



## Multistate Tax Commission Memorandum

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

To: Executive Committee  
From: Frank D. Katz, General Counsel  
Date: April 24, 2006  
Subject: Proposed model add-back statute

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**Genesis** The Corporate Income Tax Sheltering Work Group of the MTC's State Tax Compliance Initiative recommended the development by the Commission of a model Combined Reporting statute as the most effective remedy against myriad tax shelters. The Work Group recognized, however, that some states might not wish to go all the way to combined reporting at this time, but they might be willing to accept the smaller step of a statute providing for the add-back of certain royalty and interests expenses typically incidental to the licensing by a related intangible holding company of the unitary businesses valuable trademarks and trade names. Several states have enacted these so-called "add-back" or "expense disallowance" statutes.

**Status** The Uniformity Committee assigned the project to a special drafting group that worked out a draft. After discussion at meetings, the Uniformity Committee approved the draft and the Executive Committee directed a public hearing be held. The Hearing Officer filed an initial report with the Executive Committee in July 2005, which recommended additional time to receive further written comments, and an amended report in October 2005 with recommendation for revisions. The Executive Committee at its November 2005 meeting accepted the suggestions in the Hearing Officer Report that three aspects of the proposal be revised: (1) the exception to add-back if the related party is taxed on the income in a state at a high enough level, (2) the exception to add-back if the related party is taxed on the income in a foreign country under certain conditions, and (3) adding two definitions in Section 2. The Executive Committee sent the proposal back to the Uniformity Committee to work out the revisions.

The special drafting group revised the appropriate sections. The addition of the definitions was pro forma. The exceptions to add-back where the related party pays tax either in a state (subsections (c)(i)) or in a foreign country (subsection (c)(ii)) were combined in a single subsection and changed to a credit for tax paid on the income from intangibles or interest in the other jurisdiction to ensure that there was no double tax and no discrimination against foreign commerce. The revised section reads as follows:

(c)(i) If the related member was subject to tax in this state or another state or possession of the United States or a foreign nation or some combination thereof

on a tax base that included the intangible expense paid, accrued or incurred by the taxpayer, the taxpayer shall receive a credit against tax due in this state in an amount equal to the higher of the tax paid by the related member with respect to the portion of its income representing the intangible expense paid, accrued or incurred by the taxpayer, or the tax that would have been paid by the related member with respect to that portion of its income if (1) that portion of its income had not been offset by expenses or losses or (2) the tax liability had not been offset by a credit or credits. The credit so determined shall be multiplied by the apportionment factor of the related party in such taxing jurisdiction. However, in no case shall the credit exceed the taxpayer's liability in this state attributable to the net income taxed as a result of the adjustment required by subsection (b).

The Uniformity Committee approved the revisions and recommended the revised proposal to the Executive Committee.

After the Uniformity Committee's approval, I received an inquiry from Karen Nakamura of PWC as to what the underlined sentence intended. ["The credit so determined shall be multiplied by the apportionment factor of the related party in such taxing jurisdiction."] I started to respond to Karen and realized that I, too, was confused. I check the origin of the provision and discussed it with the special drafting group. We have concluded that while we were correct in seeing a problem requiring apportionment, we were incorrect in solving it. I am suggesting a slight revision of what the Uniformity Committee approved.

The credit needs to be apportioned because, if the related party is paying tax, it is likely to be paying tax where it is located on the full amount of royalty payment from the licensee for use of the license in all the states in which the licensee does business. We don't want to grant a credit in each state for the tax paid by the related party on the full amount of the income earned by the licensee in all the states. We want to grant a credit only for the portion of the tax paid by the related party that corresponds to the portion of the income in received from the taxpayer for doing business in the particular taxing state. So only a portion of that credit should be granted in any one state—the portion that represents the taxpayer's apportionment factors in that state. So it is the apportionment factors of the taxpayer, not the related party, in the taxing state, not the other taxing jurisdictions, that need to limit the credit.

**Recommendation** I am therefore recommending to the Executive Committee that it approve the revised, Uniformity-Committee-approved model statute with the following change in the underlined sentence:

The credit so determined shall be multiplied by the apportionment factor of the taxpayer in this state.

I have attached the full proposal.

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

Revised Draft Approved by Uniformity Committee  
with one suggested revision  
4-19-06

## **Section 1.**

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

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

(ii) "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.

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

(iv) "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.

(v) "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.

(vi) "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) If the related member was subject to tax in this state or another state or possession of the United States or a foreign nation or some combination thereof on a tax base that included the intangible expense paid, accrued or incurred by the taxpayer, the taxpayer shall receive a credit against tax due in this state in an amount equal to the higher of the tax paid by the related member with respect to the portion of its income representing the intangible expense paid, accrued or incurred by the taxpayer, or the tax that would have been paid by the related member with respect to that portion of its income if (1) that portion of its income had not been offset by expenses or losses or (2) the tax liability had not been offset by a credit or credits. The credit so determined shall be multiplied by the apportionment factor of the taxpayer in this state. However, in no case shall the credit exceed the taxpayer's liability in this state attributable to the net income taxed as a result of the adjustment required by subsection (b).

(ii) 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.

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

(ii) "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.

(iii) "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.

(iv) "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.

(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 during the taxable year.

(c) (i) If the related member was subject to tax in this state or another state or possession of the United States or a foreign nation or some combination thereof on a tax base that included the interest expense paid, accrued or incurred by the taxpayer, the taxpayer shall receive a credit against tax due in this state equal to the higher of the tax paid by the related member with respect to the portion of its income representing the interest expense paid, accrued or incurred by the taxpayer, or the tax that would have been paid by the related member with respect to that portion of its income if (1) that portion of its income had not been offset by expenses or losses or (2) the tax liability had not been offset by a credit or credits. The credit so determined shall be multiplied by the apportionment factor of the taxpayer in this state. However, in no case shall the credit exceed the taxpayer’s liability in this state attributable to the net income taxed as a result of the adjustment required by subsection (b)

(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].