

**Informational Hearing
of the
SENATE SELECT COMMITTEE on
CALIFORNIA-EUROPEAN TRADE
Senator Lou Correa, Chair**

***Water's Edge: California Jobs and
International Investment Opportunities***

**May 19, 2010
Sacramento, CA**

SENATOR LOU CORREA, CHAIR: . . . California-European Trade. This morning's hearing is entitled, "Water's Edge: California Jobs and International Investment Opportunities." It is intended to explore California's trade relationship with countries from around the world. We're going to examine California's complex method of taxing multinational businesses, with an emphasis on how California can foster foreign investment here and how to allow our home-grown California businesses to expand both here and abroad.

As all of you know, right now we're going through some very hard times here in California as well as other places throughout this country and around the world. Here in California—and in my county, Orange County—unemployment continues to be stubbornly high. So, I believe we have to do everything we can to explore every and all opportunities to create jobs and economic opportunity for our California residents.

As you know, California is a leader among high-tech and biotech industries around the world, and we need to continue to foster these industries here locally. Perhaps less well-known is a huge presence in California of investments and jobs directly attributable to companies that are foreign-owned or have foreign headquarters here in California. Hundreds of thousands of Californians are actually employed in California by international firms.

If I can today, we're going to break up this presentation into three panels. The first panel will consist of a water's-edge tax expert presentation, with the Franchise Tax Board, and they'll give us a historical overview of water's-edge law and California's method of taxing multinational companies and how water's edge has evolved.

Second panel, we'll have distinguished representatives from some of our most important international trading partners, and they'll provide us with their perspective on the importance of water's edge and how that plays into cultivating international trade.

And finally, our third panel will include representatives from a broad spectrum of California firms: high-tech, biotech, as well as health-related industries. And they'll speak about the implications of the water's-edge law for their businesses and why we should maintain water's edge for the future growth.

I look forward to this very interesting presentation.

And finally, at the end, if we have time, I will open it up for public comment should we have any.

If I can start, I'll ask the Franchise Tax Board to please step up.

MR. CARL JOSEPH, MULTISTATE TAX BUREAU, FRANCHISE TAX BOARD: Good morning. My name is Carl Joseph. I'm the assistant chief counsel for the Multistate Tax Bureau for the Franchise Tax Board. My bureau deals with issues involving the unitary method of taxation, and of course, water's edge falls into that bailiwick.

SENATOR CORREA: I presume "water's edge" doesn't refer to Newport Beach property.

MR. JOSEPH: Well, in a way maybe. It's sort of a colloquial term for essentially looking at activities that happen only in the United States. So, the water's edge could, in fact—you could look at it as saying Newport Beach would be the "water's edge," except for Hawaii, perhaps.

By way of background, since I was tasked with giving you a historical perspective on where this all came from, that sort of gets you going on how far

back in time do you really want to start, because the California history with taxing corporations is a long one. What I decided to do, in the little handout that I gave you, is I went back to the '20s and '30s. California made the choice to look at corporation income in California, not by looking at the separate books and records of California activity—in other words, sales that happened here or expenses that happened here—but instead, to do something called the “unitary method.”

The unitary method is a recognition that activities that happen inside the state and activities that happen outside the state are all necessary for one business enterprise to earn the income that it earns. And then, the values of that enterprise, rather than looking at separate accounting books and records, should be determined in the various states where it does business by looking at the activities that take place in the state. The typical way of doing this is by looking at the amount of property it has in the state versus property everywhere; the amount of payroll it has in the state versus payroll everywhere; and then, of course, sales in the state versus sales everywhere. These are, essentially, proxies to sort of try to get a sense as to the level of activity of that business enterprise in the state.

Now, this method, which started in the late '20s and '30s, culminated in a decision by the California Supreme Court in 1941 in a case called *Butler Brothers*. And I gave you a little quote from there, from the case, that basically said, “If there is any evidence to sustain a finding that the operations of [the] appellant in California . . . contributed to the net income derived from its entire operation in the United States, then the entire business of [the] appellant is so clearly unitary as to require a fair system of apportionment”—apportionment’s the use of property, payroll, and sales—“by the formula method in order to prevent overtaxation to the corporation or undertaxation by the state.”

So, at that point now, California is utilizing a method that essentially looks towards not only things that happen here but everywhere in the United States, perhaps, of a business enterprise. Now, the important thing to remember is a business enterprise can be run as divisions under one

corporation, where you have just one corporation with offices in various places, or it can choose to operate as separate corporations in separate states.

Under the unitary method, that's a distinction without a difference. We look to the business enterprise, not its legal form. So, you could have a company that has a separate corporation in California, a separate one in Nevada, a separate one in all fifty states if they wanted to, and if they were all doing business as a unitary business under certain tests laid down—like in this *Butler Brothers* case about the operations being all unitary together, the use of payroll and things, the operations, the employees all work together—that it doesn't matter whether or not they choose to operate in various corporations or as one big corporation, it's still economically one enterprise.

So, time goes on and that's fine. You know, other states utilize this method as well. By the time you get into the '60s, you start to see some indication historically that California is starting to not only look at the business enterprise that exists just in the United States, but now we're looking at the business enterprise wherever it happens to have an activity, as long as it's still one unitary business: flows of value are going back and forth, common operations, perhaps steps in a vertical structure, like drilling oil out of the ground in one company, refining it in another, and selling it in another one. You know, as long as they're all in one business enterprise, now we're looking not to just the United States, but take it to its logical extension: anywhere in the world.

The first case, I believe, that really sets down that as being something that was consistent with that unitary principle, I believe was—published at least—was this appeal of *Beecham* which went to the State Board of Equalization. And it was a case involving years in the '60s, but it came out in 1977. In that case, the board—in, I don't think, a very surprising opinion—basically said, “. . . foreign source income is no different from any other income when it comes to determining, by formulary apportionment, the appropriate share of the income of a unitary business taxable by a particular state. [It] does not involve [the] . . . taxation of foreign source income any more than does

apportionment . . . involve taxation of income arising in other states. In both situations, the total income of the . . . business simply provides the starting point for [determining] . . . the in-state . . .” taxable income of the taxpayer. And that’s true.

Essentially, what you have when you do the unitary method, you can think of it—well, the way I usually describe this to our new attorneys is you have questions involving—if you think of income as a pizza pie, you take all the income of a unitary enterprise from wherever it happened, in whatever form it happened, and that gives you your size of the pizza. California cannot tax the entire pizza pie. Constitutionally, we can only tax a portion of that pie that’s fairly related to activities that take place in California.

Well, the constitutional law requires that the way in which you do that is through formulary apportionment, which is, as I said earlier, historically property in the state versus property everywhere, payroll in the state/payroll everywhere, and sales in the state/sales everywhere. So, your size of that pizza pie is going to vary, based upon the size of the business enterprise. If it’s just in the United States, it’ll just be the U.S. operations. If it’s worldwide, it’s going to be a really big pizza pie. But, of course, California’s slice of that pie might be very, very small because there’s lots of payroll, property, and sales that are taking place in places other than California. It could be anywhere in the world.

So, typically, as the pie gets bigger, the slice gets smaller, and California gets a very small piece of a very big pie when we’re working at a worldwide operation versus something that’s a much more local business where we’re getting a larger piece of a smaller pie. So, this proposition in *Beecham* was not that surprising. Maybe it was at the time, but it certainly isn’t anymore.

Now, of course, what this means is you have activities that are taking place outside the United States, in the case of a worldwide enterprise, where those activities that are taking place over there have really no taxable presence in California. They may have no taxable presence in the United States—at all. Yet, we’re going to bring them into that size of the pie that I mentioned.

Well, this concept was a little outrageous, especially to foreign governments. The idea that California would be looking to activities taking place in foreign countries in order to determine the amount of taxable income in California—well, this is very different from the way federal taxation works. Federal taxation is much more based on separate accounting. If you are a U.S. firm, then your income from wherever you operate is in the base for U.S. tax. If you're a foreign company—you know, with some exceptions—you don't have a taxable presence in the United States. And, in fact, if you do, then usually there's a tax treaty that tells you how the income's going to be taxed between the two sovereigns.

So, this idea that California was going to look to this income in foreign locations was seen as shocking, I think, to a lot of foreign governments. So, as I put on the bottom of page 1 here, in 1977 the first attempt was made in a U.S.-U.K. tax treaty negotiation to deal with this problem of California looking to the worldwide activities of a unitary business. And in that treaty there was a provision that prohibited the states from taking into account income of a related foreign corporation. This was, essentially, an opportunity or a chance for the government to step in and say, this federal government: *States, don't do this.*

Well, it didn't get into the treaty. It didn't get ratified with that section in place. That section was taken out. There's a bit of a historical story about that. I was not, obviously, around at the time. But essentially, there was a push and pull from various states with the federal government about whether or not that's something that the federal government should get involved in: sovereignty of states and such things. So, by the late '70s, you have foreign governments clearly aware of California utilizing this worldwide unitary method, looking at activities everywhere to determine the size of that pie and then taking our little, tiny slice.

In the early '80s, there started to be bills introduced in the State Legislature to limit the scope of that method. The bills were not successful at that time. There's a lot of concern about revenue. There's a lot of concern

about the ability of companies to move money back and forth between various parts of their unitary businesses and things of that nature.

By 1983, when I get onto page 2 here, the issue bubbles all the way up to the U.S. Supreme Court. There's a case called *Container Corporation*. Container Corporation was a U.S. company that had subsidiaries all over the world. California utilized the worldwide method. We looked at all their income everywhere, used the formula apportionment method, took our little slice, taxed them. They said it was unconstitutional—those foreign operations should not be subject to tax, in their mind, in California. It went all the way to the U.S. Supreme Court, and long story short, the U.S. Supreme Court held worldwide combination was, in fact, constitutional. It was fine.

Again, not too shocking when you look at a case like *Beecham* where the board's saying, *There's lots of companies that aren't taxpayers in California that are included in a unitary method combined report. You don't have to be a taxpayer to determine that your income's in the size of the pie. It shouldn't matter whether or not you're talking about a foreign corporation in the sense of a U.S. corporation that doesn't have activities in California, or a foreign corporation in the sense of from another country.*

Well, that's kind of what the Supreme Court holds in *Container*. They say, *It's fine. The formula method is really the key to this. As long as it's a unitary business factually—there's flows of value, the business is operating as one enterprise, you utilize the formula method—not a problem.*

Well, after *Container* was decided, now things really heat up. Foreign governments are really upset. And so, there's a lot of effort to do something about worldwide combined reporting.

In my little handout here, I included that the United Kingdom, Japan, Canada, the Netherlands, all complained about the decision to the federal government: *Something must be done.* In fact, there was even talk, I think from the U.K., about retaliating against the United States, or California in

particular, because of this opinion. Either yanking businesses out, charging some tariff—whatever. Very upset.

The Treasury department then formed a working group to address the issue, and this working group worked through '83 and '84 to come up with some solution to this. No solution, actually, was ever made at the federal level. Certainly, the federal government could have solved this problem, but they didn't. Instead, what happened was the product that turned out, turned out, essentially, at the end of the day, to be legislation in California to do something called a "water's-edge election." What that basically was, was sort of a compromise allowing a business enterprise to file a form with the state, saying, *I do not want you to look at my worldwide business when determining that size of the pizza pie. Just look at the stuff that happened in the United States. I should be able to elect to have you do this. Get my foreign operations out of my California return.* That's what they want.

Well, that legislation in '84 didn't make it, for various reasons. Again, revenue's an issue and other things—state sovereignty still. By '85, it comes back; still doesn't make it. By '86, now we have the first water's-edge bill, and it is successful. Water's edge comes into the code for the first time in '86.

Now, through 1986, '87, '88—I think the first year you actually could file a water's-edge return was '88—there were variations and things tweaking the system. The original system basically was set up where you would make the election, you would pay a fee for the election, and then the election was like a contract, and you were stuck with it for a period of time. I think the original term was five years. I think for a while it was up to ten.

But, at any rate, so now we have the water's-edge method, and things kind of calm down. That's good. There's still an unanswered question, though, and that is: Is worldwide combined reporting okay—or constitutional, I should say—when you're talking about an enterprise where it's a foreign parent with operations in the United States through subsidiaries? Container was the opposite. It was a U.S. company.

Well, that case was going up through the system in '91, '92, '93, in a case called *Barclays Bank PLC v. Franchise Tax Board*. As that case went through the litigation, there started to be some pressure for some additional changes in the water's-edge scheme to make water's edge even more palatable to the foreign governments. And the concern, I believe, at the time was that when *Barclays* made it to the U.S. Supreme Court, whether or not the Clinton Administration would come out and write a brief against the state of California, saying, you know, *The United States government should only be able to deal in these international matters*, or whether or not they would write something favorable to California and therefore help California in its case.

In order to make things a little more palatable and to calm down the opposition there, there was additional work done on the water's-edge method. One of the things that happened is the fee went away. The term of the election changed a little bit: it went from five to seven years. There were some other things that were changed in there. And foreign governments, for the most part, at that part were pretty happy with it. You know, they could live with it. They weren't being charged a fee to do this. It allowed them to get out of it if they didn't like it. If, of course, having everybody be worldwide was helpful to your business tax in California, you didn't have to elect. So, that's good. You know, you do the math, you determine whether or not you pay more tax one way or the other, and then you make the determination whether or not you want to make the election. This is all good.

So, now the U.S. Supreme Court hears *Barclays*. There's a brief from the Clinton Administration, an *amicus*, in favor of the state. California wins in *Barclays*. They say again, *This is fine. It's not a problem. There's treaty concerns. The U.S. government can deal with those, and it's fine.*

So, by 1994, *Barclays* is decided, and now we're all kind of set in, more or less, the framework that we have today. The water's-edge election is in place. If you're a foreign entity, you would be outside if you choose.

So, that's sort of the background history on how we got to, more or less, the system that we have today.

The next page I gave you is sort of a visual representation, and this is my pizza pie analogy, more or less. Basically, everybody has to be unitary here, in the sense of their being one business enterprise. It has to have flows of value, it has to have unity of ownership, and unity of use of equipment or of operation. So, if you think of the largest, the darkest shade of blue here as being the worldwide group—without the water's edge election, that's the group whose income is going to be subject to the apportionment formula to determine our slice of the pie.

When you make the water's-edge election, that's no longer the group that shows up on the California return. What shows up on the California return is this lighter shade—just the water's-edge unitary group, okay? Included within that group, just as there would be included in the worldwide group, there are California taxpayers. Not everybody. In some cases, maybe only one. But as long as the unitary business has activities in the state of California, they will be filing a return and utilizing this method. That's the longstanding law. So, it's your choice.

Think about it this way: if you have a lot of payroll, a lot of property, and a lot of sales outside the United States, and you have a small amount in the United States or in California, the worldwide method might well be helpful to you; because, when you take into account your entire unitary business, you might have a big pizza. But California's slice is going to be very small because of the activities that take place here as a portion of everything you do. You know, if you can imagine hundreds of thousands of employees all over the world, you pay less tax than you would if you just did the water's-edge return and just looked at your activities that were within the borders of the U.S., for the most part.

So, again, it's an election: you choose. And, at that point, it's sort of a mathematical choice that each company makes.

Now, one thing important here, as I've said earlier, is it's a seven-year election. You're stuck with it. Seven years is about a business cycle. You basically have to live with your choice for that period of time. That keeps people from—well, I guess the colloquial term would be “flipping and flopping” out of or into the water's-edge method, based upon where income is earned in a particular year. Businesses vary as time goes on. They'll be profitable in some periods and not in others, and of course, your profitability across all the places where you do business can differ. And so, there may well be years where a water's-edge method is helpful and lowers your taxes and in years where they're not. Well, the election, the seven-year election, basically ties you in for a business cycle, and that prevents that sort of moving back and forth for basically no other reason than lowering taxes.

So, basically, that's the overview of how it works.

Now, the last page I gave you is—and now we start to get complicated, so hopefully, we won't get too off track—how do we determine who's in and who's out? The law basically provides that in order to be included, the first thing you always have to be is you've got to be part of the unitary business. If you're not a part of the unitary business, it doesn't matter whether or not you're part of the water's edge or not. So, once you've determined that, now we've gotten into various classifications of entities that will be in and not in. Some of these are, once again, historical, and some of them are still quite valuable or valid today.

Entities that are included within the water's edge 100 percent—their entire income, their entire factors, the whole business—are the first four that I've listed there: banks and corps incorporated in the U.S. So, basically, anybody who's incorporated in any state of the United States is going to be in the group in the water's-edge election. They're in the soil of the United States.

DISCs and FSCs—these are certain specialty type entities. They don't really exist in federal law anymore, but again, this law's been around awhile now, so you have some, for lack of a better word, some sort of “dead weight” here that probably doesn't get used very much.

The third one: corps with 20 percent or more of their average apportionment factors in the United States. This one can be a little bit tricky, but bottom line, what it comes down to is if you're a corporation and you have payroll, property, and sales in this state, and when you add up your percentages of each one—you know, say one was 10, the next one was 10, and the third one was 10—you'd have 30 divided by the fact there's three factors. You'd have 10 percent of your activity within the United States. If that number reaches over 20, then that entity gets included in the water's-edge return in its totality, okay? because it has enough activities inside the water's edge that it is now deemed to be part of that U.S. water's-edge group.

So, this is sort of a rule that says at a certain level you tip the point, and regardless of where you are incorporated, you've got enough going on in the U.S. that you should be in the return. That's what that is essentially saying.

The last one: export trade corporations. Again, they don't really exist anymore. It's sort of been there in the law for awhile.

Now, those are all the entities that are in 100 percent. You can sort of think of it really as everybody incorporated in the U.S. plus these companies that have over 20 percent of their payroll, property, and sales in the U.S.

There's another classification of entities that are partly included. Things get a little complicated here, I guess. The first one of these are companies called "controlled foreign corporations" (CFCs). These are companies that under the federal law—this is tied into the federal code—are controlled/owned over 50 percent by a U.S. parent, a company, such that they are deemed to be controlled by them. If you are a CFC and you have something under the federal code called "subpart F income"—which subpart F is a part of the Internal Revenue Code that came in, in the late '60s, and it's basically income from assets that are very moveable: things like intangibles, things of that nature. That's a gross oversimplification. There's a lot of rules in subpart F.

But the bottom line is there was a thought back in the late '60s at the federal level that there were certain types of income that could easily be moved from one place to another, and if, in fact, they were moved offshore—as I said,

the federal government looks only to activities taking place, U.S. corporations primarily—those offshore activities, they didn't want to encourage that. You know, tax planning. However you want to look at that. So, they said, *If you have these various types of income, when you earn that income in that foreign jurisdiction, we will basically deem it to be dividended back to your U.S. parent and tax it now as opposed to letting it be deferred, sitting in a foreign country until you decide to make a dividend.* You know, a lot of times at the federal level there's a lot of planning around deferral: keep things offshore in foreign corporations as long as possible—maybe there's lower tax rates, things of that nature—and only bring them to the U.S. if you absolutely have to defer that income.

You may recall that at some point in the not too recent past, the feds did sort of a one-time dividend deal where you could bring in money—repatriate all these dividends from foreign countries—and tons of money came back into the United States that was sitting in foreign companies basically being deferred from current tax in the United States for a long time. Nothing nefarious about it. That's just the way the system works.

Anyway, subpart F income was this category that even at the federal level they wanted to say, *No, you can't defer it; you have to bring it in now.* It's mostly, like I said, passive income, things that are moved pretty easily: interest dividends, intangible flows, things like that.

So, we picked that up. Now, the way in which we pick it up is a little complicated. I'm not going to waste your time with it, but the bottom line is, if you're an entity that is a controlled foreign corp that has subpart F income, you will be partially included in the water's-edge return to the extent of that subpart F income. So, you're a partial-in/partial-out entity. If you had other income, it's out.

The last one is foreign banks and corps that don't have any of the ones we talked about before but have U.S. source income. It is possible for a foreign corporation to have an activity in the United States which produces U.S. source income. When that happens, they are taxed by the federal government. They

have factors in the United States that are related to that. Typically, they'll be sales and some property and payroll perhaps. And so, what we will bring into the water's-edge group is just that income and just the factors that gave rise to that income. Sometimes this is viewed as a "deemed subsidiary." Take a foreign company and basically pretend it's two pieces: a foreign piece and a U.S. piece, and just put into the water's-edge return the U.S. piece.

So, at the end of the day, what we try to do here is we try to get a sense of—well, pretty much everybody that's on the federal return, in one shape or form, is kind of going to be in the water's-edge return: the U.S. companies, some of these special things like subpart F entities, and U.S. source income. But it should, to a large degree, equate with what's on that federal return, with some variance but not too much. And again, this is seen as at least somewhat more palatable to entities in foreign places because they're used to that. They're used to the way the federal rules work and the way international rules work between sovereigns. And so, the water's-edge method is closer to what they really are used to actually paying.

So, that's how it basically all sort of falls down. I think we did that in the right amount of time.

SENATOR CORREA: Very good.

MR. JOSEPH: Okay?

SENATOR CORREA: Thank you very much.

MR. JOSEPH: Oh, you're welcome.

SENATOR CORREA: Our next panel up, our important international trading partners, if we can have you come on up.

Welcome.

MR. JOHANNES BUCHHOLZ, GERMAN AMERICAN CHAMBER OF COMMERCE: My name is Johannes Buchholz. I'm the managing director of the German American Chamber of Commerce, and we represent the interests of German industry and trading on the West Coast.

SENATOR CORREA: Thank you very much.

HONORABLE NICOLAS MACKEL, DEPUTY CHIEF OF MISSION, LUXEMBOURG EMBASSY: My name is Nicolas Mackel. I'm with the Embassy of Luxembourg in Washington, D.C.

SENATOR CORREA: Thank you.

HONORABLE JULIUS ANDEREGG, SWISS CONSUL GENERAL: My name is Julius Andereg. I'm the consul general of Switzerland, covering the northwestern United States.

SENATOR CORREA: Thank you.

HONORABLE BART van BOLHUIS, NETHERLANDS CONSUL GENERAL: Bart van Bolhuis, consul general for the Netherlands.

SENATOR CORREA: Go ahead, gentlemen. Begin.

MR. BUCHHOLZ: I'll start then. Being German, I'll try to be succinct and to the point. Just a couple of points that I would like to voice here today that I hope will be taken into consideration in any law that's been passed in regards to there would be tampering with the water's-edge treaty.

One thing in our experience with German companies is that when German companies come over to the U.S., get established on the West Coast, is that they're here for the long haul. They like to set up shop, and then they like to also stick with it. Even in times when it's not that good, they will not pack up quickly and leave again. So, you can say that there's a certain degree of loyalty when a German company sets up shop here in California.

Now, another thing that people know about Germans is that they love laws, rules, and regulation. So, German companies, I could tell you, would get probably very nervous if the certainty principle in taxation would get slightly tampered with—i.e., the water's edge would get tampered with—as it would given the feeling that they could not trust or calculate with the certainty principle and taxation in order to stay here or not. So, that would be a big no-no for them.

The second point would be, in all moderation, all humbleness, California is, I believe, number 48 of the business friendliest states in the Union. So, it is not that much leeway to begin with, and certainly, German companies are

aware of that one, that California does not have the business friendliest environment, if I may say so. That's in regards to taxation laws, regulations.

SENATOR CORREA: Nothing personal but—

MR. BUCHHOLZ: Exactly.

The third one is when I have a company coming to my office, wants to get established here on the West Coast, in all frankness, the first question they ask me, "Isn't California bankrupt? Can we still do business here?" This is just because you have partial media blips in Germany about California being bankrupt. Obviously, I'm quick to tell them, "No. There's certain financial hardships, but that does not affect, really, business on a day-to-day basis." But it would become one more blip, sort of say, that the German media will most probably publicize in Germany that there is now this "unfair" (quote/unquote) double-taxation law in effect in California that would probably deter the companies more from coming here.

And fourth, last but not least, also I think it should be taken into consideration that other states—i.e., Arizona—they are trying very hard to attract FDIs into their area with numerous financial and other incentives. So, that would be a thing: California definitely is in competition also with other states.

So, these are just a couple of points maybe should be taken into consideration.

SENATOR CORREA: Well, let me ask you respectfully but bluntly: so what? Does Germany have a big presence in California?

MR. BUCHHOLZ: Yes.

SENATOR CORREA: How big? How many people do you employ here in California?

MR. BUCHHOLZ: I would have to look it up, but I know that just for the income tax purposes, in terms of average salary, multiplied by the average amount of employees here, accounts for about \$4 billion in income, and obviously taxation . . .

SENATOR CORREA: Four billion dollars in salary.

MR. BUCHHOLZ: Yes, in salary.

SENATOR CORREA: I've heard that the Germans directly employ—German companies in California employ more than half a million Californians. I'm not sure if that's the case, but I believe that is the number that I've heard.

MR. BUCHHOLZ: It depends on if it's a direct German company or a branch office of a German company.

SENATOR CORREA: And I guess my question is: are there industries you're looking to move into California now—green tech, solar panel manufacturers, and others—that maybe this change in law, as you said, the uncertainty would create questions in reference to possibly investing in California?

MR. BUCHHOLZ: Right. Again, as I alluded to before, it's less the case in point that people would, if they really look at the law—*Okay, this would deter me*. It would be another factor that would have more signaling power versus than being in terms of content would keep them from coming here.

SENATOR CORREA: Thank you very much.

MR. MACKEL: Thank you very much. Let me start by thanking the committee for devoting time and energy to this very important issue, and thank you in particular, Senator Correa, for your leadership on it.

Luxembourg obviously cannot boast the figures of your other major trading partners because of the sheer size of its geography and its economy. It can nevertheless serve as a case in point to underline that there is no dispensable or negligible economic and trade relationship. To the contrary. The figures and the examples that I will present to you show, I am convinced, that maintaining smooth flows of trade and investment between Luxembourg and California is in our mutual interest and ultimately beneficial to job creation in these dire times.

With your permission, and before turning to the figures and examples, let me start by underlining that the relationship Luxembourg has with the United States—and thus, also, with the great state of California—is not only to be defined by economic and trade numbers. Luxembourg and the United States

have built up over the years a strong friendship and partnership on multiple levels. Luxembourgers continue to this day to commemorate with unfaltering gratitude the sacrifice of American soldiers to liberate our country from Nazi oppression and terror, especially so in the so-called Battle of the Bulge which took place in Luxembourg in the winter of 1944/1945. Ever since, Luxembourg has been a very staunch and loyal ally of the United States, especially as a founding member of NATO, participating since 2002 and, as we speak, in the war effort in Afghanistan.

Let me turn to trade and economy. Our trade relations with the United States, and thus with California, are excellent as well. Some examples just to underscore this point: Luxembourg's Cargolux, an old cargo airline, is launch customer for the new 747-8 freighter, and it puts its old Boeing 14 747s to very good use by lifting out of LAX more than 400 tons of products made in California to Luxembourg and beyond to Europe.

Over the past 25 years, Luxembourg's SES satellite operator, the largest satellite operator in the world, has extensively sourced its 40 satellite fleet in California.

Luxembourg also exports a variety of products to the United States. Sensor technology from Luxembourg, for instance, is used in most U.S. cars to regulate safety belt and airbag behavior. But more importantly, and symbolically, the steel beams that will be used in the construction of the Liberty Towers in New York are being produced in Luxembourg. Luxembourg's historically important steel industry has specialized in very high-quality steel.

Turning to investment and technology transfer—Luxembourg hosts many U.S. companies, such as Goodyear, Delphi, Guardian, and DuPont. All of them entertaining major manufacturing and R&D activities in Luxembourg. More specifically from California, companies like Cisco, eBay, PayPal, Apple iTunes, Rovi Corp., Avery Dennison, Airtech International, and Templeton Investments entertain manufacturing, banking, and service operations in Luxembourg, and some even their European headquarters. Conversely, as of 2006, 130 billion of

FDI had been flowing into California from Luxembourg. That is more than from Taiwan, Korea, and China (including Hong Kong) combined.

SENATOR CORREA: What is that again—130 . . . ?

MR. MACKEL: Billion dollars.

SENATOR CORREA: Of?

MR. MACKEL: Foreign direct investment.

SENATOR CORREA: So, \$130 billion of foreign direct investment—to California?

MR. MACKEL: Yes.

SENATOR CORREA: Okay. That would be in the form of what?

MR. MACKEL: In the form of investment into the California economy—companies' investment funds. So, whatever based in Luxembourg invests money into California, helping California companies just either as venture capital or startup funds.

SENATOR CORREA: Venture capital, jobs, factories, all of the above.

MR. MACKEL: Exactly.

SENATOR CORREA: So, \$130 billion. Thank you very much.

MR. MACKEL: What attracts these companies to Luxembourg? The answer lies in European history and geography. Luxembourg, as you might know, is located in the heart of Europe. Around 80 percent of European Union's GDP is generated in a 500-mile area around Luxembourg. American and Californian companies, in their quest for expansion and diversification into new markets, use Luxembourg as a gateway into the European single market of 500 million consumers. Luxembourg serves thus as a hub for Californian companies to do business all over the European Union.

Luxembourg enjoys, furthermore, a unique political and social stability, and its business-friendly, no-red-tape environment is conducive to welcoming decision-makers and entrepreneurs. One of the important factors of Luxembourg's attractiveness resides also in the accessibility of key government decision-makers. Luxembourg's workforce, furthermore, is multilingual—we

have three official languages, plus most people mumble English like I do—and highly skilled.

Now, let me get to corporate taxation. In 2009, the combined minimum state and municipal corporate tax rate in Luxembourg was 28.59 percent. I hope this will dispel the erroneous impression that Luxembourg might be considered in any serious way as a tax haven. Luxembourg certainly is a paradise, sir, but unfortunately, not in a fiscal sense.

While the Luxembourg rate for indirect taxation is relatively high at 15 percent, compared to California's sales tax it's one of the lowest in Europe. Based on options offered by European Union regulation on VAT, it makes it attractive to certain business to consumer services, and thus explains why California companies like PayPal, Skype, Apple iTunes, and others are present in Luxembourg.

And this brings me to my concluding remarks about the importance of the water's-edge rule and why it is essential to maintain it. U.S. and California companies established in Luxembourg are properly taxed in Luxembourg on their revenue generated there, and our double-taxation agreement will prevent them from being taxed twice on their economic activity in Europe. An amendment to this treaty introducing the OECD information exchange standard has already been ratified earlier this year by the Luxembourg parliament, and thus, for its entry into force, awaits only U.S. ratification.

Certainty and predictability—and our German colleague referred to it as well, especially in the fiscal realm—are of utmost importance, and businesses must be able to rely on a clear framework of rules. By agreeing to the water's-edge rule, California had recognized the vital function of bilateral trade double-taxation agreements for businesses engaged in international trade. The rationale underlying this important decision has not changed as regards Luxembourg. And thus, Senator, the government of Luxembourg urges you to uphold this feature. Doing any different in these times of crisis would ultimately be hurting California businesses and jobs as well as those of a longstanding, loyal friend and ally of the United States of America.

I thank you for your attention.

SENATOR CORREA: Thank you very much, sir.

CONSUL GENERAL ANDEREGG: Thank you very much, Senator. I'm very grateful as a representative of Switzerland to have the opportunity to express our view on this important subject. I really appreciate that.

Now, I'll skip all the niceties and the generalities also, I think, to give all the other speakers the benefit of some time to express their views. I'm also very interested, of course, as you are particularly also, to hear the private sector later on. So, I will not mention more general matters like—actually, I wanted to tell you also about a family member who was serving under General George Patten's army in World War II and things like that. But you don't have to hear that.

SENATOR CORREA: One of your family members?

CONSUL GENERAL ANDEREGG: I just wanted to actually, by way of introduction, say that we are very proud in our family to have extensive family relations with the United States since many generations.

SENATOR CORREA: I have a photo of George Patten in my office. If you want to come up, you're more than happy to.

CONSUL GENERAL ANDEREGG: He was serving as a colonel in George Patten's army, and we are very proud of that. When he was visiting us in Switzerland in the '50s and '60s, he was our great hero. I think I'll limit two pages of introduction to that point, and I'll come directly to economic facts.

SENATOR CORREA: Thank you.

CONSUL GENERAL ANDEREGG: I believe you are interested in that more.

SENATOR CORREA: It's your time, sir, as you wish.

CONSUL GENERAL ANDEREGG: Now, speaking about Switzerland and the United States economic relations, one thing to me that is fascinating, when I compare our small country with the giant economic power of the United States, is that we have a couple of things in common. I see particularly a common spirit of competition and fairness. Both are market- and

performance-oriented economies: the rule of law, the freedom of enterprise, and so on.

Also, I think interesting is to observe that Switzerland and small Switzerland are consistently ranked number one or two alternatively when it comes to global competitiveness and innovation. And I hasten to say that my friends, the countries on this table, are very close also—on the top of that list, of course. But the United States is blessed with the advantage of rich natural resources and the quality of its people. Switzerland has no natural resources, but still, we have seen remarkable economic success stories in about 150/200 years.

The main criteria, according to experts in the field, for the Swiss economic success story can actually be summarized to two points. Point number one, the most important one, is stability: stability in the political sense, stability in the social sense, stability foremost also in the legal and regulatory environment. That includes, also, predictability in legislation, in design of the framework conditions for investments. And that actually has been also part of the reason why Switzerland has been together with England, and the Netherlands actually, in the forefront of early industrialization already, at the beginning of the 19th century.

The point number two criteria for the economic success stories: education, training, a skilled workforce. I don't want to go into that, but the fact is, and most people would not know about this, that Switzerland actually has the most Nobel prize winners related to the per capita criteria worldwide.

I'm sure nobody in this room would know that NASA's robots exploring the planet Mars now are powered by Swiss-made, high-performance microelectronic engines of a Swiss company called Maxon.

Now, actually, economic relations between Switzerland and the United States are a success story for both partners. Switzerland is a very good customer of U.S. exporters. U.S. exports to Switzerland are larger than from the United States to Sweden, Norway, Finland, Denmark, and Austria combined. It may be surprising, but it is a fact. Or, also, larger than those to

Russia and India combined. Still. At least in 2008. We have to observe how that's developed.

In the field of investments, Switzerland is playing an important role—more important than you would actually attribute to the size of the country. We have 560 Swiss corporations with a presence in the United States. We have calculated that the cumulative investments of Swiss companies in the U.S. economy add up to 165 billion U.S. dollars. And these investments stand for roughly 500,000 jobs in the United States. An overproportional part of these jobs are attributable to the California economy. I refer to the pharmaceutical sector, the biotechnology sector, also the food processing, and to various high-technology fields.

We have, in turn, also 650 U.S. corporations in Switzerland, and these investments stand for roughly 120,000 jobs created in Switzerland. So, we have very close economic relations.

Now on the topic at hand, Mr. Chairman. I think following up on the excellent technical presentation by Mr. Joseph, I think I can be relatively succinct on this point, on the discussion today. But having kindly been invited by you to this hearing, I owe it to you and to the other people present here to be very frank on this important issue. And please understand these comments coming from a friend and partner.

The water's-edge election represents to foreign investors in California an important, longstanding, as we have heard, and well-established compromise formula negotiated between major trading and investment nations and California, and implemented as from 1987, as we have heard.

Now, in my contacts with the heads of Swiss corporations and employees in California recently, because I'm relatively new here, since six months only—I've visited many Swiss corporations in California—I have sensed a certain degree of unrest and concern with regards to the prospect of any possible erosion of the water's-edge election. It is my impression, based on my numerous recent contacts and consultations with our investors, that any

erosion of the water's-edge election could give a negative signal to foreign investors, including those from my country.

Now, what I feel is very revealing, Mr. Chairman, to me as a nonexpert, is when I search the literature of experts in the field, it is quite interesting to see what is already written about the subject. And I quote, for instance, *CBS Money Watch*—and this is not my language; I quote: “Experts who are familiar with state tax issues are well aware of California’s historically aggressive position regarding taxation of international businesses.” It goes on: “To date, California’s ambitions to tax international businesses have only been tempered by the water’s-edge election provisions, which were first passed by the California Legislature in 1986 and subsequently amended.” And I continue to quote: “California’s current fiscal straits arguably make international businesses with a taxable presence in the state a potentially attractive target for tax administrators and the Legislature. Accordingly”—and this is very revealing; they say—“it is important for those companies, as well as those considering entry into California, to observe further developments” before they consider further on new investments in California. Now, this is not my language. This is what I see circulated now on the expert level of entrepreneurs when they make site selection decisions.

May I add on a more personal observation, Mr. Chairman, that as a diplomat having covered economic affairs now for more than thirty years worldwide, in all continents except Australia, I’m quite surprised that in a highly challenging economic environment, in which we are all struggling to maintain existing jobs and are seeking ways to stimulate and promote the creation of new employment, critical changes to the well-established compromise deals, like the water’s-edge election, seem to be considered that would be perceived as hostile to international business and would, to say the least, not encourage further direct investment in the state of California, which I think would really be a pity because our corporations certainly want to continue to do business in California.

And I am also surprised when I compare this strength to what I hear in other states in my consul district here. I have just come back, actually, recently from Washington State, particularly the Seattle area, and also from Nevada and Utah. All of these regions are offering highly competitive low-tax or even no-tax schemes, as my colleague from Luxembourg has mentioned, and these states are, by the way, engaged right now in the strong drive to diversify their industrial base. For example, into life science activities. Now, I don't know how better _____ would be particularly successful in that field, but they are aiming at that. But if you look at the Seattle area, I think we could really say that this is very serious competition also for California.

To be sure, I do not want to be misunderstood. Our corporations—and I speak on behalf of the heads of Swiss companies in California—they are glad to pay and are, of course, paying their fair share of taxes under the law. They are not asking for any special favors, but they would be unsettled about the prospect of any surprises and unilateral changes in tax law. And as a friend, I just feel obliged to recall the most important realization supported by virtually all economic historians that one of the most important conditions for long-term economic growth and job creation are stability and predictability, including also, of course, reliable legal and regulatory framework conditions.

Well, okay. Surprises in that field—of course, investors don't want to have surprises. I mean, it's as simple as that. And I really appeal as a friend just to continue to apply the provisions of the water's-edge election and thereby maintain a stable, predictable, and reliable regulatory environment that investors so desperately are seeking, which will allow them to continue to invest in California.

Now, if I have thirty seconds left, Mr. Chairman—

SENATOR CORREA: Please.

CONSUL GENERAL ANDEREGG: Since I promised to you to be very frank with you, I have to add one brief point of a more bilateral nature, because as a well-informed German—I'm sure you have also heard that the United

States and Switzerland have just recently successfully completed negotiations on a revised double-taxation agreement between the two countries.

Now, as a long story, I can in a separate meeting give you much more about it, but you don't want to hear details now. But the fact of the matter is that Switzerland has, of course, in that process made far-reaching concessions. We are entering a new era of cooperation in the measures against tax evasion.

Now, the reason I bring this up is I have no choice, but the fact of the matter is that right now, in the foreseeable future, the ratification of this new double-taxation agreement is pending in the Swiss parliament, and we are expecting that the discussions will hopefully materialize very soon in the ratification, hopefully into June or summer session of the Swiss parliament. It's a very delicate debate because some of the concessions is felt to be relatively hurtful by some in my country. But I'm convinced personally, and also my government, that we are on the right track on that. Actually, the U.S. Treasury is very happy with the new double-taxation agreement. Even the IRS is very happy. Who thought that that would be possible? But it is a fact. And we are all, our American partners in the federal government and also in my government, we are desperately hoping to ratify that double-taxation agreement as soon as possible.

SENATOR CORREA: Let me interrupt you, if I can.

CONSUL GENERAL ANDEREGG: Please.

SENATOR CORREA: You're trying to be, as you said, honest and clear, and you're saying this double-taxation agreement that is now pending before the Swiss parliament, part of it also incorporates measures to address tax evasion.

CONSUL GENERAL ANDEREGG: Exactly.

SENATOR CORREA: And so, given California's legislative work right now on this taxing matter of water's edge, do you think that would have an effect on the vote that parliament would take on this greater . . .

CONSUL GENERAL ANDEREGG: I really don't know, Mr. Chairman. Actually, I have a feeling that you as an experienced senator, you could answer that question better than I can. But my concern . . .

SENATOR CORREA: I haven't been to Switzerland in twenty years.

CONSUL GENERAL ANDEREGG: You know, one of the similarities we have here—we both have federal governments, we have, both, a two chamber system, and we are both a very old democratic tradition.

Now, what my concern is really to . . .

SENATOR CORREA: Excuse me. I'd like to welcome Senator Gloria Negrete McLeod. Welcome, Senator.

CONSUL GENERAL ANDEREGG: Thank you very much.

My concern, frankly, is—and I am very frank with that—my concern is that any bad news at this stage of the game, human nature being as it is also among parliamentarians in my country, is that any bad news on corporate taxation that might be interpreted as unfair or discriminating against foreign-direct investments in the United States—in this case in California—could at least have the potential of complicating the ongoing debate. This is my concern as a friend. Please forgive me for being so open, because I understand this is really an open exchange. It is a coincidence, of course, that this ratification procedure is up right now. I have already two correspondence of major Swiss newspapers who are interested in what is going on here, because, you know, they are stationed in San Francisco and in the Silicon Valley.

So, that's my only concern that I wanted to raise on the bilateral basis. Forgive me for having taken a bit more time.

SENATOR CORREA: Thank you very much for taking time to actually be here today.

CONSUL GENERAL ANDEREGG: Thank you, Mr. Chairman.

CONSUL GENERAL van BOLHUIS: Thank you, Chairman, for this opportunity to express also our concern with the matter. A concern that we share with many other European countries and around this table today. We expressed our concern also in a letter to the governor a few weeks ago, and our

concerns are very consistent with the issues that we raised already during the '80s. This was mentioned before.

Our country is not directly affected by this proposed legislation. We are not a tax haven, and we are not listed. The Netherlands Antilles are, in fact. That should be a mistake because they are on the white list of the OECD and their corporate tax will rise up to 15 percent, and they will skip also the economic free zones that are buttering(?) some parties in the state as well.

If you want any additional information about the Netherlands Antilles on taxation, I can give you.

So, we are not directly affected, but nevertheless, there's a lot of concern why.

As you know, Mr. Chairman, we like to say that we are pioneers in international business, and we are funding international business wherever because we strongly rely on international business for our economy, as you know. That goes for California as well. Remember the hearing that we had a few months ago under your leadership in which we all stated the importance of international trade and international investment for California. You might recall the fact that trade with the Netherlands and investments from the Netherlands counts for 75,000 jobs in California alone. We're number five investor in this great state, and around 7 billion of FDI is involved. But, for our country as well, foreign direct investments, especially from the United States, are very, very important.

I know many reasons why a country can be attractive for foreign direct investments and international trade in a broader sense. First of all, it was mentioned before: stability and predictability. Of course, its location. It's the quality of the workforce, it's innovation capacity. Taxation, of course, can be one of the drivers, one of the reasons, but it's seldom the main driver for foreign investments. If it is, you should really be a bit worried, if that's a good driver, because investments that are too much driven by taxation are very footloose investments, and a lot of countries around the world can share experience with that kind of investments with you. A very important factor in

attracting foreign investments, in our opinion, is the openness of the economy, and that's one of the success factors of the Netherlands, of course, in attracting investments from the United States and others.

We have a broad range of bilateral treaties on double taxation, avoiding double taxations, which are very helpful for foreign investors.

Our concern—or better to say the concern of international business, of course, is that double taxation is very harmful for their business. As it's stated before, taxation should take place where the economic activity takes place. It's a very important principle for international business. We think that this proposal can not only be harmful for California as such, but also could be a painful precedent for other states and could be harmful for international business as a whole. I think the unitary method, as stated before, doesn't work in an international context in a world that is globalizing, and it doesn't work in an open economy. We, of course, understand the concern with the people that brought forward this proposal, the concern about tax havens, and we share those concerns. But solutions should be found in an international context, and a forum like the OECD in Paris is very helpful in this. Unilateral steps are not very helpful in this matter.

And addressed as well, negotiated, the water's-edge election. It works, so why fix something that isn't broken? I think only yesterday we had a presentation of the governor, stating the importance of international trade in California. I wrote my notice on this paper about the governor's _____ on economic development. I was reading California is the number one state for attracting foreign-direct investments. California's home to 51 Fortune 500 companies.

Just let me conclude. The attractiveness for California, amongst a lot of other things, California is still a very open economy and strongly international connected via trade and investment. We don't want to lose a partner like that.

Thank you.

SENATOR CORREA: Thank you very much.

And I just wanted to ask the panelists a general question. All of you here are not in the private sector. You're in the private-public sector. So, you don't actually have any direct interest in any of these firms, private sector firms, and you're essentially here testifying as representatives of your government of your different countries to address trade relations, so to speak, between California and your respective countries. [Collective "yes."] I just want to make sure that we understand this panel is not about the private sector.

Thank you very much, gentlemen. Thank you for your time.

Gloria, just to bring you up to speed—we had the Franchise Tax Board, this first panel, speak on the water's-edge tax law. We just had some foreign representatives speak, and now we're going to have the private sector come on up.

Our third panel, of course, represented from California industry. So, if you can please come up. Welcome. Some high tech, biotech, and some others.

Welcome all. And I remind you to please introduce yourselves before you speak for the record: your name and who you represent.

MR. DONALD J. LEWIS, NESTLÉ HOLDINGS, INC.: Good morning, Mr. Chairman. I'm Don Lewis. I'm with Nestlé. I'm their assistant director of State Taxes for their U.S. operations. And I want to thank you for your time, and members of the board for their time, to allow us to . . .

SENATOR CORREA: Thank you, and welcome, Mr. Lewis.

MR. LEWIS: I'm here as a representative for both Nestlé, first, and I'll get into it, but The Organization for International Investment.

My employer Nestlé is the largest food company in the world, well known for its many businesses and brands, some of which you'll be familiar with: Carnation, Nesquick, Coffee Mate, Stouffers, Hot Pockets, Jenny Craig, Dreyer's ice cream, Purina, Friskies, Gerber, Arrowhead, Calistoga. Obviously, you can see we run the gamut. We take you from birth right through to your pet. I'm of age: I remember the advertisement for Nestlé of Farfel the Dog. So, that kind of gives you how long Nestlé's . . .

SENATOR GLORIA NEGRETE McLEOD: [Inaudible.]

MR. LEWIS: Nestlé has its principal headquarters in Glendale, California, and between all of our businesses, we employ 7,000 people . . .

SENATOR CORREA: Is that your world headquarters or just . . .

MR. LEWIS: That's U.S. operations. World headquarters is in Switzerland.

In addition to our headquarters, we have manufacturing facilities, distribution facilities; of course, the Jenny Craig Weight Loss Centers and sales offices. We're very active in the local community. Many members of our headquarters are mentoring and tutoring students in about twelve elementary schools which we've adopted. We're active in the RIF program—which is, I understand, Reading is Fundamental—and have provided over one million books to this program.

As I stated earlier, we are the company next door. We are a U.S. company. It's just that we're a little bit different in that we have a foreign parent.

The second organization I do represent is The Organization for Foreign Investment. It's a business association of U.S. subsidiaries, such as ourselves, with foreign parents. A lot of the companies are many large international companies which are household names, which you'll see from the attached list. And that group of companies insources 5 million jobs to the U.S., of which 572,000 are in California. We support a payroll in the United States of over . . .

SENATOR CORREA: So, your group represents 5-7-2 . . .

MR. LEWIS: Five million jobs in the United States, of which 572,000 are in California.

SENATOR CORREA: About 10 percent.

MR. LEWIS: About 10 percent, that's correct.

The payroll in the United States that we support is \$400 billion.

SENATOR CORREA: Four hundred billion . . .

MR. LEWIS: In the U.S., of which 4 billion would be in California through all of these various companies.

SENATOR CORREA: A 4 billion payroll in California.

MR. LEWIS: Four billion payroll. I can't speak to investment because I don't have those numbers.

Again, we're constantly insourcing these companies. They're always insourcing into the United States and always looking to continually insource in the United States to take advantage of the resources that you heard about earlier.

Mr. Joseph provided you the history on the water's edge. There was a lot of uproar back in the '70s and '80s, so it's not something that we have to go back into. But two of the reasons highlighted were the fact that worldwide combination substantially increases the risk of double taxation. And by double taxation we mean the foreign company would be taxed in its home country and would be taxed in California. You also have this situation where we're required to restate all of our financial statements to put them in a U.S. financial presentation in order to accomplish this worldwide method of combination. Something which the water's edge solved by giving us the opportunity not to have to do that. So, you have additional costs, which we must bear, in order to satisfy any potential change to the water's-edge election.

And again, as you heard, the foreign companies were up in arms about this. The U.S. government got involved, the U.S. State Department got involved. You know, fast forward all the way to 2006, where we had the regulation process, and the FTB did amend the Regulation 2510—I won't bore you with the letters—which effectively said that any income that was not effectively connected to a U.S. business, meaning had no relationship to a U.S. business, would not be swept into the water's-edge net.

Now, as these changes and all of this conversation was taking place, a lot of this was prefaced on the fact that the FTB was concerned about the so-called abuses—the so-called, what they purveyed as loopholes—and they were worried about companies sending money abroad and out of the reaches of taxation. In order to bring a comfort level to the state of California, we put right into that changed regulation—we put in the regulation something that specifically says if the transaction that's being questioned is specifically

identified for the purpose of tax evasion, then the rules are off. You have a right to include that income. So, we put that right into the regulation change in 2006.

Not only do you have that in the regulation that deals strictly with the water's edge, FTB has many other tools where they can attack these types of transactions. You have tax shelter provisions. You have case law which challenges transactions that don't have economic substance. So, you have all of these tools available to you to attack these transactions, notwithstanding the fact that the U.S. government is always looking at these transactions, and any time they challenge a tax avoidance transaction and are able to repatriate the income back and tax it, California would be entitled to their share of this income. So, it's not like you're alone in the battle. There are tools, there's many mechanisms, which will repatriate the income if it's a tax avoidance transaction.

Now, it was clear from 2006 that you wanted to maintain the integrity of the water's-edge election. You had the understanding that any change to it would just create administrative burden, it would just create confusion, so you said, okay, and we went back at the time—so, we looked back, and the legislative intent, when it came in, was not to include noneffectively connected income. And we're saying any departure from that is just going to create confusion on top of confusion, and I myself, dealing with the compliance side of it at the same time as this side of it, can tell you that trying to satisfy any change where it reaches past the U.S. operations is somewhat impossible to accomplish. It takes an inordinate amount of time to get to some number, and any number that we would come up with would be subjective. It could never be accurate because you've got translation gains, you've just got different methods of accounting. So, it is pretty difficult to accomplish.

So, as insources—meaning the OFII companies—we are very concerned that the current proposal that's out there could change the water's-edge election and require us to include income which has no relationship to California at all. As you've heard earlier from many speakers, it would create a

disincentive to potentially continue to invest in California, because, one, we don't want the additional burden, and two, we don't think it's fair to saddle us with the additional cost.

So, in conclusion, any significant changes to the water's-edge taxation, as we see it, would result in double taxation for the foreign country or foreign affiliates. It would unnecessarily strain ties and economic relationships with the rest of the world when at a time of economic downturn all of that cooperation is needed. California would be out of step with the rest of the states and even the United States' own international tax policies, and it'd definitely be a clear disincentive for firms to invest in California and insource jobs to California.

So, if you look at the four negative points, they add up to California potentially not getting any additional investment in the future and not ending up with additional jobs which are so critical now to your recovery.

Thank you.

SENATOR CORREA: Thank you.

MR. WM. GREGORY TURNER, NIELSEN, MERKSAMER: Mr. Chairman and Members—my name is Greg Turner. I'm an attorney with Nielsen, Merksamer here in Sacramento. I'm here today on behalf of the California Healthcare Institute. CHI is a research and advocacy organization that represents the interests of California's leading biomedical companies, academic and research institutions, as well as those companies that support the biomedical community.

Biomedical is a growing industry in California that has become really a part of California's economic fabric. In 2008, I think it was measured that we produced \$80 billion of revenue. We have about 870 products in the pipeline. In that year, we employed 274,000 people in California, and if you expand that out to the companies that are related to or support the biomedical industry, where it's biopharmaceuticals and medical device industry, laboratory services, those job numbers approach three-quarters of a million people here in California.

We certainly view our role here in California as a bright one and want to contribute to California's economic growth in the future. That, of course, requires for us a participation on the part of the state to have an environment that allows us to do that, sort of as a California-grown industry. We need—and this example—the protections of the water's-edge election that allow us to grow globally. Without it, I think as a number of speakers have mentioned before, prior to the water's-edge election, a lot of companies—foreign, frankly, and domestic—viewed worldwide combination as effectively double taxing their income.

It's been mentioned a lot, but the reason that happens is because not every country follows the same methodologies, either on accounting or tax purposes. So, for measuring, your Euro and Asian profits on an accounting or for tax purposes differs, and so, those differing rules are not only complex for a company to comply with, which is a huge cost on a global scale, but also, the differing rules overlap. And so, even from a California company's perspective, as we grow globally, that's critically important for us to be able to continue as essentially a California growing industry.

There are some unique aspects to the biomedical industry that I think are important to understand in the context of the water's edge, too, is that as we expand into foreign markets, without the water's edge it becomes increasingly difficult for us to do that. We've got manufacturing requirements that often require us to be in foreign countries. It's not simply about expanding into a market for cost reasons. We often have to manufacture in foreign countries whether to be closer to the market, closer to our customers for the types of products we produce. It may have to do with the capacity or capability here in California, or the United States, that simply doesn't exist. So, we need to be in those foreign markets to be able to produce the products that we do. We also have just the realization that in order for us to be able to provide the products that we do to our customers, sometimes we need to be in that market physically manufacturing in order to be able to do that.

So, it's not just a matter of "as we expand globally" that we can manufacture and produce here in California and ship by FedEx. We have to actually have substantial presence in some of those foreign markets. So, the water's edge operates as a way for us to be able to do that without substantially adding to our costs and the complexity of our filing returns, which, there again, now allows us to continue essentially as California-headquartered companies. And so, keep that in mind too. We've talked a lot today about the impact on foreign companies that want to invest in California. It's also critically important to a lot of California industries who are trying to go globally, and I think that that global growth benefits California as well.

You know, another unique aspect to the biomedical industry is our planning horizon. I think Mr. Joseph mentioned that the election on the water's edge is seven years, because it roughly measures the business cycle. On the biomedical world, our planning horizon isn't even ten years. It's twenty and twenty-five years, because we've got to account for the research that goes into developing products, the extraordinary degree of testing that's involved in bringing products to market, and then ultimately the manufacture and marketing of products, and that happens over a very long period of time.

A couple of other words I think that speakers have used repeatedly today are "predictability" and "stability." So, from a California company perspective—California growing industry perspective—predictability and stability are critically important to us, because if we've measured our costs over a twenty/twenty-five-year period, and there's been a substantial shift in something that's as important as the water's edge, it impairs our ability to bring products to market in a profitable way. And so, we certainly want to convey that message as well is that the water's edge is important both in terms of its protection but in terms of its long-term stability. And the water's edge has really kind of stood up to that so far. I think Mr. Joseph mentioned the last major modifications were in 1994. There's been tweaks here and there, and that happens from time to time, certainly. But by and large, the water's

edge has withstood the test of time and has provided a degree of predictability and stability for California companies.

Now, I know there have been periods over the years where people have complained about corporate loopholes or taxpayers taking advantage of their tax positions. And I guess I would say it's been talked a little bit about so far, but I want to at least repeat a little bit, which is, there are plenty of tools in place for the state of California—the Franchise Tax Board—to attack either abusive transactions or specific taxpayers who are taking advantage of the system, whether it be in reliance on the federal government, which is itself something important to understand. The federal government, as we've already heard, is in the position to be able to negotiate treaties with specific countries.

SENATOR CORREA: I want to interrupt you to introduce Senator Roy Ashburn. Welcome, sir.

SENATOR ROY ASHBURN, MEMBER: Good morning. How are you?

MR. TURNER: Good morning.

Real quick-like, I was just talking about the existing tools that the state of California has in order to attack—or to address concerns about tax avoidance. We do have a great reliance on the federal government for their ability not only to negotiate treaties with foreign governments but also their resources and auditing. We benefit. We sort of can piggyback off of their auditing efforts of foreign companies. And so, to the extent that adjustments are made, those flow through the state of California, but California also has its own tools available to it.

We've talked a little bit about subpart F income. Go back to the history of the water's edge, that was the element included within the water's edge to deal with tax havens originally. And so, we have those tools available to us already. We also have whether it be transfer pricing rules or inverted corporations. We've done a number of things, I think, to try to address any concerns that might exist in terms of specific types of transactions.

But what we don't want to see happen is that we allow the rhetoric of concern about businesses not paying their fair share be used to undermine

what has been a successful structure—the successful part of California’s taxation of multinational companies in the water’s edge.

So, at least in terms of the message from the biomedical companies who have really grown up here in California and want to continue to do that, remember for us the water’s-edge election stands for an ability for us to grow in foreign markets. We have to be in those locations in a lot of circumstances to be able to grow. That benefits our California companies, our California headquartered businesses, and that we need the stability and predictability of the water’s edge in order to make those long-term commitments to our project development.

SENATOR CORREA: Thank you very much.

MR. TURNER: Quite welcome.

SENATOR CORREA: Next speaker?

MS. MICHELLE PIELSTICKER, CALIFORNIA TAXPAYERS’ ASSOCIATION: Good morning, Mr. Chair, members of the committee. My name’s Michelle Pielsticker. I represent the California Taxpayers’ Association. For those who are unfamiliar with Cal-Tax, we represent about 400 large and small businesses on taxation and fiscal issues here in California.

I’d really like to thank you, Mr. Chair, for convening this hearing today, because it reminds us all of the original purpose of the water’s-edge election and just how momentous it was in staving off an international trade war. The history of water’s edge is fascinating and it’s illuminating. The fact that it took ten years and the great political minds of major players—such as Willie Brown, Al Alquist, John Vasconcellos, and Tom Hannigan, and others as well which I’ve neglected to mention—to achieve the water’s-edge election is remarkable. But that’s how important and complex the issue was.

In the eyes of our foreign trading partners, absolutely something had to be done about mandatory worldwide combined reporting. But attempting to fix what our trading partners viewed as taxation beyond our borders was like trying to fix a leaky pipe, and I want to add some context to what Mr. Joseph talked about earlier. This was a very long process. We started with attempting

unitary reform in 1977 with a series of informational hearings, and we didn't get to the water's edge until 1983—the first bill wasn't introduced. We had other unitary reform measures, but water's edge didn't come until 1983. And it still took until 1986 to get an actual bill.

I also want to mention that with regard to that pie that Mr. Joseph referred to, some of the issues that people had with unitary combined reporting and that pie was that there were distortions created based on currency fluctuations based on how different countries use payroll. For example, we may have a large salary here. They may have a small salary and a huge benefit package in another country. And those factors can be distortive if you're looking at them in a unitary sense.

Although by the time 1983 came around we could agree that a water's-edge limitation was in order, some of the things that still remained to be worked out were, for example: how do you treat foreign dividends and not be discriminatory against domestic corporations? So, there was sort of an inter-company dispute between the foreign corporations and the domestic corporations. Other disputes arose as to whether to include 8020 corporations. And I think what we've done is we've said, as Mr. Joseph said, any corporation that has more than 20 percent is included in the water's edge.

So, we finally get to 1985 with SB 85 (Alquist). We almost have a bill in 1985, and then at the last minute a provision gets inserted for divestiture in South Africa which kills the bill. So, we have a federally convened working group, numerous bills, lobbying by foreign delegations, a state-level working group, and then finally, Assemblyman John Vasconcellos brokered a compromise, and that included the water's-edge election, 75 percent foreign dividend relief, elimination of U.S. territories from the water's edge, and eliminating language on tax haven countries. The *New York Times* at the time quoted an Assembly staffer saying, "It's a miracle bill in that both sides won." We needed subsequent cleanup, as Mr. Joseph mentioned.

There's so much talk today about eliminating the water's-edge so-called loophole, but as the testimony today has demonstrated, the water's edge is

anything but a tax loophole. It was a delicately, carefully crafted compromise and acted at the urging of our foreign trading partners and California businesses, and it's absolutely crucial to further investment in California.

So, tinkering with the water's-edge election is the absolute worst thing California could do, either in this recessionary economy or even during an economic boom. It took too much to get us here, and as a member of the international community, it's even more crucial that California keep the water's-edge election as is, lest we risk undermining our relationship with our foreign trading partners and a brilliant compromise that was ten years in the making.

SENATOR CORREA: Thank you very much.

MR. FRED L. MAIN, MANATT, PHELPS & PHILLIPS: Mr. Chairman, members of the committee—good morning. I'm Fred Main. Today I'm up here on behalf of TechNet. TechNet is one of the leading trade groups representing industry that promotes growth and technology in the innovation economy. TechNet companies represent 200 million jobs nationwide. And they include both established companies, which would be some of the foundations of the technology economy here in California, and some of the newest venture startups that will be the foundation companies of the future.

Tax policy has been one of the key issues that impacts TechNet companies in their investment decisions. And we certainly support the current ability of companies to make a unitary election.

The current water's-edge election ensures that domestic California companies are on an equal footing with their competitors. There's been significant discussion of the impact of companies that are foreign companies operating here in California, and we certainly welcome them. But it's important to remember that a big part of the unitary compromise in the late '80s, early '90s was the ability of California companies, domicile companies in the U.S., to be treated fairly; that the concerns that they were operating in foreign countries and that their income would be disproportionately taxed in

relationship to their competitors was a major concern for the compromises that were put forward.

Now, Ms. Pielsticker pointed out the great minds of the Legislature that were involved in those compromises. Certainly not putting myself in that level of the political pantheon, but I was working on the unitary issue in the '80s for the business community, and I can just highlight that the concern over equal treatment was a key, key part of the decision, and we are very concerned that any significant changes to the water's edge and how it treats foreign income, or attempts to treat foreign income, would be of very great concern.

A couple of highlights as it relates to that: While a question is raised about the jobs or economic development that may occur in foreign countries, TechNet companies spend 80 percent of their budgets in the U.S., and that is more than half of their employees; so that inside the water's edge of the U.S., there's still a tremendous amount of economic activity. Nearly 20 percent of all American workers work for companies with overseas operations. This represents more than half of the U.S. manufacturing employment. And higher productivity leads to better jobs in the U.S. And so, California is in a global economy, and we can't look at California as just an island. We have to look at California as our companies are competing across the globe and having to compete on a fair basis.

Finally, one of the issues that is raised in a discussion of whether to change the water's edge in any significant way is the debate that started in the early '80s really became driven for a number of the domestic and U.S. companies by the fear that foreign governments would adversely tax California companies. And I think we always have to keep that in mind as we look to significant changes, that California, if it makes significant changes to the water's edge, what happens to, then, the reopening of the debates that were resolved in the '80s and '90s? We think that the current status quo has worked a very good balance, both for the investments in California and our ability of our members to compete internationally, and we'd encourage you to continue to preserve it.

Thank you.

SENATOR CALDERON: Thank you very much, panelists.

Any questions from the committee?

We can open it up for any comments from the public. Audience?
Anybody want to . . . ?

It's a very important issue, though a bit complex for the non-tax experts, but I think, again, very important. What I'd like to do is I'm going to go back and work with my committee and write up a brief summary of the information that was presented today and give it to some of the appropriate individuals in the Legislature. Some of the other members of this committee are not here today because of their conflicting schedules, but nonetheless, this is an issue that's important to California and the Legislature, and we'll be sharing the information that all of you have presented here today with the rest of the interested parties here in California.

So, with that in mind—again, I thank the members of the Senate that showed up today, members of this committee, as well as the audience for coming from as far as you did to be here and testify on this most important issue. If you feel compelled to submit any more information, please contact us and we'll be more than happy to include it as part of the record.

Thank you very much and have a good day. This committee hearing is adjourned.

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