Addback: It's Payback Time

by Charles F. Barnwell, Jr.

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Since 2000, 18 states have enacted addback rules to curb perceived taxpayer abuses based on the use of interest and intangible-related expenses between related parties. Generally, those antiabuse statutes require the payer of related-party interest, royalties, license fees, and similar charges to add back those expenses. Every state has some exceptions to the required addback, and those exceptions are discussed in detail in this article.

Unfortunately, the states failed to act uniformly and the rules have significant differences. Those differences are often subtle and can result in confusion and conflicts from state to state. The addback rules seem to have the following in common:

- most require the operating company to add back intercompany interest and expenses regarding intangibles paid to a related party;
- most states define a related party by reference to the Internal Revenue Code (discussed in detail below);
- all states have exceptions to the addback rule, and in most cases the exceptions exist to minimize the likelihood of multiple taxation;
- most states provide an exception to addback based on the recipient's tax position (the "subject-to" exceptions);
- most states have a conduit exception (that is, interest or royalty is ultimately paid to a third party); and
- most states tax both direct and indirect interest and intangible items among related parties.

As a practical matter, the addback laws in New York, Massachusetts, Michigan, Ohio, and Oregon are less relevant because of their adoptions of gross receipts or unitary tax systems. Tennessee does not require addback unless the taxpayer fails to disclose related-party transactions. Thus, there are 13 states (including the District of Columbia) where taxpayers face the confusion and sometimes multiple income tax burden brought on by the addback rules.[1]

This article delves into the sometimes subtle but important distinctions and issues confronting taxpayers in the addback states. The states have created several ambiguities and have set the stage for multiple taxation, particularly for taxpayers that fail to anticipate traps and plan against them.

The addback rules appear to raise facial constitutional issues, and taxpayers will certainly bring those issues to court over the next few years. This article focuses on the practical issues, such as the required disclosures, how to calculate exceptions, and how to avoid the traps.

Background — How Did It Come to This?

Before dissecting the addback provisions, one must understand the historical background, or why 18 states have pushed those rules through their legislatures since 2000.[2] Two court decisions in the early 1990s set the stage. The first was *Geoffrey*, a seminal South Carolina Supreme Court decision.[3] Shortly after *Geoffrey*, the Georgia Superior Court drew a second line in the sand in *Aaron Rents*.[4] Geoffrey became a widely cited victory for the states, while *Aaron Rents* became a widely cited victory for taxpayers. Although the cases dealt with similar fact patterns, the tax theory behind them was very different. The South Carolina Tax Commission asserted the new and novel[5] doctrine of "economic nexus" as it related

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[1]Refer to Exhibit 1 (p. 000) for a state-by-state comparison of the addback rule characteristics and exceptions.

[2]Alabama, Mississippi, North Carolina, and Ohio appear to be the first "offenders," having enacted addback rules in 2000 and 2001 (see Exhibit 1).

[3]*Geoffrey, Inc. v. South Carolina Tax Commission*, Respondent, 437 SE2d 13 313 SC 15, July 6, 1993.

[4]*Aaron Rents, Inc. v. Marcus E. Collins*., Civil Action File D-96025, Georgia Superior Court Fulton County, June 27, 1994. (For the decision, see *94 STN 132-18*.)

[5]New and novel at least at that time.

to intangibles; that is, the commission sought to directly tax an intangible holding company located in Delaware.[6] In contrast, Georgia sought to disallow Aaron's royalty payments to its wholly owned subsidiary, also located in Delaware.

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Although those two cases deal with markedly different theories, they have important practical similarities. Both fact patterns involved relatively new Delaware intangible holding companies, intercompany royalties, and reductions in state income taxes. During the 1990s companies such Aaron Rents and Toys "R" Us began to isolate intangible assets in holding companies in identical fact patterns. Other companies used different states and alternative intercompany tax base shifts. Although the motivations for those actions were purported to be for business reasons,[7] companies generally achieved a reduction in separate state income tax liabilities as a result of the intangible holding company structure.

Thus, retailers, manufacturers, and other taxpayers with valuable intangible assets, capitalizing on *Aaron Rents* and arguing against *Geoffrey*, recognized the business reasons for isolating intangibles and the serendipitous opportunity to reduce state taxes. Holding companies became common, as evidenced by the myriad court decisions that arose in the years that followed[8] — and as further evidenced by the extent of new addback legislation. *Aaron Rents*, although it was merely a Georgia trial court decision, was often cited and discussed at state tax practitioner forums and presumably became a defense of sorts for many companies that sought to combat state audit challenges. Many states used *Geoffrey* to justify directly taxing intangible holding companies. Companies continued to develop planning structures that used intangibles, and states continued to refine the arguments to challenge the structures.

Tax planners also recognized the opportunity to situs intangible assets in companies with predominate apportionment footprints in unitary states. That approach had several advantages over the vanilla Delaware or Nevada holding company structure. First, the unitary company typically had substantial operations within the same entity that owned valuable intangibles. Second, it provided factor relief in instances in which the "offended" state sought to tax the owner of the intangibles (as opposed to the alternative, or *Aaron Rents*, approach of disallowing the intercompany royalty). In many cases, companies with headquarters in unitary states had a natural ability to situs intangibles in the headquarters state without the need (or risks) of creating a tax haven structure.

Tax planners developed other variations on the planning theme, such as double passive investment companies. Still other companies without the advantage of unitary state parentage would create a unitary dominant company with some separate filing state leakage. For example, in some cases, even if headquarters existed in a separate filing state, the unitary state-based factors would so dilute the company's separate filing state apportionment factor that the planning remained effective.

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Audit controversy characterized the state income tax landscape, in which taxpayers sometimes won, sometimes lost. Unfortunately, in many cases the taxpayer ended up paying tax twice — on an economic nexus claim on the intangible holding company, and on a disallowance, combination, or other tax on the operating company. Perhaps one of the only aspects of the addback rules that is beneficial to taxpayers is that in at least some instances, the states have constructed them so as to minimize circumstances in which the same intangible charge gets taxed twice by the same state. However, as noted below, the exceptions to addback are often so difficult to achieve, let alone understand, that the multistate taxpayer with an intangible holding company (or derivative structure) now faces an even greater — perhaps even likely — prospect of double or multiple taxation.

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[6]It may be said that South Carolina used the long neck of the giraffe — as opposed to the long arm of the law.

[7]The Georgia Superior Court found good business purpose, other than the avoidance of tax, for Aaron's intangibles holding company and held for the taxpayer.

[8]*See, e.g., Sherwin-Williams v. Commissioner of Revenue*, 439 Mass 71 778 NE2d 504, Oct. 31, 2002; *Syms Corp. v. Commissioner of Revenue*, 765 NE2d 758, 436 Mass 505, Apr. 10, 2002. (For the decision in *Sherwin-Williams*, see *Doc 2002-24629* or *2002 STT 213-20*; for the decision in *Syms*, see *Doc 2002-8734* or *2002 STT 71-23*.)

Who's Related

In most addback states, the law requires a related member to add back interest or intangible expenses. A related member is generally defined as a related entity, a component member as defined in IRC section 1563(b), or a person to or from whom there is attribution of stock ownership under section 1563(e). Generally, a related entity is an individual, partnership, stockholder or corporation owning at least 50 percent of the value of the taxpayer's outstanding stock. The rules of attribution apply to include ownership held directly, indirectly, beneficially, or constructively. Thus, as a practical matter, a 50 percent ownership standard applies in the world of addbacks. Since the standard is not more than 50 percent, practitioners should think through common fifty-fifty joint ventures and similar structures when addback rules would consider ventures related members.

Most states define related members with reference to section 1563(b) component members. Generally, component members include members of a parent-subsidiary group in which the parent corporation owns at least 80 percent of the vote and value of all classes of stock of the related member. However, there are important exceptions. Component members do not include:

- corporations that were owned for less than half of the year;[9]
- foreign corporations taxed under IRC section 881 (foreign corporations with income not connected with a U.S. business);[10] and
- life insurance companies.[11]

Three states base the addback rule on attribution as defined in IRC section 267: "Losses, expenses and interest with respect to transactions between related taxpayers."[12]

In most states, wholly owned limited liability companies or wholly owned partnerships with a disregarded single-member LLC partner (and thus disregarded partnership) are disregarded for purposes of determining related members. However, Alabama requires that those disregarded entities be regarded for purposes of determining activity conducted by the recipient of the intangible income.[13]

Interest and Intangible Expenses

Generally, the addback rules apply to payers of intercompany royalties, and in most states, to intercompany payers of interest.[14] The statutes contemplate expenses and costs in connection with the full gamut of intangibles: patents, patent applications, trade names, trademarks, service marks, franchises, know-how, formulas, designs, patterns, processes, formats, copyrights, and similar types of intangible assets, choses in action, and accounts receivable.[15] In most cases, addback statutes extend to direct and indirect payments.[16] Direct payments are easy enough to contemplate, but what about indirect payments? Two notable examples illuminate the indirect payment issue: the embedded royalty structure and the double passive investment company structure. States using the word "indirect" arguably require the addback of intangibles or interest in either of those structures and other similar indirect intercompany configurations.

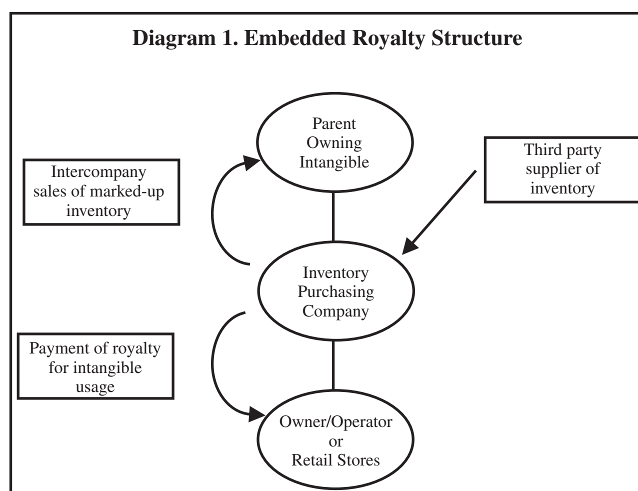

Diagram 1 demonstrates the overreaching implications of most addback statutes, or how the states now have the muscle to require addback twice or even three times — and create grossly distorted tax liabilities for multistate businesses. First, the states could require (absent an exception) the middle-tier inventory purchasing company to add back the royalty payment to the parent owning the intangibles. Second, arguably the owner-operator of the retail stores has indirectly paid a royalty to the parent in the form of a markup on inventory purchased from

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[9]Section 1563(b)(2)(A).

[10]Section 1563(b)(2)(C).

[11]Section 1563(b)(2)(D); however, if the insurance company is a member of a controlled group of insurance companies, this exclusion does not apply. Section 1563(a)(4).

[12]*See* Exhibit 1.

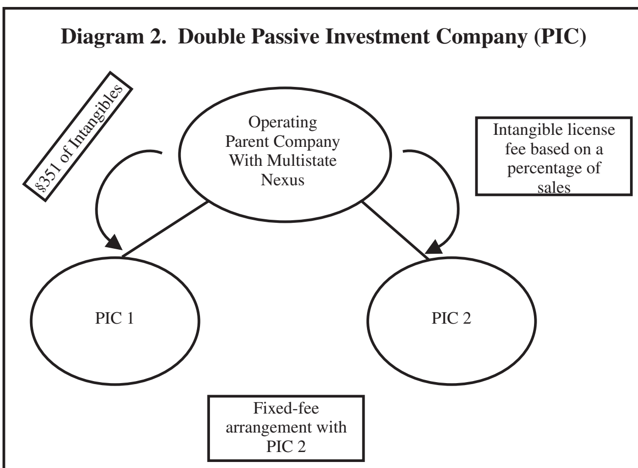
[13]Ala. Admin. Code section 810-3-35-.02(3)(c)(1).

[14]For example, North Carolina's addback rule does not extend to interest unless in connection with the timing of a royalty payment. Section 105.130.7A(b)(6)(B).

[15]Ala. Code section 40-18-1(11). However, in a bizarre twist, North Carolina's addback applies only to copyrights, patents, and trademarks (N.C. Gen. Stat. section 105-130.7A(b)(1a)).

[16]Two notable exceptions in which the statute does not appear to extend to "indirect" payments are Arkansas (Ark. Code Ann. section 26-51-423(g)) and Indiana (Ind. Code section 6-3-2-20).

the inventory purchasing company. The conduit exception (see Diagram 1 and discussion regarding conduits below) is generally limited to payments made to third parties.



In Diagram 2 the parent operating company transfers intangibles to a new holding company (PIC 1) in a typical section 351 transfer and creates PIC 2 for a "peppercorn." PIC 1 then enters into a fixed-fee arrangement with PIC 2, granting PIC 2 the right to license PIC 1's intangible property. PIC 2 then licenses the property back to parent. Typically, that latter licensing arrangement is based on a percentage of parent company revenue.

In today's addback world, it seems unlikely that a tax planner would create that structure. But before addback legislation, the structure had a certain prophylactic character. Before addback, the state's likely approach would have been a typical *Geoffrey* attack — that is, the auditing state would assert that PIC 2 had nexus as a result of its in-state licensing activity to the parent. However, since PIC 2 paid a fixed fee to PIC 1, its tax base has been reduced (presumably substantially) and the potential assessment minimized.

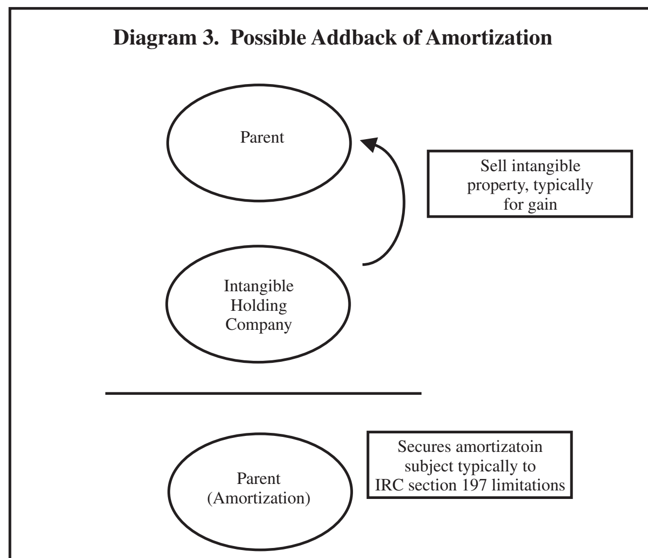
In a postaddback world, the taxpaying group appears to be at risk of double — and at least in theory, triple — taxation (hence the title of this article). First, the addback state will require the operating parent to add back the royalty payment to PIC 2. Second, absent the availability of a relevant exception (discussed below), the state could attack PIC 2 using *Geoffrey*. Under that theory, the state could force PIC 2 to add back the fixed fee to PIC 1. Finally, in a draconian scenario, the state could further argue that the parent has indirectly paid a royalty to PIC 1 via PIC 2 and force the parent to add back that indirect payment.

Amortization From the Intercompany Sale of Intangibles

Some addback states have broad addback statutes and extend their reach to "acquisition, use, maintenance, management, ownership, sale, exchange or disposition of intangible property."[17] That language appears to implicate the amortization of intangibles acquired in an intercompany context.[18] The state tax practitioner should carefully review the addback statute and related authority to determine which states require amortization addback.

Few states explicitly require the addback of amortization as depicted in Diagram 3. However, when one considers the prospect of a large tax on the intercompany gain, practitioners should proceed with caution considering the prospect of a *Geoffrey* attack on the intangibles holding company in that and similar fact patterns.

Only Kentucky seems to require the addback of intercompany management fees.



Although addback states have in theory crafted these new rules to reverse the benefits of planning using intangibles and interest, the above examples show how the rules can now work to throw taxpayers under the bus. And although every addback state has exceptions to the rules, the reader will learn that most of the exceptions contain strict language with hidden caveats. In short, taxpayers need to carefully consider the structures of old and

[17] Ala. Code section 40-18-1(10).
[18] *See* Massachusetts DOR Directive 07-9, Oct. 10, 2007, in which that implication is made explicit.

rethink how to play on the new addback field — if nothing else to stay out of harm's way.

Exceptions: Threading the Needle

As noted, all the addback states provide for exceptions under some circumstances. The exceptions place taxpayers in a quagmire of inconsistent provisions, confusing language, narrow or exacting conditions, and other caveats. What happened to the ideal of uniformity? Cynically, many states require addback only if it is "reasonable," or they provide for an exception to addback if it is "unreasonable."[19] The unreasonable exception is a uniquely subjective standard that leaves practitioners with little hope for a level playing field. Reasonable according to whom? The question of "reasonableness" has already surfaced in the Alabama courts in *VFJ*, with expected but unsatisfying implications.[20] In that decision the Alabama Court of Civil Appeals held that the addback was not "unreasonable." Disturbingly, the court held that the Alabama Department of Revenue's undocumented practice of permitting the unreasonable exception only when the addback resulted in a "disproportionate tax" constituted the primary, if only, circumstance under which addback would be considered unreasonable.[21]

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In a similar vein, most states condition exceptions to addback on the absence of tax avoidance as a motive (or sometimes primary motive). Rarely, if ever, does the state define tax avoidance. Have the states legislated away a taxpayer's right to plan? In many of the exceptions to addback, the states require that the taxpayer obtain written permission from the applicable taxing authority. With all of those preconditions, taxpayers will often find it difficult to rely on exceptions to the addback rules.

The variety of the exceptions among the states seems to highlight the fundamental unfairness of the rules. Why does one state have a subject-to exception, and another not? Why do some states make no mention of the conduit exception? Why do the subject-to rules differ from state to state? Inasmuch as the rules look to other states' rules, the inconsistency among the states leaves taxpayers in a tax theory wonderland. Now go figure out FIN 48!

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The state-by-state roster of exceptions in Exhibit 1 (p. 000) supports the following discussion regarding exceptions. The exceptions are: the subject-to exception (including the combined exception to the exception, the consolidated exception to the exception, and examples of quantitative or calculative issues); the conduit exception; the "operating intangibles company" exception; the "foreign" exception; and the "third-party revenue" exception.

Subject-to Exception

In general, the subject-to exception provides that if the recipient of the related-party income in question is subject to tax on the income in another state or foreign country, the payer will not have an addback — or, alternatively, not have a *full* addback.

Every addback state except Mississippi and New York has some form of subject-to exception. A peculiarity of the subject-to exceptions is the requirement that the taxpayer look to *another* taxpayer's (albeit related) taxability to determine its own tax liability. Stated differently, the taxpayer's addback requirement pivots on the taxability of the intangible income *recipient*.

The addback subject-to exception is reminiscent of the throwback rule, only it is much more complex. With throwback, the taxpayer is concerned only about whether the taxpayer is (typically) subject to income tax in the destination state. The addback subject-to exception pivots on the multistate *level* of tax.

A good place to begin is Virginia, which seems to have the most basic subject-to exception. In Virginia if the recipient (that is, the related holder of intangibles) is subject to tax in another state, Virginia does not require the operating company to add back.[22] That language is reminiscent of the throwback rule and leads to similar questions. Does the recipient actually have to pay tax to the subject to state, or is it that the recipient is subject to tax even if the "destination" state chooses not to impose a tax? And in determining whether the recipient is subject to tax, should the taxpayer use the destination

[19]*See* Exhibit 1 for a list of states using "reasonable" language.

[20]Ala. Civ. App., No 2060478, Feb. 8, 2008, 2008 WL 344118 *rev'g*, Ala. Cir. Ct. Montgomery County, No. CV-03-3172, Jan. 24, 2007, *aff'd*, Ala. Sup. Ct., No. 1070718, Sept. 19, 2008.

[21]For a thorough analysis of that decision, see Sarah McGahan, "The 'Unreasonable' Exception to Addback," *The Journal of Multistate Taxation and Incentives*, Aug. 2008, p. 7.

[22]Va. Code Ann. section 58.1-402B(1).

state's nexus rules, or the rules of Virginia as if they applied in the destination state?

Taxpayers may interpret Virginia's statute as requiring *no* addback if the recipient is subject to tax in just one other state — be it through unitary or separate filing. However, in the tax commissioner's rulings, Virginia seems to have a narrower interpretation.[23] Those rulings clarify that the taxpayer is to reduce addback on a state-by-state basis, for the "portion" of the "corresponding item" attributable to the recipient.

Like Virginia, most states with a subject-to provision produce a partial exception based on the amount of the addback item subject to tax by the recipient.[24] In most cases, the taxpayer calculates the adjustment by multiplying the intangible expense for the year by the effective rate. The effective rate, again in most cases, is presumably the product of the "subject-to" state's statutory rate and the "subject-to" state's apportionment factor.[25] Some states provide for an adjustment only if the recipient's tax rate on the income is within a specified range of the addback state's statutory rate.[26] Another important question is whether, in determining the adjustment to addback or in determining the qualification for exception in those states requiring a certain recipient tax rate, the state allows for aggregation. Assume, for example, that the recipient (typically the intangible holding company) operates in several states. Does the taxing state allow the sum of the effective rates of the various state rates (presumably apportionment factors times statutory rates)?[27]

Another quirk of the subject-to exception is to exclude taxes the recipient pays to states in which it is included in a combined (unitary) return. The fairness of that provision is debatable — like comparing apples to oranges. While the recipient eliminates the intercompany item so that it is "washed," the unitary group didn't receive any tax benefit on the intangible item either. It may be said that the "unadjusted" unitary tax base is subject to tax — so why should the taxpayer have to add back?

Some states (for example, Georgia and Virginia) have postapportionment consolidations. (Although Virginia calls its postapportionment approach a combined return, it is arguably more appropriately called a consolidated return.) If the consolidated group includes the recipient, is the intercompany item eliminated? Probably not. Each member has a separate apportionment factor; therefore, the tax base attribution occurs before income or loss offset of the members. Thus, the only benefit of a consolidated return is the postapportionment offset in circumstances in which one or more members have losses to be used against the income of other members. However, whether the subject-to addback exception extends to consolidated returns remains unclear.

The Conduit Exception

The conduit exception, available in most states, refers to circumstances in which the recipient pays some or all of the intangible expense or interest to an unrelated party. Thus, to the extent the recipient is receiving and then paying the item to an unrelated party, it is essentially a middleman in the transaction.

The conduit exception, while on its face quite simple, can be tricky. Does the conduit exception apply in instances in which the recipient receiving or paying the intangible item or interest is in a unitary state? It appears that it does apply, as it should. Presumably the payment to an unrelated party means that the unitary group has not eliminated the item, and the taxpayer should enjoy the benefit of the deduction. What happens if the recipient pays an intangible expense or royalty to a related party that in turn pays the expense or royalty to an unrelated party (or the payment to the unrelated party is indirect)? In most cases, including in Alabama, Georgia, and Connecticut, the addback states provide for the direct or indirect payment to a third party. However, some states, such as Indiana, do not.[28]

Taxpayers must also focus on the question of how to calculate the limitation on addback when the amount the recipient paid to the third party is less than the amount the taxpayer paid to the recipient. In most states without explicit guidance, perhaps the taxpayer should prorate the addback adjustment. Alabama has an example providing for proration.[29] Indiana's conduit exception extends only to taxpayers paying less to the recipient than the recipient pays to the third party.[30]

Exception: Intangible Payments to Foreign Related Parties

In most addback states, an exception exists if the recipient is a foreign company in a country with a comprehensive treaty with the United States. Some

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[23]Rulings of the Tax Commissioner, Document Number 07-153, Oct. 2, 2007, and Document Number 07-217, Dec. 20, 2007.

[24]*See, e.g.*, Ala. Code section 40-18-35(b)(1), in which the reduction in addback is "to the extent" of taxability.

[25]*E.g.*, Ga. Code Ann. section 48-7-28.3(d).

[26]*E.g.*, Connecticut requires the recipient's rate exceed the state's statutory rate (currently 7.5 percent minus 3 percent).

[27]To determine the effective rate of the recipient in Connecticut, the taxpayer divides the recipient's tax, in a *single state*, after credits and NOLs by the taxable income of the recipient. That rule demonstrates the inconsistency in methods of calculating exceptions to addback. Connecticut Special Notice 2003(22), July 8, 2004.

[28]Ind. Code section 6-3-2-20(c)(5).

[29]Ala. Admin. Code section 10-3-35-.02(3)(h)(2)(i)(I).

[30]Code section 6-3-2-20(c)(5).

Comprehensive U.S. Income Tax Treaties			
Australia	Greece	Lithuania	Slovakia
Austria	Hungary	Luxembourg	Slovenia
Belgium	Iceland	Mexico	South Africa
Canada	India	Morocco	Spain
China	Indonesia	Netherlands	Sweden
Cyprus	Ireland	New Zealand	Switzerland
Czech Republic	Israel	Norway	Thailand
Denmark	Italy	Pakistan	Trinidad and Tobago
Egypt	Jamaica	Philippines	Tunisia
Estonia	Japan	Poland	Turkey
Finland	Kazakhstan	Portugal	Ukraine
France	Korea	Romania	United Kingdom
Germany	Latvia	Russia	Venezuela

states impose the additional requirement that the country have an information sharing agreement with the United States as well. We provide a list of the countries that have comprehensive treaties with the United States.[31]

U.S. treaties with Bermuda and Netherland Antilles are not "comprehensive," and the treaty with Russia has no information sharing component. Exhibit 1 sets forth the state-by-state preconditions for foreign addback exception.

Exception: Recipient Is 'Greater Than' an Intangible Holding Company

That exception exists when the recipient's activity includes activity other than activity related to intangibles or interest. Only five states provide this exception.[32] It is an important exception in instances in which the recipient is based in a unitary state, perhaps with corporate headquarters, a planning format discussed above. Taxpayers with unitary-state-based operations can take advantage of that powerful exception.

Virginia's Third-Party Revenue Exception

Virginia has an "all or none" (that is, the taxpayer either adds back the entire intercompany expense or none at all) exception if the recipient receives one-third of it's gross revenue from licensing of intangible property to third parties.[33] For the exception to apply the intangible expenses and costs between related members must have similar rates and terms to the rates and terms between the recipient and unrelated parties. This is an unusual exception since it would seem to more often apply to a "pure play" (that is, a raw intangible holding company) that to a unitary-based operating company intangibles "host." If the recipent had operating revenue, such activity would have a dilutive effect on the weight of third-party intangible income.

However, if the franchisees pay the franchiser the nonroyalty franchise fee, and pay the subsidiary the franchise royalty, it would seem that most states would not require addback, because the latter structure has no intercompany payments. Should a mere change in the form of the transaction alter how it is taxed?

Summary

The addback rules are inconsistent and tricky for taxpayers and may result in multiple taxation. The rules are characterized by their ambiguous terms, such as the "unreasonable" standard and "tax avoidance," without elaboration. Exceptions to the addback rules are also inconsistent and are characterized by their ambiguous calculative provisions. Moreover, the subject-to exceptions heavily rely on the posture of the recipient to determine the liability of the taxpayer.

As those rules take hold, controversy will mount. Taxpayers should reevaluate state tax postures implemented in the preaddback period (the 1990s generally) to avoid some of the controversy. Taxpayers should also consider these punitive provisions when planning for mergers and acquisitions, because the placement of intangibles and debt could significantly alter the enterprise's effective state rate — for better or worse.

[31]IRS Notice 2003-69.
[32]Exhibit 1.
[33]Va. Code Ann. 58.1-402B(8)a(2).

Exhibit 1

		IRC							Subject to Tax							
State	**Authority**	**Section 1563(b) and (e)**	**Section 318**	**Section 163**	**Section 267**	**Effective for Years Beginning**	**Indirect**	**Foreign**	**Subject to Income Tax?**	**Combined Exclusion**	**"Elimination" Required To Exclude**	**Conduit**	**IHC Receives 3rd Party Revenue**	**Recipient > IHC**	**(Un)reasonable**	**Other/Calculation**
AL	Section 40-18-35(b)	Y	Y	Y	N	2001	Y	Any treaty	Y	Y	Y	Y(4) Rule 810-3-35-.02(3)(h)(2)	N	Y	Y(2)	(1) + (3)
AR	Section 26-51-423(g)	N	N	N	Y	Jan. 1, 2004	N	Comprehensive	Y	N	NA	N	N	Y(1)	N(2)	(3)
CT	Section 12-218c	Y	Y(1)	Y	N	Jan. 1, 2003	Y	Comprehensive (4)	N(2)	Y	Y	Y section 12-2(8)(c)(2)	N	N	Y(3)	(2), File CT unitary
DC	Section 47-1803.03(a)(19)	Y	Y	Y	N	Jan. 1, 2004	Y	Comprehensive	Y	Y	N(3)	Y(1)	N	N	N	(2) + (4)
GA	Section 48-7-28.3	Y	Y	Y	N	Jan. 1, 2006	Y	Comprehensive & Info Sharing	Y	Y	Y	Y(3)	N	N	N	(1) + (2)
IN	Section 6-3-2-20	(1)	N	Y	N	July 1, 2006	N	Foreign Corporation (2)	Y(7)	N	N	Y(3)	N	Y(5)	Y(6)	(4)
KY	Section 141.205	Y	Y	Y	N	Jan. 1, 2007	Y	Comprehensive	Y(2)	N	N	N	N	Y(2)	N	(2)
MA	Section 311; Mass. Reg. Code 63.31.1	Y	Y	Y	N	Jan. 1, 2002	Y	"Bilateral" Income Tax Treaty	Y(1)	Y	N	(2)	N	N	Y	(1)
MD	Section 10.306.1	Y	Y	Y	N	Jan. 1, 2004	Y	Comprehensive (2)	Y(1)	N	N	Y	N	N	N	(1)
MI	Section 208.1201	N	N		Y	(1)	N	NA	NA	NA	NA	NA	NA	NA	NA	NA
MS	Section 27-7-17(2)	Y	Y(1)	N	N	Jan. 1, 2001	Y	N	N	NA	NA	Y	N	Y(2)	N	
NC	Section 105-130.7A	Y	Y	N(1)	Y(4)	Jan. 1, 2001	Y	Comprehensive (3)	NA	NA	NA	Y	N	N	N	(2)
NJ	N.J. Admin Code section 18:7-5.18	Y	Y	N	N	Sept. 1, 2004	Y	Comprehensive & Info Sharing	Y(1)	N	NA	Y	N	N	Y(2)	(1) + (3)
NY	Section 208 Subdivision 9(o)	N	N	N	N	Jan. 1, 2003	Y	Comprehensive (1)	N	NA	NA	Y	N	N	N	
OH	Section 5733.042	Y	Y	Y	N	Jan. 1, 2000	Y	Addback only to Foreign PHC	Y(1)	Y	N	Y	N	N	Y	

Exhibit 1 (continued)

State	Authority	Section 1563(b) and (e)	Section 318	Section 163	Section 267	Effective for Years Beginning	Indirect	Foreign	Subject to Income Tax?	Combined Exclusion	"Elimination" Required To Exclude	Conduit	IHC Receives 3rd Party Revenue	Recipient > IHC	(Un)reasonable	Other/Calculation
OR	OR. Admin. R. section 150-314.295	N	N	N	N	Dec. 31, 2003	N	N	NA	NA	NA	NA	NA	NA	NA	
RI	Section 44-11-11(f)	Y	Y	Y	N	Jan. 1, 2008	Y	Yes, no treaty required	Y(3)	N	N	Y(2)	N	N	Y(1)	(3)
TN	Section 67-4-2006(b)(2)(0)	N	N	N	N	Jan. 1, 2005	NA	NA	NA	NA	NA	NA	NA	NA	NA	(1)
VA	Section 58.1-402B.8.a	N(1)	N	N	N	Jan. 1, 2004	Y	Comprehensive	Y income *or* capital	N	N	Y	Y(2)	Y(3)	N	(3)

Addback Chart Clarifying Notes

Authority: Generally the applicable statutory authority in addback state.

State: State requiring addback.

Section 1563(b) and (e): States with specific reference to these code subsections in defining related member.

Section 318: States with specific reference to this code section in defining related entity.

Section 163: States using that code section to define interest subject to addback.

Section 267: States using that code section to define related party.

Effective for years beginning: When the addback rule became effective.

Indirect: States requiring addback of "indirect" payments between related parties.

Foreign: Exceptions to addback when taxpayers pay related foreign entity intangible expense or interest.

Subject to Income Tax: States that grant an exception (often with caveats) when the direct or indirect recipient pays income tax to a state, multiple states, or a foreign country.

Combined Exclusion: States that exclude consideration of recipient's inclusion in a unitary or combined return from the "subject to" exception.

"Elimination" required to exclude: This column refers to the exclusion language when a recipient files in a consolidated return state. States that specifically require elimination arguably allow an exception in states where the recipient files on a post-apportionment consolidated basis.

Conduit: States that provide an exception when the recipient of related-party interest or intangible expense pays some or all of such expense to an unrelated party.

IHC receives third-party revenue: Only Virginia provides an exception when the recipient intangible holding company (IHC) receives revenue from a third party.

Recipient > IHC: Recipient does more than merely hold and manage intangible assets.

(Un)reasonable: State provides for an exception if state considers the addback "unreasonable."

Other: Special provisions, in particular those requiring precise calculations for exceptions.

Exibit1 (continued)

ALABAMA: "Disproportionate" = unreasonable. Other: (1) If the recipient is not "primarily engaged" in business of intangibles, the principal purpose is not and if it is at arm's length (presumably a transfer pricing study), there is a rebuttable presumption. (2) *See VFJ*, Ala. Civ. App., No 2050478, Feb. 8, 2008, 2008 WL 344118 *rev'g* Ala. Cir. Ct. Montgomery County, No. CV-03-3172, Jan. 24, 2007, *aff'd*, Ala. Sup. Ct., No. 1070718, Sept. 19, 2008. (3) Reduction in addback is based on tax base income apportioned to each other state. (4) Conduit rule subject to significant limitations based on group's effective borrowing rate and debt equity ratios.

ARKANSAS: (1) Even if recipient pays no income tax, addback is still not applicable if recipient has 50 full-time employees, owns $1 million of property, and has revenue from *within* the "nontax" location of $1 million. (2) While "reasonable" term not used, addback is not required if at arm's length and transaction not to avoid payment of tax. (3) It appears that if recipient subject to tax, at any rate, in any state the whole intercompany payment is deductible.

CONNECTICUT: (1) "Related member" section 1563; "Related entity" section 318. (2) For interest expense only, excluding combined states, recipient must pay tax to any *one* state of 4.5 percent (statute less 3 percent). Aggregation of effective rate among multiple states allowed but only if permission obtained. (Presumably this exception would apply to intangible expenses as well but it's not clear.) Connecticut subject to exception permitted only if the transaction's principal purpose is not to avoid tax and contract is at arm's length. Rate determined after credits and NOL. Effective rate is tax paid by recipient ("related members") divided by taxable income before apportionment. (3) Must submit petition in writing to claim "unreasonable" exception. (4) Presumably based on IRS Notice 2003-69.

DISTRICT OF COLUMBIA: (1) Royalty, exception if at arm's length and not to avoid tax. (2) Royalty exception if the recipient acquired intangible assets from an unrelated party with a valid business purpose and at arm's length. (3) "Royalty payment not deemed subject to tax merely by virtue of the related members' inclusion in a combined or consolidated return." Arguably a postapportioned consolidation would qualify. (4) Subject to rate ≥ 4.5 percent; includes gross receipts; but rate not aggregated — must presumably meet test in a single state.

GEORGIA: (1) "Business purpose" applies when primary motive is not tax and changes economics of taxpayer. (2) "Subject to" calculation state by state, the accumulated. (3) Only with valid business purpose as expressly defined.

INDIANA: (1) Uses section 1504, but substitutes 50 percent for 80 percent under section (a)(2). (2) Indiana does not use comprehensive treaty standard; addback required if related member is a foreign corporation and would be included in section 1504 affiliated group. (3) Related member need only "engage" in transaction involving intangible property with a third party. (4) If operating company receives payment from third party and pays to related party. (5) Recipient engages in "substantial business activities" unrelated to intangibles. (6) By agreement. (7) Income tax on "value-added" tax; taxpayer must "make a disclosure." Appears to be an "all or none" exception.

KENTUCKY: (1) Kentucky requires addback of related-party management fees. (2) To avoid addback of interest or intangible expenses, the subject to test is linked (through and) to the recipient having substantial business activities separate and apart from intangibles and arm's length standard.

MARYLAND: (1) Aggregate subject to effective rate is > 4 percent, or greater than or equal to the Maryland effective rate. (2) Exception, under regulations (to be drafted) extends subject to tests to gross receipts and capital/worth taxes.

MASSACHUETTS: (1) "Aggregate" effective rate is "within" 3 percent of taxpayer's statutory tax rate. (2) In some circumstances as provided in regulatory examples.

MICHIGAN: (1) The Single business tax was replaced with the Michigan business tax, effective January 1, 2008; addback notes refer to new levy (generally inapplicable).

MISSISSIPPI: (1) While section 318 is not specifically referenced in the law, its provisions are set forth. (2) If not done to avoid tax.

NEW JERSEY: (1) Allowed if recipient's rate is > New Jersey statutory rate — 3, if at arm's length and the principal purpose was not to avoid tax. (2) But only if by written agreement. (3) New Jersey has separate but similar laws for interest and other intangible expenses.

NEW YORK: (1) Tax in foreign country is > New York rate.

NORTH CAROLINA: (1) Appears to have no requirement for the addback of intercompany interest. (2) North Carolina provides for an election for either (a) the payer to deduct royalty and recipient include or (b) payer adds royalty to income. (3) Foreign rate must equal or exceed North Carolina rate. (4) IRC section 267(a)(1) arguably disallows related party deduction in that N.C. Gen. Stat. section 105-13.2(5c) follows federal treatment.

OHIO: (1) If shown to be not for tax avoidance.

RHODE ISLAND: (1) If by agreement in writing. (2) If tax avoidance not "its significant purpose." (3) Recipient subject to tax at > Rhode Island rate less 3 percent. Aggregation seems implied in section 44-11-11(f). (4) "Partial adjustments."

TENNESSEE: (1) Appears to allow related party deductions if properly disclosed.

VIRGINIA: (1) Related member is not defined in applicable code section. (2) One-third of gross revenues of recipient are received from third parties. (3) For intercompany interest only, if recipient has at least five full-time employees, no addback, and the interest is unrelated to intangibles, and transaction has a "valid business purpose." There are other specific exceptions for interest addback. (4) For interest only: if recipient receives > $2 million in revenue annually from unrelated members.

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