

100th Anniversary of the 16th Amendment

by Victoria Lau
SJSU MST Student

“ARTICLE XVI. The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration.”

February 3, 2013 marks the 100th anniversary of the 16th Amendment. This article explains why lawmakers proposed the 16th Amendment and the legislative process for it to become part of the U.S. Constitution.

Why was it proposed?

The 16th Amendment authorizes Congress to levy income tax without reference to the States' population. Congress, however, first imposed an income tax in 1862 primarily to raise revenue for the Civil War.¹ The Tax Act of 1862 also established the Office of the Commissioner of Internal Revenue² to supervise the collection and assessment of tariffs and income tax. These early tax acts included sunset dates and lawmakers allowed these first income taxes to expire in 1872. The Federal government relied on consumption taxes in the form of tariffs as its main source of revenue.

Over twenty years later in 1894, during President Cleveland's administration, an income tax at a rate of 2% on incomes over \$4,000 was enacted. This led to the Supreme Court decision in *Pollock v. Farm Loan and Trust Co.*³ which held that the uniform tax imposed by Congress was unconstitutional as a direct tax on land that was not apportioned among the States based on population. The Court formed its opinion based on its interpretation of two clauses of the Constitution: Article I, Section 2 that “representatives and direct Taxes shall be apportioned among the several States which may be included within this Union, according to their respective Numbers,” and Section 9 that “No Capitation, or other direct, Tax shall be laid, unless in Proportion to the Census.”

Many lawmakers at the time believed that the ruling was erroneous and, given an opportunity, the Court would distinguish or reverse *Pollock*.⁴ However, President Taft urged Congress to propose a constitutional amendment rather than pass another income tax bill to directly challenge the Supreme Court. Taft was concerned that such a dare would weaken the Supreme Court and harm its prestige.⁵ He would later be nominated by President Harding to serve as Chief Justice (1921 to 1930).

¹ 1861-1865: The Civil War. Tax Analysts Tax History Museum. Web 6 Feb 2013
<http://www.taxhistory.org/www/website.nsf/Web/THM1861?OpenDocument>.

² Commonly referred to as the Bureau of Internal Revenue; it was formally designated the IRS in 1953. See Records of the Internal Revenue Service. National Archives. Web 6 Feb 2013 < <http://www.archives.gov/research/guide-fed-records/groups/058.html#58.1>>

³ *Pollock v. Farm Loan and Trust Co.*, 158 U.S. 601, (1895).

⁴ Joseph Thorndike, *Why Repealing the 16th Amendment Probably Wouldn't Matter*. Tax Analysts Tax History Project, 13 September, 2013. Web 6 Feb 2013

<<http://www.taxhistory.org/thp/readings.nsf/ArtWeb/E3A711293C13EF8685257A8500487713?OpenDocument>>

⁵ Akhil Reed Amar. *America's Constitution*, 409 (2006).

How was it ratified?

Amendments to the U.S. Constitution must either be proposed by Congress with a two-thirds majority vote in both the House of Representatives and the Senate, or by a constitutional convention called for by two-thirds of the State legislatures.⁶ The 16th Amendment, like the other 26 amendments to the Constitution, was proposed by joint resolutions from Congress. It was unanimously passed by the Senate on July 5, 1909 and by the House a week later on July 12. Proposals for constitutional amendments do not require Presidential approval.

The proposed amendment must then be ratified by three-fourths of the State legislatures for it to become part of the Constitution. The federal income tax on individuals was gaining popularity by this time, but it still took 1,302 days for it to move through the States' legislatures. On February 3, 1913, New Mexico became the 36th State to ratify the amendment to meet the three-quarter threshold.⁷ There were only 48 states in the Union in 1913. New Mexico and Arizona joined in 1912 after the 61st Congress proposed the amendment. Alaska and Hawaii did not gain statehood until 1959 to make up the current 50 states in the Union.

On February 25, 1913, during the last week of the outgoing Taft Administration, Secretary of State Knox signed the proclamation to declare the ratification of the Amendment. President Wilson took office on March 4, 1913 and the 63rd Congress enacted the Tariff Act on October 3, 1913.

The 1913 Act introduced a normal income tax of 1% on net income with a personal exemption set at \$3,000 and a 6-tier additional tax with a top rate of 6% on net income exceeding \$500,000.⁸ In 2012 dollars, an individual would be liable for 1% income tax on income exceeding \$69,500 and 7% on income in excess of \$11.6 million.⁹

1913 Tax Form (<http://www.ourdocuments.gov/doc.php?flash=true&doc=57>)

In 1916, 437,000 taxpayers filed a tax return.¹⁰ This number increased to 142,890,000 by 2010; ¹¹ a 300 fold increase in the 100 years since Congress was first given the authority to impose an income tax.

⁶ The Constitutional Amendment Process. National Archives. Web. 6 Feb. 2013 <<http://www.archives.gov/federal-register/constitution/>>

⁷ House Doc. 110-50, The Constitution of the United States As Amended, 25 July, 2007 <<http://www.gpo.gov/fdsys/pkg/CDOC-110hdoc50/pdf/CDOC-110hdoc50.pdf>>

⁸ Section §II(A)(1) and (2) of the Tariff Act of October 3, 1913 on Imports into the United States, Washington GPO 1913. Reproduced by the Connell University Library on OpenLibrary.org <<http://archive.org/stream/cu31924014051373#page/n1/mode/2up>>

⁹ As calculated by the CPI Inflation Calculator provided by the Bureau of Labor Statistic. Web 6 Feb, 2013 <<http://data.bls.gov/cgi-bin/cpicalc.pl>>

¹⁰ Federal Individual Income Tax Returns with Zero or Negative Tax Liability, 1916-2010. Tax Foundation. Web 6 Feb 2013 <http://taxfoundation.org/article/federal-individual-income-tax-returns-zero-or-negative-tax-liability-1916-2010>

¹¹ SOI Tax Stats – Individual Income Tax Returns Publication 1304. Web 6 Feb, 2013 <[http://www.irs.gov/uac/SOI-Tax-Stats-Individual-Income-Tax>Returns-Publication-1304-\(Complete-Report\)#_pt1](http://www.irs.gov/uac/SOI-Tax-Stats-Individual-Income-Tax>Returns-Publication-1304-(Complete-Report)#_pt1)>

Global, US, California and the The Bay Area Economies

Jon Haveman

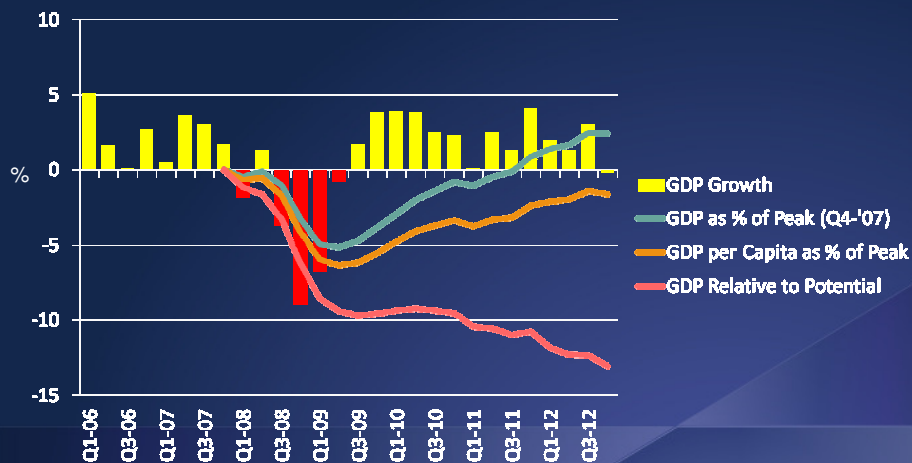
Chief Economist, BAC Economic Institute

March, 2013

The Great Recession

1-2 Punch of Credit Crisis and Consumer Retrenchment

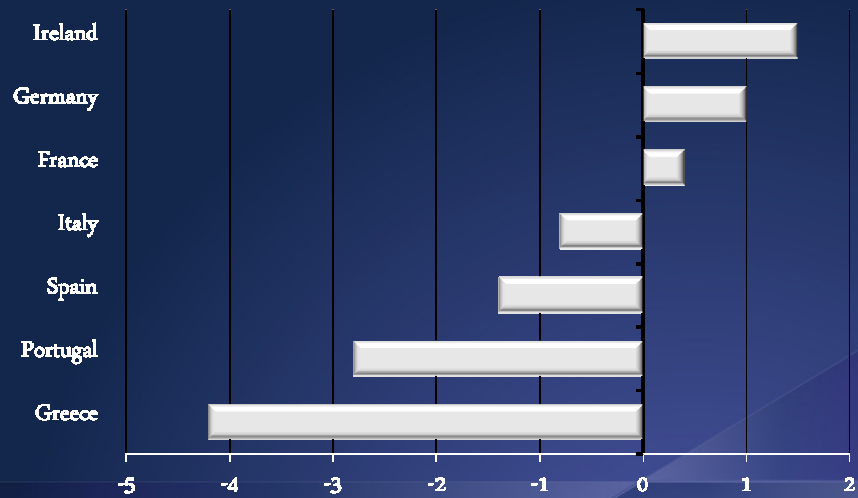
GDP Growth (SAAR) and % of Peak GDP to Q4-2012



Source: Bureau of Economic Analysis

Recession Still Grips Key European Nations

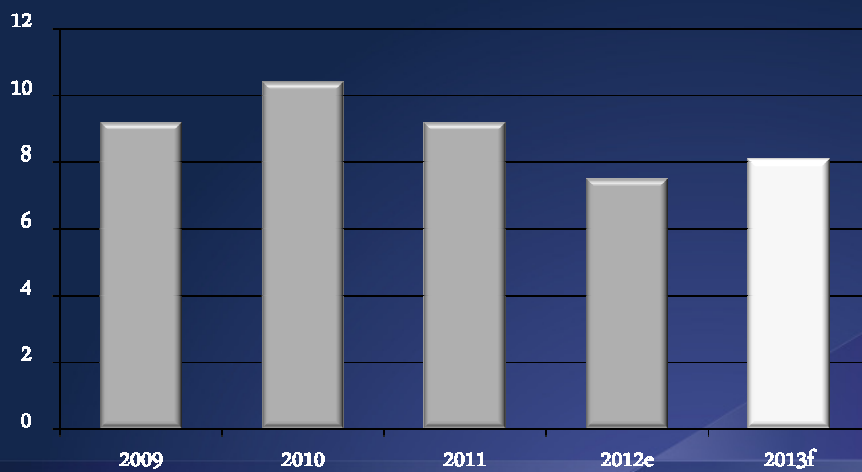
2013 real GDP, percent change over prior year



Source: Lynn Reaser, Fermanian Business & Economic Institute at PLNU

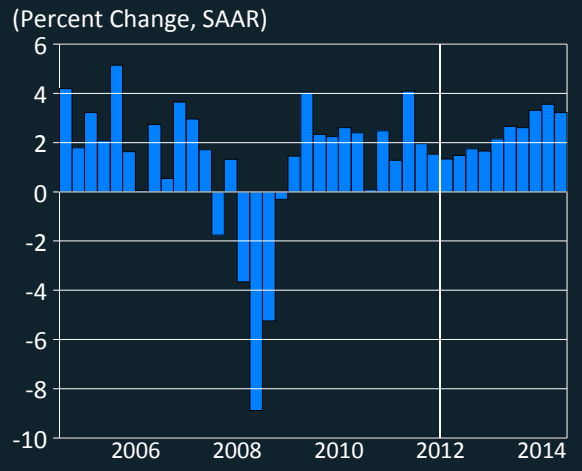
China: Soft Landing?

Real GDP, percent change over prior year



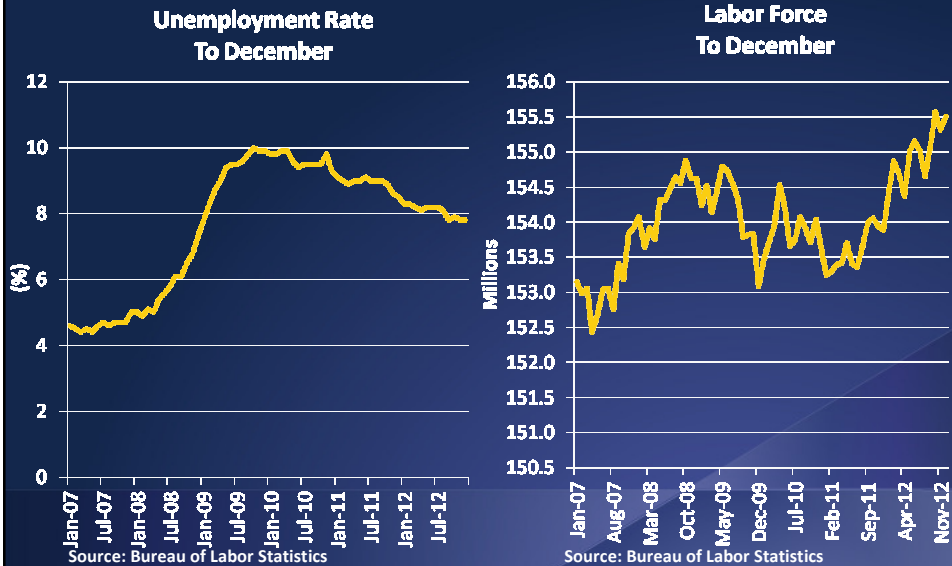
Source: Lynn Reaser, Fermanian Business & Economic Institute at PLNU

US GDP Growth Remains Sluggish



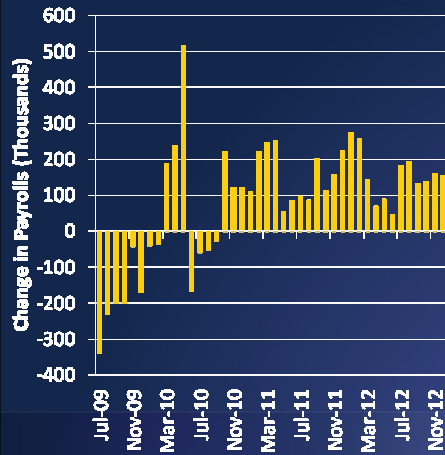
Source: UCLA Anderson Forecast

US Unemployment



Progress on Jobs

National Change in Payrolls To December



Source: Bureau of Labor Statistics

Change in Payrolls by Sector

	Jan-03 to Dec-07	Dec-07 to Dec-09	Dec-09 to Present
Total Non-Farm	7,712	-8,663	4,436
Education/Health	2,116	796	1,090
Admin Support	701	-1,151	861
Leisure/Hospitality	1,377	-617	801
Prof/Sci/Tech	1,201	-375	569
Manufacturing	-1,126	-2,277	500
Retail Trade	614	-1,219	480
Transport/Warehouse	339	-369	221
Finance/Insurance	192	-349	82
Real Estate	118	-196	2
Federal Gov't	-33	74	-26
State Gov't	105	9	-63
Information	-240	-283	-115
Construction	786	-1,836	-115
Local Gov't	678	20	-379

National Unemployment

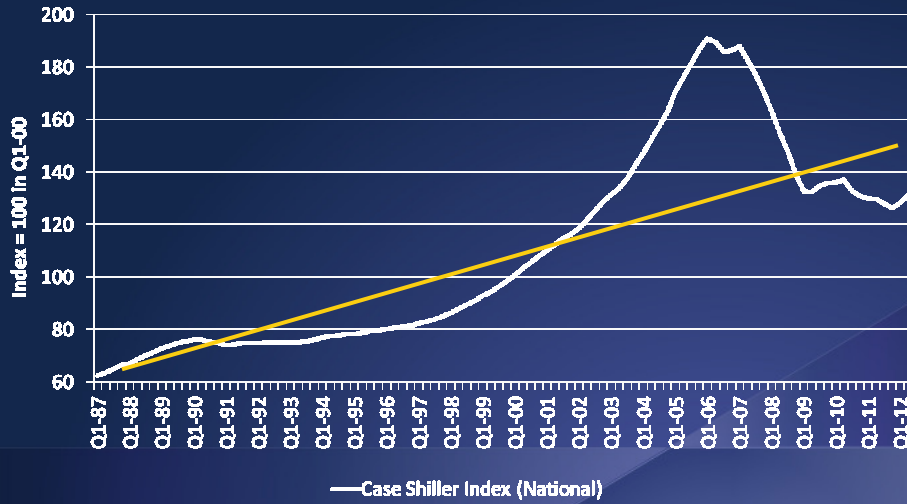
Number of Unemployed Persons by Duration of Unemployment (Thousands)

	Dec-07	Jul-09	Oct-12
Less than 5 weeks	2,716	3,150	2,632
5 to 14 weeks	2,385	3,587	2,851
15 to 26 weeks	1,181	2,895	1,836
27 weeks and over	1,327	4,951	5,002
Total	7,609	14,583	12,321
Average Duration in Weeks	16.6	25.2	40.2

Source: Bureau of Labor Statistics

National Housing Markets

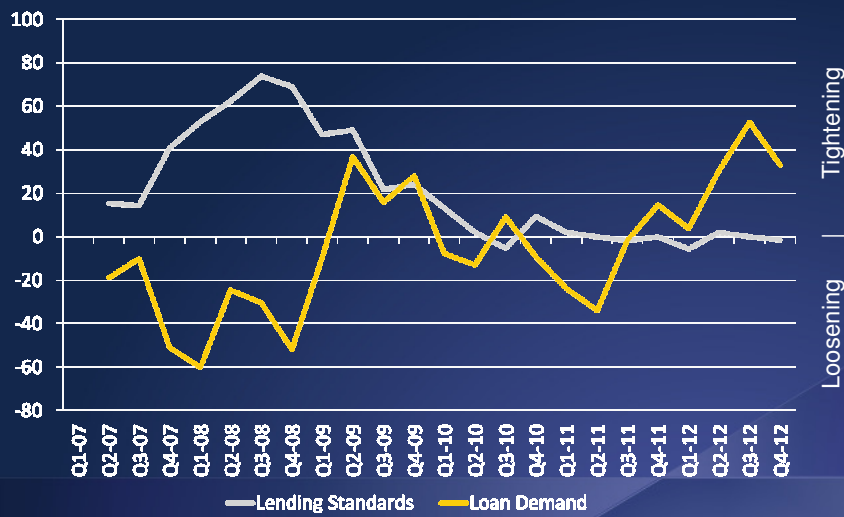
Case-Shiller US National Values to Q2-12



Source: Standard and Poor's / U.S. Census

Lending Standards: Prime Mtgs.

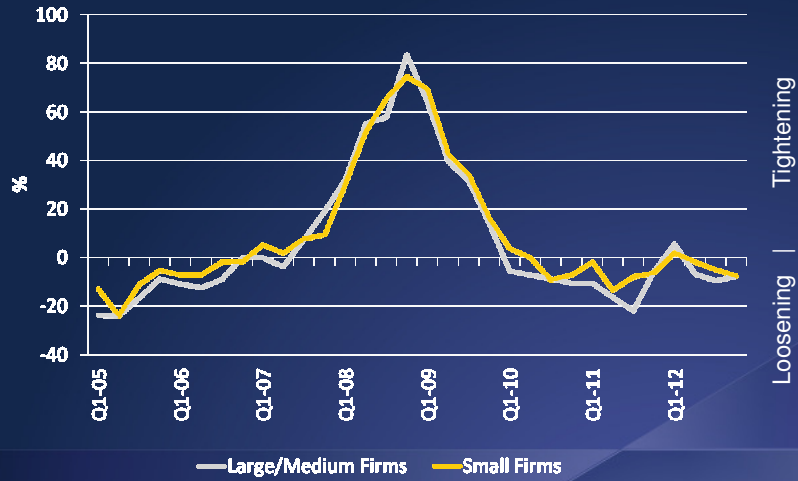
(Through Q4-2012)



Source: Federal Reserve

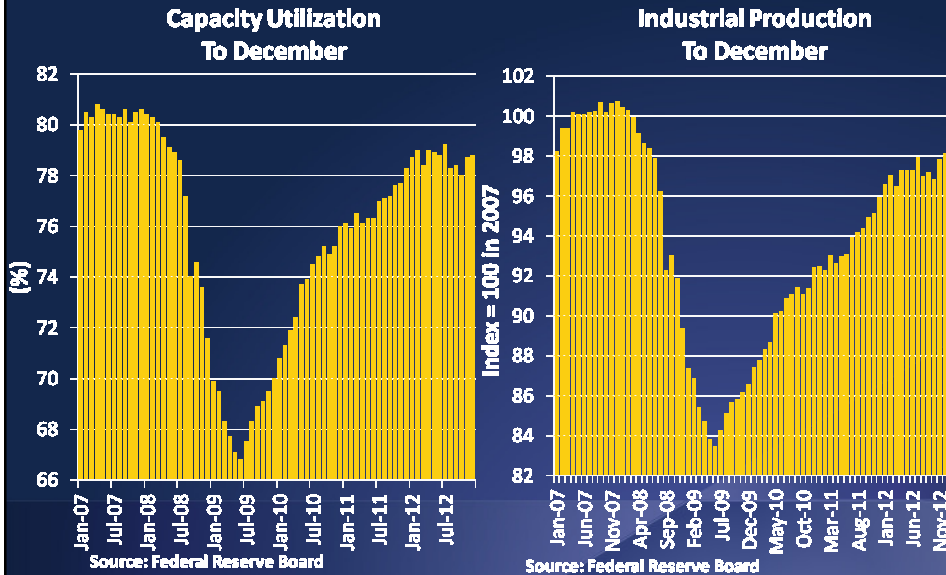
Lending Standards: C&I

(Through Q4-2012)



Source: Federal Reserve

US Production on the Rise

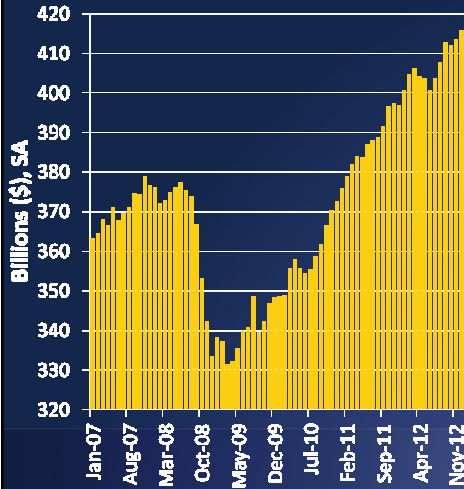


Source: Federal Reserve Board

Source: Federal Reserve Board

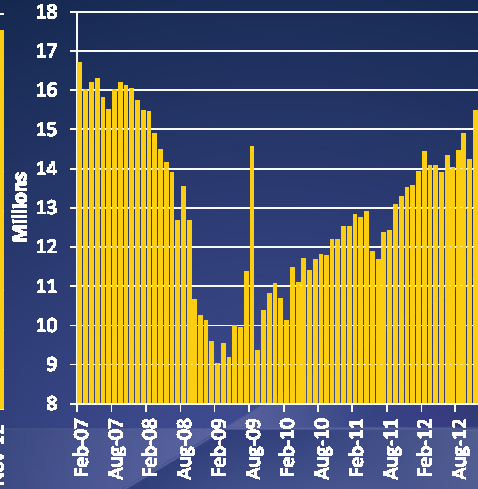
US Consumer Markets

Nominal Retail Sales
To December



Source: Census Bureau

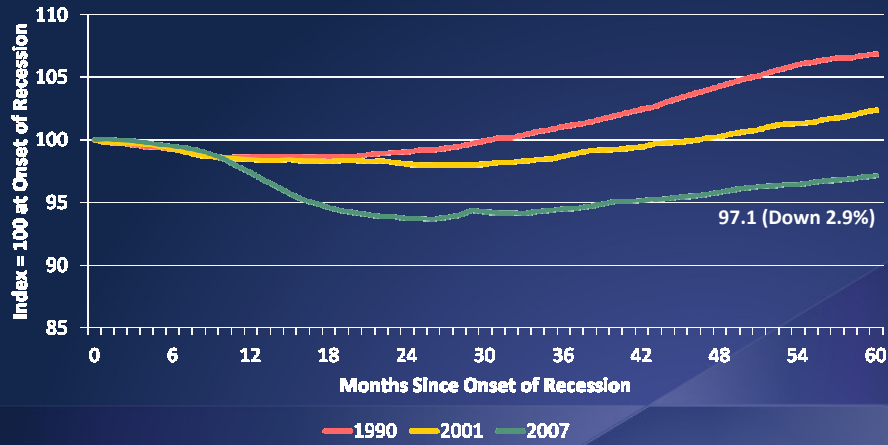
Auto and Light Truck Sales
To December, SAAR



Source: Census Bureau

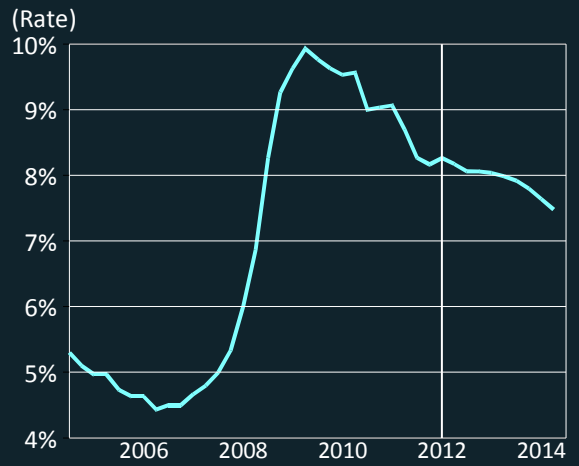
US Employment Growth

Total NonFarm Employment Growth



Source: Bureau of Labor Statistics

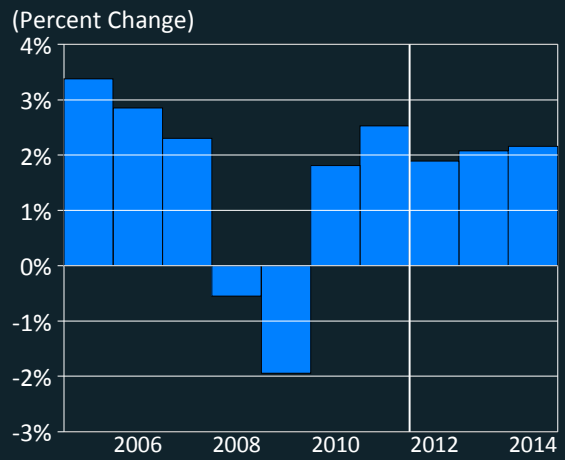
Unemployment Remains Too High



Source: UCLA Anderson Forecast

Consumers NOT coming to the Rescue: 2%

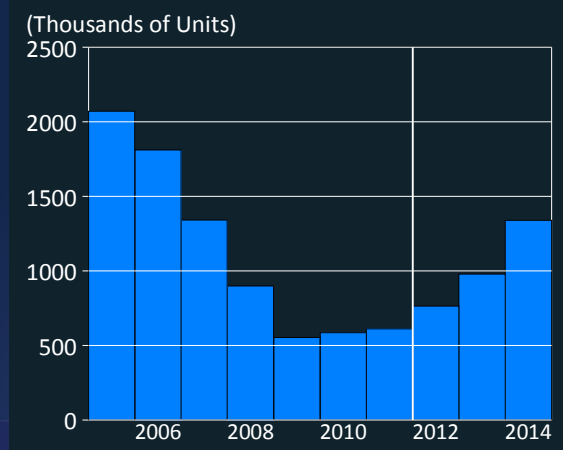
Real Consumer Spending, Annual Data



Source: UCLA Anderson Forecast

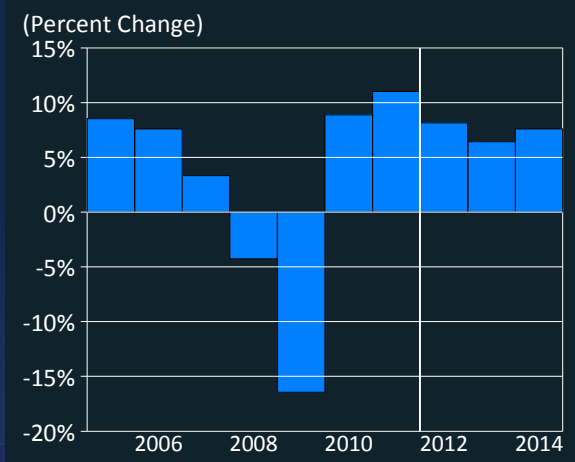
Housing Set to Rebound

Housing Starts, Annual Data



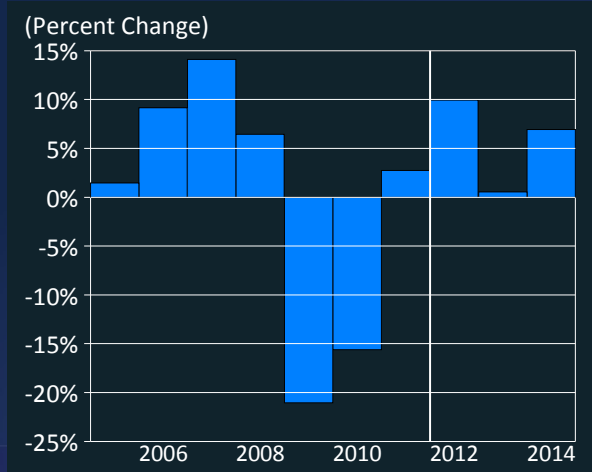
Source: UCLA Anderson Forecast

Equipment And Software Spending: Soft



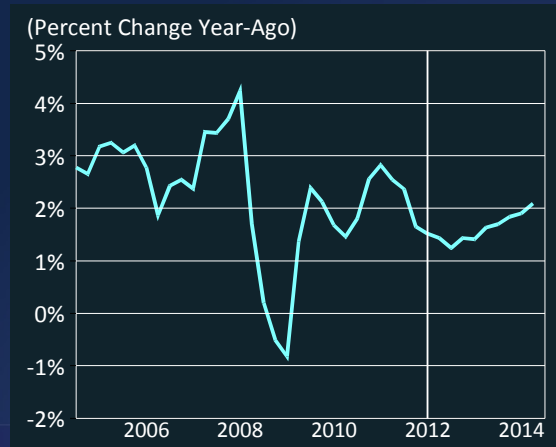
Source: UCLA Anderson Forecast

Investment in Business Structures Uneven



Inflation Stays off the Radar

Price Deflator for Personal Consumption Expenditures



Source: UCLA Anderson Forecast

California Forecast

	2012	2013	2014
Payroll Employment	1.7%	1.5%	2.3%
Unemployment	10.7%	9.8%	8.5%
Personal Income	0.9%	2.2%	3.1%

Source: UCLA Anderson Forecast

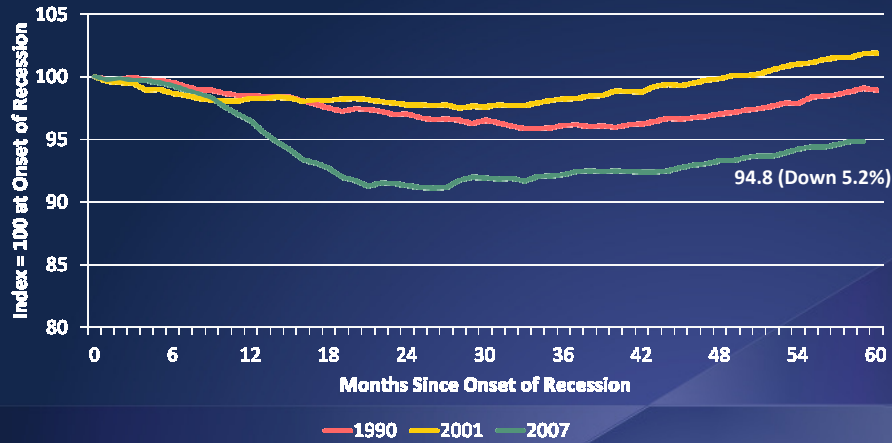
California: An Uneven Hit



Source: California Employment Development Department

CA Employment Growth

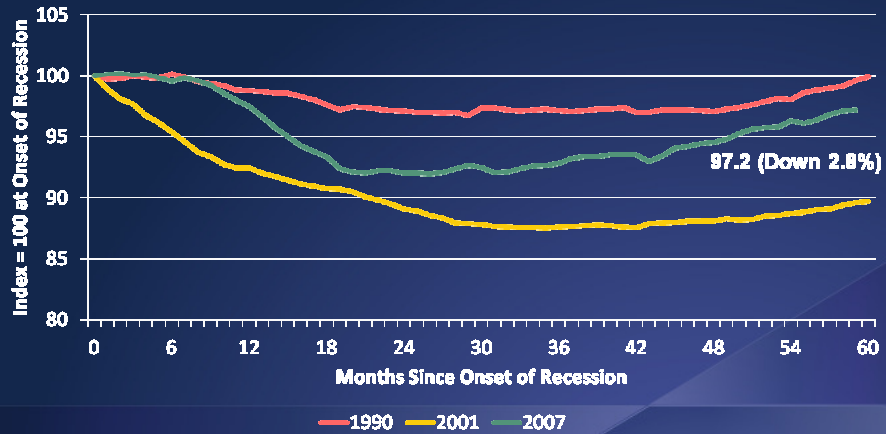
Total NonFarm Employment Growth



Source: Bureau of Labor Statistics

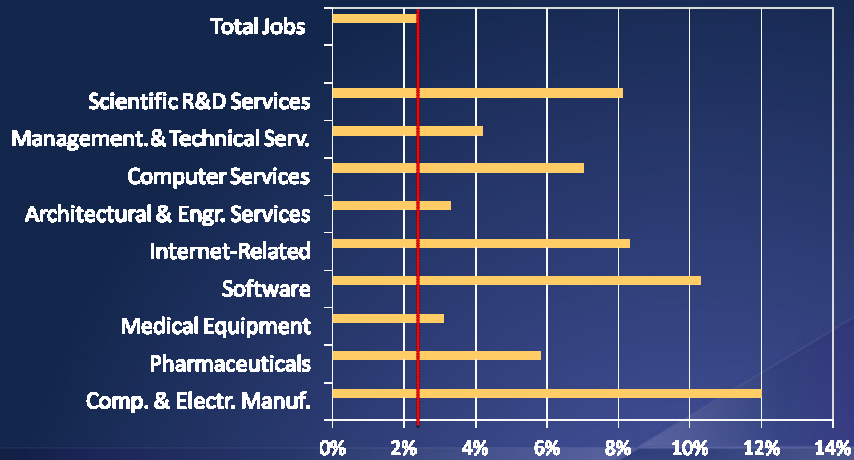
Bay Employment Growth

Total NonFarm Employment Growth



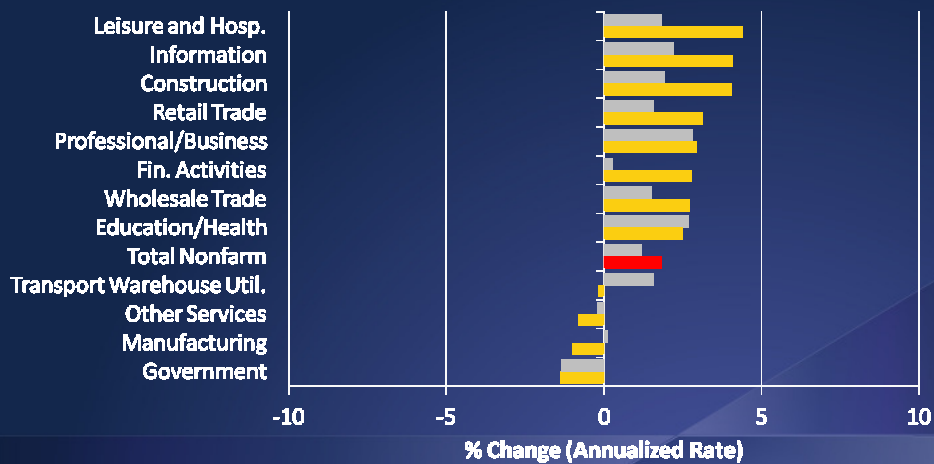
Source: Bureau of Labor Statistics

Bay Area Share of Selected U.S. Tech Jobs in 2010



Employment by Industry

CA Employment by Industry, YTD to Nov. for 2012

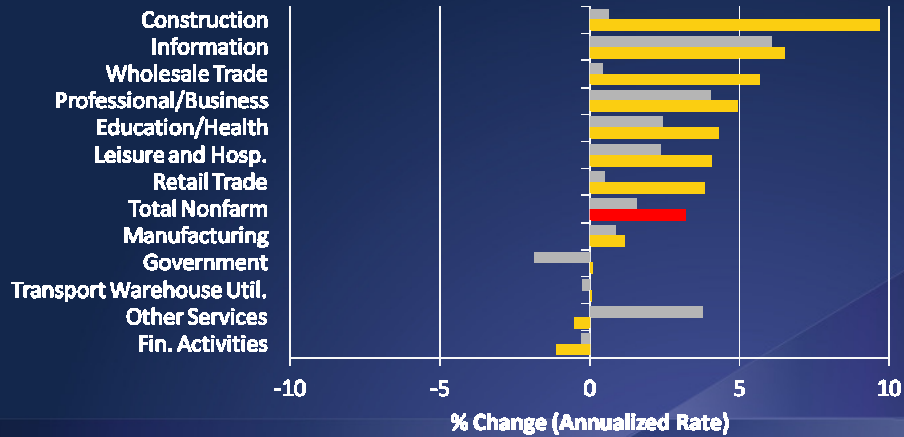


Source: California Employment Development Department

■ 2011 ■ 2012

Employment by Industry

Bay Area Employment by Industry, YTD to Nov. for 2012



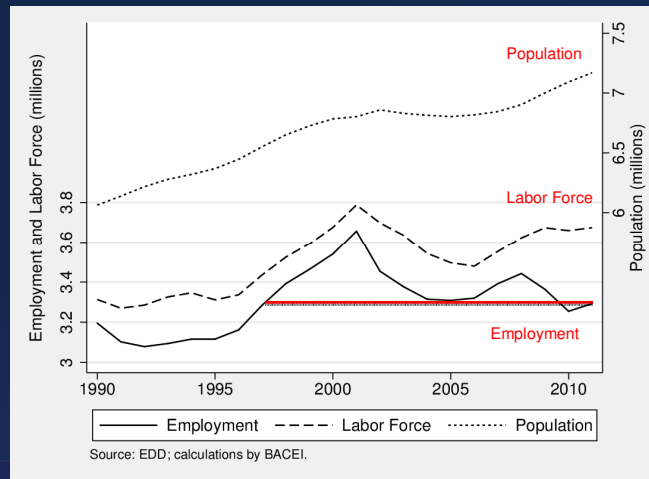
Source: California Employment Development Department

■ 2011 ■ 2012

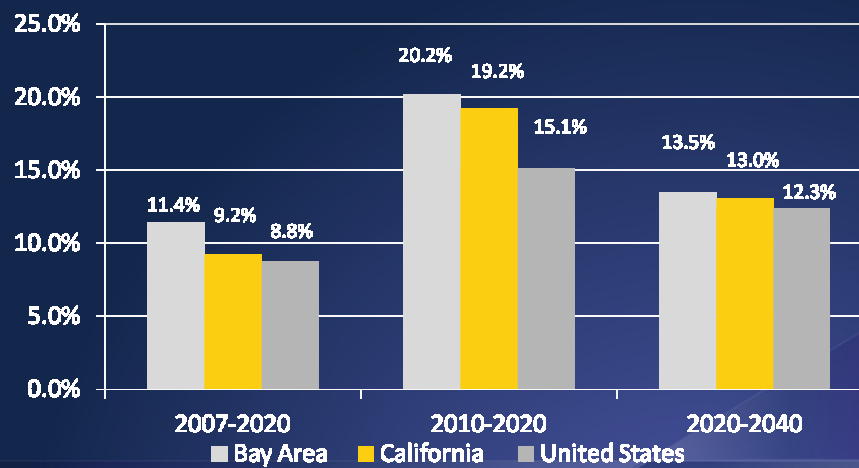
Strengths Relative to CA (12 month % growth to Nov.)

Industry	Bay Area	California
Total NonFarm	3.0	1.9
Construction	9.7	4.8
Manufacturing	1.3	-1.0
Prof, Sci, and Technical	5.5	3.7
Information	6.4	5.9
Health Care	3.8	2.1

Long Term Employment Growth Has Been Slow

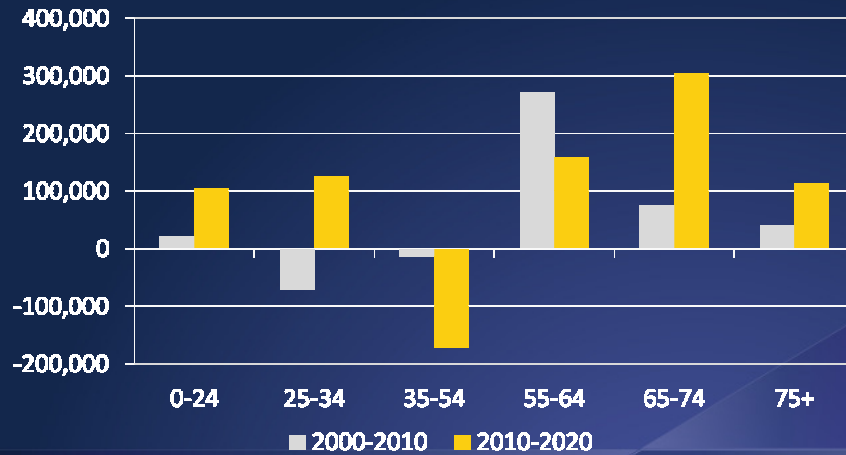


Forecast Growth in Total Jobs



Source: Center for Continuing Study of the California Economy

Bay Area Population Growth (thousands)



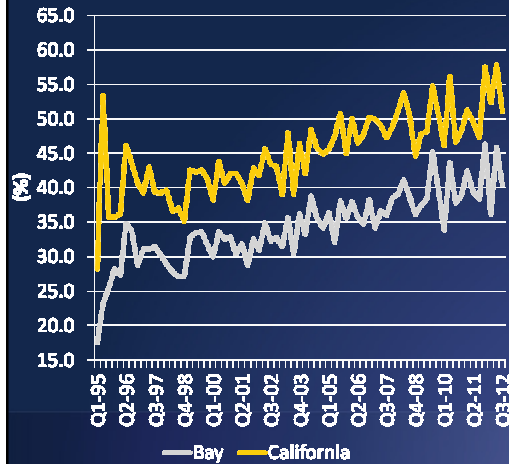
Source: Center for Continuing Study of the California Economy

REGIONAL STRENGTHS

- Quality of life
- Highly educated labor force
- Venture capital
- Innovation culture

Venture Capital

CA and Bay Shares of U.S. Venture Capital to Q3-2012



Q3-2012	Value of All Deals (Millions)	% of Total US VC
Bay Area	2,619	40
California	3,314	51
United States	6,482	

Source: PriceWaterhouseCoopers MoneyTree

REGIONAL WEAKNESSES

- Regulations
- Labor force
- Housing

Volume of Job Openings

MSA NAME	RANK	
	Openings rate, 2011	Openings rate, 2011
San Jose MSA	6	3.1%
San Francisco MSA	3	3.4%

Openings Rate = new job openings as a share of existing jobs

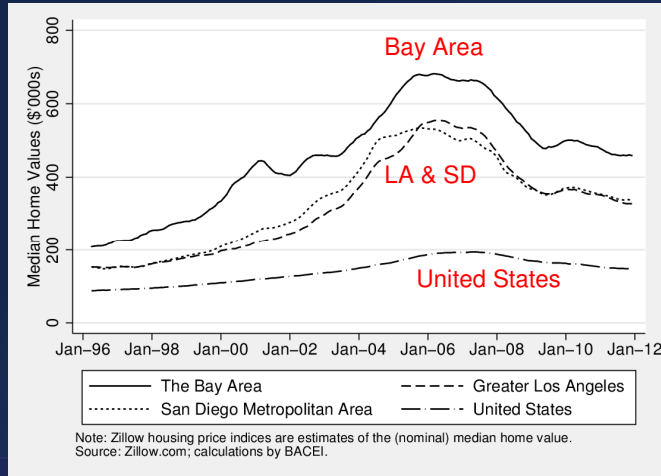
Education Gap?

MSA NAME	RANK	
	Education Gap, 2012	Education Gap, 2012
San Jose MSA	45	4.7%
San Francisco MSA	21	3.5%

Education Gap = ratio of average years of education required in job opening to average years of education in working population

High Housing Prices

(Median Home Values Over Time)



How Many Underwater?

as of Q2-12

State	# Mortgages Underwater	Negative Equity Share
Nevada	325,534	58.6
Florida	1,804,276	42.7
Arizona	521,598	39.7
Georgia	579,029	35.8
Michigan	448,447	32.8
California	1,972,012	29.0
United States Total	10,778,556	22.3

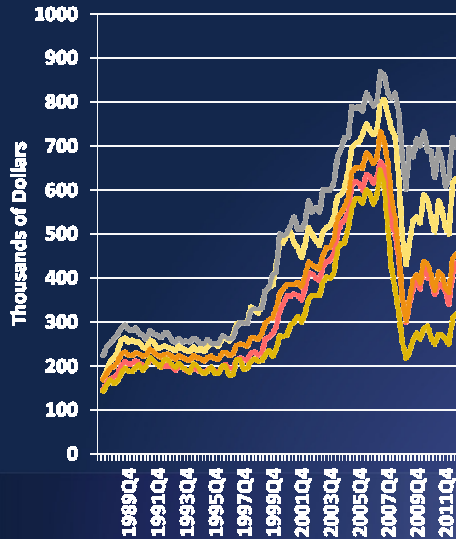
Local MSAs (Q4-11)

Oakland-Fremont-Hayward	157,146	29.0
San Jose-Sunnyvale-Santa Clara	60,382	17.5
San Francisco-San Mateo-Redwood City	33,036	10.2

Source: First American CoreLogic

Median Home Prices

Through Q3-2012



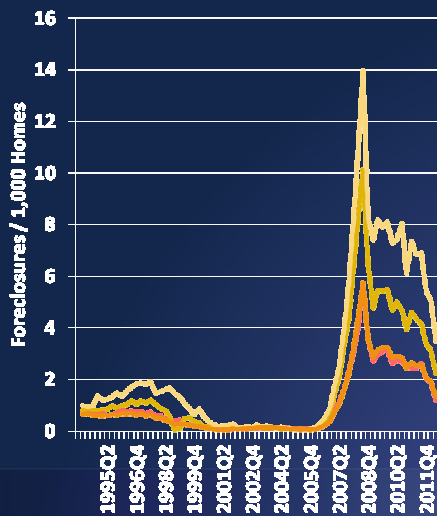
Source: DataQuick

• Price Declines – Peak to Current

- Bay Area: -31%
- Solano: -50%
- Contra Costa: -38%
- Napa: -36%
- Alameda: -28%
- Sonoma: -26%
- Santa Clara: -19%
- Marin: -18%
- San Francisco: -15%
- San Mateo: -14%

Foreclosures

Through Q3-2012



Source: DataQuick

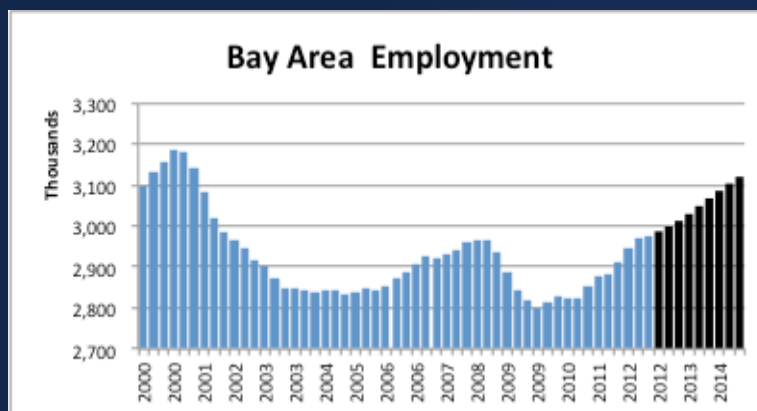
• Current Rates

- Bay Area: 1.4
- Solano: 4.0
- Contra Costa: 2.3
- Napa: 2.0
- Sonoma: 1.8
- Alameda: 1.3
- San Mateo: 0.6
- Marin: 0.5
- Santa Clara: 0.6
- San Francisco: 0.5

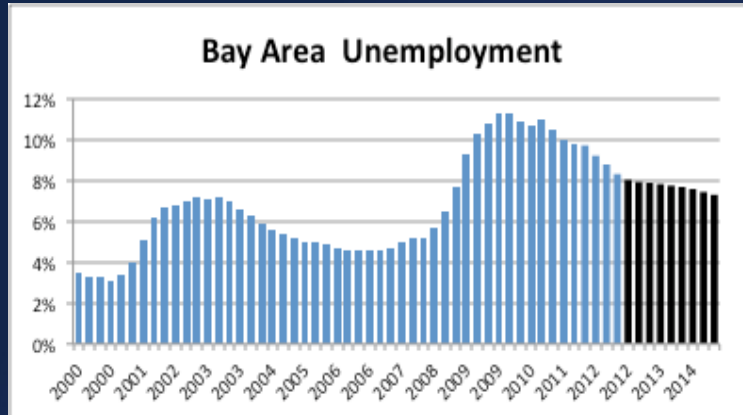
Summary

- Broader US economy still has some trouble spots, but seems to be headed in the right direction
- Bay Area economy, San Jose, in particular, has been a bright spot in the state and nation
- Housing markets seem to be recovering
 - Bubble bursting is over, recovery underway
- Bay Area economy has some broad challenges
- Threats remain to broad based economic recovery

UCLA Bay Area Employment Model

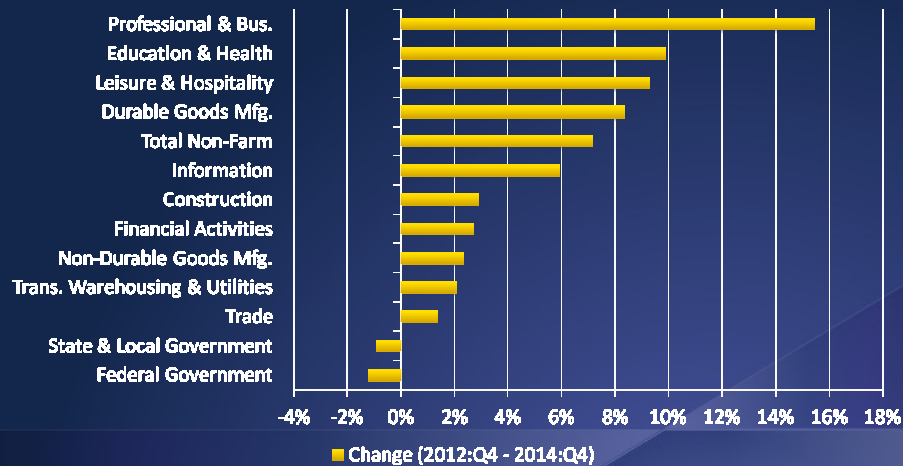


UCLA Bay Area Unemployment Model



Industry Forecast

Employment Growth Forecast by Industry to 2014



Source: UCLA Anderson, Bay Area Council Economic Institute

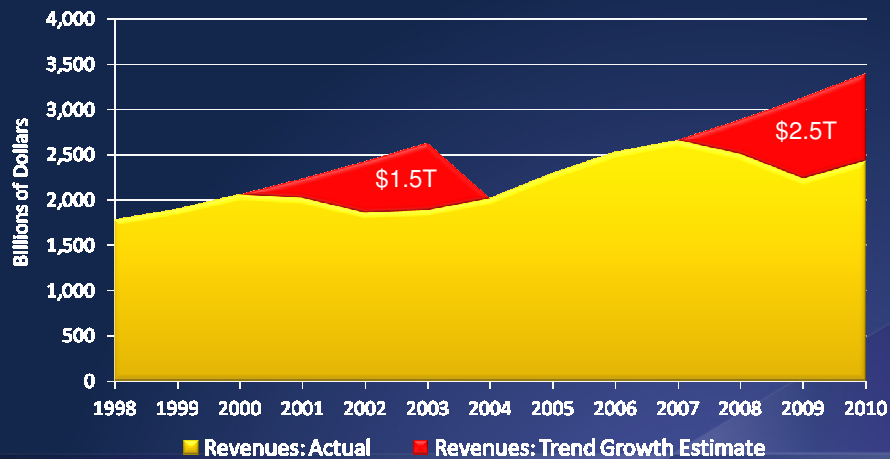
Threats to U.S. Recovery and Long Run Prosperity

- **Abroad:**
 - Europe
 - Asia
- **At home:**
 - Austerity push
 - Income inequality
 - Infrastructure

The Fiscal Austerity Issue

- **Austerity:**
 - US – cutting spending
 - EU – Greek prescription driving renewed recession
- **Continue stimulus until strong growth prevails**
- **Plenty of time later for austerity**
- **Remember 1937**

Federal Revenues



Source: Bureau of Economic Analysis

Facts on Income Inequality

- **Top 1%:**
 - Collect 24% of all income
 - Own 40% of all wealth
 - Hold 50% of all stocks, bonds, and mutual funds
 - Received 63% of all income gains in recent years
- **Problems:**
 - Downward pressure on consumption
 - Reduced income mobility in society
 - Lowers incentives to perform
 - Diminished resources devoted to societal well-being

Facts on Infrastructure

- **Global Competitiveness Report**
 - US Infrastructure rankings:
 - Railroads: 18
 - Ports 19
 - Roads 20
 - Airports 30
 - Electricity 33
 - Overall 16
- **Why?**
 - No national planning
 - Underfunded infrastructure investments
- **Upshot - traffic**
 - 4.8 billion hours in traffic
 - 1.9 billion gallons of fuel wasted
 - \$101 billion total cost

Infrastructure Related Costs

- **American Society of Civil Engineers**
 - Because of infrastructure gap:
 - US economy expected to lose, by 2020:
 - » \$1 trillion in business sales
 - » 3.5 million jobs

Bottom Line on Risks

- Japan has illustrated that austerity is not a pressing need for the United States
- Europe has illustrated that austerity can diminish growth
- US history has illustrated that excessive inequality can be dangerous
- Infrastructure has proven to be a good investment – we are not making it

Bay Area Council Economic Institute

- *Regional Analysis*
- *Business & Market Analysis*
- *Ports & Infrastructure Analysis*
- *Economic Impact Analysis*
- *Public Policy Analysis*

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Taxation of International Income – Theories, Actions and Trends

Stephen P. Sedler

Senior Vice President of Taxes and International Trade Administration
Seagate Technology
Moderator

Susan C. Morse

Associate Professor
UC Hastings College of the Law

Holly Glenn

Principal Economist
Baker McKenzie

Eric D. Ryan

Partner
DLP Piper



Tax Policies for Multijurisdictional Income

Tax Policy Conference
Friday, March 1, 2013
Santa Clara, CA USA
www.tax-institute.com

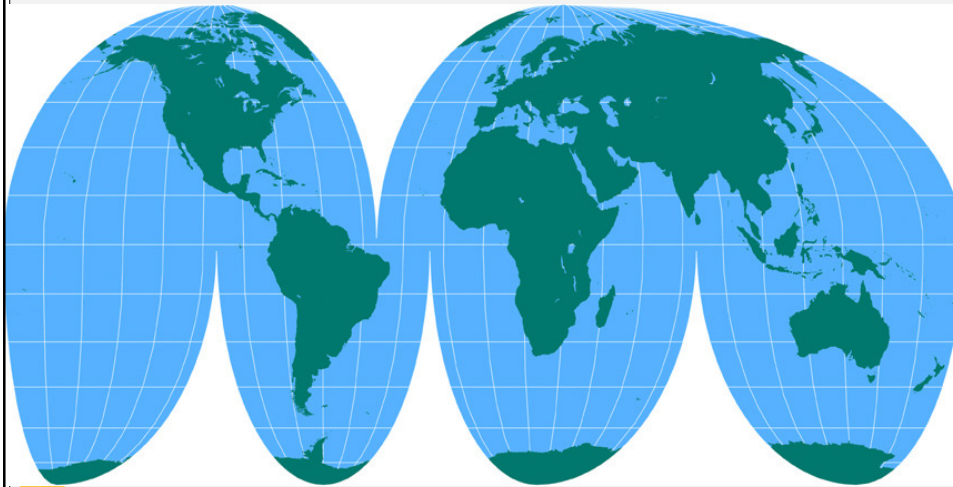
International Corporate Tax Policy Paths Past and Present

Susan C. Morse
TEI/SJSU Conference
Tax Policies for Multijurisdictional Income
Techmart
March 1, 2013

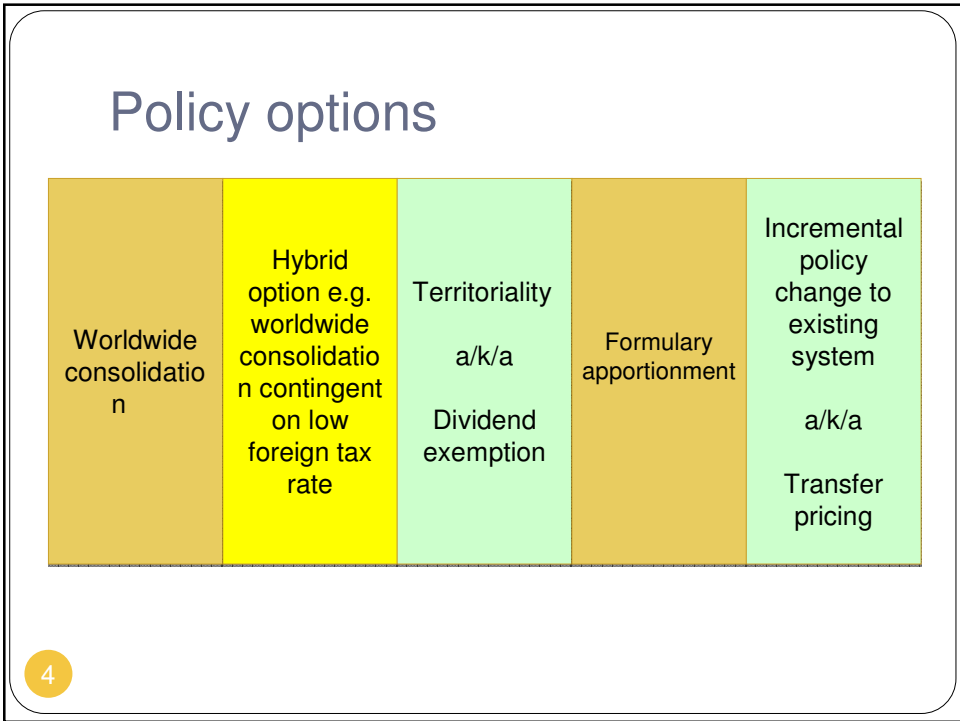
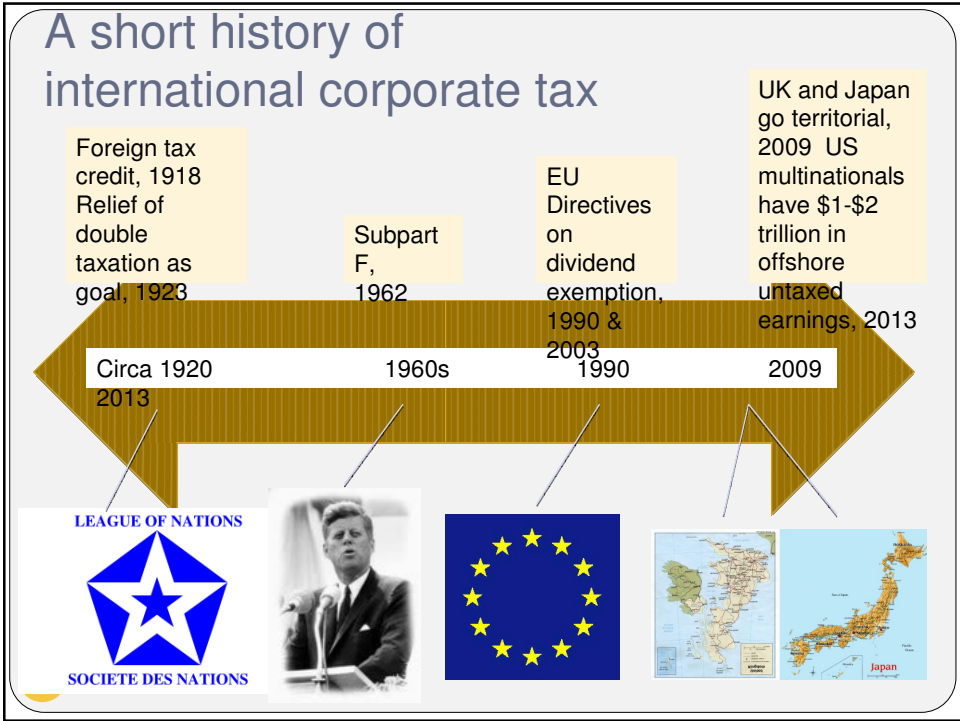


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The multijurisdictional problem



2



Territoriality / dividend exemption: Any immediate chance in the U.S.?

- Other countries' dividend exemption rules
- Camp framework and Enzi bill
- Issues include:
 - Definition of active business income
 - Minimum foreign tax requirement?
 - Interest and other expense apportionment
 - Taxation of royalties
 - Transition
- Revenue neutrality may not satisfy political objectives.

5

Incremental changes a/k/a mostly transfer pricing

- Obama administration
 - E.g. tax "excess profits" from intangibles in low-tax jurisdictions
- Business proposals
 - Repatriation holiday
- OECD
 - BEPS
 - Transfer pricing guidelines
- EU
 - CCCTB
- UN
 - Affirm arm's length proposal, but Brazil, India, China

6

Tax Policies for Multijurisdictional Income

Taxation of International Income – Theories, Actions, Trends



SAN JOSE STATE
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Lucas Graduate School of Business

The State Bar of California
The Taxation Section, Tax Policy Committee



TAX EXECUTIVES INSTITUTE, INC.

Tax Policy Conference
March 1, 2013 | Santa Clara, CA

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Introduction

- Project Summary
- Definitional Approach
- Treatment of Goodwill and Workforce in Place
- Entitlement to Intangible Related Returns
- Methods & Comparability
- Respecting Contracts
- Options Realistically Available
- Information Asymmetry
- Practical Planning Cases
- Notable Country and Other Views
- Summary / Conclusion

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Status of Discussion Draft

- Part of the “Base Erosion and Profit Shifting” project
- Timeline
- Not a consensus document
- Not a complete draft:
 - “Soft intangibles” or “market conditions”
 - Cost Contribution Arrangements
 - Allocation of intangible-related return to IP owner / funder

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Definitional Issues

- Broad or narrow definition
 - “what one party would pay another for something of value”
- Categories of intangibles
- Soft intangibles versus comparability factors
 - Goodwill
 - Assembled workforce
 - Market features and market premium
 - Corporate synergies
 - Location-based advantages

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Key Definitional Issues Remain

- “intangible” is intended to address something which is not a physical asset or a financial asset, and which is capable of being owned or controlled for use in commercial activities.
- Concept of “separately transferable”

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Practical considerations

- Granularity – Tendency to unbundle into “micro-intangibles” on the definitional side, while for valuation purposes, this approach is abandoned
- Intangibles or a comparability factors: practical application – Measurability?
- Comparability factors – will each transaction result in a profit split?

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Workforce – Intangible or Comparability Factor?

- The DD notes that:

“Some businesses are successful in assembling a uniquely qualified or experienced cadre of employees. The existence of such an employee group may affect the arm’s length price for services provided by the employee group or the efficiency with which services are provided or goods are produced by the enterprise. Such factors should ordinarily be taken into account in a transfer pricing comparability analysis.”

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Workforce – Response?

- Workforce relates to services, not intangibles
- Employees capture the value of their capabilities in their personal compensation, and tax authorities get their share when they tax personal income
- For companies to obtain some benefit from workforce, there must be a corporate “intangible,” perhaps know-how or trade secrets – so these are the relevant intangibles, not the workforce
- An “assembled” workforce is more valuable than an unassembled workforce, but only in terms of costs saved

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Goodwill – Definition?

- The DD does not provide a definition of goodwill
- However, the DD also uses the term to mean different things throughout, which creates confusion and uncertainty

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Goodwill – Many Uses/Contexts (1/2)

- Para 19 Goodwill is associated with a “brand.”
- Para 89 references goodwill in selecting comparables. Specifically, “Potential comparables should generally not be rejected on the basis of the asserted existence of unspecified intangibles or on the basis of the asserted significance of goodwill.” What could “goodwill” mean in this context?
- Example 13. The example asserts that the Country B operations have “developed substantial goodwill and ongoing concern value.”

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Goodwill – Many Uses/Contexts (2/2)

- Example 14. Goodwill may be more narrowly construed as being associated with bearing advertising costs, and may relate to trademark/brand reputation and awareness.
- Example 15. “Goodwill” in the context of a purchase price allocation.
 - “The full value of [the acquired business] should be reflected either in the value of the tangible and intangible assets transferred to Company S or in the value of the tangible and intangible assets and workforce retained by Company T. . . . It should generally be assumed that value does not disappear, nor is it destroyed, as part of an internal business restructuring.”

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The Stated Concern

- “Reflects concern on part of delegates of slicing and dicing assets with “tiny value” with all residual income allocated to low tax jurisdictions ... by separately defining assets with low values, transferee will earn the projected cash flows from the acquisition”

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Goodwill – Taxpayer Response?

- Is an acquisition framework useful for related-party transactions?
 - Most related-party transactions of intangibles are licenses, not sales
 - Trying to use market sale transactions as some sort of comparable for a license will require many (likely large) adjustments
 - Akin to market capitalization methods

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Goodwill – Taxpayer Response?

- Valuing discrete intangibles in their active use will capture the going concern value of those assets, without resorting to a separate valuation of going concern value or assertion of goodwill
- License royalties reflect the goodwill value that attaches to trademarks and trade names, thus valuations based on this evidence capture that aspect of “goodwill”

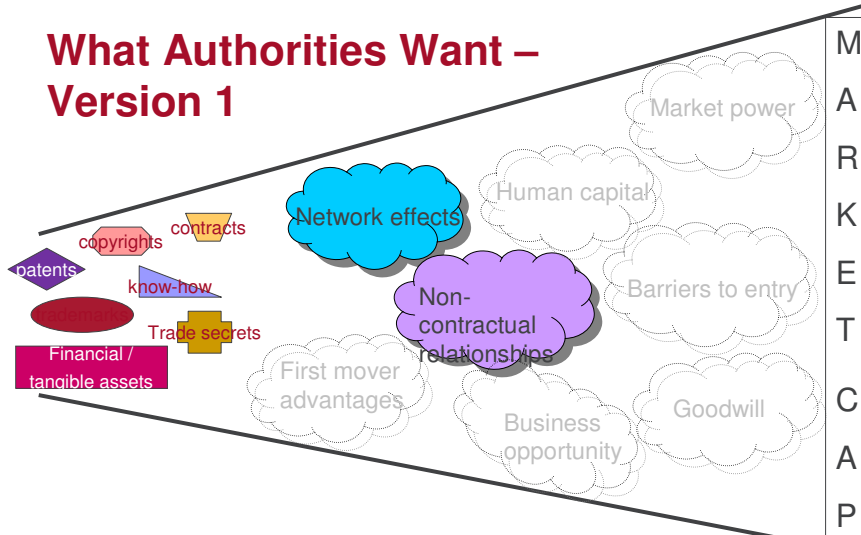
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Goodwill – Acquisition Context

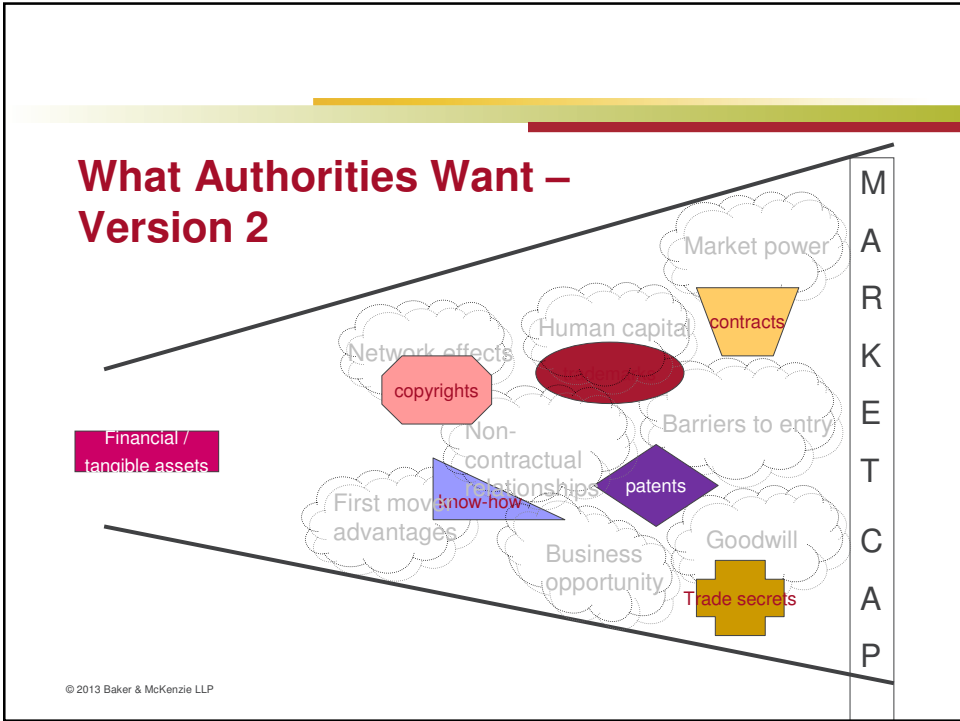
- Intangible assets which are not identified or are specifically allocated to goodwill for accounting purposes
- Control premium paid by the acquirer
- Premium to exclude competitors from the acquisition
- Premium paid because of anticipated synergies with the acquirer's other assets or activities (may or may not materialize)
- Over-optimistic evaluation by an acquirer who has imperfect information on the acquired entity (as is always the case in arm's length acquisitions)
- Should or shouldn't goodwill be assumed to correspond to the value of operating assets of the acquired entity ?

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What Authorities Want – Version 1



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- ### Entitlement to Intangible Related Returns (1/2)
- WP6 Introductory Statement for DDI: Need for alignment of relevant registrations and contractual arrangements with conduct of parties. The party entitled to use the intangible exclusively is entitled to returns.
 - Suggested changes colored by anti-abuse tone
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Entitlement to Intangible Related returns (2/2)

- Expectation of control and assumption of risk
 - Outsourcing and “informed hiring party”
 - Distinguish types of control (functions)
 - Distinguish risk held: hiring party (entrepreneurial) and service provider (commercial)
 - Legal ownership/financial investment: DDI separately or together, will not entitle return to intangibles “without more.”
 - Is the “more” the issue of “crown jewels”?
- Location of MNE intangibles & group structure an issue for tax authorities (returns earned in Ireland, Switzerland, Netherlands, Caymans)
 - Part of OECD BEPS (Base Erosion Profit Shifting) Project

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Methods & Comparability (1/3)

- 5 OECD-recognised methods remain valid, but...
- Preference for CUP/CUT, but...
- Cost approaches generally dismissed.
- Financial valuation methods (e.g. DCF), recognised, but with great reluctance.

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Methods & Comparability (2/3)

- TNMM / CPM:
 - One-sided methods heavily criticized as inappropriately allocating most or all of the residual return to the IP owner.
 - Determination of royalties for licence: not all the “excess profit” should be allocated to the licensor. Licensee should share in intangible-related return.

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Methods & Comparability (3/3)

- Rise of profit split?
 - Recognition of local, soft intangibles ?
 - Risk ?
 - Loss split?

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Respecting Contracts (1/2)

- WP6 Head of Transfer Pricing, Joe Andrus, and country delegates complain business takes 2 different stances on comparability
 - For entitlement to returns look to third party behavior
 - For timing issues for transfer pricing look to legal agreements to determine risk allocation, price, structure of others
- TPG on Associated Enterprises (AEs) contracts and dealings
 - A great variety of arrangements and contracts since no conflict of interest concerns (TPG 1.65)
 - Possible unique circumstances for AEs that meet the ALS if it's what third parties would do

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Respecting Contracts (2/2)

- Less conflict than is posited
 - Use of taxpayer's third party agreements as basis for related party agreements
 - Databases of agreements
 - Caveat: despite common features, no exactly comparable agreements with external or related parties.

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Options Realistically Available

- WP6: When considering use or transfer of intangibles, need to apply Guidelines principles of options realistically available (ORA).
 - (Perspective of both parties, going beyond an MNE's sound commercial reasons)
- Business concerns:
 - ORA shouldn't be a test for re-characterization/non-recognition.
 - TPG says no requirement to document all options

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Information Asymmetry/Hindsight (1/2)

- Key challenge is whether TPs are based on information ex ante or ex post
- Ex post approaches may be legally difficult in some jurisdictions, leading to potential double taxation

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Information Asymmetry/Hindsight (2/2)

- Taxpayers are concerned that tax authorities want to reserve the right to use both approaches, whichever produces more taxable income
- US continues to emphasize “information asymmetry”
 - Taxpayers know more than they tell authorities
 - US sees hindsight as a solution to the asymmetry

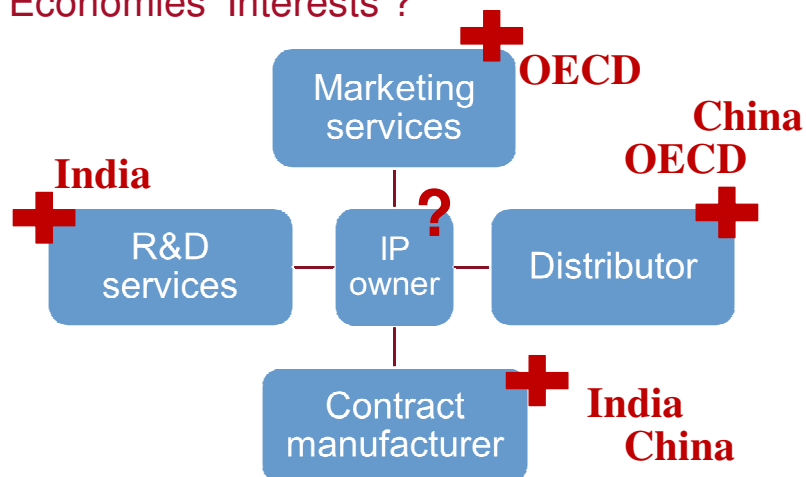
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Notable Country and Other Views

- India
- China
- United Nations

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Convergence between OECD and Emerging Economies' Interests ?



Summary/Conclusion

- Further draft to be released at some point
- What changes might there be?
- Questions?

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EVERYTHING MATTERS

Tax Policies for Multijurisdictional Income

Techmart, Santa Clara
March 1, 2013

Eric D. Ryan, Esq.
DLA Piper US LLP, Silicon Valley

Agenda



- U.S. Transfer Pricing Rules and the Arm's Length Standard
- Offshore Low Tax Structures and Pressures on the Arm's Length Standard
- U.S. Reactions to Offshore Low Tax Structures
 - IRS and Valuations of IP Transfers
 - Legislative Proposals
- Alternative to Arm's Length Standard: European Union's Combined Consolidated Corporate Tax Base (CCCTB) Proposal

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Overview of U.S. TP Rules – IRC Sec. 482



- Only 2 sentences:
 - Ability for Internal Revenue Service to make adjustments to controlled parties in order to “clearly reflect income” of the parties
 - Consideration for Intangible Property must be “commensurate with the income” attributable to the IP transferred
- No mention of “arm’s length” standard in statute
 - However, the Treasury Regulations include the arm’s length standard
 - Various court cases have endorsed the arm’s length standard
 - Mentioned in U.S. Tax Treaties
- “Commensurate with income” concept allows IRS to retrospectively review the actual profits of controlled IP licensee / purchaser
 - Criticized by some as not arm’s length but IRS defends as proper
 - Regulations provide exceptions to retroactive review and adjustment in some circumstances (highly reliable CUT, etc.)

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Overview of U.S. TP Rules – Regulations



- U.S. Treasury / IRS Regulations – lengthy and detailed
 - Fairly analogous to OECD Transfer Pricing Guidelines, but often more prescriptive and mechanical, with many examples
 - U.S. - no reference or link to OECD Guidelines
 - Functional Analysis (Functions, Assets, Risks)
 - Selection of “Best TP Method” based upon reliability criteria
 - Provide specified TP methods, depending on transaction, e.g.
 - Transfer of Tangible Goods * Services
 - Transfer of Intangible Property * Loans
- Reg. 1.482-1(b)(1) applies arm’s length standard “in every case . . . ”
 - . . . Except when not . . .
 - Query: If arm’s length standard applies in every case, then why do the Regulations need to be so lengthy and detailed?

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U.S. Safe Harbors / Exceptions (?) to Arm's Length Standard



- Loans - Applicable Federal Rate (AFR) safe harbor
 - Significant divergence between AFR and commercial rates during last several years
- Services – the Services Cost Method (SCM)
 - No mark-up or profit motive is required for certain activities
- R&D Cost Sharing Arrangements
 - No mark-up or profit motive is required for CSAs
 - IRS and Treasury assert CSAs are arm's length, but . . .
 - IRS lost *Xilinx* case (issue of whether stock options are included in cost pool). Taxpayer provided evidence of arm's length dealings, but IRS offered no commercial evidence, only theory
 - In response, IRS and Treasury changed the Regulations
 - New Regulations now subject to litigation in *Altera* case
 - IRS nuanced view: CSAs are arm's length, but no such transactions exist between third parties, so taxpayers must follow Regulations

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U.S. TP Rules – Taxpayer Adjustments



- Regulations make it clear that taxpayers cannot make amended tax returns to claim a tax refund from the IRS based upon change in transfer pricing
 - But, taxpayer can always pay more tax on an amended return
 - Rationale: IRC Sec. 482 only provides IRS with ability to make TP adjustments
- Arguably, mathematical mistakes are not “transfer pricing”
 - But *Intersport* case seems to say it doesn't matter
 - Wouldn't parties at arm's length correct their mistakes?
- Resulting taxpayer / IRS controversy dynamic
 - Prudent US taxpayers minimize US taxable income as reasonably possible, because US income decreases are not allowed
 - IRS assumes US taxpayers take extreme positions to minimize US tax, so IRS has a bias towards making adjustments, at high levels
 - If both positions are extreme, the ultimate resolution (Appeals, Court) is compromise middle position. Thus, cycle repeats.

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Tax Policies for Multijurisdictional Income

Traditional U.S. Cost Sharing Arrangements with IP Migration to Low-Tax Jurisdictions

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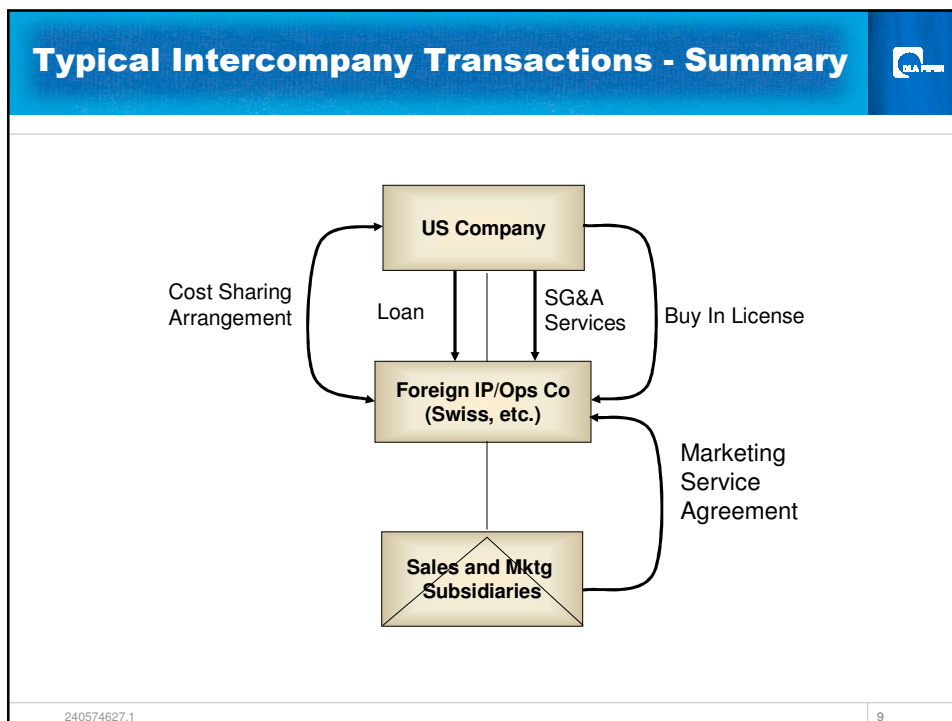
Typical Offshore IP Structure Entities

```

    graph TD
      USComp[US Company] -- Sale --> USCustomers((US Customers))
      USComp --- ForeignIP[Foreign IP/Operating Co  
(Swiss, Ireland, etc.)]
      ForeignIP -- Sale --> NonUSCustomers((Non-US Customers))
      ForeignIP --- SalesMkt[Sales and Mktg  
Subsidiaries]
      SalesMkt -- Marketing Information --> NonUSCustomers
  
```

- Performs R&D function
- Management
- U.S. Distributor
- Low-tax jurisdiction
- Has non-U.S. rights to exploit IP
- Direct sales to non-U.S. customers
- Bears commercial risks (e.g., inventory, bad debt, fx)
- Entitled to IP profits
- Conducts/contracts manufacturing
- Performs Sales and Marketing function in local jurisdictions
- “Check-the-box” tax election to be viewed as branch
- No valuable intangible assets
- Limited risks


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Tax Planning Results and U.S. concerns regarding profit shifting

- As a result of these structures, profits accumulate in specifically chosen low tax foreign subsidiaries
- “The data speak for themselves. Unequivocally, low-tax countries have a disproportionate share of profit.” U.S. Commerce Department’s Bureau of Economic Analysis, 2009
- U.S. Senate hearings, September, 2012, criticize HP and Microsoft of avoiding U.S. taxes, while acknowledging the techniques are legal
- Congressional Research Service, “An analysis of Where American Companies Report Profits; Indications of Profit Shifting,” January 18, 2013, concludes:
 - “. . . The analysis presented here appear to show that significant shares of profits are being reported in tax preferred countries and that these shares of profits are disproportionate to the location of the firm’s business activity as indicated by where they hire workers and make investments.
 - For example, American companies reported earnings 43% of overseas profits in Bermuda, Ireland, Luxembourg, the Netherlands, and Switzerland in 2008, while hiring 4% of their foreign workforce and making 7% of their foreign investments in those economies.”

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IRS Reaction to Taxpayer IP Valuation Methods	
<ul style="list-style-type: none"> ▪ Prior §1.482-7 cost sharing regulations silent on IP valuations <ul style="list-style-type: none"> ▪ Relied on methods available under §1.482-4 through §1.482-6 for IP valuation; RPSM most commonly used with finite life ▪ IRS issued Coordinated Issue Paper in 2007 stating taxpayer methods were systematically under valuing the Buy-In; offered other methods ▪ IRS litigated the RPSM under the Veritas case and lost <ul style="list-style-type: none"> ▪ Tax Court endorsed RPSM and 4 year life as arm's length ▪ Amazon case docketed in Tax Court in November, 2012 <ul style="list-style-type: none"> ▪ Taxable years 2005 and 2005 ▪ Amazon used RPSM with 7 year period (value = \$216 M) ▪ IRS uses infinite life, DCF theory (value = \$3.6 B) ▪ Why does IRS pursue this case? <ul style="list-style-type: none"> ▪ Veritas case not necessarily controlling - arguably different facts ▪ IRS did not acquiesce to Veritas decision ▪ IRS may believe Amazon case has more IRS favorable facts 	
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Recap of Cost Sharing Regulation and IP Valuation Methods	
<ul style="list-style-type: none"> ▪ New §1.482-7 regulations, generally effective on and after January 5, 2009 <ul style="list-style-type: none"> ▪ Valuations based on “enterprise value” premise, i.e. goodwill, going concern value, workforce-in place, are also included ▪ Income method, acquisition price method, and market capitalization method were introduced. Preamble suggests that these methods may also be used for valuing transfers of IP under §1.482-4 and transfers of services under §1.482-9 ▪ Provide a “Periodic Trigger” to create an IRS adjustment based on offshore profits ▪ Income method is based on a “discounted profit flow” approach, i.e., the forecast profits are present valued <ul style="list-style-type: none"> ▪ The idea is to first present value the forecast operating profits from the business (also called the cost sharing alternative) and the forecast routine returns embedded in the operating profits (also called the licensing alternative), and then calculate the IP value as difference between the two 	
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Income Method under New Regulations


- Key inputs of the Income Method are:
 - **Life:** unless it can be clearly demonstrated that IP has finite life, the default assumption is perpetual life
 - **Forecast growth rates and operating margins**
 - High growth rates and high margins result in high IP value but also provide high tax savings
 - Low growth rates and low margins reduce the IP value but also reduce the tax savings
 - **Operating margin in terminal value calculations**
 - What is the expected margin when the IP is commoditized and has become routine?
 - Routine returns
 - Discount rates
 - Valuation results highly sensitive to inputs - therefore, controversy between IRS and taxpayers likely to continue

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Proposed Legislative Reactions to Offshore Profit Shifts


- **Camp Proposal - Territorial System**
 - 25% Corporate Tax Rate
 - Foreign source dividends from CFC's taxed at 1.25% effective rate
 - Pre-effective date offshore earnings subject to 5.25% tax as well
 - Retains Subpart F with some modifications
 - Three alternative options for including low taxed CFC income
- **Obama Administration Proposal - Excess Foreign Profits**
 - Applies Subpart F to CFC operations with low tax rates (10%)
 - Where CFC income exceeds certain ROI measures
 - Also, "clarifies" that workforce-in-place, goodwill, and going concern are subject to tax in outbound transactions
- **Levin Proposal –**
 - TBD

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EU's Proposed Common Consolidated Corporate Tax Base (CCCTB)		
<ul style="list-style-type: none"> ▪ Encourage fair and transparent tax competition based on national corporate tax rates ▪ Use of one comprehensive set of tax rules in determining a company's tax base ▪ Uniform apportionment of related liability across EU countries <ul style="list-style-type: none"> ▪ Profits and Losses are offset on a cross-border basis ▪ Intra-group profits and losses are ignored <ul style="list-style-type: none"> ▪ No transfer pricing implications for these intra-group transactions ▪ Transactions with associated enterprises that have not opted into the system still subject to transfer pricing testing and documentation ▪ Interest and royalty income received from outside the group is taxable, but tax credit for withholding is shared within the group ▪ Consolidated losses can be carried forward indefinitely (no c/b) ▪ Optional, at the election of the corporation 		
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Tax Policies for Multijurisdictional Income		
<p>Alternative to Arm's Length Standard: Formulary Apportionment Under EU's Proposed CCCTB</p>		
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Substantive CCCTB Provisions – Elective Regime

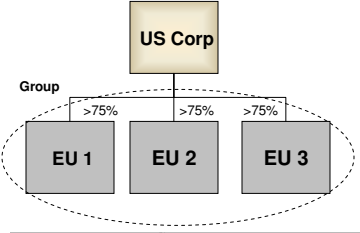


- Optional – Taxpayer elective system
 - Only companies that have opted into the CCCTB will be treated as “group members”
 - For EU resident taxpayers, the “group” consists of:
 - Qualifying subsidiaries located in the EU
 - A subsidiary is a qualifying subsidiary of its parent if the parent can i.) exercise more than **50% of the voting rights** (control test) and ii.) holds more than **75% of the company’s equity or profit entitlements** (Ownership test)
 - permanent establishments located in the EU, whether owned by EU residents or non-EU residents
 - In the case of a non-EU parent-taxpayer, the “group” comprises all of its EU subsidiaries (direct and indirect) and permanent establishments located in the EU
 - “All-in or All-out” Principle
 - Although not clear from the Directive, it appears that qualifying EU entities may only opt-in on an “all-in” basis, that is, all EU qualifying subsidiaries/permanent establishments must agree to the election
- Once elected, initial five-year term with successive three year terms
 - CCCTB members no longer able to utilize domestic Member States’ tax rules

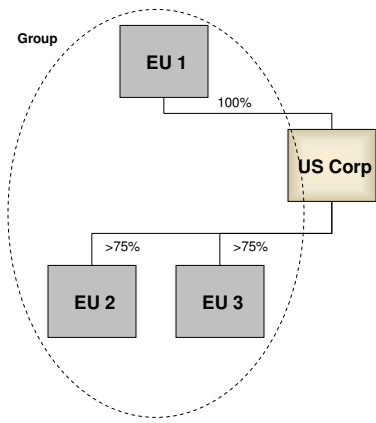
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Examples of “Group” Structures

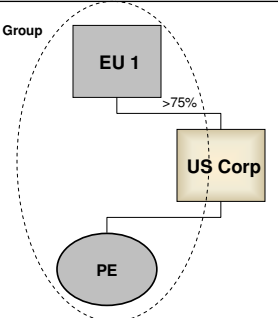




Group



Group



Group

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Substantive CCCTB Provisions – Tax Base



- Tax Base calculated as revenues less “exempt revenues” and “deductible expenses”
 - “Exempt revenues” include all dividends received, including those from non-group entities
 - **Exempt revenues do not include dividends derived from low-tax jurisdictions**
 - Revenues will not be exempt if the distributing entity is
 - i.) taxed in its country of residence on profits at a rate lower than 40% of the average statutory tax rate in the Member States; or
 - ii.) benefits from a special regime in a third country that allows for a substantially lower level of taxation than the general regime
 - “Deductible expenses” include all costs of “sales and expense,” and **specifically include all costs associated with research and development**
 - Importantly, costs incurred for purpose of deriving exempt dividend income are not deductible. As such, interest expense related to equity investments leading to dividends are non-deductible

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Substantive CCCTB Provisions – Profit Apportionment among EU Group Members



- Profit Apportionment Formula
 - Consolidated profit is shared amongst group members on the basis of an apportionment formula based on three criteria, each with equal weighting:
 - **Assets.** Fixed assets owned/leased/rented by the group member in proportion to the group as a whole
 - **Labor.**
 - 50% weight to payroll costs of a group member in proportion to the group as a whole
 - 50% weight to the number of employees of the group member in proportion to total number of employees of the group
 - **Sales.** Total sales proceeds of a group member in proportion to the group as a whole
 - Sales proceeds are allocated to group members where dispatch or transport of the goods to the acquiring person ends
 - Supplies of services allocated based on where the services are physically performed
 - **Numerical Formula:** $\text{Share Country A} = \frac{1}{3} (\text{Sales}^A / \text{Sales}^{\text{Group}}) + \frac{1}{3} (\frac{1}{2} (\text{Payroll}^A / \text{Payroll}^{\text{Group}}) + \frac{1}{2} (\text{No. of Employees}^A / \text{No. of Employees}^{\text{Group}})) + \frac{1}{3} (\text{Assets}^A / \text{Assets}^{\text{Group}})$
 - CCCTB does not affect the tax rates applied by each country after apportionment

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Impact on U.S. Multinationals

- Advantages
 - Potential for lower tax compliance costs related to European entities
 - One tax return, one point of contact
 - Potential for lower transfer pricing costs and documentation
 - Intra-group transactions disregarded
- Disadvantages
 - May reverse tax efficient planning by allocating profits to high-tax jurisdictions
 - Intra-group allocations based on transfer pricing principles (not CCCTB apportionment) may be necessary for US tax purposes – ie. to determine Subpart F inclusions, etc.
 - US transfer pricing rules are not affected by CCCTB – Multinationals will still have arm's length requirement for certain transactions.
 - Potential for increased compliance costs during transition period

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Impact on US Multinationals

Case Study #1 – CCCTB Election not Beneficial

Assumptions

System Profit: 1,000
 Ireland Profit: 700
 France Profit: 100
 Spain Profit: 100
 UK Profit: 100

Ireland, France, Spain and UK have same payroll costs and assets

France, Spain and UK each account for 1/3 of final sales to 3rd party customers

Without CCCTB Election

Tax Calculation	Income	Rate	Total Tax
▪ Ireland	700	12.5%	88
▪ Spain	100	30.0%	30
▪ UK	100	27.0%	27
▪ France	100	33.3%	33
Total Tax			170


With CCCTB Election

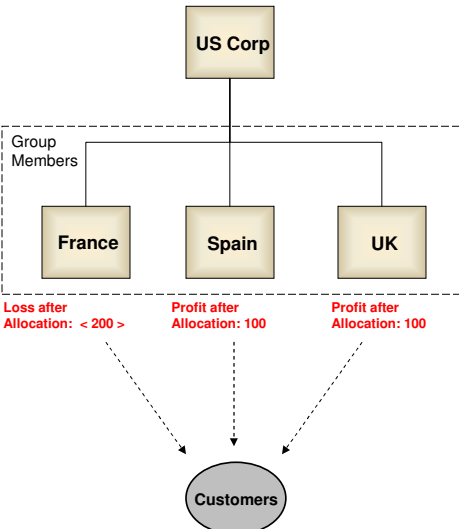
- Intercompany sales disregarded for sales factor
- Apportionment of 1,000 system profit based on payroll, assets and sales. In this example Ireland receives less system profit because its intra-group sales are disregarded

Tax Calculation	Income	Rate	Total Tax
▪ Ireland	100	12.5%	13
▪ Spain	300	30.0%	90
▪ UK	300	27.0%	81
▪ France	300	33.3%	100
Total Tax			284

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Impact on US Multinationals Case Study #2 – CCCTB Election Beneficial





Without CCCTB Election

Tax Calculation	Income	Rate	Total Tax
Spain	100	30.0%	30
UK	100	27.0%	27
France	<200>	33.3%	0
Total Tax			57


With CCCTB Election

- Entities file consolidated income tax return
- Total system income is zero after netting gains and losses

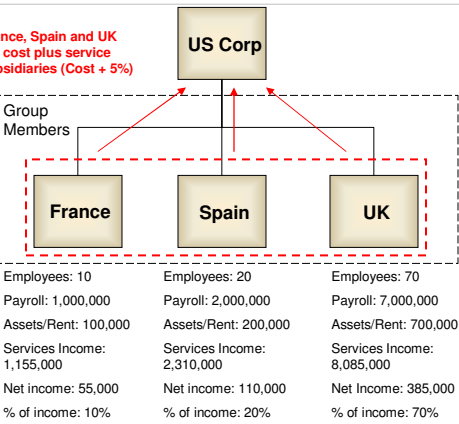
Tax Calculation	Income
Spain	100
UK	100
France	<200>
Consolidated Profit	0
Tax	0

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Impact on US Multinationals Case Study #3 – CCCTB Election Neutral



France, Spain and UK are cost plus service subsidiaries (Cost + 5%)



France	Spain	UK
Employees: 10	Employees: 20	Employees: 70
Payroll: 1,000,000	Payroll: 2,000,000	Payroll: 7,000,000
Assets/Rent: 100,000	Assets/Rent: 200,000	Assets/Rent: 700,000
Services Income: 1,155,000	Services Income: 2,310,000	Services Income: 8,085,000
Net income: 55,000	Net income: 110,000	Net Income: 385,000
% of income: 10%	% of income: 20%	% of income: 70%

- US Corp will be indifferent to the election because the profits allocated each subsidiary using the CCCTB formula will match the income derived from the cost plus services provided, since costs and subsequent revenues are a function of payroll.
- US Corp will need to show that Cost + 5% is the appropriate transfer price whether CCCTB is chosen or not, although under CCCTB apparently review of the transfer pricing issue would be limited to the chosen EU filing jurisdiction

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Adoption and Implementation



- Timing
 - 2016 or 2017 at the earliest
 - Discussion, negotiation and adoption likely at least 2 years
 - Implementation period of at least 2 to 3 years
- Questions Remain
 - Does the Directive have enough support in the EU
 - Consent of 27 Member States generally required. Some are opposed.
 - Optional v. Mandatory
 - Is the optional election a precursor to mandatory implementation?
 - Will Multinationals Support
 - Will promised reduction in compliance and administrative costs, and increased commerce, outweigh possible negative impact on international tax planning

State Taxation of Multijurisdictional Income

- Theories, Actions and Trends

Dean F. Andal

Director

PwC

Moderator

Dr. LeAnn Luna

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The University of Tennessee

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Economist

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STATE TAXATION OF MULTISTATE INCOME

LeAnn Luna, The University of
Tennessee
SJSU Tax Policy Conference
Friday, March 1, 2013

2

Possible goals for taxing business

- Revenue
- Tax exporting
- Fairness
- Tax portfolio balance
- Revenue handle
- Benefit tax

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Benefit Taxes

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- Tax businesses for their consumed public benefits to avoid cross subsidies from or to households and to properly distribute costs
- Corporate income taxes are a poor mechanism for taxing benefits
 - ▣ Benefit tax should be on all businesses, not just profitable corporations.
 - ▣ Profits a poor proxy for benefits.
 - ▣ Production states forgo revenue but still provide benefits.

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Who pays the corporate income tax?

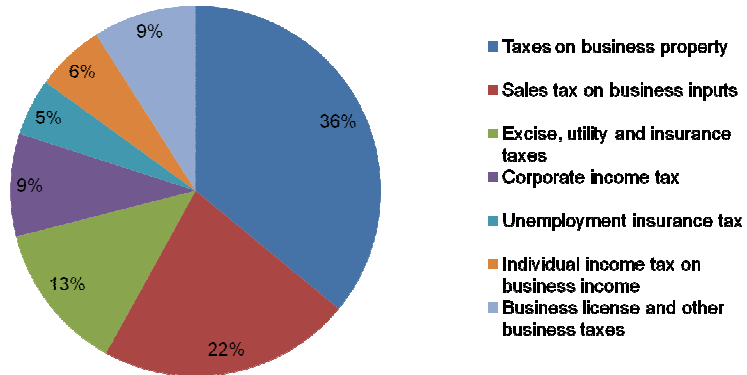
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- Generally said that businesses don't pay taxes, people do
- Choices for the tax incidence
 - ▣ Firm owners
 - ▣ Workers
 - ▣ Customers
 - ▣ Other input providers

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Composition of Total State and Local Business Taxes, FY2009

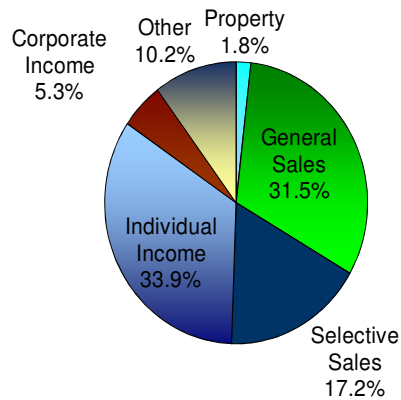
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Source: Ernst & Young. "Total state and local business taxes: State-by-state estimates for fiscal year 2009." March 2010.

PERCENTAGE DISTRIBUTION OF STATE TAX COLLECTIONS, 2011

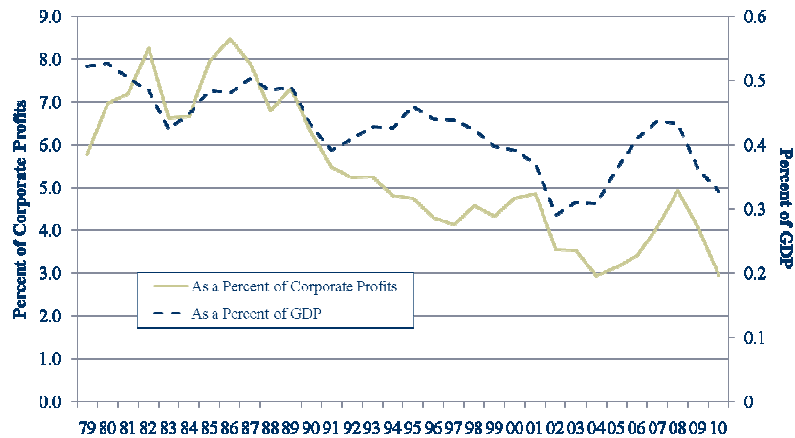
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State Corporation Net Income and License Tax Base

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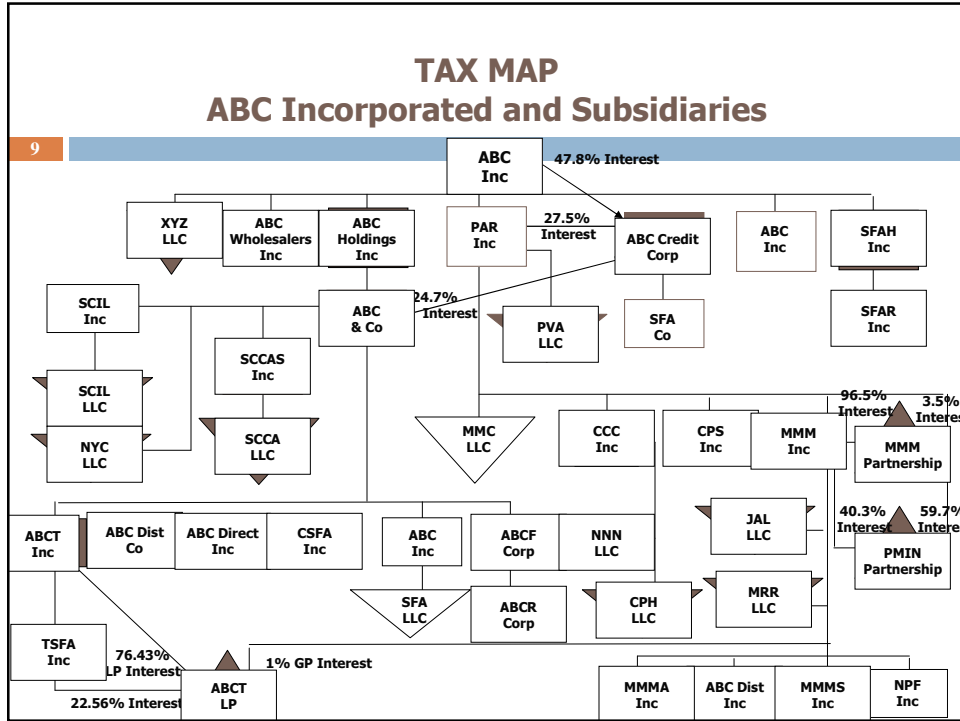
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Issues in Defining the Corporate Tax Base in Taxing Multistate Income

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- Defining the taxable business
- Nexus
- Separate versus Combined reporting
- Apportionment
- Throwback rules
- State efforts to reduce tax planning – what is the taxable entity

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Nexus

- Current Practice
 - ▣ physical presence
 - ▣ doing business
 - ▣ earning income
- Components of Nexus:
 1. Substantive nexus – power to tax, which arises either from source or residence
 2. Enforcement nexus – ability to compel collection, which arises either from personal jurisdiction or agency jurisdiction

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Economic standard versus physical presence standard

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- Economic presence allows income to be taxed where earned.
 - ▣ Neutral in the destination market. Destination basis is consistent with market efficiency.
 - ▣ Reduces tax planning
 - ▣ Problems - better on substantive than enforcement nexus
- Problems with physical presence
 - ▣ Income also earned at destination
 - ▣ Physical presence is not a reliable measure of service benefits
 - ▣ Creates planning opportunities like PL 86-272

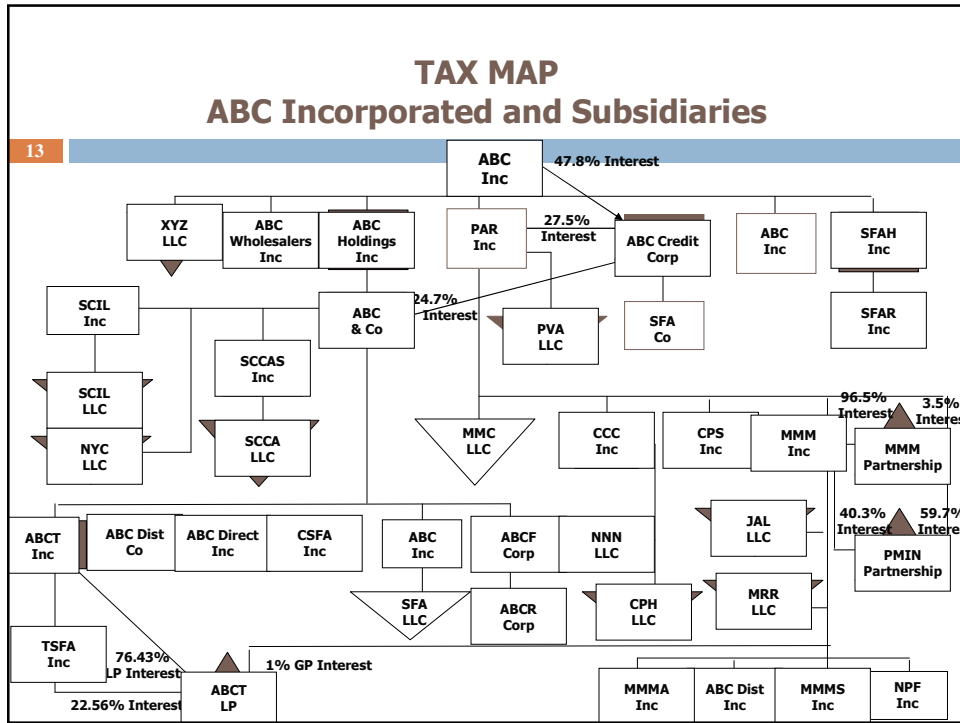
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P.L. 86-272

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- Federal law that prohibits a state from taxing the profits of a corporation if that entity's only activity in the state is to solicit for sales of tangible personal property (i.e. sets the minimum nexus standard for income tax).
- Sales are often not taxed in the home state because the sales are situated to the sales state.
- Therefore, if a corporation has no property or payroll in a state, the sales to that state can go untaxed.

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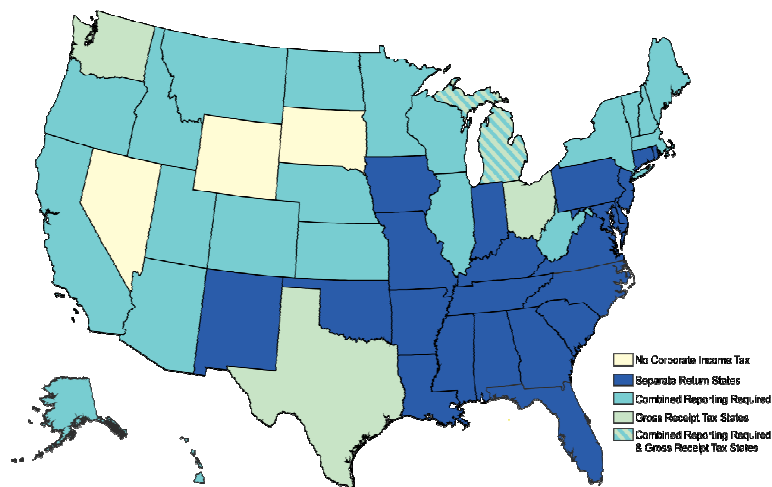
Separate Accounting

- ❑ Losses of one firm are unavailable to offset income of another, resulting in too much income being taxed.
- ❑ Shared costs may not be easily divisible across entities within the unitary business
- ❑ There may not be any basis to assign the profits among firms that result from synergies and economies of scope.

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Combined Reporting

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Combined Reporting

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- Disregards the existence of separate entities and requires a business to combine the operations of all related firms involved in a “unitary” business.
- Income of the entire group is apportioned to the states where the group does business.
- Intercompany transactions are eliminated
- Accounts for vertical integration
- In theory, the resulting tax burden is as if the combined group were collapsed into a single firm.

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Issues with Combined Reporting

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- Defining the unitary group
 - ▣ What is unitary?
 - ▣ Which firms to combine?
- Combined reporting is an averaging rather than a calculation of specific profits
- Transitional issues
- Financial accounting implications
- May generate additional revenues but harms the economy in combined reporting states

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Alternatives to Combined Reporting Used by States

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- Disallow/addback deductions between related companies
 - ▣ States vary the breadth of these statutes, which have different implications on tax planning.
- Impose nexus on PICs
- Examine PIC for valid business purposes
- Audit transfer prices
- Extend corporate taxes to unincorporated firms
- All will be incomplete, but so is combined reporting

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Business Income and Apportionment

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- Business income is apportioned using variations of a 3 factor formula (property, payroll, and sales)
- Non business income is allocated to a specific state.
- Why 3 factors? Trying to mix demand (sales) and supply (property and payroll) components
- Why increase weight on sales
 - ▣ Economic development

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Joyce versus Finnegan

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- Joyce versus Finnegan
 - ▣ Joyce – only “unitary” firms that have nexus in the taxing state will be included in the sales factor
 - ▣ Finnegan – all “unitary” firms, even those that do not have nexus in the taxing state, will be included in the sales factor.

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Throwback Rules

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- Include in the numerator of the origin state's sales factor those sales that are not taxed in destination states – 23 states
- Achieves locational neutrality if all states tax corporate income at the same rate

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Why not Throwback Rules?

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- Resulting base is inconsistent with intended tax base –
 - ▣ Imposed not because a state determines that income is earned within that state, but because another state is unwilling or unable to tax it
 - ▣ Levied at the home not the destination state rate
- Increases the origin component of the base
 - ▣ Increases incentive to move firms selling tangible personal property
 - ▣ Inconsistent with heavy weighting of the sales factor

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Final Thoughts

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- Little economic justification for the CIT, but not likely to be replaced.
- Nexus should be based on economic presence
- Increase reliance on sales factor
- Separate reporting with a broad addback statute
- Eliminate throwback rules.
- Impose entity taxes that are substitutable with the corporate form.

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State Taxation of Multistate Income – Theories, Actions and Trends: California Focus

Dr. Justin Garosi
Economist
Legislative Analyst's Office

1

Apportionment in California

- up to 1993: 3 factors, equal weight
- 1993-2010: double weighted sales
- 2011-2012: elective single sales
- 2013-: mandatory single sales

2

Winners and losers

- Exporter firms like the single sales factor
 - relatively high property and payroll, low sales in the state
- Importer firms like the traditional formula
 - relatively low property and payroll, high sales in the state
- How to beat the system
 - produce in states with single sales factor
 - sell primarily into states with big weights on property and payroll

3

single sales v. double weighted sales CA-based firm

	Single Sales	Double Weighted
% of US total in CA:		
Payroll	0.8	0.8
Property	0.8	0.8
Sales	0.2	0.2
CA apportionment ratio	0.2	0.5
× Total US profits (millions)	\$10.0	\$10.0
= CA taxable profits	\$2.0	\$5.0
CA tax payment @8.84%	\$176,800	\$442,000

4

single sales v. double weighted sales
 “out of state” firm

	Single Sales	Double Weighted
% of US total in CA:		
Payroll	0.04	0.04
Property	0.04	0.04
Sales	0.14	0.14
CA apportionment ratio	0.14	0.09
× Total US profits (millions)	\$10.0	\$10.0
= CA taxable profits	\$1.4	\$0.9
CA tax payment @8.84%	\$123,760	\$79,560

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Expansion into other states

- assume profits and location of sales don't change
- Weight > 0 on property and payroll: lower CA taxes
 - now lower share of national property and payroll in CA
 - CA apportionment ratio falls
 - CA tax bill falls
- Single sales: CA tax bill unchanged
 - now lower share of national property and payroll in CA, but property and payroll don't matter

6

Economic impact of CA policy changes

- actual effect of elective single sales may be hard to measure
- vulnerable from the start—did people really expect it to hold up?
- temporary policies seldom have much effect on location decisions

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Measuring economic impact

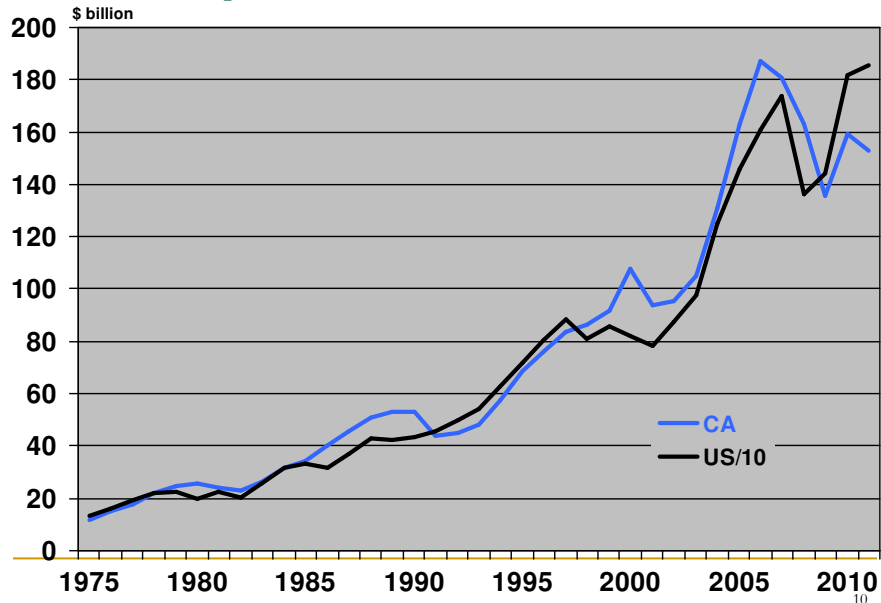
- single state studies not often useful
 - policy changes too infrequent, impact hard to disentangle from other factors
- multi-state panel studies better
 - still hard to control for other policies, factors that affect activity

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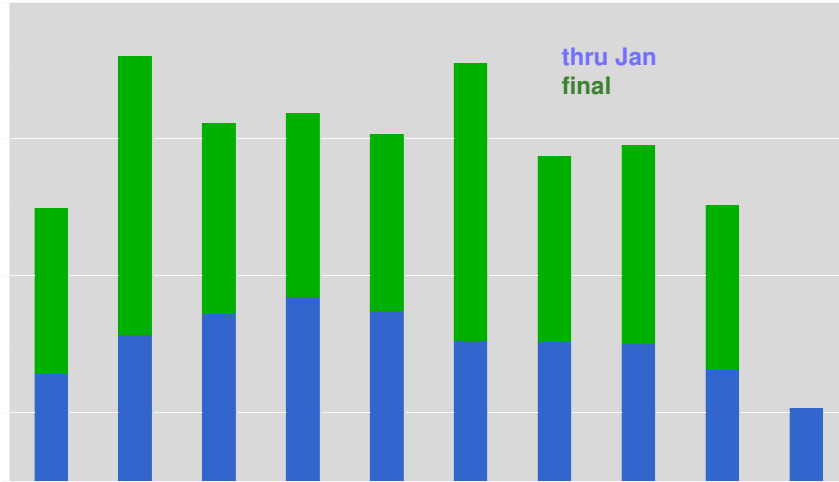
Evidence on apportionment's impact

- historical panel studies: all else equal, higher sales factors associated with modest increased job growth
 - Goolsbee + Maydew, 2001
 - Gupta + Hoffmann, 2006
- CA dynamic simulation?
 - Industry-funded consultant used CA-specific model, found similar result
 - method seemed reasonable

CA: taxable profits
US: 10% of book profits w/IVA, CCA



2012: year 2 of elective single sales
No return data yet, evidence from collections



TEI-SJSU Tax Policy Conference
March 1, 2013; Santa Clara

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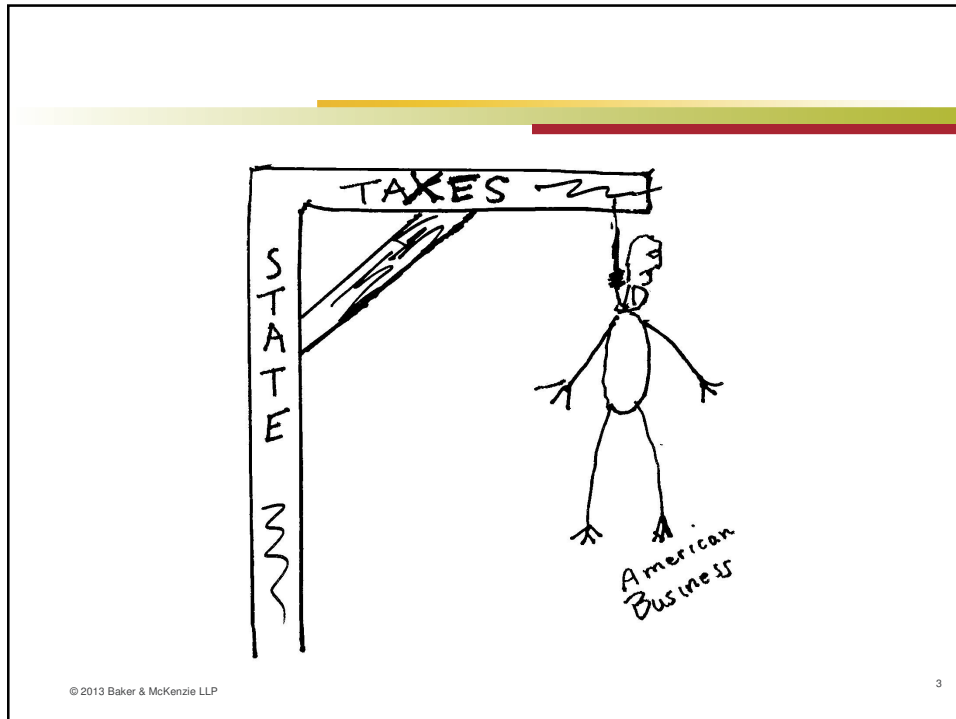
State Taxation of Multijurisdictional Income Trends in State Tax

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Trends and Practical Considerations

1. Tightening the Noose on Business
2. Finger in the Wind Apportionment
3. *Gillette* – The Sound and the Fury
4. Intersection of State Tax and International Taxation



Trends in the Last 25 Years

- The late 1980's and early 1990's were a period of aggressive and sometimes egregious state tax minimization.
 - Delaware IHCs proliferated
"Desk drawer" companies with one part-time employee earned enormous royalties, interest, and/or trading profits.
 - State tax groups were the most profitable and fastest growing segments in several of the "Big 8" accounting firms.

State Reactions to Tax Minimization

- Well planned tax minimization structures with substance sometimes survived challenges, but too many taxpayers with insubstantial structure continued to litigate and lose.
 - Many states adopted statutory disallowance of payments to related parties.
 - Businesses that for non-tax reasons put their research and development and/or intangible property in a separate legal entity sometimes paid more state tax than they would have if all domestic operations were in a single entity.

Spread of Combined Reporting

- States became reenergized to adopt mandatory unitary filings, and business opposition waned. After a long hiatus where no states adopted combined reporting, 7 states adopted combined reporting in the last 6 years. Now only a minority of states clustered in the south and southeast still use separate reporting.

Combined Reporting

- The following states have implemented mandatory combined reporting:
 - Alaska
 - Arizona
 - California
 - District of Columbia (2012)
 - Hawaii
 - Idaho
 - Illinois
 - Kansas
 - Maine
 - Massachusetts (2009)
 - Michigan (2007)
 - Minnesota
 - Montana
 - Nebraska
 - New Hampshire
 - New York (2007)
 - New York City (2009)
 - North Dakota
 - Ohio
 - Oregon
 - Texas (2008)
 - Utah
 - Vermont (2006)
 - West Virginia (2009)
 - Wisconsin (2009)

State Courts Protected State Fisc

- In a trend started before the recession but increasingly evident during the recession, state courts supported novel theories and ignored established precedents in order to protect state revenues.
 - Mandatory combination without statutory authorization.
 - *Wal-Mart Stores v. Hinton* (NC 2009)
 - *Delhaize Inc. v. Ley* (NC 2012)
 - Finger in the wind apportionment.
 - *Microsoft v. FTB* (CA 2006)
 - *Bellsouth Advertising v. Chumley* (TN 2009)
 - *General Mills* (CA 2012)

Economic Nexus

- Enactment of Statutory Dollar Thresholds
- Judicial Developments
 - State courts reign unchecked by U.S. Supreme Court

Gillette v. Franchise Tax Board: The Sound and the Fury

- Can the Legislature modify the equally weighted three-factor formula without formally withdrawing from the MultiState Tax Compact?

MTC Compact Election

The Gillette Co. & Subs. v. California Franchise Tax Bd.,
Case No. A130803 (Cal. Ct. App. 2012)

- Court of Appeal overturned the trial court.
- Found in favor of the taxpayer, upholding the taxpayer's right under California law to choose to apply the three-factor single-weighted sales formula or the double-weighted sales formula to apportion and allocate income.
- The Multistate Tax Compact, to which California was a signatory, is a binding, multistate agreement that obligates its member states to offer their multistate taxpayers the option of using either the Compact's three-factor formula to apportion income, or the state's own alternative apportionment formula.

MTC Compact Election

The Gillette Co. & Subs. v. California Franchise Tax Bd.,
Case No. A130803 (Cal. Ct. App. 2012)

- In anticipation of an adverse decision in *Gillette*, the California Legislature withdrew from the Compact on June 27, 2012. S.B. 1015.
- The bill specifically wrote into law a retroactive requirement that any election affecting a taxpayer's computation of tax must be made on an original timely filed return.
- The legitimacy of S.B. 1015 has been questioned since the Legislature passed the law by a simple majority rather than the two-thirds majority required for a tax increase in California.

MTC Compact Election

The Gillette Co. & Subs. v. California Franchise Tax Bd.,
Case No. A130803 (Cal. Ct. App. 2012)

–FTB petitioned California Supreme Court to review.

- \$750 million refund claims.
- 80,000 returns per year could be affected.

–18 of the 19 member states in Compact wrote to California Supreme Court asking for review and asserting Ct. of Appeal decision threatens

- the Compact
- state laws
- treasuries of member states
- California Supreme Court granted review January 16, 2013
- FTB opening brief now due April 17, 2013.

MTC Compact Election

The Gillette Co. & Subs. v. California Franchise Tax Bd.,
Case No. A130803 (Cal. Ct. App. 2012)

–Implications of the *Gillette* case

- Invalidates the mandatory nature of California's double-weighted sales factor;
- Calls into question any legislation, regulation or practice that requires treatment contrary to that allowed under the Compact.
 - Special Industry Formulas
 - Statutory Exclusion of Treasury and Hedging Receipts (CR&TC § 25120(f)(2).
 - *Joyce/Finnigan* approaches to inclusion of sales by affiliates protected by P.L. 86.272.

California Apportionment Law Changes

Optional Single Sales Factor

–In 2011, California altered its apportionment formula by providing corporate taxpayers with an election to use single-factor apportionment based only on sales.

Mandatory Single Sales Factor

–On November 6, 2012, voters passed Proposition 39 which makes the single sales factor mandatory for all multistate businesses (except agricultural, extractive or financial businesses) doing business in California.

MTC Challenges in Other States

Taxpayers in Michigan, Oregon and Texas have also filed actions claiming entitlement to MTC three-factor apportionment.

–*Healthnet Inc. v. DOR Oregon*, Case No.:

–*IBM v. Dept. of Treasury*, Michigan Ct. of Appeals, 306618, November 20, 2012, Petition for Michigan Supreme Court Review.

–Texas Controller's Decision No. 105,941, 01/19/2012.

Implications Nationally

U.S. Steel Corp. v. MTC, 434 U.S. 452 (1978)

- Challenged the constitutionality of the MTC and the Compact.
- The Court found no constitutional violation. The Compact did not enhance state political power at the expense of the United States; did not confer to states powers which they did not already possess; did not involve any delegation of state power to the Commission. Each state was free to withdraw from the group at any time.

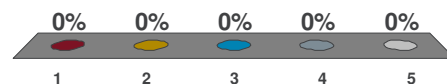
Supreme Court has consistently declined to review state tax cases.

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Will the California S Ct reverse the Court of Appeal decision in favor of *Gillette*?

1. Yes, because the FTB has stronger legal arguments.
2. Yes, because the budget impact is so large.
3. Yes, for both reasons in 1 and 2 above.
4. No.
5. Too close to predict.



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Trend

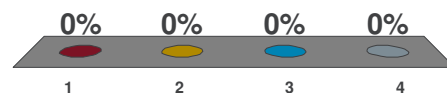
- More and more states are giving extra weight to sales factor or going to single sales factor apportionment.
- Many states also are moving to market sourcing for sales other than tangible property and abandoning cost of performance.

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Should states be free to adopt whatever apportionment methodology they want or should Congress set limits?

1. States should have complete freedom — this type of competitiveness among states is good for the economy.
2. States should be able to choose within a range but there should be limits so tax burden is not disproportionately born by out-of-state companies only selling into the state.
3. Congress should establish a mandatory formula, such as $\frac{1}{2}$ apportioned to production and $\frac{1}{2}$ apportioned to market.
4. There is little need for Congress to act, as pretty soon there will be near uniformity, as more and more states succumb to pressure of single-factor market sourcing.



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Decoupling State Tax from Internal Revenue Code (“IRC”)

- While most states follow IRC either through starting with federal taxable income, adopting IRC, or adopting state statutes that mirror IRC, most states modify to exclude some taxpayer favorable provisions, such as bonus depreciation.
- Some commentaries have suggested that states take initiative in curbing international tax minimization by adopting mandatory worldwide combined reporting.

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To prevent loss of revenue from base erosion and profit shifting, should states?

1. Follow lead of IRS in int’l transactions.
2. Take their own initiative, perhaps collaboratively through MTC or Federal Tax Administrators.



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Summary

- The states have dealt with base erosion and profit shifting for many years now.
- What, if any, lessons can the United States and other countries learn from the state experience?

Setting the Stage

Professor Annette Nellen
SJSU MST Program

Tax Policy Conference
Tax Policies for Multijurisdictional Income
March 1, 2013

History

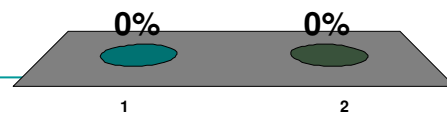
- Willis Comm'n Report (1964), page 95:
 - “when California was considering the possibility of a State income tax in 1906, a commission then making a study of the California tax system rejected the income tax as “theoretically good, but practically unworkable and un-American.”
-

Thinking about today's topic



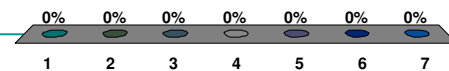
Existing tax rules for multijdx income are still workable for 21st century transactions.

1. True
2. False



Business income tax should be focused on the location of ...

1. Tangible assets
2. Customers
3. Employees
4. Intangibles
5. Where people access your website
6. Where incorporated
7. Some combination of the above



Multijurisdictional Income Tax Considerations

- Why tax?
- Where - which jdx is allowed to tax income?
 - How to avoid double taxation?
- Who is the taxpayer?
- How is income to be measured?
- How to determine how much multijdx income to attribute to a jdx?
- How to structure the system for fairness and administrability?
- Feasibility?
 - Is a business income tax feasible?
 - Alternatives?

Why tax?

What justifies a jurisdiction imposing a tax on a business?

- The need to generate revenue.
- Exercise of taxing power, within constitutional constraints
 - State test - "whether the taxing power exerted by the state bears fiscal relation to protection, opportunities and benefits given by the state. The simple but controlling question is whether the state has given anything for which it can ask return."
 - *Wisconsin v. JC Penney*, 311 US 435, 444 (1940).
 - Jurisdiction's constitution may also impose tax limitations (such as no income tax).
- Recognition that businesses use government services (benefits theory).
- Recognition that businesses use public resources.
 - Example - a jurisdiction might impose a mineral severance tax.
- Public expectation that businesses "pay their fair share."
- Attempt to align behavior with jurisdiction's goals.
 - Example - tax imposed to attempt to reduce emissions of pollutants.
 - Example - tax credit to encourage certain behavior, such as R&D or film production.
- Possibility of exporting taxes to out-of-state businesses that have customers in the jurisdiction.

General considerations in designing the tax

- What types of taxes are permitted per the jurisdiction's constitution and laws?
- What tax has a desirable link to benefits provided by the jurisdiction?
 - Limitation of an income tax is that a business only pays if it has income. A business generating a loss still uses government services.
- Administrability.
- What do neighboring jurisdictions do?
- Jurisdiction's need for a balance of revenue sources rather than relying only on one type of tax.

Which jdx is allowed to tax the income? (where to tax)

- What justifies placing income or a transaction in the base of the tax system of a particular jurisdiction?
 - Considerations:
 - Place of incorporation
 - Domicile or headquarters location
 - Location of customers
 - Location of production inputs (employees, equipment, intangibles, etc.)
 - How broad are production inputs defined? (anywhere someone views your website, where people view your ads, where you collect data)

Who is the taxpayer?

- Legal considerations – what authority does jurisdiction have to impose tax obligations on a business entity?
 - State level – Nexus - U.S. constitutional considerations involving the Due Process and Commerce Clauses.
 - Income taxes – Public Law 86-272 for entities that sell tangible personal property. Otherwise, state law within constitutional parameters applies.
 - Sales tax – in 1992, the U.S. Supreme Court held that a physical presence is needed before a state may impose sales tax collection obligations on a vendor.
 - International level – "Permanent Establishment" – "a fixed place of business through which the business of an enterprise is wholly or partly carried on." [OECD Model Treaty, Chapter 2, Article 5]
- Time period - How long does the authority to tax an entity last?

Who is the taxpayer?

How to define the taxpayer?

- The legal entity?
- A subunit of the legal entity?
- A consolidated group of corporations? Who is included? What ownership relationship should be used? Should foreign entities be included?
- A combined group with similar or integrated operations that may consist of a portion of one entity or portions of multiple entities (a unitary group)?
- Some other approach?

Challenges – see excerpt from Texas margin tax included in materials.

This question ties closely to the next question ---->

How to determine how much multijurisdictional income to attribute to a jurisdiction?

Sovereign vs non-sovereign jurisdictions

Sovereign jurisdictions (have greatest reach):

- Worldwide versus territorial
- Export neutrality versus import neutrality
- How to address same income taxed in more than one jurisdiction
- Measurement approach (if not taxing all income of the entity).

How to determine how much multijurisdictional income to attribute to a jurisdiction?

Non-sovereign jurisdictions (e.g. U.S. states):

- Constitutional constraints
 - State may only tax income that has "rational relationships with the taxing State." Income apportioned to a state must "be derived from the same unitary business that is being conducted at least in part in [this State]." MTC Allocation and Apportionment Regulations, Reg. IV.1.(a).(6).
 - "Rather than isolating the intrastate income-producing activities from the rest of the business, a State may tax a corporation on an apportioned sum of the corporation's multistate business if the business is unitary." *Allied Signal, Inc. v. Director, Division of Taxation* (NJ), 504 US 768 (1992).
- Measurement

Measurement (how much multijurisdictional income to tax in a jurisdiction)

General Considerations:

- Legal constraints (such as states face)
- Economic considerations (what should be attributed to the jurisdiction)
- Accounting considerations (what can realistically and reasonably accurately be measured as attributed to the jurisdiction)
- Jurisdiction:
 - How to prevent shifting of multijurisdictional income to low-tax jurisdictions.
 - Administratability
- Business:
 - How to avoid income being taxed by more than one jurisdiction.
 - Compliance costs and ability to even comply.

Measurement (how much multijurisdictional income to tax in a jurisdiction)

Approaches:

1. Separate accounting
 - Capture/isolate revenue and expenses for activities within the particular jurisdiction.
 - Need to be sure intracompany and intercompany transactions properly measured and recorded (transfer pricing).
 - How to resolve differences between jurisdictions.
2. Formula apportionment
 - Nexus (relevant so know if even have to apportion; see next example)
 - Definitions of business and non-business income
 - Apportionment factors and how defined; alternatives.
 - Sourcing rules and how tangible personal property is defined
 - Throwback rule
 - How to resolve differences between jurisdictions.

Example – how nexus rule and design of system affects where income is taxed

- X manufactures widgets in California and sells them all to customers in Kansas.
 - Employees and property are in CA
 - Sales are in KS, but approved and filled from CA
- Is X's income attributable to CA or KS or both?

Theories

- Benefits theory:
 - Should tax in CA – it is where X gets most of its government benefits.
 - But, KS will say X gets benefits in KS from the nice market that exists there.
- Activity theory:
 - All happens in CA.
 - But KS roads used to deliver the goods.
- Enforcement theory:
 - X has no property in KS – how will KS enforce a tax on X?

Relevance of “nexus” requirement to X’s situation

- Today – PL 86-272
 - X has no nexus in KS
 - So, per this example, seems that Congress’ action in drafting nexus standard for net income tax and tangible personal property, benefited the origin/source state rather than destination/market state.
 - All of the income taxed in CA under throwback rule.
- However, if X has nexus in KS, then income tax is split between CA and KS:
 - Assume equal weighted 3 factor apportionment
 - CA = Property 100/100 + Payroll 100/100 + Sales 0/100 = 2/3 = 67%
 - KS = Property 0/100 + Payroll 0/100 + Sales 100/100 = 1/3 = 33%
 - All of X’s income is taxed with most apportioned to CA.

Additional Observations for X

- Unequal weighting of apportionment factors:
 - Assume CA double-weights sales (it did) and KS has equal weighting (it does)
 - $CA = \text{Property } 100/100 + \text{Payroll } 100/100 + \text{Sales } 0/100 \times 2 = 2/4 = 50\%$
 - $KS = \text{Property } 0/100 + \text{Payroll } 0/100 + \text{Sales } 100/100 = 1/3 = 33\%$
 - Now only 83% of X's income is subject to income tax and X likes CA more – may even put more property and payroll there!

Measuring income

- How to define the base?
- What deductions and exclusions should there be? Why?

Fairness and administrability

- **Administrability considerations**
 - Should small taxpayers be exempt or have streamlined filing or computation procedures?
 - Should more jurisdictions work together for uniformity?
 - U.S. states
 - PL 86-272 – Congress mandate
 - UDITPA – not all states adopt or adopt as written
 - EU - Common Consolidated Corporate Tax Base
 - Common income tax base
 - Each of the 27 countries sets its own rate
 - http://ec.europa.eu/taxation_customs/taxation/company_tax/common_tax_base/index_en.htm
- **Avoiding having the same income taxed in more than one jurisdiction. ---→**

Avoiding multiple taxation

- Countries and states need to work together to design principles or laws that help prevent multiple taxation of income, are logical, and administrable.
 - Tax treaties
 - Compacts
 - Model laws
 - Have a higher jurisdiction exercise authority
 - Example: Congress enacted Public Law 86-272 in 1959 to provide the rule on when a state can impose income tax obligations on a business that sells tangible personal property.
- **Challenges:**
 - Reaching and maintaining consensus on the rules.
 - Interpretation of the rules.
 - Desire by a jurisdiction (and taxpayers) to change the rules for economic development or other purposes.

Activities versus tax obligation; and desire for workable laws

- “In some States the company which has its salesmen make collections and investigate credit becomes liable to file an income tax return, while in other States it has no liability even though its activities are more extensive. In some States a company is liable because it employs a telephone answering service in conjunction with the solicitation of orders by its salesmen, while in other States it has no liability even though it maintains a full-fledged sales office in the State.”
 - Chapter 18, page 594 of Willis Comm'n Report (1964)

Feasibility

- Does an income tax work for multijurisdictional income?
 - Is a significant revenue producer, jurisdictions unlikely to want to give it up.
 - What alternatives exist?
 - Would they be better?
 - Consumption tax approach, such as BAT (business activity tax)?
 - Justification – ultimately, all tax paid by individuals.
 - Would likely need to apply beyond just corporate entities, but to all types of businesses.

Simple example

X Company owns and operates one restaurant in San Jose.



Federal – all income taxed in US
State – all income taxed in CA



Still simple?

X Company owns and operates two restaurants – one in San Jose and one in Phoenix.



Where to tax?

- Federal – all taxed in US
- CA and AZ?



What now?

X Company owns and operates 3 restaurants –

- San Jose
- Phoenix
- Vancouver



Where to tax?

How much income taxable in each jurisdiction?

- Is separate accounting with transfer pricing feasible?
- Is formula apportionment of tax base better?
 - Can there be a common tax base?
 - How to avoid < or > 100% of base being subject to tax?

Back to simple example - maybe

- X owns and operates one restaurant in San Jose AND operates a farm that provides organic food to several restaurants.



- Restaurant – income
- Farm – loss

■ What if:

- All customers and property in CA
- Some farm customers in other states
- Farm loss due to selling to AZ customers



Issues with 21st Century Transactions

- Digital transactions and services.
 - Existing rules may not address or not address well, new types of transactions and activities.
- Ease of reaching customers leads more businesses of all sizes to have customers in many jurisdictions.

Addressing Base Erosion and Profit Shifting



The Permanent Subcommittee On Investigations - Hearings

Offshore Profit Shifting and the U.S. Tax Code

Permanent Subcommittee on Investigations

September 20, 2012 02:00PM

Location: Room G-50, Dirksen Senate Office Building



Senator Levin activities

- Hearing 9/20/12 – “Offshore Profit Shifting and the U.S. Tax Code”
 - “U.S. multinational corporations benefit from the security and stability of the U.S. economy, the productivity and expertise of U.S. workers and the strength of U.S. infrastructure to develop enormously profitable products here in the United States. But, too often, too many of these corporations use complex structures, dubious transactions and legal fictions to shift the profits from those products overseas, avoiding the taxes that help support our security, stability and productivity.”
- S. 268 (113th Congress) - Cut Unjustified Tax Loopholes Act
 - Congressional Record, 2/11/13, S592 – S594

The Hon. David Bradbury, Asst Treasurer, Australia, Nov. 2012



- “the point is to highlight how the **digital disruption** brought about by the internet and changes in technology have transformed the way economic activity is occurring- and these changes are putting pressure not only on businesses but also on the corporate tax system in Australia and around the world.
- In turn, this challenges some of the concepts that form the building blocks of our current international tax architecture - source, permanent establishments and residency.
- Increasingly, Governments are discovering the lack of effectiveness in the digital age of international tax concepts created for the industrial age.
- This has been highlighted by the compelling evidence revealed by the UK Public Accounts Committee examination of the Taxation of Multinational Corporations.
- Media reports of the Committee's hearings state that Amazon paid no tax in the UK despite £3.3billion in sales by routing transactions through Luxembourg, where it faced an effective tax rate of 2.5 per cent.
- And now we see that the weaknesses that technology companies have exposed in the international tax architecture are spreading to other industries and activities.
- The UK Public Accounts Committee was told that Starbucks had paid no taxes in the UK for three years, despite sales totalling £1.2 billion - in part due to royalty payments for the use of the brand.”

<http://assistant.treasurer.gov.au/DisplayDocs.aspx?doc=speeches/2012/013.htm&pageID=005&min=djba&Year=&DocType>

“Digital disruption” also leading to:

OECD report on Base Erosion and Profit Shifting (BEPS)

- “12/02/2013 - Global solutions are needed to ensure that tax systems do not unduly favour multinational enterprises, leaving citizens and small businesses with bigger tax bills.
- An OECD study commissioned by the G-20 - Addressing Base Erosion and Profit Shifting (BEPS) - finds that some multinationals use strategies that allow them to pay as little as 5% in corporate taxes when smaller businesses are paying up to 30%. OECD research also shows that some small jurisdictions act as conduits, receiving disproportionately large amounts of Foreign Direct Investment compared to large industrialised countries and investing disproportionately large amounts in major developed and emerging economies.
- “These strategies, though technically legal, erode the tax base of many countries and threaten the stability of the international tax system,” said OECD Secretary-General Angel Gurría. “As governments and their citizens are struggling to make ends meet, it is critical that all tax payers - private and corporate - pay their fair amount of taxes and trust the international tax system is transparent. This report is an important step towards ensuring that global tax rules are equitable, and responds to the call that the G-20 has made for the OECD to help provide solutions to the global economic crisis.”
- Many of the existing rules which protect multinational corporations from paying double taxation too often allow them to pay no taxes at all. These rules do not properly reflect today’s economic integration across borders, the value of intellectual property or new communications technologies. These gaps, which enable multinationals to eliminate or reduce their taxation on income, give them an unfair competitive advantage over smaller businesses. They hurt investment, growth and employment and can leave average citizens footing a larger chunk of the tax bill.”

<http://www.oecd.org/newsroom/oecd-urges-stronger-international-co-operation-on-corporate-tax.htm>

And to new theories of corporate tax

- Report on taxation of digital economy in France (Jan. 2013)
 - “A new definition of a permanent establishment, specifically introduced for the data-driven economy, should be based on the notion of users as co-creators of value.”
 - Alternative or in the meantime – a Pigovian tax on use of resident’s data if the company does not “comply with stronger privacy and user empowerment requirements” (aim is also to encourage the company to so comply so they won’t owe the tax).
 - Summary on *Forbes*, “Corporate Tax 2.0: Why France and the World Need a New Tax System for the Digital Age,” By Nicolas Colin
 - <http://www.forbes.com/sites/singularity/2013/01/28/corporate-tax-2-0-why-france-and-the-world-need-a-new-tax-system-for-the-digital-age/>
 - French version (200 pages) exists; English translation expected

Texas Margin Tax
Rule §3.590 of Title 34, Part 1, Chapter 3.V.

Example of considerations in defining "who" is the taxpayer.

Excerpt

(b) Definitions. The following words and terms, when used in this section, shall have the following meanings, unless the context clearly indicates otherwise.

(1) Affiliated group--Entities in which a controlling interest is owned by a common owner, either corporate or noncorporate, or by one or more of the member entities.

(2) Combined group--Taxable entities that are part of an affiliated group engaged in a unitary business and that are required to file a combined group report under Tax Code, §171.1014.

(A) A combined group may not include a taxable entity that conducts business outside the United States if 80% or more of the taxable entity's property and payroll are assigned to locations outside the United States. If either the property factor or payroll factor is zero, the denominator is one. For example, if Corporation Z has no property, but does have payroll located entirely outside the United States, Corporation Z will not be included in the combined group. The combined group may not include a taxable entity that conducts business outside the United States and has no property or payroll if 80% or more of the taxable entity's gross receipts are assigned to locations outside the United States. See Tax Code, §171.1014.

(B) A combined group may not include an exempt entity.

(C) A combined group must include eligible entities even if those entities do not have nexus as described in §3.586 of this title (relating to Margin: Nexus).

(D) Eligible pass-through entities including partnerships, limited liability companies taxed as partnerships under federal law, limited liability companies that are disregarded under federal law and S corporations are included in a combined group.

(E) Passive entities are not included in the combined group; however, the pro rata share of net income from a passive entity shall be included in total revenue to the extent it was not generated by the margin of another taxable entity.

(3) Combined group report--A report that includes the business of all members of the combined group.

(4) Controlling interest.

(A) Controlling interest means:

(i) for a corporation, either more than 50%, owned directly or indirectly, of the total combined voting power of all classes of stock of the corporation, or more than 50% owned directly or indirectly, of the beneficial ownership interest in the voting stock of the corporation;

(ii) for a partnership, association, trust or other entity other than a limited liability company, more than 50%, owned directly or indirectly, of the capital, profits, or beneficial interest in the partnership, association, trust, or other entity;

(iii) for a limited liability company, either more than 50%, owned directly or indirectly, of the total membership interest of the limited liability company or more than 50%, owned directly or indirectly, of the beneficial ownership interest in the membership interest of the limited liability company.

(B) Examples are as follows:

(i) Corporation A owns 10% of Corporation C and 60% of Corporation B, which owns 41% of Corporation C. Corporation A has a controlling interest in Corporation B and a controlling interest in Corporation C of 51% of stock ownership because it has control of the stock owned by Corporation B.

(ii) Corporation A owns 10% of Limited Liability Company C and 15% of Corporation B, which owns 90% of Limited Liability Company C. Corporation A does not have controlling interest in Limited Liability Company C and does not have a controlling interest in Corporation B. Corporation B has a controlling interest in Limited Liability Company C.

(iii) Individual A owns 100% of 10 corporations, each of which owns 10% of Partnership B. Individual A has a controlling interest in each of the ten corporations and in Partnership B.

(iv) Corporation A holds a 70% interest in Partnership B that owns 60% of Limited Liability Company C. Corporation A owns the remaining 40% of Limited Liability Company C. Corporation A owns a controlling interest in Partnership B and, taking into account Company A's direct and indirect ownership of Limited Liability Company C, a 100% controlling interest in Limited Liability Company C.

(v) Corporation A owns 10% of Limited Liability Company C and 45% of Corporation B, which owns 90% of Limited Liability Company C. Corporation A would hold a 10% interest in Limited Liability Company C which would not constitute a controlling interest. Corporation B has a controlling interest in Limited Liability Company C.

(vi) Partnership P is owned equally by Limited Liability Company A, Limited Liability Company B and Limited Liability Company C. Three unrelated individuals each wholly owns one of the limited liability companies. None of the limited liability companies owns more than 50% of Partnership P. There is no controlling interest.

(vii) Individual A and Individual B each owns 50% of Partnership X. Individual A and Individual B each also owns 50% of Partnership Y. Individual A and Individual B are not husband and wife. Since neither individual owns more than 50% of each partnership, neither individual has a controlling interest in the partnerships.

(C) Other circumstances. In addition to the foregoing tests, the comptroller may consider any other circumstances that tend to demonstrate that the more than 50% direct or indirect common ownership test was met or was not met.

(D) Membership termination. Membership in an affiliated group shall be treated as terminated in any year, or fraction thereof, in which the conditions listed in this paragraph are not met, except as follows:

(i) when an affiliate is sold, exchanged, or otherwise disposed of, the membership in an affiliated group shall not be terminated if the requirements of this paragraph are again met immediately after the sale, exchange, or disposition.

(ii) The comptroller may treat the affiliated group as remaining in place if the conditions of this paragraph are again met within a period not to exceed two years.

(E) Attribution. Except as otherwise provided, an entity is owned when a controlling interest is directly held or the interest is constructively owned. An individual constructively owns stock that is owned by his or her spouse.

(F) Membership in more than one group. If an entity is a member of more than one affiliated group, the entity is treated as a member of the affiliated group (or part thereof) with respect to which it has a unitary relationship. If the entity has a unitary relationship with more than one of those affiliated groups, it shall elect to be treated as a member of only one group. The election shall remain in effect until the unitary business relationship between the entity and the other members ceases, or unless revoked with approval of the comptroller.

(5) Reporting entity--The combined group's choice of an entity that is:

(A) the parent entity, if it is part of the combined group, or

(B) the entity that:

(i) is included within the combined group;

(ii) is subject to Texas' taxing jurisdiction; and

(iii) has the greatest Texas business activity during the first period upon which the first report is based, as measured by the Texas receipts after eliminations for that period.

(6) Unitary business--A single economic enterprise that is made up of separate parts of a single entity or of a commonly controlled group of entities that are sufficiently interdependent, integrated, and interrelated through their activities so as to provide a synergy and mutual benefit that produces a sharing or exchange of value among them and a significant flow of value to the separate parts. In determining whether a unitary business exists, the comptroller shall consider any relevant factor, including:

(A) whether:

(i) activities of the group members are in the same general line, such as manufacturing, wholesaling, retailing of tangible personal property, transportation, or finance;

(ii) the activities of the group members are steps in a vertically structured enterprise or process, such as the steps involved in the production of natural resources, including exploration, mining, refining, and marketing; or

(iii) the members are functionally integrated through the exercise of strong centralized management, such as authority over purchasing, financing, product line, personnel, and marketing.

(B) Other factors. In addition, the comptroller may consider other factors that may be applicable, including guidelines in Supreme Court decisions that presume activities are unitary. All affiliated entities are presumed to be engaged in a unitary business.

(C) New entities. When a taxable entity acquires another entity, a presumption exists for finding a unitary relationship during the first reporting period. Any party may rebut such presumption by proving that the taxable entities were not unitary. If such presumption is rebutted, then the taxable entities shall not be considered unitary as of the date of acquisition. When a taxable entity forms another taxable entity, a unitary relationship exists as of the date of formation unless the business is not unitary on a longer term basis. An acquired entity is required to file a report for the period prior to acquisition.

(D) Non-arm's-length prices. Goods or services or both are supplied at non-arm's length prices between or among entities. Existence of arm's-length pricing between entities, however, does not indicate lack of unity.

(E) Existence of benefits from joint, shared or common activity. A discount, cost-saving or other benefit can be shown to result from joint purchases, leaseholds, or other forms of joint, shared or common activities between or among entities.

(F) Relationships of joint, shared or common activity to income-producing operations. In determining whether a joint, shared, or common activity is indicative of a unitary relationship, consideration shall be given to the nature and character of the basic operations of each entity. Such consideration shall include, but not be limited to, the entity's sources of supply, its goods or services produced or sold, its labor force, and market to determine whether the joint, shared, or common activity is directly beneficial to, related to, or reasonably necessary to the income-producing activities of the unitary business.

(G) Holding entities. The tests for a unitary business established by this section apply in determining whether a holding entity is included or excluded from a unitary business.

(7) United States--The 50 states and the District of Columbia. It also includes the territorial waters of the United States and the seabed and subsoil of those submarine areas that are adjacent to the territorial waters of the United States and over which the United States has exclusive rights, in accordance with international law, with respect to the exploration for or exploitation of natural resources. It also includes the possessions and territories of the United States and the Commonwealth of Puerto Rico.

Also see FAQ from Texas Comptroller of Public Accounts at http://www.window.state.tx.us/taxinfo/franchise/faq_comb_rpt.html.



Tax Policies for Multijurisdictional Income
 Tax Policy Conference
 Friday, March 1, 2013

State Taxation of Multijurisdictional Income: History, Actions and the Role of Congress

Greg Turner

Vice President, Senior Tax Counsel
 Council On State Taxation
 Sacramento, CA



Council On State Taxation

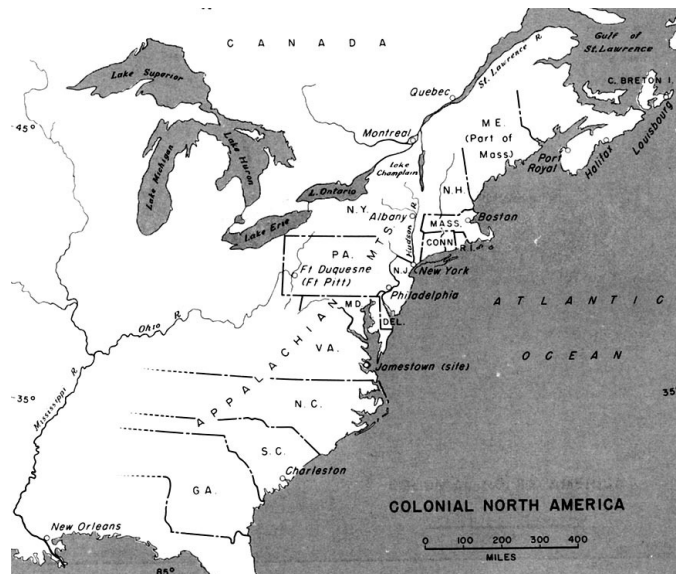


The Colonial Era

The North

The Middle

The South



Council On State Taxation



The Articles of Confederation and Perpetual Union between the States of ... ”

Each State retained:

- “its sovereignty, freedom, and independence, and every power, jurisdiction, and right . . . not . . . expressly delegated to the United States in Congress assembled.”

Congress was granted:

- The power to enter into treaties, raise armies, and declare war.



U.S. Constitution

Import-Export Clause

The Commerce Clause

- The Early Years
 - ✓ *Gibbons v. Ogden*
- The Century of the Bright Grey Line
 - ✓ *Cooley v. Board of Wardens (1851)*
- The Re-emergence of State Authority
 - ✓ *Northwestern States Portland Cement (1959)/*
Complete Auto Transit (1976)



Unitary Theory and the Birth of Multijurisdictional Taxation

Origins of the Unitary Business Principle

- ✓ Concept began in the context of Railroad Taxation
Union Pacific Railway Co. v. Ryan, 113 U.S. 516 (1884)

- ✓ First extended to state income taxes in 1920
Underwood Typewriter v. Chamberlain, 254 U.S. 113 (1920)

- ✓ The Unitary Business Principle applied to Multi-corporate enterprises was first articulated in the 1940's
Butler Brothers v. McColgan, 17 Cal.2d 664 (1942)
Edison California Stores v. McColgan, 183 P.2d 16 (1947)



Rise of State Taxation of Multijurisdictional Income

1957

- NCCUSL Adopts Uniform Division of Income for Tax Purposes Act (UDITPA)

1959

- *Northwestern States Portland Cement v. Minnesota*
- Congress Enacts PL 86-272 (Interstate Income Act of 1959) as a “stop gap”.
 1. Affirmative limitation on State taxing authority
 2. Commissioned special Congressional Subcommittee



Rise of State Taxation of Multijurisdictional Income

1964 – The Willis Committee Report

1966 – California Adopts UDITPA

1967 – Multistate Tax Compact Becomes Effective on adoption by Seventh State.

1974 – CA Becomes a Full Member of the Compact (§ 38006)

1978

- **U.S. Steel v. MTC (1978) 434 U.S. 452**
- **Moorman Mfg. v. Bair (1978) 437 U.S. 267**



Rise of State Taxation of Multijurisdictional Income

1983 – Container Corp. v. FTB (1983) 463 U.S. 159

1986 – CA Enacts “Water’s Edge” Election

1993 – CA Moves to “hyper-weighting” the Sales Factor

2010 – CA Moves to “Elective” Single Sales Factor



Future History...

- ✓ **Interstate/ International Competition and the Global Economy**
- ✓ **Federal Tax “Reform” and Congressional Intervention**
- ✓ **The Return of Due Process?**
- ✓ **The Return of World Wide Combination?**