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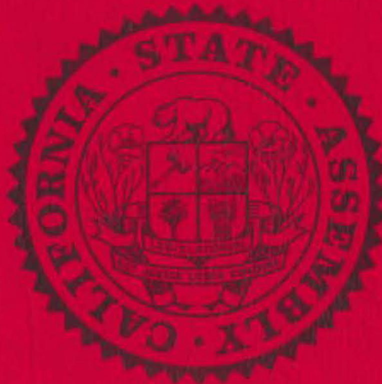
CALIFORNIA'S BANK AND CORPORATION TAX

VOL. VI

UNITARY METHOD OF APPORTIONMENT:

NEW DEVELOPMENTS



A Briefing Book
Prepared by Staff of the

ASSEMBLY REVENUE AND TAXATION COMMITTEE

WADIE P. DEDDEH
Chairman

for
COMMITTEE INTERIM HEARING

December 16, 1981

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PREFACE

This briefing book on the unitary method of apportionment has been prepared for use by Committee members and other interested parties in connection with the hearing of the Assembly Committee on Revenue and Taxation in Sacramento on December 16, 1981.

The objectives of the book are two-fold:

1) to provide a brief background on the subject, particularly for new Committee members and others who have not attended Committee hearings on this subject in the past, and
2) to review 1981 developments as they relate to this issue.

For further background information, the reader is referred to earlier reports of this Committee: California's Bank & Corporation Tax, Vol. II: Unitary Method of Apportionment, 496 pp., Nov. 1979 (Publication #750); Unitary Method of Apportionment: A Second Look, 71 pp., Nov. 1980 (Publication #810). They may be purchased by contacting the Assembly Publications Office, P.O. Box 90, State Capitol, Sacramento 95814.

This briefing book was prepared by David Doerr, Chief Consultant to the Assembly Revenue and Taxation Committee.

UNITARY METHOD OF APPORTIONMENT:

NEW DEVELOPMENTS

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UNITARY METHOD OF APPORTIONMENT: NEW DEVELOPMENTS

POLICY ISSUES

ISSUE

California uses the unitary method of apportionment, with world-wide combination, to determine that portion of the income of multistate and multinational corporations which is subject to tax by California. Should California's application of the unitary method of apportionment be revised? If so, to what extent?

QUESTIONS

1. Is world-wide combination, as part of the unitary method of allocating income, the best way to determine the amount of income of multinational corporations which is subject to taxation by California?

2. What are the alternatives to world-wide combination? What are the advantages and disadvantages of these alternatives?

3. Are there unique differences between foreign-based corporations (and subsidiaries thereof) and domestic corporations? Should there be a difference in the formula for foreign-based corporations? If so, should there be further distinctions by industry groups? For example, should foreign-based energy companies, steel companies, and owners of agricultural lands (or their subsidiaries) continue to be subject to world-wide combination in the same manner as their domestic counterparts?

4. What are the fiscal ramifications of the various alternatives? If there is a revenue shortfall, to whom should the tax burden be shifted?

5. What are the potential economic effects of maintaining current law and of the various alternatives to current law?

BACKGROUND

The term "unitary method of apportionment" (sometimes referred to as "unitary tax", which is a misnomer) refers to the method used by California to determine state taxable income of multistate and multinational corporations which do business in California. The term "unitary" is used to indicate that the entire operations of such a corporation are treated as a single unit and the income is allocated or apportioned by formula, rather than accounted for separately by operation or location.

The unitary method of apportioning income to California for purposes of the Bank and Corporation tax has generated substantial controversy in recent years. The application of the unitary method to the "world-wide" income of multinational corporations has been the most significant area of disagreement between state tax officials and the business community. World-wide combination is the inclusion in the computation of the California tax return "world-wide" information from the corporations comprising the unitary business with respect to profits, property, payroll and sales. California taxes its share of world-wide profits depending on its percentage of world-wide property, payroll and sales.

Present Law

The California franchise or income tax applies only to that portion of a corporation's total net income that is "derived from or attributable to sources within this state".

All corporations, whether created or organized in a foreign country or in the United States, are now treated

similarly under unitary apportionment principles applied by California.

Where a corporation or group of related corporations operates both within and outside of California, the Franchise Tax Board first determines which corporate or intercorporate activities are sufficiently related to be included in the corporate taxpayer's unitary business income base. The "business income" of such unitary operations is then apportioned by formula, by determining the total "world-wide" income of the unitary business and then apportioning a share to California based on a three-factor apportionment formula.

Case law has cited Section 25101 of the Revenue and Taxation Code as the controlling statute in this area:

> "When the income of a taxpayer subject to the tax imposed under this part is derived from or attributed to sources both within and without the state, the tax shall be measured by the net income derived from or attributed to sources within this state in accordance with the provisions of Article 2..."

Article 2 of the Revenue and Taxation Code, the Uniform Division of Income for Tax Purposes Act (UDITPA), provides guidelines to be used by the Franchise Tax Board (FTB) in allocating income by formula. (For text of UDITPA, see Appendix I, yellow pages).

Section 25137 permits variation from the standard allocation and apportionment provisions when they do not fairly represent the extent of the taxpayer's business activity in this state.

How the Unitary Concept is Applied

When the FTB determines that the business conducted both within and without California is unitary, the portion of the business income from that unitary business which is "derived from or attributable to sources within this state" is determined by formula apportionment. This approach is followed where the unitary business is conducted by a single corporation or by separate corporations under common ownership or control.

In determining whether a single corporation with operations within and without California is engaged in a unitary business, or whether a group of separate corporations within and without California is required to determine its income by use of a "combined report", the geographic locations of the corporate business activities are immaterial. Foreign sources as well as domestic sources of income are all taken into account. Then an apportionment formula is applied to determine the amount of income derived from California sources.

The FTB uses an arithmetic average of three factors to allocate unitary business income in California. The three factors are property, payroll and sales.

California property, payroll and sales as a percent of world-wide property, payroll and sales is computed. The average of the three ratios is then applied to "world-wide" income to determine the share of income of the unitary business which is apportioned to California. It is to this income figure that the California corporation tax rate is applied.

Although this formula will result in distortions in many cases, the courts have repeatedly ruled that the formula need not be precise and that a rough approximation is sufficient.

For some businesses, there are special formulas and exceptions to the general apportionment formula.

The following example of a mythical corporation shows the application of the three-factor formula:

EXAMPLE -- MYTHICAL CORPORATION

	In California	Total - all over the world	% Calif. to world
Sales	$1,000,000	$20,000,000	5%
Property	4,000,000	40,000,000	10%
Payroll	2,000,000	10,000,000	20%
Average			11.6666%

Total world-wide income of corp. $5,000,000

Income allocable to California:

World-wide income of corp.	$5,000,000
Unitary apportionment factor	x 11.6666%
	$ 583,300

California Tax:

California Income	$ 583,300
Bank & Corp tax rate	x 9.6%
TAX	$ 55,997

Non-Business Income

Income derived from unitary business operations is apportioned by formula. Other "nonbusiness" income, i.e., income attributable to intangible assets or to other property not related to the principal or unitary business (including

dividends, interest, rents and royalties) is allocated entirely to the taxpayer's commercial domicile, i.e., the "headquarters" office. (This issue is now on appeal with the State Board of Equalization.)

Interest expense also affects the taxability of dividend and interest income. In general, under Section 24344(b) interest expense is allowed as a deduction against business interest income subject to apportionment. Additional interest expense is deductible against nonbusiness interest and dividend income by the amount of their interest expense. Corporations which are not commercially domiciled in this state must reduce their interest expense by an amount equivalent to their non-business interest and dividend income which would have been reportable if their commercial domicile had been in this state.

Rationale For Unitary Apportionment

The unitary method was developed early in the history of state taxation of corporate income. Originally it applied mainly to corporations with operations in several states of the U.S. It was believed that such corporations could manipulate their internal accounts in such a way as to shift profits earned in California or another high tax state to a state with low or no taxes on corporate income. As multinational corporations became more common, the same principle was applied to them.

This method assumes that the income of certain corporations with multiple operations or facilities cannot be accurately assigned to a specific location.

For example, the income of a firm which manufactures components in one state, assembles the components into a finished product in a second state, and markets the product on a nationwide or regional basis is treated on a unitary basis. Under this concept the total income is treated as a single unit and no attempt is made to determine specifically what portions of the income were derived from component manufacturing or assembly.

The Alternative To The Unitary Tax

The main alternative to the present "world-wide combination" suggested by its opponents is to rely upon the "separate accounting" method. This method would allow the California operations of a multistate or multinational corporation to continue to be treated as a unitary business *within* the U.S. but such firms would be required to conduct intercompany transactions with *overseas* branches of their parent firm at prices reflecting fair market value. Audits of such firms would be conducted to ensure that such intercompany transactions were conducted "at arms length" and not used to avoid taxes on California profits. The federal government currently uses this system for purposes of the federal corporate income tax.

Arguments In Favor Of The Unitary Method Of Apportionment

Supporters of the unitary method argue that, while the concept may be somewhat arbitrary, and the three-factor formula may produce some distortions in profits taxed by California, in general the system works fairly to tax the complex and interconnected operations of multistate and multinational corporation. The alternative to the unitary system--the separate accounting method--would require the taxpaying corporation to provide a set of records reflecting the "arms length" transactions among subsidiaries. Since the California subsidiary is part of a multinational or multistate corporation, an assumption of "arms length" transactions with other parts of the parent firm may be at least as arbitrary as the assumption underlying the unitary method. In addition, supporters argue that while audits of the unitary apportionment rely on such things as payrolls, sales and property values which can be measured in the market place, the use of "arms length" pricing relies upon values for transactions where there may be no corresponding free market. Such audits, they argue, may be more onerous than current unitary method audits.

They further argue that separate accounting is not working well at the federal level and would be impossible for a state to enforce without an army of auditors.

Finally, supporters of the unitary method argue that total repeal of the unitary methodology may result in a large revenue loss to California.

Arguments Against the Unitary Method of Apportionment

Opponents of the unitary method of apportionment argue that:

--The three-factor formula is based on the questionable assumption that property, sales and payrolls produce equal profits in all parts of the world. This may not be true, particularly for investments in foreign economies that differ markedly from the U.S. If profits are relatively higher in California, the unitary system exports profits and produces a lower California tax. If profits are relatively lower in California, the unitary system credits California with profits earned elsewhere and subjects them to California tax.

--Calculation of the payroll,sales, and property factors and the need to prepare consolidated earnings statements impose unreasonable record-keeping burdens on foreign corporations.

--The unitary system may discourage investment in new plants in California because any investment in California payrolls, sales or property will, under the unitary system, cause some part of U.S. or worldwide profits to be taxed by California even though the California operations of the firm suffer a loss. (However, the unitary system may encourage investments in California in circumstances where the relative profits earned in California are larger than the relative property, payroll and sales in California created by the investment. In these situations, such investments will reduce California tax liability.)

--The California method may lead to international double-taxation of profits and frustrate efforts to coordinate national taxing systems. This issue arose during consideration of the U.S.- United Kingdom tax treaty which would have banned California's unitary system. Several multinational firms have expressed the desire for California to abolish its unitary tax because some less developed "Third World" countries may seek to copy this system.

--The major objections appear to be to the use of "world-wide" combination and the inclusion of foreign income and factors in the computation, rather than to the "unitary method of apportionment" in total.

--Foreign domiciled businesses cite additonal special problems, such as:

- in many foreign countries, historical cost data are not kept, making accurate computations of the property factor difficult
- accounting procedures are often not uniform
- there are problems in foreign exchange rates
- some countries have imposed currency controls
- in some cases, information requested by the FTB violates foreign laws regarding confidentiality, sometimes involving defense secrets of another country
- the apportionment factors do not adjust for cultural differences in employment in foreign countries, which affect calculations of value.

Fiscal Implications

According to the Franchise Tax Board, approximately 72% of the net income reported for bank and corporation tax

purposes is attributable to apportioning corporations and approximately 50% of net income is attributable to multinational corporations, for the 1975 income year.

Applying these percentages to the estimated 1979-80 bank and corporation tax, the amount of tax estimated to be paid by corporations (approximate figures) would be as follows:

Multinational corps ---	$1,283,000,000
Multistate corps ------	564,500,000
California-only corps--	718,500,000
	$2,566,000,000

It is difficult to estimate the impact of any potential change in the unitary approach on state revenue. In order to develop an accurate estimate, the current tax liability for each multinational corporation would have to be computed both by using audited world-wide unitary figures and then by using audited USA-only unitary and overseas separate accounting figures. Then a further study should be made to determine the offsetting effect in revenues of the economic impact of the bill. Obviously, these studies would require a very major investment of time and money.

The most recent estimates available are those developed by the Franchise Tax Board in connection with bills introduced in 1981. Refer to Appendix II, buff pages.

Recent Legislative History

Although proposals to modify California's unitary method of apportionment were introduced in the Legislature as early as 1978 (AB 2363, Hughes; AB 3415, Fazio), intensive legislative review of the issue did not occur until late in 1979. The Assembly Revenue and Taxation Committee held an interim hearing in Los Angeles on November 13, 1979, to hear testimony from a number of witnesses, including some which came from as far away as London, England. The primary focus at that hearing was AB 525, by Assemblywoman Teresa Hughes, which had been introduced in the California Assembly on February 12, 1979.

Upon reconvening in 1980, the Assembly passed AB 525. This measure exempted foreign-domiciled corporations and their subsidiaries from world-wide combination under the unitary metbod of apportionment. These companies would still have been subject to the unitary method on income and factors within the USA. Energy companies, steel companies and owners of agricultural property were excluded from the bill (that is, would have remained subject to world-wide combination). In addition, the bill had a sunset date of 1988.

The Senate passed a different version of the bill and the two houses were unable to agree on common language. The major disagreement between the two houses was on the treatment of foreign energy companies (principally Shell Oil Company). The Assembly did not want to include foreign energy companies within the provisions of AB 525; the Senate wanted them included. A Conference Committee report, which adopted the Assembly view on this issue, was adopted by the Assembly on August 31, 1980, but failed to secure the needed votes in the Senate.

As a result, a second interim hearing on the subject was held by the Assembly Revenue and Taxation Committee in San Diego on November 7, 1980. The central issues of AB 525 were reviewed by the Committee, with added emphasis on the energy company controversy. Representatives of the Franchise Tax Board, the administration, and the business community were present to testify.

1981 DEVELOPMENTS ON THE UNITARY ISSUE

The unitary method of apportionment continued to be an issue for the California Legislature in 1981. There were a number of developments, both in Sacramento and Washington, D.C., which kept this question controversial.

New California Legislation

Three bills, each with a different approach, were introduced in the California Assembly in 1981. AB 55 (Hughes) was a repeat of AB 525 of the prior year. AB 765 (L. Stirling) limited the application of the unitary formula to domestic operations of all foreign based corporations. This represented the 1980 Senate view on this issue. AB 1238 (Deddeh) limited the unitary method of apportionment to domestic operations of all companies. (For a more detailed comparison of the three measures as of May 6, 1981, and texts of all the bills, see Appendix II, buff pages.)

The Assembly Committee on Revenue and Taxation took no action on these bills in 1981, making them two-year bills.

Ford Motor Company Proposal

At the Assembly Revenue and Taxation Committee hearing on May 6, 1981, Ford Motor Company advanced an alternative to the proposed unitary bills, which members of the Committee believed merited further study.

Ford proposed that all corporate taxpayers be given the option of:

"1. Being subjected to the existing California franchise tax calculated on the present world-wide combined unitary tax (WCUT) basis; or

2. Being subjected to an annual California franchise tax consisting of the sum of:

   a. A tax (at existing rates) on an apportioned part of income from U.S. sources, i.e., total income less income which, for U.S. income tax purposes, constitutes foreign source income; and

   b. A tax, at rates determined by the legislature, on the greater of:

      (1) the gross book value of tangible property located in California; or

      (2) the combined net worth, as shown on the balance sheet of the taxpayer's federal income tax return, apportioned to California."

The company cited the following advantages to the plan:

"• Those taxpayers who now view the WCUT as advantageous will not be forced to switch to a procedure which they oppose.

• Those multinational taxpayers who sincerely believe that California's WCUT approach subjects foreign source income to taxation in California can elect the second alternative and thus be assured that investment in California will not generate a tax on income from sources or investments outside the U.S.

• The double tax measure under the second alternative results in a tax structure that is not unlike that existing in many other U.S. states (e.g., New Jersey, Pennsylvania, Oklahoma, Louisiana, Alabama, Kentucky, Georgia, etc.), which levy both a tax measured by net income and a tax on net worth or property employed in the state.

• By adjusting the rates on the supplemental tax under Alternative 2, the legislature can guard against any significant tax revenue loss until the positive impact of the alternative on California investment materializes. The legislature creating the option could provide a schedule of slowly declining rates for the supplemental tax under Alternative 2 which recognizes the positive revenue impact of increased California investment. Indeed, the legislation might provide that the supplemental tax would terminate or the rate thereof very substantially diminish if the split roll concept were adopted."

(For the complete text of the Ford Motor Company letter, see Appendix III, pink pages.)

FTB Fiscal Study

Subsequent to hearings on the unitary bills, Assemblyman Wadie P. Deddeh, Chairman of the Revenue and Taxation Committee, requested the Franchise Tax Board to provide the Committee with the fiscal impact, with appropriate comments, of several alternative approaches to the unitary issue, including the Ford suggestion.

The Franchise Tax Board furnished the following tax rates on multinational corporations which would offset approximately $500 million of state revenue loss from AB 1238, had it been in effect in 1979:

	Measure of tax on multinational corps	Tax rate
(1)	Net worth	.14%
(2)	State net income	5.00%
(3)	Property in California	.15%
(4)	Compensation in California	1.01%
(5)	Sales in California	.20%
(6)	Average of (3), (4) and (5)	.24%

For the text of the Franchise Tax Board response and Chairman Deddeh's letter, see Appendix IV (pink pages).

Congressional Bills

Bills have been introduced in the U.S. Congress to restrict the use by States of the unitary method of apportionment for determining a state's share of taxable corporate income. In 1978, the federal administration attempted to limit the states' use of this apportionment method by provisions in the U.S.-United Kingdom Tax Treaty. The U.S. Senate refused adoption of this portion of the treaty.

In 1981, Congressman Conable introduced HR 1983 in the House and Senator Mathias introduced S. 655 in the Senate.

According to the Senator, his measure would "conform the state rules to the Federal rules within the very narrow areas of (i) the time at which states tax the foreign source income of foreign affiliates, and (ii) the quantity or portion of foreign source dividends which are taxed.

"These results would be accomplished as follows:

"First, the proposed legislation would provide that a state may not take into account or include in income subject to tax the income of any foreign corporation in any year prior to the year in which such income is included in income subject to tax under the Internal Revenue Code. Thus, the foreign source income of a foreign subsidiary of a U.S. parent corporation would be taxed only if and to the extent paid back to the U.S. as a dividend or deemed paid back by application of Subpart F. In the case of a foreign parent corporation of a U.S. subsidiary, the foreign source income of the foreign parent (and any of its foreign affiliates) would never be taxed because under the Internal Revenue Code that income is not taxed by the Federal Government.

"Second, in the case of dividends received by a U.S. parent corporation from a foreign subsidiary, the proposed legislation would permit a state to tax no greater portion of that dividend than the Federal government effectively taxes. The excluded portion of any dividend would be determined by multiplying the amount of the dividend by a fraction. The numerator of that fraction is the total amount of tax withheld at the source on all such dividends plus the total amount of taxes which by application of section 902 and section 960 to all such dividends, the U.S. parent corporation is deemed to have paid. The denominator of the fraction is 46 percent of all such dividends. For the purpose of applying this fraction, the amount of the dividend includes the amount of any gross-up under section 78.

Example

1.	Amount of dividend actually received.......	$115.50
2.	Gross-up dividend to reflect 23 percent foreign tax rate..........................	$150.00
3.	Foreign taxes paid (23% x $150)...........	34.50
4.	Grossed-up dividend x 46 percent..........	69.00
5.	Item 3 divided by item 4 (in percent)......	50
6.	Excluded portion of dividend ($150 x 0.50).	$ 75.00

"The rationale for this exclusion of a portion of a foreign source dividend is the same as the rationale for the foreign tax credit--the avoidance of double tax. However, the result is not to require the states to allow a credit for foreign taxes which would tend to wipe out all state tax on foreign source dividends

because the national tax rates in most foreign countries exceed the rates of tax imposed by the states. Instead, the result of the exclusion is to permit the states to tax, at whatever rate they apply to other income, only that portion of a foreign source dividend which the Federal government effectively taxes after taking into account the foreign tax credit.

According to the author, S. 655: "...will help smooth the flow of interstate and international commerce in this country; it will remove the risk of double taxation for United States and foreign corporations; and it will bring the States into conformity with the Federal Government and most other countries on the taxation of foreign source intercorporate dividends... By purging a major inefficiency in our tax system, it would make U.S. business more competitive in international markets, and it would remove a constant source of irritation in our relations with our foreign trading partners."

Congress has not acted on either measure as of this writing. (For the text of S. 655, see Appendix V, brown pages. The provisions of HR. 1983 are identical.)

Ken Cory Article

State Controller Ken Cory, writing in the national publication, Tax Notes in the May 25, 1981, issue, argued the merits of the unitary method of apportionment.

According to Cory, the problem in taxing multinational corporations centers around the "transfer" prices charged by one corporate subsidiary to another:

"These are not true market transactions in the sense that they represent nothing more than a company doing business with itself. They are internal bookkeeping transactions and involve no real transfer of revenue outside the corporate organization.

"When the various divisions are in different jurisdictions which have different rates of taxation there is an obvious opportunity to play a "shell-and-pea" game in order to avoid taxes. If the refining division faces higher taxes than the crude producing division, taxes can be reduced simply by increasing the price at which crude oil is sold to the refining division. As a result, the refining division makes little or no profits and pays little or no taxes, while the producing division makes lots of money where the tax rates are low. In addition, it is not unknown for an international oil company to set up off-shore companies specifically for the purpose of avoiding taxes.

"Two points should be made. First, all integrated (or "unitary") corporations that operate across jurisdictional boundaries are capable of such manipulation. In terms of sheer magnitude, however, nothing matches the capability of the major oil companies. Second, it is important to recognize that this shifting of profits need not involve fraud or other illegality. The Internal Revenue Service (as well as the tax authorities in other nations) uses the so-called "arm's-length" method of accounting in assessing the legitimacy of intracorporate transfer prices. According to this system, transfer prices used for an item would be compared to the price that would prevail in a true market, or "arm's-length", transaction. In the petroleum industry, at any given time, there is never a single

price for crude oil, gasoline, or any other petroleum product. There are clusters of "market" prices which reflect various long-term contract prices and spot market prices. The absence of any one clear "market price" gives considerable latitude to managers in setting intracorporate transfer prices.

"In comparison with the necessity of untangling a host of intracorporate transactions and comparing them against an arm's-length standard, the unitary method presents no extraordinary problems of fairness or workability. In fact some tax scholars have found it a theoretically superior instrument of tax policy. But, tax theory aside, there is one overwhelming argument for the unitary approach: it can actually be used to collect taxes. It is no exaggeration to say that the arm's-length method completely fails to provide the states with a workable method for taxing corporate income earned within their jurisdictions."

(For the complete text of the Cory article, see Appendix VI, blue pages.)

U.S. General Accounting Office Study

"Separate accounting" as administered by the U.S. Internal Revenue Service, which is the proposed alternative to world-wide combination under the unitary method of apportionment, was the subject of criticism in a report by the U.S. General Accounting Office released September 30, 1981.

According to the report:

"When multinational corporations price transactions with their subsidiaries, they often have the opportunity to take advantage of disparate corporate tax rates by shifting income.

Ideally, such prices are adjusted by IRS under Code Section 482 to those for similar transactions between unrelated parties--the so-called "arm's length standard". However, IRS often has difficulty identifying a true arm's length price on which to base adjustments.

"In its review of current IRS examination data on 519 U.S. multinationals, each having assets over $250 million and having engaged in transactions with its foreign subsidiaries, GAO found that only 3 percent (12 of 403) of IRS' total recommended section 482 adjustments to reported income were based on a true arm's length price. The remaining adjustments were based on estimated prices constructed by IRS using complex guidelines prescribed by the Department of the Treasury--guidelines which have caused administrative burden and uncertainty both for IRS and taxpayers."

Included among the recommendations of the GAO is one to the Secretary of the Treasury to "begin a study to identify and evaluate the feasibility of ways to allocate income under Section 482, including formula apportionment, which would lessen the present uncertainty and administrative burden created by the existing regulations.

The Department of Treasury and the IRS are in disagreement with this recommendation.

(For excerpts from the GAO study, see Appendix VII, green pages.)

U.S. Supreme Court Cases

On November 9, 1981, the U.S. Supreme Court agreed to hear two cases relating to the unitary method of apportionment.

The issue in the California case--Container Corp. of America v. Franchise Tax Board, 81-523--is whether it is constitutional for the state to include income from a concern's foreign subsidiaries in calculating corporate income tax.

The justices also agreed to hear a case from Illinois, Chicago Bridge & Iron Co. v. Caterpillar Tractor Co., 81-349, involving a taxing method almost identical to California's.

In a holding two terms ago in a dispute between Mobil Oil Co. and the state of Vermont, the high court ruled that dividend income from the foreign subsidiaries of a multinational corporation headquartered elsewhere can be included in a state's apportionment formula.

APPENDIX I

Text, Uniform Division of Income for Tax Purposes Act (UDITPA)

Article 2. Uniform Division of Income for Tax Purposes Act

§ 25120. Definitions.
§ 25121. Application.
§ 25122. Taxpayer taxable in another state—defined.
§ 25123. Nonbusiness income.
§ 25124. Rents and royalties.
§ 25125. Capital gains and losses.
§ 25126. Interest and dividends.
§ 25127. Patent and copyright royalties.
§ 25128. Business income.
§ 25129. Property factor—defined.
§ 25130. Property valuation.
§ 25131. Average value of property.
§ 25132. Payroll factor—defined.
§ 25133. Compensation.
§ 25134. Sales factor—defined.
§ 25135. Sales of tangible personal property.
§ 25136. Other sales.
§ 25137. Other apportionment methods.
§ 25138. Construction of this act.
§ 25139. Title.
§ 25140. Dividends received by corporations having commercial domiciles in this state.

25120. Definitions. As used in Sections 25120 to 25139, inclusive, which shall hereafter be referred to as "this act," unless the context otherwise requires:

(a) "Business income" means income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations.

(b) "Commercial domicile" means the principal place from which the trade or business of the taxpayer is directed or managed.

(c) "Compensation" means wages, salaries, commissions and any other form of remuneration paid to employees for personal services.

(d) "Nonbusiness income" means all income other than business income.

(e) "Sales" means all gross receipts of the taxpayer not allocated under Sections 25123 through 25127 of this code.

(f) "State" means any state of the United States, the District of Columbia, the Commonwealth of Puerto Rico, any territory or possession of the United States, and any foreign country or political subdivision thereof.

Business income.— The income from the sale of stock received as partial payment for products sold in a unitary business was determined to be business income. *Appeal of General Dynamics Corporation*, Cal. St. Bd. of Equal., June 3, 1975; aff'd on rehearing Cal. St. Bd. of Equal., September 17, 1975.

Gain realized on the dispostion of exclusive National Football League territorial franchise rights in conjunction with the merger of American and National football leagues constitutes business income. *Appeal of New York Football Giants, Inc.*, Cal. St. Bd. of Equal., February 3, 1977.

The loss resulting from the sale of goodwill connected with the taxpayer's California dairy operations was held to be apportionable business income. *Appeal of Borden, Inc.*, Cal. St. Bd. of Equal., February 3, 1977.

Rebates paid to a corporation on liquidation of an employee's pension trust were held to be business income. *Appeal of Kroehler Manufacturing Company*, Cal. St. Bd. of Equal., April 6, 1977.

Rental income derived from the rental of buildings by a contractor which designed and constructed the buildings is "business income" subject to apportionment. *Appeal of The O. K. Earl Corporation*, Cal. St. Bd. of Equal., April 6, 1977.

25121. Application. Any taxpayer having income from business activity which is taxable both within and without this state shall allocate and apportion its net income as provided in this act.

25122. Taxpayer taxable in another state—defined. For purposes of allocation and apportionment of income under this act, a taxpayer is taxable in another state if (a) in that state it is subject to a net income tax, a franchise tax measured by net income, a franchise tax for the privilege of doing business, or a corporate stock tax, or (b) that state has jurisdiction to subject the taxpayer to a net income tax regardless of whether, in fact, the state does or does not.

25123. **Nonbusiness income.** Rents and royalties from real or tangible personal property, capital gains, interest, dividends, or patent or copyright royalties, to the extent that they constitute nonbusiness income, shall be allocated as provided in Sections 25124 through 25127 of this act.

25124. **Rents and royalties.** (a) Net rents and royalties from real property located in this state are allocable to this state.

(b) Net rent and royalties from tangible personal property are allocable to this state:

(1) If and to the extent that the property is utilized in this state, or

(2) In their entirety if the taxpayer's commercial domicile is in this state and the taxpayer is not organized under the laws of or taxable in the state in which the property is utilized.

(c) The extent of utilization of tangible personal property in a state is determined by multiplying the rents and royalties by a fraction, the numerator of which is the number of days of physical location of the property in the state during the rental or royalty period in the income year and the denominator of which is the number of days of physical location of the property everywhere during all rental or royalty periods in the income year. If the physical location of the property during the rental or royalty period is unknown or unascertainable by the taxpayer, tangible personal property is utilized in the state in which the property was located at the time the rental or royalty payor obtained possession.

Application of section.— This section applies only to nonbusiness income. Business income must be apportioned by formula as prescribed by Section 25128. *Appeal of Parador Mining Co., Inc.*, Cal. St. Bd. of Equal., February 3, 1977.

25125. **Capital gains and losses.** (a) Capital gains and losses from sales of real property located in this state are allocable to this state.

(b) Capital gains and losses from sales of tangible personal property are allocable to this state if:

(1) The property had a situs in this state at the time of the sale, or

(2) The taxpayer's commercial domicile is in this state and the taxpayer is not taxable in the state in which the property had a situs.

(c) Capital gains and losses from sales of intangible personal property are allocable to this state if the taxpayer's commercial domicile is in this state.

25126. **Interest and dividends.** Interest and dividends are allocable to this state if the taxpayer's commercial domicile is in this state.

25127. **Patent and copyright royalties.** (a) Patent and copyright royalties are allocable to this state:

(1) If and to the extent that the patent or copyright is utilized by the payor in this state, or

(2) If and to the extent that the patent or copyright is utilized by the payor in a state in which the taxpayer is not taxable and the taxpayer's commercial domicile is in this state.

(b) A patent is utilized in a state to the extent that it is employed in production, fabrication, manufacturing, or other processing in the state or to the extent that a patented product is produced in the state. If the basis of receipts from patent royalties does not permit allocation to states or if the accounting procedures do not reflect states of utilization, the patent is utilized in the state in which the taxpayer's commercial domicile is located.

(c) A copyright is utilized in a state to the extent that printing or other publication originates in the state. If the basis of receipts from copyright royalties does not permit allocation to states or if the accounting procedures do not reflect states of utilization, the copyright is utilized in the state in which the taxpayer's commercial domicile is located.

25128. **Business income.** All business income shall be apportioned to this state by multiplying the income by a fraction, the numerator of which is the property factor plus the payroll factor plus the sales factor, and the denominator of which is three.

25129. **Property factor—defined.** The property factor is a fraction, the numerator of which is the average value of the taxpayer's real and tangible personal property owned or rented and used in this state during the income year and the denominator of which is the average value of all the taxpayer's real and tangible personal property owned or rented and used during the income year.

25130. **Property valuation.** Property owned by the taxpayer is valued at its original cost. Property rented by the taxpayer is valued at eight times the net annual rental rate. Net annual rental rate is the annual rental rate paid by the taxpayer less any annual rental rate received by the taxpayer from subrentals.

25131. **Average value of property.** The average value of property shall be determined by averaging the values at the beginning and ending of the income year but the Franchise Tax Board may require the averaging of monthly values during the income year if reasonably required to reflect properly the average value of the taxpayer's property.

25132. **Payroll factor—defined.** The payroll factor is a fraction, the numerator of which is the total amount paid in this state during the income year by the taxpayer for compensation, and the denominator of which is the total compensation paid everywhere during the income year.

25133. **Compensation.** Compensation is paid in this state if:

(a) The individual's service is performed entirely within the state; or

(b) The individual's service is performed both within and without the state, but the service performed without the state is incidental to the individual's service within the state; or

(c) Some of the service is performed in the state and (1) the base of operations or, if there is no base of operations, the place from which the service is directed or controlled is in the state, or (2) the base of operations or the place from which the service is directed or controlled is not in any state in which some part of the service is performed, but the individual's residence is in this state.

25134. **Sales factor—defined.** The sales factor is a fraction, the numerator of which is the total sales of the taxpayer in this state during the income year, and the denominator of which is the total sales of the taxpaver everywhere during the income year.

25135. **Sales of tangible personal property.** Sales of tangible personal property are in this state if:

(a) The property is delivered or shipped to a purchaser, other than the United States government, within this state regardless of the f.o.b. point or other conditions of the sale; or

(b) The property is shipped from an office, store, warehouse, factory, or other place of storage in this state and (1) the purchaser is the United States government or (2) the taxpayer is not taxable in the state of the purchaser.

25136. **Other sales.** Sales, other than sales of tangible personal property, are in this state if:

(a) The income-producing activity is performed in this state; or

(b) The income-producing activity is performed both in and outside this state and a greater proportion of the income-producing activity is performed in this state than in any other state, based on costs of performance.

Parts manufactured outside California.— The assembly, in California, of a large steam generating system whose components were fabricated outside California is not the sale of property which is "other than tangible personal property" and is, therefore, not properly within the scope of this section. *Appeal of The Babcock & Wilcox Co*, Cal. St. Bd. of Equal., January 11, 1978.

Sale and redemption of intangible debt securities.— In computing the receipts factor of the apportionment formula, the taxing agency properly invoked Section 25137 to exclude the return of capital element from sales of short-term debt security working capital investment. *Appeals of Pacific Telephone and Telegraph Company*, Cal. St. Bd. of Equal., May 4, 1978.

25137. Other apportionment methods. If the allocation and apportionment provisions of this act do not fairly represent the extent of the taxpayer's business activity in this state, the taxpayer may petition for or the Franchise Tax Board may require, in respect to all or any part of the taxpayer's business activity, if reasonable:

(a) Separate accounting;

(b) The exclusion of any one or more of the factors;

(c) The inclusion of one or more additional factors which will fairly represent the taxpayer's business activity in this state; or

(d) The employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.

Authority to invoke.— Deviations from the statutory allocation and apportionment procedures are authorized only in exceptional circumstances where those procedures do not fairly represent the extent of the taxpayer's business activity in this state. The party who seeks to deviate from the statutory formula bears the burden of proving that such exceptional circumstances are present. *Appeal of Donald M. Drake Company*, Cal. St. Bd. of Equal., February 3, 1977; *Appeal of New York Football Giants, Inc.*, Cal. St. Bd. of Equal., February 3, 1977.

The special procedures authorized by Section 25137 may not be employed unless the party invoking the section first establishes that UDITPA's basic provisions do not fairly represent the extent of the taxpayer's business activity in this state. *Appeal of Parador Mining Co., Inc.*, Cal. St. Bd. of Equal., February 3, 1977, *Appeal of Danny Thomas Productions*, Cal. St. Bd. of Equal., February 3, 1977

Construction contractors special formula.— Taxing agency properly invoked Section 25137 in issuing a special formula for construction contractors. *Appeal of Donald M. Drake Company*, Cal. St. Bd. of Equal., February 3, 1977; *Appeal of The O. K. Earl Corporation*, Cal. St. Bd. of Equal., April 16, 1977.

Regulation limiting the inclusion of "construction in progress" in the property factor, only to the extent that such costs exceed progress billings, is a deviation from the statutory formula authorized by Section 25137. *Appeal of The O. K. Earl Corporation*, Cal. St. Bd. of Equal., April 6, 1977.

Professional sports special formula.— Statutory payroll factor procedures are distortive when applied to a professional football club. Taxing agency's special payroll factor formula for football clubs upheld. *Appeal of New York Football Giants, Inc.*, Cal. St. Bd. of Equal., February 3, 1977.

Taxing agency failed to establish that statutory sales factor procedures were distortive when applied to a professional football club. Deviation from statutory formula not authorized. *Appeal of New York Football Giants, Inc.* Cal. St. Bd. of Equal., February 3, 1977.

25138. Construction of this act. This act shall be so construed as to effectuate its general purpose to make uniform the law of those states which enact it. Enactment of Article IV of the Multistate Tax Compact (as set forth in Section 38006 of the code) pertaining to the allocation and apportionment of income shall be construed as a reenactment of Sections 25120 to 25137, inclusive, without any inference that a change in interpretation is implied by such enactment.

History: Stats. 1974, Ch. 1381, in effect September 26, 1974 amended to provide that the allocation and apportionment provisions of the state law were not affected by Stats. 1974, Ch. 93 (ratification and approval of Multistate Tax Compact).

25139. Title. Sections 25120 and 25139, inclusive, may be cited as the Uniform Division of Income for Tax Purposes Act.

25140. Dividends received by corporations having commercial domiciles in this state. Accounting procedures shall be adopted which will separately reflect the revenues attributable to dividends received by corporations having commercial domiciles in this state.

In view of pending litigation concerning the proper treatment of intercompany dividends, it is not intended by enactment of this act that any inference be drawn from it in such litigation.

History: Stats. 1966 (First Extra Session), p. 735, in effect October 6, 1966, deleted the former language added by Stats. 1966, Ch. 2, which stated that the Legislature did not intend, in the enactment of this article, to provide for the taxation of intercorporate dividends except in the state of commercial domicile of the receiving corporation, and added the present language.

APPENDIX II

Texts and Comparison
1981 California Legislation on
Unitary Method of Apportionment

COMPARISON OF LEGISLATION

as of May 6, 1981

Unitary Method of Apportionment

	Current Law	AB 55 (Hughes)	AB 765 (L. Stirling)	AB 1238 (Deddeh)
Method of determining California share of multinational corporation taxable income	California share of income determined by using combined reporting of affiliated corporations and by applying world-wide apportionment factors to world-wide income.	For domestic corporations--current law. For foreign domiciled corporations (and their subsidiaries)--prohibits world-wide combination; will use USA unitary and separate accounting. Foreign energy & steel companies and foreign corps owning Calif. agricultural land must use current law.	For domestic corporations--current law. For foreign domiciled corps (and their subsidiaries)--prohibits world-wide combination; will use USA unitary and separate accounting.	All corporations (foreign & domestic) given option of: (a) current law, (b) excluding income & apportionment factors of foreign corps they control.
FTB Audit Required	-	Yes	Yes	Yes
Dividends	Allocated to state of commercial domicile.	No change	No change	Repeals allocation provision.
Fiscal: (FTB estimate)				
1981	-	-	-$70	-$800 plus
1982	-	-$40	-$80	-$900 plus
Effective date	-	1982 income year	1981 income year	1981 income year

CALIFORNIA LEGISLATURE—1981–82 REGULAR SESSION

ASSEMBLY BILL No. 55

Introduced by Assemblymen Hughes, Imbrecht, Deddeh, Hallett, and Elder

December 2, 1980

REFERRED TO COMMITTEE ON REVENUE AND TAXATION

An act to add Section 25101.9 to the Revenue and Taxation Code, relating to taxation, to take effect immediately, tax levy.

LEGISLATIVE COUNSEL'S DIGEST

AB 55, as introduced, Hughes (Rev. & Tax.). Bank and Corporation Tax Law: unitary business.

Under the existing Bank and Corporation Tax Law, the income of a unitary business which is subject to taxation is determined by means of an apportionment formula based on income derived from or attributable to sources both within and without the state.

This bill would provide that in determining the income subject to tax of a bank, corporation, or other entity, there shall not be taken into account the income and apportionment factors of any other bank, corporation or other entity, if such bank, corporation, or other entity is (1) created or organized under the laws of a foreign country, and (2) not owned and controlled by a United States corporation or residents of the United States.

Corporations engaged in the energy business and in the steel business and the business of owning agricultural land in this state are excepted from the provisions of the bill.

This bill would take effect immediately as a tax levy.

This bill would provide that if any provision of this act is held unconstitutional for specified reasons, this act shall be invalid in its entirety and shall be repealed.

Vote: majority. Appropriation: no. Fiscal committee: yes. State-mandated local program: no.

The people of the State of California do enact as follows:

1 SECTION 1. The Legislature finds that generally
2 accepted accounting methods in general use by foreign
3 based taxpayers are materially different from accounting
4 methods used by United States based taxpayers, and
5 income statements prepared under foreign accounting
6 standards are not readily converted to income statements
7 based on the California Bank and Corporation Tax Law.
8 The Legislature further finds that many unresolved
9 problems have arisen in accounting for changes in
10 foreign exchange rates, both in the determination of
11 income and in constructing apportionment data of
12 foreign based taxpayers, on a basis consistent with that
13 used to determine income earned in California by United
14 States taxpayers. The Legislature further finds that the
15 cost burden of converting income statements of foreign
16 based taxpayers to income statements more comparable
17 to those of United States based taxpayers is often
18 substantially greater than any resulting tax on income
19 considered to be earned in California. The Legislature
20 further finds that the inclusion of foreign income in
21 determining the tax liability of foreign economic
22 interests wishing to invest in California has frequently
23 resulted in unfair taxation of foreign based taxpayers and
24 consequently acted as an impairment to investment and
25 hindered the creation of new opportunities for
26 employment and the diversification of the economic base
27 of this state.
28 SEC. 2. The Legislature further finds and declares
29 that the energy business is not included under the
30 provisions of this act as, in general, the entities that such
31 businesses control are established by geographical and
32 political boundaries, rather than functional operations,

1 for purposes not related to basic economics of the market.
2 SEC. 3. Section 25101.9 is added to the Revenue and
3 Taxation Code, to read:
4 25101.9. (a) Notwithstanding any other provision of
5 this chapter (except as provided in subdivision (g)), in
6 determining the income subject to tax of any bank,
7 corporation, or other entity liable to report under this
8 part, there shall not be taken into account the income or
9 apportionment factors of any other bank, corporation, or
10 other entity if such other bank, corporation, or other
11 entity:
12 (1) Is created or organized under the laws of a foreign
13 country; and
14 (2) Is not owned or controlled by a United States
15 corporation or residents of the United States.
16 (b) For purposes of this section, the activities
17 conducted within or directed from the United States by
18 any bank, corporation, or other entity meeting the
19 conditions set forth under paragraphs (1) and (2) of
20 subdivision (a) shall be deemed to be conducted by a
21 separate bank, corporation, or other entity which does
22 not meet such conditions, and, except as provided in
23 subdivision (g), the income and apportionment factors of
24 any such bank, corporation, or other entity shall be
25 determined upon the basis of the books of account
26 maintained by such bank or corporation or other entity
27 with respect to the activities conducted within or
28 directed from the United States and the income and
29 apportionment factors with respect to such activities shall
30 be taken into account in the manner authorized by this
31 chapter.
32 (c) The Franchise Tax Board shall audit, at least once
33 every four years, the separate accounting and arm's
34 length transactions of any bank, corporation, or other
35 entity determining income pursuant to this section.
36 (d) This section shall not apply in determining the
37 income allocable to this state from a unitary business
38 whose principal activity is the energy business, the steel
39 business, or owning agricultural land in this state. For the
40 purpose of this subdivision, the term "energy business"

1 means operations pertaining to the obtaining, processing,
2 or marketing of a source of energy, including exploring,
3 discovering, developing, mining, drilling, processing,
4 manufacturing, treating, transporting, refining,
5 producing, acquiring, managing, marketing, or
6 researching in connection with any energy source such as
7 coal, oil, petroleum products, natural gas, and uranium,
8 but does not mean operations pertaining to the following
9 alternative energy sources: solar, geothermal, coal
10 gasification, wind, biomass, and photovoltaic. For the
11 purpose of this subdivision, the term "steel business"
12 means the manufacture or sale of products rolled,
13 formed, shaped, drawn, extruded, forged, cast,
14 fabricated, or otherwise similarly processed, or processed
15 by a combination of two or more of such operations, from
16 steel made by the open hearth, basic oxygen, electric
17 furnace, Bessemer, or other steelmaking process. For the
18 purpose of this subdivision, "agricultural land" is land
19 owned or leased for 30 years or more and used for the
20 production of agricultural commodities for commercial
21 purposes.
22 (e) For purposes of this section, direct or indirect
23 ownership or control of more than 50 percent of the
24 voting stock shall constitute ownership or control.
25 (f) The following definitions shall apply for the
26 purposes of this section:
27 (1) The term "residents of the United States" means
28 residents of the United States, its territories, or
29 possessions, or the Commonwealth of Puerto Rico.
30 (2) The term "United States corporation" means a
31 bank, corporation, or other entity organized under the
32 laws of the United States, its political subdivisions, its
33 territories, or possessions, or the Commonwealth of
34 Puerto Rico.
35 (g) Nothing in this section shall preclude the
36 Franchise Tax Board from distributing, apportioning, or
37 allocating gross income, deductions, credits, or
38 allowances between or among organizations, trades, or
39 businesses, if it determines that it is necessary to do so in
40 order to prevent evasion of taxes or clearly to reflect the

1 income of any of such organizations, trades, or businesses.
2 (h) In view of pending litigation concerning the
3 question of whether a corporation liable to report under
4 the Bank and Corporation Tax Law is required to take
5 into account the income and apportionment factors of
6 other corporations operating in a foreign country, it is not
7 intended that any inference be drawn from the
8 enactment of this act in any litigation concerning such
9 question.
10 SEC. 4. It is the intention of the Legislature that the
11 provisions of this act not apply to domestic multinational
12 corporations. If any provision of this act or the application
13 thereof to any person or circumstance is held invalid or
14 unconstitutional because it discriminates against
15 domestic multinational corporations, or that it violates
16 the Commerce Clause of the United States Constitution
17 because it discriminates against domestic multinational
18 corporations, then this act shall be invalid in its entirety
19 and shall be repealed.
20 SEC. 5. It is the intent of the Legislature that the
21 appropriate policy committee in each house of the
22 Legislature conduct interim hearings 10 years following
23 the enactment of this act for the purpose of reviewing
24 and studying the impact of this act and subsequently
25 reporting their findings to the Legislature.
26 SEC. 6. This act provides for a tax levy within the
27 meaning of Article IV of the Constitution and shall go into
28 immediate effect. However, the provisions of this act
29 shall apply in the computation of taxes for income years
30 beginning on or after January 1, 1982.

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CALIFORNIA LEGISLATURE—1981–82 REGULAR SESSION

ASSEMBLY BILL No. 765

Introduced by Assemblymen Larry Stirling, Dennis Brown, Hallett, and Naylor
(Coauthor: Senator Marz Garcia)

March 4, 1981

An act to add Section 25101.9 to the Revenue and Taxation Code, relating to taxation, to take effect immediately, tax levy.

LEGISLATIVE COUNSEL'S DIGEST

AB 765, as introduced, L. Stirling. Bank and Corporation Tax Law: unitary business.

Under the existing Bank and Corporation Tax Law, the income of a unitary business which is subject to taxation is determined by means of an apportionment formula based on income derived from or attributable to sources both within and without the state.

This bill would provide that in determining the income subject to tax of a bank, corporation, or other entity, there shall not be taken into account the income and apportionment factors of any other bank, corporation or other entity, if such bank, corporation, or other entity is (1) created or organized under the laws of a foreign country, and (2) not owned and controlled by a United States corporation or residents of the United States.

This bill would take effect immediately as a tax levy.

This bill would provide that if any provision of this act is held unconstitutional for specified reasons, this act shall be invalid in its entirety and shall be repealed.

Vote: majority. Appropriation: no. Fiscal committee: yes. State-mandated local program: no.

The people of the State of California do enact as follows:

1 SECTION 1. The Legislature finds that generally
2 accepted accounting methods in general use by foreign
3 based taxpayers are materially different from accounting
4 methods used by United States based taxpayers, and
5 income statements prepared under foreign accounting
6 standards are not readily converted to income statements
7 based on the California Bank and Corporation Tax Law.
8 The Legislature further finds that many unresolved
9 problems have arisen in accounting for changes in
10 foreign exchange rates, both in the determination of
11 income and in constructing apportionment data of
12 foreign based taxpayers, on a basis consistent with that
13 used to determine income earned in California by United
14 States taxpayers. The Legislature further finds that the
15 cost burden of converting income statements of foreign
16 based taxpayers to income statements more comparable
17 to those of United States based taxpayers is often
18 substantially greater than any resulting tax on income
19 considered to be earned in California. The Legislature
20 further finds that the inclusion of foreign income in
21 determining the tax liability of foreign economic
22 interests wishing to invest in California has frequently
23 resulted in unfair taxation of foreign based taxpayers and
24 consequently acted as an impairment to investment and
25 hindered the creation of new opportunities for
26 employment and the diversification of the economic base
27 of this state.
28 SEC. 2. Section 25101.9 is added to the Revenue and
29 Taxation Code, to read:
30 25101.9. (a) Notwithstanding any other provision of
31 this chapter (except as provided in subdivision (g)), in
32 determining the income subject to tax of any bank,
33 corporation, or other entity liable to report under this
34 part, there shall not be taken into account the income or
35 apportionment factors of any other bank, corporation, or
36 other entity if all of the following applied to the other
37 bank, corporation, or other entity:
38 (1) Created or organized under the laws of a foreign

1 country.
2 (2) Not owned or controlled by a United States
3 corporation or residents of the United States.
4 (b) For purposes of this section, the activities
5 conducted within or directed from the United States by
6 any bank, corporation, or other entity meeting the
7 conditions set forth under paragraphs (1) and (2) of
8 subdivision (a) shall be deemed to be conducted by a
9 separate bank, corporation, or other entity which does
10 not meet such conditions, and, except as provided in
11 subdivision (g), the income and apportionment factors of
12 any such bank, corporation, or other entity shall be
13 determined upon the basis of the books of account
14 maintained by such bank or corporation or other entity
15 with respect to the activities conducted within or
16 directed from the United States and the income and
17 apportionment factors with respect to such activities shall
18 be taken into account in the manner authorized by this
19 chapter.
20 (c) The Franchise Tax Board shall audit, at least once
21 every four years, the separate accounting and arm's
22 length transactions of any bank, corporation, or other
23 entity determining income pursuant to this section.
24 (d) For purposes of this section, direct or indirect
25 ownership or control of more than 50 percent of the
26 voting stock shall constitute ownership or control.
27 (e) The following definitions shall apply for the
28 purposes of this section:
29 (1) The term "residents of the United States" means
30 residents of the United States, its territories, or
31 possessions, or the Commonwealth of Puerto Rico.
32 (2) The term "United States corporation" means a
33 bank, corporation, or other entity organized under the
34 laws of the United States, its political subdivisions, its
35 territories, or possessions, or the Commonwealth of
36 Puerto Rico.
37 (f) Nothing in this section shall preclude the Franchise
38 Tax Board from distributing, apportioning, or allocating
39 gross income, deductions, credits, or allowances between
40 or among organizations, trades, or businesses, if it

1 determines that it is necessary to do so in order to prevent
2 evasion of taxes or clearly to reflect the income of any of
3 such organizations, trades, or businesses.
4 (g) In view of pending litigation concerning the
5 question of whether a corporation required to file a
6 return under this part is required to take into account the
7 income and apportionment factors of other corporations
8 operating in a foreign country, it is not intended that any
9 inference be drawn from the enactment of this act in any
10 litigation concerning that question.
11 SEC. 3. The Legislative Analyst shall report to the
12 Legislature during the 1988 portion of the 1987-88
13 Regular Session of the Legislature on the impact of this
14 act.
15 SEC. 4. This act provides for a tax levy within the
16 meaning of Article IV of the Constitution and shall go into
17 immediate effect. However, the provisions of this act
18 shall apply in the computation of taxes for income years
19 beginning on or after January 1, 1981.
20 SEC. 5. If any provision of this act or the application
21 thereof to any person or circumstance is held invalid or
22 unconstitutional because it favors foreign-based
23 corporate entities over domestic-based corporate
24 entities, or for any other reason, by final court decision,
25 then this act shall be invalid in its entirety and shall be
26 repealed.

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AMENDED IN ASSEMBLY SEPTEMBER 15, 1981

CALIFORNIA LEGISLATURE—1981–82 REGULAR SESSION

ASSEMBLY BILL No. 1238

Introduced by Assemblyman Deddeh

March 19, 1981

An act to amend Sections 24344 and 25126 of, and to add Section 25101.9 to, the Revenue and Taxation Code, relating to taxation, to take effect immediately, tax levy.

LEGISLATIVE COUNSEL'S DIGEST

AB 1238, as amended, Deddeh. Bank and Corporation Tax Law: unitary business.

Under the existing Bank and Corporation Tax Law, the income of a unitary business which is subject to taxation is determined by means of an apportionment formula based on income derived from or attributable to sources both within and without the state.

This bill would provide that *except as otherwise specified,* in determining the income subject to tax of a bank, corporation, or other entity, there shall not be taken into account the income and apportionment factors of any other bank, corporation or other entity ~~; if the bank, corporation, or other entity is created or organized under the laws of a foreign country~~ *having more than 80% of its average property, payroll, and sales factors during the income year attributable to locations outside the United States, District of Columbia, the Commonwealth of Puerto Rico, any territory or possession of the United States, and any political subdivision thereof.*

This bill would take effect immediately as a tax levy.

Vote: majority. Appropriation: no. Fiscal committee: yes. State-mandated local program: no.

The people of the State of California do enact as follows:

~~SECTION 1. The Legislature finds that generally~~
SECTION 1. Section 24344 of the Revenue and Taxation Code is amended to read:

24344. (a) Except as limited by subsection (b), there shall be allowed as a deduction all interest paid or accrued during the income year on indebtedness of the taxpayer.

(b) If income of the taxpayer is determined by the allocation formula contained in Section 25101, the interest deductible shall be an amount equal to interest income subject to allocation by formula, plus the amount, if any, by which the balance of interest expense exceeds interest ~~and dividend~~ income ~~(except dividends deductible under the provisions of Section 24402)~~ not subject to allocation by formula. Interest expense not included in the preceding sentence shall be directly offset against interest ~~and dividend~~ income ~~(except dividends deductible under the provisions of Section 24402)~~ not subject to allocation by formula.

SEC. 2. Section 25101.9 is added to the Revenue and Taxation Code, to read:

25101.9. (a) Notwithstanding any other provision of this chapter (except as provided in subdivision (c)), in determining the income subject to tax of any bank, corporation, or other entity liable to report under this part, there shall not be taken into account the income or apportionment factors of any other bank, corporation, or other entity having more than 80 percent of its average property, payroll, and sales factors during the income year attributable to locations outside the United States, District of Columbia, the Commonwealth of Puerto Rico, any territory or possession of the United States, and any political subdivision thereof.

(b) For purposes of this section, the activities conducted within or directed from the United States by any bank, corporation, or other entity created or organized under the laws of a foreign country and not owned or controlled by a United States corporation or by

1 *a resident of the United States which meets the*
2 *conditions set forth in subdivision (a), shall be deemed to*
3 *be conducted by a separate bank, corporation, or other*
4 *entity which does not meet those conditions, and, except*
5 *as provided in subdivision (c), the income and*
6 *apportionment factors of any such bank, corporation, or*
7 *other entity shall be determined upon the basis of the*
8 *books of account maintained by such bank or corporation*
9 *or other entity with respect to the activities conducted*
10 *within or directed from the United States and the income*
11 *and apportionment factors with respect to the activities*
12 *shall be taken into account in the manner authorized by*
13 *this chapter.*
14 *(c) Nothing in this section shall preclude the*
15 *Franchise Tax Board from distributing, apportioning, or*
16 *allocating gross income, deduction, credits, or allowances*
17 *between or among organizations, trades, or businesses, if*
18 *it determines that it is necessary to do so in order to*
19 *prevent evasion of taxes or clearly to reflect the income*
20 *of any of the organizations, trades, or businesses.*
21 *(d) In view of pending litigation concerning the*
22 *question of whether a corporation liable to report under*
23 *this part is required to take into account the income and*
24 *apportionment factors of other corporations operating in*
25 *a foreign country, it is not intended that any inference be*
26 *drawn from the enactment of this act in any litigation*
27 *concerning that question.*
28 *SEC. 3. Section 25126 of the Revenue and Taxation*
29 *Code is amended to read:*
30 25126. *(a)* Interest ~~and dividends are~~ *is* allocable to
31 this state if the taxpayer's commercial domicile is in this
32 state.
33 *(b) The dividends from subsidiaries excluded under*
34 *Section 25101.9 can be included in the base for taxation*
35 *to the extent the dividends are actually taxed by the*
36 *federal government.*
37 *SEC. 4. The Legislative Analyst shall report to the*
38 *Legislature during the 1988 portion of the 1987–88*
39 *Regular Session of the Legislature on the impact of this*
40 *act.*

SEC. 5. This act provides for a tax levy within the meaning of Article IV of the Constitution and shall go into immediate effect. However, the provisions of this act shall apply in the computation of taxes for income years beginning on or after January 1, 1981. ~~accepted accounting methods in general use by foreign based taxpayers are materially different from accounting methods used by United States based taxpayers; and income statements prepared under foreign accounting standards are not readily converted to income statements based on the California Bank and Corporation Tax Law. The Legislature further finds that many unresolved problems have arisen in accounting for changes in foreign exchange rates, both in the determination of income and in constructing apportionment data of foreign based taxpayers, on a basis consistent with that used to determine income earned in California by United States taxpayers. The Legislature further finds that the cost burden of converting income statements of foreign based taxpayers to income statements more comparable to those of United States based taxpayers is often substantially greater than any resulting tax on income considered to be earned in California. The Legislature further finds that the inclusion of foreign income in determining the tax liability of foreign economic interests wishing to invest in California has frequently resulted in unfair taxation of foreign based taxpayers and consequently acted as an impairment to investment and hindered the creation of new opportunities for employment and the diversification of the economic base of this state.~~

~~SEC. 2. Section 24344 of the Revenue and Taxation Code is amended to read:~~

~~24344. (a) Except as limited by subsection (b), there shall be allowed as a deduction all interest paid or accrued during the income year on indebtedness of the taxpayer.~~

~~(b) If income of the taxpayer is determined by the allocation formula contained in Section 25101, the interest deductible shall be an amount equal to interest~~

1 ~~income subject to allocation by formula, plus the amount,~~
2 ~~if any, by which the balance of interest expense exceeds~~
3 ~~interest income not subject to allocation by formula.~~
4 ~~Interest expense not included in the preceding sentence~~
5 ~~shall be directly offset against interest income not subject~~
6 ~~to allocation by formula.~~
7 ~~SEC. 3. Section 25101.9 is added to the Revenue and~~
8 ~~Taxation Code, to read:~~
9 ~~25101.9. (a) Notwithstanding any other provision of~~
10 ~~this chapter (except as provided in subdivision (h), in~~
11 ~~determining the income subject to tax of any bank,~~
12 ~~corporation, or other entity liable to report under this~~
13 ~~part, there shall not be taken into account the income or~~
14 ~~apportionment factors of any other bank, corporation, or~~
15 ~~other entity, if the other bank, corporation, or other~~
16 ~~entity is created or organized under the laws of a foreign~~
17 ~~country.~~
18 ~~(b) For purposes of this section, the activities~~
19 ~~conducted within or directed from the United States by~~
20 ~~any bank, corporation, or other entity meeting the~~
21 ~~conditions set forth under subdivision (a) shall be~~
22 ~~deemed to be conducted by a separate bank, corporation,~~
23 ~~or other entity which does not meet those conditions;~~
24 ~~and, except as provided in subdivision (h), the income~~
25 ~~and apportionment factors of any bank, corporation, or~~
26 ~~other entity shall be determined upon the basis of the~~
27 ~~books of account maintained by the bank or corporation~~
28 ~~or other entity with respect to the activities conducted~~
29 ~~within or directed from the United States and the income~~
30 ~~and apportionment factors with respect to the activities~~
31 ~~shall be taken into account in the manner authorized by~~
32 ~~this chapter.~~
33 ~~(c) Notwithstanding any other provision of this~~
34 ~~chapter, in determining the income subject to tax, any~~
35 ~~bank, corporation, or other entity liable to report under~~
36 ~~this part may elect to take into account the income or~~
37 ~~apportionment factors of any owned or controlled United~~
38 ~~States and foreign bank, corporation or other entity.~~
39 ~~(d) The Franchise Tax Board shall audit, at least once~~
40 ~~every four years, the separate accounting and arm's~~

~~length transactions of any bank, corporation, or other entity determining income pursuant to this section.~~

~~(e) For purposes of this section, direct or indirect ownership or control of more than 50 percent of the voting stock shall constitute ownership or control.~~

~~(f) The following definitions shall apply for the purposes of this section.~~

~~(1) The term "residents of the United States" means residents of the United States, its territories, or possessions, or the Commonwealth of Puerto Rico.~~

~~(2) The term "United States corporation" means a bank, corporation, or other entity organized under the laws of the United States, its political subdivisions, its territories, or possessions, or the Commonwealth of Puerto Rico.~~

~~(g) Nothing in this section shall preclude the Franchise Tax Board from distributing, apportioning, or allocating gross income, deductions, credits, or allowances between or among organizations, trades, or businesses, if it determines that it is necessary to do so in order to prevent evasion of taxes or clearly to reflect the income of any of the organizations, trades, or businesses.~~

~~(h) In view of pending litigation concerning the question of whether a corporation liable to report under this part is required to take into account the income and apportionment factors of other corporations operating in a foreign country, it is not intended that any inference be drawn from the enactment of this act in any litigation concerning that question.~~

~~SEC. 4. Section 25126 of the Revenue and Taxation Code is amended to read:~~

~~25126. Interest is allocable to this state if the taxpayer's commercial domicile is in this state.~~

~~SEC. 5. The Legislative Analyst shall report to the Legislature during the 1988 portion of the 1987/88 Regular Session of the Legislature on the impact of this act.~~

~~SEC. 6. This act provides for a tax levy within the meaning of Article IV of the Constitution and shall go into immediate effect. However, the provisions of this act~~

1 ~~shall apply in the computation of taxes for income years~~
2 ~~beginning on or after January 1, 1981.~~

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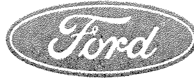
APPENDIX III

Ford Motor Company Proposal



Office of the General Counsel

Ford Motor Company
The American Road
Dearborn, Michigan 48121

April 20, 1981

Assemblyman Wadie P. Deddeh, Chairman
Assembly Revenue and Taxation Committee
Room 2013 - State Capitol
Sacramento, California 95814

Dear Chairman Deddeh:

We very much appreciated the opportunity to discuss with you the problems associated with either the continuation or elimination of the worldwide combined unitary tax (WCUT) concept as now practiced by California.

It is clear to us that most multinational corporations believe California's WCUT approach is unfair because it can lead to the taxation by California of income, which by accepted international tax standards, is earned totally outside the United States. This business viewpoint is, as demonstrated by testimony given to your committee, significantly impairing job producing investment in California by multinationals. However, as you pointed out, the continuing drain on state revenues required to counter the adverse effects of Proposition 13 on local government, makes it very difficult for California to undertake any modifications in tax policy which could, even temporarily, reduce tax revenues.

In the course of our discussions it occurred to us that there might be a way for California to escape its present dilemma, i.e., the inability to adopt a good long-run tax policy because of the potential short run revenue loss associated therewith. This escape would take the form of offering all corporate taxpayers an option of:

1. being subjected to the existing California franchise tax calculated on the present WCUT basis; or

2. being subjected to an annual California franchise tax consisting of the sum of:

a. a tax (at existing rates) on an apportioned part of income from U.S. sources, i.e., total income less income which, for U.S. income tax purposes, constitutes foreign source income; and

b. a tax, at rates determined by the legislature, on the greater of:

(1) the gross book value of tangible property located in California; or

(2) the combined net worth, as shown on the balance sheet of the taxpayer's federal income tax return, apportioned to California.

By applying the alternative (option 2 above):

1. all U.S. source income of a group of corporations conducting a unitary business in the U.S. would continue to be subject to consolidation;

2. the apportionment factors would be restricted to tangible property, payroll, and receipts which give rise to U.S. source income;

3. the establishment of two alternative bases (i.e., California tangible property and apportioned net worth) for the supplemental tax ensures that service oriented taxpayers do not obtain an unnecessary and unwarranted preference over manufacturing or processing taxpayers;

4. the net worth base of the supplemental tax would be calculated on a combined basis if a group of corporations were deemed to be conducting a unitary U.S. enterprise even though the group did not file a consolidated U.S. income tax return; and

5. the taxpayer's election of the basis of taxation, once made, could not be changed without approval of the Franchise Tax Board or unless the taxpayer can show that the tax paid under the method originally elected has, over the period since the election was made, been equal to or greater than the tax which would have been paid over the same period under the method to which the taxpayer desires to switch.

It appears to us that the creation of an election has a number of advantages.

a. Those taxpayers who now view the WCUT as advantageous will not be forced to switch to a procedure which they oppose.

b. Those multinational taxpayers who sincerely believe that California's WCUT approach subjects foreign source income to taxation in California can elect the second alternative and thus be assured that investment in California will not generate a tax on income from sources or investments outside the U.S.

c. The double tax measure under the second alternative results in a tax structure that it not unlike that existing in many other U.S. states (e.g., New Jersey, Pennsylvania, Oklahoma, Louisiana, Alabama, Kentucky, Georgia, etc.) which levy both a tax measured by net income and a tax on net worth or property employed in the state.

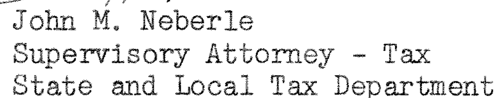
d. By adjusting the rates on the supplemental tax under alternative 2, the legislature can guard against any significant tax revenue loss until the positive impact of the alternative on California investment materializes. The legislation creating the

option could provide a schedule of slowly declining rates for the supplemental tax under alternative 2 which recognizes the positive revenue impact of increased California investment. Indeed, the legislation might provide that the supplemental tax would terminate or the rate thereof very substantially diminish if the split roll concept were adopted.

The critical element of this proposal is, of course, the rate or rates adopted for the supplemental tax under the second alternative. We do not have sufficient data to estimate what, from a revenue standpoint, that rate would need to be. As you recognize, if that rate is too high, the alternative would not achieve its intended purpose because it would not create a viable option to multinational taxpayers to the present WCUT approach. For this reason, we suggest that in examining that question, care should be taken to distinguish between the actual (i.e., actual WCUT collections) as opposed to potential (i.e., calculated but disputed and uncollected WCUT liability) revenue loss which would occur if taxpayers were permitted to elect an income tax measured by apportioned U.S. source income.

We recognize that this suggestion may raise a number of problems which we may not have considered. Therefore, we would be happy to discuss this matter further with you or members of your staff. As long as you are analyzing this approach, we will not discuss it with any other party without your direction or concurrence.

Very truly yours,



John M. Neberle
Supervisory Attorney - Tax
State and Local Tax Department

APPENDIX IV

Franchise Tax Board
Correspondence on Alternative
Sources of Revenue

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REVENUE AND TAXATION COMMITTEE

STATE CAPITOL, ROOM 2013
(916) 322-3730

WADIE P. DEDDEH
CHAIRMAN

August 10, 1981

Mr. Gerald Goldberg
Executive Officer
Franchise Tax Board
Aerojet Center
Sacramento, California 95857

Dear Mr. Goldberg:

Thank you very much for your recent letter on the progress of your staff in updating the revenue estimates for the various "unitary" proposals before the Committee this year.

I have one further request. You may recall that at the Committee's hearing on the subject this Spring, the Ford Motor Company made a proposal for an alternative source of revenue (attached). I would appreciate it very much if you could provide us with estimated tax rates necessary to offset the loss from AB 1238, by instituting one of the following additional taxes:

1) The greater of

   a - The gross book value of tangible property located in California, or

   b - The combined net worth, as shown on the balance sheet of the taxpayer's federal income tax return, apportioned to California

   (This is the Ford proposal)

2) An increase in the present bank and corporation tax rate

3) A tax imposed on the property of a corporation in California, as defined by Sec. 25130

4) A tax on compensation in California, as defined by Sec. 25133

5) A tax on sales in California, as defined by Sec. 25135

6) A tax on the greater of (3), (4), or (5)

7) A tax on the average of (3), (4) and (5)

I would also appreciate hearing your views as to the feasability of these options, any pitfalls we should know about and your preference, if any, for any one of them.

We are considering holding interim hearings on this subject in late Autumn. We would appreciate a response by November 20th.

Thank you for your help. Please contact Dave Doerr (322-3730) if you have any questions.

Sincerely,

WADIE P. DEDDEH

WPD:js

Enclosure

State of California | Franchise Tax Board

Memorandum

To : Hon. Wadie P. Deddeh
Chairman of the Assembly
Revenue and Taxation Committee
State Capitol, Room 2013
Sacramento, CA 95814

Date :

File No.: GG:AND:TM:520:ab

Telephone: ATSS (8) 438-0144
(916) 355-0144

From : Gerald H. Goldberg

Subject: Alternative Revenue Sources for AB 1238

As requested in your August 10, 1981, memo, we have developed estimated tax rates on various factors which would be required to offset the loss from AB 1238. These estimates are based on our sample of 1979 income year returns. Each estimate represents additional revenue of around $500 million which would have been the "range" impact of AB 1238 for that year. We will respond in the order of your questions.

Question 1a

Gross book value of tangible property in California and property defined by Sec. 25130 (Question 3) pertain to basically the same business property. Refer to Question 3 for tax rate.

Question 1b

We were unable to use actual combined net worth figures since this information is not available in our sample data base. We were, however, able to make a substitution for combined net worth. In the U.S. Corporation Statistics of Income publication, net worth is defined as stockholders' equity in the assets of a corporation (total assets minus the claims of creditors). Specifically, net worth is the net of:

(1) capital stock,
(2) paid-in or capital surplus,
(3) retained earnings, appropriated,
(4) retained earnings, unappropriated, and
(5) less: cost of treasury stock.

Based upon this definition, net worth was computed to be equal to 25.6% of the total assets on the returns of all active corporations that filed Federal returns. For this analysis, therefore, we have used 25.6% of total assets of apportioning multinationals for net worth.

Factor	Number of Multinationals	Amount	Required Tax Rate
Net worth	8,467	$358.5 billion	0.14%

Question 2

We have estimated the increase in the bank and corporation tax rate for (1) all corporations and (2) multinationals only that would be required to raise replacement revenues.

Factor	Number of Corporations	Amount (est.)	Additional Tax Rate
(1) State Net Income - All Corporations	154,468	$20 billion	2.5%
(2) State Net Income - Multinationals only	8,682	$10 billion	5.0%

The feasibility of imposing a higher rate on nonmultinational corporations not benefiting from AB 1238 (at least in the short run) is doubtful.

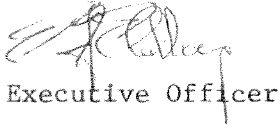
Questions 3 - 7

Factor	Number of Multinationals	Amount	Required Tax Rate
Property	7,564	$330.3 billion	0.15%
Compensation	7,565	49.6 billion	1.01%
Sales	8,433	249.4 billion	0.20%
Average		$209.8 billion	0.24%

To the extent corporations regard such supplemental taxes as disincentives for California operations, corresponding revenue would be less than expected. Also, efforts by corporations to minimize the impact of an additional tax on compensation, property, or sales would simultaneously cause a reduction in regular franchise tax revenues over what would otherwise result by reducing California numerator factors used in the apportionment formula. Indeed, any State "income" tax on tangible property in California may be contested on constitutional grounds as possibly violating Article XIII A property tax limitations.

A State tax on U.S. net worth after apportionment is intriguing, but needs more extensive analysis as to feasibility and practicality. Undoubtedly, corporations would argue that such a basis for tax is capricious and represents an even more extreme application of unitary thinking. Such a tax could also be construed as possibly violating either Article XIII, Sec. 2, or Article XIII A of the State Constitution.

Questions or comments concerning these estimates should be directed to Allan N. Desin at 355-0144.



Executive Officer

APPENDIX V

Text of S. 655, Mathias

S. 655

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That (a) chapter 77 of the Internal Revenue Code of 1954 (relating to miscellaneous provisions) as amended by adding at the end thereof the following new section:

"Sec. 7518. Income of Corporations Attributable to Foreign Corporations.

"(a) In General.—Where two or more corporations are members of the same affiliated group of corporations—

(1) for purposes of imposing an income tax on any corporation which is a member of such group, no State, or political subdivision thereof, may take into account, or include in income subject to such tax, any amount of income of, or attributable to,

(2) any other corporation which is a member of such group and which is a foreign corporation, unless such amount is includable in the gross income of the corporation described in paragraph (1) for purposes of chapter 1 (including any amount includable in gross income under subpart F of part III of subchapter N of chapter 1) for the taxable year in which or with which the taxable period (or purposes of State or local law) ends.

"(b) Income Tax Defined.—For purposes of this section, the term 'income tax' means any tax which is imposed on, according to, or measured by net income.

"(c) Affiliated Group Defined.—For purposes of subsection (a), the term 'affiliated group' means a common parent corporation and one or more chains of corporations connected through stock ownership with such common parent corporation.

"(d) Certain Corporations Treated as Foreign Corporations.—For the purpose of this section, a domestic corporation shall be treated as a foreign corporation if under section 861(a)(2)(A) a dividend received from such corporation in the taxable year referred to in subsection (a) would not be treated as income from sources within the United States.

"(e) Certain Dividends Paid or Deemed Paid.—

"(1) Dividends excluded from tax.—If a corporation receives in any taxable year a dividend from a foreign corporation (or is by application of section 951 treated as having received such a dividend), in imposing an income tax on such corporation no State, or political subdivision thereof, may tax, or otherwise take into account—

"(A) in the case of a dividend received from a corporation with respect to which an election under section 936 is in effect for the taxable year in which such dividends are paid, the amount of deduction allowed by section 243.

"(B) in the case of a dividend received from a corporation described in subsection (d) which is not described in paragraph (A), more than the lesser of—

"(i) the amount of the dividend exclusive of any amount of dividend determined under paragraph (3), or

"(ii) the amount by which the dividend plus any amount of dividend determined under paragraph (3) exceeds the excluded portion of the dividend determined in accordance with paragraph (2).

"(C) in the case of a dividend received from any other foreign corporation more than the lesser of—

"(i) the amount of the dividend (exclusive of any amount determined under section 78), or

"(ii) the amount by which the dividend plus any amount determined under section 78 exceeds the excluded portion of the dividend determined in accordance with paragraph (2).

"(2) Excluded portion of a dividend.—The excluded portion of any dividend shall be determined by multiplying the amount of the dividend (including any amount of dividend determined under section 78 or paragraph (3)) by a fraction—

"(A) the numerator of the fraction shall be the sum of—

"(i) the total amount of tax withheld from all such dividends at the source.

"(ii) the total amount of tax which by application of section 902 or section 960 to all such dividends, the domestic corporation is deemed to have paid, and

"(iii) the total amount of tax deemed paid by application of paragraph (3).

"(B) The denominator of the fraction shall be 46 percent of all such dividends.

"(3) Special rule with respect to dividends received from domestic corporations treated as foreign under subsection (d).—A corporation that receives a dividend which is described in subparagraph (B) of paragraph (1) shall—

"(A) treat as a dividend for purposes of subparagraph (B) of paragraph (1), and

"(B) treat as a tax deemed paid for purposes of subparagraph (A) of paragraph (2), foreign income taxes which such other corporation has paid or deemed paid in the same proportion on or with respect to the accumulated profits of such corporation from which such dividend was paid, which the amount of such dividend bears to the amount of such accumulated profits in excess of all income taxes (other than those deemed paid).

For purposes of this section, only a tax for which a credit against tax would be allowable under section 901 (determined without regard to the limitations in sections 904 and 907) shall be taken into account."

(b) Effective Date.—The amendment made by this section shall apply to taxable periods (for purposes of State or local law) beginning after December 31, 1980.

(c) Amendment of the Table of Sections.—The table of sections for chapter 77 of such Code is amended by adding at the end thereof the following new item:

"Sec. 7518. Income of corporations attributable to foreign corporations."

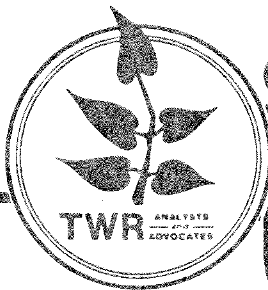
APPENDIX VI

"Oil Companies' Disappearing Profits:

A Case for the Unitary Method",

by Ken Cory, in *Tax Notes*,

May 25, 1981



THE OIL COMPANIES' DISAPPEARING PROFITS: A CASE FOR THE UNITARY METHOD

by Ken Cory

Ken Cory is the Controller of the State of California and the Chairman of the California Franchise Tax Board. Cory is currently the chairman of the Multistate Tax Commission and oversees California's system of unitary taxation based on worldwide combined apportionment.

In this article, Cory argues that the unitary method of taxation offers the states the only effective and administrable system for taxing corporate income. Using the major oil companies as an example, he details how multistate and multinational corporations can easily avoid state income taxes through the use of transfer prices. Cory states that the arm's-length method of taxation is no match for the complicated transactions of major corporations. He concludes that the imposition of federal limits on the use of the unitary method would unfairly threaten the states' taxing powers and aggravate their already-serious fiscal problems.

Clearly the nation is in serious trouble. Industry reels under the impact of inflation and taxation, unemployment rises and the burden of the poor becomes even heavier.

At the same time, these impacts have not been equally distributed between sections of the economy or the country. The connection between the record profits of the very large oil companies and the record losses of the very large automobile companies is easily perceived. The fact that gasoline prices are high and rising clearly has something to do with the fact that Chrysler is afloat only at government sufferance. The differences between the unemployment rates in Houston and Detroit are similarly not unconnected.

Nor is the auto industry alone. Indeed, were one scoring winners and losers, the winners are the oil companies and the losers are everybody else. The record oil industry profits last year were a disproportionate 40 percent of all manufacturing profits.

State Tax Avoidance

The tax consequences are less apparent but no less real. They are of increasing importance as the Administration justifiably moves to return a large share of government power and responsibility to the states. A great deal has been written about the failure of the international oil companies to pay their share of federal income taxes, but very little has been written about the increased tax burden this has placed on other businesses. Even less has been written about the ability of the international oil companies to avoid state taxation, and the added burdens this places on other state taxpayers as the states scramble to find added revenues to finance their new responsibilities.

Rising oil profits require a reexamination of the international oil companies' ability to avoid state taxation and force smaller, less profitable businesses to pick up their share of the taxes. The Citizen/Labor Energy Coalition recently issued a report citing the following data compiled from state revenue departments:

> *"...In 1979, Conoco, Amoco, Exxon and Mobil paid state income taxes amounting to 0.3 percent, 0.4 percent, 0.9 percent, and 1.4 percent of their total corporate profits in state income taxes, respectively. These figures are less than the rate paid by the average family of four making $16,000 the year before.*
>
> *"...In Colorado, Gulf and Cities Service reported no taxable income in 1978, despite combined sales in the state of $33.7 million.*
>
> *"...Wisconsin fared even worse that year, with Exxon, Gulf, Tenneco and Union of California all alleging that their oil business in the state was a losing proposition, and therefore paying no state income taxes."*

With other industries feeling the shock of energy prices and the Administration asking state governments to carry a greater burden, the question of effective state taxation of the international oil companies has become a very serious matter. Some states have attempted to get at the problems by using sales taxes on gasoline or gross receipts taxes. Such taxes hardly address the problem since their burden falls directly and immediately on the consumers. A more sophisticated approach is clearly required.

Transfer Price Shell Game

The states' problem in taxing oil companies centers around what are called "transfer prices." These are the prices that one division or corporate subsidiary of a vertically integrated company charges other divisions or

Rising oil profits require a reexamination of the international oil companies' ability to avoid state taxation....

61

subsidiaries in the same company. For example, an oil company's crude oil producing division "sells" crude oil to its refining division and the refining division in turn "sells" gasoline, heating oil, and other refined products to its marketing divisions. These are not true market transactions in the sense that they represent nothing more than a company doing business with itself. They are internal bookkeeping transactions and involve no real transfer of revenue outside the corporate organization.

When the various divisions are in different jurisdictions which have different rates of taxation there is an obvious opportunity to play a "shell-and-pea" game in order to avoid taxes. If the refining division faces higher taxes than the crude producing division, taxes can be reduced simply by increasing the price at which crude oil is sold to the refining division. As a result, the refining division makes little or no profits and pays little or no taxes, while the producing division makes lots of money where the tax rates are low. In addition, it is not unknown for an international oil company to set up off-shore companies specifically for the purpose of avoiding taxes.

Two points should be made. First, all integrated (or "unitary") corporations that operate across jurisdictional boundaries are capable of such manipulation. In terms of sheer magnitude, however, nothing matches the capability of the major oil companies. Second, it is important to recognize that this shifting of profits need not involve fraud or other illegality. The Internal Revenue Service (as well as the tax authorities in other nations) uses the so-called "arm's-length" method of accounting in assessing the legitimacy of intracorporate transfer prices. According to this system, transfer prices used for an item would be compared to the price that would prevail in a true market, or "arm's-length," transaction. In the petroleum industry, at any given time, there is never a single price for crude oil, gasoline, or any other petroleum product. There are clusters of "market" prices which reflect various long-term contract prices and spot market prices. The absence of any one clear "market price" gives considerable latitude to managers in setting intracorporate transfer prices.

There is more than ample evidence that the integrated oil companies manipulate transfer prices to minimize taxes. In one Canadian case Exxon was shown to have used a paper subsidiary in the Dutch Antilles to evade many millions of dollars of Canadian taxes. And a recent report from Canada's Director of Investigations and Research, Consumer and Corporate Affairs alleges that "During the period 1958 to 1973. . .excessive costs were imposed on Canadian consumers as a result of overcharges on transfer prices for imported crude oil levied by foreign parent companies on their Canadian subsidiaries. . . ." Prior to 1973, the integrated oil companies shifted their profits to the production end of the business to maximize their tax savings through the use of the depletion allowance and foreign tax credits. Since 1973, these same companies have used this vertical structure to shift profits and, not incidentally, to maintain the downstream control OPEC needed to support its price structure. In fact, the integrated oil companies have opposed divestiture legislation by arguing that the oil industry is essentially unitary and that there are efficiencies inherent in vertical integration that cannot be measured merely by examining transfer prices.

The Unitary Solution

To deal with the transfer price problem, a number of states, and in particular California, have employed the "unitary" method of corporate taxation. Essentially this method looks at that part of the corporation which is located within the state and attempts to identify the real economic contribution it makes to the overall corporate unit. While the formulae vary from state to state, in general, they determine the portion of the corporation's revenue subject to state taxation on the basis of the amount of property, payroll, and sales within the jurisdiction.

The unitary system of corporate taxation is not without flaws. Most obvious is the difficulty of determining what is a "unitary" corporation. It is generally agreed that a conglomerate corporation whose parts do little or no business with each other should not be treated as a unitary entity. For example, a firm that runs a car rental operation in one jurisdiction and a hamburger chain in another is hardly unitary. In taxing the hamburger chain a state would not be justified in looking at revenue earned by the car rental. There are, of course, closer cases where the unitary nature of the corporation can be reasonably disputed. But the general standard is sufficiently clear and workable: are the commonly owned entities operated as an economic unit? In short, it is the business reality that is the test.

. . there is one overwhelming argument for the unitary approach: it can actually be used to collect taxes.

In comparison with the necessity of untangling a host of intracorporate transactions and comparing them against an arm's-length standard, the unitary method presents no extraordinary problems of fairness or workability. In fact some tax scholars have found it a theoretically superior instrument of tax policy. But, tax theory aside, there is one overwhelming argument for the unitary approach: it can actually be used to collect taxes. It is no exaggeration to say that the arm's-length method completely fails to provide the states with a workable method for taxing corporate income earned within their jurisdictions.

Some critics of the unitary method are willing to tolerate its use by states in taxing multistate corporations, but they object to its use in taxing the earnings of multinational corporations. They claim that looking at the worldwide earnings of a corporation in order to determine what portion the state may tax results in unfair taxation of foreign earnings. This argument misses the point. *The purpose of the unitary method is to determine what part of a corporation's total income (whether multistate or multinational) can appropriately be said to have been earned within the state,* not to tax income earned outside the state. Or, put another way, what contribution did the activities within the state make to the total earnings of the corporation? This is a wholly legitimate question for any taxing jursidiction to ask. It is painfully obvious that the arm's-length method provides no useful answer.

Political Battle on the Horizon

Despite this failure of the arm's-length method, multinational corporations have been quite successful in promoting efforts to restrict the ability of states to use the unitary method. Two years ago there was a bitter fight in

the Senate over a provision in the United Kingdom Tax Treaty limiting the unitary method. Ultimately a reservation to the provision prevailed by a close margin. The unitary method has also withstood a number of broad-based legal challenges. In two recent cases—brought by Mobil and Exxon—the Supreme Court reaffirmed the constitutionality of the unitary method and rejected claims that worldwide apportionment amounts to double taxation.

It is irrational to rely on a system that permits 40 percent of manufacturing profits to remain out of the range of effective taxation.

These courtroom defeats have encouraged the oil companies and multinationals to focus their opposition to the unitary method on legislative remedies. Republican Sen. Charles McC. Mathias, Jr., and Rep. Barber Conable, the ranking Republican on the House Ways and Means Committee, have introduced legislation to prevent states from using the unitary method to tax multinational corporations. Needless to say, the bills have very powerful support. Advocates of the bills are now interested in attaching some form of the legislation to the pending tax-cut bill. This strategy could force Congress to consider the unitary method in a loaded political setting that would hardly be conducive to a deliberate exploration of the issues.

It is worth noting that the federal government has similar problems in dealing with transfer prices and a strong argument can be made for the use of the unitary approach by the Internal Revenue Service. While the U.S. Treasury Department supported the U.K. Tax Treaty and the Mathias bill, it has used the unitary approach itself. Unfortunately, the IRS has not done so systematically, and it certainly has not done so with the international oil companies.

With the rapid increase in both energy prices and profits, we simply have no choice but to find an effective means of taxing the international oil companies. It is irrational to rely on a system that permits 40 percent of manufacturing profits to remain out of the range of effective taxation. To ask that the states do so in the context of the current economic policies borders on madness. It requires other businesses whose profits are already suffering to bear more than their share of the burden. The unitary method may not be a perfect solution, but it is a reasonable, workable, and equitable approach and at the moment we have no other.

READER COMMENTS WELCOMED

We'd like to publish reader comments on this article in our "Letters to the Editor" column. If you'd like to make your views known, please write us promptly.

Please note that letters must be signed, and that we reserve the right to edit them in the interest of brevity. However, the full texts of all letters that we receive will be made available in the Tax Notes Microfiche Edition.

CONGRESSIONAL HEARINGS

MATSUNAGA BILL WOULD GIVE INVESTMENT CREDIT TO RACE HORSE BREEDING SYNDICATES. The Senate Finance Subcommittee on Taxation and Debt Management held a postponed hearing last week on a series of "miscellaneous" tax bills. (See *Tax Notes*, May 11, 1981, p. 1064 for a listing of the bills considered at the hearing.)

In addition to the bills previously scheduled for a hearing, the Finance Subcommittee also heard testimony on S. 450, a bill introduced by Finance Committee member Spark Matsunaga, D-Hawaii, which would grant an investment tax credit to persons who invest up to $100,000 in "work and breeding horses." The principal beneficiaries of the bill would be investors in race horse breeding syndicates. *Doc 81-4843*

ESTATE TAX HEARINGS TO CONTINUE. Sen. Steven D. Symms, R-Idaho, the Chairman of the Senate Finance Subcommittee on Estate and Gift Taxation, has announced that his subcommittee will continue its hearings on major estate tax issues on June 5. For earlier coverage of the Subcommittee's hearings, see *Tax Notes*, May 11, 1981, pp. 1079-1080, and April 27, 1981, p. 952.

The June 5 hearing will "focus on particular problems of the estate and gift tax laws, including the special use valuation for farm property and the interaction of estate tax laws with the gift tax," according to the hearing announcement. The bills to be considered at the hearing include the following:

- **Abolition of Estate Tax.** S. 404 would repeal the federal estate and gift tax.
- **Exclusion; Marital Deduction.** S. 395 would increase the federal estate and gift tax exclusion to $600,000 and provide an unlimited marital deduction.
- **Exclusion; Use Valuation.** S. 858 would increase the federal estate and gift tax exclusion to $600,000 and revise the rule relating to the special use valuation of farmland.
- **Marital Deduction.** S. 574 would allow a marital deduction of up to $750,000 and would "provide a similar deduction for heirs other than the spouse."
- **Crop Share Rentals.** S. 23 would "make it clear that crop share rentals qualify as a standard of valuation under section 2032A."
- **Retroactive Use Valuation.** S. 557 would allow estates that filed estate tax returns before July 13, 1978, to elect the special use valuation for farmland.
- **Gift Tax Reporting.** S. 995 would permit the reporting of gift tax on an annual basis.

Persons wishing to testify at the June 5 hearing must submit requests in writing to the Finance Committee not later than May 29, 1981. *Doc 81-4844*

APPENDIX VII

Excerpt, Comptroller General's
Report to the House Committee on
Ways and Means, on the Subject
of Determining the Income of
Multinational Corporations,
September 30, 1981

COMPTROLLER GENERAL'S REPORT TO THE HOUSE COMMITTEE ON WAYS AND MEANS

IN DETERMINING THE INCOME OF MULTINATIONAL CORPORATIONS, IRS COULD BETTER PROTECT U.S. TAX INTERESTS

D I G E S T

Multinational corporations have both the incentive and the opportunity to shift income between jurisdictions to take advantage of disparate corporate tax rates. One incentive is minimization of taxes. The opportunity lies in the pricing of interorganizational transactions. Obviously, possession of incentive and opportunity does not axiomatically lead to abuse--but to tax administrators, American and foreign, it represents a vulnerability to guard against.

IRS, however, has not yet developed baseline information on the incidence and magnitude of multinational corporation noncompliance in terms of improper shifting of income. Thus, IRS has no sound basis for determining the amount of audit resources to be assigned to address the problem, nor for gauging the success of those resources that are applied to it.

Further, IRS enforcement difficulties are compounded by the complexities involved in measuring the amount of income misallocated in those instances where this is believed to have occurred. Ideally, interorganizational pricing is to be adjusted to that for similar transactions between unrelated parties--the so-called "arm's length standard."

However, in the modern economic system of multinational corporate business, a true arm's length price can rarely be identified. When an arm's length price cannot be identified, Department of Treasury regulations for Internal Revenue Code Section 482 provide both the corporate taxpayer and the IRS examiner some guidance for arriving at a constructed price. The regulations and the resulting enforcement

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process, however, create an unacceptable level of uncertainty and a significant administrative burden both for corporate taxpayers and IRS examiners.

For example, there is often no similar transaction on which to establish an arm's length price. In these instances, the Treasury regulations do not provide corporate taxpayers with sufficient certainty for planning their financial strategies and considering the tax consequences of their pricing of intercorporate transactions. IRS, faced with the same lack of certainty, must construct an estimated price for adjustment purposes. Both corporate taxpayers and IRS examiners have characterized the end result of the adjustment process as being unpredictable.

The Chairman of the House Ways and Means Committee asked GAO to study section 482 enforcement. GAO reviewed current IRS examination data on 519 U.S. multinational corporations, each having assets over $250 million and each having engaged in transactions with their foreign subsidiaries. GAO found that only 3 percent (12 of 403) of IRS' total recommended section 482 adjustments to reported income for such transactions were based on a true arm's length price. These adjustments amounted to 3 percent ($7.4 million of a total $277.5 million increase) of the total income adjusted for section 482 issues. The tax impact of the total $277.5 million in adjustments, while not known precisely, can be estimated using a corporate tax rate of 48 percent at roughly $133.2 million. (See p. 29.)

While IRS has only limited resources, the number and volume of complex international intercorporate transactions as well as the amounts of income involved continue to grow. In the short term, IRS and Treasury should, GAO believes, make several specific improvements in the way they presently administer section 482. In addition, IRS should consider ways to get a measure of corporate noncompliance regarding arm's length pricing, and Treasury should begin a study to ascertain whether ways exist to make section 482 enforcement easier to administer, more certain, and more equitable for all concerned. (See pp. 24 and 53 to 54.)

IRS CAN IMPROVE ITS CURRENT SECTION 482 ENFORCEMENT ACTIVITIES

IRS needs more management information than it now has to measure what it is doing to enforce section 482 against what needs to be done. Lacking such information, IRS cannot determine with reasonable assurance the impact of its current efforts nor adjust its strategy as may be necessary to make the best use of its limited resources.

Considerable information is available within IRS concerning IRS' enforcement activities and the operations of multinational corporations, but this information has not been analyzed to answer management's needs. The case-by-case results of IRS' section 482 enforcement activities are documented in various reports prepared during the examination and appeals processes. Information on the operations of multinational corporations is also available to IRS from the Form 2952 which must be submitted by U.S. corporations for each foreign subsidiary they control. (See pp. 9 to 11.)

Other information IRS needs is not so readily available. For example, IRS needs a better idea of the extent of noncompliance with section 482 regulations that exists within the universe of multinational corporations.

IRS has, in the past, shown that it can respond to similar problems in developing management strategies where unknown factors exist. IRS now needs to focus its expertise on ways to obtain a better measure of the total noncompliance with section 482 that exists in the multinational corporate universe. (See p. 11.)

CRITICAL REPORTING REQUIREMENTS SHOULD BE EXTENDED

IRS examiners use the form 2952 as their starting point for most examinations involving international transactions. Data provided on this form is critical to the successful identification of many section 482 adjustments. Section

6038 of the Internal Revenue Code authorizes IRS to require this information only from U.S. parent corporations, but similar information is also needed for U.S. subsidiaries of foreign parents. In 1974 there were 6,538 controlled U.S. corporations with assets totaling more than $76 billion. GAO believes that having similar information readily available for these types of corporations would enhance IRS' identification and examination of section 482 issues in international transactions between U.S. subsidiaries and their foreign parents. (See pp. 18 to 20.)

TREASURY SHOULD ADJUST THE SAFE HAVEN RATE AS NECESSARY TO MORE CLOSELY REFLECT THE REAL COST OF BORROWING

Another needed change concerns the use of the safe haven interest rate, a fixed rate of interest which IRS examiners are permitted to use in lieu of an arm's length price in certain types of transactions as a basis for making income adjustments. The economic climate since 1968 has produced rapidly changing interest rates on the open market. The safe haven interest rates established by Treasury have not kept pace. (See pp. 15 to 16.)

GAO's analysis showed that 83 of the 84 section 482 adjustments involving loan or advance transactions made between August 1972 and June 1975 in its sample were based on a safe haven interest rate of 5 percent. During the period when these adjustments were made, the prime interest rate was always higher than the 5 percent rate, ranging from a low of 5.25 to a high of 12 percent. Treasury implemented a new, higher adjustment rate of 12 percent in July, 1981. This new rate has already been overtaken by the continuous rise in the cost of money which has seen the prime rate reach about 20 percent. (See p. 17.)

Safe haven interest rates which are substantially lower than the open market rate can result in U.S. corporations reporting less income for tax purposes. Further, such safe haven rates are unfair from the perspective of those U.S. corporations which cannot use them. Thus, GAO believes Treasury should adjust the safe haven rate as often as necessary to make the rate realistically reflect the cost of borrowing on the open market. (See pp. 23 to 24.)

ADMINISTERING THE ARM'S LENGTH STANDARD UNDER CURRENT REGULATIONS IS UNCERTAIN AND BURDENSOME TO BOTH IRS AND TAXPAYERS

Making income adjustments using the arm's length standard has posed administrative burdens on both IRS and corporate taxpayers. Because of the structure of the modern business world, IRS can seldom find an arm's length price on which to base adjustments but must instead construct a price. A constructed price is at best an estimate. Because Treasury regulations do not provide sufficient guidance, corporate taxpayers lack reasonable assurance concerning how income on intercorporate transactions that cross national borders will be adjusted and the enforcement process is difficult and time-consuming for both IRS and taxpayers.

The current regulations provide some guidance for those instances in which an arm's length price cannot be identified but, too frequently, the examiner must use considerable judgment in dealing with data that does not directly relate to the specific situation at hand. Adjustments in which an examiner was able to identify an arm's length price resulted in only 3 percent ($7.4 of $277.5 million) of total adjusted income and constituted only 3 percent (12 of 403) of all section 482 adjustments in GAO's sample. Adjustments for 87 percent of total adjusted income were based on the safe haven rules and various alternative techniques permitted by the regulations. The remaining adjustments were arrived at by methods which could not be determined from available documentation or were not applicable to the arm's length standard. (See p. 29.)

Whether or not an arm's length price is obtainable, administering the regulations is a complex process. An examiner must identify questionable transactions, perform a functional analysis, and search for a comparable uncontrolled price. If such a price is not identifiable, the examiner must construct one using alternative techniques. The process as a whole thus creates administrative burden and a degree of uncertainty that is unacceptable for both examiner and taxpayer. (See pp. 36 to 40.)

SHOULD SECTION 482 ADJUSTMENTS BE MADE MORE CERTAIN AND LESS BURDENSOME? TREASURY SHOULD SEEK THE ANSWER

For some time, parties affected by and knowledgeable about arm's length adjustments--corporate taxpayers, courts, experts in the field, and officials at IRS--have criticized section 482 enforcement under the current regulations on the basis that (1) the analytical approach to determining arm's length prices often leads to unreasonable results and (2) the examinations require extensive corporate expense and labor. In addition, a substantial body of expert opinion and several court decisions have also criticized the high degree of burden and uncertainty posed by the current regulations. (See pp. 43 to 47.)

IRS examiners told GAO they believe that, under the current regulations, some potential section 482 adjustments are not being developed. They stated that section 482 work is a "high risk venture" where much audit work can result in little additional tax. They pointed out that, because of this, some examiners might not develop a section 482 adjustment because of the difficulty involved in reaching an agreement on an arm's length price or on the basis for making the adjustment. IRS examiners attributed this situation to both the difficulties in the enforcement process and the time it takes to do the work. (See pp. 40 to 43.)

GAO's statistics on the section 482 adjustments IRS made can be interpreted to lend some credence to the examiners' comments. For example:

--Only 200 of the 519 multinational corporations in GAO's sample had section 482 adjustments involving their foreign subsidiaries.

--The bulk of the total $277.5 million was concentrated in only a few of the 403 total adjustments. Eleven of the 403 adjustments accounted for over one-half of the $277.5 million.

--Adjustments involving the sale of tangible property, the category of intercorporate transaction where the largest amounts of revenue are at issue, were also concentrated.

Thirty-five U.S. parents and 89 of their foreign subsidiaries experienced adjustments on tangible property sales of $4.4 billion. The other 12,248 foreign subsidiaries of the 519 U.S. parents experienced no adjustments to a total of $28.1 billion in intercorporate sales transactions. (See p. 42.)

Neither GAO nor IRS knows how much noncompliance exists, nor how many more adjustments IRS should have made. However, given the difficulty inherent in administering section 482 through the current Treasury regulations, the examiners' statements, and the statistics on the adjustments IRS made, it can reasonably be concluded that the potential for greater enforcement exists.

In the early 1970s, Treasury considered several regulation changes in response to criticism made at that time. The changes, however, were not implemented. Today the need is even greater for Treasury to consider revising the regulations than it was a decade ago. A 1981 study undertaken at the joint request of IRS, Treasury, and the Department of Justice has also recommended revising the regulations to reduce administrative burden and increase certainty, thus lending support to GAO's conclusions (p. 43.)

Tax experts and corporate taxpayers have suggested that Treasury reconsider the appropriateness of the arm's length standard in an economic world more complex than that which existed when the standard was adopted in 1934. For example, one alternative suggested is to expand the use of the safe haven concept, thus creating greater certainty. Another alternative frequently suggested is the use of formulas for apportioning income in certain situations. Apportionment formulas are presently used by 45 States, and some experts believe these formulas, when applicable, reflect market realities better than the arm's length standard. (See pp. 50 to 52.)

A major objection to the use of formula apportionment across national borders is that tax treaties between the U.S. and other nations specify the arm's length standard for adjusting corporate income. For the U.S. to adopt a different method could result in multinational

corporations incurring double taxation. GAO recognizes the significance of this problem. (See p. 52.)

GAO suggests that IRS consider ways to get a measure of noncompliance and that Treasury be the focal point for a study to identify ways to improve the guidance provided concerning section 482 enforcement. After IRS and Treasury have completed this work, Treasury should be able to make an informed decision as to whether and how to change the section 482 regulations. (See p. 53.)

RECOMMENDATIONS TO THE COMMISSIONER OF INTERNAL REVENUE

IRS presently lacks sufficient information to assess the effectiveness of its section 482 enforcement and design future strategy with informed judgment. The need to make informed strategy decisions will assume even greater importance in the future as the number of intercorporate transactions continues to grow in disproportion to IRS' limited resources. To place the Service in a position to make informed decisions regarding how best to deploy those resources, GAO recommends that the Commissioner of Internal Revenue:

--Aggregate and analyze existing data from a management perspective, consider ways to get a measure of noncompliance, and establish procedures for continuously assessing the appropriateness of IRS' section 482 enforcement strategy.

GAO also made other recommendations to improve IRS' enforcement activities (p. 25.)

RECOMMENDATIONS TO THE SECRETARY OF THE TREASURY

The current Treasury regulations for implementing code section 482 create uncertainty and administrative burden for both IRS and corporate taxpayers. Since better guidelines are needed, GAO recommends that the Secretary of the Treasury:

--Begin a study to identify and evaluate the feasibility of ways to allocate income under

section 482, including formula apportionment, which would lessen the present uncertainty and administrative burden created by the existing regulations.

GAO also recommended that the Secretary:

--Adjust the safe haven interest rate as frequently as necessary to realistically reflect the current costs of borrowing on the open market.

RECOMMENDATION TO THE CONGRESS

To provide IRS the authority to require the information it needs from foreign-controlled U.S. corporations, GAO recommended that the Congress amend section 6038 of the Internal Revenue Code to further provide that every United States person, as presently defined by the code, shall furnish such information as the Secretary may prescribe by regulation with respect to any foreign corporation which controls such person.

AGENCY COMMENTS AND GAO'S EVALUATION

Treasury agreed in principle with GAO's conclusions and recommendations concerning the need to more frequently adjust the safe haven interest rate. Treasury stated that a change in the current safe haven rate was made on July 1, 1981, and it anticipated that the rate in the future will be adjusted periodically so as to reflect major changes in interest costs.

Both Treasury and IRS generally agreed with GAO's recommendations concerning specific improvements that need to be made to current section 482 enforcement procedures. However, both agencies expressed disagreement with the recommendation that Treasury undertake a study to identify ways to lessen the uncertainty and administrative burden created by the existing regulations. In so doing, both agencies, GAO believes, minimized the seriousness of the difficulties which section 482 enforcement has presented and continues to present all affected parties. As GAO noted, uncertainty as well as the administrative difficulties and burden on all parties affected by section 482 enforcement have been documented in all previous studies on the subject, the most recent being a January 1981 study undertaken at the joint request of the IRS Commissioner, the Assistant Attorney General, and the Assistant Secretary of the Treasury for Tax Policy. (See pp. 54 to 57.)

CHAPTER 3

HOW CAN SECTION 482 ENFORCEMENT BE MADE MORE CERTAIN AND LESS ADMINISTRATIVELY BURDENSOME? TREASURY SHOULD SEEK THE ANSWER

Adjusting multinational intercorporate transactions for tax purposes under current section 482 regulations is administratively burdensome for both IRS and the corporate taxpayer. Moreover, the considerable amount of judgment necessary in most income adjustments recommended under the regulations creates uncertainty. In recent years, the regulations have been a source of dissatisfaction to all parties affected, including the courts.

In essence, section 482 enforcement is criticized because the theory on which it rests no longer corresponds to the realities of intercorporate transactions. In theory, a section 482 adjustment should be made when income reported for a multinational intercorporate transaction varies from the comparable uncontrolled price of a similar transaction between two unrelated businesses. The comparable uncontrolled price is the arm's length price for the transaction. In practice, however, IRS examiners have difficulty finding a comparable uncontrolled price for most transactions. Of the examinations we reviewed, only 3 percent (12 of 403) of IRS' recommended adjustments between parents and foreign subsidiaries were based on comparable uncontrolled prices. The income adjusted through these arm's length prices amounted to only 3 percent of the total income adjusted for section 482 issues.

The regulations provide some guidance for those instances where an arm's length price cannot be identified but, too frequently, the examiner must use considerable judgment in analyzing extensive data which often does not directly relate to the specific situation at hand. To the extent that the facts do not directly relate, the adjustment price becomes estimated.

Tax experts and corporate taxpayers have suggested that Treasury reconsider the appropriateness of the arm's length standard in an economic world more complex than that which existed when the standard was adopted in 1934. For example, one alternative suggested is the use of formulas for apportioning income in certain situations. Apportionment formulas are presently used by the States, and some experts believe these formulas, when applicable, reflect market realities better than the arm's length standard. Another alternative frequently suggested is to expand the use of the safe haven concept, thus, creating greater certainty.

We recognize that some difficult international issues might be raised if the U.S. adopted new approaches to taxing multinational transactions. We, do not, however, believe that this prospect should deter Treasury from studying whether alternatives, or a combination of alternative and present approaches, could make section 482 enforcement administratively easier, more certain, and more equitable for all concerned.

IRS MAKES RELATIVELY FEW ADJUSTMENTS ON THE BASIS OF COMPARABLE INDEPENDENT PRICES

The 1968 regulations issued by Treasury provided IRS with guidelines for making section 482 income adjustments. The regulations explain the arm's length standard, the principle underlying section 482 adjustments, as follows:

> "The purpose of section 482 is to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer, by determining, according to the standard of an uncontrolled taxpayer, the true taxable income from the property and business of a controlled taxpayer * * *. The standard to be applied in every case is that of an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer."

For example, uncontrolled transactions with respect to the transfer of tangible property are defined as

--sales by an member of the controlled group to unrelated businesses,

--sales to a member of the controlled group by unrelated businesses, and

--sales in which the businesses are not members of the controlled group and are not related to each other.

IRS first tries to identify independent transactions which are exactly comparable or so nearly identical to the transaction in question as to have no effect on price. In the absence of such independent transactions, the regulations permit IRS to use other alternative techniques to apply the arm's length standard. The alternative techniques generally involve constructing adjustment prices based on independent transactions that fall short of being exactly comparable or nearly identical to the transaction in question. The regulations provide guidelines for making adjustments to the following five categories of intercorporate transactions: (1) sale of tangible property, (2) transfer or use of intangible property, (3) loans and advances, (4) performance of services, and (5) use of tangible property (rent).

The regulations permit the use of alternative techniques for adjustments in all five categories of transactions when a comparable uncontrolled price cannot be found. The regulations also require the use of safe haven rules under certain conditions for transactions in categories (3), (4), (5).

Our study showed that few section 482 adjustments are made using prices based on comparable uncontrolled transactions. As shown in the following table only 3 percent of the 403 IRS recommended section 482 adjustments were based on arm's length prices determined through comparable uncontrolled transactions. The 403 adjustments involved 200 of the 519 multinational corporations in our data base and their controlled foreign corporations. 1/

Basis for adjustment	Number of adjustments	Percent	Adjusted amount	Percent
Amounts determined through Comparable uncontrolled transactions	12	3	$ 7,384,342	3
Alternative techniques	107	26	181,251,869	65
Safe haven rules	240	60	60,410,769	22
Total	359	89	249,046,980	90
Other:				
Not determinable from report (note a)	25	6	7,592,307	3
Not applicable (note b)	19	5	20,855,126	7
Total	403	100	$277,494,413	100

a/Information not shown in records we examined.

b/Use of section 482 to make adjustments where neither safe haven rules nor arm's length prices were applicable. For example, returning total income to the U.S. because of sham foreign subsidiary.

As shown above, 26 percent of the section 482 adjustments were made using alternative techniques. These require an even greater degree of subjective judgment by the examiner than does

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1/IRS also made other section 482 adjustments amounting to $330 million which involved 235 of the 519 corporations. We did not analyze these adjustments because the transactions did not involve a controlled foreign corporation. However, 200 of the 235 corporations are the same corporations represented in our statistics because they also had adjustments involving their foreign subsidiaries.

the identification of an arm's length price. The income adjusted through alternative techniques amounted to 65 percent of the total adjusted. The tax impact of these adjustments is not known precisely but can be roughly estimated at $87 million based on a corporate tax rate of 48 percent.

In the next few pages we describe in greater detail the kinds of alternative techniques available to IRS examiners in adjusting income for the five categories of intercorporate transactions. Our discussion shows that the application of alternative techniques where no comparable uncontrolled price can be found creates administrative difficulties and uncertainty for both IRS and the corporate taxpayer. In most cases, the adjustment that results from applying the alternative techniques is based on data that does not directly relate to the specific situation at hand.

Most adjustments involving
the sale of tangible property
involve considerable judgment

IRS considers tangible property adjustments to be the most important of the five categories discussed in the regulations because the largest amounts of revenue are involved. Tangible property adjustments in our data base amounted to 45 percent ($125.1 of $277.5 million) of the total income adjusted by IRS under section 482.

When a comparable uncontrolled price for a tangible property adjustment cannot be identified, the regulations direct examiners to apply the resale price method, then the cost plus method, and finally a fourth method defined as "some appropriate method." (See app. III for a description of these pricing methods). These methods must be applied in sequence until an appropriate basis for an adjustment is found.

Our statistics show that IRS was able to identify prices established through comparable uncontrolled transactions in only 15 percent (5 of 34) of its tangible property adjustments. Even more revealing is that the adjustment amounts based on comparable uncontrolled transactions represented only about 2 percent ($2.3 of $124.2 million) of the tangible property income which was adjusted by IRS through determinable methods.

Pricing method	Adjustments Number	Adjustments Percent	Amount Total	Amount Percent
Comparable uncontrolled transactions	5	15	$ 2,347,236	2
Resale price method	4	12	7,801,901	6
Cost-plus method	9	26	7,229,240	6
Any other method	16	47	106,796,497	86
Total	34	100	$124,174,874	100
Not determinable	3		964,019	
Total	37		$125,138,893	

Information in the reports IRS provided us was not sufficient to determine the pricing method used for 3 of the 37 adjustments. However, only 5 of the remaining 34 adjustments were made using prices obtained from comparable uncontrolled transactions. When comparable uncontrolled transactions could not be identified, IRS examiners most often used the fourth or "any other" method. Thus, 86 percent of the income adjustments resulting from the sale of tangible property were made using that method for which the regulations provide the least guidance.

The following examples taken from reports prepared by IRS economists and international examiners on examination cases we reviewed illustrate the amount of work and the considerable degree of judgment required of an examiner.

Corporation A, a U.S. parent, sold component parts and materials to its foreign subsidiaries. The foreign subsidiaries assembled finished or semifinished devices that they sold back to the U.S. parent. The economist could not identify comparable uncontrolled transactions within the controlled group because the U.S. parent and the foreign subsidiaries made no similar sales to unrelated parties. Also, the economist was unable to find comparable uncontrolled transactions outside the controlled group because the multinational corporation's interaffiliate transactions were in a form contrary to normal trade practices. The economist found that normal trade practices in that industry would have the U.S. parent providing without charge the component parts and materials to the foreign subsidiaries which, in turn, would function as contract assemblers and be paid for the services provided. The economist developed an adjustment based on an analysis of what would be an appropriate amount (labor costs plus profit) to reimburse the foreign subsidiaries for assembling the items sold to the U.S. parent corporation. The economist, in computing the adjustments, used profit margin percentages obtained from

an independent contract assembler that performed work somewhat similar to that done by the foreign subsidiaries. The economist noted that the information obtained from the independent contract assembler was incomplete and imcompatible in several important areas.

Corporation B, a U.S. parent, sold chemicals to a foreign controlled distributor corporation at a markup of 10 percent over manufacturing costs. The examiner could not identify comparable uncontrolled transactions within the controlled group because no similar sales were made to unrelated parties. The examiner developed the adjustment based on the gross profit percentages that selected independent (third party) U.S. distributors earned selling the U.S. parent corporation's chemicals. However, the examiner adjusted the independent U.S. distributors' profit percentage using three factors to compensate for differences in the operations of the independent distributors and the foreign controlled distributor. The examiner made the adjustments based on a gross margin of 36.3 percent computed as follows:

Factors	Gross profit percentage
U.S. distributors' gross margin	27.7
Differences in	
Sales function	4.1
Warehousing function	0.5
Markets	4.0
Total	36.3

The examiner identified the differences in operations after considerable discussion with representatives of the corporation. Because the foreign-controlled distributor was located in a tax haven country, it was to the U.S. parent corporation's benefit to have its foreign distributor's gross profit percentage as high as possible. Therefore, the U.S. corporation officials argued that the different factor percentages should be higher. The examiner stated in his report that the adjustment made could not be tied down to a realistic, factual situation.

As shown below, the results of our analysis of IRS adjustments to sales of tangible property are not dramatically different from those of other studies:

Study	Year of study	Percent of adjustments using pricing method: Comparable uncontrolled	Alternative methods: Resale	Cost Plus	Other	Total	Total
Conference Board (note a)	1972	28	13	23	36	72	100
Department of Treasury (note b)	1973	21	11	27	41	79	100
Indiana University (note c)	1980	24	14	30	32	76	100

a/Michael G. Duerr, Tax Allocations and International Business: Corporate Experience with Sec. 482 of the Internal Revenue Code, (New York: The Conference Board, 1972). The Conference Board is an independent, nonprofit business research organization.

b/U.S. Department of the Treasury, Summary Study of International Cases Involving Section 482 of the Internal Revenue Code (Washington: Treasury, 1973).

c/Jane O. Burns, "How IRS Applies the Intercompany Pricing Rules of Section 482: A Corporate Survey," Journal of Taxation, 54 (May 1980), 308-14. Dr. Burns, presently of the Graduate School of Business, Indiana University, is a former Vice-President of the American Taxation Association and Treasurer of the American Accounting Association's International Accounting Section.

Adjustments involving the transfer or use of intangible property

Intangible property includes such things as patents, inventions, trademarks, brand names, and technical data. (See app. IV.) Ownership of valuable intangible property can provide a corporation with a competitive advantage and rewards which enable above normal profits.

Similar to adjustments involving tangible property pricing, few intangible property adjustments were based on comparable uncontrolled transactions. IRS recommended 73 intangible property adjustments between U.S. parent corporations and their foreign subsidiaries in the examinations we reviewed. We could not determine the method used in making 18 of the adjustments because the examiner's report did not contain sufficient information. However, only 3 of the remaining 55 adjustments (5 percent) were based on prices obtained from comparable uncontrolled transactions. The 3 adjustments represented about 4 percent ($2.3 of

$61.1 million) of the total amount adjusted for intangible property. The remaining 52 adjustments were made by the examiner using an alternative technique. When a comparable uncontrolled price cannot be found for an adjustment involving intangible property, the regulations give the examiner 12 factors to consider in making the adjustment. The use of these factors requires that the examiner construct the adjustment price. Normally, however, an examiner does not have to use all 12 factors before arriving at a basis for the adjustment.

The following example illustrates how a price is constructed by an IRS economist or an international examiner when prices from comparable uncontrolled transactions are not available.

> Corporation A, a foreign-controlled U.S. subsidiary, paid a royalty rate of 9 percent on sales of a drug its foreign parent corporation licensed it to manufacture and sell. The examiner could not identify comparable uncontrolled transactions to use in making the adjustment because the foreign parent corporation did not have similar licensing agreements for the drug with unrelated parties. The examiner developed an adjustment that recognized a 5 instead of a 9 percent rate based on his findings that the drug was "second line" rather than "unique and superior" as claimed by the U.S. corporation. The examiner attributed the drug's extremely high sales to sensational advertising and unparalleled promotion by the U.S. corporation. The examiner constructed the 5 percent royalty rate based on the following information.
>
> a. Discussion with personnel who negotiated the royalty rates indicated that over the years the 5 percent rate had become acceptable to both parties.
>
> b. For many years a rate of return of 5 percent on a financial investment was considered good in the corporate sector. This factor was one of the main considerations in arriving at a rate acceptable to both parties.
>
> c. There had been other studies of drug royalty rates which indicated that the most common rate charged was 5 percent.

As a 1979 report by the Organization for Economic Cooperation and Development pointed out, 1/ it is difficult to identify comparable uncontrolled transactions since the owner of intangible

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1/Transfer Pricing In Multinational Enterprises (Paris: Organization for Economic Cooperation and Development, 1979).

property, particularly the owner of a patent, is essentially the owner of a monopoly right which may not be made available to unrelated businesses.

Most adjustments involving loans and advances, services, and rents are made using safe haven rules

The method most frequently used to make section 482 adjustments in the examinations we reviewed involved the safe haven rules. (See app. I.) Safe haven rules must be used by examiners to determine adjustment prices or rates only when the corporation makes loans and advances, provides a service, or rents tangible property to its foreign subsidiaries, and then only if the corporation does not routinely engage in these types of transactions with other parties. If the corporation is in the business of making loans and advances, providing similar services or renting similar property to unrelated businesses, the examiner cannot use the safe haven rules and must try to obtain a price from a comparable uncontrolled transaction. When safe haven rules can be used, the examiner does not look for a comparable uncontrolled price but immediately refers to the safe haven rules. The regulations, however, allow a corporation to contest an adjustment made by the safe haven rules. If a corporation can support an arm's length price for the transaction, IRS must accept the arm's length price rather than one arrived at using the safe haven rules.

Of the 274 adjustments in our data base involving loans and advances, services, and rents, 240 adjustments (87 percent) were made using the safe haven rules. The amount adjusted using the safe haven rules represented 86 percent ($60.4 of $70.3 million) of the total amount of income adjusted by IRS for these three categories of transactions. (See app. V.)

IRS could not use the safe haven rules to determine the adjustment price for the remaining 34 adjustments because the nature of the transaction being adjusted represented an integral part of the corporation's business. The amount adjusted in such instances must be based on an arm's length price. However, similar to adjustments involving tangible and intangible property pricing, few of these 34 adjustments were made based on prices obtained from comparable uncontrolled transactions. Information in the reports we reviewed was not sufficient to determine if comparable uncontrolled prices were used for 4 of the 34 adjustments. However, only 4 of the remaining 30 adjustments were based on comparable uncontrolled prices. The four adjustments represented only 28 percent ($2.7 of $9.8 million) of the total income adjusted for these three categories of transactions using techniques other than safe havens.

The regulations do not provide any guidance to examiners for determining the price to use for loans and advances, services, and rents when comparable uncontrolled transactions cannot be identified and safe haven rules cannot be applied. Of the 30 adjustments made by determinable techniques other than the safe haven rules, 28 involved service category transactions between U.S. parents and foreign subsidiaries. Prices for only three of these 28 adjustments were based on comparable uncontrolled transactions. Thus, the remaining 25 service category transactions we reviewed were adjusted solely on the basis of examiner discretion. Income adjusted for the 25 transactions amounted to $6.8 million.

POTENTIAL ADJUSTMENTS MAY BE MISSED UNDER CURRENT SECTION 482 REGULATIONS

The administrative complexity produced by the current section 482 regulations may result in potential adjustments not being made. The regulations prescribe a complex and time-consuming process for making adjustments. First, the examiner must identify questionable transactions. If safe haven rules do not apply, the examiner must perform a functional analysis of the transactions, search for comparable uncontrolled prices (which our analysis indicates are rarely obtainable), and then construct comparable uncontrolled prices using judgment to the degree needed. Because examiners work on several cases simultaneously, precise data on the average time required for a section 482 adjustment is lacking. However, our interviews with IRS examiners and the statistics we developed indicate that IRS' limited number of examiners are unable to cover the universe of multinational intercorporate transactions. Thus, given the complexity of the current regulations and IRS' limited resources with which to implement them, there is a need for revised guidelines which could be more easily administered and which would bring greater certainty and less burden to section 482 enforcement.

Questionable transactions warranting detailed analysis are difficult to identify

To enforce section 482 under the arm's length standard, IRS must examine in detail the particulars of intercorporate transactions. Because of the large number involved, IRS cannot possibly do this for all transactions between corporations and related foreign subsidiaries. For example, the 519 multinational corporations in our data base generated $32 billion in sales with about 12,000 foreign subsidiaries. Thus, the first step of IRS' enforcement process is the decision as to which transactions are to be reviewed in detail during the examination.

The IRS manual provides some guidance to examiners for identifying questionable transactions between U.S. corporations and related foreign corporations which may warrant detailed analysis. Part of this guidance is in a section entitled "Pointers to International Tax Avoidance" which contains several indicators of the possible existence of non-arm's length dealings. (See app. VI.) For example, two of the indicators are:

--Controlled foreign subsidiaries located in tax haven countries. A tax haven country is any country whose laws provide an escape from taxes on income which would otherwise be taxed in another country.

--Consolidated worldwide profits are higher than U.S. profits. This type of situation can be an indication that profits of the U.S. corporations are being diverted to a tax haven country.

Information needed for applying these pointers is obtained from the multinational corporation's tax return and supporting books and records. The identification of questionable transactions from these pointers is often more difficult than the equivalent process for many other code sections, because there is no account or amount shown on the tax return to indicate whether section 482 should become an issue. Therefore, the examiner must resort to the guidelines described above to identify transactions which may not be in compliance with the arm's length standard.

A functional analysis to show what the U.S. and the foreign corporation did to earn the income in question is difficult to perform

Once questionable transactions have been identified, examiners must begin the process of determining if an adjustment is needed and, if so, the amount. Where safe haven rules cannot be applied, examiners must obtain detailed information concerning the transactions in question. To determine whether the intercorporate transactions were priced at arm's length, examiners must usually perform a functional analysis. A functional analysis involves a probe into exactly what the parent and its subsidiary actually did in relation to the income earned. A functional analysis is required because IRS believes that facts regarding comparable transactions must be analyzed to determine with accuracy just what should be measured.

According to IRS' manual, a functional analysis is based on the economic principle that in a business enterprise, or a group of enterprises, each function should earn its fair share of any resulting profits. When various functions are performed, the

enterprise that provides most of the effort, and/or the rare or unique functions, should earn most of the profit. IRS measures the relative importance of each function through functional analysis. The IRS manual requires the examiner to obtain sufficient data to answer questions such as: What was done? What significant functions were involved in doing it? Who performed each function, and what was the economic value of each function performed by each party? The manual specifies that normally the functional analysis begins with the organization which initiated the transaction and carries through until the transaction generated income from outside the controlled group.

To illustrate, if a parent sells goods to its foreign subsidiary, it is not enough in most instances to determine what price the corporation paid, the terms of payment, etc. In addition, the examiner must determine what the corporation did with the goods. For example, if the goods were resold by the foreign subsidiary, the manual states that the examiner should determine:

a. Whether the corporation had a sales staff. If so, the examiner should determine how many and their compensation.

b. Whether it was necessary to provide technical assistance to the foreign purchaser. If so, the examiner should determine who did it (the foreign corporation or the parent) and the kind of technical assistance provided.

c. Whether the foreign corporation warehoused the goods or extended credit to its customers. If so, the examiner should determine the amount of capital needed to perform this function and/or the extent of bad debt experience.

IRS suggests that examiners prepare a checklist to document the results of the functional analysis. To prepare the checklist, examiners must list all the significant functions performed and then indicate who performed them, the U.S. corporation or the foreign subsidiary. (See app. VII for an example of a functional checklist.)

Once the significant functions and who performed them have been identified, the functions themselves must be analyzed. This analysis requires that examiners obtain other information to answer questions such as: Could anyone else perform the functions? How difficult are they? What skills are required? What equipment is used? According to IRS, it is critical that examiners focus on the relative importance of each function in terms of contribution to the total profit picture. Thus, a functional analysis requires data which may take considerable time to obtain and an analysis which will take still more time.

Once an examiner has completed a functional analysis, the next step is to search for a comparable uncontrolled price. The

IRS manual requires the examiner to begin by investigating the validity of the method used by the corporation in arriving at the price it used. For example, if the commission charged to a foreign corporation was based on commissions charged to independent parties, the independent transactions should be examined to determine if the commission can be used as a comparable. When a comparable price cannot be found from within the corporation's own controlled group the examiner must look to third party data. This step would require obtaining appropriate information from government sources, industrial organizations, investment services, and the private business sector.

Regardless of where comparables are obtained, the examiner must develop sufficient information concerning them to show that the transactions used are in fact comparable. This requires details concerning the terms at which the comparable transactions were handled and the circumstances surrounding the transactions, including a comparison between (1) functions performed by each party involved in the comparable transaction and (2) functions performed by the parent and foreign subsidiary in the questioned transaction.

IRS considers third party transactions comparable to the controlled transactions if the property and circumstances in the uncontrolled transactions are identical to those in the controlled transaction; or if they are so nearly identical that they have no effect on price or can be reflected by a reasonable number of adjustments to the uncontrolled sales. IRS also instructs its examiners that in some cases a single "best" comparable may not be found. Instead, there may be several independent transactions each of which differs from the questionable transaction in some significant way . However, considered together, the several independent transactions may be used to determine an arm's length price for the questionable transaction within a usable narrow range.

The IRS examination reports we reviewed provided some insight into the difficult and time-consuming work involved in performing a functional analysis and in analyzing arm's length transactions to determine adjustment amounts. The key aspects of a functional analysis and the development of a transfer price by an IRS economist can be illustrated by the following example.

> Corporation A, a U.S. parent, bought electronic items from its foreign subsidiary. The IRS economist, as part of the functional analysis, researched the manufacturing process for the electronic products and found that it consisted of (1) silicon manufacturing which involved processing of high-purity silicon into slice form, (2) front end manufacturing which involved processing the slices to active elements with electronic functions built in, and (3) assembling and testing which involved assembling bars or chips into packages

and testing for varying environmental, functional, and electrical characteristics. According to the economist's report, the first two high-technology parts were performed by the U.S. parent. It was in the assembling and testing that the foreign subsidiary entered the manufacturing process. The functions performed by the foreign subsidiary included

--scribing the complete silicon slice,

--breaking the slice into chips,

--assembling good chips into finished devices with headers, lead frames, bonding material, lead wires, molding components and,

--testing finished devices and packaging.

On the basis of information developed through this analysis of the manufacturing process, the economist concluded that the foreign subsidiary should have been compensated for only assembly and test services. The economist then developed transfer prices for electronic items based on an analysis of what would be an appropriate amount (labor costs plus profit) to reimburse the foreign subsidiary for assembling and testing the items for the U.S. parent. The economist interviewed 10 independent contract assemblers (with facilities in foreign countries) to determine (1) the trade practices which prevailed when these contractors dealt with U.S. companies, and (2) the net profit margin which these contractors earned. The economist decided that the independent contract assemblers were functionally comparable to the foreign subsidiary's operation and that the independent net profit margins ranged from near zero to over 20 percent. Factors affecting the profit margins included the market conditions and the mix of simple and complex devices. One independent contract assembler provided the economist with its gross profit margin for 1 year for six major product categories and its income statement data. The economist converted the gross margin on sales percentages to net margin on cost percentages which then became the comparable profit rates used to compute the section 482 adjustment.

Some adjustments may not be made because the enforcement process is administratively difficult and time-consuming

In talking with examiners in the seven IRS districts we visited, we learned that they believe that some potential section 482 adjustments are not being developed. Examiners in three districts attributed this situation to both the difficulties in the

enforcement process and the time it takes to do the work. They stated that some examiners give higher priority to other international tax issues, such as foreign tax credits, because it is less difficult and less time-consuming to identify the additional tax. They added that section 482 work is a "high risk venture" where much audit work can result in little additional tax. They pointed out that because of this, some examiners hesitate to "go out on a limb" in attempting to develop an adjustment and focus only on cases of flagrant abuse. The examiners indicated that a section 482 adjustment might not be attempted because of the difficulty involved in reaching agreement on an arm's length price or on the basis for making the adjustment.

IRS was unable to provide us with data on the average length of time required to identify and develop a section 482 adjustment. One reason for this is that examiners work other international tax issues at the same time they are developing section 482 adjustments and sometimes work on several examinations simultaneously. Examiners also pointed out that the time needed to develop an adjustment can vary greatly depending on the type of adjustment being developed, the pricing method which must be used, and the cooperation of corporate officials.

A few examiners explained why the enforcement process takes so long. The primary reasons, according to the examiners, are that it takes time to study the corporation and/or its industry to become sufficiently knowledgeable to perform a functional analysis and to analyze comparable transactions, and that it takes time to obtain the substantial data and records that are needed from the corporation and other sources. These examiners also told us some of their experiences which can provide some insight into why the enforcement process is lengthy.

--Two examiners stated that to make an adjustment an examiner should (1) review the taxpayer's return including pertinent schedules, (2) review form 2952 for intercorporate pricing, (3) review prior IRS reports for section 482 adjustments (4) visit the library to study activities of the corporation through news articles, shareholder reports, etc., and (5) analyze the corporations' ability to make money by comparing profits to assets, payroll, sales, etc.

--One examiner said that if the corporation is not cooperative or does not have an adequate recordkeeping system, it could take over 1 year for the examiner to obtain sufficient information to determine whether an adjustment should be made.

--Another examiner said that obtaining access to corporate records to develop adjustments is a difficult task. He explained that questions on international tax issues are

the last ones answered because they have the potential to generate large amounts of tax dollars. He said it has been his experience that corporate officials answer only the questions asked and then with the least amount of data possible.

IRS examiners have also stated that they are unable to cover the universe of potential adjustments. During interviews in 1977 with House Committee on Ways and Means Oversight Subcommittee staff, IRS examiners said that when they are faced with numerous records of transactions, they generally rely on either a scanning of the records or the examination of a few of the largest dollar transactions over a 1- or 2-month period. It is obvious that with such techniques only a few transactions can be examined and that if transactions are not examined, potential adjustments cannot be identified.

Our statistics can be interpreted to lend credence to the examiners' comments. For example:

--Only 200 of the 519 multinational corporations in our data base had section 482 adjustments involving their foreign subsidiaries.

--The total profit (before taxes) of the corporations examined was $43,513.8 million. However, the adjustments amounted to only $277.5 million, a relatively small impact on corporate profit. The adjustments increased the profit of U.S. parents by 0.9 percent ($277.5 of $31,798.0 million) and reduced the profit of foreign subsidiaries by 2.4 percent ($277.5 of $11,715.8 million).

--The bulk of the total $277.5 million was concentrated in only a few of the 403 total adjustments. Eleven of the 403 adjustments accounted for over one-half of the $277.5 million.

--Adjustments involving the sale of tangible property, the category of intercorporate transaction where the largest amounts of revenue are at issue, were also concentrated. Thirty-five U.S. parents and 89 of their foreign subsidiaries experienced adjustments on tangible property sales of $4.4 billion. The other 12,248 foreign subsidiaries of the 519 U.S. parents experienced no adjustments to a total of $28.1 billion in intercorporate sales transactions.

Neither we nor IRS know how much noncompliance exists, nor how many more adjustments IRS should have made. However, given the difficulty inherent in administering section 482 through the current Treasury regulations, the examiners' statements, and the

statistics on the adjustments IRS made, we think it reasonable to conclude that the potential for greater enforcement exists.

The difficulty in making section 482 adjustments and the impact this difficulty has on enforcement was recognized as early as 1962 in a House report. 1/ The report stated that, in practice, the difficulty in determining a fair price under this code provision severely limits the usefulness of its power, especially when there are thousands of different transactions between a domestic corporation and its foreign subsidiaries.

A recent report documents the fact that section 482 adjustments continue to be a problem for all concerned. The study, dated January 12, 1981 and written by Richard Gordon, Special Counselor, International Taxation, was undertaken in response to a joint request by the Acting Commissioner of IRS, the Assistant Attorney General, and the Assistant Secretary of the Treasury for Tax Policy, and in response to congressional pressure upon IRS to take significant action against tax haven abuses. 2/ The study concluded that section 482 is one of the most important tools available to IRS for dealing with tax haven tax haven transactions but found that both IRS and taxpayers have had difficulties with the current section 482 regulations. The study recommended that the regulations be amended so as to ease some of the administrative burden placed on both taxpayers and the IRS and to achieve greater certainty in pricing international transactions.

CORPORATIONS, COURTS, TAX EXPERTS, AND IRS OFFICIALS HAVE CRITICIZED THE SECTION 482 REGULATIONS

Representatives of all groups affected by and knowledgeable about section 482 enforcement under the arm's length standard have voiced continuous and substantive criticism of the regulations. The criticisms focus on the fact that section 482 enforcement creates a large administrative burden and that the end result of a section 482 enforcement action is too often unpredictable and subjective.

1/U.S. Congress, House, Allocation of Income Between Related Foreign and Domestic Organizations, 87th Congress., 2nd sess., House Rept. 1447 (1962).

2/Richard A. Gordon, Tax Havens and Their Use by United States Taxpayers--An Overview (Washington: 1981).

A 1972 study by the Conference Board documented the views of corporate officials. 1/ Their principal objections to IRS' section 482 enforcement were that (1) the analytical approach to determining arm's length prices often leads to unreasonable results and (2) the examinations require extensive corporate expense and labor. The following are some specific criticisms of corporate officials as documented in the Conference Board report.

--Some officials believed the fundamental concept of arm's length dealing between related corporations is unrealistic. In a world of competition among multinational firms, they ask why the parent corporation should not favor its subsidiaries over unaffiliated corporations. The subsidiaries are expected to pay dividends while the unaffiliated corporations are not.

--Some officials described the examiner's determination of an arm's length price as "arbitrary." Some corporate tax executives stated that they did not know how the examiner got the figure proposed, and the examiner either could not or would not explain its derivation. In some of these cases, the corporation accepted the figure because the proposed adjustment was small.

--Some officials drew attention to the expense and labor involved in international examinations. The officials objected to what they considered an unnecessary load of paperwork. For example, the tax manager of one company declined to guess the cost of satisfying IRS examiners that international transactions do not violate section 482 regulations, although he believed the costs to be considerable. He said that he did not object because he considers the defense against IRS allocations a necessary function of his tax department. He did state, however, that the examiners raise many questions that take time and trouble to answer without being closely related to the examination.

A 1980 study report 2/ indicates that the concerns of corporate officials as included in the 1972 Conference Board Report are still concerns today. The study showed that arm's length prices have not been successfully applied to the extent anticipated by IRS when the regulations were approved. The study stated that, while the arm's length standard is based on the

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1/Duerr, op. cit.

2/Burns, op. cit.

premise that a subsidiary is legally and economically separate from its parent corporation, only 41 percent of the corporations indicated that their organizations actually operate in this manner. In addition, the study showed that while the corporations were composed of numerous legally separate entities, 49 percent stated that they make most intercompany pricing decisions as though the organization was one economic unit. The study concluded that this difference in philosophy between the arm's length standard and multinational corporations is basic to the section 482 controversy. The 1980 study also concluded that (1) considerable uncertainty surrounds the implementation of section 482 through the regulations, and (2) section 482 adjustments are very costly. Although most corporate officials indicated in both studies that they accepted the arm's length premise, they expressed concern that the regulations were vague and confusing.

Several court decisions have also pointed out the administrative difficulty in section 482 adjustments. Specifically, a Court of Claims judge's decision in a 1978 case involving E. I. Du Pont De Nemours and Company stated the following:

> "As evidenced by the magnitude of the record compiled in this case, the resolution by trial of a reallocation controversy under section 482 can be a very burdensome, time-consuming and obviously expensive process--especially if the stakes are high. A more manageable and expeditious means of resolution should be found. The evidence adduced in this case through Dr. Irving Plotkin, a skilled practitioner of the discipline of econometrics, strongly suggests that the promulgation of universally applicable safehaven criteria to facilitate the administration of section 482 may now be both entirely feasible and eminently proper." 1/

Another regulation problem--uncertainty--surfaced as a result of an Appeals Court decision in 1980 to reverse an earlier Tax Court ruling in a case involving the U.S. Steel Corporation. The Appeals Court accepted a price from a transaction which IRS and the Tax Court deemed not comparable because there were significant differences in the circumstances of the intercorporate transaction and the transaction used as a comparable. The decision stated the following:

> "In very few industries are transactions truly comparable in the strict sense used by Judge Quealy. Every transaction in wheat, for example, is more or less the same, except for standard variations in amount, time of

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1/E. I. Du Pont De Nemours and Company v. U.S., 608 F. 2nd. 445 (Ct. Cls. 1979).

delivery and place of delivery. But few products or services are as fungible as wheat. To say that Pittsburgh Steel was buying a service from Navios with one set of expectations about duration and risk, and [U.S.] Steel another, may be to recognize economic reality; but it is also to engraft a crippling degree of economic sophistication onto a badly drawn statute which--if 'comparable' is taken to mean 'identical,' as Judge Quealy would read it--would allow the taxpayer no safe harbor from the Commissioner's virtually unrestricted discretion to reallocate." 1/

One tax expert, in commenting on the judicial history of section 482, said that when readily comparable transactions have been available the decisions by the courts have been rather straightforward. However, when readily comparable transactions were not obtained the courts have had much greater difficulty in reaching a judgment. In such cases, the courts have generally required the corporation to show that its intercorporate transaction prices are correct rather than showing that IRS' allocation is erroneous.

IRS representatives have also expressed concerns about the subjectivity of section 482 adjustments. For example, they told us that:

--An examiner develops a price after studying all available data. However, the examiner has no assurance that the price developed is an arm's length price. The concept of an arm's length price is great in theory but in practice the price established is judgmental.

--An examiner finds it very difficult to obtain comparable uncontrolled prices. Approval from the third party is needed if a disclosure of the information is to be made. Generally third parties are reluctant to grant disclosure permission because of market competitiveness and the secrecy surrounding corporate activity.

Much of the criticism of section 482 enforcement, regardless of the source, seems to center on the incompatability between the nature of multicorporate business activities and the arm's length standard. The nature of modern multicorporate business activities makes it difficult for IRS examiners to locate comparable uncontrolled prices on which to base adjustments.

1/U.S. Steel Corporation v. Commissioner of Internal Revenue, 617 F. 2d 942 (2nd Cir. 1980).

For example, the 1972 Conference Board report and other studies by tax experts gave several reasons why the comparable uncontrolled price method is seldom used in developing tangible property adjustments. These studies point out that many products, such as components and semifinished goods, are sold only to controlled subsidiaries because multinationals are often structured as an integrated production process. For such transactions, no open market equivalent exists. Other products, such as finished goods and raw materials, may be sold to both controlled and uncontrolled buyers, but the transactions may not be comparable because (1) different customers have different amounts of bargaining power, (2) customers have different objectives and are governed by different laws and regulations; and (3) customers receive different amounts and kinds of service.

In addition, the Conference Board report points out that the concept of a comparable uncontrolled price does not always correspond to intercorporate pricing practice. Only a few corporations base their intercorporate prices on comparable uncontrolled transactions. From questionnaires submitted by 512 corporations and 90 personal interviews, Conference Board researchers learned that corporate officials base prices for intercorporate transactions on long-range plans, not on prices for comparable uncontrolled transactions. Corporate officials more often ask the question "What are we earning this year and what will we earn 5 years from now?" rather than "What is the correct markup percentage on this component?"

In addition to long-range planning considerations, other factors may influence intercorporate prices. For example, a parent corporation may engage in a transaction with its foreign subsidiary at a low price in order to give the subsidiary a competitive advantage in the foreign market. Intercorporate pricing practices may also differ from uncontrolled transactions because a subsidiary is expected to pay dividends where an unrelated corporation is not. It is argued, moreover, that intercorporate prices are often not a matter of public knowledge and that even if a corporation wanted to base a transfer price on a comparable transaction, the corporation might have difficulty finding the necessary information.

Finally, some experts on section 482 enforcement argue that treating intercorporate transactions as separate taxable events conducted at arm's length can result in the creation of false profits or losses. They base this argument on the premise that a gain or loss cannot actually be realized until a transaction is made between a member of the controlled group and an independent party.

IRS AND TREASURY HAVE CONSIDERED CHANGING THE SECTION 482 REGULATIONS

In 1971 IRS statistics confirmed that there is often a lack of comparable uncontrolled transactions on which to base arm's length prices for section 482 adjustments. In connection with these statistics, the Deputy Assistant Secretary of the Treasury, in a June 1971 memorandum, made the following comments:

> "We think it is time to concede that in the absence of comparable third party transactions plainly analogous to the transaction being examined, the most we can hope for is the assurance of a reasonable return to the U.S. taxpayer for its cost and effort in producing or marketing the product, as the case may be. In cases where such third-party comparables are not readily available, a precisely correct determination of the hypothetical arm's length price is impossible. Under the best of circumstances the answer finally settled upon can only be a rough and unproven estimate of what would have been the terms of the transaction if the parties had not been related."

During 1971 Treasury and IRS considered, but did not implement, several regulation changes involving the sale of tangible property transactions. The changes were considered to make section 482 enforcement using the arm's length standard less difficult and more fair. According to the Deputy Assistant Secretary, consideration of the changes was needed because of the persistent criticism of the regulations by corporate officials, professional groups, corporate associations, and trends in court cases. The proposed changes were circulated to Treasury, IRS, and the Department of Justice for comment but no action was taken. The proposed changes included:

--Reducing uncertainties encountered by multinational corporations in determining whether an intercorporate transaction would be subject to an adjustment by revising the regulations to extend the use of safe haven pricing.

--Revising the priorities given to various methods of determining an arm's length price. Specifically, only prices actually obtained from comparable uncontrolled transactions involving the corporation in question would be given priority. The search for an arm's length price would thus be limited to within the corporation.

--Specifying in the regulations how the examiner should arrive at an arm's length price when using the fourth ("any other") method.

A 1978 closing memorandum noted that several of the comments received on the proposed changes indicated that large businesses would benefit while small businesses would be adversely affected. Other comments indicated an overall satisfaction with the existing regulations. IRS' Economic Advisory Group commented that the proposed changes would condone the non-arm's length pricing of intercorporate transactions and significantly reduce the revenue IRS achieves from section 482 enforcement. Apparently for these reasons, no further action was taken.

TREASURY SHOULD STUDY THE FEASIBILITY OF IMPROVING THE SECTION 482 REGULATIONS

The regulation changes considered by Treasury and IRS were drafted in 1971. Since then, experts in the field of section 482 enforcement, independent studies such as the 1972 Conference Board Study, court opinions, and corporate officials have continued to express substantive criticisms of the uncertainty and administrative burden created by the section 482 regulations. The validity of the arm's length premise has been questioned and specific changes to the regulations have been suggested.

We believe the problems experienced in implementing the section 482 regulations are sufficiently serious to be addressed. To do this, Treasury should, as a first step, undertake a study to evaluate the feasibility of the suggested changes to section 482 as well as to identify additional ways to allocate income.

Corporate officials and experts have suggested ways to make section 482 adjustments more certain

Some officials have suggested changes to the regulations which would provide greater certainty before an IRS examination and would thus allow them to better plan their financial strategy. The suggestion offered most frequently by corporate officials was that Treasury identify some means of establishing a range of prices within which U.S. corporations could operate without fear of later adjustments. Some executives have suggested that safe haven ranges be worked out on an industry or product-line basis. Others have suggested that some division of profit between the U.S. corporation and its foreign subsidiaries be set as a reasonable yardstick. In either case, the officials believed the safe haven range would eliminate the uncertainty concerning the pricing of intercorporate transactions and reduce unproductive administrative costs to both the corporations and IRS. Underlying the comments of many officials who favored a safe haven range for pricing is the conviction that such a range, however difficult to establish, would be an improvement over the present system of determining arm's length prices. The expanded

use of safe havens would allow corporate officials a degree of certainty they now lack as to the tax consequences of their pricing of intercorporate transactions. Those corporations whose market situation required pricing structures that fell outside the safe haven range would be no worse off than they are today. They would still have to bear the burden of proving that their prices were justified.

Tax experts, in articles based on court cases, studies, and other sources of information, have also stated that regulation changes are needed. Their suggestions have generally revolved around the use of safe havens and profit splits as acceptable methods to use in determining section 482 income allocations. For example, corporate officials suggested in the Burns study that Treasury expand the use of safe haven rules, establish acceptable profit splits or a minimum percentage of the profit to be included in U.S. income, and adopt formulas such as those available to Domestic International Sales Corporations (DISCs) for calculating transfer prices.

In connection with the above comments, IRS has established centralized pricing units for a few commodities (see p. 6). These units control the price that must be used by international examiners in making section 482 adjustments. The price established by the pricing units is known by both corporate officials and IRS examiners. According to IRS, the pricing units were established to better use limited resources and to provide for uniform and consistent treatment of common issues among corporate taxpayers.

Other experts and studies have suggested using formula apportionment, where applicable, instead of the arm's length standard

Other experts and studies have questioned the validity of the premise underlying the arm's length standard that a parent corporation and its subsidiary are in all instances operating as two separate corporations. These experts and studies have argued that when a multinational parent's operations are sufficiently integrated with its foreign subsidiaries, formula apportionment, as used by the States, is a more appropriate method to use in allocating the income. In these situations, they believe the arm's length standard is fundamentally flawed because it is not consistent with the economic reality of the operations of the related corporate group.

In contrast to the arm's length standard, formula apportionment under the unitary method views controlled corporations which conduct integrated business operations as a single unit or business for tax purposes. The premise is that these controlled corporations are coordinated by a central management policy and

organizational structure which seeks to maximize profits. It is argued that since all of the controlled corporations which are involved in the integrated operations are considered to be part of the same unitary business, intercorporate transactions cannot produce a real economic gain or loss. Thus, profit or loss is determined solely by transactions with unrelated businesses, the same as for a "truly" independent corporation.

Under formula apportionment, a formula is used to apportion the income between the commonly controlled corporations. The formula represents the relationship of the individual corporation's activities to the total activities for the controlled group. The factors most discussed for use in the formula are the ones used by the States to tax multistate and multinational manufacturing and mercantile corporations. All 45 States which tax corporate income use some combination of property, payroll, and sales as formula factors. The apportioning of the income by such a formula is merely a device for the division of the income earned. The formula does not impose any tax on the income.

Formula apportionment might eliminate some problems associated with using the arm's length standard

Advocates of formula apportionment indicate that this method is not only more appropriate to use in situations involving integrated operations among controlled corporations but could actually eliminate some of the problems associated with using the arm's length standard. Advocates claim that this has been demonstrated by the States, particularly California.

They explain that the States use formula apportionment primarily because of (1) the extensive potential for tax avoidance through non-arm's length transactions between controlled corporations, (2) the need to substantially increase the number of their auditors to address this potential through the arm's length standard, and (3) the belief that enforcement through the arm's length standard is not working well at the Federal level. They also point out that formula apportionment eliminates the arm's length assumptions that

- --an arm's length market price can always be established;
- --general overhead and administrative expenses can be fairly allocated among the commonly controlled corporations involved in the integrated operations; and that
- --it is possible to determine the proper amount of profit allocation to different functions such as manufacturing and selling.

In addition, advocates claim formula apportionment would eliminate the complaints of multinational corporations (1) that they do not know at the time transactions take place whether they will result in an IRS allocation and (2) that they are operating under regulations characterized as vague, confusing, and impossible to interpret in terms of international business.

Formula apportionment would present different problems

Critics of formula apportionment raise several objections to its use. The more important criticisms include (1) the difficulty in defining those controlled corporations which should be included in the unitary business operations of the multinational corporations; (2) the lack of comparability of the factors used in the formula from one country to another; (3) the administrative burden associated with obtaining the data needed to use formula apportionment; and, (4) the fact that the arm's length standard has worldwide acceptance.

Advocates acknowledge that the above criticisms of formula apportionment have validity. However, they also believe that these problems have solutions. For example, they recognize that a corporation would not know in advance of an IRS examination whether or not it would be considered unitary unless the definition of unitary is uniformly applied and administered. However, they also cite one State which uses formula apportionment under the unitary concept as having initiated an advance ruling program to eliminate this problem.

The advocates also acknowledge that there may be some distortion in the factors used in the formula from one country to another. However, they believe that it is possible to eliminate the distortion in the factors--to a great extent--through the use of comparability tables. Concerning the administrative burden, the advocates indicate that some U.S. multinational corporations now prepare sophisticated financial analyses for U.S. purposes and that this information could be used in applying the apportionment formulas. As such, formula apportionment should not place any greater burden on the administrative resources of the corporations than the arm's length standard. They also believe that formula apportionment would place much less of a burden on IRS' resources than does section 482 enforcement under the arm's length standard. They indicate that this is one of the reasons why the States have adopted this method.

CONCLUSIONS

Making income adjustments using the arm's length standard has posed administrative burdens on both IRS and corporate taxpayers. Because of the structure of the modern business world,

IRS can seldom find an arm's length price on which to base adjustments but must instead construct a price. As a result, corporate taxpayers cannot be certain how income on intercorporate transactions that cross national borders will be adjusted and the enforcement process is difficult and time-consuming for both IRS and taxpayers.

Parties affected by and knowledgeable about arm's length adjustments--officials at IRS and Treasury, corporate taxpayers, courts, and experts in the field--have voiced substantive and ongoing criticisms of the section 482 regulations. Treasury's decision in the early 1970s to consider several regulation changes indicates that it recognized the validity of the criticism at that time. Given the continued flow of criticism since then and the continued growth in the number and complexity of intercorporate transactions as compared to IRS' limited resources, it seems to us that the need is even greater now than it was a decade ago for Treasury to consider revising the regulations.

Experts have suggested that changing the regulations to expand the use of the safe haven concept would bring greater certainty to the enforcement process. Other experts have suggested that using the formula apportionment method, when appropriate, would eliminate the need to search for an arm's length price, reduce administrative burden, and make section 482 enforcement more certain. The States, whose examination resources are even more limited than IRS', use formula apportionment for these reasons.

A major objection to the use of formula apportionment across national borders is that tax treaties between the U.S. and other nations specify the arm's length standard for adjusting corporate income. For the U.S. to adopt a different method could result in multinational corporations incurring double taxation. We recognize the significance of this problem. However, we also believe that as a world leader and international policy-setter, the U.S. should not be hesitant to take the lead in searching for better ways to administer the tax consequences of intercorporate transactions that cross national boundaries.

In this regard, Treasury should be the focal point for a study to identify ways to improve section 482 enforcement. The need for such a study will become even more urgent if IRS' measure shows extensive noncompliance. After Treasury has completed this study, it should be able to make an informed decision as to whether and how it should change the section 482 regulations.

RECOMMENDATION TO THE SECRETARY OF THE TREASURY

We recommend that the Secretary of the Treasury initiate a study to identify and evaluate the feasibility of ways to allocate income under section 482, including formula apportionment,

which would lessen the present uncertainty and administrative burden created by the existing regulations.

AGENCY COMMENTS AND OUR EVALUATION

While IRS and Treasury recognized that section 482 enforcement procedures present problems, both agencies expressed disagreement with our recommendation that Treasury undertake a study of the regulations. In so doing, both agencies, we believe, minimized the seriousness of the difficulties which section 482 enforcement has presented and continues to present all affected parties. As we noted in our report, uncertainty as well as the administrative difficulties and burden on all parties affected by section 482 enforcement have been documented in all previous studies on the subject, the most recent being a January 1981 study undertaken at the joint request of the Acting Commissioner of IRS, the Assistant Attorney General, and the Assistant Secretary of the Treasury for Tax Policy.

In addition, both Treasury and IRS expressed serious reservations about our statistics and seemed to think that they presented a misleading picture of section 482 enforcement. Both agencies seemed to believe we understated the extent of present section 482 enforcement and overstated the administrative difficulties. We incorporated into the report more specific recognition that IRS made some section 482 adjustments which we excluded from our sample. We also clarified the explanation of our scope and our rationale for excluding certain adjustments. We believe our statistics accurately reflect the pertinent data available and, together with the other evidence presented in the report, convincingly show that the problems inherent in enforcing section 482 are substantial.

IRS' and Treasury's Reservations Concerning the Recommended Treasury Study

IRS seemed to interpret our report as recommending that Treasury reconsider the fundamental principle of the arm's length standard. In this regard IRS pointed out that Treasury was in the process of revising the regulations and stated that, specifically, Treasury was studying ways to amend the regulations relating to a safe haven rule for the sale of tangible property and would publish proposed regulation changes shortly. IRS thought that Treasury's approach of revising parts of the regulations was better than such wholesale reworking of the regulations as IRS understood us to have recommended. In addition, IRS did not think that it had enough experience to participate in a reconsideration of the arm's length standard.

we did not in fact recommend a wholesale reworking on a one-time basis but simply that Treasury study the regulations. It was our intent that Treasury would take whatever course is indicated by the study results. Moreover, we believe that IRS' 12 years of experience in this area should enable it to participate effectively in such a study.

Treasury stated that it disagreed with our recommendation that it consider adopting formula apportionment as a substitute for the arm's length standard. However, we did not make such a recommendation. What we recommended was that, as part of its study of section 482 enforcement procedures, Treasury should consider all alternatives, of which formula apportionment is but one.

Treasury objected to the use of formula apportionment on several grounds. Treasury stated that formula apportionment has little merit because a corporation could have an increased tax burden as a result of its subsidiaries becoming more profitable. Thus, according to Treasury, formula apportionment does not attempt to achieve the statutory objective of correctly reflecting a taxpayer's income. Treasury also asked whether formula apportionment should be used even when comparable uncontrolled prices are available.

Treasury's response suggests to us that Treasury may have thought we recommended the use of formula apportionment to make income adjustments in all cases. In contrast to the arm's length standard, formula apportionment under the unitary method views controlled corporations which conduct integrated business operations as a single unit or business for tax purposes. The formula is used to apportion the income between taxing jurisdictions. Since the formula sources the income of the controlled group to each taxing jurisdiction, arm's length price determinations for individual transactions are not needed. However, it is important to keep in mind that formulas are applied only to unitary businesses. If the controlled corporations are not considered to be unitary in their business operations, then any transactions that need to be adjusted would be adjusted using the arm's length standard. Thus, if, after its study, Treasury were to decide to use formula apportionment, it would simply have an additional enforcement tool available to complement the arm's length approach.

Treasury further stated that we minimized the administrative difficulties that would result from the use of formula apportionment. As an example, Treasury cited the practical problems involved in deciding whether or not a corporation should be considered unitary. It was not our intent to minimize the administrative difficulties nor to emphasize the benefits of formula apportionment. It was our intent, however, to point out that the approach is characterized both by benefits and difficulties and to give examples of each (see pp. 50 to 52).

We included a discussion of formula apportionment in our report because tax experts and studies we encountered in our review cited formula apportionment as one alternative that might lessen administrative burden and uncertainty. There is, however, no empirical evidence available to prove or disprove the feasibility of implementing the approach at the Federal level. It was our intent that the Treasury study we recommended would develop such empirical evidence.

Treasury also stated that formula apportionment is not widely used by the States in a multicorporate context. Treasury also said that some States which apply the formulas worldwide are considering abandoning them. However, Treasury gave no support for these statements. Evidence available to us does not support Treasury's contention. In response to a questionnaire we sent to each of the 45 States with a corporate income tax, 26 States replied that they use formula apportionment under the unitary method in cases involving multicorporate entities (affiliated corporations) located within the United States while 11 States replied that they apply formula apportionment worldwide. None of the States responding to the questionnaire indicated an intent to abandon formula apportionment. To our knowledge, the only change that a State is currently contemplating to restrict rather than expand the use of formula apportionment is in the form of legislation being considered in California. That legislation would restrict the use of formula apportionment only to the extent of excluding foreign parents of U.S. corporations in certain types of industries.

Both Treasury and IRS cited a 1979 report by the Organization for Economic Cooperation and Development in support of their reservations about the use of formula apportionment. IRS suggested we state in our report that OECD has rejected the use of formula apportionment because it presents difficulties for taxpayers. Treasury suggested we consider the OECD criticism of formula apportionment as inconsistent with the provisions of current U.S. tax treaties. We did consider the OECD report during our review. We chose not to discuss the OECD comments on formula apportionment because they were not supported by empirical data to the same extent as other studies which we did include. The OECD statements that formula apportionment presents difficulties for taxpayers were based on comments submitted by its member countries, and the OECD report does not present empirical data to support its conclusions. The OECD report did, however, correctly point out that use of alternatives to the arm's length standard is incompatible with the OECD Model Double Taxation Convention. Again, we did not recommend that Treasury should implement formula apportionment much less undertake any such implementation unilaterally. If a Treasury study were to show through empirical data that formula apportionment did indeed have merit, Treasury would still need to give considerable thought to the best approach of obtaining international

support for change and implementation of the concept. Alternatives might include taking a leadership role appropriate to a world power such as the U.S. and, in this leadership role, educating other countries to the benefits of formula apportionment or other techniques providing for effective implementation.

IRS and Treasury Criticism of GAO Statistics

Both IRS and Treasury seemed to think that our statistics presented a misleading and, in some cases, inaccurate picture of section 482 enforcement, a picture which overstated the difficulties involved. We believe our statistics accurately reflect the data available to us and convincingly show that the difficulties involved in enforcing section 482 are both real and substantial.

IRS questioned whether we had included all relevant section 482 adjustments in our statistics. Specifically, IRS thought we erroneously excluded $330 million in adjustments from our sample. We excluded the $330 million because these adjustments did not involve a foreign subsidiary and, thus, did not in a real sense cross national boundaries. We focused our review on adjusted transactions involving foreign subsidiaries because we believe that it is in adjustments made to such transactions that the real workability and effectiveness of the arm's length standard must be measured.

IRS also noted that our statistics did not include any cases from the oil industry. IRS assumed that this was because such cases were not closed during the period covered by our sample. IRS was correct in this assumption. Since the data available to us did not include cases involving the oil industry, we cannot address IRS's statement that such adjustments exceed $600 million annually.

IRS also thought we had understated the total number of adjustments which were based on a comparable uncontrolled price. IRS said we should have taken into account that 240 of the 403 adjustments were attributable to situations where the use of safe haven pricing rules was mandatory. Had we excluded these 240 transactions from the total of 403 adjustments, we would have reported that 7 percent, not 3 percent, of IRS' section 482 adjustments were based on comparable uncontrolled prices. We did not exclude these 240 adjustments based on safe haven rules because our purpose was to show how many of the total section 482 adjustments in our sample were based on comparable uncontrolled prices. Safe haven prices by definition are not comparable uncontrolled prices. Rather, they are prices established by IRS and Treasury to be used in specific situations. IRS has recognized that safe haven prices are not comparable uncontrolled prices and will permit a corporation to use a comparable

uncontrolled price instead of a safe haven price if such a comparable uncontrolled price can be supported. Thus, in terms of our purpose we would have been remiss had we excluded the safe haven adjustments from our computations.

IRS added that its current data (examinations completed during fiscal year 1980) showed that 20 percent of its recommended section 482 adjustments were based on arm's length prices using the comparable uncontrolled method. We did not review the data IRS cited and thus do not know whether it is readily comparable with our results. Even so, using comparable uncontrolled prices in only 20 percent of the adjustments is not, in our opinion, an indicator of substantial success.

Treasury thought we concluded that the present regulations are seriously defective solely because the comparable uncontrolled price method is only infrequently used. Treasury said we failed to recognize that other methods outlined in the regulations are only alternatives for arriving at an arm's length price and not departures from that principle. We did distinguish between adjustments based on the identification of a comparable uncontrolled price and adjustments based on an estimated price constructed by an IRS examiner using one of the alternative methods permitted when a comparable uncontrolled price cannot be easily identified (see pp. 28 to 29). We did so because we do not believe that an estimated price is the same as a comparable uncontrolled price. Moreover, our conclusion that section 482 enforcement under the current regulations is uncertain and administratively burdensome is not based solely on our statistical analysis of the sample. Our review of the recent relevant literature by experts in the field of section 482 enforcement also led us to this conclusion, a conclusion to which our statistical analysis lends support.

Treasury further pointed out that we did not identify any specific indications that uncontrolled prices are not used in cases of intercompany pricing which do not lead to an IRS adjustment. We made no statement concerning such cases because this type of information is not available. Neither Treasury nor IRS has developed methods to obtain the data needed to measure the extent of noncompliance that exists within the universe of multinational corporations. IRS, however, agreed with our recommendation that it develop such data (see p. 26). Treasury's position seems to be that, if the transaction was not adjusted, it met the arm's length standard. We do not think this position is realistic when analyzed in light of the information we were able to obtain. Although the information available to us provided only an indication that increased potential for adjustment exists, we believe this possibility should not be ignored. IRS examiners told us that only a few transactions can be examined and if transactions are not examined, potential adjustments cannot be identified. They also stated that some examiners give

higher priority to other international tax issues because other issues are less difficult and less time-consuming. Our statistics can be interpreted to lend credence to the examiners' statements (see p. 41).

Treasury further questioned our conclusion that difficulties exist in applying the section 482 regulations by stating that our statistical analysis was misleading or unpersuasive. Specifically, Treasury objected to our statistic that only 200 of the 519 corporations experienced adjustments because, according to Treasury, these data are subject to various interpretations and do not necessarily reflect difficulties with applying the regulations. Treasury also questioned our comparison between the $277.5 million in section 482 adjustments and the $43.5 billion total income of the examined firms. Treasury stated that a significant portion of the income may be unrelated to transactions between affiliates. To be sure, the fact that only 200 of the 519 corporations experienced adjustments could be interpreted differently, although Treasury did not make clear how this might be done. We made our interpretation in the total context of information on section 482 enforcement available to us, including examiners' statements that difficulties in section 482 enforcement may cause some adjustments to be missed, and such statistics as could be developed. We believe that, taken in a total context, the evidence suggests that a greater potential for section 482 adjustments does indeed exist.

Finally, IRS felt that we understated the frequency with which comparable uncontrolled prices are used in making tangible property adjustments, the category of adjustments where the largest amounts of revenue are involved. IRS stated that its more current data (examinations completed during fiscal year 1980 and 6 months of fiscal year 1981) showed that 50 percent of these adjustments were made using comparable uncontrolled prices (as opposed to 15 percent in our data base). IRS added that the other studies of section 482 (see p. 33) which showed that only 21 to 28 percent of tangible property adjustments were made using comparable uncontrolled prices did not support our conclusion.

We did not review IRS' current data and thus do not know if it is readily comparable with that in our sample. However, we do believe the other studies of section 482 enforcement support our conclusion that comparable uncontrolled prices are not frequently used in making tangible property adjustments. The other studies, completed during 1972, 1973, and 1980 showed that comparable uncontrolled prices were used in 28, 21, and 24 percent of tangible property adjustments respectively. The higher percentages shown by the three studies and by IRS' current data may be due to the fact that those statistics include adjustments involving DISCs, Western Hemisphere Trade Corporations (WHTCs), and U.S. possession

corporations. Such adjustments were not included in our statistics because the transactions did not involve a foreign subsidiary. These studies also concluded that comparable uncontrolled prices were difficult to identify and were thus not frequently used in making tangible property adjustments. Moreover, even if IRS' most current data indicating a substantial increase in the use of arm's length prices for tangible property adjustments over that shown by other studies is readily comparable with our sample transactions, administrative burden and uncertainty for all affected parties would still exist in one-half of all tangible property adjustments.

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

ASSISTANT SECRETARY

JUL 10 1981

Dear Mr. Anderson:

I appreciate the opportunity to present the Treasury Department's comments on the draft GAO report "Allocation of Income and Deduction Within Multinational Corporations --- A Growing Problem for IRS, Treasury and Corporate Taxpayers".

In general, the report contains useful information, but we have substantial reservations about its conclusions with respect to the problems associated with intercompany pricing. Our specific comments are set forth below.

Formula Apportionment

Our principal concern with the draft report is the recommendation that the Treasury consider the adoption of formula apportionment as a substitute for the "arm's-length" principle in the current regulations. This preference for formula apportionment is not based on any analysis of the conceptually correct method for intercompany pricing, which should be the starting point for any review of the 482 regulations. In terms of economic rationale, formula apportionment has little merit because a corporation could have an increased tax burden merely as a result of its affiliates becoming more profitable or as a result of paying higher wages in the jurisdiction applying the formula. It therefore does not attempt to achieve the statutory objective of correctly reflecting a taxpayer's income.

Formula apportionment is not, as the report indicates, widely used by the states in a multicorporate context. Rather, it is, with very few exceptions, used by the states only to divide the income of a single multistate corporation, which is a totally different matter.

The report's case for formula apportionment rests entirely on the view that it would be administratively convenient and reduce taxpayer uncertainty. Even on this basis, however, the report is not convincing because it minimizes the practical problems with respect to formula apportionment. The report does not demonstrate how such methods would improve or simplify the illustrative cases. An example of an important practical problem in applying formula apportionment in a multinational situation is the definition of a unitary business. In that regard, the report is unrealistic in assuming that an advance ruling system for determining the composition of the unitary group would be

administratively simple. Another significant practical problem is the valuation of intangibles, which would be important for many high technology multinationals.

It would also be useful for the report to review the experience of jurisdictions that have used the unitary method. Some of the few states who use it, such as California, are considering abandoning it. The experience of European countries contributed to the very strong OECD criticism of "global" methods in its 1979 report on transfer prices. Moreover, formula apportionment is not consistent with our present treaty policy. Finally, the unitary method has been alleged to create an unfavorable business climate for foreign corporations doing business in a unitary state.

The Availability of Comparable Uncontrolled Prices

The report concludes that the present regulation is seriously defective because the comparable uncontrolled price method is only infrequently used in IRS adjustments. We understand that the IRS has made data available to you indicating that uncontrolled prices are used much more frequently than your data indicates. In any case, the report fails to adequately recognize that the other methods outlined in the regulations are only alternatives for arriving at an arm's-length price, not departures from that principle. Furthermore, there is no specific indication that uncontrolled prices are not used in cases of intercompany pricing which do not lead to an IRS adjustment.

Whatever the exact frequency with which uncontrolled prices are available, they are readily available in a number of cases. In that regard, should formula apportionment be used even when uncontrolled prices are available?

Evidence on the Shortcomings of the Current Regulations

Much of the other data presented to demonstrate problems with the current regulations are misleading or unpersuasive. For example, the report states that "only" 200 of the 519 multinational corporations in the GAO sample had Section 482 adjustments. These data are subject to various interpretations and do not necessarily reflect difficulties with applying the current Section 482 regulations. Furthermore, the report states that Section 482 adjustments amounted to "only" $277.5 million compared to the total income of the examined firms of $43.5 billion. The use of total income as the standard for comparison has no logical basis because, among other reasons, a significant

portion of the income may be unrelated to transactions between affiliates. Finally, the many examples of Section 482 cases discussed in the report are informative, but they do not necessarily relate to the report's major conclusions and the recommendations to the Secretary of the Treasury.

Safe Haven Interest Rate

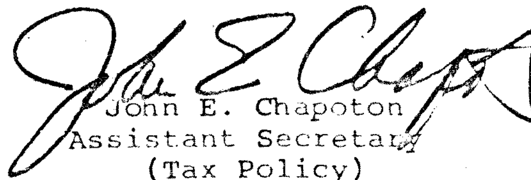
The report recommends that "the treasury adjust the safe haven rate as frequently as necessary to realistically reflect the current costs of borrowing." As you are aware, a change in safe haven interest rate has been implemented effective July 1. The Treasury has explored the use of self-adjusting rate but has found that it would lead to many practical problems for taxpayers. However, we anticipate that the safe haven interest rate will be adjusted periodically in the future to reflect major changes in interest costs.

Future Work

These comments are not intended to suggest that there are no problems with the application of the current Section 482 regulations. We realize that the arm's-length principle may have both conceptual and practical limitations in a world of integrated firms selling differentiated products. The Treasury has examined and will continue to examine specific problems in the regulations, and will propose changes if they appear useful or warranted. We will also work with the IRS on issues raised by the recently completed survey on 482 adjustments. However, additional analysis is necessary before we can conclude that a major review of the regulations is warranted.

My staff will be happy to expand on our comments.

Sincerely,



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