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Alan Pasetsky: This article seems to imply that there's just a revenue windfall at the end of the rainbow of a huge number for anyone who implements this. This is the loophole that will solve all loopholes. Not only is it not a loophole, there is no guaranteed [00:00:30] revenue at all.

Nikki Dobay: Hello, and welcome to Gettin' Salty, a state and local tax policy podcast hosted by Greenberg Traurig. My name is Nikki Dobay, shareholder in the Sacramento, California, and Portland, Oregon offices. I'm very pleased to be joined today by Alan Pasetsky, Tax Policy Advisor at the Global Business Alliance.

Alan, thank you for joining me today.

Alan Pasetsky: Thank you so much for having me again, Nikki.

Nikki Dobay: So Alan, [00:01:00] we are going to talk about one of your favorite topics: a rebuttal to a really bad state tax policy. There was recently an article that was published in State Tax Notes, by Michael Mazerov, about all the great things that states should know about mandatory worldwide combined reporting. And as we usually do when these types of articles come out, we start emailing frantically back and forth. So we thought, " [00:01:30] Well, maybe we shouldn't just email. Maybe we should get together and chat about this on a podcast."

I think you have some thoughts about this article, so let's just walk through those. Let's just start at the top. What's one of the most frustrating things about this article and how it's laid out?

Alan Pasetsky: Well, thanks, Nikki. And you're right, I'm very passionate about this topic. I've been dealing with it for over 30 years, and I think the author and others think that if [00:02:00] we just wait long enough, people will forget about why worldwide is not mandatory anywhere.

So the problem with this whole article, to me, is it's very misleading and disingenuous. That's what drives me crazy. And why do I say that? I say that because the arguments made don't point out the many counter-arguments on the other side, which are much more persuasive as to why water's-edge reporting is really the best method.

Nikki Dobay: Is there anything new in this article? [00:02:30] It seems like there's a lot of the old fear tactics that have been regurgitated many times popping up throughout. Did you see anything new in there? Are there any new arguments we need to start thinking about?

Alan Pasetsky: Actually, that's an interesting question. The answer is no. Even the context is talking about the Jeffrey case and other transactions from the 1980s. Even he mentioned something from the '60s. [00:03:00] He mentions constitutionality, which was addressed years ago, and no one is really challenging that.

I think the concern in that article, which is not legitimate, to my knowledge, is that every transaction between related parties is nefarious and isn't a legitimate business deduction. That's the premise that he starts with. And that's just a false premise, because companies are required to, and make, legitimate ordinary-course payments to their affiliates. Both out [00:03:30] to affiliates and that come in from affiliates, as well, which he also ignores.

Nikki Dobay: These payments, not only are there legitimate business purposes behind them, but these companies are following the rules that exist in the world. They're following the transfer pricing rules, which the IRS does audit. He makes claims that the IRS doesn't audit this. That's a big issue that he likes to push, is that [00:04:00] the IRS doesn't police this. The states can't rely on the IRS and these rules, and we should throw the whole system out. Is that true?

Alan Pasetsky: Absolutely not. He's obviously never been in a corporate tax department preparing tax returns. Because if he was, he'd realize that every intercompany transaction with a foreign affiliate is thoroughly documented. It's supported by a transfer pricing study filed with the tax return that may [00:04:30] cost the company millions of dollars to have prepared. It's thoroughly reviewed by the IRS. You make a great point, where the article says the IRS rarely challenges major multinational taxpayer transfer pricing practices. That's what he says. That's completely untrue. One of the first IDRs a company gets is, "Show us your transfer pricing documentation," and it's thoroughly reviewed. So I don't know where he comes up with that.

Another point he doesn't mention is most large multinationals are [00:05:00] under automatic IRS audit. It's not just an audit roulette game. You have multiple auditors, five to 10 on-site, doing these audits. So like you said, the rules are in place. The federal rules govern this. The federal rules should govern this, and states shouldn't be coming up with their own transfer pricing. Because do we really want a world where a royalty is five percent under federal rules, but the state will do its own analysis. They will know for our purposes that royalty is four [00:05:30] percent, and then in another state it's 2.5%. States don't have the resources to engage the experts necessary to do these very complicated calculations.

Nikki Dobay: Well, I think this point about these companies are constantly under audit, really needs to be raised. Because I know in talking to clients and when I was at cost talking to members, the IRS auditors are there all the time. So I [00:06:00] think we just need to dispel this idea that the IRS isn't doing their job. And frankly, what he's saying about the IRS is a little bit disparaging. So I think we just need to lay that to rest.

He goes into some details about not only does the IRS not audit these things, which is untrue, but also that they don't challenge these. I think there may have been a period when there weren't many court cases on this, but we're [00:06:30] seeing the IRS winning in this space. So I think that this idea that the IRS isn't challenging these issues or these issues aren't being litigated is just also untrue. And it is happening. We've seen some big cases come out against some big companies in the transfer pricing area in the last few years.

Alan Pasetsky: Nikki agree with that. It's funny, he uses that fact to point out, "Well [00:07:00] look at all the abuse because there's cases out there that show there's some companies who have been aggressive in their transfer pricing." Sure, there's always companies that will be aggressive, and this is a very nebulous gray area. There's no answer as to what a proper transfer price is. Even the rules create a range. I would use that fact that there's some cases out there the way you would, to say the IRS is enforcing the rules, and the proof is in the pudding with their success on some cases.

Nikki Dobay: Right.

Alan Pasetsky: [00:07:30] The other thing thing he doesn't point out is that when the federal government does make an adjustment, whether in a case or in a settlement, the states automatically get the benefit of that adjustment.

Nikki Dobay: Right.

Alan Pasetsky: So you have to file hundreds, if not thousands, of amended returns for every company affected in every state to reflect that. So the state gets the additional revenue without having to expend $1 of resources other than processing the payment. And he neglects to point that out. And I think [00:08:00] that's a very important fact that state legislators don't realize.

Nikki Dobay: Well, let's talk about that a little more. This was raised at a recent MTC meeting. If the states move away from the water's edge methodology, where most states starts with a number that comes from the federal return, either adjusted gross income or federal taxable income; if we move away from that, what is the point of attaching [00:08:30] your federal return to your state return? Or filing an amended return if there's been a federal adjustment? The states will be completely untethered to anything that happens at the federal level. And frankly, I don't know how taxpayers comply, and I don't know how states administer that.

Alan Pasetsky: Yeah, I think this article and prior articles really downplay the complexity of worldwide reporting. They say things that [00:09:00] are completely inconsistent with the Supreme Court law, which is that only unitaries can be included in the group. So once you get over that hurdle, which is a huge hurdle as in the group, because obviously again, another gray area, companies will disagree with status to who's in the group, because there's no clarity. Okay, how do you calculate the income that's included in the apportionment factors? And like you say, you're creating a whole new world because you're dealing with foreign currency, foreign [00:09:30] books, not under GAAP or federal tax rules. I have to convert all this into some reasonable sub-calculation, which again, a state will not have the resources to audit or necessarily agree on, because there's no clarity. So this really does concern me.

I've had discussions with some of the people on the other side, and they think it's very simple. You put in the whole group and it's easily converted because this data is available [00:10:00] and included in, for example, SEC filings. I can tell you for our members, they don't have these SEC filings. They don't because they're not required to. They're foreign headquartered companies, and they don't have interactions or conversations with all of their foreign affiliates to make these unitary determinations. They don't even speak the same language. So how is this going to be figured out? You've got me.

Nikki Dobay: Well...

Alan Pasetsky: And I... Yeah, go ahead. I'm sorry.

Nikki Dobay: No, [00:10:30] no. Just a couple points I want to highlight. You mentioned the unitary question. In the article he says this is constitutional, but he fails to point out, "Yes, worldwide combined reporting has been upheld as constitutional, but it all hinges on whether or not the group is unitary." And I would say in listening to him and others speak, of course they're [00:11:00] unitary. Of course these companies are unitary, and I think that just could not be more untrue. There's many, many companies, I just don't think they understand the complexity of some of these issues to just say, "Everybody's unitary." And to your point, that's going to be a big fight within the group, and you may not even have companies that are willing to talk with you about this, to try to figure this out.

So even if we can get [00:11:30] over the unitary hurdle, your point about where is this information coming from? They say it's all publicly available. We've also heard all the information is on the form 5471. Can you dispel that myth about this information is not just all contained on the 5471, and what that means for people?

Alan Pasetsky: Sure. So first of all, the 5471 is a form that relates to foreign subsidiaries of U.S. companies. It does have [00:12:00] some financial information of foreign subsidiaries, but it is not in the form and calculated based on taxable income that can be necessarily used in a worldwide return. And I've confirmed that with some of our members. But the bigger issue is what about all the foreign affiliates around the world that are not under U.S. subsidiaries, who would need to be looked at to see if they should be included in the unitary group? For those companies, which is mostly my [00:12:30] members, which are foreign headquartered international companies, there is nothing that would lead you to a comprehensive reasonable look at the data. It's just not there. The closest would be the global consolidated financial statement, but that's all the companies added up.

And to your point, it's a unitary case-by-case analysis for each affiliate in your group. The argument that everyone is unitary because [00:13:00] they all have one goal to increase the shareholder value of the group is not the test. It's not the Supreme Court test. Because if it was, it would be a consolidated requirement just based on ownership. But we know it's not based on stock ownership only. So until the Supreme Court changes that, and there's no reason they would or should, this is a hugely complicated, complex matter.

Nikki Dobay: Let's shift gears a little bit and talk about then this idea [00:13:30] of, I'm going to say these words, I don't mean them to sound pejorative; they use these words, tax havens. Those words have been thrown around for a long time. We had tax haven legislation with our water's edge filing in a few states. It came in, it's going away. But the article really points to a few specific countries that he labels as tax havens. And I think, [00:14:00] correct me if I'm wrong, there's things going on in the international tax community that are really shifting how countries are taxing corporations and what rates are going to be in place. So can you dispel these ideas, that there's still these tax havens out there?

Alan Pasetsky: I can go on for hours on this one.

Nikki Dobay: Okay.

Alan Pasetsky: So what is a tax haven? To some people, it's any country where they just don't like the rate. The corporate US rate's only [00:14:30] 21, and there's a talk about moving it to 15. So do we think anyone with a lower rate than the U.S. Is a tax haven, or are the islands where some of the rates were zero tax havens? How do we define that is the first question. In the article. He points out countries such as Ireland and Switzerland. Ireland and Switzerland for years have had tax rates a little lower than the U.S. Rate. Does that make them tax [00:15:00] havens? I don't think so.

Nikki Dobay: Mm-hmm.

Alan Pasetsky: But he doesn't point out that because of the global pillar two, which we won't get into here, minimum tax that was agreed to at 15%, Switzerland has already raised their rate to 15%. Ireland is going to raise their rate, and many countries around the world are going to raise their rates to 15%. The fact that that is not mentioned in this article is very misleading, because does that to me not make them a tax haven under any guidelines? If the whole world agrees [00:15:30] 15% is legitimate, that should be good enough for the author of the article.

Then there's other points on that key. What about a company that is incorporated in a tax haven, that's been there forever, that's where their headquarters is?

Nikki Dobay: Right.

Alan Pasetsky: Why are they not allowed to be there?

Nikki Dobay: Right.

Alan Pasetsky: Why is that not legitimate?

I'll add one more. Some of my members were engaged in business in the U.S. long before there was a U.S. tax code. They were making payments in ordinary transactions [00:16:00] to their foreign parents and affiliates for royalties or for interest, not for any tax reason, because there was no tax code. So to say that these kinds of payments were for tax purposes is completely, again, irresponsible. Not everything is done for tax avoidance as the author would like you to believe.

Nikki Dobay: What else do you want to cover? We've covered a lot of ground in a pretty short amount of time, and I'm not really sure what is left [00:16:30] with this article when you think through that, a lot of the arguments are just tired, they're outdated, they are misinformed based on the actual facts. What do you really want legislators to know about this issue?

Alan Pasetsky: A couple of things that we haven't mentioned. The revenue. Because revenue is the most important aspect to legislators. They can't spend on social and other programs without having the revenue coming in. This article seems to imply that there's just a revenue windfall [00:17:00] at the end of the rainbow of a huge number for anyone who implements this. This is the loophole that will solve all loopholes. Not only is it not a loophole, there is no guaranteed revenue at all. Why? Because, A, we don't know who's in the unitary group; B, it doesn't reflect the apportionment, the dilution that will result from bringing in foreign companies. A huge omission is that it doesn't reflect that losses from affiliates will also come in. It also doesn't reflect that states are already [00:17:30] taxing some foreign income, such as through guilty or foreign dividend, that might be lost in implementing worldwide.

Now, he doesn't, or anyone, doesn't want to take my word for that. Look at Vermont, a state that really was gung-ho on implementing worldwide. They finally took a look the revenue and concluded it could actually cost them a million dollars a year because of the reasons I mentioned, especially that they would lose the taxation of foreign income they are [00:18:00] already taxing that they know will be coming in. So there's no guaranteed revenue here, and that's one of the big points I'd like to make.

Secondly, he mentions add back rules.

Nikki Dobay: Yeah.

Alan Pasetsky: There are a multitude of states that have, probably in the neighborhood of 20-25 states, that have add back rules. He says that add back rules have been gutted due to lobbying efforts and creating exceptions that just make it non-useful. Well, I don't buy that at all. The add back rules are actually [00:18:30] created and work to deal with the perceived abuse he says is out there.

Nikki Dobay: Right.

Alan Pasetsky: He says that the treaty exception, for example, is inappropriate. Well, the U.S. does not have tax treaties with what they deem as tax haven countries.

Nikki Dobay: Yeah.

Alan Pasetsky: So if the federal government has a treaty with one of these countries, that should be a great exception. A, it's not a tax haven. And B, it's objectively administrable.

Nikki Dobay: [00:19:00] Right.

Alan Pasetsky: You don't have to deal with funky, reasonable, subjective exceptions. And again, there's an exception in many of the add backs that talk about ordinary arms length business purpose transactions. Why is that a problem? Why is that something that should not be allowed as a good deduction, or to implement a huge worldwide reporting change?

And finally, one more I'd like to point out, is he condemns the international community for caring [00:19:30] about this issue in the 1980s. My point would be, is why shouldn't they care?

Nikki Dobay: Right.

Alan Pasetsky: Wouldn't a state care if a Canadian province decided to impose worldwide reporting in their province tomorrow, tax a U.S. affiliate that has nothing to do with Canada? I think state legislators wouldn't be too happy about that.

So those are some of the issues I think that legislators would be interested in.

Nikki Dobay: I would [00:20:00] also note that there seems to be this real anger with these large companies and these perceived abuses. These are companies that are following the rules, doing what they're supposed to be doing. To your point, there are companies that take aggressive positions, which the IRS is challenging. There are some bad actors out there. We're not here saying that everybody is doing everything [00:20:30] without malice. There are definitely a group where there is some profit shifting and nefarious things going on. But by and large, that's not what worldwide would address, a mandating worldwide would address.

And states have these tools already. There are anti-abuse rules within the state code. To your point, if the IRS finds something abusive, they're going to adjust it and the states are going to get the benefit of that adjustment. So I just think that [00:21:00] there's really this idea that everything's bad,. Companies are bad, and that's just not true. For those bad actors. There are rules to address them. And I don't think we need to get rid of the entire system as it stands to deal with some perceived abuse that is legal. It's just the way the rules work. I'd love to see this argument go away. I don't think we're going to see it go away, [00:21:30] but I guess we can hope.

Alan Pasetsky: We can hope, Nikki. I mean, I thought this was dying.

Nikki Dobay: Dead in the eighties.

Alan Pasetsky: I think people just forgot.

Nikki Dobay: Yeah.

Alan Pasetsky: I mean, it's 30, 40 years ago. I think people don't remember what happened. They don't remember the federal government getting involved. They don't remember the international community getting involved. And now that states tax a lot of this foreign income and through the implementation of guilty, we [00:22:00] are Pillar II and countries raising their rates, I think there's less of a need for this than ever.

One other thing I wanted to point out is the author talks about shifting of income. He doesn't talk about the impact of the 2017 federal tax reform, where companies are now bringing income into the U.S. because of certain benefits like FDII. There's some data from the tax foundation where there is a lot of income coming in from Ireland now because of that. Well, that will increase [00:22:30] state revenues because it's fully taxed. I don't see that mentioned anywhere in the article. It's only this perception that every payment is evil, that highlights and is the foundation of this article.

Nikki Dobay: All right, well we'll leave it there today. I'm sure we'll be back talking about this one again at some point, but fingers crossed it won't be too, too soon.

Before I let you go, I have to ask a surprise non-tax question, and I've been thinking about this one. [00:23:00] So we've recently bought a new car and it made me think, I think there's two types of people. There's people that give their cars a name and there's people that don't. So first question is, do you give your cars names, and if so, what are their names? So we do, and we've been searching for a new name for our car, for this new car. But I also made me think when I was like, "Oh, I'm going to have to say the names on the air." Because we're not very creative in the names, we usually just [00:23:30] take whatever the car is and make that its name. We had a Tesla and we named it Tessie, we have a Macan and we named it Macanie. Once, this is going back very long time ago, I had a citation and I named it Ci. So do you name cars, Alan?

Alan Pasetsky: Wow. I've never heard this before. I do not name my cars.

Nikki Dobay: All right, well.

Alan Pasetsky: Wow.

Nikki Dobay: Oh yeah, there's people that name their cars, so think about [00:24:00] it.

Alan Pasetsky: I'm considering this now.

Nikki Dobay: Okay, all right. Well, on the next one we'll see if you've started to name your cars.

Alan Pasetsky: I promise I'll give you a list of names next time.

Nikki Dobay: Okay. All right.

Well Alan, thank you so much for joining me. It's always a pleasure to talk about this topic, and thank you to the listeners for tuning in. If you would like information about Alan or I, it will be in the show notes, and I will be with you soon. On the next, Gettin Salty.