# PUBLICATION

## SALT Spotlight: 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 tax planning. As a result, it may now be time again to revisit planning.

Multistate businesses should consider the following features of the current state tax planning landscape in the context of existing state income tax planning.

**A**. Add-Back Statutes.

- Twenty-one 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 also target other planning.
- States are seeking to limit the benefits of statutory exceptions contained in various state add-back statutes. (For an analysis, see an 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. Under a "subject to tax" exception, the intangible or interest expense paid to a related party is deductible if that part is subject to a net income tax. However, if a state imposes economic nexus on the IHCO and an add-back provision without a "subject to tax" exception on the payor, multiple taxation ensues. For example, Massachusetts and New Jersey have enacted add-back statutes, but do not provide a "subject to tax" exception. In these states, multiple taxation is occurring on audit. While Massachusetts will accept adjustments, New Jersey has not been as accommodating.

**B**. Economic Nexus.

- Economic presence nexus is evolving. 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. To date, courts from as many as 13 states have endorsed economic nexus.
- State courts are now crafting a "substantial economic presence" test that examines the level of an out-of-state business's activity directed into the state and whether the business has sales sourced to the state under income apportionment statutes. Therefore, an income apportionment trend may exacerbate the economic nexus dilemma for certain taxpayers, especially those with large amounts of gross receipts derived from the performance of services - market sourcing of receipts to the sales factor. State courts in Indiana, Massachusetts and West Virginia have used their market sourcing apportionment rules, which source gross receipts to the customer location,

as a basis to assert taxing jurisdiction.

- As taxpayers have had to adjust to threats of economic presence nexus, the next battleground may be "source jurisdiction." For example, New York (and possibly Illinois) will assert jurisdiction to tax capital gains and other investment income based on the presence of the dividend payor or stock issuing corporation, but not the taxpayer.

**C**. <u>Transfer Pricing.</u>

- 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. It is common to 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.
- The CPM and other profits based transfer pricing 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. 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. Intercompany transactions must also be evaluated from nexus-creating and apportionment perspectives.

**D**. <u>What is the Motive?</u>

- States continue to apply the sham transaction doctrine to challenge motive, abuse, and economic utility of state income tax planning. The prior 12 months have 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. These include IHCOs, captive REITs and investment subsidiaries, as well as common corporate arrangements that are not tax motivated, such as centralized cash management systems.

**E**. <u>Unitary Combined Reporting.</u>

- This method of apportionment that was once largely found only west of the Mississippi is now firmly entrenched east of the Mississippi. Starting in 2006, and continuing strongly into 2009, a number of states now require this method, including Massachusetts, Michigan, New York, Texas, Vermont, West Virginia, and Wisconsin.

**F**. <u>Nexus Questionnaires.</u>

- A number of states are sending extensive nexus questionnaires to companies that may have business contacts with the state. The questionnaires are designed to elicit responses supporting state tax nexus with the responding company and require responses under penalties of perjury, so companies should consult with counsel and exercise careful consideration when responding to the questionnaires.

**G**. <u>Strategies and Penalties.</u>

- 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. Therefore, taxpayers may want to invest more up front in 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.
- A number of states are enacting strict liability penalties or using special penalties as "sticks" to encourage participation in amnesty programs. Other states have enacted penalties targeting what they view as "inconsistent filing positions." These measures all need to be considered with respect to current tax planning.

These are just some of the considerations that may point you to revisiting your state income tax planning. If you would like to discuss these or other state and local tax matters, please contact one of the attorneys in our Tax Department.