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09
State revenue audit efforts seek to help close budget gaps

23
As more countries implement VAT regimes, companies respond to reform

31
Today's global contest for economic development opportunities

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Table of contents

Introduction *iii*

Business changes call for new tax structures: The uneasy journey toward a 21st century state tax system *1*

Trends in state income tax controversies: Needing revenue, some states follow federal approaches or offer amnesty for cash *9*

To tax or not to tax…funnel cakes? Not a simple question in today's increasingly complicated sales tax environment *17*

The complexities of a value added tax: The impact of changing VAT rates *23*

The global view: Business development incentives at home and abroad *31*

Introduction

At the dawn of a new decade, the economy, while still shaky, appears to be recovering from the worst economic conditions since the Great Depression. However, serious budget challenges remain in at least 48 of the 50 states.

The 2010 mid-term election saw a great influx of new state legislators and governors who ran on a platform of no tax increases. Just how, then, will states address their burgeoning fiscal needs to cover costs in areas such as Medicaid and K-12 education? The federal government, which had provided billions of dollars in aid to the states, is unlikely to continue to provide assistance. Further budgetary cuts will be particularly difficult after three years of significant cuts.

In *Business changes call for new tax structures: The uneasy journey toward a 21st century state tax system,* Bryan Mayster and Ferdinand Hogroian discuss whether now is the time to consider whether states should eschew fiscal band aids and try to upgrade their tax regimes to reflect modern American life.

Another area where states continue to seek revenue can be found through enhanced auditing techniques. In *Trends in state income tax controversies: Needing revenue, some states follow federal approaches or offer amnesty for cash*, Jack Kramer and his team identify increasingly aggressive state revenue audit efforts to help close budget deficits and potential areas for future consideration. From the federal codification of economic substance to the disclosure of uncertain tax positions, states are carefully exploring whether these developments could present opportunities to supplement decreased tax revenues.

Of course, state taxpayers have long grappled with another set of indirect tax concerns. While corporate and individual income tax collections have dropped precipitously over the past few years, sales tax decreased only modestly by comparison. In *To tax or not to tax…funnel cakes? Not a simple question in today's increasingly complicated sales tax environment,* John Cooney and Jennifer Jensen caution that states understand the sales tax as a stable tax that is ripe for dramatic changes and expansion.

Indirect taxes also are increasingly a focus of state tax administrators. In *The complexities of a value added tax: The impact of changing VAT rates,* Thomas Boniface and his team highlight a growing concern for state and local taxpayers: the growing influence of value added taxes. Driven largely by the impact of the global recession, an unprecedented level of VAT rate changes are taking place around the globe. Rates are increasing, bases are broadening, and more countries are implementing VAT regimes. Boniface explores issues that address how well your company may be responding to this reform.

And, finally one opportunity to grow revenue without tax increases is to attract new business to a state. In *The global view: Business development incentives at home and abroad*, Ken Hunter, Tom Henry and team discuss how technological advances have changed the way companies view economic incentives. No longer is the issue whether to expand operations in State A or State B; today there is a global contest for economic development opportunities. If states wish to attract new or retain existing businesses, they no longer will be competing with just their neighbors, but with emerging economies around the globe.

While no one can say for sure what state tax regimes will look like at the dusk of this decade, one thing is for sure: business must be prepared to address changes to the state tax systems and the complexities that result as each state confronts its distinctive fiscal needs. Our intention as we wrote this journal was not to prophecy as to what the specific changes will be, but to provide a context for you to analyze changes and what they may mean for your business.

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Business changes call for new tax structures: The uneasy journey toward a 21st century state tax system

The 21st century has already been marked by major changes in the way Americans live. For a culture criticized during much of the last half-century for its television viewing habits, it appears that Internet usage for many Americans may be eclipsing television viewership.[1] While land-line phones dominated the 20th century, a recent study reported that 82% of American adults own one or more mobile devices or cell phones,[2] with an increasing number opting to forsake any landline. Even email — whose ascendency as a primary communication method for the 21st century appeared assured just a few short years ago — may be usurped by texting, instant messaging, social media, and other more informal and instantaneous channels.[3] There are many more examples of these major cultural shifts, but just these few observations illustrate a broader point: American life changed dramatically and in ways unforeseen over the course of the 20th century, and the pace and scope of change has only accelerated over the first decade of the 21st century.

As we embark on the second decade of the 21st century, therefore, it is important to ask: Has government and the tools it employs kept pace with the changes in society? More specifically, for purposes of this paper, have the state and local tax systems adequately adjusted to these changes? Are we content knowing that the income tax apportionment rules used by many states in this digital download era are the same ones employed when vinyl LP records were first introduced to the public? Is a state tax system based in large part on laws created in a very different technological age an anachronism?

To answer these questions, one may start with the commentary from tax practitioners. Every year, it seems, commentators and prognosticators dissect the prior year's legislative and judicial actions affecting the state tax arena, and find simply a nuanced version of "more of the same" for the direction in which the states are headed. Certainly, a challenging

1 For the first time ever, the average American online consumer reports spending as much time online as watching television offline. Understanding the Changing Needs of the US Online Consumer, 2010, Forrester Research, Dec. 13, 2010.

2 Cell Phones and American Adults, Pew Research Center, Sept. 2, 2010.

3 Id. See also, E-mail Gets an Instant Makeover, Richtel, Matt, The New York Times, Dec. 20, 2010.

Can the outmoded taxes of the prior century be reformed by precise (and complicating) changes to their application, or is a more fundamental overhaul needed?

economy tends to prompt states to adhere to the tried and true, either for raising revenue (rate increases, base expansion, etc.) or stimulating investment (targeted credits and incentives, exemptions, and the like). Tough economic times often are not conducive to undertaking tax reform, and recent experience shows that overestimating the performance of a new tax structure can have severe consequences.[4] However, as states appear to be on a prolonged road to recovery,[5] now may be the best time to consider whether states should finally eschew fiscal "band aids" and try something bolder to arrive at a 21st century state tax system.

4 See, for example, The Tax That Fell to Earth: Lessons From the Texas Margin Tax's Launch, Hamilton, Billy, Tax Analysts Document No. 2010-18838, Sept. 7, 2010, reflecting that the Texas Margin Tax has underperformed by as much as $2 billion per year.

5 See State Revenue Report, Dadayan, Lucy, and Boyd, Donald J., Rockefeller Institute for Government, Oct. 2010: "While some economic indicators signal some improvement in overall economic conditions, fiscal recovery for the states typically lags a national economic turnaround and is likely to take several years."

Shifting gears in the new millennium

Arguably, back in 2000, state tax regimes largely bore the hallmarks of a 20th century state tax system. While economic activity had shifted to supplying services without regard to state and national boundaries and to building value in intangibles, state tax systems continued to be based in an old economy mindset. For example, states generally employed the bedrock system of apportioning multistate income as provided for under the Uniform Division of Income for Tax Purposes Act (UDITPA), and sourced service and intangibles income based on a default rule contrary to provisions for sourcing sales of tangible personal property (the primary focus at the time of UDITPA's 1957 adoption). This rule fails to reflect the contribution of market states and, some argue, duplicates the function of the property and payroll factors. UDITPA also provides that the property and payroll factors should be weighted equally with the sales factor, even though, in the digital world, companies may have far less costs of production to generate the kind of significant revenues seen in the manufacturing base during the year of UDITPA's formation.

Turning to state sales taxes, which have their basis in the taxation of tangible personal property, the taxation of other products and services continued to be the exception to the rule. Nexus rules for imposition of a sales tax continued to be based on a physical presence.

It should be noted, however, the first decade of the 21st century has reflected some significant changes, many of which were not forecast ten years ago. Contrary to the long-standing East–West divide between separate entity reporting and unitary group combined reporting states, several eastern states adopted the combined reporting method, including a de facto combined reporting adoption in New York and the embracement of unitary combined reporting in Massachusetts. Several states also embraced a move toward so-called market sourcing of revenues derived from performing services and from intangible property, as well as a dramatic tilting of apportionment formulas toward the sales factor, and a diminution of the property and payroll factors. The sales tax base has expanded, both in terms of treating software (and access to it) as "tangible personal property," and in terms of capturing digital products and services. Finally, states continued to aggressively push the boundaries of their income and franchise tax jurisdiction with economic nexus standards and of their sales and use tax jurisdiction with vendor presumption, affiliate nexus, and related measures. These changes, though intended to address changes in the US economy, may be seen as dancing at the periphery of a more fundamental issue: Can the outmoded taxes of the prior century be reformed by precise (and complicating) changes to their application, or is a more fundamental overhaul needed?

In fairness, some states have recently undertaken wholesale tax reform efforts. Since 2005, three populous states — Ohio, Michigan, and Texas — embraced new forms of business taxation based, in part, on gross receipts or modified gross receipts. Increasingly, state tax commentators are calling for an end to outdated state corporate income taxes,[6] and states, hungry for revenues and seeing declining tax receipts even with corporate tax modernization measures, are considering major changes to the way they tax business. In fact, nearly half the states have established commissions or special legislative committees that are currently reviewing existing tax systems and recommending reforms.[7]

6 See Why Are We Taxing Corporate Income?, Brunori, David, Tax Analysts, Sept. 7, 2010.

7 Council On State Taxation, COST Legislative Alert 10-30, Sept. 21, 2010.

A rough road for would-be reformers

California's former governor, Arnold Schwarzenegger, undertook the bold effort of establishing the Commission on the 21st Century Economy, which on September 29, 2009, delivered its final report[8] regarding recommendations to change California's tax laws with the goal of stabilizing state revenues and reducing volatility, while at the same time improving California's business climate and competitiveness. In brief, the report called for a complete repeal of the corporation franchise (income) tax and the state-level sales and use tax, an overall reduction in personal income tax burdens, and replacement of the revenue from these sources with a broad-application "business net receipts tax" (BNRT), at a rate recommended not to exceed 4%. The plan would be phased in over a five-year period, from 2012 to 2016.

The commission's report was supported by nine of its fourteen members, including six of the seven appointed by the governor and three of the seven appointed by the legislature. However, the report prompted a firestorm of opposition, including from leading state tax experts, businesses, public sector employee unions, public policy advocates, and others.

Given the influence that California possesses over state and national policy, and the relative size of its economy on the world stage, it is worth analyzing the benefits of the proposals asserted by the commission, as well as why the critical reaction to them has stalled any movement before the legislature. The commission's report notes that "[i]n the 1920s and 1930s, when the tax system's foundation was being set in place, manufacturing and agriculture dominated the state and residents mostly bought and sold tangible goods." In the intervening years, however, "the forces of globalization and technological progress have transformed California into a state of not one but many economies," including a vibrant technological sector and the growth of several service industries. "These changes in the economy directly affect the state's tax system and its ability to generate stable revenues that grow apace with the economy," the report recognizes. The report cites California's tax system—even though it already reflects many of the changes adopted in other states during the first decade of the 21st century—as being

8 http://www.cotce.ca.gov/documents/reports/documents/Commission_on_the_21st_Century_Economy-Final_Report.pdf

fundamentally flawed. According to the report, California's current tax system:

- produces revenue volatility
- is overly narrow and "increasingly reliant on a narrow segment of taxpayers"
- makes California uncompetitive, having high marginal rates and leaving some economic activities "essentially 'double-taxed'" and
- is overly complicated.

The commission's recommendations sought to address these deficiencies in the current system through a package of tax decreases and simplification, paid for in whole by a new tax on businesses, the BNRT. The BNRT, the commission asserted, "would give the state a comparatively stable, reliable revenue stream that will grow the economy in much the way that an income-related tax base would grow. It will allow the state to reduce its dependence on other more volatile taxes — specifically, the personal income tax and the corporate income tax."

However, business interests balked at the potential for a huge tax increase (given that the BNRT would fund all of the proposed tax reforms advanced by the commission). Organizations concerned with state funding objected to the potential hit to state revenues from scrapping existing tax systems and their known tax receipts. And public interest groups, citing the pass-through of the BNRT to consumers, decried the perceived regressive nature of the proposal. As summed up by a letter to the commission from a leading group of state tax academicians, while they may differ on their concerns regarding the BNRT and its viability as a proposal for consideration in future tax reform efforts, "[w]e all agree, however, that recommending the adoption of the BNRT at this stage would be highly imprudent."

Will one road or many lead to the 21st century tax regime?

Part of the problem with undertaking tax reform and modernization is that there is often a lack of consensus around a vision for the ultimate destination of the effort. The California Commission on the 21st Century Economy's final report laid out "basic principles that tax analysts and economists use in evaluating the quality of tax systems." They represent some generally accepted tenets of good tax policy:

- *Economic efficiency.* Taxes should, to the extent possible, avoid influencing or distorting the decisions and actions of businesses and individuals, and should be neutral with respect to forms of income and consumption.
- *Fairness and equity.* Taxes should treat similarly situated taxpayers the same, and should reflect fairness, such as being progressive — providing relief to those with less ability to pay — or by tying the burden of the tax to the value of government services provided.
- *Administrative ease.* Taxes should be cost-effective, minimizing administrative compliance and enforcement costs for taxpayers and the taxing authority. Further, taxes should be simple, apparent, and clear.
- *Revenue generation.* Taxes should provide a revenue stream that is adequate, reliable, and stable over time.

The commission's efforts ultimately ran afoul of most, if not all, of these areas in the eyes of many stakeholders. Certainly there were concerns about whether the BNRT would encourage out-of-state economic activity and investment to avoid the imposition of the tax (unlike a true value-added tax, there would be no cross-border adjustments, but rather, the tax would be subject to formulary apportionment). An untried tax, with little if any corollary among the states, also raised concerns about administration, enforceability, and revenue generation.

However, perhaps the greatest roadblock to serious consideration, let alone adoption, was the second point: fairness and equity. This may ultimately be the most substantial barrier to any tax reform or modernization effort. The BNRT, as a receipts-based tax, clearly would have imposed a greater burden on certain labor-intensive, low-margin industries. Businesses were sensitive to the wide disparity among apparent "winners and losers" under this proposed regime, as well as to the overall burden imposed by a relatively high rate for such a tax. Further, an impassioned argument was made on behalf of lower-income individuals that the proposed flattening of the personal income tax, elimination of deductions, and pass-through of a large portion of the BNRT to consumers would have resulted in a dramatic increase in the tax burden for those individuals and in regressivity of the system in general. The proposed elimination of the corporate income tax also prompted cries of corporate giveaways, despite the massive proposed business tax replacement (again due to the asserted pass-through of the tax).

One lesson of the California initiative is that when undertaking tax reform there must be a balance of competing interests, so that while there may be winners and losers vis-à-vis taxpayers' current tax burden, the result after reform will be a more equal playing field for businesses. This goes to the commission's first goal, which encompasses the point of not influencing the decision making of businesses and individuals. However, state policymakers have long recognized that this is only half of the equation. It is essential that, with respect to interstate competition, states intentionally and effectively influence the decision making of both businesses and individuals.

The art comes in satisfying the stakeholders: that there will be enough tax revenue to preserve and enhance the quality of life for residents, that low-income taxpayers will be lifted up, through both economic development and progressivity in the tax system, and that businesses will be able to compete in the global marketplace and win. Policymakers must do all this while navigating the minefield of changes to existing preferences built into the system and managing expectations regarding the level of services provided by the state.

States need to lead the way

To say all this is not to surrender to the same old rhetoric about tax reform, with lofty expectations but little to show in terms of results. Several states, as noted, have undergone significant tax changes in the last decade. Although there are arguably varying levels of success in these states, it is important to note that states continue to perform in their role as a "laboratory of democracy," as they were famously described by Justice Louis Brandeis.[9] While the US government continues to discuss deficit reduction, states, due to their budget constraints, may be the first to show the way to a 21st century tax system that embodies fiscal responsibility and sustainability.

Given the speed at which business, and everyday life, has been transformed in America, states will need to adapt their tax systems in short order and must remain flexible to meet revenue needs commensurate with these developments. The "band-aids" and "laser-like" technical changes of the past are unlikely to produce such a result. While it is premature and speculative to say whether there will be a national sales tax or value-added tax in the United States, experiments with bold new tax structures in the states could pave the way for widespread adoption of a modernized state tax system—and even provide an example for federal policymakers.

9 New State Ice, Co. v. Liebmann, 285 U.S. 262, 311 (1932).

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Trends in state income tax controversies: Needing revenue, some states follow federal approaches or offer amnesty for cash

Over the past few years, state legislatures and tax departments have become increasingly aggressive in their efforts to raise revenue to help close state budget deficits. These aggressive measures include adopting state versions of federal initiatives and offering amnesty programs. Many of these initiatives include heightened penalty provisions. Taxpayers must keep informed of these changes and each state's specific tax and budget considerations in order to appropriately plan for the future and to defend themselves on audit because of increased audit activity.

States take cues from federal government

When the federal government enacts tax legislation or the Internal Revenue Service (IRS) adopts a new policy, state tax professionals quickly ask, "Will the states conform to the federal changes?" Typically, the answer is, "It depends on the state." States often piggyback federal initiatives where there is an opportunity to raise additional state revenue. Recent federal changes that raise state issues include the IRS' scrutiny of international tax havens and offshore accounts, codification of the economic substance doctrine, and requirements to disclose uncertain tax positions.

International tax havens and offshore accounts

Recently, the IRS has scrutinized the transactions of domestic entities with offshore accounts or affiliated entities operating or organized in international tax havens. Internal Revenue Code (IRC) provisions address international tax haven concerns in a federal consolidated return context, but states have only begun to address these issues.

In 2009, the IRS instituted a special voluntary disclosure program "to bring taxpayers that have used undisclosed foreign accounts and undisclosed foreign entities to avoid or evade tax into compliance with the United States tax laws."[1] This

1 Volutary Disclosure: Questions and Answers, IRS, http://irs.gov/newsroom/article/0,,id=21007,00.html (accessed Feb 1, 2011)

program provided taxpayers a six-month period to participate in the voluntary disclosure and penalty reduction framework for offshore financial interests. In 2009, the IRS and the US Department of Justice also announced that banks would disclose information to the IRS regarding US-based holders of offshore accounts, providing additional information for the IRS to examine domestic owners of offshore accounts.

Since the announcement of the IRS voluntary disclosure program in 2009, at least six states have developed similar voluntary disclosure programs targeting offshore accounts and similar financial arrangements. In its announcement for an offshore account voluntary disclosure program, the Wisconsin Department of Revenue warned that it had requested information from the IRS regarding holders of offshore bank accounts and that "entities with a Wisconsin filing requirement who do not voluntarily notify the department … of income from foreign bank accounts … can expect to be contacted by the department."[2] State voluntary disclosure programs may signal the start of new, proactive measures by states to ensure that income associated with offshore funds are reported properly on taxpayers' returns.

Prior to 2010, only a few states addressed tax havens in their income tax statutes or regulations. In 2010, state legislatures increasingly targeted foreign tax havens. Seven states proposed legislation that would require combined groups making water's-edge elections to include in the combined return both the income and apportionment factors of an affiliated entity incorporated or doing business in a tax haven country. A tax haven is generally defined as a jurisdiction that is identified as such by the Organization for Economic Cooperation and Development. While none of the 2010 legislative proposals passed, it is likely that states will continue to look to close perceived tax loopholes and for increased sources of revenue since many states are facing significant budget deficits.

Federal codification of economic substance

On March 30, 2010, President Obama signed into law the Health Care and Education Affordability Act of 2010 (the Act). The Act codified the economic substance doctrine, which was a judicially created doctrine denying tax benefits to transactions determined to lack economic purpose other than tax savings, in IRC section 7701(o). The new statute requires a taxpayer to satisfy a two-part test to establish economic substance before the resulting tax benefits may be taken on a return:

1. The transaction must change the taxpayer's economic position in a meaningful way (apart from income tax effects)
2. The taxpayer must have a substantial purpose for entering into the transaction (apart from income tax effects)

If it is subsequently determined that the transaction lacked economic substance, then the taxpayer will be subject to a 40% strict liability penalty for any underpayment resulting from the transaction. Taxpayers that adequately disclose the transaction on the return are still subject to a 20% strict liability penalty.

While many states adopt specific definitions found under Subtitle F of the IRC, "Procedure and Administration," state statutes generally do not adopt IRC section 7701 or other provisions of Subtitle F. Therefore, the federal codification of the economic substance doctrine may not directly impact state controversies. Like many federal changes, however, the codification of economic substance may result in state level changes.

2 Voluntary Disclosure Program for Taxpayers with a Wisconsin Filing Requirement Related to Foreign Bank Accounts, Wisconsin Department of Revenue, http://www.revenue.wi.gov/taxpro/news/091103.html (accessed Feb. 1, 2011).

The federal codification of the economic substance doctrine has focused taxing authorities on transactions lacking economic substance and business purposes. Over the next few years, additional states may seek to codify the economic substance doctrine at the state level or target transactions lacking business purposes.

Traditionally, state tax savings has been an acceptable business purpose for federal tax purposes. While IRC section 7701(o) only addresses state tax benefits to the extent that such benefits are derived from federal tax effect, it is possible that state legislatures will enact similar economic substance tests for transactions affecting state tax liabilities. The harshness of the penalties, even with adequate disclosure, may result in a chilling effect on transactions that involve tax planning aspects.

Over the past decade, the issue of economic substance has been addressed at the state level through legislative enactments, judicial determinations, and administrative or penalty provisions. Since 2001, seven states have codified some form of the economic substance doctrine. Alabama, one of the earliest states to act, requires that a transaction must have "substantial purpose and economic substance" to avoid the add-back of interest and intangible expense. In 2010, Washington State defined tax avoidance transactions and now imposes a 35% nondisclosure tax avoidance transaction penalty.

Over the past ten years, numerous state courts have disregarded tax avoidance transactions lacking economic substance and business purpose. For example, the Wisconsin Tax Appeals Commission determined that certain intercompany royalty transactions lacked economic substance and business purpose and were undertaken primarily for the purpose of tax avoidance. As such, the commission disallowed the taxpayer's royalty deductions for Wisconsin tax purposes.[3]

The federal codification of the economic substance doctrine has focused taxing authorities on transactions lacking economic substance and business purposes. Over the next few years, additional states may seek to codify the economic substance doctrine at the state level or target transactions lacking business purposes.

3 Hormel Foods Corp. v. Wis. Dep't of Revenue, No. 7-I-17 (Mar. 29, 2010).

Federal disclosure requirements: Schedule UTP

On January 26, 2010, the IRS issued guidance that requires taxpayers with over $10 million in assets to disclose uncertain tax positions on their federal returns.[4] Since the original announcement, the IRS has continued to issue guidance on the reporting requirements for the newly developed Uncertain Tax Position Statement (Schedule UTP). The 2010 Instructions to Schedule UTP provide that the purpose of the form is to disclose "information about tax positions that affect the US federal income tax liabilities of certain corporations that issue or are included in audited financial statements and have assets that equal or exceed $100 million." To this end, Schedule UTP requires certain taxpayers "to provide a concise description of each uncertain tax position for which the corporation or a related entity has recorded a reserve in its financial statements, or for which no reserve has been recorded because of an expectation of litigation."[5] Schedule UTPs will be phased in over five years; taxpayers with assets over $100 million are required to attach the schedule starting in 2010, the asset threshold will decrease to $50 million in 2012, and finally to $10 million starting with tax year 2014.

How state taxing authorities will use the information provided on Schedule UTP will continue to develop over the next several years, but some aspects are certain. State access to the information listed on Schedule UTP may be accomplished in a variety of ways. No specific action will be necessary in states that already require the federal return to be attached to the state's corporate return. In other states that request specific pages or supporting schedules from the federal return, the states may add Schedule UTP to the list of federal attachments already required to be submitted with the state returns. Moreover, the federal and state governments already have information-sharing agreements through which states may also receive the Schedule UTP information.

States may be able to access the information provided on Schedule UTPs, but the schedules may not provide significant pertinent information at the state level. For example, if a federal group of affiliated entities files a consolidated return, only a single Schedule UTP will be required, and therefore, the entity that generated

4 I.R.S. Announcement 2010-9, 2010-7 IRB 408.

5 I.R.S. Announcement 2010-76, 2010-41 IRB 432.

While Schedule UTP may provide limited benefits to the states, like many federal initiatives intended to raise revenue or increase compliance and disclosure, it is likely that states will start to adopt similar reporting requirements at the state level.

the form will not be specifically identified. This significantly limits the use of this information in separate company filing states. Moreover, state-specific uncertain tax positions resulting from transactions that only affect state tax liabilities may not be captured on Schedule UTP.

While Schedule UTP may provide limited benefits to the states, like many federal initiatives intended to raise revenue or increase compliance and disclosure, it is likely that states will start to adopt similar reporting requirements at the state level. These state disclosure requirements will continue to develop over the next several years.

Carrot and stick approach

More than 19 states have offered amnesty programs since January of 2009; these programs have increased in popularity to quickly supplement decreased tax revenues and to close budget gaps. Amnesty programs present significant traps for unwary taxpayers that do not carefully assess whether to participate in the amnesty.

Recent state tax amnesty programs have generated substantial revenues. For example, in 2009, New Jersey brought in $725 million through its 45-day tax amnesty program, far exceeding the projected revenue of $200 million. More recently, Pennsylvania's 2010 amnesty program brought in more than $260 million, surpassing the state's $190 million goal. With the economy recovering slowly, states will continue to struggle with budget deficits at least through 2012, particularly with the decrease in federal stimulus spending. Therefore, many states likely will continue to seek additional sources of revenue, and the tax amnesty trend is likely to continue.

Amnesty benefits, costs, and risks

Although the benefits of participating in tax amnesties may seem obvious, taxpayers should be aware of the costs and risks when choosing whether to participate. Often, the devil is the details.

While amnesty programs vary from state to state, most share some common themes. Amnesties generally are available for a very limited period of time (usually six to eight weeks) and increasingly include all taxes collected by the taxing authority. Most amnesty programs waive all or most of the penalties for prior taxes owed, and a few programs may waive all or a portion of the interest. Although taxpayers may be required to pay a significant amount of cash in a short period of time, tax amnesties generally appear to provide significant taxpayer benefits.

Many amnesty programs contain an alarming provision, however, whereby post-amnesty penalties are applied to taxpayers with outstanding liabilities that fail to participate in an amnesty program. Many of these penalties may be open to constitutional due process challenges.

The 2005 California amnesty program presented one of the harshest "sticks" to taxpayers that did not participate in an amnesty they were eligible for, including:

- An increase in the accuracy-related penalty from 20% to 40% on new tax assessments
- A 50% amnesty penalty on existing unpaid interest for years for which the taxpayer could have applied for amnesty
- An additional 50% amnesty penalty on accrued interest on tax assessments that became final after March 31, 2005

Since 2005, other states have followed California's lead. For example, both Oregon and Maine adopted a 25% post-amnesty penalty applied in addition to all other penalties under state law. Another hefty stick wielded by some states is the requirement that the taxpayer relinquish all rights to appeal the taxing authority's assessment, while other states require the taxpayer to relinquish the right to refunds on payments made under amnesty. While some states are cautious about offering amnesties since the programs may be viewed as benefitting taxpayers that were previously avoiding their responsibilities, the revenues brought in by other state amnesty programs may spur additional states to join the amnesty trend.

New York's amnesty program included similar penalty provisions. In 2005, New York offered an amnesty program waiving penalties for corporate taxpayers with understatements attributable to tax avoidance transactions before January 1, 2005. Taxpayers that failed to participate were subject to a penalty equal to 100% of the interest payable on the understatement. In 2008, New York re-established the amnesty program for the same period (i.e., before January 1, 2005). If taxpayers chose to participate without appeal rights, they were eligible for waiver of penalties; taxpayers choosing to participate with appeal rights were eligible to waive penalties, except the negligence and substantial understatement penalties. Taxpayers participating in the 2008 program were only eligible for abatement of 50% of the penalty from the 2005 program if the taxpayer engaged in listed or reportable transactions.

Other penalty provisions

Many states have increased penalty provisions in an effort to increase revenues. California has led the charge with respect to many of these heightened penalties.

In 2008, California adopted a new 20% understatement penalty applicable to corporate taxpayers with an understatement of tax exceeding $1 million. This strict liability penalty is retroactive for open tax years beginning on or after January 1, 2003, and is in addition to other penalties that may be imposed.

The California Taxpayer's Association recently challenged the 20% understatement penalty based on California's constitutional requirement that taxes be approved by two-thirds of the legislature (rather than

a majority) and on grounds of due process under the 14th Amendment because the penalty lacked review procedures. The matter ultimately went to the California Court of Appeal, which upheld the constitutionality of the penalty.[6] Given California's success in defending the penalty, other states may seek to follow California's new penalty model. As with many amnesty penalties, these types of strict liability penalties may have the potential to be subject to constitutional challenge.

Awareness facilitates better preparation

States continue to aggressively seek additional tax revenues in order to help close their widening budget deficits. The next several years promise additional complexities as state legislatures enact new laws and taxing authorities expand tax audit measures. Taxpayers must stay up to date on these initiatives in order to effectively manage their tax audits and controversies.

6 See Cal. Taxpayers' Ass'n, 190 Cal. App. 4th 1139 (Cal. Ct. App. 2010).

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To tax or not to tax…funnel cakes? Not a simple question in today's increasingly complicated sales tax environment

State legislators and pundits often tout consumption taxes, such as the sales tax, as a simple means to increase tax revenues during difficult fiscal times. Such taxes, however, are not simple and are becoming more complicated. For example, one would think that defining a bakery item for sales tax purposes would not be difficult, but state efforts are turning this seemingly simple issue into a complex one. Take, for example, a recent description of bakery items from the Texas Comptroller in her Tax Policy News publication:

> *Sales of bakery items by mobile food vendors are exempt from tax unless the item is sold on a plate, in a bowl or with eating utensils. "Bakery items" are baked goods typically prepared in bakeries such as doughnuts, cookies, cakes, pies and pastries. Although funnel cakes are considered bakery items, they are subject to sales tax since funnel cakes are generally sold on plates. Please be advised that battering and deep frying a food item does not automatically qualify it as bakery item. For example, a Twinkie is an item that is not typically made in bakeries. Twinkies® that are battered and deep fried are taxable, whether sold on a stick, plate or with other eating utensils or not.* (September 2010).[1]

After reading this, a tax conscious person might be tempted to ask for a funnel cake on a napkin, as there is no indication whether or not a napkin causes a funnel cake to become taxable.[1]

Funnel cakes aside, sales tax is serious business. Nationwide, sales and gross receipts taxes are the second-largest source of state revenue, averaging 32.6% of total collections, compared with 6.3% from corporate income

1 Retrieved January 26, 2011, from http://www.window.state.tx.us/taxinfo/taxpnw/tpn2010/tpn1009.html

With income tax collections plummeting and sales tax collections decreasing only modestly by comparison, one can easily guess where states will turn in an effort to close budget shortfalls — sales taxes with their relative stability during a recession compared to individual and corporate income taxes.

taxes, according to the 2009 US Census. While individual income tax collections decreased 11.7% from 2008 to 2009 and corporate income tax collections decreased 20.7% over the same period, general sales and gross receipts taxes decreased only 5.4%. With income tax collections plummeting and sales tax collections decreasing only modestly by comparison, one can easily guess where states will turn in an effort to close budget shortfalls — sales taxes with their relative stability during a recession compared to individual and corporate income taxes.

With this in mind, it is no surprise that:

- Legislators and tax administrators are subtly increasing rates while expanding the reach of sales tax to more taxpayers and more transactions.
- Taxpayers are seeing diligent enforcement by the states and audit activity.
- State revenue departments are struggling to use existing complex laws that have not caught up with developing technology to tax transactions that, in the past would not have been subject to tax (the same statutes and rules used to decide the taxability of funnel cakes are being used to decide the taxability of cloud computing).

It is more likely now than ever before that this 'perfect storm' of events brought on by the recession and rapid technological developments will bring dramatic sales tax changes to businesses operating in the United States.

New revenue through rate increases and base expansion

Attempts by states to bring in more money through legislation include increasing tax rates, eliminating exemptions, taxing more services, and expanding the tax base and jurisdictional reach through vendor presumption laws and retailer notification requirements.

Not surprisingly, given the states' budget shortfalls, approximately 1,000 overall tax rate increases, both at the state and local levels, happened across the nation in 2009, according to Commerce Clearing House (CCH).[2] In 2010, three states increased their statewide sales and use tax rates: Arizona from 5.6% to 6.6%; Kansas from 5.3% to 6.3%; and New Mexico from 5.0% to 5.125%.

States are also repealing exemptions and giving serious consideration to repealing a lot more of them. For example, New York recently repealed its clothing exemption, Massachusetts temporarily repealed its alcohol exemption (but it was recently reinstated by voter mandate), and Pennsylvania's governor proposed the repeal of all 74 state exemptions to reduce the overall tax rate in the state.

2 "Watch Out: Sales Tax Audits Are on the Rise," Figures, CCH, January 2011 (http://newsletters.cchgroup.com/node/338)

As businesses consider which states are the most tax friendly, they should note that the exemptions of today may be the taxable activity of tomorrow.

States are not only looking at repealing existing exemptions, they are also looking to expand the tax base through the taxation of services. As businesses consider which states are the most tax friendly, they should note that the exemptions of today may be the taxable activity of tomorrow.

In addition to rising rates and an expanding tax base, businesses also are facing states' attempts to expand their reach to out-of-state companies using "click through nexus" and "vendor presumption" laws. In 2008, for example, New York enacted its click through nexus statute. This legislation creates the presumption that sales by out-of-state retailers are taxable sales if the out-of-state retailers contract with in-state third-party "affiliates", on a commission basis, to refer New York customers to the out-of-state retailers' websites using Internet links on the affiliates' websites. There is a de minimis threshold (the out-of-state retailer's cumulative gross receipts from New York customers from the New York resident's referral must exceed $10,000 during the preceding four quarters). New York now casts a much wider net in hope of bringing in Internet retailers as taxpayers. Following New York's example, North Carolina and Rhode Island enacted similar legislation in 2009. Rhode Island has considered repealing its vendor presumption statute.

In 2010, also in an attempt to bring out-of-state retailers under their jurisdictions, Colorado and Oklahoma enacted vendor presumption laws, using different approaches than New York. On February 24, 2010, Colorado enacted H.B. 1192, which creates a presumption that a retailer that does not collect Colorado sales tax is doing business in the state if it is part of a controlled group of corporations that has a component member that is a retailer with a physical presence in the state. On June 9, 2010, Oklahoma enacted similar legislation with several variations.

Colorado also devised an unusual way to either persuade out-of-state retailers to voluntarily collect tax or encourage Colorado residents to pay the state's use tax. In H.B. 1193, also enacted on February 24, 2010, Colorado created a requirement for all noncollecting out-of-state retailers (there is a de minimis exception) that do not collect and remit Colorado sales tax to notify their customers of their use tax obligations on their websites, invoices, and catalogues (with a $5 penalty for each failure to provide notice). In addition, a noncollecting retailer must notify all of its Colorado purchasers by January 31 of the total amount purchased by the Colorado purchaser during the previous calendar year for which no sales tax was remitted, and provide an annual statement by March 1 to the Colorado Department of Revenue summarizing the total Colorado purchases for each purchaser during the preceding calendar year. These moves by Colorado place a significant burden on out-of-state retailers and failure to comply will result in stiff penalties. Not surprisingly, this legislation is facing challenges. Shortly after Colorado's enactment, Oklahoma also adopted a similar notification requirement minus the end-of-year reporting. The trend among the states is to expand their jurisdictional reach through legislation that, in some cases, may have questionable constitutional support.

Even as states face budget shortfalls and look at cutbacks and hiring freezes, they generally tend to continue to hire new auditors, recognizing that they are a source of revenue as opposed to a cost.

Increased audit activity yields cost-effective returns

In addition to more aggressive statutes, US businesses are seeing a significant rise in audit activity by the states. Even as states face budget shortfalls and look at cutbacks and hiring freezes, they generally tend to continue to hire new auditors, recognizing that they are a source of revenue as opposed to a cost. According to Idaho Tax Commission Chairman Royce Chigbrow, $1 million invested in the audit division can result in $10 million in additional tax revenues.[3] Other states are also doing the math and hiring more auditors. According to a May 18, 2010, Wall Street Journal article,[4] during fiscal year 2010, New York conducted 1,077 sales tax audits of New York City restaurants compared with the 646 the previous year. Those reviews found the restaurants owed the state $71.9 million in sales tax, compared with the $40.6 million assessed the year before — a 77% increase. Additionally, more and more states are beginning to use third-party auditors. Third-party auditors are often paid a commission based on the revenue they bring in.

In addition to increased audits, state revenue departments are re-interpreting statutes and regulations to retroactively audit taxpayers. For example, the North Carolina Department of Revenue has re-interpreted the rules covering the standards for nexus in the delivery of digital goods and services. The state is now sending letters of audit to businesses in the state citing the need for payment of back taxes resulting from digital nexus extending back to 2003. Furthermore, in Iowa, the Iowa Supreme Court[5] upheld state legislation that retroactively ratified a municipality franchise fee on cable services. The court held that the legislation passed the test for substantive due process in that the legislative act passed constitutional muster "simply by showing that the retroactive application of the legislation is itself justified by a rational legislative purpose" — in this case, protecting the financial stability of the local municipalities that had already spent the collected franchise fees.

There is no question that taxpayers are seeing more audits and experiencing higher and more controversial assessments. The states' need for more money, however, can also bring about more opportunity for taxpayers. Many tax administrators recognize that rather than pursuing a contentious tax issue that may take years to resolve (and could wind up in the taxpayer's favor), they might be better served by settling the issue with taxpayers who are willing to pay something. States are also generally receptive to voluntary disclosure agreements where, in exchange for a taxpayer coming forward and paying tax for prior years, states may waive penalties and interest and limit the look-back period.

3 "Tax commission says more auditors could boost state revenue," Brad Iverson-Long, Idaho Reporter. com, February 3, 2010, http://www.idahoreporter.com/2010/tax-commission-says-more-auditors-could-boost-state-revenue/

4 "Eateries in Tax Crackdown," Sumathi Reddy, The Wall Street Journal Online, May 18, 2010, http://online.wsj.com/article/SB10001424052748704314904575250794154630652.html

5 Zaber v. City of Dubuque, No. 07-1819, Iowa S. Ct. (June 4, 2010)

Defining new technologies provides new tax opportunities

While the challenges noted so far are significant, and in and of themselves will pose problems for unsuspecting businesses, perhaps the greatest challenge is the difficulty states are having in interpreting and applying existing statutes to new technologies. In recent years, the general definition of tangible personal property has been modified to include prewritten computer software, regardless of the method of delivery. Many state revenue departments have begun to interpret the "regardless of the method of delivery" language and "prewritten computer software" to include digital products. In addition, if a state does not tax electronically delivered software or digital goods, a product can now be interpreted to be a taxable information or data processing service.

Although a number of states have deemed through legislation that software is tangible personal property, many statutes and regulations do not articulate and are not equipped to address issues such as remote users, cloud computing, and digital media. This leaves the door open for states to decide how to tax technology "on the job" during the course of an audit. Once again, taxpayers, who in the past did not believe that they were selling a taxable item, may now find themselves facing high audit assessments. This is especially true with the emerging prominence of cloud computing service offerings.

Revenue need will fuel future sales tax expansion

Taxpayers and states alike may long for the days when how to tax a funnel cake was the most difficult question of the day. However, the states need money and they are looking for more ways to get it. Income tax receipts are unpredictable and shrink drastically during tough times. So states are turning to sales tax to make up lost ground in the economic downturn. As states are rewriting their statutes to try to tax businesses and activities they historically did not tax, they also are employing more auditors to figure out ways to operate in a more complex environment. As a result, US businesses can expect to face more sales tax issues in the future.

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The complexities of a value added tax: The impact of changing VAT rates

As the US economy labors under unprecedented debt, the debate over whether to implement a US Value Added Tax (VAT) is spreading from the White House to the Senate Finance committee to the kitchen tables of struggling families across the country. Nearly every industrialized country has one and the possibility of Congress seriously debating the enactment of a broad based consumption tax as an apparently simple solution to the country's woes continues to grow. Businesses in the US are keenly aware of the growing likelihood of a VAT and, in anticipation of its enactment, are seeking to better understand what it means to them: will it cause Congress to lower or eliminate the corporate income tax; will it create an even greater administrative burden; will it create a drag on customer purchases; and, as has happened across the globe, will the VAT rate be steadily ratcheted up.

To answer these questions, many large and mid-sized US businesses are placing the responsibility for global VAT with their US tax department personnel. Rather than delegating VAT duties to overseas controllers, US tax departments are creating new roles for an "indirect tax" department. At many US business offices today, we are seeing a conversion from a siloed tax department to a flexible business unit that has adapted to a global economy by merging the traditional sales tax and VAT functions.

While the US debates and prepares for a potential VAT, other countries recently have been implementing new VAT regimes or reforming their existing regimes. Why? VAT raises a lot of money.

While the US debates and prepares for a potential VAT, other countries recently have been implementing new VAT regimes or reforming their

Country	January 1, 2010	January 1, 2011*	Percentage point change
Finland	22%	23%	1
Greece	19%	23%	4
Mexico	15%	16%	1
Poland	22%	23%	1
Portugal	20%	21%	1
Romania	19%	24%	5
Spain	16%	18%	2
St Kitts & Nevis	0%	17%	17
Thailand	7%	10%	3
UK	17.50%	20%	2.5

* Changes implemented by January 1, 2011

existing regimes. Why? VAT raises a lot of money. By simply increasing VAT rates or broadening the consumption base, a VAT will raise much needed additional revenue to quell deficits. Although we have seen a reduction in international corporate income tax rates over the past ten years, the same is clearly not true of VAT. And, apparently, increasing VAT rates produces significant revenue without discouraging investment, as would happen with a corporate income tax. But with the recent rash of global VAT rate increases, its complexity is highlighted. What appears to be a routine legislative change can present complicated issues for the daily operation of a business.

Over 130 countries impose some form of VAT, all of which differ somewhat in their substance and administration. In many jurisdictions, VAT has become the tax instrument of choice to raise revenue.

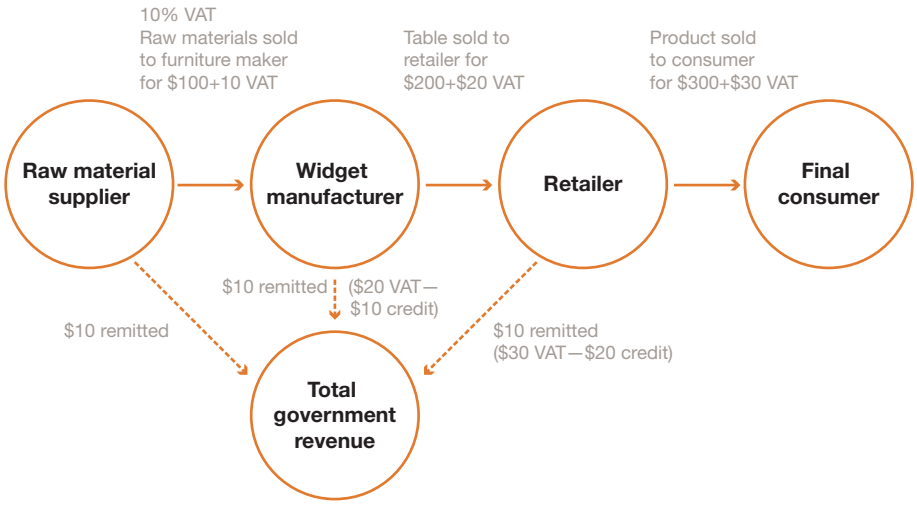
The table above shows a small sample of recent rate changes:[1]

It is imperative that US multinational businesses devote an adequate level of attention to understanding how recent changes in the VAT rates can affect the timing of tax points as this will change how a business is calculating its VAT liability. A "tax point" is the time when a VAT liability accrues. It is generally different than the time when a VAT liability is reported or when a VAT payment is made to the tax authorities.

The following analysis considers the complexity associated with analyzing and responding to the impact of VAT rate changes.

1 Rising VAT Rates Here to Stay, International Tax Review (Sept. 2010), accessible at: http://www.internationaltaxreview.com/Article/2661833/Search/Rising-VAT-rates-here-to-stay.html?Keywords=vat+rises&PartialFields=(CATEGORYIDS%3a10329)&Brand=ITR

How VAT works



Source—GAO report

The diagram above shows an example of how a VAT is accounted for during a series of transactions in a supply chain.

A widget manufacturer buys input materials from a domestic supplier. The domestic supplier charges and collects VAT at the applicable rate. Subsequently, when the widget manufacturer sells the widgets to a retailer the manufacturer charges and collects VAT on the gross value of transaction (output VAT). The manufacturer should be entitled to an offsetting credit for the amount of VAT it paid on the input materials (input VAT). Therefore, the net VAT payable to the tax authorities by the manufacturer is the difference between the output VAT charged to the retailer and the input VAT paid to the supplier. When the retailer sells the widgets to the final end user, VAT is charged and collected on the sales amount and the retailer remits this amount, reduced by any input VAT paid, to the tax authorities.

Application of the (new) VAT rate

There are two main consequences to increasing VAT rates: (1) increased VAT collected on sales (output VAT) and (2) increased VAT payable on purchases and imports (input VAT). At first, it appears easy for businesses to implement these changes by simply changing the percentage on the invoice.

Unfortunately, it is not as straightforward as it seems. Making a rate change on VAT collected and payable has a broad impact on an enterprise resource planning (ERP) system and often it takes substantial resources and time to implement the change. The short notice some governments give for making the rate change adds to the challenges a business can face.

The tax point determines which VAT rate should be applied. In the European Union (EU) the tax point rules are derived from the EU VAT Directive. The basic rule in the EU is that the tax point shall occur when the goods or services are supplied, a payment is received or an invoice is issued, whichever event occurs first.

There are, however, several exceptions to this basic tax point (e.g., continuous supplies of goods and services, cross-border supplies, etc.).

Moreover, EU member states may amend the tax point rules in the event the rates are changed.[2] Below we describe how these different rules apply in selected countries that have raised their VAT rate in 2011. For taxpayers doing business in these countries it is crucial to establish how these rules are implemented locally in order to be compliant.

A. Continuous supplies of goods or services

The general rules for continuous supplies of goods (e.g., gas, electricity or water) or services (e.g., leasing of goods) is that VAT becomes due when the period expires to which statements of account or payments pertain.[3] EU member states may, however, provide that VAT becomes due on the issue of an invoice or the receipt of a payment.[4]

Example[5]

An IT business in the United Kingdom (UK) leases servers. The IT business issues invoices at the beginning of each quarterly rental period. In 2011, this means that the Q1 rental period would include a period up to January 3, 2011 (when the rate is 17.5%) and the remainder of the quarter (when the rate is 20%)

As stated above, the UK tax point for continuous supplies/services occurs whenever an invoice is issued or a payment is received (whichever is earlier). Thus, if the invoice is issued on January 1, 2011, the whole lease amount would be taxed at 17.5%.[6]

2 Article 95, EU VAT Directive 2006/112/EC.

3 Article 64(1), EU VAT Directive 2006/112/EC.

4 Article 66, EU VAT Directive 2006/112/EC.

5 For purposes of these examples, the amounts are VAT-inclusive. Thus, the rate is adjusted to reflect this inclusion.

6 We note that in the UK special legislation provides taxpayers with the option to charge the old or the new rate for sales that span the change in rate. However, there is also complex antiforestalling legislation in place to prevent artificial avoidance.

B. Prepayments

As a basic rule in the EU, a VAT tax point arises when an advance payment is made for the supply of goods or services.[7]

As described above, the tax point rules can be interpreted differently throughout Europe. As an example, we describe how to deal with prepayments with the rate changes in the UK and Poland.

Example

An IT business with locations in the UK and Poland sells computers to local clients. In both countries the IT business will sell the computers for a total value of $500,000, VAT excluded, and will deliver them at the end of March 2011. The customers could have chosen to: (1) prepay the full amount in December 2010, or (2) make a prepayment of $200,000, VAT excluded, in December 2010 and pay the balance on delivery. The IT business will face the following VAT treatment in the various jurisdictions.

UK

1. Full prepayment

   VAT is due on the date when the payment is received. As the payment is received before the tax rate increases, the old rate of 17.5% would be due:

   $500,000 * 17.5% = $87,500

2. Payment in installments

   VAT is due on the date when the payments are received. As the payments are received before and after the tax rate rises, the old rate (17.5%) and the new rate (20%) would apply:

7 Article 65, EU VAT Directive 2006/112/EC.

$200,000 * 17.5%	=	$35,000
$300,000 * 20%	=	$60,000
Total UK VAT due:		$95,000

Poland

1. Full prepayment

   VAT is due on the date when the payment is received. As the payment is received before the tax rate increases, the old rate of 22% would be due:

   $500,000 * 22% = $110,000

2. Payment in installments

   VAT is due on the date when the payments are received. As the payments are received before and after the tax rate increases, the old rate (22%) and the new rate (23%) would apply:

$200,000 * 22%	=	$44,000
$300,000 * 23%	=	$69,000
Total Polish VAT due:		$113,000

C. Tax points in an international context

For businesses that operate internationally, the following rules for tax points are also important to consider. As of January 1, 2010, new rules exist for determining the tax point for business to business (B2B) services within the EU where the VAT liability is shifted to the customer (to self account, similar to the US compensatory use tax). VAT becomes due at the moment the services are performed or when they are paid for, depending on which occurs first. Thus, the invoice date is no longer relevant in this respect. For continuous supplies of services, the tax point will be the earlier of the end of each billing or payment period or the date on which payment is made.

In the case of cross-border continuous supplies that are not subject to billing or payment periods, the tax point will be December 31 in each year.[8]

Furthermore, for businesses based in the EU that are required to account for acquisition VAT on the purchase of goods from another EU country, VAT becomes due on the 15th of the month following the one in which the goods were sent or on the date that the supplier issues the invoice (whichever occurs first).[9]

Example

A UK tax advisor provides tax advisory services for a Polish established business. The services conclude on December 15, 2010. The Swiss tax advisor sends an invoice for its services on January 10, 2011. In Poland, for services, the tax point should occur the earlier of the issuance of an invoice, a payment or within seven days when the service is finished, In this case, the Polish entity has to account for reverse charge VAT on when the services are supplied, i.e., in December 2010. Thus, the Polish business has to apply the old rate of 22% on the amount payable.

D. Interim conclusions

From the examples described above, it becomes clear that the rules regarding tax points can be interpreted differently by country. Businesses carrying out business in a country that changes its VAT rate must be aware of these differences and of the anti-forestalling legislation in place in order to comply with the local rules. This might be especially relevant for businesses dealing regularly with prepayments and continuous supplies like businesses active in the telecom or building industry.

8 Article 64(2), EU VAT Directive 2006/112/EC.

9 Article 67, 68 and 69, EU VAT Directive 2006/112/EC.

Initially, VAT rate changes seem to be primarily an additional administrative burden for businesses. However, there may be some significant savings.

E. Turn a threat into an opportunity

Initially, VAT rate changes seem to be primarily an additional administrative burden for businesses. However, there may be also some significant savings.

As pointed out in the examples above, a supply made in a period when VAT rates are increased can still be taxed at the lower historic rate. In applying the tax point rules correctly, businesses and their customers can benefit from these rules. Businesses that cannot, or that can only partly recover their input VAT (e.g., insurance businesses, hospitals, or holding companies) might benefit from the application of the lower VAT rates. However, there are special rules in that the transactions must be in line with the normal commercial practice. Indeed, assessing the individual VAT position of the supplier and its customer in respect to the VAT rate increase can be seen as beneficial. Therefore, assessing the VAT position in the countries where VAT rates have recently increased is recommended.

Changes to the invoicing and accounting systems

Having noted the various VAT consequences of the rate increases, businesses should also make sure that all changes are properly managed in their accounting systems.

The key issue for businesses is to correctly record the VAT rate in the sales and purchase books and to correctly transmit this information to the VAT returns. Businesses must also ensure that the correct VAT rate is shown on the invoices it sends out and receives.

As described above, in the situation where there are two or more tax points created, the VAT position might not always be straightforward. If the payment is received or the invoice is sent out before the actual supply takes place, the accounting system must be able to identify the correct VAT rate to that specific transaction. Complexity is increased for businesses that operate internationally as these rules differ by country.

Another problem for businesses to tackle is the correct booking of credit invoices. In principal, the same rate must be shown on the credit invoice as on the original invoice. Our experience is that not every business is able to correctly embed this in its accounting system. Thus, it can lead to unnecessary losses when VAT percentages rise. This can be especially challenging for retail businesses when goods sold under warranty

are returned. Many businesses are not able to refund to their clients the price of the goods with the VAT rate applicable at the time the goods were sold. Businesses that are using an ERP system to manage their VAT position might consider performing a mapping of all possible new scenarios. As VAT is often embedded in different modules of the ERP system, it is crucial to review and update all impacted modules.

If businesses are not compliant, they risk VAT assessments and potentially penalties being imposed by the local tax authorities.

Changed VAT rates present challenges as well as potential opportunities

Regardless of whether business believes a US VAT is a constructive solution to today's fiscal deficits, companies are nonetheless making great strides in preparing for and addressing this tax regime. The "indirect tax" role is now a high priority of many US companies' tax departments. One clear complication for these indirect tax specialists is addressing the volatility of the tax rate. Throughout the world, it appears that there is very little political resistance to increasing the VAT rates. These increases are particularly burdensome on companies operating internationally. The amount of time necessary to identify and update invoice and accounting systems cannot be underestimated. Fortunately, there are opportunities to benefit from lower VAT rates by applying the correct tax point rules. We recommend that businesses review their current treatment of VAT rate changes to assess their impact on operations.

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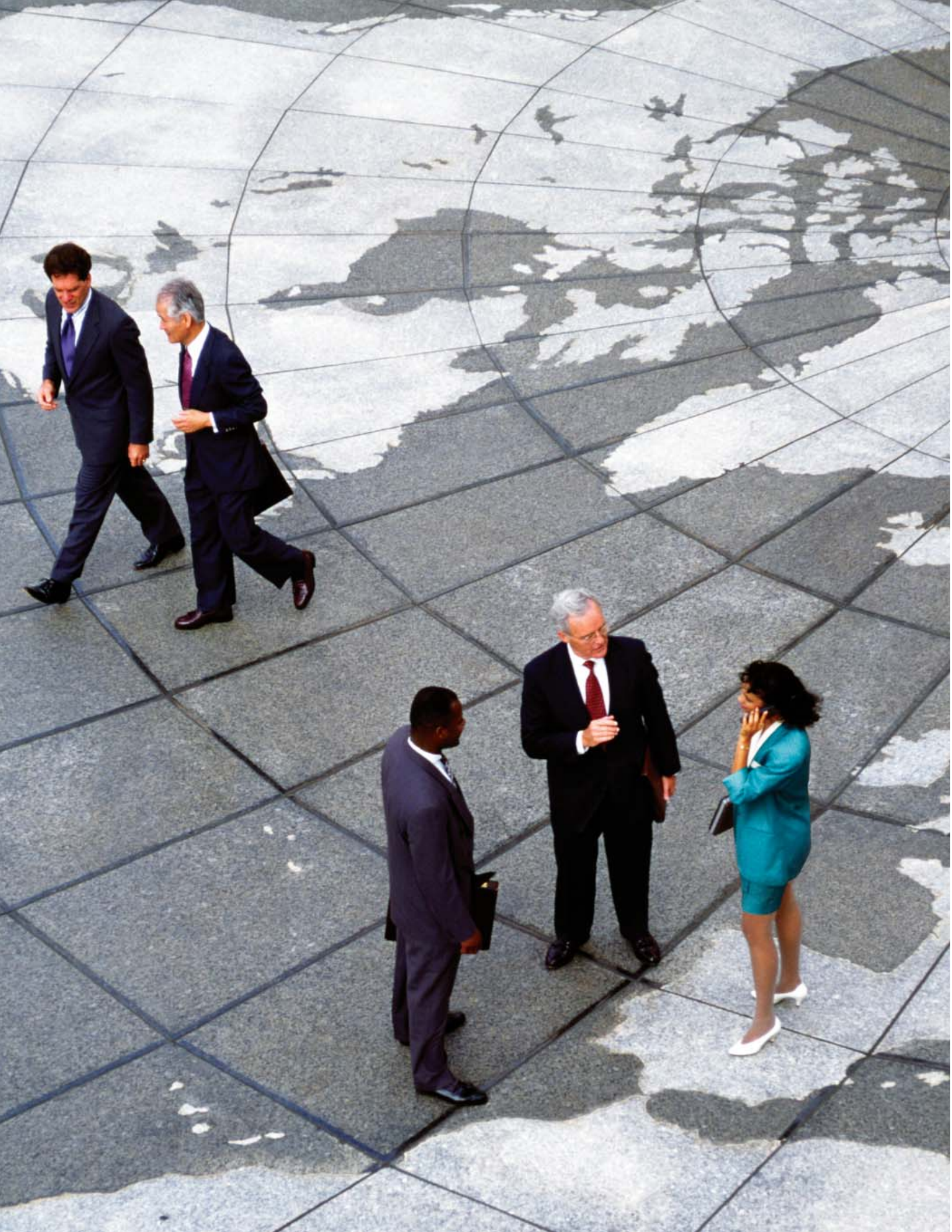

The global view: Business development incentives at home and abroad

In today's global economy, technological advances and instantaneous information flow allow companies to easily operate across borders around the globe. The need to rapidly expand operations and establish a presence in emerging economies is forcing companies to take a more global view of incentives. These technological advances and the need to operate in emerging economies have also changed the way governments deal with expansion and economic development incentives. What used to be a competition between states, local jurisdictions, and regions for jobs and capital investment has now become a global contest for economic development opportunities. In this article, we will discuss general trends in economic incentives and review several countries' and regions' incentives programs.

A primer on credits and incentives

For years, countries, states, and local jurisdictions have offered a number of inducements to companies willing to relocate or expand their operations. These inducements are as varied as the jurisdictions that offer them. In their simplest form, they include income tax credits for investments in capital assets used in a company's business or job creation credits for hiring within targeted employee groups. Over time, the variety and breadth of inducements has grown significantly. Tax benefits now include a wide array of industry- and activity-specific tax abatements, credits, sales and property tax exemptions,

What used to be a competition between states, local jurisdictions, and regions for jobs and capital investment has now become a global contest for economic development opportunities.

tax holidays, and rebates, as well as accelerated deductions for expenses incurred with respect to targeted business expansion or preferential apportionment methods (collectively referred to as "tax benefits"). Many of the credits can be carried over and used in future tax years or sold to unrelated companies, providing much needed cash flow for growing businesses.

In addition to tax benefits, other inducements often include loan enhancements, various cash grants, reduced utility rates and worker compensation insurance costs, site selection and preparation assistance, employee training and relocation support, and other financial incentives (collectively referred to as "economic incentives"). Some of the benefits are provided via specific statutory provisions while others are more discretionary in nature and, therefore, subject to negotiation with specific state and local agencies. As an added bonus, benefits received in the form of refundable tax credits and grants may qualify for an exclusion from taxable income for federal and state purposes; however, adjustments may be required to the basis of capital assets acquired using such grants.

While they are not financial incentives in the strict sense, other benefits with a positive impact on the bottom line include financially stable governments, effective trade agreements, business regulatory reform, an improved business climate, an educated workforce, sophisticated technology and telecommunication infrastructures, effective transportation networks and infrastructures, stable and supportive economy, protections from copyright and patent infringement, and more. A number of jurisdictions also market cultural and lifestyle benefits including art and music centers, parks and recreation improvements, and other quality of life enhancements.

Today's market realities

The economic downturn has spurred competition for targeted growth industries that are aligned with a jurisdiction's overall strategic development plan. This competition is evident in how aggressively country, state, and local economic development agencies pursue targeted industries and the range of support services provided to targeted companies. This "soup-to-nuts" approach offered by many jurisdictions brings together a variety of agencies to provide a coordinated approach to attracting target industries.

In offering a growing list of tax benefits and economic incentives, countries, states, and localities hope to spur job growth, encourage industry innovation, and maintain a stable economy for their residents. However, many countries, states, and localities have started to consider the cost of such inducements — treating them like any other expenditure and evaluating whether there is an alignment of objectives and outcomes; that is, does the tax benefit or economic

incentive serve its intended purpose and is the cost of the inducements in line with the ultimate outcome. With that said, numerous jurisdictions are embarking on a critical evaluation of existing tax benefits and economic incentive programs using a performance-based approach that may result in a dramatic change in how future programs are structured.

In implementing performance-based evaluation criteria, countries, states, and localities are behaving more like businesses as they weight business development options, such as site selection, to determine the financial feasibility of a specific economic development project. This evaluation requires the upfront identification and use of appropriate metrics to measure a projected return on investment, and a regular review of results to ensure ongoing viability of a project. New Jersey's Urban Transit Hub Credit has a performance requirement and is an excellent example of this approach. Specifically, a company must demonstrate to the New Jersey Economic Development Authority, at the time of application, that the state's financial support of the proposed capital investment in a qualified business facility will yield a net positive benefit to both the state and the eligible municipality before the credit is granted.

The following are examples of changes several state tax reform study commissions in the United States are proposing to their tax credits and incentives programs. It should be noted that the same analysis is being made at the country level around the world.

A study[1] by a Georgia tax reform commission published in January 2011 suggests that tax credits be evaluated using four specific criteria:

- If the objective of tax credits is to reduce taxes, then they should offset tax liability.
- If the objective is to provide an incentive for job creation, then the tax credit should be independent of whether the taxpayer has a tax liability.
- Target tax credits to the appropriate objectives and evaluate their effectiveness in achieving that objective.
- Ensure that tax credits create a net return to the state.

The Georgia study also suggests that the state views parity in individual and corporate tax rates as an incentive. Such parity would address the shift in recent years in the way business is done in today's economy—away from a corporate structure to a flow—through entity structure. Even more dramatically, the study suggests that the state eliminate all economic development credits in 2012 and create a fund with an annual dollar cap, that would allow the Georgia Department of Economic Development to attract new and existing companies considering locating or expanding in the state. The idea would be to allow the department to create two credits available to any company, large or small, existing or new to Georgia, based on the number of jobs created or the amount of capital invested. The study also calls for the elimination of all other tax credits by 2014.

A similar December 2010 study by the Connecticut Department of Economic and Community Development in consultation with the Connecticut Department of Revenue Services called for the elimination of several tax credits, property tax abatements, and exemptions because they have negative or very limited positive impacts, or have little or no participation. The report even calls into question the value of the enterprise zone program, which it says generates little economic and fiscal impact and may require municipal and state efforts disproportionate to their benefits. In an effort to set realistic expectations for the reader, the report assumes that there were more firms eligible for existing tax credits and abatement programs than those that claimed the tax credits and abatements during the period. Possible reasons for under utilization may include a decision not to take advantage of them because of the cost of applying or complying exceeded the benefits to the company.

In line with these studies, a November 2010 Missouri Tax Credit Review

1 2010 Special Council on Tax Reform and Fairness for Georgians, Final Report, January 7, 2011.

Commission study[2] recommended the elimination of 28 tax credit programs that had "outlived" their usefulness and did not create a justifiable benefit in relation to their cost to taxpayers. In addition, the study provides recommendations to improve the efficiency of 30 tax credit programs to provide a greater return on investment for taxpayers. It also recommends an annual cap on all programs to gain budget certainty and that the state develop a voluntary tax credit buyback or exchange of outstanding tax credits for less than face value to reduce the state's outstanding tax credit liability of $1 billion. Other recommendations include changes to state and federal laws to improve the efficiency and value of available tax credits. The study suggests that adoption of the recommendations would, among other things, better position the state to compete in the economy of today and the future.

Some jurisdictions have gone beyond thinking about limiting or ending tax benefit and economic incentive programs and put those ideas into action. For example, in an attempt to address its significant budget shortfall, the state of New York enacted a temporary deferral of certain tax credits for tax years beginning on or after January 1, 2010, and ending before January 1, 2013. The deferral applies to a range of investment, enterprise zone, employment, and environmental credits. A number of other states have proposed or enacted similar provisions to manage deficits. In addition, states are more aggressively enforcing and implementing clawback provisions in cases of noncompliance with program requirements.

Given the push for transparency in how tax benefits and economic incentives work, some states, including Massachusetts and Rhode Island, have enacted provisions that require public disclosure of the names of tax credit recipients, as well as the amounts and the types of tax credits received and the type of project involved. A similar 2010 proposal failed to pass in California. In his veto message to the legislature, Governor Schwarzenegger said the bill "inappropriately seeks to publish confidential tax information for no apparent benefit."

Even though countries, states, and localities remain concerned about the cost of tax benefit and economic incentive programs, many continue to promote their programs here and abroad, acknowledging the need to stay competitive. In doing so, the jurisdictions acknowledge the long history of how the programs are used as a catalyst for job creation and capital investment. Michigan, for example, heavily promotes its various economic development programs, citing its strategy to diversify and grow its economy and create jobs to compete in the global economy. Similarly, Ohio in 2010 announced that it awarded sizable loans and tax credits for various economic

2 Report of the Missouri Tax Credit Review Commission, November, 30, 2010.

Just as companies have relied on domestically available tax benefits and economic incentives to grow their businesses in the United States, now may be the time to consider the tax benefits and economic incentives available in emerging markets abroad and to take a more global view of business expansion.

development projects. Some believe that continuing to offer tax benefits and economic incentives may be a critical component of the economic recovery, which has stalled in part due to the failure of banks to lend much-needed cash, and the slow growth in consumer and government spending.

The economic recovery and the need to stay competitive in the global economy was the subject of a January 2011 PwC study, *The World in 2050*. The study discusses the accelerating shift of global economic power and the challenges and opportunities the shift may provide leading world economies. On the one hand, the study notes, competition from emerging market multinationals will increase steadily over time and the latter will move up the value chain in manufacturing and some services. At the same time, rapid growth in consumer markets in the major emerging economies associated with a rapidly growing middle class will provide great new opportunities for Western companies that can establish themselves in these markets. Establishing a presence in emerging markets includes a need to be on the ground with the appropriate facilities, which requires long-term vision and investment. Nonetheless, just as companies have relied on domestically available tax benefits and economic incentives to grow their businesses in the United States, now may be the time to consider the tax benefits and economic incentives available in emerging markets abroad and to take a more global view of business expansion.

The global view of competition for business development

While home may be where the heart is, it may not necessarily be the best place to look for future growth. Technological advancements allow for instantaneous communications and timely access to supply chains, making capital and resources more mobile. Just as important, today's global economy — and the ease with which companies operate across borders — means that investors can look beyond the confines of their existing locations when identifying where to expand operations. As a result, the competition for companies in targeted growth industries has moved into the global marketplace, with countries around the world vying for foreign investment.

The tax benefit and economic incentive structures here at home differ dramatically from the way business is done in Europe and other established and developing economies around the world.

In charting a growth strategy, companies must address a number of concerns, including the economic, political, and social makeup of a region. Sensitivity to cultural concerns is also an important component in any successful growth strategy. Just as important, companies must understand how any planned move to migrate or expand operations outside their residence may be perceived by investors, customers, and taxing authorities. Of course, the decision to migrate or expand operations may be lauded or reviled, depending on where you sit. A 2010 decision by a large candy manufacturer to move its European headquarters to Zurich from the United Kingdom provoked a massive public reaction. While company executives stated the move was for sound business purposes, many asserted that the move was motivated largely to take advantage of tax systems.

Similar finger pointing occurred when a large solar panel manufacturer based in Massachusetts announced it would move manufacturing operations to China and lay off 800 employees by the end of March 2011. Company representatives, while sympathetic to the impact on its current employees, stated that China offered a deal that could not be beat. In addition to labor cost savings of up to 95%, the company was able to borrow two-thirds of the funds needed to build its facility from two Chinese banks at an interest rate of less than 5%, with no interest or principal payments until 2015. The offer was much more attractive than the $21 million grant from Massachusetts, which only covered 5% of the costs of a new facility.

Companies must also consider how credits and incentive programs operate around the world. Just as in the United States, some programs are subject to statutory restrictions that establish clear guidelines for qualification. However, there are often a number of discretionary programs that require negotiation with designated representatives of a tax or economic development agency. Without a clear understanding of statutory requirements and discretionary program guidelines, companies will at best miss important opportunities. At worst, they may tie themselves up in unintended knots that limit future expansion.

What to look for in a global growth strategy

In the US, most tax benefits come in the form of tax credits. States operate independently from one another when it comes to granting tax benefits and economic incentives, which often results in significant competition between states.

The tax benefit and economic incentive structures here at home differ dramatically from the way business is done in Europe and other established and developing economies around the world.

For example, European Union member countries are subject to strict guidelines in providing state aid to companies expanding or migrating operations in a member country. In addition, unlike the focus on tax credits here at home, European Union member countries generally provide a mix of state aid including grants, cash or otherwise.

In regulating state aid within European Union member countries, the European Commission recognized that a company that receives government support obtains an advantage over its competitors, which may distort competition and affect trade between member states. Therefore, the European Commission generally prohibits state aid unless authorized by the commission. To ensure that this prohibition is respected and exemptions are applied equally across the European Union, the European Commission plays an important oversight role in assuring compliance with state aid rule grant guidelines. In regulating aid offered by member countries, the European Union hopes to avoid "the race to the bottom" — the term often used to describe the competition between jurisdictions here at home as they court business development.

While there is no precise definition for what constitutes state aid, such aid generally encompasses aid from state resources, selective aid favoring a particular undertaking, and aid affecting competition and trade between European Union member states. Examples of state aid may include cash grants from state bodies, including European Union funds; state loans and guarantees; interest and tax reliefs; tax-favored structures; government holdings of all or part of a company; or the provision of goods and services on preferential terms. Non-state aid — the type not subject to oversight of the European Commission — includes general measures that are not selective and apply to all companies regardless of their size, location, or sector. Examples include general taxation measures, infrastructure improvements of general benefit, or employment legislation.

In general, European governments are increasingly prioritizing state aid for high value-added investment projects that bring quality jobs, research and development investment, and improve the competitiveness of underperforming regions. Total state aid granted by European Union member states amounted to $388.6 billion in 2008, or 2.2% of the European Union's gross domestic product. More than 75% of that aid was allocated to industry, and Germany, France, Italy, and the UK granted more than 50% of the aid, excluding crisis grants. In recent years, the geographical coverage of qualifying regional incentive areas has reduced in Western Europe and increased in Eastern Europe. Much like in the US, there is an increasing trend in the EU to support initiatives dealing with research and development and innovation; safeguarding the environment; job training and development; and aid for small to mid-sized industries. In reference to small to mid-sized industries, a 2009 European Commission study notes that there are more than 23 million small to mid-sized enterprises in the EU, which represents 99% of European undertakings.

In line with the focus on grants, the study notes that access to financing is the biggest challenge to small to mid-sized companies. Investors historically shy away from financing start-ups or newer small to mid-sized companies given the risks involved. Those challenges, as the global financial markets take a harder look at start-up companies, has led the European Commission to develop additional ways to promote cash flow and reduce administrative burdens on startups. In providing appropriate financing

support along with structural improvements, small to mid-sized companies will fuel economic growth within the EU, the study suggests.

In general, EU state aid applicants must meet a range of criteria, including demonstrating why a grant is needed. In addition, while some EU grants tend to be focused on designated, disadvantaged regions and must comply with European Commission regulations, regional and national authorities have their own aid programs that address individual priorities in terms of the type of projects they support. However all state aid has to comply with state aid ceilings set by the European Commission regardless of whether the aid is financed from local, regional, national, or European community sources.

Keep in mind, not all countries on the continent are members of the European Union. For example, Switzerland is not subject to European Commission restrictions on granting incentives for business development. As a result, Switzerland has set a high bar for its neighboring countries. Based on recent guidance from the Greater Geneva-Berne Area Economic Development Agency, incentives may include state and local tax reductions or tax holidays, as well as contributions toward investment, training, and research and development programs. In addition, companies engaged in qualifying industrial and technological activities that meet certain investment thresholds may qualify for financial assistance for costs incurred in the identification, purchase, or leasing of industrial and commercial premises and research and development facilities. Targeted companies may also receive financial contributions of up to 30% of qualifying investments and costs, loan guarantees, and interest payment support. In a nod to help small to mid-sized companies expand their international markets, Switzerland also provides assistance with market-research studies, competitive analysis, and other surveys, as well as funding to participate in international business conventions and trade shows.

Other country incentives — a snapshot

The availability of tax benefits and economic incentives is not limited to the United States or European Union. For example, a recently released PwC study of global tax structures, Worldwide Tax Summaries 2010/2011, provides insight regarding the various tax benefits and economic incentives available around the world, including those in rapidly developing economies such as the BRIC countries[3], the E7 countries[4] or the N-11 countries[5].

Brazil, by far the largest and most populous country and one of the fastest growing economies in South America, provides just one example of the type of tax benefits and economic incentives available to target industries. Brazil offers a total or partial exemption from excise taxes, duties, and social contribution payments on imported goods and equipment used in certain approved investment projects. In addition, Brazil offers a range of regional incentives in the form of tax exemptions and reductions to encourage development in target areas. Capital investments may also qualify for sales and use tax exemptions and accelerated depreciation deductions, in addition to low-cost financing options. Furthermore, Brazilian corporate taxpayers can apply a percentage of their income tax liability to approved

3 The BRIC countries are comprised of Brazil, Russia, India, and the People's Republic of China.

4 E7 countries represent the seven major emerging world economies and are comprised of the People's Republic of China, India, Brazil, Mexico, Russia, Indonesia, and Turkey. The E7 countries are predicted to have larger economies than the G7 countries (i.e., United States, Japan, United Kingdom, Germany, France, Canada and Italy) by 2050.

5 The N-11, or Next Eleven, countries are comprised of Bangladesh, Egypt, Indonesia, Iran, Mexico, Nigeria, Pakistan, Philippines, South Korea, Turkey and Vietnam, which are viewed has having the potential, along with the BRICs, of becoming the world's largest economies in the 21st century.

capital investment projects, which may qualify for partial or full income tax exemptions.

Tax benefits and economic incentives currently available in the Russian Federation include a variety of regional incentives in the form of reduced primary and profit tax rates available to certain large investors or entities operating in specific industries. In addition, there are a number of incentives available in special economic zones to encourage technical research and implementation, industrial production, tourism and recreation, and ports. These incentives include a combination of reduced profits tax, property and land tax exemptions, as well as customs duty and value-added tax exemptions. There are also a number of activity-specific incentives, including a value-added tax exemption for certain research and development service offerings; bonus deductions for certain research and development service-related expenses; accelerated depreciation deductions with respect to fixed assets used in science and technology activities; and reduced rates for contribution payments to social funds for high technology activities. In addition to this, it is worth mentioning that the Russian tax legislation provides for special tax regimes to support small and medium-sized businesses.

India is another example of the competition for business expansion and development. Tax incentives are offered for new industrial undertakings in designated states and districts. Companies may qualify for a full or partial income tax exemption for up to 20 years. Another significant benefit is the ability to immediately expense the cost of qualifying capital expenditures. A number of tax incentive provisions require companies to comply with specific criteria with respect to the timing and threshold level of investment, as well as the need to comply with entity formation requirements. The current menu of tax incentives, as well as incentives such as land grants to support expanding operations, will likely allow India to become less dependent on outsourcing and more on manufacturing exports, building on it strong engineering skills and rising levels of education in the general population over the next decade.

China's corporate income tax law adopts a predominately industry-oriented, limited geography-based tax incentive policy. Tax incentive policies, which are applicable to domestic and foreign investments, mainly include industry-specific tax reductions, holidays, exemptions, investment tax credits, foreign tax credits, and preferential expensing of research and development costs. Based on the industry at issue, China may also provide assistance in locating, purchasing, and developing land on which to build operating facilities as well as providing below-market loans to build and expand operations.

Indonesia, an E7 country, provides qualifying businesses a deduction against net income for the cost of qualifying assets, an acceleration of depreciation deductions, extended net operating loss carry-forwards, and a reduced withholding tax on dividends paid to nonresidents. In addition, Indonesia may provide qualifying entities value-added tax and sales tax exclusions, and an exemption or postponement of import duties on qualifying capital assets, equipment, and processing materials. Indonesia also provides preferential tax treatment of qualifying tax-neutral mergers, consolidations, and business splits.

South Korea, an N-11 country, provides a variety of tax credits for qualified inbound investments in facilities for productivity enhancement, safety, and temporary investment, many of which can be carried forward up to five years. In addition, it provides tax credits for technology, labor, and human resource development. South Korea also provides tax credits for investments in energy-economizing facilities and environmental protection. In an effort to attract foreign investment, Korea provides various incentives and benefits under its Foreign Investment Promotion Law, including a state and local corporate income tax exemption for a stated number of years, as well as withholding tax, value-added tax, and special excise tax exemptions.

One country experiencing rapid economic growth but often excluded from the list of up-and-coming economies is South Africa, which provides eligible companies cash grants for projects designed to improve critical infrastructure, which may be exempt from tax. Based on the project, grants may be applied to the development of qualifying infrastructure, the costs of moving machinery and equipment from abroad, job training and development, or environmental improvements. In addition, South Africa provides incentives and accelerated depreciation for investments in venture capital companies. Incentives are also available for industrial exports. Those incentives are in line with recent studies by a variety of government agencies that cite the need to diversify its economy away from traditional commodities and nontradable goods and services to businesses that can successfully compete in export markets. In doing so, the studies suggest, South Africa will successfully address its most salient problem: low labor utilization.

What does it all mean?

As the competition for business development moves into the global market, companies in the US are well advised to keep a watchful eye on how federal, state, and local governments balance the pressure to limit tax benefit and economic incentive programs against the need to support business growth and job development. Just as important, companies need to stay informed about the types of programs offered outside the US by nations with a strong desire to be key players in the global economic recovery. Understanding the opportunities available requires a coordinated approach built on a global perspective that allows identification and evaluation of appropriate tax benefit and economic incentives programs.

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