It's OK to do state tax planning

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What is state tax planning? Is it okay to do state tax planning? When is it not okay? These are perennial questions asked of tax practitioners.

"Am I hallucinating here? Just what in the hell do you think you're doing?" - Mr. Hand in Fast Times at Ridgemont High (1982).

As Judge Learned Hand famously observed in Helvering v. Gregory, 69 F.2d 809, 810-11 (2d Cir. 1934), "Any one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes." Well stated then and equally applicable now.

What motivates people and businesses to make tax-influenced choices?

What creates an environment in which state tax planning may occur? Tax systems adopted by the States create the conditions that drive taxpayers' choices between different options presented by state tax laws. One classic driver is the tax rate that each state sets for a particular tax. For example, Kentucky has adopted an individual income tax rate of 6 percent; in contrast, Indiana has adopted a state individual income tax rate of 3.4 percent, and Tennessee has no individual income tax. Corporate income tax rates also operate as drivers as do sales tax rates and property tax rates.

Differentials in tax rates can also occur within a state between localities. For example, Jefferson County, Kentucky has adopted a general occupational license tax rate of 2.2 percent; in contrast, Shelby County has adopted an occupational license tax rate of 1 percent, and Oldham County has opted not to impose such a tax. The incentive to make tax-influenced choices correlates directly with the disparity between tax rates put in place by states and localities for various taxes. The higher the effective tax rate differential, the more incentive there is for taxpayers to make tax influenced choices.

Tax rates are not the sole driver of tax-influenced choices. The availability of tax credits, deductions and exemptions can also influence taxpayers' behavior. For example, the Kentucky General Assembly has enacted a generous 50 percent recycling income tax credit that motivates taxpayers to invest in recycling equipment. Other examples include the Kentucky sales tax exemption for machinery for new and expanded industry as well as the use of energy in manufacturing above certain levels which are intended, at least in part, to incentivize manufacturers to locate their factories in Kentucky, rather than elsewhere. Examples of credits and exemptions are not, however, limited to taxes on businesses. For example, the Kentucky sales tax includes an exemption for food, unlike Tennessee, which does not.

In sum, differentials in state and local tax rate levels and the availability of credits, exemptions and deductions operate to influence taxpayers' behavior.

What is tax planning?

As demonstrated by the examples below, what tax planning is can be in the eye of the beholder. Some might say that tax planning is like pornography in that you cannot precisely define what it is but you know it when you see it.

Locating in one state or locality or moving from one to another

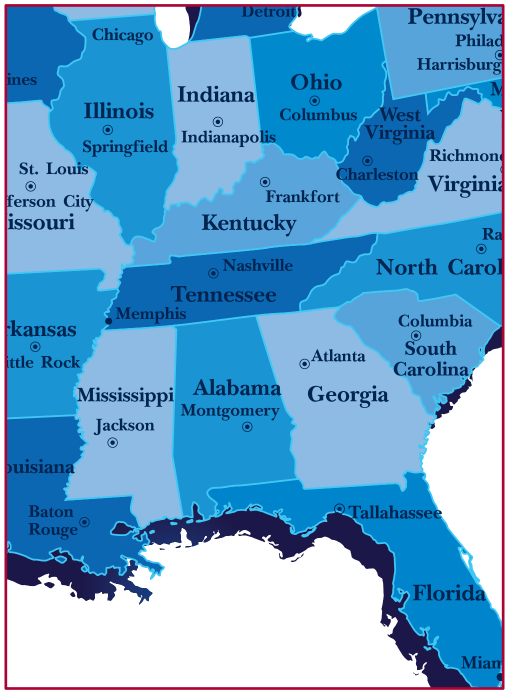
Differences in the tax rates that states levy on income, purchases or property, i.e., income tax, sales tax and property tax rates, sometimes motivate an individual to choose the state in which he or she resides or motivate a business to locate its operations such as its headquarters, a factory or a distribution center inside or outside of a particular state. When someone moves from Kentucky to a state with a lower individual income tax rate like Indiana or to a state with no individual income tax like Tennessee, Florida or Nevada, is this state tax planning? When a manufacturer with nationwide sales moves its factory from a state with a corporation income tax that apportions income using a double-weighted sales factor to a state with a single sales factor which reduces its effective income tax rate, is this state tax planning?

When a person from Tennessee crosses the border to shop for groceries in Kentucky so as not to pay sales tax on food, is this state tax planning? It certainly benefits the market state, which in this case is Kentucky. Does it matter whether or not the Tennessee resident pays Tennessee use tax on groceries brought back to Tennessee?

Choice of business entity

There are several different legal entities in which businesses may choose to operate, which presents opportunities to pick from many different options. For example, a business could operate as: a sole proprietorship; a partnership; a corporation; a corporation taxed as an S corporation; a limited liability company taxed as sole proprietorship, partnership, corporation or S corporation. Other options exist. Moreover, a business can choose to operate as a single legal entity with divisions or as multiple legal entities. There are infinite variations.

Each business's choice as to the form of legal entity in which it operates can have significant tax consequences. Most notably, a corporation's income is subject to multiple levels of tax; once at the corporate level, and again at the shareholder level when the corporation pays dividends. In contrast, the



income of a pass-through entity such as partnership or S corporation is taxed only at the owner level, and the losses of the pass-through entity can often offset, i.e., reduce, other income of its owners from other sources. Thus, it is often more tax efficient for small and mid-size companies to operate as pass-through entities rather than as corporations. When a business chooses to operate in a particular form, is that state tax planning?

Elections and credits

The federal government and certain states provide affiliated corporations with a statutory election to compute their income as a group, i.e., a consolidated return election. Kentucky does not have such an election; rather, an affiliated group of corporations must file a mandatory nexus consolidated return. There is no choice. Kentucky does, however, provide many credits that companies can take advantage of, such as the recycling credit, as previously noted.

It is interesting that Kentucky chose to eliminate the election to file a consolidated Kentucky income tax return. The Commonwealth took away that choice. Why?

Special entities

Some entities are taxed differently. For example, insurance companies are not taxed on their income; rather, they pay a premiums tax. The federal government provides for an election for a corporation to be treated as a domestic international sales corporation, sometimes referred to as a DISC. Is it tax planning to form or operate as such a special entity like an insurance company?

Tax efficient structures

For federal income tax purposes, a group of corporations can elect to file a consolidated federal income tax return. The same or a nearly identical result can be obtained by forming that same group using limited liability companies and electing to treat the subsidiary entities as disregarded so that the group of LLCs files as one entity for both federal and state income tax purposes. Is this state tax planning? When a company structures its operations in such a manner so that it meets the criteria to qualify for a state tax exemption, credit or other legislatively provided incentive, is that tax planning?

"You're on dangerous ground Mr.Spicoli." - Mr. Hand in Fast Times at Ridgemont High.

Gregory v. Helvering, 293 U.S. 465, 469 (1935) provides the point of analysis for determining when

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state planning should be disregarded, "[T]he question for determination is whether what was done, apart from the tax motive, was the thing which the statute intended." In many, if not all, of the circumstances above, one must simply ask if what was done was what the statute intended, and if that is so, it was okay to do the state tax planning and the structure should be regarded.

"Relax, all right? My old man is a television repairman, he's got this ultimate set of tools. I can fix it." - Jeff Spicoli in Fast Times at Ridgemont High.

The availability of different states and localities with different taxing systems, different rates, exemptions and credits are tools that individuals and businesses can use to live and operate in a tax efficient manner. To paraphrase Judge Learned Hand, it is okay to do state tax planning.

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