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STEPHEN R. MILLER
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June 20, 2007

MEMORANDUM

To: Senator Hansen

From: Joseph T. Kreye, Sr. Legislative Attorney, (608) 266–2263

Subject: Technical Memorandum to **2007 SB 210** (LRB–2631/1) **by DOR**

We received the attached technical memorandum relating to your bill. This copy is for your information and your file.

If you wish to discuss this memorandum or the necessity of revising your bill or preparing an amendment, please contact me.

MEMORANDUM

June 14, 2007

TO: Joseph Kreye
Legislative Reference Bureau

FROM: Rebecca Boldt
Department of Revenue

SUBJECT: Technical Memorandum on SB 210 -- Adding Payments to Related Entities to Federal Taxable Income for State Income Tax and Franchise Tax Purposes.

The Department has the following technical concerns with the bill:

A. Definition of "Related Entity"

It should be clarified that the definition of "related entity" in secs. 71.01(9b), 71.22(9b), 71.42(4m), and 71.738(3m) includes real estate investment trusts (REITs), regulated investment companies (RICs), and real estate mortgage investment conduits (REMICs). The definition of "related entity" should be amended as follows:

> "Related entity" means any person related to a taxpayer as provided under section 267, 318, or 1563 of the Internal Revenue Code during all or a portion of the taxpayer's taxable year, including any real estate investment trust, regulated investment company, or real estate mortgage investment conduit as provided under sections 856, 851, or 860D of the Internal Revenue Code, more than 50 percent of the voting power or value of the beneficial interests or shares of which are owned directly or indirectly by the taxpayer during all or a portion of the taxpayer's taxable year.

B. Conditions Allowing Related Party Expenses

Sec. 71.80(23)(c) may be more restrictive than intended. It provides that all three of the given conditions must be met in order to allow related party expenses:

1) The transaction at issue did not have tax avoidance as its principal purpose,
2) The related entity to whom the taxpayer paid, accrued, or incurred the expense paid, accrued, or incurred that amount to an unrelated person, and
3) The related entity was subject to a tax imposed by a state, U.S. possession, or foreign country (subject to certain qualifications) on the income attributable to the related party expenses.

The second and third conditions in sub. (23)(c) are types of evidence that a transaction did not have tax avoidance as its principal purpose, but it is possible for an entity to meet the first condition in sub. (23)(c) without meeting the other two. Such an entity would not be engaging in the abusive tax avoidance this bill is intended to prohibit.

The author may wish to require the first condition (the transaction at issue did not have tax avoidance as its principal purpose), and provide that in addition, the taxpayer must meet either condition 2 or condition 3, or any condition the Department deems relevant based on the facts and circumstances. Language to accomplish this is as follows:

> (c) The adjustments under ss. 71.05(6)(a)21., 71.26(2)(a)7., 71.34(1)(j), and 71.45(2)(a)16. shall not apply to any expenses or costs of a transaction that did not have tax avoidance as its principal purpose, provided the transaction satisfies one of the following conditions:
>
> 1. The related entity to whom the taxpayer paid... (same as former (c)2., except as modified by C. – H. below)
> 2. The related party was subject to tax on... (same as former (c)3., except as modified by C. – H. below)
>
> 3. The transaction meets any other conditions the department deems relevant, based on the facts and circumstances, to determine whether the transaction had tax avoidance as its principal purpose.

C. Apportionment Factor Considerations

Sec. 71.80(23)(c)3. provides that if a related entity was subject to tax on its income from a related party transaction at or above a certain tax rate (3% below the Wisconsin rate of 7.9%), then the related party expenses are allowable. However, this test does not consider that the tax paid on that income is greatly affected by the apportionment percentage. As written, this language would enable a taxpayer to engage in related party transactions with entities for which only a small percentage of income is apportioned to a taxing state.

A solution to this problem could be to use an "effective tax rate," which is the maximum statutory tax rate in a taxing state multiplied by the entity's apportionment percentage under the laws of that state. The effective tax rates in each state where the taxpayer is taxed would be added together to arrive at the taxpayer's "aggregate effective tax rate." The same would be done for the related party to whom the taxpayer pays the expenses or costs. If the effective tax rate of the related party (essentially the tax rate the related party paid on the income from the taxpayer) is below that of the taxpayer (the tax rate that would have been paid by the taxpayer in the absence of the transaction) by a certain threshold, the taxpayer would be required to prove by other means that the primary purpose of the transaction was not tax avoidance.

Instead of setting the threshold at 3% below the Wisconsin rate of 7.9%, the threshold for the aggregate effective tax rate could be stated as a percentage of the aggregate effective tax rate of the entity that pays the tax. To be equivalent to 3% below the Wisconsin rate, that percentage would be at least 60% of the aggregate effective tax rate of the paying entity. (60% is approximately equal to (7.9%-3%)/7.9%).

The specific changes to the bill to accomplish this are as follows:

- For purposes of sec. 71.80(23)(c), define "aggregate effective tax rate" and "effective tax rate" as follows:

  "Aggregate effective tax rate" means the sum of the effective tax rates imposed by a state, U.S. possession, foreign country or any combination thereof on a related entity.

"Effective tax rate" means, as to any state, U.S. possession, or foreign country, the maximum statutory rate of tax imposed by the state, possession, or foreign country, multiplied by the apportionment percentage, if any, applicable to the related entity under the laws of that jurisdiction.

- In sec. 71.80(23)(c)3., replace "tax rate" with "aggregate effective tax rate."
- In sec. 71.80(23)(c)3., replace "not less than 3 percentage points below" with "at least sixty percent of."
- In sec. 71.80(23)(c)3., where sec. 71.27 is referenced (relating to tax rate), also reference secs. 71.04, 71.25, and 71.45 (relating to apportionment percentage).

D. Corresponding Subtraction Modification

If a related party expense is disallowed and is required to be added back under this bill, and the related party to whom the expense is paid files Wisconsin returns, there is no provision in this bill that allows the related party to subtract income attributable to the disallowed expense from its Wisconsin income. The result would be that Wisconsin would tax the income twice, once to the taxpayer and once to the related party. To put the taxpayer in the same situation as if the related party transactions never happened, the bill should include the following language:

A subtraction shall be made for any amount added to the income of a related entity which paid expenses or costs to the taxpayer as provided under ss. 71.05(6)(a)21., 71.26(2)(a)7., 71.34(1)(j), and 71.45(2)(a)16.

E. "Other Expenses or Costs"

In sec. 71.80(23)(c)2. and 3., the types of expenses allowed under certain conditions include interest expenses or costs, intangible expenses, and management or service fees, but not "other expenses or costs." However, "other expenses or costs" paid, accrued, or incurred to a related party are subject to the same limitations in the bill as interest expenses or costs, intangible expenses, and management or service fees. A solution to this would be to add "other expenses or costs" after "management or service fees" in sec. 71.80(23)(c)2. and 3.

F. "Tax on Net Income"

The language in sec. 71.80(23)(c)3. is ambiguous when it describes tax paid on the income from a related party transaction. It is not clear whether "tax on its net income" would include franchise taxes, such as Wisconsin's, which are not levied on net income but rather measured by net income. Further, using "the measure" instead of "a measure" would clarify that the measure refers to the tax described in that sentence. Suggested changes are as follows:

3. The related entity was subject to tax on or measured by its net income in this state, or any state, U.S. possession, or foreign country; ~~a~~ the measure of tax paid included ...

G. Subject to Tax in Combined Returns

The language in sec. 71.80(23)(c)3. appears more restrictive than intended when it defines "any state, U.S. possession, or foreign country" to which the related party paid tax. This definition excludes jurisdictions under whose laws the taxpayer "files ***or could have elected to file***" (emphasis added) a combined or consolidated return, if that return results in eliminating the tax effects of a transaction between the taxpayer and the related entity. However, the only way the return could eliminate the effects of such a transaction is if combined or consolidated reporting is actually used. Thus, the language "or could have elected to file" is not necessary.

H. Typographical Error
In sec. 71.80(23)(c)3., the third-to-last line (p. 8, line 3) states "... if the report of return results in eliminating ... ," The word "of" should be replaced with the word "or."

If you have any questions regarding this technical memorandum, please contact Michael Oakleaf at 236-0223 or via email at Michael.oakleaf@dor.state.wi.us.

cc: Senator Hansen