For Challenges to the Addback Statutes

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Maryland taxable income, which is generally defined as the corporation’s federal taxable income, as modified. See Md. Code sections 10-102, 10-301, and 10-304(1). With the enactment of its addback statute, one of the modifications is a requirement that taxpayers add back the following expenses when calculating their Maryland income:

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

Md. Code section 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 section 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,” and a licensing fee, as well as any other similar cost or fee. Md. Code section 10-306.1(a)(5).4 “Related members” include stockholders and entities related to them within the meaning of Internal Revenue Code section 318 that own at least 50 percent of the taxpayer’s outstanding stock, component members within the meaning of IRC section 1563, and persons to or from whom there is an attribution of stock ownership within the meaning of IRC section 1563. See Md. Code section 10-306.1(a)(8)-(9).

In contrast to this typical model, North Carolina’s addback statute takes a slightly different tack. Instead of disallowing the expense itself (essentially on a preapportioned basis), the North Carolina statute targets only royalty payments received for the

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3 For an overview of these statutes, see also Hellerstein and Hellerstein, State Taxation, para. 7.13[3] (2004 Cumm. Supp. No. 2).

4 The definition of what constitutes an intangible expense or interest subject to disallowance varies among the statutes. For example, New Jersey requires IRC 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 of 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 section 40-18-1(9); Conn. Stat. section 12-218c(a)(2); Md. Code section 10-306.1(a)(5)(ii); Mass. Gen. Laws ch. 63 section 31(a)(2); Miss. Code section 27-7-17(2)(a)(i); N.J. Rev. Stat. section 54:10A-4.4(a); Ohio Rev. Code section 5733.042(A)(3); Va. Code section 58.1-302. Other states appear not to require such expenses to be added back.
use of trademarks in North Carolina and treats all those payments effectively as taxable income derived from doing business in the state. See N.C. Gen. Stat. section 105-130.7A(a). In the event both the payer and the recipient of the royalties are related members, the payments may either be (a) included in the income of the recipient and deducted by the payer or (b) added back to the income of the payer and excluded from the income of the recipient. See N.C. Gen. Stat. section 105-130.7A(a). Thus, North Carolina effectively allocates to the state all royalties relating to the 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 addback statutes. Although the scope and requirements of these exceptions vary between the states, the types of exceptions found in the addback 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 some 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, some of the addback 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 addback 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 addback 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 more of a summary format.

The recipient is taxable on the income by the addback state or another state.

Although the specific form of this exception varies from state to state, several states allow taxpayers to avoid the addback 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 addback.

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 section 58.1-402(B)(8)(a)(1), (9)(a)(4)(i); see also Ark. Code section 26-51-423(g)(1)(A). The instructions to its 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).

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 4 percent (see Md. Code section 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 3 percentage points. See 2003 Conn. Acts section 78(c) (Spec. Session); Conn. Department of Revenue Services, Special Notice 2003(22), July 8, 2004 (Connecticut’s statutory rate of tax is 7.5 percent; therefore, the taxpayer “must establish that the interest paid to the related member was actually taxed at a rate no less than 4.5%” (7.5 percent minus 3 percent)); Mass. Gen. Laws ch. 63 section 31J. Finally, New Jersey ties its benchmark to the rate of tax applicable to the payer, by requiring the rate of tax applicable to the recipient to be equal to or greater than the rate of tax applied to the payer less 3 percentage points. See N.J. Rev. Stat. section 54:10A-4(k)(2)(I).

The Recipient’s Tax Burden. The second variant is the method used to calculate the recipient’s tax burden to determine whether it has met the benchmark. Several factors affect this calculation. First, the formula itself differs. Connecticut’s statute focuses on the amount of tax the recipient actually pays, and thus determines the recipient’s rate of tax by dividing the

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5. 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.


9. 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 payer’s New Jersey apportionment factor actually will be determinative of whether the exception applies.
amount of tax paid (after credits have been applied) by the recipient’s taxable income before apportionment and net operating loss carryforwards. See Conn. Department of Revenue Services, Special Notice 2003(22), July 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 section 10-306.1(a)(4); N.J. Reg. 18:7-5.18(a).viii. As illustrated in the following example, New Jersey similarly considers the state’s statutory rate of tax and the apportionment percentage, but does so for both the payer and the recipient.

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

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

Thus, a taxpayer will meet this benchmark as long as its New Jersey apportionment factor is 33 percent 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 addback statutes consider only 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. Department of Revenue Services, Special Notice 2003(22), July 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 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 section 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, $25 of which is eliminated because it is a transaction among members of a combined report. Also suppose that Company A has 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 0.6), 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 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 section 10-306.1(a)(2). New Jersey and Connecticut, on the other hand, consider only the rate of tax paid to one state. See N.J. Rev. Stat. section 54:10A-4(k)(2)(I); Conn. Department of Revenue Services, Special Notice 2003(22), July 8, 2004.

Relief From the Addback. The third variant that comes into play is the manner in which relief is provided once the payer has proved that the recipient was taxable on the associated income. In most cases, this exception is essentially binary: If the recipient is taxed at rate 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 payer obtains no relief. See Ark. Code section 26-51-423(g)(1); N.J. Rev. Stat. section 54:10A-4(k)(2)(I); Md. Code section 10-306.1(c)(3)(ii); 2003 Conn. Acts section 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 in which the tax imposed by another state reduces the tax imposed on the taxpayer claiming the credit on a dollar-for-dollar basis.

However, Alabama’s exception allows relief from the addback statute on a sliding scale. More specifically, Alabama requires taxpayers to addback 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

10 Despite the limitation in the statutory exception, Connecticut explicitly provides an opportunity to seek relief if the recipient’s aggregate rate of tax (for all states) exceeds the benchmark. See Conn. Department of Revenue Services, Special Notice 2003(22), July 8, 2004. However, to obtain such relief, a taxpayer must seek relief under the state’s reasonableness exception, which requires the taxpayer to file a petition prior to paying the tax and establish, by clear and convincing evidence, that the addback of those expenses is unreasonable. Id.
of income in post-allocation and apportionment income reported to the taxing jurisdiction." Ala. Admin. Code r. 810-3-35-.02(2)(g). 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 percent of its income to separate-company-filing states, the taxpayer is required to add back only 95 percent of its intercompany interest and intangible expenses. See Ala. Admin. Code r. 810-3-35-.02(3)(g)(1).

Several states have attempted to limit their addback statute to address only pure intangible holding company structures.

In contrast to the exceptions described above, the other exceptions typically found in addback 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 when 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 section 78(c) (Spec. Session); Mass. Gen. Laws ch. 63 section 31J(b); N.J. Rev. Stat. section 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 section 26-51-423(g)(1)(A); Conn. Department of Revenue Services, Special Notice 2003(22), July 8, 2004; Va. Code section 58.1-402B(8).

The recipient is not an intangible holding company.

Several states have attempted to limit their addback statute to address only pure intangible holding company structures.12 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.” See Ala. Code section 40-18-35(b)(3); see also Miss. Code section 27-7-17(2)(c)(i)(i) (providing a similar exception where the recipient’s primary business is not related to intangibles).

Virginia provides an exception to its intangible addback 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 section 58.1-402B(8)(a)(2).

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

Certain addback statutes provide an exception for members of specified industries, presumably in recognition that these 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 addback statute for interest paid by a bank to a bank. See Md. Code section 10-306.1(c)(3)(i). Virginia also provides an exception to its interest expense addback 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 section 58.1-402B(9)(a). Connecticut has a special exception for insurance companies, hospitals, and medical service corporations. See 2003 Conn. Acts section 78(c) (Spec. Session); Conn. Department of Revenue Services, Special Notice 2003(22), July 8, 2004.

Numerous states provide an exception when the income passes through the recipient to a unrelated party.

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 a unrelated party.13 For example, Maryland’s statute provides that the addback 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 tax year. Md. Code section 10-306.1(c)(3)(i). New Jersey’s exception to its interest addback statute is more narrow in that it requires that the payer also guarantee the debt for the conduit exception to apply. See N.J. Rev. Stat. section 54:10A-4(k)(2).

The payer 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 addback


12 A variation of this exception can be found in Alabama, Mississippi, and Virginia. See, e.g., Ala. Code section 40-18-35(b)(3); Miss. Code section 27-7-17(2)(c)(ii); Va. Code section 58.1-402B(8)(g)-(9).

The result reached is unreasonable.

Finally, most addback statutes also contain a catch-all exception that allows the tax authorities and the taxpayer to override the addback in which 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 establishing that conclusion prior to filing its tax return. See, for example, Conn. Department of Revenue Services, Special Notice 2003(22), July 8, 2004 (construing 2003 Conn. Acts section 78(d)(1) (Spec. Session) and indicating that evidence that the addback 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 percent 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. On the other hand, Alabama suggests that the taxpayer must show that the application of the addback statute causes the tax to bear no fair relationship to the taxpayer’s Alabama presence. See Ala. Admin. Code r. section 810-3-35-.02(3)(b).

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 section 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 addback rule, some of the addback 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 in which the deduction is allowed if the recipient is subject to tax on the corresponding income. Whereas that exception eliminates the payment from the payer’s income (that is, 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 payer’s income as a result of the Connecticut addback statute. See 2003 Conn. Acts section 78(f) (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 addback provision] or other similar provision in this chapter.” N.Y. Tax Law section 208(9)(o)(3). Moreover, North Carolina’s regime effectively reaches the same result by giving the payer and the recipient the choice of which entity is to report the income. See N.C. Gen. Stat. section 105-130-7A(a), (c).

Most addback statutes also contain a catch-all exception that allows the tax authorities and the taxpayer to override the addback in which the disallowance of the deduction is ‘unreasonable.’

Maryland’s relief measure goes further and eliminates the payment from the recipient’s income if that payment has been subject to Maryland’s or another state’s addback 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 section 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 addback statutes, we focus on the first three of those prongs: namely, whether the state has substantial nexus; whether the royalty addback statutes discriminate against interstate commerce; and whether the taxes produced by the addback statutes are fairly apportioned.

Substantial Nexus

The requirement of the Commerce Clause of the U.S. Constitution 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 Corp. v. North Dakota, 504 U.S. 298 (1992). Recently, however, states have

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began to challenge the fundamental assumption that the physical presence standard is applicable to taxes other than sales and use taxes — for example, 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. Director, 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). (For the North Carolina Court of Appeals’ decision in A&F Trademark, see Doc 2004-23413 or 2004 STT 239-18. For the New Jersey Tax Court’s decision in Lanco, see Doc 2003-23197 or 2003 STT 209-13.)

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 when the state seeks to measure a corporate taxpayer’s income by reference to the income of other corporations (that is, 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 Halliburton Oil Well Cementing Co. v. Reily, 373 U.S. 64 (1963). Thus, a state may not impose a heavier tax burden on 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 instate entities. See Armco Inc. v. Hardesty, 467 U.S. 638 (1984); Fulton Corp. v. Faulkner, 516 U.S. 325 (1996). (For the U.S. Supreme Court’s decision in Fulton Corp. v. Faulkner, see Doc 96-5316 or 96 STN 36-42.)

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. 3d 476 (1979), 976 (2003), cert. denied, 540 U.S. 1178 (2004). (For the California Court of Appeal’s decision in Farmer Bros., see Doc 2003-12776 or 2003 STT 101-14.) In other words, if a state moves to eliminate double taxation of income (for example, 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 in which intrastate commerce would bear a single tax burden. See Armco 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.

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**When the multiple taxation arises from a conflict in the tax systems of different states, the Commerce Clause is unlikely to provide relief.**

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 on 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). (For the Supreme Court of Pennsylvania’s decision in Philadelphia Eagles, see Doc 2003-10749 or 2003 STT 84-20. For the Supreme Court of Pennsylvania’s decision in Northwood Constr., see Doc 2004-17811 or 2004 STT 175-19.) However, broadly viewed at least, the external consistency requirement operates in coordination with the requirement (often expressed in due process terms) that a state must 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, when the multiple taxation arises from a conflict in the tax systems of different states, the Commerce Clause is unlikely to provide relief. See, for example, Moorman Mfg. Co. v. Bair, 437 U.S. 267 (1978) (approving 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 account-
ing); 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). (For the New York Court of Appeals’ decision in Zelinsky, see Doc 2005-25309 or 2003 STT 228-10.) 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 when 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 Addback Statutes**

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

**Substantial Nexus**

Any challenge based on 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.16 See Hunt-Wesson Inc. v. Franchise Tax Board, 528 U.S. 458 (2000).17 (For the U.S. Supreme Court’s decision in Hunt-Wesson, see Doc 2000-5169 or 2000 STT 36-58.) Thus, while a state generally has broad license to determine what expenses are to be deductible from income when 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 addback statutes based on such an argument, prevailing on that position would be an uphill battle. As described above, the constitutional standard governing this issue was established in Allied Signal v. Director, Division of Taxation. Under that decision, a state must simply demonstrate that the income is from operational sources rather than investment sources, a standard that appears readily met in most cases. Allied Signal, of course, did not deal with a factual pattern such as those triggering the addback statutes, in which 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 payer and the recipient in order to compute the payer’s income by reference to the recipient’s income. Again, however, one would expect that in most cases a state would have little problem in establishing a unitary relationship between the recipient and the payer. 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 not likely to represent a significant hurdle in most cases. See Container Corp. of Am. v. Franchise Tax Bd., supra.

Nonetheless, there may be cases when 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 percent 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 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 Addback State**

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

Suppose for example, that Company A and Company B are both located 100 percent in Connecticut. Suppose further that Company A pays a $100 royalty to Company B and that the addback statute would otherwise apply to this payment. Under 2003 Conn. Acts section 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 addback statute.

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

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16 Because the addback statute seeks to impose a tax on the payer (by disallowing the deduction) who is present in the taxing state, these statutes effectively sidestep the related nexus issue—that is, can the state impose a tax on a recipient that has no physical presence within the state? As noted, this issue is the subject of judicial litigation in a number of states. See AD&T Trademark Inc. v. Tolson, supra; Lanco Inc. v. Dir., Div. of Taxation, supra. The two issues are, of course, related. Assuming that the addback state can establish that the income arose from sources within the state—that is, 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 addback statute’s provision to collect the tax from the payer even if the tax itself may be viewed as being imposed on the recipient. See International Harvester Co. v. Wisconsin Department of Taxation, 322 U.S. 435 (1944)) (based on 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)).

17 In Hunt-Wesson, of course, the interest deduction was calibrated to income items (nonbusiness 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 item (viewed from the perspective of the recipient) are inextricably intertwined in the addback statutes, making any challenge based on the remoteness of the income item perplexing.
Connecticut’s tax regime appears to violate the Commerce Clause in this case because the transaction between A and B is taxed but 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. 2003); Farmer Bros. Co. v. Franchise Tax Bd., supra (applying the internal consistency clause to transactions between two different taxpayers).18 (For the North Dakota Supreme Court’s decision in D.D.I, see Doc 2003-5988 or 2003 STT 47-27.)

Benchmarking the Recipient’s Tax Burden By a Single State

At least two states, Connecticut and New Jersey, condition their exception to the addback 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 percent 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 addback statute, because B does business in all four states, the benchmark is not met.

A tax discriminating against one form of interstate commerce over another (that is, between business operations conducted in multiple states rather than a single state) would certainly seem to be the type of tax prohibited by the Commerce Clause, although the authors are not aware of any authority directly addressing the issue. However, such a notion draws inferential support from the Supreme Court’s decision in Kraft General Foods v. Iowa Department of Revenue & Finance, 505 U.S. 71 (1992), in which the Court struck down a tax scheme that favored domestic commerce over foreign commerce. In so doing, the Court made it clear that the absence of a benefit for local commerce does not excuse an otherwise discriminatory tax. Rather, it is the effect on the commerce generally (in that case providing a more favorable dividend deduction for domestic dividends than for foreign dividends) that determines whether the system offends the Commerce Clause. Cf. Haliburton Oil Well Cementing Co. v. Reily, 373 U.S. 64, 72 (suggesting that Commerce Clause protections are intended to protect taxpayers from having to make uneconomic decisions to concentrate or disburse business operations based on state tax laws).

Discrimination in Favor of Foreign Commerce

It would appear that a challenge might also be possible against addback statutes that favor foreign commerce over domestic commerce, although the authority for any such challenge is considerably less clear. The Connecticut addback 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 payer need not add back the royalty regardless of the rate of taxation imposed on the recipient. See Conn. Department of Revenue Services, Special Notice 2003(22), July 8, 2004. In contrast, when the royalty is paid to a domestic entity, the payer must show that the recipient is taxed on the item at a tax rate in excess of Connecticut’s tax rate minus 3 percent to qualify for the exception to the addback requirement. See 2003 Conn. Acts section 78(c) (Spec. Sess.). Arguably, providing a more favorable tax deduction for foreign commerce may be viewed as unconstitutional discrimination against domestic commerce.

It would appear that a challenge might also be possible against addback statutes that favor foreign commerce over domestic commerce.

As noted, there is authority establishing that domestic commerce may not be favored over foreign commerce. See Kraft Gen. Foods v. Iowa Department of Revenue and Fin., supra. However, we are not aware of any 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, since 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 on the Recipient’s Presence In a State With a Favorable Tax Regime

Perhaps the most fundamental constitutional question presented by the addback statutes is whether a state, by its tax regime, may effectively penalize a taxpayer for doing business with an affiliate that operates in another state with a favorable tax regime.19 A taxpayer bringing such a challenge must largely

18 As described above, the North Carolina addback statute similarly limits relief for the payee to those cases where the payee includes the item in its income. See N.C. Gen. Stat. section 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, that conclusion may be overly simplistic because 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 which 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 internal consistency because it apparently relieves multiple taxation only when both the recipient and payer are fully taxable in the state on income earned from within the state.

19 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 addback exception presents unsettled constitutional problems. Nonetheless, the parallel to such credit mechanisms seems incomplete. In particular, because the addback statutes are an exception to an otherwise generally allocable deduction, the addback 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 payer state considers acceptable (i.e., that the recipient state utilize a separate-company filing regime and adopt a tax rate that is sufficiently high to discourage any advantage to locating within the recipient state). Because of these features, the addback statutes and their exceptions simply seem more intrusive on the policies of their sister states.
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.\footnote{But see Cuno v. DaimlerChrysler Inc., 383 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). (For the U.S. Sixth Circuit’s decision in Cuno, see Doc 2004-17647 or 2004 STT 173-28.)} Consider the following example:

Suppose that Company A is located 100 percent in Connecticut and borrows all of its capital from Company B, located 100 percent 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 New York tax rate of 7.5 percent, 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 percent. 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 policymakers, 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 when Company B simply decides to move to Nevada, which currently forgoses 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 when the recipient is operating in a tax-favored jurisdiction?

**Perhaps the most fundamental constitutional question presented by the addback statutes is whether a state, by its tax regime, may effectively penalize a taxpayer for doing business with an affiliate that operates in another state with a favorable tax regime.**

While Connecticut may be expected to argue that its addback 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 those 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 not aware of any direct authority for supporting a challenge on this theory. However, the addback statutes may be generally compared with 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:

[T]he 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 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 on 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 those taxes).

In this regard, the taxes imposed on the party of a royalty or interest by the payer 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 payer state. Yet, as with 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 Addback State**

At the end of the day, the addback 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 payer is located. When one considers with the intangible asset, whether it be a loan or a trademark, viewed as a state’s attempt to allocate the income associated with factor representation for the dividend-paying entity. 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, 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?

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 percent 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 Hellerstein and Hellerstein, *State Taxation*, para. 9.15[4][a] (2004 Cumm. Supp. No. 2).

**Conclusion**

Litigation testing the new addback statutes has just begun. Attacks based on existing Commerce Clause precedents are most likely to be directed toward the working of particular discrete exceptions rather than the general addback 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 *Calfarm Ins. Co. v. Deukmejian*, 48 Cal. 3d 805, 821 (1989) (“The final determination of 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’”).

**Taxpayers should be mindful of the ultimate results a successful challenge to the statute might bring.**

An attack based on 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.

Finally, it should be noted that the constitutional issues presented by the addback statutes may be readily resolved simply by adopting a combined reporting system such as that pioneered by California. Because the addback 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 those statutes are successfully challenged. Thus, taxpayers should be mindful of the ultimate results a successful challenge to the statute might bring.

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21 See the discussion regarding the exception that applies when the recipient is taxable on the income by the addback state or another state, *supra*.