STATE OF WASHINGTON

DEPARTMENT OF REVENUE

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December 1, 2012

TO: The Honorable Ed Murray, Chair
Senate Ways and Means Committee

The Honorable Ross Hunter, Chair
House Ways and Means Committee

FROM: Brad Flaherty, Director

SUBJECT: Intercompany Transactions Report

The Department respectfully submits the attached Intercompany Transactions Report, pursuant to 2ESSB 6143, Section 205 (Ch. 23, Laws 2010, 1st Sp. Sess.). 2ESSB 6143 includes numerous provisions limiting the ability of Washington businesses to use affiliated entities to avoid Washington tax in a manner contrary to the intent of the taxing statutes. During the 2010 session, opponents of the legislation raised the countervailing concern that businesses with legitimate, non-tax reasons to operate in a multi-affiliate structure generally have an increased tax burden because Washington has no exception to taxes for intercompany transactions.

Therefore, at the request of the business community, including the Association of Washington Businesses (AWB), 2ESSB 6143 included a provision directing the Department of Revenue to conduct a review and provide a report on the state's tax policies on intercompany transactions. The purpose of the report was to provide context for future legislative discussions on the taxation of intercompany transactions.

However, businesses and organizations participating in the initial stakeholder meetings discussing report content were unwilling to provide detailed information on the frequency and forms of intercompany transactions necessary to allow the Department to undertake a meaningful fiscal and policy discussion in this area.

Therefore, the Department undertook to provide a general discussion on the policy of taxing of intercompany transactions and potential alternatives, issuing a draft for public comment late in 2011. Stakeholders objected to the report, with concerns that were elevated by a recent appellate court case, *Getty Images v. City of Seattle,* 163 Wn.App. 590, 260 P.3d 926 (2011). The *Getty* decision issued just months before the report's original due date of December 1, 2011. This decision called into question the taxation of certain multi-affiliate structures used to limit additional Washington state taxes.

With the agreement of AWB and other stakeholders, the Department obtained an extension for the study. The Department then held a series of additional stakeholder meetings to reach an agreement on the specific content of the study. Recognizing resource limitations, stakeholders ultimately requested that the report contain a high-level discussion of intercompany transactions without detailed discussions on policy alternatives. Instead, stakeholders requested that the Department focus its efforts on (1) regulations implementing the "tax avoidance" provisions of 2ESSB 6143 (Sections 201-203); (2) regulations clarifying exemptions commonly used by businesses operating in a multi-affiliate structures to limit additional Washington state taxes in light of the *Getty* decision; and (3) developing guidance for specific intercompany transactions, especially common paymaster arrangements. The Department is working with stakeholders in these areas.

The report was prepared by our Legislation and Policy Division under the direction of Assistant Director Drew Shirk. If you have questions about this report, please contact Drew at (360) 534-1547 or email drew.shirk@dor.wa.gov.

cc: Tom Hoemann, Secretary, Washington State Senate
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Department of Revenue
Washington State

Intercompany Transaction Review

Final Report to the Legislature

December 1, 2012

I. Introduction

The Washington State Legislature passed 2ESSB 6143[1] during the 2010 legislative session. This legislation, at the request of the business community, directed the Department of Revenue to conduct a review and provide a report on the state's tax policies with respect to the taxation of intercompany transactions, including particular focus on a comparison with the tax policies of other states.

The purpose of the study was to draw attention to the impact that Washington's laws taxing income from intercompany transaction has on Washington businesses. However, in early stakeholder discussions with the business community, the Department determined it would be unable to obtain sufficient information on the scope and frequency of intercompany transactions necessary to undertake a meaningful fiscal analysis of that impact.[2]

Therefore, based on additional discussions with stakeholders, the Department has drafted this report as a high-level discussion of the impact that taxing income from intercompany transactions has on Washington businesses. The report also provides information on potential alternatives, but does not contain estimated revenue impacts or recommendations regarding these alternatives due to the general unavailability of data in this area.

II. Major Tax Impacts of Intercompany Transactions

The term "intercompany transaction" is typically defined to include transactions between related entities as well as transactions between units of a single entity. For purposes of this report, the term "intercompany transactions" will refer only to transactions between related entities or "persons," which is defined in Washington's tax code to include individuals, formal entities, partnerships, and formal and informal associations.

In Washington, the transfer of property or services between units (e.g., divisions, departments, or branches) of the same entity is generally exempt from tax. However, the same transaction between affiliated entities may result in income subject to the B&O tax, and in some cases, sales, use, or other taxes. This is true regardless of how closely related affiliate entities are to each other or how much is charged for the property or services. Taxing income from intercompany transactions thus effectively taxes transactions that have no economic effect, and may also subject businesses operating through an affiliate structure to the effects of tax "pyramiding."

Taxing from transactions without economic effect

Intercompany transactions are generally eliminated from consolidated financial statements to avoid misrepresenting the overall financial position of a group of closely-related affiliate entities. These intercompany transactions do not create additional wealth for the business enterprise.

[1] Ch. 23, Laws 2010, 1st Sp. Sess. The text of this section of the legislation is included in full in Appendix A

[2] The Department does not collect or have access to data identifying intercompany transactions in particular, and no means of estimating the current volume of transactions without information provided by taxpayers on a voluntary basis. Moreover, the Department does not have the staffing or resources to produce a dynamic study, which is generally considered necessary to produce realistic fiscal estimates for any significant policy changes in this area.

However, these transactions may still result in Washington tax liability, generally under Washington's Business and Occupation (B&O) tax.

The B&O tax is a privilege tax that must be paid by "every person for the act or privilege of engaging in business." "Person" includes individuals, state-chartered business entities, and formal and informal associations of individuals, with no exclusions based on relationship to any other person. "Business" is also broadly defined to include all activities engaged in for "gain, benefit, or advantage" of the actor or "for any other person or class directly or indirectly." Thus, each person's business activities are subject to the B&O tax, regardless of the person's relationship to any other taxpayer or any common or altruistic purpose.

For example, assume a group of affiliates selects one affiliate entity to handle all human resources requirements for the group. The selected entity acts as the legal employer for the employees of all members of the group, each paying a share of costs of the human resource management and accounting activities conducted by the selected entity, and reimbursing it for employee wages, benefits, and taxes. This sharing of human resource costs is treated as a series of sales by the selected entity to the other affiliates, and all amounts received by the selected entity, except in limited circumstances, are taxable income for B&O purposes. This common arrangement is utilized by businesses in many states, but it creates an additional layer of tax for affiliate groups doing business in Washington.

As another example, assume a construction company forms a wholly-owned subsidiary to own and develop a specific parcel of land. The subsidiary may be a mere shell, with no real substance or existence apart from its parent. However, it is a separate legal entity. Thus, if the subsidiary purchases construction services from the parent construction company, the transaction will create income for the parent subject to B&O tax. The transaction would also be considered a retail sale subject to retail sales tax. There are no exemptions available for this intercompany transaction, and it represents a substantial additional tax impact to what is, for practical purposes, a unitary construction enterprise. Yet the transaction has no substantive economic effect for its participants, with the "gain" to the parent from the sale being offset by the "cost" to the subsidiary.

B&O tax and pyramiding

The B&O tax is a gross income tax, with no cost or expense deductions. A seller must include as gross taxable income the full selling price received for goods sold. If the buyer then resells the goods, the buyer (now a seller) must also include the full selling price received in gross taxable income, with no deduction for the amount paid for the goods, or credit for the taxes paid by the original seller. Thus, B&O tax on the value of the goods may be paid multiple times.[3] This

[3]B&O tax pyramiding has been explained :

> In the production and sale of wood cabinets, there are several stages in the process, each of which is often performed by a different enterprise. One enterprise harvests the timber, another mills the lumber, a third manufactures the cabinets, and a final enterprise sells the cabinets to the ultimate consumer at the retail stage. Other enterprises, such as wholesalers, may also be in the chain.
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> Under a B&O tax, the total value of a good is taxed when it is sold from one enterprise to another in the production chain. This total value includes the value of intermediate products along the way. The value of the timber is embedded in the value of the lumber; the value of the lumber is embedded in the manufactured cabinets, and so on. The gross value of the product at each stage includes taxes paid on intermediate products, so the tax accumulates (pyramids) as it moves through the production chain.

"pyramiding" of tax is in contrast to a "value-added" tax, like Canada's goods and services tax (GST). A value-added tax generally provides taxpayers with a credit for taxes paid on the purchase of goods and services. Thus, only new value added at each level of the production is subject to tax. Similarly, a net income tax permits taxpayers to deduct costs of doing business from taxable income, which effectively prevents pyramiding.

In a pyramiding system, a business enterprise that operates through multiple affiliates bears a higher portion of the taxes related to the final product. When one affiliate in a business enterprise sells products or services that it produces using materials or services purchased from another affiliate, the business enterprise as a whole will pay B&O tax on both (1) the sales price received on the final product, and (2) the sales prices charged between the affiliates for materials or services used to create the final product. When participants in a production chain are not affiliated, the total amount of B&O taxes related to the final product is spread among unrelated persons. Thus, the B&O tax is said to favor vertical integration "creating non-neutral tax treatment to the disadvantage of non-vertically integrated businesses."[4]

But there are instances where businesses may prefer to operate as a multiple-affiliate structure to obtain efficiencies or isolate liabilities. Thus, Washington's tax on income from intercompany transactions has the potential to distort economic and business decisions. In other cases, a business may not have the flexibility to elect a single entity business model to avoid pyramiding. For example, an affiliate structure may be required to obtain financing. It is not uncommon for a speculative construction company to be required to purchase land for development through a wholly-owned special purpose entity in order to qualify for a construction loan. Affiliate structures are even required by statute in certain industries, such as under the Telecommunications Act of 1996. This statute requires local exchange carriers to provide certain service through separate entities and to charge market prices to any affiliates using those services.[5] Market pricing is also required by federal regulation for international sales between members of a group of commonly-controlled entities of a U.S. based taxpayer.[6] These market-pricing requirements prevent the use of below-cost pricing that could otherwise reduce the impact of tax on intercompany transaction income.

Analysis of Washington's current tax system shows that the B&O tax in total pyramids 2.5 times. The amount of pyramiding varies considerably by industry.

Tax Alternatives for Washington State: A Report to the Legislature, Washington State Tax Structure Study Committee (November 2002) at 36.

[4] *Id.* at 36.

[5] 47 USC § 272.

[6] The Internal Revenue Service ("IRS") and foreign jurisdictions regulate all "controlled transactions" so as "to ensure that taxpayers clearly reflect income attributable to controlled transactions and to prevent the avoidance of taxes with respect to such transactions." Treas. Reg. §1.482-1(a)(1). A U.S. based taxpayer is generally subject to these transfer pricing requirements when it has international operations. A "controlled transaction" or a "controlled transfer" refers to a transaction or a transfer between two or more members of the same group of controlled taxpayers. Treas. Reg. §1.482-1(i)(8). Under I.R.C. §482, the IRS has the authority to examine these transactions or transfers to determine whether they comply with U.S. rules for transfer pricing or require adjustment. Treas. Reg. §1.482-1(f). In order to comply with the transfer pricing regulations, taxpayers generally must follow an arm's length principle for all controlled transactions or transfers. Treas. Reg. §1.482(b).

IV. How Other Jurisdictions Address Intercompany Transactions

Washington is among a small minority of states that treat affiliates engaging in transactions as completely separate taxpayers for all purposes. For federal income tax purposes, and under many state systems, the effects of many intercompany transactions are generally reduced or eliminated because closely-affiliated entities determine income on a combined or consolidated basis. In addition, many states disregard certain wholly-owned entities for tax purposes.

Washington does not have a combined reporting or consolidated return option, or any other broadly applicable mechanism, to reduce or eliminate the B&O tax impacts of affiliate transactions. This is not a necessary result of the difference between an income tax and a gross-receipts tax system. Several other states levy some type of gross receipts tax on businesses, and each has tax reporting provisions that function to mitigate the impact of pyramiding within an affiliate group. This overview discusses the systems of Ohio and Texas.

Ohio

Ohio's Commercial Activity Tax (CAT) has the same pyramiding structure as Washington's B&O tax. However, the CAT includes a modified consolidated reporting mechanism that reduces the effects of pyramiding, but ties it to nexus reporting requirements. Commonly-owned entities must file as either a combined taxpayer or as a consolidated taxpayer.[7] A consolidated taxpayer includes all income sourced to Ohio of all commonly-owned entities within the consolidated group, regardless of whether those entities have nexus with Ohio, but intercompany transactions are eliminated.[8] A combined taxpayer may exclude entities that do not have nexus with Ohio, but is not permitted to exclude intercompany transactions.

Texas

Texas imposes its business franchise tax on the combined total revenue of an affiliate group engaged in a unitary business, less the greater of several potential deductions (including cost of goods sold).[9] Each entity in unitary group separately calculates gross revenue, eliminating revenue received from group members, [10] and calculates available deductions. The revenues and deductions are then combined, and the combined group determines which deduction to utilize. The group computes and pays tax on the net amount apportioned to Texas as a single entity.

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[7] Ohio Rev. Code Ann. §5751.012; Ohio Admin. Code §5703-29-02.

[8] *See* Ohio Admin. Code §5703-29-02 *and* Information Release CAT 2005-05, *Application of Common Owners and Joint Ventures.*

[9] Tex. Tax Code §171.101.

[10] Tex. Tax Code § 171.1014(c).

V. Conclusions

The taxation of intercompany transactions continues to be a difficult area of tax administration. Both the Department and the business community desire to take steps to alleviate the complexity and adverse impacts in this area.

The most apparent solution for intercompany transactions, consolidated or combined filing, would represent a substantial shift in Washington's tax structure. The solution is of interest to the business community, and the Department believes it may have some administrative benefits as well. However, it would require a significant analysis to determine the potential economic impact of any consolidated or combined filing system. The analysis would require data on current affiliate transactions and would need to address complex nexus and apportionment issues. Although the Department does not currently have the resources to undertake this type of in-depth analysis, it is certain that the widespread elimination of tax on intercompany transactions would have an immediate and significant fiscal impact to the state.

However, it may be appropriate to evaluate targeted legislation to reduce the tax impact of intercompany transactions in particularly problematic circumstances, such as:

- Disregard of certain wholly-owned entities; and
- Paymaster and shared employee arrangements. The Department is working with stakeholders on potential proposed legislation in this area for the 2012 legislative session).

Finally, there are some specific types of affiliate transactions where the Department believes additional administrative guidance can produce benefits for the state and taxpayers, such as:

- Pool purchasing and shared expenses; and
- Types of exempt affiliate transactions, such as loans, dividends, and profit distributions.

The Department will continue to work with taxpayers to develop guidance in these areas.

APPENDIX A

2ESSB 6143 provides, in pertinent part:

> NEW SECTION. Sec. 205. (1) The legislature finds that this state's tax policy with respect to the taxation of transactions between affiliated entities and the income derived from such transactions (intercompany transactions) has motivated some taxpayers to engage in transactions designed solely or primarily to minimize the tax effects of intercompany transactions. The legislature further finds that some intercompany transactions result from taxpayers that are required to establish affiliated entities to comply with regulatory mandates and that transactions between such affiliates effectively increases the tax burden in this state on the affiliated group of entities.
> (2) Therefore, as existing resources allow, the department of revenue is directed to conduct a review of the state's tax policy with respect to the taxation of intercompany transactions. The review must include the impacts of such transactions under the state's business and occupation tax and state and local sales and use taxes. The department may include other taxes in the review as it deems appropriate.
> (3) In conducting the review, the department must examine how this state's tax policy compares to the tax policy of other states with respect to the taxation of intercompany transactions. The department's review must include an analysis of potential alternatives to the current policy of taxing intercompany transactions, including their estimated revenue impacts if practicable.
> (4) In conducting this review, the department may seek input from members of the business community and others as it deems appropriate.
> (5) The department must report its findings to the fiscal committees of the house of representatives and senate by December 1, 2010. However, if the department has not completed its review by December 1, 2010, the department must provide the fiscal committees of the legislature with a brief status report by December 1, 2010, and the final report by December 1, 2011.