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by Don Griswold

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Don Griswold works to encourage informed public discourse about the social justice implications of state and local tax policy. Previously, he worked as a *Fortune* 10 conglomerate's executive tax counsel, a Big Four accounting firm's national partner in charge of state tax technical services, a nationwide SALT litigation partner with two AmLaw 100 firms, and an adjunct professor of tax at Georgetown University Law Center.

In this installment of Just SALT — part 3 of his six-part series on corporate income tax avoidance in the states — Griswold illustrates "siphoning" strategies and reminds readers that the most effective state countermeasure is true unitary combined reporting.

State corporate income tax (CIT) avoidance, estimated to cost the public $17 billion a year,[1] is the dominant segment of a larger corporate state and local tax planning industry that reduces other tax revenue as well. Sales and use tax (SUT) strategies include "drop kicks" (seller contributes assets to a NewCo and sells the stock — not subject to SUT — to buyer, who then liquidates NewCo and keeps the assets)[2] and "kickbacks" (company shares its big city tax "savings" with a low-rate tax haven town in exchange for setting up a sham purchasing office in that town).[3] The latter, a type of "procurement company" structure, may be used to escape CIT as well, and will be illustrated in part 4 of this series at Figure 12.

A state personal income tax avoidance strategy made infamous in the wake of the Pandora Papers exposé last fall[4] — incomplete non-grantor trusts built on the nexus isolation and asset placement building blocks discussed in part 1 of this series — also helps the rich and superrich duck their creditors and their federal gift tax obligations. Real estate transfer taxes have been dodged with drop kicks,[5] state unemployment taxes with "SUTA dumping,"[6] real property taxes with asset stashing,[7] and tobacco taxes with old-fashioned cross-border smuggling.[8] Unclaimed property liabilities — which are not strictly taxes but are typically handled in corporate tax departments because planners there find willing buyers — have been

[1] Richard Phillips and Nathan Proctor, "A Simple Fix for a $17 Billion Loophole: How States Can Reclaim Revenue Lost to Tax Havens," Institute on Taxation and Economic Policy (ITEP) (Jan. 2019). The lost revenues are itemized by state in Table 5 at p. 15.

[2] Bruce P. Ely, William T. Thistle, and Michael W. McLoughlin, "Recent Developments in State Taxation of Pass-Through Entities and Their Owners," WG&L, at 15 (2010).

[3] Gregory Karp, "RTA Sues American Airlines Over Fuel Sales Tax Practices," *Chicago Tribune*, Mar. 12, 2014.

[4] *See* Will Fitzgibbon and Asraa Mustufa, "Another President Under Investigation, U.S. Condemned as Tax Haven by European Parliament as Pandora Papers Fallout Continues," International Consortium of Investigative Journalists, Oct. 22, 2021; and Elaine Segarra Warneke, Tiffany Christiansen, and Annette Kunze, "Legislative Proposal C — Taxation of Income From an Incomplete Gift Non-Grantor (ING) Trust" (2021).

[5] E.J. Dionne Jr., "New York Closes Loophole in City Realty Transfer Tax," *The New York Times*, Aug. 8, 1981 (after the skyscraper atop New York's Grand Central Terminal was sold transfer tax free).

[6] Albert Crenshaw, "Firms Boost Use of Ploy to Reduce State Taxes," *The Washington Post*, Dec. 26, 2003 (the tax avoider company — with a poor "experience rating" and thus a high state unemployment tax act tax rate for firing too many employees — creates a NewCo, qualifying it for the lower "new employer rate," and transfers old employees to the NewCo).

[7] Joseph K. Eckert, Robert J. Gloudemans, and Richard R. Almy, *Property Appraisal and Assessment Administration* 83 (1990). The "income approach" to appraising value, described here, may be manipulated by separating the real property from intangibles (like a hotel's trade name) that are central to the property's projected income stream.

[8] Jerry Markon, "Feds Begin Crackdown on Cigarette Smuggling," *The Washington Post*, May 18, 2003.

escaped by numerous retailers using "gift card companies."[9]

The Six S's of CIT Planning

Planners at various firms have varying names for similar strategies. Some names used in this series — like Naked Delaware holding company, East-West Split, Procurement Co, Captive REIT, and Factor Co — are in nearly universal circulation among SALT professionals, whether they work in the corporate, government, or advisory communities. For other strategies, the diagrams will be immediately recognizable for most players in the CIT avoidance industry, even if the names selected — like The Entrepreneur, Stuffed Substance IHC, Natural "In Lieu" Operations Shelter, and Financial Warehouse — are perhaps more adviser-specific.

To help state tax auditors and policymakers get inside the heads of CIT-avoidance planners, I have organized a selection of common CIT-circumvention strategies into six family groups: siphoning, stripping, straddling, stuffing, stashing, and secreting (the Six S's). Here in part 3, siphoning strategies will be described and illustrated. It may be useful at this point for readers to look back at the Legend (Figure 1) in part 1 of this series[10] to recall the meaning of the shapes and abbreviations used in the forthcoming illustrations.[11]

Siphoning

Strategies that act like a siphon — sucking tax base out of a corporate entity that is subject to a state's tax jurisdiction and spitting it into an entity located somewhere safe (a jurisdiction where the recipient entity is subject to little or no tax) — are common in CIT planning. Innovative planners build these strategies with multiple building blocks,[12] including nexus isolation, asset placement, transfer pricing, and apportionment engineering. For a time, they were also built on the foundation of a notorious U.S.-based tax haven.

Delaware has long been on the shortlist of shameless tax haven states that "cannibalize"[13] their sister states' tax bases in exchange for large quantities of small fees charged by in-state service providers. The Delaware holding company (DHC) — exempting royalties, interest, and other intangibles-based income from tax[14] — was the first structural CIT-avoidance strategy to be commodified by the Big 4 accounting firms. By the time the South Carolina Supreme Court released its decision[15] outing Toys R Us for setting up a DHC, the strategy was relatively common, but in the decade following that 1993 decision, its use exploded. The DHC (explained and illustrated immediately below at Figure 5) became "the little black dress" that Big 4 advisers wore to every CIT-avoidance party.

Naked DHC and Turbocharged IHC

Figure 5 illustrates side by side the classic RoyaltyCo based on a DHC and a "turbocharged" variant loaning the royalty receipts right back up to the parent. These are but two of the almost endless variations on this theme.

RoyaltyCo: The first siphoning strategy that jumped to nationwide attention in state tax circles has stayed in the state tax limelight for decades. The best-known CIT avoider of all time was once the dominant chain retailer of children's toys: Toys R Us, whose "Geoffrey the Giraffe" mascot adorned the backlit glass sign above store entryways, beckoning to children who gleefully dragged their tired parents behind them.

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[9] *French v. Card Compliant*, Del. S. Ct. Case No. 327, 2019; and Joe Carr, Nick Boegel, and Michael Kenehan, "Unclaimed Property: Who Ate My Gift Card Balance?" BDO US LLP, at 23 (2016).

[10] Don Griswold, "Innovation Principles for Multistate CIT Planning — Part 1," *Tax Notes State*, May 16, 2022, p. 729.

[11] Please recall as well that no nonpublic information is identified to any specific person or entity in this series of articles.

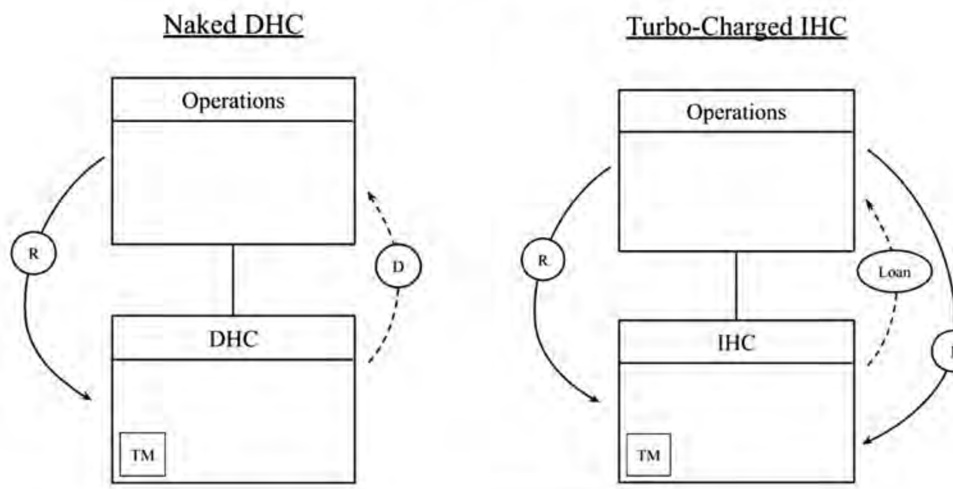
[12] Griswold, *supra* note 10, at 732.

[13] Daniel Hemel, "South Dakota's Tax Avoidance Schemes Represent Federalism at Its Worst," *The Washington Post*, Oct. 7, 2021.

[14] Del. Code Ann. tit. 30, section 1902(b)(8).

[15] *Geoffrey v. South Carolina*, 437 S.E.2d 13, 313 S.C. 15 (1993).

Figure 5.
Naked Delaware Holding Company



Toys R Us restructured its operations in 1984 to sidestep its state corporate income tax responsibilities around the country. Boiled down to its essence, the strategy was simple: Start with a historically typical structure (a single entity owns both the trademarks and the stores that use them), create a NewCo subsidiary to acquire and hold that intellectual property (the trade names "Toys R Us" and of course "Geoffrey"), organize that NewCo in a tax haven state that promises by statute not to tax it (Delaware, the king of domestic tax havens, obliged with its DHC law), try to make sure the DHC would not be subject to state CIT jurisdiction anywhere else (the power to tax elicits the power to avoid), and then contribute the trade names to the NewCo in a routinely available tax-free manner.[16]

Suddenly, Operations Co. (OpCo, the company running the stores) no longer owned critical assets that encouraged kids to drag their parents into its stores (not any old toy store, but specifically the local Toys R Us). Those assets were the multicolored company logo and that adorable cartoon giraffe. OpCo would have to pay for its use of assets that it no longer owned; it would have to pay the DHC (cheekily named Geoffrey) a royalty in exchange for a license to use the IP that it once owned. The royalty would be based on a percentage of net sales.

Using the CIT avoidance building blocks of asset placement, nexus isolation, shelter entities, and transfer pricing, Toys R Us had created a siphon, sucking tax base out of all separate-filing states because royalty payments are deductible business expenses. The siphon spit out that tax base into an entity (the DHC) that was subject to tax only in a tax haven state that declined to tax it. That entity existed only on paper, "naked" of any economic substance of any kind and existing for no business purpose other than to escape its state CIT obligations.[17]

The nakedness of DHCs became nearly as well known as the strategy became widespread. A case involving Berkshire Hathaway's Justin Boots and Acme Brick business units describes the lack of substantive company involvement in the affairs of its paper-only CIT-avoidance vehicles, and the brazen flaunting of their purposes in the very names of these entities. The case describes one entity, to which the OpCos' trademarks had been transferred, as "a Delaware corporation that, during part of the tax period in question, shared approximately 1,100 square feet of office space

[16] *See* IRC section 351, which most states follow under tax laws that generally conform to the Internal Revenue Code . . . except when they don't.

[17] *Geoffrey*, and similar cases that arose later in other states.

with 40 other companies and employed one individual who spent two hours monthly on Acme Royalty business. This individual served as officer and director for Acme Royalty, as well as 20 to 30 other companies."[18]

As scores of household names followed in Toys R Us's footsteps, some — like Kmart,[19] another now-defunct former giant of the chain retailing industry — would branch out of DHCs and into other locations for their intangible holding companies (IHCs, also known as passive investment companies). Some IHCs, like the one used by Kmart for its CIT dodging, were based in Michigan, where the now-defunct single business tax made the state a tax haven because it excluded royalties from the tax base. Others were based in jurisdictions that were more "natural" — the subject of the next illustrated strategy, in Figure 6.

In most of these cases, the DHC/IHC had no need for the cash, but the parent OpCo still needed it. Many CIT dodgers simply "swept" the cash back up from the DHC to the parent, sometimes recording such sweeps on a separate set of books (just for tax purposes, in case a revenue department auditor started nosing about), and other times not even bothering to make the accounting entries for an entity that had no substantive existence anyway— in the eyes of the outside world or (usually) of any corporate insiders except a few members of the tax department.

The more careful avoiders would go to the trouble of actually declaring a dividend and returning the cash (received as royalties) to the parent formally. This was done in a tax-favored manner because the parent would wipe out that income with a dividends received deduction.[20] The tax base cash ended up "round-tripped" in a circular flow of cash that put it right back in the same place it started. From an economic standpoint, all that had actually taken place was the creation of that siphoning deduction and the resulting reduction or elimination of CIT. The naked DHC side of Figure 5 illustrates this.

FinanceCo: In addition to siphoning by moving intellectual (intangible) property like patents and trademarks to a RoyaltyCo, planners also siphoned tax base using a different financial transaction — lending cash in exchange for interest. The DHC/IHC here (often called FinanceCo) would be set up to conduct faux intercompany lending operations. FinanceCos would hold intercompany promissory notes payable. How those notes got there, or what business purpose there might be for having them there, was hardly the point. — OpCo would pay interest to the FinanceCo-DHC, taking a deduction and escaping CIT, and then receive it back as a tax-free dividend.

A particularly aggressive form of paper siphoning took place when the parent would not even bother borrowing money from FinanceCo. Instead, the parent OpCo would simply make a contribution to the capital of the IHC subsidiary — contributing not cash but a piece of paper, a promissory note receivable, entitling the IHC to receive interest payments from the parent — without having given in exchange anything of value (other than an increase in the value of its stock).

Loan Participation Company: Another variant of the FinanceCo strategy, designed specifically for financial institutions, followed similar principles: The parent Bank or bank holding company would own a new DHC that would own a new Loan Participation Co (LPC). A capital contribution of "loan participations" (entitling the owner to interest income on some portion of a loan portfolio) would be contributed from Bank down to DHC, which would lend those participations on down to LPC. When borrowers paid interest to LPC, it was required to pay interest to DHC (retaining only a modest taxable profit). DHC sits in a tax haven, so it is not taxable on the interest; it flows that cash on up to Bank as a tax-favored dividend.[21]

These variants on the intercompany debt strategy are commonly known in the CIT planning community as internal leveraging.

[18] *Acme Royalty Co. v. Missouri*, 96 S.W.3d 72 (2002).

[19] *Kmart v. New Mexico*, 131 P.3d 22, 139 N.M. 172 (2005).

[20] Most states conform more or less to IRC section 243.

[21] "[Redacted] Business Restructuring for State Tax Minimization (STM) Feasibility Report," KPMG (Nov. 19, 1998) in Michael J. Houser, "S.B. 1172 'Fair Tax Penalties' — What You May Not Know," North Carolina Department of Revenue, tab 4 (2010).

These strategies round-trip cash around the company's planner-modified org chart (the pictorial representation of all its various legal entities in a format that shows who owns who) to transform the nature of that cash, to recharacterize it, and to launder it from taxable income into tax-free income. DHCs operated as financial laundromats.

Turbocharged IHC: An early innovation built on the integration of the naked RoyaltyCo and the naked FinanceCo was called "turbocharging" by some planners. Illustrated on the right side of Figure 5, you will see two siphons. First is the royalty from OpCo to the IHC, just like that on the left side of Figure 5. Instead of dividending the cash back up, however, the turbocharged IHC lends the money back up. Receiving a loan from its subsidiary, OpCo becomes liable for interest. Payment of interest back to the IHC creates another siphoning deduction for the parent. The money could be round-tripped nearly endlessly in this way. Double laundromat, anyone? Triple? Dare we try for quadruple?

ManagementCo: Royalties, interest, and management fee markups together made up the top three "base shifting" vehicles in the early days of structural CIT reduction planning.

In addition to intercompany licensing and intercompany debt, many planners created shared services or ManagementCo entities, particularly if the company was headquartered in a unitary combined state to which tax base could be shifted out of affiliates without increasing the group's tax in the headquarters state.

ManagementCo might employ all the back-office workers, or even staff some market-facing functions. It would take a deduction for salaries, benefits, offices, and equipment, of course, but OpCo affiliates (with high separate-filing effective tax rates) paid ManagementCo a management fee that included a markup "profit" element. The markup portion (rarely defended with a transfer pricing study but typically air-thumbed with a "cost plus 5 percent" guesstimate) was deductible for the OpCos in addition to those (real) legacy expenses, and thus created another siphon.

The *Fortune* 500 have largely moved well beyond RoyaltyCo, FinanceCo, and ManagementCo strategies (and well beyond even many of the more sophisticated strategies described below). Nevertheless, the studied eye can still find vestiges of these early strategies lurking in the dark shadows of many a CIT dodger's org chart.

Many of these old DHCs may no longer perform their original CIT elimination function for *Fortune* 500 companies, though some still churn out "savings" in the sleepiest states. Or the strategies may still be "turned on" everywhere with a relatively modest production of avoidance, left laying around in the hope that a revenue department auditor might find one, write up an audit assessment with a sense of satisfaction, and then close out the audit without finding the hidden and more sophisticated strategies that produce much larger reductions of tax.

Section 197 Amortization Alternative: Another innovation was to have the IHC sell the IP back to the parent that had originally owned it. Under IRC section 197, the purchaser of intangibles may take amortization deductions for the purchase of goodwill and some other intangibles. A federal section 197 amortization deduction could siphon tax base just as effectively as a royalty deduction, but it would escape audit notice or (should a diligent auditor find it) escape application both of the addback antidote and the transfer pricing antidote.[22]

Natural IHC

Engineered tax haven states like Delaware (states where the legislature passed specific CIT-avoidance-friendly laws to become a major destination of choice for the CIT-dodging community) remained in common use by planners for many years. Indeed, as noted above, many DHCs can still be found in corporate org charts around the country.

However, it did not take innovative planners long to recognize that an abundance of "natural" havens existed among the United States for those who wished to escape responsibility for CIT in separate-filing states.

No-CIT-State IHCs: Nevada, South Dakota, and Wyoming have been obvious choices for

[22]These and other antidotes (inadequate countermeasures employed by states in an attempt to neutralize the tax avoidance) are described in part 2 of this series: Griswold, "Innovation Principles for Multistate CIT Planning — Part 2," *Tax Notes State*, May 30, 2022, p. 921.

planners because they impose no CIT and no significant alternative business activity taxes. Several states impose significant non-CIT taxes on the activity of operating a business; gross-receipts-type taxes are imposed today by Oregon, Texas, and Washington, making them (not impossible but) tricky locations for IHCs. Wyoming and South Dakota are not particularly close to market centers, making them adequate choices for planners not looking to build up any apparent "economic substance" in their IHCs.

But Nevada's proximity to California (analogous to Delaware's proximity to New York City) makes it a highly attractive location for tax dodgers. It may not be that hard for a *Fortune* 500 company to build up an appearance of economic substance in its Nevada IHCs by persuading some residents of Sacramento or the San Francisco Bay Area to relocate just two or three hours away to Reno or Carson City.

Unitary-State IHCs: A great many locations are natural for the establishment of an IHC or other siphon-receiving entity: unitary combined reporting states. As illustrated in Figure 2 in part 1 of this series,[23] the planner's creation of domestic unitary NewCo entities and the fabrication of transactions among domestic unitary group members are essentially nonevents for purposes of determining the group's tax liability in such states.

While unitary combination makes it difficult to escape tax in those unitary combined states, there is a dark side to this light. The presence of some unitary states makes separate-filing states even more vulnerable to CIT-avoidance strategies. The planner can go to town with all kinds of clever planning to duck CIT in separate-filing states without worrying that this might increase tax in unitary states. The avoider might, for example, move its controlled foreign corporation affiliates under a unitary state IHC, so that when it receives foreign dividends that carry some tax liability with them, these are insulated from taxation by separate-filing states.

Unitary combined states are natural locations for IHCs.

[23]Griswold, *supra* note 10, at 733.

Fig Leaf IHCs: Over time, CIT planners dressed up their naked IHCs with a fig leaf or two (perhaps allocating a few hours of a company employee's weekly time to the IHC, which perhaps was charged rent for a small office and a phone line).

Figure 6 illustrates a simplified version of food maker Hormel's application of this sort of approach, building off a couple of IHCs based in its headquarters state — Minnesota, a unitary-combined-filing state. Founded on two natural shelters, Hormel[24] purchased from its advisers two siphoning strategies (intercompany interest and intercompany royalties), plus a stashing strategy (intercompany factoring of accounts receivable) that will be discussed and illustrated more fully at Figure 13 in part 4 of this series.

The maker of Spam appeared to be comfortable making sham too. Indeed, the Wisconsin Tax Appeals Commission found that "the evidence shows that Hormel's other alleged purposes for engaging in the challenged transactions were a mere 'fig leaf' covering its real purpose, which was tax avoidance."

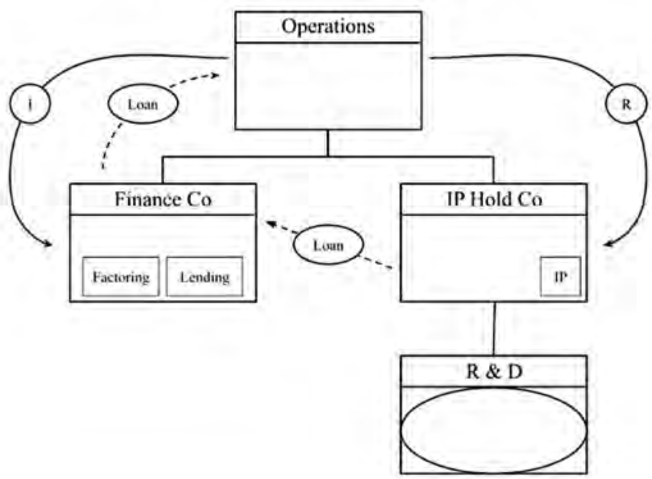
Following a pitch from EY, Hormel paid the Big 4 accounting firm a typical fee ($400,000) to create a CIT-reduction structure, which followed the three phases commonly used by all the Big 4 when they sell these CIT structural planning projects: (1) a feasibility review that modeled the CIT "savings,"[25] (2) a preliminary design phase, and (3) a design document.

As shown in Figure 6, the parent OpCo created three NewCos: It contributed its trademarks and patents for its Spam recipe to its IP-HoldCo (an IHC). On paper, it moved its research and development function (R&D employees and equipment located in the Minnesota headquarters and facilities in four other unitary states) out of the parent and into a new single-member limited liability company that defaulted by law into treatment as a disregarded entity; that is, it was treated as if it were a division of its owner.

[24]*Hormel Foods v. Wisconsin*, Wis. Tax No. 07-I-17 (2010).

[25]Tax "savings" is the industry's euphemism for "avoidance," universally used to normalize this antisocial activity.

Figure 6.
"Natural" Intangible Holding Company



R&D LLC was then contributed to IP-HoldCo along with "other operations that may be transferred to give it substance" without giving it nexus or apportionment factors in any separate-filing states, which otherwise could tax the shelter vehicles IP HoldCo and FinanceCo. (This use of the apportionment engineering and nexus isolation building blocks constitutes a stuffing strategy that will be discussed in part 6 of this series, at Figure 18.) The new FinanceCo was tasked with intercompany lending and factoring.

The result: With interest and royalty deductions, Hormel "base shifted" out of the parent OpCo (with its high separate-filing state effective tax rate) and into two tax-favored entities with no nexus or apportionment in separate-filing states.

The Wisconsin Tax Appeals Commission found in the Hormel Spam case some facts that are so typical in CIT planning that they will be familiar to the lawyers and accountants who work in corporate tax departments or for the firms that support their efforts. These include[26]:

- High-pressure sales tactics were used; the Hormel tax department "had been contacted quite often by all the major accounting firms proposing the use of an intellectual property company to save taxes."
- EY promised minimal disruption to real business operations as a result of implementing the CIT minimization plan, which "provides state tax savings and reduces downside risks without impacting management reports."
- "The accounting for [IP HoldCo] was set up in a manner so as 'not to disturb the current operating P & L's,' [profit and loss financial statements] and would have 'no impact on current management reports.'"
- "Other than the anticipated tax savings, Hormel did not analyze the costs or benefits of these planned transactions."
- Purported nontax business purposes for the restructuring did not come from anyone at Hormel. The business purposes (drafted by EY and then presented without modification to Hormel's board) were right off the Big 4 firms' business purpose à la carte menu that they routinely offered in their slide presentations to clients:
  - tool to determine IP value;
  - measure affiliates' performance against each other;
  - better IP management;
  - exploitation of IP value;
  - better product development;

[26] *Hormel Foods*, Wis. Tax No. 07-I-17.

- reduction of the cost of doing business, including taxes

- Planners at the outside advisory firm called the shots: "E&Y's plan of restructuring was the basis for the bullet points in the draft Board resolution approving the plan."
- EY set the royalty rates. However, the commission found that the rates "were not separate royalty rates for patents, trademarks and copyrights, just a single royalty rate schedule for all of the intellectual property."
- Hormel demonstrated that the purported transfer of IP from the parent to IP HoldCo was not real when, after the new structure was put in place, its filings with the U.S. Patent and Trademark Office showed the parent OpCo continuing as the owner.

In more than a few cases of CIT circumvention — whether the planner uses a naked DHC or a natural IHC with a little unitary fig leaf stuffing — the purported business purposes and economic substance are not accurate representations of the facts.

80/20 Backdoor Siphon

More than half the unitary combined reporting states extend to all multinational corporations a statutory invitation to siphon away their tax base. Having taken the prudent step of adopting some version of the unitary combined reporting method, states that stop there are vaccinated against domestic CIT siphoning strategies. Other states, inexplicably volunteering for vulnerability, have gone on to open up an 80/20 back door for tax base siphoning.

In Illinois, as in many unitary states, this is a long-standing invitation, a built-in back door out of any company's water's-edge group, should a company wish to use it. Simply engineer the affairs of a domestic affiliate so that 80 percent or more of its property and payroll is located outside the United States and — like magic — that entity would be excluded from the water's-edge combined group, primed and ready to receive tax base that has been siphoned out of Illinois.[27]

A mobile computing company named Zebra Technologies is one of many companies that accepted the 80/20 invitation simply by pretending to restructure its operations. It created a couple of new IHCs in Delaware and transferred some patents to those IHCs, which then charged the U.S. OpCo an exorbitant royalty (9.5 percent of gross sales, not even net — a telltale sign that the adviser, the company's decision-maker, or both were more greedy than cautious); "moved" the pretend IHCs to Bermuda; and paid an accommodating service provider to help Zebra pretend the IHCs were real.[28]

Figure 7.
80/20 Backdoor Siphon

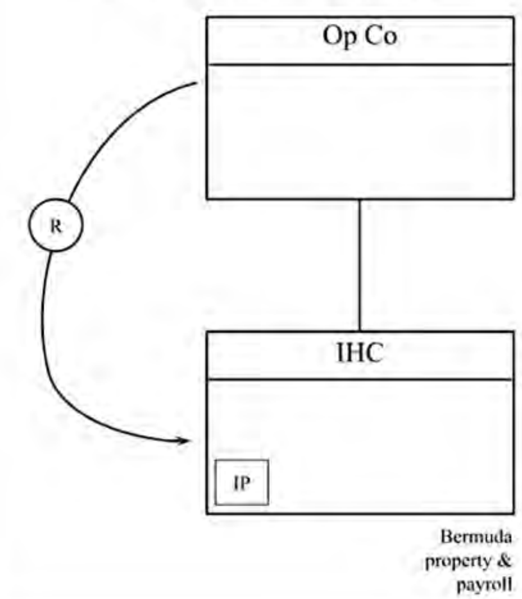


Figure 7 presents a simplified version of the new structure. Having no operations anywhere but the pretend operations in Bermuda (where the enabling service firm collected from Zebra a small fee to rent a bit of property — perhaps a brass nameplate along with the scores of others on the front door of a tiny office — and a sliver of the service provider's economic-substance-generating time), the naked IHCs still had the audacity to claim they had more than 80 percent

[27] Ill. Admin. Code tit. 86, section 100.9700(c)(2)(A).

[28] *Zebra Technologies v. Illinois*, 799 N.E.2d 725, 344 Ill. App.3d 474 (2003).

of their property and payroll outside the United States.

The consequence that Zebra (and other 80/20 users, like omnipresent chain retailer Target[29]) hoped for: The royalty siphoning strategy would avoid CIT not only in separate-filing states (the usual victims of siphoning strategies) but in many unitary combined states as well.

Who Buys This Stuff?

"It takes two to tango," several of my high-level CIT planning colleagues often said. The DHC, IHC, and 80/20 backdoor strategies, like all avoidance techniques in the siphoning and stripping[30] families, rely for their tax avoidance impact on having at least two parties — one dancing on the inside of the state's jurisdictional grasp, and the other dancing on the outside, as their hands move back and forth between inside and outside.[31] Often, though, avoiders have to fake the second dancer.

The state countermeasure recommended in this series — true unitary combined reporting (TUCR) — shines a light on this subterfuge. TUCR reveals that in economic reality, there is just one dancer pretending to tango in the dark. Any states adopting TUCR would have seen no revenue loss from these strategies. Not a penny.

Without TUCR in place across all the states, however, there is ample opportunity for aggressive companies and their planners to avoid CIT by using siphoning strategies. Let's close by naming a few more names.

Additional Buyers of Siphoning Strategies

Companies using these sorts of domestic siphoning strategies — strategies based on various combinations of the apportionment engineering, asset placement, nexus isolation, recharacterization, shelter entity, and transfer pricing building blocks — appear most likely to get caught by state revenue department auditors, for they make up the largest group of companies publicly revealed to be engaged in structural tax avoidance for CIT.

In addition to the CIT avoiders already mentioned in this series, some other companies whose strategies include those in the siphoning family are:

- Berkshire Hathaway. (In addition to the naked IHC siphoning strategy it employed for its business units discussed above, Warren Buffett's See's Candies and Columbia Insurance Co. affiliates siphoned royalties to a traditional insurance company at the receiving end of the siphon. This "adaptive insurer" strategy will be illustrated at Figure 19 in part 5 of this series as one of the straddling strategies.)[32]
- ConAgra (siphoning internal-use trademarks and stashing marks licensed to third parties).[33]
- Crown Cork & Seal Co. (DHC for trademarks and patents).[34]
- Food Lion grocery stores. (IHC for store and private-label trademarks, management fees — deployed even in the wake of its "flipping green chicken" scandal — to be discussed further in the stuffing strategies section at Figure 18 in part 5 of this series.)[35]
- The Gap Inc. (DHC later swapped out for a unitary IHC).[36]
- Kimberly-Clark Corp. (Finance and royalty IHCs, later partially converted into "embedded royalties" — thinly disguised as intercompany "rebates" rather than dressed up with more obfuscation in the Entrepreneur strategy, to be discussed in the stripping family section in part 4 of this series.)[37]

[29] *Target Brands v. Colorado*, 2015CV33831 (2017).

[30] Stripping is up next, in part 4 of this series.

[31] Figure 2 in part 1 of this series illustrates this inside/outside tango. *See* Griswold, *supra* note 10, at 733.

[32] *Utah State Tax Commission v. See's Candies Inc.*, 2018 Utah 57 (2018).

[33] *Griffith v. Conagra Brands*, 728 S.E.2d 74 (W. Va. 2012); and *Conagra v. Maryland*, 211 A.3d 611 (2019).

[34] *Maryland v. Crown Cork and Seal*, 375 Md. 78, 825 A.2d 399 (2003).

[35] *Delhaize America v. Lay*, 731 S.E.2d 486 (N.C. 2012); Gregory G. Dess and Joseph C. Picken, "Creating Competitive (Dis)advantage: Learning From Food Lion's Freefall," 13(3) *Acad. Mgmt. Persp.* 97 (1999); and Houser, *supra* note 21.

[36] *Louisiana v. Gap (Apparel) Inc.*, 886 So. 2d 459 (2004).

[37] *Kimberly Clark v. Massachusetts*, 83 Mass. App. Ct. 65, 981 N.E.2d 208 (2013).

- The Limited (Abercrombie & Fitch and Lane Bryant's royalty IHCs with turbocharging loans back).[38]
- Lorillard Tobacco Co. (whose plan was done so sloppily that its IHC — Lorillard Subsidiary Co. — appears to have been left with the planner's placeholder name from early draft design reports, and whose royalty rate was set at a very high 13 percent of net sales).[39]
- Martha Stewart Living Omnimedia Inc. (paired in CIT avoidance with Kmart, which sublicensed to its Michigan IHC the Martha Stewart trademarks that she first licensed to Kmart — through her own IHC).[40]
- MCI Worldcom (infamous for the accounting scandals that led to its demise).[41]
- Media General (intercompany royalties for Federal Communications Commission licenses and the "combination" case that the South Carolina Department of Revenue was pleased to lose).[42]
- R.R. Donnelley (in addition to its trademark IHC, it brazenly gave its FactorCo stashing entity a name that telegraphed its method of sidestepping CIT: RR Receivables).[43]
- Spring Industries (naked DHC).[44]
- TJ Maxx/Marshalls (turbocharged Nevada IHC).[45]
- Walmart Inc. (infamous for its captive REIT — to be discussed in part 5 of this series in the straddling family of strategies at Figure 16 — this *Fortune* 5 behemoth also siphoned royalties using a stripping East Co/West Co strategy for itself and its Sam's Club stores, illustrated in part 4 at Figure 8).[46]
- Wendy's Co. (siphoned trademark royalties to a captive insurer, illustrated in part 5 in the straddling family at Figure 14).[47]
- W.L. Gore & Associates Inc. (the inventor and manufacturer of Gore-Tex avoided CIT with patent and trademark siphoning as well as stashing investment securities).[48]
- Zebra Technologies Corp. (siphoning royalties to its Bermuda-based 80/20 back door).[49]

There are more, of course. Additional court case examples of CIT avoiders that use siphoning strategies include CarMax,[50] Family Dollar,[51] Home Depot,[52] IDC Research,[53] Kohl's department stores,[54] Manpower,[55] Nordstrom,[56] Praxair,[57] Sherwin-Williams paints,[58] Sony Entertainment,[59] Talbots,[60] and Vanity Fair.[61]

'Kitchen Sink' Buyers

Lists of siphoning strategy users inevitably include some avoiders that — when presented with CIT circumvention options by their planner — appear to have packed up "everything but the kitchen sink." It is difficult to determine from the

[38] *A&F Trademark v. Tolson*, 167 N.C. App. 150, 605 S.E.2d 187 (2004); and *Lanco v. New Jersey*, 908 A.2d 176, 188 N.J. 380 (2006).

[39] *Kohl's Department Stores v. Virginia*, Va. Cir. Ct., No. CL 12-1774 (2021).

[40] *Martha Stewart Omnimedia v. Michigan*, Mich. Tax Trib., No. 409820 (2011).

[41] *See, e.g.*, Barney Tumey et al., "States Will Receive $315 Million From MCI in Tax Settlement," *BNA Daily Tax Report*, Oct. 5, 2005; U.S. Bankr. S.D. N.Y., *In re: Worldcom Inc. Debtors*, "Third and Final Report of Dick Thornburgh, Bankruptcy Court Examiner," Jan. 26, 2004; Michael Mazerov, "State Corporate Tax Shelters and the Need for 'Combined Reporting,'" Center on Budget and Policy Priorities, at 1 (Oct. 26, 2007).

[42] *Media General v. South Carolina*, 694 S.E.2d 525 (2010).

[43] *R.R. Receivables v. Arizona*, 224 Ariz. 254, 229 P.3d 266 (2010).

[44] *Spring Licensing v. New Jersey*, 29 N.J. Tax 1 (2015).

[45] *TJX v. Massachusetts*, Mass. App. Ct. Dkt. No. 09-P-1841 (2010).

[46] *Wal-Mart Stores East Inc. v. Hinton*, 197 N.C. App. 30, 676 S.E.2d 634 (2009).

[47] *Wendy's v. Illinois*, 996 N.E.2d 1250 (2103); and *Wendy's v. Virginia*, CL09-3757, Va. Cir. (2012).

[48] *Gore Enterprise Holdings v. Maryland*,437 Md. 492, 87 A.3d 1263 (2014).

[49] *Zebra Technologies v. Illinois*, 799 N.E.2d 725, 344 Ill. App. 3d 474 (2003).

[50] *Carmax Auto Superstores West Coast Inc. v. South Carolina*, App. Case No. 2012-212203; Op. No. 27474.

[51] *Family Dollar Stores v. Wilkins*, 2005-V-469 (Ohio Bd. of Tax App. 2008).

[52] *Home Depot USA v. Arizona*, Ariz. Super. Ct. No. 2006-000240 (2009).

[53] *IDC Research v. Massachusetts*, 78 Mass. App. Ct. 352, 937 N.E.2d 1266 (2010).

[54] *Kohl's Department Stores v. Virginia*, Va. Cir. Ct. No. CL 12-1774 (2021).

[55] *Manpower v. Maryland*, Md. Tax Ct. No. 13-IN-00-0121 (2018).

[56] *Nordstrom v. Maryland*, Md. Tax Ct. No. 07-IN-00-0317 (2010).

[57] *Praxair Technology v. New Jersey*, 988 A.2d 92, 201 N.J. 126 (2009).

[58] *Sherwin-Williams v. Massachusetts*, 778 N.E.2d 504 (Mass. 2002).

[59] *Robinson v. Jeopardy Productions*, 315 So. 3d 273 (La. App. 2020).

[60] *Talbots v. Maryland*, 06-IN-00-0226; 06-IN-00-0227, Md. Tax Ct. (2008).

[61] *Surtees v. VFJ Ventures*, 8 So. 3d 950 (2008).

cases and news reports whether these kitchen sink buyers of a multiplicity of avoidance services were being greedy (seeking to escape every last tax penny possible) or strategic (creating a diverse portfolio of strategies — overlapping and redundant, or conceptually distinct) in order to reduce the risk that state auditors would find everything and shut it all down.

The greedy ones (and there are many) sometimes amp up their tax reduction so much that they do more than reduce their taxes — they run their avoidance entities into a loss position. Year after year, the OpCo on the sending end of a royalty siphon (for example) might generate far greater deductions than income because an aggressive or sloppy planner (more than a few are both) had teamed up with a greedy and careless avoider company (more than a few of them, too, are both) to set the intercompany royalty rates unreasonably high, with little or no mooring to market realities.

Unused losses could be carried over from year to year until used or expired; these long-term tax attributes — net operating loss carryovers — might often be accepted unchallenged by a state revenue department auditor many years later, perhaps long after the royalty arrangement had been "turned off" by the avoider, making the abusive nature of the NOLs difficult to notice. The more aggressive the strategy, sometimes, the longer its tail.

Among the kitchen sink buyers whose CIT planning portfolio includes siphoning strategies are:

- AutoZone Inc. (IHCs for trademarks and management fee markups, along with a variety of other CIT planning strategies).[62]
- Belk Department Stores (purchaser of a full package of the planner's CIT circumvention offerings).[63]
- Michael's Stores (particularly ProcurementCo stripping strategy in addition to Finance and IP siphoning strategies).[64]
- Staples Inc. (Its plethora of CIT-ducking strategies included royalties siphoned to a unitary-stuffed recipient in a stripping East-West arrangement, online nexus isolation, ProcurementCo, and more.)[65]
- Target Corp. (It purchased multiple strategies including unitary-based IHC Royalty and Finance Companies, ProcurementCo, and an 80/20 Hong Kong-diluted back door — to be illustrated at Figure 11 in part 4 of this series — all supported poorly with off-the-shelf business purposes and perfunctory "corporate formalities.")[66]
- Tractor Supply Co. (This niche retailer — comfortable with stocking pet food, horse riding clothing, and tractor repair parts together —was apparently also comfortable stocking up on a diverse set of planning strategies, including trademark royalties and interest siphoned to unitary-stuffed IHCs, Shared Services Co, ProcurementCo, and an Employee Lease Co for payroll factor apportionment engineering.)[67]

Piggybackers

Also, recall (from part 2 of this series)[68] that siphoning strategies used at the federal level (shifting tax base to overseas tax havens) have a direct piggyback effect in U.S. states, avoiding CIT not only in separate-filing states, but also in water's-edge unitary combined states and worldwide unitary combined states that offer a water's-edge election. The Institute on Taxation and Economic Policy and the U.S. Public Interest Research Group estimate that the annual

[62] *Autozone Investment Corp. v. South Carolina*, Docket No. I9.ALJ-1 7.0068.CC (S.C. ALC 2020).

[63] *Belk Inc. v. South Carolina*, Docket No. 2O-ALJ-f7-02f 1-CC (S.C. ALC 2020).

[64] *Michael's Stores v. South Carolina*, Docket No. 19-ALJ-17-0044-CC (S.C. ALC 2020).

[65] *Staples v. Maryland*, 2597 (Ct. Spec. App. Md. 2018).

[66] *Target Brands v. Colorado*, 2015CV33831 (2017).

[67] *Tractor Supply v. South Carolina*, Docket No. 19-ALJ-17-0416-CC (S.C. ALC 2020).

[68] Griswold, *supra* note 22.

piggybacking loss to water's-edge unitary combined states exceeds $14 billion;[69] the California Budget and Policy Center estimates its share of that annual revenue loss is $4 billion.[70]

Apple, one of the world's largest corporations, is a good example of the piggybacking problem. It "sidesteps billions in taxes" with various siphoning and stashing planning strategies, including use of an investment affiliate located in the natural tax haven of Reno, Nevada.[71]

> The major strategy Apple uses to reduce its U.S. tax bill is to artificially shift large amounts of its domestic profits into tax havens. This allows Apple to avoid paying U.S. taxes on these profits while also paying very little in foreign taxes. . . .
>
> Like many other multinationals, Apple exploits this loophole by using accounting maneuvers to shift its U.S. profits overseas (often only on paper) and then indefinitely deferring U.S. taxes on them.[72]

The only antidote to the states' automatic piggybacking on this type of massive federal tax avoidance siphoning is adoption of TUCR.

Next up: Part 4 of this series will explain and illustrate another of the Six S's of CIT avoidance planning — stripping. ■

[69] ITEP, *supra* note 1.

[70] Kayla Kitson, "California Loses Nearly $70 Billion Annually Through Tax Breaks: Much of the Loss Is to High-Income Households & Corporations," California Budget and Policy Center (Apr. 2022).

[71] Charles Duhigg and David Kocieniewski, "How Apple Sidesteps Billions in Taxes," *The New York Times*, Apr. 28, 2012.

[72] ITEP, "Fact Sheet: Apple and Tax Avoidance" (Nov. 2017).