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# New Single-Sales Factor Apportionment and Intangible Holding Company Addback Rules

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In Spring 2005 the Georgia State Legislature enacted, and Gov. Perdue signed into law, H.B. 191, making significant changes to Georgia's corporate income tax law, including:

1. Transition to a single-sales factor formula over three years from a traditional three-factor apportionment formula based on property, payroll, and sales;
2. Inclusion of all gross receipts from regular business activity in the sales factor regardless of primary business activity; and
3. Addback to taxable net income of otherwise deductible intangible expenses and costs resulting from transactions with related members.

## Summary of Key Changes

### ***Transition of Apportionment Method to a Single-Sales Factor***

Georgia historically apportioned taxable net income through a traditional three-factor formula, with evenly weighted property and payroll factors, and a double-weighted sales factor. The new law phases in a single-sales factor formula over three years. During this phase-in, the property and payroll factors remain equally weighted, but the sales factor weight will steadily increase. Specifically the statute phases in the apportionment factor changes as follows:

- 80 percent sales, 10 percent property and 10 percent payroll for tax years beginning on or after Jan. 1, 2006 and before Jan. 1, 2007.<sup>1</sup>
- 90 percent sales, five percent property and five percent payroll for tax years beginning on or after Jan. 1, 2007 and before Jan. 1, 2008.<sup>2</sup>
- 100 percent sales for tax years beginning on or after Jan. 1, 2008.<sup>3</sup>

### ***Inclusion of All Regular Business Gross Receipts in the Apportionment Factor***

Applicable to tax years beginning on or after Jan. 1, 2006, H.B. 191 virtually eliminates the current differences between the sales factor components for businesses that derive income primarily from the manufacture, production, or sale of tangible personal property, and those sales factor components used by all other businesses.

Under prior law, businesses engaged primarily in selling tangible personal property included in their sales factor only those regular business receipts from the sale of tangible personal property; that is, the sales reflected on Federal

Form 1120, line 1. The new law amended this provision to require these businesses to also include in their factor the gross receipts from other regular business activities.

In regard to those companies engaged in businesses that are *not* primarily involved in the manufacture or sale of tangible personal property, the new law provides that these businesses must additionally include in their sales factor those receipts from sales of tangible personal property received through regular business activities.<sup>4</sup>

The Department of Revenue recently promulgated regulations providing additional guidance on the allocation and apportionment of income for corporate taxpayers.<sup>5</sup> As interpreted under these regulations, unless otherwise explicitly excluded, gross receipts reflected in the sales factor means all gross receipts from activities that constitute the taxpayer's regular trade or business. Nevertheless, the regulations provide detailed guidance regarding certain receipts that are specifically excluded from the sales factor computation. In addition, the regulations address how to determine which receipts are attributable to customers within Georgia and which are attributable to Georgia's marketplace.<sup>6</sup> Under the statute and regulations, gross receipts from activities not in the taxpayer's regular trade or business continue to be allocated and not apportioned.

### ***Addback of Deductible Interest Expenses and Intangible Expenses***

Applicable to tax years beginning on or after Jan. 1, 2006, H.B. 191 added O.C.G.A. § 48-7-28.3 which requires an adjustment to taxable net income to include otherwise deductible intangible expenses and costs resulting from certain transactions with related members.<sup>7</sup>

This adjustment is commonly known as the "addback" rule.<sup>8</sup> The new law addresses (i) which expenses and costs are subject to the requirement, (ii) exceptions to the disallowance of the deductions, and (iii) disclosures necessary to sustain such exceptions. The addback requirement applies to a corporation filing a separate Georgia return as well as the separate taxable income computation of each member included in a Georgia consolidated return.<sup>9</sup>

**Intangible Expenses and Costs.** The addback provision applies to deductions made for intangible expenses and costs paid, accrued, or incurred to related parties to the extent allowed as a deduction in calculating federal taxable income.<sup>10</sup> Intangible expenses and costs are those related to the acquisition, use, maintenance, management, ownership, sale,

exchange or disposition of intangible property. These expenses or costs can include licensing, royalty, patent, technical, and copyright fees.<sup>11</sup>

**Interest.** Interest expenses and costs are added back to income if such amounts are related to or are incurred in connection with the acquisition, use, maintenance, management, ownership, sale, exchange, or disposition of intangible property. Such interest might include, but is not limited to, deductions otherwise allowed under IRC § 163.

**Exceptions to the Addback Rule.** If proper disclosure is made, a taxpayer is not required to add back any intangible expenses and costs to the extent these items meet one of the three following exceptions:

- The expenses are received as income in an arm's length transaction and the income is allocated or apportioned to and subject to tax in Georgia or another state imposing a tax on the income of the related member;<sup>12</sup>
- The expenses are paid, accrued, or incurred to a related member domiciled in a foreign nation that has in force a comprehensive income tax treaty with the United States, the transaction has a valid business purpose, and the expenses and costs are determined at arm's length rates;<sup>13</sup> or
- The related member directly or indirectly paid such expenses or costs to a non-related member and the transaction has a valid business purpose.<sup>14</sup>

"Valid business purposes" is defined in H.B. 191 as "one or more business purposes . . . which alone or in combination constitute the primary motivation for some business activity or transaction, which activity or transaction changes in a meaningful way, apart from tax effects, the economic position of the taxpayer." Avoidance or reduction of taxes is not a valid business purpose.<sup>15</sup>

The new statute specifies that these exceptions, even if met, will not prevent the Commissioner from making adjustments under the existing authority of Georgia Code Section 48-7-58, to correct any asserted distortion of income.<sup>16</sup>

**Disclosure to Sustain Exemptions.** In order to successfully claim any of the exceptions to the addback rule, a taxpayer must disclose on its return information about the related members and the states or foreign jurisdictions where related members file income tax returns, as well as details of the transactions with these members. The Commissioner of Revenue is granted discretionary authority to require additional information.<sup>17</sup>

**Penalties.** The penalty to a taxpayer failing to make the required adjustment is 10 percent of the additional tax that would be due as a result of the addback requirements.<sup>18</sup>

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## Endnotes

1. H.B. 191, 148th Gen. Assem., Reg. Sess. (Ga. 2005) (Ga. H.R. Comm. on Ways & Means, Subcomm. on Income Tax Substitute Bill), § 4.
2. H.B. 191, § 7.
3. *Id.*
4. H.B. 191, § 4 (2)(C)(ii).
5. Reg. 530-7-7-.03, amended Dec. 2, 2005, applicable to taxable years beginning on or after Jan. 1, 2006.
6. *Id.*
7. A related member is a person that, with respect to the taxpayer during all or any portion of the taxable year, is: (1) a "related person," (2) a component member as defined in Internal Revenue Code ("IRC") § 1563(b), or (3) a person to or from whom there is attribution of stock ownership in accordance with IRC § 1563(e). A "related person" is a stockholder and/or a member of the stockholder's family who is enumerated in IRC § 318 and owns at least 50 percent of the outstanding stock based on the attribution rules of IRC § 318. A related person can be an individual or a partnership, estate, trust, corporation, or limited liability company. O.C.G.A. § 48-7-28.3 (a)(7), (8).
8. O.C.G.A. § 48-7-28.3(b).
9. O.C.G.A. § 48-7-28.3(i).
10. O.C.G.A. § 48-7-28.3(a)(4).
11. O.C.G.A. § 48-7-28.3(a)(4), (5). The list as provided by the statute is not an exclusive list of intangible expenses and could include "similar expenses and costs." Intangible property can include (but is not limited to) patents, tradenames and trademarks, copyrights, trade secrets, and similar types of intangible assets.
12. O.C.G.A. § 48-7-28.3(d)(2)(A),(B). O.C.G.A. § 48-7-28.3(d)(1)(B) defines "state" to mean any state in the United States (and the District of Columbia), but does not include states where the taxpayer files a combined or consolidated return with a related member when the return or report results in elimination of the tax effects from the transactions between the taxpayer and the related member.
13. O.C.G.A. § 48-7-28.3(e)(1)(A), (B), (C).
14. O.C.G.A. § 48-7-28.3(f).
15. O.C.G.A. § 48-7-28.3(a)(9).
16. O.C.G.A. § 48-7-28.3(h).
17. O.C.G.A. § 48-7-28.3(d)(3), (e)(2).
18. O.C.G.A. § 48-7-28.3(j). This penalty is in addition to other penalties that could be assessed under Georgia law.