MTC Arm's-Length Adjustment Project
Brief Description of Participating States Corporate Tax Practices

Note: This brief description is intended to acquaint readers with some basic features of state corporate tax practices for states participating in the MTC project noted above. It is not an official document and should not be cited or relied upon as such. Any errors are purely those of the author (Dan Bucks, Project Facilitator).

The Multistate Tax Commission's Arm's-Length Adjustment Project includes nine participating states: Alabama, District of Columbia, Florida, Georgia, Hawaii, Iowa, Kentucky, New Jersey, and North Carolina. Seven of these states allow related corporations to file tax returns as separate entities. Hawaii and the District of Columbia (effective TY 2011) require related corporations that comprise a unitary business to file a combined report on a water's edge basis—a report that is limited primarily to U.S. corporations.

In one manner or another, all of these states have the ability to adjust transactions or income among related corporations. States vary, however, in how they make those adjustments. When separate entity reporting states encounter circumstances that suggest a taxpayer that is part of a larger controlled group is inaccurately underreporting income, states may initially respond in a couple of different ways before considering arm's-length adjustments.

One remedy states may consider is to assert nexus or jurisdiction to tax with regard to the related party that appears to have received a disproportionate amount of income from the corporation filing in their state—provided that the activities of the related corporation create nexus with the state. If nexus is successfully established, the out-of-state related party corporation is required to file returns and pay taxes in the state.

Standards of state taxing jurisdiction or nexus arise out of U.S. constitutional law, a federal statute (P.L. 86-272)[1], and state statutes and case precedents. States that regularly assert nexus with regard to out-of-state related party corporations are those that have developed the "economic nexus" approach. With that approach, corporations not protected by P.L. 86-272 can be subject to taxation in a state if they regularly and systematically direct activities at a state. Leasing the right to use an intangible asset in a state is an example of activities directed at a state that can create tax nexus for the leasing company. The "permanent establishment" rules in U.S. tax treaties with other nations do not apply to or bind the states.

[1] In general and brief terms, P.L. 86-272 protects companies from taxation in a state if they sell only tangible goods into the state through staff limited to taking orders within the state and fulfill the orders from outside that state.

Under another remedy, states may disallow a deduction by a corporate taxpayer if the deduction was created through transactions with a related party. The decision to disallow or "add back" the expense may, depending on the state, be based on a state's determination that the transactions did not serve a business purpose, or that the transactions resulted in the taxpayer inaccurately reporting income, or that the related party transactions were not conducted at arm's length. States may use more specific standards for making these determinations. Many states, for example, judge the accuracy of income reporting based on whether the income represents the taxpayer's business activity in the state.

State practices vary with regard to the sequence and extent of either asserting nexus or disallowing expenses with regard to related party circumstances. Some states may apply these two methods in a structured, sequential way. As a first step, some states may assert nexus with regard to a related party corporation. If nexus is not justified, these states will next consider a disallowance of the expense. After considering, but not applying, these two types of remedies, the states will next consider arm's length adjustments to the transactions.

Other states may choose to apply either method on a case-by-case basis depending on what is judged most appropriate to a taxpayer's facts and circumstances. A state may even propose to the taxpayer a choice between the two approaches as a basis for resolution of a case. Finally, some states may choose to use either the assertion of nexus or the disallowance of expenses exclusively, and not apply the other method.

In one state the entire related party transaction process begins and ends with adding back related party expenses once a transaction is found to meet one of three criteria. A transaction failing to be at arm's length is one of the criteria that will trigger an add-back of expenses. If this state does not disallow a related party expense, it does not seek to make any other type of adjustments.

Finally, at least one state has not pursued either of the preceding remedies (nexus or add-backs). Instead, that state has addressed related party transactions directly through an arm's length analysis using the comparable profits method.

Approximately two dozen states use combined reporting as their primary corporate tax filing method, including two states in the project. States with combined reporting laws require related parties to file unitary combined reports up to the limits of a group defined in their laws. For related parties outside the statutory limits of a unitary group, combined reporting states can make assessments using arm's-length adjustment principles. While that is not yet a common practice, the increased awareness of profit shifting between jointly controlled U.S. and foreign entities creates the potential for additional use of arm's length adjustments to address those circumstances.

The key point of this discussion is that arm's length adjustments are often not the first type of remedy a state considers when it discovers related party transactions that appear to result in the inaccurate underreporting of income by a corporation. States have some additional remedies available to them other than those that are applied by the IRS.

Once states do reach the arm's-length adjustment step, they may frequently apply the comparable profits method or, alternatively, the comparable uncontrolled price method. If the comparable profits or price methods are not satisfactory, states have at times applied forms of profit splitting based on 1) equalizing rates of return among related parties or 2) adjusting income among related parties proportionate to the relative factors of each of the parties. Finally, if none of the arm's length adjustments are considered satisfactory, a limited number of separate entity states may also consider, as a final step, requiring a combined report among related parties.

Attached is a list of statutory citations for the legal authority of each state to apply remedies to related party transactions for corporate income tax purposes.