STATE INCOME TAX

Not So Fast: Relying on the Statute of Limitations in Combined Reporting Audits

Statutes of limitation can be an effective tool in protecting against unreasonable state tax audits because they provide a defined look-back period beyond which an assessment is automatically void. However, a statute of limitations may not always be as reliable as it seems. Recent decisions demonstrate a multi-state trend of state tax departments attempting to skirt the statute of limitations in combined reporting audits.

Charles Wakefield
Alston & Bird, LLP
New York, NY
Phone: (212) 210-1281
Email: charles.wakefield@alston.com

Zach Gladney
Alston & Bird, LLP
New York, NY
Phone: (212) 210-9423
Email: zach.gladney@alston.com

Article begins on page 9

SALES AND USE TAX

Streaming Can Be Taxing

States have inconsistently adapted to technology in order to maintain portions of their sales tax revenue. Historically, sales tax applied to the sale of tangible personal property ("TPP") which included rentals. When music that used to be sold on compact disc was phased out by MP3s, states and other taxing jurisdictions moved to maintain that revenue and created a new taxing category for "digital products." A new problem for tax agencies is streaming services such as Netflix or Spotify.

Lance Johnston, JD
Taxnologi Solutions, LLC
Greenwood Village, CO
Phone: (303) 955-5970
Email: ljohnston@taxnologi.com

Article begins on page 12

STATE INCOME TAX

Not So Fast: Relying on the Statute of Limitations in Combined Reporting Audits

Charles Wakefield
Alston & Bird, LLP
New York, NY
Phone: (212) 210-1281
Email: charles.wakefield@alston.com

Zach Gladney
Alston & Bird, LLP
New York, NY
Phone: (212) 210-9423
Email: zach.gladney@alston.com

The purpose behind a statute of limitations is to protect the taxpayer from stale claims and to promote diligence by the Department. Like the equitable doctrine of laches, statutes of limitations are "designed to promote justice by preventing surprises through the revival of claims that have been allowed to slumber until evidence has been lost, memories have faded, and witnesses have disappeared."[1]

Whether a group of related companies should be permitted or required to file tax returns on a combined basis is highly fact-driven, considering the purpose of each entity, the activities of management, their operational and administrative processes, their flows of funds, intercompany agreements, rights and uses of intellectual property, etc. Thus, deciding which entities are included and excluded from a combined return is often a detailed exercise involving voluminous documentary review, discussions with management, and an extensive understanding of how separate but related entities function during a specific moment in time. Because combined reporting is such a fact-sensitive inquiry, having a clear statute of limitations is more important in the combined reporting area than in virtually any other state income tax context. Yet, as we have seen in a number of states, the statute of limitations in the area of combined reporting is the least clear.

For example, In *Target Brands, Inc. v. Department of Revenue,* the Colorado Department of Revenue attempted to assess tax more than five years after the statute of limitations closed with respect to a subsidiary that was not included in the combined return of its parent corporation.

Target Brands, Inc. (TBI) did not file stand-alone income tax returns for 1999 through 2001. However, TBI was audited by the Department in 2003 as part of the Department's audit of "Target Corp. and Subsidiaries." TBI's existence had been disclosed in Target Corp.'s tax returns and its business activity had been accurately described in those returns. With full knowledge of TBI's income, payroll, and property, the Department determined that TBI was not doing business in Colorado and therefore owed no Colorado income tax for 1999-2001. The Department's auditor testified that "there was no indication that . . . [TBI] needed to file a Colorado return." Notwithstanding that finding, the Department reviewed TBI years later and assessed tax on grounds that it should have filed an income tax return in Colorado for the 1999 through 2001 tax years under an economic nexus theory based on its Target Corp.'s use of intellectual property owned by TBI.

"Because combined reporting is such a fact-sensitive inquiry, having a clear statute of limitations is more important in the combined reporting area than in virtually any other state income tax context. Yet, as we have seen in a number of states, the statute of limitations in the area of combined reporting is the least clear."

Under Colorado's tax code, the presumptive statute of limitations for the assessment of any tax, penalties, and interest is one year after the expiration of the time provided for assessing a deficiency in federal income tax. Since the standard limitations period for assessing a deficiency in federal income tax is three years, the presumptive limitations period for Colorado income tax purposes is four years.

Despite the fact that the Department had already looked at TBI during its prior combination audit of Target Corp., it took the position that TBI was not "the subject" of the audit and, therefore, the statute of limitations did not bar an assessment of tax. However, because TBI was indisputably disclosed in Target's 1999-2001 combined group tax return, the court found that the statute of limitations applied to the Department's assessment of TBI. The District Court framed its holding as based in equitable considerations:

1 *Telegraphers v. Railway Express Agency, Inc.*, 321 U.S. 342, 349 (1944).

Continued on page 10

> A statute of limitation is an almost indispensable element of fairness as well as of practical administration of an income tax policy. Taxpayers are entitled to finality with respect to their tax obligation—a fundamental tenet of fairness that would be severely undermined if the statute of limitations never closed even after a taxpayer is audited and a determination made by the Department that the taxpayer's non-filing status was appropriate. Such a result would leave a taxpayer like TBI indefinitely subject to taxation for years that were already audited, even where (as here) the taxpayer's non-filing status was approved by the Department. This is untenable, and runs afoul of the policies underlying the statute of limitations.

Similar to Colorado, other states' tax departments have attempted to circumvent the statute of limitations by making "adjustments" to net operating losses in years closed to assessment by the statute of limitations to deprive taxpayers of future year benefits. Because these so-called "adjustments" increase the taxable income of the taxpayer in years open to assessment, they have virtually the same effect as a tax assessment, and therefore should be subject to the same limitations. However, courts have not always been willing to take action to bar such efforts.

For example, in *SunGard Data Systems, Inc. v. Commissioner of Revenue*, No. 8461-R (Minn. Tax. Ct. 2015), the Minnesota Tax Court upheld the Commissioner or Revenues elimination of net operating losses in closed years based on a combined reporting "adjustment."

SunGard had timely filed Minnesota income tax returns for 2005 and 2006 on a separate-company basis. After the statute of limitations had closed for assessing tax for 2005 and 2006, the Commissioner conducted an audit of SunGard's 2007, 2008 and 2009 tax returns, which were also filed on a separate-company basis. As a result of the audit, the Commissioner assessed tax based on its conclusion that SunGard engaged in a unitary business with its subsidiaries for 2007 through 2009. Although the statute of limitations had expired, for 2005 and 2006, the Commissioner also "adjusted" the net operating loss that SunGard reported on its closed year returns based on the tenuous assertion that 2005 and 2006 could be "included in the unitization" based on a single statement made by an employee who no longer worked for the company. The Tax Court sustained the Department's adjustment, which substantially increased the amount of the tax assessed in the open tax years, because SunGard was unable to procure the testimony of the former employee or introduce evidence that the employee's statement was incorrect.

The Minnesota Tax Court's decision in *SunGard* is flawed because it ignores the fundamental premise of the statute of limitations. By allowing adjustments to taxable income in years closed to assessment, the taxpayer is at a significant disadvantage of having to prove its case without the ability to obtain the evidence necessary to do so due to the passage of time.

Case law in other states supports the conclusion that net operating losses from closed years may not be adjusted based on a legal determination that a company should have filed on a different basis during the closed years. In *General Electric Co. v. Arizona Department of Revenue*,[2] the Arizona State Board of Tax Appeals examined the case of a company that had filed Arizona income tax returns using the "separate accounting method." Under Arizona law, a company could choose from one of two methods of reporting its income, but was required to receive permission from the Arizona Department of Revenue to use the separate accounting method. The Arizona Department of Revenue performed an audit and determined that the company failed to get permission to use the separate accounting method, and instead should have reported its income using the "apportionment method." Based on its conclusion, the Arizona Department of Revenue issued assessments disallowing net operating loss carry-forwards from closed tax years by recalculating taxable income for those loss years using the "apportionment method" and concluding that the company had no net operating losses from those closed tax years. The Arizona State Board of Tax Appeals, however, ruled that the Arizona Department of Revenue could not recalculate net operating loss carry-forwards from closed tax years by applying a reporting method other than that used during the closed tax years, even when such carry-forwards were utilized in open years under audit. Later Arizona State Board of Tax Appeals case law has cited *General Electric* for the conclusion that the "[r]ecalculation of a [net operating loss] based upon retroactive changes in reporting methods is improper."[3]

General Electric demonstrates that the adjustments resulting from a change in an affiliated group's filing methodology are not mere computational corrections to the carryover deductions; instead, the analysis involved in determining if a taxpayer should file separate or combined returns in Minnesota is a highly fact-driven legal determination. Permitting adjustments to closed periods in this circumstance would force a taxpayer to fully litigate the

---

2 Dkt. No. 227-82-I, Ariz. Bd. of Tax Apps., 1983 Ariz. Tax LEXIS 22 (June 15, 1983).

3 *See, e.g., Walgreens v. Ariz. Dep't of Revenue*, Dkt. No. 484-86-I, Ariz. Bd. of Tax Apps., 1988 Ariz. Tax LEXIS 7 (Feb. 10, 1988).

Continued on page 11

underlying issue of whether a group of affiliated companies operated a unitary business during years that are time-barred by the statute of limitations as the only available recourse to challenge an auditor's assertions relating to those years. A taxpayer's ability to defend against such a legal determination is significantly diminished over the passage of time. The closing of the statute of limitations increases this difficulty as taxpayers rely on the limitations period when maintaining documentation required to defend legal positions taken on a return. The ability of an auditor to assess tax on the basis of such a legal assertion relating to closed tax years would permit the auditor to nullify the statute of limitations, rendering the limitations period meaningless in these circumstances.

When faced with a combined reporting audit, taxpayers should be aware that an auditor may not be content with strictly reviewing years that are open to assessment. Given the risk that a state may attempt to go beyond the statute of limitations to assess tax or make an "adjustment" that has the same effect as an assessment, companies should make sure to strategically retain the documentation necessary to establish the correctness of their filing positions, and assert arguments rooted in equity.