taxnotes® state

Volume 104, Number 7 ■ May 16, 2022

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by Don Griswold

Reprinted from *Tax Notes State*, May 16, 2022, p. 729

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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 begins a six-part series illustrating many of the principles underlying proactive structural planning seeking to reduce the multistate income tax obligations of large corporations. He explains foundational analytical building blocks to illustrate recurrent strategy types and the inadequacy of current state countermeasures in subsequent parts. Throughout the series, he proposes that the best counter to planners' ongoing innovations would be state adoption of true unitary combined reporting.

Proactive state corporate income tax (CIT) planning — restructuring a corporate group's legal entities and the financial transactions among them in a way that reduces the group's multistate income tax obligations in a lawful manner — remains alive and well today. This is true despite two decades of creative government countermeasures since the heyday of state CIT minimization in the Roaring '90s, a period that Nobel Prize-winning economist Joseph Stiglitz has described as a time of "innovativeness" that sometimes led companies to "increase their profits more by figuring out how to avoid taxes than by producing better products."[1]

Lawful state CIT avoidance cost the public $17 billion of state tax revenue ($2.85 billion from multistate planning, the rest from "offshoring") in 2018.[2] How is it that states have remained so "vulnerable to a wide variety of corporate tax shelters and tax-avoidance strategies"[3] despite tightened accounting and disclosure rules for aggressive tax positions, targeted antiabuse laws, and the adoption by over half the states of water's-edge unitary combined reporting?

Writing in *Tax Notes*, one well-known innovator of such strategies has explained that today's planning is "more complex than strategies of earlier generations"; that if a strategy can garner an opinion that it is "more likely than not" to beat a state challenge in court, "the bite of FIN 48" is merely a flesh wound; that financial statement reserves for uncertain tax positions mean little to companies that care most about "cash flow"; and that UTPs become bookable tax reductions for old years when the assessment limitations period expires or states simply give away earlier years in amnesties and voluntary disclosure programs.[4] "It makes sense to do state planning," this adviser explains, "even if the planning takes a few years to 'mature' into financial statement earnings."

Most importantly, the state CIT adviser industry provides large corporations with a well-

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[1] Joseph Stiglitz, "The Roaring Nineties," *The Atlantic*, Oct. 2002.

[2] 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), at 10, 14, 15 (Jan. 2019).

[3] Michael Mazerov, "State Corporate Tax Shelters and the Need for 'Combined Reporting,'" Center on Budget and Policy Priorities, at 1 (Oct. 26, 2007).

[4] Charles E. Barnwell Jr., "State Tax Planning — What's Left?" *State Tax Notes*, Dec. 21, 2009, p. 857. Barnwell was one of my two mentors in the 1990s as I began my long career in state and local tax avoidance innovation. No nonpublic information is traceable to any specific person or entity in this series of articles.

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funded intellectual infrastructure that is constantly innovating. By the time underresourced state revenue departments figure out one generation of planning strategies, industry is already on to the next. No increase in the sophistication of audit techniques, and no set of reactive antiabuse laws, can keep up with this industrial-scale innovation. If states keep on playing the CIT game as they have played it for decades, industry will continue to win, and the public will continue to lose.

This little series of articles seeks to raise awareness of industry's enduring innovation advantage by illustrating how state CIT planners think. I hope that the perspectives shared here will help state auditors identify and neutralize the next generations of planning. My goal here, though, is to persuade the state tax policymaking community to push for widespread state legislative adoption of a CIT filing method that will neutralize industry's advantage in one fell swoop. I call this approach "true" unitary combined reporting (TUCR).

TUCR is a worldwide unitary combination filing method that includes four primary elements:

- worldwide unitary combination with no water's-edge election (no exclusion of foreign affiliates) to neutralize state tax piggybacking on federal tax strategies that shift profits out of the United States;
- "multi-industry" unitary combination that includes payers of specialized taxes (like banks and insurers) to eliminate opportunities arising from discontinuities among varying business activity tax bases; and
- "throwback" sales factor apportionment sourcing to limit corporations' ability to generate "nowhere income" (a slice of the profit pie that escapes tax everywhere) by increasing the likelihood that the worldwide apportioned share of their taxable income will be 100 percent.[5]

[5]In this proposal, I have chosen not to wade into the controversial *Joyce/Finnigan* debate even though it ultimately must be addressed and resolved in order to make TUCR consistent across the states in matters — including a multi-entity unitary group's apportionment, throwback calculations, and the siloing or sharing of tax attributes like carryovers of state tax credits and net operating losses — that are central to TUCR's ability to neutralize multistate CIT avoidance planning completely. *See generally* "Finnigan Briefing Book Provided to Phil Skinner," Multistate Tax Commission; *In re the Appeal of Joyce Inc.*, Calif. Board of Equalization 1966); and *In re the Appeal of Finnigan Corp.*, No. 85-623-LB (Calif. BOE 1990).

So, let's get to work. Here in part 1 of the series, we will enter into the mindset of a state CIT planner by exploring some of the most common elements that constitute the building blocks of state CIT planning.

A Primer: CIT From a Planner's Perspective

If a state has the power to tax a company, the company's CIT liability is its tax base multiplied by its effective tax rate (ETR; statutory tax rate multiplied by the company's apportionment percentage). If the company has multiple legal entities, the state's filing method (separate or combined) determines how the calculation works for the group:

If jurisdiction, then
Tax = [Tax Base] x ([Statutory Tax Rate] x Apportionment %])
subject to separate or coming filing rules.

Complexity and inconsistency beset the corporate income tax laws of the 50 states just as they do the Internal Revenue Code, so even this rudimentary equation provides a rich source of material for developing a host of CIT minimization strategies.

Jurisdiction

If a state is powerless to impose tax on a legal entity, that entity becomes highly prized by tax planners as a place to concentrate taxable income. For that reason, isolation of a legal entity from a state's power to tax has been central to much state CIT planning.

Planners often start with P.L. 86-272, which provides a federal safe harbor from CIT for businesses that limit their in-state activity to soliciting sales of tangible goods, then proceed to the constitutionally established outer limits of state CIT imposition power ("nexus"), which for a quarter century planners argued was limited by an ambiguous U.S. Supreme Court ruling[6] to legal entities having a "physical presence" (ownership of property, employment of personnel, or contractors) in the state. The "nexus isolation" building block (discussed below) is still present in many CIT strategies despite a 2017 Supreme

[6]*Quill v. North Dakota*, 504 U.S. 298 (1992).

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Court ruling that retroactively subjects to tax jurisdiction any legal entity having "an extensive virtual presence" in the state.[7]

Tax Base

Reduce a corporation's tax base, and you reduce its tax. State CIT tax bases are "net" income, obtained by deducting from gross income a variety of expenses. Deductions are highly manipulable elements, and thus are highly prized by tax planners, who have a field day with tax base "erosion" and other techniques discussed below.

Most states' CITs are imposed on a tax base that begins with a company's federal income tax base, which then makes a variety of addition and subtraction modifications, along with other adjustments. States do not always conform to all IRC income tax provisions (depreciation and the dividends received deduction are frequent areas of nonconformity), and the significant differences between the federal consolidated group and the various types of state filing methods (discussed below) make, for example, the federal consolidated return regulations (addressing intercompany transactions) irrelevant or problematic.

Apportionment

Analogizing a corporation's tax base to a pie, apportionment addresses how big a slice is portioned out to each state that has jurisdiction to tax it. States properly want fair and full apportionment, while planners want lots of pie left remaining on their client's plate. States divide up ("apportion") the profit pie by using a formula that examines measurable proxies for business activity. Many states now apportion based solely on a sales fraction, though for decades most included property and payroll fractions as well.

Let's illustrate by imagining ABC-Co — a seller of goods that has nexus with Pennsylvania, conducts activities that forfeit the safe harbor of P.L. 86-272, and thus is liable for CIT in Pennsylvania (which has adopted single-sales-factor apportionment).[8] Imagine that ABC-Co has $100 million of total gross sales receipts across the country in a given tax year, $12 million of that attributable to customers located in Pennsylvania. ABC-Co, then, has a 12 percent Pennsylvania apportionment fraction:

$$\frac{\text{\$12M PA Sales}}{\text{\$100M Sales Everywhere}} = \text{12\% Pennsylvania apportionment}$$

ETR

Planners find it useful to think in terms of a legal entity's ETR, calculated by multiplying the state's statutory CIT rate by the company's apportionment fraction for that state. Consider the company in the paragraph above: 12 percent of its taxable income is apportioned to Pennsylvania. If we round up Pennsylvania's 9.9 percent statutory CIT rate to 10 percent to simplify the math, the company has a 1.2 percent ETR in Pennsylvania. For reasons explained below, planners often add up a company's ETRs in every state that follows the separate-filing (S/F) method. The resulting "S/F ETR" is often set as a bogey for the "state tax minimization" planning team to eliminate completely.

Filing Method

Most large business enterprises today operate with multiple legal entities, as a result of acquisitions or other legitimate business reasons, but also to avoid tax and other regulatory obligations. While the IRC takes a "federal consolidated group" approach to such multi-entity businesses, states generally use one of three basic methods, sometimes allowing taxpayers to choose among them: separate filing, water's-edge unitary combination, and worldwide unitary combination.[9]

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[7] *South Dakota v. Wayfair Inc.*, 585 U.S. ___ (2018).

[8] 72 Pa. Stat. section 7401(3)2(a)(9)(A)(v).

[9] A fourth method, in which some separate-filing states require multiple nexus entities to file a combined return after apportioning their gains and losses, is a wrinkle not addressed here.

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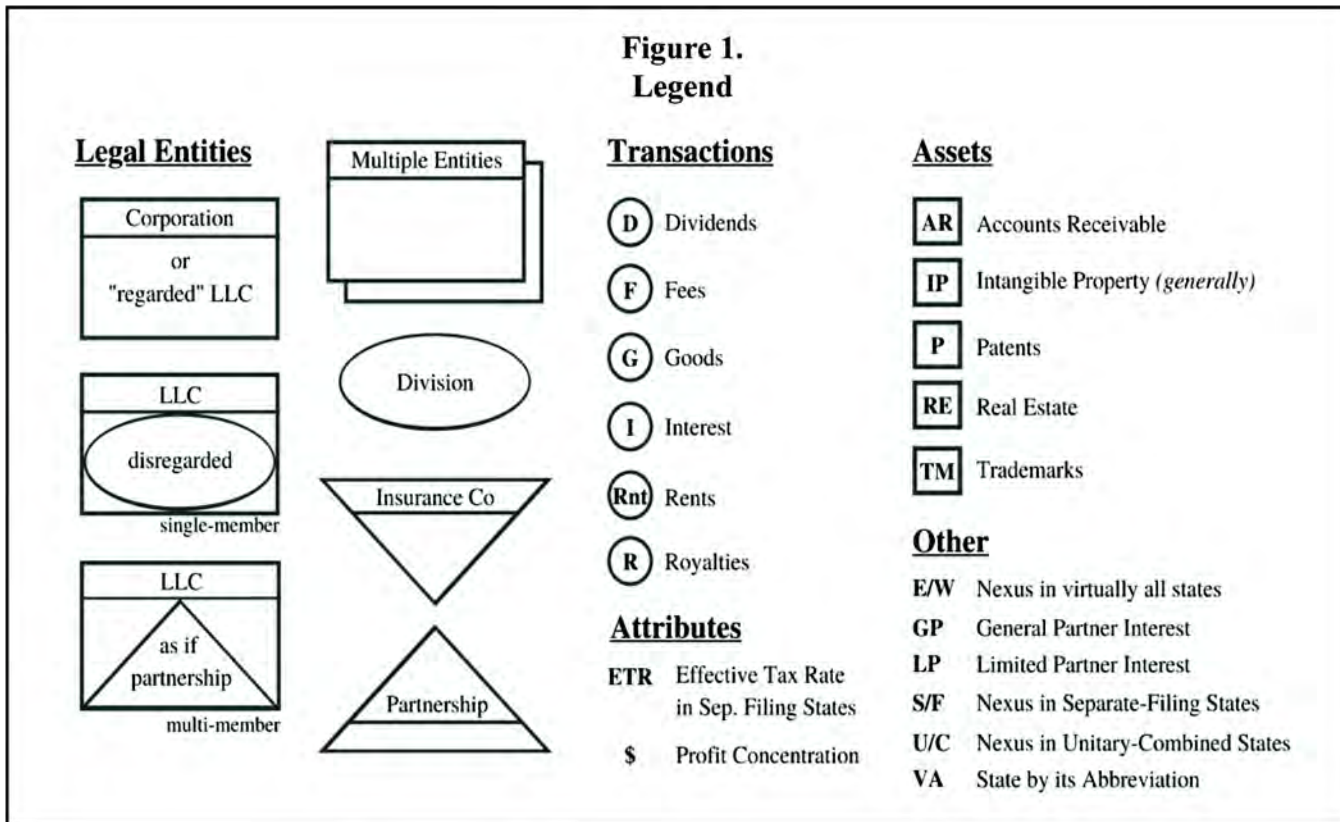

Separate-filing methods ignore the business reality that an integrated "unitary" business group operates for all intents and purposes as if it were a single legal entity; separate-filing states require each entity that "has nexus" with the state to file its own separate CIT return, ignoring the interrelated mutual dependency of the group as a whole. This system makes the separate-filing state highly vulnerable to efforts by planners to escape some of that tax.

"Unitary combined reporting" methods come today in two major forms. Comporting well with the business reality of integrated mutual interdependence among members of a unitary group, but virtually nonexistent at present,[10] the "*worldwide* unitary combination method" determines the tax base and apportionment factors of in-state legal entities (those that "have nexus") by combining tax base and apportionment data from all unitary legal entities (whether they have nexus or not) around the world. Most common is the "*water's-edge* unitary combination method," which — departing from business reality for multinational corporations — excludes foreign affiliates from the calculations. This approach leaves massive holes in water's-edge unitary combined states' protection. Worldwide unitary combination — particularly when strengthened to become TUCR — would be the single most effective antidote to CIT avoidance.

The varying levels of protection offered by these three filing methods are illustrated in Figure 2. First, though, it may be useful to familiarize yourself with the legend in Figure 1, which will be useful throughout this multipart series of articles.

[10]New Hampshire's recent decision to evaluate moving from water's-edge to worldwide combined reporting is welcome news. *See* Benjamin Valdez, "New Hampshire Creates Worldwide Reporting Study Commission," *Tax Notes Today State*, Apr. 13, 2022.

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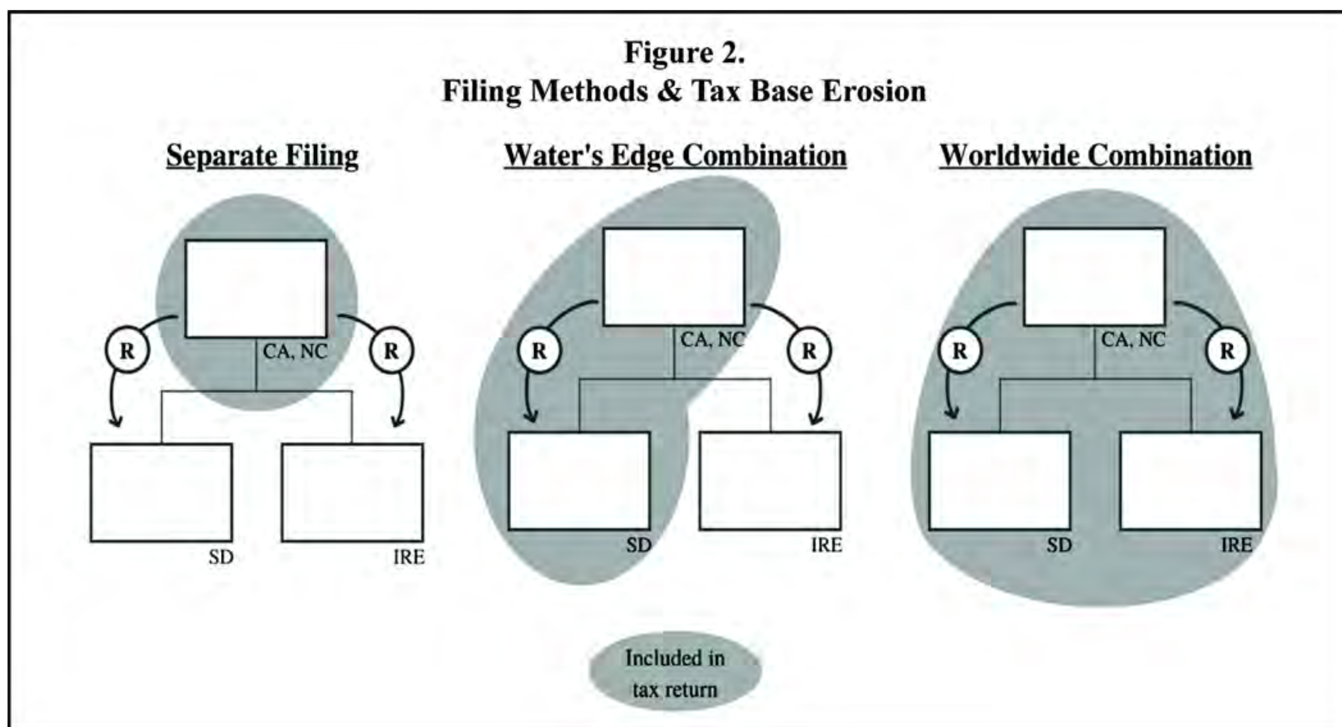

In Figure 2, Parent has nexus in North Carolina (a separate-filing state) and California (a water's-edge combination state). Parent has created two NewCos — one in South Dakota (which does not impose a CIT),[11] and another in Ireland (until recently, a notorious tax haven)[12] — transferring its domestic trademarks to one and its foreign trademarks to the other, and now paying royalties (shown with arrows) for that use. The shaded ovals represent the reach of the state's filing method. The separate-filing state (North Carolina) loses tax base that has been siphoned off by both of Parent's contrived royalty deductions, foreign and domestic. The water's-edge combined state (California) does not lose tax base for the domestic royalty because both sides of that transaction (royalty deduction and royalty income) are within the combined group, canceling each other out; but California does lose tax base for the foreign royalty because its combination stops at the water's edge.

Only worldwide combination (with or without the TUCR enhancement) prevents this base erosion completely, including (and canceling out) the deduction and income sides of both the foreign and domestic royalties that were artificially created by the tax planner.

Building Blocks for CIT Planning

To begin our discussion of building block elements, recall that the tax formula discussed above in the planner's CIT primer includes three core attributes — jurisdiction (nexus), tax base, and apportionment — that can be manipulated by the planner at will. Mixing and matching these planning elements in the contexts of a corporate group's particular (and manipulable) fact pattern, the planner develops one or more structural CIT avoidance strategies for consideration by its corporate client. Later in this series we will discuss a variety of these strategies, grouping them into "families" that share similar features.

Some of the naming conventions and organizing taxonomy here will have been used by planners that the reader has come across; others may not. The goal here is to suggest a common vocabulary and a common way for auditors, policy analysts, and policymakers to think about the CIT avoidance problem.

[11] South Dakota Department of Revenue, Corporate Income Tax.

[12] Liz Alderman, "Ireland's Days as a Tax Haven May Be Ending, but Not Without a Fight," *The New York Times*, July 8, 2021.

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Apportionment Engineering

Much structural CIT planning in separate-filing states boils down to (1) creating tax-favored legal entities and then (2) concentrating most of the group's profits there instead of in tax-disfavored affiliates. Qualify a company as a nexus-isolated intangibles holding company (IHC) tax shelter in a tax haven state like Delaware (infamous for its Delaware intangible holding companies, or DHCs),[13] for example, and you've got an entity with a zero apportionment fraction, and thus an ETR of zero in separate-filing states. Alternatively, put that IHC in a state like Wyoming that imposes no CIT,[14] and you've got another zero-ETR entity where you can park your income-producing assets.

Zero is tempting for a planner. Advisers still propose variations on the DHC/IHC structure (illustrated later in this series) today, decades after they became notorious, and many sophisticated companies still have these structures in the organization chart's diverse grab bag of simple and sophisticated avoidance strategies.

But zero is not the only game in town. CIT planning is often an exercise in ETR arbitrage, relocating taxable income from an entity with a high ETR to an entity with a lower ETR. For such "apportionment engineering" work, apportionment factors sourced to unitary states become valuable attributes for the planner. Move them around as much as you like and they will have no impact in unitary states, but they can drive separate-filing state apportionment (and thus S/F ETR) down when cleverly rearranged.

To illustrate the engineering of a desirable low-S/F ETR entity, recall the ABC-Co example in the primer above. ABC-Co starts out with a high Pennsylvania apportionment fraction, calculated like this:

$$\frac{\$12\text{M PA Sales}}{\$100\text{M Sales Everywhere}} = 12\%\ \text{Pennsylvania apportionment}$$

But imagine that the planner discovers in the client's org chart a large affiliate, XYZ-Co, which is also subject to Pennsylvania CIT (perhaps because it owns a distribution center in the state) and sells $300 million of goods each year — but only to customers in unitary combined filing states (like California). Imagine also that, as a stand-alone entity, XYZ-Co's apportionment in Pennsylvania, where it makes no sales at all, is zero:

$$\frac{\$0\text{ PA Sales}}{\$300\text{M Sales Everywhere}} = 0\%\ \text{Pennsylvania apportionment}$$

Simply merge XYZ-Co into ABC-Co and (voila!) the resulting entity (call it New ABC-Co) has $12 million of sales to Pennsylvania customers and $400 million of sales everywhere. New ABC-Co's apportionment calculation looks like this:

$$\frac{\$12\text{M} + \$0\text{ PA Sales}}{\$100\text{M} + \$300\text{M Sales Everywhere}} = \frac{\$12\text{M}}{\$400\text{M}}$$

$$= 3\%\ \text{Pennsylvania apportionment}$$

The planner's exercise in apportionment engineering cut New ABC-Co's Pennsylvania apportionment from 12 percent to 3 percent. Again, rounding Pennsylvania's statutory tax rate up to 10 percent to keep the math simple, New ABC-Co's ETR dropped from 1.2 percent to 0.3 percent. The savvy planner will look for an XYZ-Co that has a much lower profit margin than ABC-Co, bringing in lots of "unitary factors" to dilute apportionment without bringing in additional tax base (offsets to tax reductions).

Additive apportionment dilution can be supplemented with subtractive dilution if a "factor trap" entity is created — perhaps a captive insurance company or (in days gone by) the infamous Texas limited partnership (both discussed later in this series). To completely neuter apportionment engineering, a state must adopt TUCR with a worldwide and multi-industry method.

Asset Placement

Another common element in CIT planning focuses on the strategic placement of assets within the corporate group. Asset placement can affect any or all of the three manipulable core attributes

[13] *See, e.g.*, "Delaware: An Onshore Tax Haven," ITEP (Dec. 2015).

[14] Janelle Cammenga, "State Corporate Income Tax Rates & Brackets 2021," Tax Foundation (Feb. 3, 2021).

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in the CIT formula — nexus, tax base, and apportionment. Real and tangible assets like office buildings and equipment, when moved, may strip a legal entity of nexus (remove it from a state's power to impose CIT) or create nexus for it. If the state's apportionment formula includes a property factor, asset placement affects the portion of an entity's tax base that may be taxed in a separate-filing state. If the asset attracts an income stream (rent, royalties, or interest, for example), that asset's placement also manipulates the sales factor in every separate-filing state.

Three types of assets are of particular interest to planners when they work on manipulation of the tax base: assets that attract income streams from third parties; assets that the company anticipates selling at a large gain or a large loss; and assets that, if separated from the affiliated user, can move tax base from one entity to another. For the latter type, intragroup assets like patents, trademarks, real estate, promissory notes, and accounts receivable can produce the kinds of intercompany transactions that are essential to creating deductible expenses for entities with a high ETR in separate-filing states.

The asset placement building block is central to the stashing, straddling, and siphoning families of strategies described and illustrated later in this series. Adoption of TUCR would neutralize the effectiveness of asset placement as a building block in most structural CIT planning strategies.

Complexity

Try a little exercise when you have too much time on your hands (and access to a good online state tax research tool): Find a company that has had published court decisions in multiple states, each state prosecuting its attempt to shut down a CIT avoidance strategy or two that its revenue department identified on audit. From time to time, you will find that two states will have identified entirely different planning strategies, each missing a significant strategy that the other state's auditors caught.

This may not be accidental. When aggressive companies engage creative advisers — particularly when such an engagement reoccurs multiple times over a period of years, perhaps with a different adviser each time — the planning company will have deployed a diverse portfolio of strategies throughout its legal structure. Planners hope that auditors will stop once they find the "low hanging fruit." The more sophisticated (and recent) the strategy, the more likely it is to be hidden in a series of complex and obscure intercompany relationships among multiple obscure entities that are designed, quite simply, to tire out the state's audit team or run out the clock on the audit.

Income Concentration

Strategy identifiers like "income shifting," "profit siphoning," "base shifting," and "base erosion" all refer to building blocks that move taxable income from a tax-disfavored entity to a tax-favored entity. For the most part, these strategies concentrate the tax base in a tax-favored entity by moving it there, with attendant apportionment changes that the planner will include in a spreadsheet in which it models projected "savings" (avoidance).

The income concentration element, though, can also be achieved by letting the tax base just sit in the entity in which it historically resided. Income concentration may be paired with apportionment engineering — converting the original entity itself from tax-disfavored (high ETR in separate-filing states) to tax-favored (low or no S/F ETR).

This "sit still" income concentration may be paired with the nexus isolation building block (discussed below) by stripping out of the entity all operations that carry separate-filing state nexus with them, leaving only unitary state nexus (and thus a zero S/F ETR) behind. It can also be combined with two frequently paired building blocks — supply chain segregation and transfer pricing — to strip down a multifunction operating entity into a sleek entrepreneur-type holding company that claims entitlement to most of the group's profits while containing few of the group's nexus- or apportionment-producing activities in separate-filing states. (This will be illustrated later in the series.)

Whether income concentration is achieved by moving the income or skinnying down the ETR, this central element of many CIT avoidance strategies can be eliminated with legislative adoption of TUCR.

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Nexus Isolation

While apportionment engineering concedes an entity's nexus but seeks to dilute the portion of its income that the state may tax, the "nexus insulation/isolation" building block goes for broke, seeking to reduce the entity's S/F ETR down to zero.

For decades, U.S. Supreme Court precedent on the topic was squishy enough to allow every planner to claim that its DHCs and IHCs had no CIT nexus anywhere except for the tax-haven-hosting state in which they had pretended to set up shop.[15] They filed no tax returns for such entities, taking a "catch me if you can" approach to their tax compliance obligations.

Companies whose business is limited to the solicitation and sale of tangible goods (plus a handful of ancillary activities) might also rely on the added protection of a federal law that provided a broad safe harbor from state CIT jurisdiction.[16] With a nexus-insulated entity in the group, other building blocks could be used to siphon, stash, and stuff the planner's way to "optimal" (very low) tax levels.

In 2017, however, the Supreme Court retroactively pulled the rug out from under planners who sought to use the nexus isolation building block. The Court's *Wayfair*[17] decision arguably stands for the proposition that virtually any entity with a website has commerce clause "substantial nexus" everywhere . . . so the planner's hope for nexus isolation may turn on litigation over a due process "minimum contacts" nexus; on the state's "doing business" tax jurisdiction statute, which is often very broad; and on the post-*Wayfair* status of P.L. 86-272 (has this federal safe harbor been mooted because some of every company's online presence is inescapably unrelated to solicitation of sales?).

The uncertain viability of planners' "no nexus" assertions is not, however, any reason for vulnerable states (separate-filing states and, to a lesser but still financially massive extent, water's-edge unitary states) to think they can escape the continued embarrassment and revenue devastation of giving away the fisc to CIT planners. Post-*Wayfair*, some of the nexus battles will continue to be litigated. In any event, nexus insulation is not a necessary element to many CIT planning strategies. TUCR remains the only complete answer.

Nonconformity

State CIT systems generally take a corporation's federal corporate income tax base as the starting point for the tax calculation. From the CIT planner's perspective, this is great news because most federal tax strategies that shrink (temporarily or permanently[18]) the tax base — like siphoning profits to overseas tax havens — also shrink the CIT base. This is sometimes referred to as "piggyback planning."

Separate-filing states are not the only victims of their general conformity to a federal tax base that is routinely and massively reduced by federal tax planning. Go back and take another look at Figure 2. Unitary combined states, with limited exceptions, end combination at the water's edge, leaving themselves exposed to all the federal tax siphoning strategies to which separate-filing states are exposed. Separate-filing and water's-edge unitary states all lose over $14 billion in tax revenue annually to general conformity to the avoidance-riddled federal corporate income tax base.[19] State adoption of TUCR (grounded on a worldwide filing group) would eliminate the state revenue hits that attend initial conformity to the federal income tax base.

Disappointing state legislative debates regarding global intangible low-taxed income[20] — will a state choose not to conform to these federal antiabuse rules or decouple its way into continuing vulnerability — stand in contrast to reasonable conformity/nonconformity policy debates in connection with the many inherent

[15] *Quill*, 504 U.S. 298.

[16] P.L. 86-272.

[17] *Wayfair*, 585 U.S. ___.

[18] If a taxpayer is patient enough to wait for the next corporate welfare giveaway, in the form of the tax-free or tax-favored "repatriation" provisions that Congress adopts from time to time, deferral of tax liability becomes permanent.

[19] *See* ITEP, *supra* note 2.

[20] The Tax Cuts and Jobs Act of 2017 adopted some provisions that put a bit of a dent in federal tax avoidance with its GILTI rules — effectively imposing a minimum tax on some types of planning structures — and all the states should conform. A state's failure to conform to the GILTI regime is simply voluntary vulnerability. *See* Daniel Bunn, "Gift or Lump of Coal: U.S. Cross-Border Tax Changes Won't Be Home for Christmas," Tax Foundation (Dec. 20, 2021).

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incongruities between federal and state group filing methods.

One such incongruity — inconsistent conformity to some rules governing deductions for dividends received from an affiliate — was used by me and my team in the 1990s to create an infamous CIT avoidance scheme in the "straddling" family of strategies illustrated later in this series: the captive real estate investment trust. Some inconsistencies are industry specific. Insurers, for example, are taxed federally on their net income while most states impose a gross receipts tax on premiums, leading planners to innovate the "captive insurer" and "adaptive insurer" CIT strategies (also illustrated in forthcoming articles).

Recharacterization

Federal and state governments on audit sometimes attempt to combat tax minimization planning by recharacterizing the nature of some transactions or entities on the grounds that they are shams (lacking sufficient economic substance or a dominant nontax business purpose) or organized into a series of steps designed to produce a tax-reducing result that would not exist under a simpler set of steps.

Planners do the same thing, but in reverse; this building block is omnipresent in CIT planning. Recharacterization — in the sense of changing the appearance of facts so that a tax auditor may not notice that tax avoidance is occurring — may include creating entities that exist only (or almost only) on paper;[21] claiming deductions for transactions under written "agreements" in which there actually exists only one party, not two;[22] or maintaining two sets of books (the true financial accounting records presented to SEC-attestation auditors and a second set maintained only for preparation of tax returns and for presentation to revenue department CIT auditors).[23] Dividends paid by a specialized entity can be laundered by passing them through an intermediate buffer entity on the way to the ultimate recipient, altering the treatment of those dividends.[24] (This building block appears in the REIT strategy illustrated later in the series.) The list goes on.

Shelter Entities

For state CIT avoidance to succeed, jurisdiction must be eliminated, apportionment must be diluted, or tax base must be reduced. Regarding the latter, quite frequently "reduce" means "move." Taxable income is often removed from one legal entity's tax base by moving it to the tax base of an affiliated legal entity. Broadly speaking, the recipient entity — the next building block up for discussion — is a "tax shelter" entity.

Best known to the public are tax shelter entities explicitly established and hosted in tax haven jurisdictions. Internationally, the most infamous tax havens include jurisdictions spread all over the world — Bermuda, the British Virgin Islands, and the Cayman Islands in the Caribbean; Ireland, Luxembourg, the Netherlands, and Switzerland in Europe; Hong Kong and Singapore in Asia; and more. Much closer to home, the United States — particularly including the states of Alaska, Delaware, Nevada, South Dakota, and Wyoming — has been added to lists of jurisdictions that actively host secrecy and tax haven activities.[25]

The most widely known state corporate income tax haven in the United States, of course, is Delaware, host of the infamous DHC tax shelter entity discussed earlier and illustrated later in this series. The now-defunct "Michigan single business tax holding company" may or may not have been designed intentionally to cannibalize revenue from its sister states, as was the DHC, but it functioned similarly as a state-designed tax shelter vehicle.[26]

Tax shelter entities are designed by planners as well as by tax-haven-hosting states, as we have seen in our exploration of the apportionment engineering building block above. Bespoke IHCs

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

[22] *See, e.g.*, Jesse Drucker, "Friendly Landlord: Wal-Mart Cuts Taxes by Paying Rent to Itself," *The Wall Street Journal*, Feb. 1, 2007, p. A-1.

[23] *Hormel Foods v. Wisconsin*, WI TAX No 07-I-17 (2010).

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

[25] 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 "Corporate Tax Haven Index," Tax Justice Network (2021).

[26] *See Martha Stewart Omnimedia v. Michigan*, No. 409820 (Mich. Tax Trib. 2011); and *Kmart v. New Mexico*, 131 P.3d 22 (N.M. 2005).

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(also known as intellectual property holding companies, royalty companies, trademark holding companies, finance companies, passive investment companies, and the like) — much like off-the-shelf state-hosted entities like DHCs[27] — generally receive profit shifting out of affiliates that are heavily taxed in separate-filing states. These IHCs generally locate (or pretend to locate) their headquarters and substantial apportionment factors in unitary combined states (in which domestic structural CIT planning is ineffective) or in states that do not impose a CIT at all.

CIT-minimizing corporations also use natural tax shelter entities, requiring no host state to offer them, no planner to engineer them — the preexisting LossCo. Find a legal entity in the affiliated group that is expected to produce significant net operating losses (or carry these NOLs over to future years) for the foreseeable future, and the corporation has a natural entity into which it may shift CIT base siphoned out of an entity with a high ETR in separate-filing states.[28] Or vary the approach by converting the profitable affiliate into a disregarded single-member limited liability company and have the LossCo buy it and let the LLC's tax base flow up and become absorbed by the NOLs.

A LossCo with expiring NOLs (those that the entity will be unable to use before the carryforward period expires) is a particularly attractive building block for CIT planners because it extracts value out of a wasting asset. Perhaps even more attractive to the planner, though, is the LossCo that runs losses year in and year out, because the planner will not need to build in an "exit strategy" to minimize the tax cost of getting out of the structure when it stops producing tax reductions. An example might be a publicly traded holding company that does little more than borrow from outside banks, carrying interest expense deductions that it cannot offset by itself.

A natural LossCo will not be found in every org chart, of course. In that case, an unnaturally perpetual LossCo can be engineered by planners. A common version of this strategy is usually produced inadvertently by less sophisticated planners who set such artificially high transfer prices that the DHC/IHCs suck their royalty-paying operating company affiliates into a perpetual loss position. The resulting NOL carryforwards can become so large that years later, a more sophisticated follow-on adviser may suggest folding the DHC back into the operating company. This makes for a much less obvious target for state auditors, who may not think to look back to long-closed years to discover that the innocuous-looking NOLs were actually generated years ago by aggressive tax planning.[29]

Consequently, companies with NOLs should be viewed by state tax auditors as potentially no more "natural" than the run-of-the-mill IHC with adviser-gerrymandered nexus and apportionment factors.

Supply Chain Segregation

There are and always have been, of course, supply chains for every type of good or service in every economy. Supply chains are often highly complex. Raw materials are acquired, extracted, stored, transported, divided, combined, manufactured, assembled, packaged, and otherwise transformed multiple times along the upstream supply chain; and then on the downstream, the goods are marketed, sold, stored, and transported multiple times along the way to multiple business-to-business and eventually end-user customers; and finally, the used goods are sent along through the waste management, processing, and disposal part of the supply chain. Service industries have their analog.

Many business enterprises specialize in a narrow sliver or two of the enormously complex supply chains of which they are a part. Others may be more vertically integrated, performing a larger swath of the supply chain. Some businesses historically performed multiple steps in their

[27] *See TD Banknorth. v. Vermont Department of Taxes*, 967 A.2d 1148 (Vt. 2008).

[28] Such strategies may be employed in some unitary-combination states as well because some such states — like California — silo NOLs as they do credits, departing from the "as if a single taxpayer" treatment that is the consistent tax policy objective of unitary combination, and preventing the sharing of such tax attributes among different legal entities within the unitary group. (But we promised not to get into the *Joyce/Finnigan* debate.)

[29] In such cases, state auditors may be able to pick up large taxable gains under IRC section 311(b) if the intangible property has appreciated significantly in value over time.

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pieces of the supply chain within a single legal entity, while others separated the work into a variety of business entities.

The building block here involves segregating different pieces of a business enterprise's slice of the supply chain into separate legal entities. This planning element may be combined with other elements (apportionment engineering, nexus isolation, asset placement, transfer pricing) — for which the ultimate goal is concentrating taxable income in low S/F ETR entities — within a structure aimed at appearing to a revenue department auditor like "business as usual" instead of like what it is: clever manipulation of entities and their financial relationships in order to escape tax.

Here again, as with many other elements of structural CIT planning, TUCR neutralizes this building block by treating the business enterprise for tax purposes the way the business enterprise treats itself for operational purposes — like a single entity.

Transfer Pricing

Distilled to its essence, most structural CIT planning today achieves its tax-minimizing goals primarily by manipulating a corporate group's legal entities, the transactions among them, and (the final building block we shall discuss) the prices of those transactions.

Just how much tax can a planner escape with the creative setting of the price on an intercompany royalty, interest rate, factoring discount, sales price, or management fee? Genuine prices are set in the marketplace — where independent parties negotiate with one another — but a group of commonly controlled companies do not comprise a marketplace of independent parties. Intercompany transactions are always intragroup, and thus completely manipulable by the planner.

Faced with this manipulability problem, federal and international tax systems — in which the far more effective antiavoidance tool of unitary combined reporting has historically been unavailable — rely heavily on transfer pricing rules that are founded on the arm's-length fiction. Imagine a buyer and a seller standing in a marketplace — perhaps a farmer and a traveling merchant in colonial times meeting on the bucolic town green — each distrustful of the other as they haggle over price. They stand a good distance apart, keeping each other "at arm's length." They are strangers; hugging is not happening. Then fast-forward to the extensive development of this concept in IRC section 482 and its surrounding constellation of regulations, rulings, court decisions, and economists' analyses . . . all based on the shaky foundation of an inadequate legal fiction.

Planners rely on the transfer pricing fiction as one of their building blocks, but, fortunately, the states need not play this game. As will be explained more completely in part 2 of this series, states' efforts to counter the transfer pricing building block are a carnival sideshow into which planners are happy to distract them. Worldwide unitary combination (with the TUCR enhancements) makes this building block irrelevant. Treat intercompany transactions within a true unitary group like what they are — the mere movement of money from the right to the left pocket — and most CIT avoidance evaporates.

Conclusion

These 10 CIT planning elements are not the only building blocks available to the corporate state tax planning community, but they are among the most commonly used elements for the manufacture of scores of CIT avoidance strategies. Next, rather than jumping directly into a discussion of those strategies, part 2 of this series will address countermeasures — antidotes, if you will — that states have taken, or could take, in an attempt to close the multibillion-dollar CIT planning loophole identified by the Institute on Taxation and Economic Policy.[30] Spoiler alert: I will argue that not one of the antidotes currently in use comes close in effectiveness to the measure that every state legislature should adopt without further delay: TUCR — true unitary combined reporting. ■

[30] *See* ITEP, *supra* note 2.

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