Legislative Fiscal Bureau

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May 27, 2009 Joint Committee on Finance Paper #375

Sales and Use Tax Treatment of Disregarded Entities (General Fund Taxes -- General Sales and Use Tax)

[LFB 2009-11 Budget Summary: Page 276, #1]

CURRENT LAW

A disregarded entity is a separate entity from its owner, but the disregarded entity and its owner are treated as a single entity for income or franchise tax purposes. Businesses may establish separate entities from their owners, such as single-member limited liability companies (LLCs), for liability reasons; so that if the business is sued, the owner would not be liable for the lawsuit. The owner then chooses to disregard these separate entities for the purposes of the business owner's income or franchise tax return.

Under current law, the owner of a single-owner entity that is disregarded as a separate entity for purposes of the income or franchise tax is regarded as a separate entity for purposes of the sales and use tax. According to the Department of Revenue (DOR), separate entity treatment under the sales and use tax for disregarded entities has encouraged some businesses to engage in a number of tax avoidance strategies, some of which have become common practice. Some examples are described below:

Separate Transportation Companies. An owner entity may create a separate transportation company solely to haul products for the owner. In the absence of the separate company, the owner would owe tax on its purchases of trucks, trailers, and other hauling equipment. However, the separate transportation company would qualify for the sales tax exemption for vehicles purchased by common or contract carriers.

Sales for Resale. The sales and use tax is imposed on sales at retail. Purchases of merchandise by sellers for resale are exempt from the tax. DOR indicates that business owners may establish a separate entity to purchase items for resale to the owner for $1, which results in the sales tax being imposed on the final sale for $1 rather than on the original purchase price of the items.

Construction Contractors. Under current law, construction contractors are required to pay the sales tax on materials they purchase and use in real property construction, even if the structure is sold to a governmental unit or other exempt entity. DOR indicates that contractors may create separate supply companies that purchase the materials and then resell them to the exempt entity for which the structure is being built. Such arrangements result in the materials remaining untaxed since the supply company purchases the materials without tax for resale, and the sale of the materials to the exempt entity is not taxable.

GOVERNOR

Provide that a single-owner entity that is disregarded as a separate entity for income or franchise tax purposes would also be disregarded as a separate entity for sales and use tax purposes. The proposal would eliminate the ability of parent companies to avoid the sales and use tax for purchases made by subsidiary entities which would have been taxable if the separate entities were disregarded for purposes of the sales and use tax. The proposal would become effective on the day after publication of the budget bill. Assuming an effective date of July 1, 2009, the administration estimates that the proposal would increase sales and use tax revenue by $19,800,000 in 2009-10 and $21,000,000 in 2010-11.

DISCUSSION POINTS

1. Under federal law, disregarded entities separate from their owner, such as LLCs, are disregarded as separate entities for federal income tax purposes as the assets, liabilities, income, loss, and other tax attributes of these companies are combined with those of its owner. Disregarding separate entities simplifies federal income tax reporting of business operations for owners of multiple separate entities, and often reduces overall federal income and franchise tax liability.

2. Under current law as enacted in 1997 Act 27, Wisconsin disregards separate entities for purposes of the income and franchise tax; however, Wisconsin treats a disregarded entity as a separate entity from its owner under the sales and use tax. For the purposes of reporting and collecting the sales and use tax, current law requires the owner of separate entities that are disregarded for purposes of the income or franchise tax to file a single sales and use tax return, which includes all entities. [It should be noted that in a separate provision of the budget bill, the Governor has proposed that owners of disregarded entities for the purposes of the income or franchise tax may elect to file separate electronic sales and use tax returns for each disregarded entity.]

3. According to Commerce Clearing House publications, the majority of states have conformed to the federal income and franchise tax rules disregarding separate entities for the purposes of state income and franchise taxes. Similar to current Wisconsin law, most other states have continued to treat entities disregarded for purposes of the income and franchise tax as separate

entities for purposes of the sales and use tax. However, some states, such as Alabama, Connecticut, Kansas, and Tennessee, have statutes that broadly conform to the federal classification of separate single-owner entities as disregarded entities for all state and local tax purposes. A few states, such as Missouri, have adopted the federal classification of single-owner entities specifically for purposes of the sales and use tax. Other states, such as South Carolina, have relied on their Department of Revenue's ruling that separate single-owner entities would be ignored for sales and use tax purposes.

4. In 1998, DOR published a private letter ruling concerning the sales and use tax treatment of separate entities that are disregarded for purposes of the income and franchise tax. The ruling explicitly defined that a transfer of ownership of property between disregarded entities was a "sale" for purposes of the sales and use tax. Therefore, a disregarded entity would be required to hold a seller's permit for sales made to another disregarded entity; however, a sale made by an unrelated seller to one disregarded entity, which was subsequently sold to a second disregarded entity, would be considered a sale for resale in the first instance and a taxable final sale in the second instance.

5. According to DOR, the current law treatment of disregarded entities has been established for over a decade and has allowed corporations time to engage in strategic tax planning to avoid the sales and use tax. The Department's estimated fiscal effect of the Governor's proposal assumes that these types of tax avoidance strategies have reduced sales and use tax collections by approximately 0.5% of total collections per year. It is difficult to estimate the exact amount of sales tax revenue that is avoided and not collected through these tax avoidance strategies, as owners of disregarded entities do not volunteer the amount of tax that would have been paid if the disregarded entities were treated as one entity under the sales and use tax. The assumed fiscal estimate appears reasonable.

6. In recent years, the Legislature has passed a number of provisions designed to prevent businesses from structuring their operations so as to avoid Wisconsin income and franchise taxes by shifting income to affiliated firms located in other states or using transactions with affiliated firms to create deductible expenses in Wisconsin. For example, 2007 Act 20 included additional disclosure requirements and penalties for taxpayers and their advisors that engage in tax avoidance strategies. 2007 Act 226 required Wisconsin businesses to add back to Wisconsin income interest and rent expenses paid to affiliated entities if there is not a legitimate business purpose for the expenses. 2009 Act 2 expanded the Act 226 provisions to also include management fees and intangible expenses. Act 2 also requires combined reporting, for income and franchise tax purposes, by companies that are engaged in a unitary business with one or more other corporations beginning with tax year 2009. The disregarded entity provisions recommended by the Governor in AB 75 would be consistent with these recent law changes and other efforts by DOR to prevent the use of tax avoidance strategies.

7. An argument could be made that the owner of a smaller company, which does not have the resources to engage in tax planning, is at a competitive disadvantage as compared to a larger corporation under current law. Smaller companies may not have the knowledge or resources to structure their business operations to establish separate entities for sales tax planning purposes, as

compared to larger companies. A counter-argument could be made that larger companies have already invested time and resources to structure their business operations with respect to the current statute and DOR's ruling on separate single-owner entities. Companies may not have invested the time and resources to structure business operations as such if they had assumed that the current law treatment of separate entities under the sales tax would change.

8. DOR has requested the following three modifications:

a. Specify that the disregarded entity provisions would take effect on July 1, 2009, or the day following publication of the budget bill, whichever is later.

b. Clarify that purchases made prior to the effective date of the disregarded entity provisions would be treated as provided under current law.

c. Specify that purchases of building materials, if the materials are affixed and made a structural part of real estate and the amount payable to the contract is fixed without regard to the costs incurred in performing a written contract that was irrevocably entered into prior to the effective date of the disregarded entity provisions, or that resulted from the acceptance of a formal written bid accompanied by a bond or other performance guaranty that was irrevocably submitted before the effective date of the disregarded entity provisions, would not be subject to the proposed change in sales tax treatment.

DOR has requested the change to the effective date to prevent the change in treatment of separate entities under the sales and use tax from becoming effective prior to July 1, 2009. The additional two requested modifications are to prevent the sales and use tax from being imposed on purchases made prior to the effective date of the disregarded entity provisions, and to prevent the imposition of the sales tax on purchases made pursuant to contracts which were agreed upon and cannot be rebid on to account for the entity's proposed change in tax treatment.

ALTERNATIVES

1. Approve the Governor's proposal with modifications to include the two transitional provisions and the proposed change in the effective date as described above in Discussion Point #8.

2. Delete provision.

ALT 2	**Change to Bill** Revenue
GPR	- $40,800,000

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