



MULTISTATE TAX COMMISSION

**Report of the Hearing Officer  
regarding the proposed  
Model Statute for Combined Reporting**

**April 25, 2005**

**Submitted by Shirley Sicilian  
Hearing Officer**

## Table of Contents

- I. Introduction
- II. Summary of Procedure
  - A. Development of the Proposal
  - B. Public Hearings
  - C. Next Steps – Executive Committee Consideration and Action
- III. Summary of Substantive Provisions
- IV. Public Comment and Hearing Officer Recommendations
  - A. Criteria for Combination.
    - 1. Unitary Business Requirement
    - 2. Relevance of Arm’s Length Pricing
    - 3. Entities Not Subject to a Corporate Income Tax
    - 4. Partnerships
    - 5. Water’s Edge Election
      - (a) Members Doing Business in a Tax Haven
        - (1) Definition of a “Tax Haven”
        - (2) “Doing Business” in a Tax Haven
        - (3) Foreign Commerce Clause
      - (b) Subpart F Income
      - (c) Members Earning 20% of Income from Activities Deductible by Another Member
      - (d) Initiation and Withdrawal of Election
  - B. Method of Combination
    - 1. Group Members as Individual Taxpayers vs. the Combined Group as a Single Taxpayer
      - (a) Apportionment Factor Numerators
      - (b) Credits
      - (c) Losses
    - 2. Deferred Intercompany Transactions
    - 3. Elimination of Dividends
    - 4. Compliance Burdens
  - C. Implications of Adopting the Model Combined Reporting Statute

### Exhibits

- Exhibit A McDermott, Will & Emery (MW&E) – Kimberley Reeder and Margaret Wilson
- Exhibit B Southerland, Asbill & Brennan (SAB) – Kendall L. Houghton and Jeffrey A. Friedman
- Exhibit C Council On State Taxation, American Council of Life Insurers, American Insurance Association and the Property Casualty Insurers Association of America (Insurance Group)
- Exhibit D United Services Automobile Association (USAA) – Amy Cannefax
- Exhibit E Heller Ehrman (HE) – Roy E. Crawford
- Exhibit F Organization for International Investment (OFII)
- Exhibit G Model Statute with Hearing Officer’s Proposed Changes



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**I. Introduction**

On November 11, 2004, the Multistate Tax Commission (MTC) Executive Committee approved an MTC proposed model statute on combined reporting for public hearing. The appointed hearing officer has held two public hearings and received five sets of written comments on the proposed model statute. This Report provides a procedural summary of the proposed model statute, an explanation of its key substantive features, a review of the public testimony received, and the hearing officer's recommendations for addressing that public testimony.

**II. Summary of Procedure**

**A. Development of the Proposal**

In June of 2003, the MTC Executive Committee requested the Uniformity Committee consider whether it would be feasible, appropriate and of service to the states for the MTC to develop model laws for combined reporting. After a review of preliminary research<sup>1</sup>, the Uniformity Committee reported in July, 2003, that development of such model laws was feasible; would be useful for MTC member states; and would promote MTC principles of uniformity, ease of administration and sound tax policy. The Committee noted that this conclusion was consistent with a recommendation contained in the MTC's Federalism at Risk Report, published in June of 2003, that states adopt combined reporting for jointly owned and operated companies in order to appropriately report and assign income where it is earned.<sup>2</sup> On July 30, 2003, the

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<sup>1</sup> See memorandum dated July 29, 2003 to Ted Spangler, Chair, and members of the Uniformity Committee from Shirley Sicilian titled *Executive Committee Request Regarding Combined Reporting*. The memorandum provided a general description of combined reporting, summarized its potential benefits, and identified key policy questions which would need to be addressed in developing a combined reporting rule.

<sup>2</sup> *Federalism at Risk, A Report by the Multistate Tax Commission*; p. 25 (June, 2003)

Executive Committee directed the Uniformity Committee, through its Income & Franchise Tax Subcommittee, develop model combined reporting statute and regulations.

The Income & Franchise Tax Uniformity Subcommittee organized the project into three phases: 1) education, 2) policy direction and 3) drafting. During the education phase, the Subcommittee established standard definitions for common terms used in discussing combined reporting, reviewed a number of MTC staff memorandums on the topic,<sup>3</sup> and heard a series of seminars on legal, mechanical and policy aspects of combined reporting.<sup>4</sup> In addition, the Subcommittee received several thought-provoking and constructive comments from the public at its March and July meetings, and during numerous teleconferences.<sup>5</sup>

The Subcommittee began the policy development phase by producing a list of combined reporting “pro’s and con’s.” It then compiled a list of fifteen key policy issues to be addressed in the model statute or regulations.<sup>6</sup> During its March, 2004 meetings and three follow-up teleconferences, the Subcommittee provided direction on each of these fifteen policy issues for staff to follow in preparing a first draft of a combined reporting statute. In doing so, the Subcommittee took into consideration the recommendations of the MTC State Tax Compliance Initiative Steering Committee regarding adoption of combined reporting as a solution to corporate income tax compliance concerns.<sup>7</sup>

The Subcommittee reviewed and discussed the first draft statute at its July, 2004 meeting in Mystic, Connecticut. At that meeting, a small group of Subcommittee members volunteered to research the issue of whether corporations that are not income taxpayers should be included in the combined group, and report their findings to the

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<sup>3</sup>The Committee reviewed three memorandums from MTC staff member Shirley Sicilian: 1) dated October 6, 2003 to members of the Income & Franchise Tax Uniformity Subcommittee titled *Combined Reporting – State Statutes and Two Cases re Inclusion of Non-Income Taxpayers in the Unitary Group*; 2) dated December 15, 2003 to members of the Income & Franchise Tax Uniformity Subcommittee titled *Combined Reporting: 1) definition of common terms, and 2) interaction with Joyce and Finnigan rules*; and 3) dated February 10, 2004 to Jennifer Hayes, chair, and members of the Income & Franchise Tax Uniformity Subcommittee titled *Combined Reporting: More on Definitions of Common Terms*.

<sup>4</sup> The seminars were given by Michael Brownell, Senior Staff Attorney with the California Franchise Tax Board. Mr. Brownell addressed the following topics: March 14, 2004 – Overview of California’s Approach to Combined Reporting and Some Alternatives; April 27, 2004 – Charitable Expenses & Holding Companies; May 25, 2004 – Intercompany Transactions; June 30, 2004 – Treatment of Partnerships.

<sup>5</sup> Professor Richard Pomp, Mr. Arthur Rosen, Ms. Diann Smith, Mr. Robert Montellione, and others provided helpful participation and comments.

<sup>6</sup> Mr. Brownell was the primary author of the combined reporting policy issues list.

<sup>7</sup> *Corporate Income Tax Sheltering Work Group Report*; Prepared for the State Tax Compliance Initiative Steering Committee; pp 15-16, 24-29 (June 17, 2004).

Subcommittee.<sup>8</sup> A second draft statute, which incorporated Subcommittee members' amendments from the July meeting, as well as recommendations of the small research group, was reviewed by teleconference on October 1, 2004. A group of insurance industry representatives met with members of the small research group on October 13, 2004 and provided insight and comments which led to further changes to the draft statute. The proposed model statute currently before the Executive Committee was posted to the MTC website on October 29, 2004.

On November 8, 2004 the Income & Franchise Tax Uniformity Subcommittee discussed the draft and voted to adopt it as a proposed model statute with a favorable recommendation to the Uniformity Committee.<sup>9</sup> On November 9, 2004, the Uniformity Committee considered the recommendation of the Subcommittee and voted to recommend the proposal favorably to the Executive Committee. On November 11, 2004 the Executive Committee approved the proposal for public hearings.

## **B. Public Hearings**

Public Hearings were held January 4, 2005 in Oakland, California and March 29, 2005 in Washington, D.C., following more than 30 days notice in each case. Oral public comments were received at both hearings. In addition, six sets of written comments were received prior to the closure of the public comment period on April 1, 2005. The written comments are attached as Exhibits:

- Exhibit A McDermott, Will & Emery (MW&E) – Kimberley Reeder and Margaret Wilson
- Exhibit B Southerland, Asbill & Brennan (SAB) – Kendall L. Houghton and Jeffrey A. Friedman
- Exhibit C Council On State Taxation, American Council of Life Insurers, American Insurance Association and the Property Casualty Insurers Association of America (Insurance Group)
- Exhibit D United Services Automobile Association (USAA) – Amy Cannefax
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<sup>8</sup> Members of the small research group included Ted Spangler (ID); Wood Miller (MO); Mary Loftsgard and Robert Wirtz (ND); Janielle Lipscomb (OR); Robynn Wilson (AK); Michael Brownell and Larry Bobiles (CA).

<sup>9</sup> The Income & Franchise Tax Uniformity Subcommittee also appointed a small work group to consider whether it should recommend an amendment to the model statute to incorporate *Finnigan* style calculation of apportionment numerators as opposed to the *Joyce* approach currently contained in the model. On March 17, 2005, the small group recommended to the Subcommittee that the model statute should retain the *Joyce* rule. The small group noted that states adopting the model statute may also wish to separately consider a throw-back rule. The Subcommittee accepted the small work group's reconfirmation of the *Joyce* approach and voted to take no further action.

### **C. Next Steps – Executive Committee Consideration and Action.**

This Report summarizes and makes recommendations for addressing the comments received through the public hearing process. For some comments, no change is recommended; while for others, alternative statutory language is proposed. The Executive Committee has several options. The proposed statute may be approved and passed on to the full Commission, amended and passed on to the Commission, disapproved entirely, or referred back to an earlier step in the process. If the Executive Committee chooses to pass any version of the proposal on to the Commission, it first authorizes (pursuant to MTC Bylaw 7) a polling of the affected Commission Member States to ensure that a majority of the affected States would consider adoption of the draft proposal. (This survey does not determine if the affected States will adopt the proposal—only whether the affected States will consider adoption of the proposal.) If the majority of the affected Commission Member States so indicate, the matter is referred to the full Commission for possible adoption as a recommended model uniform statute.<sup>10</sup> Once a model uniform statute has been adopted by the Commission, the Income & Franchise Tax Uniformity Subcommittee anticipates it will begin development of regulations to complement and expand on the principles reflected in that final version.

### **III. Summary of Substantive Provisions**

The proposed model statute requires combination of all unitary entities that are subject to the state corporate income tax or that would be subject to the state corporate income tax if they were doing business in the state. Business conducted by any corporation through a partnership is treated as conducted directly by that corporation, to the extent of the corporation's distributive share of the partnership income. This is true whether the partnership is a general partnership, a limited partnership, an LLC or other entity treated as a partnership, or an S corporation. Other commonly-controlled, unitary entities, not otherwise subject to required combination because they are not income tax payers, may also be required to be included in the combined group by regulation if doing so would better reflect the proper apportionment of income of entire unitary businesses, or on a case-by-case basis if there is tax evasion.

Combination of eligible entities is required on a world-wide basis, unless taxpayers choose to make a water's-edge election. A water's-edge election limits the combined group to eligible domestic corporations, foreign corporations with U.S. source income, and corporations doing business in tax-haven countries.

The combined report required under this proposed model statute does not disregard the separate identities of the taxpayer members of the combined group. Each taxpayer member is responsible for tax based on its apportioned share of the business income of the combined group, together with that member's own allocated (nonbusiness)

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<sup>10</sup> Of course, all recommendations of the Commission are advisory to the States. For a recommendation to become effective in any State, that State must affirmatively adopt the proposal.

income, and its apportioned share of business income from any other combined group of which the taxpayer is a member. Business income of the combined group is calculated as the sum of all members' individually determined net business incomes. Dividends paid by one to another member of the combined group are eliminated from income, and no special treatment is provided for included foreign source income.

Because individual group members are recognized as separate taxpayers, as a general rule, a deduction or credit may be taken only by the specific taxpayer that earned it, and not against the total combined income or liability of the group. Likewise, the amount of total combined business income apportioned to a state is calculated as a function of each taxpayer's own factors in that state (the *Joyce* method), as opposed to the factors for the entire group as a whole in that state (the *Finnigan* method).

The statute does provide one exception to this general rule preserving the separate identity of the taxpayer. A charitable contribution deduction is allowed to be taken first against the business income of the combined group (subject to federal income limitations as applied to the entire business income of the group), and any remaining amount may then be treated as a nonbusiness expense allocable to the member that incurred the expense (subject to the federal income limitations applied to the nonbusiness income of that taxpayer member).

#### **IV. Public Comment and Hearing Officer Recommendations**

##### **A. Criteria for Combination.**

##### **1. Unitary Business Requirement**

Two commenters suggested it is not perfectly clear under the proposed statute that unity is required for combination. (MW&E p. 4-5; SAB oral comments) Both indicated their concern arises from the proposed language allowing the Director to adopt a regulation requiring combination “of any persons that are not included pursuant to [the mandatory combination provision], *but that are members of a unitary business*, in order to reflect proper apportionment of income of entire unitary businesses.” (Emphasis added.) One of the two commenter suggested this language could possibly allow combination of unrelated taxpayers. (MW&E p. 4) The Hearing Officer believes this language clearly requires combination of only unitary entities. And, because the MTC's regulatory definition of unity requires common ownership and control, it would not allow combination of unrelated taxpayers. However, some states do treat the “common ownership and control” requirement as separate from the unity requirement. Thus, we recommend an explanatory note be added on this point to ensure clarity.

Several commenters expressed concerns with the proposed model's definition of “unitary business.” The model defines a unitary business as:

a single economic enterprise that is made up either of separate parts of a single business entity or of a commonly controlled group of business 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.

#### Section 1.F.

One commenter suggested this definition “provides little guidance by which taxpayers may determine whether they are indeed engaging in a unitary business.” (MW&E p. 3; see also p. 4) We agree this proposed statutory definition is brief. Our intent is that the statute be supplemented by regulation. Indeed, this statutory language was drafted to dovetail precisely with the MTC’s existing model uniform regulation defining a “unitary business.”<sup>11</sup> The adopted MTC regulation begins with the identical language, and then expands on that definition at length. Because the statutory definition is derived from existing, adopted regulatory language, it would not, as one commenter warned, set a “new definitional standard.” (SAB p. 1-2) In the Hearing Officer’s opinion, the nine page MTC regulation associated with this proposed statutory language fully addresses commenters’ concerns because it does thoroughly incorporate “the broad parameters of the unitary business principle [that] have been articulated by the U.S. Supreme Court in [its] long-standing opinions.” (MW&E p. 2)

One commenter noted the definition of “unitary business” does not include any mention of “what constitutes a ‘commonly controlled group.’” (MW&E p. 4) This question, too, is addressed through the existing MTC regulation. Under the regulation, common ownership and control are required for unity, and are defined at length.

Three commenters suggested that even if the proposed combined reporting statute is intended to work together with our adopted regulation, that intent should be made clear in the model statute. (SAB p. 1-2; MW&E p. 4; COST oral comments) The Hearing Officer agrees. The scope of this project is to draft a uniform model combined reporting statute. The definition of “unitary business” has already been addressed through a previous MTC uniformity project and we do not intend to address that issue again through this project. The Hearing Officer recommends brackets be placed around the definition of unity in the model statute, and a note be added to clarify that this statutory definition is intended to work together with the MTC’s model uniform regulation. If a state intends to define “unitary business” in a manner inconsistent with the MTC’s adopted regulation, it will need to insert its own brief statutory definition and develop its own regulations to expand on that definition accordingly.

## **2. Relevance of Arm’s Length Pricing**

Under the proposed model statute, combination is required of all unitary corporate income taxpayers, rather than permitted upon the request of either the corporation or the department, or contingent upon some type of showing by either the corporation or the department. One commenter suggested the model be amended to allow separate reporting

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<sup>11</sup> See MTC General Allocation and Apportionment Regulations; Regulation IV.(b) Unitary Business (revised January 15, 2004) at <http://www.mtc.gov/UNIFORM/ADOPTED.HTM>



unless it can be shown that transactions between the entities are not at arm's length: "so long as related taxpayers charge each other the same amounts that they would charge to an unrelated business for the same transaction, no distortion or improper reflection of income would result." (MW&E p. 5) The commenter suggested that "[i]n fact, when related corporations do deal with one another on arm's length terms, combination may actually result in distortion." (MW&E p. 5) As a result, this commenter suggests the model require combined reporting "only when related corporations: (1) are engaged in a unitary business and (2) experience distortion attributable to a failure to conduct their intercompany transactions at arm's length." (MW&E p. 6)

In the opinion of the Hearing Officer, there is no rationale for conditioning combination on both a determination of unity and a finding of distortion through non-arm's length pricing. Combined reporting will attribute unitary business income in a manner conceptually superior to separate accounting whether or not the unitary entities are engaged in arm's length transactions. Indeed, under combined reporting, the income of a unitary business attributable to a state will not vary depending on whether a business chooses to operate as one corporation with numerous divisions or to incorporate those divisions into subsidiaries will not impact the amount of income produced by the business as a whole, subject to apportionment, and attributable to the state. By contrast, attempting to employ separate accounting where a business has chosen to incorporate its divisions is very difficult, if not, in truth, impossible. Separate accounting "...ignores or captures inadequately the many subtle and largely unquantifiable transfers of value that take place among the components of a single enterprise."<sup>12</sup> The premise of combined reporting is that the synergies, interdependencies, and sharing of knowledge, know-how, and experiences that are typical features of a unitary business often cannot be properly captured by separate accounting.<sup>13</sup> With combined reporting, the enterprise-wide contributions to income that result from these features are not pigeon-holed into a few affiliates. Rather, they are apportioned across the entire enterprise, as they would be for a single corporation operating through divisions. In this way, the substance of the business activity conducted in the state controls the amount of income subject to apportionment, regardless of the organizational structure of the business entity or entities conducting those activities and regardless of any transactions that may take place between separately incorporated entities. Once unity has been determined, combination should occur, and there is simply no need to perform an additional test for arm's length pricing.

Nor does it make sense to "flip" the tests – so that a determination of unity is only required if there is a "gateway" finding of non-arm's length transactions. Adequately testing for arm's length pricing is extremely complex and time-consuming. Even if the test for arm's length pricing were no more burdensome than a test for unity, why subject taxpayers to two tests (first a test of arm's length pricing; and in cases where that test is

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<sup>12</sup> *Container Corp. of America v. Franchise Tax Bd. Of California*, 463 U.S. 159, 165; 103 S.Ct. 2268, 2940 (1983).

<sup>13</sup> *Designing a Combined Reporting Regime for a State Corporate Income Tax: A Case Study of Louisiana*; 61 Louisiana Law Review 699, 704, by Michael J. McIntyre, Paull Mines and Richard D. Pomp (2001).

not met, an additional test of unity) when it is only necessary to subject them to one (a test of unity)? In addition, required combined reporting of all eligible entities will help ensure the rule is applied uniformly, regardless of the impact on tax liability in individual cases. For these reasons, the Hearing Officer finds there is no need to modify the model statute to incorporate an additional test for arm's length pricing.

### **3. Entities Not Subject to a Corporate Income Tax.**

Under the proposed model statute, only corporations subject to an income tax are specifically required to be combined. However, it is recognized that a single unitary business may be carried on by many types of business entities acting together, not just corporations and certainly not just corporations that are corporate income taxpayers. It is also recognized that it would be theoretically correct and, in many states, legally acceptable to statutorily require the inclusion of all such business entities in the combined group in order to properly apportion the income of the entire unitary business. In recognition of the theoretical basis for combination of all entities engaged in the unitary business, the model statute also authorizes combination of unitary non-corporate-income taxpayers to be required by regulation, provided such combination can be accomplished in a manner that will generally reflect a reasonable apportionment of income for those types of unitary entities. This theoretical consideration would not have been much of an issue until a few years ago - when the federal government began breaking down some of the barriers between different types of financial services industries.<sup>14</sup> One outcome of these changes is that industries such as banking and insurance companies, which are often not corporate income taxpayers, may now branch out and engage in a unitary business with other financial service industries that are subject to the corporate income tax.

Joint written comments on the potential for combination of non-corporate-income taxpayers were provided by the Council On State Taxation, American Council of Life Insurers, American Insurance Association and the Property Casualty Insurers Association of America (the Insurance Group). Similar comments were filed by United Services Automobile Association (USAA). These comments give a thorough review of the insurance company state tax system (including retaliatory taxes), benefits of this tax system for the states and the industry, and policy issues raised by the proposed model statute. (Exhibit C) Policy issues raised by the Insurance Group include complexities, implications and uncertainties for the insurance tax system if combination is viewed as indirectly subjecting insurance company income to a corporate income tax.

In fact, the *original* draft of the proposed model statute would have explicitly included all corporations, whether or not corporate income taxpayers, in the combined group. In addition to the theoretical basis for such inclusion, it was also recognized that including non-taxable entities in a combined group does *not* subject those entities, or their income, to a state's corporate income tax. For example, unitary entities that do not have nexus with the state, and cannot be taxed by the state, are routinely included in the combined group. Including these non-taxable entities in the combined group only includes those entities' income from the unitary business in the total pot of unitary

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<sup>14</sup> See *e.g.*, Riegle-Neal Act and Gramm-Leach-Bliley Acts of 1994 and 1999.

business income from which the taxable corporations' share is apportioned. The tax is then levied only on the taxable corporations' and their share of that income. The non-taxable corporations are not subject to the tax. Nor is any of the income from the unitary business that is attributable to those entities subject to tax.

This distinction was recognized in *State ex rel. Dept. of Revenue v. Penn Independent Corp.*<sup>15</sup>, where the Oregon Tax Court found the apportionable income of a unitary group should include the income of an insurance corporation even though that corporation was not subject to Oregon's corporate income tax, but instead paid a gross premiums tax. The Tax Court noted "[i]t is important to remember that including the income of a nontaxable member of a unitary group does not subject that income to taxation by Oregon. It merely provides the base from which the taxable corporation's share is apportioned."<sup>16</sup> Indeed, the appropriateness of this holding has been recognized by Walter Hellerstein: "Although the result in this case is unusual, Judge Byers's thoughtful analysis of the theoretical justification for the result is plainly correct."<sup>17</sup>

However, after the original draft was issued, the Insurance Group raised its concerns. A small MTC subcommittee work group met with members of the Insurance Group to discuss these concerns. After discussion, the small work group agreed with the Industry Group that combination of entities which operate under significantly dissimilar financial and tax regimes can create mechanical issues which would need to be worked out, and that the resolution of those mechanical issues is likely to be different depending on the type of business entity or industry at issue. The small group agreed to balance the industry concerns against the correctness of combination and recommended to the Committee that the original draft be modified. The small group recommended that combination of dissimilar business entities could be attained through regulations which address the specific mechanical issues associated with combination for each of the different types of business entities. For example, combination of insurance companies may engender questions of how to establish "taxable income" for the insurance company that at the state level is subject only to a tax on gross premiums. Combination of non-income taxpayer financial institutions may raise issues surrounding the treatment of financial instruments in the calculation of the sales or property factors. In addition, different entities subject to different tax regimes in different states, *e.g.*, exempt organizations under IRC section 501(c)(3) may or may not be legally subject to combination in those states. A review of state legal authority for combination of each of the different entities may be required. For these reasons, the current version of the proposed model statute authorizes combination of other types of unitary entities to be required by regulation, so that appropriate rules can be developed to address each type of situation, rather than statutorily requiring combination in all situations. If the proposed

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<sup>15</sup> *State ex rel. Dept. of Revenue v. Penn Independent Corp.* 15 Or. Tax 68 (1999).  
<http://www.publications.ojd.state.or.us/TC4321.htm>.

<sup>16</sup> *Penn Independent*, p. 74

<sup>17</sup> Hellerstein, *State Taxation: 2001 Cumulative Supplement No. 1*, ¶ 8.11[3][e].

model rule is adopted, the Committee will consider drafting model regulations for combination of one or more different types of business entities.

The model statute does also allow for combination to be required by the director on a case-by-case basis, but only in situations involving tax avoidance or evasion. Although it may be clear in individual cases that combination would better reflect the income or loss of a particular taxpayer, or better reflect proper apportionment of income of a particular unitary business, the remedy allowed in these situations is through regulation, and not through authority to combine on an individual, case-by-case basis.

The Hearing Officer believes these modifications to the original draft, reflected now in the draft before the Executive Committee, represent a compromise that reasonably balances the concerns of the industry with the need to adequately take into account these important segments of a single unitary business, and therefore the Hearing Officer does not recommend further changes.

#### **4. Partnerships**

Under the model statute, business conducted by a corporate income taxpayer through a partnership is treated as conducted directly by that corporate taxpayer, to the extent of the corporation's distributive share of the partnership income. This is true whether the partnership is a general partnership, a limited partnership, an LLC or other entity treated as a partnership, or an S corporation. Because the corporation is considered to be engaged in the partnership business directly, as though through a division, the corporate partner's distributive share of the partnership income and factors will "flow up" for apportionment on the partner, as opposed to the partnership, level, irrespective of any threshold level of the partner's ownership interest, distributive share or any other measure of its stake in the partnership. Under this statutory "as if done directly" treatment, if a partnership has state source income, so will the partner. The principle is consistent with federal sourcing rules that treat a resident of a foreign country as having U.S. source income if the partnership or an S corporation of which the resident is a member has income from a U.S. source (IRC §875(1); §1366(b)). And it has been sustained in state court.<sup>18</sup>

One commenter suggested the model should explicitly specify whether it follows the "aggregate" or the "separate" theory and noted the myriad of issues that arise from the inclusion of partnership income in the combined report. (COST oral comments) The Hearing Officer believes the statute is adequately clear regarding the basic policy to be followed, but agrees that additional, more detailed guidance could be provided, and recommends the appropriate procedure for providing that guidance is through regulation.

#### **5. Water's Edge Election**

Whether or not, or the extent to which, foreign affiliates are included in the combined group is one of the most significant policy issues addressed in the proposed

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<sup>18</sup> *Valentino v. Franchise Tax Board*, 87 Cal.App.4<sup>th</sup> 1284 (2001).

model statute. In principle, a combined group should include all affiliates participating in the group's unitary business, domestic and foreign. If combination includes only domestic corporations, then the apportionment of income associated with the foreign activity of a multinational unitary business can be manipulated through changes in the corporate structure. The income (or loss) and apportionment factors associated with the foreign activity could be excluded by conducting the activity as a foreign affiliate, or it could be included by conducting the activity as a foreign division of the domestic corporation. Many tax experts have noted this policy rationale supporting world-wide combined reporting.<sup>19</sup> Indeed, the U.S. Supreme Court has also recognized the rationale and upheld state imposition of world-wide combined reporting.<sup>20</sup>

Despite its conceptual superiority, the world-wide approach is extremely unpopular with multinational corporations and much of the international tax community.<sup>21</sup> Indeed, a number of hearing participants lent support to that supposition in both oral and written comments. (See e.g. MW&E p. 7-8; OFII p. 1) As a practical matter, a water's-edge combination is likely to be administratively simpler, for both the taxpayer and the state, and far less contentious. Thus, the proposed model statute requires world-wide combination, with a water's-edge election. (Section 5) This approach takes a policy position in support of world-wide combination, yet also realizes the practical benefits of administrative simplicity and conflict minimization that can be achieved through a water's-edge election. No commenters recommended a change to the basic approach requiring world-wide combination but allowing a water's edge election. However, several took issue with various specific aspects of the water's edge election, and these comments are addressed below.

#### (a) Members Doing Business in a Tax-Haven

Two commenters referred to the model's retention in the water's edge combined group of entities doing business in tax havens as a "back-door implementation of world-wide combination." (SAB p. 2; OFII p. 1) In the opinion of the Hearing Officer, the retention of tax haven companies in a water's edge election is justified in order to address documented wide-spread abusive international tax sheltering, and its limited application to only those countries identified as "tax havens" falls far short of a "quasi world-wide combination." Just as combined reporting is critical to addressing income shifting across

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<sup>19</sup> See *Use of Combined Reporting by Nation States*, by Michael J. McIntyre, Tax Notes International; p. 945 (Sept. 6, 2004). See also *Designing a Combined Reporting Regime for a State Corporate Income Tax: A Case Study of Louisiana*; *Supra*, p. 732; citing to *Slicing the Shadow: A Proposal for Updating U.S., International Taxation*, by Reuven S. Avi-Yonah, 58 Tax Notes 1511 (March 15, 1993); *Design of a National Formulary Apportionment Tax System*, by Michael J. McIntyre, 84<sup>th</sup> Conf. on Tax'n, Nat'l Tax Ass'n 118 (Frederick D. Stocker ed. 1991); other citations omitted.

<sup>20</sup> *Container*, 463 U.S. 159, 103 S.Ct. 2983; *Barclays Bank PLC v. Franchise Tax Bd. Of California*, 512 U.S. 298, 114 S.Ct. 2268 (1994).

<sup>21</sup> *Designing a Combined Reporting Regime for a State Corporate Income Tax: A Case Study of Louisiana*; *Supra*, p. 732.

states, it is also critical for addressing the serious problem of income shifting to foreign tax-haven jurisdictions. A July, 2003 study by the Multistate Tax Commission estimated the state revenue impact from corporations shifting income earned inside the U.S. to other nations.<sup>22</sup> Using conservative national estimates of international income shifting through transfer pricing, the study estimated state revenue losses of \$5.3 billion for fiscal year 2001 alone.<sup>23</sup> World-wide combination addresses this issue by including all eligible unitary corporations, foreign as well as domestic, in the combined group. The proposed model's requirement that foreign corporations doing business in a tax haven jurisdiction be maintained as members of the combined group is necessary to avoid re-opening the foreign tax-haven opportunity through the water's-edge election. And, as further addressed below, the model's proscribed definition of tax-haven will reasonably limit the corporations to which the rule will apply.

### **(1) Definition of "Tax Haven"**

#### **▪ Use of OECD Criteria**

The definition of "tax haven" in the proposed model statute is based on existing standards and criteria established by the Organization for Economic Co-operation and Development (OECD) in its 1998 report entitled *Harmful Tax Competition: An Emerging Global Issue*.<sup>24</sup> One commenter suggested the Section 1.I.i. should more specifically identify "to which list of OECD 'tax havens' it refers: there were 35 jurisdictions identified by the OECD in its 2000 Progress Report yet only seven jurisdictions identified in the 2004 Progress Report." (MW&E p. 10) Similarly, "there were 47 countries identified in the 2000 Progress Report of the [OECD] as having a potentially 'harmful preferential tax regime,'" however, to date, none have been identified as having an actual "harmful preferential tax regime." The Hearing Officer believes it is intended that Section 1.I.i. refer only to jurisdictions and regimes that are actually on the

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<sup>22</sup> *Corporate Income Tax Sheltering and the Impact on State Corporate Income Tax Revenue*; A Report of the Multistate Tax Commission by Elliott Dubin; p. 4 (July, 2003).

<sup>23</sup> *Ibid*, p.5. The MTC study bases its estimate on estimated federal revenue losses attributable to international tax sheltering of \$30 billion. This number is consistent with a 1990 estimate by the Subcommittee on Oversight of the House Ways and Means Committee, chaired at the time by Rep. J.J. Pickle. Estimates from other sources have been higher, exceeding \$53 billion annually. See *An Estimate of 2001 Lost U.S. Federal Income Tax Revenues Due to Over-Invoiced Imports and Under-Invoiced Exports* by Simon J. Pak and John Zdanowicz, (October 31, 2002).

<sup>24</sup> *Harmful Tax Competition: An Emerging Global Issue*, OECD, 1998. <http://www.oecd.org/dataoecd/33/1/1904184.pdf> In 2001, the OECD deleted consideration of whether a jurisdiction has a significant untaxed offshore financial/other services sector relative to its overall economy as one of the criteria for distinguishing between "cooperative" and "uncooperative" tax havens. However, the consideration of significant untaxed offshore services remains one of the OECD criteria for the determination of whether a jurisdiction is a tax haven. Thus we have retained this consideration as one of several criteria to be examined in determining the existence of a tax haven under the model statute.

OECD lists during the year in question.<sup>25</sup> Thus, the language of Section 1.I.i. could be clarified as follows:

- I. “Tax haven” means a jurisdiction that, during the tax year in question,:
- i. ~~has been~~ is identified by the [OECD] as a tax haven or as having a harmful preferential tax regime ...

▪ **Director Discretion**

The proposed model allows discretion on the part of the Director with respect to tax havens in two ways. First, the Director may classify a jurisdiction as a tax haven if he or she “determines [the jurisdiction] has created a tax regime which is favorable for tax avoidance, based upon an overall assessment of relevant factors, ...” (Section 1.I.iii.) Second the Director “may treat an activity of the member as not having been conducted in a tax haven” if the activity is “entirely outside the scope of the laws, provisions and practices that cause the jurisdiction to meet the criteria established in [the definitional section.] (Section 5.A.vii.) Three commenters objected to the amount of discretion afforded the Director with respect to tax havens. (MW&E p. 10; SAB p. 3; COST oral comments) One commenter explained that “[t]he obvious effect of such discretion is the lack of uniformity across states that implement [the] proposed model statute.” (SAB p. 5) The Hearing Officer acknowledges the importance of uniformity and believes amendments are possible which would reduce the amount of discretion afforded the Director without seriously compromising the effectiveness of the model provisions, as follows:

Changes to Section 1.I.:

- I. “Tax haven” means a jurisdiction that:
- ...ii. exhibits the following characteristics established by the OECD in its 1998 report entitled Harmful Tax Competition: An Emerging Global Issue as indicative of a tax haven or as a jurisdiction having a harmful preferential tax regime, regardless of whether it is listed by the OECD as an un-cooperative tax haven:
- (a) has no or nominal effective tax on the relevant income; and
- (b) (1) has laws or practices that prevent effective exchange of information for tax purposes with other governments on taxpayers benefiting from the tax regime;

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<sup>25</sup> It should be noted that Section 1.I.ii. could include jurisdictions that were once, but are no longer, on the OECD list of uncooperative tax havens. The OECD recognizes that removal of a jurisdiction or regime from its list does not mean that that jurisdiction or regime is no longer a tax haven under its definition, only that it has become a “cooperative tax haven” as opposed to an “uncooperative tax haven.” As long as a “cooperative tax haven” is still a “tax haven,” the jurisdiction will continue to meet the OECD definition in Section 1.I.ii. This is not inconsistent with the OECD’s own caveat that a conclusion that a regime is not actually harmful does not in any way preclude the application of any domestic measure (such as CFC, FIF or any anti-abuse provisions) of a country to that or any other regime in *OECD’s Project on Harmful Tax Practices: The 2004 Progress Report*, Part II ¶18.

(2) has tax regime which lacks transparency. A tax regime lacks transparency if the details of legislative, legal or administrative provisions are not open and apparent or are not consistently applied among similarly situated taxpayers, or if the information needed by tax authorities to determine a taxpayer's correct tax liability, such as accounting records and underlying documentation, is not adequately available;

(3) facilitates the establishment of foreign-owned entities without the need for a local substantive presence or prohibits these entities from having any commercial impact on the local economy; ~~or~~

(4) explicitly or implicitly excludes the jurisdiction's resident taxpayers from taking advantage of the tax regime's benefits or prohibits enterprises that benefit from the regime from operating in the jurisdiction's domestic market; or

~~iii.~~ (5) ~~the director determines~~ has created a tax regime which is favorable for tax avoidance, based upon an overall assessment of relevant factors, including whether the jurisdiction has a significant untaxed offshore financial/other services sector relative to its overall economy.

Changes to Section 5.A.vii.:

the entire income and apportionment factors of any member that is doing business in a tax haven. If the member's business activity within a tax haven is entirely outside the scope of the laws, provisions and practices that cause the jurisdiction to meet the criteria established in Section 1.I., ~~the Director may treat~~ the activity of the member shall be treated as not having been conducted in a tax haven.

## (2) "Doing Business" in a Tax Haven

Four commenters remarked that inclusion in the water's edge election of any taxpayer "doing business" in a tax haven is overly broad. (MW&E p. 9; SAB p. 2-4; OFII p. 1-2; COST oral comments) One commenter suggested that it is presumably the "process of organizing" an entity in a tax haven jurisdiction that creates some tax benefit. (MW&E p. 9) One commenter noted that Montana and Alaska both include only those corporations that are "domiciled in" a tax haven.<sup>26</sup> (SAB p. 3) The Hearing Officer agrees that the "doing business" criteria is overly broad. However, in the opinion of the Hearing Officer, a rule limiting inclusion to taxpayers domiciled, particularly legally domiciled, in a tax haven may not be adequate for our purposes. A corporation incorporated in one country can have a commercial domicile in a haven and take advantage of the secrecy and low tax rate rules of the haven. The Hearing Officer recommends that the language be modified as follows:

...the entire income and apportionment factors of any member that is doing business in a tax haven, where 'doing business in a tax haven' is defined as being engaged in activity sufficient for that tax haven jurisdiction to impose a tax under United States constitutional standards.

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<sup>26</sup> Mont. Code §§15-31-322 and Alaska Code §43.20.073



### (3) Foreign Commerce Clause

Two commenters suggest the MTC's adherence to the OECD's criteria would violate the foreign commerce clause. (SAB p. 4; OFII p. 2) The foreign commerce clause restrictions established in *Japan Lines* are that state tax measures may not impose a risk of multiple taxation at the international level and may not prevent the federal government from "speaking with one voice" on international policy matters. The model does not violate either of these restrictions. First, the model is fundamentally an adoption of world-wide combination, which has been upheld by the U.S. Supreme Court. The water's edge election is just that – an election – and it is at the taxpayer's option. Nothing is "imposed" through an election allowing taxpayers to limit the inclusion of the foreign unitary affiliates which could otherwise constitutionally be required to be included in their combined report.

Second, the United States is a member of the OECD, the organization which has produced the definitions the model proposes to follow. That the model will incorporate and follow definitions adopted by an organization of which the federal government is a member will promote, not prevent the federal government's ability to "speak with one voice." A commenter suggested that the OECD's 1998 criteria have been "clearly rejected by the Federal government," and thus the MTC's reliance on these criteria would violate the foreign commerce clause. (SAB p. 4) As evidence of rejection, the commenter pointed to testimony provided in 2001 by Treasury Secretary Paul O'Neill to the Senate Committee on Governmental Affairs. (SAB p. 4)

In the opinion of the Hearing Officer, Sec. O'Neill's testimony has been misinterpreted. Indeed, Sec. O'Neill reported his concern with prior OECD provisions. But the conclusion of his testimony was that these concerns have been addressed. In fact, Sec. O'Neil stated:

Our review of the OECD project has been guided by two fundamental principles. First, we must do everything that we can to enforce our own tax laws, including working to obtain needed information that is in the hands of other countries. Second, we will not interfere in the internal tax policy decisions of other countries. These principles led me to conclude that the United States should attempt to refocus the OECD initiative on its core element: the need for countries to be able to obtain specific information from other countries upon request in order to prevent noncompliance with their tax laws.

I am happy to report that, together with other OECD member countries, we have made substantial progress in focusing the initiative on its core element of effective information exchange and in addressing aspects of the initiative that seemed unfair to non-OECD countries. ... I would like to summarize three significant modifications to the OECD tax haven work, each of which I will describe in greater detail below. First, coordinated defensive measures would not apply to "uncooperative" tax haven jurisdictions any earlier than they would apply to similarly-situated OECD member countries. Second, the "no substantial

activities" criterion will no longer be applied to determine whether or not a jurisdiction is considered to be an "uncooperative" jurisdiction. Third, the time for tax haven jurisdictions to make a commitment to transparency and information exchange has been extended from July 31st to November 30th.

*The United States argued for each of these modifications within the OECD, and strongly supports them.*

Testimony of Sec. O'Neil, emphasis added

Sec. O'Neill clearly believes his concerns have been addressed and shows strong support for the OECD's provisions as modified. And, none of the modifications changed the OECD's 1998 criteria, incorporated in the proposed model, which are used to identify tax havens. Modifications to the date by which coordinated defensive measures will be taken against uncooperative tax havens (Sec. O'Neill's first point) and to the deadline for tax havens to make transparency commitments (Sec. O'Neill's third point) had no impact whatsoever on the OECD's 1998 criteria for identifying tax havens. Sec. O'Neill's second point merely eliminates a criterion for distinguishing between cooperative and non-cooperative tax havens, but does not eliminate or change any of the criteria established in 1998 for determining whether the jurisdiction is a tax haven in the first place. In the opinion of the Hearing Officer, the testimony presented by Sec. O'Neill, if anything, is strongly supportive of the OECD provisions as they now stand and are reflected in the proposed model.

#### **(b) Subpart F Income**

Under the proposed model, controlled foreign corporations (CFCs) are to be included in the water's edge election to the extent of their subpart F income. One Commenter suggested the section could be read to wholly include a CFC "if it earns even one dollar of Subpart F income." (MW&E p. 8-9) The Hearing Officer agrees and recommends the model language be amended as follows:

[Members of the combined report under a water's edge election include] any member of a "controlled foreign corporation," as defined in [IRC] Section 957, to the extent of the income of that member that is defined in [Subpart F]....

Section 5.A.v.

The same commenter suggests a need for "an explicit acknowledgment in either [the Subpart F] section or the dividend elimination provision that the same item of Subpart F income will not be included in the income of multiple entities in a tiered CFC structure." (MW&E p. 9) The Hearing Officer believes such a clarification is unnecessary. If the CFC is non-unitary or otherwise excluded from the combined group, its Sub F income will not be included as such in the combined report, so dividends paid out of any of that CFC's income (including Sub F income) to any member of the combined group should be included as income of that member and should not be

eliminated. On the other hand, if the CFC is unitary and included in the combined report, dividend elimination would clearly be required under Section 3.C.ii (d).

The commenter also suggests the “high tax” exception to the Sub F rule be clarified to indicate “whether it is possible for a taxpayer to treat income as Sub F income for federal purposes yet seek to take advantage of the high tax exception for state purposes.” (MW&E p. 9) The Hearing Officer believes that an amendment clarifying high tax Sub F income is never included in a combined report would be sufficient to address this question. As long as the model excludes high tax income from the combined report, then even if the taxpayer elects not to exercise the high tax provision for federal purposes, the income will still be excluded from the combined report for state purposes. The Hearing Officer recommends the following amendment to Section 5.A.v. (water’s edge election):

[A]ny item of income received by a controlled foreign corporation ~~may~~ shall be excluded if ~~the taxpayer establishes to the satisfaction of the Director that such~~ income was subject to an effective rate of income tax imposed by a foreign country greater than 90 percent of the maximum rate of tax specified in [IRC] Section 11;

Section 5.A.v.

Clarification of this issue for purposes of a world-wide combined filing may be accomplished through regulation.

**(c) Members Earning 20% of Income from Activities Deductible by Another Member**

The proposed model would include in the water’s edge combined report “any member that earns more than 20 percent of its income, directly or indirectly, from activities that are deductible against the business income of the other members of the combined group, to the extent of that income and the apportionment factors related thereto...” (Section 5.A.vi.) The purpose of this proposal is to address the potential for income shifting through intangible holding companies which would otherwise be excluded from the combined report under a water’s edge election. One commenter expressed a concern that the provision is potentially over-broad. As an example, the commenter pointed out that a foreign parent manufacturer selling to a related party U.S. distributor could potentially see most of its income included in the water’s edge group under this provision. (MW&E p. 9; COST oral comments) Another commenter cited this provision as overly burdensome because it would impose an “annual requirement to assess whether any foreign affiliate [meets the criteria]. (SAB p. 2)

In the opinion of the Hearing Officer, the breadth of this provision could be reduced without significantly jeopardizing its effectiveness as follows:

any member that earns more than 20 percent of its income, directly or indirectly, from intangible property or service related activities that are deductible against

the business income of other members of the combined group, to the extent of that income and the apportionment factors related thereto;

Section 5.A.vi.

**(d) Initiation and Withdrawal of Election**

The availability of any election can have revenue implications as taxpayers would reasonably choose the methodology that produces the lower tax in each case. The model statute minimizes the potential for this type of impact by making the water's-edge election more of a long-term consideration. Under the proposal, the election is binding for all future tax years, and may be withdrawn or reinstated after withdrawal only in restricted circumstances. One commenter voiced a concern that these circumstances are too restricted and recommended an election withdrawal option after a fixed period. (COST oral comments). In the interest of compromise, the Hearing Officer believes there would be no problem with a 10 year rolling option. A non-rolling option that defaults to the existing election, unless changed, for another 10 year period could also be acceptable. The Hearing Officer recommends the following amendment:

A water's-edge election is binding for and applicable to the tax year it is made and all tax years thereafter for a period of 10 years. It may be withdrawn or reinstated after withdrawal prior to the expiration of the 10 year period, only upon written request for reasonable cause based on extraordinary hardship due to unforeseen changes in state tax statutes, law, or policy, and only with the written permission of the Director. If the Director grants a withdrawal of election, he or she shall impose reasonable conditions as necessary to prevent the evasion of tax or to clearly reflect income for the election period prior to or after the withdrawal. Upon the expiration of the 10 year period, a taxpayer may withdraw from the water's edge election. Such withdrawal must be made in writing within one year of the expiration of the election, and is binding for a period of 10 years, subject to the same conditions as applied to the original election. If no withdrawal is properly made, the water's edge election shall be in place for an additional 10 year period, subject to the same conditions as applied to the original election.

Section 5.B.iv.

One commenter voiced a concern that the circumstances under which the Director may disregard the election are too broad. (See MW&E p. 10) The Hearing Officer agrees that the circumstances could be more fully described, but believes this would be more appropriately accomplished through regulation. The same commenter suggested that if the election is disregarded in part, in no circumstances should the Director's disregard of the election result in the payment of more tax than would have been paid on a world-wide combined basis. (MW&E p. 10-11) The Hearing Officer disagrees. It is possible that in any one year a world-wide combination would produce a significantly lower tax liability than a water's edge election. If a water's edge election is disregarded

in part because, for example, the taxpayer has availed itself of an abusive tax shelter, the result should not be an even lower tax (through world wide combination) than would have otherwise resulted had the taxpayer not used the abusive tax shelter.

## **B. Method of Combination**

### **1. Group Members as Individual Taxpayers vs. the Combined Group as a Single Taxpayer**

As mentioned above, the combined report required under the proposed model statute does not disregard the separate identities of the taxpayer members of the combined group. The model is quite consistent in its treatment of the combined group as a set of individual entities rather than a single taxpayer: business income subject to apportionment is calculated as the sum of all members' individually determined net business income or loss; as a general rule, deductions and credits are taken only by the specific taxpayers that earned them; and, the amount of total combined business income apportioned to a state is calculated as a function of each taxpayer's own factors in that state (the *Joyce* method), as opposed to the factors for the entire group as a whole in that state (the *Finnigan* method).

An exception to this general rule is that charitable contribution deductions are allowed to be taken first against the group business income, and any remainder is then allocable to the specific taxpayer that earned the deduction. One commenter cited to this exception, plus a "sales factor throwback [recommendation] to be applied on the basis of *Finnigan*," and the fact that "a taxpayer's share of business income apportionable to the state is calculated by reference to all business income of the individual members in combination," as indication that there is an "MTC preference in each discrete instance of drafting for the approach – "taxpayer" defined as the discrete entity/member of a unitary group v. "taxpayer" defined as the combined unitary group – that is likely to generate the greatest tax liability for the taxpayer." (SAB p. 6; also COST oral comments)

The Hearing Officer would disagree with the characterization of a throwback rule as a *Finnigan* style attribute. However, this point is irrelevant as the model statute takes no position on throwback.

The Hearing Officer would agree that a taxpayer's share of business income apportionable to the state is calculated by reference to all [net] business income of the individual members in combination. However, such combination is not the equivalent of treating the entire combined unitary group as a *single taxpayer*. It is simply the recognition of the entire combined unitary group as a *single business*. The proposed model then utilizes the combined report as a worksheet for properly apportioning the total income from that *single business* across the *individual taxpayer* members that are engaged in that single business.

So in fact, the only true exception to the general rule cited by the commenter is the charitable contribution deduction. Under the proposed statute, a charitable deduction

is allowed to be taken first against the business income of the combined group (subject to federal income limitations as applied to the entire business income of the group), and any remaining amount may then be treated as a nonbusiness expense allocable to the member that incurred the expense (subject to the federal income limitations applied to the nonbusiness income of that taxpayer member).

The Hearing Officer agrees that consistency in whether each individual group member or the group as a whole is considered the taxpayer is a rationale goal. Although the proposed model is not perfectly consistent in its treatment of group members as individual taxpayers, the exceptions to the general rule are limited and reasonable. For example, perfect consistency would require us to abandon the model's treatment of the charitable deduction, which would result in "trapping" of these particular incentives at the parent level from which these contributions are often made. (One industry commenter specifically noted appreciation for the model's handling of charitable deductions [COST, oral comments]). An alternative model could be developed which perfectly consistently treats the entire group as a single taxpayer. Such a model would allow credits and deductions earned by any one entity to be usable by the entire group. In addition, under this "single taxpayer" model the state apportionment factor numerators would reflect the property, payroll and sales of the entire group as a single taxpayer, not just those entities considered to have nexus when viewed as if each were an individual taxpayer.

In the opinion of the Hearing Officer, the proposed model's approach of generally treating each member as an individual taxpayer, with a small number of exceptions where necessary and reasonable, is a sensible approach. The model's deviation from this approach in the case of charitable deductions in particular is an example of a limited, reasonable allowance and should be appreciated by taxpayer groups. Therefore, the Hearing Officer does not recommend a change to the model on this point. Additional comments on the treatment of apportionment factor numerators, credits and losses are discussed below.

#### **(a) Apportionment Factor Numerators**

As noted above, the proposed model follows the *Joyce* approach and determines apportionment factor numerators for each taxpayer member on an individual taxpayer basis. This approach is consistent with the MTC's Policy Statement on Information Concerning Practices of Multistate Tax Commission and Signatory States under Public Law 86-272, which was originally adopted in 1986. The policy choice was also recently reaffirmed by a small work group assigned to review the issue by the Income & Franchise Tax Subcommittee. No commenters objected to the model's use of the *Joyce* approach for determining the apportionment factor numerators. One commenter remarked that it "agree[s] wholeheartedly with the Model's use of a *Joyce* approach to determining the proper apportionment of the combined tax base on a taxpayer-by-taxpayer basis." (MW&E p. 7)

#### **(b) Credits**

As noted above, the proposed model also requires tax credits be allowed only on an individual taxpayer basis (unless the credit statute explicitly directs otherwise). Two commenters took the position that credits “should be applied to offset the income of the combined group.” (MW&E p. 6; also COST oral comments) However, credits do not “offset *income*,” they offset *tax liability*. If the proposed model were to treat the entire group as a single taxpayer with a single tax liability, then it might make some sense for credits to be applied against that single tax liability. But in a model such as the proposal before the Committee which treats each group member as an individual taxpayer with an individual tax liability, there is simply no rationale, absent statutory direction, for allowing a tax credit earned by one taxpayer member to offset the separate tax liabilities of other taxpayer members.

In addition, it is not at all clear to the Hearing Officer how credits could reasonably be apportioned and tracked from year to year if the commenters’ position were adopted. For each credit earned by an individual taxpayer, a determination would need to be made as to whether the credit arose from an investment that was unitary business related and apportionable, or non-business related and not apportionable, or some of each. Taxpayers would need to separately track their use of credits and prioritize which credits were being applied first, in order to know whether a particular carryover credit were unitary business related and (possibly) available for use by the entire business in the second year, or not unitary business related and available for use only by that taxpayer in the second year. Some of both types of credit might carryover. Characterizing, apportioning and tracking the usage of different types of credits by multiple members of a unitary group, especially if the group members are changing from year to year, would certainly require a much more complex administration than that required under the approach recommended by the model.

For the above reasons, the Hearing Officer does not recommend a change to the proposed model on this point.

### (c) **Losses**

As noted above, the proposed model also restricts net operating loss carryover deductions to the individual taxpayers that originally earned them. Two commenters believe this aspect of the proposed model is “inconsistent with the combined reporting concept. ... If a group of corporations are required to combine their income in order to produce an accurate reflection of the income attributable to any one state, then the same logic ought to extend to the losses generated by that same group of corporations.” (MW&E p. 6; COST oral comments) One commenter explained that “[i]f income is computed on a combined basis, it is logical that losses (and carryforwards) must also be computed and applied in a similar fashion.”

In the opinion of the Hearing Officer, this position is only partly correct. The Hearing Officer agrees with the commenters that a net loss, like net income, is subject to apportionment among the members of the combined group. However, once apportioned,

the net loss has been identified as attributable to a particular taxpayer member. It may be used to offset other types of income of that member - *e.g.*, the taxpayer's allocated non-business income, or business income arising from a different combined group. There is no rationale for allowing any remaining amounts of loss attributed to a particular taxpayer member to be *re-apportioned* among the entire group in the following year. Rather, the loss, once apportioned, should remain associated with the factors by which, and the individual taxpayer to which it was attributed in the year it was created. In addition, continued re-apportionment of NOL carryforwards would entail the same potentially significant administrative difficulties discussed with respect to apportionment of tax credits, above. Thus, the Hearing Officer does not recommend any changes to the model based on this point.

## **2. Deferred Intercompany transactions**

The model provides that restorations of deferred company income resulting from an intercompany transaction between members of a combined group shall be apportioned as business income. One commenter suggested that a specific determination should be made in each case as to whether the restoration should be treated as business or non-business income. In the opinion of the Hearing Officer, this is not necessary because only business income should be deferred in the first instance, so all restorations should be restorations of business income. To ensure that that is the case, the Hearing Officer recommends the following amendment:

Except as otherwise provided by regulation, business income from an intercompany transaction between members of the same combined group shall be deferred in a manner similar to 26 CFR 1.1502-13. Upon the occurrence of any of the following events, deferred business income resulting from an intercompany transaction between members of a combined group shall be restored to the income of the seller, and shall be apportioned as business income earned immediately before the event: ...

Section 3.C.ii(e)

## **3. Elimination of Dividends**

The proposed model provides that:

All dividends paid by one to another of the members of the combined group shall, to the extent those dividends are paid out of the earnings and profits of the unitary business included in the combined report, in the current or an earlier year, be eliminated from the income of the recipient. This provision shall not apply to dividends received from members of the unitary business which are not a part of the combined group.

One commenter suggested amendments to this language to clarify the proper treatment of dividends paid by one to another member of the combined group out of pre-acquisition (or pre-unity) earnings and profits, and whether earnings and profits are determined for the purpose this provision on a separate return basis or on a "recomputed" basis as a share of combined business income. In the opinion of the Hearing Officer, this



statutory language correctly states the intended rule in general terms. It is acknowledged that additional guidance would be helpful on these (and other) points, and the Hearing Officer recommends the appropriate method for providing such guidance would be through regulations.

#### **4. Compliance Burdens**

One commenter expressed a concern for “compliance burdens” generated by the proposed model statute. (SAB p. 2) However, most of these concerns are simply related to the need for a taxpayer to calibrate foreign affiliates income with the income that would be recognized under state law. This is necessary if the taxpayer does not make the water’s edge election. And in some cases, may be necessary under the water’s edge election. Additional guidance may be provided by regulation to minimize any burdens. Other examples of potential burden given by the commenter have been addressed above.

#### **C. Implications of Adopting the Model Combined Reporting Statute**

One commenter suggested that if a state adopts the proposed model combined reporting statute, it may repeal any throwback, throwout or add-back provisions. (MW&E p. 3) In the opinion of the Hearing Officer, this is incorrect with respect to throwback or throwout provisions, and is not necessarily the case with respect to add-back provisions. The purpose for the throwback rule is to avoid no-where income, and avoid discrimination against wholly instate businesses that can’t cause nowhere income to “fall between the cracks.” The policy of throwback is just as important and necessary to that objective in a combined reporting setting than in a single entity setting. Add-backs may still be appropriate for taxpayers that elect water’s edge and create foreign intangible holding companies or for insurance companies if combination isn’t available. That said, the Hearing Officer would note that these issues are beyond the scope of recommendations for changes to the model combined reporting statute.

Respectfully Submitted,

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Shirley K. Sicilian

Hearing Officer

Exhibit A      McDermott, Will & Emery (MW&E) – Kimberley Reeder and Margaret Wilson

**COMMENTS ON MULTISTATE TAX COMMISSION  
PROPOSED MODEL STATUTE FOR COMBINED REPORTING**

**Submitted By: Kimberley Reeder, McDermott Will & Emery LLP – Silicon Valley  
Margaret Wilson, McDermott Will & Emery LLP – New York**

We submit the following comments to the Multistate Tax Commission (“MTC”), in response to the invitation of the MTC following publication of the November 11, 2004 draft of the Proposed Model Statute for Combined Reporting (the “Model”) (as approved by the MTC Executive Committee for Public Hearing). These comments do not explore the benefits or disadvantages of combined reporting generally, but rather analyze issues raised by the specific Model that has been proposed as the statutory model for those states that choose to adopt a combined reporting system of state corporate taxation.

**General Comment: A State’s Taxing Scheme Must Be Intellectually Honest**

The approach taken by the Model requires combined reporting for every group of corporations that engages in a “unitary business.” The stated goal of the Model is to encourage states to “adopt combined reporting for jointly owned and operated companies in order to appropriately report and assign income to where it is earned.”<sup>1</sup> One must consider, however, the impact of combined reporting in a state that has already enacted any number of other provisions designed to achieve this same goal – namely, the proper reflection of income in the state. Any state that adopts combined reporting must reevaluate the need for those other “tools” in light of the purported ability of combined reporting to – standing alone – accomplish a proper reflection of the income of the unitary business in the state.

Indeed, over the years states that have followed separate reporting regimes (or even some states that have taken various approaches to combined reporting) have adopted a number of different provisions designed to close the “loopholes” of which states believed taxpayers had wrongfully taken advantage – thereby shifting income to another state or otherwise reducing state tax liabilities.

For example, states have long decried the “nowhere income” that results from constitutional or statutory (under Public Law 86-272) protection against taxation in certain states or from the affirmative decision by some states not to impose a corporate income tax at all. In response to this perceived abuse (although it is difficult to understand how following statutory provisions is abusive), roughly two dozen states have adopted throwback provisions under which receipts otherwise assigned to those non-taxing jurisdictions are included in the numerator of the shipping state’s apportionment fraction (even though it would not have been so assigned under the shipping state’s own normal apportionment rules). Similarly, West Virginia and New Jersey have enacted throw-out rules, that remove receipts from the denominator of the state’s apportionment fraction if those receipts have not been included in the numerator of an apportionment fraction in another jurisdiction. Both of these rules cause more income to be

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<sup>1</sup> MTC Memorandum from Shirley Sicilian, Deputy General Counsel, to Wood Miller, Chairman, and Members of the MTC Income & Franchise Tax Uniformity Subcommittee, October 29, 2004.

apportioned to the throwback or throw-out rule state. The increase, however, is based on a perception that the taxpayer is somehow avoiding taxation rather than any actual expansion of activities or presence in the throwback or throw-out rule state. Indeed, the taxpayer has no more economic or “earning” activity in the throwback or throw-out state, yet more of its income is apportioned to that state. In contrast, no state provides specific statutory relief to automatically correct situations where a taxpayer is taxed on more than 100% of its income across the various jurisdictions in which it does business.

More recently, many states have adopted anti-intangible holding company legislation, such as “add-back” statutes designed to deny deductions for interest or royalty payments where those amounts are paid to a related corporation. The stated purpose of these provisions is to prevent corporations from shifting income out-of-state through payments made to a corporation that is not subject to tax in the state in question.

If the justification for adopting the combined reporting approach reflected in the Model is that it results in the appropriate reporting and assigning of income to the jurisdiction where it is earned, then throwback, throw-out, “add-back” and similar rules should be unnecessary. As such, any enactment of the Model should be accompanied by the elimination of these provisions from the state’s tax statutes.

## **Comments On the Model**

### **1. The Crux of the Model Is the Scope of a “Unitary Business,” Yet Little Guidance/Few Standards Are Provided in the Model**

Regardless of how any state chooses to statutorily define the parameters of a “unitary business” subject to combination, it is necessarily constrained by the federal constitutional limitation that has become known as the “unitary business” principle. This is true no matter what the state statutes or regulations governing combination may provide. No state may combine a corporation that is not subject to its taxing jurisdiction with one that is so subject, unless the two corporations engage in a “unitary business.”

The broad parameters of the unitary business principle have been articulated by the U.S. Supreme Court in several long-standing opinions.<sup>2</sup> Each of these cases explored the scope of a state’s power to tax the income of a corporation or a group of corporations with a commercial domicile outside that particular state. Under these Supreme Court decisions, the general test for a unitary business looks for centralization of management, functional integration, and economies of scale among the various corporate divisions or entities.<sup>3</sup>

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<sup>2</sup> *Allied-Signal, Inc. v. Director, N.J. Div. of Taxation*, 504 U.S. 768 (1992); *Container Corp. of America v. Cal. Franchise Tax Board*, 463 U.S. 159 (1983); *ASARCO Inc. v. Idaho State Tax Comm’n*, 458 U.S. 307 (1982); *F.W. Woolworth Co. v. Taxation and Rev. Dep’t of New Mexico*, 458 U.S. 354 (1982); *Exxon Corp. v. Wisconsin Dep’t of Rev.*, 447 U.S. 207 (1980); *Mobil Oil Corp. v. Comm’r of Taxes of Vermont*, 445 U.S. 207 (1980). The unitary business principle is at times used to determine when, under the federal Constitution’s Due Process Clause, dividends, interest, and capital gain earned by a taxpayer corporation as a result of that taxpayer’s ownership of another corporation can be included in the taxpayer’s preapportioned tax base.

<sup>3</sup> *See, e.g., Mobil Oil*, 445 U.S. at 438.

The Supreme Court in two cases – *ASARCO* and *Woolworth* – found that the Due Process Clause prevented a state from taxing income flowing from affiliated corporations because those affiliated corporations were not part of the same “unitary business” that was conducted by the closely-related corporate taxpayer at issue. In each case, the state had the jurisdiction to tax one corporation, but sought to include in its apportionable tax base income that it had received from affiliated or subsidiary corporations over which the state did not have nexus. The Court applied its three part test for determining a unitary business – namely, centralization of management, functional integration, and economies of scale – to determine whether the various entities were part of the same unitary business (allowing taxation of income generated by each of them), or were discrete business enterprises.

Of course, any state may, through its own state-specific laws, either eschew combination completely or approach combination more narrowly by employing standards under which certain corporations, even though engaged in a unitary business, will not be forced (or permitted) to combine. For example, New York State will not force (or permit) the combination of every group of two or more corporations that engage in a unitary business, but rather will only do so if there is both a unitary business *and* a distortion of income when each individual corporation files its own return. Combination is not required if related taxpayers deal with one another on arm’s length terms, as income among the related corporations is already properly reflected – just as it would be if the same transactions had been engaged in with unrelated businesses.

*ASARCO* and *Woolworth* prove that mere common ownership or the potential for control are not automatically enough to justify taxation. This unitary business principle thus necessarily limits any state’s attempt to combine and tax the income generated by a group that includes non-nexus corporations. No matter what definition of “unitary” a state may articulate, every case must be analyzed under its own unique facts using the Supreme Court’s three part test for “unitary business”: centralization of management, functional integration, and economies of scale.

Under the Model, the sole determining factor for requiring combined reporting by separate corporations is whether those corporations engage in a “unitary business.” The Model, however, provides little guidance by which taxpayers may determine whether they are indeed engaging in a unitary business. While this creates compliance difficulties for taxpayers and also the very type of audit difficulties that the Model’s combined reporting approach purportedly is meant to avoid (as discussed further in Point 3, below), one need only look to the varying definitions provided in Supreme Court precedent to realize that it may indeed be impossible to statutorily define the term.<sup>4</sup> The Model may be an appropriate means for articulating how combined reporting should be implemented once triggered, but an inappropriate means for articulating the preliminary standard for when a unitary business exists and combination would be required.

The Model’s definition of a “unitary business” is (leaving aside partnership interests):

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<sup>4</sup> See MTC Memorandum, *supra* note 1, at 7, stating that the reason the Model does not preclude combination if intercompany transactions are engaged in at arm’s length is that this approach “would defeat the advantage of combined reporting over other, more labor intensive approaches to achieving proper attribution of income” and would avoid “complex and time-consuming audit inquiries.”

“Unitary business” means a single economic enterprise that is made up either of separate parts of a single business entity or of a commonly controlled group of business 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.” [Model, Section 1, Definition F]

Acknowledging that any attempt to codify the unitary business principle is difficult at best, this definition simply leaves too much open to interpretation to provide taxpayers or taxing authorities with an administrable rule. The sole basis for forcing combination under the Model is the existence of a “unitary business,” yet the Model does little to articulate the scope of what this entails.

We are aware that the MTC has separately developed a model regulation – indeed, one that is several pages long – that articulates standards for determining what is a unitary business (the “MTC Unitary Regulation”).<sup>5</sup> Regardless of our opinion of the MTC Unitary Regulation, the Model does not incorporate the MTC Unitary Regulation, either by its terms or by reference. Thus, one cannot simply presume that any state adopting the Model approach will also incorporate the MTC Unitary Regulation by statute or by regulation.

Equally important is the lack of any definition of what constitutes a “commonly controlled group.” Again, the MTC Unitary Regulation includes a definition of this term, but that definition is not incorporated into the Model. One possible, and workable, approach would be to use the federal standard contained in Internal Revenue Code §1504(a)(2). In any event, this concept is too central to the combined reporting scheme not to be expressly defined (and uniformly defined by the states). The Model’s triggering provision for combination similarly only states that a “taxpayer engaged in a unitary business with one or more other corporations shall file a combined report.” Model, Section 2, A. Certainly combination with an “unrelated” corporation cannot be required (the constitutional unitary business standards would not allow it), but one cannot discern under the Model where the line is drawn between those corporations that are related and those that are unrelated.

Moreover, under the Model, it appears that combination with an unrelated taxpayer may not be out of the question. In addition to the mandatory combination requirement, the Model also gives a taxing authority discretion to require that “the combined report include the income and associated apportionment factors of *any persons that are not included* pursuant to [the mandatory combination provision], but that are members of a unitary business, in order to reflect proper apportionment of income of entire unitary businesses.” This language infers that corporations need not be commonly owned in order to be “members of a unitary business.” What entities are not included in the mandatory combination provision but are nonetheless “members of a unitary business” or “entire unitary businesses.” What are “entire unitary businesses”? Are they something broader than the single unitary business that is already being forcibly combined under

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<sup>5</sup> MTC Allocation and Apportionment Regulations, Regulation IV.1.(b) (revised January 15, 2004).

the preceding section of the Model? At the least, this loosely worded discretionary authority provision must be clarified such that there are some limits on which entities can be combined.

**2. There Is No Justification for Refusing A Standard that Avoids Combining Corporations that Engage in Solely Arm's Length Transactions**

The Model requires combined reporting for members of a “unitary business” without regard to whether the intercompany transactions between members of a unitary business are priced as arm’s length transactions. The approach to forced combination followed by states such as New York, Connecticut, Virginia, Georgia and New Jersey – namely, requiring combination only when corporations engaged in a unitary business experience a “distortion” of their separate incomes – achieves the proper reflection of income that is purportedly the prime justification for the Model’s approach and is not necessarily more difficult to administer than the approach under the present Model.

To the extent that the goal of implementing mandatory combined reporting is to achieve a proper reflection of the income attributable to the state, that goal is not frustrated by unitary corporations that engage in intercompany transactions at arm’s length prices. So long as related taxpayers charge each other the same amounts that they would charge to an unrelated business for the same transaction, no distortion or improper reflection of income would result. Moreover, even if this means that some income would be allocated outside of the state in question, if a related member of the unitary business is truly engaged in its business outside of the state in question then no income has been improperly shifted outside the state. Admittedly, there may be some taxpayers who push these intercompany relationships to their limit, but there are many that have chosen to structure their businesses in separate corporations for any number of reasons. Indeed, taxpayer corporations are in business to make money for their shareholders – the fact that their decisions are “economically motivated”<sup>6</sup> not only is not malevolent, but is actually required in order to fulfill the corporation’s obligations to its shareholders.

In fact, when related corporations do deal with one another on arm’s length terms, combination may actually result in distortion. If forced to report on a combined basis, one company’s apportionment factors will necessarily impact the apportionment of the other company’s income, even though the two corporations did in fact for economic purposes operate in the same manner as unrelated corporations. One must question whether this does result in a more accurate reflection of the income earned in each state in which the corporations do business as compared to reporting on a separate basis.

Furthermore, there is no empirical basis for the conclusion that using an “arm’s length”/distortion-based standard (at least in part) for mandatory combination would result in more “complex and time-consuming audit inquiries” than would audits that solely analyze whether corporations are engaged in a “unitary business” under the Model. Admittedly, a distortion requirement does introduce the need for transfer pricing studies, which may be cumbersome. However, as stated above, the analysis of whether a unitary business exists is a complex one even under the constitutional parameters set by the United States Supreme Court.

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<sup>6</sup> MTC Memorandum, *supra* note 1, at 7.



The Model's definition of a "unitary business" certainly does not ease the administration of this standard, but rather convolutes it by introducing new undefined concepts such as being "sufficiently interdependent, integrated and interrelated" or having the requisite amount of "synergy."

If, instead, the Model were to require combined reporting only when related corporations: (1) are engaged in a unitary business and (2) experience distortion attributable to a failure to conduct their intercompany transactions at arm's length, the standard likely would be much more easily administrable. The complex analysis of whether sufficient synergies and interdependence exists between two corporations could be avoided altogether as long as the two corporations engaged in only arm's length transactions with one another. This standard is seemingly no more difficult to apply than the unitary analysis – indeed, it is applied in the federal tax context on a regular basis under Internal Revenue Code Section 482 principles. Introducing a "non-distortion" or arm's length transaction component to the standard for requiring combined reporting does not seem inherently more complex than unitary business analysis, and may in fact result in a more accurate reflection of income.

### **3. Consistency Requires that Combined Income Reflect Combined Losses and Jointly Earned Credits**

If income is computed on a combined basis, it is logical that losses (and carryforwards) must also be computed and applied in a similar fashion. Instead, the Model provides that net operating losses are unique to each individual taxpayer and cannot be used by the unitary business on a combined basis.

We believe this approach is inconsistent with the combined reporting concept. If a group of corporations are required to combine their income in order to produce an accurate reflection of the income attributable to any one state, then the same logic ought to extend to the losses generated by that same group of corporations. Regardless of where in the tax computation process a given state chooses to provide for the deduction of net operating losses, there is no justification for isolating those net operating losses to the specific corporate entity that incurred them. This is not merely an apportionment question related to determining what portion of the entire tax base is attributable to a particular taxpayer with regard to a specific state. Instead, the deduction of net operating losses is determinative of the tax base itself. If the income used to compute that tax base includes the income of all corporations in the unitary group, then consistency similarly demands that all net operating loss carryforwards or carrybacks generated by members of the group be deducted from that base.

Similarly, tax credits should be applied to offset the income of the combined group. In the specific context of the research credit, it is certainly appropriate to apply the credit proportionately to the income of group members that shared the expenses that gave rise to the credit. To impose an artificial separate-entity limitation on such credits allows "the enterprise-wide contributions to income" that are the essence of the unitary business to be "pigeon-holed into a few affiliates."<sup>7</sup>

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<sup>7</sup> MTC Memorandum, *supra* note 1, at 5.

The resolution of these types of issues may warrant a separate project on how to calculate combined income, losses, credits, etc. The New York State Department of Taxation and Finance is currently undertaking such a project.

**4. Combined Reporting Must Not Be Used As a “Back Door” Means of Taxing Non-Taxpayers (Under the Guise of “Mere Apportionment”)**

Putting aside the propriety of any throwback rule (as was at issue in *Finnigan*), we agree wholeheartedly with the Model’s use of a *Joyce* approach to determining the proper apportionment of the combined tax base on a taxpayer-by-taxpayer basis.<sup>8</sup> More specifically, to the extent that any corporation included in the combined report cannot be taxed by the state in question, that corporation should not pay tax on its apportioned share of the total combined tax base, nor should its apportionment factors result in an increased tax liability for any of the other members of the combined group. Doing otherwise has exactly the same economic result as imposing tax on the nontaxable corporations themselves, and thus would frustrate the legislative and constitutional provisions that protect these corporations.

**5. All Deferred Intercompany Transactions Should Not Give Rise to Business Income**

The Model provides that deferred income resulting from an intercompany transaction between members of a combined group shall, upon being restored, “be apportioned as business income.” As with any other income, the determination of whether a particular item is business income or nonbusiness income must be made based on the standards employed by the state. The fact that an item of income is deferred and then later restored should not obviate the need for this analysis.

**6. Water’s Edge Election Provision Contravenes Key Policy Objectives Underlying Election and Is in Need of Many Clarifications**

Section 5 of the Model allows taxpayers to make a water’s-edge election to exclude certain entities from the combined report. Several issues are raised by the definitional and administrative parameters of the water’s-edge election under the Model.

**a. History and Policy Objectives**

Before beginning a discussion of the substantive issues surrounding the Model’s water’s-edge provisions, it is important to review the history surrounding California’s water’s-edge election provisions and the policy objectives that the legislation was intended to serve. Although several states have enacted water’s-edge election provisions, the controversy surrounding the enactment of California’s provisions is particularly instructive.

Subsequent to the U.S. Supreme Court’s approval of the worldwide unitary method in *Container*,<sup>9</sup> the global business community as well as foreign governments raised concerns about the impact of the worldwide unitary method of taxation on foreign trade. In response to these

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<sup>8</sup> MTC Memorandum, *supra* note 1, at 12.

<sup>9</sup> See *Container*, *supra* note 2.

concerns, the Reagan administration organized a working group tasked with drafting recommendations on the taxation of multinationals. Originally enacted in 1986, the water's-edge legislation stemmed from recommendations made by this working group.

In 1993, tension over worldwide combined reporting arose once again when Barclays Bank filed its second petition for writ of certiorari with the U.S. Supreme Court challenging California's worldwide unitary method in the context of a foreign parent corporation.<sup>10</sup> While the case was pending before the U.S. Supreme Court, the California legislature amended the state's water's-edge provisions in response to threats by the United Kingdom to engage in retaliatory taxation of U.S. companies doing business in that country. Relevant to this discussion, one of the significant changes to California's water's-edge provisions in 1993 was the elimination of the Franchise Tax Board's ability to disregard a taxpayer's water's-edge election.<sup>11</sup>

This history reveals that the water's-edge election has its roots in compromise. That is, although the worldwide unitary method of taxation was eventually sanctioned by the U.S. Supreme Court in both *Container* and *Barclays*, U.S. trade partners believed that the taxing methodology yielded an unfair result. Permitting a water's-edge election is effectively an acknowledgement that, although constitutionally permissible, the worldwide method of unitary taxation should be tempered to diminish its perceived negative impact on the global business environment. This point is underscored by the fact that all of the sixteen states currently employing combined reporting either require or permit taxpayers to report on a water's-edge basis.<sup>12</sup>

As will be described in greater detail below, in order to acknowledge the element of compromise inherent in the water's-edge election it is necessary to provide taxpayers will a *meaningful* election. Therefore, the parameters of what entities will be included in the water's-edge group must not be too broadly drawn and, perhaps most important, the election must provide at least some modicum of flexibility for taxpayers.

#### **b. Entities Included in the Water's-Edge Combined Report**

These comments will focus largely on our concerns with certain entities that have been targeted for inclusion in the water's-edge group under Model provisions: (1) members earning Subpart F income; (2) members earning more than 20 percent of their income from activities that create deductions against business income for other members; and, (3) members "doing business" in a tax haven. As described below, these categories have been defined so broadly that it may leave little practical room for exclusion from the water's-edge group.

*Controlled foreign corporations earning Subpart F income.* Clarification is needed on this provision. As drafted, it appears that a controlled foreign corporation ("CFC") may be wholly included in the water's-edge report if it earns even one dollar of Subpart F income ("any member that is a "controlled foreign corporation" . . . to the extent the income of that member is defined

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<sup>10</sup> See *Barclays Bank PLC v. Franchise Tax Board*, 512 U.S. 298 (1994).

<sup>11</sup> For a detailed discussion of the 1993 amendments to California's water's-edge provisions see Eric J. Coffill, "A Kinder, Gentler 'Water's Edge' Election: California Wards Off Threats of U.K. Retaliation as Part of Comprehensive Business Incentive Tax Package," 93 STN 206-5, October 25, 1993.

<sup>12</sup> See MTC Memorandum, *supra* note 1, at 10.

in Section 952 of the Internal Revenue Code”). In addition, because there is no exclusion from Subpart F income for amounts previously taxed, there should be an explicit acknowledgement in either this section or the Model’s dividend provision (Section 3.C.ii.d.) that the same item of Subpart F income will not be included in the income of multiple entities in a tiered CFC structure. Moreover, the exclusion from this provision of “any item of income received by a controlled foreign corporation . . . [where] the taxpayer establishes to the satisfaction of the Director that such income was subject to an effective rate of income tax imposed by a foreign country greater than 90 percent of the maximum rate of tax specified in Internal Revenue Code Section 11” (the “high tax” exception) should be further clarified. That is, it is possible that, because of the foreign tax credits allowed under the federal tax system, a taxpayer would choose to nevertheless have certain income treated as Subpart F income even if it meets the requirements of the high tax exception. Because a state likely will not grant any benefit for foreign tax credits, the Model should clarify whether it is possible to treat income as Subpart F income for federal purposes yet seek to take advantage of the high tax exception for state purposes.

*Members earning income that creates deductions.* Under this provision, “any member that earns more than 20 percent of its income, directly or indirectly, from activities that are deductible against the business income of the other members of the combined group” will be included in the group to the extent of such income and apportionment factors related to the income. Given the common operational arrangements that occur within a group, including intercompany debt and manufacturing/distribution arrangements, the applicability of this provision is potentially so broad that it has the potential to eviscerate the water’s-edge election. In particular, it is unclear whether the term “deduction” encompasses cost of goods sold. Thus, for example, a foreign parent manufacturer, that meets no other criterion for inclusion in the water’s-edge group, selling to a related party U.S. distributor could potentially see most of its income included in the water’s-edge group under this provision.

*Members “doing business” in tax havens.* As an initial matter, we note that looking to the notion of whether a member is “doing business” in a tax haven is confusing and may not reach the type of conduct that a state is attempting to target. “Doing business” is a state law concept that is typically thought of as a corollary to nexus. It is generally not, however, “doing business” in a tax haven that would cause a combined group, from a state, federal or international tax perspective, to derive benefit from the tax haven jurisdiction (*i.e.*, taxpayers are not locating manufacturing plants or salespeople in the Cayman Islands). Presumably, it is the process of *organizing* an entity in a tax haven jurisdiction that creates some federal/international tax benefit.

We want to point out that certain aspects of the definition of “tax haven” provided in the Model should also be reconsidered. The definition provided in Section 1.I.i. must be further clarified. As currently drafted, the provision includes any country identified as a “tax haven” or as “having a harmful preferential tax regime.” There were 47 countries identified in the 2000 Progress Report of the Organization for Economic Co-operation and Development (“OECD”) as having a potentially “harmful preferential tax regime;” however, to date, none have been identified as having an actual “harmful preferential tax regime.” In a similar vein, it should also be noted that Model’s definition should reference to which list of OECD “tax havens” it refers: there were 35

jurisdictions identified by the OECD in its 2000 Progress Report yet only seven jurisdictions identified in the 2004 Progress Report.<sup>13</sup> As a general note, the MTC should recognize that the OECD's process of identifying tax havens and addressing the issues surrounding such jurisdictions was viewed by many as, at best, controversial and, at worst, protectionist.<sup>14</sup>

In light of the complexity and controversy surrounding this issue, we also question the wisdom of granting the Director the authority, under Section 1.I.iii., to determine that any additional tax regime should be classified as a "tax haven."

With regard to the "safety valve" provision provided in Section 5.A.vii., it will be in only limited circumstances where a member of a group will be able to demonstrate that its business activities are "*entirely* outside the scope of the laws, provisions and practices" (emphasis supplied) that cause the jurisdiction to meet the criteria of a tax haven. To the extent that the purpose of this provision is to provide some equity to taxpayers that, despite their minimal connection to a tax haven jurisdiction, conduct substantial operations that generate income taxable in other jurisdictions, it should be revised.

**c. Initiation and withdrawal of the election**

We have serious concerns with the Model's provisions on the initiation and withdrawal of the water's-edge election. Notably, there is no parity between the rights of the taxpayer and the taxing authority with regard to the election. That is, although a taxpayer is forever bound by its choice of water's-edge reporting (unless, perhaps, it seeks the permission of Director to end the election), the Director has broad authority to disregard the election. The Director's authority is purportedly limited to circumstances in which (1) any member fails to comply with any provision of [this act] or (2) if a person otherwise not included in the water's-edge combined group was "availed of with a substantial objective of avoiding state income tax." However, the scope of these limitations is unclear. How does a member fail to comply with a provision of the act? Why is any tax election made if not for the purpose of minimizing tax (and, in fact, the MTC has acknowledged that under a regime that permits a water's-edge election "taxpayers would reasonably choose the lower tax methodology"<sup>15</sup>)? Perhaps, the circumstances described in (2) were meant to target conduct perceived as "abusive." However, if this is the case, the language should explicitly describe the conduct that is prohibited.

It is also worth noting that the Franchise Tax Board's discretion to disregard a water's-edge election was eliminated in the 1993 amendments to California's water's-edge rules. This change appears to reflect the fact that such discretion was widely viewed as quite controversial. We recommend that, to the extent such discretion is retained in the Model, a limitation should be added to reflect that in no circumstances should the Director's disregard of a water's-edge election result in the payment of more tax than would have been paid on a worldwide combined basis. Otherwise, we can imagine circumstances in which the Director's disregard of an election

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<sup>13</sup> For a general discussion and analysis of this OECD initiative *see* Alex Easson, "Harmful Tax Competition: An Evaluation of the OECD Initiative," 2004 WTD 111-18, June 9, 2004.

<sup>14</sup> *See e.g.*, Daniel J. Mitchell, "An OECD Proposal to Eliminate Harmful Tax Competition Would Mean Higher Taxes and Less Privacy," 2000 WTD 200-15, October 16, 2000.

<sup>15</sup> *See* MTC Memorandum, *supra* note 1, at 10.

“in part” (*e.g.*, inclusion of entities with high income and low apportionment factors in the water’s-edge group, but exclusion of entities with reversed fact patterns) could lead to an inequitable result.

Exhibit B      Southerland, Asbill & Brennan (SAB) – Kendall L. Houghton and Jeffrey  
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April 1, 2005

Ms. Shirley Sicilian  
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Multistate Tax Commission  
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Dear Shirley:

We appreciate the opportunity to provide the Multistate Tax Commission (“MTC”) with our written comments on the MTC’s Draft Proposed Model Combined Reporting Statute. Many of these written comments reflect our oral testimony at the March 29<sup>th</sup> public hearing; where questions from the MTC indicated a need for further elaboration on a particular subject, we have endeavored to provide more detailed analysis herein.

**A. Definition of “Unitary Business”**

A substantial body of authority – statutory law, regulations, administrative rulings and court decisions – has developed over many years with respect to the definition of a “unitary business,” both within states that employ combined reporting today, and as issued by the U.S. Supreme Court. Settled expectations are upset by introducing a new definitional standard.

The draft statute evidences no attempt to reconcile the proffered definition of “unitary business” with the existing provisions of MTC member states or those other states that require unitary combination. In fact, the definition does not even square with the MTC’s Proposed Regulation IV.(b) – i.e., the “uniform” definition of “unitary business.” [At least that Proposed Regulation attempts to enumerate a variety of criteria – none of which are dispositive by themselves – that might indicate unity.] It is possible that the MTC expects states adopting the MTC Proposed Model Statute to also adopt its Proposed Regulation IV.(b); however, it is equally possible that states will not do so, in which case taxpayers will be forced to interpret and



apply the truncated, and arguably unconstitutional,<sup>1</sup> definition of a unitary business currently contained in the MTC's Proposed Model Statute.

This definition has far-reaching implications, including the boundaries of Business/Non-Business income (*cf.*, *e.g.*, the Supreme Court's rulings in *Mobil*, *Allied-Signal*). Given the relative stability of the current definitional landscape, and taxpayers' and tax administrators' common understanding of the principles enunciated by the U.S. Supreme Court in this regard, it is unwarranted for the MTC to undertake to introduce a new set of guidelines, much less a new formulation of existing guidelines.

## **B. Significant Compliance Burden Associated with Proposed Mechanics**

The draft Combined Reporting Statute would impose substantial compliance burdens and costs on taxpayers, which must be carefully considered in the process of formulating sound tax policy. The burdens identified with this draft statute include:

- Requirement to create separate Profit/Loss Statements for each member of the return-filing group.
- Currency translation issues relating to foreign members of the group.
- Non-US entities may elect to determine income computed on Consolidated Profit and Loss [financial] Statements submitted to the SEC – which introduces a new calculation that may materially differ from taxable income.
- For water's-edge filers, the annual requirement to assess whether any foreign affiliate (1) has an *average* of its payroll, property, and sales factors within the U.S. that meets or exceeds 20%, or (2) earns more than 20% of its income, directly or indirectly, from activities that are deductible against the business income of other members of the combined group, to the extent of that income and the apportionment factors related thereto.
- For water's-edge filers, the annual requirement to monitor levels of activity of each unitary group member in each designated tax haven jurisdiction, and to compare foreign activities and contacts to the relevant tax haven jurisdiction list for each state in which the combined group files a water's-edge return (more on this below).

## **C. Definition of Combined Reporting Group: "Tax Haven" Methodology Constitutes Back-Door Implementation of Worldwide Combination**

### **1. "Doing Business" v. Incorporation as the Tax Haven Standard**

A close reading of the draft statute makes clear that the purported "water's-edge election" includes many types of non-U.S. entities and goes well beyond what any combination state today requires. In fact, many taxpayers would characterize a return filed under this statute as a "quasi-

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<sup>1</sup> To the extent that applying the MTC's one-sentence definition of "unitary business" and applying Supreme Court's ample jurisprudence in this regard would effectuate different unitary determinations, the MTC definition is flawed.

worldwide combined” return rather than a water’s-edge return, based upon the proposed tax haven standard. First, the draft statute sweeps any entity that “does business in” a tax haven into the so-called “water’s-edge” combined return. Second, the statute accords substantial discretion to state revenue commissioners to add new “tax havens” to the already substantial list referred to in the draft statute.

As a matter of policy, this shift in drafting approach is poorly considered; regardless of the genesis of the proposed tax haven standard, the water’s-edge provisions constitute bad rule-making as well as bad tax policy. We recognize that some states have adopted rules that treat corporations “domiciled in” so-called tax haven countries differently than they treat corporations elsewhere for purposes of inclusion in the water’s-edge combined return.<sup>2</sup> While this differently formulated (and arguably less sweeping) tax haven standard itself raises serious Foreign Commerce Clause concerns, the introduction of a rule that forces *any* corporation that merely “does business in” a tax haven country effects a sea change in unitary combined reporting methodology.

As a matter of fact, most multinational taxpayer groups may be deemed to have “done business in” most so-called tax havens, whether through permanent establishments, sales activities, or other corporate transactions that may or may not give rise to revenues but certainly do not give rise to [Commerce Clause] “substantial nexus” with such countries. A particular flaw in the statute as drafted is its failure to define the term “doing business” for purposes of including a foreign affiliate in the water’s-edge return. Given that the tax haven inclusion provisions relate to foreign entities, it might be assumed that the MTC intends taxpayers to apply the “permanent establishment” standard incorporated in international tax treaties. On the other hand, the MTC is concurrently supporting the notion of “factor presence nexus” for income tax purposes; this factor nexus proposal is another way of stating that the threshold requirement is merely that the foreign entity have economic presence – as opposed to a physical presence that is more than *de minimis* and that is related to the establishment or maintenance of a market – in a tax haven jurisdiction. In any event, the “doing business in a tax haven” standard treats all contacts with and business conducted in such foreign jurisdictions as reprehensible, and subject to such “penalties” as inclusion in an otherwise water’s-edge return.

Moreover, the fact that the MTC has failed in this draft of its proposed statute to define “doing business in a tax haven” gives rise to additional suspicion on the part of the business community that the MTC intends to create a “reverse loophole” for it and its member states to employ on an “as-needed” basis to expand the filing group to include affiliates that do not otherwise present a water’s-edge profile but that are profitable. The proviso that “[i]f the member’s business activity within a tax haven is entirely outside the scope of the laws, provisions and practices that cause the jurisdiction to meet the criteria established in Section 1.I, the Director *may* treat the activity of the member as not having been conducted in a tax haven,” provides cold comfort to taxpayers. It does not serve either to define the applicable threshold for inclusion in a water’s-edge return, or to provide assurances that implementing states will not apply the threshold in order to increase the tax due from a unitary group; and in any event, it is

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<sup>2</sup> See, e.g. Mont. Code §15-31-322 and Alaska Code § 43.20.073.

applicable only at the discretion of a revenue commissioner, and therefore is subject to inconsistent application from state to state.

Finally, the MTC's effort to dissuade non-US companies from doing business with entities in countries it considers "tax havens" represents bad tax and social policy. The MTC's proposal could be viewed as an attempt to isolate residents and businesses located in "tax havens." The MTC has not provided a rationale for penalizing these individuals and businesses – many of whom have little or no ability to impact the taxing structure imposed in their resident country. Also, it is particularly ironic that while many state representatives are fiercely supportive of state sovereignty and will, for example, resist federal legislation that will impact their ability to impose taxes, these same state representatives will be considering a proposal that will cast judgment as to the appropriateness of other sovereign nations' tax policy. The reader queries, why would the MTC encourage a foreign "tax haven" to adopt a corporate income tax, but not expect the same of all fifty states? We are confident that if the MTC moves forward with such a provision, commentators will be searching for the MTC's true motivation in attempting to cut off individuals and businesses located in state-ordained tax havens from trading with the rest of the world. Given the states' own hostility toward attempts to limit the flexibility in setting their taxing structures, we are doubtful that the MTC's proposal can be justified.

## **2. Definition of Tax Haven Violates the Foreign Commerce Clause**

The definition of "tax haven," especially the fact that it is subject to expansion at a revenue commissioner's discretion, evidences "cherry-picking" of foreign jurisdictions for state income tax purposes – certain foreign jurisdictions are deemed to be "in" the water's-edge geographical reach, as it were, and certain foreign jurisdictions are "out." In this case, foreign entities that merely do business in the targeted foreign countries are materially impacted and burdened. Such a state-level practice certainly runs counter to the Foreign Commerce Clause restrictions that the U.S. Supreme Court articulated in *Japan Lines* (i.e., state tax measures may not create a risk of multiple taxation at the international level, and may not prevent the Federal government from "speaking in one voice" as to policy matters).

The "one voice" standard established by the Court is that a "state tax at variance with Federal policy will violate the 'one voice' standard if it either implicates foreign policy issues which must be left to the Federal Government OR violates a clear Federal directive."<sup>3</sup> The ability of a state to label tax havens based upon the OECD criteria actually conflicts with clear Federal directives.

In testimony before the Senate Committee on Governmental Affairs in 2001, then-Treasury Secretary Paul O'Neil called for significant changes to the OECD harmful practices initiative largely because the United States "should not presume to interfere with the internal tax policy decisions of sovereign nations."<sup>4</sup> In June, 2001, the Administration and other members

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<sup>3</sup> *Container Corp. of America v. Franchise Tax Bd.*, 463 US 159, 194 (1983).

<sup>4</sup> Hon. Paul O'Neill, Secretary of the Treasury, testimony before the Senate Committee on Governmental Affairs, Permanent Subcommittee on Investigations, July 18, 2001. Available at the Committee's website, at [[http://www.senate.gov/~gov\\_affairs/071801\\_psioneil.htm](http://www.senate.gov/~gov_affairs/071801_psioneil.htm)].

of the OECD reached an agreement on a modification of the tax competition initiative. Under the agreement, the initiative would no longer classify certain tax system design features that are characteristic of tax havens as "harmful tax practices." Instead, the initiative would focus on promoting exchange of information and increased "transparency" in the operation of legislative, legal, or administrative rules.

The MTC's reliance on criteria adopted by the OECD in 1998, but later clearly rejected by the Federal government, violates the "one voice" prong of *Japan Lines*. The Federal government chose not to interfere with the internal tax policy of sovereign nations, but the model statute allows MTC member states to contradict and undermine that position, by taxing companies that do business in these countries differently than these states would tax companies that do business in other countries. Moreover, any system that allows states to independently evaluate and determine what countries are "tax havens" – whether based on OECD designations (per MTC Proposed Model Statute Section 1 (I)(i)), OECD criteria for identifying "un-cooperative tax havens" (per MTC Model Statute Section 1(I)(ii)), or based on a state commissioner's discretionary designation (per MTC Model Statute Section 1(I)(iii)) – would directly contradict the Federal government's stated desire not to interfere with tax policy in sovereign nations.

### **3. Discretion of the Director to Label a Country a Tax Haven Contradicts Fundamental Principles of Uniformity**

The draft model statute establishes additional criteria – in one instance, criteria to be automatically applied; in the other instance, criteria that may be applied at the discretion of a commissioner – for individual states to label particular countries as tax havens even if they are not on the OECD list of tax havens/harmful preferential tax regimes. If a country is not on the OECD list but exhibits the OECD criteria for such regimes, the country is treated as a tax haven for water's-edge election purposes. The Director also has the discretion to label a country a tax haven if the country creates a "tax regime which is favorable for tax avoidance." The obvious effect of such discretion is the lack of uniformity across states that implement this Proposed Model Statute. What may be a tax haven in one state may not be a tax haven in another. This lack of uniformity runs counter to one of the MTC's primary missions.

#### **D. Inconsistent Treatment of Net Operating Losses and Other Taxpayer Attributes: "Heads, I Win – Tails, You Lose" Makes for Bad Tax Policy**

A virtual *Finnegan/Joyce* philosophical tug-of-war between MTC member states has erupted over how to define "taxpayer" for purposes of combined reporting. The MTC described its statutory drafting efforts in a November 2004 memorandum authored by Shirley Sicilian, which accompanied the draft statutes as it was being presented to the MTC's full Uniformity Committee and Executive Committee for adoption and scheduling of public hearings. In that memorandum, the MTC acknowledges the tension between *Joyce* and *Finnegan* concepts, stating that while the draft statute adopts *Joyce*'s recognition of individual group members as separate taxpayers (e.g., deductions and credits are to be taken only by the taxpayer that generated/earned them), "[t]he statute does provide some exceptions to this general rule preserving the separate identity of the taxpayer."

Curiously, the MTC's Income and Franchise Tax Uniformity Subcommittee simultaneously requested Mike Brownell of California's Franchise Tax Board to prepare a paper on the question whether the draft statute required revision (subsequent to, and despite, the Subcommittee's vote to endorse the Model Statute to the MTC Uniformity and Executive Committees) to reflect, in whole or in part, the *Finnegan* approach (i.e., treatment of the "taxpayer" as the combined group) rather than the *Joyce* approach. We view this action as evidence of the very real conflict among the states themselves over how to define "taxpayer" for purposes of combined reporting. While the Subcommittee voted in March 2005 at the MTC's Winter Meeting to leave the draft statute "as is,"<sup>5</sup> the credibility of the MTC's current draft statute is undermined by the MTC's preference in each discrete instance of drafting for the approach – "taxpayer" defined as the discrete entity/member of a unitary group, v. "taxpayer" defined as the combined unitary group – that is likely to generate the greatest tax liability for the taxpayer.

A taxpayer that files a return in accordance with this proposed "model" statute is potentially subject to the following internally inconsistent tax treatment of its income and tax attributes. A quick survey indicates that:

- A taxpayer's share of business income apportionable to the state is calculated by reference to all business income of the individual members in combination (i.e., calculated by reference to *Finnegan*);
- Partnership income is calculated by reference to the individual taxpayer's distributive share of a partnership's unitary income (*Joyce*);
- Tax attributes – post-apportionment net operating losses, credits, nonbusiness income – are generally applied on a *Joyce* basis, available only to the particular group member that generated those attributes;
- Sales factor throwback is recommended to be applied on the basis of *Finnegan*; and
- Charitable expenses incurred by a member of the combined group are first subtracted from the combined group's business income, next are treated as an allocable nonbusiness expense of the member that incurred the expense (mixture of *Joyce* and *Finnegan*).

We submit that this "heads, I win – tails, you lose" construction of a "model" combined reporting statute results in something that fails to resemble "model" tax policy. Furthermore, based on the public comments by MTC member states at the 2004 Fall Meeting discussion of this project, as well as the acknowledgments of Hearing Officer Sicilian at that meeting in this regard, we forecast an unavoidably non-uniform adoption process, whereby states that currently employ the *Joyce* approach will redraft the *Finnegan* provisions, and "*Finnegan*" states will redraft provisions of the "uniform" statute that employ the *Joyce* approach.

#### **E. Commissioner Discretion to Depart from "Uniform" Guidelines of Proposed Model Statute**

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<sup>5</sup> The Uniformity Subcommittee noted that the paper expressed the option for states to retain the *Joyce* approach (and benefits) generally, but also adopt a *Finnegan*-style sales throwback rule to eliminate the corollary "gap" that *Joyce* creates. This sort of reasoning is consistent with the drafting weakness addressed in this section of our comments; the MTC and its member states appear to want it both ways.

Another troubling feature of the draft statute is the extent to which it accords discretion to state tax commissioners to deviate from the strictly uniform provisions of the statute. Commissioners have discretion to:

- Define the scope of the filing group, by adding “tax haven” jurisdictions to the water’s-edge return (as discussed more fully, *supra*);
- Require combined filing where the Proposed Model Statute would not otherwise require it (e.g., between income taxpayers and non-income taxpayers that have a unitary relationship), if the separately reported income “ does not clearly reflect income or loss of such person... or represents an evasion of tax by such person..., and the Director determines that the comparable uncontrolled price method prescribed by regulations pursuant to Section 482 of the Internal Revenue Code cannot practically be applied...;” and
- Permit a unitary business with foreign operations to determine income based on the consolidated profit and loss statement prepared for filing with the SEC, if such a method will “reasonably approximate income” under the state revenue code.

While the last provision may provide some relief to taxpayers from the significant compliance burdens associated with combined reporting, the result of these exercises in discretion is to move away from the supposed virtues (and reduction in taxpayer burdens) that uniform legislation in this arena is intended to effect.

It also bears noting that whereas the MTC Proposed Model Statute accords to state commissioners a fair amount of discretionary authority to address filing situations that do not fairly represent the taxpayer’s business activity in a state, there is no corollary discretion accorded to taxpayers to file on alternative bases – either automatically or upon request of permission to do so – if a taxpayer itself believes that the MTC Proposed Model Statute as applied would result in an unfair representation of the taxpayer’s in-state activity. When taxpayers perceive that a statute is designed to create this imbalance in rights, they will naturally object to its implementation.

## CONCLUSION

We believe that the MTC’s Proposed Model Combined Reporting Statute is not necessary for implementing combined reporting and is misplaced. If the MTC wants to address abusive transactions and similar issues, then they should relegate this issue to a separate effort (e.g., several MTC income and franchise tax compliance initiatives are already underway).

The MTC itself notes in its memorandum of explanation (distributed at the November 2004 Income and Franchise Tax Uniformity Subcommittee meeting) that none of the 16 states currently using combined reporting requires WWCR; yet, it proposes a worldwide combined reporting regime as the “default,” with a “water’s-edge plus” election as the only alternative. It appears that the MTC implicitly recognizes this effort has no chance of uniform implementation,

because it concurrently developed and approved (MTC Uniformity Committee, 2005 Winter Meeting) a Model Expense Add-Back Statute that will soon undergo the same public hearing process. States that currently implement combined reporting have the “better” approach, according to the MTC’s judgment of tax policy, but the MTC is lobbying separate return states to adopt what is perceived to be a politically more viable -- but equally ill-conceived -- option.

If you have any questions about our comments, we would be pleased to discuss them with you at your convenience. Again, we appreciate the opportunity to provide this input and hope that our concerns will be reflected in the MTC Hearing Officer’s Report to the MTC Executive Committee.

Sincerely,



Kendall L. Houghton



Jeffrey A. Friedman

Exhibit C      Council On State Taxation, American Council of Life Insurers, American Insurance Association and the Property Casualty Insurers Association of America (Insurance Group)





VIA Email: [ssicilian@mtc.gov](mailto:ssicilian@mtc.gov)

March 28, 2005

Shirley K. Sicilian  
Multistate Tax Commission  
444 N. Capitol Street, N.W., Suite 425  
Washington, D.C. 20001-1538

Re: **Comments on the Multistate Tax Commission’s Model Uniform Statute for Combined Reporting: Section 2 Applied to the Insurance Industry**

The Council On State Taxation (COST), the American Council of Life Insurers (ACLI), the American Insurance Association (AIA), and the Property Casualty Insurers Association of America (PCI) (hereinafter referred to collectively as “the Coalition”) respectfully submit the following comments and recommendations as they relate to sections 1 and 2 of the draft Model Uniform Statute for Combined Reporting as released by the Multistate Tax Commission on November 11, 2004 (the Model). Most importantly, as more fully described in the “Recommendation” section of the Coalition’s submission, we urge that section 2 of the draft be modified to require mandatory combination of insurance companies and non-insurance company affiliates only in order to prevent abusive tax avoidance transactions or tax evasion. Such a modification will

take into account the unique, interstate taxing systems under which insurance companies are taxed and yet will still allow taxing authorities to address any abusive tax avoidance in this area. In support of this recommendation, we submit the following comments that--

- explain the current system of insurance company taxation and the benefits of the current system to both insurance companies and taxing jurisdictions;
- discuss the policy and technical concerns and uncertainties surrounding mandatory combination for the insurance industry;
- explain the special concerns related to states that have an income tax for insurance companies; and
- recommend alternative language for the treatment of insurance companies in the Model.

COST's membership consists of approximately 570 of the largest corporations engaged in interstate and international business, including a growing number of direct or indirect insurance company members. The Coalition's insurance trade associations represent the great majority of the insurance (life and property and casualty (P&C)) industry.<sup>1</sup>

## **INTRODUCTION**

The forced combination of insurance companies with unitary, affiliated non-insurance companies would, for both the insurance industry and the states –

- raise critical tax policy concerns;
- add tax burdens and uncertainties;
- create a myriad of administrative and substantive issues; and
- because the insurance industry is subject to the McCarran-Ferguson Act (McCarran), 15 U.S.C. §§ 1011 *et seq.* and a unique interstate tax system result in

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<sup>1</sup> ACLI represents 354 member companies operating within the United States. These 354 member companies account for 74% of total assets, 69% of the life insurance premiums, 79% of annuity considerations, 51% of disability income insurance premiums and 81% of long-term care insurance premiums in the United States. AIA represents more than 435 insurers, writing nearly \$120 billion in annual premium (comprising 27% of the nation's P&C insurance market (including 36% of commercial lines)), and PCI represents more than 1,000 insurers, writing \$173.6 billion in annual premium (comprising 39.1% of the nation's P&C insurance market).

unforeseeable and unintended results that actually contravene the goal of uniformity.

**STATE INSURANCE COMPANY TAX SYSTEM:**  
**AN INTERSTATE NETWORK**

Since the 19th century, the foundation for the state taxation of insurance companies has been the premium tax. All but one state (Hawaii) supplement the premium tax with a retaliatory tax on “foreign insurers” (i.e., insurers domiciled in states other than the taxing state), along with a variety of fees and assessments. (In most states, non-U.S. insurers are defined as “alien” insurers for insurance tax purposes.) P&C insurers often are subject to additional premium taxes and/or assessments on certain lines of business (e.g., on fire lines to fund firefighter operations, fire pensions, fire marshals’ offices, and on workers’ compensation to fund workers’ compensation administration and/or second injury and other funds).

As further discussed below, this system has served both the states and industry well, providing a steady, predictable and generally growing stream of revenue to the states while minimizing the costs of administration for the insurance industry and the states.

**Premium Taxation**

Premium taxes are essentially gross receipts taxes on insurance companies. That is, the tax is computed by multiplying insurance company gross underwriting receipts (i.e., premiums) by the applicable tax rate. In general, premiums are the consideration that an insurance company receives for agreeing to indemnify a third--party policyholder against a specific risk or peril. *Couch on Insurance* 3d §69:1. In other words, premiums are the revenue that an insurer receives from policyholders under an insurance contract.

State premium tax laws provide for a tax on premiums to the extent the underlying risk is located in the state. With one exception (Oregon), all states, even those without a corporate income tax, levy a premium tax on insurers licensed to sell insurance in the state. Failure to pay a state’s premium tax can result in the revocation of a company’s

certificate of authority. In most states, premium taxes are administered by the departments of insurance.

Until the middle of the 20th century, the insurance industry was subject only to state regulation. The absence of federal regulation was partly attributable to the U.S. Supreme Court's holding that insurance was not part of interstate commerce. *Paul v. Virginia*, 75 U.S. (8 Wall.) 168 (1868). In 1944, however, the Court reversed itself and ruled that the business of insurance was part of interstate commerce and could be regulated by the federal government under the Commerce Clause. *U.S. v. South-Eastern Underwriters Ass'n.*, 322 U.S. 533 (1944). Concerned about the impact of this decision on state regulation and taxation of the insurance industry, Congress enacted McCarran, which removed the Commerce Clause from consideration in the regulation and taxation of the business of insurance. Hellerstein and Hellerstein, *State Taxation* (3<sup>rd</sup> ed.) ¶ 6.08.

Under McCarran, primacy in the regulation of the insurance industry falls to the states. Pursuant to this regulatory authority, each state requires all licensed insurance companies to file an annual statement of their financial condition on forms promulgated by the National Association of Insurance Commissioners ("NAIC"). Unique and uniform accounting and financial reporting rules developed by the NAIC are utilized in preparing this report. See, NAIC, *Accounting Practices and Procedures Manual* as of March 2003, P-1 to P-12 (2003).

On Schedule T and the related State Business Pages of the annual statement, insurers are required to provide a state-by-state allocation of premiums, annuity consideration, deposits and policyholder dividends. Schedule T serves as the starting point for the premium tax calculation. Only premiums written or collected directly from policyholders are required to be allocated to the states on Schedule T.

Consistent with state tax laws, premiums are generally allocated to a state on Schedule T if the risk associated with the premium is located in that state.

From this starting point, individual state laws may require minor adjustments to arrive at taxable premiums. Most states permit a deduction or exclusion for cancelled, refunded or returned premiums. Most states allow deductions for policyholder dividends. Exclusions for premiums received from the taxing state or its political subdivision are common as well. Reinsurance premiums are taxed to the direct writer and (to avoid double taxation) not to the reinsurer. Federal law prohibits the state taxation of certain revenues, such as crop insurance premiums, Medicare Part C premiums and premiums collected to provide health benefits and long term-care to federal employees.

General state premium tax rates range from a low of 0.4% (Illinois health rate) to a high of 4.265% (Hawaii). A 2% premium tax that is in place in 16 states. *See NAIC, Retaliatory Tax Manual* (NAIC, Kansas City) 2003. Different rates may apply to different types of insurance. For example, Alabama taxes health premiums at 1.6%, life premiums at 2.3% and P&C premiums at 3.6%. Sometimes, different rates apply to different lines of P&C business. For example, South Carolina taxes workers' compensation premiums at 2.5% and most other lines of P&C insurance at 1.25%. In addition to the state-level premium tax, sub-state jurisdictions may have separate and additional taxes on premiums. Local rates are usually around 1% (in Louisiana, South Carolina, Georgia, and Alabama for example), but rates in Kentucky can be as high as 12%, depending on the line of insurance.

State law often provides insurers with credits or offsets against their premium tax liability. Thus, credits often are provided for workers' compensation or other special purpose assessments or taxes (P&C insurers) and for assessments paid to state sponsored guaranty associations created to protect policyholders in the event of an insurance company insolvency (particularly for life and health insurers). Many states also make available credits designed to foster job growth, investment and economic development (e.g., wage credits, home office credits, investment credits, "CAPCOs").

## **Retaliatory Taxation**

Retaliatory taxes (in place in 49 states and the District of Columbia) are a unique feature of the state insurance tax system. Retaliatory taxes are imposed only on foreign insurers.

Retaliatory taxes (discussed further below) essentially represent the excess, if any, of certain burdens and obligations imposed by the insurer's home state over those imposed by the taxing state. For example, an insurance company domiciled in Pennsylvania, where the premium tax rate is 2.0%, could be liable for retaliatory taxes in Connecticut, where the tax rate is 1.75%. In this simplified example (which takes account only of the premium tax), the retaliatory tax would be equal to 0.25% (2.0% less 1.75%) of the Pennsylvania company's Connecticut premiums.

Retaliatory taxes are typically calculated by comparing (depending on the state) the "taxes," "fees," "requirements," "obligations," "prohibitions," "restrictions," and "burdens" -- "of whatever kind" -- imposed by the retaliating state upon the foreign insurer with similar burdens imposed by such insurer's home state. As discussed above, the retaliatory tax equals any excess of the former over the latter. As a general rule, retaliation is expressly required to be calculated under state law on an "aggregate" basis (i.e., comparing the sum of all burdens on the home state and retaliating state sides). In some states, certain items (e.g., "special purpose assessments" on particular lines of insurance) are expressly excluded. In most all states, the foregoing terms (in quotation marks) are undefined by state law or rules. In most states, retaliatory taxes are administered by the departments of insurance.

Multistate insurance companies organized in states with high premium tax rates tend to pay more retaliatory taxes. Risk of a retaliatory tax backlash against a state's domestic insurers doing business in other states is generally seen as instrumental in keeping tax rates relatively uniform and deterring the states from imposing excessive taxes on the industry.

Since retaliatory taxes are imposed only on foreign insurance companies, they could appear to discriminate against interstate commerce and therefore be unconstitutional under dormant Commerce Clause jurisprudence. However, because McCarran cedes regulation of the insurance industry to the states, there are no Commerce Clause restrictions on the states' power to impose such discriminatory taxes. In addition, the U.S. Supreme Court has upheld the constitutionality of retaliatory taxes under the Equal Protection Clause, finding that retaliatory taxes serve a legitimate state purpose of promoting the interstate business of domestic insurers by deterring other states from imposing discriminatory or excessive taxes on these insurers. *Western and Southern Life Insurance Co. v. Board of Equalization*, 451 U.S. 648 (1981).

### **Reciprocal Income Taxation**

Two states (Illinois, Nebraska) have adopted reciprocal income tax provisions to protect their domestic insurers from adverse retaliatory tax effects in other states. This is done by relieving the income tax burden imposed by each of these two states on certain foreign insurers. In Illinois, for example, the income tax rate applied to a foreign insurer may be reduced (subject to a floor) in relation to the total tax that would be imposed by the insurer's home state on its net income allocable to Illinois. When no such tax is imposed on such income by the foreign insurer's home state, the Illinois tax rate may be reduced to zero. Domestic insurers in these states do not qualify for income tax relief under these reciprocal income tax provisions.

### **Reciprocal Taxation**

Several states (e.g., Connecticut, Wisconsin) have adopted insurance reciprocal tax and fee statutes, generally as an adjunct to their retaliatory tax statutes. While retaliatory taxes essentially result in a foreign insurer paying the greater of the included burdens in its home state or taxing state, reciprocal provisions limit the foreign insurer's liability to the lesser of such burdens in such states.

### **Reciprocal Nonretaliation**

Several states (e.g., Massachusetts, Minnesota, New York, Rhode Island) have adopted insurance reciprocal nonretaliation statutes. Under these laws, the enacting state commits

to a mutual forbearance from retaliation (i.e., against insurers domiciled in other states that do the same).

### **Retaliatory Tax Credits**

In a number of states (e.g., Massachusetts, New York, Virginia), insurers are allowed partial credits against premium tax to mitigate the costs of retaliatory taxes they are obliged to pay to other states. In this manner, relatively higher tax states act to relieve the retaliatory tax burden imposed on their domestic industries when they do business in other states.

### **Insurance Tax System: Other Burdens**

Insurance companies are required to pay a variety of additional taxes, assessments and fees.

In all states, state guaranty associations assess insurance companies to cover the cost of insurer insolvencies. As noted above, in many states (e.g. Alabama, Georgia, Kentucky, Louisiana, Mississippi, South Carolina) local jurisdictions (e.g., municipalities, counties, fire districts) impose premium taxes on insurers. P&C companies are subject to a number of special purpose assessments and taxes related to fire lines and the workers' compensation business, and health insurers are typically required to contribute to the finances of state sponsored uninsured risk pools. In addition, the operations of state insurance regulatory agencies are often funded through the premium tax or other assessments on the insurance industry.

## **BENEFITS OF THE STATE INSURANCE COMPANY TAX SYSTEM**

### **Stable Source of Revenue**

State premium taxes have been a steady and abundant source of revenue for state governments. In fiscal year 2003, insurance companies paid approximately \$12 billion in premium taxes to the states, an increase of \$2.2 billion or 23.2% over the amount of taxes paid by the industry in fiscal year 2000. In contrast, total state and local tax receipts increased only 5.2% during this period, while receipts from state corporate income taxes



actually declined by 3.2%. For fiscal year 2003, premium taxes were approximately one-quarter of all state corporate income and premium taxes.<sup>2</sup> Thus, even during a period of significant budget deficits and declining corporate tax receipts, premium taxes have remained a consistent and reliable source of state revenue.

### **Predictable Source of Revenue**

As a gross receipts tax, premium taxes are more predictable than other sources of revenue. Income taxes fluctuate significantly with economic conditions and the cyclical nature of profitability in certain industries. The volatility of insurer profitability can be dramatically impacted, in the case of P&C insurance, by such events as Hurricane Andrew, the Northridge earthquake, the terrorist attacks of September 11, and the multiple hurricanes that hit Florida just this past year. Corporate income taxes also tend to follow the economy, but can change significantly for non-economic reasons (e.g., federal tax law changes). While premium taxes are responsive to economic conditions, they tend to rise slower in good times and fall less rapidly when times are hard. *See* Nicholas W. Jenny, *State Tax Revenue on Upward Track*, State Tax Notes, January 24, 2005.

Thus, insurance companies pay taxes regardless of whether they are profitable. In contrast, unprofitable corporations generally do not pay income taxes. Moreover, some states assist these loss corporations by making deductions for net operating losses available, further impacting the predictability of corporate tax receipts.

Compounding the volatility of corporate tax receipts is the link between state income taxes and federal income taxes. Most states use federal taxable income as the starting point in the state income tax calculation. Accordingly, when Congress enacts tax code changes that have the effect of increasing or decreasing federal corporate income taxes, in the absence of compensating state legislation, state corporate tax receipts will be impacted accordingly. In contrast, the premium tax base is governed by uniform NAIC

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<sup>2</sup> Robert Cline, William Fox, Tom Neubig and Andrew Philips, *Total State and Local Business Taxes: A 50-State Study of Taxes Paid by Business in Fiscal 2003*, State Tax Notes, Mar. 1, 2004, 737.

accounting and reporting rules. These rules change only with the input of the states that might be impacted.

The steady predictability of insurance premium taxes is also beneficial to the insurance industry. Retaliatory taxes help to assure that premium taxes rates are relatively consistent from state to state. Such predictability is useful in setting prices and reserves for insurance products. It also facilitates the ability of insurers to make reliable estimates of future costs as they plan for expansion and growth.

### **Administrative Ease and Legal Certainty**

For both the taxpayer and the tax collector, premium taxes are relatively easy to administer. As noted above, the taxable premiums are disclosed on Schedule T and the related State Business Pages of the insurer's mandatory annual statement filing, and the tax is determined by simply applying the tax rate to those net taxable premiums. While the retaliatory tax calculation can occasionally be complicated, and there may be deductions, exclusions and credits available, there is a long history of rulings, cases and practices that help to simplify compliance and administration in these areas.

Because the administrative burden of the premium tax is relatively light, efficiencies are realized by both insurers and regulators. Insurance companies are generally able to file their annual premium tax returns before the end of April, without the benefit of extensions. This short filing period allows insurers to liberate resources for other projects, while providing state tax collectors with ample time to review the filings. Indeed, many states are able to complete desk audits on each premium tax return that is filed.

Finally, the premium tax system operates in a relatively settled legal environment. Nexus and other constitutional issues in premium taxation have largely been decided, while the nature of the tax limits the opportunities for tax planning. Accordingly, there is little evidence of "tax shelter" activities in the premium tax area and few instances of legislatures closing "loopholes" in the premium tax statutes.

### **Credit Certainty**

The unique nature and limited scope of the premium tax regime enhances the ability of states to realize and measure the benefits they hope to achieve on providing incentives like tax credits to the insurance industry. Thus, there are fewer unintended beneficiaries when states make premium tax credits available and, accordingly, less political fallout when the time comes to remove them. Similarly, the limited scope of the premium tax provides the states with the flexibility of raising additional revenues from the industry without directly impacting other business sectors. Finally, because the premium tax is a relatively easy tax to compute, the impact of incentives and targeted tax increases can be more readily predictable and reliable. This can be important for states, for example, where they provide credits to encourage industry investment and jobs.

### **POLICY ISSUES**

Because of the longstanding, settled nature of the nationwide system for taxing insurance companies and the interstate dynamics of this system, the forced combination of insurers with non-insurer affiliates under the Model in its current form, if adopted by the states, could be expected to —

- reduce uniformity and predictability,
- generate complexity and audit and compliance inefficiencies,
- interfere with state economic policy objectives, and
- spawn a new wave of insurance tax litigation in the states.

### **Interstate Tax Network**

Common to the state insurance tax statutes described above (i.e. premium and retaliatory taxation and its statutory progeny, reciprocal income taxation, reciprocal taxation, reciprocal nonretaliation, and retaliatory tax credits) is an interlocking network of provisions of state law that cause the tax rules affecting insurance companies in one state to depend on the tax rules affecting insurance companies in another state.

For many years, all of these provisions have operated together to achieve relative predictability, moderation and balance in the state taxation of insurance companies. It is unclear how the treatment of insurer income under the Model would affect, or be affected by, the operation of these provisions. What does seem predictable, however, is that to the extent that the forced taxation of insurer income under the Model becomes enmeshed in this system, it would severely compromise the goal of interstate tax uniformity.

At the same time, adoption of the Model could jeopardize the state insurance retaliatory tax system. This form of taxation, long supported by the insurance industry, is the glue that holds the state insurance tax system together. While retaliatory taxation has been upheld under the Equal Protection Clause, it has been shielded from Commerce Clause attack by McCarran. This shield may not apply to a combined return that includes insurance companies, however, leaving retaliatory tax systems vulnerable to the extent that they have the effect of taking into account the tax consequences of including insurers in a combined report with non-insurers for corporate income tax purposes.

### **Insurance Companies -- Non-Income Tax States**

It is unclear how forced combination could be implemented at all in states where insurers are not subject to an income-based tax. Such forced combination would depend on resolving the vexing complexities of fairly determining state taxable income for insurers where no applicable state rules exist.

## **Insurance Companies -- Income Tax States**

In all states that subject insurers to both premium-based and income-based taxes (e.g., Florida, Illinois, Nebraska, New Hampshire, New York (life insurers only)), statutory formulas have been adopted that avoid or greatly limit the double taxation of insurance company income.<sup>3</sup> These formulas work in conjunction with the retaliatory tax system to suppress or eliminate adverse retaliatory tax impacts that otherwise would arise for domestic insurers doing business in other states.<sup>4</sup> These formulas also help to assure that the premium/income taxing state receives its fair share of retaliatory tax revenue from foreign insurers doing business there. Introduction of the Model into this tax milieu would raise concerns, not only about the uncertain retaliatory outcomes, but also about the disparate effects on states (and on insurers doing business in those states) that have adopted the foregoing formulas (i.e., premium/income taxing states today), and on states (and on insurers doing business in those states) that have not (i.e., pure premium tax states today).

Several states that subject all insurers to premium tax also impose income-based taxes (without a cross-tax credit), but only on domestic insurers. These states (e.g., Arkansas, Wisconsin) exempt foreign insurers to protect their domestic insurers from added retaliatory tax exposure when they write business in other states. Hence, domestic insurers today have little incentive to challenge these income tax statutes (e.g., on equal protection or uniformity (“reverse discrimination”) grounds). At best, the current Model would unfairly single out domestic insurers in these states for forced combination, potentially further increasing their tax burdens relative to their out-of-state (foreign)

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<sup>3</sup> For example, some five states that impose a premium-based and income-based tax (styled as an “income” or “franchise” tax) on both domestic and foreign insurers allow either the income/franchise tax to be used as an offset against the premium tax or the premium tax to be used as an offset against the income tax. Illinois imposes a low rate premium tax along with a unitary income tax that only permits combination with other insurers. New York imposes (on life insurers) a franchise tax, comprised of a tax based on income and a tax based on premium, both capped at a percentage of premiums. (Beginning in 2003, New York taxes P&C insurers under a simple 2% premium tax.)

<sup>4</sup> These formulas are not the same as the retaliatory tax credits discussed elsewhere in these comments. The formulas operate to minimize retaliatory taxes paid by domestic insurers to other states by suppressing the insurance tax burden in the insurers’ home state. The credits operate to subsidize domestic insurers for retaliatory taxes that must be paid to other states, in effect, because the insurers’ home state imposes a relatively high insurance tax burden.

competitors in the same market. At worst, the Model would add a pivotal incentive for such insurers to challenge these direct and indirect income taxes. In such cases, the strength of the retaliatory tax disincentive will be inversely related to the extent to which unitary income taxation has retaliatory tax effects.

### **“In-Lieu” Tax Provisions**

The forced combination of insurers with non-insurer affiliates could conflict with longstanding “in-lieu” tax provisions in the 37 states that have adopted them.

Insurance companies are almost universally treated as special entities for state tax purposes. In 37 states, insurance companies are subject to a gross premiums tax in lieu of a corporate income or franchise tax. In several states (e.g., Maine, Wyoming), there is a specific statutory prohibition against modifying or repealing the in lieu provisions, absent express statutory directives to do so.

The legislative intent and scope of these in-lieu provisions do not contemplate the forced combination of insurance and non-insurance companies. Forced combination of insurers and non-insurers would run afoul of the in-lieu concept in instances where an increase results in the aggregate tax burden of the commonly controlled group.

Further, as a consequence of their being included in a single combined reporting group with non-insurers under the Model, insurance companies would directly or indirectly become subject to net income taxes in addition to premium taxes. The resultant double tax on underwriting income would be inconsistent with the statutory formulas (described above) that avoid or limit this outcome in all states today that subject insurers to both income-based and premium-based taxes.

Attempting to reconcile existing in-lieu provisions with rules requiring combined filings would be disruptive and cause further inconsistencies, including, but not limited to —

- avoiding double taxation by reducing gross premiums tax rates and/or allowing

cross-tax credits;

- creating credit utilization issues among members of the combined reporting group;
- impairing the recoupment of guaranty fund and workers' compensation assessments; and
- subverting economic incentive credits, and the state economic goals they promote, through the indirect taxation of insurers.

State premium tax in-lieu statutes will serve as a basis for disruptive challenges to the inclusion of insurance companies in combined returns. Insurance companies, especially domestic insurance companies, and many non-insurance companies and states may well engage in lengthy, costly, and relationship-damaging legal battles.

A variety of federal and state constitutional challenges can be expected to arise under due process, equal protection, uniformity and commerce clauses.

### **Economic Policy Uncertainty: Insurance Premium Tax Relief**

Many states recently have reduced the rate at which they subject insurance companies to premium taxation. Just in the past few years, premium tax rates were reduced (sometimes on a phased basis) in Idaho (1.5%), Indiana (1.3%), Illinois (0.5%), Iowa (1%), Ohio (1.4%), Texas (1.6% (P&C) 1.75% (life)), and Washington, D.C. (1.7%). Serious legislative consideration is being given today to reducing premium tax rates in Georgia, Missouri and New Hampshire. At least to some extent, the revenue that is lost when premium tax rates are lowered is offset by increased retaliatory tax collections from insurers domiciled in states imposing higher burdens.

In adopting such rate relief, state legislatures have struck a balance between alleviating budgetary stresses and attracting insurance industry jobs and investment. Other factors, including enhancing insurance capacity and affordability, also have come into play.

Because the tax effects of the forced combination of insurers under the Model are unknowable, so too would be the effects of the Model on the important state policies that

underlie this downward trend in premium tax rates.

### **Regulatory Uncertainty**

Forcibly combining regulated and non-regulated companies under the Model would create a multitude of regulatory and legal issues for state regulators:

- State departments of insurance and the NAIC would be concerned that proper consideration is given to protection against insolvencies, rate approvals, and other insurance regulatory matters. Under NAIC's Statements on Statutory Accounting Principles #10, state income taxes are treated as immaterial for statutory accounting purposes and are reclassified to other administrative expenses above the line (i.e. only federal income taxes are included on the income tax expense line of the profit/loss statement on the insurance department report). Under SSAP #10, insurance companies are also not allowed to record a state income tax effect with respect to deferred tax assets/liabilities. Only the federal effect is eligible as an admitted asset for statutory accounting. Forced combination would require the NAIC to address the complexities of state income taxes because they would no longer be an immaterial expense for many insurance companies.
- Through the nationwide insurance guaranty fund system, states oblige the insurance industry to pay for its own insolvencies. State agencies concerned with protecting insurance policyholders, as well as those concerned with tax policy and economic development, would want to fully assess whether targeting their financially-strongest insurers for added tax burdens could have destabilizing effects.
- The many state insurance departments that rely on premium tax revenues to support their operations also may have concerns about whether the introduction of a new insurer-generated revenue source might compromise this funding, particularly when viewed in light of the statutory in-lieu provisions (discussed above).

### **Apportionment Uncertainty**

Forcibly combining insurance and non-insurance companies is inconsistent with the model language in UDITPA. UDITPA's apportionment factors and sourcing rules are not designed to be applied in determining local taxable values of insurance companies that are distinct from the manufacturing and retail-type companies addressed in the model law. In recognition of this fact, UDITPA expressly excludes insurance companies from its coverage. Because of this exclusion, model rules for the multistate apportionment of



insurance company values for income tax purposes have never been considered, let alone formulated, to this day.

Methods of sourcing of receipts for non-insurance services will not fit the tax and regulatory practices for sourcing insurance company receipts. The established sourcing of insurance company premium on an insurer's annual statement does not conform to the (cost of performance-based) sourcing rules for other service industries. The determination of net income and the selection of appropriate apportionment formulas for insurance companies therefore would need to be developed, causing additional uncertainty and non-conformity among the states.

### **Audit and Compliance Inefficiencies**

Income taxation through the combination of insurers under the Model adds layers of complexity, as well as audit and compliance costs, to a settled system. Historically, combination rules have been established in a non-insurance company world. Therefore, existing rules were not created with insurance companies in mind, resulting in a lack of regulations, case law, letter rulings, or virtually any guidance on how to implement the combination of insurance companies and non-insurance companies.

## **RECOMMENDATIONS**

The Model should be amended to specifically exempt insurers from forced combination, absent abusive tax avoidance results.

### **Proposed Revisions**

The Coalition recommends that the MTC revise Section 2B to provide, in its entirety, as follows (redlined comparison of MTC draft):

~~The Director may, by regulation, require the combined report include the income and associated apportionment factors of any persons that are not included pursuant to Section 2.A., but that are members of a unitary business, in~~

~~order to reflect proper apportionment of income of entire unitary businesses. Authority to require combination by regulation under this Section 2.B. includes authority to require combination of persons that are not, or would not be if doing business in this state, subject to the [State income tax Act].~~

~~In addition, i~~f the Director determines that the reported income or loss of a taxpayer or taxpayers engaged in a unitary business with any person not included pursuant to Section 2.A. represents an abusive tax avoidance transaction or an evasion of tax by such taxpayer or taxpayers, and the Director determines that the comparable uncontrolled price method prescribed by regulations pursuant to Section 482 of the Internal Revenue Code cannot practically be applied, the Director may, on a case by case basis, require all or any part of the income and associated apportionment factors of such person to be included in the taxpayer's or taxpayers' combined reports(s).

With respect to inclusion of associated apportionment factors pursuant to Section 2.B., the Director may require the exclusion of any one or more of the factors, the inclusion of one or more additional factors which will fairly represent the taxpayer's business activity in this State, or the employment of any other method to effectuate a proper reflection of total income subject to apportionment and an equitable allocation and apportionment of the taxpayer's income.

The Coalition further recommends that the MTC revise the definition of "Taxpayer" in section 1.B of the Model to read as follows:

B. "Taxpayer" means any person subject to the tax imposed by [State Corporate income tax act], except for any person subject to the tax imposed by [State insurance premium tax statute].

### **Explanation**

As currently drafted, Section 2B of the Proposal provides that the Director may require combination of persons not otherwise included in a unitary group using two methods: by regulation, or on a case by case basis. The first paragraph of Section 2B provides that the Director may require combination by issuing a regulation:

The Director may, by regulation, require the combined report include the income and associated apportionment factors of any persons that are not included pursuant to Section 2.A., but that are members of a unitary business, in order to reflect proper apportionment of income of entire unitary businesses. Authority to require combination by regulation under this Section 2.B. includes authority to require combination of persons that are not, or would not be if doing business in this state, subject to the [State income tax Act].

The second paragraph of Section 2B provides that the Director may also require combination on a case by case basis:

In addition, if the Director determines that the reported income or loss of a taxpayer engaged in a unitary business with any person not included pursuant to Section 2.A. represents an avoidance or evasion of tax by such taxpayer, the Director may, on a case by case basis, require all or any part of the income and associated apportionment factors of such person be included in the taxpayer's combined report.

As currently drafted, the definition of "Taxpayer" would include insurance companies in states where such companies are subject to both the corporate income- and premium-based taxes (with formulas in each case, as discussed above, to mitigate or eliminate the double taxation of underwriting income). The Coalition's recommended change to section 1.B, shown above, would – for reasons described in these comments – exclude such companies.

#### **Use of IRC Section 482 is Appropriate**

In the first draft of the Model, Section 2B provided that the Director was authorized to make adjustments on a case by case basis only when he or she determined that "the comparable uncontrolled price method prescribed by regulations pursuant to Section 482 of the Internal Revenue Code cannot practically be applied." This limitation was removed in the new draft Model. The Coalition questions the removal of this limitation and recommends that Section 2B should be revised as stated above.

### **No Mandatory Combination**

The current Model could force insurance companies to be involuntarily combined with non-insurers even where there is no evidence of abusive tax avoidance or evasion. Thus, even in the absence of examination or evaluation of an individual company's factual situation, an insurer could be forced to combine with a noninsurance group. The coalition opposes such mandatory combination.

### **Limited Director Discretion**

The Model permits the Director to force combination of insurers and non-insurers by regulation using a broad and undefined standard ("in order to reflect proper apportionment of income"). The Coalition believes that granting broad discretion to the Director invites controversy, and that it is in the best interests of taxpayers and state tax authorities to minimize the opportunity for such controversy by drafting the narrowest provision necessary to accomplish the MTC's goals.

The revision suggested herein would accomplish this goal by limiting the Director's discretion to those situations in which it is necessary to correct abuses. In our prior discussions, representatives of the MTC have suggested that the Director must have authority to require combination in order to combat abusive tax avoidance schemes. The revision to section 2 of the Model suggested herein – authorizing the Director to require combination on a case by case basis where he or she believes the taxpayer is attempting to abusively avoid or evade tax – provides the Director sufficient authority to combat abusive schemes without inviting unnecessary controversy. Use of this narrower standard will drastically limit the controversies and litigation that could arise as a result of the adoption of the Model, providing states a more predictable source of revenue.

### **CONCLUSION**

The Coalition continues to have a high level of concern with the MTC Model which would force the inclusion of insurance and non-insurance companies in the same

combined income tax return. We believe this approach, absent tax abuse or evasion, is fraught with critical tax policy concerns, unaddressed and potentially unforeseen regulatory hurdles and the strong possibility of damaging legal problems.

We look forward to continuing our dialogue with you and we would be pleased to meet with you to further discuss these comments.

For additional information please contact:

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Exhibit D United Services Automobile Association (USAA) – Amy Cannefax





9800 Fredericksburg Road  
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March 28, 2005

**BY ELECTRONIC MAIL**

Shirley K. Sicilian  
Multistate Tax Commission  
444 N. Capitol Street, N.W., Suite 425  
Washington, D.C. 20001-1538

Re: Comments on the Multistate Tax Commission's Model Uniform Statute for Combined Reporting:  
Section 2 Applied to the Insurance Industry

Dear Ms. Sicilian:

We are writing to you to express the United Services Automobile Association's strong objections to the Commission's proposed Model Uniform Statute for Combined Reporting as it would apply to the insurance industry. By way of background, USAA is a highly competitive, fully integrated, financial services company known for its financial strength and its outstanding service to its members. USAA provides insurance, banking, and investment products to more than 5 million members of the U.S. military and their families. Because of USAA's unique and fully integrated structure, the Commission's current proposal, if adopted, would be nearly impossible for USAA to comply with.

The USAA Property & Casualty Insurance Group is a direct writer of personal lines insurance products. Based on year-end 2003 financial information, USAA was the nation's fifth largest writer of homeowners insurance and the seventh largest writer of personal automobile insurance. USAA is one of only three property and casualty insurers to hold the highest possible ratings from each of the three principal nationally recognized statistical rating organizations.

USAA Life Insurance Company is among the nation's most respected life insurers, with more than \$11 billion in owned and managed assets. USAA Life offers a wide range of products and services, including life insurance and annuities, directly to its members. USAA Life is one of a handful of life companies to earn the highest possible financial ratings by the principal nationally recognized statistical rating organizations.

In addition to the insurance operations, USAA Investment Management Company (IMCO) offers a wide range of investment products and services, including mutual funds, brokerage services, and discretionary asset management services. As of year-end 2004, IMCO had \$30 billion in USAA mutual fund assets under management through 1.6 million accounts. IMCO also manages \$18.2 billion in assets for USAA and its subsidiaries, and is responsible for \$807.8 million in discretionary assets and custody of \$14.8 billion in brokerage assets.

USAA Federal Savings Bank (FSB) and its two subsidiaries, USAA Savings Bank and USAA Relocation Services, Inc., provide a full range of financial products to both military and non-military customers. The Bank's 2,800 employees serve more than 2.7 million USAA members with more than 4.8 million products. Since its establishment in 1983, the Bank has provided worldwide service as a branchless financial institution by utilizing direct banking by mail, telephone and online services.

USAA Real Estate Company (RealCo) acquires, develops, finances, and manages commercial real estate properties for USAA, outside investors and various co-investment funds and partners. RealCo owns and manages a geographically diverse portfolio of properties in 17 states and the District of Columbia, and operates USAA Realty Company, a wholly owned subsidiary that provides property management and leasing services. RealCo manages \$3.5 billion in assets, which includes office and industrial buildings, retail, hotels, and raw land.

USAA Financial Planning Services (FPS) provides financial advice and services to help USAA members achieve their financial objectives. To understand their unique circumstances and preferences, FPS advisors and planners work directly with USAA members to guide them to appropriate solutions through consultations, which range in complexity from single topic conversations to comprehensive financial plans. These financial experts are not paid transaction-based compensation.

USAA operates in all 50 states, the District of Columbia, and three of the four U.S. Territories. The principal tax placed upon our insurance operations by the states is the premium tax. This is a "gross receipts" tax that varies from state-to-state. Because of the retaliatory nature of state premium taxes and the significant uncertainty and policy issues associated with trying to integrate an income tax scheme within a premium tax system containing state-to-state retaliation and in-lieu clauses, requiring insurers to file combined reports would create compliance and audit nightmares for USAA and other insurers. The current language, which allows forced combination of insurance and non-insurance companies at the discretion of the Director, places too much discretionary authority in the Director in light of the complex state and local insurance tax systems currently in place. We strongly recommend limiting this authority to situations involving abusive tax avoidance transactions and tax evasion.

USAA is a member of the Council on State Taxation, the American Insurance Association, and the American Council of Life Insurers. We fully support the statements and recommendation contained in the comment letter dated March 24, 2005, submitted by those associations and other insurance-related organizations.

We appreciate the opportunity to provide comments on the draft amendments.

Respectfully submitted,

Amy Cannefax  
Vice President, Taxes

cc: The Honorable Bruce Johnson, Commissioner, Utah State Tax Commissioner and Chair,  
Multistate Tax Commission

The Honorable Carole Keeton Strayhorn, Texas Comptroller of Public Accounts

Exhibit E Heller Ehrman (HE) – Roy E. Crawford

February 1, 2005

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Multistate Tax Commission  
444 N. Capital Street NW  
Suite 425  
Washington, D.C. 20001-1538

**Re: Proposed Model Statute for Combined Reporting**

Dear Sir/Madam:

I have reviewed the Proposed Model Statute for Combined Reporting, as approved November 11, 2004 for public hearing.

Section 3 (Determination of taxable income or loss using combined report), Subsection C (Determination of the business income of the combined group), subparagraph ii(d) provides:

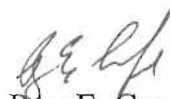
All dividends paid by one to another of the members of the combined group shall, to the extent those dividends are paid out of the earnings and profits of the unitary business included in the combined report, in the current or an earlier year, be eliminated from the income of the recipient. This provision shall not apply to dividends received from members of the unitary business which are not a part of the combined group.

This provision raises two questions that could and probably should be expressly dealt with in the proposed model statute:

1. What is the proper treatment of dividends paid by one to another member of the combined group out of pre-acquisition (or pre-unitary) earnings and profits? Are these dividends nonbusiness income of the recipient as a matter of law, and if so, sourced to the commercial domicile of the recipient?

2. Are earnings and profits determined, for the purpose of application of this provision, on a separate return basis or on a "recomputed" basis as a share of combined business income?

Very truly yours,



Roy E. Crawford  
Special Counsel

Exhibit F      Organization for International Investment (OFII)

**THE ORGANIZATION FOR INTERNATIONAL INVESTMENT  
OBJECTS TO THE MULTISTATE TAX COMMISSION'S  
PROPOSED MODEL COMBINED REPORTING STATUTE**

**Introduction**

The Organization for International Investment ("OFII") is the leading association representing the interests of U.S. subsidiaries of international companies (membership list enclosed). U.S. subsidiaries make a significant contribution to the U.S. economy: "insourcing" 5.4 million jobs, spending an annual \$27.5 billion on U.S. research and development, paying \$22 billion in federal taxes annually and exporting a \$137 billion in goods from the U.S. – 20% of ALL U.S. exports.

**Comments on the MTC's Proposed Model Combined Reporting Statute**

OFII's written comments focus primarily on various features of the water's-edge election contained in the draft statute. Nevertheless, the members of OFII also are very concerned with the adverse impact on the ability of any state that adopts this draft statute to attract "insourcing," or inbound investment by foreign entities. OFII believes that such states will be at a competitive disadvantage vis-à-vis other states that do not adopt this draft statute. An additional general concern is that the compliance burden and expense imposed by this statute on OFII's membership will be significant.

OFII Supports the Availability of a Water's-Edge Filing Method. The water's-edge filing method is important for a variety of reasons. While Section 5 of the MTC proposal is entitled "Water's-Edge Election," OFII believes that this provision does not amount to a true water's-edge election. For instance, the terms of Section 5 contemplate the inclusion of virtually, if not in fact, every foreign member of a unitary group, including (but not limited to):

- a foreign entity if its payroll, property, and sales factors within the United States is 20% or more;
- a foreign entity that earns more than 20% of its income, directly or indirectly, from activities that are deductible against the business income of other members of the combined group; and
- a foreign entity if it is "doing business" in a tax haven.

OFII believes it is not an exaggeration to state that the cumulative effect of these water's-edge provisions is to force worldwide combination onto any unitary group with foreign affiliates.

"Doing Business" is an Improper Tax Haven Standard. Of particular concern to OFII is the provision that sweeps any entity that "does business in" a tax haven into the so-called "water's-edge" combined return. As a matter of tax policy, this approach is poorly considered. A rule that forces *every* corporation that merely "does business in" a tax haven country to join the water's-edge return has a direct impact on most multinational taxpayer groups, which may be deemed to have "done business in" most so-called tax havens. While observers can disagree as to the appropriateness of various countries' tax systems, the punishment of foreign residents and businesses through the state tax regime proposed by the MTC creates significant policy and constitutional concerns.

A critical flaw in the draft statute is its failure to define the term "doing business" for purposes of including a foreign affiliate in the water's-edge return. Does the MTC intend for taxpayers to apply the "permanent establishment" standard incorporated in international tax treaties? Or does the MTC contemplate a more aggressive "economic nexus" standard (e.g., the MTC's "factor presence nexus" proposal)? In any event, the "doing business in a tax haven" standard requires clarification, and should be recast so as not to penalize all contacts with, and business conducted in, foreign jurisdictions.

The statement that “[i]f the member’s business activity within a tax haven is entirely outside the scope of the laws, provisions and practices that cause the jurisdiction to meet the criteria established in Section 1.I, the Director *may* treat the activity of the member as not having been conducted in a tax haven,” does not assuage OFII’s concerns. It does not serve to define the applicable threshold for inclusion in a water’s-edge return, nor does it provide assurances that implementing states will not apply the threshold in order to increase the tax due from a unitary group. Moreover, its discretionary use by revenue commissioners ensures that it will be applied inconsistently from state to state.

The Definition of Tax Haven Poses Foreign Commerce Clause Concerns. The draft statute’s definition of “tax haven” appears to “cherry-pick” foreign jurisdictions for state income tax purposes – and the fact that the list of tax havens is subject to expansion at a revenue commissioner’s discretion aggravates this problem.<sup>1</sup> Foreign entities that merely do business in the targeted foreign countries will be materially impacted and unduly burdened by this practice. Such a state-level practice certainly poses concerns to OFII’s membership that the current draft statute might violate the Foreign Commerce Clause.<sup>2</sup> The Court has stated that a “state tax at variance with Federal policy will violate the ‘one voice’ standard [of *Japan Line*] if it either implicates foreign policy issues which must be left to the Federal Government OR violates a clear Federal directive.”<sup>3</sup> The ability of a state to label tax havens based upon the OECD criteria appears to conflict with clear Federal directives.

The MTC’s reliance on criteria adopted by the OECD in 1998, but later clearly rejected by the Federal government,<sup>4</sup> may have the effect of violating the “one voice” prong of the Foreign Commerce Clause. The Federal government chose not to interfere with the internal tax policy of sovereign nations, but the model statute appears to permit MTC member states to contradict and undermine that position, by taxing companies that do business in these countries differently than these states would tax companies that do business in other countries. Moreover, any system that allows states to independently evaluate and determine what countries are “tax havens” would appear to contradict the Federal government’s documented position that it does not wish to interfere with tax policy in sovereign nations. The result of this mechanism appears to be an unavoidable lack of uniformity among the states and between the states and the federal government; this lack of uniformity creates additional taxpayer compliance burdens and appears to undercut the MTC’s mission.

### Conclusion

OFII appreciates the MTC’s grant of an extension to file these comments, and will be happy to discuss them with the MTC staff and membership.

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<sup>1</sup> If a country is not listed by the OECD but exhibits the OECD criteria for such regimes, the draft statute treats the country as a tax haven for water’s-edge election purposes. A revenue commissioner also has the discretion to label a country a tax haven if the country creates a “tax regime which is favorable for tax avoidance.”

<sup>2</sup> In *Japan Line Ltd. v. County of Los Angeles*, 441 U.S. 434 (1979), the U.S. Supreme Court held that a tax impacting foreign commerce is subject to stricter Commerce Clause scrutiny than taxes impacting interstate commerce. In addition to the four Commerce Clause prongs articulated in *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977), the Court created two additional Foreign Commerce Clause restrictions: (1) state tax measures may not create a risk of multiple taxation at the international level, and (2) state tax measures may not prevent the Federal government from “speaking in one voice” as to policy matters.

<sup>3</sup> *Container Corp. of America v. Franchise Tax Bd.*, 463 US 159, 194 (1983).

<sup>4</sup> Hon. Paul O’Neill, Secretary of the Treasury, testimony before the Senate Committee on Governmental Affairs, Permanent Subcommittee on Investigations, July 18, 2001. Available at the Committee’s website, at [[http://www.senate.gov/~gov\\_affairs/071801\\_psioneil.htm](http://www.senate.gov/~gov_affairs/071801_psioneil.htm)].



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Exhibit G      Model Statute with Hearing Officer's Proposed Changes