



An Overview of State Initiatives Targeting Tax Efficient Structures

**State Tax Roundtable for Utilities & Power
Lakeshore Towers
Irvine, California
November 5, 2009**

NEXUS: THEN AND NOW

Three areas of focus when discussing whether there exists sufficient nexus for purposes of state taxation

- PL 86-272 (15 USC §381 et. seq.) (1959)
- Due Process Clause
- Commerce Clause/Dormant Commerce Clause

NEXUS: THEN AND NOW

PL 86-272 (excludes certain activities from state taxation)

- States prohibited from taxing net income of non-residents whose activities in the state are limited to the solicitation of sales of tangible property where approval of the order **AND** the shipment or delivery of the goods occur outside the state;

AND

- independent contractors in state, even if maintains an office in state.

NEXUS: THEN AND NOW

Due Process Clause

- Must have minimum contacts with taxing jurisdiction to support imposition of tax

Commerce Clause/Dormant Commerce Clause

- National Bellas Hess, Inc. v. Department of Revenue of Ill., 386 U.S. 753 (1967)
 - Bright-line physical presence requirement established in context of sales and use tax

NEXUS: THEN AND NOW

Commerce Clause/Dormant Commerce Clause (cont'd)

- Complete Auto Transit, Inc. v. Brady, 430 U.S. 274 (1977)
 - U.S. Supreme Court outlined 4 part test to uphold a state tax that impacts interstate commerce. The tax must:
 - (1) be applied to an activity with a substantial nexus with the taxing state;
 - (2) be fairly apportioned;
 - (3) not discriminate against interstate commerce in favor of intrastate commerce; and
 - (4) be fairly related to the services provided by the state.

NEXUS: THEN AND NOW

Commerce Clause/Dormant Commerce Clause (cont'd)

- **Physical v. Economic Presence: What activities are sufficient to create a substantial nexus?**

- Quill Corp. V. North Dakota, 504 U.S. 298 (1992)

- Bright-line, physical presence required in area of sales and use tax

- Geoffrey, Inc. v. South Carolina Tax Comm'n, 437 S.E. 2d 13 (S.C. 1993), cert. denied 510 U.S. 992 (1993)

- Presence of intangible property in state through licensees' use of trademarks in state

NEXUS: THEN AND NOW

Commerce Clause/Dormant Commerce Clause (cont'd)

- **Physical v. Economic Presence: What activities are sufficient to create a substantial nexus? (cont'd)**

- Lanco, Inc. v. Director, Division of Taxation, (908 A.2d 176 N.J. 2006)
 - Corporation business tax may be constitutionally applied to impose an income tax on licensing fees attributable to New Jersey
- A&F Trademark, Inc. v. Tolson, 605 S.E. 2d 187 (N.C. Ct. App. 2004), cert. denied, 126 U.S. 353 (U.S. Oct. 3, 2005)
 - Licensing trademarks to a related retail company operating stores located within state created substantial nexus with North Carolina sufficient to satisfy the Commerce Clause.

NEXUS: THEN AND NOW

Commerce Clause/Dormant Commerce Clause (cont'd)

- **Physical v. Economic Presence: What activities are sufficient to create a substantial nexus? (cont'd)**

➤ Tax Commissioner of W. Va. v. MBNA America Bank, N.A., 640 S.E.2d 226 (W. Va. 2006), cert. denied, FIA Card Services, fka MBNA Am. Bank v. Tax Comm'r of W. Va., Dkt. No. 06-1228 (U.S. Sup. Ct. June 18, 2007)

- An entity's physical presence in a state is not required to meet the 'substantial nexus' prong of *Complete Auto Transit* test, and economic contacts alone are enough to create income tax and franchise tax nexus for an out-of-state credit card company

NEXUS: THEN AND NOW

Commerce Clause/Dormant Commerce Clause (cont'd)

- **Physical v. Economic Presence: What activities are sufficient to create a substantial nexus? (cont'd)**
 - Capital One Bank and Capital One F.S.B. v. Commissioner of Revenue, Dk. Nos. C262391 and C262598 (Mass. App. Tax Bd. June 22, 2007)
 - The Supreme Court of Massachusetts affirmed the Tax Board, holding that physical presence was not required to satisfy the “substantial nexus” prong of the *Complete Auto* test adopting the West Virginia Supreme Court’s analysis in *MBNA*

NEXUS: THEN AND NOW

Means by which states have established or tried to circumvent physical presence standards for establishing nexus:

- Economic nexus
- Sham entity/lack of economic substance
- Forced combination and unitary reporting
- Add back and disallowance statutes

NEXUS: THEN AND NOW

Economic nexus: focus is on economic benefit derived from use of property in state

- Geoffrey, Inc. v. Commissioner of Revenue, No. C27816 (Mass. App. Tax Bd. July 24, 2007)
 - Following its holding in Capital One (previous slide), the Massachusetts Supreme Court held that “substantial nexus” can be established where a taxpayer domiciled in one State carried on business in another State through the licensing of its intangible property that generates income for the taxpayer

See Also:

- Tax Commissioner of W.Va. v. MBNA and Capital One Bank

NEXUS: THEN AND NOW

Sham entity/lack of economic substance

- IDC Research, Inc. v. Commissioner of Revenue, (Mass. App. Tax Bd., Nos. C267868, C268725 and C271245, April 17, 2009)
 - Found licensing arrangement to be a sham transaction with no economic substance
- The TJX Companies, Inc. v. Commissioner of Revenue, 2009 WL 886904 (Mass. App. Ct. April 3, 2009)
 - The Massachusetts Appeals Court affirmed the disallowances of the royalty and interest payments
- Sherwin-Williams Co. v. Tax Appeals Tribunal, No. 94107 (N.Y. Sup. Ct., App. Div. 3rd Jud. Dept., Oct. 28, 2004)
 - Forced combination with intangible holding companies (IHCs) because failed to rebut the presumption of distortion in connection with the royalty rates, the interest rate or the charges for inter-company services

Compare with:

- Sherwin Williams Company v. Commissioner of Revenue, 436 Mass 71 (2002)
 - Found economic substance in transaction apart from tax savings in that SPE had licensing arrangements with third parties and invested some of the proceeds from its royalty income outside of the affiliated group

NEXUS: THEN AND NOW

Forced combination and unitary reporting

- Sherwin-Williams Co. v. Tax Appeals Tribunal, No. 94107 (N.Y. Sup. Ct., App. Div. 3rd Jud. Dept., Oct. 28, 2004)
 - IHCs served no legitimate business purposes, were formed solely as a means to avoid tax and lacked economic substance
- See also Burnham Corp. and In re Express, Inc. et al.,
- Forced combination may be rebutted by showing:
 - economic substance;
 - valid business purpose; and
 - arm's length terms of transaction/commercially reasonable terms

NEXUS: THEN AND NOW

Add Back and Disallowance Statutes

- VFJ Ventures, Inc. v. Surtees, 8 So.3d 950 (Ala. Civ. App., Feb. 8, 2008), aff'd, 8 So.3d 983 (Sep. 19, 2008), cert. denied, 129 S.Ct. 2051 (Apr. 27, 2009)
 - Applicability of add-back statute rested upon meaning of “unreasonable” under Alabama statute
 - Business purpose or substance of the operations of VFJ's Delaware-based subsidiary was not relevant to the determination of the reasonableness of whether the expense should be added back under the statute, but rather whether "the tax resulting from the application of the statute has no 'fair relation' to or is out of proportion to the corporation's activities in Alabama."

NEXUS: THEN AND NOW

Multi-State Tax Commission 8/17/06 Model Statute Requiring the Add-Back of Certain Intangible and Interest Expenses

- **Definitions:**
 - Intangible Expenses
 - Interest Expenses
 - Related Member
 - Valid Business Purpose

- **Exceptions:**
 - Credit for Taxes Paid by Related Member
 - Conduit Transactions
 - Expenses Subject to Tax in other Jurisdiction
 - Alternative Adjustments/Computations

NEXUS: THEN AND NOW

Multi-State Tax Commission 8/17/06 Model Statute Requiring the Add-Back of Certain Intangible and Interest Expenses (cont'd)

- Definitions:

- Intangible Expenses:

- Acquisition, use, maintenance or management, ownership, sale, exchange or other disposition to extent allowed by the Internal Revenue Code of 1986, as amended (the “Code”)
- Amounts allowed as deductions under section 163 of the Code
- Losses related to factoring and discounting transactions
- Royalty, technical, patent, etc., fees
- Licensing fees
- Other similar expenses and costs

- Interest Expenses:

- As allowed under 163 of the Code
- Related Entity:
 - »(i) Individual and related members as set forth in section 318 of the Code, (ii) stockholders and stockholders’ partnerships, LLCs, estates, trusts or corporations, or (iii) corporations and related parties that require attribution of stock from corporation to party or from party to corporation under attribution rules under the code, in all cases, that own directly, indirectly, beneficially or constructively, in the aggregate, at least 50% of the value of the outstanding stock or corporation, as applicable

NEXUS: THEN AND NOW

Multi-State Tax Commission 8/17/06 Model Statute Requiring the Add-Back of Certain Intangible and Interest Expenses (cont'd)

- Definitions (cont'd):

- **Related Member:**

Defined as a person that, with respect to the taxpayer during all or any portion of the taxable year, is a:

- (i) Related entity, (ii) component member as defined in section 1563(b) of the Code, (iii) person to or from whom there is an attribution of stock ownership in accordance with section 1563(d) of the Code, and (iv) person that, notwithstanding its form of organization, bears the same relationship to the taxpayer as a person described in (i) through (iii)
- Definition (iv) is NOT widely included in the add-back statutes adopted by the various states and does not require related member to be part of consolidated group (only CT, GA, MA, OR have adopted his definition)

- **Valid Business Purpose:**

- One or more business purposes, other than the avoidance or reduction of taxation, which, alone or in combination, constitute the primary motivation for some business activity or transaction, which activity or transaction changes in a meaningful way, apart from tax effects, the economic position of the taxpayer
- The economic position of the taxpayer includes an increase in the market share of the taxpayer or the entry by the taxpayer into new business markets

NEXUS: THEN AND NOW

Multi-State Tax Commission 8/17/06 Model Statute Requiring the Add-Back of Certain Intangible and Interest Expenses (cont'd)

- Exceptions:
 - Credit for Taxes Paid by Related Member
 - Conduit Transactions
 - Establish by clear and convincing evidence that (i) related member during the same taxable year, directly or indirectly paid, such portion to a non-related member; and (ii) transaction giving rise to intangible expenses/costs was undertaken for a valid business purpose
- Expenses Subject to Tax in other Jurisdiction
 - Establish by clear and convincing evidence that (i) the related member was subject to tax on its net income in this state or another state or possession of the United States or some combination thereof; (ii) the tax base included the intangible [interest] expense incurred by the taxpayer; and (iii) the aggregate effective rate of tax applied to the related member is no less than [X%] [the statutory rate of tax applied to the taxpayer under this chapter minus Y percentage points]

NEXUS: THEN AND NOW

Multi-State Tax Commission 8/17/06 Model Statute Requiring the Add-Back of Certain Intangible and Interest Expenses (cont'd)

- Exceptions (cont'd):
 - Alternative Adjustments/Computations
 - The add-back is not required (and therefore no credits against such add-backs can be taken), if the corporation and the commissioner agree in writing to the application or use of alternative adjustments or computations.
 - The commissioner may, in his/her discretion, agree to the application or use of alternative adjustments or computations when he/she concludes that in the absence of such agreement the income of the taxpayer would not be properly reflected.

NEXUS: THEN AND NOW

Multi-State Tax Commission 8/17/06 Model Statute Requiring the Add-Back of Certain Intangible and Interest Expenses (cont'd)

- Exceptions (cont'd):
 - Expenses Subject to Tax in Foreign Jurisdiction
 - The add-back is not required (and therefore no credits against such add-backs can be taken), with respect to the portion of intangible [interest] expenses for which the taxpayer establishes clear and convincing evidence that:
 - »(i) the intangible [interest] expense was paid, accrued or incurred to a related member organized under the laws of a country other than the United States;
 - »(ii) the related member's income from the transaction was subject to a comprehensive income tax treaty between such country and the United States;
 - »(iii) the related member's income from the transaction was taxed in such country at a tax rate no less than that imposed by this state; and (Currently only NC has this exception)
 - »(iv) the intangible [interest] expense was paid, accrued or incurred pursuant to a transaction that was undertaken for a valid business purpose and using terms that reflect an arm's length relationship.

NEXUS: THEN AND NOW

- No less than 24 states have enacted some form of forced combination or unitary reporting requirements based upon substantial inter-corporate transactions and 8 other states have pending legislation under consideration.
- No less than 19 states have enacted some form of add-back or disallowance statute.
- At least 18 states have a conduit exception. All but 4 require that the transaction have a valid business purpose.
- 15 states have a subject to tax exception. 7 of these states require a minimum aggregate effective tax rate.
- 11 states have some form of exception allowing for an agreed upon alternative computation.
- 8 states have an “unreasonable” exception, 6 of which require clear and convincing evidence of the “unreasonableness” of the add-back.
- 6 states have an exception for related members organized under the laws of a jurisdiction other than the United States. 4 of the 6 states also require proof of a valid business purpose. Only NY, NC and WV also require that the foreign related member’s income be taxed at a rate equal to or greater than that of the taxpayer’s state.
- At least 14 states have state specific exceptions such as disclosure prerequisites, related member non-tax location criteria for taxpayer to qualify for deduction and unitary election filings

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