Changes to New York's Royalty Addback Rules

by Timothy P. Noonan and Elizabeth Pascal

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Multistate tax planning is frequently a game of cat and mouse between taxpayers and tax authorities. Taxpayers set up corporate and passthrough entities in part to benefit from business-friendly tax rules in particular states, with some structures becoming the tax-planning design of the moment. Through audits, judicial proceedings, and legislation, states then try to counteract what they see as the negative revenue consequences of those structures. Inevitably, no two states — let alone all 50 — take the same approach, resulting in a multitude of similar but far from identical statutes and regulations to solve perceived problems. That then offers new multistate planning opportunities, and the cycle begins again.

Such is the story of the intangible holding company (IHC). As some states moved toward combined reporting and others required separate reporting, multistate businesses took advantage of the split by setting up IHCs in low-tax states, no-tax states, or in unitary states in which the royalty income would net with the group's royalty expenses. Operating companies in higher-tax, separate-reporting states would transfer ownership of intellectual property to the IHC, pay a royalty for the use of the intellectual property, and then take a deduction from their federal taxable income for the intercompany payment. The result was that the operating company reduced its taxable income in separate-reporting states through the intercompany royalty payments and the IHC had a low (or no) tax burden on what could be substantial income from licensing fees.

To capture the revenue flowing to IHCs, states took different approaches. Some raised nexus issues, taking the position that the IHC was subject to tax wherever the operating company had nexus. That approach was largely successful in many states,[1] but raised interesting issues about the constitutionality of economic nexus in the income tax area. Other states initially took a business purpose or sham approach in litigation, again with moderate successes. And some took a legislative approach focused on the denial of royalty expense deductions at the operating company level. This article focuses on New York's efforts to enact and enforce that kind of provision.

A. Royalty Addbacks in General

As noted, some states have passed legislation over the past 15 years requiring taxpayers to add back deductions for royalty and interest payments to related entities.[2] Those statutes typically contain some limited exceptions to the addback requirement. First, taxpayers are often not required to add back the royalty or interest payments if the income was already subject to tax in that state, another state (the other states exception), or in a foreign country with a tax treaty with the United States (the treaty exception). Second, the addback is sometimes not required if a royalty paid to a related entity was then paid to an unrelated third party (the

[1]Courts in North Carolina, Iowa, Oklahoma, New Mexico, Maryland, Louisiana, Washington, Indiana, New Jersey, Ohio, Massachusetts, and Illinois have found economic presence to be sufficient for nexus.

[2]*See, e.g.*, Mass. Gen. Laws ch. 63, section 31I(b); Miss. Code Ann. section 27-7-17(2); Ohio Rev. Code section 5733.042; R.I. Gen. Laws section 44-11-11.

conduit exception). Finally, some states do not require the addback if the payments have a valid business purpose apart from reducing taxes or if the addback is unreasonable.

B. New York's Addback Statute

New York has frequently taken its own path in the tax arena, choosing to legislatively attack the same tax loopholes recognized by other states, but in its own way. It was a relative latecomer in requiring the addback of related-party royalty and licensing payments, following similar legislation in Ohio, Massachusetts, North Carolina, and Alabama.

New York's first addback statute was passed in 2003. It required taxpayers to add back royalty and interest payments to related entities or persons unless: (1) the related member paid the royalty during the same tax year to a non-related member for a valid business purpose in an arm's-length deal (that is, the conduit exception); or (2) the royalty payments were paid to a related member organized under the laws of a foreign country subject to a comprehensive tax treaty with the United States and the payments were taxed in that country at a rate equal to or greater than the rate in New York.[3]

In 2007 New York added another exception for payments between entities that filed a combined return in New York.[4] The law applied to all income and franchise taxes, including New York City's corporation and unincorporated business taxes.

The 2003 law had several features distinguishing it from many other state addback laws. First, rather than define the term "related member" according to the definition under the Internal Revenue Code,[5] which required a 50 percent interest in the related company, the New York statute defined it as a controlling interest in a corporation or other entity. A controlling interest meant either 30 percent or more of the total combined voting power of all classes of stock in a corporation or 30 percent or more of the capital, profits, or beneficial interest in that voting stock.[6] Second, the New York statute permitted a taxpayer to deduct royalty payments it received from a related member during the tax year if the payer was also a New York taxpayer required to add back the royalty payments under the 2003 law.[7]

And thus arose the so-called royalty payment loophole. New York's intentions in permitting the payment-received exclusion were perhaps noble, aiming to prevent New York taxpayer-recipients from being taxed on income that had already been taxed by New York to the payer of the royalties. But the effect was to permit the same type of income shifting that New York was trying to avoid. If the payer had a lower business allocation percentage in New York, the recipient of the royalty payments could then exclude the payments from its taxable income even if it had a much higher business allocation percentage, resulting in a lower overall tax burden to the related group.

C. 2013 Changes

It took 10 years for New York to revamp its statute. The new provision, passed earlier this year, eliminates the royalties-paid exclusion and models the statute after the Multistate Tax Commission's model addback statute.[8]

The 2013 law[9] defines a related member consistently with the IRS, substituting the 50 percent ownership requirement for the previous 30 percent. It requires all royalty payments to be added back unless they meet one of four exceptions:

(1) the related member was subject to tax on income that included the royalty payment and it paid over the royalty in the same tax year to a third party for a valid business purpose (the conduit exception);

(2) the related member was subject to tax on income that included the royalty payments in New York or another state or U.S. possession, the effective tax rate applied to the related member is not less than 80 percent of the rate applied to the taxpayer in New York, and the transaction giving rise to the royalty payment was undertaken for a valid business purpose (the subject-to-tax exception);

(3) the payment was made to a non-U.S. taxpayer subject to a comprehensive tax treaty with the United States, the related member was subject to tax on income that included the royalty payment at an effective rate at least equal to New York's rate, and the transaction was undertaken for a valid business purpose (the treaty exception); or

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[3]N.Y. Tax Law section 208(9)(o), as enacted by L. 2003, c. 62, Part U3, section 1. The law change created corresponding provisions for other tax types. *See* N.Y. Tax Law section 612(r); N.Y. Tax Law section 292(a)(6); N.Y. Tax Law section 1453(r).

[4]N.Y. Tax Law section 208(9)(o)(2)(A), as added by L. 2007, c. 60, Part J, section 4.

[5]Most states incorporate the definition of the term "related member" under section 465(b)(3)(C), substituting a 50 percent ownership requirement for 10 percent.

[6]N.Y. Tax Law section 208(9)(o)(1)(A) and (B).

[7]N.Y. Tax Law section 208(9)(o)(3).

[8]*See* Statement in Support, L. 2013, c. 59, Part E — Close the royalty income loophole.

[9]N.Y. Tax Law section 208(9)(o), as amended by L. 2013, c. 59, Part E, section 2. The law applies to all tax years beginning on or after January 1, 2013.

(4) the taxpayer and the commissioner agree in writing to the use of an alternative adjustment or computation.

The taxpayer has the burden to demonstrate by clear and convincing evidence that one of the exceptions apply.

The Tax Department has recently issued a technical service memorandum to explain the law change. In addition to restating the new provisions, TSB-M-13(6)C provides examples to calculate the effective rate of tax imposed by another state. The calculation requires, as under the new law, that the maximum statutory rate be decreased to reflect any credit or offset of net income that "is dependent upon the related member either maintaining or managing intangible property or collecting interest income in that jurisdiction."[10] The effective tax rate for another jurisdiction is zero when the intercompany royalty payment is eliminated or offset on a combined or consolidated return.[11]

D. Comprehensive, Yes. But Constitutional?

There is no question that the new statute eliminates the previous opportunities for New York taxpayers to shift intercompany royalty payments to achieve state tax benefits. But since those statutes have emerged, practitioners and multistate taxpayers have questioned their constitutionality. In particular, many have argued that some provisions violate the commerce clause's requirements as articulated in *Complete Auto Transit Inc. v. Brady*, 430 U.S. 274 (1977). Under that seminal case, a tax statute must pass four tests to survive a commerce clause challenge: the state must have substantial nexus with the activity taxed; the tax must be fairly apportioned; the tax cannot discriminate against interstate commerce; and the tax must be fairly related to the taxpayer's activities in the state.

In New York, two provisions are viewed as potentially vulnerable to constitutional challenge. The first was the royalties-received exception that was eliminated under the 2013 law. Because the provision provided in-state taxpayers with a benefit unavailable to out-of-state taxpayers, some argued that the exception was unconstitutional. Although that exception is no longer available to New York taxpayers for tax years beginning in 2013, it is still potentially challengeable for prior tax years. Second, the subject-to-tax exception is viewed as possibly open to challenge because it seeks to tax income not attributable to New York simply because no other state has decided to tax it. In other words, it punishes taxpayers who choose to locate an affiliate in a low-tax or no-tax state, thereby discriminating against interstate commerce.

[10]N.Y. Tax Law section 208(9)(o)(1)(B).

[11]*Id.*

But based on challenges to other states' addback statutes, it'll be interesting to see if a constitutional challenge will gain traction in New York. Perhaps the most closely watched case was Alabama's ***VFJ Ventures***.[12] There, the taxpayer, a large manufacturer and marketer of denim apparel, was required under Alabama's addback statute to include royalty payments to its affiliate companies, Lee and Wrangler, located in Delaware, where they were not subject to tax. Alabama's highest court dismissed the taxpayer's various arguments that the addback statute violated the commerce and due process clauses of the U.S. Constitution. In particular, the taxpayer argued that the addback requirement sought to tax income paid to an entity that did not have nexus with Alabama. It also argued that Alabama's exception to the addback for royalty and interest payments that was subject to tax in Alabama[13] disproportionately favored in-state taxpayers. Finally, VFJ Ventures argued that the law disfavored IHCs. The Alabama Supreme Court, as well as the lower courts, rejected all the taxpayer's arguments and upheld the statutory provision.

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Many observers hoped that the Supreme Court would review the case and provide some degree of consistency to the multistate morass of addback statutes,[14] but those hopes were dashed when the Supreme Court denied certiorari in 2009.

Elsewhere, challenges to the constitutionality of addback statutes have been primarily administrative. For example, in Virginia, a combined filer argued that it should not be required to add back 100 percent of the royalty payments to out-of-state affiliates under the other states exception.[15] In part, the taxpayer argued that the addback statute violated the due process and commerce clauses by unduly burdening interstate commerce. The tax commissioner disagreed, finding that the tax met all

[12]*Ex Parte VFJ Ventures Inc.*, 8 So. 3d 983 (Ala. 2008), *cert. denied*, 129 S. Ct. 2051 (2009).

[13]Ala. Code section 40-18-35(b)(1).

[14]*See, e.g.* Donald M. Griswold et al., "The National Implications of Alabama's Add-Back Statute: Why the U.S. Supreme Court Must Grant Cert in *VFJ Ventures*," 18 *Multistate Tax Report* (Mar. 27, 2009).

[15]Tax Commission Ruling 13-165.

applicable tests under *Complete Auto Transit*. Further, although the commissioner permitted the taxpayer to deduct royalty payments to two affiliates under the conduit exception, it noted that the Virginia Department of Revenue still had the option of making an equitable adjustment if the taxpayer's income improperly reflected its business in Virginia, although it chose not to do so.

E. Conclusion

New York has taken significant steps to close a perceived loophole by amending its addback statute. Although constitutional challenges may come, there are so far no indications that they will be successful. More likely, challenges will come in the form of specific applications of the statute, such as what constitutes a valid business purpose. By then, taxpayers will likely have moved on to new opportunities for multistate tax planning, providing a new set of challenges to states seeking to increase tax revenues. And so the cat-and-mouse game continues, with us practitioners playing in the center of it all.✰

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