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Is State Tax Planning Still Viable? REITs and RICs

by Charles F. Barnwell

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Introduction

As more states adopt unitary reporting,[1] the opportunity has eroded for base shifting — that is, controlling separate filing state tax bases through intercompany charges — and the using of tax havens or unitary-based holding companies. Further erosion has occurred because separate filing states have enacted laws requiring the addback of intercompany intangible expenses, as well as long-arm economic nexus laws and regulations. As a result, practitioners have experienced a shift in planning fundamentals. One result of that shift has been an increased use of "captives" of various types. Another shift has been characterized by less attention to the tax base and more attention to apportionment strategies. Ironically, as the sales factor "gains weight" on a multistate terrain, apportionment factor planning has a greater effect because, arguably, the sales factor is perhaps the most malleable of the three standard factors. And as the planning tool kit has evolved, so have the nature of state audit challenges and issues.

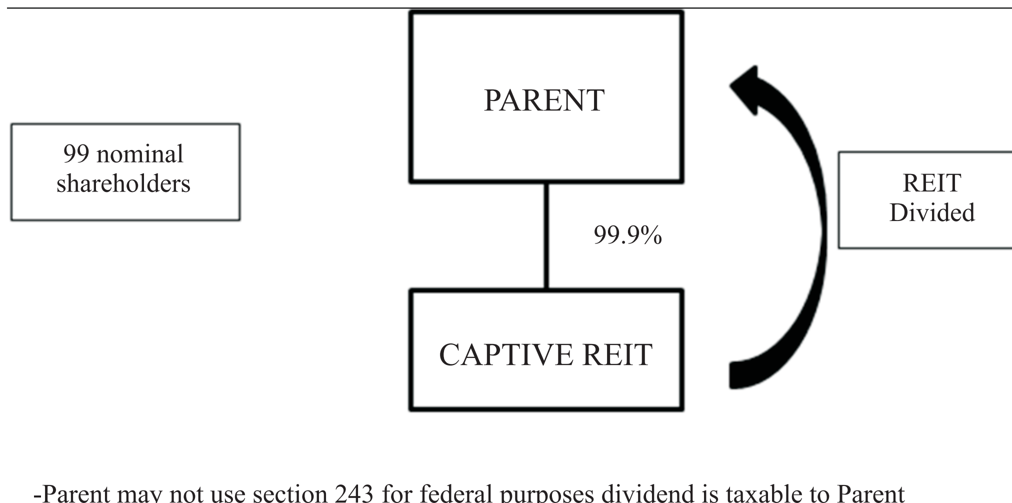
[1]Recent joiners are New York, Massachusetts, Wisconsin, and even states adopting alternative approaches, such as Michigan (the Michigan business tax) and Texas (the margin tax).

Various Planning Structures in the 'Captive Jungle'

Because under federal law real estate investment trusts, regulated investment companies, subchapter T cooperatives, insurance companies, and partnerships have special federal tax treatment, state tax planners have devised strategies using those entities at the state level when significant disparities exist between federal and state law. In some cases corporate taxpayers already have captive entities within the preexisting corporate group for valid business purposes, and planners simply capitalize on the inherent opportunities. In other cases corporate taxpayers create those alternative entities for varying business reasons, including to reduce state taxes.[2] Each alternative entity presents its own unique planning advantages. Naturally, state tax auditors are more motivated to attack scenarios in which the alternative entity was created solely for state tax purposes — but this is not often an easy determination. Some industries, for example, may offer a better natural fit for some captive types. For example, it is easier to understand the existence of a captive REIT in a corporate family of entities dedicated to real estate sales and management, or a captive RIC created by an enterprise in the financial services industry. As another example, it is easier to understand a captive cooperative in the world of agribusiness in which subchapter T cooperatives are common. Although the discussion of these various captive entity types focuses on each captive type, planners may mix and match them, take all or part

[2]The level of ownership required to be a captive varies by entity type — REIT, REMIC, cooperative, and so on — and perhaps by state. A REIT requires 100 or more shareholders (section 856(a)(5)), but typically 99 of the 100 "persons" are nominal owners, with the parent typically 99 percent or more of the captive REIT.

Figure 1.
"Captive" REIT



-Parent may not use section 243 for federal purposes dividend is taxable to Parent

-Dividend in many states is excluded/exempt because states generally have their own rules

-About 20 states have enacted an anti-REIT abuse law*

-Captive REIT > generally 99% owned by Parent

*CCH Table at 10,620

of the structures offshore, or create structural alternatives to minimize state taxes on future transactions. There appears to be significant variation in the design and operation of captives.

Use of a Captive REIT

The REIT, a statutory mechanism under IRC sections 856 and 857, is simply a corporation that derives most of its income[3] and has most of its assets invested in real estate and elects to be taxed as a REIT. The REIT is entitled to a dividends paid deduction assuming it meets other statutory requirements. For federal purposes, the REIT shareholder is required to include the REIT dividend in taxable income and is not entitled to relief under section 243. However, many states allow an exclusion or exemption of all or most dividends from subsidiaries or majority-plus held entities. Dividends in those states are excluded or exempt from income under "normal" dividend exclusion provisions without regard to whether distributed from a REIT or an ordinary subchapter C entity.

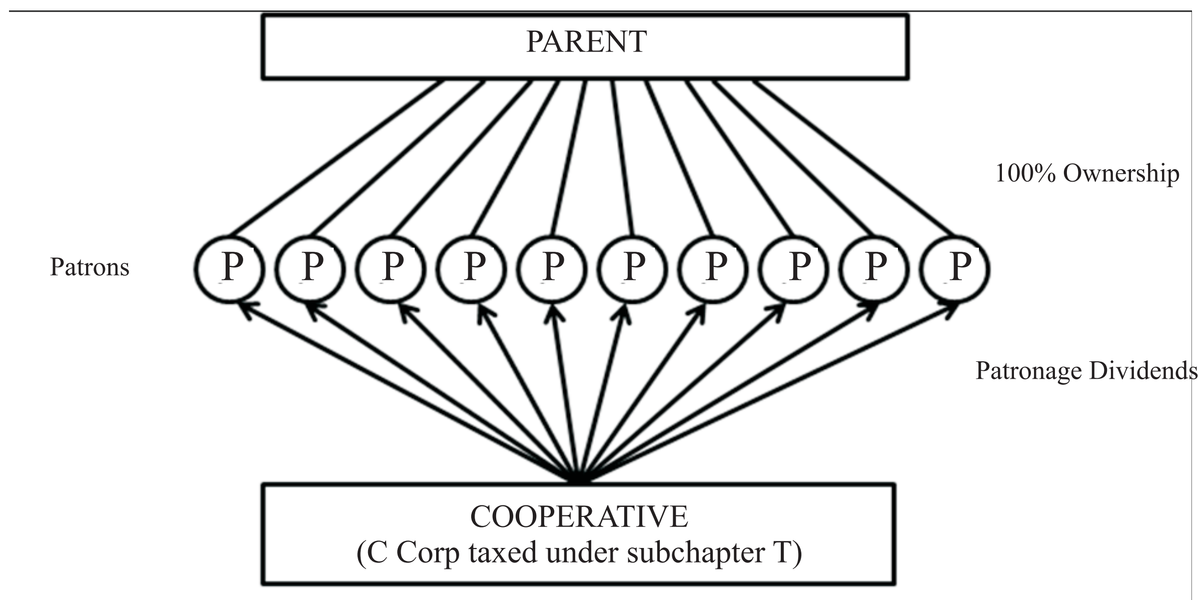
A REIT can have two important implications in the state tax arena. First, the state may not have provisions that parallel federal provisions denying a section 243 dividend exclusion. In many cases at the state level, a dividend from a captive REIT is treated no differently from a dividend from a subsidiary. Secondly, REIT apportionment attributes may be severed from core operations, particularly in separate filing states or in unitary states where REITS are not considered included entities. If those attributes are predominately in states with high tax rates, this separation of REIT apportionment attributes from attributes of the taxpayer may result in a reduction in apportionment factors and the effective state tax rate.

As a result of captive REIT proliferation, 20 states have enacted anti-captive REIT provisions.[4],[5] Other states have tried to include the REIT in

[3]IRC section 851(c).

[4]CCH Table at para. 10,620

Figure 2.
Captive Cooperative



-Probably needs 10 or more patrons

-Cooperative may have different fiscal year-end for federal and state tax

-IRS appears to have settled with some audits in 2009 deferral issue

combination, or argue for an outcome similar to federal treatment despite the lack of statutory authority the state may have for such an argument.[6] Captive RICs have been used in a manner similar to captive REITS, although there are important differences in their design and implementation.

Captive Cooperative

Similar to the captive REIT or RIC, cooperatives under IRC subchapter T are entitled to a dividends paid deduction.[7] Cooperative patrons, essentially shareholders that share in the benefits of cooperative purchasing or sales power through aggregation, must include patronage dividends from the cooperative in taxable income.[8] However, many states fail to distinguish between a patronage dividend and an ordinary dividend. Thus, to the extent that states allow some sort of exclusion or exemption for dividends, particularly dividends from subsidiaries, patronage dividends may escape tax — assuming that under state law a patronage dividend is treated as a dividend for state purposes.

> ***Patronage dividends may escape tax — assuming that under state law a patronage dividend is treated as a dividend for state purposes.***

The captive cooperative raises some challenging questions, particularly regarding business purpose. The objective of a cooperative, in theory, is to generate collective bargaining or selling power. Members join forces to achieve economies of scale and achieve

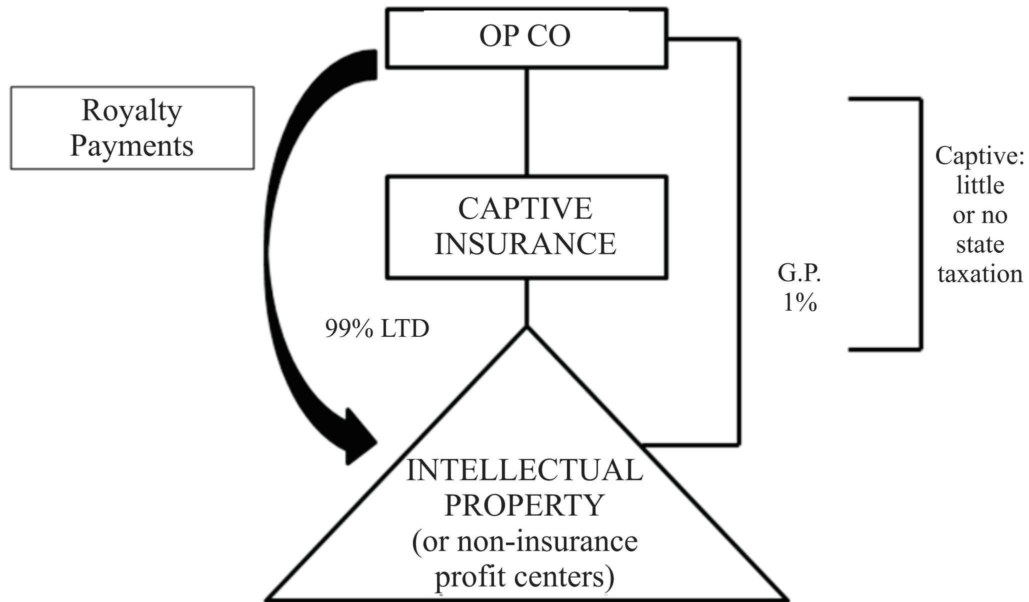
[5]Federal tax planners used captive REITS to trigger tax free liquidations, leading ultimately to the enactment of IRC section (c).

[6]For a thorough look at a captive REIT challenge, see *HMN Financial, Inc., and Affiliates, Appellants v. Commissioner of Revenue, Appellee*, 7911-R, May 27, 2009 Minnesota (RIA).

[7]IRC section 1382(b).

[8]IRC section 1385(a).

Figure 3.
Captive Insurance Company



-Is captive insurance company predominately an insurance company

-Addback rules appear likely to apply

greater influence over market forces. However, a captive cooperative — as the structure in Illustration 2 shows — is in essence a single unitary business with a single profit motive. Nonetheless, it appears that under applicable federal law, it is possible for a number of patrons, all owned by a common parent, to collectively own a captive cooperative.

Only a few states seem to distinguish ordinary dividends from patronage dividends. Thus, to the extent that states allow special dividend exclusions, deductions or exemptions, it is possible that patronage dividends are dividends for purposes of state taxation in many states.

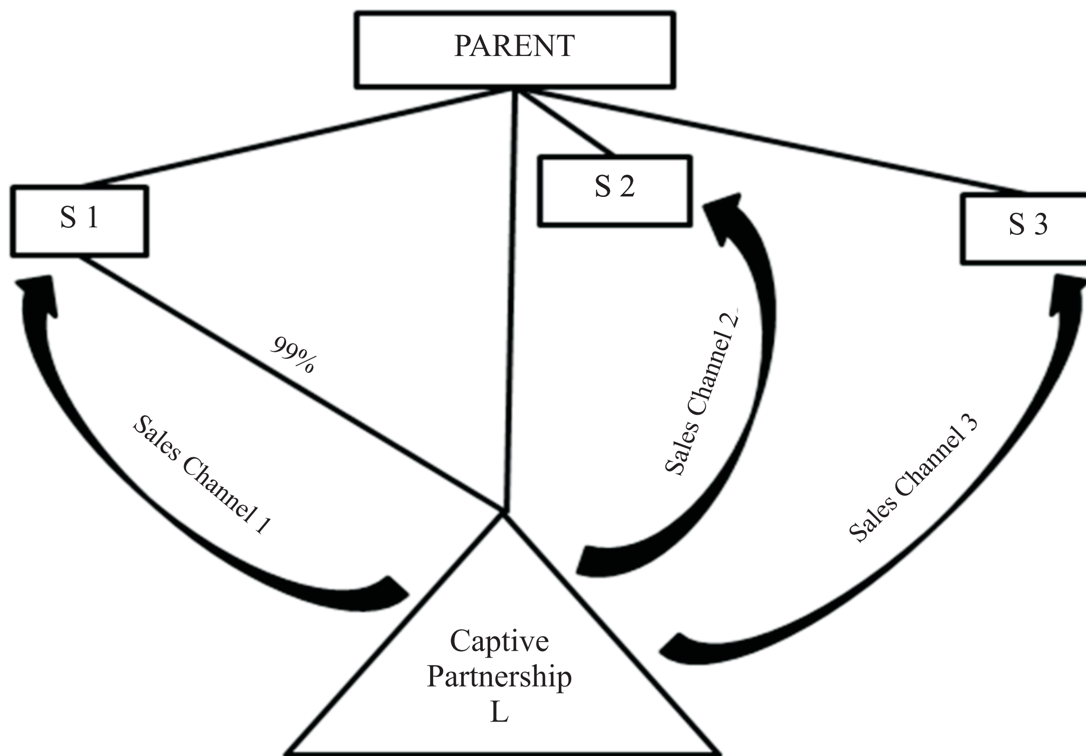
Captive Insurance Company

In most states, insurance companies pay premium taxes in lieu of other taxes.[9] The positioning of non-insurance operations, or income-producing intangibles in conduits with the insurance company owing a significant ownership interest, minimizes if not eliminates state income taxation on income earned by the conduit.

As noted, the context for a captive entity has a direct bearing on the effectiveness of the planning. In the case of captive insurance, if the enterprise is primarily engaged in insurance, that structuring seems to harmonize, and states are probably less likely to challenge that planning. For example, perhaps a large insurance company operates a subsidiary insurance title company as a limited liability company as opposed to a corporation that “natural” positioning, choosing the right entity form, is certainly within management’s prerogative. However, what about retailers, manufacturers, or even banks? Although the business purposes for captive insurance companies exist, what about structures in which the captive insurance company owns non-insurance operations? State challenges may include:

[9]Insurance companies are generally exempt from income taxes in most of the 45 states imposing income taxes. Exceptions include Florida and Tennessee.

Figure 4.
Captive Partnership



Sales to / from non-California locations

- the assertion that the insurance company, including its interest in the non-insurance conduit is not predominately insurance;[10]
- the addback of payments of royalties and intangible expenses; or
- combination and inclusion of the insurance company in the combined return.

Captive Partnership to Minimize State Taxation

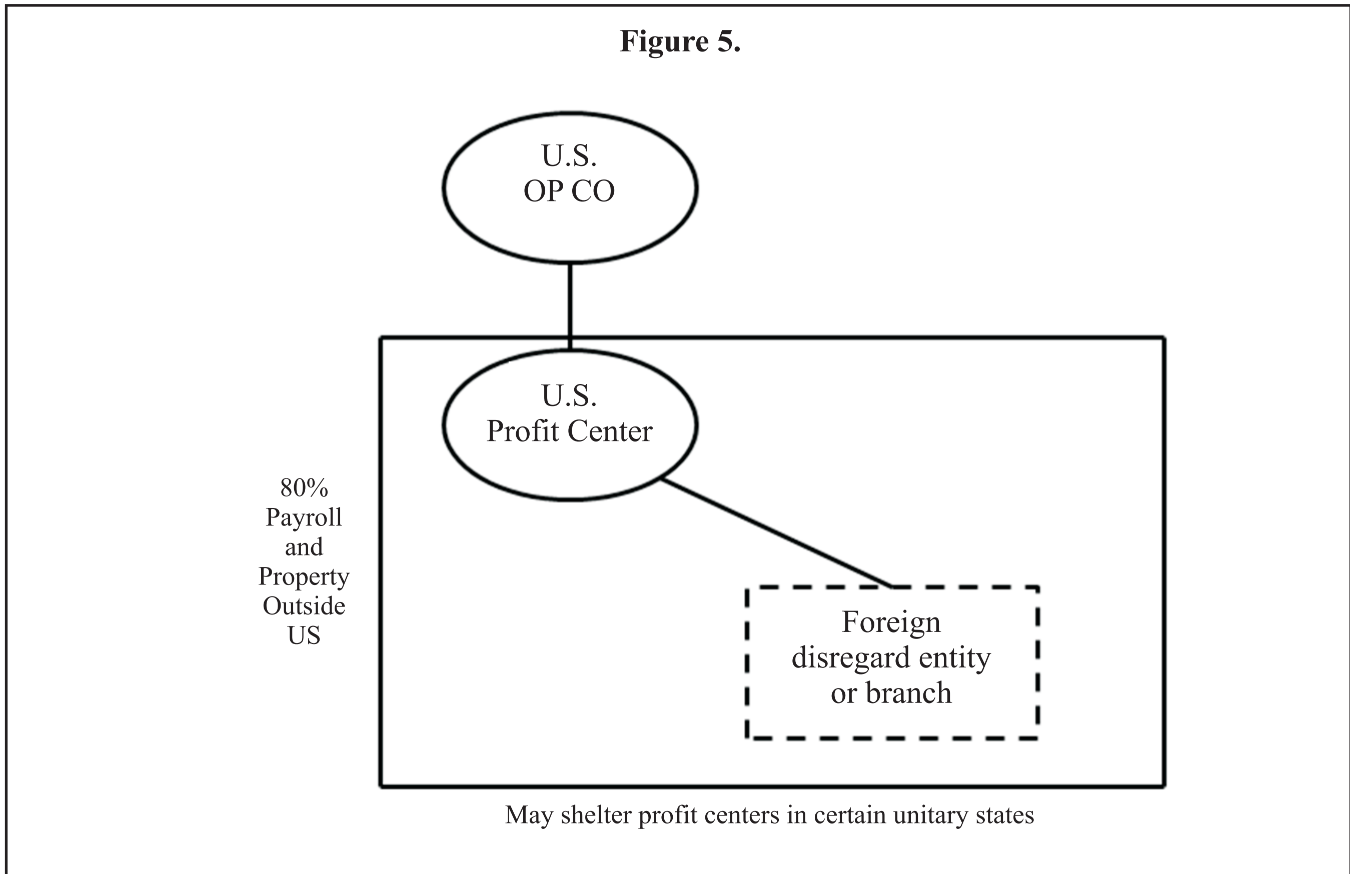
As noted, planners have used a partnership (or more broadly any conduit) with a captive insurance company to shield non-insurance operations from state income taxation. There are other advantages to having a captive partnership — essentially a partnership consisting of partners that are members of a federal affiliated group or of a unitary group.

For example, consider a scenario in which Parent P has Subs S1, S2, and S3. S1 and Parent form a partnership, L, with the ownership structure in Illustration 4.

Further assume that L makes substantial sales to all three subsidiaries. Sales to S3 and S2, non-partner members of the group, originate at docks outside California, and are destined to go to non-California locations.

Under Cal. Code Regs. section 25137-1(3), sales between a corporation and a partnership in which the corporation is a partner are eliminated from the sales factor. Thus, sales by S1 to Parent are eliminated in determining the apportionment factor. However, it seems clear from the regulation that sales to a non-partner are included in the sales factor. In the diagram, note three sales channels, 1, 2, and 3. Under a literal reading of Cal. Code Regs. section 25137-1(3), channel 1 sales are eliminated. However, channel 2 and 3 sales are not eliminated.

[10]There are several court cases regarding whether a company is an insurance company for federal tax purposes. See *Bowers v. Lawyers Mortgage Co.*, 285 U.S. 182 [10 AFTR 1604] (1932); *United States v. Home Title Insurance Co.*, 285 U.S. 191 [10 AFTR 1592] (1932). *See also Inter-American Life Insurance Co. v. Comm'r*, 56 T.C. 497, *aff'd per curiam*, 469 F.2d 697 [31 AFTR 2d 73-412] (9th Cir. 1972).



Because those sales originate and terminate outside the state, it would appear that this captive partnership has a dilutive effect on the group's California apportionment factor.

One might argue that if the state tax planner engineered such a structure to avoid California taxes, a California Franchise Tax Board auditor might reach a different conclusion from that reached if the structure came about purely for business reasons. But the determination of truly how, or why, that structure and outcome exists can be challenging. If a Big Four firm was involved in the structuring, can the auditor conclude that the structure was created for tax avoidance?

Use of an 80/20 Captive

In many unitary states, domestic corporations with over 80 percent of payroll and property outside the United States are excluded from the combined group.[11] Unitary businesses have used this 80/20 captive concept to remove income from the unitary business tax base. As with other captive scenarios, the company may have such a structure naturally embedded. For example, a multistate/multinational manufacturer may have a domestic entity with manufacturing in the United States and in foreign countries, with over 80 percent average payroll and property in the foreign jurisdiction. In this natural structure, 80/20 unitary states would exclude this entity, even though that material domestic manufacturing may occur within the entity.

At the other end of the spectrum, consider a captive 80/20 company owning a small office, with a few employees and significant intellectual property. Further assume that the intellectual property has little or no cost basis, a common reality in companies with valuable indigenous intellectual property. This "forced" scenario leads to a significant erosion of the domestic unitary tax base.

A related scenario may involve positioning a foreign branch or a disregarded single-member LLC below a classic Delaware holding company. The result of that a scenario is similar — and equally bold. These last two scenarios point to the reality of state tax planning: The less "natural" the structure, the greater the anticipated challenges. There appears to be a spectrum in most state tax planning

[11]Arizona and Illinois two states that generally exclude domestic 80/20 companies from the combined return.

using captives — that the challenges anticipated will vary directly with the level of natural integration achievable in any given context. That natural integration is inherently subjective.

'Churning' and Related Dilutive Strategies

As noted above, as states go unitary or create addback statutes, limiting the practitioner's ability to minimize taxes through base shifting or the use of intercompany charges (most commonly royalties, interest, and management fees), practitioners have turned to apportionment as a new planning frontier. And ironically, as the sales factor has gained weight, apportionment planning has a greater effect since the sales factor is arguably the most malleable of the three standard factors.

Thus, matters focused on planning that stretches the denominator of the sales factor have surfaced in the courts, while cases dealing with base shifting seem to be fading from view. Examples of sales factor dilutive planning include "churning" and similar strategies, as well as the use of *Finnigan/Joyce* planning in unitary states.

"Churning" is perhaps an unfair moniker, as it implies a planner's deliberate or abusive effort to dilute the sales factor. This strategy pivots on the ambiguity regarding what constitutes "gross receipts" or "sales" for apportionment purposes. If gross receipts include all receipts, the gross proceeds from the ongoing, if not daily, sales of commercial paper and similar cash-equivalent trading are receipts. Churning on its face can lead to either a very bad answer or a very good one. If the trading activity occurs in a state that would include such receipts in the apportionment factor, this could significantly increase the sales factor numerator. If the trading activity occurs in a state that does not recognize such receipts, the downside of churning does not exist. Conversely, to the extent the taxpayer has nexus in states other than headquarter states, inclusion of churned receipts will have a dilutive effect on the sales factor.[12]

In addition to the turnover of cash equivalents, other trading activity may generate significant gross receipts. For example, many companies in mining, energy, and agribusiness typically have active commodity hedging activities. These activities may generate receipts in significant quantities. And as with treasury receipts, the effect of this activity can be disastrous or beneficial depending on where the trading activity occurs within the taxpayer's multistate apportionment profile.[13]can

***Finnigan* and *Joyce*[14]**

Much has been written on the back-and-forth authority, the so-called *Finnigan* and *Joyce* rules.[15] Taxpayers have fallen into unintended consequences by failing to anticipate the harsh results that may occur. But state tax planners have also taken advantage of those rules to minimize taxes.

The epicenter of *Finnigan* planning seems to be California, at least until California switches back to *Joyce* again. This planning will take on a powerful dimension when California permits taxpayers to elect single-sales-factor apportionment, scheduled for 2011. With 100 percent sales factor weighting, the *Finnigan* rule can perhaps eliminate most franchise tax for California-based companies selling

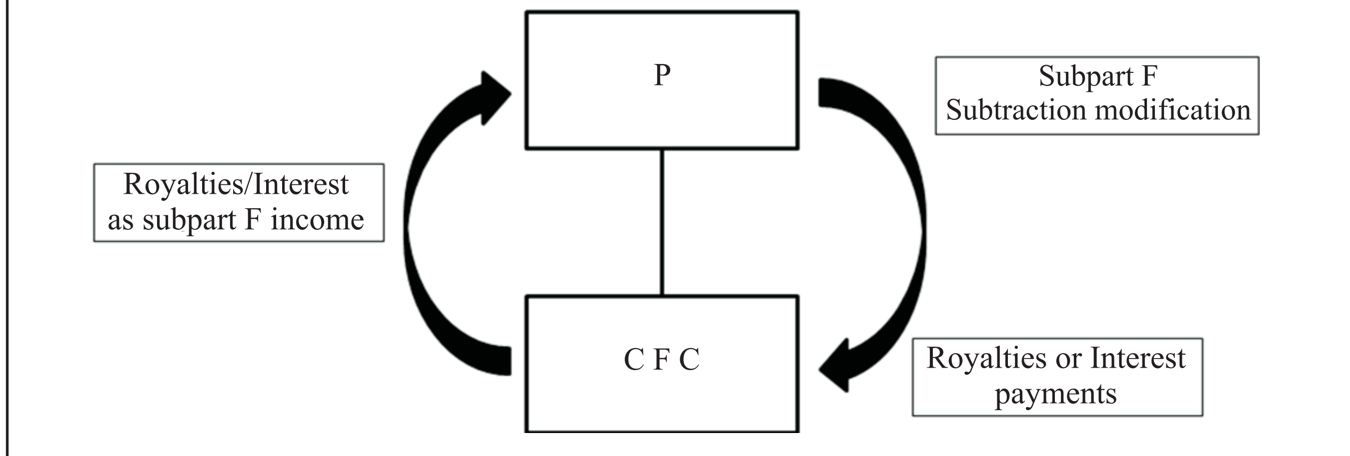
[12]See Charles F. Barnwell Jr., "The Sales Factor, Top Five Issues Taxpayers Need to Consider," *Journal of Multi-State Taxation and Incentives*, Feb. 2008, for a detailed analysis of the churning issue.

[13]*See General Mills, Inc. & Subsidiaries v. Franchise Tax Board*, San Francisco, 1st District Appellate Court No. A120492. Apr. 15, 2009. Petition for review denied.

[14]Cal. State Bd. of Equalization, No. 66-SBE-070, 11/23/66 and Cal. State Bd. of Equalization, No. 88-SBE-022, 8/25/88 (*Finnigan I*), *reh'g denied.* No. 88-SBE-022-A, 1/24/90 (*Finnigan II*, which also specifically overruled *Joyce*).

[15]For a detailed explanation of planning using *Finnigan* and *Joyce,* see Barnwell, *supra* note 12.

Figure 7.
Characterization of Intercompany intangible as Subpart F Income



throughout the United States by eliminating throwback.[16] The planning envisioned is best illustrated with an example:

California Importer ABC brings inventory in from Asia and stores it in Ontario. It sells the inventory to distributors and retailers throughout the United States. Currently, ABC is a single entity with significant income, but is protected in other states under P.L. 86-272.

Unfortunately for ABC, under section 25135, sales into other states are thrown back. Assuming that ABC elected single-factor apportionment, 100 percent of ABC's income is apportioned to California.

State Tax Planner creates Newco, a subsidiary that buys inventory from ABC (its parent company) to sell at retail throughout the United States. Newco has an aggressive service and marketing platform and is unable to confine its activities to the solicitation of tangible personal property — that is, it is conducting nonimmune activities in the other 49 states. Newco has little profitability, and the dollar volume of sales is extremely small compared with ABC's separate-entity sales.

Under this scenario, none of Newco's sales are thrown back to California. The trade-off is that Newco exposes the ABC unitary group, consisting of Newco and ABC to tax on the entire unitary tax base in states that have adopted the *Finnigan* rule. However, in states following *Joyce*, only Newco's sales (minor in comparison to ABC's) are in the numerator. Moreover, ABC retains immunity in separate-filing states. As a result, ABC has significantly minimized its California franchise tax liability.

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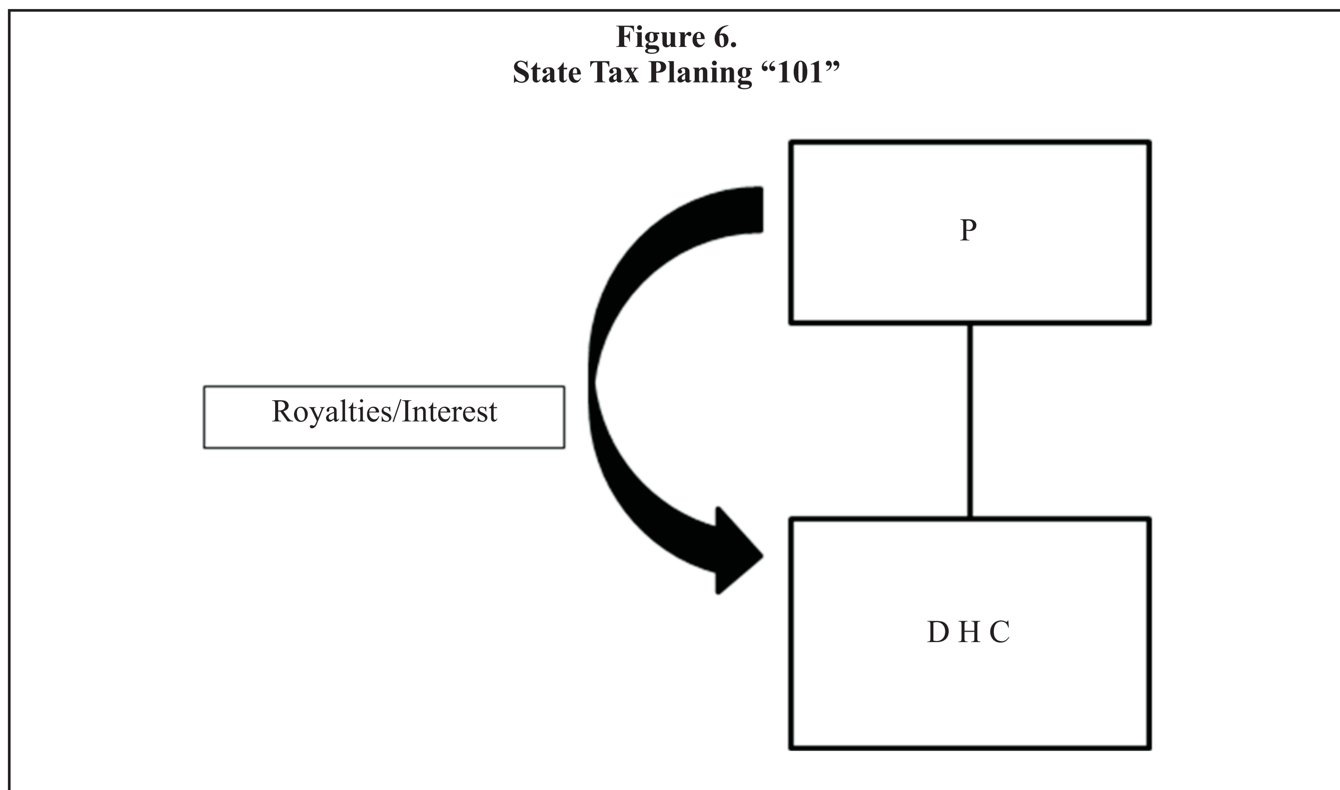
[16]New California law, effective for years beginning on or after January 1, 2011, California 2009-10 Third Extraordinary Session, codifies the *Finnigan* rule, and makes the throwback implications explicit:

> 25135. (a) Sales of tangible personal property are in this state if:
> (1) The property is delivered or shipped to a purchaser, other than the United States government, within this state regardless of the f.o.b. point or other conditions of the sale.
> (2) The property is shipped from an office, store, warehouse, factory, or other place of storage in this state and (A) the purchaser is the United States government or (B) the taxpayer is not taxable in the state of the purchaser.
> (b) For taxable years beginning on or after January 1, 2011, for purposes of determining whether sales are in this state and included in the numerator of the sales factor, all sales of the combined reporting group properly assigned to this state under this section shall be included in the sales factor numerator for this state regardless of whether the member of the combined reporting group making the sale is subject to the taxes imposed under Chapter 2 (commencing with Section 23101) or Chapter 3 (commencing with Section 23501) of this part. All sales not assigned to this state pursuant to subdivision (a) shall not be included in the sales factor numerator for this state if a member of the combined reporting group of the taxpayer is taxable in the state of the purchaser.
> (c) The Franchise Tax Board may prescribe regulations as necessary or appropriate to carry out the purposes of this section.

Figure 6.
State Tax Planing "101"



Given the relatively new vintage of California's readoption of *Finnigan*, time will tell if the FTB will challenge such *Finnigan* planning.

Subpart F Planning

The earnings of controlled foreign corporations[17] are generally not taxed in the United States until repatriated. However, there are important exceptions, most notably regarding personal holding company income — generally passive items such as interest, rents, royalties (with exceptions), and dividends. Before subpart F, enacted by Congress in 1962 (sections 951-965), U.S. corporations could transfer investment portfolios into tax haven countries and obtain a permanent deferral on those items. But under current law, subpart F income of this type is generally taxable in the United States as earned. Subpart F eliminated the permanent deferral opportunity, and international tax planners generally see little value in transferring portfolio assets offshore. However, with important exceptions and limitations, many states do not tax subpart F income. Therefore, state tax planners may have the opportunity, with good business purpose, to minimize state taxable income by converting passive or domestic personal holding company income into foreign-sourced income, that is, converting intercompany intangibles into subpart F income.

Example 1 illustrates a basic base shift in a domestic context. Because of addback rules, economic nexus and the enactment of unitary tax laws by many states, that basic planning has lost most of its impact. Example 2 is fundamentally the same strategy, except that the host income concentration point is a CFC. By converting this passive income into subpart F income in most cases add-back rules do not apply and planning objectives are largely accomplished. There are significant complications, such as section 367(d), involved in planning for subpart F income, particularly in instances involving the transfer of appreciated property offshore.

Financial Accounting Standards Board Interpretation No. 48 'Accounting for Uncertainty in Income Taxes'

With FIN 48, many of the above structures, particularly the captive structures, have become dinosaurs. The prevailing wisdom is, why implement a strategy if there is no net book benefit? And planning focused mostly on special purpose captives, coupled with conservative accounting principles, leads to a full reserve of any planning benefits that may accrue. As a practical matter, even if these structures are implemented, and succeed on audit, the taxpayer may have to wait three or four years

[17]A CFC is an entity in which U.S. shareholders own greater than 50 percent of the entity's stock measured by vote or value. IRC section 957(a).

until the statute of limitations has run to book planning benefits. FIN 48 has reshaped state tax planning.

Conclusion

The above planning strategies are not recommendations of the author. The author has observed all these strategies in practice, with variations from case to case. In some cases the taxpayer has had what appears to be a "real" business purpose, and in other cases, frankly, the author has observed little business purpose. One theme seems to stand out: Some planning strategies fit some industries better than others. That fit is a subjective but real consideration, and goes directly to the effectiveness of planning.

In conclusion, state auditors continue to challenge planning across the board — with different arguments and perspectives. Over the past 10 years, the state tax planning community, much like the federal and international planning communities, has become more conservative — and state audit practices have become more aggressive. ✰