Constitutional Challenges to Add-Back Statutes

BY MICHAEL J. SEMES (BLANK ROME LLP)

Part I of this article outlined the general format of an add-back statute, defined as a statute that adds back certain inter-company expenses to a corporation’s taxable income. These statutes may also be viewed as disallowing these same types of expenses, and were in many cases adopted as the result of fiscal desperation both to plug a historically large budget hole and to close a perceived future tax planning loophole. In this Part II, the author examines constitutional challenges taxpayers may bring against add-back statutes and concludes that the constitutional vulnerability of add-back statutes combined with a somewhat bleak economic outlook may create a sort of perfect storm, leaving them open to successful challenge.

For purposes of Part II, the following scenario will be used, with several variations. The example is intentionally over-simplified to allow a greater focus on the constitutional issues discussed.

• Parent, which has taxable income of $24,000,000, manufactures products in a state that has adopted an add-back statute (State ABS).

• Parent forms a subsidiary, DIHC, Inc. (DIHC).

Background on the Internal Consistency Test of the Commerce Clause

The Supreme Court of the United States has held that the Commerce Clause requires a taxing scheme to be internally consistent. A taxing scheme that imposes a greater burden on interstate commerce than intrastate commerce is not internally consistent and, therefore, violates the Commerce Clause. Stated another way, “the formula must be such that, if applied by every jurisdiction, it would result in no more than all of the unitary business income being taxed.”

The internal-consistency doctrine invalidates a state taxing scheme that creates the risk of multiple taxation. Therefore, to prevail on an internal consistency challenge, a taxpayer does not have to prove that multiple taxation actually resulted. As the Supreme Court has stated, to be internally consistent, a state tax system “must be such that, if applied by every jurisdiction, it would result in no more than all of the unitary business income being taxed.”

As stated in Hellerstein:

If a state taxing statute will expose an interstate enterprise to a greater burden than that imposed on a comparable intrastate enterprise on the assumption that the statute has been adopted by every state, the danger of subjecting interstate commerce to greater tax burdens than those imposed on intrastate commerce suffices to constitute a Commerce Clause violation. The taxpayer need not demonstrate that it has in fact suffered actual multiple taxation or discrimination. This is a sound principle, because the possibility that one might encounter multiple taxation or discrimination by engaging in interstate commerce can inhibit interstate activity as much as actual multiple taxation or discrimination.

In the context of the add-back used in the example above, these internal consistency principles may be stated two different ways. First, State ABS’s add-back scheme violates internal consistency if it imposes a greater tax burden on Parent when it conducts its activities across state borders than if it had confined its activities within ABS’s borders. Interstate commerce is burdened if either (a) there is a risk of multiple taxation; or (b) a greater tax liability results compared to in-
Add-Backs

Parent

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<tr>
<th>Tax Rate</th>
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<tbody>
<tr>
<td>State ABS</td>
<td>8.5%</td>
<td>$24,000,000</td>
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<td>Total</td>
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DIHC

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 contrasting commerce. Second, if every state were to adopt State ABS’s add-back scheme, more than 100% of the Parent unitary group’s income would be subject to tax.

Add-Back Statutes Impose a Greater Burden on Interstate Commerce Than on Intrastate commerce

In the example at the top of the page, the following state income tax result occurs when ABS’s add-back scheme is applied.

The application of State ABS’s add-back statute increases to $24,000,000 the amount of taxable income apportioned to State ABS. This, in turn, has two impacts. First, the total taxable income of Parent’s unitary group that may be subject to state taxation is $24,000,000. Second, the State ABS tax liability of Parent (and the aggregate tax liability of the Parent unitary group) has increased to $2,040,000 (from $1,530,000).

If DIHC had conducted its activities in State ABS instead of Delaware, the following state income tax results would have occurred:

These charts illustrate the following:
1. Before applying State ABS’s add-back statute:
   a. $24,000,000, or 100%, of Parent’s unitary business income was permissibly subject to tax by states; and
   b. Parent’s aggregate state tax liability was $1,530,000, or an effective rate of 6.38%.
2. After applying State ABS’s add-back statute:
   a. $24,000,000, or 100%, of Parent’s unitary business income is subjected to tax by states; and
   b. Parent’s aggregate state tax liability was $2,040,000, or an effective rate of 8.5%.
3. If DIHC had conducted its operations in State ABS instead of Delaware:

   If every jurisdiction were to adopt State ABS’s taxation scheme, more than 100% of Parent’s unitary business income would be taxed.

   a. $24,000,000, or 100%, of Parent’s unitary business income was permissibly subject to tax by states; and
   b. Parent’s aggregate state tax liability was $2,040,000, or an effective rate of 8.5%.

The above illustration demonstrates that State ABS’s add-back statute subjects Parent’s unitary business income to the risk of multiple taxation. State ABS’s add-back statute subjects DIHC’s income to State ABS tax while Delaware maintains the constitutional right to tax 100% of DIHC’s income. If DIHC had conducted its affairs in State ABS instead of Delaware, the risk of multiple taxation would not have occurred.
Because the Parent unitary business group exposes itself to a risk of multiple taxation when it conducts its affairs across borders instead of confining its activities within State ABS, the State ABS taxing scheme imposes a greater burden on interstate commerce than on intrastate commerce. Therefore, the State ABS add-back statute appears to violate internal consistency.

The author is not aware of any case law directly on point. Application of the well-established internal consistency principles of the Supreme Court of the United States leads one to conclude that State ABS’s add-back statute appears to be skating on thin constitutional ice.

If every jurisdiction were to adopt State ABS’s taxation scheme, more than 100% of parent’s unitary business income would be taxed.

The charts on the top of the page illustrate the results under the example if every jurisdiction were to adopt State ABS’s taxing scheme. The critical result under the application of this hypothetical is the elimination of Delaware’s exemption (§ 1902(b) (8)), which would cause Delaware to subject 100% of DIHC’s income to tax.

Therefore, if every jurisdiction (in this example, State ABS and Delaware) applied State ABS’s taxing scheme, more than all of Parent’s unitary business income would be subject to tax. Parent’s unitary business income is $24,000,000 and if every jurisdiction adopted State ABS’s taxing scheme Parent’s unitary business group would be subject to tax on $30,000,000. Therefore, State ABS’s taxing scheme, as applied in this example, violates internal consistency.

Admittedly and intentionally, the example utilized above is simplistic and does not consider the nuances of each state’s add back taxing scheme – in particular the exceptions that each state may provide to its add back statute. Nonetheless, the general principles set forth above demonstrate the constitutional vulnerability of add back statutes.

A significant magnitude of tax has been paid in conformity to the plain language of add-back statutes in recent (and not so recent in the case of Ohio, which enacted its add-back scheme more than a decade ago) years. There is no doubt that the amount still within the applicable refund limitations period is enough to cause an acute case of budget angst in many states. This order of magnitude, coupled with the questionable constitutional foundation upon which add-back statutes generally rest, causes one to conclude that a perfect storm may be looming on the horizon.

Be watchful. Perhaps the sky is clear today, but will it remain so? The weather can make abrupt changes in these sorts of times.

1. See generally Hellerstein & Hellerstein, State Taxation, ¶ 7.13[3][a].
2. As described in Part I, many state taxing authorities and state legislative assemblies perceive that companies that avail themselves of Delaware’s exemption are engaging in an intolerable form of tax avoidance. See, e.g., Pennsylvania Tax Reform Commission - <http://www.revenue.state.pa.us/tax_reform/cwp/view.asp?a=323&q=243253>http://www.revenue.state.pa.us/tax_reform/cwp/view.asp?a=323&q=243253 (“Separate com-
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Company reporting . . . allows tax-planning opportunities such as the use of Delaware holding companies, to shift income outside the Commonwealth.) This perception and historic budget deficits in the first several years of this millennium have predicated the proliferation of the “add-back” statute.

3. The constitutional principles discussed in this article apply to every state’s add-back statute. Therefore, no one state will be used as the example.


6. A negative connotation is implied when a taxpayer’s plan, design, structure, transaction, etc. is described as a “scheme.” The likely constitutional infirmity of “add-back” statutes discussed herein demonstrates that it is equally appropriate to assign this moniker to “add-back” statutes.

7. Many add-back statutes either limit their applicability to instances where the recipient of the inter-company charge is not taxable or provide an exception where the recipient is subject to tax or a certain amount of tax. As noted above, the state in which the recipient’s income may be subject to tax (e.g., Delaware, Nevada, etc.) may change its laws. Therefore, the fact that the recipient is not currently subject to tax does not alter the fact that a risk of multiple taxation exists. Moreover, any add-back statute that hinges its applicability on the taxing law of another jurisdiction seems nonetheless offensive and constitutionally infirm, i.e., a statute that says “if the state in which the recipient does business doesn’t tax recipient’s income or doesn’t tax it at what we believe to be a sufficiently high rate, we are going to add that income back to our base and subject it to tax. Many add-back statutes follow this sort of pattern. Austin v. New Hampshire, 420 U.S. 656 (1975) (New Hampshire tax was invalid because it was imposed only on nonresidents of states that granted a credit for New Hampshire tax paid).

8. Although the author is not aware of any decisions on this issue, the author is aware that internal consistency cases are currently being litigated in Ohio and Alabama. See Campbell Soup Company v. Wilkins (pending before the Ohio Board of Tax Appeals) and VFF Ventures, Inc. v. Carlisle (pending before the Circuit Court of Montgomery Alabama).

Michael J. Semes (215-569-5476 and semes@blankrome.com) is a partner in the business tax group of Blank Rome where he focuses his practice on state and local tax litigation and planning. Mr. Semes is a former partner at Price Waterhouse Coopers and chief counsel of the Pennsylvania Department of Revenue.