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EXTERNAL ALERT

District of Columbia Budget Mandates the D.C. Council to Implement Unitary Combined Reporting, Broadens the Related-Party Addback Statute, and Decouples from Federal Debt Discharge Deferral

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Overview

On December 18, 2009, Mayor Adrian Fenty signed the "Fiscal Year 2010 Budget Support Act of 2009" (the "Act"),[1] thereby making permanent the emergency legislation enacted previously by the Council of the District Of Columbia ("D.C. Council").[2] The Act became effective in the District of Columbia ("District") on March 2, 2010, following the required 30-day period for United States Congressional review. The Act includes a provision mandating that the D.C. Council amend the D.C. Code to enact required unitary combined reporting. Thus, the Act does not itself implement combined reporting. However, assuming that the D.C. Council amends the tax code as mandated, the combined reporting requirement would apply to tax years beginning after December 31, 2010.

The Act also broadens the District's related-party addback statute to include interest expense that is not attributable to intangibles.[3] This change applies retroactively to tax years beginning after December 31, 2008. Additionally, the new law decouples from Internal Revenue Code ("IRC") § 108(i) deferral treatment of qualified discharge of indebtedness income. Although the Act is silent regarding the effective date of this change, the 2009 District Corporate Franchise Tax form references decoupling from IRC § 108(i), thus suggesting a January 1, 2009 effective date.[4]

In the material that follows we summarize these provisions along with some of the other revisions contained in the Act, including excise tax and sales and use tax rate changes, and the authorization of an amnesty program.

Unitary Combined Reporting

The Act requires the D.C. Council to amend the D.C. Code to provide for mandatory combined reporting by certain unitary groups. The legislation does not specify how the unitary combined report would be determined or which entities would be included in the report as part of the unitary group. The Act states simply that "all corporations taxable in the District of Columbia shall determine the income apportionable or allocable to the District of Columbia by reference to the income and apportionment factors of all commonly controlled corporations organized within the United States with which they are engaged in a unitary business."[5]

Assuming that the D.C. Council amends the D.C. Code, mandatory combined unitary reporting would apply to tax years beginning after December 31, 2010.[6] However, until the tax code is actually amended, existing law provides for separate returns.

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[1] Fiscal Year 2010 Budget Support Act of 2009, D.C. Act 18-255 (referred to as "D.C. Act 18-255" for footnote citation purposes).

[2] The D.C. Council previously enacted three pieces of emergency legislation, all of which were signed by Mayor Fenty, and each one of which was effective for 90 days only. See, D.C. Acts 18-187, 18-207, and 18-260. This earlier legislation contained substantially the same language ultimately enacted in the permanent legislation.

[3] Previously, as related to interest, addback applied only to interest directly or indirectly attributable to use, maintenance, or management of intangibles. D.C. Code Ann. § 47-1803.03(b)(7)(C)(iv).

[4] Instructions, 2009 D.C. Corporate Franchise Tax Form D-20. However, see the discussion that begins at the bottom of page 2 of this alert regarding the uncertainty of the effective date.

[5] D.C. Act 18-255 § 7231.

[6] *Id*.

Expansion of Intercompany Addback Requirement

Since 2004, District taxpayers have been required to add back certain royalties paid to related parties. Specifically, the royalty deduction was disallowed if the related-party payment was connected to the use, maintenance, or management of licenses, trademarks, copyrights, trade names, service marks, patents, and other similar types of intangible assets.[7] The 2004 addback provision also applied to interest expense directly or indirectly for, related to, or in connection with the use, maintenance, or management of intangible assets.[8]

Under the Act, the addback requirements have been expanded applicable retroactively to tax years beginning after December 31, 2008. The revised provision now states that no deduction shall be allowed for, "Any otherwise deductible interest expense or intangible expense if the interest expense or intangible expense is directly or indirectly paid to, or accrued or incurred by, one or more related members in connection directly or indirectly with one or more direct or indirect transactions."[9] By amending the addback provision to include "any interest expense or intangible expense," the addback has been broadened to cover a larger population of potential transactions, including related party interest expense items that are not attributable to the use, maintenance, or management of intangibles.

Exceptions - There are two exceptions to the required addback.

Conduit Exception: The addback does not apply to the extent the taxpayer establishes that:

1. The related party transaction did not have a principal purpose of avoiding District income tax and was made pursuant to arm's-length conditions; and
2. During the same taxable year the related member directly or indirectly paid interest expense to, or the interest expense or intangible expense was accrued or incurred by, a person who is not a related member.[10]

Subject-to-Tax Exception: The addback does not apply to the extent the taxpayer establishes that the related-party transaction did not have a principal purpose of avoiding District income tax, was made pursuant to an arm's-length contract and rates, and:

1. The related member was subject to a tax measured by its net income or receipts in the District, a state or possession of the United States, or a foreign nation (that has entered into a tax treaty with the United States government);
2. The measure of the tax imposed by the District, a state or possession of the United States, or a foreign nation (that has entered into a comprehensive tax treaty with the United States government) included the interest expense or intangible expense received by the related member from the corporation; and,
3. The aggregate effective tax rate imposed on the amounts received by the related member is equal to or greater than 4.5%; provided, that a related member receiving the interest or intangible payment shall not be considered to be subject to a tax merely by virtue of the related member's inclusion in a combined or consolidated return in one or more states.[11]

Potential Impact on 2009 Extension Payments - Because the amended related-party addback provisions are effective retroactively for tax years beginning after December 31, 2008, taxpayers should consider whether an additional payment would be due with any extension requests for tax year 2009 returns.

IRC § 108(i) Decoupling

The Act decouples from IRC § 108(i), which governs the deferral treatment of certain income related to qualified discharge of indebtedness. Consequently, an adjustment to District taxable income will likely be required for taxpayers with income subject to IRC § 108(i).[12] The legislation does not

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[7] D.C. Code Ann. § 47-1803.03(b)(7).

[8] D.C. Code Ann. § 47-1803.03(b)(7)(C)(iv).

[9] D.C. Act 18-255 § 7081, amending D.C. Code Ann. § 47-1803.03.

[10] *Id*.

[11] *Id*.

[12] D.C. Act 18-255 § 7121, amending D.C. Code Ann. § 47-1803.02.

provide an effective date for this provision. The Office of Tax and Revenue has indicated, informally, that this law change became effective on August 26, 2009.[13] However, the instructions that accompany 2009 D.C. Form D-20 reference decoupling from IRC § 108(i), thus suggesting that this change may apply beginning January 1, 2009.

Other Tax Law Changes

The Act contains numerous other changes, including the following:

- An increase of the general sales and use tax rate from 5.75% to 6% (effective October 1, 2009)[14]
- An increase in the gasoline excise tax[15]
- An increase in certain tobacco taxes[16]
- The authorization of an amnesty program to be administered by the District's Chief Financial Officer, the details and terms of which have not yet been established[17]

Financial Statement Impact

Pursuant to Accounting Standards Codification Topic 740, *Income Taxes* (FASB Statement No. 109, *Accounting for Income Taxes*), companies are required to account for the effect of a change in income tax law in the period that includes the enactment date of the applicable law change. As noted previously, the Act does not itself enact combined reporting because the DC Council must first amend the D.C. Code as mandated by the legislation. Assuming that the tax code is amended, that amendment could have significant financial statement implications in the reporting period that includes the date of such amendment. Thus, if the DC Council amends the tax code, we recommend that companies consult with applicable advisors for further guidance regarding the financial statement impact of that law change.

Regarding the other income tax law changes contained in the Act, namely, expansion of the intercompany addback provisions and decoupling from IRC § 108(i), these changes could have significant financial statement implications in the reporting period that includes March 2, 2010, (the date that the Act became enacted upon expiration of the 30-day period for United States Congressional review).[18] Thus, we recommend that companies consult with applicable advisors for further guidance regarding the financial statement impact of these law changes.

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[13] This effective date is based on the August 26, 2009 effective date of D.C. Act 18-187, which included an IRC § 108(i) decoupling provision. Because this change was "emergency" legislation, it applied for 90 days only.

[14] D.C. Act 18-255 § 7241, amending D.C. Code Ann. §§ 47-2002 and 47-2202.

[15] D.C. Act 18-255 § 7241, amending D.C. Code Ann. § 47-2301(a).

[16] D.C. Act 18-255 § 7241, amending Chapter 24 of Title 47 of the D.C. Official Code.

[17] D.C. Act 18-255 § 7111, amending Chapter 44 of Title 47 of the D.C. Official Code.

[18] As noted previously, prior to adoption of the permanent legislation encompassed in the Act, earlier emergency legislation was enacted, the first of which became law on August 26, 2009, and which contained provisions expanding the addback rules and decoupling from IRC § 108(i). Each emergency legislative act contained substantially the same language ultimately enacted in the Act, but was effective for only a 90 day period.

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