The Commonwealth of Massachusetts

Department of Revenue

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COMMISSIONER

April 18, 2008

The Honorable Therese Murray
Senate President
Room 330
State House
Boston, MA 02133

Dear President Murray:

Thank you for the opportunity to discuss the corporate tax reform bill with you. As we discussed, the bill as reported out by the Joint Committee on Revenue and the House Committee on Ways and Means closely matched the Governor's proposed bill. However, several subsequent changes were made in H4672 (passed last Thursday by the House, and referred to here as the "House bill" or H4672), which were incorporated at the last minute (see section 45 of H.4672), and the Department of Revenue has identified five areas of primary concern with those revisions. These changes primarily benefit a limited group of very large, sophisticated, multi-national businesses. If left unchanged, these changes will materially reduce the additional revenue anticipated from the Governor's combined reporting bill by at least $100 million to $200 million annually. For FY 09, the impact is projected to be a revenue reduction of between $60 million and $120 million.

1. **Consolidated Return Election.**

During the work of the Study Commission on Corporate Taxation, at the last meeting of the Subcommittee on Combined Reporting, a member proposed that the Massachusetts combined reporting rules should include a "safe harbor" provision allowing businesses to elect to include members of their "federal consolidated group" as their "unitary group", to provide predictability about the scope of the state's combined reporting impact on a large corporate group with affiliates engaged in different types of businesses. There was a consensus within the Subcommittee that future consideration of some form of safe harbor would be appropriate. The full Commission, in endorsing combined reporting, did not address any specific safe harbor proposal.

As background for understanding this issue, it should be noted that:

- A "unitary group" for state combined reporting purposes refers to a group of two or more corporations under common ownership that are "interdependent, integrated or interrelated through their activities".
- A "federal consolidated group" refers to the group of corporations that a taxpayer uses to file its federal return, which, for a large multi-national company, might include multiple unitary groups within it. There is no requirement within the federal consolidated return rules that the members of the group be engaged in a unitary or related business.

In response to the discussions within the Subcommittee on Combined Reporting, even though only one unitary state in the country allows such an election, the Governor's bill contained a provision allowing such an election pursuant to DOR regulations. (Arizona has a consolidated return filing that may either be elected by the taxpayer or imposed by the state. Unlike the provision in the House bill, the Arizona election, if made, would be permanently binding on the taxpayer.) The intent of the Governor's bill was to allow for companies to be able to use their federal consolidated group, subject to DOR regulations that would seek to protect against significant distortion on a unitary group's income from using the federal consolidated return.

The House bill, however, goes too far in that it gives business taxpayers such an election as a matter of right, and explicitly states that DOR will not have any regulatory or consent authority to such an election. Thus a taxpayer can make the election even if the result is to substantially distort the amount of income attributed to Massachusetts. As with any agency, it is vital for the DOR to have regulatory authority to administer the state tax code to provide guidance in areas that need clarity and to respond to tax-avoidance efforts that become apparent.

Moreover, because of the apportionment distortions (described in paragraph 3 below) authorized by the House bill when financial and non-financial institutions are combined in a federal consolidated return, the election will allow out-of-state financial institution affiliates to dilute apportionment of non-financial businesses in Massachusetts, even though the financial business is completely unrelated (i.e. non-unitary). Thus, the consolidated election has the potentially for drastically reducing the tax of particular taxpayers, who would certainly choose to make the election. Any taxpayer that might pay more tax under the election would be unlikely to choose it. Thus the election by right is an obvious source of revenue loss for the Commonwealth.

2. **Exemption for U.S. Companies with Overseas Operations.**

The Governor's legislation requires affiliated companies doing business in the U.S. as a unitary group to file one return that combines their incomes and apportions the total to Massachusetts. The major benefit of such a combined report is that it stops businesses from shifting income to out-of-state affiliates in tax haven states such as Delaware.

The House bill, however, inserts language which carves out a new opportunity to avoid Massachusetts tax by shifting income – this time to certain U.S.-organized affiliates doing business overseas. The House bill explicitly exempts member companies that have on average more than 80 percent of their property, payroll and receipts outside the United States from having to be part of a unitary group. While no explanation for the insertion has been given, there are published descriptions of major U.S. corporations, including Wal-Mart, McDonalds, and Burlington Northern, using so-called "80-20 companies" to avoid state tax in states that require combined filing. (See the attached article, *Why Wal-Mart Set Up Shop in Italy*, Wall Street Journal, November 17, 2007, Page C1.) This amendment may allow sophisticated multi-national businesses to continue to shift income out of Massachusetts – directly undermining the goals of the Governor's tax reform. In other states, these provisions have led to protracted litigation as states successfully challenge the tax-avoidance schemes of these "80-20" companies.

Comparison with Minnesota experience and data

While Massachusetts tax returns do not include information on these "80-20" corporations, Minnesota does collect such information, and we are able to derive an approximate Massachusetts revenue impact from recent analyses conducted by the Minnesota Department of Revenue. The "80-20" provision of the House legislation is in fact similar to a provision in Minnesota's corporate tax law that provides a special 80% deduction for income derived from "foreign operating corporations" (i.e., "80-20" companies), except that the Massachusetts House provision would provide an exemption for *all* such income, not just 80% of it, as is the case in Minnesota.

Data on the amount of income from "80-20" companies was used by the Minnesota Department of Revenue in recent analyses of proposals to restrict or eliminate the "80-20" deduction in that state. The Minnesota Department of Revenue estimated that by fiscal year 2011 use of the 80% tax deduction currently in place will result in tax revenue that is $96 million lower than it would have been without the 80% deduction. This translates to a $120 million revenue loss if the deduction were 100%, as it would be under the Massachusetts House legislation. (This estimate includes only "active income" of foreign operating corporations under the Minnesota provision; if "passive income" under that provision is included, the revenue loss is $185 in fiscal 2011, or $231 million with a 100% deduction.) However, because the Massachusetts economy is about one-third larger than that of Minnesota, and its effective tax rate on corporations and banks is slightly higher than Minnesota's, the tax revenue loss from an exclusion of "80-20" income would be higher than $96 million -- about $140 million to $170 million annually at current tax rates, though the revenue loss would decline as tax rates are reduced under the House proposal.

It should be noted that the Minnesota estimate is based on actual deductions taken on tax returns, so it is very reliable. While the estimate may seem high, the Minnesota experience appears to indicate that once such a provision is enshrined in statute, special purpose "80-20" companies are set up to take advantage of it. That is likely to be the case in Massachusetts as well if the House provision is retained. Since more than half of the $200-$300 million in new tax revenue that would be collected under unitary combined reporting is attributable to 20 to 40 large multinational corporations, a significant amount of revenue could be lost if even a few of them have or set up the overseas structures permitted under this exemption. In any event, it is clear that the potential revenue loss from this provision alone could be substantial -- more than $100 million annually.

3. **Apportionment Method.**

The House bill requires use of an apportionment method in a combined return that will dilute the Massachusetts apportionment for a group of sophisticated businesses whose affiliated group includes both financial institutions and non-financial business corporations.

Broadly speaking, Massachusetts corporate tax code provides for "three-factor" apportionment, whereby a company's Massachusetts tax liability is determined by the proportion of its Massachusetts "property, payroll and receipts" to its aggregate property, payroll and receipts in the U.S. The Massachusetts tax code, however, contains several distinctions for calculating a company's apportionment factors, depending on the nature of the company's business (e.g. applying a "single sales factor" to manufacturing companies.) Under the Governor's combined reporting bill, a unitary group's apportionment factors would be subject to adjustment pursuant to regulations promulgated by the DOR to account for differences in the apportionment formulae applicable to the members of the unitary group.

The House bill requires that the apportionment factors of financial and non-financial institutions be added together ***without adjustment***, even though by statute apportionment factors are calculated differently for financial and non-financial institutions. The result is that the larger apportionment factors for financial institutions – which include interest income and intangible assets that non-financial institutions do not count – will swamp and in all cases reduce the apportionment percentages of the non-financial institutions. For any business whose financial operations are out of state, which is an increasingly common fact pattern, the Massachusetts apportionment of the in-state businesses will be diluted and their tax will be reduced. Other states, such as California, that combine factors of financial and non-financial institutions require adjustments to counteract this effect.

Again, as a majority of revenue from combined reporting would be attributable to a few dozen large companies, potentially tens of millions of dollars could be lost if even a limited number of them dilute their Massachusetts apportionment percentages through the combination of financial and non-financial entities.

4. **FAS 109 (Accounting Rules on Changes in Deferred Tax Assets or Liabilities)**

The House bill creates a new deduction for businesses if the book accounting value of the deferred tax assets of the business (e.g., loss or credit carryforwards) are decreased by combined filing or if the amount of the deferred tax liabilities (e.g., for example, arising where accelerated depreciation deductions were taken for tax purposes, resulting in smaller tax deductions relative to book accounting in future years) are increased by combined filing. The effect of this provision is to require the Commonwealth to compensate businesses for any negative effect caused by the book accounting treatment of the tax law changes as they relate to deferred tax assets or liabilities. The deduction created by the House bill would be spread over 5 years and any excess deduction could be carried forward indefinitely until used.

The Department is concerned that deferred tax liabilities of a business may increase any time that its effective state tax rate increases. A taxpayer that has been shifting income out of Massachusetts and that will no longer be able to do so because of combined reporting will see an increase in its effective tax rate (even if the Commonwealth's stated tax rate decreases). Under the House bill, such a taxpayer could claim a new Massachusetts deduction as an offset.

There are other possible areas where book tax assets might need adjustment, creating a tax deduction under the proposal. For example, loss carryforwards of non-Massachusetts affiliates from years before 2009 might have less book value in a combined reporting regime. Similarly, use of accelerated depreciation taken by non-Massachusetts affiliates before 2009 might create greater deferred tax liabilities in a combined reporting regime. For individual companies, the amounts could be significant, thus creating significant new tax deductions and greatly lowering the tax revenue that the Commonwealth may anticipate from combined reporting.

It is unclear why the Commonwealth should compensate corporate taxpayers for the financial statement impact of changes in tax law, or why in particular it should compensate for adoption of combined reporting. The new deduction provided for in the House bill would likely negate significant amounts of income that would otherwise be taxed under the combined reporting rules, thus significantly reducing the tax revenues that would otherwise be collected from adoption of combined reporting.

5. **Regulatory Authority.**

The House bill significantly limits the regulatory authority granted to the Department of Revenue in the Governor's bill. For example, under the Governor's bill, the Commissioner could require inclusion of additional affiliates, e.g., overseas subsidiaries, in a combined return when "such inclusion is necessary to prevent the avoidance or evasion of taxes owed to the commonwealth." Deletion of this authority obviously limits the ability of the Commissioner to police future tax avoidance efforts that may arise.

In addition, beyond limiting compliance authority, the House amendments would create blanket rules that make little sense in the highly complex areas affected by this legislation.

For example, while the Governor's bill provides that, subject to DOR regulations, transactions between affiliated members are generally disregarded or eliminated, the House bill would in certain areas mandate such treatment, creating blanket eliminations without provision for the exercise of regulatory authority. In comparable federal situations – e.g., federal consolidated returns – the IRS is granted extensive regulatory authority, and federal regulations provide numerous exceptions or special rules. The House bill may preclude Massachusetts from adopting exceptions parallel to those followed in the federal rules or in those of other major states. Mismatches, such as this, between Massachusetts rules and the rules used for purposes of federal and other state tax jurisdictions have long been the basis for state tax planning and litigation. No explanation, other than an asserted generic distrust of the DOR discretion, is given. The Department's concern is that changes such as this may be an attempt to prevent state challenges to future corporate tax planning structures and abuses, such as future use or misuse of the 80-20 company exemption (discussed above) that the House amendments insert.

Thank you for the opportunity to share our views with you. We would be glad to discuss these further or to address additional issues as they arise.

Best regards,

Navjeet K. Bal

Navjeet K. Bal
Commissioner of Revenue

Cc: The Honorable Salvatore F. DiMasi, Speaker of the House
The Honorable Steven C. Panagiotakos, Chairman, Senate Committee on Ways and Means
The Honorable Robert A. DeLeo, Chairman, House Committee on Ways and Means
The Honorable Cynthia Stone Creem, Senate Chairwoman, Joint Committee on Revenue
The Honorable John J. Binienda, House Chairman, Joint Committee on Revenue
Leslie A. Kirwan, Secretary, Executive Office of Administration and Finance

Why Wal-Mart Set Up Shop in Italy

By JESSE DRUCKER , Wall Street Journal
November 14th, 2007

More than 4,500 miles separate a small Wal-Mart Stores Inc. office in Florence, Italy, from the company's dozens of Illinois retail outlets. But thanks to a convoluted tax arrangement, court records show, Wal-Mart's Italian operation has helped the giant retailer cut its state tax bill in Illinois by millions of dollars a year.

Wal-Mart set its affairs so that its Italian outpost is the only operating unit of a real-estate subsidiary that controls billions of dollars of the retailer's property in Illinois and other states. Because technically its only employees are based in Italy, the real-estate unit claims its operations are foreign, exempt from Illinois corporate income taxes.

Earlier this year, the Illinois Department of Revenue objected to the Italian tax maneuver, demanding $26.4 million in back taxes, interest and penalties. Wal-Mart paid the amount in dispute and then sued the state for a refund, according to a complaint filed in May in Illinois Circuit Court in Springfield, Ill.

A Wal-Mart spokesman declined to comment beyond a prepared statement: "We have a disagreement with the state of Illinois over our tax liability last year, and we've asked a judge to resolve that for us." He declined to explain why Italy was chosen as the home of this particular foreign operation or whether Wal-Mart has other such arrangements.

The dispute with Wal-Mart is part of a wider effort by some states to crack down on what they believe is abusive use of so-called 80/20 companies. These companies are domestic subsidiaries that conduct at least 80% of their business overseas. States typically don't tax income from outside the U.S., and many companies have used 80/20 subsidiaries to legitimately shield foreign operations from state taxation.

But authorities in several states have challenged a number of companies over the 80/20 units, claiming the structure was improperly used to shift income away from the purview of state taxing authorities.

The misuse of 80/20 companies is "shocking to the conscience," said Brian Hamer, director of the Illinois Department of Revenue. "These kinds of manipulations clearly were never contemplated by the state legislatures," added Mr. Hamer, who wouldn't comment on any single company or legal case. "It ought to have been clear to businesses that this was highly questionable conduct."

Illinois tax authorities are in a dispute with Mc Donald?'s Corp. over nearly $11 million stemming from its use of an 80/20 subsidiary. Details are sketchy, but Mc Donald?'s, based in Oak Brook, Ill., says in court papers that a Delaware financing unit that owns restaurants in St. Thomas, Virgin Islands, conducts 80% or more of its business activity outside the U.S., exempting its operations from being included in Illinois tax calculations.

Minnesota, BNSF Wrangle
Meanwhile, Minnesota tax authorities are taking issue with interest payments made by Burlington Northern Santa Fe Corp. to a pair of Delaware subsidiaries doing business in Canada. The railway company deducted the interest associated with the payments but didn't pay taxes on most of the income received by the subsidiaries. The state's revenue department says in an audit report that this was "done purely for tax avoidance purposes." The Fort Worth, Texas, company paid a disputed $4 million in back taxes and interest and sued the state in May for a refund.

A McDonald's spokeswoman said: "We believe the results of our business have been properly reported to the state of Illinois." A Burlington Northern spokesman declined to comment.
At the prodding of the Illinois revenue department, that state's legislature in 2004 passed a law essentially shutting down the abusive use of 80/20 units. The Minnesota state legislature enacted one change in 2005 and has considered several other bills since then to shut down alleged abuse of the structure.

States Crack Down

Wal-Mart's Italian tax-planning maneuver is the latest disclosure of a strategy by the firm to cut state taxes. A page-one article in The Wall Street Journal in February focused on how the Bentonville, Ark., retailer cut taxes in some states by paying rent to a real-estate investment trust it owned, even though the money never left the firm.

That REIT strategy has been challenged by tax authorities in several sates; some have enacted laws to

close the REIT structure since the Journal article.
However, the REIT tax structure saved money only in some states -- those that tax income solely from operations within their borders. This taxation system, known as "separate reporting," can make it simpler for companies to shift income out of state to tax-friendly jurisdictions such as Delaware or Nevada.
But "combined reporting" states such as Illinois are much tougher. They add together all profits of a company's domestic operations, regardless of what state they are in, and then allocate a portion of those profits to their state.

Theoretically, combined reporting makes it harder for companies to shift income to more advantageous locales.

Because Illinois rules apply only to domestic profits -- not world-wide income -- companies can get around the rules by figuring out ways to effectively shift income overseas.

Wal-Mart's 80/20 structure worked like this: The company first transferred its Illinois stores to its in-house REI Ts?, paid rent to the REI Ts? and then deducted those payments from its taxes. The REI Ts?, in turn, paid that money to their 99% owner, a Wal-Mart unit based in Delaware.
Ordinarily, Illinois's combined-reporting rules wouldn't permit a company to cut its taxes by shifting income to a Delaware unit. But in late 2001, Wal-Mart formed a Delaware subsidiary called WMGS Services LLC, records show. WMGS, with offices in Florence, was a wholly owned subsidiary of Wal-Mart Property Co., which also was 99% owner of Wal-Mart's main REIT.

In its filing, Wal-Mart contends that Property Co.'s ownership of the Italian unit converted Property Co. into an 80/20 company. In other words, at least 80% of its employees and its property were overseas, exempting its income from taxes.

Though Property Co. is the 99% owner of the REIT -- which owns dozens of stores in Illinois -- Wal-Mart says Property Co. owns no real estate itself. And although Wal-Mart has more than 48,000 employees in Illinois, the firm contends Property Co. has no employees in the state, either.

The only employees of Property Co. were in Italy, the company says. Property Co. was set up to own the majority of the shares of Wal-Mart's main REIT and has no employees anywhere, Wal-Mart has said in court records elsewhere. (In its court filing in Illinois, Wal-Mart says that WMGS's employees and property were in Turin, Italy; an official with the company in Florence and a Wal-Mart spokesman in the U.S. say the company doesn't have an office in Turin.)

WMGS employs 22 people at its office in central Florence, according to a company official who answered the door there on a recent weekday morning. The office is responsible for procuring merchandise from around Europe, he said. Wal-Mart has no stores in Italy.