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presents

80/20 Companies and Foreign-Source Income: State Treatment

Navigating States' Tests for Shielding Income and Claiming Deductions

A Live 110-Minute Teleconference/Webinar with Interactive Q&A

Today's panel features:

Joe Neff, National Managing Director, State and Local Tax, **RSM McGladrey**, Los Angeles

Mitchell Newmark, Of Counsel, **Morrison & Foerster**, New York

Pilar Mata, **Sutherland Asbill & Brennan**, Washington, D.C.

Thursday, October 21, 2010

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80/20 Companies And Foreign-Source Income: State Treatment Webinar

Oct. 21, 2010

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Today's Program

General Environment, State Treatment Of Foreign
Income Slides 6-30
(Pilar Mata, Mitchell Newmark)

State Treatment Of 80/20 Companies Slides 31-57
(Joe Neff, Mitchell Newmark, Pilar Mata)

General Environment, State Treatment Of Foreign Income

**Pilar Mata, Sutherland Asbill & Brennan
Mitchell Newmark, Morrison & Foerster**

Foreign Commerce Clause Restrictions On State Taxing Authority

- Foreign commerce clause is broader than the protection afforded to interstate commerce.
- Criteria
 - Activity has substantial nexus with the taxing state
 - Fairly apportioned
 - Does not discriminate against interstate commerce
 - Fairly related to services provided by the taxing state
 - Enhanced risk of multiple taxation
 - No impairment of federal uniformity; speak with “one voice”
Japan Line, Ltd. v. County of Los Angeles, 441 U.S. 434 (1979)

MTC Combined Reporting Group

- Domestic corporations
- Foreign unitary affiliates if:
 - Average of property, payroll and sales factors in the U.S. is greater or equal to 20%
 - Doing business in a tax haven country
 - DISCs/FISCs
- Foreign unitary affiliates
 - Subpart F income
 - U.S.-source income (without regard to federal treaties)
 - More than 20% of income from intangibles or services deductible against business income of other group members

Worldwide Combined Reporting

- Water's edge election must be made in at least five states: California, Idaho, Montana, North Dakota and Utah.
- Excluded entities
 - Only foreign-organized corporations (Alaska, California, Idaho, Minnesota, Utah, West Virginia)
 - Also, 80/20 companies (Colorado, Illinois, Indiana, Michigan, Montana, New Hampshire, North Dakota, Vermont, Wisconsin)
- Foreign corporations treated as U.S. branches for federal purposes generally included, except in Michigan, North Dakota and West Virginia

Source: CCH, *Multistate Corporate Income Tax Guide*, 2009

Worldwide Combined Reporting - Domestic Parent

- Worldwide combined reporting runs a *risk* of multiple taxation.
 - However, arm's length pricing does as well, because of different rules and applications.
 - Not appropriate to require the adoption of arm's length pricing when apportionment does not inevitably lead to double taxation
- Worldwide combined reporting does not run afoul of “one voice” requirement.
 - Various factors argue against potential retaliation.
 - Treaties do not apply to state tax systems.
 - Congress has considered, but failed to pass, legislation.

Container Corporation of America v. Franchise Tax Board, 463
U.S. 159 (1983)

Worldwide Combined Reporting - Foreign Parent

- Multiple taxation
 - Court dismissed proposition that foreign parent aggravated risk of double taxation because of inherently greater foreign operations
- One voice
 - Potential for retaliation was not persuasive
 - Congress has shown no specific evidence of intent to preempt.
 - Rejection of U.S.-U.K. tax treaty
 - Debate, but no enactment of legislation

Barclays Bank PLC v. Franchise Tax Board, 512 U.S. 298 (1994)

Worldwide Combined Reporting - Foreign Branch

- Taxpayer was a branch of a foreign parent operating in New York.
- Taxpayer filed on basis of U.S. income only and as a separate entity; NYS set up based on worldwide income
- Taxpayer alleged that worldwide combined reporting violated U.S.-U.K. treaty requiring equivalent treatment of foreign and domestic companies.
- N.Y. Court of Appeals held that taxpayer was treated the same as a domestic entity with a branch in N.Y.; no violation of the treaty
Reuters, Ltd. v. Tax Appeals Tribunal, 82 NY2d 112 (1994)

Foreign-Source Income

In re: Infosys Technologies (New York Tax Appeals Tribunal)

- Facts
 - Taxpayer was incorporated and headquartered in India and provided software development and consulting services around the world.
 - The Division asserted that the taxpayer should have included its worldwide income in its entire net income.
 - The taxpayer argued that inclusion of worldwide income was improper, and that the New York statute “is not intended to add back foreign source income of non-U.S. corporations.”
- Issue: Whether the taxpayer should have computed its ENI allocable to New York using only its effectively connected income, or rather based on its worldwide income.
- Holding
 - The Tax Appeals Tribunal upheld the ALJ’s determination that inclusion in entire net income of the taxpayer’s worldwide income was proper.
 - The TAT held that the statutory imposition of tax on worldwide income applies equally to foreign and domestic corporations.
 - The TAT rejected the taxpayer’s argument that inclusion of foreign source income in the entire net income of foreign corporations places an unconstitutional burden on interstate commerce.

Foreign Dividends – Water’s Edge

- Issue 1: Whether dividends paid by foreign corporations in a W/E setting should be eliminated under RTC §25106 or deducted under RTC § 24402
 - FTB applied LIFO approach to pro-rate dividends between §25106 and §24402.
 - Apple asserts that § 25106 and *Fujitsu v. FTB* (2004) mandate preferential ordering, and that all dividends should be eliminated.
- Issue 2: Whether interest expense deductions should be disallowed under §24425, where Apple’s dominant purpose for its borrowing was not to provide funds to the foreign dividend payors.
- On Jan. 26, 2010, trial court found in favor of FTB on Issue 1 and in favor of Apple on Issue 2. Case is on appeal.
- Impact on DRD under §24411 and proper application of foreign investment interest offset under §24344

Apple Inc. v. Franchise Tax Board, Cal. Ct. App. Case No. A128091 (pending)

Water's Edge Election

- Rules vary by state but generally exclude foreign affiliates from a combined report.
 - Which foreign entities are included/excluded
 - Whether foreign entity should include only U.S. source income
 - Whether 80/20 rule should include domestic entities
 - Effect on inter-company transactions between domestic and foreign affiliates
- California
 - Income and apportionment factors of unitary CFCs are included
 - Subpart F income over earnings and profits
 - Issues regarding extent to which Subpart F regime has been adopted (*Fujitsu v. Franchise Tax Board*)

Foreign-Based Entities

- Economic nexus
 - Assert jurisdiction to tax even absent any physical presence in the state
 - Focus on entities receiving royalties and other payments from the deployment of intangibles in the state
 - Expanded water's edge
 - Some states are requiring the inclusion of foreign entities receiving substantial U.S. source income in the water's edge group.
 - Foreign entity is likely not physically present in the taxing state.
 - Tax haven countries
- Source: Organization for International Investment

Treaty Protected Income

- Under OECD and U.S. Model Tax Treaty, a non-U.S. corporation generally is not subject to U.S. tax on business income derived in the United States, unless the income is attributable to a “permanent establishment in the United States.
- “Permanent establishment” varies by treaty but is generally defined as a facility, a construction site, or an agent of the non-U.S. entity with authority to enter into contracts.
- The standard for establishing nexus for state income tax purposes is lower than the standard for establishing a permanent establishment.

Foreign Entities Exempt From U.S. Tax

- Many states use federal taxable income as the starting point for determining the state tax base; result is that state tax liability is zero
 - *See, e.g.*, Ariz. Rev. Stat. §43-1101
- Other states use worldwide income as the starting point for determining state tax base; result is that there is state tax liability even though no federal tax liability
 - *See, e.g.*, N.Y. Tax Law §208(9)(c)

Foreign Entities Exempt From U.S. Tax (Cont.)

- Policy considerations
 - Subjecting a treaty protected taxpayer to state income tax undermines, in part, the benefit of a treaty.
 - Many non-U.S. companies are not aware of the state tax exposure.
 - Most states do not seek to audit treaty-protected entities.
 - Increase in combined reporting states may increase number of controversies

Foreign Dividends

- Most states, with the exception of Oklahoma and Vermont, provide some form of relief via a dividends-received deduction or other modification for foreign dividends.

Foreign Dividends – Inclusion In Tax Base

- Multiple taxation
 - Concern is taxation by multiple states
 - Court indicated that it could not control such issues, but chose not to intervene
- One voice
 - Taxpayer had framed issue as multiple taxation
 - Congress had not spoken
- Apportioned share of dividends from unitary foreign subsidiaries may be included in state tax base
 - “Linchpin of apportionability ... is the unitary business principle”
 - Stevens dissent regarding factor representation

Mobil Oil Corp. v. Commissioner of Taxes, 445 U.S. 425 (1980)

Foreign Dividends - Discrimination

- Alleged discrimination against foreign commerce
 - Single-entity state with federal conformity
 - Domestic dividends entitled to dividends-received deduction; foreign dividends were not
- State scheme struck down as facially discriminatory
 - Issue was interstate commerce, not Iowa/foreign commerce
 - Conformity and administrative convenience were not a defense.
- Led to rejection of similar approaches in Rhode Island, Minnesota, Ohio and New Mexico; states amended statutes to allow deduction for foreign dividends

Kraft General Foods, Inc. v. Iowa Department of Revenue, 505 U.S. 71 (1992)

Foreign Dividends - Water's Edge

- Several states brought cases involving water's edge combination with taxation of foreign dividends.
 - *Appeal of Morton Thiokol*, 864 P2d 1175 (Kan. Sup. Ct. 1993)
 - *E.I. DuPont de Nemours v. State Tax Assessor*, 675 A2d 82 (Maine Sup. Ct. 1996)
 - *General Electric Co. v. Dep't of Revenue Administration*, No. 2005-668 (N.H. Sup. Ct. 2006)

Foreign Dividends - Factor Relief

- Not required to meet constitutional requirements and will not save a facially discriminatory scheme
 - *Conoco, Inc. v. Tax. & Rev. Dep't*, 931 P.2d 730 (N.M. Sup. Ct. 1996)
 - *NCR Corp. v. Tax. & Rev. Dep't*, 856 P.2d (N.M. Ct. App. 1993)
 - *NCR Corp. v. Comm'r of Rev.*, 438 N.W.2d 86 (Minn. Sup. Ct. 1989)
 - *NCR Corp. v. Tax Comm'n*, 439 S.E.2d 254 (S.C. Sup. Ct. 1993)
 - *Caterpillar, Inc. v. Comm'r of Rev.*, 568 N.W.2d 695 (Minn. Sup. Ct. 1997)
 - *Unisys Corp. v. Commonwealth*, 812 A.2d 448 (Pa. Sup. Ct. 2002)

Dividends From Foreign Entities

Colgate Palmolive (Florida District Court)

- Taxpayer conducted business worldwide and received significant dividends from foreign subsidiaries.
- Issue: Whether Florida's limitation of net operating loss carryovers to losses generated by deductions, and not to foreign tax credits, was discriminatory
- Holding
 - The tax scheme was not discriminatory.
 - The court reasoned that taxpayers choosing to deduct foreign taxes, rather than taking the tax credit, could carry over losses created by these deductions.
 - The court noted that foreign-source dividends are not included in income for Florida purposes.

Expenses Paid To Foreign Entities

- Royalties and interest paid to foreign entities
 - Nexus
 - Addbacks
 - Deduction disallowance
 - Price adjustments
- Service payments to foreign entities
 - Deduction disallowance
 - Price adjustments

Addback Statutes

- Addback statutes disallow otherwise allowable deductions for intangible expenses paid to affiliates; sometimes for interest payments, management fees and rental expense
- Common exceptions include:
 - Recipient subject to tax on income in excess of a benchmark rate
 - Recipient is in a foreign country with a U.S. income tax treaty.
 - Specific industry exceptions
 - Recipient is a conduit for payment to third parties.
 - Parties elect to file on a combined basis.
 - Unreasonable exception

General “Subject to Tax” Addback Challenge

- Should a state be permitted to disallow an otherwise allowable deduction simply because the recipient operates in a state with a favorable tax regime?
- Examples
 - Delaware’s policy of lowering tax rate on investment income
 - Nevada’s policy of not taxing corporate income
 - California’s policy of requiring combined reports and eliminating intercompany income

Maryland Addback Statute: Foreign Commerce Clause Challenge

- Original addback statute (effective for tax years beginning after 12/31/03) provided exception for payments made to related members subject to tax by Maryland or another state, but did not provide exception if related member was subject to tax by a foreign nation
- Maryland thereafter amended the add-back statute to include exception for payments subject to foreign tax, but the amendment was effective for tax years beginning after 12/31/04
- Therefore, one-year window (2004) where exception provided for payments made to domestic affiliates, but not to foreign affiliates

Foreign Treaty Addback Challenge

- Many states have enacted “subject to tax” exceptions that apply to payments subject to tax by a foreign nation that has an income tax treaty with the United States.
 - *See, e.g.*, Ala. Code §40-18-35; Ark. Code § 26-51-423; Conn. Gen. Stat. §12-218d; D.C. Code §47-1803.03; Ga. Code §48-7-28.3; Mass. Gen. Laws § 31K; Md. Code Tax Gen. § 10-306.1; Mich. Comp. Laws § 208.1201; N.J. Stat. §54:10A-4.4; N.Y. Tax Law § 208; N.C. Gen. Stat. §105-130.7A; Va. Code §58.1-402; W. Va. Code §11-24-4b.
- Should a state be permitted to disallow an otherwise allowable deduction simply because the recipient operates in a foreign nation that does not have a tax treaty with the United States, if the recipient is taxed on that income?

State Treatment Of 80-20 Companies

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State Corporate Income Taxation

- Philosophical dichotomy with respect to state taxation of corporate income
 - Separate reporting
 - Combined reporting

Taxation Of 80/20 Domestic Companies In Separate Reporting States

- Characterization of a domestic entity as an 80/20 company has no effect in separate reporting states.

Variation In Treatment Of 80/20 Companies In Combined Reporting States

- The income and apportionment of domestic (incorporated in U.S.) 80/20 companies are included in water's edge report. *E.g.: California*
- The income and apportionment of companies that maintain less than 20% of their property and payroll within the U.S., regardless of country of incorporation, are excluded from a water's edge group. *E.g.: Alaska, Arizona, Colorado, Illinois, Minnesota, Montana, New Hampshire, North Dakota and Utah.*
- Treatment depends on country of organization and type of income. *E.g.: Wisconsin*

Domestic 80/20 Companies Included In Water's Edge Group: California

- California Revenue and Taxation Code Sect. 25110 allows a water's edge election, whereby any member of the unitary group which is incorporated outside the U.S. and which has a U.S. apportionment factor (as measured by property, payroll and sales within and without the U.S.) of less than 20% is excluded from the combined report.
- Domestic 80/20 companies included per Sect. 25110(a)(3)

California: Inbound Dividends

- From domestic 80/20 company: 100% dividends-received deduction per CRTC Sect. 25106, as 80/20 company is included in water's edge return.
- From foreign 80/20 company: 75% dividends-received deduction per CRTC Sect. 24111, if entire income of 80/20 company is excluded from water's edge return.

California: Inbound Dividends (Cont.)

- From foreign 80/20 company, some portion of whose income and apportionment factor are included in water's edge return: Per *Appeal of Apple Computer**, a California Board of Equalization decision, the portion of the dividend related to income included in water's edge return is subject to a 100% dividends-received deduction, with the remainder subject to the 75% deduction per CRTC Sect. 244.

* Currently under litigation at Superior Court level

Domestic 80/20 Companies Excluded From Water's Edge Group: Illinois

- Illinois Compiled Statutes, Sect. 35 ILCS 5/1501(a)(27) excludes from the definition of a “unitary business group” any member whose business activity outside the U.S. is 80% or more of such member’s total business activity *as measured by the standard payroll and property factors prescribed.*

Domestic 80/20 Companies Excluded From Water's Edge Group: Illinois (Cont.)

- Illinois has taken administrative, judicial and legislative measures to counter tax planning involving sham 80/20 companies
 - Illinois: In *Shaklee Corporation v. Department of Revenue* (298 Ill. App. 3d 1165), ruling was that a company without any measurable business activity does not meet the definition of an 80/20 company despite meeting the technical definition (i.e., less than 20% of its property and payroll are outside the U.S.).
 - Intangible expenses paid to an excluded 80/20 company are only partially deductible (Illinois Public Act 93-0840).

Domestic 80/20 Companies Excluded From Water's Edge Group: Illinois (Cont)

- Reg. 100.2430: “For taxable years ending on or after December 31, 2004, IITA Section 203 requires a taxpayer, in computing base income, to *add back* deductions allowed in computing federal taxable income or adjusted gross income for *interest expenses and intangible expenses incurred in transactions with a person who would be a member of a unitary business group with the taxpayer, if not for the 80-20 test.*”
- The addback provisions apply to interest expense and intangibles expenses in excess of dividends received from 80/20 companies.

Wisconsin

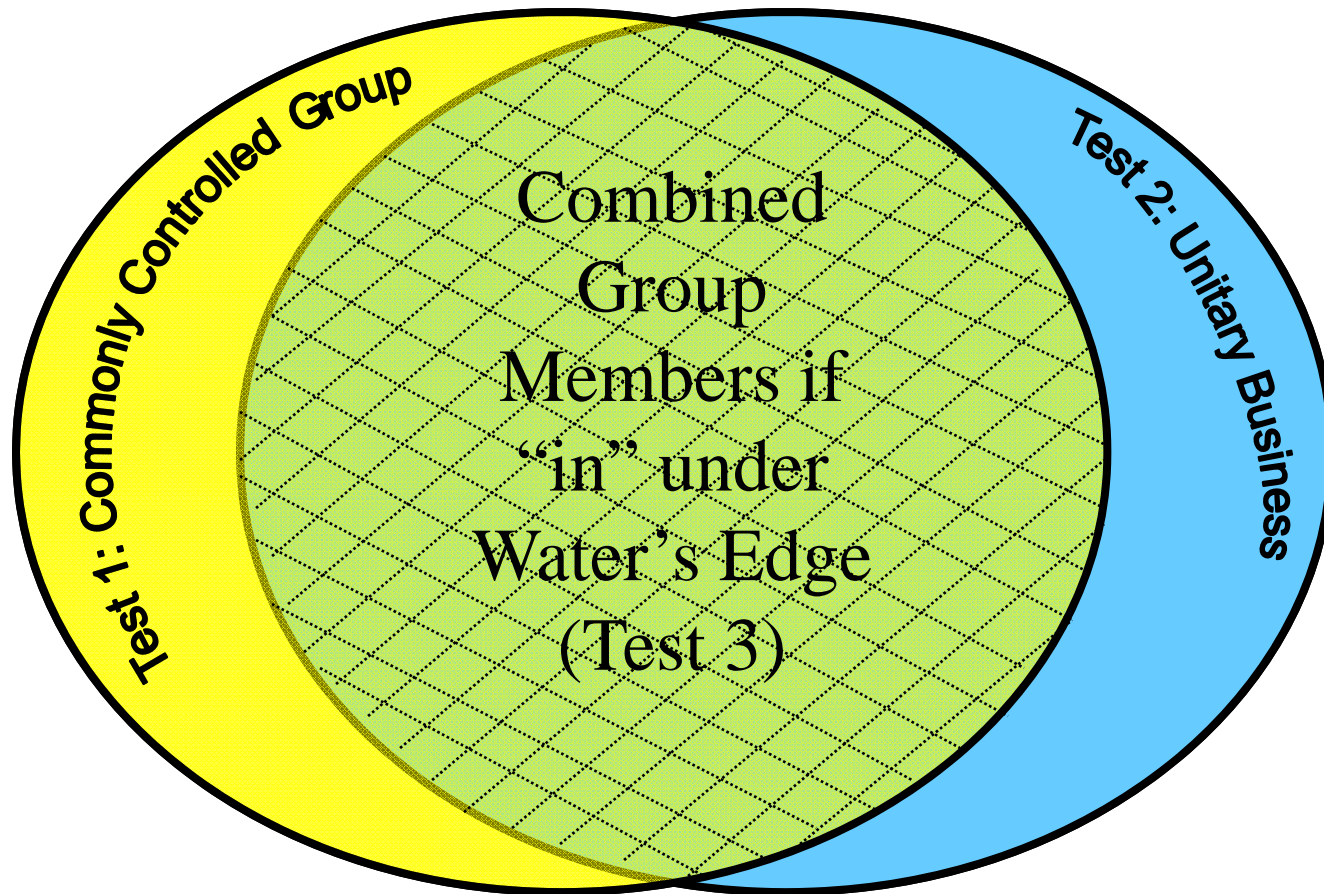
- *Effective date:* Tax years beginning on or after Jan. 1, 2009
- *Members of unitary group to be included*
- **Default:** *All unitary income* and apportionment *of domestic members* of a commonly controlled group and *foreign corporations with more than 20% of property, payroll and sales in the U.S. must be included*
- U.S.-source income (as defined by IRC sections 861-865) of foreign corporations shall be included in the measure of income.

Wisconsin (Cont.)

- **Corporations must use combined reporting if three tests are met:**
 - **Test 1:** The corporations are part of a *commonly controlled group* of corporations.
 - **Test 2:** The corporation and at least one other member of the commonly controlled group are engaged in a *unitary business*, (unless the group chooses to make a controlled group election).
 - **Test 3:** The corporation meets the “*water’s edge*” test.

Wisconsin MUCR

Summary Of Tests 1 And 2



Wisconsin MUCR

Test 3

- *Test 3: The corporation meets the “water’s edge” test.*
- The “water’s edge” test determines whether a foreign corporation is includable in a combined report.
- The water’s edge test also determines whether any of a domestic corporation’s foreign-source income is includable in the combined report.

Wisconsin MUCR

Test 3 (Cont.)

- *Test 3: The corporation meets the “water’s edge” test.*
- A corporation meets the water’s edge test if less than 80% of its worldwide income is “active foreign business income,” as defined in Sect. 861 of the Internal Revenue Code.
- **“Active foreign business income” is income which is:**
 - Derived from non-U.S. sources, and
 - Attributable to the active conduct of a trade or business by a corporation (or its subsidiary) in a foreign country or possession of the U.S.

Wisconsin MUCR

Test 3: Criteria

Criterion one: Whether the corporation is foreign or domestic

Criterion two: Whether the corporation is an 80/20 corporation

Criterion three: Sourcing of the corporation's income as either foreign-source or U.S.-source

Wisconsin MUCR

Test 3: Criterion One

- ❑ *Whether the corporation is foreign or domestic*
 - Generally based on where the corporation was incorporated or organized
 - If an entity is organized in a foreign country and is recognized in that country as a corporation, but the entity's owner elects to treat it as a branch or disregarded entity for U.S. purposes, then it is treated as a branch of its owner rather than as a separate foreign corporation.
 - A foreign corporation that is also an 80/20 corporation is considered domestic if it elects to be included in a federal consolidated return.

Wisconsin MUCR

Test 3: Criterion Two

- *“80/20” status of corporation*
- A corporation is considered an 80/20 corporation if 80% or more of its worldwide gross income during its taxable year is “active foreign business income,” as defined in Sect. 861(c)(1)(B) of the Internal Revenue Code.
- A disregarded entity’s active foreign business income and worldwide income must be combined with those of its owner.

Who Is In The Group Under The Water's Edge Test So Far ...

(Assumes Test 1 and Test 2 are already met)

Is it an 80/20 corporation?

		<u>Not 80/20</u>	80/20
Is it foreign or domestic?	Domestic Corporation	In	Depends
	Foreign Corporation	In	Out

Wisconsin MUCR

Test 3: Criterion Three

- ❑ *Sourcing of the corporation's income as either foreign-source or U.S.-source*
 - Foreign-source vs. U.S.-source is determined by sections 861 – 865 of the Internal Revenue Code.
 - All income that is “effectively connected” with conducting a trade or business within the U.S. is considered U.S.-source.
 - “Effectively connected income” can still be “active foreign business income” for purposes of the 80/20 test, to the extent not inconsistent with Internal Revenue Code.

Wisconsin MUCR

Application Of Sourcing Rules

	<u>Not 80/20</u>	80/20
Domestic Corporation	<p>What's "in":</p> <p>U.S.-source items Foreign-source items</p>	<p>What's "in":</p> <p>Only items that are <u>both</u>: U.S.-source*, and specifically listed in 71.255(2)(d)</p>
Foreign Corporation	<p>What's "in":</p> <p>U.S.-source* items only</p>	<p>(All items excluded)</p>

Effects Of Newly Enacted Federal Legislation On State 80/20 Tax Treatment

- California: New legislation should have no effect, as income and apportionment of domestic 80/20 companies are included in combined report.
- Illinois: New legislation should have no effect, as exclusion of 80/20 company income is independent of federal treatment of income.

Effects Of Newly Enacted Federal Legislation On State 80/20 Tax Treatment (Cont.)

- Wisconsin: Tax effect is not as clear, as exclusion of entity and type of income are in reference to sections of the Internal Revenue Code amended by Public Law 111-226. State has not as of yet addressed its position on the effect(s) of the federal changes on the income and apportionment of a unitary group.

Judicial Decision - 80/20 Classification

Zebra Technologies (Illinois Appellate Court)

- Facts
 - Taxpayer owned two subsidiaries that were located in Bermuda and were responsible for managing and licensing IP domestically and internationally.
 - The subsidiaries rented office space, purchased a computer for \$1,000 and employed a person in Bermuda to manage their affairs.
- Issue: Whether taxpayer demonstrated that the Bermuda subsidiaries were 80/20 companies
- Holding
 - The taxpayer failed to meet its burden.
 - Substantial business activity was conducted on behalf of the Bermuda subsidiaries in the U.S. related to quality control and management of the intellectual property, and it was not paid for by the Bermuda subsidiaries.
 - The court held that the taxpayer knew and could have computed the amount of this activity in order to prove its case.

Judicial Decision - Dividends From 80/20

Amerada Hess (North Dakota Supreme Court)

- Facts
 - Amerada Hess owned an 80/20 company from which it received dividends.
 - By statute, 80/20 companies were specifically excluded from the water's edge combined group; however, 60% (30% in later years) of the 80/20 company's net book income was included in the income of the water's edge combined group.
 - By regulation, transactions between a member of the combined group and an affiliated corporation that had been excluded from the group were excluded in computing income.
- Issue: Whether double taxation resulted from the department's assertion that the income from the 80/20 company be included in the water's edge combined group income, and that dividends from the 80/20 company that were eliminated in Amerada's consolidated federal tax return be added back to income
- Holding
 - The commissioner's assessment, though arguably unfair, was in accordance with North Dakota law and was not unconstitutional because there were "two separate entities being taxed on income derived from two separate events ..."

Implementation - 80/20 Companies

Sales factor

- Varying methodologies – Differences in state rules for sales factor computation may result in an entity being classified differently for 80/20 purposes, from state to state.
- State sourcing (sales of intangibles or services) may result in different classifications .
 - Cost of performance
 - Preponderance v. proportional
 - Consider the “income-producing activity”
 - *Ameritech Publishing* (Wisconsin Court of Appeals)
 - Market-based sourcing

Implementation – Alternative Apportionment

Alternative apportionment

- Sales factor
 - States are using alternative apportionment to modify taxpayer's sales factor, even where taxpayers have filed in accordance with statute
 - *Bell South* (Tennessee Court of Appeals)
- Payroll factor
 - Attribution of employees of one corporation to another corporation
 - Attribution of employees is typically based on the right to direct and control the activities of the individual, rather than who pays the individual
 - 20 NYCRR §4-5.2
 - *Phillip Morris* (Missouri Supreme Court)
 - *Cincinnati, New Orleans and Texas Pacific Railway* (Kentucky Court of Appeals)
 - An alternative payroll factor, e.g., based on billable person days, could remedy the effect of the disparity of wages in different countries.
 - *Infosys Technologies* (New York State Tax Appeals Tribunal)