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California's Bank and Corporation Tax Volume III: Unitary Apportionment and World Wide Combination

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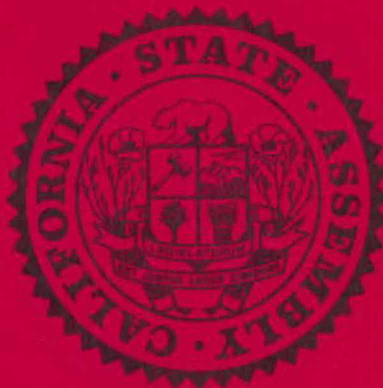
CALIFORNIA'S BANK AND CORPORATION TAX

VOLUME III

TRANSCRIPT OF HEARING

UNITARY APPORTIONMENT AND WORLD WIDE COMBINATION



Prepared by Staff of the

ASSEMBLY REVENUE AND TAXATION COMMITTEE

WILLIE L. BROWN, Jr.
Chairman

INTERIM HEARING
November 13, 1979
Los Angeles

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TRANSCRIPT OF HEARING

UNITARY APPORTIONMENT
AND
WORLD WIDE COMBINATION

INTERIM HEARING

ASSEMBLY COMMITTEE ON REVENUE AND TAXATION

ASSEMBLYMAN WILLIE L. BROWN, JR.

CHAIRMAN

LOS ANGELES, CALIFORNIA

NOVEMBER 13, 1979

80-2-437

ASSEMBLY REVENUE AND TAXATION COMMITTEE
ASSEMBLYMAN WILLIE L. BROWN, JR., CHAIRMAN

A G E N D A

INTERIM HEARING ON CALIFORNIA BANK AND CORP. TAX

NOVEMBER 13-14, 1979
LOS ANGELES

I. UNITARY - commencing at 10:00 a.m., November 13*

1. Opening remarks - Chairman Willie L. Brown, Jr.
2. Statement by author - Teresa Hughes
3. Ben Miller, Franchise Tax Board
4. N. C. Munro, Head, Tax Department, Confederation of British Industries, London
5. Stafford Grady, Chairman, Lloyds Bank of California
6. David Hammond, Taxation Manager, EMI, London
7. D. J. Hayward, Tax Manager, B.A.T. Industries, London
8. Anthony Money, Financial Controller, Foseco Inc.
9. Richard King, Business & Transportation Agency, State of California
10. JoAnne Garvey, Committee on Unitary Tax
11. Roy Crawford, Committee on Unitary Tax
12. Michael Wells, Committee on Unitary Tax
13. James F. Devitt, Chairman, Committee on State Taxation
14. Dan Lundy, IT&T
15. Chris Wada, Sony Corp. of New York
16. Henry Ota, Legal Advisor, Japanese Business Association of Southern California
17. Richard Ratcliff, Reynolds Metals
18. Thomas Wenglein, Xerox Corp.
19. R. L. Delap, California Council for International Trade
20. Dave Brainin, California Department of Finance
21. Earl MacIntire, U.S. Steel Corp.
22. Burns Stanley, Ford Motor Company

* Will be continued next day if necessary.

PREFACE

On November 13, 1979, the Assembly Committee on Revenue and Taxation held a hearing on the unitary method of apportionment for California bank and corporation tax purposes. The location was at the State Building in Los Angeles, California.

A background report was prepared for that hearing entitled "Unitary Method of Apportionment." This document is available through the Assembly Publications Office, Box 90, State Capitol, Sacramento, California, 95814, at a cost of $13.10.

The transcript of the November 13 hearing has been reproduced from cassette recording tapes. Unfortunately, the recordings were not as clear as we would have liked. In fact, it was exceedingly difficult, and in some cases impossible, for our transcribers to decipher some parts of the testimony. Where the testimony could not be understood, the term (inaudible) appears in the transcript. We apologize for these technical problems.

CHAIRMAN WILLIE L. BROWN, JR.: This hearing is to address the question of bank and corporation tax in the state. We probably should start our meeting by having the Franchise Tax Board testify first, so that we know exactly what the status of the bank and corporation tax system is in this state, particularly as it relates to unitary formula. Then we'll follow that with comments by individuals who might wish to make them, representing whatever they propose to represent. Let me indicate that we have a sign up system and I believe that there is a preprint of the agenda. However, it may be necessary to deviate somewhat for the convenience of witnesses. So don't be alarmed if you find yourself being called upon at a time different from what it says on this particular agenda. We have had introduced in the California Legislature, several pieces of legislation in the area of the unitary tax. We ask authors of the measures to come before us and give us the benefit of their legislation. We have such an author here today. I believe Teresa Hughes intends to make a presentation. And I believe some other members of the Legislature may be coming to do so. The Assembly Revenue and Taxation Committee today and tomorrow will be looking into the important issues that affect taxation of corporations by the state. The first priority, of course, will be the review of the unitary tax system. We will try to make some decision as to how we whould tax subsidiaries of foreign based corporations who have facilities in this state. There have been some screams about the present system particularly from some of my friends from the Union Jack. They have been very upset with the way we have handled the whole tax question.

We will attempt as best we can with the incredible agenda that we have to cover the entirety of the issue. The agenda has

been organized to allow everybody who wishes to say something to be able to testify whether you are from the public sector or from the private section. The fact that we have so much interest in this subject, is evidence of the effect it has on the business community. We want to adopt, as best we can, some system that will not be identified as a rip-off, although the results may be the same, and we want to do it in such a manner that it palatable to those that feel that they are being ripped off. But in all seriousness, we want, as best we can, to adopt a system that allows for a fair payment of revenue by those persons who earn revenue in the state. That obviously means that, if you are based in California, there are some benefits that are derivative that may not show on your books in California and may cause us to have some concern and therefore proceed to levy taxes. We will not be concluding on anything today or tomorrow. We will simply be gathering the necessary information to reduce the amount of time it will take us in the forthcoming session of the Legislature to address the issue.

We don't always have as much time in those hearings as we do in these hearings and those of you who have never been there you will find that you are before the Committee on Revenue and Taxation when you find yourself in the unfortunate position of having to appear before that body in an advocacy role. Let me now call upon my colleague from Los Angeles. But before I do, I should introduce the members of the committee who are present. I thought I say Floyd Mori. To my right is my colleague from San Francisco Bay Area, Floyd Mori a member of this committee. And to my left is the Vice Chairman of this committee, Tom Hannigan a man who on and off will be presiding. Let me now ask my colleague from Los Angeles,

one of the members of the Legislature who has introduced a piece of legislation in this area, Assemblywoman Teresa Hughes.

ASSEMBLYWOMAN TERESA HUGHES; Thank you Assemblyman Brown. I am delighted that the committee saw fit to hold this hearing in Los Angeles, where we have many, many concerns about unitary tax. And I think that it's very timely that we spend this time during the interim to study the subject matter in depth. This is the second piece of legislation that I have had addressing itself to the unitary tax. I think that it not only helps foreign corporations, but also domestic corporations. The biggest problem that I have in my district and that we have across the state is the economic problem: the probjem of jobs. California certainly is one of the best places, I feel, for industry to come. With the restrictions of the unitary tax system, we discourage rather than encourage individuals to come. I'm interested in the testimony that is going to be given today. I don't proport that AB 525 is the panacea to solving all of those problems. However, I'm delighted that some of the domestic corporations have changed their initial attitude which was a negative one regarding the possibility of doing away with unitary tax first for the foreign corporations. I hope that, in the spirit of good judgment, we can reach some sort of agreement and gather some data that will make it possible for us to modify, if not completely abandon the unitary tax. Thank you.

CHAIRMAN BROWN: Let me indicate to those of you who may not be aware, but the British Parliament is holding up, so I'm told, ratification of the U.S. - U.K. tax treaty pending this hearing. It is fun to be able to hold up the British Parliament. Being as mischievious as I am, I'm toying with the idea of keeping them

waiting for awhile and maybe they'll invite us to come over.

For your benefit though, let me indicate we do intend as best we can to make some progress. However, I would say that the California Legislature probably moves much slower than Parliament and I'm not sure that we are any more productive but we certainly attempt to be equally as productive. I'm sure that we will not reach a conclusion in this hearing that will give Parliament any direction one way or the other. But it might be very instructive.

Did you finish your opening remarks, Assemblywoman Hughes? All right. Assemblywoman Hughes will be joining us although not a member of the committee but she'll be joining us for the remainder of the hearing. Now let me ask Mr. Ben Miller, from the Franchise Tax Board to approach the podium and proceed to five us the Franchise Tax Board views on this issue.

MR. BEN MILLER: Thank you Mr. Brown, With your permission, I will sit at the table here. For the committee's information, the Department has put together a slide presentation which gives a basic background of the unitary concept; how it is operated and how it has developed by the courts of California and we will define certain of the important terms in the unitary concept. So with your permission we would like to proceed with that show and when that's finished, I would then have some comments to offer. For point of reference Mr. Chairman, this slide show has been from training programs we have put together for our new audit staff and gives a good background of the unitary concept. Jack, I think that's a slide ahead. (Slide presentation). Currently 44 states and the District of Columbia impose either a corporate income tax, a corporate privilege tax measured by net income or for a double tax

structure which combines both of these taxes. In the double tax structure states, one of the taxing provisions is designed to tax exclusively interstate business. California is one of the 11 states plus the District of Columbia which utilizes a double tax structure. The present California Bank and Corporation Tax Law imposes a tax under two chapters of the Bank and Corporation Tax Law, Chapter 2 of the Franchise Tax and Chapter 3, the Corporate' Income Tax.

The franchise tax became effective in 1929 and is imposed on corporations which are doing business in California. Section 23101 means actively engaging in any transaction for the purpose of financial or pecuniary gain or profit. The foreign corporation which maintains a stock of goods in the state and makes deliveries in the state pursuant to orders taken by employees in this state, is doing business.

The second chapter is the corporate income tax. This law was enacted in 1937 and it poses a tax on all general corporations which, while not doing an intra-state business in California, derive income from sources within California. The corporate income tax was enacted to help implement the franchise tax by taxing income from interstate commerce. Prior to the adoption of the corporate income tax, foreign corporations whose only activity in California was the transaction of interstate commerce, were not subject to a tax burden comparable to the franchise tax imposed on domestic corporations and foreign corporations doing business in California.

Public Law 86-272 was enacted by Congress in 1959 in an attempt to limit state taxation of corporations engaged exclusively in interstate commerce. Prior to the enactment of Public Law 86-272,

the United States Supreme Court ruled in the case of Northwestern States Portland Cement Company versus Minnesota, and Williams versus Stockham Valves and Fittings, Inc., that individual states have broad jurisdiction to tax corporations on net income derived from interstate commerce. Basically, Public Law 86-272 exempts from tax under limited conditions, income derived by foreign state corporations from the transaction of interstate commerce within the state. The exemption applies only to those corporations which are dealing solely in interstate commerce. The exemption under Public Law 86-272 is limited to interstate activity consisting solely of the solicitation of orders for the sale of tangible personal property where such orders are sent outside the state for approval and the orders are filled from an inventory located outside the state. To date, the constitutionality of Public Law 86-272 has been upheld by Louisiana, Missouri and Oregon Supreme Courts.

When a taxpayer earns income derived from or attributable to sources both within and without California, the state must use some method of determining the income attributable to the activity within this state. Generally, California accomplishes this determination of income through the use of methods which are referred to as "Allocation" and "Apportionment". Basically, the theory of apportionment and allocation is to attribute income to each state in which a corporation is doing business or deriving income. At first glance, you might feel that the solution to this problem would be to use separate accounting whereby you would compute the revenue and expenses in each state, thus arriving at a separate net income for each. However, as you will see in a moment, the use of separate accounting in most instances will not accurately reflect the income

from each state. Assume a foreign corporation has a manufacturing plant and a sales office in California. What could be more accurate and simple than to take the receipt by the business conducted by the two operations in the state, deduct the direct and indirect expenses to arrive at the net income attributable in the state. Our first example was quite simple and an example where apparently it would be no problem to compute the California income.

But let us take a look at another example where the facts become a little more complicated. In this example we have a corporation with its headquarters in California but its manufacturing and selling activities are in Oregon. The California headquarters activities have, except for minor reimbursement for administrative expenses, no gross receipts. The headquarters has incurred expenses that are attributable to Oregon which far exceeds their expense reimbursement. Is California entitled to tax any of the income for the entire operation? It is difficult to imagine that the administrative services performed in California produced no income for the corporation, yet by use of separate accounting the California business would reflect a net loss.

Let's further complicate our problem. Assume the corporation headquartered in California has its manufacturing plant in Oregon and its sales division in Nevada. Here again separate accounting will not attribute a net income to California. How about Oregon? Will it have a net income attributable to it? Or will Nevada end up with all the income because all the sales are made in that state. You could, by use of generally accepted accounting practices, determine that a profit is attributable to the manufacturing in Oregon. This would be accomplished by having the Oregon manufacturing

plant pass its products to the sales division in Nevada at a price that is in excess of the cost of manufacturing the product. We could even attribute a profit to California by charging the Oregon and Nevada operations for its administrative services in excess of the actual cost of the administrative functions. But the question is how? Who would determine the proper charges to be made between the three operations. What would the state have to support its audit determinations. The answer to these questions lies in the allocation and apportionment methods which are a derivitive of the unitary business concept.

The unitary concept got its start from the property tax laws. It first arise in the unit rule which was developed in the case of Union Pacific Railway Company versus Cheyenne. In this case the court held that railroad cannot be considered as mere land alone, but instead its value depends upon the whole line as a unit to be used as a thoroughfare and means of transportation. A separate rail mile is almost valueless by itself. One must look at the entire operation.

Although California had determined income of a single unitary corporation by formula application since 1929, the validity of the formula method for determining income was not considered by the California Supreme Court until 1941. This occurred in the case of Butler Brothers v. McColgan, where Butler Brothers argued that it was not engaged in an unitary business. Butler Brothers was an Illinois corporation with the main office in Chicago. The business was wholesale dry goods with seven distributing houses located in principle cities throughout the United States including San Francisco. The corporation had a simple buying division which made volume pur-

chases at favorable prices for the entire business. The corporate overhead expense, executive salaries and central buying and advertising expenses were allocated to these seven houses. Each house stocked its own goods, handled sales, solicitation, credit collection and kept books showing its separate operation. The Corporation computed the California income by separate accounting for its California house, plus a deduction for its share of the overhead. This resulted in an $83,000 California loss, while the operation of all its houses resulted in a $1,149,677 gain. However, the Franchise Tax Commissioner contended that the operation was unitary and that the formula method was the proper method used to compute the income from business derived from within California. The California Supreme Court, in its opinion stated that "it is only if its business within the state is truly separate and distinct from its business without the state, so that the segregation of income may be made clearly and accurately, that the separate accounting method may properly be used". Thus apportionment is necessary when interstate operations are carried on and the business then within the state cannot be segregated from business done without the state. If the California operations contributed to the net income derived from the corporation's entire operations, then the business is unitary and apportionment is necessary to prevent overtaxation to the corporation and under taxation to the state.

The next major case involving the unitary concept was the case of Edison California Stores, Inc., versus McColgan. In this case, the court established the other major test to determine a unitary business which commonly referred to as the "contribution or dependency" test. Edison California Stores, Inc. was a parent of

15 subsidiary corporations, one of which was a California corporation. Each of the subsidiary corporations operated a retail shoe store. Edison's parent corporation was a Delaware corporation which had its main office in St. Louis, Missouri. The parent corporation had a central management division, central purchasing department, central distributing department, central advertising department, central polity setting, and central accounting. The California corporation sold exclusively in this state the merchandise it received from the parent. The shipment to each store was based on an analysis of daily reports sent to the headquarters. The California subsidiary computed its California income by use of separate accounting. Edison Stores felt California could not force formula apportionment when the taxpayer is a California corporation and is not a foreign parent corporation as in Butler Brothers. In reviewing Edison's operations, the California Supreme Court found that the same elements of unity that existed in Butler Brothers also existed in Edison's operations. It said "In the present case, all of the elements of a unitary business are present. Unity of ownership, unity of operation by centralized purchasing, management, advertising and accounting and unity of use in the centralized executive force and general system of operation. The court further said that, "If the operation of the portion of the business done within California is dependent upon or contributes to the operation of the business without the state, the operations are unitary. Otherwise, if there is no such dependency, the business within the state is considered to be separate". It noted there was no difference in principle between the unitary business here of a parent corporation owning and controlling, as units of one system, 15 corporations, and the unitary

system in Butler Brothers which was a single corporation with seven different branches in as many states.

The next important case decided with respect to apportionment, was Superior Oil Company versus Franchise Tax Board. Superior Oil was engaged in the production and sale of petroleum and petroleum products. Superior operated in more than 20 states including California and in addition had its main office in Los Angeles, California. It was not an integrated oil company, since its raw petroleum generally was sold at the well site to other companies. Superior's producing activities were centrally controlled from its executive offices in Los Angeles. Also centrally controlled were the administrative functions, such as accounting, purchasing of equipment, supplies and insurance. All production in California was sold in California and all out of state production was sold outside of California. There was no flow of products between the states. The Corporation felt its petroleum operations were unitary in nature and therefore, it must apportion that income. This resulted in $1,135,061 of income being apportioned in California. The Franchise Tax Board took the position that income is to be apportioned only when the operations within and without the state are both necessary and essential "to each other and to the functioning of the business as a whole. Only when that situation exists is it impossible to make separate accounting computations. Since there was no flow of goods, separate accounting should be used. This resulted in $10,637,633 of income to be subject to California tax. In ruling that Superior Oil was conducting a unitary business requiring formula allocation, the court also concluded that it is not necessary for there to be an interstate flow of goods before unity

can exist. Prior to the Superior Oil ruling, the Franchise Tax Board felt that before there could be unity, there must first be an interstate flow of goods. So as you can see, while the state lost this case, it won a precedent in that the state no longer had to establish the existence of interstate flow of goods for a business to be unitary.

Two methods have been devised to apportion business income to a state. These methods are referred to as the "separate accounting" method and "formula" method. As we have seen in our example, the separate accounting method does not always work. The theory behind the composition of the apportionment formula is the formula to be composed of factors made up of the various elements which fairly attribute a portion of the business income derived from or attributable to sources within the state to such state. Although there is some dispute as to the merits of various factors or their components, the near universal apportionment formula is the so called Massachusetts formula with minor modifications. The formula is composed of a property payroll and sales factor. It was incorporated by the Uniform Division of Income for Tax Purposes Act with some clarifications as the basic apportionment formula. The three factor uniform Division of Income for Tax Purposes Act formula which was adopted by California consists of the following items: (1) owned and rental real and tangible personal property used in the trade or business; (2) Wages, salaries and other forms of renumeration paid the employees who are performing services for the corporation in its regular business activities; (3) Gross sales, net of return and allowances from general business transactions. As we have explained earlier, the income of a corporation derived from sources

within and without California is broken into two classes -- business and non-business income. Business income is apportioned to the state by use of the formula described above. Non-business income is allocated to a particular state pursuant to set rules. Bank and Corporation Tax Law Section 25120A, the Uniform Division of Income for Tax Purposes Act, Section 1(a), defines business income as follows: "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 constitutes integral parts of the taxpayer's regular trade or business operations". Bank and Corporation Tax Law, Section 25120(b), Uniform Division of Income for Tax Purposes Act, Section 1(c), defines non-business income as follows: "Non- business income means all income other than business income". In addition to the definition of business income provided in the law, the regulation provides that all income arising from the conduct of trade or business operations of a taxpayer is business income unless clearly classifiable as non-business income. Accordingly, the critical element in determining whether income is "business income" or non-business income" is the identification of the transactions and activity which are the elements of a particular trade or business. In general, all transactions and activities of the taxpayer which are dependent upon or contribute to the operations of the taxpayer's economic enterprise as a whole constitute the taxpayer's trade or business and will be transactions and activity arising in the regular course of and will constitute integral parts of a trade or business. (end slide presentation).

MR. MILLER: Thank you Mr. Chairman.

CHAIRMAN BROWN: Proceed Mr. Miller.

MR. MILLER: Thank you. As we have shown in the slide presentation, California assesses a tax on corporations which do business or have an income from sources within and without California solely on the basis of their income within California. In making this determination, California uses what is called the unitary method. The unitary method consists of two parts. One is formula apportionment and the second part is the use of the combined report. Formula apportionment is used by all of the states now 45 in number which is thus an income tax or a tax measured by income. California law is originally a draft of 1929, provided that the taxing authority could make an apportionment on the basis of any of the following factors: Sales, purchases, expenses of manufacture, payroll, tangible property or any other factor. Over a period of time, California along with the majority of the states evolved into using property, payroll and sales, which is now known as the Massachusetts formula. In 1957, the National Conference of Commissioners on Uniform State Laws approved the Uniform Division of Income for Tax Purposes Act which incorporated the standard 3 factor formula. California adopted this act in 1966. Under the combined report concept separate corporate elements of the unitary business are required to prepare a single report which accumulates their results on their individual activity, assigns the appropriate portions of profit or loss to the individual corporate element and geographic areas on the basis of the apportionment formula. Currently, there are 21 states which have judicial precedents authorizing or requiring the use of the combined report concept. In addition, there

are several other states which require the use of this concept though they have not yet had court rulings upholding it. This department's position that equitable tax administration requires the use of the combined report concept for all taxpayers. Furthermore, the California Supreme Court, in the cases of Honolulu Oil Company and Superior Oil Company, held that if a unitary business exists, the state must use the unitary method which consists of the combined report and formula apportionment.

The drafters of the Uniform Act recognized that the standard formula would not work for all industries or in all cases. Because of this, they provided an out clause, Section 25137 of the California Revenue and Taxation Code. This section provides that if the standard formula does not fairly represent the extent of the taxpayers and business activity within the state, that the board may grant relief to the taxpayer. California State Board of Equalization has considered a number of cases which either the taxpayer or the department has thought to grant a variance under Section 25137. The Board has held that variances are only to be allowed in exceptional circumstances and the party seeking a variance must establish that the standard formula does not fairly reflect their business activities. In administering the law prior to the enactment, the department had developed a number of special apportionment formulas. When UDITPA was enacted it was determined that most of these formulas should be continued. These formulas have been developed in conjunction with industry representatives and in conjunction with advice from the tax bar and the accounting firms that frequently deal with the industry and with the department. To date, special formulae have been adopted for the following

industries: Banks and financials, construction contractors, motion picture and television producers, franchisers, air transport companies, and commercial fishing.

We are currently working on a number of other formulas which could be adopted some time in the near future. With respect to an individual taxpayer, it is staff's view that a variance from the standard operation should be granted only in exceptional circumstances. UDITPA was adopted and promulgated to promote uniformity among the states in the treatment of taxpayers. Actions on the petitions of individual taxpayers defeats uniformity in several respects. First, it will almost inevitably result in different treatment for different taxpayers in essence with the same factual situation. Second, it destroys uniformity among the individual states and no two states are likely to view the petition of the single taxpayer in the same light, or even more likely a taxpayer will petition for a variance only in those states where a variance will be to his benefit. In February of 1978, the Franchise Tax Board adopted a regulation providing for open hearings on Section 25137 petition. A number of petitions have been presented to the Franchise Tax Board. The hearings have only been granted in three cases. In one of those cases the staff recommended and the board agreed and allowed the taxpayers petition. In the second case the board overruled the staff's determination as to what the extent of the taxpayers unitary business was and ruled in favor of the taxpayer and did not have to consider whether a variance was required from the standard formula. The third petition was heard on November 6 and there has not yet been a ruling on that. In 1974, California entered into the multi-state tax compact. The Multi

State Tax Compact and its administrative body, the multi tax commission, currently have 19 regular members and 12 associate members. The Multi Tax State Commission conducts joint audits for the states in both the income tax and sales areas. The Commission also works with member states in developing uniform rules and regulations for the taxation of multi jurisdictional taxpayers.

When we review the merits or deficiencies of the unitary concept, we must inevitably compare it to the federal system. Such a comparison is only natural because of our general familiarity with the federal approach. But it should only be made based upon an understanding of the underlying theories of each system. Federal systems based upon the residency concept of taxation, its premises are similar to those involved in the California's personal income tax. The primary thrust of the federal system is to tax all the income of a person or corporation which is a resident in that state. The decidedly secondary objective is to tax all the income of non-residents which is earned of course within the state.

States, on the other hand utilize a source system taxation The fundamental requirement of any system used by the states is that it provides a relatively easy, efficient and reasonably accurate means of determining the geographic source of income. The states must utilize this source system because they are prohibited by various constitutional provisions from taxing the income of non-residents earned without their borders.

Attempting to tax corporations in contrast individual, the states are confronted with taxpayers which derive their income from a variety of jurisdiction and which in most cases are non-residents in their individual states. In fact, corporations which

bear the brunt of the tax burden are most frequently those with the greatest amount of business activities in the most number of states. The increase of international commerce and the growth of multinational business. There has been a growing concern with the determination of geographic source of income at the federal level. This concern has arisen because of the significance of tax credits and the utilization of foreign jurisdiction by many large corporations. The method which has been adopted by the federal government for the determination of geographic source of incomes, so called "arm's-length" method. Under this method, the income from a particular source is determined by examining the transactions which take place between the geographic areas and determining what a fair price for the goods, commodity or services involved should be. This approach is subject to numerous defects which have been recognized by both business and tax commissioners. These defects are the result of dubious assumptions upon which the arm's length standard is based. These assumptions include but are limited to the following: (1) that all transactions both before and after the transaction being reviewed are at arm's length; (2) that a fair free market price can in fact be established; (3) that general overhead and administrative expenses can be fairly allocated; (4) that the market price is unchanged regardless of production; (5) that transactions are uninfluenced by external considerations such as tax incentives, government regulation; and (6) that it is possible to determine the amount of profit allocable to different functions, such as manufacturing and selling.

The federal system in this question is evidenced by a request by Al Ullman, Chairman of the House Ways and Means Committee,

to the General Accounting Office to study state tax methods and to compare them with the federal approach on the arm's length standard. This department has already received a questionnaire from GAO and has responded to it. We anticipate we will have further discussion with the General Accounting Office concerning their study. The current schedule calls for a report by the General Accounting Office in mid-1980. The mid-1980 schedule is adhered to, the 96th current Congress will still be in session and it is likely that whatever the GAO's findings are will have an impact on federal legislation currently being considered.

In April of 1976, a note appeared in the Harvard Law Review which compared the arm's length approach with the unitary method. The note concluded by stating that the use of the arm's length standard of the current section 482 regulations has been accompanied by serious problems most clearly evident by the surprisingly frequent reliance of revenue agents in an ad-hoc for other method approaches, based not on the theory of the regulation but on the unitary entity theory.

That the unitary method should compare favorably with the arm's length standards in making source determinations is not a surprise. The arm's length standard is a product of a residency tax system in a by-gone era when business at least for federal purposes, restricted their activities to neat, limited geographic areas. As the multi national businesses have proliferated, the defects of the arm's length standard have become more apparent. The unitary method on the other hand would develop specifically as an attempt to determine the geographic source of income. Its uniform use by the states, acceptance by the courts and recognition by

both legislative bodies and commentators as the only viable system for the states to use have validated the concept. Furthermore, the proliferation of multi-national businesses demonstrated its viability and adaptability to a changing business world.

Opponents of the world wide use of the unitary method argue that it places excessive compliance burdens on taxpayers and often reaches arbitrary and inaccurate results because of a variety of factors. Examination of the cost of compliance arguments establishes that they are based on a faulty premise. The cost of compliance with any tax audit will necessarily be greater than if no tax audit is performed at all. Critics of the unitary method are correct but the cost of compliance with the method which they advocate will in fact be greater. But this is true only because multinationals do not expect any audit, let alone a rigorous audit to be made. A rigorous "arm's-length" audit will require an examination of every single process of manufacturing and marketing of a product with close scrutiny of all determinations made as the allocation cost and determination of profit margins. Such audits could not be conducted by the states because they are beyond their current administrative capability. They are not conducted at the federal level to any significant extent either because of the same lack of administrative capabilities and the difficult subjective judgments which must be made. The alternative to the unitary method, which multinationals endorse, is the non-audit approach currently practiced under the guise of the arm's length standard. Necessarily the compliance cost must be less than unitary approach.

Opponents to the world wide application of the unitary method argue that the method acts as a disincentive to foreign

investment within California. The arguments are generally restricted to a citing of certain specific examples where business investment decisions supposedly have been influenced by the unitary method. Before far-reaching changes are made, consideration should be given to what evidence exists showing that the unitary method of taxation is in fact a disincentive. As yet, few studies have been made of this question. Sponsors and proponents of the legislation have only offered anecdotes in support of their position. Paul Ryder, Associate Director of the Industrial States Policy Center, a public interest group based in Ohio, has prepared a critical analysis of these anecdotes. He notes in general that the anecdotes are based on self-serving declarations of the multi-nationals or their representatives, offer little or no concrete support in the involved in the unitary method, and in many cases do not even attribute a disincentive to the unitary method.

As further evidence that the unitary method does not constitute a disincentive to investment in California, we would like to refer the committee to a study prepared for Fortune Magazine, or for the Fortune market research. The study was done by Belnap Data Solutions Ltd. This study was titled "Facility Location Decision." Based upon this study, California was the second most likely state for the location of a new business investment, which trails only to the state of Texas as it was the only non-southern state in the top five. According to the study, California was the most likely location for either a regional headquarters, a laboratory, or a distribution center/warehouse. This was prior to the repeal of the business inventory tax, by the way.

ASSEMBLYMAN MORI: In that study, are we talking about all

domestic as well as international corporations. What kind of companies did that study direct itself toward?

MR. MILLER: That study is directed to U.S. based companies, and would include multi-nationals as well as wholly U. S. companies. It was not directed to foreign based companies.

ASSEMBLYMAN MORI: During your whole discourse today and your slide presentation, the whole emphasis is on domestic based corporations. I don't see any comments directed at the international or foreign based corporations and their problems. You've sort of minimized the problems that might occur, but really haven't addressed the issue of foreign based corporations at all, as far as I am concerned.

MR. MILLER: We don't mean to minimize the problems, Mr. Mori. I think the reason the slide presentation and material we've presented and the court cases deal basically with domestic corporations is because they deal with a business world which was, by and large, restricted to single countries, the business world of 20 years ago. The business world has developed, has become much more multi-national in character. We believe the unitary system is a method which is addressed to those problems. We do not believe the arm's length standard does address those problems.

ASSEMBLYMAN MORI: Your comments there concern me in that the business world of 10 and 20 years ago was not at all as multi-national as it is today. The complexity, not only of domestic corporations being multi-national, but foreign companies wanting to come to this country, I think, makes the issue a lot more complex and not as simplistic as you've presented it both in the slide presentation and comments here today.

ASSEMBLYWOMAN HUGHES: Mr. Brown. Question.

CHAIRMAN BROWN: Assemblywoman Hughes.

ASSEMBLYWOMAN HUGHES: Mr. Miller, do you agree that there is an additional accounting burden being placed on foreign corporations who do not conduct their business through the same American currency throughout the world that we have. For instance, the Japanese or British companies or German companies have another type of currency and then in terms of reporting to you, they have to revise or interpret this information in terms of our currency. Doesn't that place an additional burden on those companies?

MR. MILLER: Well, I think you're going to audit, you're tax the foreign based companies and their activities within the state certain information is going to have to be prepared for the taxation . . .

ASSEMBLYWOMAN HUGHES: You didn't answer my question.

MR. MILLER: I'm attempting to.

ASSEMBLYWOMAN HUGHES: Does it?

MR. MILLER: I'm attempting to answer your question. I think the burden exists under any method you choose, whether it be the unitary method or the arm's length method. I believe the burden will be less under the unitary method than it will be on the arm's length method. If we're going to conduct an audit of those corporations to determine the amount of income from California sources. If we do that under an arm's length method we're going to have to examine the underlying transactions which give rise to the final (inaudible) transaction or sale into California to properly determine their income. You have that burden regardless of the method which you adopt We believe that burden will be less under the unitary method. It

is a burden which U. S. based multi-nationals are currently carrying with respect to their own foreign operations in having to report to foreign countries. It is a burden which any foreign multinational is going to have to prepare if they are going to keep track of or determine how their U. S. operations, their foreign operations are in fact performing. They must have some means to compare these results with what goes on in their home country. We believe that the type of information we are requesting is already prepared and exists with these companies. The additional step which must be taken which I think must be taken under either system, is there must be some determination of the amount of income in U. S. dollars.

ASSEMBLYMAN MORI: You talked about a study of disincen-- tives. I don't know how many times in the past five years I've heard the issue of disincentives in California disucssed and attributed to various elements. Disincentives in the business world to me are bery subjective in nature and maybe this is why we haven't had any in-depth examination and scientific examination as to which really is a disincentive. One fact that I'm aware of in two trips to Japan in the past and Taiwan in the past year, every single business person that I talked to without exception, large, medium and small, when we discussed the prospects of investment in California, the matter of the unitary tax was raised. Now whether its subjective or imperial or whatever, I'm not talking about one or two or three, I'm talking of dozens of corporate people that I have spoken with, one element that always arises is unitary tax.

MR. MILLER: Mr. Mori, there's no doubt that the variety of matters that go into the determination as to whether to make an investment, where to locate a business activity. Taxes must

necessarily be one of those factors which impacts on that decision. There's no doubt about that and it's true that these are very subjective judgments. I think if you will look at this Fortune study that was done, it indicates on a priority basis when corporations are asked as to the significance of various factors, taxes is not the most important thing. It is the fifth or sixth most important thing. And when it comes down to actual decisions being made why did you make a determination to locate in a particular area, taxes and business climate dropped down to the ninth or tenth most important element. And in making that determination both taxes and business climate are put together in one category, so the tax element itself is necessarily going to be much lower than that. Also with respect to the tax element with respect to U. S. operations, state taxes are deductible from your Federal income tax, so automatically one half the impact disappears. With respect to foreign operations and the Japanese being one of the prime examples, most of these countries or all the developed countries allow tax credits with respect to tax paid to foreign countries or to U. S. jurisdictions. Though with respect to these companies to the extent they carry an increased tax burden within California, it is questionable whether this represents a real incentive or disincentive to them because those payments are subsidized by their own government.

ASSEMBLYMAN MORI: Let me go back to the original comment about the Fortune study. Based upon American business values and incentives or disincentives based on your perception of what disincentives are, it may be correct. However, in looking at the different kinds of cultural values or business practices that may develop, incentives or disincentives may be totally different than

what Fortune Magazine or you and I perceive as a disincentive. I think we have to understand that kind rather than our emphasis on empirical ABC numbers because they just can't be translated in terms of different cultures one to another. I think that's one thing that is totally unrecognized in any analysis that you've put forth or I've heard anywhere, that there are differences between here and the British Isles and West Germany and Japan in terms of the whole process of business practices, not only the process of exchange rates, but what is an incentive and what is not an incentive. I think from your eyes and my dyes, it may be totally different. And I would submit to you, Mr. Miller, that the unitary tax is a significant disincentive, particularly if in fact the disincentive is on the margin as it may be California. With the other things to be considered, even if it were 20th or 30th on the list of importance, that marginal decision when a business is on the margin of making that decision, someting 50th on the list may be the key element that causes that business to locate or not to locate. It doesn't have to be the first element. It could be many elements and something way down on the list that is a marginal element.

MR. MILLER: Yes, sir. I think if you have this kind of problem not only with respect to taxes but respect to business practices, accounting practices, warranty problems, any number of areas. Any time an investor from a foreign country is coming into a new country to them to make an investment there, he has a varieth of things they have to look at. A lot of those things may be different than the business practices in his country. Does that mean or does that indicate that the country which is seeking the investments must change all their laws to conform to the business

practices of the foreign investor who wishes to enter the country? I don't think that's a correct statement. I cannot quarrel with you. You've had the experience of talking with people that the unitary method is viewed as a potential problem with respect to most of these companies. It has been my experience in dealing with those taxpayers which have come forward and have requested prior rulings from us as to how the unitary method would operate with respect to their company. We in almost all cases have been able to give them satisfactory explanations of this system, how it would operate, and in many instances, they disdover they will pay a smaller tax under the unitary method than they would under some other method. I think these investments are being made once there is an awareness as to what's really involved in the unitary method. The hearing we just had before the Franchise Tax Board on November 6th involved California First Bank. Now for the years that are before the Board there are significant investments involved, but the representative at the hearing indicated that when this unitary method is carried on through the future years, the next three or four years, there will in fact be refunds. The net result of the unitary method will not be significant with respect to that particular taxpayer. Our experience indicates that this in fact happens in many situations. Taxpayers, any business can raise any argument they want. This is a disincentive. This is a problem. We have to have changes made in the system. Once they decide to make the investment, I think most taxpayers find that the system is not a problem, not one that they cannot cope with. We're continually dealing with taxpayers on a day-to-day basis where audit adjustments will have been made, protest will be made, taxpayers will be very

upset with the concept. They start working with the concept, discuss it. They are in fact able to supply the information required to make the computation. They are able to adapt to it. I can't disagree with you that the perception may be a problem. We're working on that to see what we can do to help clear up that perception. One of the things the Franchise Tax Board has done to do that is to initiate this prior ruling program. We have not had a lot of requests for rulings under that program but we tried to respond to them in a very quick fashion. It might be of interest to the committee to note within the last six months, we have been visited by a delegation from the Japan Tax Association, a group that would be similar to our U. S. Chamber of Commerce and also by representatives of the United Kingdom, who discussed possible ways that they could inform their members, businesses within those countries to prepare the necessary data to work out methods to minimize the cost of compliance. We feel this is something that will be very productive and once we get down to it and work out the actual problems involved, we don't think they will be significant. Anything can be a subjective judgment or perceived as a disincentive for business. The fear of the unknown I guess is as good as any way to look at it. Once something becomes known and you know how it operates and how to respond to it, it's much less of a disincentive. We think this is what in fact will happen with respect with most foreign corporations. One point I would like to make as to the empirical evidence which is included in our report. I think the conference board every quarter releases a study of the number of foreign companies which have made investments in the United States and which states they have located in. California is

always on top of that list. In my material I prepared for the committee, I only cited two separate quarters because those were the only two I had information on. Further information is basically the same for all quarters. In the second quarter of 1978, eighty-one foreign companies made new investments in the United States. Nineteen of those were within California. In the first quarter of 1979, there were 86 new foreign investments in the United States. Fifteen of those were in California. In both cases California was by far and away stayed with the most foreign investments. While the unitary concept may be perceived as a disincentive to investment by some people, it is readily apparent that there are many foreign corporations which are completely unaware of it in this day and age. It is just not the problem once they sit down and examine it or its a problem they can live with. I think that's the evidence we have to look to. One other point I would like to raise with respect to the current bill you are considering. I believe it was last fall and the California Appellate Court in Los Angeles specifically held that there should not be any discrimination between foreign commerce and interstate commerce. A property tax exemption, which California had enacted, which favored foreign commerce was struck down as being unconstitutional because it favored foreign commerce over interstate commerce. I think this is one of the problems which is inherent in AB 525. The Zee Toy decision is now before the U. S. Supreme Court. Perhaps this term we'll have further illumination from them as to whether the California Appellate Court decision was correct for this area. I believe the case before the Supreme Court is under the title of Sears Roebuck v. County of Los Angeles. My intention was to

remain here at the table and be available for any questions the committee members may have during the presentation. This concludes my presentation.

CHAIRMAN BROWN: Thank you very much, Mr. Miller. Let me introduce other members of the committee who have now arrived. To my left Assemblywoman Gwen Moore, to my far right Robert Naylor from San Mateo County, and nest to him Assemblyman Dennis Brown from the vast wilderness of Long Beach. Mr. N. C. Munro the head of the Tax Department, Confederation of British Industries out of London. Are you based in London?

MR. N. C. MUNRO: Based in London, sir.

CHAIRMAN BROWN: And you came for this hearing?

MR. MUNRO: Yes.

CHAIRMAN BROWN: How do we get a trip?

MR. MUNRO: Thank you very much. Mr. Chairman, members of the committee. My name is Neal Munro. As you've said, I represent the Confederation of British Industries, CBI, and I'm the head of their tax department. CBI is grateful for the chance to attend this hearing and to submit evidence in support of the Hughes-Mori Bill, AB 525. My presentation will be relatively short and will take only a few minutes of the committee's time. I should explain that the Confederation is a nonprofit making organization based in London that represents all sectors of British industry and business, going far wider than the mere term it would suggest. Our members range from the largest multi-national companies to the very smallest concerns. We also include among our members representative bodies and association, all particular commercial and industrial sectors in the UK. I wish to place this on record

for two reasons. In the first place, our wide range in membership means that we can justifiably claim to speak for the whole of British business on the question of unitary taxation. In the second place, because we are a nonprofit organization, relying on subscription for our income, we are not prosperous. We have found the cost of arranging to be represented here today comparably burdensome. Indeed, it is a step completely without precedence. But we have felt justified in taking this step and our membership have given us their authority because of the very grave concern felt by all our members about the problem of unitary tax with combined world-wide reporting. I should like to tell the committee very briefly about the main reason for our concern. In doing this I must make it clear that I'm speaking for the generality of CBI members. It is not my purpose to consider the detailed application of the unitary tax system as practiced by the Franchise Tax Board. I'm not sufficiently knowledgable and I leave that to the expert witnesses that will follow me. Nor is it my job to deal with specific cases. The other members of our delegation will do that in speaking for their individual companies. Finally, I should emphasize that CBI's evidence relates only to the application of the unitary principle to foreign based, in our case, British based multi-nationals which have part of their operations within the State of California. The Franchise Tax Board presentation which we've just hear, in my view, did not cover this question because it did not really deal with the question of foreign based companies. And it would not be appropriate for me to comment on the merits of their arguments in relation to U.S. based companies. CBI are concerned about the principle of this form of taxation. We believe it

produces arbitrary and inequitable results. We favor instead the arm's-length principle as endorsed by the Organization of Economic Cooperation and Development, OCED, and their model double tax conventions and in their recent report on transfer pricing and multinational enterprise. This organization is one which the USA among other developed countries plays a prominent part. The arm's-length principle has also been endorsed by the international chambers of commerce in a resolution passed last September. We do not favor the system of unitary tax as applied by the Franchise Tax Board to foreign based multi-nationals, because it ignores the widely varying commercial and economic climates in different countries and therefore produces an inequitable result. The Franchise Tax Board in their presentation referred to the dubious assumptions of the arm's length approach, the section 482 approach. We consider that the assumptions of the 3 factor formula used by the Franchise Tax Board are even more juvenile. The three factors are likely to vary considerably in different countries and it is wrong to assume that income is produced equally from them in different continents and different economy. As a result, the three factor formula will not necessarily produce a tax liability that can be equated with profits actually earned in California. Take a simple example of a start-up form! The start-up firm will necessarily have to make heavy initial investments and this will result in low profits or even losses computed on the arm's length basis in the first year. But for the very same reason, unitary basis will produce what appears to be a substantial profit.

This leads onto my second point which is that the unitary basis can, despite what Mr. Miller of the Franchise Tax Board said,

lead to double taxation. If a company in California is unable for any reason to show a profit on the arms length basis, it may not be possible for tax charged on the unitary basis to benefit from double tax relief in another country.

The third problem is the question of compliance. Complying with the demands of the Franchise Tax Board for information, imposes a considerable administrative burden on companies. This must not be underestimated. There are two states in this process. The first is when the Franchise Tax Board makes inquiries to establish whether the business is unitary. This information would not normally be collected by the companies for any other purpose and it is often difficult, if not impossible to obtain. Second, having been adjudged unitary by the Franchise Tax Board, the company will have to file a combined report. To do this properly British based multi-national enterprises will have to re-write their account of all their member companies all over the world which could be up to a hundred companies or even more in order to tie in with California accounting standards. Difficult adjustments will have to be made. For example, to deal with exchange rate fluctuation. The witnesses who follow me will refer to various aspects of this whole problem as it affects their own companies. So I will only make the general points that there is a real problem here for UK based groups of companies. Mr. Miller referred, in dealing with this aspect, to the visit of UK officials with the objectives of clarifying what will be required of British companies by the Franchise Tax Board. I must make it clear that we, CBI, regard this only as a palliate, not as a (inaudible). To conclude therefore, it is abundantly clear, for the reasons which I have

outlined that UK companies regard the tax climate in California as extremely adverse. This evidence may be unequibocal but what evidence apart from that can be produced. Many of our members have indicated that they are not willing to contemplate new investment in California or the present situation either. They have even taken this view in many cases although such investment would be commercially desirable. To the extent that this happens, it is damaging for business and in the long term it will be damaging for the State of California. Mr. Chairman, thank you for the opportunity to testify at this hearing.

CHAIRMAN BROWN: Mr. Munro, thank you very much and I trust that you will be around. Mr. Naylor, you have a question?

ASSEMBLYMAN ROBERT NAYLOR: Mr. Munro, could you comment on the comparative burdens that the arm's length method imposes on companies?

MR. MUNRO: Where it is necessary for the arm's length basis to be applied, for the section 482 approach to be used, it may be that the administrative burden of complying with that would be considerable. It is difficult for me to say whether it would be as considerable as complying with the Franchise Tax Board approach, but I doubt that it would be. On the other hand, companies throughout the world know that this approach is something that they might have to face. They know that it's there. It is, to that extent, predictable whereas the sort of demands made by the Franchise Tax Board are not predictable. They are very uncertain.

CHAIRMAN BROWN: Thank you very much. Let me warn the members of the committee, these microphones are voice activated so it is necessary to speak directly into the microphones for them to

be picked up. Mr. Stafford Grady?

MR. STAFFORD GRADY: Ladies and gentlemen, my name is Stafford R. Grady, Chairman of Lloyds Bank, California, and I appreciate the invitation to appear before the Revenue and Taxation Committee and the opportunity to express my views on the fairness or lack thereof of the unitary method of allocating income of multi-national business of banking, particularly as it affects Lloyds Bank, California. Lloyds Bank, California is a state chartered bank and in its present form has been in existence since 1961, although its various predecessor organizations can be traced back over 100 years, mostly under the name of First Western Bank. I will not take the time of the committee to give a detailed history of the bank, but let me say briefly that this bank was cut in two in 1961 as a result of an anti-trust action and the group of branches assigned to it did not make an economically viable unit. As a result, it has historically not been a good earning bank. Between 1961 and 1974 the bank had five separate owners. An attempt to merge with another California bank in 1971 was ordered by another action of the anti-trust division. As a result of this an application of the bank holding company act, which became law on December 31, 1972, it appeared the most likely owner of the bank would be a foreign bank. In due course, First Western Bank was acquired by Lloyds Bank Ltd., London in January 1974, and its name was changed to Lloyds Bank, California in September of that year. Thus, despite our name, I hope I've made it clear, that we are an old California State chartered bank. We now operate essentially with the same people, the same policies, at the same locations, although a few more, and with probably more autonomy than we've had before we were

foreign-owned. Moreover, as a result of the investment of an additional $25 million of capital by our English parent, the retention of most of our earnings to finance growth and expansion and the additional business we've been able to generate because of being part of a well respected three centuries old, world-wide banking family, with offices in 44 countries around the world, our profits have grown and our prospects prefer the growth, and profitability are good. Accordingly, we pay more franchise taxes. In fact, during the 6 year period during which Lloyds Bank Ltd. has owned Lloyds Bank, California, from 1974 to date, we provided approximately $1.5 million average per year in California Franchise Tax, resulting from our increased profitability. This is about triple the average amount we paid over the preceding 6 years. Our franchise tax payments since becoming foreign owned, the last 6 years, have been over 50% more than we paid in the preceding 13 years when we were not foreign owned. In fact, we estimate that our franchise tax liability for 1979 alone, $3.1 million will almost be equal to the aggregate amount, $3,170,000 we paid during the 6 years prior to our change in ownership. However, because we are foreign owned we face the prospect of having the unitary tax applied to use. Although we have not computed these figures precisely because of the many problems in interpretation and world-wide information gathering, we estimate that our franchise tax bill will increase up to 200% in some years. For instance, we estimate that our $807 thousand franchise tax provision for 1976 would be increased to approximately $2.4 million if computed under the unitary method. This would mean that our franchise tax rate would be approximately 33% of profits rather than 13% which applies to non-foreign owned

banks. Obviously, we believe this is inequitable and unfair. Unitary tax principles were designed to prevent a California corporation from shifting taxable income to a related entity in another jurisdiction to avoid paying the relatively high California franchise tax. This has not been done in our case. We are highly regulated by the State Superintendent of Banks and now with the California state government and they would not allow this. So no need for application of the unitary method to our bank is justified. By the way, this fact of what the State Superintendent of Banks does is well documented. In August of 1977, the Franchise Tax Board had a hearing in Sacramento for two days, I think the 22-23 of August. During the course of that hearing, the Chairman, Ken Cory, asked to what extent the state banking department did examine the banks and whether there was any potential shifting of income to a related entity.

At Ken Cory's request, I inquired of the State Superintendent of Banks. I got an answer dated October 24. It's very brief, but I think its very significant so far as banks are concerned. I'd like to read it to you. Dated October 24, 1977, addressed to me from Carl Schmidt, the Superintendent of Banks. "Dear Staf: This is in response to conversations that we have had concerning your desire to advise Ken Cory on certain areas of foreign banking with respect to the unitary tax controversy. As I indicated to you on the phone, we feel our examiners do a very comprehensive job of examining on state chartered banks including agencies as we call them, which are really non-domestic deposit branches of foreign banks. Although the principle area of a bank's examination concerns asset quality of the institution, we, as all bank regulators, are exceed-

ingly concerned with the capital position of a bank. Capital, as you know, either comes from outside sources or as most often the case, from retained earnings, or to put it another way, the income screen. As a result of this, our examination does reveal the income screen in clear detail and should an institution under our purview attempt to divert income to a foreign country, it would become readily apparent and would be pointed out and dealt with by our department. The concept that is prevalent with respect to the unitary tax law and California state chartered banks, owned by foreign banks, that major amounts of income are shifted to affiliates in other countries is really without foundation. I feel very comfortable that our department, in its regular examination, would certainly see this abuse should it ever occur and based upon our responsibility of maintaining the safety and soundness of these institutions on behalf of the citizens of the State of California, would call a halt to such abuses immediately."

Now mind you, this is our primary regulator as a state bank. They examine into the very thing the Franchise Tax seeks to apply the unitary tax against us for and instead it doesn't occur. Although there may be justification for application of the unitary principles within the United States where the rates of inflation, salaries and property values have at least some relativity among the states. The application of the principle where it involves total income, salaries and property values as influenced by widely varying inflation rates in 45 countries around the world as it would in our case, is unfair and it would lead to gross inequity. In addition, the administrative nightmare to assembly and convert to dollars at an appropriate exchange rate all of the information

needed to attempt accurately to compute the elements of the 3 factor formula, and ultimately the tax, is unduly burdensome and costly.

This fact is made abundantly clear by reference to the statement of accounting standards #8 published in October 1977, dealing with foreign currency financial statement. Apparently, this fact is finally dawning on those charged with the attempt to apply the unitary tax to multi-national corporations doing business in countries with different currency. I quote from the July 2, 1979, Client Newsletter of Peat, Marwick, Mitchell and Company, "Currency Transaction Problems". The staff of the Franchise Tax Board have acknowledged that they have not been able to develop an equitable method for translating foreign currency financial data into dollars. This problem is greatly compounded when the foreign based enterprise conducts business in several countries. The distortive effect which can be obtained is being illustrated in very dramatic tones in a case that is presently pending before the board. Involved in that case are a Dutch parent corporation and its United Kingdom subsidiary. In the year at issue, the unitary tax varies widely depending on the method used to convert gilders and pounds and sterling into dollars. The staff concedes that they have no existing method to deal with this sort of problem on a uniform basis and therefore are resulting to negotiating the assessment on a case by case basis.

Many businesses have failed to locate in California because of the danger of the application of the unitary tax. Others, including the Hong Kong and Shanghai Bank have considered withdrawing from California because of it. This was established beyond doubt by two days of hearings before the Franchise Tax Board on

August the 22nd and August the 23, 1977. This in turn prevents or lessens opportunities for employment of California residents and will prevent the state from achieving its rightful place as a foremost world center for international trade, commerce and banking. Application of the unitary tax principle, against the California based corporations which are foreign owned will most certainly lead to retaliation by foreign countries which can only redound to the detriment of the profitability of California based corporations which have operations in foreign countries. This point is forcefully made by the United States Supreme Court which held unconstitutional the property tax imposed by Los Angeles County on cargo shipping containers owned by Japanese shipping companies in Japan Line Ltd., vs. Los Angeles on April 30, 1979, wherein the court stated, and I quote, "It is stipulated that American owned containers are not taxed in Japan. California's tax thus creates an asymetry in international maritime taxation operating to Japan's disadvantage. The rist of retaliation by Japan under these circumstances is acute. And such retaliation of necessity would be felt by the nation, as a whole. If other states follow California's example, and Oregon has already done so, foreign owned containers would be subject to various degrees of multiple taxation depending upon which American ports they enter. This result obviously would make speaking with one voice impossible. California, by its unilateral act, cannot be permitted to place these impediments before this nation's conduct of its foreign relations and foreign trade."

By the way, we had an experience in this country in the early 30's between the United States and France which I think amplifies this situation. In the attempt to eliminate what the

United States taxing authorities felt was a discriminatory and extra-territorial attempt to tax the income and dividends of French based subsidiaries of United States corporations, the United States and France negotiated a treaty which was signed on April 22, 1932. When by 1934 France had delayed ratifying the treaty and the discriminatory and extra territorial tax by the French continued, the Congress by Section 103 of the Revenue Act of 1934, gave the President of the United States the power, by proclamation, to determine that a country was discriminating against U. S. citizens and corporations. In that event, the taxes normally collected from the citizens and corporations of that country were doubled from what they ordinarily would be with a top limit of 80% of income in order to avoid confiscation. France soon saw the light and was persuaded to ratify the treaty on April 8, 1935.

By the way, I had the privilege of serving as insurance commissioner of this state for three years and our insurance tax laws in this country are an example of this. There must be 50 different types of taxation throughout the United States, and the insurance department keeps several people busy just working out the retaliation privileges of these various tax laws. One of the matters that you are always concerned with is the revenue loss. But I would urge you to take a look at the net revenue loss, because it isn't going to do the State of California very much good if it spends $25 million to try to collect $10 million. So I think when they kick around these figures about how much loss they're going to have, you ought to take a look at what the net loss is. Frankly, the thought of taxing authorities in hundreds of countries around the world, especially third world countries

who need funds of their own for development, who would love to be able to assess a tax against the world-wide income of successful California U. S. based multi-nationals because of some operation within their border, absolutely frightens me. Such retaliation is only (redound) to our detriment substantially. Lastly, I would like to call the committee's attention to the anomoly which occurs, a point that Mr. Munro brought up earlier, attempting to comply with the vast information gathering requirements of the unitary tax concept, when foreign countries are involved. For instance, in Switzerland our parent, Lloyds Bank Ltd., is forbidden by law to disclose certain details of their operation. And yet, they would be required to give access to such information to the Franchise Tax Board with penalties for non-compliance. I appreciate the opportunity ti make this presentation and I'd be happy to try and answer any questions.

CHAIRMAN BROWN: Alright, thank you very much Mr. Grady. We'd now like to call on Mr. David Hammond, Taxation Manager for EMI, London.

MR. DAVID HAMMOND: Mr. Chairman, committee members. I'm the financial director of EMI, Hillman Theatre Corporation, a member of the EMI group of companies, whose parent company EMI Ltd., is a company incorporated in England. I'm grateful for the opportunity of being able to speak in favor of AB 525, particularly because EMI has experienced practical inequities and onerous compliance requirements of unitary taxation.

There is no fear of the unknown, this is reality. EMI has several hundred reporting entities all over the world. It trades with more than 100 countries and has subsidiaries in over

30 different countries. It has subsidiaries with publicly owned minorities in several countries. EMI operates TV stations, theaters, hotels, restaurants, bingo parlors, bowling alleys, squash racket clubs. It manufactures records, tapes, foreign theft prevention devices, technical products in the electronics field, including well known brain and body scan. EMI finances, produces, distributes, and exhibits motion pictures. It is engaged in defense contracts and research work in considerable secrecy. All in all, EMI is a very diverse organization. One of EMI's subsidiaries is presently engaged in a dispute with the California Franchise Tax Board. That corporation is Capitol Industries which at the revelant time had a publicly held minority, and is princip-ally engaged in the music business. One of the relevant years in which (inaudible) Capitol made a significant loss while the remainder of the EMI group was profitable. Because Capitol was unable to answer all questions of the Franchise Tas Board, the Board sent to London instructions entitled, "Guide for Corporations Filing a Combined Report". It started by saying that the California Franchise or Income Tax applies only to that portion of a corporations total net income that is derived from or attributable to sources within this state. And when a business is conducted both within and without California, and that business is unitary in nature, the portion of the business income from that unitary business, attributable to sources within California, must be determined by the apportionment factors. It does on to say that if a group of corporations conducts the unitary business, the members of the group are required to report and compute the measure of the tax by waht is called the Combined Report Approach, and in determining

whether or not the Combined Report Approach must be used, the geographic location of members of the unitary group is immaterial. Does this mean that in order to compute Capitol's California source income, it is necessary to combine 150 Bingo Parlors in the North of England, or a chain of steak houses in London, or a marina in a 60% controlled subsidiary in Sydney, Australia, or the activities of EMI in England as a result of its defense contract with Her Majesty's government? We are also told that the combined report should contain amongst many other things, a combined profit and loss statement in columnar form and a combined apportionment formula in columnar form for each corporation. This creates major problems to an international corporate group such as EMI. The kinds of information required by California and the requirements as to the form in which it is required to be submitted, place an immense burden on EMI that has no other reason to prepare such information. Where members of the group, and particularly the parent corporation are located outside of the United States, much of this information is either difficult or impossible for the local taxpayer to obtain. Such information is not available to our U. S. subsidiaries. In some cases providing the required information would violate corporate policy or foreign laws, especially in relation to defense contracts, not only with the British government but also with the governments of other nations. The required conversion of financial figures to dollars at scores of different rates of exchange with sharp fluctuations, devaluations, and other changes, is a nightmare. California itself, as we have heard, does not follow U. S. federal income tax accounting concepts. In fact, the cost of compliance might conceivably be far in excess of the California tax

itself. Further financial information may reflect confidential dossier, trade secrets, or other important information that cannot be made available to a government unit having no connection with the companies involved. Indeed, California's printed requirements are more onerous to EMI than the UK Inland Revenue, the U.S. Internal Revenue Service, and even the Securities and Exchange Commission. Some of the questions asked by the California Franchise Tax Board of EMI in London include: request for copies of agreements between EMI and its affiliates; questions in relation to reasons why EMI acquired Capitol; demands for summary of all intercompany charges between EMI, not Capitol, and its affiliates; questions on how many trips were made by EMI personnel, not Capitol personnel, to its affiliate, including names, dates, and business purposes. Our local subsidiaries would need to know the details of all of EMI's activities in order that it may be able to tell the California Franchise Tax Board enough to satisify its curiosity.

All of this is supposed to be necessary in order to find out how much of EMI's income, and I quote again, "is derived from or attributable to" sources within this state, so California can allocate to Capitol and therefore tax it. Thus, its obvious that some of EMI's activities and income is none of California's business. The basic rule applied in international tax law is that the profit of the various parts of an enterprise should be those which would result if the various parts were dealing with each other ar arm's length. Misallocation of the tax base under the application of unitary apportionment for foreign corporations will arise for several reasons. Labor costs vary substantially more among countries than among regions in the United States. Similarly,

substantial differences in the costs of plant, equipment, inventory, and other property distort the property factor. Such distortions are further increased by fluctuating currency conversion rates.

If that were not enough, the California Franchise Tax Board is not even consistent in its application of the three factor formula. In the payroll factor, the Franchise Tax Board uses 0 factor for EMI's 40,000 employees outside of the United States. The application of the property factor is also questionable in as much as they only included rented property if it was located in the United States. All this positively favors the Franchise Tax Board. The use of the unitary apportionment system is a highly imperfect substitute for the arm's length standard. Implicit in the unitary system is the assumption that profit rate in different units of a corporate family engaged in different activities at different locations are always the same. This is clearly not the case. And to that extent the system will misallocate income. If an international group is involved, these differences are likely to be extenuated compared with the domestic group.

Furthermore, it is quite inequitable to fund a tax liability in an alien jurisdiction from a partly inexcessible profit source. Even if the conept of formula apportionment were respectable, it does not recognize in our case, the inability of Capitol to obtain restitution from EMI's affiliates in Australia, Brazil, France, Greece, India and many other countries where exchange control and transfer pricing regulations exist. To summarize this extra-territorial expansion of California's taxing laws is a source of conflict and antagonism. It is reaching out for revenues which are not associated in any meaningful way with the state. It not

only contains the danger that such arbitrary rules might be adopted by aggressive tax administrators in other territories, but also would erode the United States tax base on its corporations operating abroad. It imposes an onerous and in some instances impossible administrative burden in maintaining records under different foreign accounting practices in countries throughout the world, just to conform with California's tax accounting concept. For taxation purposes, neither EMI or any of its known U. S. affiliates has a permanent establishment or a taxable presence in California. This bill will therefore relieve our local subsidiary of burdensome taxes and compliance costs on group income. And it is for this reason that we support and sincerely hope California will adopt AB 525. Thank you.

CHAIRMAN BROWN: Thank you very much. Any questions? There are none? Thank you. Now I'd like to call on, I believe, Mr. D. J. Hayward, Tax Manager for B.A.T. Industries of London.

MR. D. J. HAYWARD: Thank you Mr. Chairman and members of the committee for allowing us to speak to you today. Our company is in a slightly different situation from the rest of the British delegation and I hope that will be made clear during the course of the presentation which I'll keep as short as possible. B.A.T. is a company organized in England and domiciled there and it is the ultimate holding company for an international group. The latest published, audited financial report for the year ended 3rd of September 1978, showing sales of 6 billion plus pounds, about $12 billion dollars. Our operating profits were nearly 500 million pounds and net earnings of over 200 million pounds. Its most profitable division is that dealing with tobacco products.

In the U. S. the tobacco business of manufacturing and selling is carried on by Brown and Williamson Tobacco Corporation of Louisville, Kentucky. BAT Corporation conducts its business in California through sales offices and storage facilities maintained for manufactured goods awaiting delivery to wholesalers. It does not have a manufacturing facility in California. There are virtually no sales of (inaudible) BAT tobacco product in the U. S. B and W is a completely separate management entity staffed exclusively with permanent U. S. residents. If it did not have a substantial export business, its contact with other members of the group would be minimal. Agents of the Franchise Tax Board required B and W to submit combined world wide reports of the B.A.T. tobacco operations beginning with 1968. The group reluctantly had to accede to this demand. Although by comparison with the profit reporting system used prior to that date, that's a separate accounting system, the B.A.T. group has paid significantly less taxes annually to California. Nevertheless we regard the use of the unitary basis, unitary combined formula base assessment, the world wide operations to be unjust and would much more readily accept a reversion to the old basis of assessment, notwithstanding the additional tax burden that that would involve. We have made estimates of the taxes paid, that would be payable, if we were to pay under these separate accounting requirements over the 11 years since we paid tax on the unitary basis and it would be about 30% more than our actual assessments in California under the unitary tax basis. We understand that the Franchise Tax Board agents have difficulty in dealing with foreign domiciled groups. Other UK companies obviously indicated that already, so much so that the normal requirements to present

financial reports written, in accord with California tax principles is often not imposed, and in our case, was not. And the tax assessments are made by reference to financial results published by the overseas parent. In B.A.T.'s case, the Franchise Tax Board agents have utilized an arbitrary basis, this is based on a financial result of the UK parent, because of the considerable difficulties that would arise in rewriting reports from over 38 countries. Our experience so far is, therefore, that B.A.T. has incurred no considerable additional expense in providing detailed information compared with U. S. groups for certain other UK countries. But we recognize that the situation could deteriorate very quickly if the present basis or method is abandoned in favor of a more detailed requirement.

We understand, we heard from previous evidence that information is available from an Anglo-Dutch group to illustrate the problems of currence conversion. But there's another problem with respect to foreign earnings which is often overlooked. Many countries restrict or even debar transfer of funds and California makes no allowance practice. Moreover, in many cases, in fact in most cases, funds can be transferred only upon payment of the remittance taxes and those taxes are a very significant factor in determining the amount of money which is available for use by the group as a whole. Accounting requirements in the UK forces, a close up look at remittance taxes as part of the total tax charge upon income. But in reality there are no (inaudible) thing since they result simply and purely from the movement of funds from one country to another. The California Franchise Tax Board ignores this cost altogether.

A further factor which will distort income of a multinational group is that, in reviewing investment, one has to balance the group expectation against the risk involved. In some countries, these risks have to incorporate a judgment on the future economic and political stability of the country concerned and, sometimes of the political complexion or trend in national politics. As an example of the sort of thing that has been happening, the B.A.T. group is required to dispose of the major part of its investment in India which consisted of holdings in a number of companies resident there. We were forced to accept but totally unrealistic price for the investment in a major operating company in the case of another investment, we received virtually no compensation at all. And this from a company which was earning upwards of $1 million a year. Moreover, we did not know beforehand that the Indial authorities would require us to dispose of the company retrospectively, thus denying us access to our earnings for at least one full year. In fact the compensation we received was less than one year's earnings, and since it was retrospective, we had to expect the compensation as a capital sum and not ordinary income, with the substantial capital gains tax in India, which of course added insult to injury. Nevertheless, B.A.T.'s earnings incorporated those earnings from the Indial business which were not received because at that time they were incorporated and we did not know that we were going to become confiscated. And the Franchise Tax calculation was effected accordingly since we had already returned the (inaudible)-taxable for franchise tax purposes. The final irony was that we were unable to repatriate the proceeds from the disposal of our Indian assets, but had to expect the long

timetable for the receipt of the money due because of Indian exchange control restrictions. The members of the committee may recall that IBM, in a similar situation as ourselves, abandoned its investments in India altogether rather than submit to the totally unjust demands of the Indian authorities. Having argued that the worldwide profits are not a proper basis from which to judge income arising in California, we must now turn to a specific point on the formula basis for measuring income.

We do not wish to supplement the arguments with respect to cost and property values, but we must comment on the distortion introduced by the use of the sales factor. Tobacco is a traditional revenue raiser for governments the world over. The government taxes are not always levied at the same point or to the same degree. The U. S. obtains most of its tobacco leaf from sources within its boundaries, but other countries, such as the UK, are unable to grow leaf of a satisfactory quality and have to import instead upon which a tax is levied. Import duties, therefore, becomes part of the cost of the tobacco leaf itself which requires it to be financed by the manufacturer. In addition, many companies, including the U.S. levy a tax on tabacco which is usually called excise and which is part of the production cost in just the same way as factory labor cost. In some countries, the domestic sale, whether it be made to the wholesaler, retailer, or ultimate customer, there is a form of sales tax which is sometimes known as VAT. In the U. S., B & W is not required to account for state or city tobacco taxes, since at that point, at the point at which taxes arise, B & W has already disposed of the product. Import duties, excise and sales taxes vary to a very marked extent between one country and another.

To take one example, a number of B.A.T. group companies are required to account for sales taxes even though no direct sale is made by the manufacturer to the consumer. However, such taxes are not levied on a uniform basis. And whereas one company will have to purchase sales tax stamps and in effect be prepared to bear the cost of financing for such tax itself until it is reimbursed by a customer, another country will allow a credit and the manufacturer may have to account for the sales tax some three months after the sales have been made on the basis that this is the average length of time it takes for the manufacturer to receive payment for the goods sold. The incidence of those taxes also varies considerably from one country to another, so that in the B.A.T. group, for example, it is not unusual to find that level of product taxes financed by the manufacturing subsidiary is higher than 70% of the total sales value, including the tazes. On the other hand, this percent has been dropped to as low as 30% for a major manufacturing subsidiary in Africa. In the B.A.T. account, sales values include those products taxes financed by the manufacturer on the basis that it is misleading to exclude such items when working capital has to be supplemented in order to finance tax payments. But because of the incidence of the sales taxes in the worldwide profit, you get a distortion of profit between one place and another, if you assume that all sales are made at a uniform price, (inaudible) all reservations concerning unjust use of the worldwide profits in calculating income for California Franchise Tax, the B.A.T. is very concerned with the consequences with the infringement of soverignity.

Difficulties arise when countries impose restrictions on the amount of information which is to be made freely available but

there is an even greater problem. It can perhaps be best expressed by the use of an example. Assume that the business enterprise operates in the UK and the U. S. and it's U.S. profits are nil, whereas the (inaudible) UK profits and therefore, the group profits were 100. Any tax payments in the U. S. would require money to be transferred out of the UK operation in order to pay the liability. In these circumstances, the UK's fund of foreign exchange reserves is depleted by U. S. tax claims and unjustly so. Moreover, they impair the ability of the UK party of the enterprise in investing for purposes of maintaining the UK business or to make wage demands from the UK labor force. And a prolonged continuance of this state of affairs will give rise to unfortunate retaliatory measures. In this connection the bill is being presented to the Parliament by the present UK government which prevents information from being supplied to the authorities in the U. S. by UK enterprises.

Quite apart from possible retaliatory action by a foreign government, we see the California type tax system has been imitated by unscrupulous foreign government authorities who would use it as an excuse to impose confiscatory taxation under the cloak of respectability. After all there is no magic in the formula used by California, nor is there even under U. S. law, a requirement that the full three factor formula be used. A foreign government would attempt to use any combination of the existing formula with appropriate weights which would achieve its aims.

Finally, B.A.T. believes that the continuance of the present tax system will inhibit new investments in California in an era of slow growth or recession. This state can be justly proud of

its past economic achievement but in a period of depression with little capital available for new projects, what may be seen now as an acceptable additional operating expense, can well become a significant adverse factor in determining the location of new or extended facilities. In our own case, we have looked at locating a paper processing plant in California and decided against doing so and in fact located in the State of Pennsylvania, where the capital cost of the plant is $15 million. That just happened in the last few years. We therefore urge California to ratify AB 525 perhaps not as a final solution to the problem, but as a stepping stone toward that goal. Thank you.

CHAIRMAN BROWN: Thank you very much Mr. Hayward. We now arrive at the time for lunch. The committee will recess now for lunch. We will return here at 1:45 to recommence deliberations for the remainder of the afternoon. I trust those of you who are still on the calendar will in fact return. I'd like to call on Mr. Anthony Money, Financial Controller of Foseco.

MR. ANTHONY MONEY: Mr. Chairman, members of the Committee. I represent Foseco, Inc. of Cleveland, Ohio which has been a manufacturer and marketer specialist of chemical products and technical services of the U. S. Steel, foundry, and non-ferrous metal industry since 1953. It is a member of the Foseco-Mincep Ltd. group of companies, an international group of some 150 manufacturing and marketing companies in 29 countries supplying specialist products and technical services in all parts of the world. The U.S.A. operation is largest single operating subsidiary within the group. The group has three other companies in the U.S.A. supplying specialist, primarily chemical parts and services, for the con-

struction and mining industries. Of these, one is wholly owned and two have outside stockholders. The group has maintained a policy of continuous worldwide expansion and investment, whereever profitable marketing opportunities should arise, combined with multi-factory location where the size of the market so demand. This has led to a pattern of production in or close to its major markets throughout the world, and there are currently 78 factory locations manufacturing the group's product. For example, in the U.S.A., the group has 13 manufacturing units. Nine for the metallurgical industry along with 22 warehouses, and four for the supply of construction chemical products. Foseco, Inc., is the only company within the group with an operation in California. This operation is small, employing 20 persons, in the manufacture of quality improving chemicals for the steel industry. For the years 1971 through 1974, which have now been audited, the California franchise tax paid by Foseco, Inc. on the results of itself and all its sister corporations was $34,885. On its own results it would have been only $9,452. The dollar effect of the unitary tax for the four years is therefore $25,433. In addition, it is quite impractical to comply with the information request from the Board so that a further penalty of $6,357 was imposed. So together these burdens amount to more than four times the burden that would normally have been borne on Foseco, Inc.'s results alone. Foseco objects to unitary tax because it is unfair to the tax paying company. Foseco, Inc. is engaged in only one line of business, yet it is being judged by the Board on the results of sister corporations engaged in other countries and in different lines of business. It is unfair to the minority stockholders, were Foseco, Inc. to have stockholder

other than the Mincep group, the minority would suffer a tax burden based upon profits in which they have no share. It's at best a dangerous precedent. Throughout most of the world, it is accepted that a nation may tax only those profits earned within its boundaries or profits earned by persons based within these boundaries. Foseco, Inc. regards it as dangerous to establish the principle that a taxing authority may have claim on the worldwide profits of an affiliated company.

The California Franchise Tax is administered honestly but Foseco operates in several countries where the honesty of tax officials is open to doubt. Once the precedent is set, California based multi-nationals will also be open to demand on their worldwide profits from such foreign governments. Foseco is actively seeking opportunities to speed the use of its advanced chemical technologies either by direct investment or by acquisition and expansion of existing enterprises. In screening potential investments many factors are considered, but there is no doubt that the unitary tax is a very negative indicator. Foseco worldwide has a fairly high profit for employees, but only 2 out of every 1000 of its employees work in California. The California results have little effect on the worldwide profit and consequently the amount of franchise tax paid is governed primarily by the size of the California payroll. This form of payroll tax places us at a disadvantage in California compared with competitors who are less successful than ourselves worldwide. In consequence, prospective ventures in California have to offer well above average returns to overcome the tax disadvantage. Investments are often unprofitable in the early years and only later do they hopefully contribute to

corporate earning. The franchise tax being levied irrespective of profits earned in California, adds to the financial commitment and risk involved in a new venture. Again, this factor discourages new investment or the creation of jobs in California.

On existing operations, there is a constant pressure from corporate management to minimize the tax burden by reducing the California payroll to the absolute minimum. It is significant that Foseco, Inc. and its sister corporations employs 1500 persons in North America but only 20 of these are in California. Unitary tax is unfairly allocating income to California. The allocation income includes income from lines of business not carried on at all within the United States. Member corporations of the group are inhibited from operating, especially those with outside stockholders. Thus unitary tax has a strongly negative effect on investments and the creation of new job opportunities in California. California is creating a dangerous precedent which, if followed by other states or countries, can have extremely serious consequences for international business corporations the world over. Thank you.

CHAIRMAN BROWN: Thank you very much, Mr. Money. Mr. Richard King.

MR. RICHARD KING: Thank you, Mr. Chairman and thank you members of C.U.T. for allowing me to take your place on the agenda. My name is Richard King and I am giving testimony that was normally going to be given by Alan Stein who had to be called to Washington on jrgent business. I'm Director of the Office of International Trade, which is one of the offices within the Department of Economic and Business Development. As you know, one of the principal responsibilities of our Department is to actively encourage the devel-

lopment of new job opportunities for California's growing population. In working towards this goal we are in constant contact with both large and small firms headquartered throughout the world that are looking for expansion opportunities within the United States. Based on our discussions with these firms, we have found that overall the State of California is looked upon as a very attractive place to do business. California's attractiveness is most often directly related to the size of our consumer market, our excellent transportation system, and a well educated and productive labor force. Although it is logical that certain types of firms will be drawn to our State so that they may be near the center of major industrial and commercial areas there are many types of industries, many types, that have the flexibility to locate new facilities in just about any state in this country that they want to without affecting their competitiveness. It is these types of industries that are inclined to prepare detailed analysis of the comparative cost of locating in alternative states within the United States.

Before commiting their capital to a particular state, these firms will closely examine the following things: first prevailing wage rates, next the price of industrial land and construction costs, the availability in cost of financing, the receptiveness of the area for industrial and commercial development, and, of course, the level of state taxation on business activity. With one exception California is generally competitive with almost every other state when compared on the basis of these factors, but the exception, and a very flagrant exception, is in the area of state taxation.

Less than two years ago California's tax burden was exceeded only by Alaska and Hawaii. Now, with the passage of

Proposition 13 and the elimination of our inventory tax the experts say that California now ranks about 16th in the nation in terms of taxation, tax burden. This improvement in the State's tax climate has proven to be an important factor in California's ability to attract new job opportunities. The recent elimination of California's inventory tax represented an important step in improving the State's tax climate, and it has had a positive impact on the willingness of business to invest in California, but nevertheless we still must recognize the fact that California continues to have an above average tax burden, a situation which can discourage private sector firms from committing their capital to California projects.

We have found in our department that the most troublesome aspect of California's business tax system is the manner in which the unitary method of corporate taxation is applied to multi-nationals, this taxing method uses a ratio of the firm's worldwide and California's sales, payroll and plant value in determining taxable income in California. It has been our experience that this unitary method represents a serious constraint in California's ability to attract new industry since it can result in the firms having to pay state corporate income tax even if the new plant actually had a net loss. Since it is quite common for a new plant to experience net loss in the first few years of operation, the unitary method discourages firms from locating new facilities in California. In addition, the unitary concept is particularly repugnant to foreign based firms because it requires significant changes in their internal accounting and financial reporting system. Many firms headquartered in West Germany, the

United Kingdom, Japan, other countries, have decided that as long as California continues to apply the current unitary method they will not locate new facilities in our state. To give you one specific and current example, Rolls-Royce recently examined California as a potential site for a new aircraft engine plant, a plant that would have generated hundreds, perhaps thousands, of jobs but eventually decided not to locate here because of our unitary method of taxation. And we could give you many more examples. This adverse aspect of the unitary method, not only discourages new job creation in the state but is also anti-competitive in that it represents a barrier to entry for new firms. Barriers to entry, economists tell us, tend to produce higher prices and fewer jobs. This reaction to the unitary method is most unfortunate, especially considering the number of jobs and extended tax base that would result from business development.

Public finance experts have identified three aspects of a tax system that are important for economic development. These criteria are equity, efficiency, and simplicity of the tax. Now, how does the unitary method of determining the taxable income for corporations doing business in California rate in terms of these three criteria? Not very well I'm afraid.

The equity criterion essentially says that firms earning the same profit should pay the same amount in taxes. Under the unitary method in California, equally profitable firms will pay the same amount of state corporation taxes, if, and only if, the apportionment ratios are equal.

When public finance experts discussed the efficiency of a tax, they were asking whether or not the tax accomplishes desired

goals at minimum cost with a minimum of economic distortion. The unitary method has been severly criticized on efficiency grounds. The principal reason for this criticism is that the unitary method discourages new business development in the state by firms that have profitable operations elsewhere. This occurs because newly established firms typically suffer losses during the start-up period which may last three or more years for a major operation. If the firm has profitable operations outside of California then it would be subject to the corporate tax in California despite the fact that it loses money on its operations in this state. This is not equitable.

The simplicity criteria refers to the cost of administering and the cost of complying with the tax. Other things equal, the lower the administrative and compliance costs are the better the tax is. It is clear that the unitary method results in higher than necessary administrative compliance costs. For one thing, the current unitary method requires new foreign based firms to adopt new and unconventional accounting procedures in order to locate in California. This happened because California is the only major state, the only major state, and only one of three states in the United States to require the inclusion of foreign income in the unitary method. Moreover the method is not required by the Internal Revenue Service. The simplicity criterion dictates that California and the other states should adopt uniform tax procedures. California has done this for a variety of tax procedures but it has not done so in the case of the unitary method. As a consequence and result of the complexity and the inequity of the unitary method, the State of California and the private sector have devoted a significant amount

of their resources in the unitary method controversy including a great deal of litigation. Overall we feel that California is and will continue to be a good place to do business. However, our ability to attract new job opportunities will depend to a large extent on our competitiveness with other states that are aggressively chasing these same companies. And believe me, that has become a very aggressive program.

To ensure that California maintains its attractiveness for future development and job creation, the Department of Economic and Business Development would like to make two recommendations, which we believe would have an important and positive impact on the California economy. First, the Department recommends that the unitary method of corporate taxation be modified so that it would be more acceptable to foreign based corporations. Second, we recommend that when members of the Legislature, committee staff, and the State's taxing agencies consider proposed changes in the State's system, they take into account the job creation and increased capital investment that might result. Thank you very much.

CHAIRMAN BROWN: You made the suggestion that it be modified but you didn't bother to say how it should be modified. Do you care to go into that or do you want to stay away from it?

MR. KING: We decided not to put that in the testimony, Mr. Brown, but we do have some ideas as to how it should be modified but I think we should let Mr. Stein handle that particular question.

CHAIRMAN BROWN: All right. I would definitely be interested in the Administration's views on what modifications would make it more acceptable to the firms that would probably like to locate from what they said this morning.

MR. KING: I think it has been the position -- I know it has been the position of the Administration or our Department to eliminate the unitary tax. And I think in terms of modification we are implying elimination, but there are some additional thoughts on that that I think we should submit to you when Mr. Stein comes back.

CHAIRMAN BROWN: All right. Thank you very much Mr. King. Is there an organization called C U T? All right. Michael Wells, JoAnne Garvey and Roy Crawford, an organization called Committee on Unitary Tax.

MS. JOANNE GARVEY: Thank you Mr. Chairman. My name is JoAnne Garvey. I am an attorney in private practice in San Francisco. To my left is Michael Wells, an attorney in private practice in Los Angeles and to my far left is Roy Crawford who is also an attorney in private practice in San Francisco. We represent the Committee on Unitary Tax which is an organization of membership composed both of foreign based and U. S. based multi-nationals, and others who are interested in the problem of unitary tax. As private practitioners, we have represented foreign based multi-nationals, domestic multi-nationals, small corporations, large corporations and among us we have probably had quite a history of dealing with the franchise tax. We thought it might be helpful to the committee if we three as technicians might go through some of the problems which a foreign based company faces in an audit under the unitary system. Incidentally, we are not here to attack the unitary system, as it is applied in the United States. As a method of collecting tax, it works well as long as you stay within a homogeneous economy as the United States economy is. However,

once you go off shore, problems arise that weren't thought of when the unitary tax was first designed back in the 1920s. And contrary to some of the material, which has been prepared by the Franchise Tax Board, and from which Mr. Miller was testifying, it is not clearly quite as simple as everybody would perhaps believe.

In the Franchise Tax Board's material they stated on Page 62 that as it has been described previously, there are two elements of the unitary audit. One, the determination of the unitary business and two the development of the income and factors. In most cases, the determination of the unitary business is relatively simple. That is a very interesting statement because on Page 69 of the same material, the Franchise Tax Board says, "One of the principal questions which arose at the hearings that the Franchise Tax Board held in July and August of 1977 was, what are the proper parameters of a unitary business?" And I am quoting directly from their testimony. "It is virtually impossible to supply an answer to this question which establishes a set of objective criteria against which a business can be measured," and that's our first problem. Our second, again going back to the statement on Page 62 by the staff of the Franchise Tax Board, the staff says by the same token "the development of the income and factors is not difficult because four of the numbers that relate to the business as a whole and three of the numbers relate solely to the California activities. We believe that these numbers have been prepared by almost all businesses and no further compliance costs exist." That's the end of the quote by the staff.

Now, you've heard testimony this morning by representatives of the British industry and the Confederation of the British Industries

which is the British trade organization. One of the practical difficulties is the fact that they don't collect this information on an ongoing basis. What I would like to do at this point is turn the mike over to Roy Crawford who will discuss a little bit about how easy it is to really define a unitary business and how easy it is to really determine those incomes, that income, and those factors . . .

MR. ROY CRAWFORD: Okay. Starting in our little red book, starting on Page 177, the Franchise Tax Board has reproduced their proposed guidelines for the preparation of combined returns which include one country operation, on Page 178 there is a eight step list of how a foreign parent can go without preparing a unitary tax return. The first thing that we noticed is that they had completely ignored the problem which always exists of determining what the unitary business is. There are no guidelines at all. In fact, they don't even mention it. We heard testimony this morning from several businesses; EMI for example, talked about being in the fifth industry in Great Britain and other countries. If the activities of that tax-payer were conducted within the United States, it is our opinion from our experience dealing with the Franchise Tax Board that the Franchise Tax Board would not lump all this income into one group. The Franchise Tax Board would instead say that EMI is engaged in more than one unitary trade or business. One of these is the manfacturing business in the defense industry. Another would be in the entertainment business. That's totally ignored when you go off shore.

Further in the pocket part, in the pink sheets, there is a statement that I prepared two years ago at the Franchise Tax

Board hearings on behalf of Lever Brothers. Lever Brothers is a subsidiary of a Dutch company. Uni-Lever, N. V., which is a sister company to a British Company, Uni-Lever, Ltd. Uni-Lever Unlimited conducts all manner of activity throughout the world. They have steamships, they have plantations, they are engaged in activities that bear no relationship to the consumer goods business that Lever Brothers is engaged in in the United States. The Franchise Tax Board has really made no attempt and we can make no attempt to carve Uni-Lever into unitary trades or businesses is done for a United States taxpayer. They have made no attempt -- the guidelines make no attempt to say how it is done. The UDITRA regulations which have been referred to and which are reproduced in the book say how you go about making that division in unitary businesses. But for foreign taxpayers, that's a hoax.

Now let's go into determining income subject to apportionment. The Franchise Tax Board says this is no problem with the information already available, but it has to be done on the basis of the first, United States' financial accounting standards, and then finally into the California tax accounting standards. It is my guess that not a single notice of proposed assessment of additional franchise tax that has ever been issued, has been issued on the base of these proposed guidelines; everyone has been based on foreign book income. The taxpayers have not come forth with information to make this conversion.

The Lever Brothers, for example: Uni-Lever, the accounts for their investments worldwide in 500 operating subsidiaries in 70 countries, and they account for that on the basis of replacement costs. They do not currently keep records on historical cost

accounting like is done in the United States. For the Franchise Tax Board at their hearings what you must do is go back to each of these 500 subsidiaries. You must go back to the original invoices and determine what the cost was and reconstruct a set of historic cost records. As each item of property purchased will be determined by the then exchange rate, we will now reconstruct the set of historic cost records. That will furnish the basis for depreciation charges, it will furnish the basis for the property factor of the apportionment formula. Well, that just can't be done. I suppose it could be done because the raw material is available but it was said by some of the witnesses this morning the cost of that is so immense that it would well exceed the tax, and it would be a waste of energy and money and resources to do it, so they are not at all interested in doing it.

MS. GARVEY: I might add something here. One of my major clients is Barkley's Bank which is a California State Bank which is owned by Barkley's Bank International Ltd., which is in turn owned by Barkley's Bank Limited, a UK corporation. We were requested to supply a property factor. You can derive some of the information from the annual report which is being used by the auditor in our assessment hearings and we have attempted to comply. I have discussed this with the Chief Accountant in London and asked that he compile for us for Barkley's, which, of course, was founded in the 19th Century, a list of the property. Were they are still using anything, say, it was pre-World War II? He laughed and said, yes, and I said, can you get me a list at least of the acquisition dates, and he said, no, we operate in 70 countries. We have over 7,500 offices. This is impossible to comply with, we simply have

to go with those book numbers. We do have the information in California. The effect of that is, California is slightly over states in terms of the property factor. The same question was asked with respect to rental properties because you are allowed a special way of computing rental property.

For British accounting purposes, this information is not kept centrally and again it would be almost impossible to go back to the seventy countries to the 7,500 offices to try to determine what is rented and what is not rented. So, again, we reluctantly give up this information. We know then that as far as the property factor is concerned, we are not accurate, there is no way that the client can afford to be accurate. And this is simply happenstance in view of the fact that that company reports under a different financial arrangement, and a U.S. company in the same situation would be reporting.

MR. CRAWFORD: If I might expand on that point to answer the question that was raised this morning is whether the level of compliance burden would be different on an arm's length standard than on a unitary standard. In the testimony you have heard this morning, all of these examples that have been given have involved situations where information does not exist but the Franchise Tax Board seeks to be created for the purpose of the unitary audit. None of those activities would have to be accounted for at all on the basis of an arm's length standard. An arm's length audit requires only audit of inter-company transactions. Uni-Lever's investment in steamships and in plantations and in industrial goods distribution has nothing at all to do with their activities in the United States, and there is no arm's length investigation with

respect to that.

When EMI and Capitol Records are audited, it is not necessary to conduct an arm's length investigation on the cost of their defense business. The scope of an arm's length audit is immeasurably smaller than the scope of the information gathering for unitary reporting purposes.

There is another factor that hasn't been mentioned either on that point. The Franchise Tax Board does in fact piggyback the Internal Revenue Service in their 482 audit. Those few international, inter-company accounts which do exist are subject to an existing audit. That standard is a standard for every industrial nation in the world, and it is a standard under the Federal Internal Revenue accounting standards. It seems to work everywhere else.

MS. GARVEY: There are also two other factors that are ordinarily used. One is sort of a gross receipts factor. The third is a payroll factor, what goes into the payroll cost is quite often quite difficult to ascertain. I think EMI testified this morning that they are using a two factor formula because for whatever reason they can't determine payroll costs outside of the United States. The receipts factor is a gross revenue factor that is sometimes not kept. Again, this information is required under a U. S. financial accounting standards and U. S. tax standards, but it is not required under other types of accounting standards. And when that occurs a foreign company is then forced not to use the three factors, but perhaps two factors which in turn tends to overweigh a little bit in favor of California.

What I would like to move onto is, outside of the factors and the audit aspect, is a rather interesting problem, and that is

currency translation. What you have to do is translate from the currency of the parent into the currency of the United States in order to get a taxable income figure against what you can apply California's share. And, unfortunately, we can't find any chalk so I can't put this on the blackboard, but I have a very simple example that I will summarize, that illustrates one of the difficulties when you are dealing with currency translation. Assume for a moment you have three corporations: Each of these corporations has 51% of its factors of business activities outside California, and each of these has 49% of its business activities factors inside California, and that will remain constant for two years.

The first corporation is a United States Corporation and all of its activities are within the United States. Of the 51% of outside California activity is in the United States. The second corporation is a United Kingdom Corporation so its 51% of activities are in the United Kingdom, and its 49% are in the United States. And the third company is a Japanese company; again, 51% of its activity is in Japan, 49% in the United States. In the first year, each earns in California in U. S. dollars, $1 million worth of income. In the first year each company earns in its equivalent currency $1 million of U. S. income. In this case, it would be 465,116 pounds and 250 million Yen. The currency translation rates are $2.15 a pound and .004 in Yen. Each corporation under that set of circumstances pay an identical tax, $107,800 on an 11% figure, we know the tax rate is changing, but we used an 11% figure for the purposes of our illustration. The second year each corporation earns a million dollars in California and earns the same amount in its currency of home countries, but there is no real business change in

terms of what's happening in its home country, 465,116 pounds and 250 million Yen. However, the currency values have changed and in this case, the pound has declined. It is now only worth $2.10 to the dollar and so under those circumstances the British Corporation will pay $106,547 tax under our example. The United States corporation remains constant, it still pays $107,800. The Yen has become stronger against the dollar, it is now worth .008; it has now doubled in value and again these examples, I think, are fairly realist examples.

The Japanese Corporation which earns the same amount in Yen and the same amount in dollars in its two operations will now pay $161,700 in California tax only because of the currency translation impact. And this is further substantiated or illustrated by a recent chart that appeared in Fortune Magazine which is the Fortune directory of the 50 largest commercial banking companies outside of the United States. And what they have done is list the assets and then an increase or decrease in a prior year in U. S. dollars and in local currency. And this is simply to illustrate the impact of currency translations.

The 14th largest bank is the Bank of Tokyo. In U. S. dollars from prior years, its assets have increased 37.36%. In Japanese Yen, however, it shows 1.59%.

Looking down a couple of notches to the 16th largest bank, Banco de Brazil, it has shown an increase in U. S. dollars of 4.92%. But when you translate it into its own currency in Brazil vs. a raging inflation, it suddenly shown an increase of 36.75%, and that's apart of the impact of currency translation.

Everybody has been referring to the strange happenings of the Dutch and the UK Corporation with two parents, and what happened to it. Roy Crawford has that case. That's Uni-Lever and I'd like to have him describe what happens when you try to translate off actual balance sheet in a rather peculiar situation. I don't think anybody knows the answer.

MR. CRAWFORD: This is a very interesting example, because its not hypothetical. Its a concrete example. Uni-Lever publishes an annual report for Uni-Lever, Ltd., the British parent and an identical report stated in English for Uni-Lever, N. V., the Dutch company. Everything is the same, the illustrations, everything the same, except income. The difference comes because there is a change in the Sterling-Guilder rate. In the pink sheets here two years ago I reproduced the results of the most recent annual report. In that year the pound was weaker than the guilders which seems always to be the case. The retained earnings of the Dutch company went up less than 1%. The retained earnings of the British company went up 30%. It went up $70 million more than the absolute same account with the same company stated in terms of guilders. Now, if Lever Brothers is less than 10% of the Uni-Lever family, their North American operations including another subsidiary, accounts for about 8% of their overall operation. That means that over 90% of the activity of Uni-Lever in a combined return rises outside the United States. If there is a change in the exchange rate between say the pound or the guilder or the dollar of a hypothetical amount, which we'll call it 25% and give some examples we've worked out, there is a range of income determination of 80% stated in terms of dollars from the very same activity. Now if this were a company with 92% of its

activity in the United States and 8% overseas, which is the typical U. S. parent situation, the total range of change in income is only 5%. You have a multiplier effect of the effect of these exchange rate changes if the bulk of your activity is outside the United States. Almost every foreign taxpayer that has a U. S. operation has the bulk of their activity outside the United States. They are subject to wide fluctuations and earnings simply on the basis of the strength of the dollar, and for the foreign parent it's particularly peculiar to them. The weaker the dollar is, the less their investment in the United States, but the larger their tax burden, and that annoys them endlessly.

MS. GARVEY: Mike, why don't you talk a little bit about some other peculiar problems that foreign parents face.

MR. MICHAEL WELLS: Not only am I speaking, I suppose, as an attorney in private practice, but I am also an accountant and work in consultation of California Certified Public Accountants Foundation. I've written for them. I lecture and teach for them. I'm concerned and I'd like to bring it to the Board's attention that some of the problems that we are facing as an accountant and as a lawyer are the costs that we are talking about, and the costs of administering the unitary tax on a worldwide basis. It creates some severe inequities. Yes, the argument has been made that there is a certain cost of doing business in California and businesses will assume this cost. One fact that I'd like to draw to your attention is that the cost borne by foreign parent are greatly in excess. This has been mentioned before because of the change. There are cultural changes; there are reporting changes that are required.

I have an audit before the Franchise Tax Board now that started many years ago involving a Japanese corporation. This corporation has a property problem. Its records had been destroyed in World War II. Now if you could imagine what the Franchise Tax Board's position was, not surprisingly, well if you can't produce records, we won't include those assets. Now this is a manufacturing company that is capital intensive in Japan. What do you think happened to distortion of their income? Suddenly the factors for California become very, very big. The total overall effect on this one client is in the millions of dollars. Yes, this may be an isolated example, but I daresay that for this one client there are dozens more following it. It is just one more cost problem that U. S. Parents don't face. Hopefully, they will never have to face in the same way. It's something we ought to recognize. We've had conversations and discussions. Records are kept in different manners. Historical cost records are not peculiar to the United States, but they are certainly not the norm in many countries. We've imposed upon our worldwide community a totally different standard than any place else in the world. California has done that solely even as a state within the United States. This creates enormous accounting costs.

I'd like to be a little more pragmatic and realistic. I'd like to talk about the audit itself for a moment, the Franchise Tax Board audit. We've all been through many of these audits and they are talking about how the auditors do their job. They are competent and well trained in what they do, but where do they work from? They work from the financial statements of the companies that are presented. If worldwide application of the unitary tax were dropped,

these audits could be conducted on the same principles and format that the Internal Revenue Service does. Arm's length transaction provides a third party criteria that is just as objective, if not more so, in providing the translation of a three-factor formula on worldwide income. I would think that rather than having auditors commit enormous amounts of their time to this translation problem, we have an objective criteria of the Internal Revenue Service's method under arm's length, Section 482, that is not only applicable but easier to administer from the state agency concept as well.

Revenue loss is a question that we could all argue, but we have no objective figures. I think it is important for this committee to recognize that a lot of dollars have been thrown out in revenue loss. I'd like to bring it to this board's attention that whereas there may have been large dollar assessments, the hard question is: what has the state collected on the imposition of this worldwide intake? I don't know of very many dollars that have been collected on it. There are years backed up. One client has twenty years under examination now. I have clients with many years under examination. The state has not collected the money on this, and yet they're spending money on administration. This is an accounting cost. It also distorts, frankly, the balance sheets of these companies. Why does it distort them? Because under accounting principles, they have to show this as contingent liabilities, large dollars that are not affected and may not be affected in other amounts. The argument is going to be made, well, in some foreign countries they'll get a tax credit for this amount. Many countries only allow a credit to the extent that that's usable for California income. To the extent that you have a company, a typical

company that has losses, a subsidiary starting up or whatever, it will not get any credit even though we will have to pay significant amounts of California taxes as a result of the application of worldwide income. Therefore, the credit concept that is bantered about just is not applicable.

MS. GARVEY: I was quite interested in Mr. Mori's comment about cultural shock in terms of business incentive, and there is a certain amount of cultural shock. One of the speakers this morning, Mr. Hammond from EMI, mentioned the difficulty in terms of disclosure. He was talking about it in light of their official secrets act and the information that is requested. There is a cultural shock with respect to disclosure, and again we have clients that ask us why must we say anything about it. Part of the reason is that the information that in many cases that is requested for such audit may be commonplace under the United States financial information gathering practice by the S. E. C. of the Internal Revenue Service.

The United States companies are used to providing this information. Much of it is made public, and as a result competitors can see the information, but they know they're forced to make the same sort of disclosure. Where, however, a company does not ordinarily collect or dispose this information, and if they are being singled out and their competitors not, there is a fear that such information may leak because it is not the commonplace type of information disclosed. Now, it is absolutely true, and I can assure our foreign visitors who testified this morning and who will testify this afternoon. And information provided for the Franchise Tax (inaudible) level, but that information is not going to be read

all over the world. However, should in the course of the assessment, in the course of the audit, the client disagree with findings of the Franchise Tax Board, at that point the choice is: shall we appeal to the Board of Equalization? Shall we ask for hearing under Section 25137? Shall we pay and file for a refund? At that point, certain of that information may very well become quite relevant in trying to make the case. At that point, client is required to weigh that kind of confidentiality, for the confidentiality is gone. So, when you say to somebody, oh there's not going to be any problem to disclosure, that's true if you agree, and you can settle it at audit level, but quite often you can't. At that point your client is put to a very hard choice, of: yes, making this information public or no, not making it public and leaving what they believe to be an unjust, unfair assessment. And that's the cultural side in terms of how things are administered. I think probably I have covered it.

MR. CRAWFORD: I'd like to make a brief comment on the questions that are raised from time to time about the constitutionality of a bill that would exclude combination of foreign parents. We've heard about a property tax case decided by an intermediate court in California, Zee Toys, on an appeal to the Supreme Court. Zee Toys may stand for the proposition, and probably does, that you can't discriminate in favor of foreign commerce over interstate commerce. Well, I think the position of the taxpayers you've heard today is that there is, in fact, discrimination against foreign commerce. What they want to be is treated fairly. They don't want to have these unreasonable burdens and these irrational income determinations assessed against them. They wanted to be treated on

a fair basis. Is the standard the Japan Lines case decided by the Supreme Court last April or May? The Franchise Tax Board has a brief, inaccurate analysis of Japan Lines in the little red book here. We'll hear more about that. I think probably Japan Lines does apply to income tax cases. If it does apply, you must look for constitutionality to see whether this unitary tax poses an unreasonable burden of international double taxation. We've certainly heard enough stories about that today. Next question, whether it involves a matter of which there should be a single national voice or matter whether there might be foreign retaliation. I think we've heard some testimony on that. There is also a thrid constitutional possibility, and there is a general due process notion that the taxing power of the state is limited by some notion of fairness. In this case there is ample evidence to support the taxpayer's contention that costs of compliance outweigh any tax burdens of the state. If that's the case, then the unitary system as applied to that taxpayer is probably unconstitutional.

MR. WELLS: One final comment. We've heard, of course, about the problems with the United States/United Kingdon tax treaty. I would not want you to think it is an isolated example. There are presently several treaties under negotiation, amongst them are the Japan/U. S. Tax Treaty, the German/U.S. Tax Treaty and the Dutch Treaty, all of which are having serious troubles. On November 24, 1978, there is an exchange of letters and the signing of the treaty between the United States and France. At that time, the ambassador of France wrote to Warren Christoper, a California lawyer now at the Secretary of State's Office, and to George Best regarding the problems that France has with the United States tax treaty. I'd

like to read just a brief portion of that. It is the position of the government of France that the so-called "unitary apportionment" method used by certain states of the United States to allocate income to the United States from offices or subsidiaries of French corporations resulting in inequitable taxation and imposes excessive administrative burden on French corporations doing business in those states. Under that method the profit of a French company on its United States business is not determined under the basis of arm's length relations but is derived from a formula taking the count of the income of the French company and its worldwide subsidiaries as well as the assets, payroll, and sales of such companies.

In another portion it says in connection with protocol signing today, I should like to state our understanding with respect to two important unresolved issues and certain other matters contained in the application of this protocol, and that was the major one. The other involved system and employee benefit taxation, but even France, one of our historical treaty partners, is concerned about the position of the unitary tax. This is not an isolated case. We're not looking for special interest groups in a single country. But it is (inaudible) a worldwide problem that we have to deal with.

CHAIRMAN BROWN: Any questions of either one of the three? Well, thank you very much. Next on the agenda I believe is Mr. James Devitt, Chairman, Committee on State Taxation.

MR. JAMES F. DEVITT: My name is Jim Devitt. I am the current elected chairman of the Committee on State Taxation. The Committee on State Taxation is a group of corporations which was organized in the 1960s for the sole purpose of trying to prevent

the expansion of the California unitary system on a worldwide basis. From its beginning, it has expanded to its current membership which exceeds 140 corporations. Most of the, are among the largest companies in the United States. While its purposes have expanded beyond the opposition of worldwide combination, it continues to have that as uppermost purpose of existence. AB 525, does not have a direct effect on the vast majority of our members. However, at our most recent executive committee meeting, we made a resolution that I would like to read. "Whereas, COST since its inception has opposed worldwide combination, the COST executive committee now goes on record in support of the concept embodied in AB 525, and that COST should initiate amendments to expand the concept of relief from worldwide combination to all corporate taxpayers. I should also explain that my position with COST is one of an elected chairman. My real employment is that as the state and local tax department manager of Montgomery Ward and Company, with experience in worldwide combination going back a number of years. And I have heard the concept of unity expressed here in a number of manners, and anti-unitary concepts advanced. COST is not opposed to the use of a formula for the determination of the income of a single corporation doing business in the United States. That concept is embodied in the Butler Brothers case. COST is not opposed to the concepts of the Edison California Stores case, whereby combination is a natural extension of the unitary features when companies by form operate in separate corporation, where in substance, they are but one unitary business. COST does believe that a better definition of what constitutes a unitary subsidiary should be made. Among proposals advanced are that companies (inaudible) the fulings of the

Franchise Tax Board are entitled to specialized formulas because of the uniqueness of their operation should not be combined with other corporations of a general or mercantile nature and have the regular fee factor formula applied to them.

When we get into the worldwide combination and the inclusion of either subsidiaries or parents operating in foreign countries, I don't want to repear the various objections that were presented here this morning regarding the cost of compliance, the fluctuations in curriencies, nor many of the other computations of what constitutes a unitary business. I think the one item that I would like to emphasize that I don't feel has been brought forth enough this morning is the lack of harmonization of this worldwide unitary concept with the taxing methods of the balance of the world, and that becomes most important. Be it a parent or a subsidiary that is operating in France, as a French Company it is subject to French law and reports as required and is appropriate to the French government. The income that it reports through the device of the worldwide unitary concept can be filtered off into either California or the United States through worldwide combination. This income is income which was property reported and taxed in France, and no relief in that country can be expected. That is a lack of harmonization, and to me is a fatal defect in the worldwide combination features.

ASSEMBLYWOMAN HUGHES: Mr. Devitt, what is the reason for COST's about face support after last year when they were in opposition to my unitary tax bill? Is it because of the retaliatory possibilities?

MR. DEVITT: There is potential for retaliatory possibilities. COST is indicating that it is supporting the concept that is contained in 525. It may eventually support 525 in total. Last year, I believe it was last year, time has a way of fading, there was your bill and COST had a unitary bill whose number I forget, but it applied across the board prohibiting worldwide comgination, a Fazio bill, yes.

At that time we opposed your bill because we felt that there was a moderate amount of chance of success for our bill, and to the extent that your bill might pass, ours would definitely fail. The reality of Proposition 13 totally changed that. We don't believe that after that we had a chance with our bill. We see nothing that is wrong within your bill. The concept is correct. The benefits that it would extend to the foreign corporations as long as the competitive advantages that now exist with regard to the oil and steel remain in there. While we don't totally embrace it, we understand the position and probably will not oppose it. There is a possibility that we would actively support it. I can't speak as yet because we have not reached that point.

ASSEMBLYWOMAN HUGHES: What else could I do in 525 to make it a better piece of legislation? Do you have anything definitive at this point that you could suggest?

MR. DEVITT: Well, my basic suggestion would be to adopt the Fazio bill as originally introduced, (laughter), amend your bill to embrace the concept of his bill. There has been only one other point I think I would like to make. Regarding to the cost of compliance with regard to the unitary audits as they are now conducted, and the ________________ potential of 482 audit as they are viewed

by some. I would like to suggest that the 482 audits, as they are described, would never occur. The Franchise Tax Board as it audits the large corporations today, do not get into a detailed income and expense audit and leave that responsibility to the Internal Revenue Service. This is a logical position on their part because the items are being audited by a qualified organization, and they are being totally scrutinized. Any additional examination on the part of the Board would not only be redundant but would be extremely costly without resulting producting. If we got into a 482 position of audit, I suggest that the Franchise Tax Board would adopt a similar method of auditing and leave the 482 audits to the Internal Revenue Service and reap the benefits of their audits without attempting to incur the expenses of such a type of audit. I do concur that staff-wise it would almost be an impossibility to do otherwise. I think that basically concludes my comment and I thank you.

CHAIRMAN BROWN: We'll now go to Mr. Daniel Lundy.

MR. DANIEL LUNDY: Mr. Chairman and members of the committee, my name is Dan Lundy and I am Vice President and Director of taxes of International Telephone and Telegraph Corporation. I am here to testify in support of AB 525. International Telephone and Telegraph Corporation is a U. S. based company doing business in each of the United States and in about 80 countries overseas. Our business consists of operations in five major segments: telecommunications and electronics, insurance and finance, consumer products, engineered products, and natural resources. In California our sales amount to about $1 billion. We employ 18,000 workers in California, more than in any other state and our payroll exceeds $300 million here. A California state and local taxes last year amounted to more than $17

million. My company operates through foreign subsidiaries in many foreign countries. We are extremely sensitive to the requirements of good corporate citizenship in each of these countries, and we make sure our activities fully conform to these requirements. In turn, we expect we will not be victims of discrimination, that we will operate them with the same basic rules as applied to our competitors which are locally owned. In the field of taxation, non-discrimination is generally recognized as a matter of right. Instances of discriminatory taxation do occur usually through administrative practice, but when they are brought to the attention of senior officials relief is usually obatined.

I'm testifying here today because we believe the unitary method of taxation when applied to foreign based companies produces discriminatory results. We are concerned with California's practice in this matter may be used as a model by foreign countries in taxing U. S. based companies. We are also concerned that unitary taxation creates an artificial barrier to the free flow of trade and investment among nations and that its spread could cause serious disruptions of international commerce.

Finally, we are concerned that the unitary tax issue has created a major road block to the enactment of the proposed tax treaty with United Kingdom. That treaty which was signed almost four fyears ago would be a model for relieving discriminatory taxation of dividents received from OECB countries and other countries having integrated tax systems. The unitary method of apportioning income for purposes of taxation is especially inappropriate for foreign based companies. Profit margins in the United States are not comparable with those in foreign countries. The costs of labor,

capital, and property vary greatly from those in the United States. Combining a 10% return on sales in a high risk foreign country with a 5% return on an equivalent amount of sales in the United States will produce a 7½% return under California's unitary method. This is freely excessive by 50%, and it results in a tax that is 50% more than it should be.

The unitary method imposes undue administrative burdens on foreign based companies. It is difficult for a foreign based company to determine group income under the California tax principles. The accounts of foreign affilitates are maintained in foreign languages and according to foreign accounting principles. They are stated in foreign currencies and classified for foreign taxation under concepts radically different from those in the United States. Even in the country like the United Kingdom, having a commercial environment, perhaps most similar to that of the United States, deductions are not allowed for depreciation of buildings. Equipment may be written off immediately. Realized exchange losses and the interest expense are sometimes deductible and sometimes not. Provisions for deferred taxes are not made for long term timing differences between book and taxable income, and local shareholders receive credit for refunds for corporation taxes paid. Sales and other revenues may or may not be recognized when realized by overseas affiliates, and expense accruals are not made in accordance with accounting principles generally accepted in the United States. To recompute group income under California rules will usually require the establishment of new and costly accounting systems. Exposure of information could breach legal and contractual obligations. Monitoring of such information to protect against improper

disclosure will add to the expense of establishing and maintaining such systems.

The unitary method is not necessary for the accurate allocation of income to California. The Internal Revenue Service having a 46% stake in the U. S. source income of foreign based companies ascertains that profit is not improperly diverted from the U. S. subsidiaries. It does this by compelling such companies to prove that all inter-company transactions are conducted according to arm's length standards of dealing. Failure to sustain this burden of proof results in reallocations of income and consequent tax deficiencies and severe penalty. These sanctions effectively discourage improper transfer pricing, and other practices that may occur among domestic affiliates where the filing of a consolidated tax return eliminates federal concern in the matter.

With federal sanctions assuring that the income of U. S. subsidiaries of foreign based companies is properly stated, the income of such subsidiaries can properly be apportioned without reference to the operation of foreign affiliates.

In summary, we believe that the unitary method of taxation is appropriate for foreign based companies. It misallocates the income of such companies, subjects them to undue administrative burdens and is not necessary for the accurate allocation of income to California. We are concerned that the continued use of this method in determining tax of foreign based companies will provoke retaliation by foreign countries and subdivisions in which subsidiaries of United States companies operate. We are particularly concerned that the unitary tax issue will continue to frustrate negotiations to obtain treaty protection from discrimination abroad.

We respectfully urge your committee to recommend that AB 525 be enacted as soon as possible. Thank you very much.

CHAIRMAN WILLIE BROWN: Mr. Chris Wada.

MR. CHRIS WADA: Thank you very much for the opportunity to speak at this hearing. Sony would like to present to you our strong opposition to the practice of the worldwide unitary tax.

We started manufacturing color TV's in San Diego in 1972 and now we have about 1,500 employees at our manufacturing plant in San Diego, California. Our current annual payroll alone is almost $20 million and the total out of that since 1972 would amount to several tens of millions of dollars. Our San Diego plant naturally purchases utilities, all kinds of services, including transportation, maintenance, banking, et cetera, and we believe these make a significant economic contribution to the State of California. We also export color televisions made in San Diego.

Exports give this country the necessary ability to buy goods, including oil from overseas. Sony at San Diego is in the process of expansion and through such greater manufacturing capabilities, we may make over $50 million export of U. S. made or California made color televisions.

When Sony makes economic contributions to the State and to the nation, why should the Sony be penalized for having placed its production facilities in California, and for having created 1,500 job opportunities in the State. Therefore, Sony appreciates this opportunity to speak against the concept of unitary tax. Further, we express a welcome and support for Assembly Bill 525 introduced by Assemblywoman Hughes and Assemblyman Mori in this current session.

When this unitary tax on a worldwide basis is applied, gross distortions are created through wide ranges of wage rates and productivity of labor, substantial differences in the cost of the plant, equipment, inventory and other property. And further, through diferring risk factors and the rates of return, diferring sales prices and practices, fluctuating conversion rates of currency and even currency restrictions. Sony Corporation encompasses about the 50 worldwide consolidated companies in addition to about the 70 non-consolidated subsidiaries and affiliates, many of which transact business completely unrelated to Sony Corporation of America and most in places with no connection with the United States.

The historical cost of the manufacturing equipment as between the newer, higher priced equipment located in our plant in San Diego as compared to worldwide cost of comparable equipment located elsewhere in the world has no logical relation to cost earned. Similar equipment made in Japan a few years prior to the ones in San Diego have had a better productivity due from complete debugging and experiences the workers have had with equipment, thereby making a greater revenue contribution. You can not relate historical book values and the revenue contributions among the equipment of a different age and locations in the world.

Speaking of about the lifetime employment which is common in Japan, the value of lifetime employment, it is difficult to assess, but it has a great value. And for that great value employees give a special dedication to the growth of the company with their spirit. The result is their great contribution to the profit of the company. Money is not all the value that people work for. Speaking of fringe benefits, Japanese employees in Japan have

different fringe benefits from other countries, certainly including the United States. For example, employees' housing benefits are of a very important value because the shortage of the houses and the extreme scarcity of land for housing in Japan. That makes it common for most of the workers to commute by train, from far away, taking 1½ hours in the morning and the same length of time going home. Probably no other country has such a difficult housing situation as in Japan. However, in making the housing benefits highly valuable...

ASSEMBLYWOMAN HUGHES: Mr. Chairman.

CHAIRMAN WILLIE BROWN: Yes.

ASSEMBLYWOMAN HUGHES: Question. Mr. Wada, I have visited your plant in San Diego. What provision, if any, has your company made for housing of your employees in that location?

MR. WADA: Not in the United States. This is true only in Japan.

ASSEMBLYWOMAN HUGHES: If you do expand, do you have any plans for providing for housing for your employees in that area?

MR. WADA: Even if we would like to, we have to minimize any property in California because the unitary tax would penalize us.

ASSEMBLYWOMAN HUGHES: All right. If the unitary tax did not exist...

MR. WADA: Conceivable.

ASSEMBLYWOMAN HUGHES: If we were able to abandon it, would your company then be willing to come in and provide some kind of housing facilities for the people that you would employ here?

MR. WADA: Conceivable. At this point, I am not in the position or I don't have the knowledge to exactly speak about that.

ASSEMBLYWOMAN HUGHES: But there is a possibility?

MR. WADA: Yes.

ASSEMBLYWOMAN HUGHES: Do other Japanese firms provide housing for their employees when they come into a new locale?

MR. WADA: In the United States?

ASSEMBLYWOMAN HUGHES: No.

MR. WADA: In Japanm it is very common.

ASSEMBLYWOMAN HUGHES: In Japan it is very common?

MR. WADA: In Japan it is very common because like I mentioned the land is highly expensive...

ASSEMBLYWOMAN HUGHES: Right. Have you done that kind of thing in the United States at all?

MR. WADA: No, not to my knowledge, no.

ASSEMBLYWOMAN HIGHES: All right. Thank you.

MR. WADA: You're welcome. Speaking of this housing, that is of great benefit, it's of value. It's a fringe benefit which has tremendous value and has the effect of contribution for employees for revenue. Speaking about our insurance, the health insurance, like the dental coverage included in the usual health insurance in Japan and also has a very important meaning for employees, particularly compared to the United States. There are other fringe benefits which are very different in the nature from what we have in the United States. Speaking of the start-up costs at San Diego, one million out of the over one and a half million dollar difference between worldwide basis and

domestic basis demanded Sony to pay additionally comes from just the first of three years of our start-up, 1972, 1973, and 1974. Now the effect of this unitary approach is to levy the heaviest of tax burdens just when the start of the start-up cost and losses are at peak resulting in abnormally high costs in California, just at the time when the numerator increases due to new investments and new employees.

Speaking of currency problems or conversion of the currency: the U S. dollar and Yen exchange rate have a widely fluctuated since the end of the fixed rate of 360 Yen to $1 in August of 1971. The Yen kept groeing stronger and the rate changed to 300 Yen to a dollar by the end of 1971. The exchange rate then gradually reversed direction of change and the Yen fell to about 300 Yen to a dollar level and stayed there to about 1974, 1975, and 1976. It began to rise again in February, 1977. Therefore, the question is what exchange rate to use? Today, at the beginning, at the middle of the year or the end of the year? What daily rates, the rates of the day when we made a purchase or even an average rate?

In the order of 1978, 1977, 1973, 1974, the band of fluctuations were as high as 27%, 17%, 13%, and 11%, meaning that factors may be distorted over 10% easily in those years. Now, faced with the impossible task inherent in the worldwide unitary tax system should one use a convenient method ignoring the unfair, injustice being done in penalizing Sony or any other companies for having done what is good for California and for the United States.

We see in general the spirit of fairness and justice rising: On September 27, 1977, Governor Brown of California reversed his earlier position and threw his support behind the then proposed U. S. - U. K. tax treaty that would have exempted the multi-national corporations of the United Kingdom from the California unitary incomes taxes. The effort to stop the worldwide unitary tax system through the U. S.- U. K. tax treaty failed last year but there are bills in the United States Senate and House that will stop states from taxing on the worldwide unitary tax concept. Senate Bill 1688 introduced by Senator Mathias and House Bill 5776 by Congressman Conable, are the signs of widening interests in the stopping states and other local taxing authorities from taxing any income of any foreign corporation by such an arbitrary and unfair method as the unitary tax on a worldwide basis. So we were very pleased to see growing understanding of this problem and expanding efforts in eliminating this practice on the state level, as well as on the federal level.

Currently, we are expanding our Dorthan plant now in Alabama. We have started manufacturing magnetic tape in Dorthan, Alabama in 1977, and now we have over 900 employees with a $50 million investment. We have just announced that we would add a new business in Japan called the Sony Wilson, where we import Wilson products in the market in Japan. We are now Sony Prudent-ial; we will sell life insurance policies in Japan.

All of these efforts are to minimize our exposure in California, and Sony will and has to maximize this effort to invest in other states than California to protect our service from the most condemned and unfair tax system.

We like California; it is a beautiful state, rich in various produce, quality labor, comfortable climate, and logistically ideal being so near to Japan. But no one would like to be taken advantage of for liking something. What is wrong and unfair must be stopped. The State of California should use its judgment. As Governor Brown and Senator Cranston expressed their support for the U. S. - U. K. tax treaty in its complete and intact form which would have stopped application of the worldwide unitary tax in the United States.

California and its national business is very important for the benefit of not only the Sony and other international business but also for the benefit of California. And the United States will contrinue to grow as the leader of the world of trading. Sony's sincerest wish is that the State of California will give up the unitary tax concept on a world wide basis.

And I thank you very much for the opportunity.

CHAIRMAN WILLIE BROWN: Any questions of this witness? Thank you very much. I might add that with your permission we would like to make the totality of your statement, which is an abbreviated version of what you gave us orally, a part of the record.

MR. WADA: Inaudible.

CHAIRMAN WILLIE BROWN: All right. Mr. Henry Ota.

MR. HENRY OTA: I appreciate being given the opportunity to speak before this Committee on behalf of the Japanese Business Association of Southern California. I am particularly encouraged by the testimony given by Mr. Wada earlier in regards to the situation relating to Sony.

Just briefly for the information of the members of the Committee: The Japan Business Association of Southern California has as active members approximately 340 Japanese related companies. This represents approximately 80% of the Japanese companies that are doing business here in Southern California. Members of this organization, to show the significance of it, include every major Japanese corporation that has operations here in the United States.

My testimony on behalf of the Japan Business Association is significant, not just because of the views that it represents but also because this is the first occasion that this U. S. business segment, as a group, has spoken out on an issue which has such important and significant business, political and social consequences. Up to now, although these companies have been good U. S. corporate citizens, they have felt restrained in speaking out on issues and in defense of their activities in California and the United States.

In regard to Assembly Bill 525, the Japan Business Association of Southern California is in strong support of this' measure, and encourages this Committee to vote favorably for its passage. The application of the unitary tax by the State of California, as you know, has received tremendous attention in the Japanese business community both here and Japan. We believe the Chairman has been directed to him in regards to the unitary tax. We know that Assemblyman Mori has been to Japan and Vic King of the Office of International Trade has been there. And any other members of the Legislature that have been there know that this is a very important subject of conversation when anyone mentions that you are with the State Legislature from California.

This attention to the unitary tax by the Japanese business community has been fostered by three factors that I would like to discuss. The first factor relates to the inequities that have resulted by the application of this tax on California's subsidiaries of Japanese corporations. The second factor relates to some of the issues that were discussed earlier by the members of the Committee on the Unitary Tax in regards to the burdensome requirements in terms of collecting information that necessarily comes from a unitary tax audit. The third factor relates to the efforts by other states to make the California unitary tax a very strong negative factor in any decision as to where to locate their operations.

The inequities of the unitary tax can be best illustrated by an actual situation involving a company that invested over $1 million to establish a manufacturing facility here in the Los Angeles area early in the 1970s. As anyone would expect, the initial operations of this company were loss years. During the same period of time, the Japanese parent was continuing to have profitable years. Then the Franchise Tax Board, as a result of a unitary tax audit, assessed the California subsidiary several hundred thousand dollars in taxes by applying the unitary tax concept even though this corporation clearly had experienced only normal start-up losses. This was not a case of a company seeking to manipulate income and expenses as might have been presented earlier today in the illustration given by Mr. Miller of the Franchise Tax Board. This was a company that was here making a normal business investment and conducting its operations as any foreign or domestic corporation would in terms of starting up a manufacturing operation.

The logical lesson this situation teaches any foreign corporation is not to invest in California because that investment will mean a greater cost than normal, a cost that would be reflected by the application of the unitary tax.

Secondly, in regards to the burdens in terms of time and effort that is created by the unitary tax concept, we have heard testimony today, very dramatic testimony given to you members of the Committee, in regards to the efforts that have to be made by foreign corporations in terms of collecting information, sometimes developing information and always having to translate the information in a form that would be acceptable to the Franchise Tax Board. These efforts would require much more than what we would believe to be reasonably necessary in order to comply with our tax laws, and we find that no such similar effort is required by any other state.

Finally, and something that needs to be understood, in our opinion, by all members of the State Legislature, is the fact that California is losing some of its attractiveness as a focus for foreign investment, notwithstanding the efforts of members of the State Legislature, notwithstanding efforts by the Office of International Trade.

Delegations from states in the northwest, the midwest, and the south, were well supported with incentives and funding, have effectively competed to attract away from this State foreign investment involving millions of dollars and thousands of jobs. Certainly we recognize that special incentives are being given by some of these other states but it is clear that the representatives of these states have used the already existing negative feeling

about California's unitary tax, and have made it an even more significant negative factor.

California continues to have significant business advantages for companies from Japan. It is, as everyone recognizes, a very important part of the Pacific Basin economic community. However, we need to point out that despite continuing investment in this State such investment has been made with great concern about the unitary tax.

We believe that the testimony by Mr. Wada of Sony will help clarify any feelings amonst any of the members of the Committee that once a company comes to this State that the unitary tax will no longer become an issue with them. We certainly see and we feel that decisions to go to other states are significantly influenced by the existence of the unitary tax. Decisions, as to whether or not to expand plant facilities in this State, are also affected by the presence of the unitary tax. We are very happy that Mr. Wada was able to bring that to your attention in a specific situation where a considerable investment was made in this State.

In regards to investment in this State, and we know that there are reports about continuing investment by representatives from Japan, we should probably focus on the type of investment that has been coming. We are not seeing the major manufacturing operations coming to this State. We know the news reports show that states like Tennessee are attracting away from California the large television manufacturers. Of course, there are many business factors that have to be taken into account, but there is little question that the unitary tax issue is raised and considered in their decision making process.

As a result of these feelings, we, as an Association, feel that this State cannot be complacent because it may lose its opportunity to continue with tremendous financial growth. Japanese business entities have reacted to the strong urgings of the Federal Government to invest in manufacturing facilities as a means of correcting the trsde imbalance. This encouragement was emphasized by the Task Force Report on the United States-Japan trade, which was issued on January 2, 1979 by the Subcommittee on Trade of the House Committee on Ways and Means. These investments naturally mean new sources of jobs and capital, and we know that certain segments recognize these opportunities and the effect that the presence of the unitary tax has had on the amount of investment that has come to this State.

The support of the Association for AB 525 is made with one significant reservation, this relates to the amendment to the originally introduced bill which excepts corporations engaged in the steel business from the provisions of the bill. The original bill provided for the exclusion of only corporations engaged in the energy business, based on the fact that such corporations are establishes by geographical and political boundaries rather than functional operations. The corporations engaged in the steel business are not similarly situated, and therefore we must conclude that this exception is motivated by other considerations not related to the peculiarity of their business operation. If this is true, then we must take a position that the exclusion of corporations engaged in the steel business is not justified. In summary, as a spokesman for the Japan Business Association of Southern California, I am pleased to be able to join with representatives of companies from other foreign companies to support AB 525 with our noted reservation

involving steel companies. We know that you have heard a lot of comments today about the negative impact of the tax including the negative impact on investment, and we are here to let you know that these comments and problems are supported by the Japan Business Association of Southern California. The support today has come from British companies, Japanese interests, and domestic companies, through the Committee on State Taxation. This cross section we feel did have an influence on the decisions to be made by this committee. I thank you for your time.

ASSEMBLYWOMAN HUGHES: Mr. Ota, would you like to restate your objections to my exclusion of the steel industry from this bill? So that the members here on this committee who were not on the committee last year fully understand why you object?

MR. OTA: The original bill excluded from the provisions of AB 525, those companies that were involved in the energy business. The purpose for this exclusion related to the types of operation that energy companies find themselves engaged in, and these operations are definitely defined by geographic, where the oil is, and political considerations. Now, our objection to the exclusion of the steel company relates to the fact that, if that was the fundamental purpose for the need, and we see the need for the exclusion of the energy company, that the steel companies and their operations are not anywhere near similar to what the energy companies find themselves involved in. Therefore, we've been asked as an association to at least set that position forth for this committee.

ASSEMBLYWOMAN HUGHES: I have heard rumors--and correct me if I'm wrong--that one of the domestic-based steel corporations

is being bought by some Japanese concerns or vice versa, and this is the reason for your association objecting to that exclusion?

MR. OTA: Well, there have been news accounts. I'm not personally familiar, the only thing I know is what I have read in the newspapers concerning a Japanese company discussing with a California steel manufacturer possible acquisition of that company.

ASSEMBLYWOMAN HUGHES: And it's because of that gray area that, you know, I feel that it is probably more important at this point for us to exclude them because it is so controversial.

MR. OTA: We had heard and had some information that perhaps the company involved in this transaction, because of the importance of the unitary tax issue, might come to support your bill, but with the obvious exclusion of the steel companies. I think we're looking at a situation where a steel company in question is definitely going to close these facilities, and this gives an opportunity for tremendous employment and use of an existing facility where it may not occur otherwise. You know I'm not familiar with the specifics of the possibilities, but that would be my impression of the news reports.

CHAIRMAN BROWN: Thank you very much. Mr. Richard Ratcliff.

MR. RICHARD E. RATCLIFF: Chairman and Members, my name is Richard E. Ratcliff. I represent the Reynolds Metals Company. In view of the extensive hearing and testimony you have had today, I am going to make my comments very short and in general subscribe to the comments made by Mr. James Devitt with the Committee on State Taxation. Reynolds Metals Company is a member of that organization and has worked along with many other companies to

accomplish their objective. Basically, as Mr. Devitt explained, we were in support of the Fazio bill, in opposition to Mrs. Hughes' bill. At the present time our position is that we support anything that deals with doing away with the unitary combined aspect particularly with regard to the off-shore activity. The problems of the domestic multi-national corporation are somewhat different than but obviously related to those problems of the foreign corporations which you have heard an awful lot of testimony on, and at this point I would just like to state that Reynolds Metals Company is opposed to the unitary concept as implemented by California and feels that any tax collecting system ought to aim at being an equitable, fair system. I think that the theory of the present system we have fits within that category, however, unfortunately the practice has not, and we oppose the present system and would like to be in a position and intend to be in a position to work with anybody to try and correct this point. That is really all I have, Mr. Chairman. Thank you.

CHAIRMAN BROWN: Any questions? Thank you, Mr. Ratcliff. Now Mr. Thomas Wenglein.

MR. THOMAS WENGLEIN: Mr. Chairman, Members of the California Assembly Revenue and Taxation Committee, I am Tom Wenglein, manager of taxes for Xerox in California. Xerox, a New York corporation, is in the business of developing, manufacturing and marketing business products, principally copiers and duplicators. The company also develops, manufacturers and markets typing systems, facsimile equipment, educational materials, information services, aerospace products and computer-related equipment. The reason I am here is because Xerox has a significant presence

in California with research, manufacturing, marketing and distribution operations physically located in the state. Approximately 9,000 California employees earned over $190 million in 1978. $8 million in withholding taxes were remitted to the State on this payroll. The undepreciated book value of our tangible real and personal property in California exceeds $600 million. In 1978 property taxes were $14 million. It is appropriate to note that our 1978 California Franchise Tax assessment was over $6 million. Incidentally, the above numbers do not take into consideration the contributions of Xerox subsidiaries headquartered in California which employ approximately 4,000 California people.

Tax policies of the State of California discourage Xerox from expanding in the state. Specifically in 1973, this corporation made a decision not to establish its Office Systems Division in California due in a major part to what was viewed as an unfair burden as compared to other states. The facility was subsequently located in another part of the country. Major reasons for the unfair California tax burden are: One, the worldwide unitary concept with the inclusion of foreign income in a tax base, and two, the combination of separate and distinct business operations. California has a lot going for it. The decision not to locate in California was a very difficult one. California was strongly advocated by our highly skilled key scientific and technical people who would be leading our new enterprise; however, our financial staff advised management that a long-range comparison of facts and consequences indicated that in the late 1970s costs to the company of California expansion would be approximately $9.5 million more per year in additional taxes than in a state where the plant was

subsequently located. California taxes would have been $6 million more than in New York. This estimate was based upon our long-range projections and cumulative increases in property, payroll and sales. Our financial executives advised that our particular problems with the California theory of unitary taxation required consideration of tax climate in evaluating proposals to further expand plant, personnel and investment within this state pointing out that California extended its jurisdictions even further than the U. S. Internal Revenue Service. That is the increased property, payroll and sales in this state results in a higher apportionment factor being applied to an income base that includes for eign income. It was also the company's view that this problem was worsened in our particular circumstances because of significant minority interests in our foreign operations and distortions comparing California property and payroll to say United Kingdom payroll or Mexican property investment. Management then asked the scientific group to demonstrate how a location in California could result in other economies and benefits that would offset the California tax detriment. This burden could not be met and therefore Xerox located its new facilities elsewhere.

Xerox continues to be sensitive to the California unitary problem and evaluates the tax impacts on ongoing business proposals. It is our conclusion that each dollar of property, payroll and revenue in California must from the beginning earn as good a rate of return as the rest of the ongoing business. If this does not occur, for example, when in the beginning there are significant losses to Xerox, California still reaps significant additional tax revenues. That is because the investment, profitable or unprofit-

able, in a state will result in apportionment of a disproportionate amount of the entire worldwide income of the company to the state. Xerox has already been faced with this sort of problem in California where high investment payroll below aerospace and computer operations attributable additional mainstream copier profit to the state. In summary, our position is that California franchise tax is inequitable in our circumstances and puts California at a disadvantage in this competition with other states for attracting business. It is our view that the relief provided by AB 525 should include companies owned or controlled by U.S. corporations of residence. Thank you.

CHAIRMAN BROWN: Any questions? Thank you very much. Next Mr. R. L. Delap.

MR. R. L. DELAP: Mr. Chairman, Members of the Committee, I am a partner in the international accounting firm of Peat, Marwick, Mitchell and a Director of the California Council for International Trade. I am here today on behalf of the California Council for International Trade, a private association of over 600 businessmen involved in all aspects of international trade. We, as lawyers of the organization, have long been concerned about the application of the unitary method of taxation with respect to worldwide operations both with respect to foreign controlled corporations and U.S. controlled corporations. In connection with that concern we have testified on past occasions, such as July 1977 before the Senate Finance Committee considering the U.S./U.K.Treaty, before the Franchise Tax Board in July '77, before Senator Mathias on hearings involving the Interstate Taxation bill in December of 1978. Many of the concerns that we see with the unitary method as applied

to foreign operations, they have been dealt with extensively today and we will not again repeat those concerns other than to say that we will grant that there are arguments in favor of the unitary method. Those arguments are best made in the classroom because they assume that all taxing authorities are using the same method which is not the world rule and with the rest of the world using other methods we believe that California should adopt a system more in tune with the rest of the world.

With respect to the specific bill, we had some recommendations for changes. As it turns out your September 14 amendments sneaked by us. Many of the recommendations we have had effectively have been adopted in those September 14 amendments. We would suggest that the September 14 amendments are unduly complicated, difficult to read, and we have made some recommendations to say basically the same thing in more direct language but we agree with the concept. With respect to the objection of the gentleman regarding inclusion of steel business, we would suggest that if it is considered politically necessary to include the steel business in the bill that wheat is meant by the steel business be defined. There is extensive discussion what is meant by the energy business, but no discussion what is meant by the steel business. We would also suggest that the principal activity test in the section dealing with the steel business and energy business that that principal activity test be eliminated and that it refer only to the oil - the energy business and the steel business. For example, if an energy company happens to control or be affiliated with a foreign hotel chain in a foreign country and that foreign hotel chain

would be deemed unitary under the tests adopted by the courts, I don't think that it should be the intention to pull that foreign hotel business in simply because the principal activity of that overall taxpayer happens to be the energy business.

As a representative of California International Business - CCIT believes that encroachment of international commerce is important to the state and the state's economy. We agree with some of the other concepts that the general thrust of AB 525 in the future should also be directed towards U.S. controlled corporations, but we view AB 525 as a definite step in the right direction and support it. Thank you.

CHAIRMAN BROWN: Thank you very much, Mr. Delap. Now Mr. David Brainin. Where are you?

MR. DAVID BRAININ: Mr. Chairman, Members and Miss Hughes. Thanks very much for the opportunity to appear here. In our opinion we believe that formula apportionment provides for an evenhanded tax administration and reduces the bargaining and the take-it-or-leave-it attitude that many tax administrators are faced with in other states. There might, however, be some adjustments that could be made in the application of this method.

First, we believe that it should not be automatic. The Franchise Tax Board should be provided with the ability to use their judgment in order to make this procedure more flexible. We believe this flexibility is needed when it appears that a strict interpretation of the unitoary method might induce a hardship, would be unjust, or unreasonable. However, this flexibility should not be used indiscriminately nor should it be used to lessen the excellent enforcement of our tax laws. It has been contended

by many corporations with foreign-based parents that a state has no right to look at the books of a corporation's worldwide activities merely because they operate in California. Those who usually make these statements are operating within the scope of their business traditions which preclude access to their books just as it is within the tradition of U.S. corporations to open their books to the I.R.S. and to the state tax collector. We do support the concept of precluding the use of the unitary method to worldwide activities of foreign-based corporations other than energy and steel in the second amendment of the bill, this concept was included in AB 525.

Allegations have been made that the unitary tax, which is not really a tax, is a deterrent of business location in California. We believe that these allegations should be studied and if found to be true, then perhaps the Legislature could consider either or both of the following: First, that the operations of a corporation that locates in California for the first time be exempted from the application of formula apportionment for let's say a five-year period, or up to five years. Now we've heard many people today say that first years of incorporation are loss to corporations and it would be unfair to apply unitary method immediately. This would be in a sense one alternative to take care of that problem.

ASSEMBLYWOMAN HUGHES: Question, Mr. Chairman.

CHAIRMAN BROWN: Yes.

ASSEMBLYWOMAN HUGHES: Then in the sixth year when you impose unitary, do you encourage them to leave and find another state?

MR. BRAININ: I do not believe that a corporation would come into this state just to get five years of free application, I think they come into the state for long-term. I do not think there would be any corporation would come in for five years and leave on the sixth when unitary would be applied.

ASSEMBLYWOMAN HUGHES: All right. Suppose at the end of the five-year period they are ready to expand, then their expansion would be penalized by the imposition of the unitary tax, so it's a Catch 22, whether you catch them up front or you catch them later, you still catch them.

MR. BRAININ: I don't believe that's....

ASSEMBLYWOMAN HUGHES: I understand your logic in helping them to get started, but you're going to retard their expansion after the five-year period if they know that after five years Sony would not extend their plant to other municipal areas within California, other than San Diego, they're going to be thinking, "Well, if we wanted to expand, why not just go to another state.

MR. BRAININ: Well, Mrs. Hughes. My understanding of the testimony from the person from Sony wasn't that the expansion would result in a business loss. Where we're concerned, at least my recommendation here is that when you first come into this state then you have the losses. I don't know whether that will be true after you're in and you decide to expand whether that expansion also incurs losses. I think you would want expansion because he didn't want the application of unitary to apply....

ASSEMBLYWOMAN HUGHES: I'm no business giant, but pure logic leads me to believe that if you expand you're going to be hopefully making more revenue, right, and as you make that additional revenue, you make a bigger tax base and consequently, your company is going to be giving the state more money wherein they could go somewhere else and expand to a neighboring state and not have to pay that tax.

MR. BRAININ: That will be a business decision they would have to make. We think adoption of this proposal will give new corporations time to become established, would encourage plant location and the creation of jobs in the state. Secondly, the Legislature might consider chaning the weights of the three-facotr formula. As you know each factor is now equally weighted. Such a course has already been made in five states: New York, Wisconsin, Minnesota, Massachusetts and Florida. In the case of New York it was done to stem the exodus of business that was taking place. The wieghts now being used in New York are 25 percent for property, 25 percent for wages, and 50 percent for sales. A lowering of the weight of either property or wages or both would be incentive for business location in California. However, every attempt should be made to maintain the tax base and the re-weighing the apportionment factors should not be accompanied by a substantial revenue loss. The Franchise Tax Board may now have the authority to change weights, but that is not clear. It might be appropriate for the Legislature to clarify this situation. Thank you, Mr. Chairman.

CHAIRMAN BROWN: Thank you very much. Now we have Earl MacIntire.

MR. EARL MacINTIRE: Mr. Chairman, Members of the Committee. My name is Earl MacIntire and I am Manager of Governemntal Affairs for U. S. Steel Corporation. It really wasn't my intent to provide testimony today only in the event that the subject of the removing the steel exemption from the bill came up and since it has I feel obligated to proceed. So, if you will bear with me for a moment I will give you our concern as to why we're strongly urging the retention of that exclusion in the bill. And I do this not so much as the representative of a big steel corporation of the United States, but my concern over the remaining 5,000 U.S. steelworkers in the State of California. In recent years, the men and women who make steel in California have seen their jobs erode due to unfair competitive advantages that have been enjoyed by foreign steel producers. Foreign steel producers are either nationalized or heavily subsidized by their government. This fact combined with our own federal government's failure to enforce the Fair Trade Act of 1974 has resulted in foreign steel being dumped in California at prices below the producer's cost or at his home market prices.

In the early 1950's imports of foreign steel in California accounted for only five percent of the total market. By 1975 California steel imports total 1.8 million tons, or 32 percent of the California steel market. And in 1978 a record 3.5 million tons were imported for over 45 percent of the California market. During this same four year period, 9 domestic steel manufacturing facilities in California have been closed causing the loss of some 4,000 steel worker jobs. Removing the steel business from

its current exception status in AB 525 will add another unfair competitive advantage to foreign steel producers, allowing them to further dominate the California steel market and causing more steelworker job loss. Additionally this trend will create the same overdependence and price ulnerability that we now suffer because of the OPEC situation. So, I urge you in your deliberations when you consider the amendment of the bill for removing this exclusion that you give very serious thought to that, and I thank you very much.

ASSEMBLYMAN NAYLOR: Mr. MacIntire. Could you tell me how this changed law would give foreign steel manufacturers and unfair competitive advantage?

MR. MacINTIRE: Take, for example, U. S. Steel Corporation operating in the State of California and under the unitary tax law currently we are required to put our worldwide income, facilities and also our payroll into the formula just like other companies are. So, therefore, we are subjected then to a tax based on whatever worldwide interests we may have also out of the State of California, even though we are a domestic steel company in the United States of America. We say that excluding the foreign considerations of that same magnitude gives them the advantage then to be excluded from unitary tax in California that we are obligated to pay.

ASSEMBLYMAN NAYLOR: So we could achieve the same equity by allowing you the same exemption for foreign operations that we are giving foreign based corporations.

CHAIRMAN BROWN: The last name on my list is Burn Stnaley, Ford Motor Company, makers of the new size Thunderbird.

MR. BURNS STANLEY: Mr. Chairman, I will attempt assiduously to retain the innate popularity of the last speaker on a long and rather trying day of testimony.

My names is Burns Stanley. I am director of governmental tax relations for Ford Motor Company and for some 30 years have been engaged in primarily the administration, teaching or otherwise of state and local taxes. I have been coming here for some ten years. I was a predecessor of Mr. Devitt as chairman of cost and must say that even if the termination of worldwide combined reporting is around the corner that after being outside today, I have a certain feeling, a certain fondness for the concept.

Ford's stake in California is well-known I think to everyone. The fact that we have many large plants here, that we have Ford Aerospace and Communication located here to a very considerable extent, so that we have an on-going concern and a very justifiable one with the tax system of the State of California. I was privileged to appear before your committee, Mr. Chairman, on April 30th the hearing with respect to AB 525 at that time and took an unequivocal position in support of AB 525, notwithstanding that Ford Motor Company is not a direct beneficiary of the terms of that bill. I am here today to reiterate that support - it remains undiminished. Not only can I say this for Ford Motor Company today, but I also have been authorized to express to you the position of the Motor Vehicles Manufacturers Association, which consists of some twelve companies that manufacture over 99 percent of the motor vehicles manufactured in the United

States. They support the concept of AB 525 and in their resolution of support they said this: That in supporting AB 525, it is MVMA;s intention to lessen the controversy that has developed over the State Franchise Tax Board's use of a so-called worldwide combination method in calculating the tax and to ameliorate its adverse impact on the federal government's negotiation of treaties with foreign countries. Further we have the automotive industry in this country faced, certainly, with a strong competitive posture on the part of foreign based companies, nevertheless supporting this goal.

ASSEMBLYWOMAN HUGHES: I'd like to know if General Motors joins you in your position so that I can advise my constituents whether to return their Cadillacs or not.

CHAIRMAN BROWN: Miss Hughes - he said 99 percent of all the automakers - that obviously didn't include G.M. (laughter)

MR. STNALEY: Thank you, Mr. Chairman, we had to always hedge that kind of a statement you know. On a more serious not, Mrs. Hughes, yes, General Motors as the largest and most prosperous member of that consortium of twelve -

MR. STANLEY: I had really a remarkable experience here this afternoon, because I have for the first time in a long history of this sort of thing, I have seen representatives of countries from opposite sides of the world come together to express a unanimity of views toward a state tax system. A unanimity of views that condemns rather than supports and I would suggest to you that that very fact calls at least for some very mature consideration of the tax structure of any given state that evokes that resolve. When I was here on April 30, I said that there were three things that accounted for my appearance

before the committee in support of AB 525. I asked the question, and I won't go into detail on these but Iwill mention them, I asked the question as to why a company not directly covered would favor a bill that certainly to some extent would support its competition, and I answered that by saying that with the relatively small amount of money involved in this bill which I think has been estimated to be perhaps in the $10 to $12 million area at a maximum, with that relatively small amount of money involved, that the competitive disadvantage from the enactment of this measure could not be great. I said further that this tax system, the so-called worldwide combined unitary reporting system is essentially an unfair system.

ASSEMBLYWOMAN HUGHES: Mr. Chairman, yes, really this is the first time I have heard this figure quoted. It is only $10 to $12 million that we're talking about.

MR. STANLEY: Yes, ma'am, that is certainly my understanding and I think that appears in the publication that the committee has just recently issued.

ASSEMBLYWOMAN HUGHES: And compare that figure with the rise in the economy because of new jobs and buying and purchase . .

MR. STANLEY: I made that very point before, Mrs. Hughes, when I was here. Without getting into details on the philosophical underpinnings of worldwide combined reporting, let me say that it is an unfair system, it is very difficult to defend it on any basis other than that of its contribution to the treasury of the State of California. Let me give you a brief example again using the company that I know best. The published figures for Ford Motor Company in 1978 stated that worldwide Ford manufactured and sold some 6.5

million vehicles. 4.5 million of those in round figures were produced in North America, and on the manufacturing sale of those 4.5 million vehicles, and most of those sales were in North America, the vast majority of them, Ford made 52% of its after-tax net income. On the production and sale of 2 million, of the 6.5 million total vehicles, outside of North America, Ford made 48% of its after-tax net income. I submit to you that there is no way that the State of California can pick up that 48% of income earned outside of North America and not come out way ahead with windfall profit, because while the factors of property, payroll and sales that they would also pick up on the outside of production would enter into their computation. Certainly, property, payroll and sales that accompany the manufacture of 2 million vehicles in no way compares to those factors that enter into the production of 4.5 million vehicles, and the profit, as I have expressed to you, in rough terms was essentially the same. That is the pattern that follows investment abroad generally. There is a very high risk factor in going abroad in many instances and companies simply would be inhibited so far as locating abroad is concerned unless there was reasonable assurance of higher profit than would be realized in this country. So long as that's true on average, any state that uses worldwide combined reporting is going to profit by the effort and there is no question about that. Now, that doesn't, in any sense, justify the system except in the most pragmatic terms. The 2 million vehicles and the 48% of net income that Ford Company earned outside of North America cannot, I suggest to you, be attributed to the State of California. You may also have noted the published reports of Ford Motor Company's third

quarter 1979 result in which in North America some $637 million was lost in that one quarter with some $300 million being earned outside of North America. It would strain credulity to say that Ford Motor Company, because of any worldwide combined reporting tax system of a state or states, could have had manipulated its debt finances so as to throw that type of loss to this country and earnings outside.

Finally, I mentioned that the international relations of the United States are being very seriously and adversely impacted by the state taxing system. There's been mentioned here this afternoon, the French Treaty by Mr. Wells and the concern expressed in the protocol of that treaty, and more emphatically there's been mentioned the U. S. / U K Tax Treaty which has been held in abeyance and still is being held in abeyance because of the California tax system, and solely because of the California tax system. That treaty was signed by the negotiators December 31, 1975, expected to supercede a treaty, an outmoded treaty in effect since 1945. Well, the outmoded treaty is still there and after almost four years of effort we're still trying to get a modern U. S./U K Tax Treaty in place to establish an ongoing, modernized course of commercial relations between the United States and the United Kingdom; and further, I'll be less than candid if I fail to tell you that because of the adoption in 1973 of a so-called divident integration system in Great Britain, there is also a provision in this treaty that the benefits of that dividend system, which is to ameliorate to a significant extent the double taxation of corporate income that is reflected in dividents to extend that system to individual and corporate shareholders who are residents of the United States and own stock in Betty's taxpaying corporation. There's lying there today some $400 million that

would be returned to U. S. individual and corporate shareholders once this treaty is in place, and Ford Motor Company and many other companies represented in this room and elsewhere, would be significant recipients of that as I have emphasized as would many individual shareholders. The point being, not so much for you to attempt to assure that Ford Motor Company gets this recovery, but that nations speaking to each other have agreed that this is the way that things should go, and they are being precluded from doing so because of the tax system esentially of a single state. It's something that has brought people here from 6,000 miles or more from either side of us this afternoon, and it's something that really justifies very mature and very serious consideration.

One of two very brief points, now, and I'll quit: one of these is that one of the points that has always made by the advocates of worldwide combined reporting is that the alternative is the arm's length dealing test, and that's almost impossible to audit, that the Office of International Operations of the Treasury finds great difficulty in auditing at the federal level. Well, it is a difficult thing to audit, but I urge this point of view on you that that's a red herring. It's a red herring because, at the present time, California, in its pursuit of worldwide combined reporting to the extent that it brings the foreign subsidiaries of domestic companies into the picture, does very little or no auditing in that area. Therefore, if they're doing very little or no auditing in that area now but accepting on the fact of it what is submitted to them by the taxpayers, why then are they justified in saying how much trouble it would be to audit under the 482 type arm's length transaction when at least there is a 800 man crew in Washington that devotes

its time almost exclusively to good faith efforts, at least, to make meaningful audits in the foreign area?

And as Mr. Deddeh said earlier, I think that what would really happen here is that the California Franchise Tax Board would rely heavily on the OIO office, the Office of International Operations of the IRS, insofar as those audits are concerned and that the end product would be at least as reliable, and I think as significantly more so than is true today under the auditing or so-called auditing of foreign operations under the combined reporting system. So far as we've heard several mentions this afternoon of plant location and the part that taxes play and I've been listening to this for 30 years, and that is that taxes play a relatively small part because they're 7th to 8th on the list. Well, as manager for some 10 years or more of the Ford Motor Company state and local tax department, I can assure you that there was not a major location of any plant in Ford Motor Company at that time that didn't cross my desk for a tax commentary and it still continues today and that often the factors that indeed are above taxes cancel themselves out. There are lots of places you look for skilled labor forces, and there are many places that offer skilled labor force or utilities or transportation facilities, all of which are listed above taxes. When you cancel those out, and they often do cancel out, because many places offer them, very often you find that taxes are the deciding consideration, so they are significant. Certainly they're not always controlling, but they are often controlling, and so much so, that they cannot be ignored nor lightly dismissed.

Finally, one point: I hope that the suggestions that were made by Mr. Brainin, the speaker who preceded me, will not be

followed or receive too much attention from this committee. He mentioned, for example, that there should be some real consideration being given to weighing the factors of the apportionment formula, and specifically he was suggesting that sales we weighed. There are indeed a number of states that have gone that route in the last few years. We mentioned some of them, Wisconsin, Massachusetts are two, New York, Florida. What that is, for 50 years we've struggled to try to get some kind of uniform formula apportionment in this country among the states so that the states wouldn't shape those formulas just to fit their own treasury, and therefore assure multiple taxation of income of taxpayers that are located in the various states. At this, gentlement, I'm sure in all good faith is suggesting to you is that you join that parade in California and further distort the tax system by adopting prejudicial and discriminatory formula just for the sake of favoring those companies that are presently located in your state. But that will inevitably do and I've seen it in the last few years when these various states came in, it will call for retaliatory measures on the part of other states where companies are located that are suffering in California or whatever state that might adopt this weighted sales system. Now I know that's a complexity, but I say it merely to suggest to you that you not accept out-of-hand some such suggestion as that, and I thank you very much Mr. Chairman. It's been a privilege to be with you.

ASSEMBLYMAN NAYLOR: A couple of brief questions. I'm new around here and haven't been through this debate before. I'm trying to understand what their point of view is. Do you have majority control of most of your foreign operations?

MR. STANLEY: Most, but not all sir. For example, we own 100% of Ford of Britain which has some 78,000 employees, the same with Germany, where we have some 60,000, etc.

ASSEMBLYMAN NAYLOR: With respect to those, therefore, you would not benefit from AB 525, but for the minority operations you would, is that correct?

MR. STANLEY: No sir, because we would not because AB 525 excludes from its coverage foreign operations that are owned or controlled by domestic plants.

ASSEMBLYMAN NAYLOR: What about foreign operations in which you own a minority interest?

MR. STANLEY: That would be so minor as to be inconsequential, sir.

ASSEMBLYMAN NAYLOR: Why is it that you don't feel the same threat by giving foreign automobile manufacturers a competitive advantage, by giving them the advantage of this exclusion, where you won't have the advantage of the exclusion for most of your foreign operations? Is this a step in the right direction? Is that basically why"

MR. STANLEY: Yes, sir. There are two or three points that explain that: One, I think I stated that the amount of money involved from this bill is not great, and the competitive disadvantage that we would engender through that support would not be particularly significant.

Furthermore, we share this very real concern of our British friends about 3 World countries and others adopting some such system as this. We feel that the system is inately so bad,

that if we can get a foot in the door here by getting the foreign parent companies out from under with this bill that there'll be some hope for us down the road, particularly as perhaps some such proposition as Proposition 4 might make more money available to the state so its revenue restriction might not be so severe, and I don't pass judgment on that, I don't know. It's a foot-in-the-door concept. I think that we would be back in here asking you in the not too distant future, now do it for us very frankly.

ASSEMBLYMAN NAYLOR: Ok. Thank you.

CHAIRMAN BROWN: Thank you very much, sir. We have completed our agenda for today and we did it in what is relatively record time. Let me indicate to all of you who have come so far, if you were not here this morning when I opened this hearing, I indicated that no decision would be made by this committee during the course of these hearings. We obviously can provide a lot more time for extensive testimony during interim than we can at the legislative level when the bills are being heard. Come January, however, when there is a new Director of the Franchise Tax Board, or Executive Secretary or whatever you call him at the Franchise Tax Board, when the Department of Finance, Legislature, Business and Transportation Agency, the Governor's Office, and Board of Equalization will all get together including hopefully some representatives from the industry, and from those persons who are in fact effected, we will somehow fashion a piece of legislation that's reflective of some change as everyone seems to be demanding while at the same time respecting the need of the State of California to collect revenues and administer the tax laws on a just and equitable basis. Now, the last speaker indicated that Proposition 4 may remove some of the

arguments made by members of the Legislature and other individuals about lost revenue because, if in fact, we discover under Proposition 4 that there has now been accumulated more revenue than we allowed to spend anyway, one of the tax sources which could be adjusted may very well be the unitary tax, modified even more than has been proposed. The presentation by the Department of Finance indicates obviously a willingness to at least talk. There is clearly an indication that the Business and Transportation Agency, as represented by Mr. King, evidenced a desire to talk. The technicians in this state who are private practioners who are the advisors to the clients in this area have testified ably and indicated their willingness to be available to offer interpretations. I think we can in fact produce something that will be of some value come January.

Ms. Hughes, we thank you very much. We thank the members of the committee who have listened. I think this has been one of the more enlightened hearings during the interim process in which I have participated in the last 15 years. Maybe it's because I was chairing a committee and stayed in the room most of the time.

ASSEMBLYWOMAN HUGHES: For that I'd like to publicly thank you and also for holding the hearing.

CHAIRMAN BROWN: Thanks, all of you for having attended and I hope you've enjoyed it as much as we have. We will be in session again tomorrow morning commencing at 9:00 A.M. sharp. We'll only be here for a half day tomorrow, so please be on time at 9:00 A.M., and I'm going to run it and get out of here hopefully by 11:00 A.M. The meeting is recessed.

International Business Machines Corporation

Office of the President

General Products Division
Monterey and Cottle Roads, San Jose, California 95193

November 9, 1979

The Honorable Willie L. Brown, Jr.
Chairman, Committee on Revenue and Taxation
California State Assembly
State Capitol Building Room 2013
Sacramento, CA 95814

Dear Mr. Chairman:

International Business Machines Corporation (IBM) appreciates this opportunity to comment on A.B.525 relating to the application of the unitary tax system of income apportionment which exists today in California. IBM supports A.B.525 and respectfully requests that this letter be made a part of the record associated with the November 13 hearing on that subject.

IBM, which operates in over 120 countries around the world, employs 18,170 men and women in manufacturing, marketing and development facilities in California. In 1978 approximately half of our corporate revenues were generated from sources outside the United States. The unitary system of income apportionment, for California tax purposes, is thus of interest to IBM not only as it directly affects us, but also as it affects trade relations with those foreign countries where IBM operates, which are concerned about the effect of the unitary system on their corporations with subsidiaries in California.

A.B.525 would preclude application of the unitary system to enterprises (1) created or organized under the laws of a foreign country; (2) not owned or controlled by a United States corporation or residents of the United States; and (3) which have more than 80 percent of their operations outside the United States. The proposed legislation would, in effect, prohibit the use of the unitary system in determining the California tax liability of foreign-owned corporations with operations in the state. These entities would continue to be fully taxable in California on their operations within the state.

In making future decisions as to the location of facilities engaged in international trade, foreign-based corporations will certainly take into account the disruptive and discriminatory effects of the unitary tax system and tend to locate new facilities in states not using this

system. This will either reduce California's tax base or place a proportionally greater tax burden on corporations which continue to operate in California. That prospect, along with the possibility of retaliation by foreign governments against California-based corporations, should be weighed against the comparatively small revenue gains resulting from the unitary system.

California's economy depends heavily on the international business activity of corporations within its borders. The unitary system of income apportionment is disruptive to that activity by over-apportioning income to California.

Apportionment formulas based on such factors as payroll, sales and property value can logically be applied to domestic operations among the various states within the U.S. The relative costs of production, among those three factors, do not widely vary between such domestic locations. When the same apportionment ratio is applied internationally to a group of related corporations in different countries under the unitary tax method, however, the result is often an overstatement of the amount of foreign operating income attributable to the state. One of the major reasons for international trade is that different countries have a comparative advantage in producing different products. This is based on the valid assumption that each country has a unique mix embodied in its factors of production. Applying a single ratio on a worldwide basis ignores this international variety and has resulted in over-apportionment of income for California tax purposes.

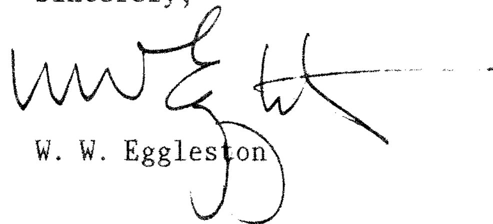
Under the unitary system, records of related entities in the United States and abroad, must be filed for state tax purposes. For an American-based corporation, such as IBM, even though we operate in over 120 countries, such records are generally kept in U.S. dollars and in conformance with U.S. accounting principles. Although a foreign-based international corporation with operations in California is required, for purposes of California taxation, to submit those records in U.S. dollars and in conformance with U.S. accounting principles, it is highly unlikely that any such foreign corporation would keep the records of its non-U.S. operations in such a manner. Thus, it must convert worldwide records into dollar amounts and into American accounting principles. Since this conversion process falls singularly on foreign-based corporations, it could be regarded by them as discriminatory.

IBM believes that the unitary system is fundamentally unfair to all international corporations with operations in California, both U.S. and foreign. While we support A.B.525 since it addresses the most

troublesome aspect of the unitary system, its application to foreign-owned corporations, we also urge the Committee, as a high priority, to consider the negative and inequitable effects which the unitary system has on U.S.-owned corporations operating in California.

If IBM can be of any further assistance, please do not hesitate to contact us.

Sincerely,



W. W. Eggleston

WWE:bsd71

cc: Members, Committee on Revenue and Taxation
The Honorable Teresa P. Hughes

AB525

ELI LILLY AND COMPANY

INDIANAPOLIS, INDIANA 46206 • TELEPHONE (317) 261-2000

November 21, 1979

The Honorable Willie Brown
Chairperson, Assembly Revenue
and Taxation Committee
State Capitol Building
Sacramento, CA 95814

Dear Mr. Brown:

Eli Lilly and Company, with a wholly-owned subsidiary, IVAC, headquartered in San Diego, California, hereby submits for the record its comments on A.B. 525, legislation which would exclude foreign corporations from worldwide combination of income reporting for purposes of state income taxes.

While A.B. 525 does not have a direct impact on Eli Lilly and Company, we support the legislation as an important first step in promoting world trade and in preventing states from extending their tax jurisdiction of foreign corporations on a worldwide basis. In the past, this extension of tax base has been accomplished by means of the so-called "unitary" or "worldwide combination" formula. As a result of this formula foreign corporations may be taxed on income even though such corporations operate solely outside the United States and derive all of their income from sources outside the United States. While the merits of the unitary method can be debated, it is not the purpose of our comments to enter into that longstanding debate. Suffice to say, that this method is not recognized, nor employed by the federal government and according to our information, is employed by only three states, one of which is California.

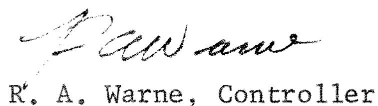
The purpose of our comments is to impress upon this Committee and the California legislature the importance of A.B. 525 to businesses in California and throughout the country. The passage of this legislation would be a clear indication to the major trading countries of the world, including Great Britain, that foreign corporations operating in California will no longer be subject to state taxes on income that has no connection with California, or to a system of taxation that requires excessive recordkeeping and reporting requirements. In return, we expect the passage of A.B. 525 to result in increased benefits for U.S. business, including California-based corporations conducting business abroad. Foreign tax treaties presently signed or under negotiation are expected to be resolved with advantage to U.S. corporations if foreign countries perceive that their corporations will be treated equitably in the United States.

While some may argue that the elimination of the unitary method in California may reduce revenues, we believe the increased foreign investment in the State will more than offset revenue loss. In addition, the State may assess taxes on foreign corporations under other methods such as the so-called "arm's-length" method which effectively controls the prices between related parties. As you may know, this method is the one employed by the federal government, and in order that states can properly enforce the arm's-length standard, the federal government makes available to the states pricing information developed in federal audits. In California, the passage of A.B. 525 combined with effective use of another method such as the arm's-length method and the increased foreign investment in California may actually increase the revenues to the State.

The State of California has always been a major economic force, not only in the United States but in the world. With a state budget larger than many foreign countries it is in a unique position to have an effect on foreign trade. California's large population necessitates that it be a producer as well as a consumer. There is widespread interest in A.B. 525 both in and out of California because its passage will have a large impact on this country's businesses and their opportunity to receive favorable treatment overseas. We believe the passage of A.B. 525 will have a tremendous benefit to the State of California which more than any other state stands to benefit from a strong foreign trade position. While it is difficult to "crystal ball" world events, it is clear that the opening of trade relations with China, the most populous nation in the world, and the rapid development of the Far East puts California in a unique position geographically. Just as the Eastern seaboard of the United States developed with the industrialization of Europe, so the West Coast is positioned to be the gateway to the Far East. California cannot take a provincial view in considering A.B. 525 but must assume a leadership role as our strongest economic state. Through such a role, California and the United States will benefit together.

We appreciate this opportunity to present our views and if you desire any additional information, please contact us.

Sincerely,



R. A. Warne, Controller

mlp

P. O. Box 2538 Houston, Texas 77001 (713) 651-0641

November 6, 1979

Mr. David Doerr
Counsel to the Committee on
Revenue and Taxation
State Capitol
Room 2013
Sacramento, CA 95814

RE: Assembly Bill 525 Concerning Taxation of Foreign Corporations

Dear Sir:

Anderson, Clayton & Co. is a multinational domestic corporation which has been in operation for 75 years. Anderson Clayton employs over 15,000 persons worldwide. The company is primarily engaged in the processing and distribution of consumer and industrial food products. Anderson Clayton maintains a significant amount of plant and personnel in the State of California. This letter expresses Anderson Clayton's support for Assembly Bill 525, as amended.

Anderson Clayton has long been opposed to the method of worldwide combination employed by the State of California for purposes of computing taxable income apportionable to California. Although Anderson Clayton will not be affected directly by this proposed legislation since it has no foreign parent, Anderson Clayton supports any and all proposals which would contribute to a more equitable method of determining income taxable by the State of California. Assembly Bill 525, as amended, would eliminate the onerous burden of double taxation on foreign income for many taxpayers doing business in California. Such a law would not only operate to create a more equitable tax structure in California, but would operate to stimulate business activity in California.

Anderson Clayton expresses its appreciation to the State of California for the opportunity to comment on Assembly Bill 525, as amended.

Respectfully submitted,

Lyle Bethune

Lyle Bethune
Assistant Controller
& Director of Taxes

LB/cr

State of California | Franchise Tax Board

Memorandum

To : Hon. Willie L. Brown, Jr., Chairman
Assembly Revenue and Taxation Committee
State Capitol, Room 2013
Sacramento, CA 95814

Date : November 27, 1979

File No.:

Telephone: ATSS ( )
(916) 355-0982

From : Martin Huff

Subject: Interim Committee Meeting on AB-525
Los Angeles - November 13, 1979

Pursuant to the permission which you granted, the department wishes to submit this memorandum to respond to and comment upon certain testimony offered at the Committee's Interim Hearing on AB-525.

Many of the witnesses represented foreign-based multinationals and their testimony dwelt heavily on an alleged difficulty of compliance in respect to record keeping such statements as "maintenance of separate books" abounding.

We believe this testimony to be in error and to be based either on a misperception of the information requirements, a lack of knowledge of the accounting techniques available to produce the necessary information, or perhaps an effort to magnify a minor problem into one which would warrant some special legislation.

There are, of course, hundreds of U.S.-based multinationals operating in many different countries of the world. All such companies are able to prepare consolidated statements in dollars for their worldwide activities and routinely do so.

The notion that foreign-based multinationals do not have an equivalent capacity to reflect their worldwide activities in the parent's currency is an absurdity.

The department's proposed guideline (Exhibit 8 of the previously submitted material) provides for the use of books and records maintained in the parent corporation's currency and requires that adjustments be made only for those items that are material.

The adjustments referred to in no sense involve "keeping separate sets of books," but involve the very routine process of converting financial accounting statements to a tax accounting basis. The familiar Schedule M in the federal corporate return is the type of adjustment involved.

Typical adjustments required for California purposes are the elimination of income taxes paid as deductions, elimination of certain types of reserve additions as expenses and adjusting depreciation to a cost basis. All of the data necessary should be routinely available or can be determined with a reasonable effort.

One allegation was that cost records are unavailable and, therefore, depreciation cannot be determined and property cannot be valued for the property factor. We believe all corporations must maintain some type of cost records. In those countries which use a replacement cost accounting concept for valuing property, the books and records will reflect a reserve showing the upward or downward reevaluation of the assets which should allow for a reasonably accurate determination of the cost value. Furthermore, Reg. Sec. 25130(a)(1) provides that if the "original cost of property is unascertainable, the property is included in the factor at its fair market value as of the date of acquisition by the taxpayer." Such property is not left out of the property factor, as was alleged at the hearing, and the fair market valuation should provide an acceptable means to calculate depreciation.

As to the "record keeping" matter, we believe the foreign-based multinationals have adequate records and that they can be adapted to reflect California computations without incurring major difficulties or costs. In other words, they are just as capable in the accounting area as are U.S.-based multinationals.

Finally, it should be noted that at least one of the witnesses which testified before your Committee, D.J. Hayward of B.A.T. Industries, indicated that his company had had little or no problem in complying with California's requests for information. Interestingly, the unitary method resulted in a reduction of his company's California tax.

A second problem alleged to exist by Chris Wada of Sony Corporation of New York was payroll factor distortion caused by the difference in labor costs and the fact that Japanese companies provide many benefits to employees not normally provided by U.S. companies. Any recent survey of prevailing wage rates will indicate that the U.S. worker is no longer in the forefront in terms of salary among the developed industrial nations. Japanese workers, along with those of most western European countries, now earn hourly wages comparable or in excess of those of U.S. workers. In addition, costs such as subsidized housing or extensive subsidized health care should be reflected in the payroll factor since if such benefits were provided to U.S. employees they would be treated as wages or income under the Internal Revenue Code. They are so included if the foreign-based company furnishes the necessary information.

Other testimony was along the line that since regulatory authorities reviewed a company's performance in California, the unitary concept was unnecessary. For example, Mr. Grady of Lloyd's Bank of California testified that he had received a letter from the California Bank Commissioner assuring him that the

audit performed by that department would foreclose any possible misreporting of income by the California subsidiary. The courts have held that the fact that the result from separate accounting differs from that reached under the unitary method does not invalidate either set of figures. Each method has been designed for a specific purpose, and these purposes do not coincide. For purposes of state taxation, the unitary method is the accepted method of accounting and is required by the California courts. It reflects the intangible contributions not accounted for under traditional financial accounting procedures.

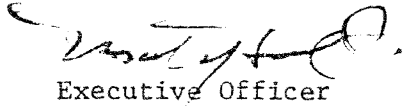
Many of the witnesses alleged that the unitary method is a disincentive to investment in California. The material which the department prepared for the Committee deals with this question in some detail. At the time this material was reproduced, we had not yet received permission to reprint portions of a study on Facility Location Decisions which is identified as Exhibit 30. A copy of this material is attached to this memorandum in order to complete the record. Most disincentive claims were directed specifically to the start-up period. If the Committee believes a disincentive is involved, the elimination of this disincentive does not require an emasculation of the unitary method as sought by AB-525.

Several of the witnesses spoke with remarkable candor and verified many of the arguments which the department has raised against AB-525. Both Mr. Devitt, testifying for COST, and Mr. Stanley, testifying for Ford Motor Company, indicated that the exclusion of foreign parents from the unitary concept was only a first step, and if AB-525 was passed in its present form they would return to the Legislature to seek a similar exemption for U.S.-based companies. Mr. Devitt, in his testimony, also agreed with the department that it would be impossible for the states to perform a Section 482 audit. From this premise, Mr. Devitt argued that the relative compliance costs of Section 482 are irrelevant. In effect, what Mr. Devitt has argued for is a non-audit of multinational corporations. Given the experience of all governments throughout the world, we believe this approach is completely unacceptable.

Mr. Delap, in his testimony, indicated that the unitary method has a great deal of theoretical merit. We agree with Mr. Delap's conclusion and also submit that it is the only practical method by which multinational corporations can be audited and is vastly superior from a compliance viewpoint to the non-audit approach denominated as the arm's-length method or Section 482 method.

In conclusion, we note that one of the principal threads which ran through the testimony of many of the witnesses was the fear that other countries

may elect to adopt California's method. We believe businesses' "fear" is justified and results from a realization that the use of the unitary method will result in multinational business paying its fair share of its tax burden throughout the world. This does much to explain the opposition from these organizations having a vested interest in not paying such fair share.



Executive Officer

cc: Members, Assembly Revenue & Taxation Committee
Members, Franchise Tax Board
Dave Doerr ✓

ME INC. Printed in USA #77234

Facility Location Decisions

A Fortune Market Research Survey
Designed and Conducted by
Belknap Data Solutions Ltd.

Exhibit 30

September, 1977

For additional copies of this survey:

Single copy: $7.00
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Make out check or money order to Fortune and mail to:

Fortune
Facility Location Decisions Survey
Room 1844B
Time & Life Building
Rockefeller Center
New York, N.Y. 10020

Productivity, transportation, energy, community attitudes and taxes will be the most important factors in selecting new plant locations in the near future.

It should be remembered that the answers were obtained during the summer of 1976. If the survey had been made during or shortly after the harsh 1976-77 winter, the importance attached to "Availability of energy supplies" would no doubt be greater than the already high level reported here.

MEANING OF "WEIGHTED SCORE"

As shown in the questionnaire in Appendix B, the respondents were asked to rate each of 26 possible factors as to their importance in locating the company's probable next new plant. The rating scale had five points, ranging from "extremely important" to "not at all important." For ease of presentation and interpretation, the distributions of the answers have been reduced to "weighted scores," whose meaning can be readily seen from this guide:

If every respondent had said:	. . . the Weighted Score would be
Extremely important	100
Quite important	75
Fairly important	50
Not very important	25
Not at all important	0

The "weighted score" thus reflects the mathematical center of gravity of the opinions expressed. ("No answers," none larger than 3% of total respondents, were pro-rated by basing the weighted scores on those answering.)

COMPARATIVE IMPORTANCE OF FACTORS IN LOCATING NEXT MAINLAND U.S. PLANT (In Rank Order)

***Q.** Please indicate . . . how important each factor would be in selecting a location for this type of plant.*

TABLE 2

Factor	Weighted Score*
	(100-0)
Productivity of workers	82
Efficient transportation facilities for materials and products	82
Availability of energy supplies	80
Community receptivity to business and industry	80
State and/or local attitude toward taxes on business and industry	79
State and/or local posture on environmental controls and processing of Environmental Impact Reports	71
Costs of property and construction	71
Ample area for future expansion	70
Water supply	68
Availability of unskilled or semi-skilled workers	66
Availability of skilled workers	65
Proximity to customers	63
Fiscal health of state and/or city	63
Adequate civic waste treatment facilities	62
Calm and stable social climate	62
Proximity to raw materials, components or supplies	61
State and/or local personal income tax structure	60
Proximity to services	60
Style of living for employees	57
A growing regional market	55
Efficient transportation facilities for people	55
Availability of technical or professional workers	53
Financing inducements	51
Availability of clerical workers	47
Proximity to other company facilities	37
Personal preferences of company executives	36

*See explanation at left.

NOTE: Distribution of actual ratings and breakdowns of the factor scores by company size and type of plant will be found in Appendix Tables A1, A2 and A3.

Half of the reported new plants in the past five years were located in the South.* The leading individual states were Texas (11%), North Carolina (7%) and California (7%). The figures in Table 5 do not reflect total plant location activity as each company was asked only about past location of a single plant similar to the most likely next new one. Companies which put up multiple plants of the same or different types in recent years are consequently represented in this table by only a single location decision.

*Throughout this report geographic groupings are based on U.S. Census definitions, which place 16 of the 48 states in the South—more than in any other region. The states included in each of the regions are as follows:
Northeast: Maine, New Hampshire, Vermont, Massachusetts, Rhode Island, Connecticut, New York, New Jersey, Pennsylvania
North Central: Ohio, Indiana, Illinois, Michigan, Wisconsin, Minnesota, Iowa, Missouri, North Dakota, South Dakota, Nebraska, Kansas
South: Delaware, Maryland, District of Columbia, Virginia, West Virginia, North Carolina, South Carolina, Georgia, Florida, Kentucky, Tennessee, Alabama, Mississippi, Arkansas, Louisiana, Oklahoma, Texas
West: Montana, Idaho, Wyoming, Colorado, New Mexico, Arizona, Utah, Nevada, Washington, Oregon, California

STATES SELECTED FOR NEW PLANT LOCATIONS IN PAST 5 YEARS

Q. *In which state was this plant located?*

TABLE 5

State	%
Northeast	**11%**
Pennsylvania	4
New York	2
New Jersey	2
All other Northeastern states	2
North Central	**24**
Ohio	5
Illinois	3
Indiana	3
Missouri	3
Wisconsin	3
Iowa	2
Michigan	2
All other North Central states	3
South	**52**
Texas	11
North Carolina	7
Alabama	5
Tennessee	5
Virginia	4
Arkansas	3
Georgia	3%
Kentucky	3
South Carolina	3
Florida	2
Louisiana	2
Mississippi	2
Oklahoma	2
All other Southern states	2
West	**13**
California	7
Colorado	2
Utah	2
All other Western states	4
	100%

(Companies which selected such a plant location in past 5 years)	(406)
(No answer as to state)	(37)
(Base = 100%)	(369)

NOTES: 1. Details may not add to subtotals or 100% because of rounding.
2. Appendix Table A4 shows a breakdown of the states selected by company size.

Efficient transportation facilities, proximity to customers and availability of unskilled or semi-skilled workers were the factors cited most often as favoring the locations selected in the past five years.

MOST IMPORTANT FACTORS IN PICKING LOCATION FOR A PLANT ACTUALLY LOCATED IN PAST 5 YEARS

***Q.** . . . which three to five factors were most important in choosing the location selected?*

TABLE 6

Factor	
Efficient transportation facilities for materials and products	41%
Proximity to customers	36
Availability of unskilled or semi-skilled workers	36
Availability of energy supplies	33
Productivity of workers	33
Community receptivity to business and industry	28
A growing regional market	26
Proximity to raw materials, components or supplies	26
State and/or local attitude toward taxes on business and industry	23
Costs of property and construction	22
Availability of skilled workers	17
Ample area for future expansion	17
Proximity to other company facilities	13
Water supply	11
State and/or local posture on environmental controls and processing of Environmental Impact Reports	11
Financing inducements	11
Availability of technical or professional workers	10
Proximity to services	8
Fiscal health of state and/or city	4
Adequate civic waste treatment facilities	4
Style of living for employees	4
Calm and stable social climate	4
Efficient transportation facilities for people	3
State and/or local personal income tax structure	2
Personal preferences of company executives	2
Availability of clerical workers	1
No answer	5
Average number of factors cited	4.5
(Companies which selected such a plant location in past 5 years = 100%)	(406)

NOTE: Analysis of factor importance by company size and type of plant will be found in Appendix Tables A5 and A6.

Texas leads as the "most likely choice" for the next plant location followed by California, North Carolina and Georgia.

STATES NAMED BY 3% OR MORE AS "MOST LIKELY CHOICE" AS LOCATION FOR NEW PLANT IN NEXT 5 YEARS

TABLE 9

Texas	11%
California	8
North Carolina	6
Georgia	6
Virginia	5
Illinois	4
Ohio	4
Kentucky	4
Alabama	3
Oklahoma	3
Tennessee	3
(Companies probably locating a new plant of specified type in next 5 years and naming area/state = 100%)	(306)

Many states appear in the running for new plant locations when second and third choices are also considered.

TOTAL MENTIONS OF STATES AS "MOST LIKELY," "SECOND" OR "THIRD CHOICE" FOR NEW PLANT LOCATION IN NEXT 5 YEARS

TABLE 10

Region / State	%
Northeast	
Pennsylvania	7%
New York	4
New Jersey	3
New Hampshire	2
Connecticut	1
Maine	1
Northeast (unspecified)	3
North Central	
Ohio	9
Illinois	7
Indiana	7
Missouri	7
Iowa	4
Kansas	3
Michigan	2
Minnesota	2
Nebraska	2
Wisconsin	2
North Central (unspecified)	5
South	
Texas	20
Georgia	13
North Carolina	12
Tennessee	10
Kentucky	9
Virginia	9%
Alabama	8
Arkansas	8
South Carolina	8
Mississippi	7
Oklahoma	7
Louisiana	6
Florida	5
Maryland	3
West Virginia	1
Delaware	*
South (unspecified)	10
West	
California	11
Colorado	4
Arizona	2
Oregon	2
Nevada	1
Utah	1
Washington	1
Wyoming	*
West (unspecified)	5
(Companies probably locating a new plant of specified type in next 5 years and naming area/state = 100%)	(306)

*Less than 0.5%.

NOTE: States not listed received no mentions. Appendix Table A8 shows possible state selections by type of plant.

The factors most frequently favoring the "most likely" state for the next new plant location are proximity to customers, efficient transportation facilities and availability of energy supplies.

FACTORS FAVORING "MOST LIKELY" STATE FOR LOCATION OF NEW PLANT IN NEXT 5 YEARS

Q. *. . . which three to five factors stand out in your present thinking as favoring the state you named above as the "most likely choice?"*

TABLE 11

Factor	
Proximity to customers	37%
Efficient transportation facilities for materials and products	36
Availability of energy supplies	34
Availability of unskilled or semi-skilled workers	33
Productivity of workers	32
A growing regional market	27
Proximity to raw materials, components or supplies	27
State and/or local attitude toward taxes on business and industry	26
Community receptivity to business and industry	22
Costs of property and construction	16
Proximity to other company facilities	14
Availability of skilled workers	13
State and/or local posture on environmental controls and processing of Environmental Impact Reports	13
Financing inducements	13
Ample area for future expansion	12
Proximity to services	10
Water supply	10
Availability of technical or professional workers	7
Fiscal health of state and/or city	5
Style of living for employees	5
Adequate civic waste treatment facilities	4
State and/or local personal income tax structure	4
Calm and stable social climate	4
Efficient transportation facilities for people	3
Availability of clerical workers	1
Personal preferences of company executives	1
No answer	5
Average number of factors cited	4.3
(Companies probably locating a new plant of specified type in next 5 years and naming area/state = 100%)	(306)

California (18%) and Texas (11%) lead the individual states mentioned as most likely locations for new **distribution facilities**. For **laboratories**, California (15%) is followed by Pennsylvania (13%) and Illinois (10%), but these differences are not statistically significant. The same warning applies to **regional headquarters**, for which California (23%) and Illinois (21%) are ahead of Georgia (13%). For new **corporate headquarters** locations, Connecticut and Minnesota (each 10%) trail New Jersey and New York (both 14%).

STATES NAMED BY 3% OR MORE AS "MOST LIKELY CHOICE" FOR LOCATION OF NEW FACILITIES IN NEXT 5 YEARS

TABLE 14

Distribution Center/Warehouse	
California	18%
Texas	11
Georgia	8
Illinois	7
Ohio	6
New Jersey	4
Virginia	4
Alabama	3
Massachusetts	3
Michigan	3
Missouri	3
Tennessee	3
(Base = 100%)	(159)

Regional Headquarters*	
California	23%
Illinois	21
Georgia	13
Texas	8
Michigan	5
Arkansas	3
Connecticut	3
Kentucky	3
Louisiana	3
Minnesota	3
New Jersey	3
Ohio	3
Oklahoma	3
Pennsylvania	3
(Base = 100%)	(39)*

Laboratory*	
California	15%
Pennsylvania	13
Illinois	10
Minnesota	6
New Jersey	6
Alabama	4
Indiana	4
Kentucky	4
Maryland	4
New York	4
Ohio	4
Wisconsin	4
(Base = 100%)	(48)*

Corporate Headquarters	
New Jersey	14%
New York	14
Connecticut	10
Minnesota	10
California	8
Michigan	8
Texas	8
Illinois	6
Florida	4
Georgia	4
Massachusetts	4
(Base = 100%)	(51)

*Caution. Small base.
NOTE: "Bases" are the number of companies probably locating new facilities of the specified type in next 5 years and specifying most likely area/state.

On the basis of total mentions as the most likely, second or third choice, California, Texas, Illinois and Georgia head the list as possible sites for both distribution facilities and regional headquarters. For new laboratory sites, California and Pennsylvania are followed by Illinois and New Jersey. In the running for new corporate headquarters locations, Connecticut (29%) outdistances New York and New Jersey (both 18%).

TOTAL MENTIONS OF STATES AS "MOST LIKELY," "SECOND" OR "THIRD CHOICE" FOR NEW FACILITY LOCATIONS IN THE NEXT 5 YEARS

TABLE 15

	Distribution Center/ Warehouse	Laboratory*	Regional Head-quarters*	Corporate Head-quarters
Northeast				
Connecticut	3%	2%	3%	29%
Massachusetts	4	4	3	6
New Jersey	7	13	8	18
New York	7	10	–	18
Pennsylvania	6	19	5	4
Northeast (unspecified)	4	–	–	–
North Central				
Illinois	14	15	21	6
Indiana	6	4	3	–
Iowa	3	–	–	–
Kansas	3	2	–	2
Michigan	4	4	5	10
Minnesota	3	6	5	10
Missouri	6	2	13	4
Nebraska	1	4	–	4
Ohio	10	8	3	4
Wisconsin	3	4	3	2
North Central (unspecified)	5	2	3	–
South				
Alabama	4	6	–	–
Arkansas	3	–	3	–
Delaware	1	4	3	–
Florida	5	2	3	4
Georgia	13	2	23	6
Kentucky	2	4	3	–
Louisiana	1	–	5	–
Maryland	2	6	3	–
Mississippi	1	–	3	–
North Carolina	8	2	–	4
Oklahoma	4	2	–	–
South Carolina	3	–	–	2
Tennessee	6	4	3	–
Texas	19	4	23	14
Virginia	4	8	8	4
West Virginia	–	2	–	–
South (unspecified)	7	–	5	–
West				
Arizona	3	2	–	2
California	30	19	26	12
Colorado	4	4	5	4
Nevada	5	–	3	–
New Mexico	1	–	3	–
Oregon	2	–	3	–
Utah	–	–	3	–
Washington	3	–	3	–
West (unspecified)	7	–	5	–
(Companies probably locating a new facility of specified type in next 5 years and specifying likely area/state = 100%)	(159)	(48)*	(39)*	(51)

*Caution. Small base.

NOTE: States not listed received no mentions.

Corporate headquarters have been relocated by one in six companies in the past five years, most frequently to (or in) Connecticut and Illinois.

CORPORATE HEADQUARTERS RELOCATION DECISIONS IN PAST 5 YEARS

Q. *In the past five years has your company relocated or decided to relocate its corporate headquarters facility?*

TABLE 16

		Largest Industrials		
	Total	**Top 100**	**Next 400**	**2nd 500**
Yes	17%	21%	21%	12%
No	80	74	74	87
No answer	3	5	4	1
	100%	100%	100%	100%
(Base = 100%)	(513)	(62)	(203)	(248)

NOTE: Details may not add to 100% because of rounding.

STATES MENTIONED BY 3% OR MORE FOR NEW CORPORATE HEADQUARTERS LOCATIONS IN PAST 5 YEARS

Q. *In which state was a location selected?*

TABLE 17

Connecticut	13%
Illinois	12
New York	10
Texas	10
California	6
New Jersey	6
Michigan	5
Pennsylvania	5
Georgia	4
Missouri	4
(Companies which made corporate headquarters relocation decisions in past 5 years and specified state = 100%)	(82)

"Personal preferences of company executives" and "style of living for employees" remain **the most important factors in the comparison between companies relocating their corporate headquarters in the past five years and those probably doing so in the next five years.** However, sharp increases show up for "state and/or local personal income tax structure," "state and/or local attitude toward taxes on business and industry" and "fiscal health of state and/or city."

MOST IMPORTANT FACTORS IN LOCATING CORPORATE HEADQUARTERS

Q. *[Three to five most important factors. See questions 7 and 8c on page 4 of questionnaire, Appendix B.]*

TABLE 18

Factor	In Past Five Years	In Next Five Years
Personal preferences of company executives	47%	56%
Style of living for employees	41	43
Availability of clerical workers	30	20
Proximity to other company facilities	30	34
Efficient transportation facilities for people	29	33
Availability of technical or professional workers	24	25
Community receptivity to business and industry	24	15
State and/or local personal income tax structure	17	36
Calm and stable social climate	17	16
Ample area for future expansion	15	8
Costs of property and construction	14	13
State and/or local attitude toward taxes on business and industry	14	33
Productivity of workers	11	8
Proximity to services	11	7
Availability of skilled workers	7	3
Proximity to customers	5	7
A growing regional market	4	3
Proximity to raw materials, components or supplies	2	–
Financing inducements	2	2
State and/or local posture on environmental controls and processing of Environmental Impact Reports	1	3
Availability of energy supplies	–	7
Fiscal health of state and/or city	–	13
Efficient transportation facilities for materials and products	–	3
Water supply	–	2
Adequate civic waste treatment facilities	–	2
Availability of unskilled or semi-skilled workers	–	–
No answer	12	8
(Companies which made corporate headquarters relocation decisions in past 5 years/probably will relocate in next 5 years = 100%)	(86)	(61)

STATES SELECTED FOR NEW PLANT LOCATIONS IN PAST 5 YEARS

Q. In which state was this plant located?

TABLE A4

		Largest Industrials		
	Total	Top 100*	Next 400	2nd 500
Northeast	**11%**	**5%**	**13%**	**11%**
Pennsylvania	4	–	4	4
New York	2	2	4	1
New Jersey	2	2	3	2
All other Northeastern states	2	–	2	3
North Central	**24**	**16**	**25**	**25**
Ohio	5	5	8	3
Illinois	3	–	2	5
Indiana	3	2	3	4
Missouri	3	–	3	3
Wisconsin	3	–	2	4
Iowa	2	5	2	1
Michigan	2	2	2	2
All other North Central states	3	2	3	4
South	**52**	**64**	**53**	**48**
Texas	11	20	11	8
North Carolina	7	2	6	8
Alabama	5	5	5	5
Tennessee	5	5	6	4
Virginia	4	2	4	3
Arkansas	3	2	3	3
Georgia	3	–	5	2
Kentucky	3	2	1	4
South Carolina	3	5	4	2
Florida	2	2	1	3
Louisiana	2	7	2	1
Mississippi	2	–	3	2
Oklahoma	2	9	1	1
All other Southern states	2	2	2	2
West	**13**	**16**	**10**	**16**
California	7	5	5	8
Colorado	2	7	–	2
Utah	2	2	1	2
All other Western states	4	2	4	3
	100%	100%	100%	100%
(Companies which selected such a plant location in past 5 years = 100%)	(406)	(51)	(167)	(188)
No answer as to state	(37)	(7)	(16)	(14)
(Base = 100%)	(369)	(44)*	(151)	(174)

*Caution. Small base.

NOTE: Details may not add to subtotals or 100% because of rounding.

Q. Referring again to the separate blue sheet, which three to five factors were most important in choosing the location selected?

MOST IMPORTANT FACTORS IN PICKING LOCATION FOR A PLANT ACTUALLY LOCATED IN PAST 5 YEARS

TABLE A5

Factor	Total	Largest Industrials: Top 100	Largest Industrials: Next 400	Largest Industrials: 2nd 500
A growing regional market	26%	24%	25%	28%
Availability of unskilled or semi-skilled workers	36	24	38	38
Availability of skilled workers	17	25	15	16
Availability of clerical workers	1	–	1	1
Availability of technical or professional workers	10	10	7	12
Proximity to customers	36	45	34	36
Proximity to raw materials, components or supplies	26	39	26	22
Proximity to services	8	6	8	9
Proximity to other company facilities	13	8	10	16
Availability of energy supplies	33	39	37	27
Productivity of workers	33	29	35	33
Efficient transportation facilities for materials and products	41	53	40	39
Efficient transportation facilities for people	3	–	3	3
Ample area for future expansion	17	14	19	17
Costs of property and construction	22	24	22	23
Water supply	11	16	15	7
Adequate civic waste treatment facilities	4	4	5	3
State and/or local posture on environmental controls and processing of Environmental Impact Reports	11	14	14	7
Fiscal health of state and/or city	4	–	4	5
Financing inducements	11	10	5	17
State and/or local attitude toward taxes on business and industry	23	20	26	22
Community receptivity to business and industry	28	24	31	27
State and/or local personal income tax structure	2	2	1	3
Style of living for employees	4	12	4	2
Personal preferences of company executives	2	2	2	3
Calm and stable social climate	4	2	5	4
No answer	5	4	5	6
Average number of factors cited	4.5	4.6	4.5	4.5
(Companies which selected such a plant location in past 5 years = 100%)	(406)	(51)	(167)	(188)

MATERIAL SUBMITTED

FOR

THE RECORD

Confederation of British Industry

21 Tothill Street London SW1H 9LP Telephone 01-930 6711 Telex 21332

9 November 1979

UNITARY TAXATION IN CALIFORNIA

SUBMISSION TO THE ASSEMBLY COMMITTEE ON REVENUE AND TAXATION FROM THE CONFEDERATION OF BRITISH INDUSTRY

The Confederation of British Industry (CBI) are grateful for the opportunity to attend this hearing and to submit evidence in support of the Hughes-Mori bill (AB 525). The Confederation represents all sectors of British business and our members range from the largest multinational companies to the smallest concerns. We also include among our members several representative bodies and associations for particular industrial or commercial sectors in the United Kingdom.

In arranging to be represented at this hearing, CBI have taken a step completely without precedent. We have done this - with the full authority of our membership - because of the very grave concern felt by all our members about the problem of unitary taxation with combined world-wide reporting. At present it is true that only a relatively small number of our members have encountered this problem. But those members who have suffered taxation on this basis have found it very troublesome, for the reasons which are outlined in this paper and which will be described in greater detail by other members of our delegation in their evidence at this hearing. And all our members are very worried about the possibility that, if it is not checked quickly, it may spread to other parts of the world. If that were to happen, the consequences for all international business would be very serious indeed.

There are four main reasons why CBI members are worried about unitary taxation.

1. They believe the principle is unfair. CBI firmly believes in taxation on what has been called the 'arms-length' principle. A foreign company operating in any given country or territorial sub-division should be taxed there as an independent enterprise dealing at arms length with its parent company or other affiliates. This is the principle of taxation which has been followed by all developed countries in the world, and which has always been adopted in their model double taxation conventions by the Organisation for Economic Co-operation and Development (OECD), of which the USA is a leading member. This principle has been further approved by the recent report of the OECD Committee on Fiscal Affairs on 'Transfer Pricing and Multinational Enterprises', an extract of which is attached at Annex A. The findings of the report on this subject have been firmly endorsed in a resolution passed by the International Chamber of Commerce last September. A copy of this resolution is attached at Annex B.

The system of unitary taxation with combined world-wide reporting as practised by the State of California does not follow these principles. Under this system, there need be no attempt to determine the profits actually earned by a Californian subsidiary of a multinational group of companies. Instead, a formula is used to attribute some of the total profits of the group to the operation in the State, generally by reference to the value of fixed assets, turnover and payroll in the State compared with the same values, world-wide, for the whole group.

The unitary basis works on the premise that a group of companies is a single unit and, on this basis, it is unreal to try to compute the profits of one operation of that group in isolation. The unitary system has its origins in the attempt to ensure a fairer allocation of tax revenue between various American States where a particular business - for example, a railroad company - had operations in several States. Whatever the impact of the unitary basis domestically, it has serious disadvantages in the international sphere.

We believe there can be no possible justification for extending the unitary principle to foreign-based multinational companies. The three factors - fixed assets, turnover and payroll - are likely to vary widely in different parts of the world, and it is wrong to assume that profits

are produced equally from property and wages in different continents and in different economies.

The application of these factors in this way will not necessarily produce a tax liability which can be equated with the profits actually earned in California. This will apply particularly to start-up businesses: their heavy initial investment will result in low profits or even losses in the early years although, for the same reason, a computation on the unitary basis will produce what appears to be a substantial profit.

2. In many cases, it will lead to double taxation. Where a company in California has been unable to earn a profit computed on the arms-length basis, it may not be possible for the tax charged under the unitary basis to benefit from double taxation relief in another country. The company will therefore suffer arbitrary unrelieved taxation. A company which suffers unitary tax on some of its operations could well pay tax world-wide on a figure which is greater than its total profits, and this is clearly an inequitable result.

3. It imposes a considerable administrative burden on companies. There are two stages in the process. Firstly, a company has to provide a considerable amount of detailed information in order to determine whether or not the business is unitary. Much of the information required seems of marginal relevance to the enquiry.

Secondly, having been ajudged unitary, the company has to deal with the problem of completing a combined report. This could be particularly onerous for foreign-based groups, who may have to rewrite the accounts of all their member companies (wherever they may be) in order to comply with the requirements of the Californian Franchise Tax Board. In the case of a large multinational group, this could involve rewriting the accounts of up to a hundred different companies, or even more. The administrative cost of providing such information, which would not be needed in this form for any other purpose, would clearly be considerable. On some occasions, moreover, it may not be possible to produce all the information required, in which case the company concerned may be faced with an arbitrary tax assessment, a charge to interest and heavy penalties for non-compliance.

4. It creates an undesirable precedent. CBI members, whether or not they have investments in California or even in the USA, are seriously concerned that other countries and other American States may be encouraged to imitate the Californian example. If the practice of unitary taxation with combined world-wide reporting were to become widespread, the implications for international business - including wholly US-owned companies - would be very serious.

Conclusion

For all these reasons, CBI members are very concerned about the system of unitary taxation with combined world-wide reporting as practised in the State of California. Some of our members have indicated that their opposition is so great that they are unwilling to contemplate any investment in California as long as it exists; even though such investment would be desirable for commercial reasons. We understand that their view is shared by businesses in other countries. Other members of our delegation will refer to the serious disincentive to new investment which unitary taxation provides; but it is clear that, to the extent that companies are deterred from investing in California, this result is harmful both to the companies and to the State itself.

If it becomes law, AB 525 would not solve the problem of unitary tax for all our member companies who have operations in California. As drafted, it would exclude companies engaged in certain types of business - for example, the energy industry. Nor would it apply to groups of companies having less than a certain proportion of their total operations outside the USA. CBI regret that the bill contains these two limitations. Nevertheless, we wholeheartedly support the aims of the Hughes-Mori bill as representing a significant first step towards a solution of the problems to which we have referred in this paper.

Economic Directorate
Confederation of British Industry
9 November 1979

ANNEX A

The so-called " global " methods

14. Proposals for radical reformulations of the approach to intra-group transfer pricing which would move away from the arm's length approach towards so-called global or direct methods of profit allocation, or towards fixing transfer prices by reference to predetermined formulae for allocating profits between affiliates, are not endorsed in this report. The use of such alternatives to the arm's length principle is incompatible in fact with Articles 7 and 9 of the OECD Model Double Taxation Convention. Such methods would necessarily be arbitrary, tending to disregard market conditions as well as the particular circumstances of the individual enterprises and tending to ignore the management's own allocation of resources, thus producing an allocation of profits which may bear no sound relationship to the economic facts and inherently running the risk of allocating profits to an entity which is in truth making losses (or possibly the contrary). A number of such methods are sometimes advocated, allocating profits in some cases in proportion to the respective costs of the associated enterprises, sometimes in proportion to their respective turnovers or to their respective labour forces, or by some formula taking account of several such criteria. They are all however to some degree arbitrary. For example, it does not follow that profit is uniformly related to cost at all stages in an integrated production and marketing process. Indeed the problem of allocating costs could well be no easier than in using the cost plus method to arrive at an arm's length price. Nor does it follow that labour costs are the same for the same labour in different

countries, or that profits are necessarily related to any simple combination of such factors. To allocate profits by such methods in a way which reduced the arbitrariness of the results to a negligible degree would necessitate a complex analysis of the different functions of the various associated enterprises and a sophisticated weighing up of the different risks and profit opportunities in the various different stages of manufacturing, transportation, marketing and so on. Nor would the information necessary for such an assessment be readily available or, in many cases, available at all. The need would be for full information about the total activities of the whole MNE. While the widest range of such information may be available to the tax authorities in the country of the parent company in a group even those tax authorities will be limited to some extent in the information which they can compile. The tax authorities of the country in which a subsidiary is situated will on the other hand be in no position to acquire even this amount of information without imposing on the MNE itself a possibly intolerable administrative burden, or a similar burden on the tax authorities of the parent company's country if they seek to get the information by way of exchange of information provisions under double taxation agreements. Nor can it be generally assumed that the tax authorities of the country of the subsidiary should in any case be entitled to quite such a wide range of information about the group's worldwide activities. In practice moreover the information may simply not be available to those authorities. Even if the information were available, however, the varied activities of any MNE and the varied circumstances and situations in which they are carried on must make it impracticable for the tax authorities of the country in which one subsidiary is situated to judge in any satisfactory manner the profitability of any of the other parts of the group situated elsewhere. Moreover, problems would still arise in the comparison of figures produced in different countries by different accounting methods and different legal requirements. Another major disadvantage of any attempt to use such global methods of profit allocation as an alternative to the arm's length principle is that their unco-ordinated use by the tax authorities of several countries would involve the danger that, overall, the MNE affected would suffer double taxation of its profits. This is not to say, however, that in seeking to arrive at the arm's length price in a range of transactions, some regard to the total profits of the relevant MNE may not be helpful, as a check on the assessment of the arm's length price or in specific bilateral situations where other methods give rise to serious difficulties and the two countries concerned are able to adopt a common approach and the necessary information can be made available.

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ANNEX B

Working document

Legal Secretariat

1979-10-01 YD/TFF

Document No. 180/195 Rev.

Original mcb

COMMISSION ON TAXATION

UNITARY TAX SYSTEMS

NOTE to National Committees and members of the Commission on Taxation

At its 17th Session on September 26, 1979, the Executive Board approved the enclosed ICC resolution on the Unitary Tax question as well as the accompanying detailed note providing analytical information on the subject.

National Committees have been urged by the Executive Board to give the widest possible publicity to this resolution to use it in consultations with their governments as appropriate.

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ICC

Doc. No. 180/195 Or. Rev.

RESOLUTION

The ICC views with concern the inevitability that an increase in cases in which profits taxes are levied by political sub-divisions unencumbered by treaty obligations, will result in mounting double taxation of profits (which tax treaties set out to avoid). This is particularly so if the basis of assessment in any such political sub-division is not entirely consistent with that of the country itself, and extends to operations carried on outside the country. This problem has manifested itself in an acute form in connection with the attempts of the State of California to impose the "global" or "unitary" form of assessment based on income of companies involved in international operations outside the U.S.

The dangers of double taxation and the administrative problems arising from the taxation policy of California, and other political sub-divisions, have undoubtedly deterred would-be investors from making investments which would otherwise have been undertaken. This approach, if it should spread, could easily become a most important threat to international trade since international operations would inevitably be confronted with a real danger of multiple taxation of the same profits and unacceptable administrative burdens. The dangers were also recognized by the Council of the OECD in rejecting the so-called "global" method in its recent report on Transfer Pricing (Transfer Pricing and Multinational Enterprises (OECD, Paris, July 1979) pp. 14-15).

The ICC reconfirms its view that, as a general rule, tax should be based on a fair measure of income as computed by reference to the amount which could be expected to arise between independent parties dealing at arm's length. This rule has universal application. The ICC therefore recommends that, in all cases where the taxation policies of political sub-divisions extend to non-domestic operations, all possible measures should be taken to ensure that the terms of an agreement or treaty dealing with taxation on income should bind all authorities having jurisdiction within the boundaries of each contracting State. This recommendation is in accordance with the OECD model taxation Convention 1977 (Art. 2) and a considerable number of international friendship, trade and shipping treaties.

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Sadami (Chris) Wada
Assistant Vice President

November 13, 1979

The Honorable Willie L. Brown, Jr.
Chairman, Revenue & Taxation Committee
California State Assembly
State Capitol
Sacramento, California 95814

Chairman Brown and Members of
the Revenue & Taxation Committee:

It is our distinct pleasure to have the opportunity to speak on the subject of unitary tax concept at your hearing being conducted at State Building, Room 1138, 107 S. Broadway, Los Angeles, California on November 13, 1979. We would like to present to you our strong opposition to the practice of the world-wide unitary tax system against which we have consistently objected.

Sony has good reasons to object.
We believe we have good reason to express our objection in view of the fact that we employ 1,500 people at our color television manufacturing plant in San Diego, California. We established ourselves in San Diego in 1972 in manufacturing color televisions and have steadily expanded its activities. In its course of growth, we have invested $50 million in the land, buildings, and manufacturing machines. Our current annual payroll alone is almost $20 million and if we add up all that we have paid since 1972, the total accumulated amount must exceed several tens of millions of dollars. Our employees certainly use their income to pay taxes and to purchase appliances, homes, automobiles, education, vacation, and other daily needs. Our San Diego plant naturally purchases utilities, all kinds of services including transportation, maintenance, banking, financing and so on; all of which make a significant economic contribution to the state of California.

We have been in the process of expansion for export business. The state and the nation need export trade. As we all know, the United States must increase its export to balance her even greater imports. Export creates job opportunities and brings home U.S. dollars. Exports give this country the necessary ability to buy goods including oil from overseas. Sony at San Diego is in the process of expansion and through such greater manufacturing capabilities, we may make over $50 million export of U.S. made color televisions in this fiscal year.

In this regard, I am sure that Sony is entitled to speak against this unfair and internationally unacceptable application of unitary tax based upon world-wide basis. When Sony, through its business and manufacturing, makes economic contribution to the state and to the nation, why should Sony be penalized for having placed its production fascilities in California and for having created over 1,500 job opportunities in this state. Sony should be complimented by California for its having selected California for the manufacturing site and for its economic contribution to the state. We are instead penalized and are demanded upon to make an additional payment of more than $1.5 million from our global income for our having business of similar as well as very or entirely different kinds in Japan, Europe, South America, and other parts of the world. We resent this unfair and impracticable method of reaching our income outside the United States, that is often created by business of different kinds as well as different structures or different systems of incentives and motivations under different social and tax systems. We resent this unitary tax method applied to the world-wide business. It disrupts the healthy growth of international business forcing upon us a great burden and inefficiency. Therefore, Sony appreciates this opportunity to speak against the concept. Further, we express our welcome and support for the Assembly Bill No.525, introduced by Assemblywoman Hughes and Assemblyman Mori in this current session.

Three-factor formula creates distortions when applied world-wide.

The unitary concept was formulated as a mechanism to enable the states to equitably allocate income as between states in which the enterprise operates, normally upon the basis of the 3-factor formula of property, payroll, and sales. These factors are deemed to be rough approximations in equal weight of the income-generating facets of the enterprise, and the societal burdens and benefits involved in connection therewith.

However, fundamental to the equitableness of the unitary concept is the assumption that all of the states have roughly comparable factors utilized in the denominator, therefore the use of the 3-factor formula arguably provides rough equity in apportioning the total tax burden among the various states in which the enterprise operates.

When this unitary concept is translated into a world-wide concept, however, the equitable underpinnings of the concept fall. When applied on a world-wide basis, gross distortions are created through wide ranges of wage rates and productivity of labor, substantial differences in the cost of plant, equipment, inventory, and other property and, further, through differing risk factors and rates of return, differing sales prices and practices, fluctuating conversion rates of currency, and even currency restrictions.

Sony Corporation encompasses about 50 world-wide consolidated companies in addition to about 70 non-consolidated subsidiaries and affiliates, many of which transact business completely unrelated to Sony Corporation of America and most in places with no connection with the United States.

Different places in the world, different management styles, different bookkeeping, different incentives, different tax systems, different fringe benefit systems, different risks and different pricing make the appli-

cation of unitary tax on a world-wide basis most unreasonable and, if forced upon, it simply creates distortions and very often injustice like the case with us here.

Historical book values and revenue contributions.
The historical cost of manufacturing equipment as between the newer, higher priced equipment located in our plant in San Diego as compared to world-wide costs of comparable equipment located elsewhere in the world has no logical relationship to profits earned. Similar equipment made in Japan a few years prior to the one in San Diego can have a better productivity due from complete debugging and experiences the workers have had with the equipment, thereby making a greater revenue contribution. You cannot relate historical book values and revenue contributions among equipments of different age and locations in the world.

Life-time employment and long-range dedication.
In Japan, employees enjoy lifetime tenure as employees of those companies they started their employment with. This lifetime tenure system provides with employees the kind of security they seek for building stable family life. The value of such lifetime employment is difficult to assess but it has a great value and for that great value employees give special dedication to the growth of the company with their spirit. The result is their great contribution to the profit of the company. The benefit to the company is more than their dedication. Continuous accumulation of technology in engineers who would know all the process and dvelopment of their technology. No time needs to be spent like when you have your engineers constantly leaving you for other jobs every three, four or five years, for training newly hired engineers. Life-time employment and its revnue contribution is not expressed in payroll as such. Money is not all the value peoples of different countries work for and the value of money is changing in different ways in different countries. All these make the use of payroll factor misleading and

highly dangerous when applied on a world-wide basis for the purpose of the unitary tax.

Fringe benefits are different.

Japanese employees in Japan have different fringe benefits from other countries certainly including the United States. For example, employee housing benefits have a very important value because of the shortage of houses and the extreme scarcity of land for housing, that makes it common for the most of workers to commute by trains from far away taking one and a half hours in the morning and in the evening in the famous crowded trains. Probably no other country has as difficult housing situation as in Japan, thereby making the housing benefit highly valuable and an important factor for revenue contribution. Dental coverage included in the usual health insurance in Japan also has a very important point meaning for employees, particularly when compared to the United States. Retirement program is also substantially different in Japan from the United States or other countries. All these elements make reliance on payroll factor for revenue contribution from human resources unreasonable and impracticable. Any efforts to remove distortions by introducing futile adjustments would further complicate the method in vain. You cannot perfect complete world-wide details on pension payments, transportation allowances, severance payments, housing benefits, coverage of health insurance, retirement benefits and other related elements, particularly when all of these are changing year to year at different degrees to different directions in as many countries as the world-wide business is realted to.

Such efforts to make adjustments will fail and will surely distort the end result.

Start-up costs at San Diego Plant

$1 million out of the over $1.5 million difference between world-wide basis and domestic basis demanded of Sony to pay additionally, come from just those first three years

of our start-up period at San Diego plant in 1972, 1973 and 1974.

The world-wide unitary approach by California is singularly inappropriate in view of this start-up situation that did exist at our San Diego plant in those years. The effect of this unitary approach is to levy the heaviest tax burden just when start-up costs and losses are at a peak resulting in abnormally high costs (and low profits) in California just at the time when the numerator (and, thus, the portion of Sony's world-wide income subject to California tax) increases due to new investment and new employees. It must be remembered that the period in which the Sand Diego plant and equipment were purchased, was highly inflationary while the capital assets in Japan and other parts of the world by and large, were not purchased during this highly inflationary period.

Currency exchange rate fluctuated.
The U.S. dollar-yen exchange rate has widely fluctuated since the end of the fixed rate of 360 yen to $1 in August, 1971. The yen kept growing stronger and the rate changed to 300 yen to $1 by the end of 1971 and then further to 253 yen to $1 in July, 1973. The exchange rate then gradually reversed its direction of change and the yen fell to about 300 yen to $1 level and stayed thereabout through 1974, 1975 and 1976 till it began to rise again in February, 1977.

The yen kept rising through 1977 and 1978 till it hit 176 yen to $1 and prompted the defense of the U.S. dollar by the Carter Administration in October, 1978. Exchange rates of other foreign currencies to the U.S. dollar or to the Japanese yen also fluctuated widely at different sppeds and ranges. These exchange rates fluctuated year to year and certainly also within each year.

The Japanese yen to U.S. dollar rates in Tokyo for 1972, 1973 and 1974 at the end of each month were:

At the end of	1972	1973	1974
Jan.	310.20	301.10	299.10
Feb.	304.00	266.50	285.80
Mar.	303.90	265.90	273.80
Apr.	304.40	265.50	280.00
May	304.60	264.80	281.40
Jun.	301.20	265.30	284.00
Jul.	301.10	263.50	297.60
Aug.	301.10	265.30	302.70
Sep.	301.10	265.50	297.50
Oct.	301.10	266.80	299.85
Nov.	301.10	279.90	300.00
Dec.	301.50	280.00	300.60

California Franchise Tax Board needs our property, payroll and sales all expressed in the U.S. dollar and that means translation of various foreign currencies into the yen and then to the U.S. dollar. The question is what exchange rates to use. Sould they be at the beginning, the middle or the end of the year? If we are to convert using above exchange rates those Japanese property, payroll and sales of 1973 into the U.S. dollar amounts, you would have three different amounts for each of the three factors, because you have three different exchange rates for those three time points. They are 301 yen, 265 yen and 280 yen. If you use 265 yen, you would have the largest U.S. dollar amounts while 301 yen would give the least U.S. dollar amounts. The difference is more than 10%. The greater the factors in Japan, the less the factors and the allocation of tax in California under the unitary system on world-wide basis.

Should the exchange rate of the date of the purchase or acquisition of each property be used for the accuracy sake of the value of properties rather than that of the last day of the year against the total yen historic value of all properties purchased or acquired over the years? But such would be next to impossible in view of tremendouse involvement in computation. But, the other approach would give a grossly different and wrong property factor. The same gross distortion creeps into payroll and sales factors unless monthly or even better but far more difficult daily rate is used to convert yen amounts to dollar amounts. Some years had less fluctuating differences than other years as listed below.

Year	Fluctuation
1972	3%
1973	13%
1974	11%
1975	6%
1976	6%
1977	17%
1978	27%

In the order of 1978, 1977, 1973 and 1974, the band of fluctuation were as high as 27%, 17%, 13% and 11%, meaning factors may be distorted over 10% easily.

If one uses an average exchange rate of the year while a certain property was acquired when the yen was the strongest against the U.S. dollar in the year, the U.S. dollar value of the property would look smaller than it really was, thereby distoring the cost of property and therefore, the income allocation according to the world-wide unitary tax system.

Just this matter of the yen-U.S. dollar exchange rate creates such a impossible problem whichever the method one selects to use to compute property, payroll and sales factors for all those years. How many more complications there would be when one has to do fair and just treatment of those three factors of international operations in U.K., Germany, France, Spain, Switzerland, Brazil, Panama, Venezuela, Hong Kong, and many other countries of different currencies. Faced with the impossible task inherent in the world-wide unitary tax system, should one use a convenient method ignoring the unfair injustice being done in penalizing Sony for having done what is good to California and the United States? The answer must be found in other taxing method than the unitary tax system based on world-wide basis.

The spirit of fairness and justice will finally prevail.
On September 27, Tuesday, 1977, Governor Brown of California reversed his earlier position and threw his support behind the then-proposed U.S.-U.K. tax treaty that, had it been ratified in the original form with Article 9(4) intact, would have exempted multinational corporations of the United Kingdom from the California's unitary income taxes. This reversal came about not because, at that point, he for the first time recognized the unfair and unjust nature of the tax system but rather because he learned that the cost of his reversal would not be as expensive as was considered earlier while its benefit in making California attractive to foreign capital investment was growing important and highly desireable.

He coauthored with Senator Alan Cranston the telegram to Senator John Sparkman, Chairman of the Senate Foreign Relations Committee, and urged the ratification of the treaty for the best interest of the State and the Nation. Dynamics of economics and politics are certainly important but we can still expect the spirit of fairness and justice perform their act.

Unfortunately the critical Article 9(4) was reserved and the treaty without it was passed in the Senate of the United States, but it is still creating problems in the U.K. because of the unacceptable form of the incomplete treaty without the Article 9(4) for the U.K.

The effort to stop the world-wide unitary tax system through the U.S.-U.K. tax treaty failed last year but there are bills in the U.S. Senate and the House that would stop States from taxing on the world-wide unitary tax concept. The Senate bill

S.1688 introduced by Senator Charles McC. Mathias, Jr. and the House bill H.R.5076 by Mr. Barber B. Conable, Jr. both in this 96th Congress are welcome and strong sign of rising interest in stopping States and other local taxing authorities from taxing any income of any foreign corporation by such an arbitrary and unfair method as the unitary tax on world-wide basis. Sony is very pleased to see growing understanding about this problem and expanding efforts in eliminating this practice on the State level as well as on the Federal level.

Stop international double tax by use of IRS Code Sect.482

Our income outside the U.S. is taxed by each country but the Franchise Tax Board tries to subject such income to the unitary tax on a world-wide basis. We would suffere, then, from such international double taxation. The Federal Government does not do this. According to the U.S.-Japan tax treaty, the U.S. Treasury Department does not in any way tax the world-wide income of Sony. The U.S. Treasury, with far more at stake, has agreed that the "arm's length" test is the only fair and workable approach and they have relyed on the accepted and time-tested provisions of Section 482 of the IRS Code in dealing with Sony Corporation and Sony Corporation of America.

Sony strongly recommend that Franchise Tax Board of California stop application of the unitary tax on a world-wide basis and follow the method used by the Federal Government in taxing Sony Corporation of America.

Our capital investments in Alabama and other areas are helping us.

Currently we are expanding our Dothan Plant in Alabama, where we now have over 900 employees with $50 million dollar investment in manufacturing magnetic recording tapes in cassettes. We just announced that we would add $25 million and 600 more people to meet both domestic and overseas demand for video cassettes. Since we started this investment in the State other than California, our exposure to California's unitary tax on a world-wide basis has improved. As long as California continues this interantional double taxation on a world-wide basis, Sony will maximize its effort to invest other States than California to protect ourselves from this most condemned and unfair tax system.

Anyone who comes for advice from our California experience, will learn we suffer from and fight against this world-wide unitary tax in California.

After all, we like California and that is why we continue our effort to stop the unitary tax on a world-wide basis.
We have a very successful manufacturing operation in San Diego and Sony is proud of our workers there. They manufacture not only for domestic sales but also for export sales and the plan for export for this fiscal year is $50 million. All of our San Diego employees are excited about this new additional production, which will expand its capacity and number of employees. Inasmuch as we are all excited about the expansion and meaningful and proud contribution to the trade balance of the United States, we are certainly concerned and even agravated about the prospect of our adverse exposure to the unitary tax of California.

We like this beautiful State of California rich in various produce, quality labor, comfortable climate, and logistically ideal being so near to Japan. But no one would like to be taken advantage of for liking something. What is wrong and unfair must be stopped. State of California should use its judgement as Governor Brown and Senator Cranston expressed their support for the U.S.-U.K. tax treaty in its complete and intact form, which would have stopped application of the world-wide unitary tax in the United States.

California and international business
For the benefit not only of Sony and other international business but also for the benefit of California and the United States to continue to grow as the leader of the world trade, Sony sincerely wish the State of California to decide to give up the unitary tax concept on a world-wide basis.

At closing, we once again express our appreciation for this opportunity to present our opinion.

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STATEMENT OF CALIFORNIA TAXPAYERS' ASSOCIATION
ON ASSEMBLY BILL No. 525 (Hughes and Mori)

The California Taxpayers' Association (Cal-Tax) desires to file this statement concerning A.B. 525 and asks that its statement be made a part of the record of the Assembly Revenue and Taxation Committee's November 13, 1979 hearing concerning such bill.

Cal-Tax is a nonprofit organization which represents over 1,300 business and individual taxpayers, both large and small, throughout the State of California. Its corporate members are engaged in many different industries and business activities and therefore have diverse interests. All of its members, however, are interested in advancing the cause of economy and efficiency in government and in improving the economic climate, including the tax structure, of California. Its full-time staff works toward these ends in supporting legislation and legislative principles which will further these objectives.

We agree with the legislative finding expressed in Section 1 of the bill that the inclusion of foreign income in determining the tax liability of foreign economic interests wishing to invest in California has resulted in unfair taxation of foreign-based taxpayers and has consequently acted as an impairment to such investments and has hindered the creation of new opportunities for California employment. We also believe that the application by the State of California of its unitary income concept on a worldwide basis has, on occasion, impacted unfavorably and unfairly on U. S. based taxpayers in respect of the tax on the foreign-source income of such taxpayers.

A.B. 525 restricts its application to companies which are doing business in California but which are owned and controlled by foreign corporations. The bill excludes from its application companies engaged in the energy business, including companies engaged in the oil business and also those engaged in the coal or uranium business. Some of our member companies do not understand or accept the rationale for this exclusion or the factual basis for the finding in Section 2 of the bill, on which the exclusion is grounded.

Other of our member companies are concerned about the potential revenue effect of Section 25137.5 which would be added

to the Revenue and Taxation Code by the bill. The Franchise Tax Board has projected that this part of the bill could involve a revenue loss to the State of several hundred million dollars annually and we have not seen any closer estimate of the revenue impact than that estimate of the Franchise Tax Board which appears in the material dated October, 1979, furnished to the Assembly Revenue and Taxation Committee and included in Volume II of the document prepared by the Committee's staff, entitled "Unitary Method of Apportionment". In the face of a potential revenue loss of such magnitude, and following the passage of Proposition 4 on the State ballot on November 6, 1979, the concern of these of our member companies is as to how such a substantial amount of revenue "loss" would be offset or made up and how such "make up" might affect them.

At the same time that we call attention to the above issues, we would urge upon the Revenue and Taxation Committee, and indeed the entire California legislature, the very great, present need to adopt equitable legislation in this area which will meet the broad, justifiable objectives of improving the tax climate in California for foreign business investors.

As this Committee has already been informed, the United States General Accounting Office is proceeding, at the request of the U. S. House Ways and Means Committee, with a study of state corporate income taxation as it affects multistate and multinational corporations. The conclusions of the GAO report, due next year, will likely include recommendations for Federal legislation which, if introduced and enacted, will take the decision out of the hands of the California legislature and California taxpayers and taxpayer organizations like Cal-Tax.

For all of these reasons Cal-Tax offers the services of its staff and of the tax representatives of its member companies to work and cooperate with the members of this Committee and, if appropriate, with representatives of the State executive branch, in an effort to try to arrive at a consensus position for a legislative proposal which, more broadly and uniformly than A.B. 525, will implement and be able to attract strong support toward achieving the general objectives of improving the California tax climate for potential foreign-based investors, without at the same time unfairly affecting other business entities which are contributing significantly to the California economy, either by excluding them from the reach of such legislation or by further increasing their franchise tax obligations by offsetting rate increases.

A further motivating source behind our offer and our concern in this area relates to the pending United States-United Kingdom Tax Treaty and Protocol. As you know, the Treaty was ratified by the U. S. Senate which excepted Article 9(4) that

would have prohibited California, or any of the other 49 States, from applying a unitary type of tax to the United Kingdom headquartered parent of any subsidiary doing business in California or in another State employing the unitary method of taxation. The Treaty and the Protocol subsequently negotiated, now await ratification by Parliament.

We understand that there is significant opposition among business groups in the United Kingdom to ratification of the Treaty in its present form without Article 9(4). It is important to understand that in negotiating this Treaty significant tax benefits were given U. S. shareholders of British corporations, partially in consideration of the protection Article 9(4) would have afforded British corporations which own subsidiaries doing business in California. It is easy to understand the resentment the British-based companies feel about this unilateral modification of the Treaty by the U. S. Senate. Since Article 9(4) had been endorsed by the U. S. Treasury Department in the course of the earlier Treaty negotiations, the subsequent U. S. Senate capitulation to the demands of a few opponents could understandably lead to the impression that the United States does not speak with one voice, to paraphrase a term used in the recent Japan Lines case decided by the U. S. Supreme Court.

If an appropriate legislative solution can be devised by California to achieve results similar to those that would have been provided by Article 9(4), then the present opposition in the United Kingdom to ratification of the Treaty would be substantially diminished. Thus, it is our desire to evidence our strong support for an effort to find a California legislative solution to this problem. We believe that Cal-Tax as a significant taxpayer-represented voice in the State can be helpful in achieving these desirable ends. In so doing, we hope to assure interested United Kingdom-based companies of our concern and commitment and at the same time to assist all of those U. S. based companies which are interested in ratification of the Treaty, in achieving their objective as well.

The complexity and potential revenue effect of the issues in this area would seem to us to justify your Committee's appointing a small task force of business and government interests, similar to the Proposition 13 task force, to investigate, deliberate and make recommendations for legislative action on this matter. Cal-Tax would be pleased to participate in any such formal endeavor.

California Taxpayers' Association

November 13, 1979

By ______________________________
L. D. Lawrence, President

STATEMENT ON BEHALF OF THE AMERICAN CHAMBER OF
COMMERCE IN THE UNITED KINGDOM
BEFORE THE REVENUE AND TAXATION COMMITTEE
OF THE CALIFORNIA ASSEMPLY
NOVEMBER 13, 1979

My name is Robert A. DeWitt. I am a partner in the law firm of Paul, Hastings, Janofsky & Walker. I am appearing before your Committee in support of Assembly Bill No. 525 on behalf of the American Chamber of Commerce in the United Kingdom.

1. Summary

The British companies which are members of the American Chamber of Commerce in the United Kingdom strongly oppose California's use of the unitary method in determining their franchise tax liability because of its effect in taxing income of their corporate groups earned outside of California having no connection with this state. Whether or not the unitary concept in theory has its effect of taxing non-California income, it clearly does have this effect in practice. Therefore, the American Chamber of Commerce in the United Kingdom strongly supports Assembly Bill No. 525 which we believe will have the effect of substantially eliminating our concerns.

Our support of Assembly Bill No. 525 is based upon the following considerations.

The practical effect of the unitary approach is particularly egregious in the case of foreign controlled

corporate groups with business operations in California because, in most cases, such business operations are only a minor part of the total worldwide operations of these controlled groups. The United States operations are usually conducted through a United States subsidiary, but the California unitary concept disregards the separate existence of the United States subsidiary and allocates a portion of the total worldwide income of the United Kingdom group to California on the basis of an arbitrary formula that in the vast majority of cases yields unsound results. The consequence in many cases is to over-allocate income to California and improperly increase the tax burden of the United States subsidiary well above the California tax that would be payable based upon actual business done in California.

The California system in this respect is contrary to well established international principles of taxation and even principles applied at the federal level in the United States.

Representatives of the American Chamber of Commerce in the United Kingdom have discussed with corporate officials of various United Kingdom companies the question of whether the unitary system is detrimental to the establishment of new and existing business in California. We have consistently been advised that United Kingdom companies are strongly of the opinion that their corporate decisions on locating in California

or expanding existing California operations will be affected by the continued existence of the unitary method. Decisions on whether to undertake new business activities in California, or to expand activities already located here, will be adversely affected by the unreasonable tax burdens which the executives of United Kingdom companies believe are the inevitable result of the unitary method.

No matter where a person travels overseas, whether in the United Kingdom, Germany, Japan or elsewhere, when California is mentioned the first concern expressed by foreign business executives who are considering United States operations, is the California unitary tax. While the California taxing structure is only one factor which executives of foreign corporations must take into account in determining where to locate their operations in the United States, it is probably as important as any factor. I know of my own knowledge that major foreign investment leading to the manufacturing of goods in the United States has been dissuaded from locating in California in large measure because of California's unitary taxing system. As more foreign companies find it advantageous to locate major manufacturing facilities in the United States, and that is certainly the trend of the future, California has a unique opportunity to greatly expand its economic base. This opportunity may well be lost to other states if the California system of taxing corporate profits of foreign controlled enterprises remains unchanged.

The United Kingdom has foreign direct investment in excess of $7 billion in the United States. A substantial share of this total United Kingdom investment goes to California. California represents a vigorous, growing market, and the United Kingdom has traditionally engaged in extensive overseas trade and investment. We believe that California is extremely shortsighted in frightening off this potential investment by maintaining a tax system which offends international tax standards to such a degree as to discourage investment in this state.

We believe it is clear that the unitary method is inhibiting foreign investment in California and will continue to inhibit such investment to an increasing degree. Unless the rules are changed with respect to subsidiaries doing business in California which are part of foreign controlled groups, we are strongly of the view that California will risk the serious loss of jobs which results from discouraging foreign investment.

2. The California Unitary Method

For many years, various states of the United States have determined the income of a corporation by allocating its total income on the basis of the relative dollar amount of property, payroll and sales to such states to total plant, payroll and sales of such corporation from all sources.

California adopted this unitary concept with respect to United States corporations whereby the total income of all members of a corporate group connected by at least 50 percent stock ownership was allocated on this basis. The rationale was that if unity of operation existed within the group (i.e., centralized purchasing, advertising, accounting and management), the difficulties of monitoring intercompany transactions between the members of the group should be avoided by an arbitrary allocation under the unitary concept.

Beginning in the early 1970s, California sought to greatly extend its unitary concept by including not only United States companies and their United States and foreign subsidiaries but also the foreign parent of any such United States company and all members of such a foreign controlled corporate group throughout the world. As a result, California sought to allocate the worldwide income of a foreign controlled corporate group, including income of members which did no business in and had no connection with California.

3. Federal and International Tax Practices

The United States government itself does not find it necessary to divide income between the United States and foreign countries by any such arbitrary apportionment formula. Instead, the United States rules for ensuring fair allocation of income of related members of a corporate group under the arms-length

standard of Section 482 of the Internal Revenue Code have worked successfully, and the Internal Revenue Service vigorously applies this arms-length standard. The federal system is probably the most highly developed and refined system in the world for monitoring intercompany transactions. Substantially every United States company with substantial foreign operations is audited by the Internal Revenue Service. The results of this monitoring are fully available to California under the system whereby states may compare income reported to them with income reported to the federal government and obtain the complete details of Internal Revenue adjustments.

The unitary concept is also contrary to well established international tax principles where the arms-length standard prevails. The practice of California of extending its unitary method to foreign owned and controlled corporate groups with a relatively minor part of their total worldwide operations in California has been met with uniform objection and resentment by foreign owned groups throughout the world. This attitude is in recognition of the fact that the unitary method as applied by California is extreme in its effects in overstating income of foreign owned corporate groups allocated to California because it imposes such unreasonable, and in some cases even impossible, administrative burdens on foreign owned worldwide groups in determining and stating "income" by California standards, and

because it is so totally contrary to long established international tax principles.

4. Fundamental Defects in Application of Unitary Method to Foreign Income

There are two basic reasons why the unitary method should not be applied with respect to income of a foreign parent or affiliated companies in third countries where the parent or affiliated companies are not doing business in the United States.

First, such a foreign owned and foreign based corporate group is likely to have operations all over the world in both developed and developing countries. Most or all of the United Kingdom groups with United States subsidiaries doing business in California fall into this class.

This means that a unitary method based on income from all such operations will necessarily allocate or apportion income based on payroll amounts, property costs and sales which cannot fairly be compared. The results are to allocate a higher portion of total income to the location where these amounts are highest, relatively speaking, unless income bears the same relationship to costs throughout the world irrespective of the amount of such costs. As compared to the United States, profit margins vary widely throughout the world and bear no such uniform relationship to costs.

The California system creates major distortions which tend to result in over-allocations of income to this state. California wages per hour are generally much higher than elsewhere in the world, and even after allowance for capital intensity and productivity, the payroll factor tends to over-allocate income to California. Property costs are also substantially higher in California than elsewhere in the world, with the same distortive effect because of the application of the property factor. California has stringent pollution control requirements, causing a relatively higher property investment per unit of production in this state without an equivalent increase in profits. In fact, such non-productive property costs may reduce actual California profits. The sales factor also causes major distortions when income arising outside a homogeneous economic system is allocated.

California ignores demonstrable differences in the relationship of profits to sales, also tending in some cases to over-allocate income to California. There are examples of United Kingdom controlled groups with diverse business activities all over the world which, by reason of the type of activities engaged in in the United States enjoy a percentage of sales here that substantially exceeds the operating profit from such sales. Sales of products sold only outside of the United States produce a lower percentage of total sales but contribute a much greater percentage of the group's operating

profit. Obviously, an allocation of group profit to California based on sales will allocate a much larger share of group income to California than would be justified. United Kingdom companies which experience this situation have repeatedly complained to the Franchise Tax Board on this basis, but the Board has rejected their complaints.

California allocates worldwide profits without adjustment for any demonstrable differences. For example, profits in developing countries may be much higher in relation to costs to reflect greatly increased risks of expropriation, currency exchange limitations, or other factors. The result may be to allocate part of this risk profit which is really a contingency reserve, to California. California allocates worldwide income even when such income includes substantial profits in foreign countries which are blocked and which for this reason would not be subject to United States federal tax in the case of a United States taxpayer until they became unblocked.

The California system applied to worldwide income also produces gross distortions because it allocates before-tax income, not after-tax income. Taxes imposed on income by governments throughout the world do not bear any uniform relationship to income and sometimes tend to be higher than in the United States. In any event, the California system

allocates to California a portion of worldwide before-tax income of a United Kingdom corporate group which has been subject to varying tax burdens in the many foreign countries where it has been earned. The result is almost certainly to produce a distortion in the amount fairly allocable to California.

There is a second major reason why, in the case of a foreign controlled corporation doing business in California, or a United States subsidiary of such foreign controlled group, California's unitary method should at most take into account only foreign income of the company doing business in California and its subsidiaries, and not income of other affiliated corporations not doing business in California. It is an unreasonable burden, if not impossible burden, for a foreign group not controlled by United States persons to provide the financial information to California that is required to make such a unitary computation. A United Kingdom owned or a United Kingdom based worldwide group does not keep its books, or determine income, payroll, plant costs and sales, in dollars, or by United States accounting standards. The required conversion of financial figures to dollars at scores of different exchange rates, with sharp fluctuations, devaluations, and other changes, is an operational nightmare for a foreign based group with extensive international operations. In some respects California itself does not follow United States

federal income tax accounting and other concepts. The costs of compliance with the California requirements in the case of a United Kingdom worldwide group might conceivably be far in excess of the California tax itself. Recognizing these factors, but being unwilling to adopt a reasonable attitude in applying the unitary concept to foreign controlled groups, the Franchise Tax Board has made assessments based upon financial reports which it has obtained of foreign based corporations which assessments often bear no relationship to the correct tax liability which would be due to California under a proper application of the unitary concept. In many cases such assessments are arbitrary and confiscatory. This puts the burden on the United States subsidiary doing business in California to obtain the correct information which often is impossible due to government restrictions on subsidiaries of the controlled foreign group doing business in other countries and other factors. The result is simply chaotic and should not be tolerated by a taxing system which is presumably based upon reason and common sense.

5. Conclusion

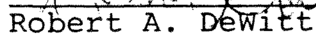
California would not lose revenue to which it is fairly entitled by limiting its unitary concept to corporations doing business in California and their subsidiaries, excluding

the foreign parent and affiliates of the foreign parent not doing business in California. The arms-length standard is effectively applied by the Internal Revenue Service to monitor intercompany transactions. California has the full advantage of the results of audits conducted by the Internal Revenue Service in such cases, and may even apply its own arms-length standards. International business does not object to the application of such standards if they are fairly applied. To the extent that the Franchise Tax Board argues that California would lose revenue under such a system, it can only be because California is presently taxing income it has no right to tax.

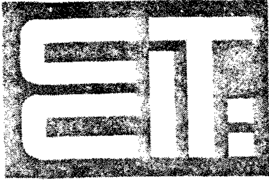
We believe that adoption of Assembly Bill No. 525 will substantially, if not entirely, remove the concerns of foreign based companies which are presently doing business in California or which are considering entering the California market. To the extent that substantial foreign investment settles in California, more jobs are made available for California residents and California is entitled to increased tax revenues as a result of profits generated here. I would like to point out that California is one of a handful of states which utilizes the unitary method of taxation and is the only state to have extended the umbrella of the unitary method to

cover the foreign parent of a California subsidiary and all of that foreign parent's worldwide operations through foreign subsidiaries having no connection whatsoever with California. California is thus the most regressive of all of the 50 states in taxing corporate income. It is time that this impediment be removed as it affects foreign investment in California. For all of these reasons I strongly urge that your Committee report out Assembly Bill No. 525 and the Bill be adopted into law in California. It is only in this way that California will once again become an attractive business opportunity for foreign investments from countries all over the world.

Dated: November 13, 1979



Robert A. DeWitt



CALIFORNIA COUNCIL FOR INTERNATIONAL TRADE

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Statement of Richard L. DeLap at an Interim Hearing of the Revenue and Taxation Committee of the California State Assembly in Support of Assembly Bill No. 525 on Behalf of the California Council for International Trade
November 13, 1979

Mr. Chairman and Members of the Committee. I am a partner in the international accounting firm of Peat, Marwick, Mitchell & Co. and a director of the California Council for International Trades. I appear on behalf of the California Council for International Trade (CCIT), a private association of over 600 California businessmen involved in all facets of international trade. A partial list of organizations affiliated with the Council through corporate and individual memberships is attached.

CCIT has long been concerned that the application of the unitary method of taxation, particularly with respect to the requirement of "combined reporting", by the California Franchise Tax Board is a major deterrent to international trade and investment in California.

We know that foreign firms which have considered establishing operations in California have in many cases been reluctant to do so, and in some cases already have decided not to do so, in large part because of the unitary tax issue. For the same reason, other foreign firms which did have operations in California have relocated to other states, and others have threatened to do so. Even California-based corporations of long standing have diverted activities outside the State solely because of unitary tax considerations.

Foreign parent corporations view the requirement that their worldwide operations be subject to review by the California Franchise Tax Board as violative of basic concepts of international business and of their privacy since they are not directly subject to the jurisdiction of the State of California; they view the necessity of converting foreign books and records to California's tax accounting principles as an immense, unnecessary and costly record keeping burden; they view the fact that the Franchise Tax Board has not publicly issued guidelines in needed areas such as the conversion of foreign currency into United States dollars, as one manifestation of the arbitrary administration of the unitary tax method.

CCIT is aware of the theoretical arguments that can be put forth in defense of the unitary method of taxation. We will grant the efficient collection and administration of taxes of multinational corporations might be facilitated if all taxing authorities throughout the world were to employ an identical unitary method of taxation. We believe, however, that debate on this matter is best left to academicians. We must deal with the real world of international trade and business. The fact is that California is unique in the world in aggressively enforcing the concept of combining both domestic and foreign corporations for the unitary method of taxation. California is not going to change the taxation practices of the rest of the world.

The law does provide relief from the apportionment provisions. The relief should apply where the apportionment provisions do not fairly represent the taxpayer's activity within the state. The provision provides for separate accounting or adjustments to effectuate an equitable allocation of income. As you have heard, inequities have occurred. In fact, the regulations under this particular provision of the law set forth special allocation rules.

They do not describe circumstances or conditions under which the apportionment provisions will not apply and relief be granted.

This Council believes that California would do well to assess its taxpayers by a method which is consistent with the systems used by other states, the United States, and other major free-world trading nations.

We believe that Assembly Bill No. 525 fills an important need and will have a beneficial impact on international trade and investment in California. We do have a few suggestions for changes in the bill (as amended on May 16, 1979).

CCIT recommends that the 80% test be eliminated from proposed Section 25101.9(a). We know of no particular reason for having such a test. The existence of the test will necessarily lead to lengthy regulations to provide precise rules to determine, among other things, to which geographic locations the factors are "attributable" and likely will result in nonproductive disputes between taxpayers and the Franchise Tax Board over arcane accounting issues. We believe that the purpose of increasing the investment of foreign capital in California can be better accomplished by eliminating such vestiges of the unitary system.

CCIT suggests that the bill simply state that a U.S. office or place of business of a foreign controlled foreign corporation will be treated as if it were a separate U.S. corporation, provided it keeps its own books and records. The bill should further provide that a U.S. corporation will not be required to take into account the income of related foreign controlled foreign corporations in a combined report. For this purpose, a U.S. branch or other place of business of a foreign corporation keeping separate books and records is considered to be a U.S. corporation and not a foreign

corporation. In a case where a foreign controlled foreign corporation has a U.S. place of business, but does nto maintain separate books and records for that place of business, its California tax liability should be determined on an apportionment basis. We believe this approach would accomplish the desired objective in a direct fashion without a need for lengthy interpretive regulations.

Proposed Section 25101.9(d) defines, to some extent, the term "energy business", but does not define "steel business". Assuming it is considered politically necessary to exclude the steel business from the provisions of AB 525, we believe some definition of what constitutes the steel business should be provided.

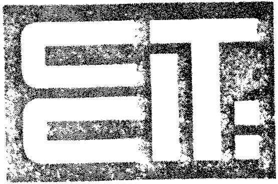
We suggest that the "principal activity" test be eliminated from proposed Section 25101.9(d) and that it provide instead that income from the proscribed business is excluded from the provisions of the bill. For example, assume a foreign oil company happens to control a chain of foriegn hotels and that, under the tests developed by the courts, the foreign hotel business would be deemed unitary with the oil business. We believe that the income of the foreign hotel business should not be subject to unitary apportionment simply because the "principal activity" of the controlling shareholder is the energy business.

We believe the inclusion of the phrase "in any day during the income year" in proposed Section 25101.9(e)(i) is unduly restrictive, unless the Section were to go an to provide that the income of such a corporation would be subject to unitary apportionment only for the portion of the year it was controlled by U.S. persons.

We find proposed Section 25101.9(e)(4) incomprehensible and recommend it be eliminated.

There are some foreign controlled firms in California which actually benefit from the unitary method of taxation as opposed to separate accounting. As a principal purpose behind AB 525 is to encourage foreign investment in California, we believe the bill should not discourage those foreign companies that would benefit from the unitary method. We recommend that the bill provide that a foreign controlled corporation may elect to compute its franchise tax liability under the unitary method in a combined return reporting worldwide operations. However, if the election is made, it would be binding on all future years and could not be revoked without the permission of the Franchise Tax Board. This would be somewhat analogous to the Federal rules on consolidated returns.

CCIT, as a representative of California international business, believes that encouragement of international commerce in this gateway state is one of the most vital economic objectives that can be pursued by California's elected and appointed officials. We believe AB 525, with the changes suggested above, can make an important contribution to that objective, and we urge its passage.



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November
15th
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OUR FILE NUMBER

11,999-8

Assembly Committee on Revenue and Taxation
California Legislature
Room 4016, State Capitol
Sacramento, California 95814

Re: A.B. 525

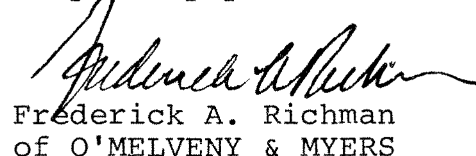
Dear Sirs:

Enclosed please find a statement by Alcan Aluminum Corporation in support of the above legislation.

We would appreciate it if you would make the enclosed statement a part of the record with respect to the hearings on A.B. 525 held on November 13-14, 1979.

Thank you for your consideration.

Very truly yours,



Frederick A. Richman
of O'MELVENY & MYERS

FAR:gs

Enclosure

cc: Assemblywoman Hughes

STATEMENT BY
ALCAN ALUMINUM CORPORATION
TO THE
ASSEMBLY COMMITTEE ON REVENUE AND TAXATION
REGARDING ASSEMBLY BILL 525
NOVEMBER 14, 1979

Alcan Aluminum Corporation hereby submits the following statement in support of AB 525 and requests that it be incorporated into and made a part of the Hearing held by the Assembly Committee on Revenue and Taxation on November 14, 1979.

Alcan Aluminum Corporation is a multistate business headquartered in Cleveland, Ohio, with 4,800 employees and assets in excess of $450 million. Its operations include 11 major fabricating plants, 24 metal service centers, 28 other service facilities for building products and other markets and a national network of sales offices. The company has fabricating establishments in California located at Berkeley and Buena Park. The company is a wholly-owned subsidiary of Aluminum Company of Canada, Ltd., which, in turn, is owned by Alcan Aluminium Ltd., of Montreal, Canada, both Canadian companies. Alcan Aluminium Ltd. in turn has subsidiaries throughout the world.

Alcan Aluminum Corporation's California tax liabilities for 1965-1971 have been determined by the Franchise Tax Board by applying the three-factor apportionment formula to the combined unitary income of the worldwide Alcan corporations. The legality of these assessments are currently before the California courts. Following is a summary of some of the facts in Alcan Aluminum Corporation's situation which illustrate what seems to be manifest unfairness in the application of a worldwide unitary combination.

Because Alcan Aluminum Corporation is a U.S. subsidiary of a Canadian parent corporation, the relationship between Alcan Aluminum Corporation and its related companies in Canada is subject to scrutiny by both the Internal Revenue Service and the Canadian Department of National Revenue. Under both the Internal Revenue Code and the Tax Convention between the United States and Canada, the relationship of related corporations must be at arm's length, and the taxing authorities of both countries are authorized to adjust the income or losses shown on the books of the corporations to reflect the income and losses which would be shown if the companies were entirely unrelated. The books of Alcan Aluminum Corporation have been in fact scrutinized by the Internal Revenue Service and the books of its parent company have been audited by the Department of National Revenue for all of the years in dispute with California.

The year 1969 can be used to illustrate the impact of the unitary tax on Alcan Aluminum Corporation. In that year, Alcan Aluminum Corporation sustained a loss in its United States operations. This loss was confirmed by the Internal Revenue Service after auditing the Company under the arm's length standard of the Internal Revenue Code. Nevertheless, by applying the three-factor formula against the worldwide income of the Alcan group, the Franchise Tax Board determined that Alcan Aluminum Corporation actually had income from California alone of $3.3 million, and the Board levied a tax for that year of approximately $229,000. In other words, even though Alcan Aluminum Corporation sustained

a loss in the United States in 1969, a loss confirmed by audit of the Internal Revenue Service, the Franchise Tax Board determined that the Company actually had $3.3 million in income from California alone. The Board was able to do this by applying its formula not against Alcan Aluminum Corporation's income or loss, but against the profitable operations of other Alcan corporations operating totally outside the United States, most having no operational connection with Alcan Aluminum Corporation whatsoever. It is clear that such a tax is levied on income earned not only outside California but outside the United States as well.

Given such a system of taxation, Alcan Aluminum Corporation obviously must consider the fact that any investment it makes in California may substantially increase its California tax liability far beyond the income shown on its own properly kept books and records. That fact is a substantial impediment to any increased investment in California and, indeed, operates as an incentive to locate operations elsewhere. In that connection, Alcan Aluminum Corporation recently closed two major plants in Riverside and Rocklin, California. While California taxes were not the only factor involved in those decisions - in any business decision there are always numerous factors involved, and no one factor is determinative - the California tax savings were one of the factors considered.

The trend of Alcan's California employment reflects the business decisions that were made to withdraw from the

State. The Company's California employment peaked in 1969 with 1,300 employees but has steadily declined since then. Presently, the Company's California employees number about 200.

The above illustration provides ample evidence that the unitary income concept is discriminatory and inherently unfair to U.S. subsidiaries of foreign-based corporations and places a particularly heavy and disproportionate tax burden on Companies such as Alcan Aluminum Corporation. We, therefore, urge the members of the Assembly Committee on Revenue and Taxation to support AB 525 which will exclude certain foreign-based corporations from unitary combinations.

The Company appreciates the opportunity to present its views to the Committee.

Alcan Aluminum Corporation

November 14, 1979