20 Years of Ambiguity in Addback Statutes

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It has been more than 20 years since Ohio enacted legislation requiring taxpayers to add back some expenses paid to related parties for state income tax purposes.[1] Since then, more than 20 states have enacted similar provisions. Those provisions are commonly referred to as addback statutes. Those statutes generally limit taxpayers from reducing their state income tax liability by deducting interest and intangible expenses paid to an out-of-state related party.

While addback statutes vary by state, they are nearly uniform in their ambiguity and lack of guidance. That has resulted in varying interpretations and applications by taxpayers. In some cases, the statutes are also constitutionally suspect. Despite their widespread infirmities, addback statutes have generated very little litigation. This article outlines the three basic components shared by all addback statutes, analyzes litigation involving those components, and explores the dearth of litigation on the subject.

A. Application of State Addback Statutes — The Three Basic Components

Before addressing the three basic components, it is important to note that addback statutes are exclusively a state income tax issue and generally arise in states that require related taxpayers to file separate state income tax returns.[2] Because most states calculate state taxable income based on federal taxable income, the types of expenses that may be captured by state addback statutes have generally already been deducted by taxpayers in calculating federal taxable income. A typical addback statute requires a taxpayer to add back to its federal taxable income some types of expenses paid to a related party unless an exception applies. Thus, state addback statutes can be separated into three components: (1) the type of expenses covered by the statute; (2) whether the expense is paid to a related party; and (3) whether an exception applies.

1. Component 1: What Type of Expense Is Covered by Addback Statutes?

Addback statutes generally apply to intangible or interest expenses paid to related parties. Although the statutes typically prevent taxpayers from realizing tax benefits from deductions for intangible and interest expenses paid to affiliated Delaware holding companies, the terms "interest expense" and "intangibles expense" often are defined so broadly that they may capture expenses other than what the addback statute intended to limit.

The Multistate Tax Commission's "Model Statute Requiring the Addback of Certain Intangible and Interest Expenses," adopted by the MTC on August 17, 2006, best illustrates the breadth of state addback definitions. The MTC model statute defines intangible expenses to include:

- expenses, losses and costs for, related to, or in connection directly or indirectly with the direct or indirect acquisition, use, maintenance or management, ownership, sale, exchange, or any other disposition of intangible property to the extent those amounts are allowed as deductions or costs in determining taxable income before operating loss deductions and special deductions for the taxable year under the code;
- amounts directly or indirectly allowed as deductions under IRS section 163 for purposes of

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[1]*See* Ohio Rev. Code section 5733.042.

[2]Recently, addback statutes have expanded to some states that require taxpayers to file combined corporate income tax returns. *See* Wis. stat. section 71.26(2)(a)(7); 35 ILCS section 5/203(E-12), (E-13).

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determining taxable income under the code if those expenses and costs are directly or indirectly for, related to, or in connection with the expenses, losses and costs referenced in (1);
- losses related to, or incurred in connection directly or indirectly with, factoring transactions or discounting transactions;
- royalty, patent, technical, and copyright fees;
- licensing fees; and
- other similar expenses and costs.[3]

While subparts (1) through (5) capture a broad array of expenses, subpart (6) creates a catchall that potentially limits the deductibility of a much broader range of expenses irrespective of the taxpayer's intent. Without further guidance narrowing the application of the "other similar expenses and costs" provision, states could use that provision to limit the deductibility of a wide array of expenses. For example, many large companies license various types of business software from unrelated third parties through a single entity, possibly the parent corporation. The parent corporation then sublicenses that software to related entities as permitted under the licensing agreement. The license of software by the parent corporation to its related entities may not be deductible under the MTC's addback statute because the license constitutes a royalty paid to a related party. Many states have similar catchall provisions.[4]

In contrast to its definition of intangible expense, the MTC defines interest expense more narrowly than do many state statutes. The MTC defines interest expense as "amounts directly or indirectly allowed as deductions under section 163 of the [IRC] for purposes of determining taxable income under the Code."[5] State definitions are similar but are often defined to include, rather than be limited to, amounts that may be deducted for purposes of determining federal taxable income.[6] That creates the same issue illustrated above: an unfettered ability of the state to potentially assert that any interest expense paid to a related entity is not deductible.

2. Component 2: Is the Expense Paid to a Related Member?

If the expense is potentially captured by the addback statute, as described above, the next step is to determine whether the party to which the expense was paid is a related member or party. While state definitions vary, generally a related member is defined as (1) a related entity (which is defined in the statute); (2) a component member as defined in IRC section 1563(b); (3) a person to or from whom there is attribution of stock ownership in accordance with IRC section 1563(e); or (4) a person that bears the same relationship to the taxpayer as a person described under (1) through (3).[7] States tend to focus on payments to affiliates that are part of the taxpayer's federal consolidated group, state unitary group, and foreign affiliates.

3. Component 3: Does an Exception Apply?

If an expense falls within the scope of the state's addback statute and is paid to a related member, the expense is not deductible unless a statutory exception applies. State addback statutes generally contain at least one, and in some cases as many as five, exceptions. However, the exceptions are often complicated, have multiple requirements, and may apply to only some types of expenses. Litigation addressing the addback statutes has primarily focused on the exceptions. Although the exceptions vary widely by state, there are some common categories. The three most common addback statute exceptions are:
- the subject-to-tax exception, which may apply when the corresponding item of income received by the related party is subject to tax in the state or another state;
- the conduit exception, which may apply when the related party paid the interest or intangible expense to an unrelated party; and
- a reasonableness exception that may apply if the taxpayer can prove that limiting the deduction is unreasonable.

Most states provide an exception if the item of income is subject to tax in a foreign country that has a tax treaty with the United States,[8] industry-specific exceptions (for example, banks or financial institutions), and an exception to the extent the additional tax required as a result of the addback would not have been incurred if the parties had been eligible to elect or had made an election to file a combined or consolidated return.[9] On their face, those exemptions may appear to be relatively easy to satisfy. However, states have made it challenging for taxpayers to satisfy the requirements.

B. Taxpayer Challenges

Despite the expansion and longevity of state addback statutes, there has been relatively little litigation involving their application. The litigation that has ensued has focused on the application of the exceptions.

1. Subject to Tax?

The most common litigated addback statute exception is the subject-to-tax exception, which is in

[3]MTC model statute section 1(a)(iv).

[4]For example, Kentucky Ky. Rev. Stat. Ann. section 141.205(1)(b)(5) defines intangible expenses to include other similar expenses and costs.

[5]MTC model statute section 2(a)(4).

[6]*See, e.g.*, Ohio Rev. Code section 5733.042(a)(4).

[7]*See, e.g.*, MTC Model Statute section (1)(a)(vii).

[8]*See, e.g.*, N.Y. Tax Law section 208(o)(2)(B)(ii).

[9]*See, e.g.*, Conn. Gen. Stat. section 12-218c(c)(3).

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almost every addback statute. The widespread presence of that exception is not surprising, given that the statutes developed as a result of states attempting to limit the deductibility of some expenses paid to related parties in order to reduce the state tax liability of the payer. However, the related-party recipient of the income may not necessarily pay tax on the corresponding income in any state. In establishing the subject-to-tax exception, states have generally agreed that if the corresponding item of income received by the related party is subject to tax in the state or another state, then the expense should be deductible. While the intent of the states in drafting that exception appears to be beneficial for taxpayers, the application of the exception has proved more challenging.

A common dispute regarding the subject-to-tax exception is whether the income received by the related party must *actually* be taxed in another state. For example, many states provide an exception from the addback requirement if the corresponding item of income is subject to tax in the same state, another state, or a foreign country. The term "subject-to-tax" is rarely defined by statute. In states where the term is undefined and the exception is not otherwise limited, the term is subject to multiple interpretations.

The term "subject-to-tax" could be interpreted to mean that the related party to whom the expense was paid is subject to the authority of another state to impose a tax. Alternatively, it could mean the related party must file a return in another state where the item of income is included in taxable income. Or it could mean the related party actually pays tax in another state. To further complicate matters, some states require the related party be subject to tax at a specific effective rate in other states or within particular percentage points of the rate imposed by the state requiring the addback.[10] Finally, other states interpret the subject-to-tax exception as not applying if the related party to whom the expense was paid files only as part of a combined return in another state. Those restrictions, limitations, and varying interpretations have created confusion and uncertainty for taxpayers.

The first court challenge to the addback statutes involved that issue. In interpreting Alabama's subject-to-tax exception, the state's court of civil appeals held that the exception should apply only if the income was *actually* subject to tax in Alabama or another state.[11] The Alabama Supreme Court upheld the decision. Alabama's addback statute provides that the corporation was not required to add back the expense if it could show that the corresponding item of income, in the same tax year, was subject to a tax based on or measured by the related member's net income in Alabama or any other state, or subject to a tax based on or measured by the related member's net income by a foreign nation that has an income tax treaty with the United States, if the recipient was a resident of the foreign nation. Under the statute, the phrase "subject to a tax based on or measured by the related member's net income" means the receipt of the payment by the related member is reported and included in income for purposes of a tax on net income and not offset or eliminated in a combined or consolidated return that includes the payer.[12]

The taxpayer argued that the subject-to-tax exception should apply if the entire federal taxable income of the related party to whom the expense was paid was subject to tax in another state regardless of the amount of the related party's income apportioned to that state. The Alabama Court of Civil Appeals disagreed and held that the related item of income must actually be taxed in the other state, thereby requiring the exception to be applied on a post-apportionment basis.[13]

More recently, Beneficial New Jersey Inc. challenged the New Jersey subject-to-tax exception.[14] The New Jersey Tax Court held that the exception did not apply because one of the five requirements of the exception — that the rate of tax on the interest received by the related member be at least 3 percentage points below the rate of tax applied to taxable interest — was not met. A regulation defined "rate of tax" as the New Jersey allocation factor (apportionment factor) multiplied by the New Jersey tax rate. The taxpayer argued that rate of tax meant the statutory tax rate. The court upheld the regulatory definition, and as a result the taxpayer did not qualify for the exception.

2. Unreasonableness (Through the State's Lens)

In many states, the unreasonableness exception provides that an expense paid to a related party will

[10]*See, e.g.*, Mass. Gen. L. section 31J(b)(iii)(C) (the related member was subject to tax on its net income in this state or another state or possession of the United Sates or a foreign nation); Md. Code Ann. Tax-Gen. 10-306.1(f)(2)(iii) (the aggregate effective tax rate imposed on the amount received by the recipient exceeds the aggregate effective tax rate imposed on the income of the payer corporation).

[11]*Surtees v. VFJ Ventures, Inc.,* 8 So.3d 950 (Ala. Ct. Civ. App. 2008), *aff'd* by *Ex parte VFJ Ventures Inc.*, 8 So.3d 983 (Ala. 2008).

[12]Ala. Code section 40-18-35(b)(1).

[13]*Surtees*, 8 So.3d 950. Even though the Alabama Department of Revenue prevailed in its interpretation and application of the exception, the Alabama Legislature amended the state's addback statute to state that the subject-to-tax exception is consistent with the decision. *See* Ala. Code section 40-18-35(b)(1).

[14]*Beneficial New Jersey Inc. v. Director, Div. of Tax'n*, No. 009886-2007 (N.J. Tax Ct. 2010).

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not be required to be added back if the taxpayer can prove the adjustment is unreasonable. The Alabama Court of Civil Appeals in *VFJ Ventures* held that the unreasonableness exception applies only when the application of the addback statute results in a tax that would be out of proportion to what could reasonably be attributed to the state.[15] The lower court held that the taxpayer qualified because the intercompany royalty payments had economic substance and business purpose. However, the appellate court rejected that interpretation and held that applying the unreasonableness exception based on a determination of business purpose and economic substance would render meaningless a separate statutory exception to the addback requirement.[16]

Conversely, the New Jersey Tax Court took a broad view of the unreasonableness exception in *Beneficial New Jersey* and allowed the exception based on a finding that the related-party loans on which interest expense was paid to a related party had economic substance.[17] The New Jersey Department of Taxation argued that the only two times a taxpayer can qualify for the unreasonableness exception are when it shows there is double taxation in New Jersey or the corporate group had a centralized cash management system. The court declined to give deference to the department's position, noting that if the State Legislature had intended such strict circumstances to qualify for the exception, it would not have drafted the statute as it did.

3. Conduit Exception

The conduit exception has also generated some litigation, and more is expected. The conduit exception may apply when the related-party recipient pays the interest or intangible expense to an unrelated third party. Also, often contains at least one additional condition. For example, New York recently enacted legislation that adds a fourth statutory requirement to the conduit exception to the royalty expense addback.[18] The statute initially required the taxpayer to show that the related member paid or incurred the amount to an unrelated person or entity during the taxable year, that there was a valid business purpose for the transaction, and that the payments are made at arm's length. The new legislation also requires that the related member be taxed on the royalty income in New York, another state or U.S. possession, or a foreign nation.[19]

In *Beneficial,* the only published challenge to the conduit exception, the New Jersey Tax Court held that the taxpayer did not meet all its requirements, including that there be a guarantee of the debt that generates the related-party payment.[20] New Jersey's conduit exception is atypical because a deduction will be permitted if the interest is directly or indirectly paid, accrued or incurred to an independent lender, and the taxpayer guarantees the debt generating the interest payment.[21] The court held that not only was the funding agreement the taxpayer offered as evidence of a guarantee executed after the relevant tax periods, but also that the agreement did not name any third-party lenders, the parties could unilaterally withdraw from the agreement, and the document did not include the word "guarantee." Also, there was no other documentary evidence of the taxpayer's role as a guarantor of the loans to third parties.

4. Constitutional Challenges

There are several potential constitutional challenges to addback statutes. First, an addback statute is clearly an indirect method for a state to impose tax on income that the state could not tax directly because it lacks nexus with the out-of-state income recipient. To circumvent nexus, the states have simply denied a deduction to the income tax payer. Second, the statutes often discriminate against interstate commerce by imposing a tax on transactions with out-of-state companies, but not transactions with in-state companies (or companies located in high-tax states). Most addback statutes have a subject-to-tax exception whereby the interest or royalty expense paid to a related member may be deducted if the corresponding item of income was subject to tax in the taxpayer's state or another state. Although application of the exception may vary, it generally results in the state tax treatment in one state depending on the activity conducted in another state. Further, the subject-to-tax exception also requires a taxpayer to examine the taxability of related income in another state to determine taxability of the income in the states where it's filing.

Finally, many of the addback statutes may also discriminate against foreign commerce by imposing tax on transactions with companies located only in specific countries. That discrimination occurs when an exception is provided only for transactions with an affiliated entity that is located in a country that has a comprehensive tax treaty with the United

[15]*Surtees,* 8 So.3d 950, affirmed by *Ex parte*, 8 So.3d 983.

[16]*Id.* The other exception requires that the taxpayer prove that the principal purpose of the transaction was not to avoid tax liability and that the related member to whom the payment is made "did not have as a principal purpose the avoidance of any Alabama tax and the related member is not primarily engaged in the acquisition, use, licensing, maintenance, management, ownership, sale, exchange, or any other disposition of intangible property, or in the financing of related entities."

[17]*Beneficial New Jersey*, No. 009886-2007.

[18]S. 2609D, A. 3009D, Ch. 59.

[19]*Id.*

[20]*Beneficial New Jersey*, No. 009886-2007.

[21]N.J.S.A. section 54:10A-4(k)(2)(I).

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States. Thus, the tax treatment in the states will vary depending on where the related-party recipient conducted business activity.

C. Why the Lack of Litigation?

There are several potential reasons why the addback statutes have been litigated infrequently. First, many of the statutes are still relatively new. Although Ohio enacted its statute in 1991, most others were not enacted until 2004 or later. With three-year income tax audit cycles, extensions of federal statute of limitations, lack of state resources and auditors, and review by administrative appeals spanning many years, we believe that most of the litigation is percolating. We anticipate increased litigation in the next four to six years.

Another reason for the lack of litigation is that states have disallowed related-party deductions on grounds other than relying on addback statutes. For example, *Kimberly-Clark Corp v. Comm'r of Revenue*, No. 11-P-632 (Mass. App. Ct. 2013), involved tax years both before and after the addback statute was enacted. The court denied a deduction for interest paid to a related party for all the tax years, finding that the debt on which the interest was accrued was not true or bona fide debt. Therefore, the court never had to address the validity of the addback statute or the exceptions.

States have also used other mechanisms to effectively deny related-party deductions. In many separate reporting states, the department has discretionary authority to require affiliated corporations to file a combined return. Some states limit that authority, but in other states, like North Carolina, the department historically had nearly unlimited discretionary authority to force a combined return.[22] The department used that discretionary authority to combine taxpayers filing in the state with out-of-state affiliated members that had been formed to hold and manage intangibles. The department generally asserted that a forced combination of the entities was necessary to reflect the taxpayer's true earnings. Challenges to the department's authority were often unsuccessful.[23]

Even states that have enacted addback statutes have continued to assert nexus over out-of-state intangible holding companies. For example, earlier this year the Maryland Court of Special Appeals held that two out-of-state affiliates of a Delaware-headquartered company had nexus in Maryland by engaging in a unitary business with their in-state parent company.[24] The case is currently on appeal to the Maryland Court of Appeals.

Other states have been less successful in their attempts to assert nexus over out-of-state affiliates. The Oklahoma Supreme Court held that the payments related to the use of intangibles a Vermont insurance company received from an Oklahoma-affiliated taxpayer did not create sufficient nexus for the Vermont company for Oklahoma corporate income tax purposes.[25] The insurance company was established under the laws of Vermont to insure various risks of Wendy's Corp. and its affiliates. The insurance company also held and managed Wendy's intellectual property and licensed the use of that property to affiliated entities. The Oklahoma Supreme Court, citing *Quill*, held that "due process is offended by Oklahoma's attempt to tax an out-of-state corporation that has no contact with Oklahoma other than receiving payments from an Oklahoma taxpayer (Wendy's International) who has a bona fide obligation to do so under a contract not made in Oklahoma."

Finally, the addback statute litigation may be limited because taxpayers are unwilling to risk the usual hazards of litigation. State courts in many states often prove to be unfavorable venues for taxpayers. States must weigh the cost and benefits of litigation, including the risk of an unfavorable application and interpretation of its addback statutes, which could result in significant revenue loss.

Conclusion

While addback statutes have created considerable uncertainty and confusion for taxpayers, we expect more litigation. As states continue to broadly apply those statutes to transactions that were engaged in for a legitimate business purpose, taxpayers will continue to challenge application of the addback statutes. ✰

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[22]For a discussion of forced combination, *see* Jonathan A. Feldman and Madison J. Barnett, "Using the Force to Combine in Separate Return States," *State Tax Notes*, Sept. 5, 2011, p. 649.

[23]*See, e.g., Delhaize America Inc. v. Lay*, 731 S.E.2d 486 (N.C. Ct. App. 2012).

[24]*Comptroller of the Treasury v. Gore Enterprise Holdings Inc.*, 209 Md. app. 524 (Md. App. 2013) (*cert. granted* Ct. Apps. Md. 2013).

[25]*Scioto Insurance Company v. Oklahoma Tax Commission*, 279 P.3d 782 (Okla. 2012) (rehearing denied June 11, 2012).

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