

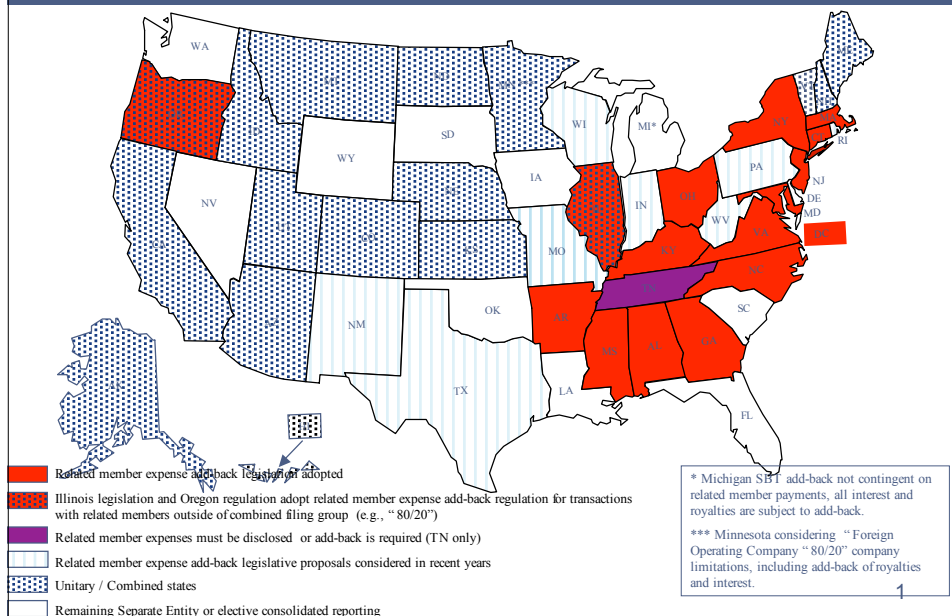
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# Add-Back Statutes: Where Do We Go From Here?

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## Related Member Add-back Legislation



### Related Member Add-back Statutes

State	Effective Date
Ohio	Originally 1991, As amended, 1/1999.
Connecticut	Tax years beginning on or after 1/1/1999; interest provision effective tax years beginning 1/1/2003.
Mississippi	Tax years beginning after 12/31/2000.
Alabama	Tax years beginning after 12/31/2000.
North Carolina	Tax years beginning on or after 1/1/2001.
New Jersey	Tax years beginning on or after 1/1/2002.
Massachusetts	Tax years beginning on or after 1/1/2002.

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### Related Member Add-back Statutes

State	Effective Date
New York	Tax years beginning on or after 1/1/2003 for royalties only, not interest.
Arkansas	Tax years beginning after 1/1/2004 (Reg. 1996-3 continues to be in effect).
Maryland	Tax years beginning after 12/31/2003.
Virginia	Tax years beginning on or after 1/1/2004.
Illinois	80/20 companies – Tax years ending on or after Dec. 31, 2004.
Washington DC	Unclear on legislation enacted 8/2/2004 – expect effective date to be addressed.
Kentucky	Tax years beginning on or after 1/1/2005.
Georgia	Tax years beginning on or after 1/1/2006.

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## Recently Enacted Add-Back Legislation

### Kentucky's Add-back Statute – Effective 1/1/2005

#### **“Related Member” Add-back Requirement:**

- Requires taxpayer to add-back certain expenses paid to related member(s), if specific safe harbors are not met.
- Statute targets expenses paid to related members that are associated with:
  - Management fees;
  - Intangible interest expenses; and
  - Intangible expenses (e.g., patents, copyrights, trademarks, etc.)

*It should be noted, however, that the requirement that a taxpayer add-back “intangible expenses” paid to a related member was inadvertently omitted from the actual text of Section 141.205 of the Kentucky Revised Statutes. It is anticipated that this will be corrected by means of a technical corrections bill.*

- Effective as of January 1, 2005.

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## Recently Enacted Add-Back Legislation

### Kentucky's Add-back Statute – Safe Harbors:

#### **Add-back of Management Fees Paid to Related Member(s) – Not Required:**

- if the taxpayer paying the expenses and the recipient of the expenses are both included in the same consolidated Kentucky corporation income tax return for that year; or
- if the taxpayer makes a disclosure, and establishes that the recipient of the expenses regularly engages in transactions with one or more unrelated parties on terms identical to that of the subject transaction; or
- if the taxpayer and the Revenue Cabinet agree in writing to an alternative apportionment method.

#### **Add-back of Intangible Interest Expenses Paid to Related Member(s) – Not Required:**

- if the taxpayer paying the expenses and the recipient of the expenses are both included in the same consolidated Kentucky corporation income tax return for that year; or
- if the taxpayer makes a disclosure, and establishes that the recipient of the expenses regularly engages in transactions with one or more unrelated parties on terms identical to that of the subject transaction; or
- if the taxpayer and the Revenue Cabinet agree in writing to an alternative apportionment method; or
- if the taxpayer makes a disclosure, and establishes the following:
  - the payment to the related member was subject to, in its state or country of commercial domicile, a tax based in whole or in part on net income; and
  - the related member is engaged in substantial business activities separate and apart from the acquisition, use, licensing, management, ownership, sale, exchange, or any other disposition of intangible property, or in the financing of related members, as evidenced by the maintenance of permanent office space and full-time employees dedicated to the maintenance and protection of intangible property; and
  - the terms of the transaction giving rise to the expense were at commercially reasonable rates and at terms comparable to an arm's-length transaction.

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## Recently Enacted Add-Back Legislation

### Georgia's Add-back Statute – Effective 1/1/2006

#### **Related Member Add-back Requirement:**

- Requires the add-back of certain “intangible expenses and costs” paid to one or more related members, if certain safe harbors are not met.
  - “Intangible expenses and costs” includes royalty, patent, technical and copyright fees; licensing fees; and other similar expenses and costs.
- Add-back statute applies to taxpayers filing separate company returns as well as taxpayers filing a Georgia consolidated return.
- Taxpayers failing to add-back related member expenses are subject to, in addition to other penalties, an additional penalty of 10% of the additional tax due as a result of the required add-back(s).
- Effective January 1, 2006

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## Recently Enacted Add-Back Legislation

### Georgia's Add-back Statute – Safe Harbors:

#### **Add-back of Intangible Expenses and Costs Not Required in the following instances:**

1. Expenses/costs paid to related member in arm's length transaction, expenses/costs allocated or apportioned by related member to a state in which a tax based on net income is imposed, and taxpayer has disclosure of the related member transaction; or
2. Expenses/costs paid to related member domiciles in foreign nation with a comprehensive income tax treaty with the U.S., related member transaction has a valid business purpose (as defined in the statute) other than tax avoidance or reduction and is at arm's length, and taxpayer disclosure of the related member transaction; or
3. Expenses paid to related member arose from transaction with valid business purpose (as defined in the statute) and are ultimately passed through to an unrelated third party during the same taxable year; or
4. Taxpayer enters into an alternative apportionment agreement with Tax Commissioner.

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## Recently Enacted Add-Back Legislation

### Example of Georgia's Add-back Statute:

	Georgia		
	<u>Op Co</u>	<u>IHC</u>	
Royalty Income	-	100,000	
Disallowance of Royalty Expense	100,000	-	
Partial Relief for Royalty Disallowance	(A) (5,000)	-	
Modified Federal Taxable Income	95,000	100,000	
Apportionment Factor (SFS)	5%	5%	
State Taxable Income	4,750	5,000	(A)
Tax Rate	6%	6%	
Tax	285	300	8

## Addback Legislative Watch List

State	Effective Date
Pennsylvania	HB 518 introduced 2/16 with related member addback. Governor's budget (H.B. 1557) includes combined reporting instead. Budget discussions continuing.
Texas	Texas tax reform proposals would call for expanded franchise tax, which includes add-backs.
Wisconsin	AB 44 introduced 3/2005, requiring addback of intangible expenses & costs. Effective for tax years after 1/1/05.
Minnesota	HF 660/ SF 753 "FOC" (80/20) language introduced Feb. 2005. Legislation failed to be approved.
Indiana	HB 1707, SB 608 introduced in 2005, failed to gain approval in committee prior to procedural deadline.

### Trends in State Proposals for Related Member Expense Add-back

- Inclusion of related member interest payments as well as royalties
  - Kentucky includes “management fees” – Texas has considered similar language
- Application to “direct and indirect” expenses and costs
- Typical “safe harbors”
  - Economic substance/arm’s length rates & terms for related member transactions
  - Purpose other than state income tax avoidance or reduction
  - Payment of income based tax by expense recipient
  - Expense recipient not “primarily engaged” in maintenance and management of intangibles
  - Ultimate pass through of expense to unrelated party
- Expansive definition of “related member”

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### MTC Proposed Model Add-Back Statute

- Definitions of intangible expense, related member and interest similar to those provided for in most existing legislation
  - Does provide for separate provisions relating to interest expense
- Applicable to both “direct and indirect” expenses and costs
- Exemptions
  - Aggregate effective rate exemption
  - Comprehensive tax treaty exemption with minimum statutory rate
  - Third party expense exemption, with valid business purpose requirement (intangible expense only)
  - Arm’s length rate of interest exemption, with valid business purpose requirement (interest expense only)
  - Provision for alternative adjustment agreement
- Explicitly states that it does not limit commissioner’s authority to make other adjustments permitted by law

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## MTC Proposed Model Add-Back Statute

### Definition of “Valid Business Purpose”:

[O]ne 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.

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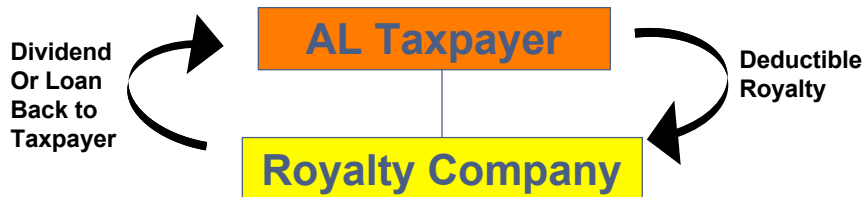
## MTC Proposed Model Add-Back Statute

### The “Aggregate Effective Rate of Tax” Exemption:

- Unlike many southeastern states, the aggregate effective rate of tax (a/k/a the “subject to tax”) exemption in the model statute operates as an absolute exemption (vs. a partial exemption).
- In order to qualify, the taxpayer must demonstrate that the aggregate effective rate of tax applied to the related member’s income exceeds a defined minimum.
- Provides that the effective rate of tax is zero in those states in which the taxpayer and the related member file on a combined/consolidated basis and the reported transactions are eliminated.
- Further provides for a “fix” to the Delaware management company by eliminating the effect of any credit or adjustment that is dependent upon the related member managing intangible property or collecting interest.

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### Application of Add-Back - Royalty Company Example

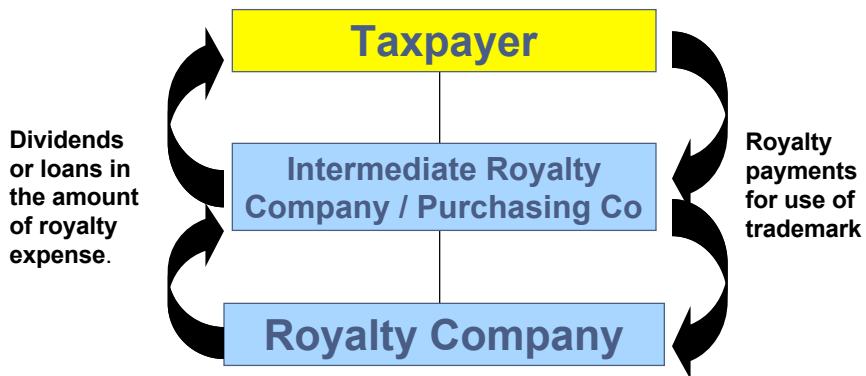


Royalty Company:

- Controls intellectual property (name and logo) and receives royalty income from affiliated AL Taxpayer.
- Claims to be isolated in tax haven state and does not file returns in separate company states.

**Any Add-back issues???**

### Application of Add-Back - Dual Royalty Company Example



- Taxpayer sublicenses IP from intermediate related member company that licenses IP from 2<sup>nd</sup> related member.
- Intermediate related member is a near break even company that may file in many jurisdictions, and may serve additional functions.

**Any Add-Back Issues???**

**Application of Add-Back**  
 - Contract Manufacturer / Sales Company / Royalty Company Example

CM pays RC a royalty based on CM sales.

SC purchases goods from CM with royalty built into the price of the goods

- Sales Company's royalty is buried in the price it pays to purchase goods from the Contract Manufacturer.
- Contract Manufacturer breaks even and Royalty Company is located in tax haven.

**Any Add-Back Issues???**

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**Application of Add-Back**  
 - East/West Structure Example

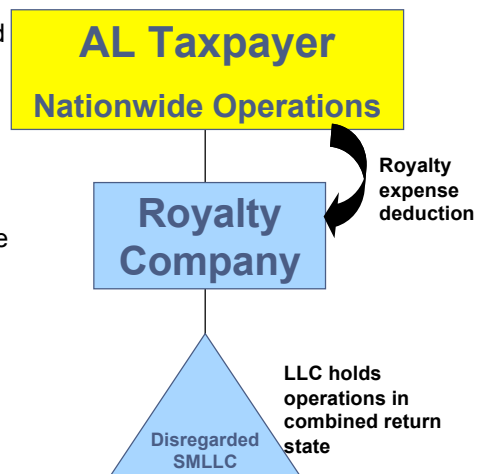
Royalty / interest expense deduction

- Multi-state (nationwide) business divides its operations into two corporations by contributing operations in the East (euphemism for separate return states) to a newly formed company, with this newly formed "West Company" retaining operations in the West (euphemism for combined return states) and all intangibles.
- **Any Add-back issues???**
- Are variations of an East / West structure is the future of state tax planning for large multi-state taxpayers?

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## Application of Add-Back - East/West “Light” Example

- In what we refer to here as the East/West “Light” Structure, taxpayer drops operations from one combined return jurisdiction into a DE/SMLLC and contributes LLC to Royalty Company.
- The LLC is used to avoid multiple transfers of hard assets.
- Allows the Royalty Company to argue that it is no longer “primarily engaged”.
- Substance added to the Royalty Company’s argument by the disregarded LLC may allow the structure to withstand state challenges.



**Any Add-back issues???**

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## Add-Back Legislation – Policy

- Can or should double tax be remedied?
  - The Ohio Model
  - The Alabama/Georgia Model
  - The Virginia/Arkansas Model
  - The New Jersey/Massachusetts Model
  - The North Carolina Model
- When is alternative relief appropriate?
- Are add-back statutes a step toward combined reporting or a barrier (convenient compromise) preventing states from going all the way?

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