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Testimony of Progressive Maryland before the Maryland Business Tax Reform Commission

November 9, 2010

Good evening. My name is Rion Dennis, Acting Executive Director of Progressive Maryland. Progressive Maryland advocates for the interests of average working families in Maryland alongside our 50 affiliated organizations and 15,000 individual members and supporters.

Progressive Maryland strongly supports combined reporting and has been working for its adoption in Maryland since our inception. We urge this Commission to recommend that the General Assembly enact it during the 2011 session. In the 23 states where it has already been enacted, combined reporting has prevented out-of-state corporations from sheltering their profits by transferring them out of state to avoid taxation.

Corporate tax avoidance is alive and well in Maryland. Earlier this year, the Comptroller reported that fully one-third of the largest corporations doing business in Maryland paid no state income tax in 2007, the most recent figures available at the time. This contributes to the problem documented in a March 2010 report by Ernst and Young for the Council on State Taxation finding that Maryland has the lowest corporate tax burden of any state in the nation.

Progressive Maryland urges the Business Tax Reform Commission to endorse the Finnigan methodology for application of combined reporting.

We also urge the Commission to carefully consider the most effective way to combat the recently reported, increasingly common practice of transfering profits overseas to avoid state and federal taxation within the U.S.

Attached to this testimony are two article by Bloomberg reporter Jesse Drucker, one from 2007 and the other of which appeared in the Washington Post late last month. The article from last month describes an elaborate and entirely legal tax avoidance scheme that Google has set up to minimize the corporate income taxes it owes both the federal government and foreign countries, which involves the use of four different subsidiaries in three different foreign tax havens – Ireland, the Netherlands, and Bermuda. Mr. Drucker is the same reporter who in 2007 on the front page of the Wall Street Journal blew the whistle on Wal-Mart's so-called "captive REIT" tax shelter that the Maryland General Assembly attempted to nullify with 2007 legislation. That shelter also involved the use of a subsidiary that did most of its business abroad, as described in the November 2007 article attached to my statement.

These two companies represent case studies of how far sophisticated multistate and multinational corporations will go in order to minimize the amount of taxes they owe to the federal, state, and foreign governments – and also how badly combined reporting is needed. The Google article discusses the fact that the IRS at least was able to compel the company to negotiate the price at which its intellectual property was transferred to one of its Irish subsidiaries – the first step in the creation of its tax shelter. But states don't have comparable resources, and the IRS has no role in policing interstate transfer prices and other interstate tax avoidance strategies because they don't affect federal corporate tax payments. States simply lack the capacity to keep up with the sophistication of multistate corporations, and if they want to ensure that these businesses pay the taxes they should, states have to try to get ahead of the curve by enacting combined reporting.

These two articles are instructive as well about some of the technical issues before you in defining the unitary group under combined reporting, and I'll devote the rest of my statement to those. As a general matter, I urge the Commission to recommend that legislation implementing combined reporting closely follow model legislation and regulations developed by the Multistate Tax Commission that define both the unitary combined group and the characteristics of a unitary business.

Two of the questions you have identified are whether to exclude specific types of entities from the unitary group and whether to include others. As I just indicated, Maryland should follow the MTC's lead in this area and define even a so-called "waters-edge" unitary group in an expansive manner. The attached article explains how Wal-Mart and other corporations aggressively exploited combined reporting laws in Illinois and Minnesota that excluded from the unitary group commonly owned subsidiaries formed in the U.S. that did more than 80 percent of their business abroad. Similarly, the Chief Auditor for the Comptroller's office told the Business Reporting Subcommittee of this Commission last November that corporations started substituting captive insurance companies for traditional Delaware Trademark Holding Companies when the latter became a red flag for state auditors trying to uncover tax avoidance. Even in many combined reporting states, captive insurance companies are excluded from the combined group, and this has also been exploited. So, in general, the message is that in defining the combined group, states should be very skeptical of arbitrarily excluding any subsidiaries formed in the United States; corporations will drive a truck through any such loophole. Conversely, states should also follow the MTC's lead in including certain foreign subsidiaries in the group, such as controlled foreign subsidiaries of U.S. parents located in tax havens. The MTC is currently revising the language in its model combined reporting statute dealing with the inclusion of foreign tax haven subsidiaries in the group, and the Commission should recommend that this MTC provision be carefully considered for incorporation in Maryland's combined reporting law once the MTC completes the project.

The Commission should also recommend that, in implementing combined reporting, the Comptroller's office should model its definition of a unitary business on the MTC's model regulation. Admittedly, there is an element of subjectivity in laying out the indicators of functional integration and interdependence between divisions or subsidiaries of a corporate group that define what we mean by a unitary business. But the state auditors and attorneys involved in the MTC's project are the people best equipped to undertake this essential task, which is a requirement thrust upon the states by the courts. They devoted several years to the process and received a great deal of business input. There is no sense in Maryland reinventing the wheel in this area. Maryland should also follow the practice of the vast majority of combined reporting states and set the ownership threshold for combination at more than 50 percent ownership, not the higher 80 percent threshold that a few states use. Corporations can control the activity of corporations in which they invest with far less than 50 percent ownership if no other owner owns a larger share; the only reason for the 50 percent-plus-one threshold was to ensure that any given corporation can be included in the combined group of only one enterprise. But there is no justification for allowing a controlled subsidiary to be excluded simply because minority investors own 21 percent of it; that would be a further invitation for abuse.

Finally, Progressive Maryland believes that from a policy standpoint, worldwide combined reporting is justified and necessary and Progressive Maryland urges the Commission to recommend it. The description of Google's international tax avoidance scheme in the Bloomberg article well illustrates how worldwide combined reporting is urgently needed and will likely become increasingly so in the years to come. In fact, wordwide combined reporting was at one point the norm among states with combined reporting, and Maryland should act now to make it the norm once again.

But if the Commission chooses not to recommend worldwide combined reporting, neither should we allow corporations to elect it when doing so will reduce their tax liability. At the federal level we don't allow people to make such elections; in fact, we require individuals and corporations alike to pay the higher of the regular or the alternative tax. Water's edge combined reporting, with an expansive definition of the water's edge group as described above, should be mandatory.

Thank you for the opportunity to testify.

Attachments:

1) "Why Wal-Mart Set Up Shop in Italy," Wall Street Journal, November 14, 2007 (http://wakeupwalmart.com/news/article.html?article=1188)
2) "Google 2.4% Rate Shows How $60 Billion Lost to Tax Loopholes," Bloomberg News, October 21, 2010 (http://www.bloomberg.com/news/2010-10-21/google-2-4-rate-shows-how-60-billion-u-s-revenue-lost-to-tax-loopholes.html)

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November 14, 2007

Why Wal-Mart Set Up Shop in Italy

Retailer Has No Stores, As Tax Spat Lays Bare

By JESSE DRUCKER
November 14, 2007; Page C1

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 **McDonald's** Corp. over nearly $11 million stemming from its use of an 80/20 subsidiary. Details are sketchy, but McDonald'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 REITs, paid rent to the REITs and then deducted those payments from its taxes. The REITs, 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.

--Rosamaria Mancini contributed to this article.

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decompressor
are needed to see this picture.

Google 2.4% Rate Shows How $60 Billion Lost to Tax Loopholes

By Jesse Drucker - Oct 21, 2010 6:00 AM ET

Google Inc. cut its taxes by $3.1 billion in the last three years using a technique that moves most of its foreign profits through Ireland and the Netherlands to Bermuda.

Google's income shifting -- involving strategies known to lawyers as the "Double Irish" and the "Dutch Sandwich" -- helped reduce its overseas tax rate to 2.4 percent, the lowest of the top five U.S. technology companies by market capitalization, according to regulatory filings in six countries.

"It's remarkable that Google's effective rate is that low," said Martin A. Sullivan, a tax economist who formerly worked for the U.S. Treasury Department. "We know this company operates throughout the world mostly in high-tax countries where the average corporate rate is well over 20 percent."

The U.S. corporate income-tax rate is 35 percent. In the U.K., Google's second-biggest market by revenue, it's 28 percent.

Google, the owner of the world's most popular search engine, uses a strategy that has gained favor among such companies as Facebook Inc. and Microsoft Corp. The method takes advantage of Irish tax law to legally shuttle profits into and out of subsidiaries there, largely escaping the country's 12.5 percent income tax. (See an interactive graphic on Google's tax strategy here.)

The earnings wind up in island havens that levy no corporate income taxes at all. Companies that use the Double Irish arrangement avoid taxes at home and abroad as the U.S. government struggles to close a projected $1.4 trillion budget gap and European Union countries face a collective projected deficit of 868 billion euros.

Countless Companies

Google, the third-largest U.S. technology company by market capitalization, hasn't been accused of breaking tax laws. "Google's practices are very similar to those at countless other global companies operating across a wide range of industries," said Jane Penner, a spokeswoman for the Mountain View, California-based company. Penner declined to address the particulars of its tax strategies.

Facebook, the world's biggest social network, is preparing a structure similar to Google's that will send earnings from Ireland to the Cayman Islands, according to the company's filings in Ireland and the Caymans and to a person familiar with its plans. A spokesman for the Palo Alto, California-based company declined to comment.

Transfer Pricing

The tactics of Google and Facebook depend on "transfer pricing," paper transactions among corporate subsidiaries that allow for allocating income to tax havens while attributing expenses to higher-tax countries. Such income shifting costs the U.S. government as much as $60 billion in annual revenue, according to Kimberly A. Clausing, an economics professor at Reed College in Portland, Oregon.

U.S. Representative Dave Camp of Michigan, the ranking Republican on the House Ways and Means Committee, and other politicians say the 35 percent U.S. statutory rate is too high relative to foreign countries. International income-shifting, which helped cut Google's overall effective tax rate to 22.2 percent last year, shows one way that loopholes undermine that top U.S. rate.

Two thousand U.S. companies paid a median effective cash rate of 28.3 percent in federal, state and foreign income taxes in a 2005 study by academics at the University of Michigan and the University of North Carolina. The combined national-local statutory rate is 34.4 percent in France, 30.2 percent in Germany and 39.5 percent in Japan, according to the Paris-based Organization for Economic Cooperation and Development.

The Double Irish

As a strategy for limiting taxes, the Double Irish method is "very common at the moment, particularly with companies with intellectual property," said Richard Murphy, director of U.K.-based Tax Research LLP. Murphy, who has worked on similar transactions, estimates that hundreds of multinationals use some version of the method.

The high corporate tax rate in the U.S. motivates companies to move activities and related income to lower-tax countries, said Irving H. Plotkin, a senior managing director at PricewaterhouseCoopers LLP's national tax practice in Boston. He delivered a presentation in Washington, D.C. this year titled "Transfer Pricing is Not a Four Letter Word."

"A company's obligation to its shareholders is to try to minimize its taxes and all costs, but to do so legally," Plotkin said in an interview.

Boosting Earnings

Google's transfer pricing contributed to international tax benefits that boosted its earnings by 26 percent last year, company filings show. Based on a rough analysis, if the company paid taxes at the 35 percent rate on all its earnings, its share price might be reduced by about $100, said Clayton Moran, an analyst at Benchmark Co. in Boca Raton, Florida. He recommends buying Google stock, which closed yesterday at $607.98.

The company, which tells employees "don't be evil" in its code of conduct, has cut its effective tax rate abroad more than its peers in the technology sector: Apple Inc., the maker of the iPhone; Microsoft, the largest software company; International Business Machines Corp., the biggest computer-services provider; and Oracle Corp., the second-biggest software company. Those companies reported rates that ranged between 4.5 percent and 25.8 percent for 2007 through 2009.

Google is "flying a banner of doing no evil, and then they're perpetrating evil under our noses," said Abraham J. Briloff, a professor emeritus of accounting at Baruch College in New York who has examined Google's tax disclosures.

"Who is it that paid for the underlying concept on which they built these billions of dollars of revenues?" Briloff said. "It was paid for by the United States citizenry."

Taxpayer Funding

The U.S. National Science Foundation funded the mid-1990s research at Stanford University that helped lead to Google's creation. Taxpayers also paid for a scholarship for the company's cofounder, Sergey Brin, while he worked on that research. Google now has a stock market value of $194.2 billion.

Google's annual reports from 2007 to 2009 ascribe a cumulative $3.1 billion tax savings to the "foreign rate differential." Such entries typically describe how much tax U.S. companies save from profits earned overseas.

In February, the Obama administration proposed measures to curb shifting profits offshore, part of a package intended to raise $12 billion a year over the coming decade. While the key proposals largely haven't advanced in Congress, the IRS said in April it would devote additional agents and lawyers to focus on five large transfer pricing arrangements.

Arm's Length

Income shifting commonly begins when companies like Google sell or license the foreign rights to intellectual property developed in the U.S. to a subsidiary in a low-tax country. That means foreign profits based on the technology get attributed to the offshore unit, not the parent. Under U.S. tax rules, subsidiaries must pay "arm's length" prices for the rights -- or the amount an unrelated company would.

Because the payments contribute to taxable income, the parent company has an incentive to set them as low as possible. Cutting the foreign subsidiary's expenses effectively shifts profits overseas.

After three years of negotiations, Google received approval from the IRS in 2006 for its transfer pricing arrangement, according to filings with the Securities and Exchange Commission.

The IRS gave its consent in a secret pact known as an advanced pricing agreement. Google wouldn't discuss the price set under the arrangement, which licensed the rights to its search and advertising technology and other intangible property for Europe, the Middle East and Africa to a unit called Google Ireland Holdings, according to a person familiar with the matter.

Dublin Office

That licensee in turn owns Google Ireland Limited, which employs almost 2,000 people in a silvery glass office building in central Dublin, a block from the city's Grand Canal. The Dublin subsidiary sells advertising globally and was credited by Google with 88 percent of its $12.5 billion in non-U.S. sales in 2009.

Allocating the revenue to Ireland helps Google avoid income taxes in the U.S., where most of its technology was developed. The arrangement also reduces the company's liabilities in relatively high-tax European countries where many of its customers are located.

The profits don't stay with the Dublin subsidiary, which reported pretax income of less than 1 percent of sales in 2008, according to Irish records. That's largely because it paid $5.4 billion in royalties to Google Ireland Holdings, which has its "effective centre of management" in Bermuda, according to company filings.

Law Firm Directors

This Bermuda-managed entity is owned by a pair of Google subsidiaries that list as their directors two attorneys and a manager at Conyers Dill & Pearman, a Hamilton, Bermuda law firm.

Tax planners call such an arrangement a Double Irish because it relies on two Irish companies. One pays royalties to use intellectual property, generating expenses that reduce Irish taxable income. The second collects the royalties in a tax haven like Bermuda, avoiding Irish taxes.

To steer clear of an Irish withholding tax, payments from Google's Dublin unit don't go directly to Bermuda. A brief detour to the Netherlands avoids that liability, because Irish tax law exempts certain royalties to companies in other EU- member nations. The fees first go to a Dutch unit, Google Netherlands Holdings B.V., which pays out about 99.8 percent of what it collects to the Bermuda entity, company filings show. The Amsterdam-based subsidiary lists no employees.

The Dutch Sandwich

Inserting the Netherlands stopover between two other units gives rise to the "Dutch Sandwich" nickname.

"The sandwich leaves no tax behind to taste," said Murphy of Tax Research LLP.

Microsoft, based in Redmond, Washington, has also used a Double Irish structure, according to company filings overseas. Forest Laboratories Inc., maker of the antidepressant Lexapro, does as well, Bloomberg News reported in May. The New York-based drug manufacturer claims that most of its profits are earned overseas even though its sales are almost entirely in the U.S. Forest later disclosed that its transfer pricing was being audited by the IRS.

Since the 1960s, Ireland has pursued a strategy of offering tax incentives to attract multinationals. A lesser-appreciated aspect of Ireland's appeal is that it allows companies to shift income out of the country with minimal tax consequences, said Jim Stewart, a senior lecturer in finance at Trinity College's school of business in Dublin.

Getting Profits Out

"You accumulate profits within Ireland, but then you get them out of the country relatively easily," Stewart said. "And you do it by using Bermuda."

Eoin Dorgan, a spokesman for the Irish Department of Finance, declined to comment on Google's strategies specifically. "Ireland always seeks to ensure that the profits charged in Ireland fully reflect the functions, assets and risks located here by multinational groups," he said.

Once Google's non-U.S. profits hit Bermuda, they become difficult to track. The subsidiary managed there changed its legal form of organization in 2006 to become a so-called unlimited liability company. Under Irish rules, that means it's not required to disclose such financial information as income statements or balance sheets.

"Sticking an unlimited company in the group structure has become more common in Ireland, largely to prevent disclosure," Stewart said.

Deferred Indefinitely

Technically, multinationals that shift profits overseas are deferring U.S. income taxes, not avoiding them permanently. The deferral lasts until companies decide to bring the earnings back to the U.S. In practice, they rarely repatriate significant portions, thus avoiding the taxes indefinitely, said Michelle Hanlon, an accounting professor at the Massachusetts Institute of Technology.

U.S. policy makers, meanwhile, have taken halting steps to address concerns about transfer pricing. In 2009, the Treasury Department proposed levying taxes on certain payments between U.S. companies' foreign subsidiaries.

Treasury officials, who estimated the policy change would raise $86.5 billion in new revenue over the next decade, dropped it after Congress and Treasury were lobbied by companies, including manufacturing and media conglomerate General Electric Co., health-product maker Johnson & Johnson and coffee giant Starbucks Corp., according to federal disclosures compiled by the non-profit Center for Responsive Politics.

Administration Concerned

While the administration "remains concerned" about potential abuses, officials decided "to defer consideration of how to reform those rules until they can be studied more broadly," said Sandra Salstrom, a Treasury spokeswoman. The White House still proposes to tax excessive profits of offshore subsidiaries as a curb on income shifting, she said.

The rules for transfer pricing should be replaced with a system that allocates profits among countries the way most U.S. states with a corporate income tax do -- based on such aspects as sales or number of employees in each jurisdiction, said Reuven S. Avi-Yonah, director of the international tax program at the University of Michigan Law School.

"The system is broken and I think it needs to be scrapped," said Avi-Yonah, also a special counsel at law firm Steptoe & Johnson LLP in Washington D.C. "Companies are getting away with murder."

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