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Innovation Principles for Multistate CIT Planning — Part 4

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, Griswold illustrates stripping strategies for multistate tax planning and continues to build the case for state legislatures to shut them down by adopting true unitary combined reporting.

Corporations and their advisers enjoy an embedded innovation advantage over the people and their governments when it comes to state tax avoidance and collection. Illustrating this advantage by grouping state corporate income tax (CIT) planning strategies into the siphoning, stripping, straddling, stuffing, stashing, and secreting families, this series seeks to demonstrate the failure of existing state countermeasures and the superiority of true unitary combined reporting (TUCR).[1]

Stripping is the topic for today, following the discussion of siphoning in part 3.[2] First, however, a note on the interchangeable use of "avoidance" and "planning" in this series.

Tax Planning vs. Tax Avoidance

A subcommittee of the U.S. Senate's Homeland Security Committee published a report in 2005 criticizing some of the country's top law and accounting firms for their roles in the innovation, marketing, implementation, and defense of federal income tax avoidance activities in the "tax shelter industry."[3] The committee's focus was on federal tax, but the firms all plied this trade for state CIT avoidance purposes as well.

No judgment is intended concerning the propriety of the devices illustrated here, whether described as "planning/reduction" or "avoidance/shelter" strategies. But the Senate's guidelines may be instructive for any reader who wishes to judge:

> In its broadest sense, the term "tax shelter" is a device used to reduce or eliminate the tax liability of the tax shelter user. This may encompass legitimate or illegitimate endeavors. While there is no one standard to determine the line between legitimate "tax planning" and "abusive tax shelters," the latter can be characterized as transactions in which a significant purpose is the avoidance or evasion of Federal, state or local tax in a manner not intended by the law.[4]

Stripping

Following the first generation of broadly marketed CIT avoidance strategies (siphoning strategies like naked Delaware holding companies (DHCs), intangible holding companies (IHCs)

[1] Don Griswold, "Innovation Principles for Multistate CIT Planning — Part 2," *Tax Notes State*, May 30, 2022, p. 921 (Innovation: Part 2).

[2] Griswold, "Innovation Principles for Multistate CIT Planning — Part 3," *Tax Notes State*, June 20, 2022, p. 1263 (Innovation: Part 3).

[3] Michael Bopp, Joyce Rechtschaffen, and Amy Newhouse, "The Role of Professional Firms in The U.S. Tax Shelter Industry," U.S. Senate Permanent Subcommittee on Investigations of the Committee on Homeland Security and Governmental Affairs (Apr. 13, 2005).

[4] *Id.* at 3-4.

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with a veneer of substance, and the like),[5] avoidance innovators started looking for enhancements and alternatives that could keep them several "catch me if you can" steps ahead of revenue department auditors.

Could the shelter entities (recipients of siphoned streams of royalties, interest, and management fees) be disguised so auditors would have a more difficult time discovering them? Could the siphon streams themselves be disguised, recharacterized, transformed, or substituted — particularly to preserve tax avoidance in states that were beginning to adopt systemic antiabuse rules like the addback of deductions for intercompany intangibles transactions?[6]

This line of brainstorming led to the development of stripping strategies. In this family, the planner often starts with a company that has historically conducted all or many of its activities within a single legal entity — an all-purpose operating company, or OpCo. The planner strips out from the OpCo a variety of activities and assets; mixes and matches the stripped-out items, separately incorporating various combinations; and in this process uses some planning building blocks described in part 1 of this series[7] — particularly apportionment engineering, supply chain segregation, income concentration, nexus isolation, and transfer pricing.

The stripping strategies selected for discussion here are East-West Co, SalesCo, The Entrepreneur (sometimes referred to as embedded royalties), an 80/20 enhancement to that strategy, Procurement Co (two variants), and FactorCo.

East-West Split

In the mid '90s and early aughts, it was not too much of an exaggeration to generalize that most states east of the mighty Mississippi River were separate-filing states while most of the states to its west had adopted the unitary combination method.[8]

A number of large chain retailers historically operated (from a managerial and economic perspective) pretty much as a single-entity operating company, with headquarters functions, procurement, distribution, nationwide marketing, trademark management, and store ownership (or leasing) all in that single entity. Such an organization had nexus everywhere it did business, and 100 percent of its income was apportioned among the states. In the first generation of cookie-cutter CIT avoidance, as we have seen, the way to sidestep one's tax obligations was to drop the intellectual property into a naked DHC. Think *Toys R Us* or *Kmart*.[9]

What might happen, planners began to think, if they could persuade senior management to strip before they siphoned?

What if they were to abandon the DHC/IHC model and simply strip out from the operating parent all the stores in separate-filing states, leaving the rest (headquarters functions and IP ownership, in addition to the unitary-state stores) behind, up at the parent? Most separate-filing states were in the eastern United States, so they might call that new entity Retail-East, even if it included a few west-of-the-Mississippi states (like Arkansas, Louisiana, and Missouri) that required separate filing. What if, further, they were to strip unitary-state stores and the IP out of the parent as well, and into its own entity, to be called NewCo Retail-West? (Maine and New Hampshire were already unitary then, but what state revenue auditor in those days would look that hard at the composition of companies called East and West anyway?)

CIT planners around the country sketched out the scenarios and started modeling them, knowing that intercompany movement of apportionment factors, income, and other elements sometimes produced unexpected results. In the chain retail world, however, where income pretty much tracks with

[5] Griswold, "Innovation: Part 3," *supra* note 2.

[6] *Id.* at 923-924 and Figure 3B.

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

[8] For a discussion of these methods, see *id.* at 731-733 and Figure 2.

[9] *Geoffrey Inc. v. South Carolina*, 437 S.E.2d 13 (S.C. 1993); and *Kmart v. New Mexico*, 131 P.3d 22 (N.M. 2005). *See* discussion in Griswold, "Innovation: Part 3," *supra* note 2, at 1264-1266 and Figure 5.

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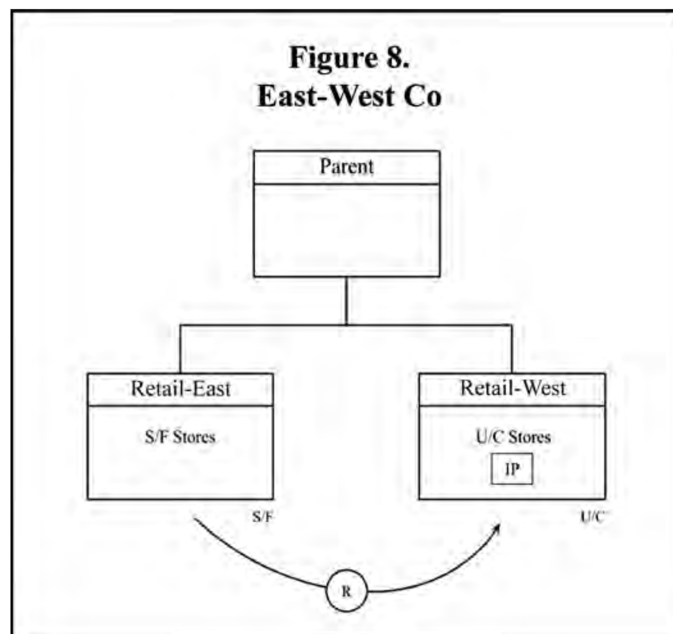
apportionment factors, the results were relatively straightforward and avoider-friendly:

- Retail-East (owner of separate-filing-state stores but not of the store name and other trademarks they used every day) would be required to pay Retail-West (owner of those marks and of the unitary-state stores) a royalty for the right to use the marks.
- Retail-West would have nexus only (or so planners thought for many years) in combined-reporting states, where the intercompany flow of royalties would, by statute, be ignored.
- Recall the analogy from earlier parts of this series: Moving a cash-packed wallet from my right pocket to my left does not alter my financial position, just as moving an income-attracting trademark from one member of a unitary group to another does not change the group's financial position. The stripping strategy would have no impact on Retail-West's CIT liability, but it makes Retail-West an excellent tax shelter entity.
- Retail-East would avoid CIT in separate-filing states as it took deductions for those royalty payments to Retail-West, just as it would avoid CIT if it paid royalties to a naked DHC.

Figure 8 illustrates a simple version of the East-West strategy that has been adopted by many companies, including ubiquitous chain retailers AutoZone,[10] CarMax,[11] Rent-A-Center,[12] Staples,[13] and Walmart.[14] (The reader may find it helpful to refer to the legend in part 1 of this series.)[15]

Figure 8.
East-West Co



In this strategy, the stripping and rearranging of store ownership and operations produces the same kind of CIT-ducking as a naked DHC. Avoiders found that the East-West strategy might be easier to defend against (and escape detection by) state auditors who were still looking for DHCs and IHCs. The trademark-owning company in an East-West strategy no longer exists only on a document inside a filing cabinet in the dingy office of an adviser in Wilmington, Delaware, or Hamilton, Bermuda; Retail-West owns scores of stores, employs hundreds of people, and earns a great deal of income from selling goods, not merely from licensing IP. With this strategy, avoiders could stay ahead of auditors — at least for a time, and time was all the avoiders required, because by the time state revenue departments became aware of East-West as a replacement for DHC, armies of planners would already be hard at work developing a third generation of strategies, always staying an innovation generation ahead of the separate-filing states.

What, you may ask, would have happened if these separate-filing states had instead adopted TUCR? TUCR would have automatically neutralized the East-West strategy (no audit required), just as it neutralizes DHCs and their ilk.

In a TUCR environment, planners' "catch me if you can" innovation advantage is meaningless when all they are doing is developing more clever

[10] *AutoZone Investment Corp. v. South Carolina*, Dkt. No. I9.ALJ-1 7.0068.CC (S.C. ALC 2020).

[11] *CarMax Auto Superstores West Coast Inc. v. South Carolina*, 767 S.E.2d 195 (S.C. 2014).

[12] *Rent-A-Center East v. Indiana*, No. 49T10-0612-TA-00106 (2015).

[13] *Staples Inc. v. Maryland*, No. 2597 (Md. Ct. Spec. App. Aug. 9, 2018).

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

[15] Griswold, "Innovation: Part 1," *supra* note 7, at 732, Figure 1.

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ways to move money from the avoider's right pocket to its left. For TUCR states, the money is still in the avoider's pants.

SalesCo

East-West stripping is attractive to a big-box chain retailer because similar operations are spread relatively evenly around the country. In contrast, a consumer products company may have sales offices and employees in all 50 states, warehouses and distribution centers located in a dozen or so of those, and manufacturing plants scattered around. If its sales function creates nexus (and tax liability) almost everywhere,[16] it can strip that function out of the profitable entity and dump it into a newly created entity, SalesCo.

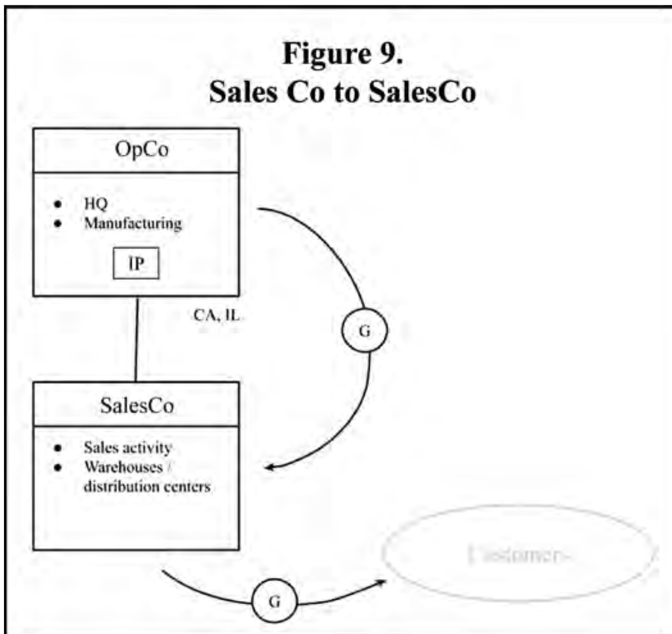

Figure 9 illustrates how a "buy/sell" SalesCo strategy works for many avoiders, particularly those with headquarters and manufacturing facilities only in combined-reporting states.[17] Assume parent OpCo is headquartered in California (a combined-reporting state), that its plants are in California and Illinois (another combined-reporting state), but that its sales operations are everywhere — that is, in all 50 states plus the District of Columbia.

The nexus-isolation, apportionment engineering, and transfer pricing building blocks of CIT planning[18] are involved here. Stripping the sales, warehousing, and distribution functions out of OpCo and into SalesCo isolates OpCo from nexus in separate-filing states. It also reduces OpCo's separate-filing-state apportionment — and thus its effective tax rate (ETR) — to zero, so a successful state nexus challenge won't net it any tax revenue. OpCo has essentially become a tax shelter entity, so setting the price of goods between OpCo and SalesCo exceptionally high will concentrate most of the group's profits in the tax shelter, leaving the high-tax entity (SalesCo) with very little tax base.

SalesCo has been a commonly employed structure, but there have been few published court or administrative decisions on the subject to publicize this ubiquity. One CIT avoider that did litigate the issue is Columbia Sportswear.[19] It resisted auditors' efforts to neutralize the strategy in a separate-filing state, Indiana. Why did it wage the fight in a separate-filing state? Because a state with TUCR (or even with water's-edge unitary combination) would have brought the avoidance structure to naught. A company like Columbia would not have even tried to use siphoning or stripping strategies to elude CIT in a TUCR state.

More stripping innovation would be necessary, though, if our consumer products company had significant headquarters or manufacturing operations in separate-filing states. Creative planners took another look at the "supply chain segregation" building block, and developed our next stripping strategy, which they fondly dubbed The Entrepreneur.

The Entrepreneur

Perhaps the Big 4 SALT partners who developed and named this strategy conceived of an "entrepreneur" as a person (corporate or

[16] OpCo may or may not have been able to insulate itself from nexus by qualifying for the P.L. 86-272 federal safe harbor. *See* Griswold, "Innovation: Part 1," *supra* note 7, at 730-731.

[17] In contrast to buy/sell SalesCos, commission SalesCo strategies are generally disfavored by planners because of old Supreme Court precedent that may allow a state — after lengthy and costly litigation — to attribute such a SalesCo's nexus to OpCo. *See Tyler Pipe Industries Inc. v. Washington*, 483 U.S. 232 (1987).

[18] *See* Griswold, "Innovation: Part 1," *supra* note 7.

[19] *Columbia Sportswear USA Corp. v. Indiana*, 45 N.E.3d 888 (Ind. T.C. 2015).

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human) who dreams up the visionary ideas, controls the intellectual capital, has at its disposal various fungible functionaries to carry out directions from the top, and receives the lion's share of the endeavor's financial rewards. If that image sounds rather like the Big 4 compensation pyramid, it also describes the transfer pricing theory that underlies this next CIT planning strategy.

Those innovative planners, the reader will recall, were working to stay steps ahead of separate-filing-state revenue department auditors. Catch me if you can. The old *Geoffrey*-style[20] naked DHC and its immediate progeny relied heavily on intercompany royalties to shift one entity's tax base to a tax-favored affiliate. But intercompany royalties stuck out like a sore thumb to auditors (who tried their best to undermine the RoyaltyCo's avoidance results with nexus, alternative apportionment, and sham challenges), and increasingly to legislators (who put their fingers in the holes of the avoidance dike with addback statutes).[21]

What could the planners do to achieve the same base-siphoning avoidance impact they got with royalties, without the structure looking like it was royalty based?

Brainstorming again — and focusing on the consumer products companies for which they had created stripped SalesCos — they recalled that when a consumer buys, say, a tube of toothpaste, much of that toothpaste's price reflects the marketing value of the trademarks that distinguish it from competitors on the grocery shelf. From that perspective, could royalty fees be considered essentially "embedded" in the sales price for goods?

Well, perhaps yes, perhaps no, but the strained analogy still might help the planners sell an "intercompany sales of goods" stripping strategy to companies that were accustomed to paying for strategies based on royalty siphons. And so The Entrepreneur strategy (sometimes called the Principal strategy) was born, continuing right where the SalesCo strategy leaves off.

Take a look back at Figure 9. The sales and distribution functions have been stripped out of the OpCo parent, which still retains, in addition to the headquarters function, a major part of the supply chain: the manufacturing stage. Let's strip that out into a NewCo and call it Contract Manufacturer (C-Manuf for short). The stripped down OpCo can now be renamed "Entrepreneur." That name might be more fitting if we were to strip out another low-value ministerial function — the back-office headquarters work like legal, tax, accounting, and IT — into a SharedServicesCo. Perhaps strip out a separate MarketingCo as well. Many avoiders' structures do have such entities, which receive management fees (with a markup on the costs of these functions), but we have omitted these for the sake of simplicity in Figure 10.

Figure 10 provides a simplified illustration of the varying ETRs (high or low ETRs in separate-filing states) created in this structure, and of the concentration of most group profit in The Entrepreneur, which serves as the tax shelter in this scheme:

- C-Manuf manufactures goods in plants located in separate-filing states. If any of those states apportion based on the traditional three-factor formula (property, payroll, and sales), or if their single-sales-factor formula sources receipts to origin (instead of the economically correct rule of sourcing to the market), then C-Manuf will have a high separate-filing-state ETR. The avoider will not want much of the group's profits there.
- SalesCo, as we saw above, will have a high separate-filing-state ETR as well, so, as in the SalesCo-alone strategy, it too will be designed to earn as little profit as possible.
- The Entrepreneur, in contrast, will be engineered to have a low ETR in separate-filing states. Perhaps it has its headquarters (and only nexus) in a combined-reporting state as in our Figure 9; in that case, its separate-filing ETR will be zero.

[20] *Geoffrey*, 437 S.E.2d 13.

[21] *See* Griswold, "Innovation: Part 2," *supra* note 1.

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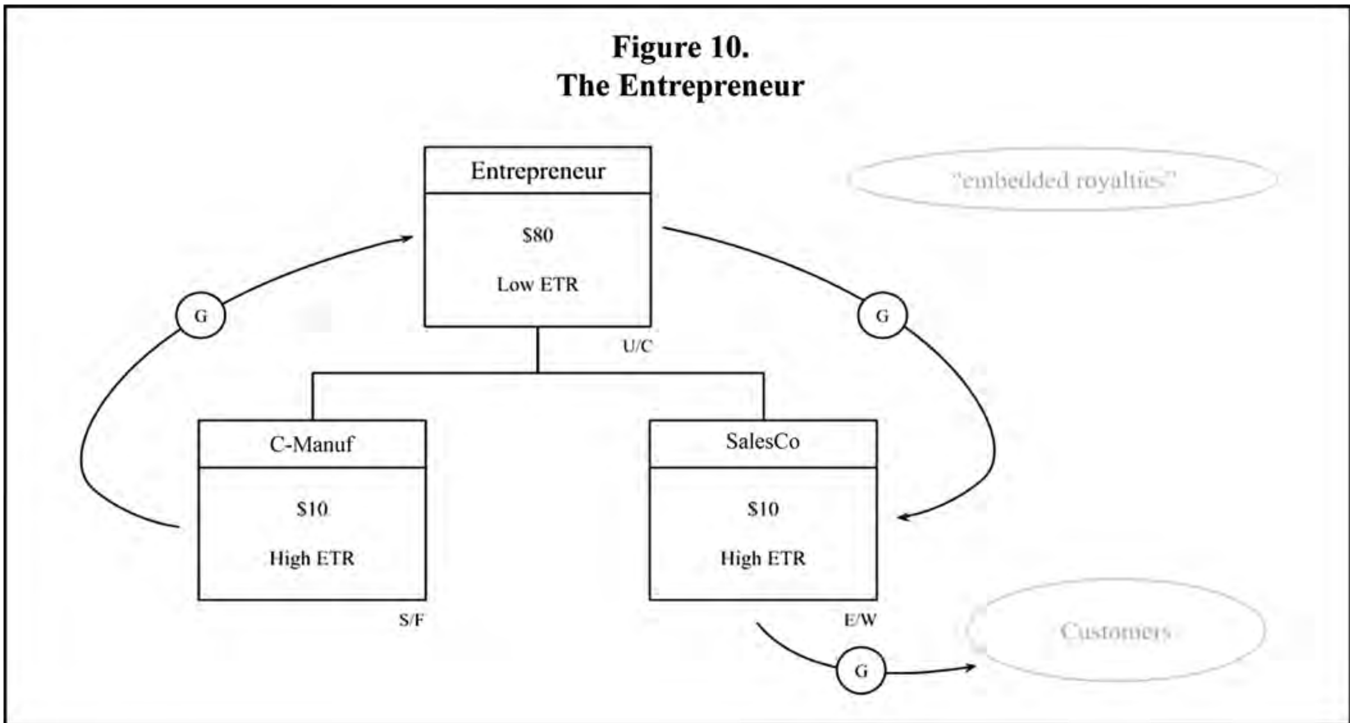

But if The Entrepreneur is headquartered in a separate-filing state, the planner will have to engage in some structural apportionment engineering to drive that ETR down, stuffing The Entrepreneur with activities that bring in unitary factors. A combined-reporting state sales office properly belongs in the SalesCo, and a combined-reporting state manufacturing plant properly belongs in C-Manuf, but the planner (modeling out alternative scenarios until the structure hits the CIT "savings" numbers promised to the client) might just swallow hard and stuff them up into The Entrepreneur anyway. Its separate-filing-state apportionment must be diluted, one way or another.

As with most of the CIT planning strategies described in this series of articles, The Entrepreneur in Figure 10 — some variant of which was apparently used by companies such as AutoZone[22] and Belk Department Stores[23] — seeks to circumvent CIT only in the most vulnerable states, those that have not adopted combined reporting. Water's-edge combined reporting (even though it provides less robust defenses than the recommended TUCR method) would shut down the avoidance described in this strategy.

Innovative planners and avoiders also thought about how water's-edge combined-reporting states automatically shut down this avoidance strategy. Crack open a soda pop, and let's talk about what they did next.

80/20 Entrepreneur Enhancement

Fortune 50 member PepsiCo (maker of Quaker Oats, Tropicana, Frito-Lay products, as well as its eponymous soft drink) adopted a version of The Entrepreneur entity stripping strategy described above, seeking to sidestep CIT in separate-filing states with a structure that looks much like that illustrated in Figure 10. Not content with escaping CIT only in separate-filing states, however, Pepsi and its advisers cast about for a way to enhance The Entrepreneur strategy so that it could duck CIT in water's-edge combined-reporting states as well.[24]

[22] *AutoZone*, Dkt. No. I9.ALJ-1 7.0068.CC.

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

[24] *PepsiCo v. Illinois*, 16 TT 82; 17 TT 16 (Ill. Tax Trib. 2021).

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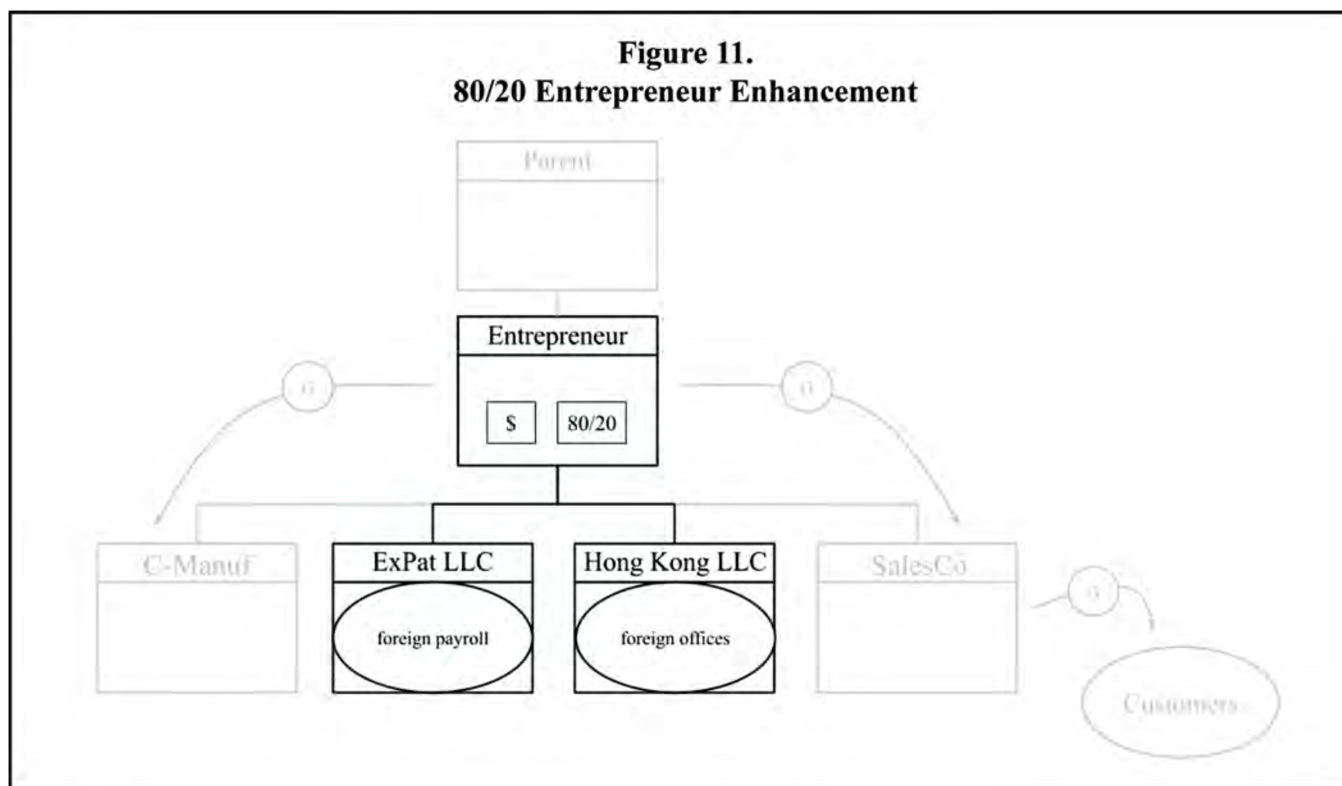

Figure 11.
80/20 Entrepreneur Enhancement

Remember the 80/20 backdoor that Zebra Technologies used to siphon tax base out of Illinois (a combined-reporting state)?[25] Pepsi and its advisers figured they could use the 80/20 exception to unitary combination in a stripping strategy, too.

Figure 11 shows how Pepsi and its advisers did it. The greyed-out boxes and arrows show Pepsi's basic Entrepreneur structure: The operating company was stripped of its manufacturing operations, which were separately incorporated in C-Manuf; its sales operations were similarly stripped out and placed into a new SalesCo. (These temporary naming conventions, or something very like them, are used by most planners as they develop their avoidance plans in the feasibility and design stages. Nearing the implementation phase, planners invite their clients to provide final names intended to obscure the structure's intent from state tax auditors.)

With little of the group's profit allocated by transfer pricing to either of these NewCos (as in Figure 10), most of the profit in Figure 11 was concentrated in what remained of Pepsi's old Frito-Lay operating company — renamed Entrepreneur Co here because it has basically nothing left in it but the brains and IP of the operation. Stripped of any separate-filing operations, The Entrepreneur Co could claim nexus insulation and zero (or tiny) engineered apportionment in separate-filing states.

This phase of its Entrepreneur strategy (shown in Figure 10), Pepsi hoped, would allow it to successfully escape CIT in all the separate-filing states.

Turning to Figure 11 now, the reader will recognize The Entrepreneur structure in grey, with The Entrepreneur itself, along with two new entities, in black.

The bold black boxes in Figure 11 illustrate the combined-reporting state enhancement. To qualify The Entrepreneur for the 80/20 back door, Pepsi needed to get 80 percent or more of Entrepreneur's payroll and property to be located outside the United States. After the initial stripping, Entrepreneur didn't have much property or payroll left to strip, so its U.S. apportionment factors could be diluted without

[25] *See* Griswold, "Innovation: Part 3," *supra* note 2, at 1270 and Figure 7.

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it having to move in much foreign property and payroll at all.

To engineer the necessary apportionment dilution, Pepsi first set up two NewCos — we'll call them ExPat LLC and Hong Kong LLC — organized as limited liability companies with Entrepreneur Co as the single member of each. Defaulting to "disregarded" status (treating the LLCs as if they were divisions of Entrepreneur Co for state and federal income tax purposes), whatever apportionment factors were possessed by these disregarded single-member LLCs would simply flow up into Entrepreneur Co and be counted there in the 80/20 qualification calculation.

For the property factors, PepsiCo transferred to Hong Kong LLC the ownership of some of its international offices. For the payroll factors, it moved (at least on paper) its preexisting network of "expatriate" employees who had been seconded from the United States to temporary assignments overseas, where they were already living and working.

Et voilà! More than 80 percent of Entrepreneur Co's property and payroll were (at least on paper) overseas. Entrepreneur Co, along with its enormous tax base, was now excluded from the unitary combined return in more than half the unitary-combined states.

After stripping out the original OpCo's separate-filing-state nexus and apportionment-producing operations and using transfer pricing to concentrate most of the group's profits there, Pepsi had created an Entrepreneur Co with most of the group's tax base but virtually none of its separate-return-state ETR. On top of that, Pepsi had turned its Entrepreneur Co into an 80/20 company as well by stuffing it with foreign property and payroll factors. Putting together a variety of building blocks and hybrid strategies, what had Pepsi achieved?

The bulk of the group's income would, Pepsi hoped, sidestep CIT almost everywhere. Illinois, California, and other water's-edge combined-reporting states will win some and lose some when they attempt to neutralize this type of avoidance structure for all those companies that try it.

Alternatively, every one of these water's-edge combined-reporting states could eliminate this tax avoidance scheme; no further litigation needed. How? By adopting TUCR.

Procurement Co

In the SalesCo and The Entrepreneur strategies outlined earlier, planners designed stripping strategies by starting with the "supply chain segregation" building block. If the sales and distribution segment of the supply chain attracts too much nexus and too much separate-filing-state ETR, the avoider cleverly strips out that segment and skinnies down the new SalesCo's tax base with transfer pricing. Similarly, if the manufacturing segment of the supply chain sits in a handful of states that greatly increase OpCo's apportionment factors there, strip out that segment and reduce new C-Manuf's tax base by asserting that it's entitled to only tiny profits.

Various strippable functions: Is there any part of the supply chain that we have not yet stripped out? The answer will, of course, vary by company. The Research and Development Co. (R&D-Co) is common in CIT avoidance structures, as are Employee LeaseCos, TransportationCos, MarketingCos, OnlineSalesCos . . . the list is long and diverse. So the avoidance innovator starts ruminating again.

Stripping out the purchasing function: In our example here, the innovator has identified yet another segment to strip. This next set of stripping strategies looks further upstream in the supply chain. Depending upon the industry, this may be the extraction of minerals from mines or food from farms, or perhaps the acquisition of unfinished goods that the company will process before selling along in the supply chain to its customer — which may be the ultimate consumer or a business-to-business customer that occupies a downstream segment of the supply chain. In all these cases, the segment about which we speak is essentially procurement.

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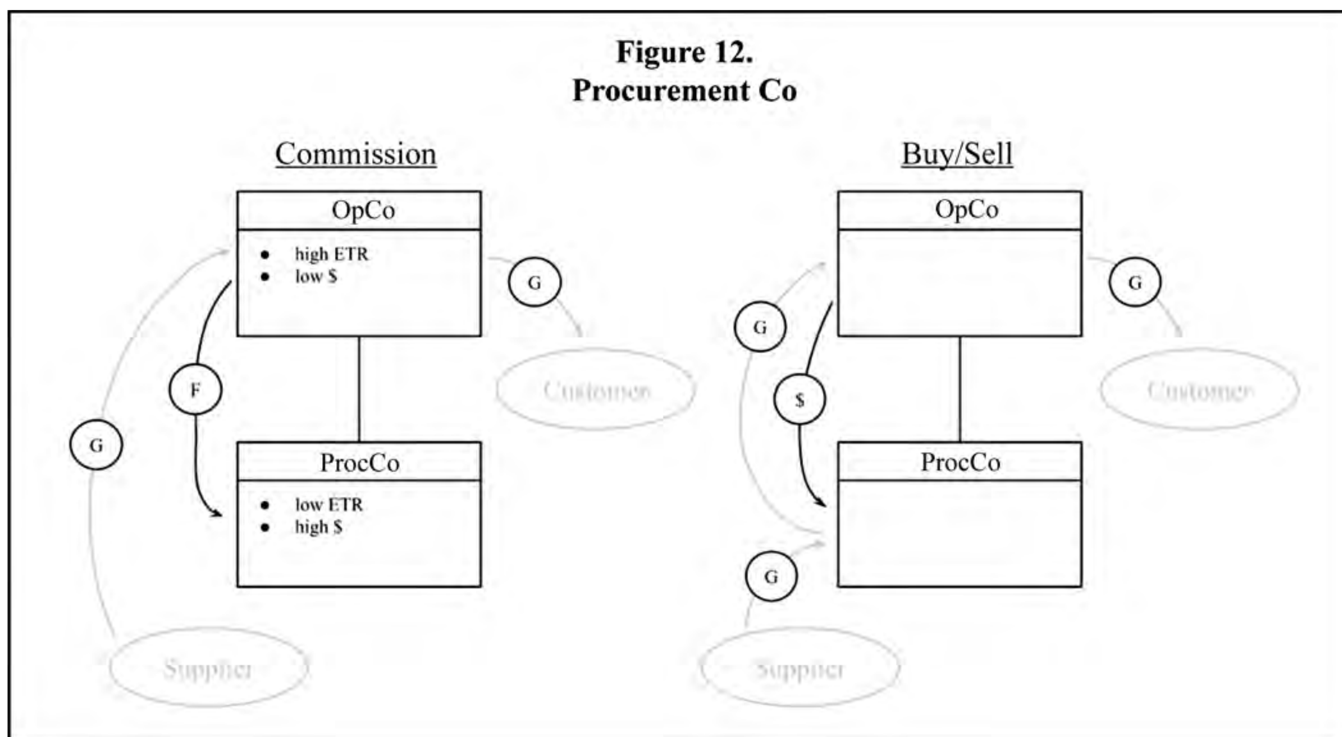

Planning innovators found that if they stripped out the organization's procurement function into its own legal entity, they could use a procurement company (typically known as ProcCo or ProCo) as a CIT side-stepping strategy as well. ProcCo may be appended to The Entrepreneur structure in Figure 10, hanging off the manufactured ManufacturingCo at the bottom left of the chart, or stripped out in any number of other structures.

A popular strategy, ProcCo has been deployed across multiple industries, but particularly in the chain retail industry, which has always been a hotbed of CIT avoidance. Michaels Stores,[26] Staples,[27] Target,[28] and Tractor Supply,[29] for example, are apparently among this strategy's users.

Figure 12 presents two common variants of a simple ProcCo structure that strips the purchasing function from an otherwise multipurpose OpCo.[30]

OpCo has a high ETR in separate-filing states, so the planner shifts OpCo's tax base to a newly stripped out ProcCo. Moving the procurement function to a combined-reporting state will give ProcCo the necessary low ETR in separate-filing states so that it can function as a tax shelter. If moving that function is not realistic, alternative means of apportionment engineering might include a strategy in the "stuffing" family, to be illustrated in part 6 of this series, in Figure 18: the Stuffed Substance IHC.

For both ProcCo variants in Figure 12, the goal is to concentrate income in the low-ETR entity, ProcCo, rather than in the high-ETR entity, OpCo. When, as here, the income concentration building block is preferred over income siphoning, the pricing building block is

[26] *Michaels Stores Inc. v. South Carolina*, Dkt. No. 19-ALJ-17-0044-CC (S.C. ALC 2020).

[27] *Staples*, No. 2597.

[28] *Target Brands Inc. v. Department of Revenue*, No. 2015CV33831 (Colo. Dist. Ct., City and Cty. of Denver, 2017).

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

[30] The reader may recall that a ProcCo can be designed by the planner to escape or defer its client's sales/use tax obligations as well as its corporate income tax obligations. *See* Griswold, "Innovation: Part 3," *supra* note 2, at 1264.

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central. The commission model reduces OpCo's tax base because OpCo takes a deduction for the commission or service fee it pays to ProcCo. The buy/sell variant is more common, perhaps because it allows the company to claim supplier-provided volume purchase discounts for ProcCo, justifying its price markup when it on-sells to OpCo.

Under either variant, the result is the same: The vulnerable separate-filing state loses revenues unnecessarily. Adopt TUCR, and the vulnerability ends.

FactorCo

Looking back down the supply chain even beyond the sales and distribution stages, the planner finds another strippable function that can be used to CIT avoidance advantage: the collections function.

When a company's customer buys on credit, the asset the business receives is not cash but an account receivable. The company's collections department generally will not be able to collect 100 percent of those receivables, and it may take time and resources to do the collecting. Irrespective of tax avoidance, a cash-strapped business may "factor" those receivables to convert them into cash . . . for a price. That price here is called "discount."

"Factor" is both a verb — the act of obtaining short-term nonrecourse financing by selling one's accounts receivable to a third party — and a noun: The cash-hungry company factors (sells) its accounts receivable to a factor (a third-party financial institution like altLine or RTS Financial) at a discount. The Factor determines that discount through an underwriting process that evaluates the quality of the receivables, the company's collections history, and so on, then adds a profit element for itself. Factoring may be done with or without notification to the company's debtor-customers. In the no-notification model (perfect for tax avoiders seeking to keep structural and transactional changes a secret from everyone except the state auditor the avoider hopes to deceive), payments still come from customers to the company, which remits them to the Factor.

Planning innovators wondered about a captive FactorCo. The company with the accounts receivable incurs a loss when it factors them at a discount to the Factor. Tax base erosion here would be caused by that artificially engineered discount.

The client need not be cash-starved; indeed, the ideal target would not be so, for in that case it may well have been doing genuine factoring in the marketplace. No. Here, the ideal target would have large accounts receivable of sufficiently poor quality (or at least with enough facts that a creative transfer pricing economist could weave a story of poor quality) just sitting on its books in the collections department.

Figure 13 provides yet another reminder that if a financial transaction is conducted in the real world, it can be created inside a corporate group to dodge CIT. Here we illustrate a typical FactorCo strategy, much like that used by "kitchen sink"[31] alleged avoidance purchasers like AutoZone[32] and Belk Department Stores,[33] as well as by avoiders like R.R. Donnelley,[34] which opted for a less diversified but perhaps more nuanced CIT avoidance portfolio.

The FactorCo must have low or no separate-filing-state ETR, so many avoiders use DHCs or IHCs (familiar from the siphoning family above). Others use affiliates into which they have stuffed dilutive unitary-state apportionment factors (from companies that operated within, or sold to customers located in, unitary combined-reporting states).[35] TUCR, of course, would have neutralized this.

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[31] *See* Griswold, "Innovation: Part 3," *supra* note 2, at 1272.

[32] *AutoZone*, Dkt. No. I9.ALJ-1 7.0068.CC.

[33] *Belk*, Dkt. No. 2O-ALJ-f7-02f 1-CC.

[34] *R.R. Donnelley & Sons Co. v. Arizona*, 224 Ariz. 254, 229 P.3d 266 (2010).

[35] *See also* Virginia Public Document Ruling No. 11-162 (2011).

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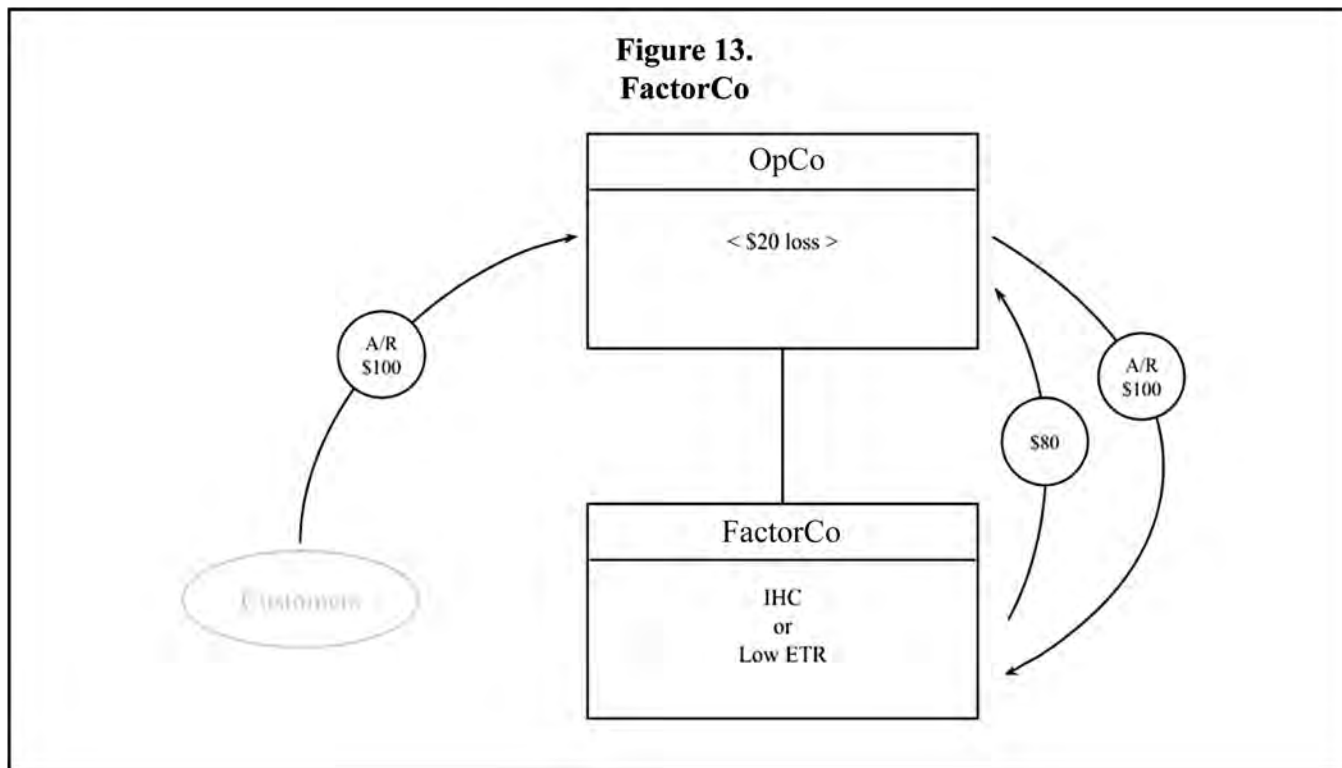

Figure 13.
FactorCo

The Tax Avoidance Tango

The stripping family, like the siphoning family of CIT avoidance strategies illustrated in part 3, victimizes vulnerable states that still rely on only a grab bag of costly, slow, and uncertain countermeasures.

For innovative tax avoidance planners and their corporate clients, the secret to successful state CIT avoidance is getting states to believe that they are stuck with the splintering of a single unitary business group into two or more independent actors, and that these actors are engaged in meaningful intercompany financial transactions with each other . . . when they are not.[36]

It takes two to dance the tax avoidance tango, but the TUCR filing method recognizes that there is in reality just one dancer here, whose embracing arms deceptively move money from his right pocket to his left.

Straddling strategies will be addressed next, in part 5. And guess what: TUCR would neutralize them, too. ■

[36] *See* Griswold, "Innovation: Part 1," *supra* note 7, at 739.

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