle, or under other provisions that would allow it to modify the apportionment factor.

In theory, states may include these proceeds in the factor. In practice, though, states that have examined goodwill's inclusion have found that goodwill isn't attributable to an income-producing activity or that it's identified with the business as a whole and, therefore, can't be assigned to a numerator. In both cases, it's been excluded from the factor calculation.

# MARKET SOURCING AND THE REVISED MTC REGULATION

A business with a unitary PTE in California, Colorado, Idaho, New Mexico, and Oregon, and which also engages in a transaction involving the sale of the PTE that's treated as an asset sale, could be faced with preparing several sales factor apportionment schedules. The schedules should reflect the following elements:

- Combination of the PTE factors with its factors
- Assignment of income from the PTE
- Inclusion of gross proceeds from the sale of intangibles
- Sale of net gain from the sale of intangibles

If the transaction is included in the factor, the numerator must be assigned. Different states have different rules for assigning the numerator, and recent adoption of market-sourcing statutes, or the revised MTC regulation, can change the assignment.

## CALIFORNIA

California's market-sourcing regulations, amended January 1, 2017, provide specific guidance. California distinguishes between a license of intangible property rights and a sale of intangible property. Proceeds from the sale of intangible assets, other than sales of stock or interest or goodwill, are assigned to the California numerator to the extent the property is used in California at the time of sale.[51]

A business often owns several kinds of intangibles, such as technology, trademarks, and workforce-in-place. Documenting that these items weren't used in California would support a position that they shouldn't be assigned to California.

California provides specific guidance for sales of stock, ownership interests, and goodwill. For these intangibles, the location of the use of the property is determined by looking to the assets of the entity that was sold. If more than 50% of the assets are intangible property, proceeds are assigned to the business' numerator based on the sales factor of the underlying entity.[52] If real or tangible personal property constituted more than 50% of the sold entity's assets, the proceeds are assigned to the California numerator based on the average of the property and payroll factors of the sold entity.[53]

In other words, although California has mandated that most businesses use single sales factor since 2013, property and payroll factors may still play a key role in determining a sales numerator.

## COLORADO

On the other hand, Colorado assigns receipts from intangibles to Colorado if the taxpayer's commercial domicile is in Colorado.[54] Because this can result in significant factor dilution, a taxpayer may want to request a ruling that the transaction be included in the factor. This would be counter to the conclusions of the two Colorado private letter rulings addressing similar circumstances that were previously discussed.

## IDAHO, NEW MEXICO & OREGON

Idaho, New Mexico, and Oregon assign receipts—or gain, in Oregon's case—based on the location of the income-producing activity. This assumes that the transaction passes the tests for inclusion in the factor.

## ADDITIONAL CONSIDERATION

Parties to these transactions often agree on some deferred payment arrangements. Deferred payments can be created through meeting future operational goals, such as earn outs, or through the release of funds that were held back to cover contingent liabilities. Either way, the seller frequently opts to follow the federal default installment sale rules. It's important to review state rules to ensure they follow federal treatment, to determine sourcing, and to identify any events that would accelerate recognition of the installment sale gain—such as California's rules regarding entities that withdraw from the state.

# DIVIDENDS

The TCJA elevates the importance of analyzing state intangibles apportionment rules. Among other provisions, new IRC Section 965 will require the recognition of certain earnings and profits of controlled foreign corporations (CFCs) in the owner's Subpart F Income, coupled with deductions to reduce the effective tax rate on the income. The federal tax on this net income is often referred to as the transition tax.

### NEW GUIDANCE

The IRS has issued guidance for reporting these adjustments and computing the transition tax. At the time of this writing, the increase to income and the associated deduction won't be included in taxable income on page one of IRS Form 1120. Instead, both will be reported on a separate schedule, and the tax associated with the net adjustments will be incorporated in Form 1120, Schedule J.

If a state adopts provisions of the TCJA, or conforms to federal taxable income as determined by the IRC as amended by the TCJA, the taxpayer may have an increase to state income. Many states either allow favorable modifications to IRC Subpart F Income, or incorporate this income into their definitions of dividends eligible for a dividends-received deduction.

Even if a state doesn't adopt the provisions, paying taxes on deemed repatriation income may result in many US shareholders receiving the income as actual dividends, which could be included in state income subject to specific modifications.

As noted above, the adjustments required by IRC Section 965 may not be included in a corporation's Form 1120 taxable income, either before or after special deductions, but will be reported on a separate schedule. In contrast, partnerships and S corporations will report these amounts as other income and other deductions on Form 1065 and Form 1120S, Schedule K.

Regardless of the mechanism, it's important to recognize that the adjustments are still a component of taxable income as defined by IRC Section 63, which incorporates all gross income minus deductions allowed by IRC Chapter 1.[55] A state that defines taxable income with reference to IRC Section 63 may require the inclusion of the IRC Section 965 adjustments as a component of taxable income—even though they're not included in taxable income as presented on Form 1120, page one.

To complicate matters further, many state forms refer to specific lines on Form 1120, such as "Line 28" or "Line 30," and may be silent with respect to IRC Section 965 income inclusions and subtractions. It will be very important to carefully analyze a state's specific conformance with federal law, and identify any modifications the state may require for the adjustments subject to the federal transition tax.

In any event, taxpayers must analyze the state apportionment rules that will apply to the income if it's included in state apportionable income. Certain taxpayers may even have a 2017 Subpart F inclusion exceeding their gross margins from operations, making an early analysis even more important.[56]

### DETERMINING STATE APOPORTIONMENT RULES

First, a taxpayer needs to determine a particular state's adoption of the TCJA provisions. At this writing, many state legislatures are still considering the TCJA's impact on their taxpayers and their anticipated revenues.

Reviewing the TCJA through the current laws of California, Colorado, Idaho, New Mexico, and Oregon is still instructive and can assist in building a general framework for analysis and designing mitigation strategies. It can also help to identify the apportionment factor schedules that must be prepared to support the positions on the returns.

### CALIFORNIA

California's corporate tax law incorporates provisions of the IRC by reference. Currently, general conformity is to the IRC as of January 1, 2015.[57] An exception to the general conformity applies to taxpayers that have made a California water's-edge election. Taxpayers that have made the California water's-edge election, or that will report Subpart F Income from nonunitary foreign affiliates, must engage in a multipart calculation of income and factor inclusions, and dividend eliminations and subtractions.[58]

At the time of this writing, California laws don't incorporate IRC Section 965.[59] Assuming that IRC Section 965 adjustments won't be included in Form 1120 federal taxable income, a typical starting point for determining state apportionable income, California taxpayers may not have any modifications to report.

However, because these provisions remove the federal tax disincentive to receiving repatriated cash, the taxpayers in receipt of cash dividend payments from foreign payors may have dividend income to report on their California returns. Water's-edge filers may deduct 75% of these foreign dividends, which would leave 25% of the dividends included in apportionable income.[60]

California's market-sourcing rules provide guidance to taxpayers that receive dividends. Dividends are addressed in Regulation 25136-2(d)(1)(A)(1), which is the same section that discusses gross receipts from the sale of goodwill. Under the rules, gross receipts are assigned based on the California portion of the assets or sales of the entity sold, depending on whether at least 50% of the assets of the entity sold consist of real and tangible property.[61]

This introduces some ambiguity, as dividends aren't generally from an entity that has been sold. However, including dividends in the same section as goodwill indicates that the FTB intends to assign receipts from goodwill and dividends in the same manner as it would assign receipts from the sale of stock.

This contrasts with receipts from interest, which are assigned using different rules.[62] Dividends from CFCs included in California apportionable income would be included in the sales factor denominator and in the numerator only in the proportion of the CFC's California property and payroll or sales, if any.

The new regulation appears to give a taxpayer clear direction for sourcing these receipts. Because the receipts are now readily attributable to a numerator, if not to an income-producing activity, taxpayers may have a position for including dividends in the sales factor.

## COLORADO

Colorado defines the IRC as the Code as amended and in effect for the taxpayer's taxable year.[63] Net income of a C corporation refers to the C corporation's federal taxable income.[64] Without further action by the Colorado Legislature, the provisions of the TCJA are in effect.

Colorado allows taxpayers with foreign source income various subtractions from apportionable income.[65] There isn't an exclusion from the denominator for dividends or other foreign source income.

As a general rule, dividend income is assigned to the Colorado numerator if the taxpayer's commercial domicile is in Colorado.[66] However, no foreign source income is included in the Colorado numerator.[67] Regardless of a taxpayer's commercial domicile, any foreign source income included in Colorado apportionable income would be reflected in the denominator but not the Colorado numerator.

## IDAHO

Idaho refers to taxable income as determined under the IRC.[68] Idaho has conformed to the IRC as amended by the TCJA, so Idaho apportionable income will likely include any deemed repatriations under the TCJA.[69] Idaho considers Subpart F inclusions as dividends, and allows a deduction of 85% of foreign source dividends.[70] The subtraction is reduced to 80% for taxpayers that elect not to file a water's-edge spreadsheet. Dividends from foreign source income that are included in apportionable business income are included in the apportionment factor.[71]

Idaho's income-producing activity rules for assigning receipts also apply to intangible property. As the income-producing activity is determined with reference to activities engaged in by the taxpayer, dividends would presumably be assigned to the location where the taxpayer performed identified activities associated with managing the CFCs that are the source of the dividend.[72]

## NEW MEXICO

New Mexico conforms to the IRC as amended.[73] New Mexico qualifies its definition of income, defining base income as income upon which federal income tax is calculated for income tax purposes.[74] At the time of this writing, the federal transition tax appears to be separately calculated and separately stated from federal income tax. A taxpayer may have a position that the IRC Section 965 income isn't included in New Mexico base income for 2017.

If the taxpayer repatriates the cash, or if the adjustment is otherwise included in New Mexico income as a dividend, the impact to New Mexico tax varies depending on how the taxpayer elects to file its New Mexico return.

### MECHANISM ONE

A taxpayer that files as a separate corporate entity may deduct the same portion of its foreign source dividend that the IRC would allow if the payor were a domestic corporation. For instance, if IRC Section 243(a)(1) would allow a 70% deduction for a dividend received from a domestic payor, New Mexico would allow a 70% deduction for the foreign dividend.[75] Dividends included in apportionable income are subject to apportionment inclusion based on New Mexico's income-producing activity rules.

### MECHANISM TWO

A taxpayer that doesn't file a New Mexico separate return isn't allowed a dividend subtraction. However, New Mexico does allow limited factor relief under its statutes requiring equitable apportionment, computed using what is commonly known as the "Detroit formula."[76] Under this formula, developed by the Ford

Motor Company and the city of Detroit, Michigan, the parent entity increases its apportionment factor denominators by the dividend payor's denominators, multiplied by the percentage that the dividend received bears to the affiliate's net profits—not to exceed 100%.

A major weakness of this formula, particularly for 2017, is that it includes only the affiliate's current year apportionment factors, when the deemed repatriation may comprise several years' worth of earnings and profits.

## OREGON

Oregon currently conforms to the IRC as of December 31, 2017, including the deemed repatriation income, but adding back the federal deduction that reduces the federal effective tax rate as a modification.[77] Oregon defines taxable income as taxable income defined under IRC Chapter 1.[78]

For years beginning on or after January 1, 2018, Oregon has incorporated the MTC's definition of sales to restrict the sales factor to receipts from transactions and activity occurring in the regular course of the taxpayer's trade or business.[79] Oregon simultaneously broadens its definition of apportionable income to include any income apportionable under the US Constitution.[80] The new laws could be interpreted as including the foreign dividends in apportionable income, while excluding them from the factor as receipts from activity not occurring in the regular course.

Both changes are effective for tax years beginning on or after January 1, 2018, so Oregon's laws before amendment, which define sales as "all gross receipts not allocated" should apply to the Section 965 adjustments.[81] An Oregon regulation specifically includes dividends in the definition of gross receipts. The same regulation identifies 10 items that are generally excluded from gross receipts, such as tax refunds and pension reversions. Dividends are absent from the list.[82] Oregon statutes also provide that the apportionment factor denominator be reduced by any Oregon dividends-received deduction, which implies that dividends remaining in apportionable income should be included in the factor.[83]

As discussed above, for years beginning before January 1, 2018, Oregon uses the location of the income-producing activity to assign receipts to the Oregon numerator. If the taxpayer can identify an income-producing activity associated with the dividend, the dividends should be included in the Oregon denominator. Taxpayers subject to Oregon's tax haven rules may need to perform additional analysis.

### TAKEAWAY

To the extent the IRC Section 965 income is included in apportionable income, a taxpayer may have a supportable position that the income or some type of factor relief, such as New Mexico's employment of the Detroit formula, may be included in the apportionment factor. However, this limited factor relief may not be sufficient to achieve multistate apportioned income that fairly reflects the income from state business activity, whether it's determined using market sourcing or income-producing activity principles.

Including dividend receipts in the factor denominator could still lead to distortion because dividend receipts generally equal net income from dividends, while receipts from performing services or selling property are often the net income derived from these activities.

Taxpayers with significant deemed repatriation income or actual dividends that are including the income in apportionable income may want to consider requesting alternative apportionment. A modification of the Detroit formula could be a component of the relief requested. Because this formula generally refers to including only current-year factors of the affiliate, taxpayers could request an inclusion of factors from every year associated with the earnings and profits that generated the repatriation or dividend income.

Taxpayers in this situation must determine each state's procedures for requesting alternative apportionment. Taxpayers can also seek formal or informal rulings. The requirements and time constraints for requesting rulings vary significantly from state-to-state, so taxpayers should begin this process as soon as possible.

# CONCLUSION

Determining multistate apportionment numerators and denominators, particularly for the sales factor, is a multidimensional analysis. In order to support a position that all income under the combination of laws for any particular state is fully apportioned, taxpayers may need to prepare several apportionment workbooks to accommodate each combination of rules.

States are constantly refining and redefining their rules for sales, and they are assigning sales to apportionment factors through statute, regulation, ruling, and case law. Taxpayers with receipts from intangibles must review the rules, including carefully parsing the specifics of state conformance and IRS guidance for reporting. They must also identify opportunities to request special apportionment and possibly redesign apportionment schedules accordingly.

## LEARN MORE

For more information about how to navigate the complexity of state tax rules and comply with reporting requirements, contact your Moss Adams professional.

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3 Tenn. Code Ann. §67-4-2007(a).

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6 Adams Express Co. v. Ohio State Auditor,165 U.S. 194 (1897).

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11 See, e.g., Cal. Code Regs. tit. 18, §25136-2(d)(1); Idaho Admin Code r. 35.01.01.266.01.d.

12 Colo. Rev. Stat. §39-22-103(2); N.M. Stat. Ann. §7-2A-2.G (tax years beginning before Jan. 1, 2017) and N.M. Stat. Ann. §7-2A-2.H (tax years beginning on or after Jan. 1, 2017); and Or. Rev. Stat. §63.810.

13 Cal. Rev. & Tax. Code §23038(b)(2)(B)(iii).

14 As for any other significant asset sale, each state's law must be applied to the taxpayer's facts to determine whether the sale resulted in allocable or apportionable income. Since this is a factual determination, the analysis here assumes the result is apportionable income.

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36 Imperial originally reported the gain as nonbusiness income allocable to its domicile state. On audit Imperial argued that if the income was determined to be business income, it should be reflected in the sales factor.

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54 Colo. Rev. Stat. §39-22-303.5(4)(c)(V).

55 IRC Section 63(a).

56 While current year apportionment considerations are, of course, irrelevant for preparing the returns of a taxpayer that supports the position that the income is not apportionable income, they may be required for the taxpayer's ASC 740 analyses.

57 Cal. Rev. & Tax. Code §23051.5.

58 Any Subpart F Income from unitary foreign affiliates included in a California worldwide combined report, of course, will be fully eliminated.

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60 Cal. Rev. & Tax. Code §24411(a). Further eliminations are available if the dividends are paid from earnings and profits that California has previously taxed.

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