All is Not Lost — Favorable Recent State Corporate Income Tax Planning Developments

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A number of developments unfavorable to tax planning during this first decade of the 21st Century have tempered and challenged state corporate income tax planning. From tax shelter regulation and new penalties to legislative loophole closing, judicial challenges, and accounting changes, tax planning has been curtailed. Still, some recent developments show that taxpayers should persevere.

While these successes are welcome, tax planning must always follow economics, purposive activity and prudent consideration of penalties to avoid sham transactions. This decade has too many examples of state corporate income tax planning that did not.[1]

This article addresses two recent court decisions and one tax agency ruling that uphold (or guide) state tax planning involving investment companies, limited partnerships, royalties, and interest expense allocations. The article also touches on some of the possible planning implications. The developments also demonstrate that planning includes proactive assertion of tax-favorable return positions (or refund claims) based on the guidance that courts and state tax agencies provide, as well as structural planning.

Gone, but not forgotten

Before Texas amended its franchise tax effective for years on and after January 1, 2008, the Texas limited partnership was another old stand-by strategy of state corporate income tax planning. Those days are over in Texas and a few other states. However, a decision this summer from the New Jersey Tax Court may provide similar opportunities.

In *BIS LP, Inc. v. Division of Taxation*, No. 007847-2007 (N.J. Tax Ct. July 30, 2009), a subsidiary holding company, "S", held a 99% limited partnership interest in a New Jersey limited partnership (LP). The 1% general partner was S's parent corporation, "P". S did not, and had no right to, participate in the management of LP. S did not conduct any other activities and independently performed no activities in New Jersey. The New Jersey Tax Court held that S's interest in LP was an investment contract and did not provide substantial nexus for S in New Jersey.

New Jersey provides a Corporation Business income Tax (CBT) benefit to an "investment company." If a corporation qualifies as a New Jersey investment company, the company's CBT is measured by 40% of the company's entire net income. N.J.S.A. § 54:10A-5(d). The Tax Court first held that S's limited partnership interest constituted an investment contract and a qualifying asset as an "other security" for purposes of New Jersey's investment company tax benefit prior to the Division of Taxation's (Division) amendment of its regulation, N.J.A.C. § 18:7-1.15. Effective August 7, 2006, the Division amended the regulation to eliminate from the definition of a "qualified investment asset" an investment in a non-publicly traded pass-through entity. However, based on *Praxair Technology, Inc. v. Director, Div. of Taxation*, 404 N.J. Super. 287 (App. Div. 2008), cert. granted, 199 N.J. 130 (2009), the Tax Court ruled the regulatory amendment must be applied prospectively. As a result, S would have qualified as an investment company for the years at issue in *BIS LP*.

Regardless, the Tax Court also ruled that S did not have substantial nexus with New Jersey. The court found that S and P were separate entities. The Division's regulation that defines "doing business" in New Jersey includes "deriving receipts from sources within" New Jersey. N.J.A.C. § 18:7-1.6(a)2.vii. Even if S's distributive share of income from LP was a "business receipt," as argued by the Division, the Court held that S still did not have business activity in New Jersey sufficient for substantial nexus.

By regulation, New Jersey also characterizes a corporate limited partner as doing business in New Jersey if the limited partner is also a general partner, the limited partner takes an By regulation, New Jersey also characterizes a corporate limited partner as doing business in New Jersey if the limited partner is also a general partner, the limited partner takes an active part in the control of partnership business, the limited partner is otherwise doing business in New Jersey in its own right, or the business of the partnership and the limited partner are "integrally related." N.J.A.C. § 18:7-7.6(c). The Court had already ruled that the second and third requirements were not satisfied, and S was not also a general partner. Therefore, S could only have been doing business in New Jersey if its business and the business of LP were integrally related, and the Tax Court held that the businesses were not. The Court found S was a passive investor, since it had no right to participate in the management of LP and had no control or potential to control LP. S was not in the same line of business as LP; it was a holding company, and LP was in the data processing business. The court also relied on an example in the regulation – N.J.A.C. § 18:7-7.16, example IV – that stated a "true limited partner" who was not unitary with the limited partnership was not subject to CBT.

Thus, S was not carrying on New Jersey business activity and did not have substantial nexus with New Jersey to justify the imposition of CBT.

The planning implications are obvious, although taxpayers also should not lose sight of the investment company holding for open years prior to August 7, 2006. Nonetheless, the Division has filed a notice of appeal, and this case should be monitored as the appeal proceeds.

Sometimes, it is what isn't said that is important

In New York, royalties from the use of patents or copyrights in New York State are sourced to the New York receipts factor numerator. 20 N.Y.C.C.R. § 4-4.4(c). The regulation simply declares that a "patent or copyright is used in New York State to the extent that the activities thereunder are carried on in New York State." *Id*. Any other business receipts not described in regulations, including receipts from intellectual property that is not copyrighted, trademarked, or patented, are sourced to where the receipts are earned. 20 N.Y.C.R.R. § 4-4.6(a). But the regulation does not define where such receipts are earned.

In *Advisory Opinion*, TSB-A-09(14)C (Aug. 5, 2009), the New York Department of Taxation and Finance (Department) considered a taxpayer who owned copyrighted and trademarked artistic and literary intellectual property (IP). Some of its IP was not copyrighted or trademarked (non-protected IP), and the taxpayer licensed its IP and non-protected IP to businesses that manufacture, distribute, and sell consumer products. Licensees paid the taxpayer royalties based on their net sales and a minimum royalty guarantee.

The Department acknowledged in the Advisory Opinion that no Department regulation defines when the use of protected IP occurs in New York State or when receipts from non-protected IP are earned in New York State. The Department relied on Matter of *Disney Enterprises, Inc*., No. 818378 (N.Y. Div. of Tax Apps., Feb. 12, 2004), and applied the sourcing rule used in that case for the royalties from licenses of trademarked and copyrighted IP.2 The Department ruled that the taxpayer's IP was used where the activity that generates the royalty or licensing fee occurs. Under the facts, this was where the sales of the licensees occurred because the royalty was determined based on a percentage of their net sales. Likewise, receipts from licenses of non-protected IP were also sourced to where the licensees' sales occurred, as the Department concluded that was where the receipts were earned.

The Advisory Opinion may be more important for what it did not address or addressed only in passing:

First, the taxpayer received annual royalty reports that detailed the licensees' net sales on a retailer-by-retailer basis. Licensees were also required to maintain detailed, accurate and complete records of transactions with retailers. But the Advisory Opinion does not indicate whether the annual reports disclosed only the names and headquarters addresses of the national and international retailers or also their individual store locations inside and outside New York. According to the Advisory Opinion, "If the licensee does not provide the Petitioner with a breakdown of the locations of its sales, it is appropriate for the Petitioner to allocate the royalties it receives to the billing address of the licensee."

Second, the Advisory Opinion is silent as to how the minimum guaranteed royalty amount should be sourced. The activity generating this royalty would not appear to occur where sales of the licensees occurred.

Licensors of trademarked, copyrighted, patented IP and non-protected IP should study this Advisory Opinion and how it applies to your licensing arrangements to determine if royalties have been properly sourced for open audit years in order to identify tax exposure or refund opportunities. Favorable results from the Advisory Opinion should be considered for current filing positions and structure.

Interest expense addback and federal non-conformity

Michigan's former Single Business Tax (SBT) base, which was repealed effective December 31, 2007, was determined by starting with a taxpayer's federal taxable income (FTI). As a modified value-added tax, certain items that do not increase or decrease value added to a product, such as interest expense or income, are added-back to (for the payor of interest), or deducted from (for the recipient of interest), FTI in arriving at the SBT tax base.

Interest expenses were added back to federal taxable income if they were deducted in arriving at FTI. M.C.L. § 208.9(4)(f). Interest income was subtracted from FTI if it was included in FTI. M.C.L. § 208.9(7).

In *Aramark Service, Inc. v. Dept. of Treasury*, No. 284267 (Mich. Ct. App. Aug. 11, 2009), the taxpayer was the common U.S. parent corporation of an affiliated group of corporations that filed a federal consolidated return. Like many large corporations, the parent issued debt to third party lenders and loaned the debt proceeds to its subsidiaries. The parent paid interest expense to the lenders and allocated the interest charges to its subsidiaries. Although the decision does not specify whether the subsidiaries' payments of interest were via intercompany cash transfers or journal entries, the "interest paid by plaintiff's subsidiaries to plaintiff was interest arising solely from the subsidiaries' use of the money borrowed by plaintiff on the subsidiaries' behalf."

The parent corporation-taxpayer in *Aramark Service* also appears to have filed its Michigan SBT tax returns on a separate entity basis. Separate reporting was the standard, required filing option of the Michigan SBT unless the taxpayer was permitted or required to file a Michigan combined return.

The parent attached to its federal consolidated return pro forma separate federal income tax returns for itself and all of its subsidiaries. The subsidiaries' pro forma returns reflected the parent's third party interest expense allocation to the subsidiaries as their payment of the interest expense. The parent's pro forma return showed the total interest allocation as its interest income.

The court focused on the interest expense add-back statute's language that add-back was required "to the extent deducted in arriving at federal taxable income." Since the parent did not deduct interest expense in arriving at its federal taxable income as reported on the separate company pro forma federal tax return, the court concluded there was no interest expense to be added back to its FTI in arriving at its SBT base. The court found the statutory language was clear and unambiguous. (The subsidiaries were the parties to add-back interest expense, but they presumably were not Michigan taxpayers.) Plus, although not clear from the decision, it also appears that, since the parent included the interest allocation as its interest income on its pro forma federal return, the parent could deduct the interest income in determining its SBT tax base.

Intercompany interest expense allocations are a common corporate management and tax planning tool. The result in *Aramark* could extend beyond Michigan, including arrangements where affiliates may be joint obligors on parent debt. For Michigan taxpayers, open year Michigan SBT returns should be studied for potential refund claims.

Conclusion

States have increased their sophistication in examining corporate income tax planning, and their current grim fiscal situation only increases their aggressiveness and need for revenue. Still, the developments profiled in this article should encourage corporate taxpayers that valid planning implemented with the proper motives and substance remains a legal means to reduce taxes.