

# *Multistate Tax Commission*



## **Amended Hearing Officer's Report**

### **Recommendation Concerning Proposed Model Statute Requiring the Add-back of Certain Intangible and Interest Expenses**

October 10, 2005

#### **I. Introduction.**

The Multistate Tax Commission's State Tax Compliance Initiative recommended the development of a model statute requiring the add-back of certain intangible and interest expenses ("expense add-back statute"). Expense add-back statutes were initially developed to deal with the common tax avoidance scheme of using intangible holding companies to shift income earned in state to another jurisdiction in which that income was not taxed. The Compliance Initiative also recommended the development of a model combined reporting statute, which would more comprehensively deal with transfers of value among related corporations, but was concerned that some states might not be willing or able to enact a combined reporting statute and might prefer the more limited expense add-back statute. The Executive Committee delegated the drafting of the expense add-back statute to a group of state tax attorneys. The drafting group worked out the proposal, based substantially on expense add-back statutes recently passed by a number of states.

The proposal was introduced to the Income and Franchise Subcommittee of the Uniformity Committee, during a March 1, 2005 teleconference. The subcommittee discussed the proposal at its March 17, 2005 meeting and recommended approval to the full committee. The Uniformity Committee at its March 18, 2005 meeting recommended approval of the proposal to the Executive Committee. The Executive Committee at its April 28, 2005, meeting referred the proposal to a public hearing. The proposal is attached as Exhibit A.

The Interim Executive Director of the Commission appointed Frank D. Katz, General Counsel, to act as Hearing Officer, Exhibit B. A hearing was duly notified by postcard, Exhibit C, and by notice posted on the MTC website, Exhibit D, as certified by Loretta King, Exhibit E. The hearing was held in Washington, DC on July 18, 2005. A Report was filed with the Executive

Committee prior to the July 27, 2005 meeting with the recommendation that action be delayed pending further written comments. This amended report includes those comments and other revisions.

## **II. The Proposal.**

The proposal deals with the add-back of expenses for intangibles in a separate section from the add-back for interest in case a state wishes to adopt only one of the sections. Substantively, the sections are largely the same.

Both sections are structured with definitions in subsection (a), a general disallowance of intangibles or interest expense deductions in subsection (b), and then the important exceptions to the disallowance in subsection (c). The exceptions are the critical part of the proposal. The *intangible* section of the proposal sets out four exceptions to the disallowance: (i) if the taxpayer establishes by clear and convincing evidence that the related member is taxed in another state on that income at an acceptable tax rate; (ii) if the taxpayer establishes by clear and convincing evidence that the related member is organized in another country that has a tax treaty with the USA, its income is taxed at a rate at least equal to that imposed by the state, and the intangible expense was paid incident to a transaction entered into for a valid business purpose and reflects arm's length pricing; (iii) for the portion of the payment that the related member then pays to a person not a related member where the taxpayer and related party's transaction undertaken for a valid business purpose, and (iv) if the taxpayer and the tax commissioner agree to an alternative treatment. The interest section sets out identical exceptions to the disallowance as in (i), (ii) and (iv) above and a slight modification in (iii) providing an exception to the deduction if the taxpayer establishes by clear and convincing evidence that the transaction was undertaken for a valid business purpose and reflects arm's length pricing.

## **III. Public Comment at Hearings**

Diann Smith of the Council on State Taxation (COST) began her comments by stating COST's general opposition to expense add-back statutes because they are overbroad and disallow the deduction of certain basic ordinary and necessary expenses. That said, she praised the MTC's effort to achieve uniformity in this area, noting that the various statutes in the several states each have their own, unique quirks that has made compliance difficult for the multistate taxpayer. Even similar statutes end up being interpreted differently by tax administrators, increasing compliance difficulties.

In expanding on the vice of overbreadth, she gave an example of a mother/son business in Maryland to which the mother makes a loan at arm's length rate.

When mom retires and moves to Texas, which has no income tax, would the interest the business pays to mom no longer be deductible? [In fact, the exception in (c)(iii) would apply because the loan had a valid business purpose and was at arm's length pricing.] In another example, one corporation licenses use of a patent or trademark from an unrelated corporation and then is acquired by the licensor corporation but continues to pay the arm's length royalty. This is not a sham transaction but the deduction could be disallowed.

Ms. Smith then made comments on eight specific aspects of the proposed model statute.

- COST appreciates treating intangibles and interest in separate sections so that states can adopt only the intangible section and not the interest section which COST believes presents more problems with overbreadth.
- COST also appreciates the fact that the definition of “aggregate effective rate of tax” recognizes that the related party to whom the payments are made may be taxable in more than one state.
- COST approves that the effective tax rate is not figured after all credits but only after the credits relating to the expense.
- COST worries about the breadth of the definition of intangible expenses to include indirect costs. Could that include trademark expenses imbedded in the cost of goods sold?
- Abuse of factoring transactions has occurred, but is rare and uncommon. Absence a showing of affirmative abuse, they should not be added-back.
- COST strongly opposes the definition of valid business purpose. It does not object to the use of valid business purpose as the basis of an exception to the add-back, but COST doesn't want it defined in statute, and would prefer to leave it to the courts to determine. COST's particular concern was the requirement for change of economic position; a change from a C corporation to a LLC would not result in a change of economic position, but can certainly have a valid business purpose. COST also objects to the requirement that there must be an actual change in economic position rather than merely a contemplated change that may not actually come to pass.
- COST thinks the standard of clear and convincing evidence is too high, that the more usual preponderance of evidence test should be used.
- Limiting the foreign-subsidiary safe harbor to countries that have tax treaties with the United States may run afoul of the commerce clause as might requiring the tax rate for the foreign country to be equal to the taxing states while the tax rate for another state can be lower.

Karen Boucher speaking on behalf of the state and local tax technical resource panel of the American Institute of Certified Public Accountants (AICPA) made the following comments.

- She noted the constitutionality of add-back statutes is being challenged in Alabama and suggest the MTC should wait until that challenge is resolved before adopting a model statute.
- She agreed with Diann Smith that the definition of valid business purpose is too limited.
- With regard to the definition of effective tax rate, she noted that the proposal failed to consider alternative assessments to which the related party may be subject, such as the NJ alternative minimum tax, the Kentucky tax, the Michigan single business tax, the Texas franchise tax and the new Ohio business gross receipts tax.
- She echoed Diann Smith's comments about the exception for taxes paid to a foreign country—that the tax rate requirement should be the same as for other states, and that the exception should not be limited to countries with tax treaties.
- She suggested that intangible expenses should be allowed so long as the transaction was for a valid business purpose and at arm's length.
- The conduit exception should apply to interest also.
- The clear and convincing evidence standard is burdensome.

Karen Boucher also represented several financial institutions and made the following comments in that capacity.

- Financial institutions should not be subject to the interest expense add-back because lending is the greater part of their business and banking regulators are already looking at these transactions with affiliates.
- There is a substantial variation in state taxation of financial institutions, using different tax bases, making it difficult to figure comparable rates. Some state base tax on capitalization rather than income.
- There may be a constitutional issue imposing these requirements on businesses subject to different tax bases in different states.
- Even if the add-back were excepted under subsection (c)(iii), proving entitlement to that exception would be administratively burdensome.

Ms. Boucher noted her intention to file written comments. Written comments from the AICPA and financial institutions are discussed below.

Michael Fatale of the Massachusetts Department of Revenue noted that the valid business purpose definition was based on the definition in NY statute.

Garland Allen, reflecting on the comments of the ABA State and Local Tax Committee on Add-back Statutes, noted that the proposed model statute seems to perpetuate treating credits as belonging only to the single entity and not to the unitary group, even where the affiliate is part of a group filing a combined report in the other state.

#### **IV. Summary of Written Responses.**

The Council on State Taxation (COST) submitted a written version of the comments it presented at the hearing summarized above. The COST letter is attached as Exhibit F.

Kimberley Reeder and Margaret Wilson of McDermott Will & Emery LLP submitted written comments attached as Exhibit G. Their first general concern is that the Model Statute is overbroad by presuming that all interest and intangible transactions among related parties are suspect, forcing many companies that engage in intercompany transactions for reasons other than tax avoidance “to engage in the administratively difficult function of establishing their entitlement to what is in reality a relatively ordinary tax deduction.” This is particularly true, they suggest, with regard to loans and interest payments among related entities. The exception to the add-back requirement under Section 2(c)(iii) where there is a valid business purpose and arm’s length relationship requires too high a standard of proof and imposes burdensome documentation for routine intercompany transactions.

Their second general concern is that where a state refuses to permit a deduction of royalty or interest paid to a related party, it should similarly refuse to *tax* the royalty or interest the related party receives so as to avoid double taxation.

Their third general concern is that in no case should a taxpayer be required to pay more tax than it would under combined reporting.

Their fourth general concern is that the Model Statute is constitutionally flawed. Royalty payors on intrastate royalty transactions between related members will likely always be able to deduct royalties because the recipients will pay that state’s rate on income tax, thus qualifying for the exception in subsection 2(c)(i). If the transactions are interstate, however, the payor risks losing the deduction unless it qualifies for one of the other exemptions. They allege discrimination as found in *Ceridian Corp. v. FTB* and *Farmer Bros. Co. v. FTB*.

Reeder and Wilson then cite specific concerns.

- They would prefer the statute not codify definitions of business purpose and economic substance, but leave that determination to case law.
- The clear and convincing standard is too high.
- They are concerned that broad definition of “intangible expenses” could include payment of a royalty as an imbedded cost in goods sold, resulting in disallowance of part of the deduction for cost of goods sold.
- They suggest clarification in subsection (c)(i)(A) by adding to “subject to tax” the phrase “regardless of whether paid” to cover the circumstance where no tax is actually paid because of accumulated net operating losses.
- They suggest the exceptions should be the same for domestic and foreign payees, both with regard to “subject to tax” vs. “taxed” and the additional burden for foreign payees to show valid business purpose and terms that are arm’s length.
- They suggest that the conduit exception in Section 1(c)(iii)(A) be expanded to include not only where a parent sublicenses to an affiliate a third party’s intangible but where affiliate sublicenses to a third party its parent’s intangible.
- They suggest clarification of whether use of alternative adjustments or computations under (c)(iv) relate only to expense deductions or may also be used for apportionment computations, and suggest promulgations of guidelines when this authority may be used to promote uniformity.
- Finally, they note that “related member” is not defined in Section 2.

Karen Boucher submitted written comments amplifying her oral comments at the hearing on behalf of financial institutions. These comments are attached as Exhibit H. She reiterates

- Financial institutions should not be subject to the interest expense add-back because lending money for interest is their primary business.
- Banking regulators are already looking at banks’ transactions with their affiliates; banks cannot be “disadvantaged” in affiliate transactions.
- The “subject to tax” exception in subsection 2(c)(i) does not work well for financial institutions because of the substantial variation in state taxation of financial institutions, using different tax bases, making it difficult to figure comparable rates. A number of state taxes are figured not on income but on capitalization.
- Because of this different taxation of financial institutions in different states, limiting the “subject to tax” exception to income taxes is unconstitutional as exerting pressure for banks to locate in certain states (income tax states) rather than others.

- Even if the add-back would be excepted under subsection (c)(iii), proving entitlement to that exception, particularly with the clear and convincing evidence standard, would be administratively burdensome.

In addition, her written comments raised the following issues:

- Banking regulations require that banks use subsidiaries for a variety of lending purposes such as SBA loans, community development lending, student loans, mutual fund and underwriting brokerage activity, and foreign lending. These are valid business purposes and proving entitlement to an exception to add-back is onerous.
- The structure of the “subject to tax” exception using a zero percentage tax rate for combined reports disadvantages financial institutions which are required to file combined in some states when general corporations are not.
- Some states, like Maryland, have made exceptions for banks.

Finally, Ms. Boucher suggests that the interest add-back section be limited to interest related to intangible property as several states have done (NY, DC GA, MS,VA).

The American Institute of Certified Public Accountants submitted written comments, attached as Exhibit I. They summarize their concerns as follows:

- They are concerned that the statute may be subject to constitutional challenge and recommend that the MTC resolve such issues before proceeding with the proposal.
- They oppose attempts to provide a strict statutory interpretation of the term “valid business purpose.”
- The proposed statutory computation of “effective tax rate” is too narrow because it does not consider non-income taxes and potentially discriminatory by not including taxes imposed in combination states.
- The foreign country add-back exceptions should be more consistent with the add-back exceptions for entities located in the United States and there should be greater consistency between the intangible and interest expense add-back exceptions.
- The “clear and convincing” evidence standard should be eliminated.
- The add-back statute does not fairly protect legitimate business transactions.

## **V. Hearing Officer Recommendations**

### **A. General Comments.**

General concerns about overbreadth in the proposed model statute highlight the conundrum facing states in enacting tax statutes. Taxpayers often cite with glee Judge Learned Hand's famous dissent that "there is nothing sinister in so arranging one's affairs as to keep taxes as low as possible . . . for nobody owes any public duty to pay more than the law demands: taxes are enforced exactions, not voluntary contributions." The crucial part of the quotation for our purposes is the duty to pay "no more than the law demands." It is imperative that legislatures word their tax statutes in such a way to ensure that "the law demands" the payment of exactly the tax intended, to ensure, in other words, that the demands of the law minimize the ability of taxpayers to plan around payment of the intended tax through creative restructuring. Given the impressively creative minds of tax planners, legislatures may need to give their tax administrators a certain degree of flexibility to safeguard their tax bases. The result may be the complaint we heard from McDermott Will & Emery, COST, financial institutions and AICPA that this remedial tax statute is "overbroad."

Unquestionably, an expense disallowance statute does create some burden on taxpayers in disallowing only two kinds of related-party transaction, many of which may be entered into for legitimate reasons, rather than the more comprehensive approach of handling transactions among related parties in combined reporting. In proceeding with the expense disallowance statute, the Commission would be wise to emphasize the superiority of combined reporting and to acknowledge that expense disallowance is a somewhat less efficient and somewhat more burdensome substitute. Combined reporting would be a better solution, but business would need to support combined reporting for it to pass in many states. In the absence of that support, States must protect their tax base from various tax sheltering activities that they have already seen occurring. Expense disallowance statutes appear to be an effective tool in protecting the States.

The suggestion that the taxpayers not be required to pay more than they would pay under combined reporting seems particularly inappropriate. Why should taxpayers have it both ways? Combined reporting is clearly the superior system. If taxpayers agree combined reporting produces the proper amount of tax, they should be willing to accept combined reporting as a general rule, not just when it favors them.

The drafted exceptions to the add-back requirement appear to answer many of the allegations of overbreadth expressed by the commenters. Thus, the common and legitimate nature of factoring transactions would bring them within the exception in Section 2(c)(iii). (State agency lawyers report that they have seen a substantial amount of income shifting being done through factoring transactions, belying COST's claim of rarity.) The

legitimate nature of transactions among the subsidiaries of financial institutions would also come with that exception, as would the mother's loan to the mom and son business. The greater part of Karen Boucher's concerns on behalf of financial institutions focus on the "subject to tax" exception, but the everyday activities of financial institutions would fall under the exception in Section 2(c)(iii). To the extent that certain legitimate transactions such as these are common, tax agencies can, by regulation, relieve taxpayers of the burden of making repeated showings to justify each transaction. Interestingly, Ms. Boucher referred the Maryland statute as providing a proper exception for banks; but the Maryland exception is based on the same standard as the exception proposed in Section 2(c)(iii)—valid business purpose and arm's length transaction.

The AICPA expresses the concern that the proposed statute "casts too wide a net" and that the exceptions "fail to protect inter-company transactions undertaken for legitimate business reasons." It is hard to credit this concern since exactly those transactions are covered by the exception in subsection (c)(iii) for expense "undertaken for a valid business purpose."

Several questions have been raised about the constitutionality of expense disallowance statutes. McDermott Will and Emery suggest that transactions wholly intrastate would preserve the deduction (on the theory that the state would tax the royalty payments) but transactions with related members in other states may not. Thus intrastate transactions would be favored. But this is not true. Some states tax most income but not royalty income (MI). In any case, the income would be taxed only once, whether wholly intrastate or interstate. If the payment is made to an intrastate affiliate, generally the deduction will be allowed but the royalty payment to the related member will be taxed. In an interstate transaction where the royalty payment to the related member is not taxed, then the deduction will be disallowed. The two California cases (*Ceridian* and *Farmer Brothers*) are inapposite. There, the deductions were disallowed unless the dividend payor was subject to California tax. Double taxation was avoided only if California received tax once. Here, the deduction is not disallowed if the recipient pays tax in any state, not just the taxpayer's state. Karen Boucher's concern about the constitutionality as applied to financial institutions appears to apply the commerce clause standard incorrectly; the internal consistency test posits that other states have the *same* taxing system as the state whose tax is challenged. She posits other states having different taxing systems. The AICPA's constitutional concern that the expense disallowance statute permits a state to tax income earned outside the state is difficult to understand, since by disallowing the deduction from gross income, the statute only taxes income earned within the state. Nor is it at all apparent where in the Constitution there is created a right to

match income with expenses or to account for losses of subsidiaries in the same corporate group. All this said, it remains likely that non-trivial constitutional challenges to these statutes will continue. It does not appear sensible, however, for the states to simply wait until all possible challenges are resolved.

COST and McDermott Will and Emery raised an issue about the breadth of the definition of intangible expenses to include “costs for, related to, or in connection directly or indirectly with the direct or indirect acquisition, use, maintenance or management, ownership, sale, exchange, or any other disposition of intangible property.” They asked whether that would include the cost of intangibles embedded in the cost of goods. Indeed it would, and that has become a favored tax planning device. Example: A Corp. and B Corp. are wholly owned subsidiaries of C Corp., a parent corporation that owns multiple affiliates all of which are collectively involved in the manufacture and sale of clothing. C Corp. is the owner of record of the trademarks that are used in connection with the sale of clothing by the affiliated enterprise. C Corp. licenses the use of these trademarks to B Corp., which manufactures clothing using the trademarks and then sells the clothing to A Corp. at an enhanced price that reflects the price paid for the use of the trademarks by B Corp. The price paid by A Corp. for the clothing that it purchases from B Corp. includes an “embedded” royalty. A Corp. is the corporation that is doing business in the state and, through the embedded royalty, shifts income out of the state.

The commenters appear to want vagueness by resisting any definition of “valid business purpose” while retaining it as a basis of the exception to add-back requirement. It is hard to understand any valid tax policy reason for the resistance to clarity and certainty here. The AICPA “opposes defining a valid business purpose as one that changes the economic position of a taxpayer ‘in a meaningful way’ because it fails to acknowledge the difficulties taxpayers may encounter when attempting to enter new markets.” But the definition explicitly recognizes that the “economic position of the taxpayer includes . . . entry by the taxpayer into new business markets.”

Commenters suggest adding after the phrase “subject to tax” in Section 1(c)(i)(A) the additional phrase “regardless of whether paid” to cover the situation where no tax is paid due to credits or NOLs. This is unnecessary. The royalty or interest is still subject to tax. The concern would be appropriate if Section 1(c)(i)(A) said “taxed” rather than “subject to tax.” Indeed, Section 1(c)(ii)(C) does say “taxed” and your Hearing Officer recommends below a change in that provision.

Two concerns were expressed about the proposed statutory computation of “effective tax rate.” First, that it should include various alternative assessments. The alternative assessments are not income taxes and are not comparable. For payments made to affiliates in those states that imposed an alternative assessment, taxpayers will only need to show a valid business purpose to avoid the expense disallowance. The second concern is setting the effective rate at zero if the payee is in a combined reporting state. A major tax avoidance technique is the so call East/West strategy, to pay the royalty on intangibles to an affiliate in a combined reporting state which results in the elimination of the payments between the related entities. The result would be that the payor in the separate entity state would get an intangible expense deduction but the payee in the combined reporting state would see no change in its tax.

Karen Boucher’s entreaty to exclude financial institutions notes that bank regulators do not let banks be “disadvantaged” in transactions with affiliated non-bank entities. That is all well and good, but it is only half the equation. How about where the non-bank affiliates “advantage” the bank, and shift income from the state in which they do business to the bank’s state? A recent Wall Street Journal article exposed widespread tax sheltering by financial institutions.

## **B. Suggested Revisions.**

Some comments raise legitimate concerns which suggest the need for revisions that the Executive Committee may wish to consider.

1. Commenters suggest that where the statute permits a state to deny a deduction of royalty or interest paid to a related party, it should similarly deny a state permission to tax the royalty or interest the related party receives so as to avoid **double taxation**. Generally, this is not a problem since when the related party receiving the royalty or interest payment is taxed at a sufficiently high rate, the deduction is not disallowed. A problem could arise, however, where the related party receiving the payment is taxed, but not at a sufficiently high rate to trigger the exception to the disallowance. Under those circumstances, there can be what some would call double taxation. While not technically double taxation, as different entities are being taxed on different incomes, the clear purpose of the expense disallowance statute is to prevent tax avoidance, and the exception when the payee’s royalty is fully subject to tax at a comparable rate indicates an intention not to “double tax” that income. The suggested fix of disallowing the deduction by the payor but allowing the payee to exclude that income would still provide some arbitrage ad-

vantage if the royalty payee is in a low tax state (like Delaware with its squirrely new tax structure for a “Headquarters Management Corporation”). A better fix would be to pro-rate the disallowance of the deduction to eliminate any claim of double taxation. Your hearing officer does not have a ready fix to suggest here. The Executive Committee may wish to remand the proposal to the Uniformity Committee for the drafting of such language.

2. The concern about limiting the exception for **foreign subsidiaries** to only those countries with tax treaties with the U.S. appears valid. Eliminating that requirement in subsections (c)(ii)(B) of Sections 1 and 2 would solve that problem. There is also merit in the concern that taxation by the *foreign country* must be at the rate equal to the state’s rate, but the tax imposed by *another state* can be lower than the state’s rate. It may be that the “subject to tax” exception should be the same for payees in other states and in other countries. If it is the same, however, there may be advantages gained by having payees located in tax haven countries. The Executive Committee might want to remand this provision to the Uniformity Committee also for a reworking.
3. The **definitions** in Section 2 should be complete lest a state wish to enact only one of the sections, so “related member” and “related entity” should be defined there as well.

The proposal appears sound in most respects. The definitional fix suggested just above is easily done. The two other modifications would benefit from the input of the Uniformity Committee.

Respectfully submitted October 10, 2005

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Frank D. Katz

Exhibits Attached to the Report of the Hearing Officer on the Proposed Model Expense Disallowance Statute

- Exhibit A: Proposed Model Statute approved by Executive Committee
- Exhibit B: Memorandum of Appointment of Hearing Officer
- Exhibit C: Postcard Notice of Hearing
- Exhibit D: Notice of Public Hearing posted on Website.
- Exhibit E: Certificate of Loretta King attesting to proper notice of hearing.
- Exhibit F: Letter from COST
- Exhibit G: Written Comments of McDermott Will & Emery
- Exhibit H: Written Comments of Karen Boucher
- Exhibit I: Written Comments of AICPA

## EXHIBIT A

### Proposed Model Statute Requiring the Add-back of Certain Intangible and Interest Expenses

Draft Approved by Executive Committee 4-28-05

#### **Section 1.**

(a) As used in this section, the following words shall, unless the context requires otherwise, have the following meanings:

(i) "Aggregate effective rate of tax" means the sum of the effective rates of tax imposed by a state or U.S. possession or any combination thereof on a related member.

(ii) "Code" means the federal Internal Revenue Code as amended and in effect for the taxable year.

(iii) "Effective rate of tax" means, as to any state or U.S. possession, the maximum statutory rate of tax imposed by the state or possession on a related member's net income multiplied by the apportionment percentage, if any, applicable to the related member under the laws of said jurisdiction. For purposes of this definition, the effective rate of tax as to any state or U.S. possession is zero where the related member's net income tax liability in said jurisdiction is reported on a combined or consolidated return including both the taxpayer and the related member where the reported transactions between the taxpayer and the related member are eliminated or offset. Also, for purposes of this definition, when computing the effective rate of tax for a jurisdiction in which a related member's net income is eliminated or offset by a credit or similar adjustment that is dependent upon the related member either maintaining or managing intangible property or collecting interest income in that jurisdiction, the maximum statutory rate of tax imposed by said jurisdiction shall be decreased to reflect the statutory rate of tax that applies to the related member as effectively reduced by such credit or similar adjustment.

(iv) "Intangible expense" includes (1) expenses, losses and costs for, related to, or in connection directly or indirectly with the direct or indirect acquisition, use, maintenance or management, ownership, sale, exchange, or any other disposition of intangible property to the extent such amounts are allowed as deductions or costs in determining taxable income before operating loss deductions and special deductions for the taxable year under the Code; (2) amounts directly or indirectly allowed as deductions under section 163 of the Code for purposes of determining taxable income under the Code to the extent such expenses and costs are directly or indirectly for, related to, or in connection with the expenses, losses and costs referenced in (1); (3) losses related to, or incurred in connection directly or indirectly with, factoring transactions or discounting transactions; (4) royalty, patent, technical and copyright fees; (5) licensing fees; and (6) other similar expenses and costs.

(v) "Intangible property" includes patents, patent applications, trade names, trademarks, service marks, copyrights, mask works, trade secrets and similar types of intangible assets.

(vi) "Related entity" means (1) a stockholder who is an individual, or a member of the stockholder's family set forth in section 318 of the Code if the stockholder and the members of the stockholder's family own, directly, indirectly, beneficially or constructively, in the aggregate, at least 50 per cent of the value of the taxpayer's outstanding stock; (2) a stockholder, or a stockholder's partnership, limited liability company, estate, trust or corporation, if the stockholder and the stockholder's partnerships, limited liability companies, estates, trusts and corporations own directly, indirectly, beneficially or constructively, in the aggregate, at least 50 per cent of the value of the taxpayer's outstanding stock; or (3) a corporation, or a party related to the corporation in a manner that would require an attribution of stock from the corporation to the party or from the party to the corporation under the attribution rules of the Code if the taxpayer owns, directly, indirectly, beneficially or constructively, at least 50 per cent of the value of the corporation's outstanding stock. The attribution rules of the Code shall apply for purposes of determining whether the ownership requirements of this definition have been met.

(vii) "Related member" means a person that, with respect to the taxpayer during all or any portion of the taxable year, is: (1) a related entity, (2) a component member as defined in subsection (b) of section 1563 of the Code; (3) a person to or from whom there is attribution of stock ownership in accordance with subsection (e) of section 1563 of the Code; or (4) a person that, notwithstanding its form of organization, bears the same relationship to the taxpayer as a person described in (1) to (3), inclusive.

(viii) "Valid business purpose" means one or more business purposes, other than the avoidance or reduction of taxation, which alone or in combination constitute the primary motivation for a business activity or transaction, which activity or transaction changes in a meaningful way, apart from tax effects, the economic position of the taxpayer. The economic position of the taxpayer includes an increase in the market share of the taxpayer or the entry by the taxpayer into new business markets.

(b) For purposes of computing its net income under this chapter, a taxpayer shall add back otherwise deductible intangible expense directly or indirectly paid, accrued or incurred in connection with one or more direct or indirect transactions with one or more related members.

(c) (i) The adjustment required in subsection (b) shall not apply if the taxpayer establishes by clear and convincing evidence of the type and in the form specified by the commissioner that (A) the related member was subject to tax on its net income in this state or another state or possession of the United States or some combination thereof; (B) the tax base for said tax included the intangible expense paid, accrued or incurred by the taxpayer; and (C) the aggregate effective rate of tax applied to the related member is no less than [\_\_%] [the statutory rate of tax applied to the taxpayer under this chapter minus \_\_ percentage points].

(ii) The adjustment required in subsection (b) shall not apply if the taxpayer establishes by clear and convincing evidence of the type and in the form specified by the commissioner that (A) the intangible expense was paid, accrued or incurred to a related member organized under the laws of a country other than the United States; (B) the related member's income from the transaction was subject to a comprehensive income tax treaty between such country and the United States, (C) the related member's income from the transaction was taxed in such country at a tax rate at least equal to that imposed by this state; and (D) the intangible expense was paid, accrued or incurred pursuant to a transaction that was undertaken for a valid business purpose and using terms that reflect an arm's length relationship.

(iii) The adjustment required in subsection (b) shall not apply to the portion of the intangible expense that the taxpayer establishes by clear and convincing evidence meets both of the following requirements: (A) the related member during the same taxable year directly or indirectly paid, accrued or incurred such portion to a person that is not a related member, and (B) the transaction giving rise to the intangible expense between the taxpayer and the related member was undertaken for a valid business purpose.

(iv) The adjustment required in subsection (b) shall not apply if the corporation and the commissioner agree in writing to the application or use of alternative adjustments or computations. The commissioner may, in his/her discretion, agree to the application or use of alternative adjustments or computations when he/she concludes that in the absence of such agreement the income of the taxpayer would not be properly reflected.

(d) Nothing in this subsection shall be construed to limit or negate the commissioner's authority to otherwise enter into agreements and compromises otherwise allowed by law.

(e) Nothing in this section shall be construed to limit or negate the commissioner's authority to make adjustments under section \_\_ [i.e., the state's transfer pricing authority, if any].

## **Section 2.**

(a) As used in this section, the following words shall, unless the context requires otherwise, have the following meanings:-

(i) "Aggregate effective rate of tax" means the sum of the effective rates of tax imposed by a state or U.S. possession or any combination thereof on a related member.

(ii) "Code" means the federal Internal Revenue Code as amended and in effect for the taxable year.

(iii) "Effective rate of tax" means, as to any state or U.S. possession, the maximum statutory rate of tax imposed by the state or possession on a related member's net income multiplied by the apportionment percentage, if any, applicable to the related member under the laws of said jurisdiction. For purposes of this definition, the effective rate of tax as to any state or U.S. possession is zero where the related member's net income tax liability in said jurisdiction is reported on a combined or consolidated return including both the taxpayer and the related member where the reported transactions between the tax-

payer and the related member are eliminated or offset. Also, for purposes of this definition, when computing the effective rate of tax for a jurisdiction in which a related member's net income is eliminated or offset by a credit or similar adjustment that is dependent upon the related member either maintaining or managing intangible property or collecting interest income in that jurisdiction, the maximum statutory rate of tax imposed by said jurisdiction shall be decreased to reflect the statutory rate of tax that applies to the related member as effectively reduced by such credit or similar adjustment.

(iv) "Interest expense" means amounts directly or indirectly allowed as deductions under section 163 of the Code for purposes of determining taxable income under the Code.

(v) "Valid business purpose" means one or more business purposes, other than the avoidance or reduction of taxation, which alone or in combination constitute the primary motivation for a business activity or transaction, which activity or transaction changes in a meaningful way, apart from tax effects, the economic position of the taxpayer. The economic position of the taxpayer includes an increase in the market share of the taxpayer or the entry by the taxpayer into new business markets.

(b) For purposes of computing its net income under this chapter, a taxpayer shall add back otherwise deductible interest paid, accrued or incurred to a related member, as defined in section 1, during the taxable year.

(c) (i) The adjustment required in subsection (b) shall not apply if the taxpayer establishes by clear and convincing evidence of the type and in the form specified by the commissioner that (A) the related member was subject to tax on its net income in this state or another state or possession of the United States or some combination thereof; (B) the tax base for said tax included the interest expense paid, accrued or incurred by the taxpayer; and (C) the aggregate effective rate of tax applied to the related member is no less than [\_\_%] [the statutory rate of tax applied to the taxpayer under this chapter minus \_\_ percentage points].

(ii) The adjustment required in subsection (b) shall not apply if the taxpayer establishes by clear and convincing evidence of the type and in the form specified by the commissioner that (A) the interest expense is paid, accrued or incurred to a related member organized under the laws of a country other than the United States; (B) the related member's income from the transaction is subject to a comprehensive income tax treaty between such country and the United States; (C) the related member's income from the transaction is taxed in such country at a tax rate at least equal to that imposed by this state; and (D) the interest expense was paid, accrued or incurred pursuant to a transaction that was undertaken for a valid business purpose and using terms that reflect an arm's length relationship.

(iii) The adjustment required in subsection (b) shall not apply if the taxpayer establishes by clear and convincing evidence, of the type and in the form determined by the commissioner, that (A) the transaction giving rise to interest expense between the taxpayer and the related member was undertaken for a valid business purpose, and (B) the

interest expense was paid, accrued or incurred using terms that reflect an arm's length relationship.

(iv) The adjustment required in subsection (b) shall not apply if the corporation and the commissioner agree in writing to the application or use of alternative adjustments or computations. The commissioner may, in his/her discretion, agree to the application or use of alternative adjustments or computations when he/she concludes that in the absence of such agreement the income of the taxpayer would not be properly reflected.

(d) Nothing in this subsection shall be construed to limit or negate the commissioner's authority to otherwise enter into agreements and compromises otherwise allowed by law.

(e) Nothing in this section shall be construed to limit or negate the commissioner's authority to make adjustments under section \_\_\_ [i.e., the state's transfer pricing authority, if any].

## **EXHIBIT B**



### **Multistate Tax Commission Memorandum**

States Working Together Since 1967 . . . To Preserve Federalism and Tax Fairness

#### **Memorandum of Appointment of Hearing Officer**

To: Record of the Hearing on Affiliate Nexus Proposal

From: René Y. Blocker, Interim Executive Director

Date: June 3, 2005

Re: Appointment of Hearing Officer for Model Expense Disallowance Statute

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The Executive Committee of the Multistate Tax Commission approved at its meeting held April 28, 2005, the conduct of a public hearing Model Expense Disallowance Statute. Pursuant to that action and the Multistate Tax Compact, I hereby appoint Frank D. Katz, General Counsel, as Hearing Officer for this proposal. I further request that he proceed with the conduct of this hearing.

/s/

---

René Y. Blocker, Interim Executive Director

**EXHIBIT C**

Multistate Tax Commission  
444 North Capitol St. NW  
Suite 425  
Washington DC 20001



**Notice of a  
Public Hearing on a  
Uniformity Proposal  
July 18, 2005  
Washington, DC**

Mr. Frank D. Katz  
1300 Canyon Road  
Santa Fe, New Mexico 87501

09



**Multistate Tax Commission**



**Notice of a Public Hearing on a Uniformity Proposal**

**Monday, July 18th, 2005  
1:30PM EDT**

**444 North Capitol Street NW, Suite 231  
Washington, DC**

**Proposed Model Statute Requiring the Add-back of  
Certain Intangible and Interest Expenses**

To join the hearing via telephone dial: 1.719.785.9325 & use passcode: 9824351.

For more information and to obtain the text of the proposal visit  
[www.mtc.gov](http://www.mtc.gov) or call 202.624.8699.

**EXHIBIT D**



**NOTICE OF PUBLIC HEARING  
Regarding  
Proposed Model Statute Requiring the Add-back of  
Certain Intangible and Interest Expenses**

The MULTISTATE TAX COMMISSION will conduct a public hearing to obtain comments from interested parties on a Proposed Model Statute Requiring the Add-back of Certain Intangible and Interests Expenses setting forth the circumstances under which the deduction of certain intangibles expenses and interest costs paid to a related party will be disallowed and these expenses will be required to be added back to the taxpayer's net income. The Proposal is appended to this Notice as Attachment A.

The hearing on the Proposal is scheduled for:

**TUESDAY, JULY 18, 2005, 1:30 P.M.**

Hall of the States, Room 231  
444 North Capitol Street NW  
Washington, DC 20001

All comments received as part of the hearing process will be set forth in a hearing officer's report that will be submitted to the MTC Executive Committee. The Committee will read what you say and then will consider the Proposal for appropriate action. See MTC's Uniformity Recommendation Development Process step seven, available at [www.mtc.gov/uniform/9steps.htm](http://www.mtc.gov/uniform/9steps.htm)

*The hearing officer for this matter is Frank D. Katz. Please submit all questions, comments and correspondence regarding this hearing matter to: Frank D. Katz, Multistate Tax Commission, 444 N. Capitol Street, N.W., Suite 425, Washington, D.C. 20001-1538, Phone: (505) 982 4351, Fax: (505) 982 4379, E-mail: [fkatz@mtc.gov](mailto:fkatz@mtc.gov)*

All interested parties are invited to participate in these public hearings. Parties wishing to make formal oral presentations are requested to notify the hearing officer in writing at least two (2) working days prior to the hearing date. Written comments are acceptable and encouraged. They may be submitted at any time prior to or on the hearing dates or by such later date as may be announced at the closing of the public hearings. Interested parties may participate by telephone. Please contact the hearing officer for specific instructions on how to connect by telephone.

**Attachment A**

Proposed Model Statute Requiring the Add-back of  
Certain Intangible and Interests Expenses

Draft Approved by Executive Committee 4-28-05

[See Exhibit A above]

**EXHIBIT E**



**Multistate Tax Commission Memorandum**

States Working Together Since 1967 . . . To Preserve Federalism and Tax Fairness

To: Frank D. Katz, General Counsel and Hearing Officer for MTC  
Uniformity Proposal for a Model Statute Requiring the Add-back  
of Certain Intangible and Interest Expenses

From: Loretta King, Administrative Assistant

Date: July 8, 2005

Subject: Certification of mailing of “Notice Of Public Hearing Regarding Proposal  
for a Model Statute Requiring the Add-back of Certain Intangible and In-  
terest Expenses”

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In compliance with the Multistate Tax Commission Bylaw 7, a postcard notice entitled “Notice of Public Hearing on a Uniformity Proposal: Proposed Model Statute Requiring the Add-back of Certain Intangible and Interest Expenses” was mailed on June 16, 2005 to the names on the mailing lists maintained by the MTC and on the same date a “NOTICE OF PUBLIC HEARING Regarding Proposed Model Statute Requiring the Add-back of Certain Intangible and Interest Expenses” was posted on the MTC website at [www.mtc.gov](http://www.mtc.gov).



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July 18, 2005

Mr. Frank Katz  
General Counsel  
Multistate Tax Commission  
444 North Capitol Street, NW  
Suite 425  
Washington, DC 20001

VIA EMAIL

**Re: Proposed Model Statute Requiring the Add-back of Certain Intangible and Interest Expenses**

Dear Frank:

The Council On State Taxation (COST) has recently reviewed the Multistate Tax Commission's (MTC) Proposed Model Statute Requiring the Add-back of Certain Intangible and Interest Expenses. COST generally opposes such add-back statutes. However, given the current trend among the states to adopt such statutes notwithstanding opposition from the business community, COST does support the concept of a uniform statute to be used by all states choosing to adopt such a provision. However, certain aspects of the approach suggested by the MTC remain problematic; the remainder of this letter discusses COST's concerns.

**About COST**

COST is a nonprofit trade association based in Washington, DC. COST was formed in 1969 as an advisory committee to the Council of State Chambers of Commerce and today has an independent membership of 570 major corporations engaged in interstate and international business. COST's objective is to preserve and promote the equitable and nondiscriminatory state and local taxation of multijurisdictional business entities.

**General Comments on Add-Back Statutes**

COST has historically opposed the enactment of statutes requiring the add-back of otherwise ordinary and necessary business expenses such as those expenses related to intangible property and interest expenses. Such statutes as a whole violate the principle that income should be matched with the expenses that generated the income at the time that such income and expenses were incurred. COST however does recognize that due to past abuses, particularly the use of sham intangible holding companies lacking both substance and a business purpose, states began to enact what have come to be known as "expense add-back" statutes. It should be noted that Ohio has had such a statute for many years but it is only in the past four years that such provisions have become widespread.

## **EXHIBIT F**

These add-back statutes generally:

- a) require that certain types of expenses,
- b) typically expenses related to intangible property such as trademarks or
- c) interest expense
- d) between related parties,
- e) be added back to the taxpayer's net income tax base in calculating total taxable income
- f) unless some statutory exception exists.

Unfortunately, these add-back statutes suffer from two major flaws as well as a host of individual flaws. The first major flaw is that these statutes tend to be overbroad. The stated intent of these add-back statutes is to curb the use of intangible holding companies. In every state legislative debate regarding this issue in which COST has participated, the only examples publicly-cited are of a retailer making royalty payments to an intangible holding company subsidiary located in Delaware where the intangible holding company has no full-time employees. The Legislature is then presented with draft language to remedy this situation. In reality, though, these statutes reach a far broader array of transactions than suggested by the example cited and thus require the add-back of expenses that have nothing to do with improper tax sheltering or income shifting. The result has been that numerous taxpayers that have no tax sheltering activity are required to add-back expenses that were truly necessary in the taxpayer's business to generate taxable income. Maryland Governor Ehrlich, in his message to the General Assembly saying that he would allow Maryland's add-back statute to become law over his objections, noted just one of many examples as to how the Maryland statute will deny legitimate deductions that are not motivated by tax considerations.

The second major flaw in these add-back statutes, which the MTC admirably seeks to address through this process, is that like snowflakes and fingerprints, no two expense-addback statutes are the same. This has created a compliance quagmire for corporate taxpayers in calculating their taxable income for each state. This complexity is compounded by that fact that states that have similar statutory add-back language have frequently interpreted this language quite differently. An example of this involves the common exception that an add-back is not required if the affiliate paid tax on the income at a rate within a set statutory range of the taxing state's rate. States have interpreted this exception in numerous ways and through numerous channels (e.g., regulations, directives, Q&A). Sometimes only the statutory rates are compared, sometimes the affiliate's effective tax rate before NOLs and credits is compared with the taxing state's statutory rate, and sometimes after NOLs and credits. Because of the lack of uniformity and the problems it causes in taxpayer compliance, COST supports the MTC's efforts to the extent that such statutes are deemed necessary.

### **Comments on the MTC's Proposal**

COST has taken note that the proposal is written in two different sections—one involving intangible property and one involving interest expense. Presumably this was done to allow a state to adopt one provision and not the other. To the extent that such add-back provisions are deemed necessary, COST supports this bifurcated approach. Many states have chosen to require only the add-back of expenses related to intangible property rather than also generally include interest within that requirement. (In fact New York originally enacted both an intangible property add-back provision and an interest add-back provision but quickly repealed the latter.) Further, it is far more likely that ordinary, non-tax motivated business transactions will be caught in the net of an interest add-back provision than an intangible expense add-back provision so this bifurcation seems to accept the idea that the interest add-back may be unnecessary.

## EXHIBIT F

Please keep in mind COST's general opposition to such add-back statutes; the following comments are offered solely in an effort to minimize unintended consequences should a state choose to enact such a statute over business' objections.

- a. COST appreciates the apparent recognition in this proposal that an affiliate may be subject to tax on the income related to the expense in question in more than one state and thus has incorporated the concept of "aggregate effective rate of tax." Several states have seemingly limited the tax rate exception to look solely at either the taxing state itself or one other state.
- b. COST also appreciates that the MTC has not required the effective tax rate to be calculated after *all* credits are accounted for but rather only those relating to the property generating the expense in question.
- c. The definition of "intangible expense" includes "expenses . . . directly or indirectly with the direct or indirect . . . use of intangible property." It should be made clear in this section that any expenses imbedded in the cost of goods sold are not subject to this definition or to the add-back requirement.
- d. Factoring transactions are a common and legitimate business practice that promote cash flow and liquidity among taxpayers. For this reason, absent an affirmative showing of an abuse, factoring transactions should not be included in the definition of an intangible expense that will be required to be added-back in calculating taxable income.
- e. COST strongly opposes the definition of a valid business purpose; "business purpose" is a judicially created doctrine best left to interpretation by the courts. Further, even if some definition must be included, the requirement that a valid business purposes must "change in a meaningful way, apart from tax effects, the economic position of the taxpayer" is far too narrow a description. For example, the change from a C Corp to an LLC does not change the economic position of the taxpayer but few would argue it is a perfectly legitimate business transaction. Further, the use of the word "changes" seems to imply that an actual economic change occurred, not merely that one was contemplated. It could be that a taxpayer makes an adjustment in its business, affecting its intangible property expecting an economic benefit, but that benefit fails to be recognized through no fault of the taxpayer. Thus, if the economic position definition must be retained, the mere potential for change should be sufficient.
- f. The standard for avoiding the add-back should be the standard used in most tax cases—preponderance of the evidence, not "clear and convincing". There does not appear to be any principled reason why the targeted items of expense should be subject to a more stringent judicial standard of review.
- g. By limiting the safe harbor from the add-back provisions in section (c)(ii) to only those countries with which the US has a comprehensive income tax treaty, there is a risk that this provision may run afoul of the Foreign Commerce Clause.
- h. Further, by requiring that the expense paid to an affiliate in a foreign country equal the statutory rate in the taxing state but allowing a lower rate for the safe-harbor for expenses taxed in other US States, the Foreign Commerce Clause is also likely violated.

## **EXHIBIT F**

### **Conclusion**

COST appreciates the opportunity to comment on the MTC's Proposed Model Statute Requiring the Add-back of Certain Intangible and Interest Expenses while it is still in the drafting process. Although COST does not agree that add-back statutes are necessary, we support the MTC's interest in promoting uniformity among the states that have nevertheless chosen to enact such statutes. We look forward to continuing to work with you as this project moves forward.

Sincerely,



Joseph R. Crosby  
Legislative Director

**EXHIBIT G**  
**COMMENTS ON MULTISTATE TAX COMMISSION  
PROPOSED MODEL STATUTE REQUIRING THE ADD-BACK  
OF CERTAIN INTANGIBLE AND INTERESTS EXPENSES**

**Submitted By: Kimberley Reeder, McDermott Will & Emery LLP – Silicon Valley  
Margaret Wilson, McDermott Will & Emery LLP – New York**

We submit the following comments to the Multistate Tax Commission (“MTC”), in response to the invitation of the MTC following publication of the April 28, 2005 draft of the Proposed Model Statute Requiring the Add-Back of Certain Intangible and Interest Expenses (the “Model”) (as approved by the MTC Executive Committee for Public Hearing). The Model has been proposed as the statutory guide for those states that choose to require add-back of intangible and interest expenses.

These comments first explore some of the general flaws in add-back statutes such as the Model, then analyze issues raised by the specific language of the Model.

**I. GENERAL CONCERNS**

**A. STRUCTURE OF MODEL IS GENERALLY OVERBROAD,  
PARTICULARLY INTEREST ADD-BACK PROVISIONS**

As an initial matter, the Model is typical of the intangible and interest add-back statutes that have been enacted by a growing number of states. The general framework of these statutes is to deny deductions for intangible and interest expenses associated with certain related party transactions subject to enumerated exceptions.

However, starting with the broad presumption that all such related-party transactions are motivated by tax avoidance is troublesome from an analytical standpoint. That is, while some transactions between related parties may indeed be undertaken solely to achieve tax savings, it is grossly overbroad to shift the burden of proving entitlement to these deductions to all taxpayers who engage in transactions with related entities, particularly when the requisite burden of proof (*i.e.*, clear and convincing evidence) is so high.

The reasons why companies organize themselves into separate entities are myriad, as are the needs that cause them to engage in intercompany transactions.<sup>1</sup> Presuming that all such transactions are “guilty until proven innocent” penalizes a host of companies that engage in intercompany transactions for reasons other than tax avoidance by forcing them to engage in the administratively difficult function of establishing their entitlement to what is in reality a relatively ordinary tax deduction. It should be noted that the burden is not only on the taxpayer; taxing authorities face the equivalent burden of having to digest and audit the information taxpayers are required to submit in order to obtain these routine deductions.

This overbreadth is particularly burdensome with regard to loans and interest payments among related entities. Intercompany debt is often created within affiliated

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<sup>1</sup> For a more detailed discussion of the why the restructuring of legitimate business operations should be respected, *see* Peter Faber, “‘State of Practice’: Business Purpose and the *Syms* Case in Massachusetts – the Interplay of Federal and State Concepts,” 2002 STT 93-15, May 14, 2002.

## EXHIBIT G

groups when third-party debt is concentrated in a single entity to improve credit terms, in the context of an acquisition or as a result of routine cash management. The non-tax reasons for creating related party debt in these circumstances are clear: using the greater borrowing power of one entity to obtain cheaper funds for other entities in the group; acquiring a new business segment; centralizing cash and other investments in one department. In fact, when taxpayers enter into these types of transactions, tax implications may be given little if any consideration. This is especially true in the context of financial institutions where intercompany financing is a fundamental aspect of their ordinary business operations.

Given the fact that the creation of intercompany debt is an everyday business event that may be completely unrelated to tax planning, the elimination of *all* related party interest deductions out of the fear that a few such transactions may shift taxes from one jurisdiction to another equates with the proverbial use of a sledgehammer to kill a fly. New York quickly came to this realization when it repealed its interest add-back provision just a few months after enacting both an intangibles and an interest add-back. North Carolina has never required the adding back of interest expenses under its statute.

We recognize that Section 2(c)(iii), granting an exception to the interest add-back rule where a taxpayer shows by clear and convincing evidence that there is a valid business purpose for the interest expense and that the terms reflect an arm's-length relationship, was likely included in the Model to reflect some consideration of the routine nature of intercompany debt. However, even this exception is too narrow. Certainly, if interest add-back is to be employed at all, it is reasonable to impose a more lenient evidentiary standard than that used for expenses related to intangibles (see below for a discussion of the burdensome nature of the "clear and convincing evidence" standard). Moreover, requiring taxpayers to verify a valid business purpose and arm's-length interest rate with transfer pricing studies or other documentation is quite burdensome, particularly in light of the routine nature of much of the intercompany debt at issue.

### **B. MODEL SHOULD SPECIFY THAT IF A STATE DOES NOT PERMIT A DEDUCTION FOR INTANGIBLE/INTEREST EXPENSES, IT SHOULD NOT TAX INCOME**

If (and to the extent that) a state refuses to permit a deduction of intangibles expenses or interest paid to a related party, then it should similarly refuse to tax royalties and interest that a taxpayer receives from a related party. Without such an income exclusion for the recipient, the income associated with such expense is likely to be subject to double taxation.

New York, for example, has created such an exclusion from income. Under the New York statute, a taxpayer may exclude from gross income any royalties received directly or indirectly from a related member (unless the expenses related to such royalties would not have been required to be added back).<sup>2</sup> In its present form, the Model does not contain an exclusion of intangible or interest payments from the income of the recipient where related expenses have been subject to an add-back statute.

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<sup>2</sup> N.Y. Tax Law § 208(9)(o)(3).

## **EXHIBIT G**

To the extent such a provision were to be included in the Model, however, it should be carefully drafted so as to meet the requirements of the Commerce Clause's "internal consistency" test. A taxing scheme is internally consistent when, if it were "applied by every jurisdiction, it would result in no more than all of the unitary business' income being taxed."<sup>3</sup> To test internal consistency, one must evaluate the tax burden that would result if a multistate corporation were subjected in every state to the same formula employed by the one state in question. This is a hypothetical exercise by its very nature; the actual tax burden borne by the corporation in other states is not relevant. If there is a risk that more than 100% of the business' income would end up being included in the two states' tax bases in the aggregate, then the tax law being tested is internally inconsistent and, hence, unconstitutional.

An exclusion from the recipient's income that applies only where the related expenses have been subject to the add-back provisions *in that particular state* likely would not satisfy the internal consistency test. Instead, it would be important for such a provision to eliminate intangible/interest payments from the recipient's income if they have been subject to any state's add-back provision.<sup>4</sup>

### **C. IN NO CIRCUMSTANCES SHOULD A TAXPAYER BE REQUIRED TO PAY MORE TAX THAN WOULD HAVE BEEN COMPUTED UNDER COMBINED REPORTING**

Prior MTC uniformity projects, specifically the recent Proposed Model Statute for Combined Reporting, have seemingly been based on the proposition that combined reporting is most likely to provide a clear reflection of income earned in a state. Under the Model, however, a group of affiliated taxpayers could be required to pay a greater amount of tax than would have been paid had they filed a combined report. This result occurs because the income of the royalty/interest payor is increased in the add-back state by virtue of the deduction denial; however, the apportionment factors of the recipient are not taken into account in calculating the payor's apportionment percentage. As such, the Model should contain a provision that a taxpayer should not be required to pay more tax as a result of an add-back statute than it would have been required to pay if it had filed a combined report with the recipient of the intangible/interest payment.

### **D. MEMBER STATES SHOULD NOT BE ENCOURAGED TO ADOPT A STATUTE WITH CONSTITUTIONAL FLAWS**

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<sup>3</sup> *Container Corporation v. Franchise Tax Board*, 463 U.S. 159, 169 (1983). See also *American Trucking Ass'n v. Scheiner*, 483 U.S. 266 (1987) (striking unapportioned "flat" axle taxes imposed on trucking companies as internally inconsistent); *Tyler Pipe Indus. v. Washington Dep't of Revenue*, 483 U.S. 232 (1987) (multiple activities exemption from Washington business and occupation tax was internally inconsistent because an interstate manufacturer/wholesaler would pay both the manufacturing and the wholesaling tax, while an intrastate manufacturer/wholesaler would pay only the wholesaling tax); *Armco, Inc. v. Hardesty*, 467 U.S. 638, 644-45 (1984) (multiple activities exemption from West Virginia business and occupation tax violated internal consistency because the wholesale business conducted by in-state manufacturers in West Virginia was exempt while that conducted by out-of-state manufacturers was taxed, even though in-state manufacturers were subject to other components of the tax).

<sup>4</sup> See e.g., Md. Code § 10-306.1(f). This statute imposes additional constraints on exclusion from the income of the recipient.

## EXHIBIT G

Add-back statutes with exceptions based on the taxation of the recipient, including the Model, are constitutionally flawed in that they penalize transactions that cross state lines. The Model, for example, would permit the payor of an interest or royalty payment to claim a deduction if it can establish that the related-party recipient included the payment in its tax base in another jurisdiction and the recipient's aggregate effective tax rate meets certain requirements. Under such a rule, it will always be the case that if the related recipient does a substantial amount of its business in the taxing state in question (*i.e.*, if it does not have substantial apportionment factors in other states that may reduce its effective tax rate in such state), then the payor's deduction will be preserved. For example, royalty payors in *intrastate* royalty transactions between related members will likely always be able to deduct royalties because the recipient will pay that state's tax rate on the income. If, instead, the related recipient conducts a substantial amount of its business in other states, the payor then runs the risk of losing its deductions unless it can show that it qualifies for one of the other exceptions. In sum, the effect of the structure of these add-back provisions is to favor wholly in-state transactions.

The Commerce Clause, of course, forbids discrimination against interstate commerce. *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279 (1977). Importantly, there is no related party exception to the constitutional prohibitions against discrimination.

Indeed, a similar conclusion was reached by the California courts in the context of examining deductions for dividends from related parties, first in the case of *Ceridian Corp. v. Franchise Tax Board*, 85 Cal.App.4th 875 (1st Dist. App. 2000), and more recently in *Farmer Bros. Co. v. Franchise Tax Board*, 108 Cal. App. 4th 976 (2d Dist. App. 2003). In these cases, taxpayers challenged California's limitation of their state dividends received deduction depending on whether (and the extent to which) the corporation paying the dividend was a California taxpayer. In striking this limitation on the deduction as facially unconstitutional (as well as internally inconsistent), the California Court of Appeal stated:

We conclude that section 24402 is discriminatory on its face because it affords to taxpayers a deduction for dividends received from corporations subject to tax in California, while no deduction is afforded for dividends received from corporations not subject to tax in California. As a result, the dividend received deduction scheme favors dividend-paying corporations doing business in California and paying California taxes over dividend-paying corporations which do not do business in California and pay no taxes in California. The deduction thus discriminates between transactions on the basis of an interstate element, which is facially discriminatory under the commerce clause.

108 Cal.App.4th at 986-87 (citing *Armco v. Hardesty*, 467 U.S. 638, 642 (1984)). While the California-specific requirement in these cases was facially discriminatory, the effect under the Model is "as applied." That is, while an in-state transaction automatically meets the rate-based exception, an out-of-state transaction remains in jeopardy.

## **II. CONCERNS SPECIFIC TO THE MODEL**

### **A. BUSINESS PURPOSE AND ECONOMIC SUBSTANCE**

## EXHIBIT G

There is good reason why Congress has thus far refused to codify the legal standards of business purpose and economic substance. Simply put, each is too complex a standard to be codified. States should similarly be reticent to venture into this realm. In fact, the legislature of at least one MTC member state has already demonstrated some reluctance to enact a broad codification of such principles. When California considered its tax shelter rules in 2003, there was some support for a general codification of the economic substance doctrine.<sup>5</sup> Eventually, the doctrine was codified in the very limited context of a non-economic substance transaction understatement penalty.<sup>6</sup> However, the legislative history of the tax shelter provisions suggests that the limited codification included in the penalty was not intended to be viewed by a court as a substantive guidance on the doctrine as a whole.

Moreover, there is no need to codify the standard because it is already imbued in the common law that overarches taxpayer conduct. Indeed, the U.S. Supreme Court long ago acknowledged that although a taxpayer is free to adopt such organization for his affairs as he may choose," nonetheless the "Government may look at actualities and upon determination that the form employed for doing business or carrying out the challenged tax is unreal or a sham may sustain or disregard the effort of the fiction as best service the purpose of the tax statute."<sup>7</sup>

### **B. THE "CLEAR AND CONVINCING" STANDARD IS TOO HIGH**

Sections 1(c)(i), (ii) and (iii), and the corresponding sections in Section 2, require that taxpayers demonstrate that they have satisfied criteria for add-back exceptions by "clear and convincing evidence." We believe this is an exceedingly high standard that would impose great burdens on taxpayers.

The "clear and convincing" standard is higher than a "preponderance of the evidence" (i.e., greater than 50 percent), but lower than "beyond a reasonable doubt" (*i.e.*, the standard used for conviction in criminal cases). Thus, in order to claim that add-back exceptions are applicable, taxpayers would be required to show that it was highly probable that the exception requirements are met. For example, to demonstrate that the recipient was subject to tax in the recipient state, it seems logical that the type of evidence necessary to meet "clear and convincing" standard may be the tax return(s) of the recipient. However, it seems somewhat untoward to create the potential for a taxpayer's expense deduction to hinge on whether it will or can provide to add-back states the tax returns of entities not even subject to tax in such states. Moreover, it would seem to be difficult to demonstrate to such a high level of certainty that a transaction was undertaken for a valid business purpose, particularly since that term does not inherently embody such quantifiable principles.

### **C. "INTANGIBLE EXPENSE" SHOULD BE CLARIFIED**

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<sup>5</sup> See Joseph Bankman and Daniel Simmons, "Terminating Tax Shelters: Has California Broken the Legislative Logjam?" 2003 STT 245-6, December 22, 2003.

<sup>6</sup> California Rev. & Tax. Code § 19774.

<sup>7</sup> *Higgins v. Smith*, 308 U.S. 473 (1940).

## **EXHIBIT G**

The term “intangible expense” is defined in Section 1(a)(iv) of the Model to include:

expenses, losses and costs for, related to, or in connection directly or indirectly with the direct or indirect acquisition, use, maintenance or management, ownership, sale, exchange, or any other disposition of intangible property to the extent such amounts are allowed as deductions or costs in determining taxable income before operating loss deductions and special deductions ...

Although this definition is clearly intended to be broad, certain aspects of the definition appear to include transactions that would not seem to be the target of the add-back statutes. Specifically, inclusion of the undefined term “costs” adds considerable breadth to the definition. For example, it would appear that a manufacturer that paid a royalty to an affiliate for the use of certain intangible property imbedded in its product then sells such product to an affiliated retailer, a portion of the retailer’s cost of goods sold may be non-deductible. Allowing an add-back statute to be construed so broadly has the potential to interfere with many routine intercompany transactions that implicate intangibles.

### **D. DOMESTIC RATE EXCEPTION**

Under Section 1(c)(i)(A) and Section 2(c)(i)(A), it is not clear that “subject to tax” includes circumstances where the recipient does not actually pay tax because of accumulated net operating losses or credits. (Although this may have been the intent of the use of the term “tax base” in Section 1(c)(i)(B) and Section 2(c)(i)(B), it is not completely clear.). As such, we would recommend that the language “regardless of whether paid” be added after the phrase “subject to tax” in these sections.

### **E. FOREIGN RATE EXCEPTION**

It is not clear why, but the exceptions that apply when a domestic recipient meets certain requirements and those that apply when a foreign recipient meets certain requirements are not parallel in material respects.

First, although the exception that targets domestic recipients requires, in relevant part, that the recipient be “subject to tax” in another state, the exceptions for foreign recipients, in Section 1(c)(ii)(C) and Section 2(c)(ii)(C), are applicable when the income of such foreign recipient is “taxed.” It is not clear what conclusions should be drawn from this distinction.

In addition, Section 1(c)(ii)(D) and Section 2(c)(ii)(D) impose an additional hurdle where the recipient is foreign: the transaction must be undertaken for a valid business purpose and must reflect terms that are arm’s length. It seems somewhat unreasonable and, indeed, perhaps unconstitutional to impose this additional burden where the recipient is foreign (particularly given that the evidentiary standard is “clear and convincing evidence”).

### **F. “CONDUIT” EXCEPTION SHOULD BE EXPANDED**

## **EXHIBIT G**

As drafted, Section 1(c)(iii)(A) provides that one of the requirements for this exception is that “the related member during the same taxable year directly or indirectly paid, accrued or incurred such portion to a person that is not a related member.” The underlying principle embodied in this requirement would seem to be that the involvement of a third-party increases the likelihood that the transaction has not been undertaken for tax avoidance purposes. Thus, for example, where a parent company licenses an intangible from a third party and then sublicenses such intangible to its subsidiary, the subsidiary will not be required to add-back its royalty expenses (assuming other requirements are met) because the parent paid the expense to a third party. However, this underlying principle would seem to equally hold true where the related member *received* a payment *from* a third party. That is, this type of involvement of a third party would also seem to establish that a transaction has not been undertaken for tax avoidance purposes. Thus, continuing the example from above, if a parent owns an intangible (instead of licensing it from a third party) and licenses such intangible to its subsidiary and the subsidiary then sublicenses such intangible to a third party, the subsidiary should not be denied an expense deduction (at least to the extent of its sublicensing activities). New Jersey has included such language in its add-back statute.<sup>8</sup>

### **G. WHEN “ALTERNATIVE ADJUSTMENTS OR COMPUTATIONS” WILL BE PERMITTED SHOULD BE CLARIFIED**

Under Section 1(c)(iv) and Section (2)(c)(iv), the taxpayer and the Commissioner are permitted to agree in writing to the use of “alternative adjustments or computations.” First, it should be clarified whether the adjustments/computations at issue may relate to the expense deduction itself, apportionment computations, or both. In addition, given that the purpose of the Model is to promote uniformity, guidelines should be included in the Model on when it might be appropriate for the commissioner to rely on such authority. Increased clarity will promote not only uniformity of application, but greater certainty for taxpayers as they determine whether the add-back statute might be applicable to their fact pattern.

### **H. “RELATED MEMBER” IS NOT DEFINED IN SECTION 2**

It should be noted that the term “related member” is noted defined in Section 2 of the Model. Moreover, there is no cross-reference in Section 2 to the definition of the term in Section 1 (as related to intangible expenses).

MPK 94424-1.009900.0021

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<sup>8</sup> N.J. Stat. Ann. § 54:10A-4.4(b)(3).

## EXHIBIT H

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# Deloitte.

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August 29, 2005

Mr. Frank Katz  
Multistate Tax Commission  
444 N. Capitol St., NW, Suite 425  
Washington, DC 20001-1538

Dear Mr. Katz:

### **Comments the Proposed Model Statute Requiring the Addback of Certain Intangible and Interest Expenses**

On behalf of a group of financial institutions, we are submitting these comments on the Proposed Model Statute Requiring the Add-back of Certain Intangible and Interest Expenses.

We understand the desire of the Multistate Tax Commission ("MTC") and its member states to limit what it believes to be situations in which corporations have undertaken certain planning structures which the MTC deems abusive; however, the current language casts too wide of a net. For the following reasons, we believe that traditional financial institutions fall outside of the alleged abusive planning structures the MTC believes are problematic and therefore should be exempted from the model interest add-back statute.

- Lending money is the primary business of traditional financial institutions. A review of the financial statements of the majority of traditional financial institutions will reveal that loans comprise a large percentage of the balance sheet assets, and interest income and expense are among the largest items reported on the income statements.

The alleged abusive planning structures that the MTC believes are problematic involve situations where a taxpayer in a nonfinancial industry creates a subsidiary to license intangibles (and subsequently financing) to the affiliated group. In these situations, the financing activity is outside of the taxpayer group's normal business and typically comprises a small percentage (if any) of the net income in the federal consolidated return. Taxpayers in the nonfinancial industries that have not created this allegedly abusive planning structure within their organization structure have no reporting obligation under the proposed model statute.

Unlike the situation the MTC has identified as problematic, lending money is the primary business of traditional financial institutions and such entities do generate net income in their federal consolidated return from such activities. Accordingly, without an exemption for traditional financial institutions, the model statute requires traditional financial institutions to report on transactions that are part of their normal business operations; thus, placing a disproportionately larger burden on financial institutions than it does on general corporations.

- In addition, unlike transactions undertaken by general corporations and their affiliates, for traditional financial institutions the banking regulators already review intercompany transactions for traditional financial institutions and impose limits to and set guidelines for such transactions between related entities. Banks are subject to the strict regulation of either the Office of the Comptroller of the Currency ("OCC") or the Office of Thrift Supervision

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("OTS"), and under both regimes banks are not permitted to be "disadvantaged" in their transactions with affiliated non-bank entities. Thus, if a bank tried to make a loan at a rate that is not at arm's-length pricing, the bank earning the interest income would be earning too little on the intercompany loan and therefore violating the prohibition against disadvantaging a bank (rule 23A/23B violation). Accordingly, it is axiomatic that a regulated bank cannot and would not make a loan to an affiliate at a rate that disadvantages the bank.

- Unlike general corporations, financial institutions create various subsidiaries because a bank itself is not allowed to conduct certain activities, or to contain certain activities that are subject to the differing regulatory oversight.

For example, a bank typically will have a separate subsidiary to provide Small Business Administration (SBA) loans. A small business investment company must be licensed by the SBA and as a legal entity separate from the bank, it is exempt from the Glass-Steagall Act restrictions on equity ownership in non-bank business.

Many banks have separate community development corporation subsidiaries to make investments in projects such as low income housing, rehabilitation properties, already established community development companies and other investments because some of its investments can not be held in a bank (i.e., are "bank ineligible" assets).

Segregating student lending in a separate subsidiary provides non-government guaranteed student loan origination.

Most states require that a mutual fund broker/dealer must be separately registered as a broker/dealer to transact this type of business.

Section 25(a) of Federal Reserve Act requires that a separate legal entity be created to engage in foreign banking operations (Edge Act Corporation).

Banks are required to have a separate legal entity subject to regulation by the National Association of Securities Dealers to provide underwriting of, dealing in or making a market in securities (Section 20 broker/dealers).

Banks are required to have a separate legal entity to insure, guarantee or indemnify against loss, harm or damage, illness, disability, or death, or provide or issue annuities and act as principal, agent or broker for purposes of any of the foregoing in any state. Additionally, many states require separate legal entities to operate in their state due to various state insurance laws.

Banks also are required to have a separate legal entity that underwrites credit related insurance (insurance which pays off the loan balance upon the death or disability of the insured).

- Banks provide lending to affiliates in the ordinary course of their trade and business because "bank funding" rates properly applicable to bank affiliate lending is the cheapest form of funding. Not only is this quite legal and appropriate, but it is appropriate from a business point of view because it makes the borrowing most economically efficient.

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- The proposed model statute does provide a "subject to tax" exception to the intercompany interest expense disallowance. This exception requires that the aggregate effective income tax rate be within a certain number of percentage points of the state's statutory income tax rate. Traditional financial institutions are subject to varying tax rates and on bases other than income tax (e.g., capital bases and taxes on assets) in many states. Because the capital and asset bases are so large (generally many multiples of an institution's income tax base), the tax rates typically are much lower than the corporate income tax rate. Moreover, the only taxes taken into consideration in computing the aggregate effective tax rate exception are income taxes. Thus, application of the effective tax rate calculation provides unusable results for traditional financial institutions. See Attached Examples.

If an overall intercompany interest disallowance exception is not provided for traditional financial institutions, at a minimum the "subject to tax" exception for such entities should be modified to eliminate the threshold percentage requirement and to provide that the exception is satisfied if the financial institution receiving the interest income is subject to any type of business tax (including a franchise tax measured on net income, a franchise tax for the privilege of doing business, a corporate stock tax (including a bank shares tax), a tax on assets, a premium tax, a gross receipt tax, a value-added tax, a net worth tax and the Michigan Single Business Tax).

- The definition of "effective rate of tax" provides that the effective rate of tax is zero in any state where the related member and paying entity file a combined or consolidated return and the transactions between the taxpayer and the related member are eliminated or offset. A number of states require financial institutions to file a unitary combined return even though general corporations are allowed or required to file separate returns (e.g., New York, Tennessee, etc.). Although the intercompany income and expense may be eliminated, the receiving entity's tax base, payroll and property are taken into consideration and do increase the group's tax base, apportionment percentage and resulting tax in the combined or consolidated return state. In addition, in some of the forced combination states the apportionment factors are different for financials and nonfinancials which adversely effect the apportionment of bank affiliates. Moreover, any income received from unrelated parties generates an increased tax liability – and some of the states that require financial institutions to file unitary returns have adopted the *Finnigan* approach thus requiring affiliates that themselves do not have nexus with the state to include their "market-sourced" receipts in the numerator of the unitary group's receipts factor.

In many instances the financial institution affiliate may have little or no activity in the combining state (or substantially less than other members) but because of the larger factors of the combined group a disproportionate amount of the entity's income is taxed there. This may be more likely in the case when a financial institution is headquartered in a state that requires a combined or unitary filing.

The issue is amplified in certain locations where the combined state and local rates are relatively high and banks and affiliates are required to file combined returns, while other taxpayers are not. Additionally, in some jurisdictions general corporations may be able to exclude intercompany interest income from their income base if it is from a subsidiary. For example a banking subsidiary, which has 1% of its activity in a state and is forced to file a combined return with its parent that has 50% of its activity in that state, will be taxed on 50% of its income. Since it files a combined return with its lender-parent, the effective rate used in

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the analysis is zero. In contrast, a general corporation with the same 1% in-state activity and a parent with 50% apportionment in that state will be taxed on only 1% of its income. For the tax effective rate analysis, the parent will be treated as having an effective rate of approximately 50% of the state statutory rate.

As illustrated throughout this document, traditional financial institutions are taxed and operate differently than general corporations and therefore should be exempted from the interest add-back statute. At a minimum, a calculation of the state tax with and without the affiliate included in the combined or consolidated return should be computed and the increased tax resulting from the affiliate being included in the combined return should be included in determining the effective rate.

- In addition, because of the varying tax bases applied to financial institutions, the model statute is unconstitutional when applied to a financial institution located in a state that imposes an income tax as compared to a similar institution located in a state that imposes a tax on a non-income tax base. See Attached Example.
- There is precedent for providing an exemption to the intercompany interest disallowance provisions for banks.

Maryland Tax General Article Sec. 10-306.1(c) provides that the disallowance of intercompany interest expense does not apply if: (1) the transaction giving rise to the payment of the interest expense between the corporation and the related member did not have as a principal purpose the avoidance of any portion of the tax due under this title; (2) the interest expense was paid pursuant to arm's-length contracts at an arm's-length rate of interest or price; and (3) the corporation and the related member are banks

Maryland Tax General Article Sec. 10-306.1(a)(3) defines "Bank" as: (i) a bank holding company as defined in the federal Bank Holding Company Act of 1956, as amended, or a bank, trust company, savings bank, or savings and loan association incorporated or chartered under the laws of this State, another state, or the United States; or (ii) a subsidiary or affiliate of an entity described in item (i) of this paragraph.

We encourage the MTC to add to the model proposed statute an exception for traditional financial institutions.

- The proposed model statute does provide an exception to the intercompany interest expense disallowance where the taxpayer establishes by clear and convincing evidence, of the type and in the form determined by the commissioner, that (A) the transaction giving rise to interest expenses between the taxpayer and the related member was undertaken for a valid business purpose, and (B) the interest expense was paid, accrued or incurred using terms that reflect an arm's length relationship.

We believe that the majority (if not all) intercompany lending by traditional financial institutions would satisfy those requirements. However, the time and effort to provide the required information to each state for each intercompany lending situation would be burdensome – AND these are not even among the transactions that the MTC has alleged are abusive. Recall that traditional financial institutions are in the business of lending money and

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are required for various regulatory and state provisions to set up a number of different subsidiaries to conduct certain activities. The institutions typically fund the operations of these subsidiaries through arm's length lending activities. Thus, if a traditional financial institution had created each of the eight (8) subsidiaries noted above and each of those subsidiaries filed returns in 25 states, the affiliated group essentially would be required to establish by clear and convincing evidence, of the type and in the form determined by the commissioners in each of the states where the subsidiaries file, the valid business purpose and arm's length relationship for 200 such transactions (8 subsidiaries x 25 states). Accordingly, we encourage the MTC to add to the intercompany interest expense model statute an exception for traditional financial institutions.

In addition to the burden placed on taxpayers, this exception does not provide a uniform standard among the states or among taxpayers because it merely provides that the commissioner of each state will decide the type and form of evidence the taxpayer must provide and then also the commissioner will decide whether he/she believes the provided evidence satisfies the valid business purpose and arm's length pricing standards that commissioner establishes. Thus, if the overriding goal of the proposed model statute is uniformity – this exception falls extremely short of that goal.

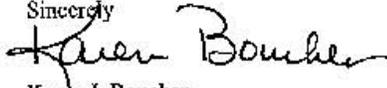
Moreover, the "clear and convincing" evidentiary standard would be a significant burden on taxpayers and is a standard that is not easily defined, which will further result in non-uniform application among the states and possibly between taxpayers by a single state. The burden of proof should be changed to something less than "clear and convincing" that has a more universal interpretation, such as a "preponderance of the evidence".

Accordingly, again we encourage the MTC to add to the intercompany interest expense model statute an exception for traditional financial institutions.

- The MTC should consider (learn from) the recent mistakes of states which have attempted to enact similar legislation to what is being proposed by the MTC. For example, following the enactment of its intercompany disallowance provisions, New York realized that it had cast too wide of a net and was requiring significant taxpayer compliance and possible disallowance of expenses that were legitimate business transactions. New York subsequently modified its law to limit the interest expense disallowance only to those interest expenses related to intangible property. Similarly, the District of Columbia, Georgia, Mississippi, and Virginia only disallow intercompany interest expenses related to intangibles. North Carolina only disallows interest expenses to the extent the amounts are paid, accrued, or incurred for a time price differential charged for the late payment of any royalty expenses, losses, or costs. We encourage the MTC to follow the lead of these states and limit the proposed model statute to interest related to intangibles.

If you have any questions regarding the above comments, please contact me at 414-977-2710.

Sincerely



Karen J. Boucher

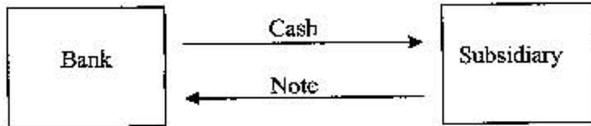
Attachments

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P.06

### Varying Tax Rates and Bases Make the Effective Tax Rate Calculation Unusable



Bank makes a loan for legitimate business purposes and at an arm's length rate to Subsidiary, which is not a trademark holding company.

#### **Subsidiary**

100% of Subsidiary's income is subject to Wisconsin corporate tax, which is imposed at the rate 7.9%. Thus, Subsidiary's state effective tax rate is 7.9%.

#### **Bank**

Bank's apportionment is 60% to Virginia and 40% to North Carolina.

States	Appt	Type of Tax	Tax Rate	Effective Rate
Virginia	60%	Franchise	1%*	.60%
North Carolina	40%	Income & Franchise	6.9% .15%	2.76% .06%

\* Note, the Virginia tax is based on capital and thus even though the rate is low, the base is significantly larger than the corporate income tax base.

Thus, although bank is fully taxed, its effective **income** tax rate is 2.76% which is more than 5% less than Wisconsin's statutory rate. If Bank's effective tax rate is expanded to include the franchise taxes it pays, then its effective rate is 3.42%, which still is more than 4% less than Wisconsin's statutory rate.

Regardless of which taxes are included, assuming Wisconsin adopts the proposed model statute, the "subject to tax" exception would not apply and Subsidiary would not be allowed to deduct the interest expense paid to Bank unless it establishes by clear and convincing evidence, of the type and in the form determined by the Wisconsin Secretary of Revenue, that the transaction giving rise to interest expenses between the Bank and the Subsidiary was undertaken for a valid business purpose, and the interest expense was paid, accrued or incurred using terms that reflect an arm's length relationship. This requirement puts an unreasonable additional compliance burden on the financial institution which does nothing to further the objectives of the MTC model language.

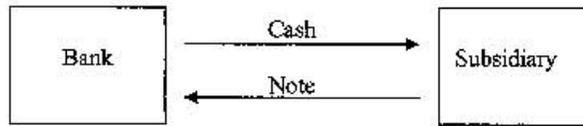
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### Varying Tax Rates and Bases Make the Effective Tax Rate Calculation Unusable



Bank makes a loan for legitimate business purposes and at an arm's length rate to Subsidiary, which is not a trademark holding company.

#### Subsidiary

50% of Subsidiary's income is subject to Maryland corporate income tax and the remaining 50% is subject to Virginia corporate income tax. Thus, Subsidiary's state effective tax rate is 6.5%.

States	Appt	Type of Tax	Tax Rate	Effective Rate
Maryland	50%	Income	7%	3.50%
Virginia	50%	Income	6%	3.00%

#### Bank

Bank is headquartered in Delaware and thus is subject to Delaware tax on 100% of its income even though it also is subject to tax in other states. Bank's apportionment is 100% to Delaware, 10% to Maryland and 20% Virginia.

States	Appt	Type of Tax	Tax Rate	Effective Rate
Delaware	100%	Income	1.7%	1.70%
Maryland	10%	Income	7%	.70%
Virginia	20%	Franchise	1%*	.20%

\* Note, the Virginia tax is based on capital and thus even though the rate is low, the base is significantly larger than the corporate income tax base.

Thus, although bank is taxed on 110% of its income and on 20% of its capital, its effective income tax rate is 2.4% which is 4.6% less than Maryland's statutory rate and 3.6% less than Virginia's statutory rate. If Bank's effective tax rate is expanded to include the franchise taxes it pays, then its effective rate is 2.6%, which still is more than 3% less than the Virginia and Maryland statutory tax rates.

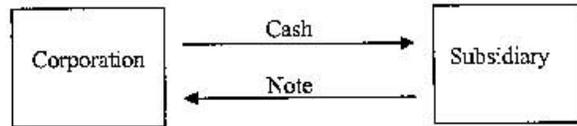
Regardless of which taxes are included, if Maryland and Virginia were to adopt the proposed model statute, the subject to tax exception would not apply and Subsidiary would not be allowed to deduct the interest expense paid to Bank unless it establishes by clear and convincing evidence, of the type and in the form determined by the Maryland Comptroller and the Virginia Tax Commissioner, that the transaction giving rise to interest expenses between the Bank and the Subsidiary was undertaken for a valid business purpose, and the interest expense was paid, accrued or incurred using terms that reflect an arm's length relationship.

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### Varying Tax Rates and Bases Make the Effective Tax Rate Calculation Unusable



These are the same facts as the previous example other than entity making the loan is a general corporation, rather than a bank. Corporation makes a loan for legitimate business purposes and at an arm's length rate to Subsidiary, which is not a trademark holding company.

#### Subsidiary

50% of Subsidiary's income is subject to Maryland corporate tax and the remaining 50% is subject to Virginia corporate income tax. Thus, Subsidiary's state effective tax rate is 6.5%.

States	Appt	Type of Tax	Tax Rate	Effective Rate
Maryland	50%	Income	7%	3.50%
Virginia	50%	Income	6%	3.00%

#### Corporation

Corporation is headquartered in Delaware and its apportionment is 70% to Delaware, 10% to Maryland and 20% Virginia.

States	Appt	Type of Tax	Tax Rate	Effective Rate
Delaware	70%	Income	8.7%	6.09%
Maryland	10%	Income	7%	.70%
Virginia	20%	Income	6%	1.20%

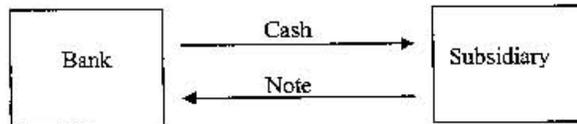
Corporation's effective tax rate is 7.99%, which is higher than both Maryland's and Virginia's statutory rates. Accordingly, if Maryland and Virginia adopt the proposed model statute, Subsidiary is allowed to deduct the interest expense paid to Corporation for both Maryland and Virginia tax purposes.

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### **Varying Tax Rates and Bases Make the "Subject to Tax" Exception Unconstitutional**



Bank makes a loan for legitimate business purposes and at an arm's length rate to Subsidiary, which is not a trademark holding company.

#### **Subsidiary**

100% of Subsidiary's income is subject to Wisconsin corporate tax, which is 7.9%. Thus, Subsidiary's state effective tax rate is 7.9%.

#### **Bank**

Bank apportions 100% of its income to Wisconsin and thus its effective rate also is 7.9%.

If Wisconsin adopts the proposed model statute, Subsidiary would be allowed to deduct the interest expense it pays to Bank.

If instead of being located in Wisconsin, Bank was headquartered in Delaware and its income were large enough, its effective income tax rate would be 1.7% and Subsidiary would not be able to use the "subject to tax" exception.

Similarly, if Bank were located in Virginia and apportioned 100% of its capital to Virginia, its effective income tax rate would be zero (0) and its effective capital tax would be 1% and again Subsidiary would not be allowed to use the "subject to tax" exception.

Because the exception is only useable if a substantial portion of the related entity income is subject to state income taxes, on its face this exception discriminates against taxpayers based on the states in which they operate and also discriminates against taxpayers that are subject to state business taxes other than an income tax. The practical effect of these discriminations is to coerce businesses to locate their activities in certain states.

**AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS  
WRITTEN COMMENTARY IN SUPPORT OF ORAL TESTIMONY  
DELIVERED TO THE MULTISTATE TAX COMMISSION**

**JULY 18, 2005, HEARING ON ITS PROPOSED MODEL STATUTE  
REQUIRING THE ADD-BACK OF CERTAIN INTANGIBLE  
AND INTEREST EXPENSES**

**Submitted to the Multistate Tax Commission  
August 31, 2005**

**AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS  
Comments on Proposed Model Statute Requiring  
Add-back of Certain Intangible and Interest Expenses**

**EXECUTIVE SUMMARY**

The *Proposed Model Statute Requiring the Add-back of Certain Intangible and Interest Expenses* (hereinafter, proposed add-back statute, see Attachment A) attempts to address perceived abuses – such as entity isolation – in the corporate income tax area by limiting the ability of taxpayers to deduct certain intangible and interest expenses paid to related parties. More importantly, the proposed model statute attempts to bring consistency to an area in which a significant number of states<sup>9</sup> have enacted diverse and complicated laws that are difficult for states to administer and even more difficult for taxpayers to comply with.

As stated by MTC representatives, the proposed model statute is offered as an alternate to a second MTC proposal, the *Uniform Statute for Combined Reporting* which would mandate combined reporting by a taxpayer engaged "in a unitary business" with one or more other corporations. In addition, the combined reporting proposal allows state revenue di-

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<sup>9</sup> Currently, the following states have some form of inter-company expense addback statute: Alabama, Arkansas, Connecticut, District of Columbia, Georgia, Illinois, Kentucky, Maryland, Massachusetts, Mississippi, New Jersey, New York State and City, North Carolina, Ohio, South Carolina, and Virginia. Indiana, Minnesota, Missouri, Rhode Island, Texas, and Wisconsin have attempted, but failed, to implement an add-back statute. Of note, the Pennsylvania Tax Reform Commission recommended against adopting an add-back statute citing constitutional concerns (that disallowance would tax income earned outside the state) and indications from other states that the revenue impact of expense disallowance legislation can vary widely depending on the scope of the add-back provisions. Tennessee requires taxpayers to add back all payments to affiliated businesses, and permits a deduction only where a taxpayer provides detailed information regarding the underlying transaction and the affiliated member. Oregon attempts, via regulation, to prohibit deductions for royalties or other fees paid for the use of intangible assets. Indiana has consistently attacked the use of multi-entity structures by asserting sham-transaction or economic substance doctrines, or via combined reporting.

rectors to, “by regulation, require that the combined report include the income and associated apportionment factors of any persons that are not included” as corporate income taxpayers “but that are members of a unitary business, in order to reflect proper apportionment of income of entire unitary businesses.” Absent an election to file on a water’s-edge basis, unitary members would be required to file on a worldwide basis. Net income and apportionment factors would be determined on a combined basis, while tax attributes (e.g., NOLs, credits) would be computed on a separate-entity basis. The proposal includes a number of other provisions in addition to those discussed above. We are not commenting on the merits of the proposed combined reporting statute at this time.

The AICPA has identified a number of concerns regarding the proposed add-back statute:

- We are concerned that the statute may be subject to constitutional challenge and recommend that the MTC resolve such issues before proceeding with the proposal.
- We oppose attempts to provide a strict statutory interpretation of the term “valid business purpose.”
- The proposed statutory computation of “effective tax rate” is too narrow and potentially discriminatory.
- The foreign country add-back exceptions should be more consistent with the add-back exceptions for entities located in the United States and there should be greater consistency between the intangible and interest expense add-back exceptions.
- The “clear and convincing” evidence standard should be eliminated.
- The add-back statute does not fairly protect legitimate business transactions.

## ANALYSIS AND RECOMMENDATIONS

### I. Potential Constitutional Concerns

It appears that the proposed add-back statute, taken as a whole, may be subject to constitutional challenge where its application results in (1) taxing income earned outside the state, (2) a failure to match income with the expenses incurred to generate such income, or (3) a failure to account for losses of subsidiaries within the same corporate group.<sup>10</sup> In addition, it appears that certain of the safe harbor exceptions may be discriminatory by treating similarly-situated taxpayers differently based solely on the jurisdictions in which they choose to do business.<sup>11</sup> In an effort to reduce litigation costs for all parties, the

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<sup>10</sup> See, e.g., Pennsylvania Tax Reform Commission, Final Report, Sec. 17, pg. 2 at [http://www.revenue.state.pa.us/tax\\_reform/cwp/view.asp?a=323&q=243218](http://www.revenue.state.pa.us/tax_reform/cwp/view.asp?a=323&q=243218).

<sup>11</sup> See Ala. Code Sec 40-18-35(b)(1). On its face, the statute discriminates against those businesses which choose to locate in low tax jurisdictions, such as Delaware or Nevada. A taxpayer is penalized by the add-back statute merely because its intangible management company is located in such a tax-advantaged state, or if it locates in one of the numerous states that require combined or consolidated income tax reporting by affiliated corporate groups. Challenged by *VFJ Ventures, Inc. v. Carlisle*, Ala. Cir. Ct., Montgomery County, No. CV 03-3172, Notice of Appeal and Complaint filed December 2003. “[Alabama’s] add-back statute requires that certain interest and intangible expenses paid to a “related member” be added back to

constitutionality issues regarding such provisions should be resolved prior to the add-back statute moving forward.

## II. Eliminate “Valid Business Purpose” Definition

The AICPA opposes attempts to provide a strict statutory interpretation of “valid business purpose”<sup>12</sup> in the add-back statute. Terms such as “valid business purpose” and “economic substance” have long been debated in federal and state courts with little consistency among those rulings that depend heavily on the various factors that support a valid business purpose for a particular business. Although we understand the MTC’s desire to offer parameters by which states can determine whether a transaction has a valid business purpose, we strongly suggest that the MTC avoid wading into the definitional quagmire that has plagued federal legislators in their attempts to seek hard and fast rules in these areas.

The proposed definition establishes a subjective “primary motivation” test that has no precedent in federal case law and, if enacted, would force impractical comparisons between tax benefits and other economic effects. Similarly, such a definition may prevent taxpayers from structuring their affairs in ways that best serve the needs of their specific business operations and investors but also happen to have tax efficiency. Any incorporation of a business purpose or economic substance test into the model act must recognize that tax planning is a permissible activity.

## III. Eliminate “Meaningful Change” Evaluation Standard

The AICPA opposes defining a valid business purpose as one that changes the economic position of the taxpayer “in a meaningful way” because such a vague term fails to acknowledge the difficulties taxpayers may encounter when attempting to enter new markets. A “meaningful change” in a taxpayer’s economic position may not occur for a number of years, or indeed not happen at all, despite a taxpayer’s ongoing efforts to develop a new market for its product. As with the “primary motivation” test discussed above, this standard lacks clarity and would likely result in tax administrators applying a quantitative standard that is neither fair, reasonable nor practical in many cases.

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the taxpayer’s Alabama income if they are not subject to a tax measured by or based on net income in another state.

“Thus, the practical effect of this discrimination is to coerce businesses to locate their activities in either Alabama or, at a minimum, in another separate return state (as opposed to a combined or consolidated reporting state) to avoid the disallowance of valid interest or royalty expenses. Absent meeting one of the other add-back exceptions, disallowing the licensee’s expenses as a deduction if the licensor’s income is not “reported and included in income for purposes of a tax on net income, and not offset or eliminated in a combined or consolidated return” is an attempt to coerce businesses to direct their activities in-state or to another separate reporting state. This is not permissible under the U.S. Constitution and **the U.S. Supreme Court has repeatedly struck down taxing statutes that foreclose a company’s ability to make tax-neutral decisions as to where to direct its business.** See *South Central Bell Telephone Company v. Alabama*, 526 U.S. 160 (1999).

<sup>12</sup> See Sections 1(a)(viii) and 2(a)(v).

#### **IV. Modify Effective Tax Rate Computation**

The AICPA believes that the computation of “effective tax rate”<sup>13</sup> must consider alternative assessments (*e.g.*, the New Jersey alternative minimum assessment, the Kentucky alternative minimum calculation), and certain non-income based taxes (*e.g.*, the Michigan single business tax, the Ohio commercial activity tax, the Texas franchise tax) that operate as a substitute for general income taxes.

In addition, we believe that the effective tax rate should be computed before deduction for tax credits allowed in other states, other than with regard to the exception provided in the add-back statute. We oppose provisions in the proposed add-back statute that strictly prohibit the inclusion of taxes imposed in combined or consolidated return states. Such provisions arbitrarily punish companies based on the tax laws of the other states that they operate in, and may, in fact, represent a form of discrimination against interstate commerce.<sup>14</sup>

#### **IV. Foreign Country Exception**

The exception to the add-back adjustment for receiving entities located in foreign countries<sup>15</sup> should be modified to more closely resemble the exception provided for receiving entities located within the United States.<sup>16</sup>

#### **V. Consistency in Add-back Exceptions**

The intangible expense exception should be expanded to provide that an add back would not be required where: (1) the inter-company transaction is undertaken for a valid business purpose; and (2) the intangible expense is paid at arm’s length.<sup>17</sup> Similarly, the in-

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<sup>13</sup> See Sections 1(a)(iii) and 2(a)(iii).

<sup>14</sup> The Commerce Clause of the U.S. Constitution forbids states to employ taxation schemes that discriminate against interstate commerce. See *Camps Newfound/Owatonna, Inc. v. Town of Harrison, Me.*, 520 U.S. 564, 577-78, 580-81 (1997); *Fulton Corp. v. Faulkner*, 516 U.S. 325, 330-31 (1996). A taxation scheme that operates to favor intrastate business over interstate business or that imposes negative tax consequences based on whether a business’s activities are interstate versus intrastate discriminates against interstate commerce – and is “virtually per se invalid” according to U.S. Supreme Court precedent. See, *e.g.*, *Fulton* and *Oregon Waste Systems, Inc. v. Dep’t of Environmental Quality of Oregon*, 511 U.S. 93 (1994).

“Once a state taxing scheme is found to discriminate against interstate commerce, it is typically struck down without further inquiry. *Chemical Waste Management v. Hunt*, 504 U.S. 334, 342 (1992). A facially discriminatory tax can be saved only by a showing that the tax advances legitimate local purposes that cannot be served by reasonable non-discriminatory alternatives. *South Central Bell Tel. Co.*, 526 U.S. at 169; *Camps Newfound/Owatonna*, 520 U.S. at 581; and *Chemical Waste Management*, 504 U.S. at 342-44. Nevertheless, any justification offered for the discrimination must “pass the strictest scrutiny” under the Commerce Clause. *Fulton Corp.*, 516 U.S. at 345. Because the State has failed to offer any justification for its discriminatory add-back statute, its assessment against Plaintiff violates the Commerce Clause of the U.S. Constitution.”)

<sup>15</sup> See Sections 1(c)(ii) and 2(c)(ii).

<sup>16</sup> See Sections 1(c)(i) and 2(c)(i).

<sup>17</sup> See, *e.g.*, Section 2(c)(iii).

terest expense exception should be expanded to provide a “conduit exemption” comparable to that provided for intangible expenses.<sup>18</sup>

## **VI. “Clear-and-Convincing” Evidence Standard is Inequitable**

The AICPA believes that the “clear-and-convincing” evidence standard<sup>19</sup> is burdensome and excessive. This standard is generally only appropriate when applied as the burden of proof in cases involving the potential loss of an important interest such as the termination of parental rights and is misplaced as a standard to overcome a presumption of guilt. The AICPA strongly suggests that the MTC consider a more equitable standard.

## **VII. Proposal Casts Too Wide a Net**

The add-back exceptions in the proposed add-back statute fail to protect inter-company transactions undertaken for legitimate business reasons or reasons other than tax avoidance (*e.g.*, better cash flow management, appropriate allocation of management costs and services, factoring of receivables, asset protection). Accordingly, the MTC should consider additional add-back exceptions.

## **Attachment A**

### **Proposed Model Statute Requiring the Add-back of Certain Intangible and Interests Expenses**

Draft Approved by Executive Committee 4-28-05

[Omitted]

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<sup>18</sup> *See, e.g.*, Section 1(c)(iii)

<sup>19</sup> *See* Sections 1(c)(ii) to (c)(iii) and 2(c)(i) to (c)(iii).