



STATE OF WASHINGTON  
**DEPARTMENT OF REVENUE**  
OFFICE OF THE DIRECTOR

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December 1, 2010

**TO:** Tom Hoemann, Secretary  
Washington State Senate  
  
Barbara Baker, Chief Clerk  
Washington State House of Representatives

**FROM:** Tremaine Smith, Interim Director *TJS*

**SUBJECT:** INTERCOMPANY TRANSACTION REVIEW

During the 2010 legislative session, the Washington State Legislature passed 2ESSB 6143 (chapter 23, Laws of 2010, 1st Special Session) which required the Department of Revenue to disregard certain specific intercompany transactions undertaken for the purpose of unfair tax avoidance. While this legislation was under consideration, the business community expressed interest in legislation that would permit taxpayers to disregard or otherwise eliminate taxes on other intercompany transactions. Therefore, the Legislature directed the Department of Revenue to conduct a review of the state's tax policies on intercompany transactions.

The Department is to report its findings to the fiscal committees of the House of Representatives and Senate. If the review is not complete by December 1, 2010, the Department must provide a status report by that date, with a final report provided by December 1, 2011.

The review is not complete. Accordingly, the Department of Revenue respectfully submits the following status report.

The report was prepared by Kate Adams, Tax Policy Specialist. If you have any questions concerning the status report, please contact Mark Craig, Assistant Director of the Research and Legislative Analysis Division, at (360) 534-1534.

Attachments

cc: The Honorable Christine Gregoire, Governor  
Members, Senate Ways and Means Committee  
Members, House Finance Committee

# **Intercompany Transaction Review**

## **Status Report to the Legislature**

**Washington State Department of Revenue**  
**Tremaine Smith, Interim Director**

December 1, 2010

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## I. INTRODUCTION

In general, transactions between affiliated entities (intercompany transactions) are subject to tax in the same manner as transactions between unaffiliated entities. Intercompany transactions are only disregarded in limited circumstances. In most cases, Washington's tax structure requires that excise tax reports be filed separately for each entity, not on a combined basis.

During the 2010 legislative session, the Washington State Legislature passed 2ESSB 6143 (Chapter 23, Laws 2010, 1st sp. sess.) which required the Department of Revenue to disregard certain specific intercompany transactions undertaken for the purpose of unfair tax avoidance. (*Sections 201-206.*) While this legislation was under consideration, the business community expressed interest in legislation that would permit taxpayers to disregard or otherwise eliminate taxes on other intercompany transactions.

In response, the legislature directed the Department of Revenue to conduct a review of the state's tax policies on intercompany transactions. (*Section 205, hereinafter the "Review"*). The legislation requires that the Review include:

- An analysis of the impacts of intercompany transactions under the state's business and occupation tax and state and local sales and use taxes, and other taxes as the department deems appropriate.
- An examination of how Washington's tax policy compares to the tax policy of other states with respect to the taxation of intercompany transactions.
- An analysis of potential alternatives to the current policy of taxing intercompany transactions.
- Estimated revenue impacts of such alternatives, if practicable.

The Department is to report its findings to the fiscal committees of the House of Representatives and Senate. If the Review is not complete by December 1, 2010, the Department must provide a status report by that date, with a final report provided by December 1, 2011.

The review is not complete. Accordingly, the Department of Revenue respectfully submits the following status report.

## II. FOCUS OF THE REVIEW

The Department has sought to focus the review in the areas of research and analysis that will best accommodate the interests and needs of the business community. The Department believes that a results-oriented approach would be the most effective Review approach. If it identifies the policy alternatives that are appropriate in the current financial and political climate, the Department could then focus on obtaining the precise information necessary to inform the legislature of the potential fiscal impact of implementing any or all of the alternatives.

The Department has identified three general alternatives to the state's policy of taxing intercompany transactions that may be appropriate to evaluate in the final report:

- Revise existing state tax policy to eliminate taxes on all intercompany transactions, subject to limited exceptions (e.g., through combined reporting);
- Retain the current policy of taxing intercompany transactions and create additional and/or broader exceptions for specific intercompany transactions; or
- Implement limited policy changes that eliminate taxes on certain classes of intercompany transactions.

In order to further refine the direction of its review, the Department sought input from the business community at a recent meeting with the Association of Washington Businesses. At the meeting, the Department specifically requested the members to identify the focus they would prefer the Department take in its review. Members responded that they prefer a more general analysis that would support the evaluation of broad or limited policy changes rather than a series of specific exemptions.

### **III. PARTICIPATION BY THE BUSINESS COMMUNITY**

The legislation requires that the Review be conducted with input from the business community and others as the Department deems appropriate. Stakeholder participation will be critical to the success of the Review, as discussed below.

As of the date of this report, the Department of Revenue has started outreach to Washington's business community. Efforts include internet publications and meetings with the Association of Washington Businesses and state and local tax practitioners.

#### **A. Outreach Goals**

- Inform taxpayers of the Review, its purpose, and the Department's role.
- Encourage taxpayers to provide specific information on:
  - Financial data on intercompany transactions.
  - Business needs for affiliate structures and intercompany transactions.
- Encourage taxpayers to participate in the analysis portions of the Review.

#### **B. Future Outreach Activities**

- Issue press releases related to the Review and request business participants.
- Selected industry mailings:
  - Medical,
  - Construction,
  - Banking/Credit Issuers,
  - Insurance, and
  - Telecommunications.
- Individual stakeholder requests for participation.
- Invitations to participate directed to Association of Washington Businesses (AWB), state and local tax practitioners including the State and Local Tax Section of the

Washington State Bar Association (WSBA) and the Washington Society of CPAs (WSCPAs).

- Invitations to participate directed to major Washington businesses.

#### **IV. ISSUES OF IMPLEMENTATION**

In light of the preferred focus of the Review, discussed above, data collection will be a significant constraint to the Department's ability to provide a meaningful evaluation of the fiscal and business impacts of broad or even limited policy change.

##### **A. Necessary Data**

In order to provide a meaningful review of the impacts that Washington's current tax policy has on intercompany transactions, the Department of Revenue will need to determine:

- The frequency with which entities engage in various intercompany transactions or alter business plans to avoid undertaking such transactions.
- The compliance rate for reporting and remitting taxes that arise out of intercompany transactions that do take place.

These items will also provide the baseline for the Department to use in estimating revenue impacts of any potential alternatives to Washington's current tax policy on intercompany transactions.

##### **B. Availability of Data**

Due to the fact that Washington is not a combined reporting state (i.e., in Washington, affiliated entities do not file a single consolidated tax return); the Department of Revenue does not collect discrete data on intercompany transactions. In addition, the Department's access to federal tax information does not include data on intercompany transactions.

While the Department's records of completed audits may contain information on intercompany transactions, compiling that information would require individual review of each audit report. The Department would also need to review hundreds of audit reports to obtain enough information to generate valid statistics. The Department does not currently have sufficient resources to complete this type of review.

Therefore, the Department's review will need to rely on information collected from specific taxpayers and/or representatives of the business community, which requires cooperation and a willingness to provide this data. Taxpayers are generally reluctant to provide information to the Department. This is compounded by the fact, candidly admitted by practitioners, that it is not uncommon for taxpayers to fail to report intercompany transactions to avoid tax consequences. In addition, businesses are particularly cautious about disclosing information that could be competitively sensitive. For these reasons, the Department is not optimistic that it will be able to obtain data sufficient to provide meaningful fiscal information.

### **C. Specific Industries**

Depending on stakeholder response, the Department may be able to obtain sufficient information to evaluate the impact that any broad or limited policy change could have in specific industries. For example, the Department may be able to obtain sufficient information to provide a meaningful evaluation on the potential impact of disregarding wholly-owned entities in specific contexts (e.g., the construction industry or telecommunications).

### **D. Exemption Focus**

The Department believes that data issues would be less acute if the review focused on collecting information necessary to evaluate expanded exemptions for specific intercompany transactions. For example, the Department believes that it could collect data to provide meaningful analysis for intercompany transaction exemptions in the following areas:

- Division of a manufacturing and sales operation into a separate manufacturing and separate marketing company.
- Pass-through treatment for affiliate paymasters/employers of record.
- Disregard of transactions between certain wholly-owned companies and the owners.
- A specific rule to address tax exemptions for contributions and distributions.
- A specific rule to address a B&O tax exemption for affiliates to provide functionally-related insurance services to insurance companies.

However, this focus is not the expressed preference of the business community. Stakeholder feedback received to date supports an evaluation of broad or limited policy changes, rather than a series of specific exemptions.

## **V. CONCLUSION**

As of the date of this report, the Department will attempt to complete the Review in accordance with the currently expressed preferences of the business community, as current resources allow. However, stakeholder participation will be crucial if the Department is to obtain data sufficient to allow a meaningful fiscal analysis to be included in the Review. If the Department is unable to include this analysis, the Review may be of limited use to the Legislature.

Nonetheless, the Department will continue to work with stakeholders to refine the scope of the Review to accommodate stakeholder interests as practicable, and within the confines of available resources.