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International Bank Tax Newsletter
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State Tax Update

A Summary of Recent State Tax Developments affecting the Banking Industry

By David Turzewski and Fred James,
KPMG LLP

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Tax Rates

Banks should consider the impact of the following rate changes on their current and deferred tax provisions:

Connecticut

The 20 percent corporate surtax is extended to tax years commencing prior to January 1, 2016. The surtax does not apply to taxpayers that pay the $250 minimum tax, or that have less than $100 million in gross income for the tax year. However, taxpayers filing unitary or combined returns are subject to the surtax regardless of income. HB 6704 (signed June 18, 2013).

Indiana

For tax years beginning on or after January 1, 2014 the Financial Institutions Tax (FIT) rate is 8.0 percent; for tax years beginning on or after January 1, 2015 the FIT rate is 7.5 percent; for tax years beginning on or after January 1, 2016 the FIT rate is 7.5 percent; and, for tax years beginning on or after January 1, 2017 the FIT rate is 6.5 percent. HB 1018 (signed Apr. 26, 2013).

New Mexico

For tax years beginning on or after January 1, 2014, the corporate income tax rate is reduced to 7.3 percent; for tax years beginning on or after January 1, 2015, the rate is reduced to 6.9 percent; for tax years beginning on or after January 1, 2016, the rate is reduced to 6.6 percent; for tax years beginning on or after January 1, 2017, the rate is reduced to 6.2 percent; and, for tax years beginning on or after January 1, 2018, the rate is further reduced to 5.9 percent. HB 641 (signed Apr. 4, 2013).

North Carolina

The current 6.9 percent corporate income tax rate will drop to 6.0 percent for tax years beginning on or after January 1, 2014. The rate is further reduced to 5.0 percent for tax years beginning on or after January 1, 2015. Additional one percent reductions will take place for tax years beginning on or after January 1, 2016, and January 1, 2017, if tax revenues collected in the 2014-2015 and 2015-2016 fiscal years exceed certain amounts. HB 998 (signed July 23, 2013).

West Virginia
Effective for tax periods beginning on or after January 1, 2014, the West Virginia corporate income tax rate will decrease from 7.0 percent to 6.5 percent as scheduled, due to the state's General Revenue Fund surplus meeting certain threshold amounts. West Virginia Tax Dep't Administrative Notice 2013-20 (Aug. 30, 2013).

Nexus

California
Bankruptcy-remote special purpose entities created for the purpose of bundling and selling securitized loans had substantial nexus with California. Although these entities lacked a physical presence in the state, nexus was established because of their deeply integrated relationships with in-state financing subsidiaries, as demonstrated by the interdependence and circular flow of funds among the entities. *Harley Davidson, Inc. v. Franchise Tax Board* (Cal. Super. Ct., San Diego County May 1, 2013).

Massachusetts
Applying the sham transaction doctrine, the Commissioner disregarded a number of transactions that, in its view, appeared to be undertaken solely to create nexus with Massachusetts so that a Canadian-based loss entity could be included in the Massachusetts combined group. *Allied Domecq Spirits and Wines USA, Inc. v. Comm'r of Revenue* (Mass. App. Tax Bd. May 22, 2013).

Oregon
A corporate excise exemption applicable to certain out-of-state financial institutions—extranational institutions, foreign associations, and out-of-state banks, as defined by Oregon law—conducting certain limited in-state activities (e.g., acquiring foreclosed property, holding mortgages secured by property in state) has been repealed. HB 3477 (signed July 21, 2013).

Tax Base

Indiana
A taxpayer's foreign sourced dividends could be deducted in computing its net operating loss carryovers. *Caterpillar, Inc. v. Indiana Dep't of State Revenue* (Ind. T.C. Mar. 28, 2013).

Massachusetts
Implementation of the FAS 109 deduction has been delayed until 2015. HB 3538 (signed July 12, 2013).

Oregon
Oregon's related party expense disallowance statute (Or. Rev. Stat. § 314.296) is repealed effective for tax years beginning on or after January 1, 2013. A retroactive exception applies when the recipient of the intangible income is a related foreign corporation and the transaction had a valid business purpose. HB 3069 (signed June 24, 2013).

Effective for tax years beginning on or after January 1, 2014, the income or loss and apportionment factors of any unitary group member incorporated in certain enumerated tax haven jurisdictions must be included in computing Oregon taxable income. HB 2460 (signed Aug. 1, 2013).

Apportionment

Massachusetts
A financial institution taxpayer that had no regular place of business within or without Massachusetts, but that had a Massachusetts address where its books and records were maintained, was required to include 100 percent of its loans in the Massachusetts property factor numerator because Massachusetts was the taxpayer's presumed commercial domicile. *First Marblehead Corp. v. Comm'r of Revenue* (Mass. App. Tax Bd. Apr. 17, 2013).

Effective for tax years beginning on or after January 1, 2014, receipts from the sale of a service will be attributed to Massachusetts to the extent the service is delivered to a location in Massachusetts. Receipts related to certain types of intangible property will be attributed to Massachusetts to the extent the intangible property is used in Massachusetts. HB 3535 (veto overridden July 24, 2013).

For tax years beginning on or after January 1, 2014, if the location of sales of non-tangible property cannot be determined or approximated under the new market based sourcing rules, such sales will be excluded from the numerator and the denominator of the sales factor entirely. Additionally, sales other than sales of tangible personal property attributed to a state where the taxpayer is not taxable or sales where the location of the sales cannot be determined or reasonably approximated are excluded from the numerator and the denominator of the sales factor. HB 3535 (veto overridden July 24, 2013).

Minnesota
Effective for tax years beginning on or after December 31, 2012, all sales made by a unitary business into Minnesota must be included in determining the apportionment factors and net income of a member of the unitary business group subject to Minnesota tax (i.e., Minnesota has adopted the so-called *"Finnigan"* apportionment rule). HF 677 (signed May 23, 2013).

Effective for tax years beginning on or after December 31, 2012, apportionment factors of foreign organized entities (other than C Corporations), to the extent their income is included in the federal taxable income of a domestic entity, must be included in determining the Minnesota unitary group's apportionment factors. HF 677 (signed May 23, 2013).

New Jersey
For purposes of determining whether a taxpayer's receipts must be thrown out of the New Jersey sales factor, only one nexus standard—the economic nexus standard upheld in *Lanco*—applies. *Lorillard Licensing Co. v. Dir., Div. of Taxation* (N.J. T.C. Aug. 9, 2013).

Pennsylvania
Effective for tax years beginning on or after December 31, 2013, new market-based sourcing provisions apply. Service receipts will be attributed to Pennsylvania if the service is delivered to a location in Pennsylvania. If the service is delivered to a location in and outside Pennsylvania, the sale is attributed to Pennsylvania based on the percentage of total value delivered to a location in Pennsylvania. HB 465 (signed July. 9, 2013).

Filing Methodology

Massachusetts
A taxpayer that owned interests, directly or indirectly, in sixteen trusts that purchased and securitized student loan portfolios was in substantial competition with banks and financial institutions because the trusts earned almost all of their income from activities similar to those performed by banks. As such, the taxpayer was considered a financial institution subject to the Financial Institution Excise Tax. *First Marblehead Corp. v. Comm'r of Revenue* (Mass. App. Tax Bd. Apr. 17, 2013).

Michigan
Taxpayers that file as financial institutions in Michigan must file amended returns to properly report eliminations and negative equity for entities included in a combined financial institution franchise tax return. For the 2008 through 2011 tax years under the Michigan Business Tax, and for the 2012 tax year under the Corporate Income Tax, the inability to separately present eliminations on the required annual returns results in incorrect computations of liability for some financial institutions. Beginning October 1, 2013, all affected taxpayers should file original or amended tax returns to properly report equity and eliminations for all affected tax years. *Michigan Department of Treasury Notice to Taxpayers Regarding Financial Institution Unitary Filing and Reporting of Eliminations for the MBT and CIT, September 30, 2013.*

North Dakota
The financial institution tax is repealed and affected entities are subject to the corporate income tax effective for tax years beginning on or after December 31, 2012. SB 2325 (signed May 6, 2013).

Pennsylvania
Effective for the calendar year beginning January 1, 2014, significant reforms apply to the bank shares tax, including, but not limited to, (1) new nexus rules, (2) an expanded definition of financial institution, (3) a revised base, (4) a new single receipts-factor apportionment formula, and (5) a rate reduction from 1.25 percent to 0.89 percent. HB 465 (signed July 9, 2013).

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Foreign Banks and the Conclusive Presumption Rules under Section 166

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Background

Banks may take a bad debt deduction under section 166(a)(1)[1] for any debt, including a security, which becomes worthless within the tax year.[2] In addition, banks may take a bad debt deduction under section 166(a)(2) for partially worthless debt in an amount not in excess of the part charged off within the tax year.

Establishing worthlessness for tax purposes can be difficult. Neither the Code nor the regulations provide a specific definition of worthlessness. The regulations provide, however, that whether a debt is worthless is a question of fact to be determined based on all pertinent facts and circumstances, and that key factors include the value of the collateral, if any, securing the debt and the financial condition of the debtor.[3] In this regard, courts have identified certain facts and circumstances that are relevant to the determination of worthlessness including a decline in the debtor's business, a decline in the value of property securing the debt, insolvency of the debtor, and bankruptcy or receivership actions of the creditor in pursuing collection.[4] Additionally, worthlessness is generally associated with identifiable events demonstrating the worthlessness of the debt and justifying the abandonment of hope of recovery.[5]

Banks, however, may avoid this difficult, fact-intensive inquiry for some of the debt they hold. Treas. Reg. section 1.166-2 includes two alternative rules that, if met, provide banks with a conclusive presumption that a debt is worthless.[6] The first rule provides that debt is conclusively presumed to be worthless to the extent it is charged off during the tax year if the bank (1) is specifically ordered by its supervisory authority to charge off the debt, or (2) charges off the debt in accordance with established policies of the bank's supervisory authority and such authority, in the first audit following the charge off, confirms in writing that it would have ordered the bank to charge off the debt had there been an examination at the time of the charge-off.[7]

Alternatively, a bank may make a "conformity election," in which case there may be a conclusive presumption of worthlessness based on the bank's internal loan review process and determination of worthlessness for regulatory purposes.[8] Subject to certain requirements, a bank that has made the conformity election obtains a conclusive presumption of worthlessness for debts charged off, in whole or in part, during the tax year if the charge-off (1) results from a specific order of the bank's supervisory authority, or (2) corresponds to the bank's classification of the debt, in whole or in part, as a loss asset under regulatory loss classification standards.[9] A debt is a loss asset if it is assigned to an asset class that corresponds to a loss asset classification under certain specified federal banking guidelines.[10] In order to make a valid conformity election, a bank must have received, in connection with the most recent examination of its loan review process, an express determination from the bank's supervisory authority that the bank maintains and applies loan loss classification standards that are consistent with the regulatory standards of that supervisory authority.[11]

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[1] Unless otherwise specified, all section references are to the Internal Revenue Code of 1986, as amended (the "Code") and the Treasury regulations promulgated thereunder.

[2] For non-banks and foreign banks, the deduction for worthlessness for debt instruments that are securities is governed by section 165. Section 165(g) and 166(e). For domestic banks, however, section 166 rather than section 165 applies to debt that is a security. Section 582(a) and 166(f)(2). A security is defined in section 165(g)(2) to include a bond, debenture, note, or certificate, or other evidence of indebtedness, issued by a corporation or by a government or political subdivision thereof, with interest coupons or in registered form.

[3] *See* Treas. Reg. section 1.166-2(a).

[4] *See, e.g.,* American Offshore, Inc. v. Commissioner, 97 T.C. 579 (1991); Bank of Kirksville, 943 F.Supp. 1191 (W.D. Mo. 1996).

[5] *See, e.g.,* Cole v. Commissioner, 871 F.2d 64, 67 (7th Cir. 1989).

[6] Until 1986, lenders in general could claim a bad debt deduction under section 166 using either the specific charge-off method or the reserve method. Under the specific charge-off method, a taxpayer computes a bad debt deduction on a loan-by-loan basis for debt that is determined to be uncollectible. The reserve method allows a taxpayer to deduct additions to a reserve amount that reflects the debt held by the taxpayer that is expected to become worthless. The Tax Reform Act of 1986 repealed the reserve method under section 166. Small banks may still use the reserve method under section 585; however, large banks must use the specific charge-off method.

[7] Treas. Reg. § 1.166-2(d)(1).

[8] Treas. Reg. § 1.166-2(d)(3).

[9] Treas. Reg. § 1.166-2(d)(3)(ii)(A)(1).

[10] Treas. Reg. § 1.166-2(d)(3)(ii)(C). The applicable guidelines are the standards set forth in the Uniform Agreement on the Classification of Assets and Appraisal of Securities Held by Banks and Thrifts, or similar guidance issued by one of the banking supervisors.

[11] Treas. Reg. § 1.166-2(d)(3)(iii)((D).

Notice 2013-35

On May 20, 2013, the IRS issued Notice 2013-35, which requests comments on whether changes to bank regulatory standards for loan charge-offs require changes to the conclusive presumption rules described above, and whether application of the current rules is still consistent with the principles of section 166.

Notice 2013-35 states that the conclusive presumption rules are intended to reflect a policy that when there is sufficient similarity between the standards a tax administrator uses to permit a deduction for a bad debt and the standards a regulator uses to identify a loan that should be charged off, in whole or in part, the tax administrator should accept the determination of the regulator for purposes of section 166. The standards and processes applied by a regulator must result in loan classifications that are similar enough to the criteria for worthlessness under section 166 to make regulatory criteria and examination by regulatory authorities an acceptable surrogate for independent investigation by the IRS. Although Treasury and the IRS believed that this similarity existed when the conclusive presumption rules were adopted, subsequent changes in the standards or processes that bank regulators use to determine worthlessness of a debt may have undermined the assumptions underlying the conclusive presumption rules.[12]

Thus, in light of changes in regulatory standards relevant to loan charge-offs, Treasury and the IRS are evaluating the conclusive presumption rules. Notice 2013-35 requests comments on the rules, including on (1) whether the conclusive presumption rules should be modified to reflect the changes in bank regulatory standards and processes since the adoption of the rules, (2) whether the current bank regulatory standards are sufficiently similar to the standard of worthlessness under section 166 such that they may appropriately be used in formulating revised conclusive presumption rules, (3) whether the current conclusive presumption rules should be replaced with a single rule, or if the regulations should retain more than one conclusive presumption of worthlessness, and (4) whether limits should be placed on the extent to which the timing of a deduction under section 166 may vary from the time when the regulatory standards mandate a charge-off.

KPMG Observations

Historically, foreign banks have not used the conclusive presumption rules described above to determine worthlessness under section 166. However, given the regulatory changes since the adoption of the conclusive presumption rules and the Service's current evaluation of the conclusive presumption rules, there may be an opportunity in the future for foreign banks to use revised conclusive presumption rules under section 166.

[12] Since the adoption of the conclusive presumption rules, there have been a number of significant changes to the regulatory standards for loan charge-offs. For example, in 2004, bank regulators adopted the 2004 Uniform Agreement on the Classification of Assets and Appraisal of Securities Held by Banks and Thrifts, rescinding the prior 1991 agreement in place when the conclusive presumption rules were adopted. The 2004 standards classify applicable debt securities by relying on FASB pronouncements.

The Empire (aka IRS) Strikes Again to Disallow Related Party Interest Deduction

By Angela W. Yu and Rowan Liu, KPMG LLP

In a recently released Chief Counsel Advice (CCA 201334037), the IRS disallowed current deductions for interest expense incurred by a domestic corporation ("Taxpayer") on debt owing to a related foreign lender under the provisions of §267(a)(3) and the regulations promulgated thereunder.[1] This issue is especially relevant to foreign banks with U.S. subsidiaries that benefit from deductions arising from interest payments made to a foreign related party.

The IRS, in recent years, has applied a number of different provisions to disallow or defer related party interest deductions for debt owing to a foreign affiliate including:

- Challenging the characterization of the instrument as debt (instead of equity) for U.S. tax purposes under §385 or substance over form principles;
- Denying all or a portion of the interest deduction under §482 principles;
- Denying treaty benefits to the recipient under either the conduit financing rules of Treas. Reg. §1.881-3, the anti-hybrid rules of §894(c), or common law principles; and
- Deferring interest deductions under the earning stripping rules of §163(j) or the cash method accounting rules under §267(a)(3) (or §163(e)(3) in the case of an original issue discount obligation).

Taxpayer in CAA 201334037 borrowed funds in the form of advances from its foreign parent ("Parent"). Taxpayer maintained a "general account" for all of its operating income and expenses; the interest payments at issue were drawn from such account. Parent advanced additional funds to Taxpayer (wire transferred into the same general account) shortly before or after each interest payment to cover the payments. These additional advances were either arranged under existing lines of credit or in exchange for unsecured notes ("New Notes") subordinated to Taxpayer's existing and future senior debts. Parent never transferred the New Notes to an unrelated party for value. The balance of the advances from Parent increased substantially during the tax years in issue.

The IRS identified three categories of interest payments subject to disallowance: (1) interest payments that were directly netted against new advances from Parent; (2) portions of new advances "earmarked" for interest payments on pre-existing debts; and (3) payments made close in time to new advances from Parent.[2] The IRS, citing case law, concluded that the three categories of interest payments were not actually paid because Taxpayer used funds advanced by Parent to make these payments (i.e., there was a "circular cash flow" between Parent and Taxpayer with respect to the interest payments).[3] The IRS acknowledged that "significant portions of [the] advances funded *bona fide* Taxpayer operating expenses." Taxpayer did not contend whether any of the interest payments were traceable to advances from third parties instead of from Parent. It is not clear whether a court would agree with the IRS's position if Taxpayer could demonstrate that the funds for the interest payments was traceable to other sources and, hence, did not constitute the type of "circular cash flow" contemplated by the cases cited.

It is clear, however, that the CCA stands for the proposition that the IRS is applying a heightened level of scrutiny to intercompany financing transactions. As with any dealings among related parties, the facts and circumstances surrounding an intercompany financing transaction must support the position that the parties are acting in accordance with the arm's-length standard. For example, it does not necessarily mean that payments of interest funded by borrowings from the same lender will automatically not be respected, just that taxpayers should structure the payments and borrowings in a way that prevents the IRS from linking one to the other.[4]

Proper documentation and structuring of intercompany financing transactions will improve taxpayers' chances of withstanding IRS challenges. In *NA General Partnership v. Commissioner*,[5] the tax court sustained the taxpayer's characterization of intercompany debt and allowed interest deductions paid on close to $5 billion of principal. The taxpayer's victory in that case depended, in large part, on contemporaneous documentation showing that (1) the debtor reasonably expected to generate sufficient cash flow to service the debt; (2) the terms of the debt was comparable to third party offerings; and (3) the parties substantially complied with the terms of the loan.

Regardless of the amount of the transaction, taxpayers that incur intercompany interest deductions should be prepared for the strong likelihood that the IRS will raise the issue upon an examination. With all the ammunition in the IRS's arsenal, those taxpayers who properly plan, document and implement cross-border debt instruments, like the taxpayer in *NA General Partnership*, will be in the best position to sustain their interest expense deductions.

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1 Treas. Reg. §1.267(a)-3(b)(1) requires a taxpayer to defer claiming an interest expense deduction for interest accruing on amounts owed to related foreign persons until such amounts are considered paid under the cash method of accounting.

2 Category 3 accounted for the bulk of the interest payments at issue.

3 The IRS also rejected the taxpayer's argument that the unsecured notes issued in exchange for the advances were cash equivalents, and thus, payments of interest. Generally, a promise to pay is cash equivalent if it is (1) issued by a solvent obligor, (2) unconditional and assignable, (3) not subject to set-offs, and (4) of a kind that is frequently transferred to lenders or investors without substantial discount. *Cowden v. Commissioner*, 289 F.2d 20 (5th Cir. 1961). The IRS found that the unsecured notes failed to meet the fourth requirement because they are not transferred or appear to be of a kind that is frequently transferred to lenders.

4 *See Menz v. Commissioner*, 80 T.C. 1174 (1983) (interest payments funded with advances from the lender receiving the payments were "paid" for purposes of cash accounting when the borrowed funds became commingled with other funds of the taxpayer and were subject to taxpayer's unrestricted control before being used for interest payments.)

5 TC Memo 2012-172 (2012).

Treaty and IGA Update

By Anthony Marsicovetere,
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As mentioned in our previous quarterly newsletter, a number of pending U.S. tax treaties and protocols to existing tax treaties have stalled with the U.S. Senate. In late 2011 Senator Rand Paul, R-Ky, placed a hold on Senate floor consideration of the pending Swiss and Luxembourg protocols as well as the pending treaty with Hungary. According to Tax Analysts, various sources stated Senator Paul placed this hold based on his objection to the treaty information sharing provisions contained in these agreements. These agreements contain updated information exchange provisions that implement the OECD standard on information exchange.

No new Intergovernmental Agreements(FATCA IGAs) were signed during the quarter. A number of countries continue to be in the process of negotiating their IGAs.

For decades, KPMG's International Bank Tax practice has been recognized for its presence in and commitment to working with foreign banking organizations. We have nine dedicated tax partners and directors who are supported by 30 managers and staff, in addition to specialists in transfer pricing, state and local tax, M&A tax, and other tax disciplines. We serve our clients locally and globally through our international network of member firms. The professionals in our International Bank Tax practice have the knowledge, experience, and skills to help our clients address their most pressing tax challenges, sort through today's complex business problems, and achieve their goals.

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