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TESTIMONY OF BASAV SEN
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Maryland Business Tax Reform Commission
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Good afternoon and thank you for the opportunity to speak today. I represent the United Food and Commercial Workers, a North American union of 1.3 million retail and food processing workers. More than 35,000 of our members are in the State of Maryland.

The UFCW is concerned that the livelihoods of our members are adversely affected by state and local budget cuts while some corporations that benefit from public goods and services do not pay their share of taxes. Today I would like to highlight the egregious pattern of tax avoidance of one particular corporation. The behavior of this corporation provides a strong justification for why Combined Reporting is needed to close unfair corporate tax loopholes.

Wal-Mart is the largest private sector corporation in the world measured both by sales and by number of employees. They are also adept at using their subsidiary structure to avoid state taxes, and have hired expensive consultants to help them do so.

I congratulate the Maryland legislature for having closed the captive real estate investment trust or REIT loophole that permitted Wal-Mart and other companies to pay rent to themselves and deduct those rental payments from their revenue for purposes of state income tax reporting. *However, while Maryland has closed this particular loophole, the state remains vulnerable to loss of tax revenue resulting from corporations using their subsidiary structure to shift income to low-tax or no-tax jurisdictions, unless combined reporting is enacted.* Combined reporting is the single most effective way to prevent corporations from using their subsidiary structure for tax avoidance.

One concrete example is Wal-Mart's use of an Employee Services Company subsidiary. Most Wal-Mart employees are on the payroll of a subsidiary called Wal-Mart Associates Inc., which leases the employees back to the operating subsidiary. This arrangement reduces the apportionment fraction of Wal-Mart's operating subsidiary by nearly eliminating its payroll factor. The payroll factor is in effect transferred to an entity with very low taxable income. Combined reporting will close this loophole by requiring the combined group to calculate a common apportionment fraction for the entire group.

I emphasize that this is only one example. Through tax litigation in North Carolina, a number of Wal-Mart's internal tax documents have become available to the public, including memos and correspondence between Wal-Mart and accounting firm Ernst & Young. One of these documents is an August 2002 presentation by Ernst & Young to Wal-Mart titled "Ideas for State and Local Tax ETR Reduction," which includes a number of sophisticated ideas for reducing Wal-Mart's state tax burden. I have included this document as an attachment to my testimony today. We know that Wal-Mart uses at least two of the strategies discussed in this document: Employment Services Company (referred to earlier) described on pages 14-15 and Captive

Insurance Company described on page 37. We do not know if Wal-Mart is using any of the other ideas. *However, most of these tax avoidance methods rely on using subsidiaries to shift income, and therefore most of them would be eliminated by combined reporting.*

The relationship between Wal-Mart and Ernst & Young is yet another argument for combined reporting as a tax fairness issue. The small businesses you have heard from today cannot afford to pay millions of dollars in consulting fees to Ernst & Young to set up Delaware or Nevada subsidiaries for them to avoid paying their fair share of Maryland taxes.

The UFCW strongly urges you to recommend combined reporting for corporate income taxes, to restore fairness to the way businesses are taxed in Maryland. Thank you.

STATE AND LOCAL TAX SERVICES

August 2002

WAL★MART®

Ideas for State and Local Tax ETR Reduction

Executive Summaries

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Non-Structural Planning

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REIT Additional Assets

Executive Summary

USE EXISTING REITS TO SHELTER INCOME FROM OTHER INCOME-PRODUCING ASSETS HELD BY AFFILIATES

Benefit Summary

To the extent that additional "real estate assets" or other assets can be transferred to the REITs and remain compliant with the REIT income and asset tests, additional savings may be achieved.

Tax Analysis

To understand how much "cushion" exists, the following describes the relevant tests:

REIT GROSS INCOME TESTS

There are primarily two gross income tests relevant to our situation:

(1) The 75% Test - At least 75% of the REIT's gross income must be derived from "real estate assets." [Internal Revenue Code ("IRC") § 856(c)(3)]

(2) The 95% Test - At least 95% of the REIT's gross income must be derived from the same items that qualify for the 75% income test and/or from dividends or interests derived from any source. [IRC § 856(c)(2)]

REIT ASSET TEST

IRC § 856(c)(5)(A) requires that at least 75% of the assets of a REIT be held in the form of "real estate assets, cash and cash items (including receivables), and Government securities" at the close of each quarter of each REIT tax year.

The term "real estate assets" includes real property, shares in other REITs that meet the requirements for REIT qualification and stock or debt instruments attributable to the temporary investment of new capital that meet the requirements for REIT qualification for the one year beginning on the date the trust receives such new capital. [IRC § 856(c)(6)(B)]

The term "real property" includes interests in real property and interests in mortgages on real property. In various unpublished rulings, the Service has held that many forms of real estate mortgage loans qualify

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including mortgage participations, mortgage pooling arrangements, "straight pass-through" or "fully-modified pass-through" mortgage-backed certificates guaranteed by GNMA, CMOs taxed as a REMIC and hypothecation loans. Each must be reviewed for adequate real estate security. If non-real estate assets also secure the loan, a proration to a non-real estate asset occurs when the FMV of the real estate falls below the mortgage principal balance.

A "cash item" is not defined in either the IRC or Treasury Regulations but has been defined in a number of published rulings. For example, certificates of deposit are cash items [Rev. Rul. 77-199, 1977-1 C.B. 195] but banker's acceptances are not. [Rev. Rul. 72-171, 1972-1 C.B. 208] "Government securities" include securities issued by the following government agencies: a) the Federal Housing Administration, b) the Federal National Mortgage Association, c) the Federal Home Loan Bank, d) the Federal Land Bank, e) the Federal Intermediate Credit Banks, f) the Banks for Cooperatives, and g) the Public Housing Administration, among others. [Rev. Rul. 64-85, 1964-1 (part 1) C.B. 230; Rev. Rul. 71-537, 1971-2 C.B. 262; Rev. Rul. 76-426, 1976-2 C.B. 17]

Key Implementation Steps

- Determine amount of cushion available for both the REIT income and asset tests.
- Identify additional real estate assets or other income-producing assets.
- Contribute assets to REIT.
- Monitor REIT assets and income to ensure compliance with REIT tests.

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Securities Trading

Executive Summary

USING GROSS RECEIPTS FROM THE SALE OF FINANCIAL INSTRUMENTS IN THE SALES FACTOR

Benefit Summary

In certain states, Wal-Mart may be able to include the gross receipts derived from the sale of certain liquid short-term and long-term investments in the denominator of its sales factor and, for numerator purposes, source such gross receipts to the state in which the cash management/investment function is located.

In apportioning business income on a multistate basis, Wal-Mart should address the question of whether the sales factor includes the gross receipts, as opposed to the net gain, from the sale of these financial instruments. In certain states, Wal-Mart may be able to include the gross receipts derived from the sale of financial instruments in the denominators of its sales factors and, for numerator purposes, source such gross receipts to Arkansas, where the cash management/investment function is located. The frequency and size of the sales could result in a decrease of Wal-Mart's sales factors and overall apportionment percentages, producing a significant tax savings if the receipts are sourced outside of the taxing state.

Tax Analysis

GUIDANCE FROM UDITPA

A plain reading of the Uniform Division of Income for Tax Purposes Act ("UDITPA") seems to indicate that the total gross receipts from the sale of intangible assets, including particularly short-term financial instruments, must be included in the denominator of the sales factor. Under UDITPA Section 15, the sales factor of the three factor apportionment formula is defined as "a fraction, the numerator of which is the total sales of the taxpayer in this state during the tax period, and the denominator of which is the total sales of the taxpayer everywhere during the tax period."

UDITPA Section 1(g) defines sales as "all gross receipts of the taxpayer" other than those related to items of nonbusiness income specifically allocable to a particular state under Sections 4 through 8 of UDITPA. (The term "gross receipts" is not defined by UDITPA.) When a taxpayer sells tangible assets, taxpayers and taxing authorities agree that the total gross receipts from the sale are includable in the sales factor. The argument can be made that the statutory scheme demands the same treatment for intangible assets.

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UDITPA Section 17 provides that sales of intangible property should be sourced to the state where the income-producing activity occurs. In the case of short-term financial instruments, the income-producing activity is the activity of managing the investments (i.e., buying, selling, analyzing, etc.) Thus, it can be argued that the receipts should be sourced to the state where the cash management function is located. As stated above, inclusion of the gross receipts in the sales factor denominator can result in significant tax savings if the cash management function occurs outside of the taxing state.

Several state courts have interpreted UDITPA statutes or other substantially similar statutes to require, in various situations, inclusion of the gross receipts from the sale of certain financial instruments (such as liquid short-term investments) in the sales factor, including unitary jurisdictions such as California and Illinois.

STATES ATTEMPTS TO ATTACK FAVORABLE INTERPRETATION OF UDITPA

While taxpayers seeking to use gross proceeds rather than net gain focus on a literal reading of UDITPA and/or favorable state statutes, states often attempt to avoid the literal application of UDITPA and/or their own statutes and look to Section 18 of UDITPA for relief from perceived unfair apportionment, should this be the proper interpretation.

Some taxing authorities have argued that inclusion of total gross receipts from the sale of intangible instruments is sufficiently distortive to warrant deviation from the standard apportionment formula under UDITPA Section 18, which specifically provides:

> If the allocation and apportionment provisions of this Act do not fairly represent the extent of the taxpayer's business activity in this state, the taxpayer may petition for or the [tax administrator] may require, in respect to all or any part of the taxpayer's business activity, if reasonable:
>
> (a) separate accounting;
>
> (b) the exclusion of any one or more of the factors;
>
> (c) the inclusion of one or more additional factors which will fairly represent the taxpayer's business activity in this state; or
>
> (d) the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.

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Relying on UDITPA Section 18, or similar state relief statutes, some taxing authorities have argued successfully that only net profit should be included in the sales factor while others have taken the position that the receipts should be thrown out of the formula entirely. See, e.g., *Appeals of Pacific Telephone and Telegraph Company*, Cal. St. Bd. of Equal., May 4, 1978 [SBE-XXIII-375, 78-SBE-028]; *Westinghouse Electric Corp. v. Porterfield*, 261 N.E.2d 272 (Ohio 1970) (construing Ohio "business done" factor to exclude gross receipts from sale of marketable securities); see generally 1 Jerome R. Hellerstein & Walter Hellerstein, *State Taxation*, Paragraph 9.18[2] (2d ed. 1993); Walter Hellerstein, *State Taxation of Corporate Income From Intangibles: Allied-Signal and Beyond*, 48 Tax L. Rev. 739, 847-48 (1993).

There is little authority regarding the level of distortion necessary to deviate from the standard apportionment formula. In *Hans Rees' Sons, Inc. v. North Carolina*, 283 U.S. 123 (1930), the United States Supreme Court held that distortion of 250% was sufficient to deviate from the standard apportionment formula whereas in *Container Corp of America v. Franchise Tax Board*, 463 U.S. 159 (1983), the Court held that a 14% distortion was insufficient. Logically, therefore, it seems the level of distortion necessary to require that the standard formula be altered must be somewhere between 14% and 250%. In *Appeal of Merrill, Lynch, Pierce, Fenner & Smith, Inc.*, California State Board of Equalization, 89-SBE-017, June 2, 1989, the SBE determined that distortion of 23 to 36 percent was insufficient to allow exclusion of the proceeds from the sale of investment instruments from the receipts factor. In its decision, the SBE wrote, "These figures [23-36%] are, as the Supreme Court said of the difference shown in *Container Corp.*, supra, a far cry from the more than 250% difference which led us to strike down the state tax in *Hans Rees' Sons, Inc.*, and a figure certainly within the substantial margin of error inherent in any method of attributing business income among the components of a unitary business."

In *Appeal of Merrill*, the SBE further emphasized that "rough approximation" of income that is attributable to the taxing state satisfies the requirement that the formula fairly reflect the taxpayer's business activity in California. In fact, inclusion of gross receipts in the sales factor rarely (if ever) will result in sufficient distortion because it will affect only one factor out of three and thus its effect on the overall tax liability will be only one-third of its effect on the sales factor. For example, if inclusion of gross receipts from the sale of short-term financial instruments causes the taxpayer's receipts factor denominator to double, assuming the percentage of activity reflected by each factor in the taxing state is roughly the same, the sales factor will be reduced by ½ and the tax will be reduced by 1/6 (1/4 in states that have double-weighted sales factors).

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GUIDANCE FROM MTC

A plain reading of the Multistate Tax Commission's ("MTC") interpretive regulations reveals that the total gross receipts from the sale of intangible assets must be included in the denominator of the sales factor. MTC Reg. IV.15.(a) provides "the term 'sales' means all gross receipts derived by the taxpayer from transactions and activity in the regular course of the trade or business."

On July 27, 2007, the MTC adopted a resolution which provides a uniform definition of "gross receipts." The resolution amends MTC Reg. IV.2.(a) to add the following:

> (5) 'Gross Receipts' are the gross amounts realized (the sum of money and the fair market value of other property or services received) on the sale or exchange of property, the performance of services, or the use of property or capital (including rents, royalties, interest and dividends) in a transaction which produces business income, in which the income or loss is recognized. . . Gross receipts, even if business income, do not include such items as, for example:
>
> 1) Repayment, maturity, or redemption of the principal of a loan, bond or mutual fund or certificate of deposit or similar marketable instrument;
> 2) The principal amount received under a repurchase agreement or other transaction properly characterized as a loan . . .

STATES ATTEMPTS TO ATTACK FAVORABLE INTERPRETATION OF MTC

Some taxing authorities have argued that MTC Reg. IV.18.(c)(3), or their state's equivalent, provides a basis for excluding the gross receipts from the sales factor entirely. That regulation provides in relevant part:

> Where business income from intangible property cannot readily be attributed to any particular income producing activity of the taxpayer, the income cannot be assigned to the numerator of the sales factor for any state and shall be excluded from the denominator of the sales factor. For example, where business income in the form of dividends received on stock, royalties received on patents or copyrights, or interest received on bonds, debentures or government securities results from the mere holding of the intangible personal property by the taxpayer, the dividends and interest shall be excluded from the denominator of the sales factor.

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Accordingly, some taxing authorities have taken the position that receipts from the sale of the intangible instruments result from the mere holding of the intangibles or at least cannot be attributed to any particular income producing activity and, therefore, the receipts should be thrown out of the sales factor altogether. The flaw in this argument is that taxpayers with excess cash invested in short-term financial instruments virtually always have a cash management function in an identifiable location with employees devoted to the active management of the investments. Indeed, by definition, short-term investments require considerable attention. Thus, the income does not result from mere holding of intangible personal property and, in fact, can be assigned to the numerator of the sales factor for one or more states. This view is corroborated by Benjamin F. Miller, California Franchise Tax Board counsel for multistate tax affairs who, along with two co-authors, opined in an article: "Presumably, activity exceeds 'mere holding' when a formal cash management function exists." See also Herbert, Miller, Weiss, "*Sales Factor and Intangibles: What's Up and What's Down*," State Tax Notes (Nov. 8, 1993) 1102, 1104.

MTC'S ATTEMPT TO ATTACK FAVORABLE INTERPRETATION

The MTC unusually attempted to address the issue through promulgation of a regulation. To that end, it adopted the following addition to MTC Reg. IV.18. Where the taxpayer realizes gains or losses from the sale or other disposition of intangible property held as part of the taxpayer's operational investments, e.g., working capital, only the net gain from such sales or dispositions reported as taxable will be included in the sales factor. The MTC's proposed regulation provides compelling evidence that despite the apparent clarity of the statutes and the regulations, the issue of whether gross receipts, rather than net profits, from the sale of intangibles must be included in the sales factor is quite controversial. The controversies are playing out in the administrative arena and possibly in the courts. For example, the issue is pending in at least one case currently on appeal before the California State Board of Equalization. It will be some time until the controversies are resolved by the courts or by amendments to state statutes. In the interim, there will remain opportunities for taxpayers.

Key Implementation Steps

- Research applicable states for treatment of certain qualifying transactions and impact on Arkansas income tax liability.
- Interview relevant Wal-Mart Treasury Department personnel to determine magnitude of qualifying transactions and whether accounting systems capture necessary data to take filing positions.
- Determine income/franchise tax savings through modeling based on qualifying transactions amounts, if applicable.

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- Calculate potential refund claims for prior year tax returns and current apportionment impact on current returns.

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SALT Cash Finder

Executive Summary

STATE & LOCAL TAX ("SALT") REFUND STUDY SERVICES

Benefit Summary

A detailed review of Wal-Mart's overall state and local tax position can result in significant cash refunds, credits or tax return filing methodologies/positions which yield on-going benefits (lower effective tax rate).

Process

With the "SALT Cash Finder" process, E&Y's SALT professionals can provide the needed knowledge, experience, resources, and process improvements to help Wal-Mart identify potential refunds and credits. E&Y will work with Wal-Mart to identify the areas of tax that may present the greatest opportunities. We have extensive experience in multistate refund review studies. We utilize extensive resources designed specifically to facilitate the refund review process, including 50-state databases and matrices for refunds in all types of tax.

During a SALT Cash Finder engagement, our subject matter specialists will work with Wal-Mart to assess the types of tax where Wal-Mart believes opportunities exist and develop the right review team to meet its needs. During the initial evaluation period we will meet with department decision makers and their liaisons to understand and confirm Wal-Mart's state and local tax position. We will review returns and their source data and key transactional information to identify and quantify potential refund opportunities. We will then present the resulting strategies and their potential refund/credit value. If applicable, we will also present expected future savings of those opportunities.

SALT CASH FINDER FOCUS

The SALT Cash Finder service is a low risk, high benefit opportunity that focuses on both income and non-income based taxes. Taxes that we can specifically address include:

INCOME/FRANCHISE TAX

While potential refund dollars may be directly proportional to the amount of tax a company pays, other factors such as company size, structural and transactional complexity, and location of operations may also affect the amount of refund potential. Though, in general, companies with various multistate legal entities present may

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realize the most opportunity for income/franchise tax refunds, we have had significant successes with clients of all sizes in all industries.

SALES AND USE/EXCISE TAX

Our Sales and Use Tax professionals use an industry-focused approach to identify sales/use tax overpayments or overpayments to vendors that a client may have made. Our services include, among others, reverse sales and use tax audit and an accounts payable refund analysis. Services may also include a review of excise taxes that are paid by the company. Typically, the higher the level of purchases, the greater opportunity for refunds. Other factors such as a company's purchasing and payment processes, and recent changes in tax laws may affect the amount of refunds or credits available.

PROPERTY TAX

Personal property tax savings are identified through the acquisition cost adjustments, unrecorded disposals ("ghost assets"), non-taxable items and intangibles (as permitted by local property tax rules), classification adjustments (to provide for faster depreciation), fair market value determinations, and exemptions and abatements (e.g., pollution control equipment exemption). Real property tax savings opportunities exist in the areas of valuation, exemption, misclassification and equalization.

EMPLOYMENT TAX

Various company events that affect the status of employees can lead to opportunities for payroll tax refunds. Examples include merger and acquisition activity or downsizing. Our employment tax specialists around the nation have significant experience working closely with companies with over 500 employees to identify refunds and potential long-term payroll tax savings.

BUSINESS INCENTIVES

Our network of Business Incentives professionals conduct detailed reviews that helps clients increase return on their capital and human investments by retroactively taking advantage of state and local income/franchise tax credits they might have overlooked, or not fully explored. We analyze a company's tax and business records for the last 3-4 years. This assessment focuses on identifying the location and type of new facilities, as well as the amount of human resource and other capital investments made at each location. We then match the client's activities with relevant state and local income/franchise tax credit opportunities.

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Key Implementation Steps	▪ Determine scope of review (i.e., determine what type of returns will be reviewed). ▪ Determine priority of states to review. ▪ Review identified returns and accompanying workpapers for refund opportunities and favorable filing methodologies/positions.

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Employment Services Company - Payroll Factor Analysis

Executive Summary

USE OF EXISTING EMPLOYMENT SERVICES COMPANY ("ESC") TO REDUCE PAYROLL FACTOR OF OPERATING COMPANIES

Benefit Summary

By charging a "marked-up service fee," payroll may remain with ESC and not the operating companies, for payroll apportionment factor purposes. Thus, the apportionment ratio of the operating companies may be reduced. Since ESC's taxable income is intended to be relatively low compared with the operating companies, an overall net benefit may result.

Tax Analysis

It is critical that the employees be viewed as employees of ESC. The analysis generally hinges on who is the common law employer. The following discusses UDITPA and the MTC regulations as guidance in making this determination.

PAYROLL FACTOR -- UDITPA AND MTC GUIDANCE

UDITPA is generally interpreted to limit the factor to employee compensation, but the Act does not define "employee." In determining who is an employee, the definition in the Federal Insurance Contributions Act (IRC § 3101 and following) and the cases and rulings thereunder are widely followed. That definition adopts the common law rules, the essence of which is that an employment relationship exists when the person for whom the services are performed has the right to control and direct the individual who performs the services, not only as to the result to be accomplished, but also as to the manner of accomplishing that result. It is the right to control rather than the exercise of that right that is generally determinative. As a practical matter, the taxpayer includes in the payroll factor all compensation paid to individuals with respect to whom the taxpayer pays Federal Insurance Contributions Act ("FICA") taxes; but if it can be shown that certain individuals are "employees" within FICA special rules but not within common law rules, their compensation may be excluded.

While UDITPA bases the payroll factor on "compensation" and does not use the word "employee," the related MTC regulations confine the payroll factor to compensation paid to "employees for personal services" and

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defines "employee" as an individual who has the status of an employee under the usual common-law rules applicable to determining the employer-employee relationship. The MTC regulations also state that "employee" includes any officer of a corporation. The comments to UDITPA state "payroll attributable to management or maintenance should be excluded from the factor." The MTC regulations do not follow the comment.

In order for ESC to include the employee compensation in its payroll factor, most states (by following UDITPA and the MTC regulations) generally require that ESC be considered the "common law employer." The primary test for determining if an employer/employee relationship exists in many states is the common law definition. This definition focuses on which entity has the right to "direct and control" the employees. According to the common law rule, the following list of activities generally must be performed by ESC if there is going to be an employer/employee relationship: (1) Provide performance evaluations; (2) Determine assignments; (3) Determine compensation; (4) Hire, supervise and terminate employees; (5) Provide tools and materials for job performance; (6) Schedule and control the hours worked by employees; (7) Review and approve time and expense reports; (8) Pay all payroll related taxes and file related payroll returns (Forms W-2, etc.).

Key Implementation Steps

- Using a reasonable mark-up estimate for the intercompany services fee, prepare a state income tax model and calculate the net savings from having ESC keep the payroll factor.
- Verify that strategy will not interfere with current employment related incentives currently being claimed by the operating entity.
- Verify that strategy will not interfere with current employee benefit programs or legal liability risk profile.
- Verify that strategy will not interfere with current employment tax and withholding procedures.
- Analyze any employee leasing company regulatory concerns that may apply to the structure.
- Modify existing intercompany services agreements to accommodate strategy.
- Complete IRC § 482 transfer pricing report to support mark-up.
- Determine income/franchise tax impact (with particular attention to Arkansas income tax impact) of eliminating payroll factor from operating companies through modeling calculations.

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Structural Planning

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Purchasing Cooperative

Executive Summary

USE OF COOPERATIVE TO REDUCE STATE TAX AND DEFER FEDERAL TAX

Benefit Summary

A non-exempt cooperative may be used to convert taxable income to nontaxable "patronage dividends" and potentially "trap" in-state apportionment values in separate and certain consolidated return states. To the extent the cooperative's distribution qualifies as a "patronage dividend," the cooperative should not be subject to state tax at the cooperative level (due to conformity with federal "dividend paid" deduction provisions) and should not be subject to tax at the patron level (provided the patron is located in a "tax haven state").

In addition, there appears to be an opportunity for the patrons to delay recognition of the income received from their dealings with the cooperative for at least 20 ½ months resulting in the deferral of federal and, to the extent owed, state income taxes as well. Such a deferral requires that the cooperative be deconsolidated.

Tax Analysis

TAXATION OF COOPERATIVE

The opportunity exists with respect to nonexempt cooperatives defined under IRC § 1381(a)(2) that distribute "patronage dividends" as defined in IRC § 1388(a). A corporation that is "operating on a cooperative basis" is subject to Subchapter T, which taxes nonexempt cooperatives as a hybrid - meaning they are taxed like an ordinary corporation with respect to nonpatronage-sourced income, but like a "flow through" entity with respect to "patronage-sourced income" [i.e., can deduct all qualified patronage dividends paid to its patrons per IRC § 1382(b)]. Therefore, to the extent a nonexempt cooperative generates "patronage-sourced income," the cooperative should not pay either federal or state tax (due to conformity with federal "dividend paid" deduction provisions).

SUBCHAPTER T - OPERATE ON A COOPERATIVE BASIS

To fall within the provisions of Subchapter T, a corporation must be "operating on a cooperative basis." Based on the Internal Revenue Service's ("Service" or "IRS") most-recent pronouncements concerning cooperatives, Tech. Adv. Mem. 93-03-004 (Oct. 7, 1992) and Priv. Ltr. Rul. 92-35-011 (May 21, 1992), an association seeking

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to obtain a ruling confirming that it is "operating on a cooperative basis" must have the following characteristics: subordination of capital, democratic control, operation at cost, joint effort, and limited nonmember business.

PATRONAGE DIVIDENDS

A cooperative is allowed to deduct patronage dividends paid to its patrons. [IRC § 1382(b)] In order to qualify for the deduction, the patronage dividend must be:

- Paid to a patron "on the basis of the quantity or value of business done with or for such patron" which has evolved to mean "patronage-sourced income;"
- Paid pursuant to a pre-existing obligation of the cooperative;
- Determined by reference to the net earnings of the cooperative from business done with or for its patrons;
- Properly paid, meaning it may be all in money or may consist of part money and part "qualified written notice of allocation" which informs the patron of the dollar amount of the noncash dividend; and
- Distributed within the payment period, which begins on the first day of the cooperative's fiscal year and ends 8 ½ months after the close of that year.

TAXATION OF PATRON

The cooperative's distribution should not be taxed at the patron level to the extent the "patronage dividend" can be directed to a "tax haven" entity. IRC § 1385(a)(1) states that each patron "shall include in gross income the amount of any patronage dividend. . . ." Therefore, unless the cooperative distribution can be characterized as a "dividend" under IRC § 316, the "patronage dividend" will be taxed to the recipient.

It is unlikely that the "patronage dividen d" would qualify as a "dividend" under IRC § 316. Treas. Reg. § 1.1388-1(a)(1)(iii) states that a "patronage dividend" is an amount paid "[w]hich is determined by reference to the net earnings of the cooperative organization from business done with or for its patrons." Note that "[f]or purposes of such subdivision (iii), net earnings shall not be reduced by any taxes imposed by subtitle A of the Code, but shall be reduced by dividends paid on capital stock or other proprietary capital interests." Thus, any amount of net earnings available to qualify as a "patronage dividend" will be reduced by any amount deemed to be "dividends paid on capital stock or other proprietary capital interests." For this reason it is unlikely that a "patronage dividend" would also qualify as a "dividend paid on capital stock."

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Nonetheless, to the extent patrons are organized as limited partnerships or dual member LLCs, there may be an opportunity to direct the patronage dividend - through the partnership agreement - to a corporate limited partner (or non-management member in the case of an LLC) conducting business only in a "tax haven" state.

FEDERAL TAX DEFERRAL

The cooperative structure also may yield a 20-½-month federal tax deferral. This federal benefit is derived from the fact that a patronage dividend can be paid out anytime within the payment period that begins "the first day of the cooperative's fiscal year and ends 8 ½ months after the close of that year." [IRC § 1382(d)] The cooperative will report the income when it declares the patronage dividend, but the patron need not report the income until it is received, which would be at least 20 ½ months later. Since the federal consolidated return rules prohibit such a deferral, it will be necessary to deconsolidate the cooperative. [Treas. Reg. § 1.1502-13(c)]

Key Implementation Steps

- Form captive cooperative to operate purchasing (or other shared) function to trap apportionment values, shelter income and defer federal and state taxes.
- Operate cooperative on a cooperative basis pursuant to IRC Subchapter T.
- Cooperative declares and distributes a "patronage dividend" to patron within the payment period beginning on the first day of the cooperative's fiscal year and ends 8 ½ months after the close of that year.
- Verify that cooperative's "patronage dividend" qualifies for a "dividend paid" deduction for federal tax purposes.
- Patron reports "patronage dividend" upon receipt from cooperative.
- Confirm intended federal and international tax objectives.

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"Domestic" CFC – Subpart F Planning

Executive Summary

CONVERT TAXABLE INVESTMENT PORTFOLIO INCOME TO NON-TAXABLE SUBPART F INCOME TO REDUCE KANSAS (AND CERTAIN OTHER UNITARY STATES) TAX BASE

Benefit Summary

This strategy is intended to convert U.S.-source income from non-appreciated "portfolio interest" generating assets into IRC Subpart F income, which is eligible for a 80% deduction in Kansas and either excluded from income or eligible for a 70%, 80% or 100% deduction in many other unitary states. In addition, an opportunity exists to create internal debt structure that results in IRC Subpart F income. This strategy is intended to be tax-neutral at the federal and international tax level.

Tax Analysis

While Kansas statutes do not specifically provide for combined reporting, the statutes do empower the Director of Taxation to allocate income and expenses among related taxpayers if necessary to properly reflect income [Kan. Stat. Ann. § 79-32,141 and Kan. Admin. Regs. 92-12-77]. The Director has used, and the courts have upheld, this power to require combined reporting for unitary businesses. However, this power only extends to corporations incorporated in the United States, making Kansas' combined report what is typically called a "domestic" combined report [See *In The Matter Of The Appeal Of Morton Thiokol, Inc.*, 254 Kan. 23, 864 P.2d 1175 (Kan. 1993), where the Kansas Supreme Court held that the legislature's intent in crafting the statute allowing combined reporting was clearly to require domestic combination].

Kansas provides a deduction from its tax base for amounts included in federal taxable income pursuant to the provisions of IRC § 78 and 80% of dividends received from corporations incorporated outside the U.S [Kan. Stat. Ann § 79-32,138(c)(v) and (vi)]. Informal conversations with the Kansas Department of Revenue indicate that IRC Subpart F income also receives the 80% deduction under this provision.

By having Wal-Mart Stores, Inc. contribute its non-appreciated "portfolio interest" generating assets to an existing or new controlled foreign corporation ("CFC") that is tax-favorably domiciled inside or outside the U.S., 80% of resulting IRC Subpart F income may be deducted from Wal-Mart's Kansas unitary combined tax base.

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In addition, it is intended that the CFC be excluded from Wal-Mart's Kansas unitary combined filing group. Other unitary combined filing states (although not all-inclusive) that may provide tax-preferred treatment for IRC Subpart F income include: Alaska, Arizona, Illinois, Maine, Minnesota, Montana, Nebraska and Utah. In addition, this strategy may also result in Arkansas tax savings for Wal-Mart Stores, Inc. Consideration should be given to the tax effects of the loss of sales factor denominator values associated with the investment income in relevant unitary states.

Cash generated by the CFC from its investment portfolio may also be loaned back to the federal Form 1120 filing group, creating interest deductions on certain unitary combined returns and intercompany interest income for the CFC (with the similar intent of creating IRC Subpart F income).

This strategy is intended to be neutral at the federal and international tax level. Thus, the strategy is limited to "portfolio interest" generating assets and intercompany interest income since U.S. withholding taxes can be avoided on these types of assets (assuming appropriate country of incorporation and location of domicile is utilized). It is important that appropriate federal and international tax personnel be consulted in qualifying this strategy based on Wal-Mart's federal and international tax objectives. Accordingly, further analysis should be performed to avoid adverse federal income tax issues on implementation (e.g., withholding tax, loss of foreign tax credit due to FTC sourcing, etc.).

Key Implementation Steps

- Confirm expected amounts of state taxable investment income to be earned by federal Form 1120 filing group for next several years.
- Confirm state tax objectives of strategy are feasible with Wal-Mart's Treasury Department.
- Confirm state tax objectives of strategy do not run contrary to federal and international tax objectives.
- Conduct remaining research to determine all unitary states in which strategy may qualify for intended benefits.
- Identify existing CFC or form new CFC to "house" investment portfolio.
- Determine optimum commercial domicile for CFC.
- Transfer investment portfolio to CFC.
- Educate appropriate accounting personnel on maintaining bookkeeping requirements of strategy.

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DMLLC Structure – Pennsylvania Capital Stock/Franchise Tax

Executive Summary

USE OF DUAL-MEMBER LIMITED LIABILITY COMPANY ("DMLLC") TO REDUCE PENNSYLVANIA CAPITAL STOCK/FRANCHISE TAX

Benefit Summary

By segregating Pennsylvania operations into a separate DMLLC taxed as a partnership for federal income tax purposes, an opportunity exists to reduce Pennsylvania capital stock/franchise ("CSF") tax.

Tax Analysis

TAXATION OF LLC

Taxpayers for CSF tax purposes include LLCs, corporations, business trusts and certain other entities. The CSF tax is based upon a taxable entity's capital stock value, which is determined under a formula that considers the entity's "average net income" and "net worth." Average net income is the entity's book net income or loss as reported for federal income tax purposes for the current and prior four years, divided by five. Further, a new entity is formed, its book net income history starts anew. Net worth is the sum of the entity's capital stock, surplus and undivided profits as set forth on its federal income tax return. [72 P.S. § 7601]

Distributions by the LLC will directly reduce the book income and overall equity of the LLC, the components upon which Pennsylvania CSF tax is computed. In the case of an LLC that is taxable as a partnership for federal income tax purposes, Pennsylvania's CSF tax law provides that in determining an LLC's average net income, its net income is reduced by the amount of distributions made to any member deemed to be materially participating in the LLC's activities for purposes of IRC § 469. Distributions made to an LLC member within 30 days after the end of a year can be treated as having been made in the preceding year. [72 P.S. § 7601(a)]

Reducing net income by distributions made to members who materially participate in the activities of the LLC can serve to reduce or eliminate its CSF tax so long as the LLC is taxed as a partnership for federal income

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Illinois "Sales Finance Company" – Credit Card Company

Executive Summary

USE OF A "FINANCIAL ORGANIZATION" TO REDUCE ILLINOIS TAX BASE

Benefit Summary

Illinois Income Tax Act ("IITA") §1501(a)(27) defines a "unitary business group" to include only corporations subject to the same apportionment methodology as proscribed in IITA §304. Since general and financial organizations are subject to different apportionment methodologies, the Illinois tax base can be reduced to the extent income can be shifted to a non-Illinois financial organization. By forming a "sales finance company" to purchase credit card receivables, Illinois income tax savings can be realized by excluding the "sales finance company" from the Illinois unitary group. A tax effective structure isolates future interest income from the Illinois unitary group and certain separate return states.

Tax Analysis

IITA §1501(a)(27) provides that "[I]n no event . . . will any unitary business group include members which are ordinarily required to apportion business income under different subsections of Section 304." Financial organizations apportion their business income pursuant to subsection (c) of IITA §304. General corporations, on the other hand, apportion their business income pursuant to the rules contained in subsections (a) and (h) of IITA §304.

IITA §1501(a)(8) defines a "financial organization" by listing several entities, one of which is a "sales finance company." A "sales finance company" is defined broadly to include any person:

- Primarily engaged in the business of purchasing customer receivables;
- Making loans upon the security of customer receivables. . . .

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IITA §1501(a)(8) defines "customer receivables" as "an installment, charge, credit, or similar contract or agreement arising from the sale of tangible personal property or services in a transaction involving a deferred payment price payable in one or more installments subsequent to the sale:..."

Under 86 Ill. Adm. Code ("Ill. Reg.") §100.9710(d)(10)(c), the "primarily" test is satisfied if more than 50% of the company's gross income is from services characteristic of a sales finance company. Accordingly, a corporation that buys credit card receivables may qualify as a financial organization, resulting in its earned interest income escaping Illinois and separate return state income tax, provided the sales finance company does not have nexus in these states. If the sales finance company establishes nexus with Illinois, savings are still attainable to the extent the interest income is not received in Illinois under IITA §304(c)(1)(C).

Key Implementation Steps

- Determine feasibility of a "sales finance company" for Illinois tax purposes.
- Form "sales finance company" to purchase credit card receivables from affiliates.
- Consider internal sale versus external securitization.
- Consider customer impact of sending payments to affiliate.
- Consider accounting treatment, cash flow transfer, receivable valuation and bad debt procedures.
- Formalize intercompany relations through executed contracts.
- Avoid nexus in Illinois for "sales finance company."

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Stapled Stock Entity – Exclusion from Kansas Unitary Group

Executive Summary

USE OF A STAPLED STOCK ENTITY TO REDUCE KANSAS (AND CERTAIN OTHER UNITARY STATES) TAX BASE

Benefit Summary

This strategy should reduce Wal-Mart's taxable income in Kansas and certain other unitary states by shifting income to an entity that is not included in the unitary filing group.

Tax Analysis

While Kansas statutes do not specifically provide for combined reporting, the statutes do empower the Director of Taxation to allocate income and expenses among related taxpayers if necessary to properly reflect income. [Kan. Stat. Ann. § 79-32,141, and Kan. Admin. Regs. 92-12-77] The Director has used, and the courts have upheld, this power to require combined reporting for unitary businesses. However, this power only extends to corporations incorporated in the United States, thereby making Kansas' combined report what is typically called a "domestic" combined report. [See *In The Matter Of The Appeal Of Morton Thiokol, Inc.*, 254 Kansas 23, 864 P.2d 1175 (Kan. 1993), where the Kansas Supreme Court held that the legislature's intent in crafting the statute allowing combined reporting was clearly to require domestic combination]

Since entities incorporated in jurisdictions outside of the U.S. are not included in the Kansas combined report, to the extent income can be shifted from an entity included in the Kansas combined report to a foreign stapled corporation (through leveraging or other finance activities, factoring, etc.), such income can be removed from the Kansas tax base. It is also possible to use this strategy to transfer Kansas apportionment factors to the foreign stapled corporation as long as it earns modest income.

Other domestic combination states (although not all-inclusive) in which this strategy may provide benefit include Nebraska and Oregon. Assuming the stapled entity is domiciled outside the U.S., additional unitary combined filing states (although not all-inclusive) that may exclude the stapled entity from the unitary group

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include Illinois and Minnesota. This strategy may also yield benefits in states where Wal-Mart has made consolidated return elections.

The stapled stock arrangement requires that the stock of one corporation cannot be transferred without transferring the stock of the other corporation. [IRC § 269B(c)(3)] Thus, the foreign stapled corporation would be "stapled" to a U.S. affiliated corporation within Wal-Mart's group. By stapling the stock of the foreign corporation to the stock of the domestic corporation, the foreign corporation should be treated as a domestic corporation for most purposes of the Internal Revenue Code, except for inclusion in the federal consolidated income tax return. [IRC § 269(a)(1)] In order to qualify for this treatment, at least 50% of the interests in the foreign corporation must be "stapled" to the stock of the domestic corporation. [IRC § 269B(a)(1)] The use of a stapled stock arrangement may also allow for transferring appreciated assets to the foreign corporation without triggering the outbound tax under IRC §367, and may also achieve certain federal income tax objectives.

It is important to note that only 80% of the dividends received from the foreign stapled corporation will be deductible as a dividends received deduction under IRC § 243. Thus, proper planning must be in place to assure the strategy does not increase Wal-Mart's federal income tax liability. This might be achieved by loaning cash back, avoiding dividends and developing an optimum exit strategy.

Note that in a "post-Enron" environment and amidst the focus on "tax haven" operations, this strategy is expected to get more scrutiny by the IRS, as well as some states. Issues include debt versus equity, zero-basis, deemed dividend and the potential for a defeated stapling. E&Y has also recently learned that the IRS has issued administrative guidance analyzing the viability of tax benefits arising from stapled stock structures under IRC § 269B and I.R.S. Notice 89-24, 1989-1, C.B. 660. This guidance has not yet been published, but is expected to be published shortly. The focus of this guidance will likely to be to challenge this type of planning based on lack of business purpose and economic substance regardless of the IRS' recent lack of success in the courts on these specified types of issues. [See, e.g., *Compaq Computer Corp. v. Commissioner*, 277 F.3d 778 (5th Cir. 2001); *United Parcel Service of America, Inc. v. Commissioner*, 254 F.3d 1014 (11th Cir. 2001) and *IES Industries v. United States*, 253 F.3d 350 (8th Cir. 2001).]

Key Implementation Steps

- Identify assets/operations to transfer to the stapled entity.
- Confirm state tax objectives of strategy do not run contrary to federal and international tax objectives.
- Conduct remaining research to determine all unitary states in which strategy may qualify for intended benefits.

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- Determine optimum commercial domicile of stapled entity.
- Prepare Transfer Pricing Report to substantiate pricing of intercompany transactions.
- Formalize intercompany relations through executed contracts.
- Avoid nexus in Kansas for stapled entity.
- Determine appropriate exit strategy.

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Additional Considerations

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Multistate Strategies

IRC § 118 Treatment of Incentives & Credits - Currently, Wal-Mart receives various incentives and credits to establish business operations in a particular location or as an inducement to hire additional employees. These economic development incentives, which are provided by community groups, local jurisdictions, or state governments, come in a number of forms including land, cash grants for general or specified uses, and tax subsidies such as refunds, credits and abatements of various taxes. The taxable income generated by these incentives is potentially eligible for long-term deferral under the provisions of IRC § 118. Assuming that IRC § 118 does apply to an economic development incentive, the manner in which IRC § 362(c) is utilized to reduce the basis of related property has a substantial impact on the extent of the available tax savings. The claiming of IRC § 118 with respect to economic development incentives furnished in the form of credits and other tax subsidies may allow for the filing of refund claims or the adoption of the position on current and future returns without the necessity of filing a request for change of method or the need to alter existing agreements or transactions in any way.

State Specific Strategies

Arkansas

Revised Apportionment Methodology for Sales Other Than Sales of Tangible Personal Property - Arkansas statutes provide for the assignment of receipts arising from sales other than sales of tangible personal property using its income-producing activity test. [Ark. Code Ann. § 26-51-717] Through the use of a revised apportionment methodology, a taxpayer's sales factor may be reduced.

California

Financial Corporation - This strategy reduces California franchise tax for companies having significant income from accounts receivable and lease financing activities. A California taxpayer creates an out-of-state subsidiary domiciled in a tax-advantaged state that will be treated as a financial institution for California purposes. The accounts receivable and/or lease financing functions are transferred to the subsidiary. Since a financial corporation in California includes a variety of intangibles in its property factor and is included in a combined filing with other non-financial unitary affiliates, this strategy dilutes the California combined property factor.

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Illinois

Joyce Planning - Through evaluation of open Illinois Income and Replacement Tax returns, a taxpayer can determine whether Illinois destination sales are included in the numerator for unitary affiliates that otherwise did not have taxable nexus in Illinois. Illinois follows the "Joyce Rule" established by the California State Board of Equalization in *Appeal of Joyce Inc.* to determine if the activity of a nonresident is sufficient to create nexus. [*Hartmarx Corporation and Subsidiaries*, 309 Ill. App. 3d 959 (1999)] Under Ill. Reg. §100.9720(c)(1)(C), "a person shall not be considered to have engaged in business activities with a state during any taxable year merely by reason of sales in such state. . . " Accordingly, only activity conducted by a nonresident taxpayer, and not other members of the Illinois unitary business group, will be considered for purposes of determining if Illinois destination sales should be included in the numerator of the Illinois sales factor.

Treasury Department Operations - By performing substantial gross receipts generating treasury operations outside of Illinois, the Illinois unitary group's sales factor denominator may be dramatically increased. A substantial increase in the sales factor denominator would reduce the overall apportionment percentage and the Illinois apportioned tax base. In the Circuit Court of Cook County, on a motion for Partial Summary Judgment, the Court held that the composition of the sales factor, as set forth in 35 ILCS 5/304(a)(3)(A), is a fraction, in the numerator of which is the total sales of the person in this State during the taxable year, and the denominator of which is the total sales of the person everywhere during the taxable year. Furthermore, the term "sales" is defined in 35 ILCS 5/1501(a)(27) as "all gross receipts of the taxpayer not allocated under Section 301, 302, and 303." Accordingly, the sales factor should include the gross receipts from treasury operations and not the net gain.

Kansas

Maximizing Personal Property Tax Credit - Kansas provides a refundable credit against the Corporate Income Tax liability of a taxpayer equal to 15% of the property tax levied on certain commercial and industrial machinery and equipment. Kansas statutes define commercial and industrial machinery and equipment as property classified for property taxation purposes pursuant to section 1 of article 11 of the Kansas constitution in subclass (5) or (6) of class 2 and machinery and equipment classified for such purposes in subclass (2) of class 2 [Kan. Stat. Ann. § 79-32,206]. These classes include commercial and industrial machinery and equipment used for income-producing purposes such as manufacturing equipment, cash registers, computers, copiers, furniture, refrigeration equipment, gas pumps, medical equipment, construction

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equipment, and other tangible personal property used for profit. The credit may be claimed on amended corporate income tax returns as Kansas has a three-year statute of limitations.

Minnesota

Foreign "Disregarded" Limited Liability Company - A taxpayer can exclude the income and apportionment factors of a single-member limited liability company ("Foreign SMLLC"), which is organized outside of the United States, from the Minnesota unitary reporting group. As an eligible entity under federal "check-the-box" regulations, Foreign SMLLC will be disregarded for federal income tax purposes and will be treated as a division of its Parent. Under this strategy, a Parent corporation contributes income-producing assets to Foreign SMLLC. The income and related apportionment factors from the income producing assets should be excluded from the Minnesota unitary group since Minnesota treats Foreign SMLLC as an entity separate from its parent since it's a foreign (i.e., outside of the United States) organized entity. [Minnesota Revenue Notice 98-08 (May 26, 1998)] Accordingly, if Foreign SMLLC does not have a connection with Minnesota sufficient to create nexus on its own, then Foreign SMLLC should not report income subject to Minnesota franchise tax. This strategy may also integrated into the Domestic CFC Planning discussed in detail above.

Pennsylvania

Investment in U.S. Treasury Securities - Taxpayers may elect (annually) to use the single factor apportionment formula based upon total assets to determine the taxable capital stock value. US Treasury securities are specifically exempt from the numerator of the single factor apportionment formula [61 PA. Code ("Penn. Reg.") §155.10(d)(5); *See:* 31 U.S.C. §3124 (federal immunity from state taxation)] Neither the statute nor the regulations require the amount of such assets to be offset by any liabilities incurred to purchase the securities.

Philadelphia Business Privilege Tax - With the Philadelphia Business Privilege Tax, a taxpayer which engages in manufacturing, wholesaling and/or retail sales can utilize an alternative method for computing the tax on gross receipts. A taxpayer who elects to use an alternative method of computing the tax on receipts may deduct not only the cost of goods but also the cost of labor applicable to such receipts. "Cost of goods" includes expenses such as freight charges, direct costs for independent contractors, container and packaging costs and the actual cost of goods purchased for resale. "Cost of labor" includes costs such as salaries, wages, employment taxes, worker's compensation premiums medical and dental insurance premiums, employer contributions to retirement plans, and uniform and tool allowances. Additionally, taxpayers that are filing an

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initial tax return have the opportunity to make a one-time election with the Net Income Method on the Business Privilege Tax Return. The two Net Income Methods include the use of: 1) net profit (or loss) from the operation of a business according to the accounting system of the business or 2) net profit (or loss) properly reported to the federal government. This one-time election is an irrevocable election which must be used in all subsequent years.

Other Considerations

Tax Savings Achieved Through Intercompany Charges

Contract Retailing/Warehousing/Distribution - This strategy minimizes state taxes in separate filing states by isolating a taxpayer's nexus-creating activities (such as retail stores, warehousing, distribution activities, etc.) into companies with controlled profits, while shifting income to an entity with limited nexus and a low effective tax rate. Appropriate transfer pricing accomplishes such controlled profits. This strategy also may be employed as an apportionment factor engineering or "factor trap" strategy.

"Sales Finance Company" - Charging Intercompany Interest - By forming a "sales finance company" capitalized with intercompany note receivables due from subsidiaries, tax savings can be realized by excluding the "sales finance company" from the Illinois unitary group. A tax effective structure isolates the targeted intercompany interest income from the Illinois unitary group while the accompanying intercompany interest expense remains within the Illinois unitary group thus reducing the tax base.

IITA §1501(a)(8) defines a "financial organization" by listing several entities, one of which is a "sales finance company." A "sales finance company" is defined broadly to include, among other qualifications, any person primarily engaged in:

- Making loans upon the security of customer receivables; or
- Making loans for the express purpose of funding purchases of tangible personal property or services by the borrower. ...

Under Ill. Reg. §100.9710(d)(10)(c), the "primarily" test is satisfied if more than 50% of the company's gross income is from services characteristic of a "sales finance company." Accordingly, a corporation that lends funds to related parties that are secured by customer receivables or for the express purpose of funding purchases of tangible personal property or services may qualify as a financial organization, resulting in its

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earned interest income escaping Illinois income tax, provided the Illinois "sales finance company" does not have nexus in Illinois or the income is not received in Illinois should nexus exist.

Internal Leveraging - Reduce Pennsylvania corporate net income tax ("CNI") - By segregating Pennsylvania operations into a separate corporate entity, an opportunity exists to reduce Pennsylvania corporate net income tax ("CNI") and Pennsylvania capital stock/franchise tax ("CSF"). The new Pennsylvania separate corporation ("Newco") will be subject to Pennsylvania CNI and CSF taxes. Although subject to these corporate taxes, Newco's tax bases for these taxes will be greatly reduced by intercompany transactions with its parent company. For example, Newco can be capitalized by a high degree of debt from its parent company. This high degree of debt from its parent company along with other contractual arrangements will allow Newco to strip earnings with management fees, interest payments on the debt and royalty charges. These management fees, interest payments and royalty charges will serve as expenses that will offset the income of Newco and reduce its income bases used for calculating Pennsylvania CNI tax. The same expenses will also reduce its book income base used for calculating Pennsylvania CSF tax.

Subsidiary Investment/Loan to Parent - Through the use of substantial investment in a captive finance subsidiary or Delaware investment company and intercompany loan, Pennsylvania capital stock/franchise ("CSF") tax savings are achieved by reducing (1) Wal-Mart Stores East, LP ("East LP") taxable assets percentage and (2) separate-company book income. Pennsylvania corporate net income tax savings (and certain other separate-entity state corporate income taxes) can also be achieved by reducing taxable income from interest expenses paid on the intercompany loan.

First, East LP would secure a short-term loan from a unrelated third-party bank in which East LP would contribute the loan proceeds to a captive finance subsidiary or Delaware investment company. Second, the captive finance company or Delaware investment company will make an intercompany loan to East LP in which East LP will make interest payments to the captive finance company or Delaware investment company.

It is critical for East LP to be filing under the single factor apportionment for CSF purposes which can be elected annually. Certain assets are specifically exempt under Pennsylvania law for single factor apportionment purposes. For example, in the case of a corporation owning, directly or through subsidiaries or subsidiary corporation, a majority of the total issued and outstanding shares of voting stock of a corporation, shares of stock owned in the other corporation are exempt [72 P.S. §1894 (Act of April 20, 1927, P.L. 311, No. 177); Penn. Reg. §155.10(d)(3)(iv)] Because investments in subsidiary corporations are treated as exempt assets, a corporation that is utilizing single factor apportionment to calculate its Pennsylvania capital

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stock/foreign franchise tax liability may exclude from its numerator of the apportionment calculation its investment in subsidiary corporations [Penn. Reg. §155.10(f)].

Other Structural Considerations

SMLLC Isolation Strategy - This is a very aggressive strategy with considerable risk. Taxpayers may be able to isolate its high profit out-of-state operations from California tax by transferring its California nexus-producing operations into an SMLLC with an out-of-state corporate member. Assuming the out-of-state corporate member does not consent to California's taxing jurisdiction, thus resulting in the SMLLC paying California tax on a stand-alone basis, there may be an opportunity to sever nexus for the corporate member and the remainder of its affiliated group with no other California contacts. The tax base of the SMLLC would need to be managed with various intercompany charges. Depending on specific fact patterns, other operations could be transferred into the SMLLC as well. If the "no-nexus" position for the out-of-state corporate member and the remainder of the affiliated group is defeated, a fall-back position may involve avoiding California numerator apportionment factor values from rolling up into the out-of-state corporate member. Both of these positions carry significant risk given California taxation principles addressed in the recent *Valentino* decision from the California Court of Appeals in March, 2001.

Disaffiliation - In states that define membership in a combined / unitary or consolidated group ("the group") in terms of ownership or control of voting stock or voting power, either the combined tax base or the combined apportionment ratio of a "commonly-controlled group" ("common or combined group") can be reduced by removing Target from the common group. To achieve this, the common group must transfer either direct or constructive ownership of stock possessing at least 50% of Target's voting power to one or more unrelated 3rd parties. This may be accomplished either through: (1) transfer of adequate Target voting stock to an unrelated 3rd party; or (2) contribution of Target voting stock to a limited partnership or an irrevocable voting trust in which the general partner or the trustee, respectively, is an unrelated 3rd party.

Captive Insurance Company - Both Arizona and California tax "insurance companies" based on premiums in lieu of income. In addition, both states exclude "insurance companies" from membership in a combined return. As a result, to the extent income and / or instate apportionment values can be transferred to an "insurance company," both Arizona and California (and other unitary state) tax can be reduced.

Arkansas Dual-Member Limited Liability Company - By forming a dual member limited liability company that elects to be treated as a corporation for federal income tax purposes, a taxpayer may be able to convert taxable operating income earned in Arkansas to non-taxable dividends.

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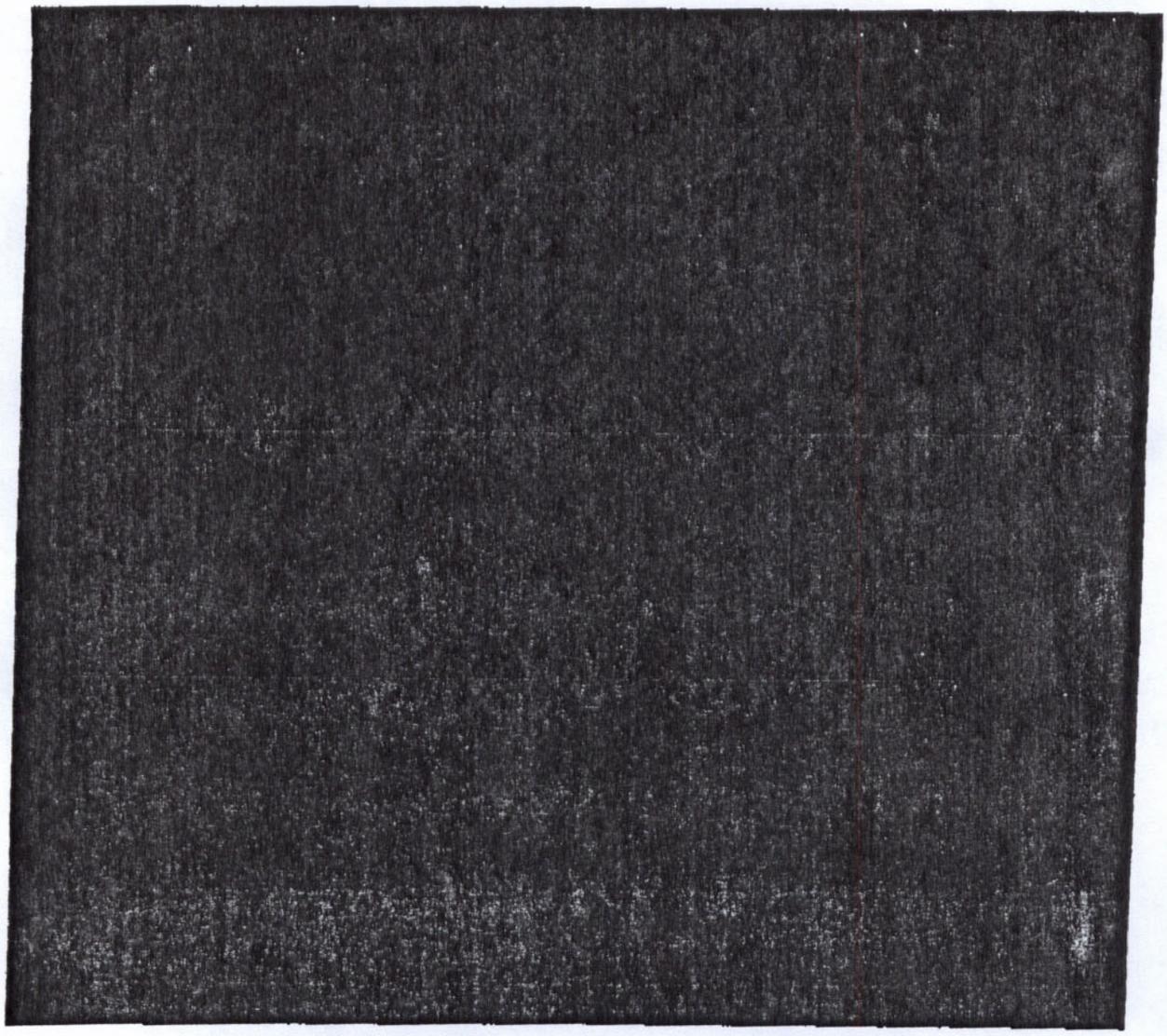

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