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LOUISIANA DEPARTMENT OF REVENUE TO ISSUE PROPOSED REGULATIONS ON COMBINED REPORTING

By

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At the annual liaison meeting between members of the Louisiana State Bar Association Section of Taxation and the Louisiana Department of Revenue on November 19, 2004, the Department announced that it would be issuing proposed regulations addressing situations in which the Secretary of the Department would exercise what the Department maintains is the Secretary's unfettered discretion to compute a taxpayer's Louisiana corporation income tax liability using some form of a combined reporting methodology. Even though (i) the Louisiana corporation income tax statutes expressly prohibit taxpayers from filing consolidated or combined returns (La. R.S. 47:287.480(3)(a)), (ii) the statutes nowhere mention any authority on the part of the Department to "require" consolidated or combined returns, (iii) the Louisiana Legislature has repeatedly rejected efforts by the Department to enact a combined reporting regime in Louisiana, and (iv) there is pending litigation in the Louisiana courts regarding the extent, if any, of the Department's discretion to use a consolidated or combined reporting methodology for determining a taxpayer's Louisiana income tax base, the Department nonetheless is moving forward to promulgate regulations specifically stating instances in which the Department will "force" a taxpayer to compute its Louisiana taxable income using a combined reporting methodology. The Department maintains that language in La. R.S. 47:287.430(3)(b), which permits the Secretary to require "... consolidated statements as in [her] opinion are necessary, if any, in order to determine the taxable income received by any one of the affiliated or related corporations," is sufficient authority for its position regarding the forced use of a combined reporting methodology. The Department apparently believes that "consolidated statements" and "combined returns" are synonymous.

Also at the liaison meeting, representatives from the Department discussed (i) recent decisions in Louisiana state and local tax cases, (ii) developments from the 2004 First Extraordinary and Regular Sessions of the Louisiana Legislature, and (iii) proposed regulatory guidance that the Department intends to issue in the coming months. By far, however, the most interesting and potentially disruptive announcement was the announcement regarding the "combined reporting" proposed regulations. Taxpayers should closely follow developments in this area and get involved in commenting on the proposed regulations at the appropriate time.

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Under the proposed combined reporting rules, the Secretary will apparently not be required to allege wrongdoing or tax avoidance in order to determining a taxpayer's Louisiana taxable income using the Department's unspecified combined reporting methodology. All that would be required for the Secretary to impose a forced combined reporting methodology would be the Secretary's finding that the statutorily prescribed separate reporting methodology does not clearly reflect Louisiana taxable income. There are no guidelines in the draft of the proposed regulations explaining the circumstances that must be present for determining when the prescribed separate reporting methodology does not clearly reflect Louisiana taxable income. One situation where a forced combined reporting methodology likely will be required under the proposed regulations includes affiliated groups where one or more members of the group receive royalties from the licensing of intangibles to an affiliated manufacturing company. At this point, this apparently will be the only specifically identified situation in which the Department will force the use of its version of a combined reporting methodology.

At the liaison meeting, the Department attempted to temper its stunning announcement by stating that it does not intend to use the proposed regulations to aggressively seek combined reporting from a multitude of businesses. The Department's reassurance, however, appeared disingenuous in light of its discussion that the proposed regulations will provide the Secretary with virtually unfettered authority to require the use of the combined reporting methodology, without any limitations. In particular, the Department acknowledged that whenever there is an affiliated group of corporations filing one or more returns in Louisiana, the Department will examine the allocations with an eye toward requiring the use of the combined reporting methodology. Further, the Department stated that until the Louisiana Legislature enacts a combined reporting income tax regime by law, which it has repeatedly declined to do, the Secretary's purported "discretionary authority" under La. R.S. 47:287.480(3)(b) is the "bullet" that the Department will use to combat perceived under reporting of Louisiana taxable income.

The Department's interpretation that La. R.S. 47:287.480(3)(b) grants the Secretary the discretionary authority to require the use of the combined reporting methodology and the conditions under which the Secretary may exercise that authority has been the subject of protracted litigation. The case at center stage in this controversy is *John Neely Kennedy, Secretary, Department of Revenue and Taxation, State of Louisiana vs. Winn-Dixie Louisiana, Inc.*, Docket Nos. 487,680 and

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561,806, which is pending before the 24th Judicial District Court in Jefferson Parish, Louisiana. (The authors represent Winn-Dixie in the referenced litigation.) In *Winn-Dixie*, the district court recently granted the Department’s Motion for Summary Judgment that the Secretary properly exercised her discretionary authority under La. R.S. 47:287.480(3)(b) to require the use of a combined reporting methodology to compute the taxpayer’s Louisiana taxable income. However, the district court’s judgment provides no reasoning for its ruling in favor of the Department and the intended scope of this judgment is not known. Winn-Dixie has asked the court for a clarification of its ruling and moved for a new trial on this issue.

Considering that *Winn-Dixie* and other cases regarding the use of a forced combined reporting methodology are far from final (no appellate court in Louisiana has ever addressed the issue), Louisiana taxpayers, the Louisiana Legislature, and the courts all should be puzzled by the timing of the Department’s decision to issue regulatory guidance under La. R.S. 47:287.480(3)(b), especially in light of the Legislature’s repeated rejection of the combined reporting regime in Louisiana. Taxpayers and their advisors should pay close attention to the ongoing developments of Louisiana’s income tax regime identity crisis regarding whether it is a separate-reporting state, a discretionary forced combined reporting state administered at the total unfettered discretion of the Department, or some hybrid thereof. Even though the proposed regulations likely will address only one specific situation in which the Secretary will exercise her discretion to require a “consolidated statement,” which she equates to a combined reporting methodology, taxpayers should not be lulled into believing that this is the only situation in which the Department will attempt to exercise its “discretionary” authority. History tells us that the Department will aggressively seek to use the “forced combined reporting methodology” in audits at its sole discretion when affiliated groups are involved and there are intercompany transactions between members of the affiliated group.

In light of the proposed combined reporting regulations, which have not yet been made public by the Department, Louisiana taxpayers and their advisors are left with little, if any, guidance as to exactly when and how the Department will force the use of a combined reporting methodology. In addition, there is no guidance whatsoever from the Department as to how the combined reporting methodology will be implemented or what constitutes a unitary business for purposes of the combined reporting regulations. Taxpayers and their advisors who file combined reports in states that actually provide for such returns by law know all too well the

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many intricacies of the combined reporting regime. The Department's proposed regulations apparently will not address any of these most important issues. Thus, we apparently will be left with a situation where the Department has the unfettered discretion as to when and how it will use the combined reporting methodology.

At the liaison meeting, representatives of the Department suggested that Louisiana income tax practitioners likely will have to resort to private letter ruling requests to obtain guidance regarding the Department's income tax treatment of affiliate groups operating in the state. Based on comments by the Department at the liaison meeting, it is likely that any such private letter ruling will lean toward the forced use of a combined reporting methodology. This uncertain and burdensome process creates another hurdle for business development in Louisiana, as companies considering locating in Louisiana may not wish to incur the time and expense of requesting a private letter ruling to obtain guidance regarding the basic question of whether Louisiana is a separate or combined reporting state. The uncertainty surrounding whether combined reporting will be required in Louisiana undoubtedly will have a negative impact on business development in Louisiana.

Other issues addressed by the Department at the liaison meeting include the Department's new initiatives to detect resident non-filers, stamp-out tax fraud, and increase use of computer matching between Department records and those of the Internal Revenue Service. Further, the Department stated that in the coming year it will increase its audit activity in the severance tax arena and will perform more joint auditing with auditors for local tax jurisdictions. The Department also announced its rededication to expediting its processing of pending matters. In connection with this effort, the Department urged tax practitioners to identify matters ripe for resolution under its revamped alternative dispute resolution authority, particularly pending legal matters that are based on factual concerns rather than legal issues.

Taxpayers know that there never is a dull moment in Louisiana. There certainly is more to come in this arena, so stay tuned.

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Remember that these legal principles may change and vary widely in their application to specific factual circumstances. You should consult with counsel about your individual circumstances. For further information regarding these issues, contact:

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