

Increased state tax agency scrutiny of related-party transactions



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The fiscal crisis in many states has deepened with most running a significant budget deficit. State governments are looking where they can for new revenue sources. One common response to revenue needs has been to tighten tax rules governing related-party transactions. In an effort to counter perceived tax avoidance, states have focused attention on dealings between owners and their companies and on transactions among affiliated businesses.

Multistate businesses commonly employed aggressive tax planning strategies in the 1990s and 2000s that included the use of related entities to lower their effective state tax rate. Across the country, states have different income tax rates ranging from low to high. Five states impose no corporate income tax at all. Nine states have no broad-based personal income tax.

Many states do not tax certain types of entities, such as partnerships or limited liability companies (LLCs). Over time, a large number of businesses have converted to these non-taxable, flow-through entities, resulting in lower tax revenue from corporate taxpayers.

States have also enacted preferential apportionment methods or filing conventions in an attempt to lure businesses to their state or favor existing companies located there. This diversity and complexity encouraged sophisticated business structures and creative tax planning strategies designed to take advantage of those differences. Usually, these tax planning strategies involved the use of multiple entities and related parties.

The heightened scrutiny of related-party transactions (among family members, between business owners and their companies, and among affiliated entities) targets: intercompany sales of products and services, loans, leases, licensing and royalty agreements, management fees, and sales or exchanges of fixed assets. An increasing number of states are enacting laws, or implementing rules to disregard or severely discourage such transactions from an income tax or business entity tax perspective. State responses have included:

- > Adding back expenses from related-party transactions, e.g., rent, interest, royalty payments
- > Requiring related entities to file combined returns (historically required for "C" corporations, but now being required for partnerships, LLCs and S corporations)
- > Mandating increased disclosure in tax returns and transparency in reporting

This trend is snowballing among states. For example, in Wisconsin, previous measures to enact tougher state tax legislation had been defeated for many years. In 2009, Wisconsin passed legislation requiring combined reporting in a matter of days. Combined reporting eliminates intercompany transactions and treats all the related entities as one taxpayer. Massachusetts, Michigan, and Texas have also recently joined the ranks of combined reporting states.

Of the 24 states that have enacted related-party reporting and add-back requirements, the majority created those rules between 2000 and 2007. Twenty-three states have mandatory combined reporting, and eight states have both tax add-backs and mandatory combined reporting. According to one estimate, adopting combined reporting will increase a state's corporate tax revenues on average by \$95.7 million. It is no wonder states have rushed forward with this type of legislation.

This presents both an issue and an opportunity for individuals and businesses. They must gain an awareness of state statutory and administrative mechanisms aimed at related-party transactions. This is essential to reduce their risk of incomplete tax compliance and to identify possible avenues for tax planning. In some cases, ensuring that a related-party transaction reflects "arm's length" terms will be sufficient to preserve the associated tax benefits. Documenting a "business purpose" other than decreased state taxes is key. Economic substance is also usually required as opposed to "paper" transactions without real changes in assets or liabilities. There are safe harbors in these new tax laws for legitimate business purposes such as legal liability or succession planning.

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If related-party transactions are not handled properly, they can result in additional state tax as well as interest and penalties. Risks include:

- > Disallowance of expenses
- > Audit adjustments to force combined filing
- > Missing available "safe harbors" or the ability to petition for relief/alternate reporting
- > Penalties for negligence or fraud
- > Interest charges on delinquent taxes
- > Possible financial impairment under the FIN 48 provisions of FAS 109, or under FAS 5

Our advice to business and individual clients involves taking an approach of compliance that stems from solid information. First, companies should map out all related-party transactions of a material nature. Don't neglect to look at international affiliates for exposure.

For closely held companies, examine important contracts or large transactions with shareholders or LLC members. In some cases, the activities of an affiliate can create nexus, or a business tax filing requirement for all related entities.

Link this map to states where you have business activity and match the business activity to state compliance requirements. As you determine how to comply with the laws, you may still be able to take advantage of safe harbors and examine transactions for possible planning opportunities. Careful analysis of an affiliated group's facts and a state's tax laws might permit the exclusion or inclusion of companies in a combined return such that the overall state tax result is favorable. You will need to quantify your financial exposure with respect to taxes and FIN 48 and FAS 5 reporting. Don't forget to factor in additional compliance costs such as return preparation time, possible investments in better software, and potential Internal Revenue Code Section 482 studies. Document the nature of related-party transactions and your support for claiming deductions or not filing combined returns.

State statutory and administrative rulings in this area are nothing less than a minefield for the uninformed or unconcerned. In September 2003, 40 states and the District of Columbia signed a "memorandum of understanding" to partner with the IRS to fight abusive tax-avoidance schemes, including plans to share information regarding both the abusive transactions, as well as the taxpayers who participate in them. Keep in mind, however, that many tax-saving strategies are perfectly legal and simply take advantage of the diversity of laws that govern state taxation. The key is making informed decisions regarding business taxation and understanding your level of comfort with the associated risks. Given their continuing fiscal challenges, states' scrutiny of related-party transactions and their enactment of new legislative solutions are not likely to cease until they conclude that they have the tools to address aggressive state tax planning and to reach all of the economic profit or value generated by a business enterprise and its owners

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