Multistate Tax Commission

Corporate Income Tax Sheltering Work Group Report

Prepared for the
State Tax Compliance Initiative Steering Committee

June 17, 2004

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I. State Tax Compliance Initiative

The Multistate Tax Commission Executive Committee authorized the State Tax Compliance Initiative in April 2003 to develop methods of improving compliance with state taxes in three key areas:

- Business income tax sheltering
- Pass-through entity shareholder income reporting, and
- Sales and use tax compliance, including both business use tax and nexus issues.

The Compliance Steering Committee was established by the Executive Committee to develop plans for improving state tax compliance in these areas.

The Corporate Income Tax Sheltering Work Group, which considers the first of the three compliance areas, held its initial meeting in July 2003 in Salt Lake City, Utah. At this and a series of teleconference meetings, the group identified a list of significant problem areas with tax sheltering and the incomplete reporting of corporate income. Section II provides a brief overview of the corporate income tax. The problem areas identified by the workgroup issues are identified in Section III of the report. Section IV describes solutions to these problems areas that can be adopted either separately or jointly by the states. Pro/Con statements on these solutions are presented in Section V. The final section provides recommendations of the work group.

The work group is chaired by Gerald Goldberg (California). Its membership has included representatives from 13 states:

Joe Garrett, *Alabama* Michael Mason, *Alabama* Tamara Harris, *Arizona* Walter Anger, *Arkansas* Danny Walker, *Arkansas* Michael Brownell, *California* Caglar Caglayan, *California* Ben Miller, *California* Ben Jablow, *Florida* Lynn Chenoweth, *Idaho* Gary Gear, *Idaho* Dick McFarland, *Idaho* Ted Spangler, *Idaho*	Jennifer Hays, *Kentucky* Michael Fatale, *Massachusetts* Alan LeBovidge, *Massachusetts* Shona McHugh, *Montana* Brian Staley, *Montana* Lennie Collins, *North Carolina* Mary Loftsgard, *North Dakota* Janielle Lipscomb, *Oregon* Eric Smith, *Oregon* John Mintken, *New Hampshire* Chuck Redfern, *New Hampshire*

II. State Taxation of Corporate Income

Forty-four of the states and the District of Columbia tax the net income of corporations that is earned within their states. These states generally tax the portion of business income that is apportioned to their state and nonbusiness income that is allocated to their state in accordance with the provisions of the Uniform Division of Income for Tax Purposes Act (UDITPA) or their own state provisions. The Multistate Tax Compact, which created the Multistate Tax Commission, includes the provisions of UDITPA; thus, members of the MTC generally follow UDITPA guidelines for apportionment of income among the states. In additions, several states tax the activities of corporations using tax structures that are closely related to the net income tax. These include the Michigan Single Business Tax, the Texas Franchise tax, and the Washington Business and Occupations Tax. Corporate income taxes and similar taxes on corporate income accounted for $25.9 billion in revenues in 2002.[1] An analysis of corporate income tax revenues relative to total state revenues and corporate profits can be found in Recent Trends in State Corporate Income Taxes.[2] **Appendix A** of this report provides a summary table of significant features of state corporate income taxes.

In its recent report, Federalism at Risk,[3] the Multistate Tax Commission made several recommendations regarding the corporate income tax. These recommendations can be found in **Appendix B** of this report. The work of the State Tax Compliance Initiative builds upon this previous work by focusing on specific issues that pose a threat to the state corporate income tax base. Others have also examined compliance issues with the state corporate income tax and made recommendations that can be considered by the states.[4] The accuracy of reporting of corporate income for both financial and tax purposes has received substantial attention over the past year. The State Tax Compliance Initiative aims to increase awareness of steps that States can take to improve corporate income tax compliance and make recommendations of actions that the States should adopt.

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[1] U.S. Census, State Government Tax Collections, 2002 (Revised March, 2004), http://www.census.gov/govs/statetax/0200usstax.html

[2] Elliott Dubin, *Recent Trends in State Corporate Income Taxes*, Multistate Tax Commission Review, 2000 (September 2000): 7 (available at www.mtc.gov)

[3] Multistate Tax Commission, Federalism at Risk, June 2003 (available at www.mtc.gov)

[4] See Michael Mazerov, *Closing Three Common Corporate Income Tax Loopholes Could Raise Additional Revenue for Many States,* Center on Budget and Policy Priorities, May 23, 2003; Richard Pomp, *The Future of the State Corporate Income Tax: Reflections (and Confessions) of a Tax Lawyer,* The Future of State Taxation, edited by David Brunori, The Urban Institute Press, Washington, DC., 1998; William Fox and Lee Ann Luna, *State Corporate Tax Trends: Causes and Possible Solutions,* National Tax Journal, LV (September 2000); *Combined Reporting: A Comprehensive Method of Closing Corporate Tax Loopholes*, Massachusetts Budget and Policy Center, March 27, 2003, http://www.massbudget.org/article.php?id=155; and *Setting the Record Straight on Combined Reporting,* Massachusetts Budget and Policy Center, March 30, 2004, http://www.massbudget.org/article.php?id=205

III. Significant State Tax Sheltering Problems

The Corporate Income Tax Sheltering Work Group has identified thirteen high priority corporate income tax sheltering issues. These can be grouped into four major areas: Entity Isolation, Uniformity, Sales of other than Tangible Personal Property, and Federal-State Issues.

The specific issues identified under each of the four major areas are:

III.A. Entity Isolation

A number of States accept or require that taxes on or measured by income be computed on the basis of the books and records of separate corporate entities without regard to the fact that the entity may be a member of a commonly owned and controlled group of entities that function as a single business. Taxpayers have the opportunity to reduce taxes in an individual state by forming entities to either geographically or functionally isolate transactions or activities of the business within an entity. If the entities engage in transactions with each other the pricing of those transactions will determine which entity reports income, and how much income the entity has from the transactions. The accuracy of the separate entity returns is dependent upon the correctness of the pricing of transactions between members of the group.

The states have experienced a number of problems with taxpayers' use of separate entities as a means of avoiding state income taxes. These devices include manipulations of income between related entities by 1) failure to reflect intercompany transactions at fair value; 2) the creation of multiple entities to create expenses and to isolate the corresponding income in a separate legal entity in a state where that income is not taxed; and 3) the creation of separate entities as "nexus shields" by limiting the "presence" of the entity to a single state.

The specific strategies identified as giving rise to the greatest concern and how they operate are as follows:

III.A.1. Intangible Holding Companies (IHC)

A unitary business transfers its patents and trademarks to a subsidiary incorporated in a state that does not tax such income. The subsidiary maintains its only office in that state. Operating subsidiaries pay licensing fees to the intangible holding company giving rise to an expense on their books thereby reducing their income and shifting income to the intangible holding company. The IHC is typically organized in a state that either has no corporate tax, does not tax income from intangibles, or has a comparatively low tax rate.

More recently, the unitary business incorporates the IHC in a combined reporting state so its existence has limited tax consequences or places the licensing activity in an operating entity in a state that uses combined reporting. In a combined reporting state the income from the licensing activity will be included in the tax base regardless of where the licensing activity is located but it will be excluded from the tax base of the separate entity states.

III.A.2. Nexus Carve Outs

The creation of a separate entity that restricts its activities within a state may also allow a business to shield individual entities from taxation under the nexus standards of the Commerce Clause. Public Law 86-272 may allow an entity to make sales into a state without being subject to taxation within that state regardless of whether there are unitary group members subjected to tax by that state. This may yield significant savings in state taxes. These savings may be multiplied in the absence of throwback rules and inconsistent reporting by the taxpayer.

III.A.3. Security Holding Companies

A unitary business transfers the securities it holds to a separate entity organized or incorporated in a state that either does not tax such income or taxes it at a low rate. The returns on income from the securities (dividends, interest and gain or loss) are isolated in the entity. The entity does business in only one state. The income is removed from the operating entities. This strategy may give rise to additional savings through the use of intercompany loans that create an expense for one entity and income for another and by transferring assets that might otherwise be included in the apportionment formula.

III.A.4. Management Companies

A separate entity is incorporated to perform management functions. It operates in a single state. It has little or no property beyond an office, typically has only a few employees, and has only sales arising from servicing its related operating entities. The operating entities have an expense for the management fee paid to the management company and the fee is the management company's income. All of the management company's income is assigned to a single state, which does not tax that income or taxes it an advantageous rate.

III.A.5. Special Purpose Entities

There are a variety of special purposes entities such as Real Estate Investment Trusts (REITs), Regulated Investment Companies (RICs), and Insurance Companies that either receives special treatment under state income tax laws or are not subject to state corporate taxes on or measured by income. Transferring assets to such entities transfers the income realized from those assets to those entities. This strategy may give rise to additional savings through the use of intercompany loans which create an expense for one entity and income for another and by transferring assets that might otherwise be included in the apportionment formula.

III.A.5.a. Real Estate Investment Trusts (REITs)

With a REIT, the apportioning corporation can drop its real estate assets or mortgage portfolio into the subsidiary REIT. Under the Internal Revenue Code, the REIT serves as a pass-through entity and generally pays no federal or state income tax. Federal law generally denies a dividend received deduction for payments from the REIT. However, some states have not conformed to that rule. Thus, the shareholder of the REIT also asserts the right to a dividend-received deduction with respect to the same dividend. For real estate assets, the net effect is that the parent obtains a lease deduction for use of its own property with no corresponding rental income being taxed.

For separate entity states that have conformed to the federal dividends received deduction, a REIT holding company can be interposed between the REIT and the apportioning corporation. The REIT shareholder is then able to take the dividends received deduction because it receives the dividend not directly from a REIT but from the REIT holding company. These schemes are frequently used by large retailers and financial institutions.

III.A.5.b. Regulated Investment Companies (RICs)

A taxpayer invests in a Regulated Investment Company (RIC) in which is has a more than 50% ownership interest. Taxpayer asserts that it and the RIC are properly included in a combined report. The state's rules conform to federal law, except that the rule providing for denying the recipient a dividend received deduction does not provide for a denial of a dividend elimination between members of a combined reporting group. The RIC asserts entitlement between members of a combined reporting group. The RIC asserts entitlements to a dividend paid deduction, while the unitary parent corporation claims a dividend elimination for dividends paid between members of a unitary group.

III.A.5.c. Insurance Companies

Virtually all states tax insurance companies on the basis of their gross premiums. As a result any income earned by insurance companies is not subject to tax. If income producing assets are transferred to an insurance subsidiary, from commonly-owned affiliates, the income from those assets will not be taxed until the insurance subsidiary declares a dividend. Then it will only be taxed if the state taxes dividends. The states have become aware of the fact that corporate taxpayers are creating entities that qualify as insurance companies and are transferring income producing assets to the subsidiaries thereby removing the income from the entities that would pay a tax on or measured by income. The assets can be left, tax free, in the insurance company and the insurance company can loan money to it affiliates. The loan will require the payment of interest, an expense for the income tax paying entity, and income from the insurance subsidiary that will not be taxed.

III.A.6. Foreign Intangible Holding Companies

This is a variation on the Intangible Holding Company strategy in that the entity is organized in a foreign country. In that circumstance the correct reporting of income may be an issue for the Internal Revenue Service. The IRS may perform an arm's-length audit to ensure the correct geographic assignment of income between the United States and the foreign country. To the extent the foreign intangible holding company's income is derived from the use of the intangibles in other foreign countries this income is likely to escape United States taxation and therefore state taxation.

III.A.7. Corporate Inversions

United States-based businesses can establish a foreign country-based holding company as the parent company. Even in a water's-edge combined report environment this strategy allows the parent company to be excluded from the water's-edge return, because the parent company is no longer a U.S. domestic corporation. It can also be used to transform what were Controlled Foreign Corporations subject to the Internal Revenue Code's Subpart F provisions into foreign corporations that are no longer controlled by a United States corporation.

III.B. Uniformity

The fifty States and the District of Columbia all have the power to assess taxes on or measured by corporate income. Their taxing powers are subject to constraints imposed by the United States Constitution, principally the Due Process Clause of the Fourteenth Amendment and the Commerce Clause. Within those constraints, however, the States have great flexibility in determining the amount of income that they can properly assert jurisdiction over. First, they can and do define income differently and allow different deductions. Second, the States provide for different tax credits. Third, they have different rules relating to "combining" or consolidating the results of related entities. Fourth they have different rules for classifying income as allocable or apportionable. And finally, the states use different apportionment rules and formulas. All of these things reflect determinations made by the individual state legislators and are a product of our federalism. Nonetheless, all of these give rise to a lack of consistency which burdens taxpayers with multiple compliance concerns and also gives rise to multiple opportunities for tax planning to take advantage of the differences and to create "nowhere" income. The specific strategies identified as given rise to the greatest concern and how they operate are as follows:

III.B.1. Inconsistent Reporting

It is the experience of the states that some taxpayers will report a transaction in a different manner to states that have identical, or virtually identical, allocation and apportionment rules. A common example occurs with respect to the sales factor where a taxpayer claims that its activities in a state where it sells its product are insufficient to allow a state to tax it and it claims with respect to the state from which the product is shipped that its activities in the destination state are sufficient to be taxed so that it can avoid having the sale "thrownback" to the state of shipment. Another common example arises with respect to the reporting of income as business or nonbusiness income. The item is reported as business income in the state where it would be assigned if it was nonbusiness income and it is reported as nonbusiness income in some or all of the other states.

III.B.2. Structural Non-Uniformity

The states have different laws and regulations. In some cases the courts, or the administrators, of the states interpret the same law differently. This lack of uniformity provides planning opportunities. The result is that taxpayers may be able to shield significant amounts of income from state taxation. Greater uniformity in state laws and interpretations will lead to the appropriate corporate income being taxable by the states. Corporate tax planners model the tax statutes of the various states and plan organizational structures and transactions to take advantage of the differences in state tax laws to minimize state income tax payments. In some instances there is no purpose to the structure or the transaction other than to minimize state income taxes. These tactics yield significant tax savings. For the uninformed or poorly advised they may also act as a trap and corporate taxpayers may pay tax to the states on more income than they actually earn. Adoption of uniform laws by the states would make state income taxes a zero sum game and eliminate the incentive for tax planning.

III.B.3. Telecommunications Industry

The business of telecommunications companies almost invariably has connections throughout the country if not the world. Their income is typically derived from an enormous number of individual transactions (calls) which are delivered through either their own systems or the systems of others to which they are connected. These systems traditionally have involved large capital investments justified by the volume of the traffic they can handle. New technologies and the structure of the industry have in some cases reduced the need for large investments in tangible assets. Each member of the industry is likely to have reporting requirements in many states. Because the industry itself does not conform to the original UDITPA model of mining, manufacturing and mercantile operations, UDITPA's standard rules do not provide appropriate direction for the assignment of income. As a result the states have developed a hodgepodge of rules to assign income that varies not only between the states but also frequently between members of the industry even within a single state.

III.B.4. Financial Industry

The standard UDITPA formula was developed in the 1950's to address an economy that consisted largely of manufacturing, mining and mercantile companies. UDITPA as written specifically excluded financial organizations. At that time financials tended to restrict their activities to a single state and issues of allocation and apportionment between the states were not significant. Times have changed and members of the financial industry no longer are required to restrict their activities to a single state and therefore questions of allocation and apportionment of income have become significant. Because the financial industry does not fit neatly within the three-factor apportionment formula set forth in UDITPA the states have individually developed their own rules for the assignment of income of banks and financials. In 1994, the Multistate Tax Commission adopted the Recommended Formula for the Apportionment and Allocation of Net Income of Financial Institutions. These rules have generally been adopted by 22 states. The industry has continued to evolve and the MTC rules may now be dated. Individual development has led to a lack of uniform treatment. The lack of uniform rules gives rise to the over taxation and under taxation of the income of the industry.

III.C. Sales of Other than Tangible Personal Property (Section 17 of UDITPA)

The standard UDITPA formula was developed in the 1950's to address an economy that consisted largely of manufacturing, mining and mercantile companies. The bulk of the receipts of these companies arose from selling tangible personal property. Section 16 of UDITPA provides generally that the sales of tangible personal property are assigned to the state where the customer is located. If the taxpayer is not taxable in that state the sales are thrown back to the state from which the product was shipped. Section 16 was intended to reflect the contribution of the market state in recognition of the fact that the payroll and property factors reflect the contribution of the states where the product is produced.

Section 17 of UDITPA provides rules for the assignment of sales of other than tangible personal property. Assignment for purposes of section 17 is made on the basis of income producing activity. Because income producing activity often involves the use of property and the contribution of employees it may replicate the property and payroll factors. It may not reflect the market in the case of the providing of services or the licensing of intangible property. Also section 17 does not contain a throwback rule. Finally section 17 operates on an "all or nothing" basis. If income producing activity occurs in more than one state, all of the sales is assigned to the single state where the greatest amount of income producing activity occurs.

At the time UDITPA was written sales of other than tangible property generated a comparatively small portion of the total receipts of most business. The assignment or the receipts from such sales was unlikely to materially affect the sales factor and they appear to have been included in the sales factor as an afterthought for purposes of completeness. As the United States economy has changed it has become more service oriented. Sales of other than tangible property probably now represent more than one-half of the total receipts of business organizations in the United States. In addition, many states have moved from an equally-weighted three-factor formula or property, payroll and sales to a formula that places greater, and in some cases, exclusive weight on the sales factor.

The assignment of sales of other than tangible personal property on the basis of income producing activity often does not accomplish what is generally accepted as the purpose of the sales factor – reflection of the contributions of the market state. In addition, the arbitrariness of the all or nothing ruling exacerbates the dissatisfaction with the rule. It is the single area of the apportionment rules which is most likely to give rise to a requirement by tax administrators, or requests by taxpayers, for a variation from the statutory rules, or the adoption of special apportionment formulas by statute or regulation.

III.D. Federal-State Issues

Actions at the federal level frequently have state tax consequences or the potential for state tax consequences. Frequently these consequences are indirect. The States have either not taken advantage of the opportunities that exist or have been foreclosed from using them because of the failure of federal lawmakers to realize the need to authorize state action.

III.D.1. Corporate Sheltering

The marketing and employment of tax sheltering devices and strategies has increased dramatically over the last several years. Many of these devices are of questionable validity. The tax revenues involved are so significant that the Internal Revenue Service has established a list of questionable transactions and has received enforcement tools aimed at the promoters of these devices and strategies. For virtually every state, devices and strategies that impact federal tax collections also have an impact on state collections.

III.D.2. Proscriptive Federal Legislation

The United States Constitution vests the power to regulate interstate and foreign commerce in the Congress, Art. I, Sec. 8, cl 3, the "Commerce Clause." Much of the United States Supreme Court's state tax jurisprudence involves so-called "dormant commerce clause" applications, that is areas where there has been no specific federal legislative action. The Commerce Clause, however, is also an affirmative grant of power to the Congress. Under the Commerce Clause Congress can specifically prohibit state action, Public Law 86-272 and the Internet Tax Moratorium as examples, or specifically authorize state action, such as the McCarran-Ferguson Act which allows states to tax and regulate insurance companies without regarding to the limitations of dormant Commerce Clause analysis. Congressional actions, however, have traditionally been proscriptive in nature. State efforts have been focused on preventing further proscriptive actions.

Public Law 86-272 was enacted almost 50 years ago as a temporary measure to provide protections to interstate businesses pending the study of state taxation of interstate business. It provides a shield from state corporate income taxation, or taxes measured by income. Public Law 86-272 permits a business to make an unlimited amount of sales into a state and pay no income tax provided that it limits its activities in the state to the solicitation of sales of tangible property and approves and fills the orders from outside the state. Business interests are currently sponsoring legislation to expand the protections provided by Public Law 86-272 to other activities and to include other taxes under its provisions. Public Law 86-272 can be used by a multi-form business to establish nexus carve-outs where sales are run through a separate entity. The separate entity, by limiting its presence in the state, is free from tax while related entities that are part of the same economic business are free to engage in other activities including those in support of sales.

III.D.3. Failure to Consider States in Federal Solutions

Most States conform generally to the Internal Revenue Code. Some States even automatically conform to amendments to the Internal Revenue Code. Conformance is not possible, however, when the federal action affects issues involving foreign commerce unless specifically authorized by Congress. An example would be federal efforts to deal with corporate "inversions." Congress can authorize actions by either the federal or state governments. When such issues are presented to the Congress the focus has traditionally been only on the federal implications. If the legislation does not also authorize similar State action the dormant Commerce Clause is likely to prevent conformity. See Kraft General Foods, Inc. v. Iowa (1992) 505 US 71.

IV. Solutions to Tax Sheltering Problems

The Corporate Income Tax Sheltering Work Group has identified the following solutions to the compliance problems identified in Section III.

IV.A. Combined Reporting

Combined reporting involves the preparation of a "return" or schedule that computes the income of affiliated corporations on a consolidated financial statement basis. The income is then divided between income of the unitary business and income which is outside of the unitary business. Nonbusiness income is specifically allocated to a state or entity. The combined business income is apportioned among the states based on a group-level apportionment percentage. In the combined report, income from intercompany transactions is generally eliminated or deferred, and then later taken into account only when the asset is sold to an entity outside of the combined reporting group. Because the total income earned by the group is ultimately captured and apportioned, intercompany pricing generally becomes irrelevant.

There are a number of models of apportionment in a combined reporting context. In general, the business income of the unitary group is assigned to a given state based on the group's share of the property, payroll, and sales in the state compared to the property, payroll, and sales of the group everywhere. Tax may be determined on a collective basis or each corporation in the group that is taxable in the state may file its own return. To determine an individual taxpayer's liability each of the taxpayer's in-state apportionment factors are divided by the group's apportionment factor, averaged, and the percentage is applied to the business income of the group. That is a process commonly known as intrastate apportionment (i.e., division of group's income apportioned to a given state between the members that are taxable in that state). Typically, each taxpayer member determines its own liability based on its intrastate apportioned share of combined reporting income, as well as any nonbusiness income it earns on its own.

Some states employ a form of unitary combined reporting that takes into account the business income of all members of the unitary group (worldwide combined reporting), whether or not those members are foreign. However, the general practice is some form of limitation on the use of combined reporting (by election or by rule) to income or entities within the United States. This limited form of combined reporting is generally referred to as water's-edge combined reporting. There are other variants such as nexus combination where the combined report is limited to those entities that are taxable within the state.

Water's-edge combined reporting comes in a number of variations. The water's-edge may by limited to only domestically incorporated entities. Some states pick-up foreign country incorporated entities only to the extent of their United States activities while others may pick up all the income and activities of foreign country incorporated entities if they have any presence in the United States. Other states pickup the activities of "controlled foreign corporations" through incorporation of Subpart F of the Internal

Revenue Code. Finally, Montana has extended to water's-edge to include the activities undertaken in "tax haven" jurisdictions or by corporate inversions.

A threshold question that needs to be answered is whether combined reporting is applicable whenever a unitary relationship exists or whether it is resorted to only when it is necessary to obtain a fair reflection of income. If the combined report is used only when it is necessary to fairly reflect income then the tax administrator will have to meet an initial burden of proof in showing that the separate books and records do not meet this standard. This issue is likely to be contested by the taxpayer.

IV.B. Geoffrey Litigation

The states have experienced a number of problems with taxpayers' use of separate entities as a means of avoiding state income taxes. One of the favored entity isolation strategies is to create an intangible holding company. Intangible property, such as patents, copyrights or trademarks, are transferred to a wholly owned entity that is established in a state with favorable tax treatment or a state that uses combined reporting. The holding company licenses the patents, copyrights or trademarks to one or more related entities creating an expense for the operating companies and income for the holding company. The holding company may have only a few or no employees and may not have an office.

In 1993 the State of South Carolina successfully litigated a case against Geoffrey, Inc. a subsidiary of Toys "R" Us that was an intangible holding company that owned the Toys "R" Us trademark and logo and received a percentage royalty on sales made in Toys "R" Us stores. Geoffrey, Inc. v. South Carolina, (1993) 437 S.E. 2nd 13, cert. denied 126 Led 2nd 451. South Carolina took the position that the licensing of intangibles for use in South Carolina gave rise to an intangible or economic presence within the state sufficient to subject Geoffrey, Inc. to South Carolina's corporate income tax. It should be noted that Geoffrey had no employees and no tangible property anywhere. Geoffrey was incorporated in Delaware, but for purposes of that state's tax statutes was not subject to a tax there. The amount of income assigned to South Carolina was equal to the royalties paid to Geoffrey on the sales made by the South Carolina stores. It is not clear from the case whether the income assignment made to South Carolina was on the basis of specific allocation or a sales factor apportionment.

The State of New Mexico has made a similar assessment with respect to Kmart Properties, Inc., the intangible holding company of Kmart. KPI was established in Michigan and had three employees and a rented office in that state. KPI was not subject to a tax measured by its royalty income in Michigan. New Mexico asserted that KPI had nexus in New Mexico because of the economic presence involved in licensing the intangibles for use in the state. New Mexico made an additional attributional nexus argument that because the local stores had a duty to protect the value of the names licensed by the holding company, the employees of each of the stores acted as a representative for the holding company. The New Mexico hearing officer sustained the state's determination of nexus on both grounds. The Court of Appeals affirmed in an unpublished opinion. The New Mexico Supreme Court has granted certiorari, but has delayed action in the case.

IV.C. Expense Disallowance

The typical Expense Disallowance statute ("ED Statute") consists of a broad and objective general rule that disallows particular expenses, generally interest expenses and expenses relating to intangibles, paid to a related party. Many state statutes then allow for exceptions to the general rule. The standard for qualifying for exceptions varies. Some exceptions require an agreement with the taxing authority while others do not. Some exceptions are more subjective like the "unreasonable" exception found in a number of ED Statutes, while others like the "subject to tax" exception may be more objective. The "subject to tax" exception found in many ED Statutes is phrased as an attempt to prevent double taxation.

IV.D. Income Realization Requirement

Distributions from special purposes entities such as Real Estate Investment Trusts, Regulated Investment Companies and Insurance Companies are frequently allowed as deductions in computing the income of their shareholders. Assets can be placed in such entities to exempt them from income taxation and then when distributions of the profits are made to shareholders they are exempted from income taxation by allowing a deduction with respect to the dividends or other distributions that are made. Even in circumstances where the distributions may be taxable, the profits realized by these entities can be "warehoused" in such entities and not distributed thereby at least deferring taxation and if timed correctly perhaps avoiding taxation completely. For example, insurance companies are typically taxed by states on the basis of their gross premiums; that is, any income realized is not taxed. If a deduction is allowed with respect to dividends received from insurance companies the income of the insurance companies is never taxed. Even if a deduction is not allowed with respect to dividends the insurance company can forgo declaring dividends and retain its income thereby deferring income taxation. If the shareholder has a loss from other operations the dividend can be declared at a time when the losses shield the dividends from taxation.

State statutes can be amended to deny the deductions in whole or in part or to require the shareholders to report "deemed" distributions. Standards can be legislatively established that allow for preferential treatment with respect to normal operations but which would trigger distributions when tax avoidance is the principal reason for retaining profits in the special purposes entities.

IV.E. Arm's Length Audits

Commonly owned corporate taxpayers frequently do not have a need to precisely or accurately compute prices for intercompany transactions. Prices can be set within a range of values and in many circumstances there are no, or limited, comparable uncontrolled transactions to which the pricing decisions can be compared. An expense for one entity is income to the other. The income and expense necessarily equal each other and therefore cancel each other out. For purposes of the consolidated financial statements of the business the intercompany transactions are irrelevant. As a consequence the pricing of transactions between related entities is of no significance for financial reporting purposes and can be set at levels that minimize taxes.

By overcharging an affiliate corporation for products or services, a selling entity has more taxable income than it would otherwise have and the purchasing entity (when the purchasing entity sells the goods to an unrelated purchaser) will have correspondingly less income. If the state tax rate where the selling corporation does business is substantially lower than the state tax rate where the purchasing corporation does business, the combined taxes paid in both states by both entities is less than if fair value was paid.

Arm's length audits refers to an examination by a tax administrator of a transaction, generally between related parties, to determine if it was entered into at a fair price; that is, the price that would have been arrived at by a willing buyer and a willing seller. If it was not done on that basis then the pricing of the transaction, and therefore the income and expense of the respective parties, is adjusted to what it should be.

IV.F. Sham Transaction Analysis

The sham transaction doctrine treats the transaction as if it was unreal and therefore had not occurred. It is based upon either common law principles or the statutory right of a tax administrator to disregard transactions lacking economic substance or a business purpose other than tax avoidance. Generally the tax administrator must show that there is no other reason than, or that the predominate reason was, tax avoidance. This solution is similar in effect to an expense disallowance statute.

IV.G. Reporting Option

This strategy provides the taxpayer with an option of using combined reporting, but only with the state's permission, or alternatively the taxpayer will have to accept some other adjustment such as having its intercompany expenses disallowed.

IV.H. Uniform or Model Statutes or Regulations

The Commissioners on Uniform State Laws propose model uniform laws for adoption by the states. It provides a forum for bringing together interested parties, supported by academia, to debate and arrive at solutions uninfluenced by the parochial concerns of individual parties. Adoption of uniformity proposals by the states gives rise to similar laws in all of the states. To the extent the proposals are adopted, construction by any one state can be used to construe the law in other states. The activities of the Commissioners on Uniform State Laws has had a number of successes.

The Uniform Division of Income for Tax Purposes Act (UDITPA) is one of its products. UDITPA was proposed in the 1950's. In the 1960's it was adopted by close to a majority of the States but it has never achieved the level of acceptance that many other State uniform acts have received. With the passage of time even states that adopted UDITPA have succumbed to political pressures and have modified UDITPA. The principle example of this is the abandonment of the equally-weighted three-factor formula in favor of a formula that places an increased emphasis on the sales factor.

IV.I. Special Industry Model Rules

Section 18 of UDITPA allows the tax administrator to allow or require the use of allocation and apportionment methods other than those required by the other provisions of UDITPA when the standard methods do not fairly reflect the activities of the taxpayer in the State. The reporter for UDITPA recognized that section 18 could be used to address industries that did not conform to the assumption inherent in UDITPA. Section 18 of UDITPA places discretionary authority in the tax administrator to allow or require variations from the standard rules. As such it allows for the promulgation of rules for an industry. Under the authority of Section 18 the MTC has adopted special rules for Construction Contractors, Airlines, Railroads, Trucking Companies, Television and Radio Broadcasting and Financials.

IV.J. Centralized Database

A centralized database would collect the year-by-year filing positions taken by the taxpayer with respect to each state and could be updated to reflect any audit adjustments made by a state. It could be maintained in connection with descriptions and summaries of individual state laws that would allow for the identification of required reporting differences.

IV.K. Section 18 Relief

Section 18 was placed in UDITPA to provide relief when the standard rules do not work. It specifically authorizes the tax administrator to allow or require variations from the standard rules. Reliance on section 18 requires a showing that the standard rules do not fairly reflect the activities within a state. It has been used as authority for adopting uniform rules for regular occurring circumstances that do not fit the standard rules and for industry solutions.

IV.L. Throwback Rules and Throwback Affidavits

UDITPA assigns sales of tangible personal property on a destination basis to the state where the customer is located. Goods may be shipped into a state where a taxpayer is not taxable either because it lacks a sufficient presence in the state, or because its activities are protected by Public Law 86-272. In those cases UDITPA has a "throwback" rule which provides that the sales are assigned to the state from which the product was shipped. The rationale behind the rule is that all income should be assigned to some jurisdiction that has the ability to tax the income. In the absence of a throwback rule sales would be assigned to the destination state where the income could not be taxed and "nowhere" income would be created through the use of the apportionment formula. Not all states have adopted throwback rules. In addition, the UDITPA throwback rule applies only to sales of tangible personal property.

In auditing whether the throwback rules apply the state from which the goods are shipped would require a taxpayer claiming that the sales should not be thrownback to submit an affidavit attesting to the activities engaged in for each state in which it asserts sales should be assigned. If the affidavits are accepted the auditing state would provide them to the destination state. The affidavit could be used by that state in any dispute as to whether the taxpayer was taxable in that state so that the sale should not be thrownback to some other state.

IV.M. Inconsistent Filings - 51-jurisdiction Spreadsheet

State tax statutes could contain a requirement that corporate taxpayers account for their reporting of income to all States in conjunction with the filing of their tax return. The spreadsheet would allow a state to compare a taxpayer's filing position in their state with the filing position taking in a sister state with comparable laws. It could be shared amongst the states to ensure that taxpayers have correctly disclosed their filing positions. A proposal for a federal requirement for a 51-jurisdiction spreadsheet was made by the Worldwide Unitary Taxation Working Group in 1984.

IV.N. Disclosure of Inconsistent Filing Positions

State statutes or regulations could contain a requirement that a taxpayer disclose when it files its returns that it has taken an inconsistent position with respect to the treatment of an item on a return filed with another State that has similar laws.

IV.O. Disclosure - Penalties and Presumptions

Without penalties or presumptions as a consequence of a failure to provide required information the requirement is more likely to be ignored. For example, if a state determined that inconsistent filing positions had been taken in filing returns with itself and a sister state it would be able to assert a presumption that the filing position in the other state would be correct in the circumstances where it would result in a greater tax for itself. The ability to assert penalties or apply presumptions would establish consequences to this requirement and would achieve greater compliance with it.

IV.P. Amnesty

This strategy provides taxpayers with the opportunity to correct prior inconsistent filing positions whether inadvertent or purposeful. It would need to be coupled with the imposition of penalties for failure to report inconsistent filing positions in order to provide for an incentive for taxpayers to take advantage of amnesty. The current California Voluntary Compliance Initiative (See under IV.R.1) is a successful example of a state income tax amnesty. This initiative provides investors an opportunity to come forward and amend their returns, backing out any tax avoidance transactions to avoid new and enhanced penalties

IV.Q. Whistleblowers

States often receive leads on taxpayer noncompliance that trigger single-state enforcement efforts. A coordinated process for evaluating and referring whistleblower complaints would enable the states to make more effective use of information from whistleblowers and leads from the public.

IV.R. Listed Transactions

Taxpayers have been required to report, on their tax return, if they have participated in specific abusive or questionable transactions that have been identified by the IRS or a State.

IV.R.1. Federal Listed Transactions and IRS-State Memorandum of Understanding

The Internal Revenue Service has identified and defined "listed transactions" for federal income tax purposes that have been marketed by tax professionals throughout the country. These transactions are likely to have state consequences as well. One of the ways for the States to achieve leverage from federal issues is to establish greater cooperation with the federal government and the Internal Revenue Service, in particular, on specific issues. The federal "listed transactions" process and the Memorandum of Understanding (MOU) that has been signed by the federal government with a number of states is an example of steps that can be taken. Efforts under the MOU have provided thousands of leads to California and resulted in earlier sharing of information on tax shelter cases between the federal government and the states.

IV.R.2. State Listed Transactions

In addition, there are state-only strategies that have been marketed by tax professionals that may be lacking in factual or legal support. California has passed legislation to address state-only shelters and provide for a voluntary compliance initiative before new and higher penalties come into effect.

In October 2003, California enacted SB614 to combat abusive tax avoidance transactions fashioned after the Grassley-Baucus bill pending at the federal level. The new law provides the state with powerful tools to combat abusive tax avoidance transactions, including extending the statute to 8 years for these transactions, imposing heavy penalties on the investors and promoters, and adding requirements for reporting, registration, and maintenance of lists.

Under the new law, California has the authority to list state-only transactions similar to the federal "listed transactions". In its first Chief Counsel Announcement, California listed two state-only transactions involving Real Estate Investment Trusts (REITs) and Regulated Investment Companies (RICs). In the same announcement, California has also incorporated all of the federal "listed transactions".

IV.R.3. State Information Sharing

Forty-four of the states have also recently entered into a Memorandum of Agreement through the Federation of Tax Administrators to exchange information on investors in and promoters of abusive tax avoidance transactions.

IV.R.4. Multistate Listed Transactions

The states, through a multistate process, could define "multistate listed transactions" that are subject to reporting and disclosure under state law. Transactions could be reportable either to individual states or to a multistate clearinghouse. Reportable "transaction" could include federal listed transactions or transactions or reporting defined by the states, that have a potential for tax avoidance. Reporting could also be required from taxpayers on income reporting characteristics, such as income tax nexus, definition of business and non-business income, and apportionment factors by state. In order to participate in this process, states would need to enact legislation that allows for the designation of listed transactions. To ensure that transactions are reported, states would need to include penalties on promoters or taxpayers for not reporting listed transactions.

IV.S. State Specific Federal Legislation

States can make their collective voice heard with Congress to prevent the enactment of legislation that restricts their taxing ability or alternatively to encourage the passage of federal legislation that allows the states to tax to the extent permitted under the Due Process Clause of the Fourteenth Amendment.

IV.T. State Inclusion in Federal Legislation

Most States conform generally to the Internal Revenue Code. Some States even automatically conform to amendments to the Internal Revenue Code. Conformance is not possible, however, when the federal action affects issues involving foreign commerce unless specifically authorized by Congress. An example is federal efforts to deal with corporate "inversions." Congress can authorize actions by either the federal or state governments. When such issues are presented to the Congress the focus has traditionally been only on the federal implications. If the legislation does not also authorize similar State action the dormant Commerce Clause is likely to prevent conformity. See Kraft General Foods, Inc. v. Iowa (1992) 505 US 71.

V. Application of Solutions to Specific Problems – Pro/Con Statements

Pro/con statements for each of the Section IV solutions are presented in this section. This is organized by major problem area from Section III and by the type of strategy that the solution addresses. The purpose of providing a statement of the Pros and Cons is to allow state policy makers to evaluate each of the solutions. The Cons are frequently phrased in the manner in which its proponents might state them. Policy makers need to have some understanding of objections that are likely to be raised by opponents of change. The listing of the Cons should not be construed as an endorsement by the Corporate Income Tax Sheltering Working Group of their validity.

Any individual solution may address a number of strategies or tactics. To the extent possible the strategies or tactics are grouped for discussion purposes. However, the Pros and Cons of a solution may differ with respect to the various strategies or tactics. This may necessitate a different specific discussion for each of the strategies. At times a solution may need to be tailored or modified to respond to a particular strategy or tactic.

Entity Isolation

Entity Isolation – Combined Reporting (IV.A)

Intangible Holding Companies (III.A.1)
Security Holding Companies (III.A.3)
Management Companies (III.A.4)

Pros:

- **Theoretically Accurate.** Combined reporting is widely accepted as a theoretically appropriate measure of income earned in a state or jurisdiction, even when the taxpayer is engaged in a worldwide unitary business. It provides a better estimate than separate entity reporting of the geographic location of income. For the same reasons that formulary apportionment is superior to separate accounting for attributing income within a single corporation, it is superior for a commonly owned group of corporations engaged in a single business enterprise ("a unitary business"). The factors – property, payroll and sales – measure real economic activity contributing to a business' ability to earn income, i.e., its use of capital, labor and the market. By measuring the real activities of a unitary business rather than the activities of separate corporate entities, combined reporting is less susceptible to tax planning practices that do not reflect economic reality and reduces unhealthy forms of tax competition between and among states.

- **Tax Equity.** If used uniformly by all states in which a taxpayer does business, combined reporting results in neither double taxation of income nor "no where income."

- **Sanctioned by the U.S. Supreme Court.** Combined reporting has been sanctioned by the United States Supreme Court. Many states have implemented it without a statutory basis. If a statutory basis is provided, it should withstand judicial challenges.

- **Neutralizes Tax Impact of Income Shifting through Non-Market-Based Inter-company Transactions.** Because combined reporting includes all business income and losses of a unitary group in a single combined report, the members of the unitary group cannot obtain an advantage by manipulation of intercompany pricing. Generally, income is not taken into account until the object of an intercompany transaction is sold to an unrelated party. The income that is combined includes the income of both the member that sold in the intercompany transaction and the member that purchased in the intercompany transaction. Thus, if there is a pricing manipulation, understated income by one member is balanced by the inclusion of overstated income by the other member. In general, this obviates the need to do an audit examination, commonly referred to as an "arm's-length audit" under section 482 of the Internal Revenue Code. Because the unitary and apportionment audit examination is generally far less resource intensive to the states (and to taxpayers) than a section 482 examination, a combined report is a far more efficient examination, as well.

- **Neutralizes Tax Impact of Income Shifting to Intangible Holding Companies.** Because the royalty expense of one member is equal to the royalty income of the other included member, the income and expense are both included in the same combined report and therefore offset, which puts the business in approximately the same position that it would have been had the intangible holding company not been created. The combined business income of the group is the same as the business income of the member determined without regard to the royalty expense. Because a separate entity has been created, income of the unitary group is "intrastate apportioned" between two members rather than one. In general, however, the sum of the taxes paid by both entities in a given state are roughly comparable to the taxes that would have been paid by the single entity if the intangible holding company had not been created. Thus, the combined reporting method is seen as superior to anti-abuse statutes, which rely upon sham transaction and business purpose doctrines to defeat such planning devices.

- **Tax Equity between Multi-State/Multi-National Businesses and In-State Businesses.** *Purely in-state taxpayers obtain no benefit from the creation of multiple entities because all of the income, whether realized in one entity or several entities, is subject to the state's tax*. To the extent combined reporting reduces the ability of multi-state and multi-national businesses to shift income out of state and avoid state taxes, it creates equality, consistency and fairness between purely in-state taxpayers and multistate/multinational taxpayers.

- **More Consistent, Predictable Tax Base.** Combined reporting tends to generate a more consistent and predictable tax base because corporate structuring or the use of manipulative devices cannot readily be accomplished to undermine a state's ability to impose its tax based on the portion of the unitary business conducted in that state.

- **Avoid Arbitrary Results.** Combined reporting helps avoid arbitrary results that may occur when taxing a single corporation within a large multistate business enterprise. (For example, the separate corporation has a large income while the overall unitary business is suffering major losses, or vice versa.)

- **Revenue Enhancement.** While the tax effect of combined reporting is neutral from an overall perspective, in practice combined reporting will have a generally positive impact on state tax revenue because it reduces the ability of corporations to benefit from shifting income earned in a particular state to an out-of-state affiliate. Combined reporting addresses tax planning opportunities arising from entity isolation. Taxpayers are in control of their organizational structure. State taxes may not dictate corporate organizational structures, but it would be naïve to think that corporations will forgo opportunities to reduce state tax costs through corporate structuring when they arise and can be accomplished without other costs that exceed the savings involved. Where profits of a unitary business have been concentrated in an out-of-state affiliate, combination will recognize these profits as part of the income of the unitary business, subject to apportionment, and will likely increase the amount of tax due the state.

- **Efficiencies in Audit and Compliance**. States and taxpayers are already familiar with the unitary business principle. States are required by the Due Process Clause of the Fourteenth Amendment and United States Supreme Court jurisprudence to employ the unitary method even in the context of separate entity reporting. The determination of whether income is business or nonbusiness income requires application of the unitary business principle to separate entities also. Extending those determinations to all the entities included within a consolidated financial reporting group presents no greater challenges and may in fact simplify the process. Use of combined reporting, and the use of a single return for reporting purposes for all members of the unitary business, will reduce the number of returns filed and will eliminate the need to review intercompany transactions to make sure that income is fairly reflected. States and taxpayers will be able to use federal consolidated returns as a starting point for the preparation and review of state returns.

Cons:

- **Fact Intensive.** Opponents will argue that the combined reporting method requires a unitary determination. What constitutes a unitary business is frequently a subjective determination. It may not be easy to determine what commonly-controlled entities are within and without the unitary business. In cases involving corporations engaged in the same line of business or which constitute component parts of a vertical manufacturing process, the unitary determination is usually fairly straightforward. However, in cases of dissimilar or merely complementary business, the unitary determination can be fact intensive and difficult, requiring a qualitative (not quantitative) determination of "contribution or dependency" between the corporations, "flows of value" and "substantial mutual interdependency," which are somewhat subjective standards that have their origins in constitutional Due Process Clause and Commerce Clause jurisprudence. (See, in general, *Container Corp. v. Franchise Tax Board* (1983) 463 U.S. 159 at 183.) Because determination of which companies belong in the unitary group can give rise to fact-intensive audits and litigation, there may be a perceived lack of predictability and certainty.

  On the other hand, such determinations are generally far less resource intensive than an arm's-length audit under section 482. Supporting and sustaining adjustments under the authority of section 482 have proven costly and difficult for non-combined reporting states. Furthermore, states are already required by the Due Process Clause of the Fourteenth Amendment to apply the unitary principle when a single taxpayer does business within and without the state.

- **Fiscal Impact Difficult to Predict.** It may be difficult for a separate entity state to estimate the fiscal impact of conversion to combined reporting. Combined reporting is a neutral accounting system from an overall perspective. It should neither generally increase nor generally decrease tax revenues. Its application to individual SPECIFIC taxpayer situations can either increase or decrease the amount of tax due, depending on the facts of the particular case. In some cases, combination will offset an in-state corporation's profits with an out-of-state affiliate's losses, and reduce the amount of tax due. In other cases the reverse will be true. Combination will also affect the "weight" of in-state apportionment factors, as the property, payroll, and sales of the out-of-state affiliates are included in the apportionment formula. The affect of combination on apportionment factors could be positive or negative, depending on the specific facts of each case.

- **Not a "*Cure All.*"** Combined reporting is not a cure-all to entity isolation problems. See **Nexus Carve-Outs (III.A.2).**

  - ✓ **Non-Income Taxpayer Affiliates.** Many combination states subject certain entities to a separate taxation scheme. For example, many combination states do not tax the income of insurance companies, but instead subject the insurance company to a gross premiums tax. If, as a result, combined reporting between an insurance company and a general corporation is not permitted, an insurance company can become a tax-sheltering device for a general corporation parent. If a general corporation contributes more capital to the insurance company subsidiary than it reasonably needs for insurance risks, taxation of income from dividends, interest, gains, rents, royalties, etc., may be avoided, if such income is generally beyond the reach of both the income tax and the gross premiums tax.

  - ✓ "**Nexus Carve-Out.**" Combined reporting cannot easily cure another form of entity isolation, known as a "nexus carve-out." For example, assume an entity has nexus with a state, and is therefore required to apportion income attributable to sales of tangible personal property that have a destination in that state. If the entity separately incorporates its taxable activity in that state, it may, with planning, assert the protection of Public Law 86-272 with respect to its destination sales. If the state follows the principles of *Appeal of Joyce, Inc.,* (Cal. State Bd. of Equal., No.66-SBE-069 (Nov. 23, 1966)), sales of the newly created (and now exempt) entity are no longer assigned to the numerator of that state. If the point of origin state does not have a "throwback" rule, income attributable to the sale escapes taxation in any state, resulting in "nowhere income," which encourages corporate tax planning that combined reporting under Joyce cannot cure. This problem can be avoided if the combined reporting state adopts the principles of *Appeal of Finnigan* (Cal. State Bd. of Equal., No. 88 SBE-022A (Aug. 25, 1988), reh'g denied (Jan. 24, 1990)), which assigns the sale to the destination state if *any* member of the unitary group is taxable in that state. The business income of the group is apportioned with respect to the group as a whole, reflecting the sales of the "exempt" entity, and the resulting apportioned income is then "intrastate apportioned" among the members of the group that are taxable in that state. While the method described in the *Appeal of Finnigan*, supra, was sustained in *Citicorp North America v. Franchise Tax Board* ((2000) 83 Cal.App.4th 1403, cert. den., 533 U.S. 963), it has not been widely adopted by the states and is usually controversial.

- ✓ **Foreign Subsidiaries in Tax-Haven Countries.** Allowing for the use of combined reporting on a water's-edge basis will not control entity isolation on an international level and may give rise to constitutional concerns implicating the Foreign Commerce Clause and Commerce Clause discrimination. If a water's-edge basis is chosen, elective or required, the water's-edge needs to be defined. On the other hand, widespread use of the alternative, worldwide combined reporting would revive the international controversy that arose in the 80's and 90's.

- **Significant Transition Effort.** Transitioning to a combined reporting method will require the separate entity states and state practitioners to master methods of combined report mechanics, which may require a transition period before adoption. Training will be required for auditors, appeals officers, and legal staff on the concepts, rules, regulations and requirements of combined reporting.

- **Special Transitional Issues.** A change from single entity to combined reporting will create transitional issues related to whether a unitary group should be required or permitted to reconstruct the tax attributes from the earlier separate entity period of reporting. For example, in a combined report context, intercompany transactions are effectively disregarded and a transferee takes the basis of the transferor. Companies that acquired assets when they filed on a separate basis will carry assets at their cost, while assets acquired when combined will have a carryover basis resulting in a lack of similarity in valuation. This may mean that asset values will have to be restated to ensure consistency. There may be transition issues related to the choice of effective dates in cases where members of the unitary business have different accounting periods.

- **Mechanical Issues.** Combined reporting can present a number of mechanical issues similar to those in consolidated reporting, particularly for situations when members leave the common group. Unique federal/state issues arise when the federal consolidated return group is not substantially identical to the combined reporting group. In addition, because, unlike the consolidated return rules, there is no common "joint and several" tax liability for the group as a whole; a number of distinct state level issues are created associated with the integration of nonbusiness income and the process of intrastate apportionment.

- **Policy Issues.** Several additional policy issues will need to be addressed if a state adopts combined reporting. For example, a state will need to determine whether it will follow *Joyce or Finnegan* rules, whether it will adopt a worldwide or water's-edge approach, and whether it will include flow-through entities in the combined group. (See Nexus Carve-Out above)

- **Initial Litigation.** Because of the fact-intensive nature of a unitary inquiry, it takes some time to develop a supporting body of administrative and judicial decisions. The use of a combined report will give rise to increased litigation, at least initially, while a state's definition of a unitary business is developed.

- **Need for Additional Uniformity.** Lack of uniform statutory and regulatory standards can contribute to inconsistent determinations. Reported jurisprudence shows that reasonable minds can and do differ as to whether particular taxpayers are in a unitary business relationship, thus creating the appearance of arbitrary decision-making. In addition, a lack of uniformity, consistency and clarity regarding the tax treatment of nexus and throw back rules, pass-through entities, tax-exempt entities (such as insurance companies) in a combined report of income can make even legitimate tax planning difficult. A perceived lack of predictability can cause combined reporting to be seen as an anti-business tax policy.

- **Perceived as Inaccurate by Some.** Some have objected to the use of the combined reporting method, claiming it does not have a direct correlation to the amount of income that is actually "earned," *as determined by traditional separate accounting*, by each of the members, if the intercompany pricing were actually adjusted to an arm's length value under section 482. This has caused some in the business community to view the unitary method as "anti-business." (Note: Despite the fact that the results of a unitary combined reporting apportionment may not necessarily produce the same apportioned income as would be the case of a section 482 adjustment if it were properly done under federal standards, combined reporting is considered an acceptable means of accounting for intercompany transfers of value because "separate accounting … may fail to account for contributions to income from functional transaction, centralization of management and economies of scale" (*Mobil Oil v. Comm. of Taxes* (1980) 455 U.S. 425 at 438). Both methods are "imperfect proxies to an ideal which is not only difficult to achieve in practice, but also difficult to describe in theory." (*Container Corp. v. Franchise Tax Board* (1983) 463 U.S. 159 at 183.)

Entity Isolation – Combined Reporting (IV.A)

Nexus Carve Outs (III.A.2)

Pros:

- **The Finnigan Rule Has Been Approved As Consistent With Unitary Theory.** Under *Finnigan* nexus determinations are made on the basis of the presence of the unitary business. This is consistent with unitary theory and combined reporting that recognizes and apportions income only when it results from dealings with outsiders. Unitary theory treats separate legal entities as if they were divisions of a single corporation. The method described in the *Appeal of Finnigan* (Cal. State Bd. of Equal., No. 88 SBE-022A (Aug. 25, 1988), reh'g denied (Jan. 24, 1990)), was sustained in *Citicorp North America v. Franchise Tax Board* ((2000) 83 Cal.App.4th 1403, cert. den., 533 U.S. 963). It has been adopted by regulation in Utah and Kansas. It was approved in Arizona in *Airborne Navigation v. Arizona Department of Revenue* ((1987) 395-85-I, Ariz. Board of Tax Appeals).

Cons:

- **Finnigan has not been widely adopted.** Even the California Board of Equalization that originally promulgated *Finnigan* has abandoned it, *Appeal of Wynn's International* (1999) 98R-0857 Cal State Board of Equalization). The courts of several other states have specifically rejected it.

- **Litigation Will Result.** Adoption of the *Finnigan* rule will lead to litigation. Whether or not its use can be sustained will not be known for several years and will give rise to a period of protracted uncertainty.

- **Finnigan May Violate Public Law 86-272.** Public Law 86-272 limits the ability of a state to assert an income tax based upon the activities of the person in the state. It is questionable whether courts would construe "person" to include a unitary business as compared to a corporation.

Entity Isolation – Worldwide Combined Reporting (IV.A)

Foreign Intangible Holding Companies (III.A.6)
Corporate Inversions (III.A.7)

Pros:

- **Judicially Accepted.** The use of worldwide combined reporting has been judicially validated by the United States Supreme Court, *Container Corporation of American v. Franchise Tax Board* (1983) 463 U.S. 159, and *Barclays Bank PLC v. Franchise Tax Board* (1994) 512 U.S. 298.

- **Incorporate Through Election.** For those states that have adopted a water's-edge election, the description of what entities are included in the water's-edge group can be modified to include those types of formal structures that are believed to give rise to unacceptable tax advantages. Because the combined report group is determined by a taxpayer's election, it can be tailored to address specific issues that might otherwise be considered to give rise to constitutional challenges. Because a taxpayer elects to file on a water'-edge method a state can describe the water's-edge in a manner that might be subject to constitutional challenge under the foreign commerce clause if a state required that method of filing. For example, a state could require that a water's-edge return include the income and factors of entities established in foreign tax havens. A state could not require a taxpayer to do this because of foreign commerce concerns, but if a taxpayer elects it probably cannot object. It can be argued that a taxpayer that elects "waives" constitutional objections.

Cons:

- **Foreign Country Concerns.** Increased use of worldwide combined reporting may cause foreign countries to complain to the federal government about a state tax practice that they consider to be inconsistent with international practice. Such complaints may cause the federal government to adopt restrictions on state tax policies because of the affect that those policies have on foreign relations or foreign commerce. However, to the extent the use of worldwide combined reporting is expanded to deal only with tax avoidance strategies, it is unlikely to draw the attention of major foreign trading partners of the United States.

Entity Isolation - *Geoffrey* Litigation (IV.B)

Intangible Holding Company (III.A. 1)

Pros:

- **Administrative Implementation.** The strategy can be implemented administratively. Many states would be able to use their existing doing business statutes to assert nexus and the taxability of intangible holding companies.

- **Open Statute of Limitations.** Because taxpayers have typically taken the position that intangible holding companies do **not** have a reporting requirement in states other than where they are incorporated, no returns will have been filed, and therefore there are no statute of limitations bars to assessments. **At least since the time of the Geoffrey decision in 1993, it would be very difficult for a taxpayer to claim that it was not on notice as to the potential application of this doctrine.**

- **Minimal Factual Investigation Required.** The necessary information to construct a return **for an intangible holding company engaged in in-state licensing activity is typically** obtained from the affiliated in-state licensee. A state does not have to assume the burden of showing that the transaction is a "sham" or of showing that the royalty-licensing fees are set at other than an arm's-length price. The books and records of the holding company are accepted as they exist and, **assuming that the state's law permits this**, the overall income is apportioned to the state.

- **Limited Concern as to Multiple Taxation.** There is unlikely to be multiple taxation of income because **an intangible holding company is typically established** in a state that provides favorable tax treatment with respect to the receipt of such income. **Also, an intangible holding company is typically structured so that it is taxable, if at all, only in the state in which it is established.**

- **Favorable Legal Precedent.** Two state court cases decided subsequent to the Geoffrey decision have approved the Geoffrey intangible/economic presence constitutional theory on facts resembling those in that case. See KMART Properties, Inc. v. Taxation & Revenue Dept. of State of New Mexico, No. 21,140 (N.M. Ct. App. Nov. 28, 2001); Comptroller of the Treasury v. SYL, Inc., 825 A.2d 399 (Md. Ct. App. 2003). Other state cases have suggested that the court would approve the theory on similar facts. See Borden Chemicals & Plastics, L.P. v. Zehnder, 726 N.E.2d 73 (Ill. Ct. App. 2000); Couchet v. State Lottery Comm'n, 659 N.E.2d 1125 (Ohio 1996). There is only one state court case that involves facts that resemble the Geoffrey facts in which the court rejected the Geoffrey theory. See Lanco v. Director, Division of Taxation, No. 005329-97, 2003 N.J. Tax LEXIS 18 (NJ Tax Ct. Oct. 23 2003). The Geoffrey case itself and the more recent Syl decision in Maryland were each denied certiorari by the United States Supreme Court. Although the denial of certiorari has no precedential value as such, these denials suggest that the U.S. Supreme Court does not perceive the Geoffrey analysis as being as problematic as taxpayers sometimes claim.

Cons:

- **Unsettled Precedent.** The assertion of nexus over an intangible holding company is likely to give rise to litigation. It should be expected that the company would litigate this question to the highest level. A final decision is likely to take years. Although the states have had success in Geoffrey-type cases, the issue concerning whether a "physical presence" is constitutionally required in cases that relate to corporate income tax has not been addressed by the U.S. Supreme Court subsequent to Quill Corp. v. North Dakota, 504 US 298 (1992) (applying a physical presence theory to a state's use tax collection duty). Hence, the legitimacy of these cases remains somewhat uncertain.

- **State Law Issues.** Even if the Geoffrey theory is appropriate as a matter of U.S. constitutional law, there may be questions concerning the application of this theory under state law. For example, there may be a question as to whether the state can assert nexus under its own statute. See *ACME Royalty Company v. Director,* 96 S.W.3d 72 (Mo. 2002). Also, because the intangible holding company will typically not have any property or payroll any place other than the jurisdiction in which it is established, it will be necessary for the state to establish a sales factor under its own law to apply a tax.

- **"East-West" Strategy and the Problem of a "Watered Down" Apportionment Percentage.** Assuming that the state can successfully impose tax on the intangible holding company, tax planning can greatly minimize this tax. In cases in which the holding company is established in a combined reporting state, the holding company is often assigned a substantial amount of property and payroll that would otherwise belong to one of the other affiliated entities in the combined group. Consequently, the apportionment percentage of the intangible holding company is substantially watered down. This general strategy is often referred to as an "East-West Strategy" because east coast states tend to be separate reporting states and west coast states tend to require a combined report.

- **Potential Application in States that Apply Throwback.** If a state that applies a throwback law embraces the use of an economic/intangible nexus approach, it may be required to recognize this same theory when evaluating throwback in other states even when these other states do not themselves apply a similar nexus theory. This would be the case, for example, if the state that applies the economic/intangible nexus theory is required to apply its own law when making a throwback determination. Most states would consider this to be a worthwhile trade-off. However, a state can be whipsawed if its nexus assertions are contested, because its throwback **determinations (which will be favorable to taxpayers) will simply be accepted.**

- **Progressively Worse Fact Patterns.** The factual setting of the *Geoffrey* case may have influenced the decision. In theory since the intangible holding company had minimal physical or other attributes, the case could have been tried on a sham transaction theory. *See Syms Corp. v. Comm'r,* 765 N.E.2d 758 (Mass. 2002). This could make future litigation more difficult as corporate tax planners have become more sophisticated. See the discussion of the East-West Strategy, above.

Entity Isolation - Expense Disallowance Statutes (IV.C)

Intangible Holding Company (III.A.1)
Security Holding Company (III.A.3)
Management Company (III.A.4)
Special Purpose Entities (III.A.5)
Foreign Intangible Holding Companies (III.A.6)

Pros:

- **No Jurisdictional Issue.** Unlike Geoffrey-type cases, the application of an ED statute does not raise any jurisdictional issues because the methodology is to deny an expense to a company that is otherwise subject to tax.

- **Legislative Deference.** Although it can be expected that the states' various ED Statutes will be contested on various theories, these statutes will be benefited by the fact that the creation of a deduction, as well as the conditions to be placed thereon, is a matter of legislative grace. States should be granted broad latitude in conditioning their business expense deductions because legally they can eliminate these deductions outright.

- **No Need for Special Apportionment Rules.** The standard three-factor apportionment rules may not satisfactorily source the income of an intangible holding company. Many states that have adopted an intangible economic nexus policy have also had to adopt special apportionment rules for intangible holding companies. However, ED Statutes raise no comparable issues. Disallowing a particular expense keeps the corresponding item of income in the payor's apportionable income base to be apportioned to the state based on the payor's apportionment factors.

- **Mechanical, Objective Application.** ED Statues generally function mechanically, disallowing the expense in question as paid or incurred to a related party. There is relatively little subjectivity involved in determining whether a taxpayer has this type of expense and whether it has paid or incurred this expense to a related party. This lack of subjectivity makes administration of an ED Statute much simpler in concept than the application of intangible or economic nexus or the assertion of the sham transaction theory. These latter approaches are more complicated because they are more fact dependent. Subjectivity may be introduced into the analysis if the ED Statute provides for exceptions that are subjective. Depending upon the nature and extent of these exceptions, the difficulty of administering the ED Statute will be enhanced.

- **Statutes Can Be Customized.** The enactment of an ED Statute permits a state to specifically tailor the law and the pertinent exceptions to meet the perceived abuse. For example, the law may be limited to payments that are derived from the use of an intangible, and in particular, may be specifically limited to the use of trademarks or similar intangible property. In addition, these laws can be drafted as general prohibitions so that the rule can be construed flexibly over time.

- **Exception Claims (and the Required Substantiation) Must Be Referenced on a Taxpayer's Return.** Typically, ED Statutes require that a taxpayer seeking to assert a particular exception must affirmatively claim this exception on its tax return and also provide specific evidence with its return to support the exception claim. These requirements diminish a taxpayer's capacity to play the "audit lottery" as to transactions that the state generally considers abusive. Also, these requirements address the difficulty that some states have had in attempting to develop an evidentiary record in cases in which, years after the taxpayer's filing, the state seeks to contest the taxpayer's claimed deduction.

- **Clear Revenue Estimates.** Historically, the states have not been able to easily identify all of the companies engaged in tax practices that the states consider to be abusive, and therefore estimating the cost of these abuses has proved difficult. Regardless of the actual revenue generated, ED Statutes allow tax administrators to require disclosure of specific tax deductions that are either claimed or conceded by intangible holding companies. Therefore, ED Statutes permit tax administrators to determine exactly how much revenue is implicated by these deductions. Even if the data that is generated by the state's ED Statute indicates that the statute is not addressing the problem as intended, the state will at least know this and can then seek to address the problem in some other way.

- **Enactment through the Legislative Process.** State legislatures seeking to address abuses that derive from inter-company payments for intangible property have tended to consider ED Statutes and combined reporting as two separate possibilities. In these cases, business lobbyists have tended to support the enactment of an ED Statute as an alternative to combined reporting. Because ED Statutes sometimes garner this type of support, they can be easier to enact than typical remedial tax legislation.

Cons:

- **Limited Application of the Statutes in Concept.** ED Statutes are intended to address some of the more flagrant state tax planning that derives from the use of intangible holding companies. But these statutes are powerless to address a large area of state tax planning that is conducted using such companies. For example, ED Statutes simply cannot address the situation in which income is shifted to another affiliate by the transfer of an income-producing asset.

- **Limited Application of the Statutes in Practice.** ED Statutes will be construed in accordance with their literal language. Typically, these statutes address an expense for the use of intangible property owned by an affiliated entity and also any interest expense that derives from the subsequent lending of this same money. Often, though not always, these statutes also address an interest expense due to an affiliated entity even when there is no underlying transaction that relates to intangible property. Other expenses such as inter-company management fees are typically not covered. Therefore, tax planning can attempt to re-characterize expenses that are disallowed under an ED Statute as expenses that are allowed. Also, there are specific types of entities, for example, REITS and insurance companies, which may not be addressed by a particular ED Statute. In these cases, tax planning can attempt to work around the statute by using these entities.

- **Difficulties with Specific and General Exceptions.** All of the ED Statutes are subject to exceptions. Some of the specific exceptions, such as the exception for payments made to an affiliate that is established in a foreign country that has a treaty in place with the United States, may themselves permit undesirable tax planning. Many of the ED Statutes contain generalized exceptions that will allow a deduction when not allowing the deduction would be "unreasonable." The notion of "reasonable" is often informed by considerations such as whether the underlying transaction was supported by economic substance and a valid business purpose other than tax avoidance. These subjective standards may be perceived as fair, but make the interpretation and administration of an ED Statute much more difficult.

- **Questions Concerning Exceptions that relate to "Double Taxation."** Most of the ED Statutes will allow an exception if the payment to the affiliated entity is "subject to tax." This raises interpretative questions as to whether the payment has to be actually taxed, and also whether the tax rate in the state(s) of the payee (either pre- or post-apportionment) must closely approximate the tax rate of the state that is evaluating the application of the ED Statute. If actual taxation on the part of the payee-entity is not required, then the use of an East-West structure can avoid the application of the statute. As a practical matter, unless a reviewing state compares its rate of tax with the actual post-apportionment tax rate imposed upon the payee by one or more states, and also requires that the latter rate closely approximates the reviewing state's rate, tax planning will be possible.

- **Enactment as an Alternative to Combined Reporting.** ED Statutes are seen by some state legislatures as a compromise to mandatory combined reporting, although an ED Statute is more limited in the types of tax planning that it can meaningfully address. Therefore, the enactment of an ED Statute may serve to prevent a legislature from taking the more meaningful action of converting from a separate company system to mandatory combined reporting.

- **Constitutional Questions.** Some taxpayers have claimed that ED Statutes raise a constitutional issue in that they discriminate against interstate commerce and, in particular, affiliated entities established outside the state. As to many, if not all ED Statutes, this would seem to be a weak claim. However, the prospect of this challenge creates some uncertainty as to the ultimate viability of these statutes.

- **Incomplete Solution for Foreign Intangible Holding Companies.** ED Statutes only work when there are transactions between the affiliated entities. In the case of foreign intangible holding companies that have transactions with other foreign entities there would be no expense to disallow for the entity subject to state taxation even though the intangible originated from state activity.

Entity Isolation – Income Realization Requirement (IV.D)

Intangible Holding Company (III.A.1)
Security Holding Company (III.A.3)
Special Purpose Entities (III.A.5)
Foreign Intangible Holding Companies (III.A.6)

Pros:

- **Federal Model Exists.** The statutes could be patterned after the federal Subpart F rules. The Subpart F rules have been in the Internal Revenue Code for approximately four decades and have been amended and modified to deal with specific abuse situations over the years. Many states have conformed or accepted Subpart F as part of their own revenue statutes.

- **No Jurisdictional Issue.** Unlike Geoffrey-type cases, the application of an Income Realization statute does not raise any jurisdictional issues because the methodology is to require the reporting of income by a company that is otherwise subject to tax.

- **Legislative Deference.** Although it can be expected that Income Realization statutes will be contested on various theories, these statutes will be benefited by the fact that income recognition, as well as the conditions to be placed thereon, is a matter of legislative grace. States can legally require income recognition as long as it does not depend on geographical-based criteria. The timing of the recognition of income is a question of legislative grace.

- **Mechanical, Objective Application.** Income Realization Statues function mechanically requiring income to be reported based upon the existence of earnings and profits by the subsidiary. This lack of subjectivity makes administration of an Income Realization Statute much simpler in concept than the application of intangible or economic nexus or the assertion of the sham transaction theory. These latter approaches are more complicated because they are more fact dependent. Subjectivity may be introduced into the analysis if the Income Realization Statute provides for exceptions that are subjective. Depending upon the nature and extent of these exceptions, the difficulty of administering the Income Realization Statute will be enhanced.

- **Statutes Can Be Customized.** The enactment of an Income Realization Statute permits a state to specifically tailor the law and the pertinent exceptions to meet the perceived abuse. For example, the law may be limited to income which is retained in a special purpose entity beyond those needed to conduct its business.

- **Clear Revenue Estimates.** Historically, the states have not been able to easily identify all of the companies engaged in tax practices that the states consider to be abusive, and therefore estimating the cost of these abuses has proved difficult.

Regardless of the actual revenue generated, Income Realization Statutes allow tax administrators to require disclosure of specific income items. Therefore, Income Realization Statutes permit tax administrators to determine exactly how much revenue is implicated by these provisions. Even if the data that is generated by the state's Income Realization Statute indicates that the statute is not addressing the problem as intended, the state will at least know this and can then seek to address the problem in some other way.

- **Enactment through the Legislative Process.** State legislatures seeking to address abuses that derive from special purposes entities could consider Income Realization Statutes and combined reporting as two separate possibilities. In these cases, business lobbyists may tend to support the enactment of an Income Realization Statute as an alternative to combined reporting. Because Income Realization Statutes may garner this type of support, they can be easier to enact than typical remedial tax legislation.

Cons:

- **"Deemed" Receipt of Income Is Unconventional.** Deeming that income has been received when there has been no actual distribution may seem inequitable. Taxes will be assessed when there is nothing from which they can be paid. The federal Subpart F rules will be dismissed as an inappropriate model for state action.

- **Difficulties with Specific and General Exceptions.** If Income Realization Statutes are enacted with exceptions there will be disputes as to what level activity should be permitted to continue on a taxed advantaged basis. To the extent the exceptions are based on subjective determinations a new area of audit inquiry will be created which state revenue departments may be ill-equipped to handle.

- **Questions Concerning Exceptions that relate to "Double Taxation."** Income Realization Statutes may be drafted to allow exceptions if the underlying income or activities of the special purpose entity is "subject to tax." This raises interpretative questions as to whether the income from which the payment is made, or is deemed to have been made, has to be actually taxed, and also whether the tax rate in the state(s) of the special purpose entity (either pre- or post-apportionment) must closely approximate the tax rate of the state that applying the Income Realization Statute. As a practical matter, unless a reviewing state compares its rate of tax with the actual post-apportionment tax rate imposed upon the special entity by one or more states, and also requires that the latter rate closely approximates the reviewing state's rate, tax planning will be possible.

- **Reversal of Special Purpose Entity Taxation.** Special purposes entities have been given favorable tax treatment to achieve specific purposes. To the extent special treatment is removed or limited it will call into question the underlying reasons for having accorded such entities special treatment originally. Proponents of special purpose entities may be able to bring significant political pressure to bear to fully preserve their special status.

- **Enactment as an Alternative to Combined Reporting.** Income Realization Statutes can be seen as a compromise to mandatory combined reporting, although an Income Realization Statute is more limited in the types of tax planning that it can meaningfully address. Therefore, the enactment of an Income Realization Statute may serve to prevent a legislature from taking the more meaningful action of converting from a separate company system to mandatory combined reporting.

Entity Isolation - Arm's-Length Audits (IV.E)

Intangible Holding Company (III.A.1)
Nexus Carve-Outs (III.A.2)
Security Holding Company (III.A.3)
Management Company (III.A.4)
Special Purpose Entities (III.A.5)
Foreign Intangible Holding Companies (III.A.6)
Corporate Inversions (III.7)

Pros:

- **Useful Where Prices are Readily Determinable.** In cases where the fair value of inter-company transactions are readily determinable, arm's-length pricing powers such as those set forth in IRC section 482 can be a powerful tool to restore income to the proper legal entity where it can be subjected to tax. As in the case of section 482, the taxing agency's powers should be subject to review under an abuse of discretion standard.

- **Useful Where Prices are Highly Distortive.** Arm's length pricing powers can also be useful in cases in which tax planning has resulted in aggressive pricing that is clearly unreasonable even if a determination as to the precise fair value is somewhat unclear. In these cases, the state can use its pricing powers to effect a settlement to achieve a result that better comports with fair value.

- **Effective as a Remedial Doctrine, even in the Absence of Broad Application.** The availability of an arm's length statute may tend to encourage careful pricing on the part of taxpayers engaged in inter-company transactions even in the absence of broad application on the part of the state. That is, the mere existence of this authority and the prospect of its use are likely to cause taxpayers to think in terms of it.

Cons:

- **Prima Facie Burden.** In order to invoke arm's-length authority under federal principles, the tax administrator carries a prima facie burden of showing that the as-reported values do not fairly reflect income. As a practical matter, this burden can be substantial.

- **Difficulty of Determining Fair Value.** The fair market value of an intercompany transaction is often not readily determinable, particularly where intangible values are involved. In such cases, a tax administrator seeking to apply **IRC section 482** must develop specialized audit skills and/or seek the advice of experts. There is frequently a wide range of uncertainty in establishing these values.

- **Unfavorable Cost/Benefit Ratio.** A section 482 audit is a highly resource-intensive process. Particularly for smaller states, whose total multi-state audit force may number less than a few dozen, the resource costs of such an audit may be prohibitive. The federal government conducts arm's length audits in cases in which the tax revenue at issue is often significantly greater. It may be difficult for a state to obtain a tax adjustment from a transfer pricing audit that is large enough to obtain adequate economies of scale to conduct such an audit.

- **Limitations of the Approach in Concept.** Even if an attempt is made to reduce every inter-company transaction to the "correct value," the goal is itself often illusive. As described by the United States Supreme Court "… separate accounting … may fail to account for contributions to income from functional transaction, centralization of management and economies of scale. Because these factors of profitability arise from the operation of the business as a whole, it becomes misleading to characterize the income of the business as having a single identifiable source." Mobil Oil v. Comm. of Taxes, 445 U.S 425, 438 (1980) (citations omitted).

- **Limitations of the Approach in Practice.** Transfer pricing powers do not cure many of problems of separate entity states caused by entity isolation (i.e., creation of multiple entities within an affiliated group). For example, transfer pricing is not typically the appropriate means to contest an expense in cases in which the state's goal is to eliminate the expense outright. Also, transfer pricing is not useful in cases in which the abuse in that income-producing property has been transferred to a low-tax state.

Entity Isolation - Sham Transaction Analysis (IV.F)

Intangible Holding Company (III.A.1)
Nexus Carve-Outs (III.A.2)
Security Holding Company (III.A.3)
Management Company (III.A.4)
Special Purpose Entities (III.A.5)
Foreign Intangible Holding Companies (III.A.6)
Corporate Inversions (III.A.7)

Pros:

- **Flexible Doctrine.** The sham transaction doctrine is longstanding and flexible. It is apropos as to any transaction that is entered into primarily for tax purposes or in which the form of a transaction is manipulated to generate a tax benefit that is dependent upon the appearance of substance. Courts have recognized the doctrine under many labels and guises; for example, "the step transaction doctrine," the "mismatching of income and expenses," and the doctrine of "substance over form." Because of the flexibility of the sham transaction doctrine, it has a unique capacity to extend to tax planning even as it evolves over time.

- **No Need for Specific Authority.** The sham transaction doctrine dates back to federal cases that were decided sixty or more years ago, including *Gregory v. Helvering, 293 U.S. 465 (1935)* and *Moline Properties v. Commissioner of Internal Revenue, 319 U.S. 436 (1943)*. Because most states assert income tax based upon federal law, this doctrine should be implicit within their law, even in the absence of a specific state statute or court case.

- **Abusive Cases Can Usually Be Settled in the Administrative Process.** Sham transaction cases are highly fact-dependent. Therefore, there is often a great deal of uncertainty as to how an individual case would be resolved if tried before a court. For this reason, in the more abusive cases, taxpayers may be willing to settle the case to avoid a trial.

- **Effective as a Remedial Doctrine, even in the Absence of Broad Application.** Assertion of the sham transaction doctrine is likely to prompt more ethical tax reporting, even in the absence of frequent assertions by the taxing authority. That is, the mere fact that taxpayers are aware that the state applies this doctrine should cause these taxpayers to think in terms of it when conducting their tax affairs.

- **Statutory Authority could Enable a State to Posit Listed Transactions.** Although it may not be necessary for a state to set forth its authority to contest sham transactions in the form of a statute, the enactment of such a statute could have an enhanced remedial effect. Further, a broadly written statute could permit the state to identify specific "listed transactions" as sham transactions through the means of administrative action.

Cons:

- **Litigation is Generally Very Difficult.** Unless the state can extract a settlement with a taxpayer, a sham transaction case must be litigated, and because of the connotations attached to the use of the theory, the taxpayer's transaction is likely to be aggressively defended. The state would carry the burden of proof of establishing that improper motives were the reason, or at least the predominate reason for the transaction. This is a very difficult standard to meet. Also, when the cases involve larger amounts of money, the state can expect that the taxpayer's defense will be even more vigorous.

- **Difficulties in Mustering the Facts.** Sham transaction cases are highly dependent upon the pertinent facts. However, factual development in sham transaction cases is particularly difficult because the cases are often highly contentious. Also, when a state has clearly targeted a certain area of transactions, this makes the factual development even more difficult. In the latter cases, factual information will generally not be that forthcoming in the early stages of the administrative process. Rather, the taxpayer's strategy may be to establish the desired factual record through company witnesses who testify at trial.

- **Problems that Relate to Careful Tax Planning.** As a practical matter, sham transaction cases work best from the state's standpoint when the taxpayer has failed in some material way to comply with the strictures of whatever transaction it claims to have undertaken. In the most blatant sham transaction cases, it is not unusual to find facts of this nature, because the actual strictures of the transaction are unimportant, and the asserted formalities are merely "window-dressing" to justify the transaction. On the other hand, when there is careful tax planning, there will be careful adherence to the various formalities that relate to the transaction and the state's case will be more difficult. This is despite the fact that it should not be possible to justify the substance of the transaction by merely adding form. In cases involving an intangible holding company, the formalities that are typically added are the assignment to the company of additional employees and physical assets and also contracts that suggest meaningful transactions with unrelated parties.

Entity Isolation - Reporting Option (IV.G)

Intangible Holding Company (III.A.1)
Nexus Carve-Outs (III.A.2)
Security Holding Company (III.A.3)
Management Company (III.A.4)
Special Purpose Entities (III.A.5)
Foreign Intangible Holding Companies (III.A.6)
Corporate Inversions (III.A.7)

Pros:

- **More Politically Acceptable.** Providing a taxpayer with an option of reporting methods, including combined reporting as one of them, may allow a state to move piecemeal to combined reporting in an area where perceived abuse may be the greatest thereby lessening political opposition.

- **Elective Solution Avoiding Litigation.** A state does not have to assume the burden of showing that the transaction is a "sham" or of showing that the royalty-licensing fees are at other than an arm's- length basis. The books and records of the holding company are accepted as they exist, and the overall income is apportioned to the state either through combined reporting, in the hands of the separate entity, or by expense disallowance. Allowing combined reporting as an option responds to arguments that might otherwise be raised about taxation without factor representation.

- **Flexible.** The option is flexible and is responsive to a number of entity isolation strategies beyond just the intangible holding company.

- **No Multiple Taxation.** There is unlikely to be multiple taxation of income because the holding companies are normally located in states that provide favorable tax treatment with respect to the receipt of such income.

Cons:

- **Forced Choice.** Businesses may claim that the packaging together of several alternatives, some of which may not be permitted under the Due Process Clause of the Fourteenth Amendment, is improper. Just because someone is allowed to "pick their poison" does not justified a policy or policies which are not otherwise permitted under the state's law.

- **Legalize Tax Planning.** Whenever a taxpayer is allowed to make an election it can engage in tax motivated planning. Because a statute allows the taxpayer to elect between alternatives it is to be expected that they will elect the alternative that minimizes taxes. To do so it legal and rational. If elections are to be offered they should be made binding for some period of time so that taxpayers cannot bounce back and forth year to year.

- **Does Not Address Past Years.** Legislation is normally prospective in operation. This solution will not address money which has been sheltered in the past. Furthermore, it is frequently argued that adopting legislation is evidence of a change in treatment. Adopting a solution will be used as evidence that the conduct which the solution addresses was legal and acceptable previously. States should consider adopting "no inference" language when adopting a solution to thwart arguments that the legislation represents a change in position.

Entity Isolation – Uniform Statutes (IV.H)

Nexus Carve-Outs (III.A.2)

Pros:

- **Statutory Relief Is The Proper Resolution of Statutorily Created Problems.** Nexus carve-outs arise because state statutes treat special purposes entities differently than regular corporations. The special treatment accorded special purpose entities reflects legislative policy and it should only be changed by legislative action.

- **Action by Some States Provides The Model For Other States.** Some states have already addressed these issues and their statutes can provide the model for other states to address these issues.

- **Litigation Will Be Avoided.** Addressing the problem head-on by legislative change will greatly reduce the likelihood of litigation that might be involved in other alternatives.

Cons:

- **Does Not Address Past Years.** Legislation is normally prospective in operation. This solution will not address money which has been sheltered in the past.

- **Loss of Federal Conformity.** In some areas the states will specifically have to move out of conformity of the special treatment accorded the entities under the Internal Revenue Code. This will increase compliance costs.

Entity Isolation – State Specific Federal Legislation (IV.S)

Intangible Holding Companies (III.A.1)
Nexus Carve-Outs (III.A.2)
Foreign Intangible Holding Companies (III.A.6)
Corporate Inversions (III.A.7)

Pros:

- **Commerce Clause Authority.** Congress is given the power to regulate interstate and foreign commerce. If Congress acts to give the states the power to legislate in an area, Commerce Clause challenges should be eliminated. Federal legislation allowing for the establishment of nexus over commonly- controlled entities and allowing for specific treatment of foreign incorporated entities in specifically described circumstances would give the states the ability to adopt solutions to the described tax avoidance/minimization strategies.

- **Avoidance of Litigation.** Passage of federal permissive legislation would remove the most significant legal ground to challenge state action.

- **Retention of the States' Ability to Tailor Solutions.** Enactment of federal permissive legislation would allow the states to respond to various areas but would not require them to take any particular steps. "Our federalism" would be preserved.

Cons:

- **Difficulty in Adopting Permissive Federal Legislation.** It would be difficult to have Congress adopt legislation that addresses a state-only problem. The states have had their greatest successes with Congress in blocking the passage of legislation. Having Congress adopt permissive legislation is a significantly different dynamic. Business interests would either oppose the legislation or seek benefits as a trade-off.

Entity Isolation – State Inclusion in Federal Legislation (IV.T)

Corporate Inversions (III.A.7)

Pros:

- **Piggybacking a federal solution may be easier than state specific legislation.** Federal legislation limiting the effect of corporate inversions on federal taxes has received significant support in the Congress. If the problem is recognized as being one that is significant to the federal government, it is likely that it will also be accepted as one that has state impacts as well. If arguments in support of a federal solution are accepted, it is likely they will be accepted as well for state purposes.

Cons:

- **Including the States May Increase Opposition.** If it is difficult to pass legislation dealing with this at the federal level, the sponsors of the bill are unlikely to want to address state concerns which might increase the opposition to any legislation.

Uniformity

Uniformity -Uniform or Model Statutes, Regulations or Rules Including Special Industry Rules (IV.H)

Inconsistent Reporting (III.B.1)
Structural Non-Uniformity (III.B.2)
Telecommunications Industry (III.B.3)
Financial Industry (III.B.4)

Pros:

- **Greater Consistency in Reporting.** If all state rules for the assignment of income were identical, taxpayers would be more likely to treat matters the same way for all states. Confusion created by different rules and interpretations would be eliminated.

- **Reduce Compliance Costs.** Uniform State laws would reduce compliance burdens and tend to assure full accountability. State taxes would become a zero sum game. Disputes would more likely be between States rather than between the taxpayer and a State.

- **Increase Use of Joint Audits.** Uniform rules would allow for the use of joint audits. One auditor, or audit team, could audit for a number of states. The taxpayer would have to respond to only one set of requests. A single audit would give rise to consistent treatment and remove the chance for multiple taxation of the same income.

- **Consistent Decisions.** Uniform laws would tend to make administrative and judicial decisions homogenous between the States. An issue could be litigated in one state with the outcome determinative of the result for all states.

- **Efficiency.** State audits would become more efficient. Joint audits would be more feasible.

Cons:

- **Reduced Flexibility.** States would forgo their ability to respond to their unique economic requirements and would be less able to exercise individual policy judgment.

- **Difficulty in Agreeing.** Obtaining agreement on the rules would be difficult to achieve. There might be too many variables to deal with to achieve complete agreement. The issues of allocation and apportionment are only one of the broad elements involved.

- **Politically Unlikely.** Uniformity is politically difficult to achieve. Even if uniformity is achieved, its benefits can only be maintained if further change is limited.

- **UDITPA Does Not Address Other Major Issues.** The only area where there is a uniform model currently is in the allocation and apportionment of income as provided for in UDITPA. UDITPA only addresses the issues of the allocation and apportionment of income. It does not address the determination of income, or the question of combined or consolidated reporting. Each of these other areas is equally significant with respect to the need for uniformity.

- **No Ability to Require Adoption.** Model rules and regulations only promote uniformity to the extent that are widely adopted. Proposed model rules and regulations without mechanisms to encourage their adoption will only lead to greater non-uniformity and more opportunities to use the rules to minimize state taxes.

- **Special Industry Rules Should Be Accomplished Statutorily.** To the extent this recommendation is to be accomplished by regulation or rule, it may be inappropriate. Section 18 of UDITPA authorizes exceptions from the standard rules if the standard rules do not fairly represent activities in the state. Exceptions for an industry should be accomplished by legislation not regulations. It is often argued that tax policy is the province of the legislative branch and should not be accomplished administratively.

Uniformity - Centralized Database (IV.J)

Inconsistent Reporting (III.B.1)

Pros:

- **Sunshine.** Knowledge that a central database of reported results exists will make it less likely than inconsistent positions will be taken intentionally. In addition, preparation and review of this information by a taxpayer should disclose inadvertent inconsistencies than can be corrected prior to filings or by amended returns afterwards.

- **Audit Efficiency.** The existence of such a database would allow for the identification of audit issues and the more efficient use of audit resources.

- **Evidentiary Tool.** The database might be used as evidence of admissions as to the proper treatment of individual items or the existence of inconsistencies might be weighed in determining credibility.

Cons:

- **Data Would Not Be Meaningful.** The differences in the tax statutes, case law, interpretations, and procedures of the States vary so greatly that the database would not be useable. Any information generated could be susceptible to misinterpretation and could lead to incorrect conclusions. If the database does not include audit adjustments, it would not be meaningful. Including audit adjustments would be burdensome and would mean that the database would not be accurate until the final amount of tax had been determined for every state.

- **Lack of an Administrative Agency.** There is no agency that is authorized to collect and maintain such a database. Issues involving improper disclosures and use of information would be significant.

- **Maintaining the Database Would Be Costly.** There is no funding mechanism for the maintenance of the database. Significant costs could be involved for the States to prepare and submit data to any centralized point. Costs would extend beyond initial reporting and would be significant in terms of reporting audit adjustments and changes. Such changes could occur over a number of years.

Uniformity - Centralized Database (IV.J)

Structural Non-Uniformity (III.B.2)
Telecommunications Industry (III.B.3)
Financial Industry (III.B.4)

Pros:

- **Identification of Methods.** A central database would lend itself to a complete description of the various alternatives being used for the purposes of assigning income to a state. In the current environment the actual methods of assigning income for a state are only known to those that practice within that state. The database could, subject to confidentiality constraints, allow members of an industry to determine whether they are being treated in a manner similar to their competitors.

- **Empirical Evidence of Differences.** A centralized database would allow for a fully informed comparison of alternative methods of assigning income and therefore a more rational selection of methods from alternatives.

Cons:

- **Confidentiality.** Existence of the database could give rise to increased risks of disclosure of information.

- **Misuse of Information.** A centralized database could be used for any number of purposes beyond tax administration. Creation of another agency that would not be an agency of a state reduces accountability.

Uniformity - Throwback Rules and Throwback Affidavits (IV.L)

Inconsistent Reporting (III.B.1)
Structural Uniformity (III.B.2)

Pros:

- **Full Accountability.** Adoption of a throwback rule promotes full accountability and acts to ensure that all corporate income is assigned to a jurisdiction that has sufficient nexus, or is permitted under Public Law 86-272, to assess a tax.

- **Evidence.** The same evidence should be relevant for determining taxability and the application of the throwback rule for both States involved in the transaction. Taxpayers should be prepared to support their filing position with evidence that would be admissible in any administrative or judicial proceeding.

- **Established Procedure.** The affidavit procedure has been used successfully by some of the States on the East Coast for several years.

Cons:

- **Employees In Charge of Tax Audits Are Not In A Position to Execute Affidavits Regarding Presence In A State.** The individuals who normally interface with state tax auditors are not in a position to make commitments that might be binding on their employers and may not have sufficient knowledge to provide accurate statements of activities.

- **Lack of Uniformity Renders Affidavits Irrelevant.** Business representatives have stated that the determination of whether there are sufficient contacts to establish a filing requirement in individual States vary so greatly that the affidavit will be of little value. They claim that differences in state laws and their interpretation and application of nexus standards and federal laws would make such an affidavit of limited value.

- **States Are Not Authorized to Audit for Other States.** Having affidavits executed is arguably tantamount to having one state audit on behalf of another state. States are generally not authorized to conduct such activity, which implicates Constitutional prohibitions on state compacts.

Uniformity - 51-Jurisdiction Spreadsheet (IV.M)

Inconsistent Reporting (III.B.1)

Pros:

- **Sunshine.** Providing for a 51-State breakdown of tax filings will make transparent inconsistent filing positions. Inconsistent filing positions may be the result of structural non-uniformity or reporting differences.

- **Availability of Information.** Taxpayers necessarily must have the information available since it is no more than a summary of the actual returns that are filed.

Cons:

- **Confidentiality.** Claims will be made that an individual State has no need or right to know the filing position that a taxpayer has taken with respect to another State. A State has no "nexus" with respect to entities that do not have a filing requirement with respect to them. All that a taxpayer is required to do is to file a return that conforms to the requirements of the particular State's laws.

- **Data Will Not Be Meaningful or Useful.** Business representatives claim that the degree of non-uniformity between the States makes it difficult to provide relevant information to each State. For example, how would a taxpayer that files combined reports in some States report in a meaningful manner to a State that does not require combined reporting?

- **Taxpayer May Not Have Access to the Information.** An individual entity does not have the ability to require related entities that it does not control to provide it with the necessary information to make the required filing.

- **Will Be Used for Impermissible Purposes.** Business representatives may express concerns that the information provided in spreadsheets may be misused to portray taxpayers as doing something "wrong" by taking inconsistent positions that are required by state statutes and case law.

- **The Information Is Not Useful.** States have had, and some still have, this type of requirement. No evidence has been presented that this information has been used by the States either individually or collectively.

Uniformity - Disclosure of Inconsistent Filing Positions (IV.N)

Inconsistent Reporting (III.B.1)

Pros:

- **Efficiency in Audit Selection.** Disclosure of inconsistent filing positions between states or changes in the treatment of an item between years for an individual state call attention to the difference and allow a State to conduct an efficient audit to determine whether the difference or change is proper.

- **Sunshine.** Requiring inconsistent positions to be disclosed will make it less likely that inconsistent positions will be taken intentionally. In addition, the duty to disclose should be a safeguard against inadvertent inconsistencies than can be corrected prior to filings or by amended returns afterwards.

Cons:

- **Information of Little Use.** The requirement to disclose inconsistent positions already exists in some states and there is no evidence that it is being used.

- **Confidentiality.** A particular state has no right to know a taxpayer's filing position in another state.

Uniformity – Disclosure - Penalties and Presumptions (IV.O)

Inconsistent Reporting (III.B.1)

Pros:

- **Compliance.** Establishing penalties or presumptions for failure to make disclosures will increase compliance.

- **Efficiency for Audit.** The existence of inconsistent filing positions or changes in filing positions provide audit flags and lead to more efficient audits for both the taxpayer and the tax agency.

- **Evidentiary.** Establishing presumptions attaches significance to the disclosure of inconsistent filing positions and will allow for the states to benefit from the disclosure in administrative and judicial proceedings, giving rise to greater economy in those proceedings.

Cons:

- **Cost of Compliance.** In large corporations compliance activities with respect to states are spread among a number of individuals. It could be administratively burdensome to comply with this requirement.

- **Improper Use of Penalties.** Tax audits should be conducted to determine if the correct amount of tax has been paid. An environment should not be created where the failure to conform to minor administrative requirements becomes a trap for the unwary and a source of state revenues.

Uniformity – Amnesty (IV.P)

Inconsistent Reporting (III.B.1)

Pros:

- **Compliance.** The strategy emphasizes voluntary compliance and allows taxpayers to rectify previous failures to disclose inconsistent positions without any stigma attached to the filing. The disclosure of inconsistent filing positions may not give rise to any increased liability as the inconsistent positions may be justified by differences in state laws or interpretations.

- **Revenue.** Use of amnesty is intended to obtain an immediate inflow of cash as the result of voluntary compliance without the delay and the expenditure of resources for audits and contesting assessments. Because states do not have penalties associated with a failure to disclose inconsistent filing positions, they would not be foregoing revenues to which they were otherwise entitled. Even if penalties were in place, the purpose of penalties is to obtain compliance. That result could be achieved by an amnesty program.

Cons:

- **Fairness.** Amnesty programs may provide shelter to those who purposefully have tried to avoid their tax responsibilities. Granting amnesty allows taxpayers to play "audit roulette" without consequences and therefore is effectively penalties against those taxpayers who have previously been meeting their filing responsibilities.

Uniformity – Whistleblowers (IV.Q)

Inconsistent Reporting (III.B.1)

Pros:

- **Efficiency.** Insiders are aware of improper filing positions that might not otherwise be discoverable or at least not discoverable without the expenditure of significant resources.

- **Fairness.** It promotes tax equity and general responsibility for the administration of taxes on an equal basis.

Cons:

- **Government Intervention.** This could be perceived as a "big brother" program, leading to criticism of state tax agencies.

- **No Mechanism to Handle Multistate Information.** A joint agency (of the states) might not be able to adequately protect whistleblowers from lawsuits, which might be filed in numerous states. There is a possibility that state whistleblower statutes may not encompass the exchange of whistleblower information among states, to the extent that the states did not develop the information through their own investigations. If so, the joint agency, joint agency staff, and state employees could be subject to suit and possible criminal prosecution.

- **Costs.** Whistleblowers often want to be compensated for their leads so a funding mechanism would need to be implemented. For example, one recent caller explained that though he could provide details of wrongdoing by his company, it would end his career—the states would have to pay him for his lost income. Most states do not currently provide for whistleblower compensation.

Sales of Other than Tangible Personal Property (Section 17 of UDITPA)

Sales of other than Tangible Personal Property - Uniform Statutes or Regulations (IV.H) and Special Industry Rules (IV.I)

Telecommunications Industry (III.B.3)
Financial Industry (III.B.4)

Pros:

- **Tailored Solutions.** Dealing with the assignment of sales of other than tangible property on a piecemeal basis allows for tailored solutions with participation of the affected industry. It may be easier to accomplish reform on a narrow basis rather than on an overall basis.

- **Uniformity.** If all the states adopt a common solution greater uniformity will be achieved. There will be neither over-taxation or under-taxation of income.

- **Efficiency.** The adoption of uniform rules will ease compliance burdens on taxpayers and make for more efficient audits, some of which can be accomplished on a collective basis.

Cons:

- **Uniformity May Not Be Achieved.** The MTC adopted a uniform method for assigning the income of financial corporations which has been adopted by only a minority of the states. There may be no reason to anticipate any greater acceptance of uniform recommendations now.

- **Ignores The Fundamental Problem.** Dealing with only several industries ignores the fundamental problem which is pervasive throughout the taxpayer community. Piecemeal solutions only emphasize the inadequacies in the treatment of the rest of the universe.

- **Nexus Is the Primary Issue.** The problems the states have in dealing with the sales of other than tangible property involve questions of nexus and taxability not the means of dividing the income. Sales of other than tangible property are difficult for that very reason; there is no concrete connection other than employees and offices that provide a taxable connection with a state.

Sales of Other than Tangible Personal Property -Section 18 Relief (IV.K)

Telecommunications Industry (III.B.3)
Financial Industry (III.B.4)

Pros:

- **Flexibility.** Section 18 of UDITPA allows a tax administrator to respond to particular circumstances where the standard rules reach unfair results. The telecommunications industry and financial industry do not fit the UDITPA mold of mining, manufacturing and mercantile businesses. Section 18 was included in the statute to recognize that some industries might require special rules. In fact, the financial industry was specifically excluded from UDITPA as promulgated.

- **Effectuation of Purpose of Sales Factor.** The sales factor, in the case of the sale of tangible personal property, assigns sales on destination basis. The intent was to reflect the contribution of the market state to the earning of income. It was intended to operate as a balance to the payroll and property factors which reflect the contributions of the place of production. The UDITPA rule for the assignment of sales other than sales of tangible property is based upon income- producing activities. This can, to a large extent, duplicate the assignments made by the payroll and property factors. Use of section 18 allows the tax administrator to overcome the rules of UDITPA for sales of other than tangible property in those circumstances where it is particularly significant.

Cons:

- **Section 18 Should Not Be Used For Normally Occurring Situations.** The argument is made that the MTC's Section 18 regulation indicates that its use should be limited to unusual and non-reoccurring situations. However, review of the MTC's Section 18 regulations establishes that this authority has been used in reoccurring situations where the general rules have been determined not to work effectively. This argument appears to take the language out of context. This admonition is properly understood as applying to *ad hoc* applications to individual taxpayers.

- **Loss of Uniformity.** The *ad hoc* application of section 18 to overcome statutory assignment rules will increase the lack of uniformity giving rise to greater complexity in filing requirements and increased compliance costs.

- **Fundamental Changes Should Be Accomplished by Statutes.** The use of a relief clause should be limited. If the normal statutory assignment rules do not work in a significant number of circumstances a solution should be accomplished by a statutory change enacted by state legislatures.

Federal – State Issues

Federal – State Issues – Federal Listed Transactions (IV.R.1)

Corporate Sheltering (III.D.1)

Pros:

- **Piggybacking the Federal Government.** The Internal Revenue Service has identified and defined "listed transactions" that have been marketed by tax professionals throughout the country. Congressional committees have obtained a significant amount of promotional and transactional documentation concerning "listed transactions". Participation in the Memorandum of Understanding will provide states with access to this material including the identities of taxpayers in their respective states who have purchased these shelters. The states that choose to pursue independent examinations of investors and promoters will benefit from the information compiled by the IRS. The information sharing arrangements contained in the memorandum will also provide a basis for states to refrain from independent examinations and instead allow states to incorporate the applicable federal adjustments for state purposes.

Cons:

- **Cost.** The federal activity concerning "listed transactions" will encompass a significant workload for the Internal Revenue Service. As with any large federal program, decisions may be made with respect to individual cases on the basis of goals or objectives that serve the program as a whole. To the extent that a state relies upon federal examination of "listed transaction" taxpayers, adjustments made in these cases by the federal government for purposes unrelated to the merits of the adjustment may not necessarily be applicable for state purposes. States may be able to obtain more significant adjustments with independent examinations; however, the resources expended to conduct these examinations would be significant. In addition, there may be some restrictions upon the use of documentary evidence obtained by the Internal Revenue Service in state adjudicatory proceedings. Even though a state may participate in the memorandum, it may still be necessary to expend resources to obtain evidence directly from a taxpayer in order to support the state's assessment in a state proceeding.

Federal – State Issues – State Listed Transactions (IV.R.2)

Corporate Sheltering (III.D.1)

Pros:

- **Notice to Public/Compliance.** Listing a transaction gives notice to taxpayers of the state's position with regard to the abusive nature of the transaction. Ideally, this will work toward achieving compliance. In those states that provide for enhanced penalties for listed transactions, it gives the state a powerful weapon against the use of these transactions. In California, for example, a number of banks restated their year-end earnings and profits as a result of listing the REIT and RIC transactions.

- **Resources.** Listing a transaction may warn taxpayers against participating in these transactions or may encourage them to come forward and report the transaction (in the case of an amnesty such as in CA). This in turn would save valuable audit and legal resources.

Cons:

- **Not Dynamic.** As soon as a transaction is listed, promoters devise a new one to take its place.

Federal – State Issues – Multistate Listed Transactions (IV.R.3)

Corporate Sheltering (III.D.1)

Pros:

- **Educating the States.** Publishing requirements for reportable transactions and income reporting characteristics would help to educate the states on tax avoidance techniques. It could also help to highlight areas where inconsistent reporting is presently required under state laws.

- **Educating Taxpayers.** Publishing reportable transactions and income reporting characteristics could improve the understanding of standards of income reporting by taxpayers. This could help to protect them from unscrupulous tax promoters.

Cons:

- **State Requirements are not Uniform.** For many income reporting items (e.g., separate vs. combined reporting, definition of business income, definition of a unitary business, definition of apportionment factors), there is not sufficient uniformity among the states to make this a useful device.

Federal - State Issues - Federal Legislation (IV.S and IV.T)

Intangible Holding Companies (III.A.1)
Nexus Carve Outs (III.A.2)
Foreign Intangible Holding Company (III.A.6)
Corporate Inversions (III.A.7)

Pros:

- **Diluted Opposition.** Attempts to allow the States to piggy-back on federal solutions to tax problems is unlikely to meet with resistance significant enough to prevent its adoption. If the issue is viewed as important for federal purposes, the States are likely to be able to ride the federal coattails.

- **Address Issues Otherwise Prohibited From Dealing With.** Passage of permissive federal legislation removes the Commerce Clause objection to state action. The Commerce Clause is not, however, the only area of Constitutional concern. Issues may also arise under the Due Process Clause of the Fourteenth Amendment. Congress has not been given the power to legislate with respect to issues involving Due Process considerations. This might affect Congressional ability to legislate affirmatively with respect to the States power to tax. The United States Supreme Court's decision in *Quill Corp. v. North Dakota* (1992) 504 US 298, where the Court distinguished between Commerce Clause nexus and Due Process Clause nexus, suggests that the Court would be predisposed to defer to Congressional judgment in this area.

Cons:

- **Federal.** The passage of state-only federal legislation is problematic. The business community and the States generally have been able to effectively lobby against each other's proposals. The lack of broad Congressional action since the adoption of Public Law 86-272 and the expiration of the Internet Tax Moratorium are evidence of the difficulties that are involved. States generally have operated in a reactive mode and are less experienced in attempting to have favorable federal legislation adopted.

- **A Federal Solution Will Not Reflect Individual State Concerns.** The States individually reflect the policies of their elective officials. The States do not all share the same common interests, and even when there are common interests, their political leaderships may support different initiatives to further those interests and there are frequently differences of opinion as to the appropriate solution. Furthermore, Congressman and Senators may not necessarily agree with State elective officials regarding policy choices. It is difficult, therefore, for the States to speak with one voice. Passage of legislation directed only to State issues would require broad-based state support that can be difficult to achieve in our federal structure.

- **A State Solution May Not Address Local Concerns.** In addition, State and local government interests may not always coincide. In that circumstance opposition to federal legislation may include local governments.

- **Federal Legislation Is More Likely To Limit Rather Than Expand State Tax Powers.** Traditionally State concerns have not been considered in dealing with federal tax issues. The interests of the States in conforming to federal action do not have a sufficient constituency to ensure that their concerns will be taken into account. State requests are likely to be lost in the background and may be little more than a token bargaining chip to be given away by interests that are not impacted by the effect of such action on the States.

VI. Recommendations

Based on its review of corporate income tax problems and solutions, the Corporate Income Tax Sheltering Work Group recommends the following:

1. **Combined Reporting.** States should adopt combined reporting for jointly owned and operated companies. Dividends from affiliates that are not members of the combined group should be treated as apportionable income unless the holding of stock or receipt of the income is clearly unrelated to the business of the owner. This reinforces the MTC Federalism at Risk recommendation on combined reporting and the MTC Uniformity Committee's current project to develop proposed uniform combined reporting statutes and regulations.

2. **Expense Disallowance Statutes.** In lieu of taking the more comprehensive step of combined reporting and perhaps as an intermediate step with consideration of combined reporting as a possible future goal, separate entity states should enact expense disallowance statutes that are broadly worded to address inter-affiliate transactions that involve intangible property and also perhaps inter-affiliate loan transactions. Exceptions for some transactions may be appropriate, but exceptions to these statutes should be objective and narrow in their application as in the expense disallowance statute for intangible property that was enacted by New York State in 2003. This recommendation could be forwarded to an appropriate group, such as a specialized uniformity task force, or returned to the Corporate Income Tax Sheltering Work Group to provide guidelines to the states on expense disallowance statutes.

3. **Overhaul of UDITPA.** It has been almost 50 years since the drafting of UDITPA. Revisions are clearly needed in the area of sales of services and to address intangibles and the financial services sector. An alternate approach is the development of additional special industry rules through the Uniformity Process of the MTC. Rules could be developed for the sales of services; the sales of financial services businesses, such as those with brokerage or insurance activities that do not fit the current financial services rules; and other areas as needed. We recommend the first approach because this is the most direct and thorough, and could be the most effective in influencing state statutes and in taxing corporate income. The MTC could propose a cooperative effort with the National Conference of Commissioners on Uniform State Laws to overhaul UDITPA. The MTC could also solicit support from professional and private sector groups for this effort.

4. **Adopt Throwback Rules.** To limit the occurrence of "nowhere income" states should enact throwback or throwout rules for both tangible goods and services. In addition, states should require that throwback affidavits be submitted and share this information with the states identified in affidavits. Guidelines for throwback

rules should be included in the current MTC effort to develop proposed uniform combined reporting statutes and regulations.

5. **Disclosure of Filing Positions.** States should enact provisions that require disclosure of inconsistent filing positions where states have similar requirements. Failure to disclose inconsistent positions should be penalized and presumptions based on failure to disclose inconsistent filing positions should be enacted to encourage appropriate reporting by taxpayers. This recommendation could be forwarded to an appropriate group, such as a specialized uniformity task force, or returned to the Corporate Income Tax Sheltering Work Group to provide guidelines to the states on disclosure requirements.

6. **Tax Sheltering and Listed Transactions.** States should take advantage of the information sharing on tax shelter activity under the IRS Memorandum of Understanding and the State Memorandum of Agreement. In addition, they should adopt listed transactions legislation that includes, by reference, federal listed transactions, and provides for the definition of state listed transactions. The 2003 California legislation provides a model for the states in this area. This recommendation could be forwarded to an appropriate group, such as a specialized uniformity task force, or returned to the Corporate Income Tax Sheltering Work Group to provide guidelines to the states on listed transactions statutes.

7. **Enforce "doing business" Statutes.** States should clearly articulate and effectively enforce their nexus standards to ensure more complete reporting of income among the states. In applying nexus standards, states should consider thresholds, taking into consideration costs of administration and compliance.

8. **Proactive Role in Federal Legislation.** The states should take a more proactive role with respect to federal legislation, including legislation that affects state jurisdiction for corporate income taxes and federal issues, such as tax sheltering and corporate inversions, that affect both the federal and state income tax base. This should include advocacy of the MTC factor presence nexus standard and elimination of the restrictions of P.L. 86-272.

9. **Enhance Exchange of Information.** Processes should be established to implement, but not be limited to, recommendations 1-8, possibly to include a clearinghouse for sharing information among the states. This information should include current and recent audit activity. Consideration should also be given to including tax shelter activity and other compliance issues.

GLOSSARY

In order to make this report more understandable to general readers, we are providing a glossary of key terms and concepts. These are arranged alphabetically.

Apportionment: The division of the income of a business engaged in interstate commerce among the states in which the business operates. (See formula apportionment.)

Business Income: That income of a business subject to apportionment among the states in which the business operates, as distinguished from nonbusiness income, which is allocated to a specific state, usually the business' headquarters state. Under the Uniform Division of Income for Tax Purposes Act (UDITPA), business income means income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations.

Combined Reporting: Combined reporting is a state tax accounting system approved by the U.S. Supreme Court. It is used by several states to ensure a full and complete division (apportionment) of income of a single (or "unitary") business enterprise operating in multiple states through multiple entities. Under combined reporting, the taxable income of separate legal entities comprising a single business operating in multiple states is added together. In contrast, under "separate entity" reporting, the taxable income for each separate legal entity is reported separately without regard to the combined income of the multistate enterprise. Combined reporting helps curb the ability of multistate enterprises to shift income away from locations where the income was earned to no-tax or low-tax jurisdictions.

Commerce Clause: Article 1, Section 8 of the U.S. Constitution grants Congress the sole power to regulate commerce among the states. The U.S. Supreme Court has interpreted the Commerce Clause to include an implied power granted to Congress to regulate state taxes that, in the judgment of Congress, interfere with its power to regulate interstate commerce. The Commerce Clause also grants Congress the power to regulate commerce with foreign nations and with the Indian Tribes.

Due Process Clause: The Fourteenth Amendment of the U.S. Constitution prohibits a State from depriving any person of their property without due process of law and from denying any person within its jurisdiction the equal protection of the laws.

Finnigan: The determination of whether nexus exists on the basis of the presence of the unitary business as opposed to a determination of nexus on an entity basis for purposes of sales factor assignments. The title is a reference to a decision of the California State Board of Equalization, *Appeal of Finnigan.*

Formula Apportionment: The process of assigning a multijurisdictional business' income to an individual tax jurisdiction by use of a mathematical formula. The formula used by most states is a combination of the firm's sales in the state, its property owned or leased in the state, and its payroll in the state. Thus, a multistate company's profits that would be assigned to a state is determined by the ratio of the firm's sales in that state to the firm's total sales multiplied by a weighting factor, plus the ratio of the firm's property in that state to its total property multiplied by a weighting factor, plus the ratio of the firm's payroll in that state multiplied by a weighting factor. The sum of the products is then multiplied by the firm's total net income to obtain this state's share of the firm's total net income. The sum of the sales weighting factor, the property weighting factor, and the payroll weighting factor must equal one.

Nexus: The connection between the business and the state that allows the state to impose a tax or tax collection duty on that business.

Nonbusiness Income: Income other than business income.

Nowhere Income: Income (usually starting with a base of federal taxable income) that is not sourced to a state. This can occur when a seller of tangible personal property has no nexus in a destination state, or a state is limited, by the U.S. Constitution or federal statute, from imposing a tax. It can also occur where states have inconsistent sourcing rules, e.g., where the origin state uses a destination-based sourcing rule and the destination state uses an origin (or cost of performance)-based sourcing rule for a transaction for income tax purposes. Some states use a throwback and throwout rules to address this situation. (See throwback and throwout rules.)

Separate Entity Reporting: The practice of determining corporate net income tax and the assignment of income to a state for each legal entity, regardless of common ownership or business operation.

Three-factor Apportionment Formula: See formula apportionment.

Throwback Rule: A rule affecting the numerator of the sales factor of the income apportionment formula, where sales made by a seller into a state in which the seller is not taxable are assigned back to the state from which the goods sold have been shipped or from which the goods were sold. (If a seller makes sales into a state in which it is taxable, the sales are assigned to the sales factor of that state.) The throwback rule has been adopted by several states to minimize nowhere income.

Throwout Rule: The throwout rule, an alternative to throwback, is a rule under which sales are eliminated from both the numerator and the denominator of the sales factor of the income apportionment formula where those sales are made into a state in which the seller is not taxable.

Uniform Division of Income for Tax Purposes Act (UDITPA): This model law, promulgated by the National Conference of Commissioners on Uniform State Laws and the American Bar Association in 1957, prescribes methods for assignment of income among the states for businesses that maintain operations in more than one state. Most income tax states have modeled their income apportionment laws on UDITPA's three-factor formula apportionment approach. A slightly amended version of UDITPA is a key component of the Multistate Tax Compact, the interstate agreement that created the Multistate Tax Commission.

Unitary Business: The branches of a corporation or members of a controlled corporate group that are treated as a single entity for calculation and assignment of income subject to tax. The unitary business principle can be applied to just a single entity or to a commonly controlled group of entities. The U.S. Supreme Court has declared that the "linchpin of apportionability in the field of state income taxation is the unitary-business principle." *Allied Signal, Inc. v. Director, Div. of Taxation, 504 U.S. 768 (1992).*

Appendix A

Significant Features of the Corporate Income Tax in the States

State	Corporate Income Tax Top Rate[a] (percent)	Adoption of UDITPA?	Combined Reporting	Throwback
Alabama	6.5	Yes	Not Allowed	Yes
Alaska	9.4	Yes	Required	Yes
Arizona	6.968	Yes	Required	No
Arkansas	6.5	Yes	Not Allowed	Yes
California	8.84	Yes	Required	Yes
Colorado	4.63	Yes	Required	Yes for 3-factor No for 2-factor
Connecticut	7.5[b]	No	Not Required	No
Delaware	8.7	No	Not Allowed	No
District of Columbia	9.975	Yes	Not Allowed	Yes
Florida	5.5[c]	No	Not Allowed	No
Georgia	6.0	No	Not Required	No
Hawaii	6.4[d]	Yes	Required	Yes
Idaho	7.6	Yes	Required	Yes
Illinois	7.3	Yes	Required	Yes
Indiana	8.5	Yes	Not Required	Yes
Iowa	12.0	No	Not Allowed	No
Kansas	4.0[e]	Yes	Required	Yes
Kentucky	8.25	Yes	Not Allowed	No
Louisiana	8.0	No	Not Required	No
Maine	8.93[f]	Yes	Required	Yes
Maryland	7.0	No	Not Allowed	No
Massachusetts	9.5	No	Not Allowed	Yes
Michigan	Single Business Tax	No	Not Allowed	No
Minnesota	9.8[g]	No	Required	No
Mississippi	5.0	No	Not Allowed[h]	Yes
Missouri	6.25	Yes	Not Allowed	Yes
Montana	6.75[i]	Yes	Required	Yes
Nebraska	7.81	No	Required	No
Nevada	No Corporate Income Tax			N/A
New Hampshire	8.5[j]	No	Required	Yes
New Jersey	9.0[k]	No	Not Allowed	No
New Mexico	7.6	Yes	Not Required	Yes
New York	7.5[l]	No	Not Required[m]	No
North Carolina	6.9	Yes	Not Allowed	No
North Dakota	10.5	Yes	Required	Yes
Ohio	8.5[n]	Yes	Allowed[o]	No
Oklahoma	6.0	No	Not Allowed	Yes

State	Corporate Income Tax Top Rate[a] (percent)	Adoption of UDITPA?	Combined Reporting	Throwback
Oregon	6.6	Yes	Required	Yes
Pennsylvania	9.99	Yes	Not Allowed	No
Rhode Island	9.0	No	Not Required	No
South Carolina	5.0	Guidance	Not Required	No
South Dakota	No Corporate Income Tax			N/A
Tennessee	6.5	Yes	Not Allowed	No
Texas	Franchise Tax[p]	No	Not Allowed	Yes
Utah	5.0	Yes	Required	Yes
Vermont[q]	9.75	No	Not Allowed	Yes
Virginia	6.0	No	Not Allowed	No
Washington	Business & Occupations Tax			N/A
West Virginia	9.0	Yes	Not Required	No
Wisconsin	7.9	Yes	Not Allowed	Yes
Wyoming	No Corporate Income Tax			N/A

Sources:Corporate Tax Rates (for tax year 2004)—Federation of Tax Administrators
Adoption of UDITPA—Multistate Tax Commission
Combined Reporting—Multistate Tax Commission
Throwback Rule—Multistate Corporate Tax Guide, Panel Publishers

[a] Some states apply a separate tax on banks or financial businesses; minimum taxes (in $) are generally not reported here.
[b] Or 3.1 mills per dollar of capitol stock and surplus
[c] Or 3.3% Alternative Minimum Tax
[d] Alternative tax of .5% of sales
[e] Plus a surtax of 3.35% (2.125% for banks).
[f] Or a 27% tax on federal alternative minimum taxable income
[g] Plus a 5.8% tax on any alternative minimum taxable income over the base tax.
[h] State can require combined reporting.
[i] 7% for taxpayers using a water's edge combination.
[j] Plus 0.5% tax on the enterprise base (total compensation, interest and dividends paid).
[k] This is the corporate franchise tax rate. The alternate minimum assessment (based on gross receipts) applies if greater than the corporate franchise tax. Corporations not subject to the franchise tax are subject to a 7.25% income tax.
[l] Or 1.78 mills per dollar of capital (up to $350,000); or a 2.5% alternative minimum tax.
[m] Commissioner may permit combined reporting.
[n] Or 4.0 mills times the value of the taxpayer's issued and outstanding share of stock with a maximum payment of $150,000. An additional litter tax is imposed as a rate of 0.11% on the first $50,000 of taxable income, or 0.22% of income over $50,000l or 0.14 mills on net worth.
[o] Allowed if unitary members are Ohio taxpayers.
[p] Imposed on earned surplus and apportioned by sales in Texas relative to sales in the U.S.
[q] Combined reporting takes effect, under the provisions of H.R. 784, in 2006.

Appendix B

MTC Federalism at Risk Recommendations and
Policy Questions for the Sate Income Tax

Recommendations

To help restore the equity and effectiveness of state income tax systems, the Commission recommends that states consider the following actions:

- Adopt "combined reporting"[1] for jointly owned and operated companies—including affiliates in international tax havens—to more appropriately report and assign income to where it is earned.

- Ensure proper filing of state income or business tax returns by those earning significant income from within a state by adopting a uniform "factor presence"[2] nexus standard. Concurrently, urge Congress to relieve the restrictions of P.L. 86-272 for those states adopting this "factor presence" nexus standard to support uniform and equitable state taxes to encourage the free flow of interstate commerce.

- Adopt uniform rules for dividing income among the states to ensure multistate income is reported to states where it was earned and to avoid the possibility of over- or under-reporting of income from interstate commerce.

- Develop uniform tax policies and cooperative administrative systems that make it easier for owners, especially non-resident owners, of pass-through entities to file returns and pay the proper amount of tax to states where income was earned.

- Develop individual or cooperative administrative systems to verify that owners of pass-through entities are paying taxes to those states from which they earn income.

- Strengthen and expand cooperative administration and enforcement among the states through early review of tax shelters considered questionable by several states, increased joint auditing and other cooperative measures, and through expanded federal-state compliance efforts.

[1] Combined reporting is a state tax accounting system approved by the U.S. Supreme Court. It is used by several states to ensure a full and complete division (apportionment) of income of a single (or "unitary") business enterprise operating in multiple states. Under combined reporting, the taxable income of separate legal entities comprising a single business operating in multiple states is added together. In contrast, under "separate entity" reporting, the taxable income for each separate legal entity is reported separately without regard to the combined income of the multistate enterprise. Combined reporting helps curb the ability of multistate enterprises to shift income away from locations where the income was earned to no-tax or low-tax jurisdictions.

[2] The full text of the "factor presence" proposal is available in the Appendix to the full *Federalism at Risk* report or in MTC Policy Statement 02-02 accessible via the "Resolutions" link at www.mtc.gov.

- Urge Congress to enact legislation to help curb federal and state corporate tax sheltering and to refrain from enacting new restrictions that would harm the ability of states to tax a fair share of the income of interstate enterprises.

- Encourage the federal government to improve compliance with the federal income tax through improved tax laws and regulations and adequate budget resources for compliance activities.

Additional Policy Questions

State policy makers might assess additional alternatives to help improve the equity and effectiveness of state income tax systems:

- Should states consider replacing business net income taxes with gross value taxes or using gross value taxes as an alternative minimum tax for businesses?

- Should states consider interstate agreements to standardize or limit special "tax incentives" in bids to attract new businesses?

- Should states more thoroughly explore the pros and cons of varying from the evenly-weighted three factor apportionment formula of UDITPA?

- Should states consider eliminating "nowhere" income through the destination sourcing of sales of services and intangibles or by adopting uniform "throwback" and "throwout" rules?