

Summaries of the SJSU-TEI Tax Policy Conference (March 1, 2013)

Introduction

The High Technology Tax Institute provides a high quality tax education conference that brings together nationally and internationally recognized practitioners and government representatives to provide insights on current high technology tax matters of interest to corporate tax departments, accounting and law firms, the IRS, academics and graduate tax students.

Selected sessions from the March 1, 2013 Tax Policy Conference are summarized in the articles that follow. We encourage you to read these summaries and to visit the High Tech Tax Institute website to view current and past conference materials in greater detail. If you were not able to attend the 2013 Institute, we hope this overview of the topics covered will encourage you to attend a future program.



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Setting the Stage

By: Victoria Lau, *MST Student*

“Theoretically good, but practically unworkable and un-American” was the view of a California commission in 1906 when it rejected a state income tax. **Ms. Annette Nellen**, *Director of the SJSU MST program*, used this quote to set the stage for the conference on Tax Policies for Multijurisdictional Income. Ms. Nellen asked the audience - comprised of experienced tax professionals from law and accounting firms, corporations and government agencies - whether or not they believe the existing tax rules for multijurisdictional income are workable for the 21st century. Using polling software, 65% said no.

Ms. Nellen addressed questions to focus the audience on the day’s topic of multijurisdictional income tax. They included: Why do jurisdictions tax? Where is income taxed? How is income measured and attributed?

The obvious answer to why jurisdictions tax income is to raise revenue. Some states, however, are limited by their constitutions and are unable to impose an income tax. In *Wisconsin v. JC Penny*, 311 U.S. 435 (1940) the Court said that to have taxing power, there must be a fiscal link between the tax and the protection, opportunities and benefits given by the state. The controlling question, according to *Wisconsin*, is has the state “given anything for which it can ask return”?

This test recognizes that businesses use government and public resources, the key concept underpinning the benefits theory; one of three theories in determining where income should be taxed. The other two theories are activity and enforcement. Ms. Nellen illustrated how the three operate with the example of a widget manufacturing company with all its employees and property located in California but all its sales in Kansas.

- The benefits theory supports taxing the company’s income in California because the employees and property are using the state’s resources. However, the company also receives benefits from Kansas because it provides the market.
- The activity theory also says the company’s income should be taxed in California where all its activities take place. However, the widgets are shipped to customers in Kansas so the delivery activity should not be ignored.
- The enforcement theory also favors California because without property in Kansas, it may be difficult for that authority to enforce a tax on the company.

Since 1959, P. L. 86-272 sets the requirement for physical presence of a company, or nexus, for a state to impose tax on sales of tangible personal property. Ms. Nellen explained that in her example, the company has no nexus in Kansas; all of its income would be taxed in California thus favoring the origin or source state rather than the destination or market state. “Does this make sense?” she queried.

Ms. Nellen advanced the example by supposing the states adopt equal weighted three-factor apportionment on property, payroll and sales. The result is that all of the company’s income being taxed with 67% in California and 33% in Kansas. Ms. Nellen then asked what if the two states adopt unequal weighting where California double-weights sales and Kansas puts equal weights all three apportionment factors? The outcome is that some of the company’s income escapes tax, as illustrated in Figure 1. This last scenario was the reality in California prior to 2013, before Proposition 39 mandated the Single Sales Factor method.

Additional Observations for X

Unequal weighting of apportionment factors:

- Assume CA double- weights sales (it did) and KS has equal weighting (it does)
- CA = Property 100/100 + Payroll 100/100 + Sales 0/100 × 2 = 2/4 = 50%
- KS = Property 0/100 + Payroll 0/100 + 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!

Figure: Illustration of two states using different apportionment weighting factors¹

While the illustrated scenario favors the company, when states adopt different income measurement approaches, the same income may be taxed by more than one jurisdiction. Double taxation can be avoided by treaties; but the treaty network at the international level is incomplete. Furthermore, the success of the State Compact movement for uniformity at the domestic level is less likely with the departure of California and South Dakota as members.

¹ Nellen, A (2013). *Setting the Stage* [PowerPoint slides]. Retrieved from TEI-SJSU Tax Policy Conference http://www.cob.sjsu.edu/acct&fin/tax-institute/2013_materials/Setting%20the%20Stage_3-1-13HO.pdf

Ms. Nellen asked the audience whether American states should require a uniform apportionment formula and definition. The audience overwhelmingly, at 77%, said yes. However, it was divided on how it can be achieved: 35% said Congress should take charge, the same percentage believed the State Compact approach is the solution, and 15% thought uniformity is unachievable.

Nearly 90% of the audience also believed that Congress should expand P. L. 86-272 to cover digital transactions and services, which are a significant part of the 21st century economy. Ms. Nellen reminded the audience that P. L. 86-272 was intended to be a temporary measure when it was introduced. "Fifty years is long enough for a temporary measure", she said. The definition of selling should be expanded, the limitation on tangible personal property should be removed and the definition of nexus should be consistent for income and sales tax.

Although the problems appear immense, Ms. Nellen listed key international and domestic initiatives already underway to address this complex tax policy issue. By setting the stage in explaining the theories and aspects of multijurisdictional income, Ms. Nellen, as the first speaker in this Tax Policy Conference, oriented the audience on the panel discussions and presentations that follow.



Mark you calenders !!!

30th Annual TEI-SJSU High Tech Tax Institute
November 10-11, 2014

High Tech Tax Institute Academy
October 17, 2014

IRS-SJSU Small Business Tax Institute
June 18, 2014

For more information on the above events please visit
<http://www.tax-institute.com>

International Tax Policy Paths

By: Kara Gaidhar, *MST Student*

In the 2013 Annual Tax Policy Conference of Taxation, **Ms. Susan Morse**, Associate Professor of Law at UC Hastings College of Law, Ms. Holley Glenn, Principal Economist at Baker & McKenzie Consulting LLC and Mr. Eric Ryan, Partner at DLA Piper U.S. LLP, Silicon Valley, discussed taxation of international income. Mr. Steve Sedler, Senior Vice President of Finance at Seagate Technology moderated the panel discussion.

Morse began by proposing that current international corporate taxation faces a multijurisdictional problem, which reveals a development over the past ninety years of numerous policies. Despite the variety and complexity of these policies, they can be segregated into two prominent, all-encompassing Tax Policy Paths of Territoriality and Incremental Changes.

Territoriality Tax Policy Path

Morse explained that most nations implement a Territorial Tax System in which they assess tax exclusively on income earned domestically, and exempt from their domestic tax base the dividends received from foreign subsidiaries. Other nations, such as the U.S., conform to a Worldwide Tax System that allows their businesses to defer tax liabilities on foreign active income until the funds are repatriated to their home nations. Of the two tax systems, the territoriality approach is preferred over the worldwide approach since it equalizes tax costs among businesses, and encourages competition and free capital flow. Advocates of tax reform recommend that the U.S. switch to the Territoriality Tax System, and point to the increasing number of developed nations that are migrating onto the Territoriality Tax Policy Path. A confluence of national tax systems toward a common international Territoriality Tax System is expected to alleviate the complexities of multijurisdictional taxation. The Incremental Changes Tax Policy Path is a parallel, but separate development from the Territoriality Tax Policy Path.

Incremental Changes Tax Policy Path

Two heavyweight contenders have emerged in the arena of Taxation of International Income and as adherents to the Incremental Changes Tax Policy Path: The European Union (EU) and the Organization for Economic Cooperation and Development (OECD).

European Union: In 2011, a EU European Commission publication emerged as a Common Consolidated Corporate Tax Base (CCCTB) Directive Proposal across European Member States to systematically address EU regional market tax obstacles that companies face when conducting business in multiple Member States. The ambitious and regional CCCTB Directive Proposal seeks to address the corporate income tax inequities that corporations face in Europe. Companies with EU-wide operations encounter the challenge of computing their taxable income based on the different rules in each Member State. The CCCTB Directive Proposal urges political consensus across Member States to develop singular and unified EU system rules for calculating corporate taxable income.



Ryan explained that The CCCTB Directive Proposal calls for Member States to allow businesses that adopt this common European tax base, to file a single, consolidated tax return for all profits and losses incurred across the EU. The CCCTB Directive Proposal's Three-Factor-Formula apportionment basis concisely defines a relation for the allocation of a multinational's consolidated profits. Each Member State could assess its own tax rate on the apportioned profit of a business operating within its national boundaries. The formulaic apportionment basis would alleviate the complexities of separate accounting that businesses face across Member States.

$$\text{Numerical Formula: Share Country A} = \frac{1}{3} \left(\frac{\text{Sales}^A}{\text{Sales}^{\text{Group}}} \right) + \frac{1}{3} \left(\frac{1}{2} \left(\frac{\text{Payroll}^A}{\text{Payroll}^{\text{Group}}} \right) + \frac{1}{2} \left(\frac{\text{No. of Employees}^A}{\text{Employees}^{\text{Group}}} \right) \right) + \frac{1}{3} \left(\frac{\text{Assets}^A}{\text{Assets}^{\text{Group}}} \right)$$

Figure: Three-Factor-Formula Model¹

Organization for Economic Cooperation and Development: The OECD Convention is a global policy forum that provides analysis and advice to thirty-four members including the U.S., and maintains cooperative relations with more than seventy non-members. The OECD Center for Tax Policy and Administration promotes international cooperation on corporate tax matters, publishes transfer pricing guidelines for multinational enterprises and tax administrations, and spearheads a Base Erosion and Profit Shifting (BEPS) project to develop comprehensive and effective strategies for countries facing BEPS issues.

The research studies of the BEPS project focus on existing rules that enable businesses to remove taxable profits from locations of business operational activity and reallocate them to locations offering tax advantages. The existing rules intend to protect multinational entities from paying double taxation, but often result in purposeful business tax avoidance, causing an unfair competitive advantage over smaller businesses. According to Angel Gurría, OECD Secretary-General, "These strategies, though technically legal, erode the tax base of many countries and threaten the stability of the international tax system".²

Glenn argued that in OECD nations, an additional variable causes the erosion of

the tax basis of taxable corporate income: weak transfer pricing guidelines associated with intangible instruments. BEPS project results are unclear about distinctions between soft intangible items of value and market conditions. Moreover, the OECD nations do not provide a comprehensive list of specified taxable intangibles or a concise position on market conditions; instead they suggest the inclusion of broadly defined intangible items of value as potentially taxable. Glenn suggested that businesses would accept comparability standards that reflect unique and real market conditions, but raised a contentious possibility of national efforts to define market access as an intangible requiring payment. Glenn's co-panelist, Ryan, noted the example of Brazil's obstructive tax rules that charge businesses a required profitability percentage cost for market access. He cautioned against the replication of the Brazil tax rules in other OECD nations, as the rules would cause disincentives for multinational entities to establish domestic operations.

The standardization and harmonization policies of both the EU and OECD are being implemented by member nations traversing the Incremental Changes Tax Policy path, and indicate a convergence of opposing jurisdictions toward the development of a common consensus.

1 Ryan, E. (2013, Mar 1). *Taxation of Multijurisdictional Income-Theories, Actions and Trends*. San Jose State University, Annual Tax Policy Conference on Tax Policies for Multijurisdictional Income, Techmart, CA. [Unpublished Power Point Slides].

2 Saint-Amans, P. (2012, Dec 2). OECD urges stronger international co-operation on corporate tax. Retrieved from <http://www.oecd.org/tax/oecd-urges-stronger-international-co-operation-on-corporate-tax.htm>

Global, US, California and the Bay Area Economics

By: Stuti Seth, *MST Student*

After the economic recession in 2010, there has been a close watch on how the world economy has been reacting and recovering. **Mr. Jon Haveman**, Chief Economist at the Bay Area Council Economic Institute, with the use of economic indicators, such as the GDP growth rate, unemployment rate, and growth of housing markets, summarized the current world, U.S., and the Bay area economic standing. Mr. Haveman started the discussion with growth prospects of major economies of the world, which included Europe and China before focusing on the U.S., and the Bay area economies.

The economy in the Eurozone remains weak and is experiencing low growth and slow recovery mainly because Ireland, Germany and France are contributing to positive growth whereas Italy, Spain, Portugal and Greece are still experiencing negative growth. Furthermore, the German government has adopted austerity measures, which is one of the prime reasons as to why Germany has been experiencing slower than expected growth. On this, Mr. Haveman made a comment on his views on austerity i.e. "austerity kills economic growth".

Mr. Haveman also discussed the Chinese economy. The Chinese GDP is shrinking from about 8.5 per cent in 2011 to below 8 per cent in 2012, and is expected to be around 8 per cent

in 2013. The year 2013 is a better year in terms of soft-landing for China and thus significant for their imports and exports.

Moving on to the US Economy, Mr. Haveman pointed out a sluggish growth indicating stalled recovery in 2012. The GDP fell from 3.1 per cent to 0.1 per cent in the last quarter of 2012 and unemployment rate, was lower as compared to previous years. The dip in the unemployment rate was mainly due to increase in job opportunities across the country. The increase in jobs are mainly in areas such as non-farm (such as mining, harvesting or cow-tipping), education and health, retail trade and manufacturing but the government jobs have fallen in number, due to reduced government spending and thus creating further drag in the economic recovery. The housing market, which was one of the prime reasons for economic downturn in 2010, is still down and depressed, and recovering from the national housing bubble.

The next segment of the discussion by Mr. Haveman covered the Bay area economics, which is recovering faster, as compared to the rest of nation, mainly because of the technology sector. Other strengths of the Bay Area include an educated labor force, access to venture capital and an innovation culture. The payroll employment is expected to grow from 1.5 per

cent in 2013 to 2.3 percent in 2014 and the Bay Area is set to contribute 2 per cent of all US jobs; thus California surely offers a growing economy. Even within California, one can see an uneven growth pattern. San Jose, San Francisco and Oakland are amongst few parts of California, which contribute towards positive growth.

Job growth in the Bay area is expected to increase by 20 per cent this decade compared to 15 per cent nationwide. Clearly, this indicates that the Bay Area is a major contributor towards growth of jobs in the years to come. However, the question arises whether or not the Bay Area has the ability in terms of population and housing facilities to meet the growing demand. The construction industry within the Bay Area is growing at about 10 per cent as opposed to 4 per cent in California. The construction activities mainly include modifications and additions, multi-family homes and commercial development. People are opting to stay and settle down in the Bay Area for reasons like increased employment opportunities and high paying jobs. The high-paying jobs increase the individual's personal income, which has a multiplier effect by increasing consumer demand and thus stimulating growth in the economy. Here, Mr. Haveman posed a potential problem: to meet the growing demand for jobs the Bay Area needs to retain people, which can happen by making housing attractive and

affordable. This can already be seen in the Bay Area with an increase in the demand for houses.

Mr. Haveman concluded the discussion with remarks on the current infrastructure spending by the government. In his opinion, U.S. is still far behind in world ranking for railroads, roads, airports and ports. Current infrastructure spending is minimal and the American Society of Civil Engineers claims that there is an infrastructure gap which is expected to cost the U.S. economy \$ 1 trillion in business sales and 3.5 million jobs by 2020. Therefore, the government should spend more on infrastructure to help generate jobs within the country and enhance the economic growth.



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