Surveying Constitutional Theories for Challenges to the Add Back Statutes
By Thomas H. Steele & Pilar M. Sansone

Over the last few years, eleven separate-company filing states have enacted so-called “add back statutes” that disallow a deduction for certain payments made to affiliates. All of these states target royalties paid for the use of trademarks, tradenames or patents. Most also disallow interest deductions. In this article, we briefly survey the basic structure of these statutes with the purpose of identifying Commerce Clause arguments that might be available for challenging all or parts of these statutes.

THE BASIC ADD BACK STATUTE

Add back statutes are directed at what states perceive to be an abusive transaction, i.e., a transaction in which a taxpayer creates deductions in separate-company filing states while sourcing the related income to states with favorable tax regimes (e.g., tax regimes that either as a matter of theory or legislative grace don’t tax such income or tax it at a favorable rate).

Maryland’s add back statute is typical. Like most states, Maryland imposes a corporate income tax on a corporation’s Maryland taxable income, which is generally defined as the corporation’s federal taxable income, as modified. See Md. Code §§ 10-102, 10-301 and 10-304(1). With the passage of its add back statute, one of the modifications is a requirement that taxpayers add back the following expenses when calculating their Maryland income:

\[
\begin{align*}
\text{Royalties} & \quad \text{Trademarks, Tradenames, or Patents} \\
\text{Interest} & \quad \text{Payments}
\end{align*}
\]

\[\text{See Md. Code §§ 10-102, 10-301 and 10-304(1).}\]

\[\text{With the passage of its add back statute, one of the modifications is a requirement that taxpayers add back the following expenses when calculating their Maryland income:}\]

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[O]therwise deductible interest expense or intangible expense if the interest expense or intangible expense is directly or indirectly paid, accrued, or incurred to, or in connection directly or indirectly with one or more direct or indirect transactions with, one or more related members.

Md. Code § 10-306.1(b)(2). For this purpose, “interest expense” is defined as “an amount directly or indirectly allowed as a deduction under section 163 of the Internal Revenue Code . . . .” Md. Code § 10-306.1(a)(7). Maryland defines “intangible expense” broadly; it includes an expense directly or indirectly related to the “acquisition, use, maintenance, management, ownership, sale, exchange or any other disposition of intangible property,” a loss in connection with discounting and factoring transactions, a “royalty, patent, technical or copyright fee,” a licensing fee, as well as any other similar cost or fee. Md. Code § 10-306.1(a)(5). “Related members” include stockholders and entities related to them within the meaning of Internal Revenue Code (“IRC”) §318 that own at least 50% of the taxpayer’s outstanding stock, component members within the meaning of IRC § 1563, and persons to or from whom there is an attribution of stock ownership within the meaning of IRC § 1563. See Md. Code § 10-306.1(a)(8)-(9).

In contrast to this typical model, North Carolina’s add back statute takes a slightly different tack. Instead of disallowing the expense itself (essentially on a pre-apportioned basis), the North Carolina statute targets only royalty payments received for the use of trademarks in North Carolina and treats all such payments effectively as taxable income derived from doing business in the state. See N.C. Gen. Stat. § 105-130.7A.(a). In the event the payor and the recipient of the royalties are related members, the payments may either (a) be included in the income of the recipient and deducted by the payor, or (b) added back to the income of the payor and excluded from the income of the recipient. See N.C. Gen. Stat. § 105-130.7A.(a). Thus, North Carolina effectively allocates to the state all royalties relating to use of trademarks within the state and then provides the parties a choice as to which (related) entity is to report and pay tax on the income.

EXCEPTIONS TO THE DISALLOWANCE

Various exceptions provided in the statutes or the regulations temper the broad sweep of the add back statutes. Although the scope and requirements of these exceptions vary between the states, the types of exceptions found in the add back statutes may be placed in broad categories to provide a framework for considering their constitutionality.

Business Purpose and Arm’s Length Pricing

Before discussing the specifics, it is important to note that certain of the exceptions described below require the taxpayer to demonstrate that the transaction was not entered into for tax avoidance purposes and that the payments reflect arm’s length pricing. Moreover, certain of the add back exceptions require the taxpayer to seek approval from the state’s tax agency before the exception may be claimed. Because these requirements do not appear to implicate the constitutionality of the statutes directly, we do not dwell on them further. Nonetheless, these requirements play an important role in qualifying for many of the exceptions, and thus taxpayers seeking to avoid, rather than challenge, the add back statutes should consult with the state’s requirements to determine whether they should obtain documentation of a business purpose and arm’s length pricing to support their claim of an exception.

Categorizing the Exceptions

In general, the exceptions to the add back statutes fall into seven broad categories. The first exception discussed is the most important and requires a somewhat more extensive discussion. Thereafter we address the other exceptions in a more summary form.
The recipient is taxable on the income by the add back state or another state.

Although the specific form of this exception varies from state to state, several states allow taxpayers to avoid the add back requirement if the recipient is subject to state tax on the associated income. The key variants among statutes adopting this exception are (1) the benchmark for determining whether the related income is subject to tax, (2) the method for establishing the recipient’s tax burden, and (3) the manner for calculating the add back.

**The Benchmark**

The most distinctive variant is the benchmark, or standard, for determining whether the recipient is subject to a sufficient amount of tax on the related income. Virginia’s exception is the broadest, and merely requires that the recipient be subject to “a tax based on or measured by net income or capital,” without specifying a minimum tax rate. Va. Code § 58.1-402(B)(8)(a)(1), (9)(a)(4)(i); see also Ark. Code § 26-51-423(g)(1)(A). The instructions to the Virginia return specify that the inclusion of the income in the recipient’s net income or capital must result “in a non-trivial increase in tax liability (or reduction of an operating loss) after consideration of all of the deductions, credits, exemptions and other tax policies and preferences affecting the tax liability of the related member.” Va. Instructions for Form 500-AB (2004).

**California Tax Amnesty Considerations in a Nutshell**

All taxpayers that owe or may owe California corporate or personal income taxes or sales and use taxes for open periods beginning before January 1, 2003 should consider the following:

**CORPORATE AND PERSONAL INCOME TAXES**

- If you will owe taxes for a period covered by the Amnesty Program (i.e., open years beginning before 1/1/03), consider paying those taxes on or by 4/1/05 to avoid the 50% interest penalty
- In evaluating whether you will owe taxes for a period covered by Amnesty Program, do not forget to identify federal RARs that will flow through to California
- If accuracy-related penalties have been or are likely to be assessed and upheld, consider entering the Amnesty Program, but understand that you will waive your right to seek a refund of any amounts paid
- If accuracy-related penalties are unlikely to be assessed or upheld, consider paying an amount you estimate might be owed outside of the Amnesty Program (i.e., under normal payment procedures) and then file a claim for refund
- If you are in the Settlement Bureau or the Protest Section, try to get the case resolved by 3/31/05 to allow payment of the agreed amount by 4/1/05

**SALES AND USE TAXES**

- If you will owe sales and use taxes for a period covered by the Amnesty Program (i.e., open years beginning before 1/1/03), consider paying those taxes on or by 4/1/05 to avoid the 50% interest penalty and doubling of other penalties and file a claim for refund
- Payment outside of the Amnesty Program only requires payment of the tax
- Payment through the Amnesty Program will enable you to avoid penalties for the nonreporting, nonpayment and underpayment of tax, and you will not waive your right to further contest the tax
- Payment through the Amnesty Program requires the payment of tax and interest
- If you are in the Settlement Bureau or the Appeals Section, try to get the case resolved by 3/31/05 to allow payment of the agreed amount by 4/1/05

For more information on California’s tax amnesty program, please see “California’s ‘Tax Amnesty’: What Every California Taxpayer Should Know” on page 21.
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Most states establish a more significant hurdle by declaration or by using a formula based on the state’s tax rate. For example, Maryland specifies that the recipient must be subject to tax at a rate not less than four percent, see Md. Code § 10-306.1(c)(3)(ii), whereas Connecticut and Massachusetts each condition their exception on the recipient being subject to tax at a rate that is equal to or greater than the state’s statutory rate of tax less three percentage points, see 2003 Conn. Acts § 78(c); Conn. Dep’t of Revenue Services, Special Notice 2003(22), Jul. 8, 2004.

Maryland makes this calculation by considering the recipient state’s statutory rate of tax and the recipient’s apportionment percentage. See Md. Code § 10-306.1(a)(4); N.J. Reg. 18:7-5.18(a)4.viii. As illustrated in the following example, New Jersey’s interest add back statute similarly considers the state’s statutory rate of tax and the apportionment percentage, but does so for both the payor and the recipient.

Suppose Company A does 99% of its business in California, a combined return state, and 1% of its business in New Jersey. Company A lends funds to Company B, an affiliate, which does 60% of its business in California and 40% of its business in New Jersey. New Jersey’s tax rate is 9%.

Under this scenario, Company A’s rate of tax would be 0.09% (1% times 9%), and Company B’s rate of tax would be 3.6% (40% times 9%). Company B would not qualify for New Jersey’s exception under these facts because Company A’s rate of tax (0.09%) is not equal to or greater than Company B’s rate of tax (3.6%) less 3% (0.6%).

However, suppose Company B did 33% of its business in New Jersey, and 67% of its business in California. Under this scenario, Company B would qualify for New Jersey’s exception because Company A’s rate of tax (0.09%) is equal to or greater than Company B’s rate of tax (3.0%) less 3% (0%).

Thus, a taxpayer will meet this benchmark as long as its New Jersey apportionment factor is 33% or less and the recipient is subject to tax in New Jersey (even at a nominal amount).

Another factor affecting the calculation of recipient’s tax burden is whether taxes paid in combination or consolidated states count against the benchmark. Most add back statutes only consider taxes paid by the recipient in separate-company filing states. See, e.g., N.J. Reg. 18:7-5.18(a)(5), Ex. 5; Conn. Dep’t of Revenue Services, Special Notice 2003(22), Jul. 8, 2004; Va. Instructions for Form 500-AB (2004). The theory, of course, is that unitary combination or consolidation states eliminate intercompany payments from income and that, in the simplest of terms, the recipient has no item of income to tax. Maryland, however, recognizes that the tax consequences of combination or consolidation are not necessarily so simple, and thus provides that the payment of the royalty or in-
interest will be treated as taxed to the extent of the lesser of the recipient’s apportionment factor or the combined (or consolidated) group’s apportionment factor. See Md. Code § 10-306.1(e). The effect of this provision can be illustrated as follows:

Suppose Company A operates wholly in California, has $150 of gross income from third parties, $25 of deductible expenses involving payments to third parties, and receives a royalty from its affiliate, B, of $25 which is eliminated because it is a transaction among members of a combined report. Also suppose that Company A has a combined factor (property, payroll and sales) of $600.

Suppose Company B operates entirely within Maryland, also has $150 of gross income from third parties, $25 of deductible expenses involving third parties and pays a $25 royalty to A. Also suppose Company B has a combined factor (property, payroll and sales) of $400.

Under these facts, Company A, by reason of filing a combined report with Company B, reports to California net income of $150, ($300 less $50 times 6/10), which California taxes to A. Although the shift of the $25 into California does not arise as the result of the payment of the royalty (which is eliminated in the combined

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report), $25 of B’s income nonetheless effectively has been shifted to A and taxed by California.

Another factor affecting the calculation of the recipient’s tax burden is whether the state considers the amount of tax paid to one state or the total amount of tax paid to all states. For example, Maryland seeks to determine the recipient’s “aggregate effective tax rate,” which it defines as “the sum of the effective rates of tax imposed by all states, including this state and other states or possessions of the United States, where a related member receiving a payment of interest expense or intangible expense is subject to tax and where the measure of the tax imposed included the payment.” Md. Code § 10-306.1(a)(2). New Jersey and Connecticut, on the other hand, only consider the rate of tax paid to one state. See N.J. Rev. Stat. § 54:10A-4(k)(2)(I); Conn. Dep’t of Revenue Services, Special Notice 2003(22), Jul. 8, 2004.10

Relief from the Add Back

The third variant that comes into play is the manner in which relief is provided once the payor has proven that the recipient was taxable on the associated income. In most cases, this exception is essentially binary: if the recipient is taxed at a rate at or above the benchmark set by the state, the taxpayer obtains the deduction; however, if the recipient is taxed on the payment but at a rate below the benchmark, the payor obtains no relief. See Ark. Code § 26-51-423(g)(1); N.J. Rev. Stat. § 54:10A-4(k)(2)(I); Md. Code § 10-306.1(c)(3)(ii); 2003 Conn. Acts § 78(c) (Spec. Session). Thus, these exceptions only eliminate double taxation if the corresponding income is subject to tax above a certain threshold, and differ from a typical credit mechanism where the tax imposed by another state reduces the tax imposed upon the taxpayer claiming the credit on a dollar-for-dollar basis.

However, Alabama’s exception allows relief from the add back statute on a sliding scale. More specifically, Alabama requires taxpayers to add back otherwise deductible interest and intangible expenses unless the corresponding item of income is “subject to a tax based on or measured by the related member’s net income.” Ala. Code 40-18-35(b)(1). Alabama does not set a minimum rate of tax as its benchmark, but rather specifies that the exception is “allowed only to the extent that the recipient related member includes the corresponding item of income in post-allocation and apportionment income reported to the taxing jurisdiction.” Ala. Admin. Code r. 810-3-35-.02(1). In other words, taxpayers are provided relief to the extent that the recipient allocates or apportions its income to separate-company filing states. Thus, if the recipient allocates or apportions 5% of its income to separate-company filing states, the taxpayer is required to add back only 95% of its intercompany interest and intangible expenses. See Ala. Admin. Code r. 810-3-35-.02(3)(g)(1).

In contrast to the exceptions described above, the other exceptions typically found in add back statutes may be readily described.

The recipient is located in a country that has a comprehensive income tax treaty with the United States.

Many states provide a special exception that is available where the taxpayer demonstrates that the ultimate recipient of the payment is located in a foreign country that has a comprehensive tax treaty with the United States.11 Some states incorporate this exception into their general exception that applies if the recipient is subject to state tax on the corresponding income, and thus similarly require the recipient’s foreign rate of tax to exceed a certain threshold. See 2003 Conn. Acts § 78(c) (Spec. Session); Mass. Gen. Law Ch. 63 § 31J(b); N.J. Rev. Stat. § 54:10A-4(k)(2)(I). However, Arkansas, Connecticut and Virginia have specified that the foreign country exception will apply regardless of the tax rate applicable to the recipient. See Ark. Code § 26-51-423(g)(1)(A); Conn. Dep’t of Revenue Services, Special Notice 2003(22), Jul. 8, 2004; Va. Code § 58.1-402B(8).
The recipient is not an intangible holding company.

Several states have attempted to limit their add back statute to address only pure intangible holding company structures. For example, Alabama provides that the taxpayer will not be required to add back otherwise deductible expenses if it can establish that the transaction giving rise to the expenses did not have tax avoidance as its principal purpose and the recipient is “not primarily engaged in the acquisition, use, licensing, maintenance, management, ownership, sale, exchange, or other disposition of intangible property, or in the financing of related entities.” Ala. Code § 40-18-35(b)(3); see also Miss. Code § 27-7-17(2)(c)(ii) (providing a similar exception where the recipient’s primary business is not related to intangibles).

Virginia provides an exception to its intangible add back provision if the recipient “derives at least one-third of its gross revenues from the licensing of intangible property to parties who are not related members” and the transaction was entered into at arm’s length rates and terms. See Va. Code § 58.1-402B(8)(a)(2).

The payor and payee are subject to a special industry exception.

Certain add back statutes provide an exception for members of specified industries, presumably in recognition that those industries engage in transactions involving intangible assets or intercompany loans as a matter of ordinary business practice. For example, Maryland provides an exception to its add back statute for interest paid by a bank to a bank. See Md. Code § 10-306.1(c)(3)(i). Virginia also provides an exception to its interest expense add back provision if the recipient has substantial business operations relating to interest-generating activities that require at least five full-time employees; the interest expenses are not related to the acquisition, maintenance, management or disposition of intangible property; and certain other requirements are met. See Va. Code § 58.1-402B(9)(a). Connecticut has a special exception for insurance companies, hospitals and medical service corporations. See 2003 Conn. Acts § 78(c) (Spec. Session); Conn. Dept of Revenue Services, Special Notice 2003(22), Jul. 8, 2004.

The recipient is a “conduit” and passes the income through to a third party.

Numerous states provide an exception when the income passes through the recipient to an unrelated party. For example, Maryland’s statute provides that the add back statute does not apply if the recipient “directly or indirectly paid, accrued, or incurred the interest expense or intangible expense to a person who is not a related member” during the same taxable year. Md. Code § 10-306.1(c)(3)(i). New Jersey’s exception to its interest add back statute is more narrow in that it requires that the payor also guarantee the debt for the conduit exception to apply. See N.J. Rev. Stat. § 54:10A-4(k)(2).

The payor and recipient are unitary and elect to file a combined report or consolidated return.

Two states (Ohio and Connecticut) also provide an exception that is tied to a combined report or consolidated tax return. In Ohio, this exception limits the tax payable under the add back statute to the amount that would have been payable had the parties filed a combined return. See Ohio Rev. Code § 5733.042(D)(4). In Connecticut, at least in regard to the interest add back, the taxpayer must actually elect to file on a combined basis with all members of the unitary group with which there are substantial intercompany transactions. See 2003 Conn. Acts § 78(d)(3) (Spec. Session). Such an election is irrevocable for five successive income years. Id.

The result reached is unreasonable.

Finally, most add back statutes also contain a catch-all exception that allows the tax authorities and the taxpayer to override the add back where the disallowance of the deduction is “unreasonable” or the parties agree to some alternative apportionment method under an analogue to section 18 of the Uniform Division of Income for Tax Purposes Act. In general, these statutes provide that the taxpayer must carry a heavy burden of proof and may require filing a petition establish-

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ing that conclusion prior to filing its tax return. See, e.g., Conn. Dep’t of Revenue Services, Special Notice 2003(22), Jul. 8, 2004 (construing 2003 Conn. Acts § 78(d)(1) (Spec. Session) and indicating that evidence that the add back is unreasonable must be “clear and convincing” and so “clear, direct and weighty” that the Commissioner comes to a “clear conviction without hesitancy” as to the validity of the taxpayer’s claim).

Some states provide guidance as to what would qualify for this exception. For example, New Jersey suggests that the taxpayer must demonstrate the extent to which the recipient pays New Jersey tax on the corresponding income or that the taxpayer is being taxed on more than 100% of its income, see N.J. Reg. 18:7-5.18(a)2 and N.J. Questions and Answers Regarding the Business Tax Reform Act of 2002, Question 7, whereas Alabama suggests that the taxpayer must show that the application of the add back statute causes the tax to bear no fair relationship to the taxpayer’s Alabama presence, see Ala. Admin. Code r. § 810-3-35-02(3)(h).

Other exceptions contemplate that the taxing authority may issue regulations to provide exceptions for transactions not currently contemplated by the state’s exceptions. For example, Maryland Code § 10-306.1(d)(2) authorizes the issuance of regulations to provide for an alternative treatment where the recipient is subject to tax in another state that is measured by gross receipts, net capital or net worth, rather than income.

Elimination of the Payment from the Recipient’s Income To Prevent Double Tax

In addition to providing exceptions to the add back rule, certain of the add back statutes provide that the computation of taxable income of the taxpayer and the recipient are to be coordinated such that the income associated with the payment is not subject to double tax. Conceptually, this provision is a mirror image of the exception described above where the deduction is allowed if the recipient is subject to tax on the corresponding income. Whereas that exception eliminates the payment from the payor’s income (i.e., the deduction is allowed); here the payment is eliminated from the recipient’s income.

In any event, the scope of this provision varies among the states. Connecticut, for example, states that the recipient’s Connecticut income and receipts factor is not to include any amounts added back to the payor’s income as a result of the Connecticut add back statute. See 2003 Conn. Acts § 78(h) (Spec. Session). Similarly, New York permits a taxpayer to deduct royalty payments received from related members “unless such royalty payments would not be required to be added back under [New York’s add back provision] or other similar provision in this chapter.” N.Y. Tax Law § 208(9)(o)(3). Moreover, North Carolina’s regime effectively reaches the same result by giving the payor and the recipient the choice of which entity is to report the income. See N.C. Gen. Stat. § 105-130-7A.(a), (c).

Maryland’s relief measure goes farther and eliminates the payment from the recipient’s income if that payment has been subject to Maryland’s or another state’s add back provision; however, this adjustment is only permitted if the transaction has a valid business purpose and arm’s length pricing and terms, and is limited to the extent that the aggregate effective tax rate imposed on the recipient exceeds the taxpayer’s aggregate effective tax rate. See Md. Code § 10-306.1(f).

OVERVIEW OF THE COMMERCE CLAUSE CONSTRAINTS

Since the Supreme Court’s decision in Complete Auto Transit, Inc. v. Brady, 430 U.S. 274 (1977), the constitutionality of taxes imposed upon interstate commerce has been evaluated against a four prong test.

- Does the state have substantial nexus with the activity taxed?
- Is the tax fairly apportioned?
- Does the tax discriminate against interstate commerce?
- Is the tax fairly related to the services provided by the state?
To provide a framework for evaluating the constitutionality of the add back statutes, we focus upon the first three of those prongs: namely whether the state has substantial nexus; whether the royalty add back statutes discriminate against interstate commerce; and whether the taxes produced by the add back statutes are fairly apportioned.

Substantial Nexus

The Commerce Clause requirement that a tax on interstate commerce have substantial nexus generally involves two distinct but related inquiries. First, a state must have jurisdiction over the taxpayer it seeks to tax. Generally, this requirement is developed in the context of the physical presence standard of Quill Corporation v. North Dakota, 504 U.S. 298 (1992). Recently, however, states have begun to challenge the fundamental assumption that the physical presence standard is applicable to taxes other than sales and use taxes, e.g., income taxes. Compare A&F Trademark, Inc. v. Tolson, 605 S.E. 2d 187 (2004) (concluding that North Carolina had jurisdiction to impose income tax upon the recipient of royalty payments for the use of intangible property within the state even though the recipient had no physical presence in North Carolina) with Lanco, Inc. v. Dir, Div of Taxation, 21 N.J. Tax 200 (2003), appeal pending, No. A-003285-03T1 (N.J. Super. Ct. App. Div.) (concluding that New Jersey could not impose income tax on a Delaware intangible holding company because the taxpayer had no physical presence in the state).

The second nexus inquiry involves whether a state has jurisdiction over the income, transaction or property it seeks to tax. In the context of reaching specific items of income earned by a taxpayer doing business within a state (other than the state of the taxpayer’s commercial domicile), the Supreme Court’s decision in Allied-Signal, Inc. v. Director, Division of Taxation, 504 U.S. 768 (1992) sets the outer boundary as requiring a showing that the income in question serves an “operational” as opposed to an “investment” purpose. Particularly where the state seeks to measure a corporate taxpayer’s income by reference to the income of other corporations (i.e., by requiring a combined report of income), this requirement is also articulated as the unitary business test, typically requiring some showing of functional integration, centralization of management and economies of scale between the entities to be combined. See Container Corp. of Am. v. Franchise Tax Bd., 463 U.S. 159 (1983).

Discrimination Against Interstate Commerce

In simplest terms, the discrimination prong prohibits a state from taxing interstate commerce more harshly than in-state commerce. See Haliburton Oil Well Cementing Co. v. Reily, 373 U.S. 64 (1963). Thus, a state may not impose a heavier tax burden upon a transaction that crosses state lines than would be imposed on a purely intrastate transaction. See Boston Stock Exch. v. State Tax Comm’n, 429 U.S. 318 (1977). Nor may a state’s tax system coerce a taxpayer to move its operations into the taxing state or pressure a taxpayer to limit its investments to in-state entities. See Armco, Inc. v. Hardesty, 467 U.S. 638 (1984); Fulton Corp. v. Faulkner, 516 U.S. 325 (1996).

A state may save a tax that appears to discriminate against interstate commerce by showing that the state’s tax system contains a compensatory or complementary tax on intrastate commerce that effectively levels the playing field. Id. However, a state cannot save a discriminatory tax by showing that the lower tax on local commerce is simply an attempt to avoid a double tax on local businesses. See Armco Inc. v. Hardesty, supra; Farmer Bros. Co. v. Franchise Tax Bd., 108 Cal. App. 4th 976 (2003), cert. denied, 540 U.S. 1178 (2004). In other words, if a state moves to eliminate double taxation of income (e.g., either through a “multiple activities exemption” or through a specific deduction for income that has previously been taxed), the state must extend that relief to eliminate double taxation arising from taxes imposed by other states as well. Id.

The Apportionment Requirement

In recent years, the apportionment prong of the Complete Auto test has
been expressed in the internal and external consistency tests first articulated in Container Corporation of America v. Franchise Tax Board, supra. Under the internal consistency test, a tax will be struck down if (assuming other states adopt an identical tax) the tax regime would impose a multiple tax burden on interstate commerce where intrastate commerce would bear a single tax burden. See Arnco, Inc. v. Hardesty, supra. Thus, under the internal consistency test, the logical risk of multiple taxation is evaluated rather than the actual imposition of multiple taxes. Id.

Under the external consistency test, a tax will be struck down if it extends to values that are not fairly attributable to activity within the taxing state. See Oklahoma Tax Comm’n v. Jefferson Lines, 514 U.S. 175 (1995). The external consistency requirement focuses upon whether the state has adopted a mechanism for apportioning the tax base rather than whether the actual results are supportable as an economic matter. Id.; see also Philadelphia Eagles Football Club, Inc. v. City of Philadelphia, 823 A.2d 108 (Pa. 2003); Northwood Constr. Co. v. Township of Upper Moreland, 573 Pa. 189 (2004). However, broadly viewed at least, the external consistency requirement operates in coordination with the requirement (often expressed in Due Process terms) that a state may not extend its taxing powers to claim income that is all out of proportion to the income earned within the jurisdiction. See Hans Rees’ Sons, Inc. v. North Carolina, 283 U.S. 123 (1931).

The Commerce Clause Does Not Prohibit Multiple Taxation Per Se

Finally, under current Supreme Court precedents, the Commerce Clause does not appear to prohibit multiple taxation of income per se. Thus, where the multiple taxation arises from a conflict in the tax systems of different states, the Commerce Clause is unlikely to provide relief. See, e.g., Moorman Mfg. Co. v. Bair, 437 U.S. 267 (1978) (applying of a single sales factor apportionment formula in the face of the three-factor apportionment formula commonly used by other states); Container Corp. of Am. v. Franchise Tax Bd., supra (approving the use of worldwide combined reporting in the face of the widespread adoption by other countries of separate accounting); Zelinsky v. Appeals Tribunal, 801 N.E.2d 840 (N.Y. 2003), cert. denied, 124 S. Ct. 2068 (2004) (approving of New York’s taxation of income earned by a resident of Connecticut who was working in Connecticut based on the “convenience of the employer doctrine,” despite the fact that Connecticut also claimed the income). But see Japan Line, Ltd. v. County of Los Angeles, 441 U.S. 434 (1979) (finding discrimination in violation of the Commerce Clause under a more rigorous test applied for foreign commerce where Los Angeles imposed a nondiscriminatory apportioned property tax on foreign-owned containers used in international shipping in conflict with the rule applied in Japan and other foreign countries that imposed a full (unapportioned) tax on containers that were owned, based and registered in the country).

APPLICATION OF THE COMMERCE CLAUSE TO THE ADD BACK STATUTES

Using these constitutional principles as a template, we hereafter identify theories that may be available to challenge certain of the add back statutes.

Substantial nexus

Any challenge based upon the substantial nexus prong of Complete Auto presumably would be based on the notion that the disallowance of an otherwise generally allowable deduction is effectively the equivalent of taxing the income to which it is linked. See Hunt-Wesson, Inc. v. Franchise Tax Board, 528 U.S. 458 (2000). Thus, while a state generally has broad license to determine what expenses are to be deductible from income where the deduction is tied specifically to one category of income, the disallowance of the deduction would be subject to attack if the state lacked substantial nexus to tax that income. Id.

While it may be possible to challenge the reach of the add back statutes based upon such an argument, prevailing on that position would appear to be an uphill battle. As described above, the constitutional standard governing
this issue was established in the *Allied Signal v. Director, Division of Taxation, supra*. Under that decision, a state must simply demonstrate that the income is from operational sources rather than investment sources, a standard that would appear readily met in most cases. *Allied Signal*, of course, did not deal with a factual pattern such as those triggering the add back statutes, where the issue is not so much a question of the character of the income as a question of whose income it is. If one views the income as belonging to the recipient, one might well conclude that the state ought to have to show a unitary relationship between the payor and the recipient in order to compute the payor’s income by reference to the recipient’s income. Given that the statute is limited to affiliated taxpayers and directed toward a specific item of income (e.g., royalties) paid by one company to the other, proving such a relationship is unlikely to represent a significant hurdle in most cases. See *Container Corp. of Am. v. Franchise Tax Bd.*, supra.

Nonetheless, there may be cases where raising the issue could be determinative.

Suppose for example that in year one Company A, a large computer manufacturer, licenses valuable operating systems from Company B, a large software company. Suppose Company A and B are both publicly traded companies with no ownership overlap. Suppose that in year two, Company A acquires more than 50% of the stock of Company B and continues to pay royalties to Company B on the same terms as before the acquisition. Finally, suppose that Company A and B otherwise operate as fully autonomous businesses that do not meet the requirements of a unitary business.

Obviously, the question here is whether a state can effectively tax to Company A income that appears to belong to Company B without having to meet the requirement of showing the two businesses are, in fact, engaged in a single unitary business.

Eliminating Double Taxation in the Add Back State

In contrast, it would appear that a more serious Commerce Clause challenge could be waged against certain add back statutes based upon the discriminatory effect of their exceptions. For example, where the add back statute provides relief from double taxation only in those circumstances where both the payor and the recipient are taxable in the add back state, the exception would appear to violate the internal consistency test.

Suppose for example, that Company A and Company B are both located 100% in Connecticut. Suppose further that Company A pays a $100 royalty to Company B and that the add back statute would otherwise apply to this payment. Under 2003 Conn. Acts § 78(f) (Spec. Session), Company B will be permitted to eliminate from income any payments that were added back to Company A’s income under the add back statute.

Suppose now that Company B moves its operation into Pennsylvania, also a separate-company filing state. Company A must again add back to income the royalty paid to Company B. Assuming Pennsylvania were to adopt Connecticut’s tax system in its entirety, Pennsylvania also would tax B on the royalty received from Company A since the add back of the royalty did not arise under Pennsylvania’s statute.

Connecticut’s tax regime appears to violate the Commerce Clause in this case because the transaction between A and B is taxed only once when it occurs within a single state but is subject to multiple taxes when conducted between two states. See *D.D.I., Inc. v. North Dakota*, 657 N.W.2d 228 (N.D.

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2003); Farmer Bros. Co. v. Franchise Tax Bd., supra (applying the internal consistency clause to transactions between two different taxpayers). 18

Benchmarking the Recipient’s Tax Burden by a Single State

At least two states, Connecticut and New Jersey, condition their exception to the add back statute by looking at whether the recipient is taxable in another state at a tax rate considered acceptably high. In this regard, the exception apparently ignores the aggregate state tax burden borne by the recipient.

Suppose for example, that Company A, located 100% in New Jersey, pays a $25 royalty to Company B, whose operations are located in four separate states: New York, Connecticut, North Carolina and Ohio. While each of these states has a tax rate that is sufficiently high to trigger an exception to the New Jersey add back statute, because B does business in all four states, the benchmark is not met.

Discrimination in Favor of Foreign Commerce

It would appear that a challenge might also be possible against add back statutes that favor foreign commerce over domestic commerce, although the authority for any such challenge is considerably less clear. The Connecticut add back statute also serves as an example for this type of challenge. Under that statute, if the recipient of a royalty operates in a country in which there is a comprehensive income tax treaty with the United States, the payor need not add back the royalty, regardless of the rate of taxation imposed upon the recipient. See Conn. Dep’t of Revenue Services, Special Notice 2003(22), Jul. 8, 2004. In contrast, where the royalty is paid to a domestic entity, the payor must show that the recipient is taxed on the item at a tax rate in excess of Connecticut’s tax rate less three percent to qualify for the exception to the add back requirement. See 2003 Conn. Acts § 78(c) (Spec. Sess.). Arguably, providing a more favorable tax deduction for foreign commerce may be viewed as unconstitutional discrimination against domestic commerce.

As noted, there is authority establishing that domestic commerce may not be favored over foreign commerce. See Kraft Gen. Foods v. Iowa Dept’ of Revenue and Fin., supra. However, we are aware of no authority for the converse proposition. Indeed, one may well argue that the Supreme Court’s decision in Japan Line, Ltd v. County of Los Angeles, supra, establishes just the opposite because the Court in that case suggested that the Commerce Clause is more protective of commerce in the international setting than it is of domestic commerce.

Disallowance Based Upon the Recipient’s Presence in a State With a Favorable Tax Regime

Perhaps the most fundamental constitutional question presented by the add back statutes is whether a state, by its tax regime, may effectively penalize a taxpayer for doing business with an

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affiliate that operates in another state with a favorable tax regime. A taxpayer bringing such a challenge must largely operate in uncharted territory although, on a visceral level, the theory for such a challenge finds support in Supreme Court decisions approving of state tax incentives as a means for states to compete in interstate commerce.

Consider the following example:

Suppose that Company A is located 100% in Connecticut and borrows all of its capital from Company B, located 100% in New York. Suppose further that Company A pays $100 in interest to Company B. Because New York taxes Company B on the receipt of that interest at the NY tax rate of 7.5%, Connecticut allows Company A to reduce its income by the amount of the interest payment.

Suppose now that New York determines that to retain its status as a financial center, it must amend its state income tax to reduce the tax rate on interest to 1%. As a consequence, Connecticut now disallows Company A’s $100 interest deduction.

Whether viewed from the point of view of Company A or the point of view of the New York policy makers, Connecticut’s reaction to the New York change in policy seems to thrust Connecticut beyond its boundaries into matters properly within the discretion of New York. In effect, Connecticut’s imposition of the tax on Company A directly frustrates New York’s policy change.

While this example may seem a bit far fetched, consider the result where Company B simply decides to move to Nevada, which currently forgoes the taxation of income in order to attract business to the state. Or consider states like Ohio, where state tax authorities encourage relocation of industry by offering credits against tax for extended periods of time. If Connecticut can frustrate such policies by disallowing a deduction for interest and royalty payments, could Connecticut broadly disallow a deduction for other business transactions where the recipient is operating in a tax-favored jurisdiction?

While Connecticut may be expected to argue that its add back statute is surgically directed at “abusive tax planning” involving loans and trademarks, in actual fact, the statutes reach many commonplace business transactions, such as intercompany financing done wholly for nontax reasons. Nonetheless, if the lender of such amounts is located in a unitary combination state or a state with no income tax, the borrower is denied a deduction. If, instead, the lender moves to a separate-company filing state, the borrower is now permitted to deduct the interest. Again, there seems to be something odd, and untoward, if not unconstitutional, about Connecticut’s influence over that decision.

The authors are aware of no direct authority supporting a challenge on this theory. However, the add back statutes may be generally compared to the New Hampshire tax considered in Austin v. New Hampshire, 420 U.S. 656 (1975). In that case, the New Hampshire tax was imposed only on nonresidents from states that would grant a credit for the amount of the New Hampshire tax. New Hampshire sought to defend the discriminatory tax by arguing that the other states could simply repeal their credit for the New Hampshire tax to “reclaim” the taxable income. Thus, the state argued:

[The argument advanced in favor of the tax is that the ultimate burden it imposes is “not more onerous in effect,” [citation omitted] on nonresidents because their total state liability is unchanged once the tax credit they receive from their State of residence is taken into account.]

Id. at 665-666. But the Court rejected this argument:

According to the State’s theory of the case, the only practical effect of the tax is to divert to New Hampshire tax revenues that would otherwise be paid to Maine, an effect entirely within Maine’s power to terminate by repeal of its credit provision for income taxes paid to another State. The Maine Legislature

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could do this, presumably, by amending the provision so as to deny a credit for taxes paid to New Hampshire while retaining it for the other 48 States. Putting aside the acceptability of such a scheme, and the relevance of any increase in appellants’ home state taxes that the diversionary effect is said to have, [footnote omitted], we do not think the possibility that Maine could shield its residents from New Hampshire’s tax cures the constitutional defect of the discrimination in that tax.

Id. at 666-667. It is important, of course, to recognize that the tax considered in Austin was facially discriminatory in that no similar tax was imposed upon New Hampshire residents. Thus, the opinion may be limited to the simple proposition that an otherwise discriminatory tax may not be upheld merely because another state may by legislation eliminate the tax by imposing its own tax. However, the decision itself appears also to be grounded in the notion that New Hampshire was overreaching in imposing its tax. Certainly, the taxpayer suffered no significant harm through New Hampshire’s imposition, as the New Hampshire tax simply replaced, dollar-for-dollar, the tax that Maine would have imposed. See Justice Blackmun in dissent at 668-669; compare Private Truck Council, Inc. v. Secretary of State, 503 A.2d 214 (1986), cert. denied 476 U.S. 1129 (1986) (striking down a “third structure” flat tax imposed only on trucks registered in other states imposing a similar “third structure” tax where the purpose of Maine’s discriminatory tax was to coerce the other states to repeal these taxes).

In this regard, the taxes imposed upon the payor of a royalty or interest by the payor state could similarly be eliminated by a decision of the state in which the recipient is located to adopt a separate-company filing requirement and impose a tax at a rate sufficiently high to meet the benchmark set by the payor state. Yet, like the tax considered in Austin, there would seem to be something misdirected about a state simply imposing its tax because its sister state has a tax regime that allows for it.

Disallowing a Deduction Has the Effect of Re-Sourcing Income to the Add Back State

At the end of the day, the add back statutes may simply be viewed as a state’s attempt to allocate the income associated with the intangible asset, whether it be a loan or a trademark, into the state where the payor is located. When one considers that a state is effectively taxing income theoretically earned by another taxpayer (e.g., the lender in an intercompany loan situation), it may be argued that the add back state’s taxing system must provide for some factor representation of the recipient in addition to the unitary relationship, discussed earlier. Certainly that would be true if the state simply required the payor and the payee to file a combined report because they were unitary. The issue may be illustrated by reference to the example we described in our discussion of the requirement that there be substantial nexus with the income the add back state seeks to tax:

Recall that in this example, Company A licenses software from Company B. In year one, both are large publicly traded entities. In year two, Company A acquires more than 50% of Company B’s stock but otherwise the two large companies continue to operate independently.

In the prior discussion, we asked whether a state should be able to tax the royalty income of Company B by disallowing the deduction for A, without meeting the requirement of showing that the two businesses were engaged in a unitary relationship. Here, we pose a related question, should the state be required to provide some factor representation for B’s operation in deciding the source of the income taxed to A?

Because the taxation occurs as a result of the disallowance of A’s deduction and a tax imposed on A, the closest authority concerning this issue may be that which has arisen in the context of whether dividend income received by a taxpayer from foreign entities must be apportioned under a system that provides for factor representation for the dividend paying entities. Unfortunately, such arguments have not fared well in the courts, although the principles continue to seem unassailable to the authors. See also
Finally, it should be noted that the constitutional issues presented by the add back statutes may be readily resolved simply by adopting a combined reporting system such as that pioneered by California. Because the add back statutes have been adopted to resolve a perceived “loophole,” it seems unlikely that separate-company filing states will simply accept a return to the prior state of affairs if such statutes are successfully challenged. Thus, taxpayers should be mindful of the ultimate results a successful challenge to the statute might bring. ■

CONCLUSION

Litigation testing the new add back statutes has just begun. Attacks based upon existing Commerce Clause precedents are most likely to be directed toward the working of particular discrete exceptions rather than the general add back rules themselves. However, because the exceptions often go to the fundamental mechanics of the statutes, a successful attack on the workings of an exception may have the effect of invalidating the entire disallowance statute. See Califarm Ins. Co. v. Deukmejian, 48 Cal. 3d 805, 821 (1989) (“The final determination [whether a statute or portion thereof is severable] depends on whether the remainder . . . is complete in itself and would have been adopted by the legislative body had the latter foreseen the partial invalidity of the statute. . . or constitutes a completely operative expression of the legislative intent. . .”); Hotel Employees & Restaurant Employees Int’l Union v. Davis, 21 Cal. 4th 585, 612-13 (1999) (an “invalid part can be severed if, and only if, it is ‘grammatically, functionally and volitionally separable.’”)

An attack based upon the core issue, namely the right of a state to penalize a taxpayer for doing business with an affiliate in a state that provides a favorable tax regime, will probably require blazing new ground. Whether those types of challenges will be successful remains to be seen.


5. The definition of what constitutes an intangible expense or interest subject to disallowance varies among the statutes. For example, New Jersey requires I.R.C. section 197 amortization costs to be added back if they are attributable to an intangible asset acquired from a related member. See N.J. Div. of Taxation, Questions and Answers Regarding the Business Tax Reform Act 2002, Jan. 6, 2004, Question No. 13. Also, as illustrated by the Maryland statute, some states include losses incurred while selling receivables (factoring) to an affiliate within the definition of an intangible expense. See Ala. Code § 40-18-1(9); Conn. Stat. § 12-218c.(a)(2); Md. Code § 10-306.1a(5)(ii); Mass. Gen. Laws ch. 63 § 311a(2); Miss. Code § 27-7-17(2)(a)(i); N.J. Rev. Stat. § 54:10A-4.4(a); Ohio Rev. Code § 5733.042(A)(3); Va. Code § 58.1-302. Other states appear not to require such expenses to be added back.

6. Indeed, in some states, the exceptions provided for intangible expenses are different from those provided for interest expenses. For example, Connecticut provided different exceptions when it enacted its interest disallowance during a different legislative session than its intangible disallowance. See, e.g., Conn. Stat. § 12-218c; 2003 Conn. Acts § 78 (Spec. Session).


8. See, e.g., Conn. Dep’t of Revenue Services, Special Notice 2003(22), Jul. 8, 2004.


10. As discussed below, although New Jersey’s formula technically looks to whether the recipient is taxable at a sufficient high rate, in many cases, the payor’s New Jersey apportionment factor actually will be determinative of whether the exception applies.

11. Despite the limitation in the statutory exception, Connecticut appears to be taking advantage of an opportunity to seek relief if the recipient’s aggregate rate of tax (for all states) exceeds the benchmark. See Conn. Dep’t of Revenue Services, Special Notice 2003(22), Jul. 8, 2004. However, to obtain such relief, a taxpayer must seek relief under the state’s reasonable demand exception, which requires the taxpayer to file a petition prior to paying the tax and establish, by clear and convincing evidence, that the add back of such expenses is unreasonable. Id.


13. A variation of this exception can be found in Connecticut, Maryland, Massachusetts, Mississippi, New Jersey, New York, Ohio

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MoFo SALT
Attorney News
Welcome

Morris & Foerster’s State and Local Tax Group would like to welcome Jeffrey Terraciano as an associate in the San Francisco office. Jeff received his B.A. in history from the University of California at Berkeley in 1998 and his J.D. from the University of Michigan Law School in 2004. Since joining the firm, Jeff has worked primarily on sales and use tax and property tax issues. Jeff’s prior experience includes working as a legal assistant in the firm’s tax group and working as an extern for U.S. Magistrate Judge Richard Seeborg.

Congratulations

Carley Roberts has been appointed Vice Chair of the State and Local Tax Committee of the Tax Section of the California State Bar. The State and Local Committee is in the process of organizing quarterly update meetings that will alternate between venues in Northern and Southern California. The meetings will have two components: (1) California tax update (including both substantive and political developments); and (2) an update on developments in the remaining 49 states. The next meeting is currently being planned for mid-to-late March. The date, time and venue will be announced in the next few weeks.

Eric Coffill, Charles J. Moll, III, and Thomas Steele were included on the 2004 Northern California Super Lawyers list. The list includes the top five percent of Northern California lawyers, as ranked by their peers.

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105-130.7A(a). However, because the North Carolina statute explicitly limits its reach to income arising from the use of intangibles within the state of North Carolina, were that statute to be replicated in other states, there would not appear to be any meaningful risk of multiple taxation since each state would simply impose tax on intangible income arising from within its borders. However, such a conclusion may be overly simplistic in that it assumes that the state would not, under its general income tax principles, otherwise impose a tax on royalties received by a company doing business within the state that arise from the use of intangible property used in other states. Assuming that the general income tax does impose such a tax under those circumstances, then North Carolina’s system could be viewed as violating the internal consistency because it apparently relieves multiple taxation only where both the recipient and payor are fully taxable in the state on income earned from within the state.

We recognize that a state might well argue that the exception mechanism described in this section operates in many ways like a typical tax credit by which a taxpayer may be relieved of, say, a use tax if it proves the transaction was previously subject to a sales tax. So viewed, it is difficult to argue that the add back exception presents unsettled constitutional problems. Nonetheless, the parallel to such credit mechanisms seems incomplete. In particular, because the add back statutes are an exception to an otherwise generally allocable deduction, the add back seems directly targeted at the income that otherwise would be taxed by another state. See Hunt-Wesson, Inc. v. Franchise Tax Board, supra. Moreover, in contrast to a typical credit mechanism, as described above, the exception mechanism is not fully calibrated to the amount of tax claimed by the other state. Rather, the exception requires that the recipient state adopt a tax policy that the payor state considers acceptable (i.e., that the recipient state utilize a separate company filing regime and adopt a tax rate that this sufficiently high to discourage any advantage to locating within the recipient state). Because of these features, the add back statutes and their exceptions simply seem more intrusive on the policies of their sister states.

20 See Cano v. DaimlerChrysler, Inc., 385 F.3d 379 (6th Cir. Ohio 2004), petition for reconsideration pending (striking down as violative of the Commerce Clause Ohio investment tax credits granted to DaimlerChrysler for purchasing new manufacturing machinery and equipment during the qualifying period, provided that the new manufacturing machinery and equipment are installed in Ohio).

21 See the discussion regarding the exception that applies where the recipient is taxable on the income by the add back state or another state, supra.


In more recent decisions, the Court has acknowledged that the internal consistency test also serves to identify whether a tax is discriminatory. See Arnevo, Inc. v. Hardesty, supra; Farmer Bros. Co. v. Franchise Tax Bd., supra.

Because the add back statute seeks to impose a tax on the payor (by disallowing the deduction), who is present in the taxing state, these statutes effectively sidestep the related nexus issue, i.e., can the state impose a tax on a recipient that has no physical presence within the state? As noted, this issue is currently the subject of judicial litigation in a number of states. See AEFP Trademark, Inc. v. Tolson, supra; Lanceo, Inc. v. Dir., Div. of Taxation, supra. The two issues are, of course, related. Assuming that the add back state can establish that the income arose from sources within the state, i.e., that the state has transactional nexus with the income (and that it is fairly apportioned), there would appear to be no constitutional impediment to the add back state’s decision to collect the tax from the payor even if the tax itself may be viewed as being imposed upon the recipient. See International Harvester Co. v. Wisconsin Dep’t of Taxation, 322 U.S. 435 (1944) (based upon the fact that the earnings involved arose from within the taxing state, the Court required a corporation to pay a tax on dividends declared even though Wisconsin courts had previously construed the statute as imposing the tax on the shareholders (including out-of-state shareholders)).

In Hunt Wesson, supra, of course, the interest deduction was calibrated to income items (non business dividends) that were independent of the payment of the interest. Here the state is effectively disallowing a deduction that produces the income that the state wishes to re-source to itself. Thus, the deduction and the income items (viewed from the perspective of the recipient) are inextricably intertwined in the add back statutes, making any challenge based upon the remote-ness of the income item perplexing.

As described above, the North Carolina add back statute similarly limits relief for the payor to those cases where the payor includes the item in its income. See N.C. Gen. Stat. §§
On September 17, 2004, the Audit Division of the New York State Department of Taxation and Finance ("Division") issued revised withholding tax field audit guidelines ("Revised Guidelines"). The Revised Guidelines set forth, among other provisions, several new audit policies relating to an employer’s obligation to withhold New York personal income tax ("PIT") from compensation paid to nonresident employees who perform some or all of their services in New York. The Revised Guidelines are effective immediately and apply to all open tax years.

Although the Division has always had the statutory and regulatory authority to require employers to withhold PIT from nonresident employees who travel to New York on business, until now there was no formal audit policy in place to verify employer compliance and, as a practical matter, there was no enforcement program designed to audit the whereabouts of nonresident employees of corporations based outside of New York. With the issuance of the Revised Guidelines, that audit policy is now in place, and the Division appears poised to implement an enforcement program aimed at ensuring that foreign corporations that send nonresident employees to New York on business comply with the withholding tax laws.

THE NEW YORK WITHHOLDING TAX

Generally, any corporation maintaining an office or transacting business in New York and making payment of wages taxable under the PIT law is an “employer” for purposes of the withholding tax and required to withhold PIT on the wages paid to any of its employees who perform any services in New York. The Revised Guidelines expressly state that whether or not a corporation is a taxpayer is not determinative of whether the corporation is an employer for withholding tax purposes. For example, a foreign corporation that has employees performing services in New York, but that is exempt from taxation pursuant to Public Law 86-272, is nevertheless an employer and thus required to withhold PIT on wages paid to those employees.

In most instances, compensation that is considered wages for federal income tax withholding purposes is considered wages for PIT withholding purposes. This includes salaries, fees, bonuses, pensions, retirement payments, remuneration paid in cash or something other than cash, such as stocks, bonds, or other forms of property, and payments for services even if an employer-employee relationship no longer exists when the payment is made. In addition, a regulation provides that the Internal Revenue Code provisions, including any applicable regulations, relating to the withholding of federal income tax apply for New York withholding tax purposes.

THE DIVISION’S NEW AUDIT POLICIES

The new audit policies set forth in the Revised Guidelines primarily relate to an employer’s obligation to withhold PIT on payments of ordinary wages and certain types of deferred compensation to nonresident employees whose primary work location is outside of New York, but who may occasionally travel to New York on business. First, with respect to payment of ordinary wages, the Revised Guidelines provide that if a nonresident employee’s primary work location is outside of New York and the employee performs services in New York, the employer will be required to withhold on 100% of the ordinary wages paid to such employee unless: 1) the employee provides the employer with a Form IT-2104.1, Certificate of Nonresidence and...
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Allocation of Withholding Tax, showing the percentage of time the employee expects to work in New York during the year; 2) the employer maintains adequate records to determine the proper amount of tax to be withheld; or 3) the employer reasonably expects the employee to perform services in New York for 14 or fewer days during the tax year.

For purposes of the 14 day rule, if the employee is expected to work in New York for more than 14 days, the employer must withhold on all wages paid to the employee. If the employee is expected to work in New York for 14 or fewer days, but actually works more than 14 days in New York, the employer must withhold on wages paid to such employee starting on the 15th day. In addition, it should be noted that, even though the employer is not required to withhold PIT on wages paid to nonresident employees who perform services in New York for 14 or fewer days, the employee is required to report such wages as New York source income and pay PIT on such wages.

Further, an employer may rely on a Form IT-2104.1 submitted by an employee as long as the employer does not have actual knowledge, or a reason to know, that the Form is incorrect. The Revised Guidelines provide that an employer may not claim that it does not have a system in place to verify that the IT-2104.1s received from employees are accurate. In addition, an employer is deemed to have reason to know that Form IT-2104.1 is incorrect if a reasonably prudent person in the position of the employer would question the claims made on Form IT-2104.1. Also, an employer is deemed to have actual knowledge or a reason to know that Form IT-2104.1 is incorrect if there has been a significant change in the employee’s work assignment or the employer gives the employer information that indicates the employee has become a New York resident. Significant changes in work assignments include promotions, change in primary work location and a change in duties. The Revised Guidelines, however, do not provide any guidance regarding whose knowledge will be imputed to the corporate employer.

Second, with respect to payments of deferred compensation or the granting of nonqualified stock options (collectively, “deferred compensation”) to nonresident employees, the Revised Guidelines provide that if all or a part of an employee's deferred compensation that is considered wages for federal income tax purposes is attributable to services performed in New York, the employer must withhold on 100% of such deferred compensation income unless: 1) the employee submits a Form IT-2104.1 for the deferred compensation reflecting the proper allocation of the income; 2) the employer has a Form IT-2104.1 on file for an employee for the current year, the employee is still performing services in New York and the deferred compensation is less than $1,000,000 for the payroll period, in which case the employer may withhold based on the Form IT-2104.1 on file for the current year; 3) the employee is no longer employed by the employer or is no longer performing services in New York and the deferred compensation income is less than $1,000,000 for the payroll period, in which case the employer may withhold based on the last Form IT-2104.1 on file for the employee; or 4) the employer has adequate records to determine the proper allocation of the deferred compensation income to New York (the “Adequate Records Method”).

If an employer withholds on deferred compensation income based on the Adequate Records Method, the employer must maintain records sufficient to enable the employer to determine the percentage of services performed in New York for all of the years in which
the deferred compensation income is earned. In addition, the Revised Guidelines expressly state that the 14 day rule does not apply with respect to deferred compensation income.

THE WITHHOLDING TAX AUDIT

During any withholding tax audit under the new policies, the Division’s auditors are instructed to request that the employer provide a listing of all employees with Forms IT-2104.1 on file and a listing of each employee’s job title and work location. Moreover, as part of the new audit policies, the Division’s auditors are instructed to review the audit files relating to any prior withholding tax, corporation tax or flow-through entity audit conducted on the employer. Auditors are instructed, as part of the pre-audit analysis, to determine how the employer’s business operates, identify which functions are carried on in New York and ascertain which employees work inside and outside of New York. To develop such information, auditors are advised to review the apportionment factors on the employer’s New York corporation tax returns and to speak with auditors who have completed corporation tax audits on the employer.

Finally, the Revised Guidelines include new procedures for examining “high wage earners” from whom no PIT is withheld and who the employer claims have no nexus with New York. If the Division’s auditor believes that a highly-paid employee may be coming to New York to perform services, the Revised Guidelines provide that the auditor should select a sample period and ask the employer for documentation relating to the employee’s travel activities during the sample period. If the auditor determines that the highly-paid employee works in New York for more than 14 days a year, the auditor may recommend that a more detailed audit be performed to determine the tax that should have been withheld. The auditor may also open an individual audit case against the highly-paid employee.

CONCLUSION

The issuance of the Revised Guidelines reflects a new emphasis within the Division to verify and enforce compliance by foreign corporations with the withholding tax laws. Foreign corporations with nonresident employees who travel to New York on business are now at a much greater risk of facing a withholding tax audit, and should begin implementing procedures to accurately determine the amount of time their employees work in New York. Certainly, serious attention has to be given to highly paid individuals who regularly and consistently spend significant time in New York, and whose compensation may not have been subjected to any New York withholding.

However, strict compliance with the New York withholding tax statute and regulations may prove an administrative, and practical, impossibility. There is also an enormous and perhaps unreasonable burden associated with requiring the filing of returns by any individual who happens to visit New York on business for a few days each year. Even more importantly, consideration should be given by the Division, and by the New York City Department of Taxation, to the potential effect on the hotels, restaurants and stores, particularly in New York City, that are dependent upon the patronage of business travelers. If companies begin to feel the burden of compliance with the withholding tax laws to be too great, and institute restrictive travel policies designed to keep employees out of New York City, the local economy will suffer significantly – and such effects may significantly outweigh the small amounts of withholding tax that the new policy seeks to collect.

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1 Tax Law § 671. Effective July 1, 1999, the New York City nonresidents earning tax was repealed. Thus, compensation paid to nonresident employees who perform services in New York City is no longer subject to New York City income tax and as a result, there is no obligation to withhold New York City income tax from such compensation. See, e.g., Notice No. N-00-7 (Department of Taxation and Finance Spring 2000).

2 20 NYCRR § 1.71(b).

3 The Division recently amended the Revised Guidelines to provide that a reasonable number of training days spent in New York will not count towards the 14 days.

4 Presumably, such burdens will also fall on the Division itself and its employees, since auditors regularly visit other states with similar withholding tax laws.
Companies that deliver goods into New Jersey on their own trucks beware. New Jersey’s Division of Taxation (“Division”) Special Projects Investigators are waiting for you at New Jersey highway truck stops. Trucks, and the companies that deliver using their trucks, are the targets.

The Division’s Special Projects Investigators stop trucks, detain drivers, and impound trucks – including the contents – of companies that are suspected of not filing New Jersey Corporation Business Tax returns. If a Special Projects Investigator stops your truck, payment is demanded on the spot under law enforcement-type threats of impounding the truck and its contents – regardless of who owns the contents. Do not expect any due process before your truck is released.

The Special Projects Investigators comb the lines of trucks that are waiting at weigh stations, and have State Police in tow to back up their threats to impound trucks. They demand payment on the spot for not impounding the truck and its contents – regardless of who owns the contents. Do not expect any due process before your truck is released.

If payment is not made, the truck is impounded and the driver is left stranded at the weigh station. The companies are given no chance to argue. Your choice is whether to pay the demand or lose your truck. Companies must pay first, then challenge the assessment – contrary to the normal procedure in New Jersey that protects the right to challenge before payment is made.

New Jersey is relying on a long-existing law designed to prevent tax cheats from leaving the state and taking their money out of reach of New Jersey. That law, N.J.S.A. 54:49-7, permits the Director to make a jeopardy assessment – in effect a spot assessment, demand, and warrant execution rolled into one. However, that law permits such a jeopardy assessment only against a taxpayer that intends to quickly leave New Jersey or to remove its property from New Jersey.

When trucks enter New Jersey, they carry identifying names and numbers. Moreover, truck drivers carry bills of lading that indicate the owner of the goods and the destination. Often, the goods in the trucks are the property of a third party, and that property is being seized without any notice to its owner. The Special Projects Investigators could copy the identifying information and record the date and time of the stop. That information could be used to contact the destinations to determine the frequency of trips into New Jersey and whether the companies do more than merely deliver their goods into New Jersey. Mere delivery is a protected activity under P.L. 86-272 – the federal law that exempts solicitation and delivery activity against state net income taxes. 15 U.S.C. § 381.

With the information from the bill of lading and investigation of the destination, a nexus questionnaire could be sent to the company to determine whether the company is subject to the Corporation Business Tax. Nexus questionnaires have been in use by the Division for years. But as the Special Projects Investigators may mention, nexus questionnaires are issued by a different section of the Division.

New Jersey has chosen an aggressive path of demanding immediate payment, rather than simply asking for information regarding the frequency and nature of trips into New Jersey and pursuing the usual avenue of assessment allowing pre-payment remedies.

We hope that the Division will go back to its kinder, gentler past. Use of a secret “field formula,” spot demands for payment, and threats of impounding trucks are not the New Jersey way.

What is next for the Special Projects Investigators – waiting on airport tarmacs? ■

On August 16, 2004, California enacted a tax amnesty (“Amnesty Program”) covering both sales and use taxes and personal and corporate income taxes. The stated purpose of the Amnesty Program is to accelerate revenue as well as raise new revenue for California. The Senate Budget and Fiscal Review Committee estimated that the Amnesty Program would generate $567.8 million in revenues for the state. At the December 1, 2004, meeting of the Franchise Tax Board (“FTB”), State Controller Steve Wesley stated that the revenues expected to be generated from the Amnesty Program should solve 14 percent of the state’s budget crisis. However, while the program is expected to result in net revenue gains in 2005 and 2006, a revenue loss is projected for 2007, when the state will be required to refund early payments made by cautious taxpayers seeking to avoid the onerous penalties of the Amnesty Program.

This article describes the major provisions of the Amnesty Program, and highlights the key differences between the sales and use tax provisions and the income tax provisions. As discussed below, the legislation employs a “carrot and a stick” approach, rewarding taxpayers who participate in the Amnesty Program, and punishing some of those who don’t. The reader should be aware that, as of the date of this writing, some important issues regarding the administration of the Amnesty Program are still being decided.

THE AMNESTY PROGRAM

The amnesty period runs from February 1, 2005 to April 1, 2005, and the Amnesty Program applies to tax liabilities due and payable for tax reporting periods beginning before January 1, 2003. The legislation provides that the sales and use tax program will be administered by the California State Board of Equalization (“SBE”), and the personal and corporation income tax program will be administered by the FTB.

Relief Provided by the Amnesty Program

The primary benefit of participating in the Amnesty Program is that the SBE and FTB shall waive all penalties and fees for the tax reporting periods for which the Amnesty Program applies for the nonreporting or underreporting of tax liabilities or the nonpayment of any taxes previously determined or proposed to be determined. In addition, no criminal action will be brought against the taxpayer unless the taxpayer was already on notice that a criminal investigation had been initiated. However, no refund or credit shall be granted of any penalty paid prior to the time the taxpayer makes a request for tax amnesty.

One significant difference between the sales and use tax program and the income tax program is that taxpayers participating in the Amnesty Program may file claims for refund on sales and use tax paid but are prohibited from filing claims for refunds for franchise and income taxes paid to the extent that the taxpayer participated in the Amnesty Program. Consequently, a taxpayer entering the income tax program (unlike the sales and use tax program), relinquishes any further rights to contest the taxes paid in the income tax program. Thus, the issues involved in considering whether to participate in the income tax program are more complex than for the sales and use tax program. (See “California Tax Amnesty Considerations in a Nutshell” for an overview of relevant considerations on page 3.)

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New Penalties

Except for taxpayers who have valid installment agreements, the Amnesty Program also creates a strict new penalty for underpayment of tax existing as of April 1, 2005, regardless of whether the SBE or FTB has determined that an underpayment exists by that date. The penalty is equal to 50 percent of the accrued interest payable for the period beginning on the last date prescribed by law for the payment of that tax (determined without regard to extensions) and ending on the last day of the amnesty period. This penalty is in addition to any other penalty that may be imposed. Thus, for example, if on June 1, 2005, the FTB initiates a personal income tax audit for tax year 2001 and issues a deficiency assessment on March 1, 2006, the taxpayer would be subject to a penalty of 50 percent of the interest that accrued between April 16, 2002, and April 1, 2005, in addition to any other penalties that might have applied.

It is important to note that this 50 percent interest penalty is mandatory; there is no statutory exception to the penalty nor any provision to waive the penalty. This has obvious implications for matters that are currently pending at audit, in protest, on appeal, or in settlement, as well as for matters that have yet to be identified by the SBE or FTB. In addition, because taxpayers may not file a claim for refund on the 50 percent interest penalty, the only way to avoid the penalty appears to be to successfully defeat the underlying tax.

In addition, for underpayments of sales and use tax found to be due after April 1, 2005, for a period prior to January 1, 2003, the SBE may assess a penalty “that is double the rate of penalties described in law.” If the SBE issues a deficiency assessment under this provision, it may do so within 10 years after the last day of the calendar month following the quarterly period for which the amount is proposed to be determined. In effect, the SBE is given a limited 10-year statute of limitation for all open years prior to January 1, 2003.

In contrast, the FTB cannot issue penalties at double the rate, nor does it have a 10-year statute of limitation. However, the accuracy-related penalty is increased from 20 percent to 40 percent for any underpayments of income tax found to be due after April 1, 2005, for a period prior to January 1, 2003. This increased accuracy-related penalty rate does not apply if the taxpayer is under audit, protest, appeal, settlement or in litigation as of February 1, 2005.

In addition, if any overpayment of tax shown on an original or amended return filed under the income tax amnesty is refunded or credited within 180 days after such return is filed, no interest shall be allowed on that overpayment.

Requirements for Participation in the Amnesty Program

There are three general requirements to qualify for participation in the Amnesty Program: (1) the taxpayer must be eligible to participate in the Amnesty Program; (2) the taxpayer must file a completed amnesty application with the SBE or FTB, signed under penalty of perjury, electing to participate in Amnesty Program; and (3) within 60 days after the conclusion of the Amnesty Program, the taxpayer must file completed tax returns for all tax reporting periods for which he or she has not previously filed a tax return and file completed amended returns for all tax reporting periods for which he or she underreported his or her tax liability, and the taxpayer must pay in full the taxes and interest due for all periods for which amnesty is requested. The taxpayer also may apply for an installment agreement, to be paid in full by June 30, 2006. It is unclear whether the FTB and SBE will automatically accept all requests for installment payments, along with the terms requested. If these agencies intend to exercise discretion in accepting or rejecting these requests, it is unclear what standards they would apply in the exercise of this discretion.

The first requirement regarding eligibility is not clearly defined. It appears that any taxpayer with an open year prior to January 1, 2003, qualifies, including taxpayers currently under audit, on a petition for redetermination, in settlement or in litigation. Consistent with the statutory requirement that the process be as streamlined as possible to ensure maximum participation, it is anticipated that the SBE and FTB will take an expansive view of who is eligible. Two clear exceptions
exist for eligibility in the program: (1) taxpayers in bankruptcy, who are required to have an order of the bankruptcy court to participate in the Amnesty Program, and (2) tax violations for which a notice of criminal action has been sent to the taxpayer.

In addition, the franchise/income tax Amnesty Program does not apply to any nonreported or underreported tax liability amounts attributable to tax shelter items that could have been reported under either the FTB’s 2004 Voluntary Compliance Initiative or the IRS’s Offshore Voluntary Compliance Initiative described in Revenue Procedure 2003-11. Thus, the Amnesty Program is not intended to provide a “second bite at the apple” for taxpayers who should have entered VCI. However, inasmuch as taxpayers were required to “self-assess” their qualification for VCI, this raises issues as to the meaning of what “could have been reported under” VCI. Although we have not received confirmation from the FTB, we assume that this limitation will only apply to items such as listed transactions or other clearly identified tax shelter transactions. In addition, we believe that taxpayers should be able to put some non-listed transactions into the Amnesty Program, even if the taxpayer also has listed transactions for those same years that are barred from the Amnesty Program.

The second requirement is self-explanatory. The SBE has released its application: SBE Form 899. In addition, the FTB has released its application forms: FTB Form 2300 PIT for individuals, and FTB Form 2300 BE for businesses. These forms are relatively straightforward two-page forms.

The third requirement also is self-explanatory, in that returns must be filed or amended and all taxes and interest must be paid by May 30, 2005, except that persons entering into installment agreements have until June 30, 2006, to pay the tax and interest due.

Administration of the Amnesty Program

The SBE and FTB are required to issue forms and instructions and take other actions needed to implement the amnesty. In addition, the SBE shall adequately publicize the Amnesty Program so as to maximize public awareness of and the participation in the amnesty. The SBE shall coordinate to the highest degree possible its publicity efforts and other actions taken in implementing this article with similar programs administered by the FTB. In addition, the FTB is also specifically required to make reasonable efforts to identify taxpayer liabilities and, to the extent practicable, send written notice to taxpayers of their eligibility for the Amnesty Program. However, the FTB’s failure to notify a taxpayer of the existence or correct amount of a tax liability eligible for the Amnesty Program shall not preclude the taxpayer from participating in the Amnesty Program, nor shall such failure be grounds for abating the 50 percent interest penalty (discussed in detail above). The FTB anticipates sending out over 2 million notices to taxpayers, many of which have already been sent.

CONCLUSION

Taxpayers should carefully consider their filing strategies when assessing the impact of the Amnesty Program on any existing or potential deficiencies for periods prior to January 1, 2003, as well as the potential for deficiencies that may be assessed after April 1, 2005, for such periods. “California Tax Amnesty Considerations in a Nutshell” on page 3 provides an overview of certain considerations to be taken into account when deciding if, and how, to participate in the Amnesty Program.
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For more information, contact Paul H. Frankel at (212) 468-8034 or Thomas H. Steele at (415) 268-7039.