



---

Date: February 22, 2010

To: Members, Senate Revenue and Taxation Committee  
The Honorable Marty Block  
Senate Republican Caucus

From: AdvaMed  
BayBio  
BIOCOM  
The California Healthcare Institute (CHI)  
The Pharmaceutical Researchers and Manufacturers Association (PhRMA)

**RE: AB 1178 (Block): Water's Edge Tax Clarification - OPPOSE**

---

On behalf of the above listed organizations, whose membership includes our state's premier life sciences companies and academic research institutions, we are writing to indicate our opposition to AB 1178. This legislation would make income earned in countries listed in Table 1 of Appendix 1 to the December 2008 Report of the United States Government Accountability Office on International Taxation (GAO-09-157) includable in income apportionable to California for corporate tax purposes. The revenue generated by this bill would be offset by a partial sales and use tax exemption for textbooks and supplies purchased for higher education.

California is the worldwide headquarters for biomedical research and development. More than 2,700 biomedical companies and 87 public and private research institutions are devoted to solving major unmet medical needs such as cardiovascular and respiratory disease, cancer, diabetes, HIV/AIDS and other infectious diseases. While we are sensitive to your goal of reducing the costs of educational materials for California students, we are gravely concerned that this bill would – contrary to the author's stated intent – dilute the water's edge tax election, capture valid economic activity in foreign jurisdictions, and subject our member companies to double taxation on some of their income. Consequently, AB 1178 impairs our member companies' incentive to invest and grow in California.

### **Water's Edge Election**

When the Water's Edge Election was passed into state law in 1986, it was done so to ameliorate tensions with international trading partners regarding the Franchise Tax Board's (FTB) use of the worldwide combination method for taxation of unitary groups. That method required foreign affiliates to be included in the unitary group's combined report, prompting strong objection from the British and Japanese who felt that the FTB was taxing economic activity within their borders. British Parliament passed legislation that allowed their treasury to penalize multinational groups of companies with operations in any U.S. state that employed the worldwide combination method. As the *Sacramento Bee* noted at the time, "Something had to be done about California's unitary taxing method – not because it is unfair or inefficient, but because the nation's most important trading partners object to it violently." (*Sacramento Bee* editorial, August 22, 1986.)

Several of our member companies with international operations file California tax returns on a water's edge basis, subjecting these companies only to tax on income derived from or attributable to sources within the United States. AB 1178 would require these companies to treat some of their foreign entities whose activity has no connection to the State of California as if their activity were conducted in the United States. Our companies strongly feel that income from foreign entities with no connection to the State of California should not be taxable as California income.

### **Tax Haven Designations**

Tax haven designations are inherently problematic. While the author has dubbed AB 1178 the "Cayman Islands Tax Loophole" bill, there are several countries on the GAO-09-157 list where significant biomedical research, innovation, and manufacturing occur – including Switzerland, Costa Rica, Hong Kong, and Singapore. While some companies may use these jurisdictions as tax havens, many others have a valid economic presence in these countries. In short, one industry's tax haven may be a valid place of business for another industry.

In December 2008, Michael Mundaca, the Deputy Assistant Secretary of the Treasury for International Tax Affairs, wrote to the GAO in reference to the GAO-09-157, outlining the problematic nature of the tax haven list: *"The list of jurisdictions in that summons was put together for a very specific purpose and was not at all intended to suggest a general list of jurisdictions that the Treasury Department and the IRS consider tax havens... Even though coming up with a list of tax haven countries has significant appeal, any list of countries is likely to be under-inclusive as well as over-inclusive, depending on the problem meant to be addressed. Moreover, because any such list is likely to be regarded as a blacklist and may be used as the basis for the imposition of sanctions or other negative measures, such a list may inappropriately negatively affect our economic and other relations with listed countries."*

### **Avoiding Double Taxation**

AB 1178 introduces severe confusion into the tax filing process for several of our member companies. The bill requires taxpayers to petition the FTB to exclude corporations doing business in a tax haven from their water's edge combined report. The bill also requires that FTB promulgate regulations which proscribes what business activity or income derived from a tax haven is deemed from the active conduct of a trade or business and thereby excluded from the water's edge combined report. It is not clear when a taxpayer is expected to petition FTB to exclude tax haven income, and it does not appear that there is a fair and accessible grievance process to appeal FTB determinations in this regard. While FTB is charged with developing regulations to address these issues, developing a regulatory scheme will take significant time and leave taxpayers without guidance on these issues in the interim.

Some of our member companies are headquartered in jurisdictions listed within the GAO-09-157. As a result of being taxed in both of the country of incorporation (federal and state if applicable) and in the state of California, these members will be taxed on the same economic activity and income twice. Therefore, at a minimum, during this interim period, companies are faced with the untenable decision of paying tax twice on some of their income or not paying and facing the potential of the 20 percent understatement penalty if the FTB ultimately rules against them.

Our organizations have always been strong supporters of higher education, and we sincerely appreciate the author's intent to reduce the burden on California students who are struggling with higher costs of attendance. However, AB 1178 would do real damage to California's multinational life sciences firms by introducing uncertainty into established tax practice while unfairly taxing economic income and activity that has no nexus to California.

**For these reasons, we respectfully oppose this legislation.**