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Is it Time to Revisit Your State Income Tax Planning?

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Taxpayers should periodically revisit their state income tax planning in light of changes in business direction, economics, corporate transactions and, of course, tax developments. The grim state fiscal outlook portends an increasingly aggressive focus by state legislators and tax administrators on state tax-minimizing structures, particularly those used by businesses engaged in intellectual property licensing and franchising. As a result, the time to revisit planning may be at hand.

Highlight of Trends in State Challenges to Tax Planning

So far, 2009 sees the states using various approaches to challenge state income tax planning. Through expanded tax jurisdiction and narrow interpretations of statutory tax benefits, states may be increasing risks of multiple taxation of interstate commerce. Aggressive examinations of the pricing of intercompany transactions and services and a focus on substance and purposive activity continue to mark state audits and challenges. In addition, new legislation targeted at special purpose entities and mandating combined reporting emphasizes that the landscape for state income tax planning has changed in fundamental ways.

Narrowing the Exceptions to the Add-Back Statutes

21 states have enacted "add-back statutes" that disallow expense deductions for intangible and interest expenses paid to a related party. While these statutes are clearly aimed at eliminating the tax benefits of traditional intangible holding company (IHCO) structures, they may also target other planning, such as factoring, internal leveraging, "embedded" intangible planning, contract manufacturing and intangibles amortization. Although predominantly enacted by separate company return states, even some unitary combined reporting states, such as Illinois and Oregon, have enacted these statutes. In unitary states, the statutes are aimed at eliminating tax benefits from planning associated with "80/20 companies," captive insurance companies and offshore special purpose entities.

Depending on a particular state's add-back statute, various exceptions from their application are provided. As economic presence nexus has taken hold, the "subject to tax" exception from these statutes has taken on increased importance. If the related party that receives royalty or interest income is subject to tax in another state (and, for some states, a foreign country that is a party to a U.S. tax treaty), the royalty or interest expense is deductible. However, states such as Alabama and Virginia have sought to limit the benefits of the exception to a post-apportionment basis. That is, the deductible amount of the intangible or interest expense is reduced to the amount of that income that is apportioned to states where the recipient is taxed. For example, if the IHCO apportions 2% of its royalty income to South Carolina and pays income tax, only 2% of the royalty expense is deductible by the payor. *Surtees v. VFJ Ventures Inc.*, 8 So. 3d 950 (Ala. Civ. App., 2008), *aff'd*, 8 So. 3d 983 (Ala. 2008), c*ert. denied*, 129 S.Ct. 2051 (2009); *Ruling of Commissioner*, P.D. 07-153 (Va. Dept. of Taxation, Oct. 2, 2007); *Ruling of Commissioner*, P.D. 09-96 (Va. Dept. of Taxation, June 11, 2009).

For an analysis of a challenge to the post-apportionment limitation of the "subject to tax" exception and its constitutional questions, see the article that was originally published in Tax Analysts' *State Tax Notes* on June 29, 2009, entitled "Is Virginia's Addback Statute Exception Susceptible to Challenge?"

In addition, a risk of multiple taxation of commerce occurs when a state has enacted an add-back statute without a "subject to tax" exception and applies economic presence nexus. For example, Massachusetts and New Jersey have enacted add-back statutes, but do not provide a "subject to tax" exception. (New Jersey provides the exception but only if the related IHCO is in a foreign country that is party to a U.S. tax treaty, N.J.S.A. § 54:10A-4.4.c.(1).) Both states apply economic presence nexus. *See Geoffrey, Inc. v. Comm'r of Revenue*, 899 N.E. 2d 87 (Mass. 2009), *cert. denied*, U.S. Supreme Court No. 08-1207 (June 22, 2009); *Lanco, Inc. v. Director*, Div. of Taxation, 879 A. 2d 1234 (N.J. App. Div. 2005), *aff'd*, 908 A. 2d 176 (N.J. 2006), *cert. denied*, 551 U.S. 1131 (2007). The IHCO is required to file a return and pay tax on its intangible income, and the licensee is required to add-back its intangible payment expense. While Massachusetts will permit taxpayers to propose appropriate adjustments in audit (Tech. Info. Release, TIR 08-4 (Mass. Dept. of Revenue, Mar. 24, 2008)), New Jersey has been recalcitrant in audits. As addback statutes and economic presence nexus spread, this risk of actual multiple taxation will as well.

Economic Presence Nexus Evolves

When the U.S. Supreme Court in *MeadWestvaco Corp. v. Illinois Dep't of Revenue*, 128 S.Ct. 1498 (2008), declined to address Illinois' argument that source of income confers jurisdiction to tax, it may have made source jurisdiction the next nexus battleground. *See Matter of Petition of Shell Gas Gathering Corp. #2*, No. 821569 (N.Y. Div. Tax Apps., June 11, 2009); *Allied-Signal, Inc. v. Comm'r of Finance*, 79 N.Y. 2d 73 (1991). Until then, eyes remain focused on economic presence nexus. States remain frustrated by the inability to collect income or franchise taxes from "virtual" businesses that generate substantial revenue from transactions with businesses or consumers without employees or bricks and mortar presence in their states.

Starting in 1993 with *Geoffrey, Inc. v. South Carolina Tax Comm'n*, 437 S.E. 2d 13 (S.C. 1993), *cert. denied*, 510 U.S. 992 (1993), states have successfully asserted taxing jurisdiction over IHCOs, issuers of credit card receivables and other businesses with economic, but not physical, connections to a taxing state. This trend continued into 2009 with Massachusetts' *Geoffrey* decision. To date, courts from as many as 13 states have endorsed economic nexus. Unfortunately, most of these decisions miss the forest for the trees. Rather than evaluating whether economic presence nexus imposes an unconstitutional burden on interstate commerce, a number of these courts remain stuck on the question of whether *Quill Corp. v. North Dakota*, 503 U.S. 298 (1992), applies to income tax or only to sales and use taxes.

Nonetheless, a handful of the courts have begun to craft an equally suspect "substantial economic presence" test. *Tax Commissioner v. MBNA America Bank*, N.A., 640 S.E. 2d 226 (W.Va. 2006), *cert. denied*, 551 U.S. 1141 (2007); Capital One Bank, N.A. v. Comm'r of Revenue, 899 N.E. 2d 76 (Mass. 2009), cert. denied, U.S. Supreme Court No. 08-1169 (June 22, 2009). In these cases, continuous and systematic solicitation of business from in-state customers (via mail or telephone) and the sourcing of gross receipts to the states based on financial institution income apportionment statutes satisfied the "substantial economic presence" test. *See also MBNA America Bank, N.A. v. Dep't of State Revenue*, 895 N.E. 2d 140 (Ind. Tax 2008).

Therefore, an income apportionment trend may exacerbate the economic nexus dilemma for corporate taxpayers, especially those with large amounts of gross receipts derived from the performance of services – sourcing these receipts to the sales factor of the apportionment formula based on the location where the benefit of the service is received (market sourcing). Traditionally, receipts from the performance of services (and sales or licensing of intangibles) are sourced based on where the greatest proportion of costs of performance are located. Usually, this is the state where the taxpayer's property and payroll are the greatest. Market sourcing, however, attributes those services receipts to the states where customers receive the benefit of the service or where an intangible is utilized. An increasing number of states, including Illinois and California (in 2011), have moved to market sourcing and away from traditional "costs of performance" sourcing.

In its July 2009 comprehensive Corporate Tax Reform proposal, New York's Department of Taxation and Finance recommends that jurisdiction to tax should be "asserted over corporations without a physical presence in New York where economic nexus was present." As more states move to market sourcing, assertions of economic presence under a "substantial economic presence" rationale against remote service providers, franchisors, management companies, advertising and merchandising companies, procurement companies and the like may increase. In addition to traditional IHCO structures, other types of income tax planning should be revisited in light of the trends evident with economic presence nexus.

Transfer Pricing – Yesterday's Profits, Today's Financial Results

For state tax planning, arm's-length transfer pricing is a critical component. There are a number of methods that can be used to establish arm's-length rates under the Treasury Regulations issued under Internal Revenue Code (IRC) § 482. Businesses commonly use the comparable profits method (CPM) or other profit-based methods (comparable profit-split method or the residual profit-split method) to establish arm's-length intercompany transfer prices. States have also come to rely on the CPM when challenging state income tax planning.

In general, the CPM considers whether the price charged in a controlled party transaction is arm's-length by determining an operating profit of a "tested party" based on objective measures of profitability of comparable, uncontrolled businesses. *See* Treas.Reg. §§ 1.482-5 and -9T(f). If the "tested party" performs nonroutine functions or owns valuable intangible property, then the CPM is generally not suitable, and the residual profit split method (RPSM) may be used. *See* Treas. Reg. §§ 1.482-6, -6T, and -9T(g). Thus, the CPM may be more frequently used in a sales and distribution planning context, whereas the RPSM may be used if the "tested party" performs nonroutine services or functions and owns valuable intangibles.

The CPM, RPSM and other profit-based methods work fine when business is healthy and profits are growing. However, in times of financial distress uncontrolled parties that may have been comparable are no longer as a result of reductions in workforce, plant closures, bankruptcy or other business circumstances. A deteriorating economy will impact operating profits, sales and costs of controlled and uncontrolled companies. The "tested party" may experience reduced revenues and operating profits while the uncontrolled comparables used to set intercompany transfer prices have not experienced similar declines. Uncontrolled comparables may become loss companies meaning that arm's-length results for controlled, intercompany transactions should generate diminished profit allocations. Further, the arm's-length nature of intercompany rates and fees set during a healthy economy will be subject to more intense scrutiny by state tax auditors if they are now driving a related party into a loss position.

In light of the current economic environment, taxpayers may need to reconsider their arm's-length transfer pricing regimes and adjust them accordingly. Changes in the values and risks of functions may also encourage adjustments to structure.

The Old and the New

Taxpayers must remain mindful of other traditional challenges, as well as new legislation aimed at tax planning. For example, states continue to apply the sham transaction doctrine to challenge motive, abuse and economic utility of state income tax planning. The prior 12 months produced a host of cases illustrating successful state challenges to planning using sham transaction and related substance over form doctrines applied to common tax planning strategies. *Wal-Mart Stores East, Inc. v. Hinton*, 676 S.E. 2d 634 (N.C. App. 2009) (captive REIT); *TD Banknorth*, *N.A. v. Dep't of Taxes*, 967 A. 2d 1148 (Vt. 2008) (investment and loan participation holding companies); *HMN Financial, Inc. v. Comm'r of Revenue*, No. 7911-R (Minn. Tax Ct., May 27, 2009) (captive REIT); *Matter of Talbots, Inc.*, No. 820168 (N.Y. Tax Apps. Trib., Sept. 8, 2008) (IHCO); *TJX*

Companies, Inc. v. Comm'r of Revenue, No. C262229-31 (Mass. App., Tax Bd., Aug. 15, 2007), *aff'd*, 903 N.E. 2d 608 (Mass. App. 2009) (IHCO); *IDC Research, Inc. v. Comm'r of Revenue*, Nos. C267868 (Mass. App. Tax Bd., Apr. 17, 2009) (IHCO). Common corporate arrangements that are not tax motivated may also be the subject of such challenges. *United Parcel Service General Services Co. v. Director, Div. of Taxation*, No. 007845-2004 (N.J. Tax Ct., June 5, 2009) (centralized cash management system).

Starting in 2006 and continuing strongly into 2009, a number of states (Massachusetts, Michigan, New York, Texas, Vermont, West Virginia and Wisconsin) have inaccurately believed that mandatory unitary combined reporting will close planning opportunities and generate revenue. While the intent of legislators and state revenue departments may be realized to some degree, the circumstances of other taxpayers may benefit from combined reporting. Nonetheless, a method of apportionment that was once largely found only west of the Mississippi is now firmly entrenched east of the Mississippi.

Conventional Wisdom

Tax planning does not only mean structural change to an organization. It can also relate to tax return positions. It is conventional wisdom that taxpayers have a greater likelihood of negotiating a settlement of a tax assessment than of a tax refund claim, even though the dollars are equal. States are often loath to pay a refund, and it is not uncommon for them to drag out a refund claim hoping for an offset, a better budget situation or, in a few egregious situations, retroactive legislation eliminating refund opportunities as recent Kentucky and Virginia situations attest. Therefore, taxpayers may want to invest more up front assessing the merits of particular tax return positions, potential penalty risks and ruling requests. Not all states will pay refund claims with "IOUs," but the impact of the state fiscal situation on the payment of refund claims and settlement negotiations should also be considered.