



Reviving retail: One tax provision at a time

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Introduction of Presenters



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Objectives of This Presentation

- To explicitly recognize the economic & financial pressures on retailers
- To discuss how the current environment impacts income tax decisions faced by retailers
- Highlight specific income tax issues of importance to retailers
- Identify best practices for retailers from an income (state & federal) tax perspective

Objectives of Retail Tax Departments

- **Tax Reduction**
 - Cash
 - Effective Rate Management
 - Benchmarking
 - FIN 48
 - Risk tolerance
 - Picking your battles
 - Preplanning for litigation

Objectives of Retail Tax Departments

- **Headcount management**
 - Doing more with less
 - Streamlining provision and tax return processes
 - State audit management
 - Integrating information flow
 - Resisting headcount reduction
 - Largely successful in this effort
 - Why a wide-acknowledged lack of available talent now and in the foreseeable future
 - Ageing of tax departments
 - Retraining of tax departments
 - Cross training of tax departments

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Objectives of Retail Tax Departments

- **Technical training budget issues**
 - Rapidly changing laws
 - New arcane state rules
 - State tax shelter rules (and related disclosures)
 - MD disclosure rules
 - MA FAS 109 credit filing deadline
 - CA deferred intercompany stock adjustments (DISA)
 - Not built into corporate compliance calendars

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Objectives of Retail Tax Departments

- **Digesting past acquisitions**
- **Dismantling ineffective/inefficient tax structures**
 - Tripping hidden gains
 - Losing existing attributes
 - Finding a rational structure going forward
 - Balancing benefits of entity simplification with opportunities presented by new structure and saving still available with legacy structure
 - Fact specific analysis

Objectives of Retail Tax Departments

- **Gross receipts taxes**
 - Disproportionate impact on retailers
 - The apparent proliferation of these types of taxes
- **Procurement & supply chain structure & planning**
- **Unitary business determinations**
 - Scrubbing new and old unitary planning ideas
 - Apportionment rules

Objectives of Retail Tax Departments

- **Conclusions**

- Retailers are facing a new and very challenging tax environment
- Tax departments have gained greater visibility in recent years
- “Doing more with less” is proving challenging to corporate tax departments
- Planning has become more of a focus. Not instead of risk management, but now, in conjunction with risk management.

Technical Agenda



- **Federal Tax Issues**
- New combined reporting trends and issues
- Entity simplification/rationalization issues
- State tax attribute preservation and utilization
- State issues pertaining to federal accounting method changes

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Tangible Property Expenditures – “Repairs” Understanding the Re-proposed Regulations

- Treasury regulation 1.263(a) – 3 Improvements

A taxpayer must generally capitalize amounts that improve a unit of property

- 1) Results in **Betterments**
- 2) **Restores** a Unit of Property
- 3) Adapts the property to a **new or different use**

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“Repairs”

- Section 162 and Treas. Reg. section 1.162-1(a) allow a deduction for all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including “**incidental repairs.**”
- Put v. Keep Test
 - “Ordinarily efficient operating condition”

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“Repairs”

Unit of property is key

- **Current law** – Roofing improvements, unit of property is the roof, not just the material covering the roof
- **Re-proposed regulations** – Roofing improvements, unit of property is the building

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“Non-betterments”

- Re-proposed regulations clarify that an amount results in a betterment if it:
 - Ameliorates a material condition or defect that either existed prior to the TP's acquisition of the property or arose during production of the UOP (regardless of whether the taxpayer was aware of the condition),
 - Results in a material addition to the UOP, or
 - Results in a **material** increase in capacity, productivity, strength, efficiency, or **quality** of the UOP or the output of the UOP.

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“Non-betterments”

- Under the re-proposed regulations, “betterment” is a facts and circumstances determination
 - Purpose of the expenditure
 - Physical nature of work performed
 - Effect of the expenditure on the UOP
 - Taxpayer's treatment of the expenditure for non-tax books and records

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“Non-betterments” – Example Facts

- X owns a chain of retail stores. X periodically changes the layout and appearance of its stores.
- These changes include the reconfiguration of the stores to provide better exposure of the merchandise and cosmetic alterations to keep the store modern and attractive to customers.
- The work is not undertaken for the purpose of repairing damaged property but rather to renew the appearance of the property.

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“Non-betterments” – Example Facts (continued)

- X incurs costs to update 50 stores during the taxable year.
- For financial statement purposes, X capitalizes all the costs of the updates and amortizes them over a 5-year period.
- Each store building, including its structural components, is a unit of property and each section 1245 property within the store is a separate unit of property.
- The work performed did not ameliorate any material conditions or defects that existed when X acquired the store buildings or result in any material additions to the store buildings.

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“Non-betterments” – Example Conclusions

Considering the facts and circumstances, including the purpose of the expenditure, the nature of the work performed, and the treatment of the work on X's applicable financial statements, the amounts paid by X for updates to its store buildings (including their structural components) **do not** result in material increases in capacity, productivity, efficiency, strength, or **quality** of the store buildings.

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“Non-betterments” – Example Conclusions (continued)

- Accordingly, the amounts paid by X for the updates to the store buildings (including their structural components) **do not result in betterments**.
- Costs related to acquisition and installation of section 1245 property are required to be capitalized.

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“Non-betterments”

Why **can** you do this now?

Proposed regulations **clarify** what constitutes a **betterment** or a **restoration**.

- Proposed rules are **consistent with current law**, but provide a more bright-line standard to apply.
- Method change is now “Automatic” under Revenue Procedure 2009-39.
- Example focuses on a type of common cost that is not a betterment.

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“Non-betterments”

- The IRS might adopt regulations, when finalized, that eliminate (or limit) the opportunity to take a section 481(a) adjustment!
- Potential Tiered issue being contemplated by the IRS.

Other accounting method opportunities for Retailers

- IBNR – Self-employed medical or co-operative advertising
- Prepaid Insurance
- Prepaid advertising (catalogs)
- Disputed Sales
- Accelerating Employment tax deductions
- Inventory Shrinkage reserves
- Missed Bonus depreciation/retro cost segregation
- Deferred Revenue – Gift cards
- Deferred lease incentives
- Others

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Combined Reporting

- **Typically statutorily mandated**
- **Basis for Unitary determinations (primarily)**
 - Three unities
 - Contribution and dependency
 - Factors of Profitability
 - Flow of value
- **Unitary reporting is:**
 - Highly factual
 - Very mechanical
 - ***Increasingly important!***

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Combined Reporting States

Recently adopted unitary reporting:	Considered adopting unitary reporting:
Vermont	Alabama
West Virginia	Maryland
Ohio (effectively with the CAT)	North Carolina
Texas	Rhode Island
Michigan	Tennessee
New York (effectively with the inter-group transaction rules)	
Massachusetts	
Wisconsin	
District of Columbia (potentially)	

The issue is, as more states adopt combined reporting, ***each regime has unique nuances and careful reading of the statute is required to fully understand the impact of these new rules.***

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What Issues Come Up in the Context of Unitary Reporting?

- Defining the unitary group
- Defining the “Taxpayer” within the unitary group context
- The mechanics of Water’s Edge elections
- Addressing issues of “Instant Unity”
- The application of throw-back rules “Joyce vs. Finnigan”

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Issues Raised By New Combined Reporting Regimes

- Lack of Conformity of these New Unitary Regimes
- Issues Raised by New Unitary Reporting Regimes:
 - New York (Intercompany Transaction Analysis)
 - Massachusetts (Unique Combined Reporting Apportionment Rules)
 - Unique West Virginia Rules (Water's Edge - Tax havens)
 - Wisconsin Rules
- The Interaction of Gross Receipts Reporting & Combined Reporting
- California's "Flip-Flop" on "Joyce vs. Finnigan"
- California's Deferred Intercompany Stock Account (DISA) Rules

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Proposed Unitary Analytical Grid

Issue/State	NY	WI	WV	MA	TX	MI	OH
Method of Unitary Determination							
Water's-Edge Election Available							
Excluded/Included entities							
WEE Duration							
Defining the "Taxpayer"							
Instant Unity Presumption							
Intra-Group Apportionment Required?							
Throwback: Joyce/Finnigan							
Attribute Utilization Entity or Group?							
Other unique state combined reporting issues							

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Instant Unity: The Analysis

- One of the less recognized state tax issues that arises from acquisitions is the question of *when the acquired and acquiring companies are allowed to or required to file on a combined unitary basis.*
- Instant unity is generally a *facts and circumstances analysis*, with some states having a presumption
 - Identify the *business units* in question
 - Develop an *integration timeline* for each acquired business unit
 - Identify the *determinative issues* and facts in the finding of a unitary business
 - Common officers and directors
 - Integrated management
 - Intercompany financing, sales of goods/services
 - Modifications of methods of operations

California (Joyce, Finnigan, Joyce) Back to Finnigan & California Proposed Changes

- **For tax years beginning on or after January 1, 2011, readopts the approach followed in Finnigan!**
 - Yet another flip-flop on this issue by California
 - Impacts sales factor “throwback” planning
- **California’s Commission on the 21st Century Economy is considering a “business net receipts tax.”**
 - It is envisioned that the new business net receipts tax rate would be about 4 percent
 - Looks like a value added tax (VAT)

California Deferred Intercompany Stock Account (DISA) Disclosure Rules Historical Background

- For tax years beginning after 2000, the FTB promulgated a regulation that provides guidance with respect to the tax treatment of intercompany transactions.
- These California regulations provide:
 - DISA is the accounting mechanism that a distributee corporation, which is a member of the combined reporting group, will use to **report and track *nondividend distributions in excess of its adjusted basis of the stock of the distributing subsidiary corporation***, which is a member of the same combined reporting group, until this intercompany item is required to be taken into account pursuant to this regulation.
 - **The balance of each DISA amount must be disclosed annually on the taxpayer's return!**

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California Deferred Intercompany Stock Account (DISA) Disclosure Rules

- **Disclosing DISA Balances**
 - In order to comply with the annual California DISA disclosure requirement, the FTB has issued **Form 3726**, DISA and Capital Gain Information.
 - In conjunction with the creation of Form 3726, the FTB has revised the corporation franchise (income) tax return to include a question asking whether taxpayers have a DISA balance and, if so, the amount of that balance.
 - An appropriately completed Form 3726 must be included with a taxpayer's original 2008 return and every year thereafter, if a member of the combined group has a DISA balance.

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California Deferred Intercompany Stock Account (DISA) Disclosure Rules (Cont.)

- **Consequences of Failure to Disclose**

- If prior DISA balances for the years 2001 through 2007 are not reported as income due to the occurrence of a triggering event described in the regulation or as required, then the **undisclosed balances may be accelerated by the FTB and required to be taken into income.**
- This acceleration could result in additional tax liability and the imposition of various penalties, including the accuracy-related penalty and the large corporate underpayment penalty.
- In July 2009 the FTB extended the DISA disclosure deadline to October 15, 2009.

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Entity Simplification Issues: Context

- **Historically Retailers used various entity structures to manage their state tax expense, for example:**
 - Base shifting strategies
 - Intellectual property companies
 - East/West splits (driving revenue into combined/unitary reporting states)
 - Embedded royalty strategies (using transfer pricing)
 - A/R Factoring entities
 - Factor trapping strategies (Co-ops, employee leasing structures, other)
 - Nexus limitation structures (sales companies)
- **What has changed?**
 - Combined reporting/forced combination
 - Disregarding of transfer pricing
 - Economic nexus

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Entity Simplification Issues: Retailer Reaction

- **Simplification of entity structure: Why?**
 - Reduce compliance cost (fewer entities/fewer returns)
 - Reduce audit controversy issues
 - Reduce the cost of maintenance/internal documentation:
 - preserving substance
 - updating transfer pricing
 - maintaining additional intercompany accounts
 - Because these costs may outweigh the remaining benefits
 - Facilitate the better offsetting of income & loss entities
 - Increased use of flow through entities

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Issue Presented By Entity Simplification Federal Rules That May Cause Problems

- **Liquidating entities:**
 - Is the entity being liquidated solvent (IRC Sec. 332 does not apply if liquidated entity is not solvent)
- **Contribution to existing entities**
 - Liabilities in excess of basis (357(c))
- **Will distributions be made within the corporate group?**
 - Beware of the distribution of appreciated assets (IRC 311(b))
- **Are assets being transferred to a captive partnership structures?**
 - Be aware of deconsolidating assets having associated deferred intercompany gains (DITs)
- **Is the ownership of existing partnership structures changing?**
 - Beware of technical terminations (IRC 708 – depreciation restart)

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State Tax Issues Presented By Entity Simplification

- **What related state income tax issues are raised?**
 - State-specific tax issues
 - Separate entity gains triggered (still an issue in separate entity states);
 - CA DISA rules
- **When entities are collapsed will state tax attributes (NOLs, Capital Losses, Credits) be lost?**
 - Beware of state specific short-period return rules

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State Tax Issues Presented By Entity Simplification

- What will be the *nexus* or *apportionment* profile of the organization be after any “entity reduction”?
- How will **intercompany account balances be settled/impacted?**
- **Property transfer tax issues – even between related entities?**
- Sales tax implications of:
 - Asset transfers
 - Inventory transfers
 - Registration issues

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What Federal Tax Issues Are In Play Regarding Tax Attribute Utilization (Note FAS 109/FIN 48)

Tax Attributes	Carry Forwards
<ul style="list-style-type: none"> - NOLs <ul style="list-style-type: none"> • Carryback rules • IRC § 382 <ul style="list-style-type: none"> - IRC § 382 limitation amounts - Capital Losses <ul style="list-style-type: none"> • Carryback rules • Netting rules - Worthless stock rules* - Bad debt rules* <p>* Tax Basis issues – is the <u>federal tax basis</u> the same as the <u>state tax basis</u>?</p>	<ul style="list-style-type: none"> - NOLs <ul style="list-style-type: none"> • Carryback (2 years) • Carryforward (20 years) - Capital Losses <ul style="list-style-type: none"> • Netting rules (limiting the use of capital loss to the offsetting of capital gains – IRC §1211) • Carryback (3 years) • Carryforward (5 years)

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General State NOLs Rules

- State NOL carryback and carryforward rules differ from federal rule of carryback two years and carryforward twenty years (provision issue)
- In general, **most states do not allow NOL carrybacks**, however:
 - **Carrybacks:** A few states allow a two year carryback and three states provide for a three year carryback of NOLs
 - **Carryforwards:** A majority of states which impose corporate income taxes adopt the federal twenty year carryforward period.
 - A significant number of states decouple and instead have either **shorter carryforward periods** or, **do not allow carryforwards at all** (MI & TX under new margins taxes).

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State NOLs Moratoriums

- Historically, states have often used moratoriums on the usage of NOLs as a revenue conservation measure
- For example:
 - In **California**, the use of California NOL deductions and carried over California NOLs is suspended for California taxpayers' 2008 and 2009 tax years.
 - Historically **New Jersey**, for privilege periods beginning in 2002 or 2003, taxpayers were not allowed to deduct NOLs.
 - In **Maine** for tax years beginning in 2009, 2010, and 2011, eliminated NOL carryforwards. Specific mechanical rules apply.
- **Key: be aware of more similar measures in the down economy!**

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Common-Law Limitations on the Utilization of State Tax Attributes

- Many state limitations commonly are based on the **Libson Shops** doctrine, **under which the pre-merger NOLs of one business cannot be used to offset the post-merger gains of the successor's business, unless there is a continuity of business interest** (*Libson Shops v. Koehler*, 353 U.S. 382 (1957)).
- **Some states have adopted statutorily some of the concepts embedded in Libson Shops.**
 - For example, New Jersey imposes NOL utilization limitations based on certain ownership changes and the whether the trade or business carried on prior to such ownership change is continued after the ownership change (N.J. Rev. Stat. §54:10A-4(k)(6)(D)).

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Common Law Doctrines Employed by States to Limit NOLs

- Some states subscribe to other common law concepts to limit carryovers, for example:
 - Some states adhere to the concept of an “**economic loss**” meaning if the taxpayer seeks to utilize a state loss through a carryback or carryforward, the taxpayer must offset the amount carried forward or carried back with any economic income, **even if the income is excluded from that states tax base** (AR,NC).
 - In certain states, NOL carryforwards or carrybacks can **only be used to offset the portion of state base consisting of federal taxable income**, not additions to the state base caused by state-specific modifications (MO, OK, MD).
 - **Where a state specific deduction pushes a taxpayer into an NOL**, the state may limit an NOL carryback to the NOL computed in accordance with federal income tax provisions (NY).

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Basic/Nuanced State Rules – Capital Losses

In the state context, the following issues commonly come into play:	Basic State Issues
<ul style="list-style-type: none"> - Can capital losses be included in the computation of the state tax base - Determination of the amount of the capital loss (basis differentials) - Decoupling from the federal capital loss netting rules - Differing carryforward and carryback periods - Inter-group reporting/utilization issues - For apportionment purposes, unique rules for the sourcing of the loss (including business/nonbusiness income) 	<ul style="list-style-type: none"> • In general the state capital loss rules parallel the federal rules. • In particular, the carryback and carryback periods coincide. • However, the use of capital losses for state income tax purposes can vary from the federal rules significantly.

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IRC 382 and State Taxation

- When determining whether a state limitation on NOLs based on a federal §382 limitation exists, several issues must be addressed, specifically:
 - (i) whether there has been an ownership change for state tax purposes;
 - (ii) the extent to which states decouple from federal code sections impacting the IRC §382 analysis; and
 - (iii) whether the IRC §382 limitation has to be apportioned!
- **Note:** since IRC §382 limits NOLs determined under IRC §172, states that decouple from IRC §172 for NOL computation purposes, may not be able to apply IRC §382 limitations.

Does the IRC 382 Limitation Amount Need to be Apportioned?

- § The IRC Section 382 limitation is based on **the value of the “old loss” corporation’s corporate stock**, multiplied by the long-term tax-exempt rate. IRC §§ 382(b)(1), (e)(1).
- § IRC §382 is an **attribute limitation provision**
- § Since **apportionment is not a federal tax concept**, the federal statute **does not provide for any type of additional calculation that would require state apportionment.**
 - § Absent a state statutory or regulatory mandate, the need to apportion the federal IRC §382 limitation for purposes of determining the amount of legacy NOLs which can be utilized in a given state, after the change date, is without basis **because there is no legal or mechanical basis for how the federal limitation should be apportioned.**
- § Practitioners also need to understand whether **separate return limitation year (SRLY)** rules or other equitable doctrines impact state NOL utilization.

An Example of State-Specific Guidance on Apportioning the 382 Limitation

- For tax years ending after January 1, 2005, a Georgia regulation provides that an ownership change for federal tax purposes applies for Georgia purposes. (GA. COMP. R. & REGS. r. 560-7-3-.06(5)(e)2)
- The **limitation** on using pre-change year Georgia NOLs in a post-change year is computed by applying the post-change year's apportionment percentage to the IRC Section 382 limitation for the post-change year. (GA. COMP. R. & REGS. r. 560-7-3-.06(5)(e)4)

Tax Shelters - Federal Tax Framework

General Tax Shelter Rules	Reportable Transaction Framework
<p>The term “tax shelter” has become a catch phrase for every effort by taxpayer’s to minimize their federal or state tax liability</p> <p>Unfortunately, the term is a trigger for the imposition of significant disclosure and penalty regimes that give rise to taxpayer liabilities without regard to the “intent” of the taxpayer</p> <p>“Tax shelter” rules can be implicated when taxpayers attempt to claim certain loss deductions that, intuitively, would not be associated with such rules.</p>	<ul style="list-style-type: none"> • Within the <u>federal</u> category of reportable transactions, one category should be of particular interest to state tax practitioners: IRC §165 loss transactions over certain specified amounts. (Reg. §1.6011-4(b)) <ul style="list-style-type: none"> – \$10 million in any single taxable year or \$20 million in any combination of taxable years for corporations. – \$10 million in any single taxable year or \$20 million in any combination of taxable years for partnerships that have only corporations as partners (looking through any partners that are themselves partnerships), whether or not any losses flow through to one or more partners.

State Tax Shelter Rules

- The reason that these transactions should be important to state practitioners is that the state rules regarding disclosing of “reportable” or “potentially abusive transactions” carry **significant penalty regimes** if taxpayer does not disclose and, in some circumstances, **pay state tax pertaining to such transactions in advance of final judicial determination** of the validity of the transaction or deduction in question.
 - **Penalties are not deductible for federal or state income tax purposes; and**
 - **State tax shelter penalties can be significant and often multilayered.** (See, for example, California’s proposed VCI in 2004. CRTS §19754(a))

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Accounting Method Changes: The State Issues

- Tax accounting methods generally deal with the issue of the **timing of income inclusion** or **expense deduction**.
- In response to the recent severe downturn in the economy, many companies, particularly hard-pressed retailers, are looking for ways to **preserve cash!**
- The federal mechanics of how to make an accounting method change are typically well understood within the practitioner community, the state income tax rules surrounding such changes are less well known.
- The issue: what modifications do states make regarding:
 - The federal accounting method change **procedures**, and
 - State specific **reporting requirements**

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General Conformity to Federal Methods

- ***In general, states conform to a taxpayer's change in accounting method for federal income tax purposes.***
- Such conformity stems from the fact that, by statute:
 - States require taxpayers to conform their state income tax reporting to the accounting methods used to report federal income; and
 - States generally adopt IRC Section 446 and other components of Subchapter E of the IRC.
- The attachment of the federal return, with the related forms, generally serves as notice that a taxpayer has requested a change in its method of accounting.

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State Specific Disconnects

- **Is Separate State Permission Required?**
- **States Decoupling from IRC Section 481**
 - Certain states - mandatory State Spread-back Rule
- **Separate Notification Requirements**
 - Understand the notification deadlines
- **Other State Specific Limitations on Accounting Method Changes**
 - Have states *conformed to newer IRC provisions*
 - Note: *some states permit a method change for State Tax Purposes without changing for Federal purposes*
- **Key: Know the rules – Avoid penalties & other unpleasant results!**

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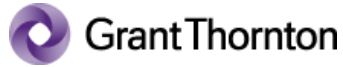
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