Income Shifting for State Tax Purposes: Nonrecognition Transactions

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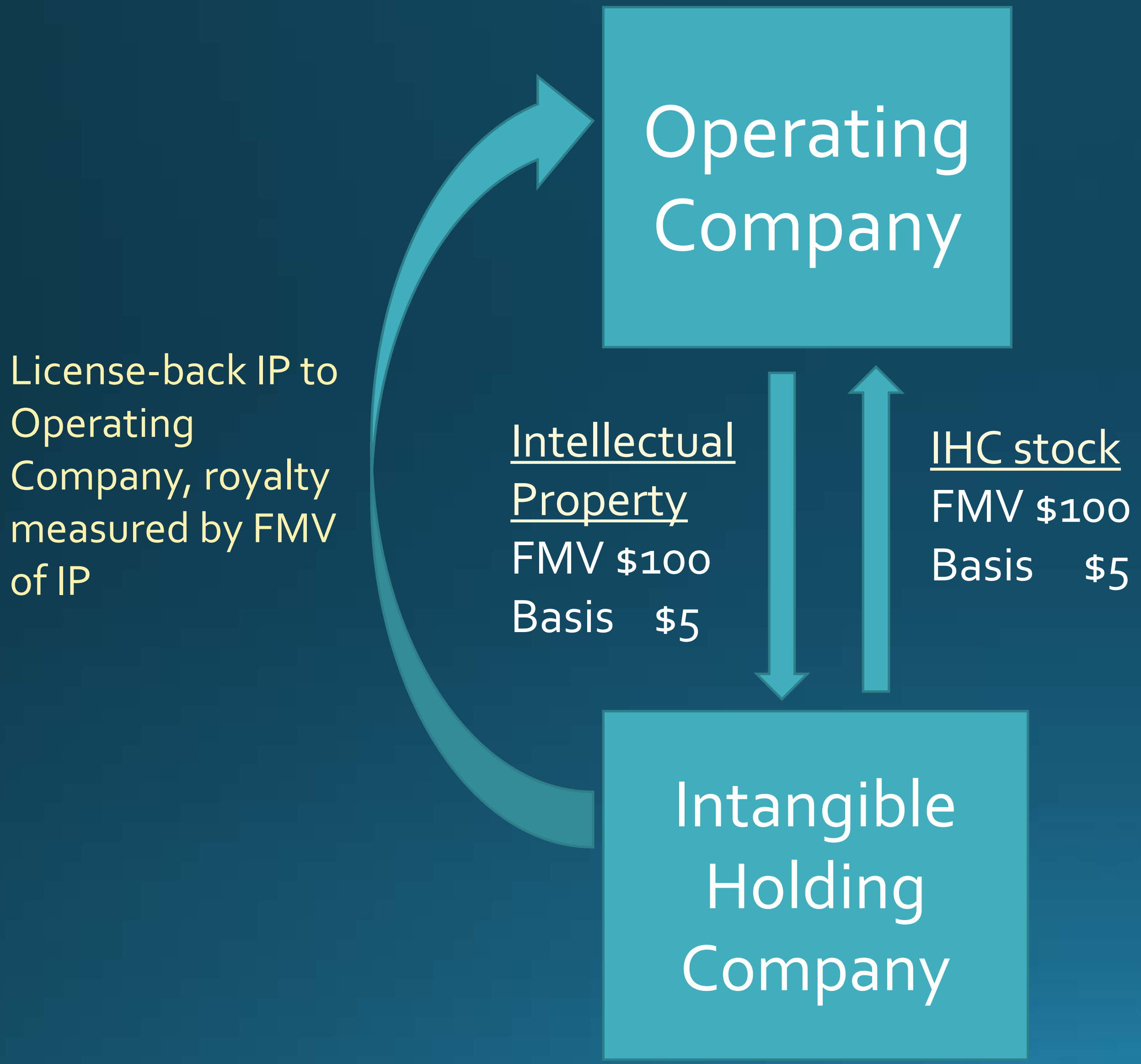
Overview

- Types of income-shifting
- Taxpayer exploitation of entities and mobility
- State countermeasures
- The weakness of transfer pricing
- Non-recognition transactions and IRC § 482
- Nothing new under the sun: IRC § 367
- Closing observations

Types of Income Shifting

- Shift to related taxpayer with lower rate
- Shift to different tax regime
- Shift to low-tax jurisdiction
- Shift income recognition to later time period (deferral)
- Accelerate deductions (indirect deferral)

Non-recognition transactions: Sec. 351 exchange



What has happened?

- No gain is recognized, and OC/IHC take stock/IP with a transferred/carryover basis
- OC has generated "FMV" deductions on "fully depreciated" assets
- OC doesn't pay toll charge: no tax on gain realized on transfer of the IP to the IHC
- Gain is deferred until if and when intangible or IHC stock is sold
- Note: accurate transfer pricing undoes none of this

Premises Underlying Federal Nonrecognition

- Continuity of interest (stock, not cash)
- Continuity of business enterprise
- Transferee and transferor are US corporations: thus, in prior example, Operating Co.'s deduction would be offset by IHC's income

State Countermeasures

- Economic substance, business purpose, and similar doctrines
- Nexus
- Combined reporting
- Addback statutes
- Section 482
  - Transfer pricing
  - *Other*
- Gross receipt taxes

Non-recognition transactions and IRC § 482

In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses. … In the case of any transfer (or license) of intangible property (within the meaning of section 936(h)(3)(B)), the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible.

Section 482.

Application of Sec. 482 in connection with nonrecognition transactions

- Transfers that result in artificial separation of income from expenses
  - Reallocate income or expenses to entity that incurred the matching expense or income
- Transfers followed by a preplanned sale or disposition of the transferred property by the transferee (the IHC paradigm)
  - Reallocate income from later sale or disposition (such as licensing) to transferor
  - Generally same effect as addbacks
  - This could be a sale to an unrelated third-party—compare with related-party nature of IHC transactions

Section 367

Transfers of property from the United States

(1) General rule

If, in connection with any exchange described in section 332, 351, 354, 356, or 361, a United States person transfers property to a foreign corporation, such foreign corporation shall not, for purposes of determining the extent to which gain shall be recognized on such transfer, be considered to be a corporation.

…

[Super-royalty provision]

Section 367

- Consistent with policies underlying nonrecognition
- Codification of a Sec. 482 approach
- Super-royalty provision similar to add-back statutes
- Applies regardless of whether there is a lease- or license-back to the transferor

Closing Thoughts for State Government Tax Litigators

- Addback statutes deserve more respect
- Business purpose and the well-advised
- If the battle is transfer pricing, you may have already lost the war
- The IRC's nonrecognition provisions are at times at odds with the structure of the state corporate income tax
- Section 482-like statutes are valuable tools for preventing tax avoidance that would otherwise result from nonrecognition transactions