The Center for State and Local Taxation
Institute of Governmental Affairs
University of California, Davis

2017 Nexus and Public Law 86-272 Problems

1. A manufacturer of floor titles was incorporated in State Q and registered to do business in States K and Y. The company's manufacturing facilities are located in State J. Sales are made into States J, Y and L. No activities take place in any other state.

   a. Does the manufacturer have nexus in States Q, J, K, L, and Y?

2. An out-state-publisher utilizes the services of a State P printing company. Publisher owns a stock of printing paper at the State P printing plant. Employees of Publisher visit the State P plant several times a year to monitor quality.

   a. Does the publisher have nexus in State P?

3. Consignor Co. ships its products into State N on a consignment basis. Consignor Co. retains title to the consigned inventory until its customer disposes of the property. Consignor Co. has no other contacts with State N.

   a. Does Consignor Co. have nexus in State N?

   The consignment arrangement is treated as a conditional sale in which the title to the inventory vested in Consignor Co.'s customer along with the right to return the property to Consignor Co.

   b. Does Consignor Co. have nexus in State N?

4. Manufacturing Co (MC) is headquartered in State A and sells tangible personal property to retailers in states B, C and D. MC employs sales reps who frequently travel to retailer locations in states B, C and D to solicit the sale of MC's product.

   a. Does MC have nexus in states A, B, C and D?
   b. Does MC have Public Law protection in A, B, C and D?

The reps offer retailers financing alternatives offered by MC which reflect competitive interest rates. MC offers this financing in order to promote the sale of its product, not specifically as a separate profit center (although MC earns a profit on the financing it offers). Most retailers are already pre-approved by MC finance personnel in State A although sales reps may provide retailers with new or updated credit application forms and assist with transmitting such to the home office in State A for approval.

c. Does MC have nexus in states A, B, C and D?
d. Does MC have Public Law protection in A, B, C and D?

MC sells its receivables to a captive factoring company (FC) based in State A. FC has no employees and is managed by MC finance personnel in State A for an administrative service fee. FC issues asset backed securities (ABS) through an investment bank located in NY which are secured by the retailer receivables owned by FC. Funds so borrowed by FC are used to pay MC for the receivables FC purchases.

e. Does FC have nexus in states B, C and D?
f. Does FC have Public Law immunity in states B, C and D?

FC engages a third party collection agency (CA) in State E which engages in all collection related activities with delinquent retailers. In this way MC hopes to distance itself and its brand from any negative interactions with its retailers around the collection process. From time to time employees of CA may visit retailers to follow up on collection issues as well as to facilitate legal proceedings.

g. Does FC have nexus in states B, C and D as a result of collection agency activities in those states?
h. Could states which impose economic nexus standards assert that FC has nexus where FC owns receivables attributable to retailers in such states, regardless of in-state activities conducted by affiliates or third parties in such states?

5. Manufacturing Co (MC) is based in State A and sells products to retailers located in States B, C and D. MC delivers its products to its customers using its own fleet of trucks for which it does not separately charge a shipping fee.

    a. Does MC have nexus in States B, C and D as a result of its truck deliveries to retailers in such states?
    b. Does MC have public law protection in States B, C and D as a result of its truck deliveries to retailers in such states?
    c. Would this answer change if MC charged a shipping fee for this service?

On their return trips, trucks which deliver to State B, C and D will backhaul defective or other returned product in accordance with MC's warranty terms. In addition trucks which

deliver to State D will back haul unrelated products from third parties seeking to ship such products to State A for a transportation fee.

d. Does MC have nexus in these states as a result of back hauling defective and other returned products?

e. Does MC have nexus in State D as a result of back hauling third party product for a fee?

From time to time, MC's trucks will stop in State E en route to its customers in States B, C and D for refuelling, servicing and required truck inspections

f. Does MC have nexus in State E as a result of the refueling, servicing and inspection activities?

g. Would the answer change if several times per year trucks may require extensive repairs (engine rebuilds etc) by a third party repair shop with which MC has a long term service contract?

6. An out-of-state retailer, headquartered in State B has a web site that is hosted by an Internet Service Provider (ISP) located in State S. The ISP has servers in States S and F. The retailer is targeting customers throughout the U.S. and maintains a list of customers who purchased on-line by home address. It sends special offers to those customers.

a. Does the retailer have nexus in States S and F because of its relationship with the ISP?

b. Would your answer be different if the retailer owned or leased the servers at the ISP's location?

c. Does the retailer have nexus in any other states?

Suppose the retailer arranges with third parties to have them provide click-through access to the retailer's website. It pays the third parties a commission on sales resulting from the click-through contacts.

d. Does the use of third parties establish nexus over the retailer?

7. Manufacturing Co., headquartered in State Z, is considering entering into a business transaction with SoftCo, a software company located in State Q. In this transaction, the SoftCo will act as an Application Service Provider (ASP) to Manufacturing Co. Manufacturing Co. will have the ability to use SoftCo software, which is resident on SoftCo's server in State Q, by accessing it through the Internet or other remote means and Manufacturing Co's data will be stored on SoftCo servers. SoftCo will charge a monthly service fee to Manufacturing Co. for the use of the software, servers, and the services of SoftCo.

a. Will Manufacturing Co. have nexus in State Q because of relationship with SoftCo?

b. Would your answer be different if SoftCo classified the monthly fee as a software license?

8. Software Co (SC) is headquartered in State A and sells off-the-shelf canned software to retailers in States B, C and D. SC employs sales reps who visit retailers in these states to solicit the sale of its software product. SC's product licenses come with a one year maintenance agreement which provides the customer with bug fixes and patches as well as software updates. Customers may also purchase an extended maintenance agreement at the time the software is purchased from the retailer or subsequently order extended agreements and software via internet download. SC's sales reps explain these options to the retailers and leave promotional materials and displays with the retailers which include explanations of these options.

   a. Does SC have nexus in States B, C and D as a result of its sales solicitation activities, which include the promotion of its extended maintenance agreements and downloadable software options?

   SC contracts with a third party fulfillment house (FH) in State D which burns SC's software code onto CDs, packages and ships such products via common carrier to SC's retail customers. FH sends SC a monthly bill for costs incurred for raw materials, overhead and a profit mark up.

   b. Does SC have nexus in State D as a result of FH's fulfilment activities on SC's behalf?

9. A State W firm in the management consulting business which specializes in office design has contracted for two jobs: one in State Y and another in State Z. The State Y job requires a consultant to visit the client's existing office (which will be completely renovated) to take on-site measurements, apply for permits, etc. The consultant will be in State Y for only 2 days. All the work necessary to come up with the recommended layout (which will be sent by overnight common carrier to the client) will be performed in State W. The State Z job was subcontracted (fixed fee) to an ex-employee of the firm who now resides in State Z. His work was reviewed, slightly adjusted, and the recommendations were mailed to the State Z client from State W.

   a. Does the management consulting business have nexus in States Y and Z?

   b. Does the management consulting business have public law protection in States Y and Z?

10. Bank of Bucks (BB) is headquartered in State O. The bank operates a large credit card business out of its wholly owned subsidiary, CreditCard (CC), headquartered in state P. In order to get new customers, BB buys lists of new home buyers in States M, N, and O and sends the persons pre-approved credit card solicitations. If the persons solicited accept the offer, they mail back the pre-approved application to CC and a card is issued. The credit card can be used in any state or foreign country and is issued pursuant to a franchise agreement BB maintains with an internationally-franchised type of card (e.g., VISA, MasterCard, Discover, etc.). If the credit card holder defaults on payments, CC hires an independent debt collection agency to collect the debts. CC has employees and tangible property only in state P. CC generates card fees and interest charges totaling $1.5 billion a year from cardholders with addresses in M, N, and O. The average value of the credit card receivables for cardholders with addresses in states M, N and O is $8.5 billion.

    a. Can BB be taxed in states M, N, or P?

    b. Can CC be taxed in states M. N, or O?

11. FarmCo operates farms in States A and B. It sells its products through a subsidiary in States C and D. It enters into a licensing agreement with a third party to sell food products bearing its trademarked names in States E and F.

    a. Does FarmCo have nexus in States C and D?

    c. Does FarmCo have nexus in States E and F

12. TradeName with offices and employees only in State A licenses its trademarks and patents to company Store that operates retail stores in State B. It receives license fees of $200 million from Store for sales in State B. Is TradeName doijng business and subject to tax in State B?

The Center for State and Local Taxation
Institute of Governmental Affairs
University of California, Davis

2017 Wynne Problem

In Wynne the United States Supreme Court held that a Maryland's taxation of resident individuals that allowed a credit for taxes paid to income sourced to other states for the state income tax but not a county income tax and which included a special non-resident tax discriminated against Maryland residents.
What are the ramifications of this decision?

1. Does the state which is the source of income have the primary right to tax that income?

2. Must a state of residence provide a credit for taxes assessed by a state that was the source of the income?

3. What if two states treat a particular item of income as being sourced to their state? Who, if anyone, must give a credit?

4. In state corporate taxation some states allocate income of the sale of a business asset located in their state and do not include income on the sale of business assets in other states as apportionable. Other states treat the income from the sale of a business asset as apportionable. Does a credit have to be allowed where this results in the income from the sale of such an asset being subject to multiple taxation, 100% by the source state and the apportioned percentage by the other states?

5. Does the Commerce Clause apply to individuals?

6. Does the Commerce Clause protect residents from their own states?

The Center for State and Local Taxation
Institute of Governmental Affairs
University of California, Davis

2017 Unitary Business \ Business Income Problem
Meadwestvasco

Mead, headquartered in Ohio, is in the business of producing and selling paper products in a number of states. In 1968 Mead acquired Data Corporation which owned an inkjet printing technology and a data retrieval system which became Lexis. In 1994 Mead sold Lexis, a division for $1.5 billion dollars and a gain of $1 billion. In SEC filings until 1994 Mead described Nexis/Lexis as a business segment and described itself as being engaged in electronic publishing and developer of a leading electronic retrieval system.

Lexis, headquartered in Illinois, operates in a number of states

- Mead launched Lexis in 1973
- Mead made capital contributions to sustain it
- Stand alone profitability between 1988 and 1993
- Lexis contributed $800 million of the $3.8 billion income reported to Illinois and $680 million of $4.5 billion in expenses claimed in Illinois

Mead provided oversight, but not day-to-day management, consisting of

Approval of Business Plan	Capital expenditures
Financings	Mergers and acquisitions
Joint ventures	

Mead and Lexis had separate Departments/Functions for

Manufacturing	Sales	Distribution
Accounting	Legal	Human resources
Credit and collections	Purchasing	Marketing

There were no significant intercompany transactions, no requirement of purchasing from each other. Mead purchased some equipment it leased to Lexis. Mead managed Lexis' free cash through nightly cash sweeps to a Mead account

Lexis organizational structure within Mead changed several times - state tax motivated

Incorporated 1973	Divisionalized 1980
Reincorporated 1983	Divisionalized 1993

Mead and Lexis filed unitary 1988 through 1994 at state insistence

There were common officers and directors and several (3) instances of high level management transfers (not mentioned by Supreme Court)

1. **Are Mead and Lexis unitary in a combined reporting sense?**

2. **Is the gain realized on the sales of Lexis apportionable income to Mead?**

3. **Is the gain apportionable income to Lexis?**

4. **Would the gain have been apportionable by Mead if Lexis was a separately incorporated subsidiary and Mead had sold stock? What would have been included in a three-factor apportionment formula?**

5. **Would the gain have been apportionable by Lexis if it was separately incorporated and sold itself?**

The Center for State and Local Taxation
Institute of Governmental Affairs
University of California, Davis

2017 Unitary Business \ Business Income Problem

Unitary Business\Business Income

A, a corporation headquartered in state I, is a worldwide manufacturer of electrical distribution and control equipment and electronic materials, components, products and systems for industrial and construction markets. A sells its products to individuals, industrial companies, the construction industry, electrical utilities, government agencies, and other manufacturers.

H is a separate unrelated corporation that provides leveraged leasing opportunities to corporate clients to provide tax shelter.

A and H formed P as a joint venture. H was the initiator of the agreement, approaching A and proposing to A that it enter the joint venture in which A would own an 80 percent equity interest in P, and H would own a 20 percent equity interest. The P Group consisted of P and four 100 percent owned subsidiaries: One, Two, Three, and Four.

The P Group was incorporated in State D. It did not maintain any physical headquarters or offices anywhere and did not have any employees. The P Group's board of directors and officers consisted of directors, officers and employees of A and H. Each member of the P Group entered into tax-benefit leveraged leasing transactions involving the leasing of machinery, equipment and other property to parties unrelated to A of H. The properties were located in states other than I or D. (See attachment)

A's purpose in forming the P, were to "(a) reduce [A's] federal income tax liability, (b) increase available cash flow, and (c) generate pre-tax profit." 80 percent of the cost of the leased assets was financed by third-party lenders, and the remaining 20 percent of the equity investments was funded by A and H.

H provided P with data processing capability for analysis of lease transactions and for the associated accounting, recordkeeping, and tax reporting. P paid H for the services. H was responsible for finding suitable lessees and presenting the transactions to the JV. A had a right of refusal both of lessees and equipment.

An A inter-office memo it stated "[t]he additional workload for A would be minimal; no additional direct employees will be required, since H's experience and automated systems are designed to minimize the burden on the joint venture partners."

A received a tax savings of approximately $130,000,000 of federal income taxes from 1984 through 1990 by including the P group in its consolidated federal return.

Assets Covered By Leases

Lessor	Asset Leased	Location of Lease	Term of Lease
P	1 Boeing 727 Aircraft	Lessee Inc in State D, HQ in State N	14 years
P	2.22% of Nuclear Generation Station	Located in State A	27 years
P	1 Oil Carrier Vessel (Sold 5/91)	Port of P, State of P	20 years
P One	136 Metrorail Vehicles	State of F	8 years
P One	50% of HQ. Office Bldg. (Sold 1992)	State of T	25 years
P Two	1 Dual-Wire Former (papermaking machine)	State of M	15 years
P Three	33% of Power Bldg.	State of Q	25 years
P Four	167 Rail Cars	State of N	27 years

1. Is P unitary with A?

2. If P is unitary with A what of P's property, payroll and sales would be included in the apportionment formula of the combined report?

3. If P is not unitary with A, are the losses incurred by P business income to it?

4. Does A have nexus in each of the States A, D, F, I, N, P, Q and T?

The Center for State and Local Taxation
Institute of Governmental Affairs
University of California, Davis

2017 Business\Nonbusiness Problem

Oil Co, an intergraded petroleum company is always looking for additional oil and gas reserves. Additional reserves are added through the acquisition of producing leases, exploration rights and either the purchase of or merger with other oil companies. Oil Co. as part of its five-year budgeting plans has allocated approximately 25% of its projected cash flow of $5 billion to the acquisition of new reserves.

On an overall basis Oil Co's cash flow projections showed excess cash generated each year above and beyond budget expenditures of over $1 billion.

Oil Co determines that it should attempt to acquire Target, a publicly traded company. Target's operations are in a geographic area where Oil Co does not have a presence but where it would like a presence. Oil Co enters the public market early in December and begins to acquire shares. It spent approximately $1 billion dollars to purchase these shares. On December 15 Oil Co announces its intentions and made a formal tender offer for Target's shares and reached an agreement with Target's management to acquire the company.

Competitor, an unrelated integrated petroleum company not wishing to have Oil Co obtain a foothold in the geographic area where it is dominant makes a counter offer on December 18. Target's board determines that it would rather be acquired by Competitor since it will be allowed to remain in charge and recommends acceptance of Competitor's offer.

By January 15 it is clear to Oil Co that it will not be able acquire control over Target and it agrees to sell the shares it has acquired in Target to Competitor and realizes a 25% profit of $250 million. This is the first time that Oil Co has been unsuccessful it attempting to purchase another company. Oil Co was unaware that the management of Target supported Competitor's offer until after it had sold its Target shares to Competitor. Immediately subsequent to the Oil Co's sale of its Target shares to Competitor it is announced that Target has discovered an "elephant" field. In addition, war broke out in the middle East and the price of oil doubled.

Target's management had been aware of the new discovery and had shared this information with Competitor but not Oil Co. When Oil Co became aware of this fact it brought a lawsuit to recover damages from the loss business opportunity of expanding into a new market and of acquiring significant new reserves. Oil Co was successful in its lawsuit and was awarded damages of $10 billion. Competitor declared bankruptcy as a result of the award. Oil Co ultimately settled its claim against Competitor for $5 billion.

Questions:

1. Is the $250 million gain business income? What facts support business income treatment? What facts support nonbusiness income treatment?

2. Is the $5 billion settlement business income? What facts support business treatment? What facts support nonbusiness treatment?

The Center for State and Local Taxation
Institute of Governmental Affairs
University of California, Davis

2017 Sales of other than Tangible Property Problem

Traditional UDITPA sourced receipts from other than the sale of intangible property on the basis of income producing activity.

Recently states have moved to sourcing such sales on the basis of the market.

The taxpayer is in the business of selling canned software and providing information services through computer terminals and phone lines. The taxpayer has a central data bank located at its commercial domicile. It provides computer terminals to its customers, which they use to perform data research. The taxpayer has satellite offices with staff who provide assistance and training to customers in performing research. Calls are usually assigned to the closest satellite office but may be assigned to any available office. The taxpayer has a treasury department that routinely invests the taxpayer's excess cash.

The taxpayer receives the following kinds of receipts:

- Rents from the leasing of terminals
- Hook-up and search charges
- Receipts from the sale of canned software
- Licensing fees from original equipment manufacturers who install the software on computers that they manufacture.
- Receipts generated by the treasury department from the frequent sale of investments.

Identify the state where each receipt may be sourced under

a) An income producing activity regulation

b) A market based sourcing regulation.

The Center for State and Local Taxation
Institute of Governmental Affairs
University of California, Davis

2017 Market Sales Assignment

California assigns sales to the state where the benefit is received. The benefit is received in the state where the taxpayer's customer has either directly or indirectly received value from delivery from that service. In the case of a business entity the benefit is received 1) based upon the taxpayer's books and records if possible; 2) by reasonable approximation, if possible; 3) where the customer placed the order, and 4) the customer's billing address.

The MTC regulation assigns the sale to the state where it is delivered. Services are broken down between "in_person: services and other services including those delivered directly, electronically or on behalf of.

Taxpayer located in State A is asked by customer in State B for advice on the filing of a tax return in State C.

Taxpayer provides a memorandum to A of its filing obligations in state C. Where should the receipt be assigned under

a. California's rule

b. The MTC's rule

The customer has the taxpayer to bring an action in State C to contest its filing position. The material is prepared in State A, submitted to customer in State B for their review and filing by the customer in State C. Where should the receipt be assigned under

a. California's rule

b. The MTC's rule

The Center for State and Local Taxation

Institute of Governmental Affairs
University of California, Davis

2017 Section 18 Problems

1. Taxpayer S is commercially domiciled in State A. S has sales of tangible property of $100,000 in state B and total sales of tangible property of $200,000. S extends credit to make the sales and manages the credit operations in State A. S sells accounts receivables with a face value of $99,000 for $95,000 to a third party located in State C. S includes sales of $295,000 in the denominator of the sales factor in State B.

   a. Can the tax administrator in State B exclude the sales of the accounts receivables under the authority of section 18?

   b. What would the tax administrator have to demonstrate to show that such sales should be excluded?

2. Taxpayer C operates in both Mexico and California. During the year the Mexican peso was devalued by a factor of 100. The taxpayer requests permission under section 18 to restate its costs of goods sold using the currency exchange rate at the end of the year for purposes of calculating its income.

   a. Should the taxpayer be allowed relief under section 18?

3. The taxpayer is a mining company. It has an operating mine in State A that has a cost basis of $10,000,000 which has been fully depleted. Taxpayer acquires an operating mine in State B that has been closed because of environmental concerns. It pays $1 for the mine. Taxpayer is able to reopen the mine. State A has determined that the denominator of the property factor for the value of the two mines is the taxpayer's original cost of $10,000,001.

   a. Does the taxpayer have grounds for a section 18 petition?

   b. What arguments would you make in support of a section 18 variance?

   c. What arguments would you make in opposition to a section 18 variance

4. The taxpayer is engaged in providing payroll processing services to third parties. As part of the service the customers deposit the amounts withheld from their employees with the taxpayer. The taxpayer invests this money for its own account, making

payments to various government agencies as required. The taxpayer receives $2,000,000 in service fees and $200,000 in profits and generates $1,000,000 from the investment of the money it holds for the third parties all of which is profit. The money held is invested for short periods of time and the total amount received on maturity or from sales is $25,000,000. The taxpayer includes $27,000,000 in the denominator of the sales factor.

a. Has the taxpayer correctly calculated the amount of the sales factor under the standard UDITPA rules?

b. Can the tax administrator successfully invoke section 18 to reduce the denominator of the sales factor?

c. What standards must the tax administrator meet?

d. Assuming section 18 can be invoked what would be the sales factor denominator as adjusted?

5. The taxpayer manufactures cars in foreign country K. It decides to open a division to distribute cars in State C and two months before the end of its accounting period it enters into a lease for a yard to store cars and begins shipping them into the state. The taxpayer does not make any sales of cars in State C until the next accounting period. State C assets a tax on a combined report basis based on a property factor numerator computed on the amount of rent paid for the two months and the value of the inventory stored in yard.

a. Can the taxpayer petition for relief under section 18?

b. What relief would you seek?

c. What arguments would you make in support of the requested relief?

The Center for State and Local Taxation
Institute of Governmental Affairs
University of California, Davis

2017 Section 18 Problem - Multigrain

Multigrain purchases grain products and manufactures the grain into, flour, cereals and mixes for baking. It has grain elevators, mills and factories throughout the country and employs approximately 10,000 people. The price of grain typically fluctuates over the course of the year. It is not unusual for the price to vary 100%, between $3/bushel and $6/bushel. Multigrain needs an assured supply of grain over the course of the year. Multigrain is registered as a hedger with the various grain exchanges located throughout the country. To protect itself against variations in the market Multigrain hedges each of its transaction, either the purchase of grain or the sale of products made with grain, by entering into a futures contract. By doing so Multigrain is able to "lock in" the margin on its purchases or sales so they it is able to manage its profits.

A futures contract is an agreement that requires that a specific quantity of grain typically 5,000 bushels be delivered at the seat of the commodities exchange on a specified date. Multigrain covers, or offsets, virtually all of its futures contracts prior to having to make or take delivery. The gain or loss realized on each contract is accounted for in Mulitgrain's cost of goods sold.

Multigrain yearly enters into futures contracts that involve 400 billion bushels of grain. It uses 400 million bushels in its manufacturing processes. The futures activity is not entered into with the expectation of making a profit on the trades themselves, but for the purpose of locking in the margin on the underlying transaction. On an overall basis these trades result in overall gains or losses of up to $10,000,000 for any particular year. Multigrain typically earns $500 million a year from its business operations.

Multigrain employs a small staff, roughly 10, of commodities traders who conduct the futures activities. They are based in a single state. In making the trades the futures staff receives constant communication from Multigrain's field agents as to purchases of grains or contracts entered into for the delivery of product. The traders entered into contracts on a minute to minute basis to buy or sell grain to match the activities of the field agents. A futures contract to sell grain is automatically "offset" whenever a futures contract for delivery of the same amount on the same date is entered into by the traders. Such "offsets" can occur within a matter of minutes or may occur over the course of weeks or even months.

Multigrain, in a UDITPA state other than where the futures activities are conducted, seeks to include the futures contracts in the sales factor on the basis that such contracts are a gross receipt arising from the conduct of the unitary business and thereby meet the definition of sales for purposes of UDITPA.

What arguments can the tax administrator make to have the futures sales excluded from the sales factor?

The Center for State and Local Taxation
Institute of Governmental Affairs
University of California, Davis

2017 Section 18 Problem Megahard

Megahard is the premier developer of programs for computers. Its name is a household term and its programs are used by the majority of computer users. It markets its programs both directly to retail consumers and it also licenses the programs to the manufacturers of computers. The computer manufacturers install the programs on the computers they sell to their customers advertising that Megahard's operating system is installed on the computers. Megahard receives royalties on those sales. The purchaser of the computer signs a license with Megahard but pays no additional royalties.

Megahard has limited manufacturing facilities. Its employees are engaged in the development and marketing of software products. It contracts out the replication and distribution of its software.

Megahard has been extremely successful and has a large cash horde that it invests in short-term securities until the money is needed to finance the development of new programs or the acquisition of other companies in related businesses.

The gross receipts from the sales of short-term securities are 5 times the sales (receipts) it receives from the marketing of its software.

1. Megahard seeks to include the receipts from the sales of short-term securities in its sales factor in a state other than its home state. What arguments would you make in support of including the receipts and for excluding such receipts?

2. In addition, Megahard wishes to reflect its software products in the property factor of the apportionment formula. Where should these properties be assigned and what arguments would you make in support of the assignment?

3. Where would you assign the royalty payments received from the computer manufacturers to the sales factor and what arguments would you make in support of that assignment?

The Center for State and Local Taxation
Institute of Governmental Affairs
University of California, Davis

2017 Section 18

Intangible Holding Company (IHC) licenses its tradenames, trademarks, and patents to a retail store (Retail) in exchange for a 5% royalty on the sales made in each state. IHC has an office and employees in a single state. These employees take steps to protect its assets in the other states from its home offices and retains third parties to bring actions in other states. It has no tangible property or employees in any other state. IHC actively develops new trademarks and tradenames and patents various items.

IHC receives royalties from Retail in other states in the amount of several hundreds of million dollars in each state.

Under the standard UDITPA formula IHC only has apportionment factors in the state its office is located. One of the other states seeks to assess tax on IHC using Section 18 of UDITPA.

1. What arguments would you make to invoke Section 18?
2. What would be the apportionment formula would you seek to use?
3. Are there alternative apportionment formulas you might propose?
4. How would you compute a sales factor for the other state?

The Center for State and Local Taxation
Institute of Governmental Affairs
University of California, Davis

2017 Intercompany Transactions

Problem 1.

Facts: S holds land with a basis of $70 for use in the trade or business of the combined reporting group. On January 1 of Year 1, S sells the land to B for $100. B also holds the land for use in the trade or business of the combined reporting group. On July 1 of Year 3, B sells the land to Y for $110.

Definitions: S's sale of the land to B is an intercompany transaction. S's $30 gain from the sale to B is its intercompany item, and B's $10 gain from its sale to Y is its corresponding item. The total gain of $40 is the recomputed corresponding item.

Questions:

1. In what year would the income be reported?

2. What would be included in the property and sales factor for each year?

Problem 2.

Facts: On January 1 of Year 1, S buys property with a 10-year useful life for $100 and begins to depreciate it under the straightline method. On January 1 of Year 3, S sells the property to B for $130. B determines that the useful life of the property is 10 years from the date of B's acquisition, and also uses the straightline method. Both S and B used the property in their unitary trade or business.

Questions:

1. What is the amount of depreciation to be claimed for each year?

2. How much gain would be reported each year and by whom?

3. What would be included in the property factor and sales factor for each year?

Problem 3.

Facts: S holds land with a basis of $70 for use in the trade or business of the combined reporting group. On January 1 of Year 1, S sells the land to B for $100. B also holds the land for use in the trade or business of the combined reporting group. On July 1 of Year 3, B sells the land to Y in exchange for Y's $110 note. The note provides for 24 monthly interest payments beginning August 1 of Year 3, and for principal payments of $55 in Year 4 and $55 in Year 5. The California apportionment percentage for the combined reporting group was 10% in Year 3, 90% in Year 4, and 93% in Year 5.

Questions:

1. What apportionment percentages will be applied to the installment gain as it is realized?

2. What entity will report gain in what years?

3. What is the effect of the sales factor of the installment sale and the receipt of payments?

Problem 4.

Facts. S holds land with a basis of $70. On January 1 of Year 1, S sells the land to Y in exchange for Y's $100 note, and S reports its gain on the installment method under section 453 of the Internal Revenue Code. Y's note bears interest at a market rate of interest in excess of the applicable federal rate, and provides for principal payments of $50 in Year 5 and $50 in Year 6. On July 1 of Year 3, S sells Y's note to B for $100, resulting in a $30 gain from S's prior sale of the land to Y. Both S's and B's income would be considered business income under section 25120(a) of the Revenue and Taxation Code. The California apportionment percentage for the combined reporting group was 8% in Year 1, 15% in Year 3, and 90% in Years 5 and 6.

Questions:

1. What apportionment percentage will be used to assign the income from the installment note?

2. When will gain be reported and by whom?

3. What is the effect on the sales factor for each year?

Problem 5.

Facts: S is a driller of water wells. B operates a ranch and requires water to maintain its cattle. During Year 1, B pays S $100 to drill an artesian well on B's ranch, and S incurs $80 of expenses related to drilling the well. B capitalizes its $100 cost for the well, and takes into account $10 of depreciation deductions in each of Years 2 through 11. If S and B were divisions of a single corporation, the $80 costs incurred in drilling the well would be capitalized and the depreciation deduction would be $8 in each of Years 2 through 11.

Questions:

1. How will income and expense be reported for each year?

1. What effect will this transaction have on the property and sales factors for each year?

Problem 6.

Facts: B operates a ranch that requires grazing land for cattle. S owns land adjoining B's ranch. On January 1 of Year 1, S leases grazing rights for one year to B for $100.

Questions:

1. How would income and expenses be accounted for in a combined report?

12 What will be included in the property and sales factor for each entity?

Problem 7.

Facts: S owns land with a basis of $70, which it uses in the trade or business of the combined reporting group. On January 1 of Year 1, S sells the land to B for $100. B also uses the land for unitary business purposes. On July 1 of Year 3, P sells 60% of S's stock to Y and, as a result, S becomes a nonmember of the combined reporting group.

Questions:

1. When, if ever, is the gain reported on the sale?

2. What effect does this transaction have on the property and sales factors?

Problem 8.

Facts: S owns land with a basis of $70 which it holds for use in the trade or business of the combined reporting group. On January 1 of Year 1, S sells the land to B for $100. B also uses the land in its trade or business. On July 1 of Year 3, B converts the land to a nonbusiness use.

Questions:

1. When, if ever, is the gain reported?
2. What effect do these transactions have on the apportionment factors?

Problem 9

Deferred Intercompany Stock Account

Facts: Parent and Subsidiary are common member of a California combined report.

Year One: S makes a distribution to P for $200 million, an amount that exceeds S's earning and profits and that exceeds P's basis in S stock by $125 million.

Under IRC §301(c)(3), there is a gain of $125 million.

Year Two: S liquidates into P pursuant to IRC Section 332.

Question: Is there any gain recognized for California purposes in Year One and/or Year Two?