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Georgia Gets A Grasp On Passive Investment Companies: New Addback Statute Reaches Intangible And Interest Income Flowing From The State

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Effective January 1, 2006, Georgia will become the 15th state (along with the District of Columbia) to implement an "addback" statute designed to stem the flow of tax dollars into out-of-state intangible holding companies or passive investment companies, also called PICs. At least another 10 states have recently considered or are considering similar addback statutes. The growing list of states statutorily eliminating the tax benefits of PICs may be signaling the end of the so-called *Geoffrey* era.

Intangible Holding Companies

Since the early 1990s, corporate taxpayers have been creating PICs—affiliated holding companies—to generate income in an affiliated corporation in another state while simultaneously generating deductions. The taxpayer can then repatriate those same dollars back from the affiliate in the form of tax-free dividends or loans. Properly structured, PICs can allow the operating corporation to lower its overall state income tax burden while at the same time allowing it to continue using the funds for which it had taken deductions. Not surprisingly, PICs have evolved as a popular tax reduction mechanism.

Consider the following example: Corporation P operating in State A creates a PIC subsidiary, Corporation S, based in Delaware. Corporation P places all its intellectual property rights in Corporation S via a tax-free contribution of capital. Corporation S then licenses the use of the intellectual property back to Corporation P in return for licensing fees. Corporation P deducts the cost of these licensing fees, reducing its overall State A income tax. Because Corporation S's only activity is to manage its inventory of intellectual property, its income is not subject to tax in Delaware. Corporation P can regain the use of the funds paid to Corporation S by receiving tax-free dividends or by taking a loan from Corporation S and paying interest. Some companies have even taken additional deductions for their interest payments to the intangible holding company.

Typically this transaction benefits Corporation P's tax burden only in nonunitary states where it operates. A unitary state generally would require Corporation P to file a consolidated return with Corporation S, and the intercompany licensing fees would be disregarded and deductions for those payments disallowed.

States Fight Back

States that have been unsuccessful in challenging PICs in court have begun to fight back with legislative solutions. Since 1999, Alabama, Arkansas, Connecticut, Illinois, Kentucky, Maryland, Massachusetts, Michigan, Mississippi, New Jersey, New York, North Carolina, Ohio and Virginia have all enacted addback statutes. In addition, Indiana, Iowa, Minnesota, Missouri, Pennsylvania, Rhode Island, Tennessee, Texas, West Virginia and Wisconsin are currently considering or have recently studied similar legislation. Georgia's addback statute marks the latest legislative effort to combat PICs.

Georgia's Addback Statute

Georgia's statute essentially disallows deductions for intangible and interest expenses paid to an affiliated entity. Specifically, it requires corporate taxpayers to add back to their Georgia taxable net income any deductible interest expenses and intangible expenses before the income is apportioned or allocated.

The addback applies both to corporations that file separate returns with Georgia and to each member of a Georgia consolidated return when computing its separate taxable income.

"Intangible expenses" are defined to mean "expenses, losses and costs directly or indirectly for, related to, or in connection with the direct or indirect acquisition, use, maintenance, management, ownership, sale, exchange, or disposition of intangible property."[1] Such expenses include costs related to licensing fees and royalty, patent, technical and copyright fees.

Under the statute, "interest expenses" include, but are not limited to, deductions allowable under section 163 of the Internal Revenue Code to the extent such costs relate to the "direct or indirect acquisition, use, maintenance, management, ownership, sale, exchange, or disposition of intangible property."[2] Unfortunately, this definition is far from clear.

The tax commissioner has the authority to enter into written agreements with taxpayers to apply an alternative method of apportionment.

Exceptions from the Addback

The Georgia General Assembly provided for three exceptions that permit taxpayers to reduce or avoid altogether addbacks:

[1] GA. CODE ANN. § 48-7-28.3(4) (as effective Jan. 1, 2006).

[2] GA. CODE ANN. § 48-7-28.3(6) (as effective Jan. 1, 2006).

1) **Affiliated entity's income subject to tax**—If Georgia or another state taxes the affiliated entity's intangible and/or interest income under an income tax (or a tax measured by income), if that income is allocated or apportioned to the taxing state, and if the affiliated entity receives the income in an arms-length transaction, then the addback will be reduced by the amount of payments meeting these requirements. The exception does not apply to income taxed by another state in which the affiliated entity files a combined or consolidated income tax report with the taxpayer or with another affiliated entity.

2) **Affiliated entity's income subject to tax in a foreign jurisdiction**—If the operating corporation pays intangible and interest expenses to an affiliated entity domiciled in a foreign country having a comprehensive income tax treaty with the United States and if the transaction has a valid business purpose and the paid amounts were determined at arms-length rates, then the addback will be reduced by the payments meeting these requirements.

3) **Payments ultimately made to a third party**—If the affiliated entity pays or incurs an expense related to the intangible or interest expenses to a third party that is not an affiliated entity and the transaction giving rise to the expenses has a valid business purpose, then the addback will be reduced by the amount of such payments. The taxpayer must be able to establish by a preponderance of the evidence that these requirements are met. This is the only one of the three exceptions specifying an evidentiary standard.

Valid Business Purpose

The term "valid business purpose" is a shorthand for the requirement that a transaction must meet both elements of the traditional "substance over form" doctrine: a valid business purpose and economic substance.[3] The taxpayer must have one or more valid business purposes for the transaction, other than tax avoidance, that constitute(s) the primary motivation for the transaction. To have sufficient economic substance, the transaction must change in a "meaningful" way, other than from tax effects, the taxpayer's economic position. A meaningful change in the taxpayer's economic position includes an increase in its market share or its entry into new business markets.

Note that in the first safe harbor—the exception for payments to an affiliated entity taxed in Georgia or another state—the taxpayer does not need to demonstrate a valid business purpose for the transaction. Because virtually all other states imposing an addback of intangible expenses require a valid business purpose for this type of exception, Georgia may eventually amend its legislation to be consistent with other states.[4]

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[3] *See* Fred O. Marcus, Esq., LIMITATIONS ON STATES' JURISDICTION TO IMPOSE NET INCOME BASED TAXES 1410:0069 (Tax Management Multistate Tax Portfolios 1999).

[4] *See* Lance S. Jacobs, *Georgia Joins Growing List of States Using Addback Laws to Combat Use of Related Party Expenses in Tax Planning*, INSIGHTS AND COMMENTARY No. 26 (BNA Tax Management Library 2005).

Disclosure of Affiliates

Both safe harbors for payments to an affiliated entity in another jurisdiction require the taxpayer to make disclosures about the affiliated entity. The taxpayer must identify the affiliated entity and provide its federal identification number on the tax return. When the affiliated entity is taxed in Georgia or another state, the taxpayer must disclose the name of each state and the amount of intangible and interest expenses allocated or apportioned to and taxed by each state for the affiliated entity. When the affiliated entity is domiciled in another country, the taxpayer must disclose the amount of intangible and interest expenses and the country of domicile of the entity. The tax commissioner may also require additional information.

Affiliated Entities

Affiliated entities include (1) "related persons;" (2) component members of a controlled group of corporations, as defined in section 1563(b) of the Internal Revenue Code; (3) persons to or from whom there would be required an attribution of stock ownership in accordance with section 1563(e) of the Internal Revenue Code; or (4) any person, notwithstanding its form of organization, that bears a similar relationship to the taxpayer.

A "related person" includes an (1) individual stockholder if he owns in aggregate with either his family or with his partnerships, estate, trusts and corporations at least 50 percent of the value of the taxpayer's outstanding stock, and (2) a corporation or related person that would require an attribution of stock from the corporation to the person or vice versa under the attribution rules of section 318 of the Internal Revenue Code if the taxpayer owns at least 50 percent of the corporation's outstanding stock.■

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