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Unitary Alert: California Court of Appeal Affirms that Shopping and Sitcoms Don't Go Together

The California Court of Appeal recently held that a cable service business, Comcast Corporation, and its majority-owned home shopping channel, QVC, should not be included in the same California combined report for California corporate income/franchise tax purposes.

The Case at a Glance

The court also ruled that a termination fee from an aborted merger was business income to Comcast. The appellate decision may temper the Franchise Tax Board's (FTB's) expansive view of unity in cases where combination benefits the state of California but also leads to increased audit risk when combination benefits the taxpayer.

California requires a taxpayer to apportion business income. Business income is generally defined as an item of income that is significantly related to a taxpayer's trade or business. In addition, California requires the combination of entities that meet statutory unitary requirements for purposes of computing California corporate income/franchise tax. Unity generally describes common characteristics between entities that justify combination of the entities' income and apportionment factors to accurately reflect the business activities in California. Absent the presence of unitary factors, California may not combine entities.

In *Comcon*, Comcast held a majority interest in QVC. While QVC paid Comcast to carry its programming, Comcast and QVC maintained separate headquarters, operated separate call centers and warehouses and retained separate departments responsible for the operations of their business. In addition, Comcast received a termination fee for an aborted merger with MediaOne. The trial court and appellate court found that the termination fee was business income due to Comcast's recurring mergers and acquisition activities. On the issue of unity, both courts held that despite the economic relationship between Comcast and QVC, the FTB was unable to show the presence of requisite unitary factors between Comcast and QVC because of the arm's-length relationship between the two companies. Due to a lack of unity, both courts barred the combination of Comcast and QVC for California income/franchise tax purposes.

Significance for Corporate Taxpayers

Corporate taxpayers that receive an extraordinary item of income related to mergers and acquisition activities may be required to apportion the income item to California. This requirement may be important for corporate taxpayers headquartered outside of California but conduct significant business activities in California because while a nonbusiness income item may be sourced to the taxpayer's headquarters, a business income item may be significantly apportioned to California.

In contrast, the *Comcon* decision on unity may provide corporate taxpayers (and the FTB) more latitude to analyze diverse business entities for purposes of determining the members of a combined report. The FTB has generally taken an expansive view of unity whereby any flow of value between commonly controlled corporations may be indicia of unity requiring combination. The appellate court decision dismissed several indicia of unity, including intercompany transactions, interrelated board members and certain common corporate functions, to find a lack of unity. The decision indicates that a unitary relationship requires more than a mere showing of some intercompany connection.

Takeaways for Taxpayers Now and in the Future

The FTB will likely appeal the decision given the tax dollars involved and precedent that the adverse unitary holding may set for the FTB. For now however, the Court of Appeal decision in *Comcon* may be relied on by taxpayers. While unity determinations are highly factual, taxpayers may reconsider facts similar to *Comcon* where de-combination may be advantageous. Taxpayers may also consider relative audit risk if de-combination is disadvantageous.

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IRS Launches Initial Compliance Campaign Objectives

IRS' issue-based approach to tax examinations could present new challenges to taxpayers.

The New State of Internal Revenue Service Tax Examinations

In 2016, the Large Business & International Division of IRS announced new compliance campaigns to comply with the Service's *Future State* initiative. The campaigns involve identifying income tax areas wherein IRS perceives significant levels of non-compliance among taxpayers, communicating such areas of non-compliance to the general public and targeting for audit specific groups of taxpayers that appear most likely to be non-compliant as to one or more of those specific areas. Through informational campaigns and the tax examination process, IRS looks to bring taxpayers into compliance as to the areas identified.

The following thirteen initial compliance campaigns represent the first step of the initiative:

- Related Party Transactions
- Tax-Free Repatriation of Property into the United States
- S Corporation Losses Claimed in Excess of Basis
- Energy Credit for Pre-Approved Projects
- Domestic Production Activities Deduction for the Film and Media Industries
- Deferred Variable Annuity Reserves & Life Insurance Reserves
- Land Developers Use of Completed Contract Method
- Offshore Voluntary Disclosure Program for Previously Declined or Withdrawn Taxpayers
- Form 1120-F Non-Filers
- Inbound Distributors and Transfer Pricing
- Micro-captive Insurance Contracts to Reduce Taxable Income
- TEFRA Linkage Plan Strategy
- *Basket Transactions* which Defer or Reclassify Income

More campaigns will be announced at an undisclosed time in the future. These campaigns will serve to fundamentally shift the tax examination approach of IRS from comprehensive, enterprise-wide examinations to issue-based examinations. In addition to the more narrowly-focused exams, compliance as to specific tax issues will also be encouraged through the use of *soft letters* encouraging voluntary correction of taxpayer oversights, the publishing of additional IRS guidance on the issues and the creation of new forms to assist taxpayers with calculations.

The remainder of this article will discuss the first three campaigns listed above. Articles in subsequent issues of *For the Record* will address the remaining campaigns.

Related Party Transactions

IRS is concerned that transactions between commonly controlled entities operating in the mid-market space have been used to shift corporate income from C corporations directly to stockholders or pass through entities, resulting in the avoidance of double taxation. Transactions that may receive scrutiny include compensation, rent, and other payments made to stockholders, partners, and family members; as well as sales and loan transactions among stockholders, partners, their families and controlled entities under terms that are inconsistent with those involving unrelated taxpayers. To mitigate potential tax exposures in this area, taxpayers should plan and document related party transactions on the same *arms-length* basis that would be employed in transactions with unrelated parties.

Tax-free Repatriation of Property into the United States

U.S. corporate taxpayers receive cash from their foreign affiliates through many avenues, including dividends, royalty payments, payments for services rendered, repayments of loans as to which the taxpayers are creditors, or borrowings under loans as to which the taxpayers are debtors. IRS is aware that some taxpayers are not reporting taxable repatriation events, so this campaign seeks to increase compliance in an increasingly complex reporting environment. The effects of this campaign may be altered or enhanced if legislative changes are enacted, such as a territorial-style system with a mandatory deemed repatriation tax.

S Corporation Losses Claimed in Excess of Basis

The income or losses of S corporations are reported to the shareholders, who then report that activity directly on their individual income tax returns. Losses reported to an S corporation shareholder may often offset taxable income that the shareholder receives from other sources, such as wages or portfolio income. However, a shareholder may not deduct S corporation losses that exceed the taxpayer's basis in the S corporation, and IRS is concerned that many S corporation shareholders do just that.

An S corporation shareholder has basis in his or her stock of the corporation, and also may have basis in loans that he or she makes to the corporation. Stock basis is *generally* calculated as (1) the shareholder's stock purchase price, plus (2) the shareholder's cumulative share of income items, minus (3) the shareholder's cumulative share of losses, and minus (4) distributions. Loan basis is *generally* calculated as (1) the face amount of the loan, minus (2) the shareholders net losses allocated against that loan after the shareholder's stock basis has been reduced to zero. Note that the forgoing sets forth the general provisions as to the determination of an S corporation shareholder's stock and loan basis; each calculation requires a strong understanding of both the specific shareholder fact pattern and the provisions of the tax law.

Taxpayers that have claimed S corporation losses in their tax returns should make certain they have adequate tax basis to do so. Taxpayers that have not claimed S corporation losses should nonetheless understand their tax basis in the event that losses may be claimed in the future. In addition, taxpayers also need to understand their tax basis to properly report distributions and loan repayments from the S corporation, or to properly report gain upon the sale of the S corporation stock. Partners in partnerships and members in Limited Liability Corporations should also be alerted that a similar campaign to target excess losses claimed by partners or LLC members would be a logical extension of the S corporation campaign.

Conclusion

The IRS shift from ongoing, comprehensive tax examinations to issue-based compliance campaigns will inevitably lead to uncertainty in the short term as IRS agents develop experience with the new process and the underlying tax issues. Taxpayers should take advantage of the public announcement of this focus area and confirm that they have not only appropriately addressed these areas in their tax return filings, but also maintain the required documentation. To the extent that corrections as to prior tax filings are in order, taxpayers should consider filing amended tax returns in advance of a potential IRS examination.

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Uncertain Tax Positions – Recent PATH Act Payroll Research Tax Credit Provides Opportunity and Complexity

Many startup companies are taking advantage of the PATH Act expansion of the federal research credit that allows qualified small businesses to designate up to $250,000 of the research tax credit as an offset to the employer's portion of OASDI (social security) payroll taxes. However, this opportunity presents unique challenges for companies evaluating uncertain tax positions under ASC 740-10 (formerly FIN 48).

Non-Income Taxes

The PATH Act opportunity to offset payroll taxes is a significant opportunity for startup companies that are not paying income taxes due to net operating losses. When preparing these companies' financial statements, it is important to note that payroll taxes are not based upon income, and therefore, the financial accounting for them is not governed by the tax accounting rules codified under ASC 740. The ASC 740 Master Glossary defines Income Tax as follows: *Domestic and foreign federal (national), state, and local (including franchise) taxes based on income*. In addition, it defines Taxable Income as the excess of taxable revenues over tax deductible expenses and exemptions for the year as defined by *the governmental taxing authority*. From these definitions, it is clear that the payroll tax would not be considered an income tax. Therefore, any payroll tax booked as well as any credit received against such a tax would be included in book income before income tax and considered *above the line* items.

Uncertain Tax Positions (Payroll Tax Credit Offsets up to $250,000)

Since payroll taxes are not covered under ASC 740, companies must look elsewhere for guidance on uncertain positions. ASC 450 (formerly FAS 5), which covers contingencies, provides the guidance necessary. ASC 450 defines a contingency as *an existing condition, situation, or set of circumstances involving uncertainty as to possible gain or loss to an enterprise that will ultimately be resolved when one or more future events occur or fail to occur*. In addition, ASC 450 describes two criteria that must be met in order to accrue a charge to income for the contingency:

1. Information available prior to issuance of the financial statements indicates that it is probable an asset has been impaired or a liability had been incurred at the date of the financial statements. It is implicit in this condition that it must be probable that one or more future events will occur confirming the fact of the loss.
2. The amount of loss can be reasonably estimated.

Based upon the above, an uncertain position related to the $250,000 payroll tax credit would require an analysis to determine the amount expected to be overturned, if any, upon audit. If an amount can be reasonably estimated it would be booked as a charge against gross income as a contingent liability.

Uncertain Tax Position (Amounts above the $250,000 Threshold)

While analyzing a company's research tax credit and payroll tax offset, a unique situation presents itself. Namely, what to do with the research credit amount above the $250,000 threshold? Since these amounts would be re-allocated back to a research tax credit offsetting income tax, an analysis of the uncertain tax position under ASC 740-10 is required in addition to an ASC 450 analysis. This results in the company applying two different accounting standards to its research tax credits. Below we will consider an example of a company with these circumstances.

Facts

1. Company qualifies for the $250,000 payroll tax credit
2. Company has $300,000 in research tax credits overall
3. Company has a net operating loss and will carry forward any credit not used as a payroll credit
4. After performing analyses under ASC 740-10 and ASC 450, the company believes it is probable that it will only receive 60% of the benefit.

What reserves should the company book?

Since the company is expecting a 40% reserve against the overall credit and can take the payroll tax credit in the current year (as opposed to the income tax credit, which will be carried forward due to NOLs), it would first apply this reduction to the income tax credit. This application would cause the remaining $50,000 ($300,000 less $250,000 refund) of research income tax credit carryforward to no longer meet the *more likely than not* threshold for recognition under ASC 740-10 and, therefore, the company cannot book an income tax benefit for any of the amount. Next, the remaining reserve would be allocated to the payroll tax. The amounts booked by the company would be as follows:

Overall reduction in credit = $120,000
Reserve under ASC 740-10 = $50,000
Contingent liability under ASC 450 = $70,000

Final Thoughts

It is important for companies to note the complexity around uncertain positions that involve the recently enacted PATH Act research payroll tax credit. The methods under ASC 740-10 and ASC 450 differ in how estimates are calculated as well as the disclosures required. A detailed review of the accounting standards is necessary for companies to ensure that the financial statements are presented accurately and adhere to the proper accounting standards.

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Tax Aspects of Franchise Ownership

There are many advantages to purchasing the rights to own and operate a franchised business.

Because the franchisor has already invested much of the effort associated with propelling a new business idea from concept to reality, the franchisee gets access on day one to trademarked and/or copyrighted branding and marketing materials, proven business methods and processes, training, as well as other advantages. On the other hand, these franchise benefits come at a cost in the form of upfront and ongoing payments to the franchisor.

The franchisee is generally obligated to make two types of payments to the franchisor: a franchise fee and a royalty. The franchise fee is usually paid in full upon entering into the agreement. The royalty is typically a periodic contingent payment calculated as a percentage of gross revenues. These costs, as well as other common upfront and continuing payments, are discussed below.

Initial and One-Time Costs

The upfront franchise fee is not immediately deductible for tax purposes because it relates to an intangible asset with a useful life that extends beyond the current year. Accordingly, the fee is amortized over 15 years. A franchisee will usually achieve better after-tax cash flows during the start-up and growth stages to the extent (s)he purchases a franchise with a relatively low franchise fee, even if the lower upfront charge is offset by proportionately larger royalty payments. The interplay of the long-term deductibility of the fee and the immediate deductibility of the royalty payments should be carefully modeled to understand the impact on after-tax cash flows.

In addition to the franchise fee, a franchisee often is required to purchase inventory, furniture, equipment, and fixtures from the franchisor, as well as to pay for up-front training fees. The franchisee can create larger initial tax deductions, which may help alleviate cash flow strains during the initial start-up phase, by negotiating a favorable allocation of these costs for tax purposes. This allocation is documented on IRS Form 8594.

Similar to the franchise fee, organizational and start-up costs (e.g., legal and consulting fees) must be amortized over 15 years, subject to an exception allowing an initial deduction of up to $5,000 of organizational costs and $5,000 of start-up costs. Costs incurred for depreciable assets such as tangible personal property and real estate may be recovered much more quickly than amortized expenses due to the Sec. 179 and accelerated depreciation deductions.

Recurring Costs

When payments are made in substantially equal or fixed amounts over the life of a franchise agreement, they can be deducted rather than capitalized if they qualify as *contingent serial payments*. Periodic payments contingent on sales of goods or services sold under the franchise (or some other variable measure of the franchise's financial performance) meet this test and are currently deductible. Contingent payments that fail to qualify as contingent serial payments must be capitalized into the basis of the franchise, which defers any tax benefit until later years. Accordingly, royalty payments under a typical franchise agreement and recurring operating costs are deductible in the year incurred.

It's important to note that a franchise agreement that provides for little or no franchise fees and, instead, casts all or most of the franchisee's payments to the franchisor as royalties, may be subject to IRS re-characterization to require a portion of the royalties to be capitalized instead of expensed.

State Tax Issues

Franchisees with business operations in multiple states should also consider the impact of sales and use taxes, taxes on net income or gross receipts, occupational taxes, and property taxes, among other state and local tax issues. Most states use a combination of factors that includes payroll, capital and sales to allocate tax to the business' entire net income. It may surprise some franchisees that the presence of capital in a state plays a role in the allocation of income to that state. To the extent a capital investment is made in a state, exposure to state income tax may increase without a corresponding increase in revenue.

Prior to initiating activities of any kind in a state, franchisees should consult with their tax advisor to quantify the likely impact on state taxes. While the overall economic benefits of expansion into a high-tax state often justify venturing in to a new jurisdiction, these decisions should be informed by thorough tax analysis to avoid unintended outcomes.

In Closing

Understanding the tax ramifications of investing in a franchised business is essential for maximizing the after-tax cash flows available. In some cases, the additional taxes paid due to a 15-year amortization of an expenditure (instead of an immediate deduction in full) may be the difference between success and failure of the venture.

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