CORPORATE INCOME TAX AVOIDANCE

MTC

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Corporate Income Tax Avoidance: Intangible Holding Companies, Captive REITS, East / West Companies and other corporate income tax planning structures that exploit separate company reporting.

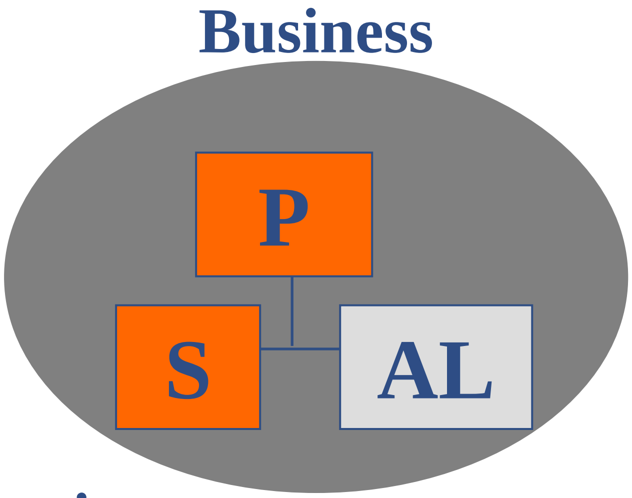
Note: The tax avoidance examples contained herein are examples of common tax avoidance structures, but are not based on a specific taxpayer.

Corporate Income Tax Avoidance

- *Piecemeal Solutions to a Systemic Problem*
- *Evolving Tax Avoidance Structures*
- *Alabama’s Expense Disallowance Statute*

Corporate Income Tax Avoidance

Background



- A large multi-state business typically consists of many related corporations.
  - Related party transactions
  - Income isolation
- Separate reporting states employ business income tax systems that impose a tax on the individual corporations that form the larger business rather than imposing a tax on business as a whole. *
- The typical multi-state business will have some, but not all, of its corporate members subject to tax in your state.

* Combined return jurisdictions technically impose their income tax on the individual corporation. However, the combined income base of the unitary business is apportioned to determine the individual corporation's taxable income.

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Problem

- **Large multi-entity multi-state businesses exploit separate reporting systems by manipulating the separate company income reported by individual group members.**
  - **Tax motivated related party transactions shift income out of state or into tax advantaged special purpose entities.**
  - **Profitable large businesses often report little or no income.**
- **Revenue losses are obviously important.**
- **The impact of tax avoidance on the integrity of the tax system is more important.**
  - **Small business and most individuals cannot avoid tax.**
  - **Tax avoidance produces a regressive system.**
  - **The tax system's lack of equity creates cynicism and distrust of government.**

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Problem

- Systemic - Not just tax shelter specific
  - Our separate company reporting corporate income tax systems are fundamentally flawed

Solutions

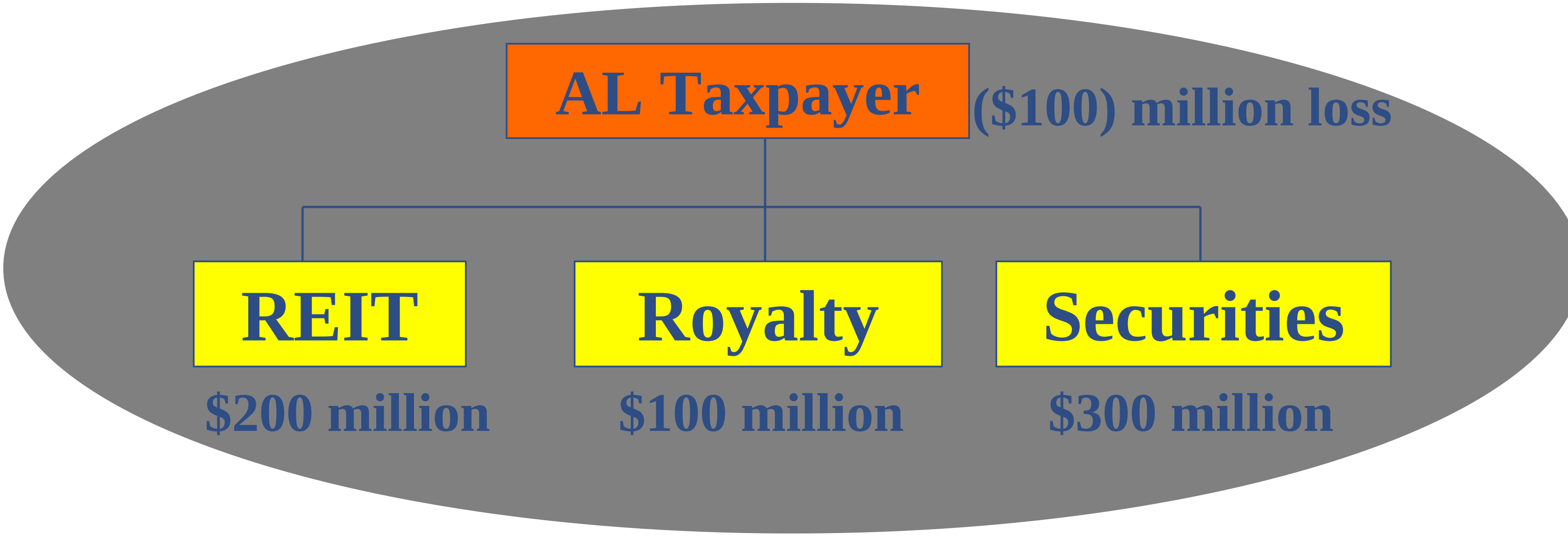
- A systemic problem requires a systemic solution.
- The two available systemic solutions are found at opposite ends of the spectrum of possibilities.
  - Eliminate / Replace the Corporate Income Tax
  - Combined Reporting
- Are systemic solutions politically out of reach?
- States are left with piecemeal responses.

Corporate Income Tax Avoidance

State Responses to Corporate Income Tax Avoidance

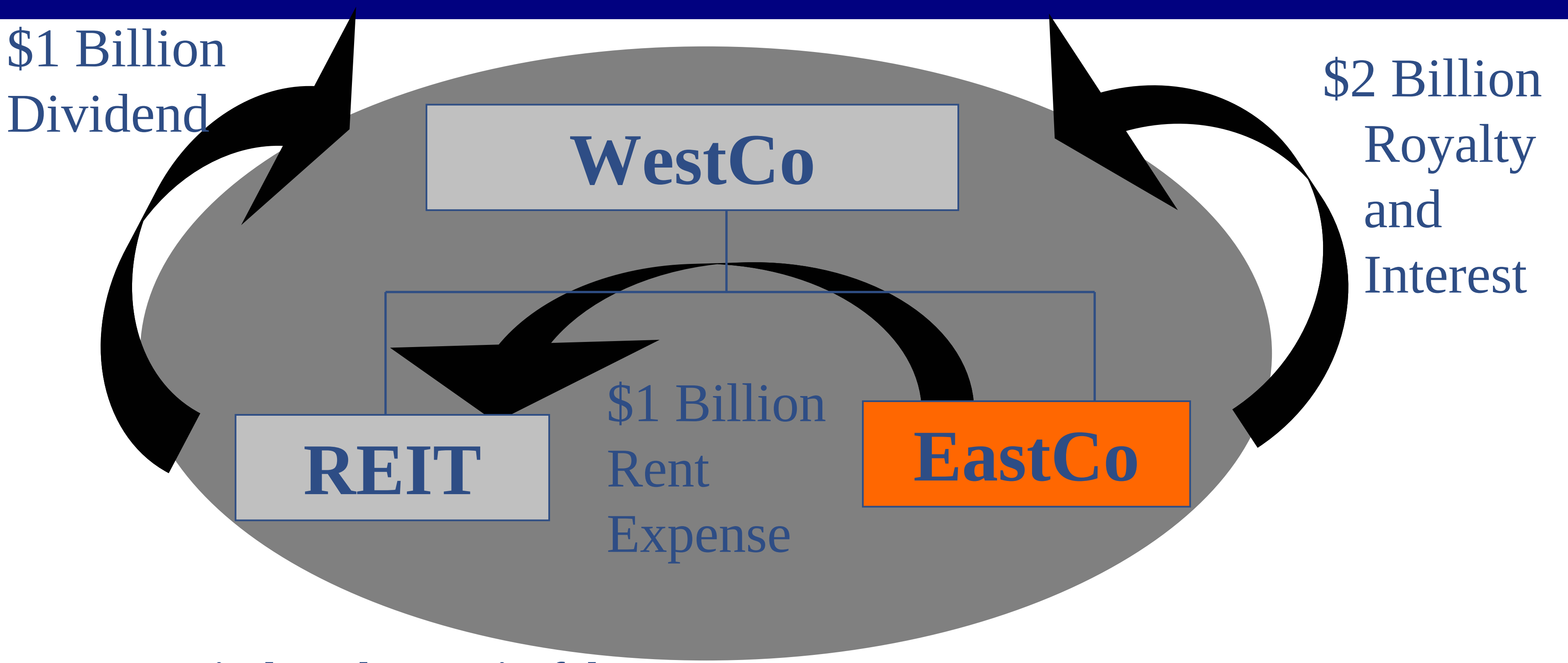
- **Economic Nexus**
  - **From *Geoffrey* (over a decade old) to *A&F Trademark, SYL, AutoZone Properties, LanCo* (all 2003-2004)**
- **Substance over form challenges:**
  - **Business purpose, economic substance, sham transaction, step transaction, forced combination**
  - ***Sherwin-Williams* and *Syms* in Massachusetts**
- **482 / Transfer pricing – Discretionary Authority Statutes**
  - **Are they more than IRS style transfer pricing?**
  - **Is my economist better than your economist?**
- **Expense Disallowance (Add-Back) Statutes**
  - **Alabama, Arkansas, Connecticut, Massachusetts, Maryland, Mississippi, New Jersey, New York, North Carolina, Ohio, Virginia**
  - ***VFJ Ventures* - Alabama circuit court case scheduled for October**

Tax Avoidance Example



- The business earns $500 million of taxable income annually.
- The REIT takes advantage of a double deduction to eliminate its Alabama taxable income.
- The Royalty and Securities companies claim to be outside of AL’s taxing jurisdiction.
  - They are thinly domiciled in Delaware.
  - They incur only $1500 of rent and $9,000 of salary expense to earn $400 million of income.

Tax Avoidance Example



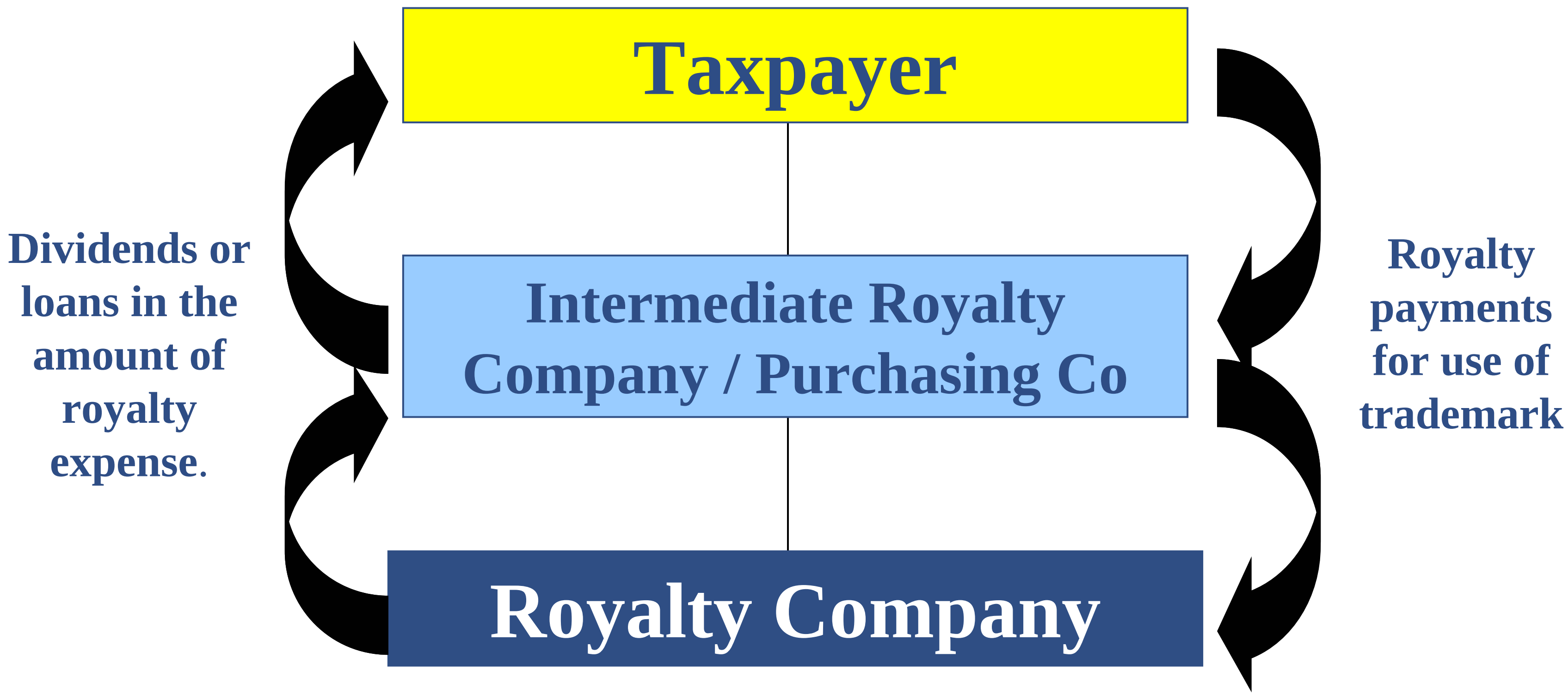
- **EastCo is the only meaningful separate company state taxpayer.**
  - **Eliminates income through deductible rent and royalty payments.**
- **REIT takes a dividends paid deduction that eliminates its taxable income and creates a double deduction.**
- **WestCo has $5 Billion of income but is located in combined return states where intercompany transactions (income) eliminate.**

Tax Avoidance Example – Royalty Company

<u>Royalty Company</u>

- **Controls intellectual property (name and logo) and receives $100 million of royalty income from FS Group members.**
- **Charges AL Taxpayer Group a fee to use name and logo.**
- **Royalty Company claims to be isolated in tax haven state, but it lacks significant economic substance.**
- **Does not file AL return.**

Tax Avoidance Example - Dual Royalty Company

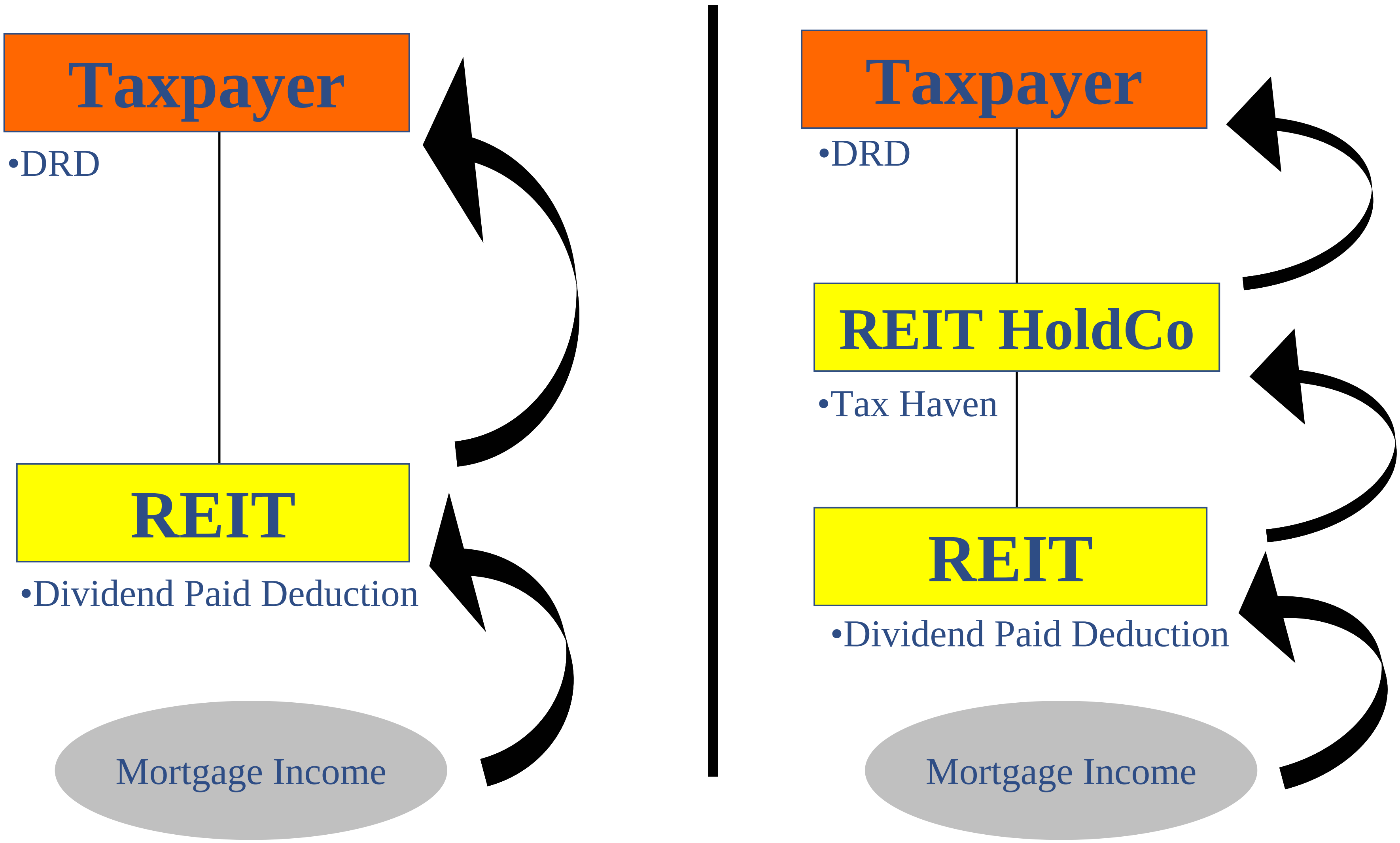


• Taxpayer sublicenses IP from intermediate related company that licenses IP from 2nd related company.

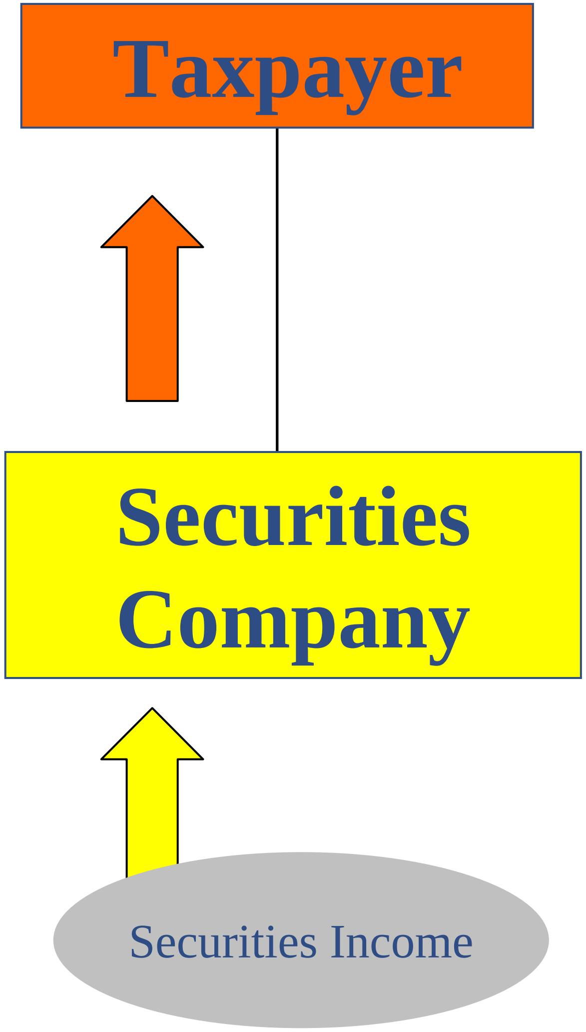
•Intermediate related member is a near break even company that may file in many jurisdictions, and may serve additional functions.

•Economic nexus??? Add-Back???

Tax Avoidance Example – Captive REIT



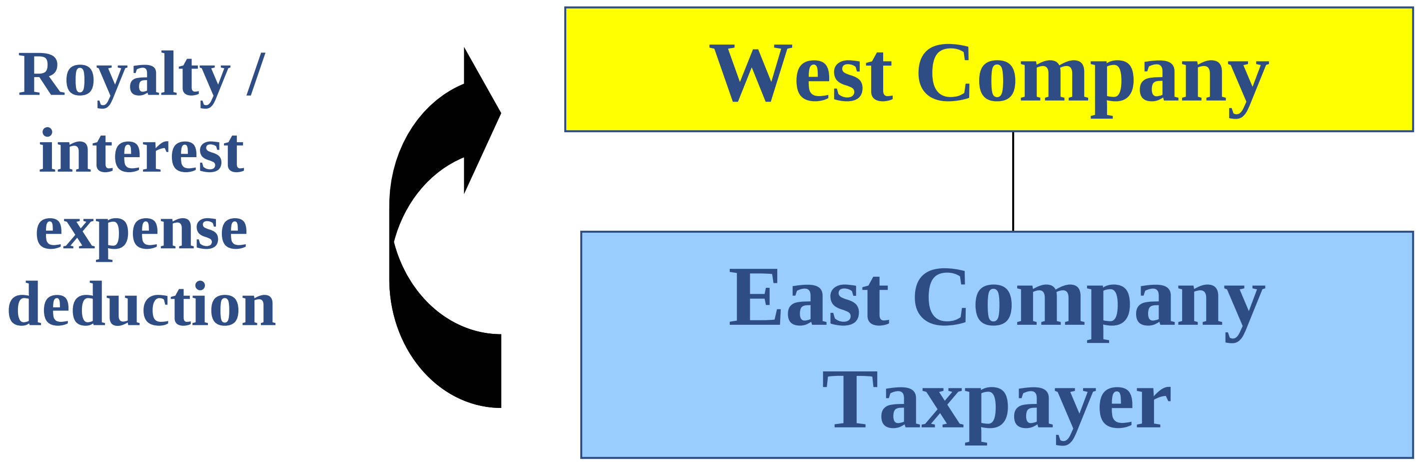
Tax Avoidance Example – Securities Company



Securities Company

- Controls AL based Group’s multi-billion dollar securities portfolio and $100s of millions of annual securities income.
- Claims to be based in tax haven and not doing business in Alabama.
  - Does not file AL return.
  - Has only shared office space in Delaware ($< $5,000 rent/yr).
  - Has only a part time employee (<$10,000 total salary exp).
  - Is the securities portfolio actually managed in AL?

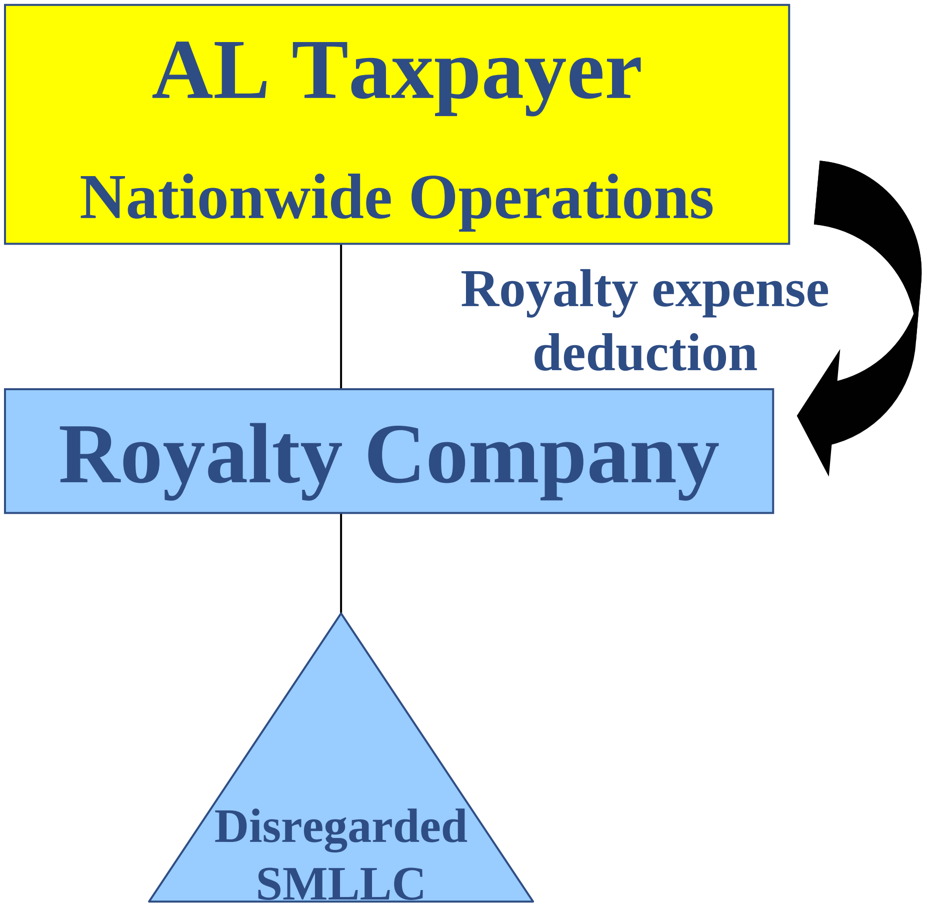
Tax Avoidance Example - East/West Structure



- Multi-state (nationwide) business divides its operations into two corporations by contributing operations in East (euphemism for separate return states) to a NewCo with West Company retaining operations in the West (euphemism for combined return states) and all intangibles.
  - May qualify for exception to add-back statute?
  - May withstand substance over form sham transaction challenge?
  - Does it have anything to lose in an economic nexus challenge? Apportionment benefit?
- Some variation of East / West structure is the future of state tax planning for large multi-state taxpayers.

Tax Avoidance Example - East/West Light

- As a step short of complete East/West structure, taxpayer drops operations from one combined return jurisdiction into DE / SMLLC and contributes LLC to RC.
- LLC is used to avoid multiple transfers of hard assets.
- Allows RC to argue that it is no longer “primarily engaged.”
- Substance added by the disregarded LLC may allow the structure to withstand state challenges:
  - Add-back
  - Sham transaction, and
  - Economic Nexus Single Factor Apportionment.



LLC holds operations in combined return state

Add-Back Statute – Problems to Consider

- **Add-back statutes may be vulnerable to:**
  - **East / West structures**
    - **Potential primarily engaged subject to tax or exception.**
  - **REIT**
    - **Rent not an intangible expense, or**
    - **No related party expense to disallow b/c 3rd party income is diverted before reaching the taxpayer.**
  - **Securities Company**
    - **No related party expense to disallow b/c 3rd party income is diverted before reaching the taxpayer.**
  - **Intermediate transactions**
    - **Disguise intangible expenses,**
    - **Intermediate related member may qualify for exception.**