COST
COUNCIL ON STATE TAXATION

Related Company Expense Disallowance

Policy Position

Position: *Legislation seeking to disallow deductions between related corporations must be carefully crafted to avoid unintended negative consequences on legitimate business practices.*

Explanation: Most states require separate legal entities to file separate corporate income tax returns. Nearly all large businesses, especially those that engage in business in multiple states with differing legal and regulatory environments, are composed of dozens of legal entities that daily engage in numerous transactions with each other. Legislation has been considered in many states to deny deductions for some of these transactions.

There are many valid business reasons why corporations form separate legal entities; separate entities are often required by regulators or business partners. The fact that some taxpayers engage in transactions designed solely to avoid tax does not therefore mean that all transactions between related parties constitute abuse of the tax code. Many ordinary business transactions have been swept up in the rush to enact legislation correcting perceived abuses. The following are examples of such ordinary business transactions:

- Centralized Treasury Function: A company maintains a centralized treasury function to ensure that the entire enterprise's cash is managed effectively. All large organizations, including state governments, have a centralized treasury for exactly this reason. Treasury transactions between a parent company and its related members do not represent "tax abuse" but rather proper corporate management.
- Patent Royalty: A foreign parent company creates a U.S. manufacturing subsidiary. That subsidiary utilizes the foreign parent company's patented manufacturing process and pays the parent a royalty for use of that process, as is required by the tax laws of the foreign country where the parent company is located. U.S. tax law requires the same royalty payment for U.S. parent corporations with foreign subsidiaries.
- Capital Management: A regulated company has excess cash from operations while an unregulated related company needs capital to expand facilities in the state. Rather than incurring debt from the capital market, the regulated company lends capital to the unregulated related company at the market interest rate.

Most states revenue agencies currently have sufficient discretionary authority to remedy transactions designed solely to avoid tax and thus do not need legislation addressing certain types of related party transactions. States that nevertheless seek legislation to disallow deductions between related parties must clearly define the transactions covered by the legislation as well as provide clear and objective safe harbors that allow deductions for legitimate related party transactions. Further, the states must bear the burden of proof that the disallowed transaction was entered into for tax evasion purposes; the taxpayer cannot be put into the position of trying to disprove the negative established by a per se rule on disallowance for all transactions of a certain nature. Such statutes must also exempt from taxation income from the same items for which deductions have been disallowed. In other words, if a state seeks to disallow a deduction for certain types of payments made to a related party, then payments received from a related party for those same types of transactions must not be subject to tax.

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