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## INTRODUCTIONS

### MEET THE TAX COMMITTEE MEMBERS

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101 Practice Series Articles
Call for Submissions

The ABA Young Lawyers Division – Taxation Section is currently accepting article submissions for its 101 Practice Series. As stated on the ABA website, the following provides more information on the 101 Practice Series itself and other requirements for submissions:

The 101 Practice Series is an online resource for new lawyers covering basic training in both substantive and practical aspects of law practice. With over 300 quick tips and tools, this series is an essential resource for lawyers in their first three years of practice and is exclusively available to ABA members. The 101 articles are specifically geared toward new lawyers. This is not a law review, scholarly journal, or magazine. The resource is designed to deliver specific, practical information in an easy-to-read format that maintains a professional presentation. The writing must be clear and concise, using common words and generally short sentences in short paragraphs to communicate practical information. When feasible, authors should write in the active voice and include tips, lists, bullet points, examples, good quotes, lively writing, and other techniques to facilitate the readers’ grasp of information. In general, the practice series follows the Chicago Manual of Style, 15th edition, and Webster’s 11th edition. Most articles are fewer than 300 words; the longest features are approximately 600 words. A completed single title author form must accompany all submissions.

Authors may write on any tax-related topic. While there is no set deadline for article submissions, articles are accepted on a rolling basis. We encourage writers to submit their

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ARTICLES

Treasury Releases Section 355 Proposed Regulations
By: M. Blair James

Section 355 of the Internal Revenue Code is an essential tool for restructuring corporations. While the U.S. federal income tax rules generally provide a corporate entity level tax and a shareholder level tax, section 355 permits tax-free corporate restructuring. A transaction qualifies under section 355 if certain statutory requirements are met, including a device prohibition and an active trade or business test.\(^1\) In addition to statutory requirements, the transaction must also meet certain regulatory requirements, including the business purpose test.\(^2\) To clarify the current device prohibition and active trade or business requirements, the Treasury released Proposed Regulations.\(^3\)

Under section 355 and the current regulations, a transaction cannot be principally used as a device for distribution of earnings and profits. While a transaction cannot be principally used as a device, the current regulations contain an all-facts-and-circumstances test.\(^4\) However, the current regulations do not provide specific guidance or thresholds regarding what constitute evidence of device, or non-device. To clarify the all-facts-and-circumstances test under the current regulations, the Proposed Regulations add a per se device test and modifies the nature and use of assets device factor.

The per se device test establishes a two-prong test which provides that a transaction is considered a device regardless of the presence of other non-device factors.\(^5\) The first prong is met when the nonbusiness asset percent of either the distributing or controlled corporation is 66 \(\frac{2}{3}\) percent or more of the total assets. The second prong is a sliding scale test. A transaction is considered a per se device if first prong is met and if:

- The nonbusiness asset percentage of one corporation is between \(66 \frac{2}{3}\) percent and 80 percent and the nonbusiness asset percentage of the other corporation is less than 30 percent;
- The nonbusiness asset percentage is between 80 percent, but less than 90 percent and the nonbusiness asset percentage of the other corporation is less than 40 percent; or
- The nonbusiness asset percentage is 90 percent or more and the nonbusiness asset percentage of the other corporation is less than 50 percent.

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\(^1\) I.R.C. § 355(a)(1)(B), (b)(2).

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When both prongs are met, a transaction is considered to have been principally used as a device; however, when one of the two prongs is not met, the transaction is evaluated under the all facts and circumstances test.

The Proposed Regulations also modify the nature and use device factors under the all facts and circumstances test. The Proposed Regulations provides two primary thresholds with regards to the ownership of nonbusiness assets. First, when the nonbusiness asset percentage of both the distributing and the controlled corporation is less than 20 percent, a transaction is not ordinarily evidence of device. Second, if difference between nonbusiness asset percentage of the distributing and controlled entity is less than 10 percent, then the difference is also not ordinarily evidence of device.

In addition to the modification of the device prohibition test, the transaction must show the distributing and controlled corporations are engaged in an active trade or business following the transaction. Under the current regulations, there is not a minimum absolute or relative size of business required to meet the active business. However, the Proposed Regulations require the distributing and controlled corporations have at least a five percent five year active business asset percentage.

The Proposed Regulations intend to clarify the current requirements under section 355 while clarifying the device prohibition and active trade or business test. When considering a potential restructuring under section 355, the Proposed Regulations and additional guidance released by the Internal Revenue Service should be considered.

The Basics of Multistate Apportionment

By: Angad Singh

Multistate apportionment is a critical aspect of state and local income taxation. Multistate apportionment allows business entities to determine how much of its earned income will be taxable to certain states. While each state uses a different formula to calculate its share of apportioned income, this article seeks to provide practitioners with a basic overview of the key concepts, terms, and formulas surrounding multistate apportionment.

However, before analyzing the rules regarding apportionment, it is important to understand the difference between allocation and apportionment. Allocation refers to state income tax treatment of so-called “nonbusiness” income, whereas apportionment refers to treatment of “business” income. Specifically, allocation generally refers to income that is outside of a company’s regular course of business. Such nonbusiness income is generally allocated 100 percent to the state where the income is generated, and thus is not subject to apportionment.
avoid income being labeled “business” income, which requires inclusion in the apportionment base of a company, the company must demonstrate that the income is unrelated to the activities of the business.8

Apportionment generally refers to income generated from a company’s regular course of trade or business. The notion of a company’s regular course of trade or business refers to the concept of the Unitary Business Principle (“UBP”). The UBP treats a business as one integrated business operating across multiple states. Generally, all income generated from the regular course of that business entity is considered apportionable across states that are related to the entity’s business activities conducted in those states. Similarly, all income that is derived from assets or investment used in that regular course of business is generally subjected to apportionment.

UBP is established based on either of the following two types of unity: enterprise unity and asset unity. Enterprise unity is generally dependent upon “functional integration, centralization of management, and economies of scale”9 of the business. However, asset unity is generally dependent upon whether a certain asset has an operational role in the operations of the company’s business.10 Once a company is considered a unitary business, a state can then apply its own apportionment formula towards the entity’s total income derived from that unitary business in order to determine what portion of the income amount is “reasonably related to activities conducted within the taxing state.”11 This resulting income amount will be taxable in that particular state.

The traditional apportionment formula is a three-factor apportionment based on payroll, property, and sales, in which each of the three factors is given equal value. Only a few select states currently use the traditional formula, such as Delaware, Hawaii, and Rhode Island. Many states have moved towards a single sales factor apportionment formula in which only the sales factor is considered in apportionment. The single sales factor formula is used by numerous states such as California, Georgia, Illinois, Michigan, New York, Pennsylvania, and Texas. Other states retain the three-factor formula, but give sales factor more weight than the other two factors. This enhanced sales factor formula is used in several states as well such as Arizona, Florida, Massachusetts, and Virginia.

To help illustrate how the formulas work, please see the sample calculations below. It is important to note that if states use different formulas, it is possible that the business taxpayer will pay tax on more than or less than 100 percent of its income (see examples 2 and 4 below).

Sample calculations:

Company X is a unitary business. Assume 50% of Company X’s property, 60% of its payroll, and 100% of its sales are in State A. We will also assume that 50% of Company X’s property, 40% of its payroll, and 0% of its sales are in State B.

1. Both State A and B use the traditional three-factor apportionment formula

10 Id. at 788-789.
State A = \((50+60+100)/3\) = 70% of Company X’s total income will be taxable in State A

State B = \((50+40+0)/3\) = 30% of Company X’s total income will be taxable in State B

2. State A uses an enhanced three-factor formula (in which sales is given double weight) and State B uses the traditional three-factor apportionment formula

State A = \((50+60+(100*2))/4\) = 77.5% of Company X’s total income will be taxable in State A

State B = \((50+40+0)/3\) = 30% of Company X’s total income will be taxable in State B

3. State A uses the single-sales factor apportionment formula and State B uses the single-sales factor apportionment formula.

State A = \(100/1\) = 100% of Company X’s total income will be taxable in State A

State B = \(0/1\) = 0% of Company X’s total income will be taxable in State B

4. State A uses traditional three-factor apportionment formula and State B uses the single sales factor apportionment formula

State A = \((50+60+100)/3\) = 70% of Company X’s total income will be taxable in State A

State B = \(0/1\) = 0% of Company X’s total income will be taxable in State B

It is crucial for practitioners to thoroughly research the formulas and key definitions used by the states involved in their client’s business before calculating the apportioned income amount due to certain unique intricacies present in certain states’ formulas. Understanding multistate apportionment can also be very helpful in providing tax planning guidance to taxpayer businesses looking to minimize their state taxes.

Angad Singh is an associate at Singh and Associates, LLP in Los Angeles, CA. Angad focuses his practice on partnership taxation, state and local taxation, and taxation issues related to real estate.

PAST EVENTS

- October 22 – we cosponsored a live program titled “LGBT Family Law Considerations and Practice Tips” at the ABA Fall Meeting in Detroit, MI.

EVENTS

- December 7-9, 2016 - 33rd Annual National Institute on Criminal Tax Fraud and the Sixth Annual National Institute on Tax Controversy in Las Vegas, Nevada. For more information, visit ABA website.
- January 19 – 21, 2017, Orlando, FL – Section of Taxation 2017 Midyear Meeting
- February 2 – 5, 2017, Miami, FL – YLD Events at the ABA midyear meeting
- May 4 – 6, 2017, Montreal, QC, Canada – YLD Spring Conference

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• August 10 – 13, 2017, New York, NY – ABA Annual Meeting

INITIATIVES

• Access to Education - The ABA YLD dedicates its resources to underserved and often overlooked communities. To combat the crisis of unequal access to education in these very populations, ABA YLD is investing in education through its 2016-2017 Access to Education public service project.

• What Do Lawyers Do? - Web-based tool and live programming for undergraduate students, particularly racial and ethnic minorities, that shares nuts and bolts information on the legal profession, steps to take to prepare for law school, and other ways to navigate your way to becoming an attorney.

• Young Lawyer Toolkit - Web-based resource center for young lawyers, regardless of practice area. The Toolkit includes five main categories: Diversity & Inclusion; Law Practice Management; Solo Practitioners; Litigation; and Transactional.