Golden Gate University School of Law
GGU Law Digital Commons

California Assembly | California Documents

11-1979

Background Information On California's Bank and Corporation Tax Volume II: Unitary Method of Apportionment

Assembly Revenue and Taxation Committee

Follow this and additional works at: http://digitalcommons.law.ggu.edu/caldocs_assembly

Part of the Legislation Commons, and the Taxation-State and Local Commons

Recommended Citation

Assembly Revenue and Taxation Committee, "Background Information On California's Bank and Corporation Tax Volume II: Unitary Method of Apportionment" (1979). *California Assembly.* Paper 460.
http://digitalcommons.law.ggu.edu/caldocs_assembly/460

This Committee Report is brought to you for free and open access by the California Documents at GGU Law Digital Commons. It has been accepted for inclusion in California Assembly by an authorized administrator of GGU Law Digital Commons. For more information, please contact jfischer@ggu.edu.

BACKGROUND INFORMATION ON

CALIFORNIA'S
BANK AND CORPORATION TAX

Volume II

UNITARY METHOD OF APPORTIONMENT

Prepared by Staff of the

ASSEMBLY REVENUE AND TAXATION COMMITTEE

WILLIE L. BROWN, Jr.
Chairman

INTERIM HEARING
November 1979
Los Angeles

KFC
875.A8
C34
v.2

No. 750

KFC
875.A8
C34
v.2

79-11-328

LAW LIBRARY
GOLDEN GATE UNIVERSITY

TABLE OF CONTENTS

Page

A. Preface 1

B. Brief Summary of Major Issues 2

C. Overview of Present Law 3

D. Text--Uniform Division of Income for Tax Purposes Act 7

E. Text--AB 525 (Hughes) as amended September 14, 1979 11

F. "The Unitary Method" -- Material furnished by Martin Huff, Executive Officer, California Franchise Tax Board 19

I Significance of the Unitary Method 20

II Introduction to the Unitary Method - Slide Presentation 21

III Summary of the Unitary Method 28
- A. Formula Apportionment
- B. Combined Report
- C. Business-Nonbusiness Income

IV Section 25137 California Revenue and Taxation Code 31
- A. Requirements to Invoke Section
- B. Special Industry Formulae
- C. Special Business Relationships
- D. Individual Taxpayers

V Multistate Tax Commission 37

VI Conduct of a Unitary Audit 38
A. Income and Factors
B. Determination of a Unitary Business

VII Comparison of Unitary Method with the Federal System 42
A. Federal Concept and Requirements - Residency
B. State Concept and Requirements - Source
C. Increasing Federal Concern with Source
E. Federal Studies

VIII Recent Court Decisions 48
A. U.S. Steel Corp. v. MTC
B. Moorman Manufacturing Co. v. Bair
C. Japan Live Ltd. v. Los Angeles
D. Mobil Oil v. Vermont
E. Dept. of Revenue v. ASARCO
F. ASARCO v. Idaho Tax Commission

IX Pending California Cases 54
A. Worldwide Combination - Domestic Parent
1. Anaconda v. FTB
2. Container Corporation of America v. FTB
3. Firestone Tire & Rubber v. FTB
B. Worldwide Combination - Foreign Parent
1. Beecham v. FTB
2. Capitol Industries - EMI v. Bennett
C. Treatment of Dividend Income - Times-Mirror v. FTB
D. Discrimination for Foreign Commerce - Zee Toys v. Los Angeles

X Current Issues 58
A. Worldwide Combination
1. Historic Background
2. Views on Unitary Method
3. Compliance Burdens
4. Federal Attitude on State Diversity
5. Discrimination For Foreign Activities
B. Business-Nonbusiness Income
1. California Position on Dividends
2. MTC Position on Dividends
3. Effect of California Following MTC
C. Determination of Unitary Business
1. Court Tests
2. MTC Regulations
3. Ruling Program
D. Disincentive to Business Investment
1. Study of California Anecdotes
2. Factors Influencing Location of Facilities
3. State Taxes as a Factor in Investment Decisions
4. Empirical Evidence

XI Federal Legislation 77
A. General Statement of States' Position
B. Historical Perspective
1. General Corporations
2. Banks
C. Current Federal Proposals
D. Trends in Federal Proposals
E. NATA Position on Federal Legislation

XII State Legislative Proposals 91
A. AB 525 (Combination)
B. AB 916 (Dividend Apportionment)
C. AB 472 (Intrastate Combination)

XIII Revenue Impact 95
A. AB 525
B. AB 916
C. AB 472

XIV Exhibits 107

1. Incidence of Bank and Corporation Tax 109

2. CCH - All States Tax Reporter 113

3. Court Decisions Supporting Unitary Method 115

4. List of Special Formulae Continued Upon Adoption of UDITPA 120

5. Copies of Special Formulae Adopted Under UDITPA 122

6. MTC Proposed Formula for Railroads 165

7. Legal Ruling 413 172

8. Proposed Guideline for the Preparation of Combined Returns which Include Foreign Country Operations 176

9. Regulation Section 25137(g) 184

10. Statement of the Franchise Tax Board Pertaining to Section 25137 Petitions 186

11. List of Membership of Multistate Tax Compact and Associate Members 189

12. "Recommendation of the Task Force on Foreign Source Income" Committee on Ways and Means U.S. House of Representative 1977, pp 25-30 191

13. "The President's 1978 Tax Program" - Detailed Descriptions and Supporting Analyses of the Proposals (1978), pp 282-297 198

Exhibits (continued)

14. General Accounting Office Questionnaire and California Responses 216

15. "Multinational Corporations and Income Allocation Under Section 482 of the Internal Revenue Code"89 Harvard 1202 (1976) 234

16. Synopsis of Recent Important Cases 273

17. Cases Involving the Unitary Concept to which California is a Party 281

18. Zee Toys, Inc. v. County of Los Angeles 284

19. Bass, Ratcliff & Gretton v. State Tax Commissioner 307

20. Keesling, "A Current Look at the Combined Report and Uniformity in Allocation Practices," The Journal of Taxation, February, 1975 312

21. Multistate Tax Commission Resolution 318

22. The U.K./U.S. Tax Treaty - A Detailed Reappraisal 320

23. Musgrave, "The U.K. Treaty Debate: Some Lessons for the Future," Tax Notes July 10, 1978 326

24. Cal. Admin. Code, title 18, Regulation §25120(c) 330

25. Multistate Tax Commission Regulation, Regulation IV 1.(c)(4) 335

26. U.S. Treasury Study - Business - Nonbusiness Income 338

27. Cal. Admin. Code, title 18, §25120(b) 357

28. Ryder,"The Disincentive to Investment: A Groundless Argument Against the Unitary Method of Taxation" 360

29. Wall Street Journal, April 6, 1978, p 4 374

31. Excerpts from Library of Congress Study 376

32. Pp 63-66, Lou Harris Study 388

33. Vaughan, State Taxation and Economic Development Excerpts 395

34. Federal Interstate Tax Legislation 411

Exhibits (continued)

35. Detailed Analysis of Title III, SB 2173, 95th Congress 419

36. NATA Position Paper on the Interstate Taxation of Business 439

G. Selected Statements in Opposition to Present California Apportionment 444

I. Statements Made at Franchise Tax Board Hearing on April 17, 1978 445

A. Roy E. Crawford, Counsel for Lever Brothers Company 445

B. Josef P. Condrau, Union Bank of Switzerland 463

II. Statements Made at Hearings Before the Committee of the Judiciary of the U.S. Senate on December 20, 1978

A. Dennis Amundson, Deputy Director, California Department of Economic and Business Development 471

B. Franklin C. Latcham, Attorney, San Francisco 472

C. Valentine Brookes, Representing Chase Brass Company 478

D. Mark Ancel, Attorney, Los Angeles 486

H. "California Franchise Tax: Combined Income Report Affects Foreign Companies." Article in Journal of Taxation, March, 1976, by Robert A. Peterson 490

I. "Attacks Intensify on State Taxation of Multi-Nationals"-- Tax Notes, November 3, 1979 496

PREFACE

This report is Volume II of a two-volume series of reports, prepared by the staff of the Assembly Revenue and Taxation Committee, on the California Bank and Corporation Tax. This volume is devoted to the unitary method of apportioning income, and consists of a overview of the unitary method and significant issues before the Committee. Additional background information is furnished by Martin Huff, Executive Officer of the Franchise Tax Board, and the proponents of AB 525 (Hughes). These source materials are so identified and are reproduced in their entirety without further comment (yellow and buff-colored pages).

(Volume I provides an overview to the Bank and Corporation Tax itself, comparison of the differences between state and federal law, and an indepth analysis of four proposals: (1) carry-over/carryback of net operating losses, (2) graduated tax rates, (3) investment tax credit, and (4) "subchapter S".)

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

BRIEF SUMMARY OF MAJOR ISSUES

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

2. If not, what is a better way? How will these alternatives work?

3. Should there be differences in the formula for foreign-based corporations? Are there constitutional problems with such differences?

4. What are the fiscal ramifications of change? If there is a revenue short-fall, to whom should the tax burden be shifted?

5. What are the economic impacts of any change? What is the impact on investment incentives? What is the impact on agriculture and ownership of agricultural property?

OVERVIEW OF PRESENT LAW

Uniform Division of Income for Tax Purposes Act

California determines the business income of multi-national corporations subject to the state corporate tax by a three-factor apportionment formula -- of property, payroll and sales in California compared to world-wide property, payroll and sales. (There are some special formulas and exceptions, however.)

All corporations whether created or organized in a foreign country or in the United States are now treated similarly under unitary business principles applied by California.

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

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

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

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

EXAMPLE - MYTHICAL CORPORATION

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

Total world-wide income of Corp- $5,000,000

Income allocable to California

$5,000,000
X 11.6666%
$583,300

California Tax

- California Income $583,300
- Rate x 9%

$52,497

Section 25137 permits variation from the standard allocation and apportionment provisions when they do not fairly represent the extent of the taxpayer's business activity in this state. Approaches listed include adding factors to or excluding factors from the standard three-factor apportionment formula and separate accounting. However, California courts have held that separate accounting cannot be used to determine the income derived from California by a taxpayer from unitary business activity. The separate accounting exception of Section 25137 is applicable only to those parts of an organization's business which are not unitary with other activities.

Under California law, interst and dividends received from non-unitary subs are treated as follows:

- California corps. - all allocated to California, however, they may be excluded if from income which is subject to California tax or from insurance company subject to gross premiums tax.

- Non-California domiciled corps. - not subject to California tax

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

"Unitary Tax"

Most of the recent discussion about the "unitary tax" has actually been a discussion about the appropriateness of "world-wide combinations" as opposed to a "U.S.A. combination" in the formula for determining taxable income.

Supporters of world-wide combination cite the potential of tax avoidance by "non-arms length" transactions among subsidiaries, thus transferring ostensible profit centers out of the country. They argue that "separate accounting," which is the most frequently suggested alternative, is not working well at the federal level and would be impossible for a state to enforce without an army of auditors.

Critics of world-wide combination cite inequities created by comparing as equal California economic factors with those in less-developed countries. The result, they contend, gives California an inordinate share of income. The critics also stress the adverse impact on the business climate in those situations where a new plant has significant start-up costs. In such situations, the plant adds to California's percentage of property and will give California a much larger share of over-all company profits, even though it may be operating at loss due to start-up costs.

Fiscal Implications

According to the Franchise Tax Board, approximately 72% of the net income reported for bank and corporation tax purposes is attributable to apportioning corporations and approximately 50% of net income is attributable to multi-national corporations, for the 1975 income year.

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

Multi-national corps ----	$1,200,000,000
Multi-state corps -------	528,000,000
California only corps ---	672,000,000
	$2,400,000,000

It is difficult to estimate the impact of any potential change in the unitary approach on state revenue. The last study made by the Franchise Tax Board was based on unaudited 1974 income year figures. To develop accurate up-to-date estimates would require a major investment of time and money.

If, as has been reported in the press by some major corporations, that overseas profits are relatively larger with respect to the three factors than U.S.A. profits, the revenue loss to the State of California from a "water's edge" apportionment could be substantial.

Prepared by David R. Doerr, October, 1979.

Article 2. Uniform Division of Income for Tax Purposes Act

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

(a) Separate accounting;

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

AMENDED IN ASSEMBLY SEPTEMBER 14, 1979

AMENDED IN ASSEMBLY MAY 16, 1979

CALIFORNIA LEGISLATURE—1979–80 REGULAR SESSION

ASSEMBLY BILL No. 525

Introduced by Assemblymen Hughes and Mori

February 12, 1979

REFERRED TO COMMITTEE ON REVENUE AND TAXATION

An act to add Sections 25101.9 and 25137.5 to the Revenue and Taxation Code, relating to taxation, to take effect immediately, tax levy.

LEGISLATIVE COUNSEL'S DIGEST

AB 525, as amended, Hughes (Rev. & Tax.). Bank and Corporation Tax Law: unitary business.

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

This bill would provide that in determining the income subject to tax of a bank, corporation or other entity, there shall not be taken into account the income and apportionment factors of any other bank, corporation or other entity, if such bank, corporation, or other entity is (1) created or organized under the laws of a foreign country, and (2) not owned and controlled by a United States corporation or residents of the United States and (3) has more than ~~80%~~ *50%* of its operations outside of the United States, its political subdivisions, territories, or possessions, or the Commonwealth of Puerto

97 30

Rico *as determined by the financial statements prepared by such entity in accordance with the generally accepted accounting principles of its country of origin.*

Corporations engaged in the energy business and the steel business are excepted from the provisions of the bill.

This bill would take effect immediately as a tax levy.

This bill would provide that if any provision of this act is held invalid, such invalidity shall not affect other provisions of the act which can be given effect without the invalid provision.

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

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

1 ~~SECTION 1. The Legislature finds that it is desirable~~
2 ~~to increase the investment of foreign capital in this state~~
3 ~~in order to stimulate the creation of new opportunities~~
4 ~~for employment and to stimulate the diversification of~~
5 ~~the economic base of this state. The Legislature further~~
6 ~~finds that the inclusion of foreign income in determining~~
7 ~~the tax liability of foreign economic interests wishing to~~
8 ~~invest in California has acted as an impairment to~~
9 ~~investment. Therefore, the Legislature hereby declares~~
10 ~~that, with specified exceptions, the method of~~
11 ~~determining the business income subject to taxation for~~
12 ~~eligible corporations should not normally include~~
13 ~~business income derived from, or attributable to, sources~~
14 ~~outside of the United States, District of Columbia, the~~
15 ~~Commonwealth of Puerto Rico, any territory or~~
16 ~~possession of the United States, or any political~~
17 ~~subdivision thereof.~~
18 *SECTION 1. The Legislature finds that generally*
19 *accepted accounting methods in general use by foreign*
20 *based taxpayers are materially different from accounting*
21 *methods used by United States based taxpayers, and*
22 *income statements prepared under foreign accounting*
23 *standards are not readily converted to income statements*
24 *based on the California Bank and Corporation Tax Law.*
25 *The Legislature further finds that many unresolved*

1 *problems have arisen in accounting for changes in*
2 *foreign exchange rates, both in determination of income*
3 *and in constructing apportionment data of foreign based*
4 *taxpayers, on a basis consistent with that used to*
5 *determine income earned in California by United States*
6 *taxpayers. The Legislature further finds that the cost*
7 *burden of converting income statements of foreign based*
8 *taxpayers to income statements more comparable to*
9 *those of United States based taxpayers is often*
10 *substantially greater than any resulting tax on income*
11 *considered to be earned in California. The Legislature*
12 *further finds that the inclusion of foreign income in*
13 *determining the tax liability of foreign economic*
14 *interests wishing to invest in California has frequently*
15 *resulted in unfair taxation of foreign based taxpayers and*
16 *consequently acted as an impairment to investment and*
17 *hindered the creation of new opportunities for*
18 *employment and the diversification of the economic base*
19 *of this state. Therefore, the Legislature hereby declares*
20 *that, with specified exceptions, the methods of*
21 *determining the business income subject to taxation of*
22 *eligible corporations should not normally include*
23 *business income derived from, or attributable to, sources*
24 *outside of the United States. The Legislature also finds*
25 *that United States based corporations may experience*
26 *similar distortions in accounting for operations*
27 *conducted outside the United States, and affirms that in*
28 *appropriate circumstances the separate accounting*
29 *method may be used by the Franchise Tax Board and by*
30 *taxpayers in accounting for foreign operations.*
31 SEC. 2. The Legislature further finds and declares
32 that the energy business is not included under the
33 provisions of this act as, in general, the entities that such
34 businesses control are established by geographical and
35 political boundaries, rather than functional operations,
36 for purposes not related to basic economics of the market.
37 SEC. 3. Section 25101.9 is added to the Revenue and
38 Taxation Code, to read:
39 25101.9. (a) Notwithstanding any other provision of
40 this chapter, in determining the income subject to tax of

1 any ~~organization~~ *bank, corporation, or other entity* liable
2 to report under this part, there shall not be taken into
3 account the income ~~derived from, or attributable to,~~
4 ~~sources within any foreign country or political~~
5 ~~subdivision thereof, by method of apportionment or use~~
6 ~~of any other method, for any organization which:~~ *of any*
7 *other bank, corporation, or other entity if such other*
8 *bank, corporation, or other entity:*
9 (1) Is created or organized under the laws of a foreign
10 country; and
11 (2) Is not owned or controlled by a United States
12 corporation or residents of the United States; and
13 (3) Has more than ~~80~~ *50* percent of the average of its
14 property, payroll, and sales factors during the income
15 ~~year attributable to locations outside of the United States,~~
16 ~~its political subdivisions, territories, or possessions, or the~~
17 ~~Commonwealth of Puerto Rico.~~ *year as determined by*
18 *the financial statements prepared by such entity in*
19 *accordance with generally accepted accounting*
20 *principles, including the rules of company consolidation,*
21 *of its country of origin and converted to United States*
22 *dollars as of the last day of its income year, attributable*
23 *to locations outside the United States.*
24 *(b) For purposes of this section, the activities*
25 *conducted within or directed from the United States by*
26 *any bank, corporation, or other entity meeting the*
27 *conditions set forth under paragraphs (1), (2), and (3) of*
28 *subdivision (a) shall be deemed to be conducted by a*
29 *separate bank, corporation, or other entity which does*
30 *not meet such conditions, and except as provided for in*
31 *subdivision (c), any such bank, corporation, or other*
32 *entity shall be subject to the tax measured by the income*
33 *from sources within this state as determined by formula*
34 *apportionment based upon its books and records.*
35 ~~(b)~~
36 *(c)* Any ~~organization~~ *bank, corporation, or other*
37 *entity* meeting the conditions *set forth under paragraphs*
38 *(1), (2), and (3)* of subdivision (a) and which *under the*
39 *laws of the state* maintains the assets of its California
40 business entirely separate and apart from the assets of its

business outside California as though it were a separate corporation and which keeps separate books of account and separate records for its California business, shall be subject to tax measured by its income from sources within this state as determined from its separate books of account.

~~(c) This section shall not preclude the inclusion of the income and use of apportionment factors of any organization, created or organized under the laws of the United States, its political subdivisions, territories, or possessions, or the Commonwealth of Puerto Rico, or of any enterprise or subsidiary, wherever created or organized, which is owned or controlled by such organization.~~

(d) This section shall not apply in determining the income allocable to this state from a unitary business whose principal activity is the energy business or the steel business. For the purpose of this subdivision, the term "energy business" means operations pertaining to the obtaining, processing, or marketing of a source of energy, including exploring, discovering, developing, mining, drilling, processing, manufacturing, treating, transporting, refining, producing, acquiring, managing, marketing, or researching in connection with any energy source such as coal, oil, petroleum products, natural gas, and uranium, but does not mean operations pertaining to the following alternative energy sources: solar, geothermal, coal gasification, wind, biomass, and photovoltaic.

~~(e) The following rules shall apply for purposes of this section:~~

~~(1) Direct or indirect ownership or control of more than 50 percent of the voting stock or similar control in any day during the income year shall constitute ownership or control.~~

~~(2) A bank or corporation owns or controls another bank or corporation if it either directly or indirectly owns or controls it, or if any third person or persons (related to each other or acting together) own or control both.~~

~~(3) If corporations, entities, or persons, related to each~~

1 ~~other or acting together, own or control (directly or~~
2 ~~indirectly) a corporation, it shall be treated as owned or~~
3 ~~controlled by a United States corporation or residents of~~
4 ~~the United States if a majority of the voting power of such~~
5 ~~control group is held by United States corporations or~~
6 ~~residents of the United States.~~
7 ~~(4) For the purposes of this section, voting stock or~~
8 ~~similar control shall be attributed to a resident of the~~
9 ~~United States or to a United States corporation if a~~
10 ~~shareholder who is a resident or a corporation which has~~
11 ~~its commercial domicile in the United States owns or~~
12 ~~controls another bank, corporation, or similar entity,~~
13 ~~wherever located, or if such bank, corporation, or similar~~
14 ~~entity is a member of the same group comprised of one~~
15 ~~or more corporate members connected through stock~~
16 ~~ownership with a common owner, which may be either~~
17 ~~corporate or noncorporate, in the following manner:~~
18 ~~(A) More than 50 percent of the voting stock of each~~
19 ~~member other than the common owner is owned directly~~
20 ~~by one or more of the other members; and~~
21 ~~(B) More than 50 percent of the voting stock of at least~~
22 ~~one of the members other than the common owner is~~
23 ~~owned directly by the common owner.~~
24 *(e) For purposes of this section, direct or indirect*
25 *ownership or control of more than 50 percent of the*
26 *voting stock shall constitute ownership or control.*
27 (f) The following definitions shall apply for the
28 purposes of this section:
29 (1) The term "organization" means *a* bank,
30 corporation, ~~or other entity or any other bank,~~
31 ~~corporation, or other entity which is owned or controlled~~
32 ~~by it if such owned or controlled bank, corporation, or~~
33 ~~other entity meets the conditions of this section.~~ *or other*
34 *entity.*
35 (2) The term "residents of the United States" means
36 residents of the United States, its territories, or
37 possessions, or the Commonwealth of Puerto Rico.
38 (3) The term "United States corporation" means a
39 bank, corporation, or other entity organized under the
40 laws of the United States ~~, its political subdivisions,~~

97 150

1 ~~territories, or possessions, or the Commonwealth of~~
2 ~~Puerto Rico.~~
3 ~~(4) The definitions set forth in Section 25120 shall be~~
4 ~~applicable to this section~~ .
5 (g) Nothing in this section shall preclude the
6 Franchise Tax Board from distributing, apportioning, or
7 allocating gross income, deductions, credits, or
8 allowances between or among organizations, trades, or
9 businesses, if it determines that it is necessary to do so in
10 order to prevent evasion of taxes or clearly to reflect the
11 income of any of such organizations, trades, or businesses.
12 SEC. 4. Section 25137.5 is added to the Revenue and
13 Taxation Code, to read:
14 25137.5. Section 25137 shall be interpreted to permit
15 separate accounting or the application of the allocation
16 and apportionment provisions set forth in this part, or any
17 other method of allocation and apportionment
18 authorized by Section 25137, to only that portion of a
19 taxpayer's unitary business done in this state, or to only
20 that portion of a taxpayer's unitary business done in this
21 state, any other state of the United States, the District of
22 Columbia, the Commonwealth of Puerto Rico, and any
23 territory or possession of the United States, where the
24 requirements of such section are otherwise met, and
25 where the records maintained by the taxpayer are
26 sufficient to permit a reasonable determination by the
27 use of such method of taxpayer's net income derived
28 from, or attributable to, sources within this state.
29 Enactment of this section shall be construed as a
30 clarification of Section 25137 without any inference that
31 a change in interpretation is implied by such enactment.
32 SEC. 5. This act provides for a tax levy within the
33 meaning of Article IV of the Constitution and shall go into
34 immediate effect. However, the provisions of this act
35 shall apply in the computation of taxes for income years
36 beginning on or after January 1, 1979.
37 *SEC. 6. If any provision of this act or the application*
38 *thereof to any person or circumstances is held invalid,*
39 *such invalidity shall not affect other provisions or*
40 *applications of the act which can be given effect without*

97 180

1 *the invalid provision or application, and to this end the*
2 *provisions of this act are severable.*

O

97 180

"THE UNITARY METHOD"

MATERIAL FURNISHED TO THE

ASSEMBLY REVENUE AND TAXATION COMMITTEE

BY

MARTIN HUFF

EXECUTIVE OFFICER

FRANCHISE TAX BOARD

OCTOBER 1979

SIGNIFICANCE OF THE UNITARY METHOD

The Bank and Corporation Tax Law of California resulted in the collection of approximately $2.4 billion in fiscal 1978/79. In 1977, the department prepared a study reflecting the incidence of the corporate franchise and income tax burden. Only 15.6% of corporations filing with California had income from sources both within and without state but such corporations reported 72.1% of the income attributed to California sources. These are the corporations to which the unitary method applies.

Of the apportioning corporations, 35.3% were multinational in nature and reported approximately 1/2 of the total income reported to California under the corporate franchise and income tax. (Exhibit 1) These are the corporations most directly interested in the various limitations on the unitary concept which are being suggested.

"California and the Unitary Method"

Slide Show

Currently, 44 states and the District of Columbia impose either a corporate income tax, a corporate privilege tax measured by net income, or 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, 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 simply states that "doing business" means actively engaging in any transaction for the purpose of financial or pecuniary gain or profit.

A foreign corporation which maintains a stock of goods in the state and makes deliveries in this state pursuant to orders taken by employees in this state is "doing business. . ."

The second chapter of taxation under California law is the corporate income tax. This law was enacted in 1937 and imposes a tax on all general corporations which, while not doing an intrastate business in California, derive income from sources within California.

The corporate income tax was enacted to complement 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 Co. v. Minnesota and Williams v. Stockham Valves and Fittings, Inc., that individual states had broad jurisdiction to tax corporations on net income derived from interstate commerce.

Basically, Public Law 86-272 exempts from tax, under limited conditions, the 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 state. 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 receipts from the business conducted by the two operations in the state, deduct the direct and indirect expenses to arrive at the net income attributable to 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 operations 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 the Oregon activity 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 attributed 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 plant in Oregon.

This would be accomplished by having the Oregon manufacturing plant pass its product 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 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 derivative of the unitary business concept.

The unitary concept got its start from the property tax laws. It first arose in the "unit" rule which was developed in the case of Union Pacific Railway Co. v. Cheyenne. In this case, the court held that a 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 a 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 principal cities throughout the United States, including San Francisco.

The corporation had a central buying division which made volume purchases at favorable prices for the entire business. The corporate overhead expense, executive salaries, and central buying and advertising expenses were allocated to the 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 this state is truly separate and distinct from its business without this 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 done 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 undertaxation to the state.

The next major case involving the unitary concept was the case of Edison California Stores, Inc., v. McColgan. In this case, the court established the other major test to determine a unitary business, which is 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 policy 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 v. 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 the income. This resulted in $1,135,061 of income being apportioned to California.

The Franchise Tax Board took the position that income is to be apportioned only when the operations within and without the state are "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 an 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 the "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 is to be composed of factors made up of the various elements of the business which fairly attribute a portion of the business income derived from or attributable to sources within a 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 the 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 rented real and tangible personal property used in the trade or business.

2. Wages, salaries, and other forms of remuneration paid 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 nonbusiness income.

Business income is apportioned to this state by use of the formula described above. Nonbusiness income is allocated to a particular state pursuant to set rules.

Bank and Corporation Tax Law Section 25120(a), 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(d), Uniform Division of Income for Tax Purposes Act, Section 1(c), defines nonbusiness income as follows: "Nonbusiness 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 nonbusiness income.

Accordingly, the critical element in determining whether income is "business income" or "nonbusiness 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. . ."

Summary of the Unitary Method

As we have shown in the slide presentation, California assesses a tax on corporations which do business or have income from sources both within and without California solely on the basis of their income from California sources.

In making the determination as to what portion of a corporation's income is derived from California sources, California uses what is usually called the unitary method. There are two basic elements to the unitary method. The first involves the use of formula apportionment and the second the use of the combined report. Most other states use the same approach, but frequently restrict the application of the concept to single corporations.

Formula apportionment is used by all of the states (45 in number) which assert an income tax or a tax measured by income./[1] The California law, as originally drafted in 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 other factors. Over a period of time, the majority of the states concluded that property, payroll, and sales were generally the most appropriate factors. This is 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 (UDITPA) which incorporated the standard three-factor formula.

UDITPA was adopted by California in 1966 effective for all income years beginning after December 31, 1966. The UDITPA has been adopted by approximately 26 states and its provisions are closely followed by most other states. (Exhibit 2) There are several states which have adopted variations from the standard three-factor formula by providing that the sales factor carries a greater weight in the apportionment formula or by utilizing a two-factor or single-factor formula. Under the combined report concept, the separate corporate elements of a unitary business are required to prepare a single report which cumulates the results of their individual activities [Edison California Stores v. McColgan /[2]] and assigns the appropriate portions of profit or loss to the individual corporate elements and geographic areas on the basis of the apportionment formula.

The states vary greatly in the extent to which they utilize the combined report concept. Some use it not at all, others use it selectively to maximize revenue, some use it most of the time, and California uses it at all times. The acceptance and use of the combined report is growing. There are presently 21 states with judicial precedent authorizing or requiring combined reporting and there are several other states which require it even though the concept has not been ruled upon by their courts. (Exhibit 3) It is the department's position that equitable tax administration requires use of the combined report concept for all taxpayers. Furthermore, the California Supreme Court has mandated the use of the combined report. Honolulu Oil Corp. v. FTB and Superior Oil v. FTB./[3] Based on these decisions, neither the Franchise Tax Board nor its staff can either require or allow a taxpayer to file anything other

than a combined report and use formula apportionment if a unitary business is involved.

An important element of the unitary method is the distinction between business and nonbusiness income. Business income means income arising from the regular course of the taxpayer's trade or business. This income is subject to formula apportionment. Nonbusiness income is all other income and specifically assigned or allocated to jurisdictions. Many people argue that a corporation cannot have nonbusiness income./[4] They state that all of a corporation's activities are directed to the earning of income and all income earned should be business income. Perhaps rather than calling such income nonbusiness income, it should more properly be referred to as "investment income" or "unrelated income." In any event, the California courts and the State Board of Equalization in several areas have drawn precise lines between what constitutes business and nonbusiness income. For example, a subsidiary and a parent corporation are engaged in a unitary business. The income of the subsidiary is included in the combined report of the parent and is business income. Dividends paid by the subsidiary or gain or loss on the sale of the subsidiary's stock is nonbusiness income./[5] These decisions of the California courts were ratified by the Legislature in adopting the UDITPA and in joining the Multistate Tax Compact./[6]

Section 25137

The draftsmen of the UDITPA realized that the standard three-factor formula would not always reach the proper result. Deviations from the standard three-factor formula are permitted upon petition by the taxpayer or when required by the Franchise Tax Board when it is established that the standard provisions of the act "do not fairly represent the extent of the taxpayer's business activity in this state."/[7]

The California State Board of Equalization has considered a number of situations in which either the taxpayer or the department has sought a variance from the standard formula./[8] The State Board of Equalization has held that variances are only to be allowed in exceptional circumstances and that the party seeking the variance has the burden of proving that such exceptional circumstances are present./[9]

In administering the law prior to the enactment of the UDITPA, the department had developed a number of special apportionment formulae for specialized industries. When the UDITPA was enacted, the department determined that in almost all instances the circumstances which warranted special industry treatment under earlier law also supported special treatment under the UDITPA. The department therefore announced that the special industry formulae would be continued, with certain modifications to conform to the UDITPA, until revised formulae could be devised. (Exhibit 4)

Formulae for special industries are generally developed in consultation with various members of the affected industry and representatives from both the tax bar and accounting firms. The state adopts a neutral position in developing such formulae since, in almost every instance, both in-state and out-of-state taxpayers will be affected. In addition, because of California's preeminent position in the development of the unitary theory, regulations and practices adopted by California are frequently followed by the other states. One of the purposes of the UDITPA is to promote uniformity among all the states and the adoption of identical special industry rules furthers this purpose and assures taxpayer compliance.

To date, special formulae (Exhibit 5) have been adopted for the following industries:

1. Banks and Financials
2. Construction Contractors
3. Motion Picture and Television Producers and Networks
4. Franchisors
5. Air Transport
6. Commcercial Fishing

Currently, nearing completion in conjunction with the Multistate Tax Commission is a formula for railroads. (Exhibit 6) Work is progressing for formulae for other industries.

As part of the process for developing special formulae, it has been the general practice of the department to issue the formulae as guidelines after they are developed in concert with the affected industry. After several years' experience with the formulae as a guideline, problems can be identified and corrected. The guidelines then will normally be adopted as formal regulations.

The second area in which Section 25137 has importance is in the area of special situations or special business relationships. Two examples of these type situations are the use of partnerships and the election of installment sale treatment.

Special rules are required for partnerships because of their special characteristics for tax purposes. In many respects, a partnership is treated as a separate business entity with its own accounting period and elections but in other respects it is ignored for tax purposes and whatever activities it carries on are attributed to the individual partners. A regulation has been adopted under Section 25137 to set forth the rules for handling partnerships./[10]

Installment sales may present unique problems for the application of the UDITPA because frequently there will be significant differences in the apportionment percentages of the taxpayer for the year of the sale and the year in which the income is reported. For example, in year 1, a taxpayer sells off all of its business assets in Colorado. At the time of the sale, the taxpayer's California apportionment percentage was 50%. No income is reported in year 1 under the installment sale election. In years 2 and 3, the taxpayer reports 30% and 70% of its gain, respectively. The

California apportionment percentage is 90% for each year. A much greater portion of the taxpayer's income is treated as California source than would have been reported if no installment sale election was made. The Board ruled in a similar situation that the apportionment percentage of the year of sale (year 1) should be utilized to apportion the gain realized on the sale and reportable in years 2 and 3. The staff has issued a Legal Ruling indicating it will follow the Board's determination in similar cases. (Exhibit 7)

A third example of special circumstances requiring detailed rules with deviations from federally permissible tax accounting procedures involves foreign operations.

The department is currently preparing a Guideline setting forth rules for the preparation of combined reports including foreign operations. (Exhibit 8) The necessity for such rules requiring the use of specific accounting methods has arisen with advent of floating currencies. Several accounting treatments acceptable for financial reporting purposes are inappropriate for unitary theory.

Another example of where Section 25137 has been applied to deviate from the standard rules of UDITPA was considered by the Board of Equalization in the Appeal of Pacific Telephone & Telegraph Co./[11] where the Board held that gross receipts from the trading and management of the taxpayer's temporarily idle working capital should be excluded from the receipts factor because it carried a greater weight in the formula than was warranted. The holding was

against the Pacific Telephone & Telegraph Co., but is of major advantage to organizations in which the parent is domiciled in California.

The third possible area for the application of the relief provisions of Section 25137 is with respect to individual taxpayers.

It is the staff's view that rulings in favor of the petition of individual taxpayers should be granted in only the most exceptional circumstances. The UDITPA was adopted to promote uniformity in the states' treatment of taxpayers. Action on the petitions of individual taxpayers defeats uniformity in two respects. First, it must almost inevitably result in different treatment for taxpayers with basically identical factual situations. Second, it destroys uniformity among the states in that no two states are likely to view the petition of a single taxpayer in the same light or, even more likely, a taxpayer will petition for a variance only in those states where it will receive a tax reduction from a favorable ruling on its petition.

In February of 1978 the Franchise Tax Board adopted Regulation Section 25137(g) which provides that in those cases deemed appropriate by the Board, it will grant a hearing on petitions, provided the taxpayer waives the confidentiality provisions, and shall hear and decide the petitions in open session. (Exhibit 9)

A number of petitions have been presented to the Board or discussed with them. In most cases, the Board has determined that it did not wish to hear the petition. Among reasons given for not hearing petitions is the petitioner's failure to supplement the

original petition or provide requested information and a determination by the Board that the material presented did not establish even a prima facie case that the standard formula did not properly reflect the petitioner's activities within the state. (Exhibit 10) The Board has granted hearings on 3 petitions./[12] It has ruled in favor of the taxpayer in one instance. In the second case, the Board overruled the staff's determination that the petitioner and various subsidiaries were engaged in a unitary business and therefore found it unnecessary to rule in the taxpayer's petition under Section 25137. The third petition is still pending hearing.

Multistate Tax Commission

California entered into the Multistate Tax Compact in 1974. The Compact and its administrative body, the Multistate Tax Commission, currently have 19 regular members and 12 associate members. (Exhibit 11) The Multistate Tax Commission conducts joint audits for the states in both the income tax and sales and use tax areas. The Commission also works with the member states in developing uniform rules and regulations for the taxation of multijurisdictional taxpayers.

In February of 1978, the United States Supreme Court sustained the validity of the Compact./[13] The Commission through its audit staff is pursuing audits of many major corporations. A number of these corporations are continuing to resist the legitimate audit inquiries of the states through the Commission and litigation is continuing.

VI

Conducting a Unitary Audit

In an audit of any large multistate or multinational corporation, we are concerned with two basic items, taxable income base and the apportionment ratio. We seldom get involved in any income and expense audit. The detailed audit of income and expense items is left to the Internal Revenue Service for U. S. corporation; we are never advised of audit adjustments of foreign country tax audits.

In our audits, we generally limit our examination to the apportionment factors and to the unusual items such as depreciation variations from federal allowances, income items that may be exempt for federal purposes, and similar items for which state treatment may be different from federal. For foreign country operations, we will review their book income as it appears in published reports or in financial statements furnished by the taxpayer to determine if the book income treatment meets state income tax rules. For any items which do not, we ask the taxpayer to furnish us with the necessary data to enable a computation under the appropriate tax rules. The taxpayer may, if it wishes, furnish a computation of the corrected data. We, therefore, are seldom in the need of the detail books and records of the taxpayer or its affiliate companies.

For totally U. S. operation companies, or those required to file U. S. federal tax returns, the income base comes from the federal tax returns. If the parent company is headquartered in the U. S. and has foreign country subsidiaries, we obtain the necessary foreign country information from the best available data which

usually are the individual financial statements of the foreign subsidiaries furnished by the taxpayer or from SEC reports.

Where the combined operations are headquartered in a foreign country, we usually rely on the published financial reports to stockholders for our starting income base. We will then attempt to place this on a U. S. federal tax base by removing the U. S. companies book income replacing it with U. S. federal taxable income. Foreign corporation book income is analyzed for items unallowable for tax purposes such as special reserves, expenses based on estimates, etc., which are revised to allowable state tax methods. This generally cannot be done without the taxpayer or its parent's cooperation. If any of the foreign corporation operations wish to convert their book income to reflect specific tax treatment procedures such as accelerated depreciation, etc., we request detailed schedules from the taxpayer to verify compliance with applicable rules and to have available records for follow-up treatment in subsequent years.

Many adjustments from book income to taxable income are merely shifting the year of recognition usually initiated by the taxpayer to gain benefits of accelerating the recognition to reduce taxable income. We do not have that much trouble with book income as long as the amount of income and expenses are realized rather than estimated. Reserves usually show up in the balance sheet and can be segregated for tax purposes with taxpayer cooperation.

The property and revenue factors many times are based on those amounts shown in the financial statements in the annual report to stockholders. We will adjust for those methods to reflect valuations in the financial statements that are not in accordance with generally accepted accounting principles. For example, replacement cost accounting for fixed assets used to reflect asset valuations in the balance sheet will be revised to original cost basis for property factor purposes. Revisions of this nature can be worked out without difficulty and with a minimum of inconvenience and effort with taxpayer cooperation.

Since the numerators in any combination come from records maintained in the U. S., the auditor will use the books and records of the California taxpayers to verify these items. The auditor will make an effort to determine these numerators on the same basis that the denominators have been developed.

The payroll factor presents a somewhat more difficult factor to construct. Where all operations are within the U. S., the U. S. and California payroll reports are a good source of the payroll detail. Where there are foreign country operations, the payrolls in the foreign countries are dependent on the taxpayer's cooperation to obtain the data. We insist that the U. S. and foreign payroll be on a consistent basis, i.e., tax base income to the employee.

In auditing for unity, we look to the activities of the subsidiaries and the function they perform in relation to their parent particularly in California. We try to determine if there is a contribution or

dependency relationship between the related corporate entities. This is usually supported by the subsidiary's records through the presence of intercompany charges for sales, purchases, specific services, etc.

We review the corporate personnel structure for common officers and/or common directors. We also review for the presence of key personnel who have been transferred from the parent or a related entity. This information is obtained generally through specific inquiries directed to the taxpayer being examined.

Information is obtained from annual reports to stockholders and published articles on the business entities being examined. This source then becomes a basis for asking for specific data to support the unity indications in the written matter reviewed.

Our primary problem arises in reviewing for worldwide activities of the foreign parent company. In many instances, the U. S. subsidiary is not totally familiar with all the activities of the parent. In these situations, we will submit questions through the subsidiary for the parent company to answer. Cooperation of the parent company is necessary to resolve these problems.

VII

Comparison of the Unitary Method with the Federal System

In discussing the merits or deficiencies of the unitary concept, comparison must inevitably be made to the federal system. Such a comparison is only natural because of general familiarity with the federal system, but it should only be made based upon an understanding of the underlying theories of each system.

The federal system is based upon a residency concept of taxation. Its premises are similar to those involved in California's Personal Income Tax Law. The primary thrust of the federal system is to tax all the income of a person or corporation which is resident in the state. A decidedly secondary objective is to tax all the income of nonresidents which is derived from sources within the state.

With respect to resident individuals or corporations, recognition is often given to the fact that other jurisdictions may seek to tax income from sources within their boundaries by allowing credits for such taxes or by excluding such income from immediate taxation until it is repatriated.[14]/ These equitable relief provisions are of even less concern to tax administrators than is the taxation of nonresidents. Consequently, under a resident tax system, there is only limited concern with the determination of the geographic source of income.

The states, on the other hand, utilize a source system of taxation in dealing with corporations. The fundamental requirement of any system utilized 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 a source system because they are prohibited by various constitutional provisions from taxing the income of nonresidents which is earned without their borders./[15] In attempting to tax corporations, in contrast to individuals, the states are confronted with taxpayers which derive income from many different states and which, in most cases, are nonresidents. In fact, the corporations which bear the brunt of the tax burden are most frequently the ones with business activities in the most states.

As was pointed out in the slide presentation, the states first encountered this problem in attempting to fairly assess property taxes with respect to the interstate railroads./[16] As income taxes developed as a source of revenue, the states adopted the means which had proved so successful in the property tax area and the unitary method based upon formula apportionment and the combined report was evolved. At the present time, all states asserting an income tax on corporations utilize some type of formula to determine the income derived from sources within their boundaries and the majority of them require a combined report or consolidated return./[17]

With the increase of international commerce and the growth of multinational businesses, there has been a growing concern with the determination of the geographic source of income at the federal level. This concern has arisen because of the significance

of tax credits and the utilization of foreign jurisdictions on the part of multinational business to shield income from United States taxation.

The method adopted by the federal government for the determination of the geographic source of income is the so-called "arm's-length" or Section 482 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, commodities or services involved should be. This approach is subject to numerous defects which have been recognized by both business and tax commentators. These defects are the result of the dubious assumptions upon which the arm's length standard is based. These assumptions include, but are not limited to, the following:

1. All transactions both before and after the transaction being reviewed are at arm's-length.
2. A fair free market price can be established.
3. General overhead and administrative expenses can be fairly allocated.
4. Market price is unchanged regardless of production levels.
5. The transaction is uninfluenced by external considerations such as tax incentives and government regulation.
6. That it is possible to determine the proper amount of profit allocable to different functions such as manufacturing and selling.

The federal government is now recognizing the shortcomings of the arm's-length approach. During consideration of the Tax Reduction Act of 1975, a Task Force on Foreign Source Income of the House Committee on Ways and Means reported, "This approach (arm's-length [added]) already produces significant problems when applied at the Federal level and would be virtually impossible to administer at the state level . . ." (Exhibit 12) The Conference Board on Tax Allocation in the application of Section 482 found that the single most used method for computing adjustment was a so-called "other" method which is surprisingly similar to the unitary method./[18] President Carter, in his Tax Reform Program for 1978, proposed that the deferral of the taxation of so-called "foreign source" income be eliminated because of the difficulties in attempting to administer Section 482 with the resultant wholesale tax avoidance being perpetuated by multinational business (Exhibit 13).

At the request of the House Ways and Means Committee Chairman Al Ullman last year, the General Accounting Office is proceeding with a study of state corporate income taxation. The study is concerned with state and federal approaches to the taxation of the multistate and multinational corporations. Several issues were listed by the Chairman, including whether state apportionment formulae are rationally based in economic theory, are equitable, or are an administrative burden, the feasibility of all states using the same apportionment methods, the effect on the states of being required to use the arm's-length method in taxing multinational corporations, whether the Internal Revenue Service is having difficulties in administering Section 482 of the Internal Revenue Code, which provides for the arm's-length method, and, if so

whether the cause is poor management, a flawed conception, or both. Its conclusions may include recommendations for federal legislation. Its recommendations often have a significant impact on Congressional action.

The department along with a number of other states has received a questionnaire from the General Accounting Office. (Exhibit 14) Further discussions with the General Accounting Office are expected and the department will seek to supply additional input.

The General Accounting Office's current schedule calls for completion of its study in mid-1980. If the mid-1980 schedule is met, the Ninety-sixth Congress will still be in session; therefore, the General Accounting Office findings could have a significant impact on the future of S.983 or S.1688. See Discussion under "Federal Legislation" infra.

In April of 1976, a note appeared in the Harvard Law Review (Exhibit 15) which compared the arm's-length approach with the unitary method. The note concluded by stating:

> The use of the arm's length standard of the current section 482 regulations has been accompanied by serious problems most clearly evidenced by the surprisingly frequent reliance of revenue agents and courts on ad hoc fourth 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 standard in making source determinations is not surprising. The arm's-length standard is a product of a residency tax system and a bygone era when businesses, at least for federal purposes, restricted their activities to neat, limited geographic areas.

As multinational businesses have proliferated, the defects of the arm's-length standard have become more apparent. The unitary method, on the other hand, was developed 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 multinational business has demonstrated its viability and adaptability to a changing business world.

VIII

Recent Court Decisions

A short synopsis of recent significant court decisions which may impact upon the unitary concept is attached. (Exhibit 16) Three are U. S. Supreme Court decisions. The other three are state court decisions, one of which has been appealed to and accepted by the Supreme Court.

The first of the decisions in U. S. Steel Corporation, et al. v. Multistate Tax Commission/[19]

The basic issue was whether or not the compact clause of the Federal Constitution (Art. I, § 10, cl. 3) was violated by the Multistate Tax Compact, which had not received Congressional approval.

The powers of the Commission, such as to adopt advisory regulations, perform audits on request, and to seek compulsory process in aide of its auditing power in the courts of any state adopting the audit procedure was also questioned.

The court held the Compact was valid because the pact did not purport to authorize the member states to exercise any powers that they could not have exercised in the Compact's absence. Also, there was no delegation of sovereign power to the Commission.

The next state apportionment issue considered by the U. S. Supreme Court arose in Moorman Manufacturing Co. v. Bair./[20] The issue was the constitutionality of Iowa's statutory single-factor sales formula for apportioning an interstate business's income for Iowa income tax purposes.

The court upheld the single factor formula on constitutional grounds, even though it was noted that 44 of the 45 other states which impose corporate income taxes use a three-factor formula involving property, payroll, and sales.

Although the court again approved formula apportionment, the court's reference to the Iowa Supreme Court decision which suggested that income apportioned by formula might be impeached by separate accounting data causes some uncertainty. This dictum is contrary to the court's reasoning in Butler Bros. v. McColgan./[21]

The latest significant U. S. Supreme Court decision involved property taxes. It is Japan Line, Ltd. v. County of Los Angeles./[22] The case is of concern because it indicated different standards may be required in taxing foreign commerce than are required for taxing interstate commerce.

The court held that a nondiscriminatory property tax on the shipping containers which had their home ports in Japan and which were used exclusively for hire in the transportation of cargo in foreign commerce violated the commerc clause (Art. 1, §8, cl. 3) of the Federal Constitution. The violation was said to occur

because the tax resulted in the multiple taxation of instrumentalities of international commerce and prevented the United States from "speaking with one voice" in regulating foreign trade.

The decision is not considered as applying to the California tax measured by income since the apportionment formula is used to determine income derived from California sources. The decision, however, causes some concern, at least until the extent of the "one voice" standard is clarified. Clarification may soon be provided by the appeal of Mobil Oil Corp. v. Vermont,/[23] appeal granted May 15, 1979.

In the Mobil case, Vermont included in apportionable income dividends from foreign (outside the U.S.) subsidiary corporations and from domestic and nonsubsidiary corporations. The Vermont court held that since the apportioned tax is not inherently burdensome, the mere possibility of multiple taxation is insufficient to void the tax on Commerce Clause grounds, citing, among other decisions, Moorman Manufacturing Co. v. Bair, supra.

On appeal to the Supreme Court, the taxpayer contends the Due Process or Commerce Clause are violated when dividend income of a corporation organized and commercially domiciled in another state is apportioned when such dividends are derived from foreign source earnings of the payor corporations, and the only connection between the recipient state and the taxing state is the sale of products in that state.

The acceptance of this appeal after the recent Japan Line decision, supra, may be significant. The court may well have accepted the case to clarify whether or not the Japan Line decision applies to taxes, other than property taxes. The court's decision could have a significant impact, particularly if the court concludes dividends paid from foreign earnings cannot be considered in determining apportionable income.

As noted in the Mobil decision, dividends of foreign subsidiaries were included in the apportionable income. Recently, the Montana Supreme Court, Dept. of Rev. v. The American Smelting and Refining Co.,/[24] considered, along with other issues, whether or not six commonly owned affiliates were unitary. One of the affiliates, which operated mines in Northern Peru, sold its production to ASARCO, and another corporation operated basically the same business as the parent in Canada. The parent provided central services, and sales between the parent and the subsidiary were significant.

The court, relying on the usual test of unity, contribution/dependency, found that the test was met, and that the same rules should be applied to incorporated wholly controlled branches as are applied to unincorporated wholly controlled branches or businesses located in another jurisdiction.

In a related case arising out of an MTC joint audit, the same taxpayer was involved in Idaho, American Smelting and Refining Co. v. Idaho State Tax Commission./[25]

The taxpayer, a multistate, multinational corporation, challenged the inclusion in business income, which was subject to formula apportionment, of various items of income-dividends, interest, rents, royalties, and certain capital gains. The taxpayer argued that these items should be considered nonbusiness income and allocated on the basis of commercial domicile (New York).

The Idaho statute defined business income to include income from tangible and intangible property if its acquisition, management or disposition constituted integral and necessary parts of the trade or business. The Idaho statute provided that gains or losses and dividends and interest were presumed to be business income, with such presumption rebuttable only by clear and convincing evidence to the contrary.

From the facts presented, the court determined that most of the income was business income. It was generated by "integral or necessary" parts of the taxpayer's business, including: interest from customer notes related to the taxpayer's mining operations; rental income from property used in mining operations; royalty payments from assets developed in the course of the regular mining business and gains from the sale of fixed assets used in every-day business activities.

This case will probably be considered by the Supreme Court at the same time it considers the Mobil decision. The business-nonbusiness income analysis is more specifically drawn in this Idaho case.

The last three cases included so-called foreign income in the apportionable base. In ASARCO, both the income and factors were included in determining the amount of income properly apportionable to Montana. The appeal to the U.S. Supreme Court was dismissed. The Montana treatment of a unitary affiliate's income and factors was the same as is the California practice. In Mobil, only the dividends paid were included in the apportionable base. In this case, no factors are taken into account.

At this time, it cannot be determined whether the Mobil appeal was accepted because of the method used for apportioning income or because a different standard may be applied with respect to foreign source income. The Mobil decision could have a significant impact as to the unitary income and factors which may be taken into account in determining the amount of income derived from California sources.

Pending California Cases

There are a number of cases pending in the California courts and, in one instance a federal court, to which the Franchise Tax Board is a party,involving application of the unitary concept. (Exhibit 17) The total number of cases is too great to provide a summary of the facts and issues involved in each of them and many of them have not progressed beyond the simple filing of a complaint and answer. There are several cases which should, however, be commented upon in this presentation.

1. Worldwide Combination - United States Parent
   Anaconda v. FTB. SF #696-859

   The trial judge rendered an opinion in favor of the taxpayer on the question of whether or not certain Latin American subsidiaries were unitary with the taxpayer's United States operations. The trial judge's determination was factual in nature. An appeal has been taken from the trial judge's determination.

   Container Corporation of America v. FTB
   SF #673-492

   The trial judge rendered an opinion in favor of the department. The judge determined that Latin American and European subsidiaries were unitary with the United States' operations in spite of the absence of a significant product flow. The judge ruled that the taxpayer's offer of proof that the foreign subsidiaries enjoyed greater profitability on a separate accounting basis did not establish the unreasonableness of the unitary result. The judge ruled that there

were no constitutional bars to foreign combination and specifically held the United States Supreme Court's decision in Japan Line Ltd. was not applicable. An appeal is expected.

Firestone Tire & Rubber Company v. FTB
LA #C-31243

A trial has been held and trial briefs submitted. The taxpayer is contesting the department's determination that its foreign subsidiaries are part of its unitary business. Taxpayer has also asserted that there is a constitutional bar to the inclusion of foreign subsidiaries in a unitary computation and that the formula factors do not reach a proper result because of disparities between domestic and foreign payroll and property values.

2. Worldwide Combination - Foreign Parent
Beecham v. FTB - SF #750-207

The taxpayer is owned by a foreign parent corporation. The taxpayer is contesting the determination of the department that a unitary business involved and is arguing that a unitary computation may not constitutionally include the factors and results of the foreign parent. The taxpayer will obviously raise Japan Line Ltd. as support for its position.

Capitol Industries - EMI v. Bennett, et al.
USDC Northern District California - C-792145CBR

Injunctive relief is being sought to prohibit the Franchise Tax Board and its Executive Officer from applying the

unitary concept to include a foreign parent corporation and its foreign subsidiaries in a combined report based upon Japan Line Ltd. The department has moved for dismissal since the taxpayer has not exhausted its administrative remedies and the applicability of the Supreme Court's decision in Japan Line Ltd. is otherwise before the courts. The federal judge has indicated he views the state's position on both the merits and procedurally, as to the dismissal, with favor.

3. Treatment of dividends and gain or loss on the sale of stock

   Times-Mirror v. FTB, LA #C-172373

   The taxpayer acquired the stock of an existing business which was complimentary to and almost immediately was integrated into its unitary business. The taxpayer was required to divest itself of the acquired subsidiary as the result of an antitrust action. Gain was realized on disposition of the stock. The trial court sustained the department's position that such gain was nonbusiness income wholly allocable to California. It follows from the court's decision that dividend income would receive the same treatment. An appeal has been filed by the taxpayer.

4. Discrimination with respect to foreign commerce

   Zee Toys, Inc. v. County of Los Angeles/[26] (Exhibit 18)

   The California Appellate Court invalidated a state statute which exempted certain products shipped in foreign commerce from property taxation. The court held that the statute unconstitutionally discriminated in favor of foreign commerce vis-a-vis interstate commerce. The court's

reasoning might invalidate any efforts by the Legislature to place limitations on the application of the unitary concept based upon the geographic location of the operations. A petition for a writ of certorari has been filed with the United States Supreme Court which was accepted on October, 1979.

Current Issues

A. Worldwide Combination

The question of whether the unitary method should be applied to the non-United States operations of a unitary business has recently attracted some attention. There are two elements to this question. First, should the non-United States elements of any business, regardless of its principal place of incorporation, be excluded from a combined report? And, more narrowly, should the non-United States operation of a foreign incorporated business be included in a combined report?

In light of the history of the development of the unitary concept, it is surprising that this question should arise now. One of the earliest United States Supreme Court decisions upholding the unitary concept involved the application of the method to a United Kingdom-based corporation with branch operations in New York. In Bass, Ratcliffe & Gretten, Ltd. v. State Tax Commission/[2/] (Exhibit 19) the use of the unitary method was upheld even though the unitary method attributed income to New York while, for federal purposes, the taxpayer reported a significant loss for its United States operations (all conducted in New York). The question of the worldwide application of the unitary concept was answered in the affirmative by the United States Supreme Court in 1924 yet 55 years later opponents of the unitary method would have the world believe that a brand new issue has arisen.

California has applied the unitary method on a worldwide basis for anumber of years. In Matson Navigation Company v. State Board of Equalization,/[28] the use of the unitary method for worldwide operations was approved for the income year 1931. State Board of Equalization cases in which the inclusion of foreign operations is reported over income years as early as 1944 and 1945./[29] Including foreign operations is not a new or novel approach by the department.

Frank Keesling, now senior partner with the Los Angeles law firm of Loeb & Loeb, and acknowledged as the "father of the unitary concept" writing in the Journal of Taxation in February of 1975, (Exhibit 20) stated:

> The question frequently arises whether the income of corporations foreign to the U.S. should be included in the combined report. The answer is an emphatic "yes." The apportionment should be made by attributing to each state a portion of the income from the entire business regardless of whether the business is conducted between two or more states of the U.S., or between one or more of such states and one or more foreign countries. This can be accomplished only by combining the incomes of all the corporations engaged in the conduct of the business. It is immaterial whether such corporations are organized under the laws of one of the states of the U.S., or under the laws of a foreign country.

The Multistate Tax Commission has gone on record in support of the principle of worldwide combination. A resolution endorsing this treatment was adopted unanimously by the Compact members in May of 1977. (Exhibit 21)

George Rudolph, a professor law at the University of Wyoming, stated:

> It seems clear, strictly as a logical proposition, that foreign source income is no different from any other income when it comes to determining, by formulary apportionment, the appropriate share of the income of a unitary business taxable by a particular state. This does not involve state taxation of foreign source income any more than does apportionment -- in the case of a multistate business -- involve the taxation of income arising in other states. In both situations the total income of the unitary business simply provides the starting point for computing the in-state income taxable by the particular state./[30]

Brian Aungiers, of Peat, Marwick, Mitchell & Co.'s London Office, states "California's formulary approach to measuring the California income of a 'unitary' business has substantial theoretical justification and may represent the wave of the future for the taxation of income of multinational enterprises by different countries." (Exhibit 22)

In a study prepared for the prestigious Brookings Institution, it is stated "ultimately, the only satisfactory solution to the problem of allocating income within the multinational firm may be international use of formulas based on national sales, assets, payrolls or some other stable base."/[31]

Professor Peggy Musgrave, in commenting on the U.S.-U.K. Tax Treaty debate, (Exhibit 23) stated:

> Due to the integrated nature of the multinational corporation and the interdependency of its parts, clearly defined and separable units of economic activity do not begin and end at political boundaries. The question then is how to unscramble the omelet in an equitable and efficient manner. Given the nature of the multinational corporation, I believe that the unitary apportionment approach, if adopted on an international scale, would go far to ensuring that there were no gaps or overlaps in the division of the tax base and would allow the application of an apportionment formula which would be acceptable on inter-national equity grounds.

Opponents of the worldwide use of the unitary method argue that that it places excessive compliance burdens on taxpayers and often reaches arbitrary and inaccurate results because of a variety of factors including different wage rates, property values, rates of return on investment and economic environments.

Examination of cost of compliance arguments establish that they are based on a faulty premise. Costs of compliance with any tax audit will necessarily be greater than if no tax audit is performed. Critics of the unitary method are correct that the cost of compliance with the method is greater than the cost of complying with the alternative they advocate, the so-called "arm's-length" method. But this is true only because the multinationals do not expect any "arm's-length" audit, let alone a rigorous audit to be made. A rigorous "arm's-length" will require an examination of every single process in manufacture and marketing of a product with close scrutiny of all determinations made as to the allocation of costs and determination of profit

margins. Such audits could not be conducted by the states because they are beyond their current administrative capabilities. They are not conducted at the federal level either, to any significant extent, because of the same lack of administrative capabilities and the difficult subjective judgments which are involved. The alternative to the unitary method, which the multinationals endorse, is the nonaudit approach currently practiced under the guise of the arm's-length standard. Necessarily, compliance costs must be less under such approach.

As has been described previously, there are two elements to a unitary audit, one - the determination of the unitary business, and two - development of income and factors.[32] In most cases, the determination of the unitary business is relatively simple. By the same token, the development of the income and factors is not difficult because four of the numbers relate to the business as a whole and three of the numbers relate to solely California activities. We believe that these numbers have been prepared by almost all businesses and no further compliance costs exist.

The difference in the relative cost of property and payroll or their relative productivities is again a problem which exists within the United States. The California Supreme Court, many years ago, dismissed this problem.[33] Multinational corporations take these variances into account and it is the existence of such differentials which provides the multinationals with their competitive edge.

A special case involving the inclusion of foreign operations occurs when the unitary business is based in a foreign country. Arguments can be raised that differences between U.S. accounting standards and foreign accounting standards make the preparation of a combined return more difficult, if not impossible. In addition, fluctuations in exchange rates between the dollar and the home currency will cause difficulties in determining income.

The department believes these problems are resolvable. With respect to accounting systems, it is true that differences exist but the similarities are much more numerous than the differences. With respect to individual taxpayers, the department has successfully reached agreements concerning the adjustments which must be made. Inquiries have been received from both the United Kingdom and Japan concerning the possibility of establishing generalized rules or methods for adjusting accounting statements. We are sure that acceptable methods and agreements can be reached.

With respect to the determination of income resulting from fluctuations in the exchange rate, the department believes that problems arise from the indiscriminate mixing of book and tax accounting concepts. There are a number of methods recognized and accepted for the translation of financial statements from one currency to another. The problem which the department believes exists with respect to many of them, for tax purposes, is that unrealized gains or losses are recognized. This is contrary to accepted domestic tax accounting. The federal

government has allowed unrealized gains and losses to be taken into account with respect to international operations because of the limited concern with the problem and deferral accorded most foreign income./[34] Because of the unitary method, the states are more directly concerned with the problem and we believe the correct answer is to defer taxation of such gains and losses until actual realization.

Opponents of the worldwide use of the unitary method argue that it differs from the international norm and its use, with respect to foreign-based businesses will give rise to significant foreign relations problems and retaliatory tax practices by such countries. Supposed evidence of this foreign concern is provided by Article 9(4) of the U.S.-U.K. Tax Treaty. The fallacy in this argument is that it was the United States Treasury which apparently raised the question and placed this clause in the treaty. This section was not requested by the United Kingdom negotiators. But to the extent there is possible impingement upon the federal government's conduct of foreign affairs, it is one which has been sanctioned both by prior treaty negotiations/[35] and specifically by the United States Senate's rejection of Article 9(4) of the U.S.-U.K. Treaty.

One of the principal fears expressed by the department in opposition to Article 9(4) was that it would inevitably be extended to all countries and would also be applicable to United States-based companies. The strenuous lobbying by United States

multinationals and the fact that they were apparently the originators of Article 9(4) lends support to the department's position. As Peggy Musgrave noted:

> It is unlikely that the states could have continued to apply the unitary method to domestic-based corporations, if they had been required by treaty to abandon it for foreign based corporations./[36]

In October of 1978, the California appellate courts/[37] indicated that an exemption from the unitary method based upon the county of incorporation would in all likelihood be unconstitutional stating:

> (S)tate taxes which discriminate between classes of interstate and foreign goods on the basis of their origin are not permitted . . . . (D)iscriminatory tax burdens which favor one class of commerce, subject to the control of Congress, over another such class, are equally prohibited.
>
> Discrimination between (1) interstate transactions and foreign transactions cannot be distinguished from (2) discrimination between two types of interstate transactions. Both interstate and foreign transactions are brought within the control of Congress by the same clause of the United States Constitution.
>
> The fact that there may be rational grounds for the state to exempt imported goods destined for transshipment to another state which do not apply to interstate goods in the same category cannot validate the exemption. It may be that there is a greater threat of business flight from California by importers accustomed to the benefits of the original package doctrine than by distributors of interstate goods. But such considerations do not justify a state's utilization of a tax differential as a means of regulating interstate and foreign commerce. Only Congress is authorized to so act.

Based upon the court's holding any attempt to limit the application of the unitary method, with respect to foreign-based businesses, would probably be constitutionally invalid.

Business - Nonbusiness Income

Under the UDITPA, business income is apportioned by the standard three-factor formula.[38] Nonbusiness income is subject to allocation to an individual state by specific provisions of the UDITPA.[39] Differences arise between the states in attempting to determine what is business income and what is nonbusiness income. The definitions provided in the UDITPA provide minimal guidance. Some clarity is provided by the UDITPA regulations adopted by the Multistate Tax Commission, which are based largely on California law. (Exhibit 24) To the extent states differ in their determination of business or nonbusiness income, significant variances may occur in their tax treatment of corporations. The principal area of disagreement at the present time relates to the classification of dividend income and gains or losses realized on the disposition of stock.

Dividends received by corporations are a significant source of total income. Preliminary data for the period beginning July 1975 and ended June 1976 shows that total corporate income for federal tax purposes is about $143 billion. Of the total, $8.8 billion is from dividends paid by U.S. corporations, and $5.6 billion is from dividends paid by foreign corporations. The total dividend income is $14.4 billion, or about 10 percent of taxable income.

Under present California law, except for financial institutions and businesses dealing in securities, dividend income is allocated to the recipient corporation's headquarters with certain deductions and exclusions./40 Intercompany dividends paid from unitary income are excluded from tax./41 A deduction is allowed for dividends paid from income included in the measure of the California tax/42 and for dividends received from an insurance company subsidiary operating in California,/43 provided at least 80 percent of each class of stock is owned by the parent. The amount of the deduction for insurance companies is determined by an allocation formula. California law is based on pre-UDITPA precedents which were preserved by the Legislature in enacting the UDITPA and again in adopting the Multistate Tax Compact./44

The Multistate Tax Commission, in adopting suggested regulations for the implementation of the UDITPA, has taken the position that most dividend income and, in particular, dividend income from stock interests related to the unitary business is business income (Exhibit 25). This position was approved by the Idaho Supreme Court./45

The same approach was also taken by the State of Vermont, a non-MTC state, and also received the judicial approval of its highest court./46 These cases and the treatment of dividend income will be reviewed by the United States Supreme Court this term. Studies which have been made with respect to the apportionment or allocation of dividend income indicates that the total tax impact for revenue purposes is not substantial./47 However, the impact on individual corporations is often significant. If dividends

are apportioned, the California tax for corporations headquartered in this state is decreased, while the California tax for corporations headquartered in other states is increased. If, most dividends are apportioned, as is the practice in states taxing dividend income, and as provided by the Multistate Tax Commission regulations, such income is simply assigned to various states where business activities are conducted instead of being taxed only the corporation's headquarters state.

If California were to adopt the treatment of dividend income as recommended by the Multistate Tax Commission, it would greatly increase the uniformity of state tax treatment and would serve to defuse many of the complaints raised by multijurisdictional taxpayer concerning inconsistent state tax practices.

In spite of the significant advance in uniformity which would result if California conforms its practice to that of most other states, the majority of the business community has actively opposed such action by the Legislature. Corporate positions on this issue provide a clear example of the duplicity in which they engage in with respect to state tax practices. For purposes of federal legislation they decry the lack of uniform state practices, but at the state level they hinder attempts at uniformity and promote actual diversity for their own benefit.

For the state-by-state tax treatment of business and nonbusiness income as of 1976, see Table 2 of a study by the U. S. Treasury Department which is attached as Exhibit 26.

Determination of a Unitary Business

One of the principal questions which arose at the hearings the Franchise Tax Board held in July and August of 1977 was: what are the proper parameters of a unitary business?

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. The unitary concept and the definition of a unitary business are court created and sanctioned. The original tests of unity of ownership, operation and use (Butler Bros. v. McColgan)/[48] and "dependence and contribution" (Edison California Stores v. McColgan)/[49] are still the bellwethers. But the application of these tests have been expanded and broadened by both the courts and the State Board of Equalization.

In 1963 the California Supreme Court, at the taxpayer's behest, found that a unitary business existed in the absence of product flow between the various divisions and corporations (Honolulu Oil Corp. and Superior Oil Co.)./[50] In 1970 the California appellate court held in Chase Brass & Copper Co./[51] that integration of top executive forces and control over major policy decisions was of paramount importance in determining whether or not a unitary business exists.

As a result of these two decisions and the development of modern management concepts emphasizing management abilities per se rather than knowledge of a particular business, the Board has by necessity been required to expand the parameters of a unitary business.

Assisting in this expansion have been the decisions of the California State Board of Equalization which, along with the courts, establish the precedents by which the staff is guided.

The Multistate Tax Commission has adopted regulations which reiterate the court tests and set forth several indicia of whether or not a unitary business exists. The factors which the regulations create a strong presumption of a single business are (1) same type of business, (2) steps in a vertical process, and (3) strong centralized management. (Exhibit 27)

The Board and the staff, in an effort to provide greater certainty to the taxpayers, has initiated an advance ruling program specifically addressed to the determination of a unitary business. We believe we have provided satisfactory guidance in all cases where rulings have been requested. These rulings are based upon the published decisions of the State Board of Equalization and the courts. In spite of the interest expressed in such a program in the summer of 1977, there has not been a significant increase in the flow of ruling requests.

Disincentive to Business Investment

Opponents of the worldwide application of the unitary method by California argue that the method acts as a disincentive to foreign investment within California. The argument is generally restricted to those seeking limitations on the use of the unitary method with respect to foreign controlled corporations but certain aspects of the argument, if valid, should be applicable to wholly United States businesses.

Before far-reaching changes are made, consideration should be given to what evidence exists showing that the unitary method of taxation is a disincentive to investment in California. As yet, few studies have been made of this question. The sponsors and proponents of limiting legislation have offered anecdotes in support of their position but nothing else.

Paul Ryder, Associate Director of the Industrial States Policy Center, a public interest study group based in Ohio, has prepared a critical analysis of these anecdotes. (Exhibit 28) He notes in general that the anecdotes are based on self-serving declarations of the multinationals, or their representatives, offer little or no concrete support of the disincentive involved in the unitary method, and in many cases do not even attribute a disincentive to the unitary method.

For example, many of the accounts of California's adverse business climate feature the decision of Dow Chemical in early 1977 not to build a $500 million facility in California. The record clearly shows and Dow Chemical itself has stated that "The California Unitary Tax was not a factor in Dow's decision."

Bechtel is cited as one of the companies fleeing California as a result of the unitary method, yet the Tax Manager of Bechtel, International, Miles Bresse, Jr. has stated:

> . . . the nature of our business results in our having an essentially neutral position on the basis of the California unitary method as an incentive or disincentive to investment in the state.

The decision of Honda to locate a United States auto plant in Ohio rather than California is another example given in support of the proposition that the unitary method is keeping foreign investors out of California. But there is little evidence which supports the notion that Honda, or perhaps any other Japanese auto maker, has seriously considered California as a location for an assembly plant. In May of 1976, a representative of Honda called the Great Lakes area a "natural location." Later a Honda Executive stated:

> Our initial studies indicated that Ohio would be an excellent place for our first U.S. manufacturing facility because of its market location, outstanding transportation system, its supply of good labor, supply of parts, and good industrial environment.

In addition, Ohio offered to provide up to $2.5 million in public improvements related to the project. There have been no statements by Honda which relate the failure to locate in California to the unitary method of taxation.

One of the prime opponents of the unitary method of taxation has been the Hongkong & Shanghai Bank which has recently announced the acquisition of a substantial interest in Marine Midland Banks, a

New York regional bank with an option to increase its ownership to 51 percent. Acquisition of controlling ownership has required that the Hongkong and Shanghai Bank dispose of its California subsidiary. In a discussion of the acquisition in April 6, 1978 Wall Street Journal, (Exhibit 29) no mention is made of California's unitary method. The acquisition is justified solely on the basis of other business considerations unrelated to taxes.

As further evidence that the unitary method of computing income derived from a jurisdiction does not constitute a disincentive to investment in California, one need only review a study made for Fortune magazine in September, 1977, on "Facility Location Decisions. (Exhibit 30) California was the second most likely state behind Texas for the location of new facilities and was the only non-southern state in the top five. According to the study, California was the most likely location for either a new regional headquarters, a laboratory, or a distribution center/warehouse.

State-local taxation typically accounts for only 2 to 3 percent of total costs of business operations and, furthermore, are deductible for federal tax purposes, thereby further reducing their impact on investment decisions./[52]

Finally, the Library of Congress has conducted a review of the tax systems of seven nations including Japan, the United Kingdom, Canada and Germany. This review indicates a minimal potential as to the effect of state taxes on investment decisions. (Exhibit 31)

The United Kingdom, for example, gives a credit for state income taxes paid equal to the amount of United Kingdom tax on the same income. Canada also allows a deduction or a credit for income taxes paid to

the states depending on the treatment given by the states. In the case of California, a credit would be given.

The Japanese multinationals have been the most vehement in the criticism of the unitary method. Such criticism however does not relate to any economic disincentive. Japan apparenly has the most liberal system of credits of any of the foreign countries reviewed. A Japanese company operating in a foreign country through a branch must include the foreign income in its tax base but is allowed a credit against its Japanese corporation tax based on the total income from sources abroad (disregarding losses) compared to Japanese income. To the extent there is an unused credit, it can then be applied to the prefectural inhabitant and municipal inhabitant tax and furthermore can be carried forward or backward for five years each way. If business is conducted through a subsidiary, there is no tax on the subsidiary's earnings until they are distributed to the parent through dividends, at which time a credit is allowed for all taxes paid. Under the Japanese system, only exceptional circumstances will cause the Japanese multinational organization to pay more tax under the unitary method than under any other method. Confirmation of the Japanese tax treatment has been provided in a paper prepared for the Japan Tax Association by Yoshihiro Miyasaka of Tohomatsu-Awki Auditing, Inc. of Los Angeles

Based upon the liberal allowance of credits by the various foreign countries involved, it appears that the unitary method of taxation is neutral in its operation with respect to a foreign company's investment decision and therefore has been improperly characterized as a disincentive to foreign investment.

Studies which have been made of the corporate decision-making process in facility locations or in the preception of a state's business climate do not place taxes, and more particular corporate income taxes at the top of the list of factors which influence such judgments. In the previously mentioned Fortune study state/local attitude toward taxes and business was perceived as only the fifth most important element in picking a plant location and fell to ninth place as a consideration when the plants wereactually located. Since this category includes both taxes as well as government attitude toward business, it is clear that the individual element of corporate income taxes ranks considerably lower.

Similar results were reported in a survey conducted by Lou Harris and Associates for the Commission for Economic Development, State of California. (Exhibit 32) Again, state taxes, either a positive or negative factor, were not among the most important elements, in the perception of the state, as a business location. Furthermore, in a comparison of California with three other states (Arizona, Michigan and New York), California was viewed as being comparable with the two industrial states and all were at a decided disadvantage to Arizona, a nonindustrial state in the area of taxes. The Harris study concludes that California's level of corporate income taxes is a secondary importance in the corporate decision-making process, with respect to facility location, to the principal concerns of labor, access to markets and supply, and the availability of power.

Finally, the empirical evidence which is available with respect to actual foreign investment shows that California more than maintains its share of foreign investment dollars. In July of 1978, the New York

Times published a report of the Conference Board which indicated that in the second quarter of 1978 81 foreign companies made new investments in the United States. California led the way in attracting new foreign investments with 19 in this quarter. New York was in second place with 11./[53] This is not a statistical aberration. Similar results are reported virtually every quarter and on a yearly basis. In the first quarter of 1979, the Conference Board survey reported 86 new foreign investments in the United States, with California showing 15 and Georgia placing second with 6./[54]

Earlier this year a paper was prepared for the Council of State Planning Agencies on State Taxation and Economic Development. (Exhibit 33) Among the findings of the paper "There is a popular myth that a reduction in the level of state business taxes will produce a flood of new development. The truth is very different. The level of business taxes has had very little impact on the local growth rate or on interstate location decisions of firms." In short, manipulation of state taxes for the advantage of potential investors is seldom productive

FEDERAL LEGISLATION

Interest in federal interstate tax legislation seems to be directly proportional to the amount of state taxes which would be saved by multistate and multinational corporations. In general, small businesses have shown little interest in the income tax provisions of such legislation because most are exempt under the provisions of P.L. 86-272.

When reviewing proposed federal legislation, the department's starting point has been that any such legislation should expose all of a business's income to tax in some jurisdiction which under appropriate legislation could impose a tax. Since a local business is subject to tax on all of its income, regardless of the nature of its income, fairness compels that the same standard be applied to all businesses. This concept was incorporated when the Uniform Division of Income for Tax Purposes Act was adopted effective in 1967.

The Uniform Act was adopted to meet the complaints of businesses that the diverse apportionment practices of the states caused significant compliance problems. It was hoped that when most states had adopted apportionment formulas similar to the Uniform Act, businesses would be satisfied since they would be afforded the certainty they had urged. They also would be protected from overtaxation. Undoubtedly, in some rare cases, part of a business's income is included in the measure of tax more than once. However, even with the Uniform Act, undertaxation in the case of a multistate or multinational corporation is the norm.

On several occasions, Congressional subcommittees have been urged to subpoena the returns of multistate and multinational corporations to review them and determine whether the norm is undertaxation or overtaxation. Perhaps your Committee may want to consider this suggestion. Based upon the department's discussions with the tax departments of other states, the staff would be greatly surprised if in any case such corporations are or would have been overtaxed under the provisions of the Uniform Act or even under the provisions and individual variations of existing state laws.

As the states increased their efforts to apply the provisions of the Uniform Act, and began to participate in joint audits through the Multistate Tax Commission, so did the interest in restrictive and preferential federal interstate tax legislation.

The only bills discussed in the text are those where hearings have been held or on current bills. For your information and for the record, attached as Exhibit 34 is a complete list of legislation which has been introduced.

Except for authorizing legislation with respect to national banks, the first federal legislation restricting state taxes occurred in 1959. That legislation, Public Law 86-272 prohibits a state from imposing a net income tax on a corporation if its only business activity is soliciting orders for sales of tangible personal property and the orders are filled from outside the state.

As P.L. 86-272 was being considered, Congress also authorized a study of state taxation of multistate businesses. The study was concluded in 1965 when the recommendations of the House Special Subcommittee on State Taxation of Interstate Commerce was included in H.R. 11798, introduced by Representative Willis.

After the bill was introduced, extensive hearings were held, with the department participating. Because of widespread, almost unanimous opposition, the bill was dropped and a somewhat milder version substituted. The substitute bill was not voted out of the House Rules Committee.

In 1967, a bill identical to the substituted bill was approved by the House on a 289 to 84 vote. No further action was taken. In 1969, an identical bill was again approved by the House on a 311 to 87 vote. This time the California Congressman voted against the bill 21 to 15.

Later similar, but more restrictive, bills were introduced in the Senate. On September 18-19, 1973, a Subcommittee of State Taxation of Interstate Commerce of the Senate Finance Committee, chaired by Senator Mondale, conducted hearings. The department also participated in the hearings. No report was issued.

In 1976, the Committee on Ways and Means established a Task Force on Foreign Source Income. At a meeting where only members could participate, Congressman Jones (Okla.) proposed that the states be required to limit their tax base to the income source rules of the Internal Revenue Code. Congressman Jones' proposal was recommended by the Task Force.

During 1978, Senator Mathias held a series of hearings across the country on his bill (S. 2173) which was the then current version in a long line of bills which originated from the 1965 House study. An extensive record was developed with respect to this proposal. Representatives from 23 states made appearances before the Committee as well as representatives from the NATA and the MTC. Without exception, the state representatives were opposed to the proposals set forth in the bill.

From 1860 to September 1976, state taxation of national banks was controlled by the federal government. In 1969, legislation was enacted lifting restrictions on state taxation of banks and directing the Federal Reserve Board to make a study of state and local bank taxation and report to Congress a moratorium on new state taxes was enacted pending completion of the study. The report was submitted at the end of 1971. Apparently dissatisfied with the Federal Reserve Board's report, Congress, in August of 1973, directed the Advisory Commission on Inter-Governmental Relations to make a new study and prepare a report. Its recommendations were submitted in May of 1975. Its recommendations were limited, and mainly proposed a jurisdictional standards test before taxes could be asserted similar to the standards provided by P.L. 86-272. The moratorium ended in September of 1976.

The legislation which was introduced, S.1900, was far more comprehensive and restrictive. It was developed by the American

Bankers Association Task Force on State Taxation. Hearings were held on November 22, 1977, by the Subcommittee on Financial Institutions of the Senate Committee on Banking, Housing and Urban Affairs. The department appeared at the hearing and opposed the bill. The bill was reintroduced this session of Congress as S.719 by Senator Cranston.

In 1979, Senator Mathias and Congressman Conable introduced legislation incorporating the Task Force on Foreign Source Income's recommendations as S. 1688 and H.R. 5076. These bills would require states to apply federal residency concepts for determining the activities or corporations which may be included in a combined report and would exempt dividend income from taxation if the income from which the dividends are paid is not from sources within the U. S.

The effect of the bill would be to insulate much of the income of multinational businesses from state corporate taxes. The bill would be particularly beneficial to multinational oil companies because most of their income and dividends are derived from their highly profitable operations outside of the U. S.

A recent publication again illustrated that most of the earnings of oil companies are attributed by them to foreign operations, as well as documented the ineffectiveness of the federal tax system as applied to multinational companies.

> . . . The eight largest oil companies 'wiped out $16.4 billion of their tax liability by utilizing the foreign tax credit . . . and managed to reduce their tax liability to $1.4 billion on $64.2 billion of gross income from operations--an effective tax rate of 2.2 percent'/[57]

Of broader scope is S-983 which is the successor to Senator Mathias' prior bill. This bill deals with both income tax concerns and sales and use tax problems. As a result of the hearings held in 1978, Senator Mathias made substantial revisions in the sales and use tax portions of the bill. Only minor revisions were made in the income on franchise tax areas in spite of the numerous objections raised by the states and the suggestions which they offered.

In the department's view, S-983 is substantively defective in a number of areas.

1. Corporations otherwise unitary are excluded from a combined report or consolidated return if a substantial portion of their income is from foreign sources.

   This exclusion of unitary corporations allows corporate taxmanship to be practiced in its highest form with significant decreases in state revenues.

2. "Foreign source" income of all corporations is excluded from the apportionable base.

The unitary method was specifically established to provide a means of making geographic source determination. Substitution of arbitrary rules based upon the federal system is illogical.

3. Language in the proposed bill is specifically aimed at the interest offset provision of California law (§ 24344).

   California law is preempted for the benefit of multistate and multinational corporations. Section 24344 contains rules for the allocation of interest when a corporation headquartered outside California has both business and nonbusiness dividend and interest income. The purpose of the California law is to prevent such corporations from borrowing money to purchase stock creating nonbusiness income and then deducting the interest expense from business income. Such treatment decreases the income subject to apportionment and increases the headquarters state's income, and in most cases is tax exempt. The dividend income is exempt because most companies are headquartered in states which do not tax nonbusiness income. This section of the federal bill prohibits such adjustment.

4. Dividends are exempted from taxation in many cases and in other cases are taxable only by the state of commercial domicile.

In addition to exempting large amounts of income now subject to California tax, if the legislation is enacted, the Legislature would be prohibited from changing California law to follow the tax treatment of dividend income recommended by the Multistate Tax Commission, and as followed by most states. The Multistate Tax Commission regulations provide for the apportionment of most dividend income.

5. Arbitrary ownership rules for combination or consolidation are substituted for unity and various classes of corporations are excluded from unitary treatment based solely on their line of business.

   These provisions permit taxpayers to control the tax impact by the form in which the activities are conducted.

   It substitutes an ownership rule for the present tests of unity, i.e., whether or not the activities contribute to or are dependent upon each other.

6. The proposal establishes "nowhere" income that is income which is not allocable or apportionable to any state.

   The establishment of a tax preserve for multinational corporations exacerbates and sanctifies corporate tax avoidance.

The above items list the more important exceptions which the department takes to the provision of S.983. The department in

testifying on S.2173, the precessor bill, prepared a much more detailed analysis which is attached as Exhibit 35. The only differences between S.2173 and S.983 is that the one-sided elections provided are prohibited./[58]

The first federal interstate tax legislation, H.R. 11798, provided that income would be assigned to a jurisdiction which had authority to impose a tax. An income tax ceiling was provided (the Internal Revenue Code), but non-U.S. source income, when repatriated, could be apportioned by the U.S. factors. The apportionment formula consisted only of a property and payroll factor. It also provided that to a large extent the tax would be administered by the Internal Revenue Service, and that judicial determination would be made by federal courts.

The substitute bill eliminated federal administration, and applied the Act only to businesses with an average net income over a five-year period of $1 million or less.

The first two federal bills were intended to expose all U.S. source income to tax in a state which had authority to impose a tax.

Even though at the time the bills were introduced the revenue impact was not too substantial, the bills were important because they would have limited California's taxing jurisdiction and substantially restricted the Legislature as to the direction and composition of the corporate tax base.

At the time the original bill was opposed, part of the concern was the direction of future federal amendments if a precedent of federal intervention in state tax matters was established. The

apportionment base is of primary concern with respect to taxes imposed on corporations since about 70 percent of the total corporate income subject to tax is determined by an apportionment formula.

Even though to date no significant restrictive federal legislation has been enacted, the provisions of current legislation when compared with the initial legislation indicates what may well have been the result if restrictive legislation had been enacted

Obviously, a local corporation pays a corporate tax on all of its income. Under the latest of the federal bills, except for dividend income and those with certain kinds of sales, most interstate businesses are required to attribute their income to some state taxing jurisdiction. The same is not the case with respect to multinational corporations.

As noted in the summary under current proposals, dividends paid from "foreign-source income" are exempt. Rents, royalties, license and technical fees from property located or services performed without the U.S. cannot be included in the income base subject as apportionment. Sales to foreign countries are included in the sales factor, even if no other activities are conducted in such country. Furthermore, a state cannot make an adjustment to apportionable income by reason of being required to exclude from such income dividends or so-called "foreign-source income." This prohibition, for example, would permit a corporation to borrow money, deduct the interest expenses from U.S. income, lend the proceeds to a

foreign subsidiary, and receive the interest paid by its foreign subsidiary tax free since such interest is from foreign sources.

The current federal proposals also permit a multinational corporation to control its tax consequences by the corporate form in which it does business. It can do so by conducting its foreign operations as a branch so long as they are loss operations. Once the operations are profitable, if a separate corporation is created, the income from such operations may not thereafter be included in apportionable income. It also appears that in many cases affiliation can be avoided by use of different family members or by establishing partnerships or trusts.

The various federal bills have been under regular review for almost fifteen years. Those urging preemptive federal legislation profess that such legislation is for the benefit of small businesses. In fact, each successive bill provides more tax relief for multinational corporations.

The latest of the bills not only severely limits the state tax base, it would also subordinate state courts and administrative bodies to the Court of Claims.

As restrictive as this bill is, undoubtedly if it, or similar federal legislation is enacted, erosions of the state corporate tax base will continue. Perhaps, it would be well to ask if the most significant part of the corporate tax base is preempted, which will be next? Our discussion has been limited to corporate income tax bills although proposed federal legislation contains major gross

receipts and sales and use tax limitations. Additional bills have been introduced covering the Personal Income Tax Law and banks and other federal depositories.

If current proposals are enacted, it seems likely that most major decisions affecting state taxes will quickly pass from the State Legislature to Congress. Congress has not demonstrated outstanding ability in balancing the federal budget or in establishing a workable tax system with respect to its tax laws, particularly for multinational corporations. It may well be though that Congress may soon be prepared to exercise its wisdom as to significant state tax laws. If this occurs, it seems apparent that the independence of states will be in grave jeopardy.

National Association of Tax Administrators

In the latter part of 1978, the president of the National Association of Tax Administrators (NATA) formed a study group to make recommendations with respect to federal legislation effecting state taxes. Both sales and use taxes and net income taxes, including taxes measured by net income, were covered in the study. A position paper was prepared which was adopted by the NATA Executive Committee in March of 1979 and by the full association at its annual meeting in Madison, Wisconsin, in June. (Exhibit 36)

The Franchise Tax Board participated in the preparation of the position paper and voted for its adoption. The NATA, in the paper, announced once again its opposition to any federal legislation in this area. The Franchise Tax Board also opposes federal legislation.

The position paper went on to outline principles and requirements which should be included in any federal legislation if Congress should conclude it was necessary or appropriate. The department endorses the NATA position paper as representing a consensus of all of the states. There are several positions with which the department disagrees but as a statement of consensus of all the states it has the department's full support.

The principle elements of the position paper provide for:

1) Freedom of the individual states to prescribe methods of apportionment or allocation subject to a ceiling limitation.

2) Limitation to particular industries where the standard formula works well.

3) No limitations on the use of worldwide income and activities for purposes of determining the income taxable by a particular state.

4) Full accountability on the part of taxpayers--that is, all income assignable to a jurisdiction which could tax it if so desired.

There are a number of other principles and rules set forth in the full text.

The NATA position paper has served as a useful framework for a dialogue between the states, representatives of business and Congressional staffers. This dialogue has been under way for a number of months and should be continuing.

Legislative Proposals

State

AB-525 (Hughes - Mori)

Predecessors to the present bill were AB-2363 (Hughes) and AB-13(X)(Hughes) introduced in 1978. The present bill is also similar to AB-855 (Greene) and SB-1266 (Briggs), both introduced in 1977.

The bill is intended to prohibit use of the unitary method to determine the income from California sources of a foreign-based multinational business unless such business is engaged in the energy or steel business. The bill also would effectively cause a retroactive change in the interpretation of Section 25137 Cal. Rev. & Tax. Code and would allow all corporations to utilize separate accounting. This would overrule two long-standing decisions of the California Supreme Court, Honolulu Oil Corp. v. Franchise Tax Board and Superior Oil Co. v. Franchise Tax Board/[59] which held that unitary businesses must determine their income from California sources on the basis of formula accounting and a combined report.

As discussed earlier in this presentation, there is no logic or evidence to support the proposed treatment of foreign controlled operations. There is absolutely no support for elimination of the

unitary concept as proposed in Section 25137.5. Only the most fanatical exponent of separate accounting has suggested that a state could efficiently, fairly, and effectively determine the income from sources within a state on a separate accounting basis. This section, if enacted, would set state tax administration back one hundred years, prior to the enactment of any income tax.

AB-916 (Bates)

For California Bank and Corporation Tax Law purposes, corporate income which is received or results from unitary business activities is subject to formula apportionment, whereas non-unitary income is specifically assigned by statutory rules.

The California courts and the California State Board of Equalization, in interpreting pre-UDITPA law, held that, with minor exceptions, dividend income and gain or losses from the sale of stock were nonbusiness income allocable to the commercial domicile of the recipient. In enacting UDITPA, the California Legislature included Section 25140, which specifically provides that no change in the treatment of dividend income was intended.

On January 1, 1976, California became an active member of the Multistate Tax Compact. Under MTC regulations, dividend income and gains or losses from the disposition of stock is subject

to apportionment by formula if the purpose of acquiring or holding the stock is related to or incidental to the unitary business. However, in view of Section 25138 of the Revenue and Taxation Code (relating to legislative intent in enacting the Multistate Tax Compact) and long-standing prior judicial decisions regarding the treatment of dividend income, California believes it is precluded from following the MTC regulation approach without express legislative authorization to such effect. California's position in this area has been sustained by the trial court in a lawsuit filed by <u>Times Mirror</u>/[60](LA C172373), appeal pending. A similar case involving <u>Standard Oil of California</u> is before the State Board of Equalization.

By amending Sections 23040 and 25138 and eliminating the first paragraph of Section 25140, this bill provides the necessary legislative changes to require the state to follow the MTC's practice of apportioning dividend income or gains and losses from the disposition of stock where the purpose for acquiring or holding the stock is related to or incidental to the unitary business.

Apportionment of income from intangibles, as provided by this bill, is arguably a superior approach to allocation based on commercial domicile and would place California in conformity with the Multistate Tax Commission and most other states. Such income is essentially the same as business income, which is already apportioned.

AB-472 (Imbrecht)

This bill would allow certain commonly owned corporations which derive income solely from sources within California to report their income for franchise tax purposes by filing a combined report rather than by separate returns.

Not allowing a combined report for an intrastate unitary business does not make any tax difference if both corporations have net income. However, where one corporation has net income and the other has a loss, the losses are not offset aginst income as they would be if a combined report computation is used.

From the standpoint of equity and tax justice, the combined report method should be allowed whenever corporations are engaged in a unitary business, regardless of whether income is earned solely in California or from sources in and out of California.

The California Supreme Court has held under current law that the combined report provisions of the Revenue and Taxation Code are only applicable to multistate businesses./[61]

XIII

Revenue Impact

Limitations on Combinations

The basic issue relating to the taxation of multinational corporations involves the development of realistic claims to tax base shares of unitary profits between various taxing jurisdictions. Ideally, the taxing method should accurately measure contributory profits only for that unitary activity occurring within the taxing jurisdiction.

However, in the real world sense where goods are manufactured in State A, processed in State B, and sold in State C, for example unitary profits resulting from these combined interdependent operations cannot be fragmented into a "manufacturing profit," a "processing profit," and a "selling profit." The only recourse is to select the "best" method of capturing contributory profits as the tax base in some meaningful sense which is administratively viable for the tax authority and predictable for the corporate taxpayer.

The full benefits of unitary operations depend on the successful cooperation and complementarity of numerous affiliates which together produce greater profits than would occur otherwise. Profit-maximizing arrangements are sought through the diversity and specialization of scattered operations which cross jurisdictional lines. Under the separate entity, arm's-length method of taxation, this additional gain from cost-reducing economies within the multinational operation would be unaccounted for since differences

between intercompany dealings with integrated affiliates and open-market transactions with outsiders are not recognized in establishing transfer prices, common overhead charges, etc.

A popular criticism of the apportionment method is that since it implicitly assigns the same rate of return to each dollar invested in property, paid out in payroll, and made in sales regardless of location and since not all capital or payroll expenditures are equally productive of profits due to imperfect capital markets, risk differentials, and various degrees of labor-capital intensity, apportionment fails to measure relative contributory profits within a taxing jurisdiction and, therefore, produces a tax base which has no significant relationship to profits. However, it can be argued that equating a dollar spent on a factor of production in one jurisdiction with a dollar spent elsewhere is not althogether inappropriate in determining relative shares of total unitary profits.

The basis for this assertion is that multinational decision-makers, in most cases, permit various outlays on factors of production between areas and concentrate on sales in selected markets because, in terms of the overall unitary effort, they are seen as advancing business objectives, one of which is the maximization of profits.

Consider the case of a multinational which pays a higher wage to workers in jurisdiction A than to workers in jurisdiction B for producing an identical product. Workers in A could be more productive in terms of quantity and value of output and contribute more to profits than those in B with the higher wage reflecting

this to some degree.

The apportionment method in that situation properly assigns a greater payroll factor to A than B, albeit not precise, in terms of labor's contribution to total profits. On the other hand, the higher wage in A could be the result of superior "union" strength and not related to greater productivity. Acquiescence in such cases by management could signify that the market in A is sufficiently strong to absorb such increases through higher product prices.

The point is that what appears to be an unjustified, inflated payroll factor relative to that of some other area might, in fact, signify management's efforts to take advantage of a rising market, which in itself is profit-oriented. In this context, the higher payroll factor in jurisdiction A is not totally unrelated to profits.

If, indeed, management determines that there are no grounds for the higher wage in A over B and that workers in B are more productive in terms of value of final product, then it would consider expansion in jurisdiction B, unless market conditions and factor availability discouraged it. If this expansion took place, additional demands placed upon factors of production would tend to drive their prices up and result in larger apportionment factors.

Corporate dollars spent, therefore, can fairly reflect the relative contribution of scattered affiliates to unitary objectives.

The apportionment method captures economies from integration at the unitary level and divides them in a manner which is consistent with corporate spending on factors of production and realized sales. Separate accounting ignores the economies of integration in concentrating on isolated parts of the complete undertaking.

If, therefore, apportionment is the most appropriate method, as it appears, then it should apply to all unitary operations regardless of location. There is no logical reason for excluding any portion of the operation of the whole, such as foreign-based (outside the United States) income under recent proposals which would tend to encourage foreign expansion over domestic.

An analysis prepared by the department for the 1974 income year showed that the revenue loss to the state in excluding all foreign-based (outside the United States) income from unitary apportionment would have been $125 million on a conservative basis. (This would be much larger today.) AB-525 (Hughes, 1979-80 R.S.) proposes to exclude from unitary apportionment income of business entities, except those engaged in energy and steel industries, which are (1) organized under the laws of a foreign country; (2) not owned or controlled by a United States corporation or a United States resident(s); and (3) have more than 50 percent of the average of its property, payroll, and sales factors outside the United States, its territories and possessions. The term "energy business" is broadly interpreted and would include oil companies.

We have estimated that the revenue loss of this proposal would be in the $10 million range beginning with the 1979-80 fiscal year. However, Section 25137.5 of the bill apparently would authorize the use of separate accounting to that portion of a taxpayer's unitary business done in the United States. Since this provision is not restricted to foreign-based corporations only, it would permit United States-based unitary businesses to use separate accounting. The revenue implications would be staggering, several hundred million annually, with the ultimate effect of undermining the unitary accounting method itself.

Apportionment of Dividends

Under the current state law, corporations are required to allocate all "nonbusiness" dividend income to the state of commercial situs and to apportion any business dividend income on the basis of the three-factor formula. For corporations not domiciled in California, therefore, the only dividends that could be taxed through apportionment would be business dividend income. These dividends would represent dividend income received from investments by financial corporations or investment companies. All other dividend transactions are considered nonbusiness under current law.

AB 916 (Bates, 1979-80 R.S.) would provide for the apportionment of all income from intangible properties if the income derived constitutes an integral part of the corporation's regular business operation and would apply to all corporations regardless of their commercial comicile (headquarter's location). This would conform California law to current Multistate Tax Commission treatment of such dividends.

The fiscal estimate for SB 1713 (Holmdahl, 1975-76 R.S.) on the identical subject showed no change in the net impact on state tax revenues, although there would be a shift of perhaps $10 million in the tax burden from California to corporations located in other states or countries. Based on this analysis, the financial impact apportioning dividend income on bank and corporation revenues is probably a wash for any given year with a greater possibility of a minor revenue gain and an estimated shift in aggregate tax burdens from domestic to foreign corporations in the $15-$20 million range.

Combined Reporting for Intrastate Corporation

AB-472 (Imbrecht, 1979-80 R.S.) would allow commonly owned or controlled corporations deriving income solely from California sources, which would be an allocating corporation if doing business within and without the state, to combine their income (losses) for tax purposes, thus making the decision optional with the corporate group.

A special sample performed in 1973 on intrastate corporations revealed that the revenue loss would probably amount to $4 million annually, which represented 0.48 percent of total bank and corporation revenue for that year. If we apply this ratio to projected revenue of $2.4 billion for the 1980 income year, the revenue loss would be $12 million.

FOOTNOTES

1. Moorman Manufacturing v. Bair, 437 U.S. 267 at 283, 57 Law.Ed.2d 197 at 219 (1978). After the case was tried, Michigan repealed its corporate income tax.

2. 30 Cal.2d 472 (1947).

3. 60 Cal.2d 417 and 60 Cal.2d 406 (1963).

4. Dexter, Taxation of Income from Intangibles of Multistate-Multinational Corporations, 29 Vanderbilt Law Review 401 (1976).

5. Cal. Admin. Code, title 18, Art. 2, Reg. § 25120(c)(4) Example (C).

6. § 25138 Cal. Rev. & Tax. Code:

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

§ 25140 Cal. Rev. & Tax. Code:

> "Accounting procedures shall be adopted which will separately reflect the revenues attributable to dividends received by corporations having commercial domiciles in this state.
>
> In view of pending litigation concerning the proper treatment of intercompany dividends, it is not intended by enactment of this act that any inference be drawn from it in such litigation."

7. § 25137 Cal. Rev. & Tax. Code:

> "If the allocation and apportionment provisions of this act do not fairly represent the extent of the taxpayer's business activity in this state, the taxpayer may petition for or the Franchise Tax Board may require, in respect to all or any part of the taxpayer's business activity, if reasonable:
>
> (a) Separate accounting;
>
> (b) The exclusion of any one or more of the factors;
>
> (c) The inclusion of one or more additional factors which will fairly represent the taxpayer's business activity in this state; or
>
> (d) The employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.

8. Appeal of Donald M. Drake Company, Cal. St. Bd. of Equal., February 3, 1977, CCH 205-598, P-H 13,102-D; Appeal of New York Football Giants, Inc., Cal. St. Bd. of Equal., February 3, 1977, CCH 205-600, P-H 13,102-E, Rehearing June 28, 1979; Appeal of Parador Mining Co., Inc., Cal. St. Bd. of Equal., February 3, 1977, CCH 205-597, P-H 13,102-F; Appeal of Danny Thomas Productions, Cal. St. Bd. of Equal., February 3, 1977, CCH 205-599, P-H 13,102-C; Appeal of The O.K. Earl Corporation, Cal. St. Bd. of Equal., April 16, 1977, CCH 205-649, P-H 13,102-Q; Appeal of Pacific Telephone & Telegraph Co., Cal. St. Bd. of Equal., May 4, 1978, CCH 205-858, P-H 13,103-F; Appeal of Milwaukee Professional Sports and Services, Cal. St. Bd. of Equal., June 28, 1979; Appeal of Boston Professional Hockey Association, Cal. St. Bd. of Equal., June 28, 1979.

9. Appeal of Donald M. Drake Company, supra; Appeal of New York Football Giants, Inc., supra.

10. Cal. Admin. Code, title 18, Art. 2.5, Reg. § 25137(e).

11. Decided May 4, 1978, CCH 205-858, P-H 13,103-F.

12. Eadington Fruit Company, Chicago Pneumatic Tool Company, California First Bank.

13. _United States Steel Corporation, et al._, v. _Multistate Tax Commission, et al._, 434 U.S. 452, 54 Law.Ed.2d 689 (1978). See Exhibit 16.

14. See, for example, IRC §§ 901-907.

15. _Underwood Typewriter Co._ v. _Chamberlain_, 254 U.S. 113, 65 Law.Ed. 165 (1920).

16. _State Railroad Cases_, 92 U.S. 575, 23 Law.Ed. 663 (1875).

17. See footnote 1 and Exhibits 2 and 3.

18. M. Duerr, _Tax Allocations and International Business 65_, Conference Board Study, 1972.

19. See footnote 13.

20. 437 U.S. 267, 57 Law.Ed.2d 197 (1978).

21. 17 Cal.2d 664, 11 Pac.2d 334 (1941), aff'd 315 U.S. 501 (1942).

22. 60 Law.Ed.2d 336 (1979).

23. _____ Vt. _____, 394 Atl.2d 1147 (1979).

24. _____ Mont. _____, 567 Pac.2d 901 (1977), appeal dismissed by U.S. Supreme Court for want of jurisdiction.

25. 99 Id. 924, 592 Pac.2d 39 (1979).

26. 85 Cal.App.3d 763 (1978).

27. 266 U.S. 271, 69 Law.Ed. 282 (1924).

28. 3 Cal.2d 1 (1935).

29. _Appeal of Rockwell Manufacturing_, Cal. St. Bd. of Equal., February 19, 1958, CCH 200-845, P-H 13,175; _Appeal of Twentieth Century Fox, Inc._, Cal. St. Bd. of Equal., July 10, 1962, CCH 201-947, P-H 13,280.

30. Rudolph, _State Taxation of Interstate Business: The Unitary Business Concept and Affiliated Corporate Groups_, 25 Tax Law Review 171 (1970).

31. Bergsten, Horst, and Moran, _American Multinationals and American Interests_, at 212, The Brookings Institution, Washington, D.C. (1978).

32. *Supra*, pp. 64-68.

33. *John Deere Plow Co.* v. *Franchise Tax Board*, 38 Cal.2d 214, 238 Pac.2d 568 (1951), appeal dismissed 343 U.S. 939, 96 Law.Ed. 1345 (1952).

34. Exhibit 8.

35. U.S./U.S.S.R. Tax Convention 1973, *Report of the Senate Foreign Relations Committee*:

> "State and local taxes of the United States and Republic taxes, duties, and dues imposed by the Union Republics of the U.S.S.R. generally are not included in the proposed convention." (pg. 7989-4)
>
> "The taxes imposed by the Union Republics of the Soviet Union (comparable to states of the United States) are not covered by the Convention because, in keeping with past U.S. policy the taxes of the state and local governments of the United States are excluded from the scope of the Convention, except for purposes of Article X." (pg. 7989-10)

36. Exhibit 23.

37. Exhibit 18, *Zee Toys, Inc.* v. *County of Los Angeles*.

38. § 25128 Cal. Rev. & Tax. Code.

39. § 25123 Cal. Rev. & Tax. Code.

40. *Appeal of Safeway Stores, Inc.*, Cal. St. Bd. of Equal., March 2, 1962, CCH 201-897, P-H 13,272.

41. § 25106 Cal. Rev. & Tax. Code.

42. § 24402 Cal. Rev. & Tax. Code.

43. § 24410 Cal. Rev. & Tax. Code.

44. See footnote 6.

45. See footnote 25, Exhibit 16.

46. See footnote 23, Exhibit 16.

47. *Infra*, p. 126.

48. 17 Cal.2d 664 (1941).

49. See footnote 2.

50. See footnote 3.

51. 10 Cal.App.3d 496, appeal dismissed 400 U.S. 961, 27 Law.Ed.2d 381 (1970).

52. Business Week, June 21, 1976, at pg. 72.

53. New York Times, July 21, 1978.

54. Wall Street Journal, May 10, 1979.

55. 15 U.S.C. 381, 384.

56. Exhibit 12.

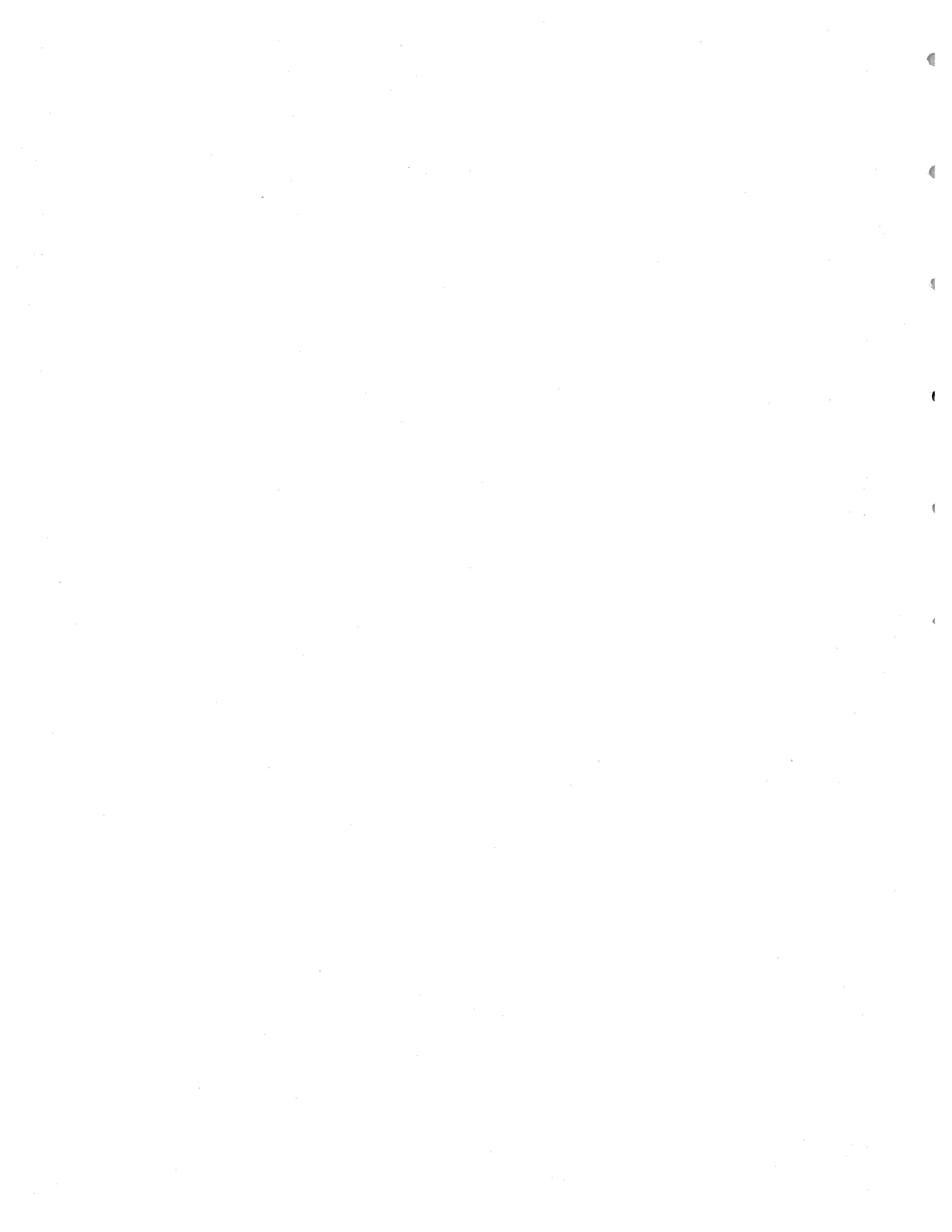
57. Tax Notes, Vol. IX, No. 7, August 13, 1979, at pg. 226.

58. §§ 303(b) and 314(a), 315(a) and 316(a) of S.2173 (1978).
§§ 302(b) and 355(a), 356(a) and 357(a) of S.983 (1979).

59. See footnote 3.

60. Infra, p. 82.

61. Handlery v. Franchise Tax Board, 26 Cal.App.3d 970, 103 Cal. Rptr. 475 (1972), appeal dismissed, 410 U.S. 921, 35 Law.Ed. 582 (1973).



LIST OF EXHIBITS

1. Incidence of Bank and Corporation Tax

2. CCH - All States Tax Reporter

3. Court Decisions Supporting Unitary Method

4. List of Special Formulae Continued Upon Adoption of UDITPA

5. Copies of Special Formulae Adopted Under UDITPA

6. MTC Proposed Formula for Railroads

7. Legal Ruling 413

8. Proposed Guideline for the Preparation of Combined Returns which Include Foreign Country Operations

9. Regulation Section 25137(g)

10. Statement of the Franchise Tax Board Pertaining to Section 25137 Petitions

11. List of Membership of Multistate Tax Compact and Associate Members

12. "Recommendation of the Task Force on Foreign Source Income" Committee on Ways and Means U.S. House of Representative 1977, pp 25-30

13. "The President's 1978 Tax Program" - Detailed Descriptions and Supporting Analyses of the Proposals (1978), pp 282-297

14. General Accounting Office Questionnaire and California Responses

15. "Multinational Corporations and Income Allocation Under Section 482 of the Internal Revenue Code"89 Harvard 1202 (1976)

16. Synopsis of Recent Important Cases

17. Cases Involving the Unitary Concept to which California is a Party

18. Zee Toys, Inc. v. County of Los Angeles

19. Bass, Ratcliff & Gretton v. State Tax Commissioner

20. Keesling, "A Current Look at the Combined Report and Uniformity in Allocation Practices," The Journal of Taxation, February, 1975

21. Multistate Tax Commission Resolution

22. The U.K./U.S. Tax Treaty - A Detailed Reappraisal

23. Musgrave, "The U.K. Treaty Debate: Some Lessons for the Future," Tax Notes July 10, 1978

24. Cal. Admin. Code, title 18, Regulation §25120(c)

25. Multistate Tax Commission Regulation, Regulation IV 1.(c)(4)

26. U.S. Treasury Study - Business - Nonbusiness Income

27. Cal. Admin. Code, title 18, §25120(b)

28. Ryder,"The Disincentive to Investment: A Groundless Argument Against the Unitary Method of Taxation"

29. Wall Street Journal, April 6, 1978, p 4

30. Excerpts-Facility Location Decision

31. Excerpts from Library of Congress Study

32. Pp 63-66, Lou Harris Study

33. Vaughan, State Taxation and Economic Development Excerpts

34. Federal Interstate Tax Legislation

35. Detailed Analysis of Title III, SB 2173, 95th Congress

36. NATA Position Paper on the Interstate Taxation of Business

EXHIBIT 1

Bank and Corporation Tax - Allocation of Tax Burdens, Individuals versus Business

The high degree of concentration of the corporate tax base at the upper income end is evident from the table below. Corporations with State net incomes $1 million and over represent 1.5 percent of the total population of corporations with net incomes but account for 69 percent of total revenue. Just over 61 percent have State net incomes below $20,000, making up only 3 percent of total revenue.

Allocation of Tax Burdens
Bank and Corporation Franchise Tax
Distribution of Corporate Tax Base
1976 Income Year

Corporations with State Net Incomes	Number of Returns	% of Total	Total State Net Income	% of Total
$1 under $20,000	69,462	61.1	$ 411,497,852	2.8
20,000 under 50,000	21,975	19.3	720,427,808	4.9
50,000 under 100,000	10,545	9.3	709,526,016	4.8
100,000 under 200,000	5,108	4.5	713,671,756	4.8
200,000 under 500,000	3,542	3.1	1,100,651,254	7.4
500,000 under 1,000,000	1,350	1.2	948,192,762	6.4
1,000,000 and over	1,632	1.5	10,203,792,235	68.9
Totals	113,614	100.0	$14,807,759,683	100.0

The tax rate is not graduated but is proportional at 9 percent of State net income. Corporations doing business in California and elsewhere which can be classified as unitary are required to allocate their income to California based on the three-factor formula of sales, property, and payroll, California versus worldwide. It is estimated that these allocating corporations are responsible for around two-thirds of the total corporate tax base. The following tables were developed from audit records on parent or key apportioning corporations. The first table shows the distribution of apportioning corporations (multistate and multinational) by State net income relative to all corporations filing returns for the year. The second table provides a distribution for multinationals only based on a sample of 849 from the 12,312 allocating corporations.

Comparison of State Net Income
Reported by Apportioning Corporations
1975 Income Year

	All Corporations[1]		Apportioning Corporations[2]		Apportioning as a Percent of Total	
Net Income Class	Number	State Net Income (000)	Number	State Net Income (000)	Number	State Net Income
Under $25,000	48,127	$ 488,970	4,539	$ 51,568	9.4	10.5
$25,000 under 50,000	14,819	525,297	1,769	66,378	11.9	12.6
50,000 under 100,000	8,585	584,907	1,483	111,225	17.3	19.0
100,000 under 500,000	7,742	1,616,112	2,734	820,200	35.3	50.8
500,000 under 1,000,000	1,178	820,637	785	588,750	66.6	71.7
1,000,000 and over	1,329	7,613,089	1,002	6,760,000	75.4	88.8
Totals	78,780	$11,649,011	12,312	$8,398,081	15.6	72.1

[1] Represents all corporations with net incomes paying more than the minimum tax.

[2] Represents parent or "key" corporations only with multistate or multinational unitary operations from audit records. A parent corporation is one which owns or controls more than 50 percent of the voting stock of another corporation. A "key" corporation represents the principal California member of an affiliated group of corporations when the parent itself is not a California taxpayer. Specific data on allocating subsidiaries is not available; this omission results in an understatement of the total number of apportioning corporations.

Apportioning Corporations
Distribution of Multinationals
1975 Income Year

Net Income Class	Parent or Key Apportioning Corporations		Estimated Distribution[1]				Multinational Percentage of Tota	
			Multinational Corporations		All Others[2]			
	Number	State Net Income (000)	Number	State Net Income (000)	Number	State Net Income (000)	Number	State Net Inco (000)
Under $25,000	4,539	$ 51,568	1,311	$ 15,679	3,228	$ 35,889	28.9	30.4
$25,000 under 50,000	1,769	66,338	279	12,047	1,490	54,291	15.8	18.2
50,000 under 100,000	1,483	111,225	234	12,358	1,249	98,867	15.8	11.1
100,000 under 500,000	2,734	820,200	1,481	444,275	1,253	375,925	54.2	54.2
500,000 under 1,000,000	785	588,750	444	332,772	341	255,978	56.6	56.5
1,000,000 and over	1,002	6,760,000	597	5,061,040	405	1,698,960	59.6	74.9
Totals	12,312	$8,398,081	4,346	$5,878,171	7,966	$2,519,910	35.3	70.0

[1] Based on stratified sample of 849 corporations for the 1975 income year. At the 95 percent confidence level, the estimated number of corporations is ±300 and the State net income of these multinationals is ±$225 million.

[2] Includes some multistate corporations which may actually be multinational on a unitary basis but cannot be determined without a field audit.

EXHIBIT 2

State	Return Due Dates		Net Operating Losses		Federal Income Tax Deductible	Due Date for Report of Change in Federal Return [3]	Federal Income Used as State Tax Base
	Calendar	Fiscal	Carry-over from Years *	Carry-over to Years **			
Ala.	3-15	15th, 3rd mo.	0		Yes	None	No
Alas.	3-15 [21]	15th, 3rd mo.[21]	1974-82	1976-86	No	60 days	Yes
Ariz.	4-15	15th, 4th mo.	1974-78	1980-84	Yes	90 days	Yes
Ark.	5-15	4½ mos.	1976-78	1980-82	No	30 days	No
Calif.	3-15 [1]	15th, 3rd mo.[1]	0		No	90 days	No
Colo.	4-15	15th, 4th mo.	1974-82	1976-86	No	30 days	Yes
Conn.	4-1	90 days	1974-78 [7]	1980-84	No	90 days [30]	Yes
Del.	4-1	1st, 4th mo.	1974-82	1976-86	No	90 days	Yes
D. C.	4-15	15th, 4th mo.	0		No	90 days	No
Fla.	4-1 [6]	1st, 4th mo.[6]	1974-78	1980-86	No	60 days	Yes
Ga.	4-15	15th, 4th mo.	1974-82	1976-86	No	180 days	Yes
Hawaii	4-20	20th, 4th mo.	1974-82	1976-84	No	90 days	Yes
Ida.	4-15	15th, 4th mo.	1974-82	1976-84	No	Immediately	Yes
Ill.	3-15	15th, 3rd mo.	1974-82	1976-86	No	20 days	Yes
Ind.	4-15	15th, 4th mo.	1974-82	1976-86	No	120 days	Yes
Iowa	4-30 [1]	Last day, 4th mo.[1]	1974-82	1976-86	Yes	None [7]	Yes
Kan.	4-15	15th, 4th mo.[11]	1974-82	1976-86	No	90 days	Yes
Ky.	4-15	15th, 4th mo.	1978 [15]	1980 [15]	No	30 days [37]	Yes
La.	5-15	15th, 5th mo.	0 [7]	1980-84 [46]	Yes	60 days	No
Me.	3-15	15th, 3rd mo.	1974-82	1976-86	No	90 days	Yes
Md.	4-15	15th, 4th mo.	1974-82	1976-86	No	90 days	Yes
Mass.	3-15	15th, 3rd mo.	1974-78 [12]	1980-84 [12]	No	3 months	Yes
Mich.[17]	4-30	Last day, 4th mo.	0 [17]		No	120 days	Yes
Minn.	3-15 [1]	15th, 3rd mo.[1]	1974-82	1976-84	No	90 days	No
Miss.	3-15	15th, 3rd mo.	1974-78	1980-84	No	30 days	No
Mo.	4-15	15th, 4th mo.	1974-82	1976-86	Yes	90 days	Yes
Mont.	5-15	15th, 5th mo.	1974-82	1976-86	No	90 days	Yes
Neb.	3-15	15th, 3rd mo.	1974-82	1976-84	No	90 days	Yes
N. H.	3-15 [42]	15th, 3rd mo. [42]	0		No	[3]	Yes
N. J.	4-15	15th, 4th mo.	0		No	90 days	Yes
N. M.	3-15	15th, 3rd mo.	1974-82	1976-86	No	30 days	Yes
N. Y.	3-15	2½ mos.	1974-82	1976-86	No	90 days	Yes
N. C.	3-15 [1]	15th, 3rd mo.[1]	1974-78 [43]	1980-84 [43]	No	2 years	Yes
N. D.	4-15 [1]	15th, 4th mo.[1]	1974-82	1976-86	Yes	90 days	Yes
Ohio	3-31 [4]	[4]	1974-78	1980-84	No	120 days	Yes
Okla.	4-15	15th, 4th mo.	1974-82	1976-86	No	1 year	Yes
Ore.	4-15	15th, 4th mo.	1974-78	1980-84	No	90 days	No
Pa.	4-15	[5]	0		No	30 days	Yes
R. I.	3-15	15th, 3rd mo.	1975-82 [21]	1976-86 [21]	No	60 days	Yes
S. C.	3-15	15th, 3rd mo.	1976-78 [7]	1980-82 [18]	No	30 days	No
Tenn.	4-1	1st, 4th mo.	1976-78 [9]	1980-82 [9]	No	None [17]	Yes
Utah	4-15	15th, 4th mo.	1974-82	1976-84	No	90 days	No
Vt.	3-15	15th, 3rd mo.	1974-82	1976-86	No	30 days	Yes
Va.	4-15	15th, 4th mo.	1974-82	1976-86	No	90 days	Yes
W. Va.	3-15	15th, 3rd mo.	1974-82	1976-86	No	90 days	Yes
Wis.	3-15	15th, 3rd mo.	1974-78	1980-84	No	90 days	No

Footnotes appear on page 1044.

114

State	Follow the Uniform Division of Income for Tax Purposes Act	Adopt the Multi-State Tax Compact [13]	Allow Federal Depreciation: Federal Guideline Lives	Asset Depreciation Range	Federal Accelerated Depreciation	Federal Bonus (20%) Depreciation	Allow Federal Depletion
Ala.	Yes	Yes [25]	Yes	Yes	Yes	No	No
Alas.	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Ariz.	No	No	Yes	Yes [18]	Yes	Yes [33]	No
Ark.	Yes	Yes	Yes	Yes	Yes [31]	Yes	No
Calif.	Yes	Yes	Yes [22]	No	Yes [10]	Yes [10]	Yes [24]
Colo.	No [34]	Yes	Yes	Yes	Yes	Yes	Yes [8]
Conn.	No	No	Yes	Yes	Yes	Yes	Yes
Del.	No	No	Yes	Yes	Yes	Yes	Yes [40]
D. C.	Yes	No	Yes	Yes	Yes	Yes	Yes
Fla.	No	No	Yes	Yes	Yes	Yes	Yes
Ga.	No	No	Yes	Yes	Yes	Yes	Yes
Hawaii	Yes	Yes	Yes	Yes	Yes [33]	Yes	Yes [30]
Ida.	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Ill.	Yes	No	Yes	Yes	Yes	Yes	Yes
Ind.	Yes	No	Yes	Yes	Yes [33]	Yes	Yes
Iowa	No	No	Yes	Yes	Yes	Yes	Yes
Kan.	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Ky.	Yes	No	Yes	Yes	Yes	Yes	Yes [30]
La.	No	No	Yes	Yes	Yes [33]	Yes	Yes [24]
Me.	Yes	No	Yes	Yes	Yes	Yes	Yes
Md.	No	No	Yes	Yes	Yes	Yes	Yes [42]
Mass.	No	No	Yes	Yes	Yes	Yes	Yes
Mich.	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Minn.	No	No	Yes	Yes	Yes [10, 33]	Yes [10]	No [36]
Miss.	No	No	Yes	Yes	Yes	Yes	Yes [47]
Mo.	No [34]	Yes	Yes	Yes	Yes	Yes	Yes
Mont.	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Neb.	Yes	Yes	Yes	Yes	Yes	Yes	Yes
N. H.	No	No	Yes	Yes	Yes	Yes	Yes
N. J.	No	No	Yes	Yes	Yes	Yes	Yes
N. M.	Yes	Yes	Yes	Yes	Yes	Yes	Yes
N. Y.	No	No	Yes	Yes	Yes	Yes	Yes
N. C.	Yes	No	Yes	Yes	Yes	Yes	Yes
N. D.	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Ohio	No	No	Yes	Yes	Yes	Yes	Yes
Okla.	Yes [33]	No	Yes	Yes	Yes	Yes	Yes [11]
Ore.	Yes	Yes	Yes	Yes [44]	Yes [11]	Yes	No
Pa.	Yes	No	Yes	Yes	No [39]	Yes	Yes
R. I.	No	No	Yes	Yes	Yes	Yes	Yes
S. C.	Yes	No	Yes [19]	No	Yes [33]	Yes	No [22]
Tenn.	Yes	No	Yes	Yes	Yes	Yes	No
Utah	Yes	Yes	Yes	Yes	Yes	Yes	No
Vt.	No	No	Yes	Yes	Yes	Yes	Yes
Va.	Yes	No	Yes	Yes	Yes	Yes	Yes
W. Va.	Yes [38]	No	Yes	Yes	Yes [33]	Yes	Yes
Wis.	No	No	Yes	Yes	Yes	Yes	No

Footnotes appear on page 1044.

Exhibit 2

EXHIBIT 3

COURT DECISIONS

ENDORSING UNITARY METHOD

Arkansas

Montgomery Ward & Co., Inc. v. Wooten, Director, Chancery Court of Pulaski County, Arkansas, Third Division, October 19, 1977, CCH Arkansas State Tax Rptr. ¶ 14-026

California

Butler Bros. v. McColgan, 17 Cal.2d 664, 11 Pac.2d 334 (1941), aff'd 315 U.S. 501 (1942)

Edison California Stores v. McColgan, 30 Cal.2d 472, 183 Pac.2d 16 (1947)

Colorado

General Motors Corp. v. State of Colorado, 181 Colo. 360, 509 Pac.2d 1260 (1973)

Union Pacific Railroad Co. v. Heckers, 181 Colo. 374, 509 Pac.2d 1255 (1973), dismissed 414 U.S. 806

Florida

Coulter Electronics, Inc. v. Florida Department of Revenue, December 29, 1978, CCH Florida State Tax Rptr. ¶ 201-470

Georgia

Phillips v. Sinclair Refining Co., 76 Ga.App.2d 34, 44 S.E.2d 671 (1947)

Idaho

ASARCO v. Idaho State Tax Commission, 99 Id. 924, 592 Pac.2d 39 (1979)

Illinois

Caterpillar Tractor Co. v. Illinois Department of Revenue, Circuit Court of Tenth Judicial District, Peoria County, February 9, 1979, CCH Illinois State Tax Rptr. ¶ 201-049

Exhibit 3

Kansas

Crawford Mfg. Co. v. State Commissioner of Revenue, 180 Kan. 352, 304 Pac.2d 504 (1956)

Kentucky

Corning Glass Works v. Department of Revenue, Bd. of Tax Appeals, July 22, 1976, CCH Kentucky State Tax Rptr. ¶201-402

Kentucky Tax Commission v. Fourth Ave. Amusement Co., 293 Ky. 668, 170 S.W.2d 42

Minnesota

Western Auto Supply Co. v. Commissioner of Internal Revenue, 245 Minn. 346, 71 N.W.2d 797 (1955)

Associated Dry Goods Corporation v. Commissioner of Taxation, Minn. Supreme Court, May 17, 1974, CCH Minnesota State Tax Rptr. ¶ 200-675

Montana

Dept. of Rev. v. American Smelting and Refining Co., 567 Pac.2d 901 (1977)

New Hampshire

Johns-Manville Corp. v. Comm. of Rev. Admin., 343 Atl.2d 221 (1975)

New Jersey

F. W. Woolworth v. Div. Dir. of Tax., 213 Atl.2d 1 (1965)

New Mexico

Champion Int'l Corp. v. Bureau of Revenue, 88 N.M. 411, 540 Pac.2d 1300 (1975)

New York

Fedders Corp. v. State Tax Comm., 45 App.Div.2d 359, 357 N.Y.S.2d 719 (1974), CCH New York State Tax Rptr. ¶ 99-864

Wurlitzer Company v. State Tax Comm., 315 N.E.2d 805 (1974)

North Carolina

Gulf Oil Corp. v. Clayton, 267 N.C. 15, 147 S.E.2d 522 (1966)

Ohio

Beau Brummell Ties, Inc. v. Lindley, 383 N.E.2d 907, aff'g Ohio B.T.A. decision of March 14, 1978, CCH Ohio State Tax Rptr. ¶ 200-170 and ¶200-280

Luxaire, Inc., Westinghouse Electric Corp., et al. v. Lindley, B.T.A. April 10, 1978, CCH Ohio State Tax Rptr. ¶ 200-193

Oregon

Coca Cola v. Dept. of Rev., 533 Pac.2d 788 (1975), CCH Oregon State Tax Rptr. 203-106

Zale-Salem, Inc. v. State Tax Comm., 391 Pac.2d 601 (1964)

South Carolina

Covington Fabrics v. S.C. Tax Commission, 212 S.E.2d 574 (1975) dismissed 423 U.S. 805, 46 Law.Ed. 26

Texaco, Inc. v. Wasson, S.C. Sup. Ct. August 17, 1977, CCH South Carolina State Tax Rptr. ¶ 200-253

Tennessee

Dickey Clay Mfg. Co. v. Dickinson, 289 S.W.2d 533 (1956)

Tidwell, Comm. of Rev. v. Security Mills, Inc., Tenn. Sup. Ct. January 21, 1974, CCH Tennessee State Tax Rptr. 200-199

Vermont

Mobil Oil Corporation v. Commissioner, 394 Atl.2d 1147 (1978). Appeal filed U.S. Sup. Ct. February 2, 1979. CCH Vermont State Tax Rptr. ¶ 200-131

Virginia

Dept. of Tax. v. Lucky Stores, Inc., 225 S.E.2d 870 (1976)

Wisconsin

Ellen Co. v. Wisconsin Dept. of Tax., 269 Wis. 372, 69 N.W.2d 453 (1955)

STATES WHICH FOLLOW

WITHOUT COURT DECISION

Alaska

North Dakota

EXHIBIT 4

LIST OF SPECIAL FORMULAE
CONTINUED UPON ADOPTION OF UDITPA

1. Trains
2. Buses
3. Trucks
4. Airlines
5. Pipelines
6. Freight Forwarders
7. Banks
8. Financials
9. Personal Service Companies
10. Stock Brokers
11. Construction Contractors
12. Professional Sports

Exhibit 4

EXHIBIT 5

STATE OF CALIFORNIA
FRANCHISE TAX BOARD
SACRAMENTO, CALIFORNIA 95857

Guideline for Apportionment of Income of Banks and Financial Corporations

I. Introduction

Banks and financial corporations conducting business activities within and without this state are required to determine and report business income derived from sources within this state as provided in the Uniform Division of Income for Tax Purposes Act (UDITPA), Sections 25120-25139, inclusive, Revenue and Taxation Code. The general regulations for UDITPA, Regs. 25120-25139, inclusive, are applicable except as otherwise provided in this guideline. The three-factor apportionment formula of property, payroll and sales provided in UDITPA and certain rules set forth in the regulations have been modified in order to provide an equitable apportionment of income.

All income of banks and financial corporations is ordinarily "business income" within the meaning of Section 25120(a), Revenue and Taxation Code.

The apportionment formula prescribed herein shall be applicable to income years beginning after December 31, 1975.

II. Definitions

A. The following definitions shall apply in the construction of this guideline:

1. The term "original cost" for property factor purposes is deemed to be the basis of the property for federal income tax purposes (prior to any federal adjustments) at the time of acquisition by the taxpayer and adjusted by subsequent capital additions or improvements thereto and partial disposition thereof, by reason of sale, exchange, abandonment, etc. If the original cost of property is unascertainable, the property is included in the property factor at its fair market value as of the date of acquisition by the taxpayer (Reg. 25130(a)).

2. "Receipts" for sales factor purposes means gross income including net taxable gain on disposition of assets derived from transactions and activities in the regular course of the taxpayer's trade or business which produce business income.

EXHIBIT 5

3. Participation loans are joint loans by more than one bank to a common borrower.

4. "Business situs" is the place at which intangible personal property is employed as capital; or the place where the property is located if possession and control of the property is localized in connection with the taxpayer's business so that substantial use or value attaches to the property.

III. Apportionment Formula

A. Property Factor

1. In general —

(a) The property factor includes all owned real and personal property, both tangible and intangible, and rented real and tangible personal property used in the business.

(b) Owned real property and tangible personal property is to be included at original cost.

(c) Owned intangible personal property is to be included at its tax basis for federal income tax purposes. Goodwill shall not be included in the property factor.

(d) Rental property is valued at eight times the net annual rental rate.

(e) Coin and currency is to be taken into account for property factor purposes.

2. The denominator of the property factor includes:

(a) Real and tangible personal property owned or rented and used in the business.

(b) Intangible personal property owned and used in the business.

3. The numerator of the property factor includes the following:

(a) Real and tangible personal property owned or rented and used in the business in this state.

(b) Coin and currency located in this state.

(c) Intangible personal property owned and used in the business determined as follows:

(i) Assets in the nature of loans (including federal funds sold and banker's acceptances) and installment obligations shall be attributed to the state where the office of the bank or financial corporation is located at which the customer applied for the loan except in cases where the loan is recognized by appropriate banking regulatory authority as being made from and as an asset of an office located in another state, in which case it shall be attributed to the state where that office is located. For purposes of this paragraph the word "applied" means initial inquiry (including customer assistance in preparing the loan application) or submission of a completed loan application, whichever occurs first in time.

(ii) A participating bank's portion of a participation loan shall be attributed to the state where the office of the participating bank is located which entered into such loan.

(iii) Loans initiated through solicitation by traveling loan officers shall be attributed to the state where the office out of which he operates is located except in cases where the loan is recognized by appropriate banking regulatory authority as being made from and as an asset of an office located in another state, in which case it shall be attributed to the state where that office is located.

(iv) Bank credit card and travel and entertainment credit card receivables shall be attributed to the state in which the credit card holder resides in the case of an individual or, if a corporation, to the state of the corporation's commercial domicile, provided the taxpayer is taxable in such state. If the taxpayer is not taxable in the state of the individual card holders residence or commercial domicile of the corporate card holder, such receivables shall be attributed to the state of the taxpayer's commercial domicile.

(v) Investments of a bank in securities, the income from which constitutes business income, shall be attributed to its commercial domicile except that:

(I) Securities used to maintain reserves against deposits to meet federal and state reserve deposit requirements shall be attributed to each state based upon the ratio that total deposits in the state bear to total deposits everywhere.

(II) Securities owned by a bank but held by a state treasurer or other public official or pledged to secure public or trust funds deposited in such bank shall be attributed to the banking office at which such secured deposit is maintained.

(vi) Investments of a financial corporation in securities, the income from which constitutes business income, shall be attributed to its commercial domicile unless the securities have acquired a business situs elsewhere.

(d) Where the taxpayer leases tangible personal property to another the entire cost of such property shall be attributed to the state of the taxpayer's commercial domicile unless the taxpayer establishes, or the Franchise Tax Board requires, that all or a portion of the cost of such property should be attributed to a different state or allocated between more than one state. (See Reg. 25122 when taxpayer is taxable in another state.)

B. Payroll Factor

1. Compensation paid during the tax period shall be included in the numerator and denominator as provided in Sections 25132 and 25133, Revenue and Taxation Code, and the regulations thereunder.

C. Sales Factor

1. Most receipts derived from transactions and activities in the regular course of the trade or business which produce business income are included in the denominator of the sales factor (see Sections 25134-25137, inclusive, and the regulations thereunder).

2. The numerator of the sales factor is that portion of the total receipts included in the denominator of the taxpayer attributable to this state during the income year.

3. Receipts from the sale, lease, rental or other use of real property shall be included in the numerator as provided in Section 25136 and the regulations thereunder.

4. Receipts from the sale or use of tangible personal property, other than lease or rental receipts, shall be included in the numerator as provided in Sections 25134 to 25137, inclusive, and the regulations thereunder. Receipts from the lease or rental of tangible personal property shall be attributed to the state of the taxpayer's commercial domicile unless the taxpayer establishes, or the Franchise Tax Board requires, that all or a portion of such receipts should be attributed to a different state or allocated between more than one state.

5. Receipts from intangible personal property shall be included in the numerator as follows:

   (a) Interest and other receipts from assets in the nature of loans (including federal funds sold and banker's acceptances) and installment obligations shall be attributed to the state where the office is located at which the customer applied for the loan except in cases where the loan is recognized by appropriate banking regulatory authority as being made from and as an asset of an office located in another state, in which case it shall be attributed to the state where that office is located. For purposes of this paragraph the word "applied" means initial inquiry (including customer assistance in preparing the loan application0 or submission of a completed loan application, whichever occurs first in time.

   (b) Interest income from a participating bank's portion of participation loan shall be attributed to the state where the office of the participating bank is located which entered into such loan.

(c) Interest income from loans solicited by traveling loan officers shall be attributed to the state where the office out of which he operates is located except in cases where the loan is recognized by appropriate banking regulatory authority as being made from and as an asset of an office located in another state, in which case it shall be attributed to the state where that office is located.

(d) Interest or service charges from bank, travel and entertainment credit card receivables and credit card holders' fees shall be attributed to the state in which the credit card holder resides in the case of an individual or, if a corporation, to the state of the corporation's commercial domicile, provided the taxpayer is taxable in such state. If the taxpayer is not taxable in the state of the individual card holder's residence or commercial domicile of the corporate card holder, the receipts shall be attributed to the state of the taxpayer's commercial domicile.

(e) Merchant discount income derived from bank and financial corporation credit card holder transactions with a merchant shall be attributed to the state in which the merchant is located, provided the taxpayer is taxable in such state. If the taxpayer is not taxable in the state in which the merchant is located, the merchant discount income shall be attributed to the state in which the taxpayer's commercial domicile is located.

(f) Receipts for the performance of fiduciary services are attributable to the state where the services are principally performed.

(g) Receipts from investments of a bank in securities, the income from which constitutes business income, shall be attributed to its commercial domicile except that:

(i) receipts from securities used to maintain reserves against deposits to meet federal and state reserve deposit requirements shall be attributed to each state based upon the ratio that total deposits in the state bear to total deposits everywhere.

(ii) receipts from securities owned by a bank but held by a state treasurer or other public official or pledged to secure public or trust funds deposited in such bank shall be attributed to the banking office at which such secured deposit is maintained.

(h) Receipts (fees or charges) from the issuance of travelers checks and money orders shall be attributed to the state where the taxpayer's office is located that issued the travelers checks. If the travelers checks are issued by an independent representative or agent of the taxpayer, the following rules apply:

(i) If the taxpayer is taxable in the state in which the independent representative or agent issues the travelers checks or money orders, the receipts (fees or charges) shall be attributed to that state.

(ii) If the taxpayer is not taxable in the state in which the independent representative or agent issues the travelers checks or money orders, the receipts (fees or charges) shall be attributed to the state of commercial domicile of the taxpayer.

(i) Receipts from investments of a financial corporation, the income from which constitutes business income, shall be attributed to its commercial domicile unless the securities have acquired a business situs elsewhere.

(f) (1) Construction Contractors. Apportionment of Income, Long-Term Construction Contracts. (A) In General. When a taxpayer elects to use the percentage of completion method of accounting, or the completed contract method of accounting for long-term contracts, and has income from sources both within and without this state, the amount of business income derived from sources within this state, including income from such long-term contracts, shall be determined pursuant to these regulations. In such cases, the first step is to determine which portion of the taxpayer's income constitutes "business income" and "nonbusiness income" under Section 25120 of the Bank and Corporation Tax Law and the regulations thereunder. Nonbusiness income is directly allocated to specific states pursuant to the provisions of Sections 25124 to 25127, inclusive, of the law. The business income of the taxpayer is divided between or among the states in which the business is conducted pursuant to the property, payroll, and sales apportionment factors set forth in this regulation. The sum of (1) the items of nonbusiness income directly allocated to this state, plus (2) the amount of business income attributable to this state constitutes the amount of the taxpayer's entire net income which is subject to tax.

(B) Business and Nonbusiness Income. For definitions, rules and examples for determining business and nonbusiness income, see Regulation 25120.

(C) Methods of Accounting and Year of Inclusion. For general rules of accounting, definitions and methods of accounting for long-term construction contracts, see Section 24651 and the regulations thereunder relating to accounting methods and Reg. 24661(c) relating to year of inclusion of income, definitions, and methods of reporting income from long-term contracts in general.

(D) Apportionment of Business Income.

(i) In General. Business income is apportioned to this state by a three factor formula consisting of property, payroll and sales regardless of the method of accounting for long-term contracts elected by the taxpayer. The total of the property, payroll and sales percentages is divided by three to determine the apportionment percentage. The apportionment percentage is then applied to business income to determine the amount apportioned to this state.

(ii) Percentage of Completion Method. Under this method of accounting for long-term contracts, the amount to be included each year as business income from each contract, is the amount by which the gross contract price which corresponds to the percentage of the entire contract which has been completed during the income years exceeds all expenditures made during the income year in connection with the contract. In so doing, account must be taken of the material and supplies on hand at the beginning and end of the income year for use in each such contract (see Reg. 24661(c)).

Example: A taxpayer using the percentage of completion method of accounting for long-term contracts, entered into a long-term contract to build a structure for $9,000,000. The contract allowed three years for completion, and as of the end of the second income year the taxpayer's books of account, kept on the accrual method, disclosed the following:

	Receipts	Expenditures
End of 1st income year	$2,500,000	$2,400,000
End of 2nd income year	4,500,000	4,100,000
	$7,000,000	$6,500,000

In computing the above expenditures, consideration was given to material and supplies on hand at the beginning and end of each income year.

It was estimated that the contract was 30% completed at the end of the first income year and 80% completed at the end of the second income year. The amount to be included as business income for the first income year is $300,000 (30% of $9,000,000 equals $2,700,000 less expenditures of $2,400,000). The amount to be included as business income for the second income year is $400,000 (50% of $9,000,000 equals $4,500,000 less expenditures of $4,100,000).

(iii) Completed Contract Method. Under this method of accounting business income derived from long-term contracts is reported for the income year in which the contract is finally completed and accepted. Therefore, a special computation is required to compute the amount of business income attributable to this state from each completed contract (see paragraph E of this regulation). Thus, all receipts and expenditures applicable to such contracts whether completed or not as of the end of the income year are excluded from business income derived from other sources, as for example, short-term contracts, interest, rents, royalties, etc., which is apportioned by the regular three factor formula of property, payroll and sales.

(iv) Property Factor. In general the numerator and denominator of the property factor shall be determined as set forth in Sections 25129, 25130 and 25131 and the regulations thereunder. However, the following special rules are also applicable:

(I) The average value of the taxpayer's cost (including materials and labor) of construction in progress, to the extent such costs exceed progress billings (accrued or received depending on whether the taxpayer is on the accrual or cash basis for keeping its accounts) shall be included in the denominator of the property factor. The value of any such construction costs attributable to construction projects in this state shall be included in the numerator of the property factor.

Example 1: Taxpayer commenced a long-term construction project in this state as of the beginning of a given year. By the end of its second income year its equity in the costs of production to be reflected in the numerator and denominator of its property factor for such year is computed as follows:

	1st Year Beginning	1st Year Ending	2nd Year Beginning	2nd Year Ending
Construction Costs	0	$1,000,000		
Progress billings		600,000		
Balance 12/31-(1/1)		$400,000	$400,000	
Construction Costs—				
Total from beginning of project				$5,000,000
Progress Billings—				
Total from beginning of project				4,000,000
Balance 12/31				1,000,000
Balance beginning of year				400,000
Total				$1,400,000
Average (½)—Value (*) used in property factor				$700,000

(*) It may be necessary to use monthly averages if yearly averages do not properly reflect the average value of the taxpayer's equity; see Section 25131 and the regulations thereunder.

Example 2: Same facts as in Example 1, except that progress billings exceeded construction costs. No value for the taxpayer's equity in the construction project is shown in the property factor.

(II) Rent paid for the use of equipment directly attributable to a particular construction project is included in the property factor at eight times the net annual rental rate even though such rental expense may be included in the cost of construction.

(III) The property factor is computed in the same manner regardless of which long-term contract method of accounting the taxpayer has elected and is computed for each income year even though under the completed contract method of accounting, business income is computed separately (see paragraph (E)).

(v) *Payroll Factor.* In general the numerator and denominator of the payroll factor shall be determined as set forth in Sections 25132 and 25133 and the regulations thereunder. However, the following special rules are also applicable:

(I) Compensation paid employees which is attributable to a particular construction project is included in the payroll factor even though included in the cost of construction.

(II) Compensation paid to employees engaged in performing services at a construction site are attributed to the state in which the services are performed. Compensation paid all other employees is governed by Section 25133.

Example: A taxpayer engaged in a long-term contract in state X assigns several key employees to that state to supervise the project. The taxpayer, for unemployment tax purposes reports these employees to state Y where the main office is maintained and where the employees reside. For payroll factor purposes, such compensation is assigned to the numerator of state X.

(III) The payroll factor is computed in the same manner regardless of which long-term contract method of accounting the taxpayer has elected and is computed for each income year even though under the completed contract method of accounting, business income is computed separately (see paragraph (E)).

(vi) *Sales Factor.* In general the numerator and denominator of the sales factor shall be determined as set forth in Sections 25134, 25135 and 25136 and the regulations thereunder. However, the following special rules are also applicable:

(I) Gross receipts derived from the performance of a contract are attributable to this state if the construction project is located in this state. If the construction project is located partly within and partly without this state, the gross receipts attributable to this state are based upon the ratio which construction costs for the project in this state incurred during the income year bears to the total of such construction costs for the entire project during the income year or any other method, such as engineering cost estimates, which will provide a reasonable apportionment.

Example 1: A construction project was undertaken in this state by a calendar year taxpayer which had elected one of the long-term contract methods of accounting. The following gross receipts (progress billings) were derived from the contract during the three income years the contract was in progress.

	1st Year	2nd Year	3rd Year
Gross Receipts	$1,000,000	$1,000,000	$3,000,000

The gross receipts to be reflected in both the numerator and denominator of the sales factor for each of the three years are the amounts shown.

Example 2: A taxpayer contracts to build a dam on a river at a point which lies half within this state and half within state X. During the taxpayer's first income year construction costs in this state were $2,000,000. Total construction costs for the project during the income year were $3,000,000. Gross receipts (progress billings) for the year were $2,400,000. Accordingly, gross receipts of $1,600,000

$$\left(\frac{\$2,000,000}{3,000,000} = 66\tfrac{2}{3}\% \times \$2,400,000\right)$$

are included in the numerator of the sales factor.

(II) If the percentage of completion method is used, the sales factor includes only that portion of the gross contract price which corresponds to the percentage of the entire contract which was completed during the income year.

Example: A taxpayer which had elected the percentage of completion method of accounting entered into a long-term construction contract. At the end of its current income year (the first since starting the project) it estimated that the project was 30% completed. The bid price for the project was $9,000,000 and it had received $2,500,000 from progress billings as of the end of its current income year. The amount of gross receipts to be included in the sales factor for the current income year is $2,700,000 (30% of $9,000,000), regardless of whether the taxpayer uses the accrual method or the cash method for accounting for receipts and disbursements.

(III) If the completed contract method of accounting is used, the sales factor includes the portion of the gross receipts (progress billings) received or accrued, whichever is applicable, during the income year attributable to each contract.

Example 1: A taxpayer which had elected the completed contract method of accounting entered into a long-term construction contract. By the end of its current income year (the second since starting the project) it had billed, and accrued on its books a total of $5,000,000 of which $2,000,000 had accrued in the first year the contract was undertaken, and $3,000,000 had accrued in the current (second) year. The amount of gross receipts to be included in the sales factor for the current income year is $3,000,000.

Example 2: Same facts as in Example 1 except that the taxpayer keeps its books on the cash basis, and as of the end of its current income year had received only $2,500,000 of the $3,000,000 billed during the current year. The amount of gross receipts to be included in the sales factor for the current income year is $2,500,000.

(IV) The sales factor, except as noted above in subparagraphs (II) and (III), is computed in the same manner regardless of which long-term contract method of accounting the taxpayer has elected and is computed for each income year even though under the completed contract method of accounting, business income is computed separately.

(vii) Apportionment Percentage. The total of the property, payroll and sales percentages is divided by three to determine the apportionment percentage. The apportionment percentage is then applied to business income to establish the amount apportioned to California.

(E) Completed Contract Method—Special Computation. The completed contract method of accounting requires that the reporting of income (or loss) be deferred until the year the construction project is completed and accepted. Accordingly, a separate computation is made for each such contract completed during the income year regardless of whether the project is located within or without this state, in order to determine the amount of income which is attributable to sources within this state. The amount of income from each contract completed during the income year apportioned to this state, plus other business income apportioned to this state by the regular three factor formula such as interest income, rents, royalties, income from short-term contracts, etc., plus all nonbusiness income allocated to this state is the measure of tax for the income year.

The amount of income (or loss) from each contract which is derived from sources within this state using the completed contract method of accounting is computed as follows:

(i) In the income year the contract is completed, the income (or loss) therefrom is determined.

(ii) The income (or loss) determined at (i) is apportioned to this state by the following method:

(I) A fraction is determined for each year the contract was in progress. The numerator of which is the amount of construction costs paid or accrued each year the contract was in progress and the denominator of which is the total of all such construction costs for the project.

(II) Each percentage determined in (I) is multiplied by the apportionment formula percentage for that particular year as determined in subdivision (vii) of this regulation.

(III) The product determined at (II) for each year the contract was in progress are totaled. The amount of total income (or loss) from the contract determined at (i) is multiplied by the total percentage. The resulting income (or loss) is the amount of business income from such contract derived from sources within this state.

Example 1: *A taxpayer using the completed contract method of accounting for long-term contracts is engaged in three long-term contracts; Contract L in this state, Contract M in state X and Contract N in state Y. In addition, it has other business income (less expenses) during the income year 1972 from interest, rents and short-term contracts amounting to $500,000, and nonbusiness income allocable to this state of $8,000. During 1972 it completed Contract M in state X at a profit of $900,000. Contracts L in this state and N in state Y were not completed during the income year. The apportionment percentages of the taxpayer as determined in subdivision (vii) of this regulation and the percentages of contract costs as determined in subparagraph (ii) above for each year Contract M in state X was in progress are as follows:*

	1970	*1971*	*1972*
Apportionment percentages for this state	*30%*	*20%*	*40%*
Percentage of construction costs of Contract M each year to total construction costs—(100%)	*20%*	*50%*	*30%*

The corporation's net income subject to tax in this state for 1972 is computed as follows:

Business Income (excluding income from Contract M)	*$500,000*
Apportion 40% to this state	*$200,000*
Add: Income from Contract M *	*$252,000*
Total business income derived from sources within this state	*452,000*
Add: Nonbusiness income allocated to this state	*8,000*
Net income subject to tax	*$460,000*

** Income from Contract M apportioned to this state:*

	1970	*1971*	*1972*	*Total*
Apportionment percentage for this state	*30%*	*20%*	*40%*	
Percent of construction costs	*20%*	*50%*	*30%*	*100%*
Product	*6.00%*	*10.00%*	*12.00%*	*28%*

28% of $900,000 = $252,000.

Example 2: Same facts as in Example 1 except that Contract L was started in 1972 in this state, the first year the taxpayer was subject to tax in this state. Contract L in this state and Contract N in state Y are incomplete in 1972. The corporation's net income subject to tax in this state for 1972 is computed as follows:

Business Income (excluding income from Contract M)	*$500,000*
Apportion 40% to this state	*200,000*
Add: Income from Contract M *	*108,000*
Total business income derived from sources within this state	*$308,000*
Add: Nonbusiness income allocated to this state	*8,000*
Net income subject to tax	*$316,000*

** Income from Contract M apportioned to this state:*

	1970	*1971*	*1972*	*Total*
Apportionment percentage for this state	*0*	*0*	*40%*	
Percent of construction costs	*20%*	*50%*	*30%*	
Product	*0*	*0*	*12.0%*	*12.0%*

** 12% of $900,000 = $108,000.*

Note: Only 12% is used to determine the income derived from sources within this state since the corporation was not subject to tax in this state prior to 1972.

Reg. 25137

Example 3: Same facts as in Example 1 except that the figures relate to Contract L in this state and 1972 is the first year the corporation was taxable in another state (see Sections 25121 and 25122 and the regulations thereunder). Contracts M and N in states X and Y were started in 1972 and are incomplete.

The corporation's net income subject to tax in this state for 1972 is computed as follows:

Business Income (excluding income from Contract L)	*$500,000*
Apportion 40% to this state	*$200,000*
*Add: Income from Contract L **	*738,000*
Total business income derived from sources within this state	*$938,000*
Add: Nonbusiness income allocated to this state	*8,000*
Net income subject to tax	*$946,000*

** Income from Contract L apportioned to this state:*

	1970	*1971*	*1972*	*Total*
Apportionment percentages for this state	*100%*	*100%*	*40%*	
Percent of construction costs	*20%*	*50%*	*30%*	*100%*
Product	*20%*	*50%*	*12%*	*82%*

82% of $900,000 = $738,000.

(F) Dissolution, Withdrawal or Cessation of Business. Except as noted in subsection (G) below, the income of a taxpayer which has elected either the percentage of completion or the completed contract method of accounting for long-term contracts and which ceases to do business, dissolves or withdraws from this state during a taxable year shall be computed in accordance with Section 23151.1 and the regulations thereunder.

(G) Computation for Year of Withdrawal or Cessation of Business—Completed Contract Method. Use of the completed contract method of accounting for long-term contracts requires that income derived from sources within this state from incomplete contracts in progress outside this state on the date of withdrawal or cessation of business in this state be included in the measure of tax for the taxable year during which the corporation withdraws or ceases doing business in this state.

(i) The amount of income (or loss) from each such contract to be apportioned to this state by the apportionment method set forth in subparagraph (E) (ii) of this regulation shall be determined as if the percentage of completion method of accounting were used for all such contracts on the date of withdrawal or cessation of business. The amount of business income (or loss) for each such contract shall be the amount by which the gross contract price from each such contract which corresponds to the percentage of the entire contract which has been completed from the commencement thereof to the date of withdrawal or cessation of business exceeds all expenditures made during such period in connection with each such contract. In so doing account must be taken of the material and supplies on hand at the beginning and end of the income year for use in each such contract.

Example: A construction contractor qualified to do business in this state had elected the completed contract method of accounting for long-term contracts. It was engaged in two long-term contracts; Contract L in this state was started in 1971 and completed at a profit of $900,000 on 12/16/73. The taxpayer withdrew on 12/31/73. Contract M in state X was started in 1972 and was incomplete on 12/31/73.

The apportionment percentages of the taxpayer as determined at subdivision (D) of this regulation, and percentages of construction costs as determined in subdivision (E) (ii) of this regulation for each year for each contract are as follows:

	1971	1972	1973	Total
Apportionment percentage for the state	30%	20%	40%	
Percentages of construction costs:				
Contract L, this state	20%	50%	30%	100%
Contract M, state X	0	10%	25%	35%

The corporation had other business income (net of expenses) of $500,000 during 1972 and $300,000 during 1973. The gross contract price of Contract M (state X) was $1,000,000 and it was estimated to be 35% completed on 12/31/73. Total expenditures to date for Contract M (state X) were $300,000 for the period ended 12/31/73.

The measure of tax for the taxable year ended 12/31/73 (based upon measure of tax for income years 1972 and 1973) is computed as follows:

	Taxable Year 1973	
	Income Year 1972	Income Year 1973
Business income	*$500,000*	*$300,000*
Apportionment percentage for this state	*20%*	*40%*
Amount apportioned to this state	*$100,000*	*$120,000*
Add: Income from contracts:		
** L (this state)*		*252,000*
*** M (state X)*		*6,000*
Total business income derived from sources within this state	*$100,000*	*$378,000*

** Income from Contract L apportioned to this state:*

	1971	1972	1973	Total
Apportionment percentages	*30%*	*20%*	*40%*	
Percentage of construction costs	*20%*	*50%*	*30%*	*100%*
Product	*6.0%*	*10.0%*	*12.0%*	*28%*

28% of $900,000 = $252,000

*** Income from Contract M apportioned to this state:*

	1971	1972	1973	Total
Apportionment percentages	*0*	*20%*	*40%*	
Percentage of construction costs	*0*	*10%*	*25%*	*35%*
Product	*0*	*2.0%*	*10.0%*	*12.0%*

**** 12.0% of $50,000 = $6,000.*

**** Computation of apportionable income from Contract M based on percentage of completion method:*

Total Contract Price	*$1,000,000*
Estimated to be 35% completed	*$350,000*
Less: total expenditures to date	*300,000*
Apportionable income	*$50,000*

*(H) **Reporting of Partnership Income.** In the case of taxpayers which receive distributive shares of partnership income, see Regulation 25137(e).*

STATE OF CALIFORNIA
FRANCHISE TAX BOARD
SACRAMENTO, CALIFORNIA 95857

Guideline for Motion Picture and Television Film Producers and Television Network Broadcasters Apportionment Formula

I. Introduction

Corporations engaged in the business of producing motion pictures, television films and television network broadcasting which conduct activities within and without this state are required to determine and report business income derived from sources within this state by an apportionment formula. The general regulations for the Uniform Division of Income for Tax Purposes Act (UDITPA) are applicable except as otherwise provided in this guideline. The three factor formula of property, payroll and sales and certain other rules set forth in the UDITPA regulations have been modified to the extent necessary to provide a more equitable apportionment of income.

The apportionment formula prescribed herein shall be applicable to income years beginning after December 31, 1972. The formula shall apply to major, independent and television motion picture producers as well as producers of television commercials and television network broadcasting. The provisions of this guideline shall also apply to independent television stations to the extent their business affairs are similar to others covered by this guideline.

II. Definitions

A. The following definitions shall apply to the construction of this guideline:

1. A "film" means the physical embodiment of a play, story or other literary or artistic work except that it does not include programs such as news and sports produced for telecast.

2. The word "film" includes a tape.

3. Each episode of a series of films produced for television exhibition shall constitute a separate film notwithstanding that the series relates to the same principal subject and is produced during a single television season.

4. "In release" means the date on which amortization of a film begins, and is referred to in the motion picture industry as the "accounting release date." For films owned by a television network, "in release" means the date on which the film is first telecast.

FTB 1058 (1-74)

5. "Rerelease" means the release of any film for general theatrical and foreign distribution, syndication, or television network exhibition at any time after its initial distribution (release period) has terminated.

6. A "film" is deemed to be tangible personal property.

7. "Rent" includes license fees for the exhibition or telecast of films.

8. "Rate card" values are those published by Standard Rate and Data Service, Inc.

III. Apportionment Formula

A. Property Factor

1. In General.

(a) The property factor includes all owned real and tangible personal property and rented real and tangible personal property used in the business.

(b) Owned real and tangible personal property is to be included at original cost (initial tax basis for federal income tax purposes) unless otherwise indicated.

(c) Rented property is valued at eight times the net annual rental rate less nonbusiness subrents.

(i) In the case of rented studios, the net annual rental rate shall include only the amount of the basic or flat rental charge by the studio for the use of a stage and other permanent equipment such as sound recording equipment, etc., except that additional equipment rented from other sources or from the studio not covered in the basic or flat rental charge and used for one week or longer (even though rented on a day-to-day basis) shall be included.

(ii) In the case of a lump sum rental payment covering more than one income year, the payment must be amortized over the lease period.

(d) The value of film is the original cost of producing the film as determined for federal income tax purposes. Films should be included in the property factor at original cost for seven years beginning

with the original or first release date. Thereafter the films shall be included at 10 percent of original cost beginning with the eighth year, decreasing 1 percent of original cost annually for ten consecutive years. However, a picture which is rereleased shall be included at its full original cost for one year from the rerelease date for each separate rerelease period. The ten-year period during which a picture is included at its residual value shall be suspended for any rerelease period. Films in release on January 1, 1973, will be included as if the above rule had been in effect prior to January 1, 1973.

(e) Value of films which are incomplete, or completed but not released, are not included in the property factor until released.

(f) Talent salaries are includible in the cost of a film.

2. Denominator.

The denominator of the property factor includes:

(a) Real property owned or rented and used in the business.

(b) Tangible personal property owned or rented and used in the business, including films, sets, props, wardrobes, etc.

3. Numerator.

The numerator of the property factor includes the following to the extent the property is in California.

(a) Real property owned or rented and used in this state.

(b) Tangible personal property, other than films, owned or rented and used in this state.

(i) Tangible personal property includes sets, props, wardrobes, etc.

(ii) If tangible personal property other than films is located in this state for part of the income year, its value shall be determined by the ratio which the number of days the property is located in this state bears to the total number of days such property was owned or rented during the income year.

(c) Films in release

The total value of films in release to theaters, television stations and television networks and by a television network for telecast are attributed to this state in the same ratio in which the total California receipts from such films as determined in paragraph C 2 (a) and (b) pertaining to the sales factor bears to the total of such receipts everywhere.

(d) Films in storage

The value of films formerly in release but currently in storage shall be determined by the same ratio as in (c) above.

B. Payroll Factor

1. Denominator

(a) The denominator includes all compensation paid to employees during the income year, including talent salaries. Residual and profit participation payments constitute additional compensation paid to employees.

(b) The amount paid to a corporation for providing the services of an actor or director who is an employee of such corporation or for loaning the services of an actor or director who is under contract with such corporation shall, if substantial, be included in the producer's payroll factor as if the amount paid was compensation paid to an employee of the producer.

2. Numerator

Compensation of employees engaged in the production of a film on location must be attributed to the state where the services are or were performed. Compensation of all other employees is governed by Section 25123.

C. Sales Factor

1. Denominator

The denominator includes all business income receipts of the taxpayer during the income year.

STATE OF CALIFORNIA
FRANCHISE TAX BOARD
SACRAMENTO, CALIFORNIA 95857

GUIDELINE FOR APPORTIONMENT OF INCOME OF FRANCHISORS

I. INTRODUCTION

A corporation engaged in the business of franchising and conducting its business activities within and without this state is required to determine and report its income derived from sources within this State under the provisions of the Uniform Division of Income for Tax Purposes Act (UDITPA). The general UDITPA regulations are applicable except as otherwise provided in this guideline. The three–factor apportionment formula of property, payroll and sales provided in UDITPA and certain other rules set forth in the regulations have been modified to the extent necessary to provide an equitable apportionment of income.

II. DEFINITIONS

A. The following definitions shall apply to the construction of this guideline.

1. The term "business of franchising" means a trade or business which includes the granting of a license by the taxpayer (franchisor) of a trademark, trade name or service mark to market a product or service under such trademark, trade name or service mark in accordance with methods and procedures prescribed by the franchisor.
2. The term "original cost" for property factor purposes is deemed to be the basis of the property for federal income tax purposes (prior to any federal adjustments) at the time of acquisition by the taxpayer and adjusted by subsequent capital additions or improvements thereto and partial disposition thereof, by reason of sale, exchange, abandonment. (Reg. 25130(a)).

III. APPORTIONMENT FORMULA

A. Property Factor

1. In General
   (a) The property factor includes all owned and rented real and tangible personal property used in the business.
   (b) Owned real and tangible personal property is to be included at original cost.
   (c) Rented property is valued at eight times the net annual rental rate.
   (d) Intangible personal property shall not be taken into account for property factor purposes.
2. The denominator of the property factor includes:
   (a) All real and tangible personal property owned or rented and used in the business.
3. The numerator of the property factor includes:
   (a) All real and tangible personal property owned or rented and used in the business in this State.

B. Payroll Factor

1. The denominator of the payroll factor includes all compensation paid to employees during the income year.
2. The numerator of the payroll factor shall be determined in accordance with Section 25132 and the regulations thereunder except that:
   (a) Compensation paid to traveling employees regularly providing administrative or advisory services at the franchisee's place of business shall be determined on the basis of the ratio which the time spent in performing such services in this state bears to the total time spent in performing such services everywhere.

B 1062 (7-75)

C. Sales Factor

1. Most receipts derived from transactions and activities in the regular course of the trade or business which produce business income are included in the denominator of the sales factor (see Sections 25134–25137, inclusive, and the regulations thereunder).
2. The numerator of the sales factor is the total receipts of the taxpayer attributable to this state during the income year as follows:
   (a) Receipts from the sale, lease, rental or other use of real and tangible personal property shall be included in the numerator as provided in Sections 25134–25137, inclusive, and the regulations thereunder.
   (b) The following receipts shall be attributed to the state in which the franchisee's place of business is located provided the taxpayer is taxable in such state:
      (1) Fees or royalties for the use of the franchisor's trade name, trademark or service mark.
      (2) Fees paid by the franchisee for national advertising placed by the franchisor.
      (3) Fees for providing administrative or advisory services at the franchisee's place of business.

      If the taxpayer is not taxable in the state in which the franchisee's place of business is located the receipts shall be attributed to the state of the taxpayer's commercial domicile. (See Reg. 25122 for when taxpayer is taxable in another state.)
   (c) Business location selection fees.
      (1) Receipts (fees) received for site selection and acquisition for a place of business of the franchisee shall be attributed to the state in which the franchisee's place of business is actually established provided the taxpayer is taxable in such state.
      (2) If the taxpayer is not taxable in the state in which the franchisee's place of business is located or the franchisee does not subsequently establish a place of business, the receipts shall be attributed to the state in which the principal office of the taxpayer's employee performing site selection and acquisition services is located except that if such services are performed by an independent contractor the receipts shall be attributed to the state of the taxpayer's commercial domicile.

State of California

Franchise Tax Board

Guideline for Air Transportation Companies

Apportionment Formula

I. Introduction

A. Section 1152 of the California Revenue and Taxation Code prescribes the allocation formula to be used by county assessors in California to determine the value of certificated aircraft and air taxis in the respective counties for purposes of the property tax assessment. Section 25101.3 provides that the allocation formula prescribed in Section 1152 shall also be used in determining the value of certificated aircraft and air taxis attributable to California for purposes of the property factor of the three-factor apportionment formula applicable under the Bank and Corporation Tax Law. These basic statutory principles are also generally applied in the payroll and revenue factors of the apportionment formula.

B. The rules set forth below are applicable to scheduled airlines, supplemental airlines and air taxis. To the extent possible, rules promulgated by the State Board of Equalization in Rule No. 202, Title 18, California Administrative Code, have been followed in order to utilize the same data for purposes of the California franchise tax. The rules are subject to change in the event changes are made in Rule No. 202 by the State Board of Equalization and such changes are adopted by the Franchise Tax Board.

C. The provisions of this guideline are applicable to income years beginning after December 31, 1971.

II. Applicable Sections of California Revenue & Taxation Code

A. Section 25101.3

(a) Except as provided in subdivision (b), the property factor as it relates to the aircraft of an air carrier or foreign air carrier, as defined in Section 1150, or the operator of an air taxi, as defined in Section 1154, shall be allocated on the basis of the formula set forth in Section 1152.

(b) Notwithstanding the provisions of Subdivision (d) of Section 1152, for the purposes of this part the valuation of property owned or rented by the taxpayer shall be determined under the provisions of Section 25130.

B. Section 25130

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

C. Section 1150

As used in this article, "certificated aircraft" means aircraft operated by an air carrier or foreign air carrier engaged in air transportation, as defined in subdivisions (3), (5), (10), and (19) of Section 101 of Title I of the "Federal Aviation Act of 1958" (P.L. 85-726; 72 Stat. 731), while there is in force a certificate or permit issued by the Civil Aeronautics Board of the United States, or its successor, or a certificate or permit issued by the California Public Utilities Commission, or its successor, authorizing such air carrier to engage in such transportation.

D. Section 1152

The allocation formula to be used by each assessor is as follows:

(a) The time in state is the proportionate amount of time, both in the air and on the ground, that certificated aircraft have spent within the state during a representative period as compared to the total time in the representative period. This factor shall be multiplied by 75 percent.

(b) Arrivals and departures is the number of arrivals in and departures from airports within the state of certificated aircraft during a representative period as compared to the total number of arrivals in and departures from airports both within this state and elsewhere in the representative period. This factor shall be multiplied by 25 percent.

(c) The time in state factor shall be added to the arrivals and departures factor.

(d) The figure produced by application of subdivision (c) equals the allocation to be applied to full cash value to determine the value to which the assessment ratio shall be applied.

E. Section 1154

As used in this section, "air taxi" means aircraft used by an air carrier which does not utilize aircraft whose maximum certificated takeoff weight is greater than 12,500 pounds in air transportation which does not hold a certificate of public convenience and necessity or other economic authority issued by the Civil Aeronautics Board of the United States, or its successor, or by the California Public Utilities Commission, or its successor. Air taxis are not subject to the provisions of Part 10 (commencing with Section 5301) of this division and shall be assessed in accordance with the allocation formula set forth in Section 1152.

III. Computation of Time Factor and Arrivals and Departures Factor

A. The property and revenue factors of the apportionment formula are based upon a time factor and an arrivals and departures factor. The payroll factor for flight personnel is based solely upon time. The statistics to be used in computing the time and arrivals and departures factors shall be the annual statistics of the taxpayer or statistics for representative periods.

B. Annual statistics for the taxpayer's income year, if available, rather than the statistics for representative periods shall be used in determining the property, payroll and revenue factors of the apportionment formula. All other rules prescribed for property tax purposes for determining air and ground time and arrivals and departures shall be applicable except as otherwise provided.

C. If annual statistics are not available, statistics for representative periods shall be used provided that permission to do so has been granted to the taxpayer by the Franchise Tax Board. In the event annual statistics are subsequently maintained on a regular basis, the taxpayer shall use such annual statistics in lieu of statistics from representative periods.

D. The representative periods to be used by authorized taxpayers in computing the property, payroll and revenue factors shall be the representative periods prescribed by the department for the income year in question. Ordinarily, the representative period for the purposes of the California franchise tax will consist of representative periods designated by the State Board of Equalization for two property tax assessment years. The statistical data developed for representative periods designated by the State Board of Equalization for property tax purposes shall be used in computing the percentage of the time factor and the arrivals and departures factor. The time factor and

arrivals and departures factor will be computed separately for each type of aircraft enumerated in Section V.

E. The percentage computed for the time factor shall be multiplied by 75 percent for purposes of the property factor, and by 80 percent for purposes of the revenue factor.

F. The percentage computed for the arrivals and departures factor shall be multiplied by 25 percent for purposes of the property factor and by 20 percent for purposes of the revenue factor.

G. As indicated previously the payroll factor is based solely upon time, therefore, there is no weighting of the factor between time and arrivals and departures.

IV. Representative Period

A. In General

(1) The rules set forth below with respect to the representative periods applicable for the purposes of the California Bank and Corporation Tax Law are based upon the representative periods designated by the State Board of Equalization for each property tax assessment year.

(2) The term "current property tax assessment year" as used in the rules set forth below means the property tax assessment year for which the State Board of Equalization designates the representative period which falls within the taxpayer's current income year for California franchise tax purposes. In the case of income year ending on February 28, it means the property tax assessment year for which the State Board of Equalization designates the representative period, the major part of which falls within the taxpayer's current income year for California franchise tax purposes. For example, if the State Board of Equalization designates February 23 through March 1 of the current calendar year as the representative period for the next property tax assessment year (beginning July 1, next), the "current property tax assessment year" is the property tax assessment year beginning July 1, next with respect to the income year ended February 28 of the current calendar year.

B. Time Factor

(1) Scheduled Carriers, Scheduled and Nonscheduled Air Taxis

(a) Scheduled Operations, Air Carriers, Scheduled and Nonscheduled Air Taxis

(i) The representative period will consist of the representative periods designated by the State Board of Equalization for (1) the current property tax assessment year and (2) the succeeding property tax assessment year unless the taxpayer's income year for California franchise tax purposes ends on or after February 28.

(ii) If the taxpayer's fiscal year for California franchise tax purposes ends on or after February 28, the representative period will consist of the representative periods designated by the State Board of Equalization for (1) the current property tax assessment year and (2) the preceding property tax asessment year.

(b) Nonscheduled Operations, Scheduled Carriers and Scheduled Air Taxis

(i) The representative period will consist of the representative periods designated by the State Board of Equalization for (1) the current property tax assessment year and (2) the preceding property tax assessment year unless the taxpayer's income year for California franchise tax purposes ends on or after July 31.

(ii) Taxpayers whose income year ends on or after July 31 should contact the Franchise Tax Board for instructions as to the representative period to be used.

(2) Supplemental Carriers

The representative period will be the same as stated in Section IV-B (1)-(b).

C. Arrivals and Departures Factor

(1) Scheduled Carriers, Scheduled and Nonscheduled Air Taxis

(a) Carriers Reporting Departures to Civil Aeronautics Board

(i) The representative period will consist of the representative period designated by the State Board of Equalization for (1) the current property tax assessment year and (2) the preceding property tax assessment year unless the taxpayer's current income year ends on or after March 31.

(ii) In the case of taxpayers whose income year ends on or after March 31, the representative period will consist of (1) the calendar quarter shown on the report filed with the Civil Aeronautics Board which is the most recent to the close of the taxpayer's income year and (2) the corresponding quarter for the taxpayer's preceding income year.

(b) <u>Air Taxis Not Reporting Departures to Civil Aeronautics Board</u>

(i) The representative period for scheduled operations of air taxis and operations of nonscheduled air taxis will be the same as stated in Section IV-B (1)-(a).

(ii) The representative period for nonscheduled operations of scheduled air taxis will be the same as stated in Section IV-B (1)-(b).

(2) <u>Supplemental Carriers</u>

(a) <u>Carriers Reporting Departures to Civil Aeronautics Board</u>

The representative period will be the same as stated in Section IV-C (1)-(a).

(b) <u>Carriers Not Reporting Departures to Civil Aeronautics Board</u>

The representative period will be the same as stated in Section IV-B (1)-(b).

V. <u>Aircraft Type</u>

A. Piston-powered

B. Turboprop-powered

C. Helicopter

D. Turbojet and Turbofan-powered

(1) Two engine

(2) Three engine

(3) Four engine

(4) DC-8 - 60 series

(5) Boeing 747

(6) DC-10 and L1011

VI. Property Valuation

A. Owned aircraft will be valued at its original cost or rental value in accordance with Section 25130.

B. The use of the taxpayer's owned or rented aircraft in an exchange program with another air carrier will not constitute a rental or subrental, whichever the case may be, of such aircraft by the airline to the other participating airline. Such aircraft shall be accounted for in the property factor of the taxpayer.

C. Rotables, parts, and other expendables, including parts for use in contract overhaul work, will be valued at cost.

VII. Formula for Determining Property Factor

A. General Definitions

(1) The following definitions are applicable to the numerator and denominator of the property factor:

(a) The "value" of owned real and tangible personal property shall mean its original cost (see Section 25130 and the regulations thereunder).

(b) "Original cost" means the initial federal tax base of the property plus the value of capital improvements to such property.

(c) "Average value" of property means the amount determined by averaging the values at the beginning and ending of the income year but the Franchise Tax Board may require the averaging of monthly values during the income year if such averaging is necessary to reflect properly the average value of the taxpayer's property (see Section 25131 and the regulations thereunder).

(d) The "value" of rented real and tangible personal property means the product of eight times the net annual rental rate (see Section 25130 and the regulations thereunder).

(e) "Net annual rental rate" means the annual rental rate paid by the taxpayer less any annual rental rate received by the taxpayer from subrentals.

(f) The phrase "property used during the income year" includes property which is available for use in the taxpayer's trade or business during the income year.

B. Denominator

(1) The denominator of the property factor shall be the average value of all of the taxpayer's real and tangible personal property owned or rented and used during the income year.

C. Numerator

(1) The numerator of the property factor shall be the average value of the taxpayer's real and tangible personal property owned or rented and used in this state during the income year.

(2) In determining the numerator of the property factor the value of aircraft attributed to this state shall be based upon the ratio that:

(a) aircraft and ground time that such aircraft were in this state bears to the total air and ground time of such aircraft everywhere, weighted 75 percent, plus,

(b) arrival and departures of such aircraft in this state bears to total arrivals and departures everywhere, weighted 25 percent.

(3) With respect to property other than aircraft, see Reg. 25219-25131, inclusive, and the regulations thereunder.

II. Formula for Determining Payroll Factor

A. General Definitions

(1) For purposes of the payroll factor, flight personnel means the air crew aboard an aircraft assisting in the operation of the aircraft or the welfare of passengers while in the air.

B. Denominator

(1) The denominator of the payroll factor is the total compensation paid everywhere by the taxpayer during the income year (see Sections 25132-25133 and the regulations thereunder).

C. Numerator

(1) The numerator of the payroll factor is the total amount paid in this state during the income year by the taxpayer for compensation.

(2) In determining the numerator of the payroll factor, compensation paid to flight personnel shall be attributed to this state based upon the ratio that air and ground time spent in performing services in this state bears to the total air and ground time spent in performing services everywhere by type of aircraft. Air time (block to block) by type of aircraft determined for the income year shall be used in computing flight personnel compensation attributable to this state. Ground time of flight personnel shall include the time required by such personnel to perform preflight and postflight activities pursuant to current employer-employee union contracts and includes time on the ground at intermediate stops on scheduled and nonscheduled flights for loading or unloading of passengers, freight, mail or other nonemergency purposes. Air and ground time of flight personnel utilized for training purposes to maintain proficiency shall also be included for purposes of the payroll factor.

(3) With respect to nonflight personnel, compensation paid to such employees shall be included in the numerator as provided in Section 25133 and the regulations thereunder.

IX. Formula for Determining Revenue Factor

A. In General

(1) Ordinarily, all revenue derived from transactions and activities in the regular course of the trade or business which produce business income are included in the denominator of the revenue factor. Revenue is usually derived by airlines from hauling passengers, freight, mail and excess baggage. For the treatment of revenue derived from transactions and activities incidental to general business operations, see Reg. 25134(b).

B. Denominator

(1) The denominator of the revenue factor is the total revenue of the taxpayer everywhere during the income year (see Sections 25134-25136, inclusive, and the regulations thereunder).

C. Numerator

(1) The numerator of the revenue factor is the total revenue of the taxpayer in this state during the income year.

(2) In determining the numerator of the revenue factor, revenue from hauling passengers, freight, mail and excess baggage shall be attributed to this state based upon: (a) the ratio which the air time of the taxpayers' aircraft spent in this state bears to the total air time (block to block) of such aircraft everywhere, by type of aircraft weighted at 80%; and (b) the ratio of arrivals and departures in this state to total arrivals and departures everywhere by type of aircraft weighted at 20%. Air time and arrivals and departures (excluding time and arrivals and departures for flight training purposes) by type of aircraft shall be used in computing revenue attributable to this state derived from hauling passengers, freight and mail. Receipts from other business activities shall be included in the numerator in accordance with Reg. 25134, et. seq.

(3) If records of actual revenue by type of aircraft are not maintained, the total revenue shall be divided into passenger and freight (which shall include express, excess baggage and mail) revenue and allocated to aircraft type on the ratio of the revenue passenger ton-miles and revenue freight (which shall include express, excess

baggage and mail) ton-miles of such type, respectively. Expressed as a formula the computation for each type of aircraft would be:

$$\frac{\text{Revenue Passenger Ton-Miles by Type}}{\text{Total Revenue Passenger Ton-Miles All Types}} \times \text{Total Passenger Revenue} = \text{Passenger Revenue by Type}$$

$$\frac{\text{Revenue Freight Ton-Miles by Type}}{\text{Total Revenue Freight Ton-Miles All Types}} \times \text{Total Freight Revenue} = \text{Freight Revenue by Type}$$

(4) Gross receipts other than from hauling passengers, freight, mail and excess baggage shall be included in the numerator as provided in Sections 25134-25136, inclusive, and the regulations thereunder.

X. Examples of Computation of Factors:

Exhibits I, II, and III attached are examples of how the apportionment percentage should be computed giving effect to the instructions in the guideline.

1. Exhibit I shows the computation of the apportionment factors where annual statistics are known. The upper portion, Columns 1 to 12, sets forth the items presumed to be known; the middle portion, the computation of the three factors; and the remainder, the formula to be used to determine the California factors.

2. Exhibit II shows the computation of the apportionment factors where annual statistics are not known. This exhibit follows the same format as Exhibit I.

3. Exhibit III illustrates the computation of the revenue factor as outlined at IX C(3) above. The computation of items a/ through g/ in the upper part of the exhibit is shown in the lower portion.

AIRLINE FORMULA - EXHIBIT I

COMPUTATION OF APPORTIONMENT FACTORS - ANNUAL STATISTICS KNOWN
(Dollars and Units in Thousands)

No. of Aircraft	Type	Cost Basis		Air Time in Minutes		Ground Time in Minutes		Arrivals & Departures		Ground Time of Flight Personnel	
		California	Total	California	Total	California	Total	California	Total	California	Total
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)
8	D4		$100,000	173'	1,730'	300'	2,474.8'	3	60	163'	652'
10	D5		200,000	412'	2,060'	500'	3,196.0'	8	20	405'	810'
2	D6		30,000								

	Property		Payroll		Revenue	
	California	Total	California	Total	California	Total
	a/ $ 9,687	$100,000	c/ $ 282	$ 2,000	e/ $ 3,240	$ 36,000
	b/ 46,027	200,000	d/ 712	2,500	f/ 10,080	42,000
		30,000				
Real Property	1,000	5,000				
Tangible Personal Property (Not Flight Equipment)	3,000	10,000				
Ground Personnel			3,450			
Other				47,375		50,000
Total	$59,714	$345,000	$4,444	$51,875	$13,320	$128,000
Percentage Attributable to California	17.3084%		8.5667%		10.4063%	
Average (Total Factors Divided by 3) 12.0938%						

For derivation of items a/ through f/, see below:

a/ $\frac{\text{Calif. Air Time Type D4 plus Calif. Ground Time Type D4}}{\text{Total Air Time Type D4 plus Total Ground Time Type D4}}$ @ 75% plus $\frac{\text{Calif. Arrivals \& Departures Type D4}}{\text{Total Arrivals \& Departures Type D4}}$ @ 25% X Total Cost Basis of Type D4 Aircraft = Calif. Property Type D4

$\frac{173' + 300'}{1,730' + 2,474.8'}$ @ 75% plus $\frac{3}{60}$ @ 25% X $100,000 = $9,687

b/ $\frac{\text{Calif. Air Time Type D5 plus Calif. Ground Time Type D5}}{\text{Total Air Time Type D5 plus Total Ground Time Type D5}}$ @ 75% plus $\frac{\text{Calif. Arrivals \& Departures Type D5}}{\text{Total Arrivals \& Departures Type D5}}$ @ 25% X Total Cost Basis of Type D5 Aircraft = Calif. Property Type D5

$\frac{412' + 500'}{2,060' + 3,196'}$ @ 75% plus $\frac{8}{20}$ @ 25% X $200,000 = $46,027

c/ $\frac{\text{California Air Time Type D4 plus California Ground Time of Flight Personnel Type D4}}{\text{Total Air Time Type D4 plus Total Ground Time Type D4}}$ X Total Payroll Type D4 = California Payroll Type D4

$\frac{173' + 163'}{1,730' + 652'}$ X $2,000 = $282.12

d/ $\frac{\text{California Air Time Type D5 plus California Ground Time of Flight Personnel Type D5}}{\text{Total Air Time Type D5 plus Total Ground Time Type D5}}$ X Total Payroll Type D5 = California Payroll Type D5

$\frac{412' + 405'}{2,060' + 810'}$ X $2,500 = $711.67

e/ $\frac{\text{California Air Time Type D4}}{\text{Total Air Time Type D4}}$ @ 80% plus $\frac{\text{California Arrivals \& Departures Type D4}}{\text{Total Arrivals \& Departures Type D4}}$ @ 20% X Total Revenue Type D4 = California Revenue Type D4

$\frac{173'}{1,730'}$ X 80% plus $\frac{3}{60}$ X 20% X $36,000 = $3,240

f/ $\frac{\text{California Air Time Type D5}}{\text{Total Air Time Type D5}}$ @ 80% plus $\frac{\text{California Arrivals \& Departures Type D5}}{\text{Total Arrivals \& Departures Type D5}}$ @ 20% X Total Revenue Type D5 = California Revenue Type D5

$\frac{412'}{2,060'}$ X 80% plus $\frac{8}{20}$ X 20% X $42,000 = $10,080

FTB 1056 (8-73)

AIRLINE FORMULA - EXHIBIT II

COMPUTATION OF APPORTIONMENT FACTORS - BASED ON REPRESENTATIVE PERIODS (ANNUAL STATISTICS NOT KNOWN)
(Dollars and Units in Thousands)

No. of Aircraft	Type	Cost Basis		Air Time in Minutes				Ground Time in Minutes				Arrivals & Departures				Ground Time of Flight Personnel			
		Calif.	Total	California		Total		California		Total		California		Total		California		Total	
				Current Year	Succeeding Year	Current Year	Succeeding Year	Current Year	Succeeding Year	Current Year	Succeeding Year	Current Year	Preceding Yr.	Current Year	Preceding Yr.	Current Year	Succeeding Year	Current Year	Succeeding Year
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)	(13)	(14)	(15)	(16)	(17)	(18)	(19)	(20)
8	D4		$100,000	3.36'	3.3'	33.0'	33.6'	6.8'	4.2'	47.64'	47.04'	.8	.85	8.5	9.0	3.3'	3.0'	33'	35'
10	D5		200,000	8.0'	7.8'	40.0'	39.0'	16.2'	17.5'	60.8'	61.8'	2.0	2.1	10.0	11.0	7.0	7.6'	38'	30'
2	D6		30,000																

	Property		Payroll		Revenue	
	California	Total	California	Total	California	Total
Aircraft D4	a/ $10,570	$100,000	c/ $ 193	$ 2,000	e/ $ 3,559	$ 36,000
Aircraft D5	b/ 46,592	200,000	d/ 517	2,500	f/ 8,360	42,000
Aircraft D6	None	30,000	None		None	
Real Property	1,000	5,000				
Tangible Personal Property (Not Flight Equipment)	3,000	10,000				
Ground Personnel			3,450			
Other				47,375		50,000
Totals	$61,163	$345,000	$4,160	$51,875	$11,919	$128,000
Percentage Attributable to California	17.7281%		8.0193%		9.3117%	
Average (Total Factors Divided by 3) 11.6864%						

For derivation of items a/ through f/, see below:

a/ $\frac{\text{Calif. Air Time for Current \& Succeeding Years plus Ground Time for Current \& Succeeding Years for Type D4}}{\text{Total Air Time for Current \& Succeeding Years plus Ground Time for Current \& Succeeding Years for Type D4}}$ @ 75% plus $\frac{\text{Calif. Arrivals \& Departures Type D4}}{\text{Total Arrivals \& Departures Type D4}}$ @ 25% X Cost Basis Type D4 Aircraft = California Property Type D4

$$\frac{(3.36' + 3.3') + (6.8' + 4.2')}{(33' + 33.6') + (47.64' + 47.04')} \text{ @ 75\% plus } \frac{(.8 + .85)}{(8.5 + 9)} \text{ @ 25\% X \$100,000 = \$10,570}$$

b/ $\frac{\text{Calif. Air Time for Current \& Succeeding Years plus Ground Time for Current \& Succeeding Years for Type D5}}{\text{Total Air Time for Current \& Succeeding Years plus Ground Time for Current \& Succeeding Years for Type D5}}$ @ 75% plus $\frac{\text{Calif. Arrivals \& Departures Type D5}}{\text{Total Arrivals \& Departures Type D5}}$ @ 25% X Cost Basis Type D5 Aircraft = California Property Type D5

$$\frac{(8' + 7.8') + (16.2' + 17.5')}{(40' + 39') + (60.8' + 61.8')} \text{ @ 75\% plus } \frac{(2 + 2.1)}{(10 + 11)} \text{ @ 25\% X \$200,000 = \$46,592}$$

c/ $\frac{\text{Calif. Air Time for Current \& Succeeding Years plus Ground Time of Flight Personnel for Current \& Succeeding Years for Type D4}}{\text{Total Air Time for Current \& Succeeding Years plus Ground Time of Flight Personnel for Current \& Succeeding Years for Type D4}}$ X Total Flight Payroll Type D4 = Calif. Payroll Type D4

$$\frac{(3.36' + 3.3') + (3.3' + 3')}{(33' + 33.6') + (33' + 35')} \text{ X \$2,000 = \$193}$$

d/ $\frac{\text{Calif. Air Time for Current \& Succeeding Years plus Ground Time of Flight Personnel for Current \& Succeeding Years for Type D5}}{\text{Total Air Time for Current \& Succeeding Years plus Ground Time of Flight Personnel for Current \& Succeeding Years for Type D5}}$ X Total Flight Payroll Type D5 = Calif. Payroll Type D5

$$\frac{(8' + 7.8') + (7' + 7.6')}{(40' + 39') + (38' + 30')} \text{ X \$2,500 = \$517}$$

e/ $\frac{\text{Calif. Air Time for Current \& Succeeding Years for Type D4}}{\text{Total Air Time for Current \& Succeeding Years for Type D4}}$ @ 80% plus $\frac{\text{Calif. Arrivals \& Departures for Current \& Preceding Years for Type D4}}{\text{Total Arrivals \& Departures for Current \& Preceding Years for Type D4}}$ @ 20% X Total Revenue Type D4 = Calif. Revenue Type D4

$$\frac{3.36' + 3.3'}{33' + 33.6'} \text{ @ 80\% plus } \frac{.8 + .85}{8.5 + 9} \text{ @ 20\% X \$36,000 = \$3,559}$$

f/ $\frac{\text{Calif. Air Time for Current \& Succeeding Years for Type D5}}{\text{Total Air Time for Current \& Succeeding Years for Type D5}}$ @ 75% plus $\frac{\text{Calif. Arrivals \& Departures for Current \& Preceding Years for Type D5}}{\text{Total Arrivals \& Departures for Current \& Preceding Years for Type D5}}$ @ 25% X Total Revenue Type D5 = Calif. Revenue Type D5

$$\frac{8' + 7.8'}{40' + 39'} \text{ @ 80\% plus } \frac{2 + 2.1}{10 + 11} \text{ @ 20\% X \$42,000 = \$8,360}$$

AIRLINE FORMULA - EXHIBIT III

COMPUTATION OF REVENUE FACTOR - REVENUE BY TYPE OF AIRCRAFT NOT KNOWN
(Dollars and Units in Thousands)

Number of Aircraft (1)	Type (2)	Revenue California (3)	Revenue Total (4)	Revenue Passenger (5)	Revenue Freight (6)	Revenue Ton - Miles Passenger (7)	Revenue Ton - Miles Freight (8)
8	D4	3,559 g/	36,000 e/	31,500 a/	4,500 c/	35	13.5
10	D5	8,360 g/	42,000 f/	40,500 b/	1,500 d/	45	4.5
2	D6		22,000	18,000	4,000	20	12.
Other			20,000				
Total		11,919	120,000	90,000	10,000	100	30.
Percentage attributable to California		9.9325%					

For Derivation of Items a/ through g/, see below

a/ $\frac{\text{Passenger Revenue Ton - Miles for Type D4}}{\text{Total Passenger Revenue Ton - Miles}}$ X Total Passenger Revenue = Passenger Revenue Type D4

$\frac{35}{100}$ X \$90,000 = \$31,500

b/ $\frac{\text{Passenger Revenue Ton - Miles for Type D5}}{\text{Total Passenger Revenue Ton - Miles}}$ X Total Passenger Revenue = Passenger Revenue Type D5

$\frac{45}{100}$ X \$90,000 = \$40,500

c/ $\frac{\text{Freight Revenue Ton - Miles for Type D4}}{\text{Total Freight Revenue Ton - Miles}}$ X Total Freight Revenue = Freight Revenue Type D4

$\frac{13.5}{30.}$ X \$10,000 = \$4,500

d/ $\frac{\text{Freight Revenue Ton - Miles for Type D5}}{\text{Total Freight Ton - Miles}}$ X Total Freight Revenue = Freight Revenue Type D5

$\frac{4.5}{30.}$ X \$10,000 = \$1,500

e/ Passenger Revenue Type D4 plus Freight Revenue Type D4 = Total Revenue Type D4

\$31,500 + \$4,500 = \$36,000

f/ Passenger Revenue Type Type D5 plus Freight Revenue Type D5 = Total Revenue Type D5

\$40,500 + \$1,500 = \$42,000

g/ See Exhibit II for Computation of California Revenue by Types of Aircraft Based on Representative Periods; Otherwise, See Exhibit I for Computation When Annual Statistics Known.

GUIDELINE FOR APPORTIONMENT OF INCOME FROM COMMERCIAL FISHING

I. Introduction

A corporation engaged in the business of commercial fishing which derives income from sources within and without this state is required to determine and report its income derived from sources within this state under the provisions of the Uniform Division of Income for Tax Purposes Act (UDITPA), Sections 25120 through 25139 of the California Revenue and Taxation Code, and the regulations thereunder, except as otherwise provided in this guideline. The three-factor apportionment formula of property, payroll, and sales provided in UDITPA and certain rules set forth in the regulations have been modified for all income years ended on or after January 1, 1979, to give recognition to the peculiarities of commercial fishing in order to provide an equitable apportionment of income.

II. Definitions

The following definitions shall apply to the construction of this guideline.

1. The term "business of commercial fishing" means a trade or business which utilizes a ship or ships in the taking of fish or the bringing of fish ashore for financial or pecuniary gain or profit.

2. The term "original cost" for property factor purposes is deemed to be the basis of the property for federal income tax purposes (prior to any federal adjustments) at the time of acquisition by the taxpayer and adjusted by subsequent capital additions or improvements thereto and partial disposition thereof, by reason of sale, exchange, abandonment, etc. (Reg. 25130(a)).

3. A "port day" is a day or part of a day spent in port or on the seas while the vessel is "in operation." A "port day" begins at the time the ship enters an area within which a state (as defined in Section 25120(f), Revenue and Taxation Code) asserts jurisdiction, including the assertion of jurisdiction for fishing, and ends when the ship leaves such area. A "port day" does not include the time a ship is "out of service."

4. A ship is "in operation" while engaged in pre-voyage and post-voyage activities as well as when it is searching for fish, fishing, or transporting fish. Pre-voyage and post-voyage activities include, but are not limited to, loading, unloading, refueling, or provisioning the ship, or when the ship is being repaired (except for repairs in shipyards, including drydocking). A ship begins being in operation for a voyage when it is manned with full crew and the vessel is ready for a fishing voyage. It ends being in operation after a voyage when the vessel is unloaded and cleaned, including the preparation of the fish wells to a fish-carrying condition.

5. A ship is "out of service" when it is not in operation. "Out of service" time includes, but is not limited to, time while a ship is idle between voyages, time for repairs in shipyards (including drydocking), and time after which a ship is seized by a foreign government and held under restraint pending disposition of charges alleging violation of such government's law. A ship is also considered out of service when it is involuntarily waiting to unload.

6. A singular word includes the plural, and the plural includes the singular.

III. Apportionment Formula

A. Property Factor

1. In general:

   (a) The property factor includes all owned and rented real and tangible personal property used in the business.

   (b) Owned real and tangible personal property is to be included at original cost.

   (c) Rented real and tangible personal property is valued at eight times the net annual rental rate.

2. The denominator of the property factor includes all real and tangible personal property owned or rented by the taxpayer and used in the business during the income year.

3. The numerator of the property factor includes:

   (a) All real and shoreside tangible personal property owned or rented by the taxpayer and used in the business in this state.

   (b) The value of a ship and ship's equipment used in the business attributable to this state determined by the ratio of the number of port days during which the ship was within this state to the total number of port days of the ship everywhere during the income year.

B. Payroll Factor

1. The denominator of the payroll factor inclues all compensation paid to employees of the taxpayer during the income year.

2. The numerator of the payroll factor includes:

   (a) The total compensation paid to employees, other than ship's personnel and fisherman, attributable to this state during the income year determined in accordance with Section 25123, Revenue and Taxation Code, and the regulations thereunder.

   (b) That part of the compensation paid to ship's personnel and fishermen attributable to this state determined by the ratio of the number of port days during which the ship was within this state to the total number of port days of the ship everywhere during the income year.

C. Sales Factor

1. All receipts derived from transactions and activities of the taxpayer in the regular course of the trade or business which produce business income are included in the denominator of the sales factor (see Sections 25134 through 25137, Revenue and Taxation Code, and the regulations thereunder).

2. The numerator of the sales factor includes:

   (a) Receipts from the sale, lease, rental, or other use of real and tangible personal property, except fish, attributable to this

state during the income year determined in accordance with Sections 25134 through 25137, Revenue and Taxation Code, and the regulations thereunder.

(b) Receipts from the sale of fish attributable to this state determined by applying the ratio of the number of port days during which the ship was within this state to the total number of port days of the ship everywhere during the income year.

9-79 750

EXHIBIT 6

MTC PROPOSED FORMULA FOR RAILROADS

Reg. IV.18.(f). Special Rules: Railroads. The following special rules are established in respect to railroads:

(1) In General. Where a railroad has income from sources both within and without this state, the amount of business income from sources within this state shall be determined pursuant to this regulation. In such cases, the first step is to determine what portion of the railroad's income constitutes "business" income and which portion constitutes "nonbusiness" income under Article IV.1 and Regulation IV.1 thereunder. Nonbusiness income is directly allocable to specific states pursuant to the provisions of Article IV.5 to .8, inclusive. Business income is apportioned among the states in which the business is conducted pursuant to the property, payroll and sales apportionment factors set forth in this regulation. The sum of (1) the items of nonbusiness income directly allocated to this state, plus (2) the amount of business income attributable to this state constitutes the amount of the taxpayer's entire net income which is subject to tax by this state.

(2) Business and Nonbusiness Income. For definitions, rules and examples for determining business and nonbusiness income, see Reg. IV.1.

(3) Apportionment of Business Income.

(i) In General. The property factor shall be determined in accordance with Reg. IV.10.-.12., inclusive, the payroll factor in accordance with Reg. IV.13., and the sales factor in accordance with Reg. IV.14.-.17, inclusive, except as modified in this regulation.

(ii) The Property Factor.

Exhibit 6

A. Property Valuation. Owned property shall be valued at its original cost and rented property shall be valued at eight (8) times the net annual rental rate in accordance with Article IV.11. and Reg. IV.11. Railroad cars owned and operated by other railroads or other companies and temporarily used by the taxpayer in its business and for which a per diem or mileage charge is made are not included in the property factor as rented property. Railroad cars owned and operated by the taxpayer and temporarily used by other railroads in their business and for which a per diem charge is made by the taxpayer are included in the property factor of the taxpayer.

B. General Definitions. The following definitions are applicable to the numerator and denominator of the property factor:

1. "Original cost" is deemed to be the basis of the property for federal income tax purposes (prior to any federal income tax adjustments except for subsequent capital additions, improvements thereto or partial dispositions); or, if the property has no such basis, the valuation of such property for Interstate Commerce Commission purposes. If the original cost of property is unascertainable under the foregoing valuation standards, the property is included in the property factor at its fair market value as of the date of acquisition by the taxpayer (Reg. IV.11.(a)).

2. "Rent" does not include the per diem and mileage charges paid by the taxpayer for the temporary use of railroad cars owned or operated by another railroad or other company.

3. The "value" or owned real and tangible personal property shall mean its original cost. (See Article IV.11. and Reg. IV.11.(a)).

4. "Average value" of property means the amount determined by averaging the values at the beginning and ending of the income tax year, but the (insert here the appropriate title of the administrative agency) may require the averaging of monthly values during the income year or such averaging as necessary to effect properly the average value of the railroad's property. (See Article IV.12. and Reg. IV.12.)

5. The "value" of rented real and tangible personal property means the product of eight (8) times the net annual rental rate. (See Art. IV.11. and Reg. IV.11.(b))

6. "Net annual rental rate" means the annual rental rate paid by the taxpayer less any annual rental rate received by the taxpayer from sub-rentals.

7. "Property used during the income year" (includes property which is available for use in the taxpayer's trade or business during the income year.

8. A "locomotive-mile" is the movement of a locomotive (a self-propelled unit of equipment designed solely for moving other equipment) a distance of one mile under its own power.

9. A "car-mile" is a movement of a unit of car equipment a distance of one mile.

C. <u>The Denominator and Numerator of the Property Factor.</u> The denominator of the property factor shall be the average value of all of the taxpayer's real and tangible personal property owned or rented and used during the income year. The numerator of the property factor shall be the average value of the taxpayer's real and tangible personal property owned or rented and used in this state during the income year.

In determining the numerator of the property factor, all property except mobile or movable property such as passenger cars, freight cars, locomotives and freight containers which are located within and without this state during the income year shall be included in the numerator of the property factor in accordance with Article IV.10.-.12., inclusive, and Regulation IV.10.-.12, inclusive.

Mobile or movable property such as passenger cars, freight cars, locomotives and freight containers which are located within and without this state during the income year shall be included in the numerator of the property factor in the ratio which "locomotive-miles" and "car-miles" in the state bear to the total everywhere.

(iii) The Payroll Factor. The denominator of the payroll factor is the total compensation paid everywhere by the taxpayer during the income year for the production of business income. (See Article IV.13.-14. and Reg. IV.13.-.14) The numerator of the payroll factor is the total amount paid in this state during the income year by the taxpayer for compensation. With respect to all personnel except enginemen and trainmen performing services on interstate trains, compensation paid to such employees shall be included in the numerator as provided in Article IV.13.-.14 and Reg. IV.13.-.14.

With respect to enginemen and trainmen performing services on interstate trains, compensation paid to such employees shall be included in the numerator of the payroll factor in the ratio which their services are performed in this state bear to their services performed everywhere. Compensation for services performed in this state shall be deemed to be the compensation reported or required to be reported by such employees for determination of their income tax liability to this state.

A. In General. All revenue derived from transactions and activities in the regular course of the trade or business of the taxpayer which produces business income, except per diem and mileage charges which are collected by the taxpayer, is included in the denominator of the revenue factor. (See Art. IV.1. and Reg. IV.1.)

The numerator of the revenue factor is the total revenue of the taxpayer in this state during the income year. The total revenue of the taxpayer in this state during the income year, other than revenue from hauling freight, passengers, mail and express, shall be attributable to this state in accordance with Article IV.15.-.17. and Regulation IV.15.-.17.

B. Numerator of Sales (Revenue) Factor From Freight, Mail and Express. The total revenue of the taxpayer in this state during the income year for the numerator of the revenue factor from hauling freight, mail and express shall be attributable to this state as follows:

1. All receipts from shipments which both originate and terminate within this state; and

2. That portion of the receipts from each movement or shipment passing through, into, or out of this state is determined by the ratio which the miles traveled by such movement or shipment in this state bears to the total miles traveled by such movement or shipment from point of origin to destination.

C. Numerator of Sales (Revenue) Factor from Passengers. The numerator of the sales (revenue) factor shall include:

1. All receipts from the transportation of passengers (including mail and express handled in passenger service) which both originate and termi-

nate within this state; and

2. That portion of the receipts from the transportation of interstate passengers (including mail and express handled in passenger service) determined by the ratio which revenue passenger miles in this state bears to the total everywhere.

EXHIBIT 7

Legal Rul. 413

Facts

A taxpayer doing business in States A, B, and C sells a substantial portion of its business assets located in State B. An election is made to report the gain on the sale on the installment basis.

Questions

1. In what year is the sale included in the receipt's factor?

2. What year's factors are utilized to apportion the gain as it is reported?

Decisions

1. The sale should be included in the year of sale regardless of the date of receipt subject to Regulation §25137(c)(1)(A).

2. The factors of the year of sale should be utilized in apportioning the gain or loss regardless of the installment sale election.

Discussion

1. In the Appeal of Donald M. Drake Company, March 2, 1977, the State Board of Equalization stated:

   "The general rule of the Uniform Act, is that a taxpayer's apportionment factors for any income year will reflect the items of property, payroll, and sales which relate to its business activity in that particular year.

   "A taxpayer's use of completed-contract accounting does not require an exception to the general rule for determining its apportionment factors. Completed-

Exhibit 7

> contract accounting is no more than a device for determining in what year profit or loss will be recognized, and items of receipt and expense are generally not ignored in pre-completion years simply because the profit or loss they produce is deferred."

This reasoning applies with equal force to installment reporting. It is the taxpayer's business activities within and without California, not the taxpayer's accounting method, which should determine the taxpayer's apportionment percentage for each income year. All the activities which give rise to the gain realized on the installment sale occur or are concluded in the year of sale. Therefore, the sale should be included in full in the year of the sale.

Proceeds from the sale of assets which would not otherwise be included in the receipts factor under Regulation §25137(c)(1)(A) are not to be included even though installment reporting is elected.

2. Income from installment sales is reported at least in substantial part in a year other than the year in which the sale took place. Apportionment of installment sale income on the basis of the factors in the year the income is reported or received would result in such income being apportioned by activities which had no connection with the earning of the income. The Board of Equalization held in Drake, supra, that the use of an apportionment factor which does not fully reflect the activities which give rise to the income was a distortion and that therefor a variance from the standard formula under §25137 is authorized.

   The Board of Equalization in Drake, supra, approved the use of a method which reflected all the activities which give rise to the income. Based upon the Board of Equalization's reasoning in Drake, supra, the gain or loss from an installment sale should be apportioned on the basis of the factors of the year of sale regardless of the year in which such gain or loss is actually reported.

   A taxpayer which in the regular course of business makes installment sales as a dealer in tangible personal property may normally apportion the gain on the basis of the factors of the year the gain is received since its apportionment factors will not normally vary significantly on a year-to-year basis.

The application of this memorandum is illustrated by the following example:

Example

X is doing business in States A, B, and C. During Year 1, X has sales of $2,000,000 (including $1,000,000 from the sale of a plant at year end excluded from the sales factor under Regulation §25137(c)(1)(A)) in State A, $3,000,000 in State B, and $5,000,000 in State C. X realized a gain of $500,000 on the sale of the plant. X elects to report the $500,000 gain on the installment basis with equal payments received in Years 2 and 3. X has sales of $100,000 in State A; $4,900,000 in State B; and $5,000,000 in State C in Year 2; and sales of $200,000 in State A; $3,000,000 in State B; and $6,800,000 in State C in Year 3. Assume the property and payroll factors are equivalent to the sales factors for each year X would report income from the installment sale to States A, B, and C, in the following manner:

Year 1 - Gain from Installment Sale 0

	A	B	C
Sales Factor	1,000,000 / 9,000,000	3,000,000 / 9,000,000	5,000,000 / 9,000,000
Apportionment Factor	11	33	56
Installment Sale Gain	0	0	0

Year 2 - Gain from Installment Sale $250,000

	A	B	C
Sales Factor	100,000 / 10,000,000	4,900,000 / 10,000,000	5,000,000 / 10,000,000
Apportionment Factor	1%	49%	50%
Installment Sale Gain (Year 1 Factor X Gain)	27,500	82,500	140,000

Year 3 - Gain from Installment Sale $250,000

	A	B	C
Sales Factor	200,000 / 10,000,000	3,000,000 / 10,000,000	6,800,000 / 10,000,000
Apportionment Factor	2%	30%	68%
Installment Sale Gain (Year 1 Factor X Gain)	27,500	82,500	140,000

EXHIBIT 8

CALIFORNIA FRANCHISE TAX BOARD

Proposed Guideline for the Preparation of Combined Returns Which Include Foreign Country Operations

I. Introduction

When any part of a unitary business has a nexus in California, the income and apportionment factors of the entire unitary business must be included in the combined report filed with California which is utilized to determine the income properly attributable to California sources. This requirement applies equally to businesses with operations solely within the United States, United States businesses with operations in foreign countries, and businesses based in foreign countries with operations within the United States. It applies whether the business operations are carried on by a single corporation or by multiple corporations.

Prior to 1970, the relative values of the currencies of the major industrial countries were the subject of international agreement and were, for the most part, stable. Beginning in 1970, currencies were allowed to "float," which has resulted in significant changes in their relative values. These changes have given rise to questions concerning the preparation of combined reports which include operations carried on in more than one country.

In choosing a translation method for the preparation of a combined return, the department has of necessity operated under constraints imposed by unitary theory and the requirement that taxpayers, identical but for the country of origin, be treated in a similar manner. These constraints and the efficient administration of the tax law have led the department to adopt the method commonly known as the profit and loss method for the preparation of combined reports.

II. Determination of Income

A. The income of a unitary business with operations in foreign countries will be computed in the following manner:

Draft
Revised 8/29/79

EXHIBIT 8

1. A profit and loss statement will be prepared for each foreign branch or corporation in the currency in which the books of account of the branch or corporation are regularly maintained.

2. Adjustments will be made to the profit and loss statement to conform it to the accounting principles generally accepted in the United States for the preparation of such statements except as modified by this guideline.

3. Adjustments will be made to the profit and loss statement to conform it to the tax accounting standards required under the California Revenue and Taxation Code.

4. The profit and loss statement will be translated into the currency in which the parent company maintains its books and records in accordance with paragraph II.C.

5. Business and nonbusiness income as determined under California law will be identified and segregated.

6. Nonbusiness income will be allocated to a jurisdiction on the basis of the rules provided for in the Uniform Division of Income for Tax Purposes Act as adopted by California. (§ 25123, et seq., California Revenue and Taxation Code.)

7. Business income will be included in the combined report prepared for the unitary business and will be apportioned on the basis of the appropriate formula for the business.

8. Income from California sources will be expressed in dollars in accordance with paragraph II.C. and the taxes computed accordingly.

B. For purposes of paragraphs II.A.2. and II.A.3. the following rules shall apply:

1. Accounting adjustments to be made to conform profit and loss statements to those utilized in the United States—

(a) Include but are not limited to the following:

(i) Clear reflection of income. Any accounting practice designed for purposes other than the clear

reflection on a current basis of income and expense for the taxable year shall not be given effect. For example, an adjustment will be required where an allocation is made to an arbitrary reserve out of current income.

(ii) Physical assets, depreciation, etc. All physical assets, including inventory when reflected at cost, shall be taken into account at historical cost computed either for individual assets or groups of similar assets. The historical cost of such an asset shall not reflect any appreciation or depreciation in its value or in the relative value of the currency in which its cost was incurred. Depreciation, depletion, and amortization allowances shall be based on the historical cost of the underlying asset, and no effect shall be given to any such allowance determined on the basis of a factor other than historical cost.

(iii) Valuation of assets and liabilities. Any accounting practice which results in the systematic undervaluation of assets or overvaluation of liabilities shall not be given effect, even though expressly permitted or required under foreign law, except to the extent allowable under paragraph II.B.2. of this section. For example, an adjustment will be required where inventory is written down below market value.

(iv) Income equalization. Income and expense shall be taken into account without regard to equalization over more than one accounting period; and any equalization reserve or similar provision affecting income or expense shall not be given effect, even though expressly permitted or required under foreign law.

(b) Currency gains or losses on closed transactions are includible, but no adjustments shall be made, nor otherwise reflected, for unrealized gains or losses resulting from the restatement or re-valuation of assets or liabilities to reflect changes or fluctuations in currency values. A closed transaction is one where any foreign exchange position taken by a corporation has been terminated by exchanging the foreign currency for the currency in which the individual corporation maintains its books and records and normally conducts its business affairs.

2. The tax accounting adjustments to be made shall include, but are not limited to, the following:

   (a) Accounting methods. The method of accounting shall reflect the provisions of Section 24651 of the California Revenue and Taxation Code and the regulations thereunder.

   (b) Inventories. Inventories shall be taken into account in accordance with the provisions of Section 24701 through 24706 of the California Revenue and Taxation Code and the regulations thereunder.

   (c) Depreciation, depletion, and amortization. Depreciation, depletion, and amortization are to be computed in accordance with rules applicable to California taxpayers.

   (d) Elections.

      (i) Elections of all California reporting entities shall be made in accordance with applicable provisions of California law or regulations.

      (ii) Elections for entities which are not subject to taxation by California but are required to be included in the combined report for the unitary business shall be made by agreement of all entities required to report to California in accordance with applicable provisions of California law or regulation.

3. No adjustment shall be required under paragraphs II.B.1. and II.B.2. unless it is material. Whether an adjustment is material depends on the facts and circumstances of the particular case, including the amount of the adjustment, its size relative to the general level of the corporation's total assets and annual profit or loss, the consistency with which the practice has been applied, and whether the item to which the adjustment relates is of a recurring or merely a nonrecurring nature.

C. For purposes of determining income, necessary translations will be made at the following exchange rates:

1. Depreciation, depletion, or amortization shall be translated at the appropriate exchange rate for the translation period in which the historical cost of the underlying asset was incurred or is deemed to have occurred.

2. All other items shall be translated at the simple average exchange rate for the translation period unless there is a substantial fluctuation as described in paragraph IV.B. within the period, in which case a simple average of the month-end rates or weighted average may be utilized.

III. Computation of Factors

In computing the formula factors, the following rules shall apply:

A. Property Factor

1. Fixed assets will be valued at original cost as defined in Reg. 25130(a) and translated at the exchange rate as of the date of acquisition.

2. Rented property, capitalized at eight times its annual rental rate, will be translated at the simple average of the beginning and end of year exchange rate.

3. Inventories will be valued at original cost and will be translated at the exchange rate as of the date of acquisition.

4. For purposes of calculating the property factor of financial corporations, financial assets are translated at the year-end rate and are defined

as assets reflecting a fixed amount of foreign currency, such as cash on hand, bank deposits, and loans and accounts receivable. Securities held or reasonably expected to be held for less than six months shall be translated at year-end rates. If a security is held, or reasonably expected to be held, for more than six months, it will be translated at the appropriate exchange rate for the translation period in which the historical cost of the asset is determined.

5. In computing the property factor, translation should normally be made into the parent company's currency in order to properly determine the percentage factor to be used.

B. Payroll and Receipts Factors

1. Translation is to be made at the simple average of the beginning and end of year exchange rates unless there is a substantial fluctuation, as described in paragraph IV.B.

2. Where the value of the foreign currency does fluctuate substantially, as described in paragraph IV.B., the exchange rate appropriate to that period shall be either (a) a simple average of the month-end rates, or (b) a weighted average taking into account the volume of transactions (reflected by the amount being translated) for the calendar months ending with or within that period.

3. In computing the payroll and receipts factors, translation should normally be made into the parent company's currency in order to properly determine the percentage factor to be used.

IV. Exchange Rates

A. For purposes of preparing combined reports, exchange rates may be derived from any source which is demonstrated to the satisfaction of the Department to reflect actual transactions conducted in a free market and involving representative amounts. In the absence of such demonstration, the exchange rates taken into account in computation of the earnings and profits of the foreign corporation are determined by reference to the free market rate set forth in the pertinent monthly issue of International Financial Statistics or successor publications of the International Monetary Fund or such other source as the Department may designate.

B. In general, the extent of fluctuation is substantial if the closing rate for any calendar month ending within the period varies by more than 10 percent from the closing rate for any preceding calendar month ending within the period.

V. Application of Guideline

In computing any of the income and factors required for a combined report, due regard will be given to the effort and expense required to obtain the necessary information; and in appropriate cases the Department, in its discretion, may accept reasonable approximations. Variations from the rules set forth above, particularly with respect to foreign-based corporations, may be allowed by the Franchise Tax Board in exceptional circumstances if applied on a consistent basis and where such variations do not result in a material difference in the reporting of income over time.

EXHIBIT 9

REGULATION SECTION 25137(g)

(g) *In cases deemed appropriate by the Franchise Tax Board it may elect to hear and decide petitions filed pursuant to Section 25137 instead of having this function performed by the staff. As a condition to having such petition considered by the Board, the petitioning taxpayer shall waive in writing the confidentiality provisions of Section 26451 with respect to such petition and to any other facts which may be deemed relevant in making a determination. Consideration of said petitions by the Board shall be in open session at a regularly scheduled meeting.*

Exhibit 9

EXHIBIT 10

Statement of the Franchise Tax Board
Pertaining to Section 25137 Petitions

In hearings held in July and August of 1977, the Franchise Tax Board expressed the belief that taxpayers were not availing themselves of the relief provisions of Section 25137 of the California Revenue and Taxation Code. In furtherance of their concern the Board adopted Regulation Section 25137(g), California Administrative Code, title 18, which provides for public consideration of petitions by the Board.

Within the past several months, the Franchise Tax Board has considered a number of petitions for relief from the standard three-factor formula under Section 25137. In order to provide guidance to taxpayers as to the Board's approach to these petitions, the following summary has been prepared.

A hearing in open session was held on the petition of Eadington Fruit Company on December 5, 1978. Eadington sold a substantial portion of its non-California business assets in 1971 and elected to report the gain on the installment basis. Prior to the sale of its non-California assets, Eadington's California apportionment percentage was approximately 50 percent. After its assets were disposed of, Eadington's California apportionment percentage rose to approximately 95 percent. Eadington's petition claimed that the use of the standard three-factor formula for the year in which the gain was reported did not properly reflect its activities in California with respect to the sale of such assets.

The Franchise Tax Board granted Eadington's petition and held that the gain realized on the sale of Eadington's non-California assets should be apportioned by the apportionment factors of the year of sale.

In the remaining cases, the Board determined that a hearing should not be granted. The reasons for not granting a hearing include, but are not limited to, the following:

1. Failure of the petitioner to supply additional material in support of the petition as requested by the staff.

2. The pendency of proceedings before the State Board of Equalization or in the courts involving the individual taxpayer and the questions presented in the petition.

Exhibit 10

In addition, the Board determined that the following grounds did not establish a basis for granting a hearing or relief:

1. A comparison of intercompany transactions to gross receipts of a unitary business.

2. Greater profitability of individual operations or geographic locations based on separate accounting data.

3. The threat of multiple taxation because separate accounting attributes a greater or lesser amount of income to a jurisdiction than does the unitary method.

4. The expected greater profitability or rate of return for one part of the unitary business as compared to another part because of greater risks.

EXHIBIT 11

LIST OF MEMBERSHIP OF MULTISTATE

TAX COMPACT AND ASSOCIATE MEMBERS

Members

Alaska
Arkansas
California
Colorado
Hawaii
Idaho
Kansas
Michigan
Missouri
Montana
Nebraska
Nevada
New Mexico
North Dakota
Oregon
South Dakota
Texas
Utah
Washington

Associates

Alabama
Arizona
Georgia
Louisiana
Maryland
Massachusetts
Minnesota
New Jersey
Ohio
Pennsylvania
Tennessee
West Virginia

Exhibit 11

EXHIBIT 12

95th Congress } COMMITTEE PRINT
1st Session }

APR 1 - 1977
CHIEF COUNSEL'S OFFICE
FRANCHISE TAX BOARD

COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

RECOMMENDATIONS OF THE TASK FORCE ON FOREIGN SOURCE INCOME

RECEIVED
MAR 28 1977
Executive Officer
FRANCHISE TAX BOARD

MARCH 8, 1977

RECEIVED
MAR 23 1977
E.T.A.

Prepared for the use of the Committee on Ways and Means

U.S. GOVERNMENT PRINTING OFFICE
81-788 O WASHINGTON : 1977

For sale by the Superintendent of Documents, U.S. Government Printing Office
Washington, D.C. 20402 - Price [illegible] cents
There is a minimum charge of $1.00 for each mail order

Exhibit 12

In many States, not all of the income of a corporation is subject to that State's apportionment formula. For example, in many States passive income such as dividend income is allocated entirely to the State of the "commercial domicile" (or in some cases the State of the "principal business location") of the corporation and is thus excluded from the income subject to the apportionment formula.

Taxation by States of foreign source income.—Virtually all States include the income of foreign branches of domestic corporations in the income which is subject to their apportionment formula. For example, if a corporation had two-thirds of its sales abroad, but the other one-third of its sales, one-half of its property, and two-thirds of its payroll in one State, the corporation would be taxed on one-half of its income by that State.

In those States which have adopted the unitary method and thus apply their apportionment formula to income of a related group of corporations, the income of foreign affiliates of U.S. corporations is subject to apportionment if the activities of the foreign affiliates are dependent upon or contribute to the business of the corporation within the taxing State. These States thus treat income of foreign corporations related to U.S. corporations in the same manner as most States treat income of foreign branches of U.S. corporations.

Dividends of a foreign subsidiary are sometimes subject to State tax when received by a domestic corporation. In these cases the dividends are taxed in the same manner as dividends from domestic corporations (i.e., taxed by the State where the corporation is commercially domiciled or has its principal place of business, added to the income subject to the apportionment formula of the taxing State, or, in some cases, taxed in both States). However, many States do not significantly tax any dividends from related corporations.

Previous attempts to modify present law.—As a result of court decisions in the late 1950s and early 1960s which expanded the constitutional limits of a State's jurisdiction to tax corporations with minimal levels of economic activity within the boundaries of that State, Federal legislation was enacted which required that a corporation at least accept and approve sales orders within any State before that corporation can be subjected to the income tax of that State. In more recent years, legislation mandating greater uniformity in the rules for State taxation of corporations has been introduced and studied. One such bill, which was reported by the House Judiciary Committee, passed the House in 1969 but was not enacted.

In 1969, a group of States reacted to the possibility of Federal legislation by adopting a multi-state tax compact, which established the Multistate Tax Commission whose duties are to establish uniform income tax regulations, auditing standards and tax forms for member States. Presently, 20 States are members of the compact (the majority of the States are Midwestern and Western States). Under the compact, the regulations of the Multistate Commission are effective in all member States, but any member State can adopt overriding regulations if they choose. Since most of these States have adopted some overriding regulations, the methods of taxing corporations still vary substantially among States which are members of the compact.

Issues

Although a larger controversy exists over the States' jurisdiction to tax income and the need for uniform rules among the States, the basic issue before the task force was whether the Federal Government should prohibit States (a) from taxing foreign source income directly, or (b) from taking into account foreign source income under the unitary method (as described above).

Alternatives

Limitations in applying the unitary method of apportionment.—States could be prohibited from requiring the reporting of income and related items of foreign corporations even though related to U.S. corporations which operate within that State. Under this proposal, the unitary method would not be applied either to foreign subsidiaries of U.S. corporations, to foreign parents of U.S. subsidiaries, or to other affiliated foreign corporations. This would not, however, prevent a State from taxing dividends paid by foreign subsidiaries, interest, or royalties received from foreign affiliates or other foreign sources, nor would it prevent the application of the three-factor formula to branch income from foreign operations of U.S. corporations operating in the State.

The reporting of income and related items of foreign corporations could be limited to activities of U.S. corporations which relate to exports from or imports to the United States, but the treatment of dividends, etc., could remain the same as above for income from other corporations.

The reporting of income and related items could be barred in the case of foreign-owned corporations with affiliates operating in any State, but allowed with respect to foreign subsidiaries of U.S.-owned corporations operating within the State (as would be done with U.K.-owned companies in the proposed convention between the United States and the United Kingdom). Dividends, etc., could remain taxable as above. Under this proposal, in the case of foreign-owned affiliated groups of corporations, any State would be limited to applying its apportionment formula to the income of any member of the affiliated group operating within that State or other States.

Limitations on direct taxation of foreign source income.—States could be prohibited from directly taxing in any way foreign source income. This means they not only would not tax income through the unitary method, but also would not tax dividends from foreign subsidiaries, foreign source interest or royalties, or branch earnings of U.S. corporations. The States could also be prohibited from taxing foreign income of individuals.

States could be prohibited from taxing through the unitary method foreign affiliates not doing business in the State or from taxing dividends from foreign affiliates of U.S. companies, but allowed to tax interest or royalties or branch income.

Analysis

Limitations on the unitary method of apportionment.—For Federal income tax purposes, an apportionment formula is not used to divide income and costs between United States and foreign countries. Instead.

income and costs are allocated between related companies using the criterion of what the costs and prices would be between these parties if they were independent parties dealing at arm's length (sec. 482). On the other hand, in computing what portion of the income of a single company is from foreign sources, an allocation of income and deductions approach is used (sec. 861). This approach already produces significant problems when applied at the Federal level and would be virtually impossible to administer at the State level as applied to interstate transactions. Thus, there is no significant disagreement that the States must use some type of apportionment formula (as distinguished from making an allocation of income and deductions by separate accounting), since there would be no practical way of determining what income of a company is earned within a State as opposed to being earned within other States (or in foreign countries).

The rationale presented for using the unitary method to combine the business activities of related corporations which contribute to the business activities of a corporation within a taxing State is that the operations form an integrated business, and whether the business is conducted through a number of separate corporations or through one single corporation should not affect tax liability.

It is disputed whether those States applying the unitary method of taxing corporate business income under an apportionment formula do, in fact, tax the income of related foreign corporations. For example, under the three-factor apportionment formula, if it takes the same dollar amount of sales, the same value of property and the same sized payroll to achieve a given level of income in the foreign subsidiary as it takes in U.S. operations, then no foreign income would be taxed by any State because the three factors would apportion the appropriate amount of income to foreign countries and to the State.

However, it is argued that in many countries abroad wages and property values are lower in proportion to income than in the United States. It is argued that, given these circumstances, the inclusion of foreign corporations under the unitary method of apportionment leads indirectly to State taxation of foreign source income by apportioning too much income to the United States. Whether or not this actually is the result in any specific case depends on whether the proportion of income to wages, property costs and sales in the specific country in which a corporation operates is higher than the proportion of the same items in the United States. In some cases, the unitary method operates to apportion more income to the United States than most people would agree should be so apportioned if each affiliate were treated as an independent entity operating on an arm's-length basis. However, in other cases the application of the unitary method may apportion less income to a State than would be apportioned under other acceptable methods.

An additional problem raised in relation to those States which have adopted the unitary method is the administrative burden which that method places on corporate taxpayers, particularly those which are foreign owned. For example, a corporation with one manufacturing plant in a unitary State has to obtain for that State's tax purposes the income, sales, property and payroll figures of all of its affiliates operating worldwide if the activities of those affiliates are dependent upon

or contribute to the activities of the corporation within that State. In the case of a foreign parent corporation, this compliance burden could be particularly costly because a foreign-owned foreign corporation ordinarily would not otherwise keep the books of its operations outside of the United States in terms of U.S. dollars or in a manner which would conform to U.S. accounting concepts.

The need for applying the unitary method may not be as great when taking into account foreign source income than when taking into account income from a number of States. The number of transactions in any State linked to foreign operations is ordinarily substantially fewer than the number of transactions linked to different States. Moreover, since taxpayers are in any event required to allocate income between U.S. and foreign sources for Federal income tax purposes, the States could adopt the Federal rules for apportioning income from foreign transactions between domestic and foreign sources.

Some critics of the unitary method of apportionment would nevertheless permit its use where the States can show that there is less than arm's length pricing in foreign transactions. If the unitary method were allowed only in this case, the State affected to the most substantial extent would be California. California State tax officials estimate that such a limitation would cost that State approximately $125 million in revenue, or about 12 percent of total corporate tax revenues.

It has also been suggested that the application of the unitary method could be limited to those cases where the business activities of the foreign subsidiaries are related to exports from or imports into the United States. Export-related transactions generate the most difficult income allocation questions under the Federal tax rules, and thus it is suggested that it is appropriate to allow the States to decide whether Federal rules should be followed in those circumstances.

If the administrative burden which the unitary method causes taxpayers is viewed as the primary problem, the application of the unitary method to foreign corporations owned by foreigners could be prohibited.

Limitations on directly taxing dividends from foreign subsidiaries.—

Except as that result may be achieved indirectly under the unitary system, no State taxes the income of foreign subsidiaries (not doing business with the State) of U.S. corporations as that income is earned; that income is taxed only when it is remitted to a U.S. corporation as a dividend. In those States which tax foreign source dividends, it is argued that double taxation results because no credit is allowed for foreign taxes paid.

The Federal Government taxes dividends from foreign subsidiaries of U.S. corporations when they are brought back to the United States, but allows a foreign tax credit for foreign (national, state and local) income taxes paid by the subsidiary. Thus, to the extent that foreign income taxes do not exceed 48 percent of foreign taxable income, the tax burden on foreign source income also taxed by a State is no greater than the tax burden on domestic source income which is taxed by the Federal Government at 48 percent and by the State as well.

As in the case of State taxation of dividends from domestic corporations, the lack of uniform rules among the States does lead to over-taxation or under-taxation in various cases. If the taxation of dividends of foreign subsidiaries is prohibited, domestic source income in some cases will be taxed more heavily than foreign source income because all income taxes paid to local governments in foreign countries, as well as the income taxes paid their national governments, are creditable against U.S. Federal tax while income taxes paid to U.S., State and local governments are only deductible, and not creditable for Federal purposes.

Recommendations

The task force makes the following recommendations with respect to State taxation of foreign source income:

(1) *Income of foreign affiliates not subject to Federal income tax.*—It is recommended that the States be precluded from taking into account, under the unitary method or any other method, the income of foreign affiliates of corporations doing business within the States until such time as that income is subject to Federal income tax.

(2) *Income of foreign affiliates subject to Federal income tax.*—It is further recommended that no limitation be placed on the power of the States to apply the three-factor formula on a domestic basis, under the unitary method or otherwise, to income of foreign affiliates which had been excluded under paragraph (1) above if and when such income becomes subject to Federal income tax.

EXHIBIT 13

The President's 1978 Tax Program

★★★★★★★★★★★★★★★★★★★★★★

Detailed Descriptions
and Supporting Analyses
of the Proposals

January 30, 1978
DEPARTMENT OF THE TREASURY Washington, D.C.

EXHIBIT 13

TERMINATING DEFERRAL

Present Law

Under present law U. S. citizens, residents, and corporations are subject to U. S. taxation on their worldwide income. Foreign corporations, including foreign corporations controlled by U. S. taxpayers, are generally subject to U. S. taxation only on income earned in the United States.

Although the income of a foreign corporation controlled by a U. S. shareholder is usually consolidated with the income of the U. S. shareholder for purposes of financial reporting, this is not the case for tax purposes. The shareholder's income subject to U. S. tax generally includes only dividends received from the foreign corporation and not the earnings that the foreign corporation retains. The U. S. tax on dividends from the foreign corporation may be offset by a credit allowed for the foreign taxes paid by the foreign corporation.

"Deferral" refers to the practice of not taxing the income of a U. S.-controlled foreign corporation until that income is distributed to the controlling U. S. shareholders. The term "deferral" is employed because the net U. S. tax liability -- equal to the difference between the U. S. tax and the credit for foreign taxes -- is "deferred" until such income is distributed as a dividend.

Deferral does not apply when the nature of the controlled foreign corporation and its income exhibit "tax haven" characteristics. Tax haven income (so-called "subpart F income") is taxed currently to U. S. shareholders regardless of whether they actually receive the income in the form of a dividend. Likewise, U. S. shareholders are taxed on their pro rata share of the retained earnings of a foreign personal holding company, and on the earnings of any controlled foreign corporation which are in effect repatriated to the United States through the purchase of certain U. S. property.

Since the practice of deferral permits the income of controlled foreign corporations to escape current U. S. taxation until that income is repatriated as a dividend, it is important that transfer prices for transactions between U. S. shareholders and their controlled foreign corporations be properly determined. It is also necessary to ensure that reorganizations involving controlled foreign corporations are not undertaken for the purpose of tax avoidance. The tax law presently contains complex provisions designed to carry out these purposes.

Reasons for Change

The fundamental defect in the concept of deferral is that it makes very substantial tax benefits turn upon an artificial factor: whether a foreign corporate charter has been interposed between foreign income and the U. S. taxpayer. In addition to curing this defect, the termination of deferral will eliminate the tax incentive that U. S. taxpayers now have to locate new investment overseas rather than in the United States.

Terminating deferral will permit the rationalization and simplification of U. S. rules for the taxation of foreign income. Termination will help stimulate competition between large multinational corporations and their smaller competitors, by removing tax benefits which accrue principally to the large multinationals. Finally, terminating deferral will reduce the incentive inherent in present law for U. S. taxpayers to avoid U. S. tax by undercharging foreign affiliates for goods, services, research, and home office overhead.

(1) Terminating Deferral Will Preclude Substantial Tax Benefits From Turning on the Choice of Corporate Structure

When losses or large foreign tax credits are desired for U. S. tax purposes, a U. S. taxpayer may obtain these benefits currently by operating overseas through a branch. When foreign income does not generate sufficient foreign tax credits to offset U. S. tax, a current U. S. tax may be avoided by interposing a foreign corporate entity. A U. S. taxpayer is thus permitted to choose, through the form of its overseas operations, between two very different sets of substantive U. S. tax rules.

There is no good reason for this state of affairs. A choice of tax rules should not be accorded simply because business operations are situated abroad rather than in the United States. Such operations, in the case of a controlled foreign corporation, are an integral part of the overall activity of the U. S.-based firm, and the profits from such operations should, for this reason alone, be subject to current taxation in the United States.

In 1969 Congress dealt with a similar situation involving the availability of the $25,000 surtax exemption for each entity in a group of related domestic corporations. Congress took the view that a commonly owned business enterprise should be entitled to only one such exemption, whether it was operated under a single corporate charter or multiple charters and regardless of any genuine business reason for having multiple charters. The issue in the case of deferral is essentially the same: even if fully justified by business considerations, the interposition of foreign corporate charters should not affect the substance of U. S. taxation.

This point is, in fact, already recognized by some provisions of the Internal Revenue Code dealing with foreign income. U. S.

corporations are allowed a foreign tax credit (the so-called "deemed paid" credit) for taxes paid by their foreign subsidiaries. This allowance, which in 1975 amounted to more than $3 billion, reflects a recognition that the existence of a foreign corporate charter should not determine tax substance.

(2) Terminating Deferral Will End a Present Tax Incentive To Invest Overseas

Deferral gives U. S. taxpayers a substantial incentive to invest overseas for purely tax reasons. This incentive arises from a combination of the absence of current U. S. tax on the retained earnings of controlled foreign corporations, and the presence of tax inducements in many foreign countries. These foreign inducements take the form of low tax rates, rapid depreciation, tax holidays, and other special tax advantages not available in the United States.

U. S. investors need not look very far for tax holidays, for such benefits are heavily marketed in the United States. One foreign country, for example, publishes a brochure urging American business to "Get in on the . . . bonanza!" The bonanza includes "tax holidays, unlimited remittance of profits, repatriation of capital, protection against risks and the assistance offered by a friendly government from application to the start of production." Another recent advertisement in a business publication has a banner headline: "Exceptional Return on Investment Continues ...." As the advertisement explains, "export profits . . . . are completely free of tax until 1990. So a U. S. subsidiary . . . . grows faster, and at less cost to the U. S. parent. In spite of the fact that profits can be freely repatriated, U. S. companies ploughed back 65 percent of them and notched up an expansion of U. S. investment of 30 percent." With an exemption from foreign tax and a deferral of U. S. tax, it is easy to understand why profit margins in this country are abnormally high.

Tax incentives to invest abroad stand in conflict with the general policy of the United States to encourage investment of U. S. capital where it will be most productive, whether in the United States or overseas. The elimination of deferral will advance this policy, since it will tend to ensure that foreign investment will be motivated by genuine economic factors.

(3) Ending Deferral Will Permit Simplification of the Rules Relating to Taxation of Foreign Income

The termination of deferral will permit the simplification of U. S. rules relating to the taxation of foreign income. Subpart F, the rules relating to foreign personal holding companies, the rules governing the foreign tax credit, and the rules regarding reorganizations of foreign corporations will all be affected.

The subpart F anti-tax haven provisions originated in a proposal submitted to Congress in 1961 by President Kennedy. The

purpose of that proposal, and of the provisions of subpart F, was to prevent U. S. businesses from exploiting the multiplicity of foreign tax systems and tax treaties so as to reduce or eliminate both U. S. and foreign tax liabilities.

Subpart F as drafted was not, however, structured to eliminate international tax avoidance by U. S. firms. It is focused exclusively upon a narrow class of so-called "tax haven" income. And its provisions are so complex that only a relative handful of persons are capable of understanding all of their implications. Although subpart F has doubtless discouraged many companies from undertaking blatant tax haven operations, highly sophisticated means of circumventing both the specific subpart F rules and their general objectives are available. Moreover, the Internal Revenue Service does not have the resources to mount an effective administrative effort to combat such schemes.

Terminating deferral for all controlled foreign corporations, as this proposal recommends, will permit the replacement of subpart F with a simpler, more comprehensible set of rules for U. S. taxation of foreign income. Terminating deferral will also permit repeal of the Internal Revenue Code provisions relating to taxation of foreign personal holding companies -- another series of provisions aimed at tax haven abuses.

Furthermore, terminating deferral will reduce the importance of the complicated rules relating to both the "deemed paid" foreign tax credit and multinational corporate reorganizations. The rules relating to the credit are not limited to controlled foreign corporations, and will have to remain in effect to cover foreign corporations owned in part, but not controlled, by U. S. persons. They will not, however, generally be required with respect to controlled foreign corporations if deferral is terminated, because a foreign tax credit will be available without regard to the "deemed paid" credit. The rules regarding corporate reorganizations will become less important because the potential for tax avoidance on the transfer of assets abroad will be diminished.

Eliminating deferral will thus have the highly desirable effect of making the U. S. system of taxing foreign income more comprehensible. The present system, complex and internally inconsistent, understood in all its detail by only a very few highly trained individuals, is simply not appropriate in the U. S. tax system. The rationalization of U. S. rules in this area will permit the Administration and Congress to see more clearly where real problems exist and to structure appropriate solutions having no unintended and unforeseen consequences for either taxpayers or the government.

(4) <u>Terminating Deferral Will Help Equity and Competition</u>

The present system of U. S. taxation of foreign income, with deferral as its centerpiece, has produced increasingly

sophisticated methods of tax planning by those involved in multinational transactions. As the Internal Revenue Service has issued new Regulations limiting opportunities for tax avoidance, and as Congress has tightened various rules in the system, taxpayers have become more and more ingenious in avoiding their impact. Offshore financial subsidiaries, holding companies, and captive insurance affiliates have proliferated. Computer programs to guide tax planning efforts have been developed. The major accounting and law firms have devised ever more refined planning techniques.

For example, the "rhythm method" of distributing dividends from foreign companies has become increasingly popular. Under this method foreign corporations only pay dividends to their U. S. parent companies in those years in which their effective foreign tax rate is high, rather than paying smaller dividends on an annual basis. Because of deferral and the "deemed paid" credit for foreign taxes paid by the foreign corporation, U. S. companies are able through this method to minimize U. S. tax on repatriated earnings. The technique illustrates how the existence of contradictory principles for taxing foreign income -- the "deemed paid" foreign tax credit which effectively treats parent and subsidiary as one enterprise, while deferral treats them as separate -- inevitably gives rise to opportunities for tax avoidance.

(5) Terminating Deferral Will Help Stop Practices Used To Avoid U. S. Tax

U. S. taxpayers have many opportunities today to avoid U. S. tax by engaging in various pricing and other practices in transactions with their controlled foreign corporations. A multinational enterprise routinely engages in many transactions with its foreign affiliates. It often sells machinery, parts, components, and finished goods to these foreign corporations, or imports the same from them. It lends them money, leases them equipment, and provides a wide range of managerial services. Basic research and development programs for the mutual benefit of the domestic taxpayer and its foreign affiliates are often centralized in the United States.

In computing foreign and domestic tax liabilities, a company must assign transfer prices to such inter-affiliate transactions. To determine whether the assigned transfer prices are appropriate for tax purposes, the United States and many other countries apply an arm's-length standard -- i.e., they require terms that would have been fixed in comparable transactions between an independent buyer and seller. The arm's-length standard is a necessary and valuable tax measure, but it is sometimes difficult to administer: multinational firms often invest abroad because no well-established market exists for the goods and services which are transferred in inter-affiliate transactions. In this situation U. S. taxpayers sometimes seek to reduce U. S. taxes by channeling

income to low-tax subsidiaries and deductions to the controlling U. S. company. Although many multinational companies follow perfectly acceptable transfer pricing practices, the experience of the Internal Revenue Service has been that some do not, and the resultant loss of U. S. tax revenues can be substantial.

Of course, extensive Regulations setting forth procedures for determining arm's-length transfer prices were published in 1968, and have limited the range of discretion previously available to taxpayers. But no one familiar with international tax planning believes that these Regulations have taken the tax incentive out of transfer-pricing. The 1968 Regulations reduced, but by no means eliminated, the flexibility which companies have in setting inter-affiliate prices.

Since the elimination of deferral will subject U. S. shareholders to current tax on the income of controlled foreign corporations, it may be expected to reduce if not eliminate the incentive to use techniques which serve to transfer excessive income to foreign corporations.

General Explanation

This proposal will phase out deferral over a three-year period. Beginning in 1981 the income of a controlled foreign corporation will be taxable as if it had been earned directly by the U. S. shareholder. This is the rule that has always obtained under the U. S. tax system where foreign operations are conducted by a U. S. taxpayer through a branch, rather than through a foreign corporation. Thus, U. S. tax liability under the proposal will closely approximate the amount that a U. S. shareholder would incur if it operated through a foreign branch. For 1979 and 1980 the above rule will apply to one-third and two-thirds, respectively, of the controlled foreign corporation's income.

The approach taken in this proposal will result in an accurate assessment of the U. S. shareholder's U. S. tax liability. Losses incurred by a controlled foreign corporation will be allowed to offset the U. S. source income of the shareholder. Similarly, foreign taxes imposed on the controlled foreign corporation will be treated as if they had been imposed on the U. S. shareholder and thus will be taken into account currently for purposes of the foreign tax credit rather than when the underlying income is actually repatriated.

The proposal allows the Treasury to consider the negotiation of tax treaties providing, in appropriate situations, that U. S. shareholders will not be taxed currently on certain income of their controlled foreign corporations operating in a treaty country.

Analysis of Impact

(1) Effect on Investment

Investment which is responding to real market forces will not be affected by the termination of deferral. Such investment represents a significant part -- but not all -- of U. S. overseas investment.

Most developed countries impose, in addition to corporate income taxes, withholding taxes on dividends, interest, and royalties paid to U. S. investors. Although the total tax burden in such countries is comparable to or higher than that in the United States, U. S. investment still flows to these countries because their markets are large and growing, consumer incomes are high, the demand for U. S. products is substantial, and a U. S. company can maintain its market position only by investing locally. Likewise, petroleum and other natural resource investments flow to countries with abundant natural resource deposits despite substantial tax and other payments to the governments in those countries. Finally, many less-developed countries attract labor-intensive production with low wage rates rather than tax incentives. These investments are far more typical of U. S. investment abroad than those motivated solely by tax considerations, and they will continue without the added benefits of deferral. Terminating deferral will thus operate to restrict only tax-induced investments.

The United States does not have any general interest in encouraging tax-induced investments. Foreign countries that offer tax incentives are not usually interested only in the type of investment that attracts exports from the United States and thus promotes domestic employment. To the contrary, foreign tax incentives are frequently aimed at the type of investment that promotes exports to the United States and thus displaces U. S. jobs. The United States has no reason to favor the latter category of investments.

There is good reason to believe that eliminating deferral will provide a moderate stimulus to total U. S. investment and employment. For some companies production in the United States is a direct and viable alternative to producing abroad. Some U. S. companies may have been induced by the combination of deferral and foreign tax incentives to stop exporting and start producing overseas. Alternatively, some companies may have stopped supplying the domestic U. S. market with goods made in the United States, electing instead to rely on imports from their own foreign affiliates. Moreover, even when domestic investment is not a direct substitute for foreign investment, domestic production can still benefit indirectly from the repeal of deferral. The capital that would have been used to finance a tax-induced foreign investment can be retained in the United States and used to finance an unrelated, but job-producing, domestic investment. The gains may be substantial in specific industries where foreign tax practices have hastened the export of jobs and capital.

(2) Competitiveness of U. S. Corporations Overseas

Some U. S. companies maintain that they cannot remain competitive in world markets without deferral. Any change which alters corporate tax burdens tends to alter the funds available for new investment, new research and development, and other programs aimed at expansion. But if this is true of deferral, it is equally true of other tax measures such as changes in the corporate tax rate or the investment tax credit.

These other methods of promoting competitiveness are better and fairer than deferral. In order to benefit from deferral, a corporation must invest abroad, not in the United States. As noted above, deferral may encourage companies to invest abroad for export back to the United States, thereby undermining the competitiveness of U. S. companies that choose to stay at home. Zenith Corporation, for example, was forced to go overseas not only by its Japanese competitors (Sony, Panasonic, etc.) but also by its American rivals (RCA, Motorola, etc.) that went abroad to carry out assembly operations. Finally, deferral promotes continued investment overseas; repatriation of profits, which would help domestic investment, is actually discouraged by deferral. None of these perverse side effects of deferral characterizes reduction of the corporate tax rate and expansion of the investment tax credit, measures which the Administration has proposed.

It should be noted, finally, that the competitiveness of a corporation depends on its overall tax burden, not on any single tax provision. Terminating deferral represents only a small offset to the benefits envisioned for companies in the Administration's tax package.

(3) Reactions of Foreign Governments

It is often argued that if the United States terminates deferral, foreign countries will retaliate by discriminating against U. S. investors so that U. S. companies will pay higher taxes to foreign governments rather than the United States. Foreign countries, it is said, may revoke the eligibility of U. S. subsidiaries for tax holidays or accelerated depreciation, or they may deem all earnings distributed and thereby subject to high withholding taxes.

Such developments are, however, unlikely in the case of developed countries. The tax rates in most of these countries match those of the United States. Furthermore, most developed countries have tax treaties with the United States that require nondiscriminatory treatment of U. S. investors. Since residents of developed countries often have substantial investments in the United States, it is doubtful that these countries would risk abrogation of their treaties with the United States.

The United States has tax treaties with only a few less-developed countries, and the tax burden in some of these countries is lower than that in the United States. However, in many cases there will be no reason for these countries to retaliate against U. S. investment, because the termination of deferral will not produce higher U. S. taxes for many of the multinational companies operating within their borders.

Numerous U. S. companies already have an overall excess of foreign tax credits, and more will fall into this category if the U. S. corporate tax rate is reduced to 44 percent, as the Administration proposes. Under the "overall" foreign tax credit limitation -- the only limitation now in effect -- operations in low and high tax countries are combined. In the case of taxpayers with excess foreign tax credits, the United States will not, upon the elimination of deferral, impose any tax on profits from low-tax countries which are "sheltered" by excess credits from high-tax countries. Thus, many U. S. companies operating in foreign countries with a low rate of tax will not bear any more U. S. tax upon the elimination of deferral, and therefore those foreign countries will not have an incentive to raise taxes in retaliation to this proposal.

Furthermore, it is by no means clear that even a low-tax country believing that the end of deferral will subject U. S. investors to a higher U. S. tax burden will choose to retaliate. In the first place, it will be made clear that discriminatory taxes aimed at "soaking up" the difference between a foreign country's rate and that of the United States are not creditable under U. S. law. Low-tax countries desirous of promoting U. S. investments may not wish to take actions that could have the effect of actually penalizing such investments. More likely, such countries may wish to "validate" some of the tax incentives that they offer by seeking treaty provisions under which U. S. investors within their borders would continue to be entitled to deferral.

In some cases the United States may wish to validate the tax incentives that a developing country offers to U. S. investors. For example, investments that promote genuine economic development, have a minimal impact on U. S. employment, or increase U. S. access to critical raw materials may serve the national interest. But rather than giving a blanket incentive to foreign investment of all types and in all countries, the United States should focus the benefits of deferral through its tax treaty program. If deferral is terminated subject to exceptions by tax treaties, less-developed countries will be far more eager to conclude treaties with the United States than they have been in the past and developed countries that have treaties with the United States or are engaged in treaty discussions may be persuaded to offer favorable concessions.

(4) Administrative Impact Upon Taxpayers

It is sometimes argued that terminating deferral will involve serious administrative problems for U. S. companies. U. S. taxpayers, it is said, will not be able to maintain or obtain adequate records reflecting the income and deductions of controlled foreign corporations, particularly when there is no majority U. S. shareholder. It is also argued that the difficulty of translating books and records kept in foreign currency and under foreign standards into U. S. currency and standards justifies the retention of deferral.

The Administration is aware that there may be some administrative difficulties in some situations. However, U. S. companies with overseas branches, which have always been required to report foreign operations currently, have been able to solve these problems. U. S. parent corporations have long reported the earnings of controlled foreign corporations for SEC and general accounting purposes. And since 1962, controlled foreign corporations of U. S. shareholders have translated their books and records into U. S. standards for the purposes of subpart F. Finally, the provisions allowing for a "deemed paid" foreign tax credit, which have been in the law since 1918, require every U. S. corporation owning 10 percent of any foreign corporation (whether or not controlled by U. S. interests) to translate foreign books and records into U. S. standards in order to obtain the benefit of the indirect foreign tax credit. Administrative problems that have been surmountable in these cases will likewise be surmountable when deferral is terminated.

Effective Date

The phase-out of deferral will apply to the first taxable year of each controlled foreign corporation ending in 1979 and to taxable years of U. S. shareholders with which or within which such taxable years of such foreign corporations end.

Revenue Estimates

Change In Tax Liability
($ millions)

Calendar Years					
1978	1979	1980	1981	1982	1983
0	88	280	768	830	897

These estimates do not take into account the effect of the proposed reductions in the corporate tax rate. The revenue gain from terminating deferral depends on the spread between the U.S. and average foreign tax rates. Therefore even a relatively small decrease in the U.S. tax rate can substantially reduce the revenue gain from terminating deferral.

Behavioral adjustments could also affect these estimates. Some investors may, for example, increase their actual dividends and thereby incur foreign dividend withholding taxes; this would reduce net taxes paid to the United States.

Other behavioral adjustments could, however, increase U. S. tax revenues beyond the above estimates. U. S. investors may invest more at home and less abroad than they would if deferral were maintained. The reduction of tax incentives to manipulate intrafirm transfer prices in order to shift taxable income away from the United States could produce substantial revenues not taken into account in the estimates. Although the potential revenue gains from these location-of-investment and transfer-pricing adjustments are impossible to estimate, they could easily outweigh any adverse revenue consequences of other behavioral adjustments attributable to the elimination of deferral.

Technical Explanation

(1) Current Inclusion of Income Earned by Controlled Foreign Corporations

The proposal will currently include in the income of U. S. shareholders their pro-rata share of the gross income and deductions of controlled foreign corporations. Income and deductions of each controlled foreign corporation will be treated as having been earned and incurred by the U. S. shareholder. The character of the income or deduction will be the same in the hands of the U. S. shareholder as it would have been if the activity had

been carried out abroad directly rather than through a foreign corporation. Controlled foreign corporations will, however, continue to be treated as corporations for the purposes of rules affecting transfer prices, corporate reorganizations, and other provisions of current law.

(2) Controlled Foreign Corporation

A controlled foreign corporation will be any foreign corporation of which either: (a) more than 50 percent of the total combined voting power of all classes of stock is owned, or is considered owned, by U. S. shareholders; or (b) more than 50 percent in the value of the outstanding stock is owned, or is considered owned, by U. S. shareholders. The use of a voting power test is consistent with present subpart F provisions. The use of a value test is consistent with the foreign personal holding company provisions.

(3) U. S. Shareholder

A U. S. shareholder is a U. S. person who owns, or is considered as owning, either: (a) 10 percent or more of the total combined voting power of all classes of stock entitled to vote of a foreign corporation; or (b) 10 percent or more in the value of the outstanding stock of a foreign corporation. For purposes of determining whether a company is a controlled foreign corporation and whether a person is a U. S. shareholder, the meaning of "U. S. person" as well as the constructive stock ownership rules will be substantially the same as those now contained in subpart F.

(4) Percentage Inclusion

The amount of a controlled foreign corporation's gross income and deductions attributable to a U. S. shareholder will be determined in proportion to that shareholder's rights to the net earnings of the corporation. This approach is substantially the same as that set forth in the current Regulations under section 1248.

(5) Treatment of Noncorporate Shareholders

Noncorporate shareholders required to include income and deductions currently will be treated as though such amounts were initially received by a domestic corporation. This rule, the mechanics of which have been developed under subpart F, will ensure equality of treatment between noncorporate and corporate shareholders.

(6) Losses

The excess of deductions over the gross income of a controlled foreign corporation will be treated as if realized directly by a U. S. shareholder, regardless of whether a corporate shareholder meets the stock ownership requirements for filing a consolidated return domestically.

If a U. S. shareholder has an overall foreign source loss attributable in whole or in part to the shareholder's pro-rata share of the losses of one or more controlled foreign corporations, the loss may offset his U. S. source income but will be subject to the recapture rules currently in section 904.

(7) U. S. Branch Rule

Gross income, deductions, and U. S. taxes of a U. S. branch of a controlled foreign corporation will be attributed to the U. S. shareholders of that corporation. This income will not, accordingly, be twice subjected to U. S. tax.

(8) Blocked Income

For the purpose of exchange control, certain foreign countries do not allow the expatriation of earnings derived within their borders. The proposal recognizes that it is inappropriate to tax currently all the earnings of a controlled foreign corporation in cases where distributions to U. S. shareholders have been "blocked" by currency or other restrictions imposed by a foreign country.

The Administration recognizes that the current rules with respect to blocked income may not be appropriate when deferral is terminated. It is anticipated that Regulations will be promulgated to describe those situations that prevailed prior to 1978 that will be treated as creating blocked income. However, any currency or other restrictions that are imposed solely against U. S. shareholders or imposed solely on a shareholder-by-shareholder basis will not be recognized as blocking income.

(9) Repatriation of Previously Taxed Income

Previously taxed income will be excluded from gross income of a U. S. shareholder when such income is distributed to the shareholder or any other U. S. person who acquires any portion of the U. S. shareholder's interest in the controlled foreign corporation.

(10) Basis Adjustments

As gross income and deductions of a controlled foreign corporation are recognized by the U. S. shareholder, an adjustment will be made to the basis of the shareholder's stock in the controlled foreign corporation. Actual distributions from the corporation that are excluded from gross income because they are attributable to previously taxed income will decrease such basis.

(11) Foreign Tax Credit

Since income and deductions will be treated as if realized directly by U. S. shareholders, foreign taxes paid by controlled

foreign corporations, regardless of tier, will be treated as if paid directly by U. S. shareholders. This rule simplifies the foreign tax credit by making unnecessary the "deemed paid" foreign tax credit calculation in the case of U. S. shareholders of controlled foreign corporations. Further, the rule removes an inequity in current law, under which a foreign tax credit is denied for any year in which a foreign corporation has a deficit calculated under U. S. principles, even though taxes were paid to a foreign country.

Eliminating deferral reduces both a corporation's ability to control the effective rate of foreign tax by controlling the source and rate of dividend distributions and the corporation's ability to minimize timing differences in deductions between the United States and foreign countries. To allow for such timing differences, it is proposed that the foreign tax credit carryback be lengthened from 2 to 3 years and that the foreign tax credit carryforward be lengthened from 5 to 7 years. It will be made clear that a foreign tax credit will not be allowed for withholding taxes applied only to U. S. investors, or on a shareholder-by-shareholder basis, or to deemed distributions.

(12) Exchange Gains and Losses

The proposal provides that unrealized exchange gains and losses will be taken into account by a U. S. shareholder. This is the rule for financial accounting purposes and it is similar to a tax rule available to U. S. branches overseas and to the rule used to determine earnings and profits under subpart F. The proposal provides, however, that a U. S. shareholder may elect, with respect to all of its foreign operations, not to take into account unrealized exchange gains and losses. This election is revocable, on a prospective basis, ten years after it has been made.

(13) Accounting, Record Keeping, and Reporting Requirements

Rules will be provided for making elections with respect to controlled foreign corporations, translating amounts from foreign currency, the computation of taxable income and earnings and profits, the keeping of records and accounts, and the reporting requirements of U. S. shareholders.

In general, taxable income and earnings and profits will be computed under U. S. standards. The Administration recognizes, however, that there are differences between U. S. and foreign standards, and will prescribe Regulations describing the extent to which deviations from U. S. standards will be allowed.

(14) Tax Treaties

The proposal allows the Treasury to consider the negotiation of income tax treaties allowing deferral to continue, in appropriate situations, in treaty countries.

(15) Corporations Organized in Puerto Rico and U. S. Possessions

A current provision of subpart F allows a controlled foreign corporation organized in Puerto Rico or a possession of the United States to be excluded from subpart F if it meets certain tests with regard to the source and nature of its income and business. This provision parallels slightly broader statutory protection from U. S. tax granted by way of a special "possessions" tax credit available to electing domestic corporations doing business in Puerto Rico and the possessions (except the Virgin Islands).

This proposal allows U. S. shareholders to continue deferral with respect to income of corporations organized under the laws of the Commonwealth of Puerto Rico or a possession of the United States (including the Virgin Islands). Income that would have been eligible for the possessions tax credit currently provided by the Internal Revenue Code if the controlled foreign corporation had been a domestic corporation will not be taxed currently to U. S. shareholders. Instead, such income will be treated in the same manner as "blocked income."

(16) Transition Provisions

In 1979 and 1980, U. S. shareholders will be required to take into income 1/3 and 2/3, respectively, of the gross income and deductions of controlled foreign corporations. The provisions of subpart F will also apply during these two years, although most of subpart F will be repealed for years after 1980. The 1/3 and 2/3 inclusion in 1979 and 1980 will apply to the income and deductions of a controlled foreign corporation after adjustment for amounts included in income by a U. S. shareholder under the subpart F provisions. Thus, if in 1979 a U. S. shareholder's controlled foreign corporation has $150 of taxable income of which $30 is foreign base company income under subpart F, the inclusion under this proposal for the U. S. shareholder will be $40 (1/3 x ($150 - $30) = $40) and the U. S. shareholder's total taxable income attributable to the controlled foreign corporation will be $70.

The rules of subpart F will apply for purposes of calculating the foreign tax credit attributable to income included under subpart F, and the rules under this proposal will apply for purposes of calculating the foreign tax credit attributable to the additional amounts included in the U. S. shareholder's income under the proposal.

(17) Other Provisions

Various provisions of the Internal Revenue Code are modified or repealed under this proposal. The foreign personal holding company provisions are repealed after 1980. Subpart F is repealed for future operations, although it will be necessary to maintain certain historical aspects. For example, the rules relating to taxation of investments in U. S. property will continue to apply to previously accumulated earnings. Also, it will be necessary to

determine whether actual distributions had been previously taxed under subpart F, and to determine the tax on certain amounts previously excluded from a U. S. shareholder's gross income under subpart F because they were reinvested in qualified shipping assets or in less-developed countries; any amounts thus excluded will be taxable when they are withdrawn from such investment. Section 1248 is also kept in force to handle accumulated earnings.

EXHIBIT 14

06

U.S. General Accounting Office
SURVEY OF STATE TAXATION OF
MULTIJURISDICTIONAL CORPORATIONS' INCOME

INSTRUCTIONS

As we have stated in our letter, the purpose of this questionnaire is to obtain information on multijurisdictional corporation activities in your State, your audit efforts covering such corporations, how you have dealt with and view separate accounting requirements, and your attitude towards the need for greater uniformity.

In order to insure valid responses, this questionnaire should be completed by State officials who are in a position to provide authoritative answers and comments. We realize that some of the answers may not fit your situation exactly. In these cases select the answer that best fits your situation.

Please note that some questions request only one response; whereas, others allow for more than one. Each question indicates if one or more than one response is acceptable. For questions requiring quantitative answers, please be as precise as possible, but estimates will suffice when actual data is unavailable.

Our objective is to obtain the most accurate and complete information you have. To obtain more precise data we plan to follow up this questionnaire in some cases with a personal interview. But, since we will be able to make only a limited number of visits it is important that you provide us with your most accurate and frank assessments on the questionnaire. For most of you this questionnaire will be the only assessment we will be making for your State.

Please complete and return the questionnaire in the enclosed franked envelope within 10 days. If you have any questions don't hesitate to call Greg Ziombra at (202)566-6503.

Thank you for your cooperation.

DEFINITIONS

To maintain a common understanding, please use the following definitions when answering the questions.

Corporation income tax - A tax which is either a direct tax on corporation income or an indirect tax measured by net income.

Separate accounting (as it relates to individual States) - A method of accounting where a multijurisdictional corporation's activities are aggregated into separate and distinct economic units (possibly hypothetical); where each economic unit is defined by individual State boundaries; thus, the corporation income attributable to a certain State is computed by associating receipts and expenses with that State.

I. CORPORATION TAXING ACTIVITIES

In this section, we are seeking information on activities relating to corporation income taxes. Included are filing and auditing of such returns, and collections on these returns. (Please refer to the definitions in the instructions.)

1. Approximately how many corporation income tax returns were filed with your State in 1977? (Please fill in the blanks.)

(1) A. 196,000 = Total number of all corporation income tax returns (3-8)

B. 35,200 = Multijurisdictional corporation income tax returns (9-14)

(1) Records are not available on a calendar year basis and are therefore furnished for 1976-7 rather than 1977.

Department records are kept on a fiscal year basis (July 1 - June 30). Nonprofit corporations are excluded.

Exhibit 14

2. How would you characterize the change, if any, in the number of corporate income tax returns filed in 1977 as compared to the number filed in 1972? (Check one box for each row.)

	1 Large increase over number filed in 1972	2 Increase over number filed in 1972	3 Little or no change	4 Decrease from number filed in 1972	5 Large decrease from number filed in 1972	
(1) A. All Corporations	X					(15)
(2) B. Multijurisdictional Corporations	X					(16)

3. What change, if any, do you expect in the number of corporate income tax returns filed in 1977 and the number that will be filed in 1982? (Check one box for each row.)

	1 Large increase over number filed in 1977	2 Increase over number filed in 1977	3 Little or no change	4 Decrease from number filed in 1977	5 Large decrease from number filed in 1977	
A. All Corporations	X					(17)
B. Multijurisdictional Corporations		X				(18)

4. Approximately how many corporate income tax returns did you field audit in 1977? (Please fill in the blanks.)

A. 17,736 = All corporations (19-24)

B. 11,752 = Multijurisdictional corporations (25-30)

5. How would you characterize the change, if any, in the number of corporate income tax returns field audited in 1977 as compared to the number audited in 1972? (Check one box for each row.)

	1 Large increase over number audited in 1972	2 Increase over number audited in 1972	3 Little or no change	4 Decrease from number audited in 1972	5 Large decrease from number audited in 1972	
A. All Corporations			X			(31)
B. Multijurisdictional Corporations			X			(32)

6. What change, if any, do you expect in the number of corporation income tax returns field audited in 1977 and the number that will be field audited in 1982? (Check one box for each row.)

	1 Large increase over number audited in 1977	2 Increase over number audited in 1977	3 Little or no change	4 Decrease from number audited in 1977	5 Large decrease from number audited in 1977	
A. All Corporations		X				(33)
B. Multijurisdictional Corporations		X				(34)

7. Approximately how much revenue has your State collected from the corporate income tax in 1977? (Please fill in the blanks.)

A. $1,641,500,000 = All corporations (35-44)

(3) B. $1,180,000,000 = Multijurisdictional corporations (45-54)

(1) Growth 22.5%
(2) Growth 34.9%
(3) Estimated, but based on studies for prior years as to percentage of tax paid by apportioning corporations.

8. How would you characterize the change, if any, in the revenue collected from the corporate income tax in 1977 as compared to the revenue collected in 1972? (Check one box for each row.)

	1 Large increase over revenue collected in 1972	2 Increase over revenue collected in 1972	3 Little or no change	4 Decrease from revenue collected in 1972	5 Large decrease from revenue collected in 1972	
A. All Corporations	X					(55)
B. Multijurisdictional Corporations	X					(56)

9. What change, if any, do you expect in the revenue collected from the corporate income tax in 1977 as compared to the revenue that will be collected in 1982? (Check one box for each row.)

	1 Large increase over revenue collected in 1977	2 Increase over revenue collected in 1977	3 Little or no change	4 Decrease from revenue collected in 1977	5 Large decrease from revenue collected in 1977	
A. All Corporations		X				(57)
B. Multijurisdictional Corporations		X				(58)

10. Approximately what percent of your State's total revenue was collected from the corporate income tax in 1977? (Please fill in the blanks.)

A. 12.2 = All corporations (59-60)

* B. 8.5 = Multijurisdictional corporations (61-62)

11. How would you characterize the change, if any, in the percent of your State's total revenue collected from the corporate income tax in 1977 as compared to the percent collected in 1972? (Check one box for each row.)

	1 Large increase over percent collected in 1972	2 Increase over percent collected in 1972	3 Little or no change	4 Decrease from percent collected in 1972	5 Large decrease from percent collected in 1972	
A. All Corporations		X				(63)
B. Multijurisdictional Corporations		X				(64)

12. What change, if any, do you expect in the percent of your State's total revenue collected from the corporate income tax in 1977 and the percent that will be collected in 1982? (Check one box for each row.)

	1 Large increase of % collected in 1977	2 Increase over % collected in 1977	3 Little or no change	4 Decrease from % collected in 1977	5 Large decrease from % collected in 1977	
A. All Corporations		X				(65)
B. Multijurisdictional Corporations		X				(66)

13. Approximately what percent of your State's total tax revenue was collected from the corporate income tax in 1977? (Please fill in the blanks.)

(1) A. 15.2 = All corporations (67-68)

* B. 10.8 = Multijurisdictional corporations (69-70)

*Estimated, see Footnote (3) p.2

(1) Major taxes and licenses

14. How would you characterize the change, if any, in the percent of your State's total tax revenue collected from the corporate income tax in 1977 as compared to the percent collected in 1972? (Check one box for each row.)

	1 Large increase over percent collected in 1972	2 Increase over percent collected in 1972	3 Little or no change	4 Decrease from percent collected in 1972	5 Large decrease from percent collected in 1972	
A. All Corporations		X				(71)
B. Multijurisdictional Corporations		X				(72)

15. What change, if any, do you expect in the percent of your State's total tax revenue collected from the corporate income tax in 1977 and the percent that will be collected in 1982? (Check one box for each row.)

	1 Large increase over percent collected in 1977	2 Increase over percent collected in 1977	3 Little or no change	4 Decrease from percent collected in 1977	5 Large decrease from percent collected in 1977	
A. All Corporations		X				(73)
B. Multijurisdictional Corporations		X				(74)

16. Approximately how many staff years did your State expend performing field audits of corporate income tax returns in 1977? (Please fill in the blank.)

236.4 Staff years (75-77)

17. How would you characterize the change, if any, in the number of staff years expended on field audits in 1977 as compared to the number in 1972? (Check one box for each row.)

	1 Large increase over the number expended in 1972	2 Increase over the number expended in 1972	3 Little or no change	4 Decrease from the number expended in 1972	5 Large decrease from the number expended in 1972	
A. All Corporations			X			(78)
B. Multijurisdictional Corporations		X				(79)

18. What change, if any, do you expect in the number of staff years expended on field audits in 1977 and the number which will be expended in 1982? (Check one box for each row.)

	1 Large increase over the number expended in 1977	2 Increase over the number expended in 1977	3 Little or no change	4 Decrease from the number expended in 1977	5 Large decrease from the number expended in 1977	
A. All Corporations		X				(80)
B. Multijurisdictional Corporations		X				(81)

II. SEPARATE ACCOUNTING

In this section, we are seeking opinions on States' acceptance and auditing of multijurisdictional corporation income tax returns when the income attributable to each State has been calculated using separate accounting principles (as defined on page one).

19. To what extent do you agree or disagree with each of the following statements? (For each statement, please check one box.)

Statement	1 Strongly agree	2 Agree	3 Undecided	4 Disagree	5 Strongly disagree	
A. Audits of returns using separate accounting principles would not increase the time per audit.					X	(82)
B. Audits of returns using separate accounting principles would not create access to record problems.					X	(83)
C. If the emphasis of multijurisdictional corporation filing of income tax returns shifted from apportionment formulas to separate accounting principles, auditor re-training would require significant time and costs.	X					(84)
D. Returns of multijurisdictional corporations using separate accounting principles more accurately reflect income earned from operations in your State.					X	(85)
E. Determining arm's length pricing for a multijurisdictional corporation's transactions would be extremely difficult.	X					(86)
F. Returns of multijurisdictional corporations using separate accounting principles would minimize the likelihood of "double" taxation. *	X					(87)
G. In audits of returns using separate accounting, the accuracy of overhead allocations is difficult to defend.	X					(88)
H. General use of separate accounting principles in multijurisdictional corporation income tax returns would be more equitable to both States and corporations.					X	(89)
I. In audits of returns using separate accounting principles, the number of transactions auditors would have to examine would increase substantially.	X					(90)

* It would maximize escape from taxation.

20. What reaction would your State have to using Treasury Regulations if your State had to audit returns using separate accounting principles? (Check all that apply.)

A. /__/ No basis to judge (91)

B. /__/ Favorable reaction--would use them as applicable (92)

C. /__/ Too complicated to use (93)

D. /X/ Subject to too many interpretations (94)

E. /X/ Would cause too many audit protests (95)

F. /X/ (1) Fail to recognize problems faced by State boundaries (96)

21. What reaction would your State have to using actual section 482 adjustments made by IRS if your State had to audit returns using separate accounting principles? (Check all that apply.)

A. /__/ No basis to judge (97)

B. /__/ Favorable reaction--would use them as applicable (98)

C. /__/ Too complicated to use (99)

D. /X/ Subject to too many interpretations (100)

E. /X/ Would cause too many audit protests (101)

F. /X/ (1) Fail to recognize problems faced by State boundaries (102)

22. If your State had to audit returns using separate accounting principles and IRS Section 482 adjustments were available would your State use them? (Check one.) (103)

A. /X/ (2) Definitely yes

B. /__/ Probably yes

C. /__/ Undecided

D. /__/ Probably no

E. /__/ Definitely no

23. What change, if any, would occur in State revenues if the filing of returns by multijurisdictional corporations shifted from the current reliance on apportionment formulas/specific allocation to a reliance on separate accounting principles? (Check one) (104)

A. /X/ (3) Significant decrease

B. /__/ Some decrease

C. /__/ Little or no change

D. /__/ Some increase

E. /__/ Significant increase

F. /__/ No basis to judge

(1) Major problem.
(2) 482 adjustments do not ordinarily apply to interstate activities, see answer to Part V.
(3) On December 1, 1978, the department estimated the revenue impact of S.2173, 95th Congress. Most of the revenue loss resulted from excluding from the combined report computation income and factors of the unitary group outside the U.S. The study concluded that if S.2173 had been in effect for the 1977 income year, the revenue loss would have been $485 million. The loss represented about 30% of the 1977 income year self-assessed tax of $1,661 million.

III. UNIFORMITY

In this section we are seeking information on the States' perception of the need for uniformity and how uniformity would affect the States if it came to exist nationally.

24. Our State position on the need for uniform State income tax laws for multijurisdictional corporations is best reflected by the following statement. (Check only one.) (105)

A. /__7 (1) Greater uniformity is needed because widespread noncompliance exists

B. /__7 Greater uniformity is needed because corporations are overtaxed under the current situation

C. /__7 (1) Greater uniformity is needed because corporations are undertaxed under the current situation

D. /X7 Greater uniformity is needed to assure that local and multijurisdictional corporations are taxed equally

E. /__7 We do not believe there is a compelling need for greater uniformity.

(1) Also applicable

25. For your State, how would costs associated with uniformity compare to the benefits? (Check one.) (106)

A. /__7 Costs significantly outweigh benefits

B. /__7 Costs somewhat outweigh benefits

C. /__7 Costs would be about the same as benefits

D. /__7 Benefits somewhat outweigh costs

E. /X7 Benefits significantly outweigh costs

F. /__7 No basis to judge

26. Our State's position on the need for Federal legislation to increase uniformity of State income tax laws is best reflected in the following statement(s). (Check all that apply.)

A. /X7 No Federal legislation is needed; States can work together to solve problems when they exist (107)

B. /X7 Congress could not write a law satisfactory to all the States (108)

C. /__7 We believe Federal legislation is needed (110)

IV. UNITARY METHOD

To ensure that our information on how your State is taxing multijurisdictional corporations is complete, we need the following data on your State's use of the unitary method.

27. What is the source, if any, of your State's authority to use the unitary method for domestic affiliated corporations? (Check one.) (112)

A. /__/ Not applicable--State does not use the unitary method

B. /__/ Statutory

C. /__/ Administrative

D. /__/ Judicial

E. /X/ Other (please specify)
Sec. 25101 R&TC as interpreted by the Calif. Courts

28. What is the source, if any, of your State's authority to use the unitary method for non-U.S. affiliated corporations? (Check one.) (113)

A. /__/ Not applicable--State does does not use the unitary method

B. /__/ Statutory

C. /__/ Administrative

D. /__/ Judicial

E. /X/ Other (please specify)
See Q. 27

29. In actual practice, about how often does your State use the unitary method for domestic affiliated corporations? (Check one.) (114)

A. /X/ Always, or almost always

B. /__/ Frequently

C. /__/ Occasionally

D. /__/ Rarely

E. /__/ Never, or almost never

30. In actual practice about how often does your State use the unitary method for foreign affiliated corporations? (Check one.) (115)

A. /X/ Always, or almost always

B. /__/ Frequently

C. /__/ Occasionally

D. /__/ Rarely

E. /__/ Never, or almost never

31. If your State has the authority to use the unitary method please provide the following information.

Unitary Basis Test

Class of Corporation	Test used to determine whether a business is a unitary business
All	See attached

__/__/__/__/__/ (116-120)

V. ADDITIONAL COMMENTS

If you have any additional comments on any of the questions or related points or topics not covered, please write your comments in the space below. Your views are greatly appreciated. Thank you. (121)

The use of federal 482 audits is of little or no benefit to the states because the IRS has no concern with determining the proper amount of income attributable to an individual state. Even with respect to the determination of U. S. source income vis-a-vis foreign source income federal audits are woefully inadequate. The unitary method is specifically designed to provide an administratively feasible method for making source determination. Use of the arm's length standard for state purposes is an attempted forced adoption of a residency based tax concept to a source tax system.

We previously furnished you a critique of Sec. 482 in the analysis of S.2173, 95th Congress, which we understand you have received.

ATTACHMENT FOR QUESTION 31

The California Supreme Court has determined that a unitary business is definitely established by the existence of: (1) unity of ownership; (2) unity of operation as evidenced by central purchasing, advertising, accounting and management divisions; and (3) unity of use in a centralized executive force and general system of operation. (Butler Bros. v. McColgan, 17 Cal.2d 664, 678 [111 P.2d 334] (1941), affd., 315 U.S. 501 [86 L.Ed. 991] (1942).) The court has also held that a business is unitary when the operation of the business within California contributes to or is dependent upon the operation of the business outside the state. (Edison California Stores, Inc. v. McColgan, supra, 30 Cal.2d at 481.) These principles have been reaffirmed in more recent cases. (Superior Oil Co. v. Franchise Tax Board, 60 Cal.2d 406 [34 Cal. Rptr. 545, 386 P.2d 33] (1963); Honolulu Oil Corp. v. Franchise Tax Board, 60 Cal.2d 417 [34 Cal. Rptr. 552, 386 P.2d 40] (1963).)

The existence of a unitary business may be established if either the three unities or the contribution or dependency test is satisfied. (Appeal of F. W. Woolworth Co., Cal. St. Bd. of Equal., July 31, 1972.)

In addition to the judicial tests, the department has adopted regulations under the Uniform Division of Income for Tax Purposes Act (Regs. 25120-25139), which incorporate the unitary concept.

Verification of Tax Provisions

Following is our compilation of your State's corporate income tax provisions affecting multijurisdictional corporations. Please review these provisions for accuracy. Make any corrections on each sheet immediately below the listed provisions. Please return this listing to us even if no corrections are made.

CALIFORNIA

CORPORATE INCOME TAX PROVISIONS AFFECTING

MULTIJURISDICTIONAL CORPORATIONS

I. Jurisdictional Test

Class of out-of-State corporations	Statutory rules defining circumstances in which State may assert jurisdiction to tax
Foreign corporations including banks and other financial institutions (excise tax).	Doing business in State.
Foreign corporations ~~including banks~~ and other financial institutions (income tax).	Deriving ~~Receipt of~~ income from sources within State.
	Certain general corporations which engage in limited activities may be exempt under Sec. 23101.5 R&TC.
	Financial corporations which engage in limited activities may pay an annual fee as provided by Secs. 191(d) and 2104 of the Corporation Code.

II. Division of Tax Base Provision

Class of corporation	Specific allocation	Formula apportionment	Separate accounting	Other method
Domestic and foreign corporations including banks and other financial institutions.	Nonbusiness income. (Income of banks is treated as business income. Therefore, not applicable to banks.) While most income of banks is business income, there are some exceptions.	Business income, and where appropriate, the combined income of two or more affiliated corporations.	~~Allowed (required if necessary to effectuate equitable allocation and apportionment.)~~ Allowed only as to portions of business not unitary. See attached opinion as to this question.	

II. Formula Apportionment Method

Class of corporation	Type of formula	Weighting of factors	Extent of use
Domestic and foreign corporations including banks and other financial institutions.	3-factor (property, payroll, sales). Special formulas have been provided for selected industries.	Equal weight.	Mandatory unless shown to be inequitable.

IV. Allocation Rules

Class of Corporations	Method	Dividends	Interest	Capital Gains	Rents	Royalties
Domesitc and foreign corporations including banks and other financial institutions.	Apportionment UDITPA rules apply for apportionment of business income.	*				
	Specific allocation UDITPA rules apply for specific allocation of nonbusiness income.					

* Under California case authorities, most dividend income and gain or loss on the disposition of stock is nonbusiness income allocable to the commercial domicile. UDITPA rules are otherwise followed for determination of business and nonbusiness income.

V. Definition and Assignment of Factors in Formula Apportionment

Class of corporation	Numerator of property factor	Numerator of payroll factor	Numerator of sales factor	Numerator of other factors
Domestic and foreign corporation including banks and other financial institutions.	UDITPA rules apply for definition and assignment of factors. California has modified the UDITPA rules in applying them to a number of industries including banks and other financial institutions, public utilities, transportation companies and a number of others.			

Calculation of Tax Base

Class of corporation	Calculation of tax base
Domestic and foreign corporations including banks and other financial institutions (excise tax).	State defined base.
Domestic and foreign corporations including banks and other financial institutions (income tax).	State defined base.

EXHIBIT 15

VOLUME 89 APRIL 1976 NUMBER 6

HARVARD LAW REVIEW

ARTICLE

UNCONSCIONABLE COERCION: THE GERMAN VERSION . . . . *John P. Dawson*

COMMENT

ANTITRUST VIOLATIONS WITHOUT DAMAGE RECOVERIES . . . . *Phillip Areeda*

NOTES

Federal Income Taxation of Employee Fringe Benefits

Intervention in Government Enforcement Actions

Multinational Corporations and Income Allocation Under Section 482 of The Internal Revenue Code

CALIFORNIA STATE LIBRARY
JUL 12 1976
LAW LIBRARY

BOOK REVIEWS

Joel I. Klein *Edith G. Henderson*

Copyright © 1976 by
THE HARVARD LAW REVIEW ASSOCIATION

EXHIBIT 15

MULTINATIONAL CORPORATIONS AND INCOME ALLOCATION UNDER SECTION 482 OF THE INTERNAL REVENUE CODE

Since the 1950's, opportunities for expanded sales and greater access to resources, as well as potential economies of scale, have caused many corporate managers to shift their business perspectives towards a more global orientation, both in terms of bases of operation and potential markets.[1] The result of this trend has been the large-scale emergence of the multinational corporation (MNC),[2] which has been defined in the business literature as "a cluster of corporations of diverse nationality joined together by ties of common ownership and responsive to a common management strategy."[3]

Although MNC subsidiary corporations are legally separate, in fact MNC parents[4] tend to view them as parts of the single global system whose overall success, rather than that of any individual component, is considered critical.[5] From a business viewpoint, then, the operations of the MNC largely transcend the geographic boundaries of the various nations of incorporation.[6] While these factors distinguish the MNC from other forms of business organization, variations in integration, diversification and the degree of supervision over affiliates may result in diversity within the category of entities which may be termed MNC's.

The differences between MNC's and other corporations and the distinctions among MNC's themselves underlie the problems of determining how these entities should be treated for legal purposes. Perhaps nowhere are such problems so clear and acute as when tax authorities are called upon to determine a country's fair share in the corporate income tax base created by a MNC.

[1] *See generally* STAFF OF SUBCOMM. ON INTERNATIONAL TRADE OF THE SENATE COMM. ON FINANCE, 93D CONG., 1ST SESS., THE MULTINATIONAL CORPORATION AND THE WORLD ECONOMY (Comm. Print 1973).

[2] *See generally* R. BARNET & R. MULLER, GLOBAL REACH: THE POWER OF THE MULTINATIONAL CORPORATIONS (1974); C. TUGENDHAT, THE MULTINATIONALS (1971); R. VERNON, SOVEREIGNTY AT BAY (1971).

[3] Vernon, *Economic Sovereignty at Bay*, 47 FOREIGN AFFAIRS 110, 114 (1968).

[4] For the sake of convenience, "parent" will refer to a corporation which exercises ultimate managerial authority over a wholly or partially owned subsidiary corporation incorporated in another country. "Subsidiary" will refer to a controlled, foreign-incorporated entity.

[5] *See* Muller, *A Qualifying and Dissenting View of the Multinational Corporation* in GLOBAL COMPANIES: THE POLITICAL ECONOMY OF WORLD BUSINESS 21, 26–27 (G. Ball ed. 1975). *See also* M. BROOKE & H. REMMERS, THE STRATEGY OF MULTINATIONAL ENTERPRISE: ORGANIZATION AND FINANCE 289–290 (1970).

[6] *See* Vagts, *The Multinational Enterprise: A New Challenge for Transnational Law*, 83 HARV. L. REV. 739, 752, 777 (1970).

This Note will examine two major theories of tax base division which could serve as a basis for United States tax practice under section 482 of the Internal Revenue Code of 1954. The discussion will focus on transfers of tangible goods between MNC components, since this has proved to be one of the most interesting and important questions of international income allocation. In light of the strengths and weaknesses of each theory, proposals for modifications of the current regulations will be evaluated and new directions considered.

I. The Problem of Income Shifting

The operation of MNC's poses substantial obstacles to individual countries' attempts to levy taxes on income earned within their borders. Unlike truly separate corporations, the MNC parent and affiliates enjoy considerable freedom from market constraints in setting transfer prices for intercompany transactions in goods and services;[7] indeed such freedom may be critical to achieving worldwide MNC profit goals. The level of transfer prices directly affects the amount and distribution of income between the various components of the MNC, and therefore the amounts of their income tax liabilities in different countries.[8] While tax avoidance may enter into a MNC's determination of transfer prices, there are many important non-income tax influences on such decisions.[9] Whatever the motivation, however, freely-established transfer pricing represents a means whereby MNC profits produced by subsidiaries in countries with high tax burdens may be shifted to other entities subject to more favorable tax treatment.[10] Whenever

[7] Throughout this Note the term "intercompany transfer" will refer to transactions in goods or services between commonly controlled, but separately incorporated components of a MNC; intercompany contributions of equity capital are not included in this definition.

[8] Assume, for example, a manufacturing subsidiary in Country *A*, a country with high corporate income taxes, and a commonly-controlled distribution subsidiary in Country *B*, a country with lower taxes; Country *A* lacks jurisdiction to tax the profits earned by the subsidiary in Country *B*. The manufacturer might sell its products to the distributor at cost, allowing the distributor to mark up and distribute the goods at an abnormally large profit. Thus, the manufacturing subsidiary will realize no profit on the transaction, and the distributor will realize more income than if it had been dealing with an independent manufacturer. The net result of this transaction is that Country *A* will be unable to collect any tax on the income produced by the sale of goods manufactured within its own borders, and Country *B* will be able to tax, at its comparatively lower rates, the entire net income realized from the sale of the product.

[9] *See* pp. 1217–19 *infra*.

[10] *See* Ritter, *General Report*, 60b Cahiers de Droit Fiscal International I/53–I/55 (1975); Surrey & Tillinghast, *General Report*, 56b Cahiers de Droit Fiscal International I/2–I/4 (1971). There are several sources of such unequal

transfer pricing has the effect of shifting income in this way, a country in which economically significant activities took place is deprived of some portion of its fair share of the taxable income of the MNC.[11]

Recognizing the ease with which such prices may be set at artificial levels,[12] most countries have taken steps to vindicate their legitimate interest in preventing arbitrary income shifting.[13] In the United States, reliance is placed on section 482 of the Internal Revenue Code of 1954, which empowers the Commissioner of Internal Revenue to allocate income and deductions between two or more controlled entities when necessary to prevent tax evasion or clearly to reflect income, and this provision has been increasingly applied to MNC's.

While it is clear that the operations of MNC's should not be permitted to deprive a country of a portion of the tax base which is rightly its own, specific conclusions as to the means by which the country's interest is best protected are difficult to draw. Indeed, section 482 itself specifies no method or theory to guide the Commissioner in making income allocations. Initially, it seems that any system for apportionment of the income taxe base must be premised on a rational theory or definition of the entity which it

---

tax burdens: (1) Unequal effective tax rates will be created by a variety of differences in marginal tax rates, tax laws and tax practice. (2) A taxpayer in one country may have unutilized deductions for operating losses while a separately incorporated affiliate in another country may have taxable income. Income shifted from the latter to the former could be offset against the losses. (3) Individual countries often provide for tax differentials within their own tax laws depending on the location or the type of taxable entity involved. For example, under the Internal Revenue Code of 1954, there are advantages which may accrue to U.S. corporations if they shift income to a tax-sheltered subsidiary organized as a Western Hemisphere trade corporation, INT. REV. CODE OF 1954, §§ 921–22. *See generally* H. LEVENSON & P. SCHMID, ALLOCATIONS (SEC. 482) SPECIFIC TRANSACTIONS A-2 to A-3 (BNA Tax Management Portfolio No. 230, 1970).

[11] *See* Musgrave, *International Tax Base Division and the Multinational Corporation*, 27 PUB. FINANCE 394, 395 (1972). Countries will have to determine whether they wish to prevent shifts of income when a legitimate business purpose other than tax avoidance is demonstrated. The majority rule in the United States is that transfer price manipulations will not be excused by a legitimate business purpose. *See, e.g.*, Treas. Reg. § 1.482-1(c) (1968); Eli Lilly & Co. v. United States, 372 F.2d 990, 999 (Ct. Cl. 1967). *But see* W. Braun Co. v. Commissioner, 396 F.2d 264 (2d Cir. 1968).

[12] Although a MNC may be able to achieve tax advantages by transfer price manipulation, not all MNC's have elected to institute tax avoidance schemes by transfer pricing because of fears that tax-motivated transfer prices will not be appropriate for certain internal purposes perceived to be more important than tax avoidance. *See* M. BROOKE & H. REMMERS, *supra* note 5, at 119; BUSINESS INTERNATIONAL RESEARCH REP. 65-7, SOLVING INTERNATIONAL PRICING PROBLEMS 5 (1965); J. CHOWN, TAXATION AND MULTINATIONAL ENTERPRISE 90 (1974).

[13] *See* Surrey & Tillinghast, *supra* note 10, at I/7–I/10.

seeks to tax. Moreover, once such a definition has been established, the system which is then constructed should itself be tested against standards of fairness and rationality; the goal of the tax system, here as elsewhere, is not to frustrate legitimate business activities or to impose burdens unjustified by any articulated policy.

In evaluating the most appropriate means to allocate the income of a MNC under section 482, the question of definition poses a substantial stumbling block. The two basic and polar alternatives — the separate entity theory and the unitary entity theory — have been suggested as the rational way to view a MNC for tax purposes, and any resolution of the income allocation problem must be based on one of these theories, either in a pure or modified form.

The separate entity theory views each of a MNC's subsidiaries which carry on business of a continuing and substantial nature as separate and independent entities.[14] Thus, governments will confer upon local operations separate legal status for tax purposes, and will expect of these separate entities the same type of tax-related conduct as they would of any truly independent entities.[15] Intercompany transactions, like transactions with unrelated parties, are treated as taxable events. Since each commonly-controlled entity is viewed as separate and independent, the government will calculate its true taxable income by adjusting intercompany transactions to conform to the results of bargains which would have been negotiated between unrelated parties dealing at arm's length in similar goods or services in similar circumstances.[16] Moreover, each entity's profit or loss on any intercompany transaction does not depend on whether the MNC as a whole has yet made or ever will make any real profit through ultimate resale to third parties of the goods or services.[17]

The unitary entity theory, unlike the separate entity theory, views a group of affiliates as a single business which for reasons of legal convenience is divided into purely formal, separately-incorporated subsidiaries. This theory reflects the belief that MNC

[14] *See* Ludwig, *General Report*, 58a CAHIERS DE DROIT FISCAL INTERNATIONAL I/64 (1973).

[15] One of the most important requirements imposed upon a separate entity is that it maintain its accounting records as if it were independent from its affiliates in order that all intercompany transfers be recorded and accounted for. *See* Musgrave, *supra* note 11, at 402.

[16] *See* Ludwig, *supra* note 14, at I/64; Surrey & Tillinghast, *supra* note 10, at I/13, I/25.

[17] *See* Ludwig, *supra* note 14, at I/68. The performance of any other portion of the MNC is totally irrelevant to the calculation of a controlled taxpayer's income, which may be determined exclusively by examining the taxpayer's own books.

parents will tend to exercise strong centralized control over all parts of the enterprise and treat each subsidiary as an interdependent part of a larger system.[18] Since all MNC subsidiaries are considered to be parts of the same unitary business, intercompany transactions cannot produce a real economic profit or loss and must therefore be eliminated from tax consideration. Rather, income is not recognized for tax purposes until some part of the MNC earns a profit from sales to an unrelated party.[19]

The decision as to which of these theories should be adopted as the basis for a system of income allocation depends, in the first instance, on the degree to which each accurately reflects the structure of MNC's and the way in which they produce income. Such a choice, once made, will largely dictate the broad outlines of the system to be constructed. Thus, the separate entity theory may be implemented either by evaluating the division of net profits between the selling and purchasing entities to determine whether arm's length bargaining would have produced such a profit split,[20] or by comparing the levels of transfer prices which were charged in specific transactions with observed prices, mark-ups, or discounts taken from comparable arm's length dealings with unrelated parties. The latter alternative — transfer price review —has been adopted by the overwhelming majority of countries which accept the separate entity theory.[21]

In order to apply the unitary entity theory, on the other hand, total MNC net income[22] must be apportioned according to an index of the real economic contribution of each subsidiary to the production of profit.[23] Two different means have been suggested as a basis for such an allocation: one which attributes income to the sources in which factors of production are physically located, and a second method which focuses not on physical location of factors, but on where profits originate.[24] The rationale of each

[18] It is doubtlessly true that if there were typically few or no significant financial interrelationships or interdependencies between MNC components, there would be much less need for centralized control by MNC parents, especially given the perceived advantages of decentralized management systems. *See generally* M. Brooke & H. Remmers, *supra* note 5, at 68–124.

[19] *See* Ludwig, *supra* note 14, at I/68. Similarly, under a unitary entity view, no individual component of a MNC may have a true profit if other parts of the MNC have overall losses exceeding the amount of the profit. *See id.*

[20] *See, e.g.*, Nat Harrison Associates, Inc., 42 T.C. 601, 621–22 (1964), *acquiesced in*, 1965-2 Cum. Bull. 5.

[21] *See* Surrey & Tillinghast, *supra* note 10, at I/12–I/13. One can speculate that the preference for transfer price review is due to the perception that companies typically bargain in terms of prices and not on a division of profits.

[22] This includes the combined net income of an entire group of MNC subsidiaries and the parent, with intercompany income omitted.

[23] *See* Musgrave, *supra* note 11, at 398–99.

[24] *See id.* at 400–01.

is slightly different, but they share the methodological similarity of using a formula to apportion income, rather than detailed analysis of specific transactions.

The first method views income after expenses as a return earned by capital. In the world of perfectly competitive markets, each unit of a factor of production — land, labor and capital — is paid the full value that the last unit produces.[25] In the real world of imperfectly competitive product markets, however, when owners of capital are the parties who own and control the productive process, each unit of labor will not be paid a wage equal to its marginal product.[26] The factor-location formula assumes that it is legitimate to attribute to owners of capital, as part of the profit produced by capital, the additional value represented by the difference between the wage rate and the marginal product of labor.[27] Thus, under this view, since capital is responsible for the entire net income of a MNC, income will be apportioned to the countries in which capital is situated according to the percentage of total MNC assets located within each country.[28]

The second method differs from the first in that it considers not only the physical location of assets but also the location of ultimate sales. In order to earn a profit, a business must supply a combination of factors of production which produce goods or services for which there is a demand. The payroll and property expenditures of the corporation represent the "supply" of productive factors,[29] while the gross sales of the company's goods represent a proxy for the demand for these factors; both are essential if income is to be earned.[30] When the factor supply is

[25] *See generally* C. FERGUSON, MICROECONOMIC THEORY 393–423 (3d ed. 1972).

[26] *See generally id.* at 426–35.

[27] This result has been termed by economists "monopolistic exploitation" of labor. *See, e.g.*, J. ROBINSON, ECONOMICS OF IMPERFECT COMPETITION 281–91 (1933), *discussed in* C. FERGUSON, *supra* note 25, at 434–35.

[28] *See* Musgrave, *supra* note 11, at 400. A variant on this type of formula would include a payroll factor representing the proportion of total payroll expenditures in each country. *Cf.* SPECIAL SUBCOMM. ON STATE TAXATION OF INTERSTATE COMMERCE OF THE HOUSE COMM. ON THE JUDICIARY, STATE TAXATION OF INTERSTATE COMMERCE, H.R. REP. No. 1480, 88th Cong., 2d Sess. 529 (1964) (inclusion of payroll element in state income taxation context).

[29] "Property" includes both real and personal property. Theoretically, the firm contributes property to the profit-production process only in the amount of the real depreciation of physical assets (or the foregone rental value of non-depreciable assets such as land) resulting from the conduct of the business. However, because this would be extremely difficult to measure, the full value of the firm's assets (such as historical cost, depreciated book value, or fair market value) is normally used as a proxy for the firm's true property contribution.

[30] While it is true that the supply of factors and the ultimate demand are both necessary to the production of profits, the relative weight which should be given to each for tax purposes is purely a matter of judgment. *See* Musgrave, *supra* note 11, at 401.

situated in a different country from the factor demand, both countries may claim a share of the income tax base resulting from the economically significant activities within their borders. Thus, total MNC income could be allocated according to a formula based on the percentage of the combined properties, payrolls and sales of the entire MNC accounted for by each country.[31]

A tax base allocation system constructed within either the separate or unitary entity theory may then be independently evaluated on the basis of its economic rationality. It is clear that the choice of criteria according to which such a system should be judged may itself reflect certain policy decisions and may skew the analysis in favor of one system over another. Recognizing the potential for such a bias, this Note seeks to isolate certain neutral criteria that are based in concerns for minimum disruption and for fair and equitable treatment of all taxpayers. These criteria include: (1) No Undue Frustration of Legitimate Business Conduct: Any rules should not hinder more than is absolutely necessary from a revenue collection standpoint efficient business conduct motivated by considerations other than tax avoidance. (2) Tax Neutrality: Absent explicit non-revenue reasons for the creation of incentives or disincentives for overseas investments by its nationals or for domestic investment by foreigners, a government should not enact rules which cause unintended differences in the tax consequences of doing business at home or abroad.[32] (3) Administrability and Fair Notice: Once the government determines the tax burden it wishes to impose on a member of an affiliated group, it should adopt rules which achieve those revenue goals in an administratively efficient manner.[33] Moreover, taxpayers should be provided with fair notice of what is to be taxed to allow proper planning and to ensure that legitimate expecta-

[31] *See id.* at 400–01 & n.15. This type of formula, known as a "Massachusetts Formula," is used to make allocations of income for state income tax purposes. *See* p. 1224 *infra.*

It should be noted that the economic rationale for this theory becomes more attenuated as one moves from income earned from sales of goods produced by combining several factors of production to income earned by performances of services, or to passive investment income not earned as part of an active trade or business. For example, in the case of a landlord owning only one piece of real estate, the geographic source of income earned from the rental of the real property would seem to be the situs of the land. If the real estate were suddenly acquired by a manufacturing corporation located in another country, but left otherwise unchanged except for the change in ownership, it would be anomalous if the presence of the acquiring company's payrolls, sales and properties located elsewhere were allowed to affect the source of the rental income.

[32] *See* Bischel, *Tax Allocations Concerning Inter-Company Pricing Transactions in Foreign Operations: A Reappraisal*, 13 VA. J. INT'L L. 490, 509–10 (1973).

[33] The costs of enforcement and compliance should not be excessive when compared to the additional revenues produced on audit.

tions about past conduct are not upset.[34] (4) International Equity and Prevention of Double Taxation: If governments claim excessive portions of the MNC global tax base or fail to apply the same standards for allocating the tax base, double taxation is likely to result;[35] as a general principle, rules which unnecessarily exacerbate such double taxation ought to be avoided.[36]

While the evaluations of the accuracy of the underlying theory and the practical merits of a system as constructed from that theory may be separately considered, it is clear that they are closely related. For example, if a tax system is based on a theory which fails to reflect essential characteristics of MNC's, then its application is likely to frustrate legitimate business behavior and to cause problems of administration, at least from the point of view of the taxpayer. Thus, careful examination of actual experience with the unitary and separate entity theories will shed light on which theory is to be preferred on both theoretical and practical grounds.

II. The Separate Entity Theory

A. Application: Section 482 Regulations

The Department of the Treasury has promulgated regulations espousing the use of only the separate entity theory for income allocation under section 482.[37] Given the focus of this Note, it is important to examine at the outset whether the United States statutory scheme provides the flexibility to adopt an opposite approach should the unitary theory emerge as more appropriate. While the question has never been squarely confronted, certain judicial decisions can be read as suggesting that the primacy of the separate entity theory is not merely a matter of administra-

---

[34] *See* Surrey, *Treasury's Need to Curb Tax Avoidance in Foreign Business Through Use of 482*, 28 J. Tax. 75, 77 (1968); Surrey & Tillinghast, *supra* note 10, at I/4, I/5.

[35] *See* Brown & Zeitlin, *Introduction: Basic Principles of United States Law*, 60b Cahiers de Droit Fiscal International II/129, II/138 (1975).

[36] The exact resolution of the tension between taxing what a country deems to be its fair share of a MNC's income and avoiding double taxation by giving deference to the tax laws of the other countries must be effected through tax treaties and administrative relief procedures. *See generally* Kauder, *International Allocations of Income: Problems of Administration and Compliance*, 9 J. Int'l L. & Econ. 1, 33–47 (1974); Kragen, *Avoidance of International Double Taxation Arising From Section 482 Reallocations*, 60 Calif. L. Rev. 1493 (1972); Madere, *International Pricing: Allocation Guidelines and Relief from Double Taxation*, 10 Texas Int'l L.J. 108 (1975).

[37] Treas. Reg. § 1.482, T.D. 6952, 1968–1 Cum. Bull. 218 [hereinafter cited as Treas. Reg. § 1.482 (1968) or § 482 regulation].

tive discretion, but is statutorily mandated.[38] Neither the language of section 482 nor its legislative history, however, compels this result.

Section 482, on its face, simply authorizes the Commissioner to reallocate income or deductions between commonly-controlled businesses whenever necessary to prevent evasion of taxes or distortions of reported income.[39] Moreover, the legislative history

---

[38] *See* Lufkin Foundry & Mach. Co. v. Commissioner, 468 F.2d 805 (5th Cir. 1972), *rev'g* 30 CCH Tax Ct. Mem. 400 (1971); Oil Base, Inc. v. Commissioner, 362 F.2d 212 (9th Cir.), *cert. denied*, 385 U.S. 928 (1966).

In *Oil Base*, an intercompany sale of goods case, the taxpayer contended that under § 482, the proper question

> is not what income arm's length bargaining would have produced, but what income properly is attributable to each of the two commonly controlled corporations as its true net income *in light of what each performs or produces*.

362 F.2d at 214 (emphasis added).

After stating the question in the same terms as would a proponent of the unitary entity theory, the taxpayer argued that its rate of return on manufacturing, rather than the intercompany division of profits, was "fair and reasonable." The Ninth Circuit rejected this test in favor of an arm's length standard "pursuant to regulation." *Id.* at 214. Thus, *Oil Base* need not be read as a statement that the arm's length test is statutorily required. Furthermore, the taxpayer's failure to adduce evidence of the division of profits, supported by economic arguments that the division was justifiable, indicates that *Oil Base* is not necessarily a rejection of the unitary entity theory when properly argued.

In *Lufkin*, the Tax Court accepted, without any evidence of arm's length prices, markups, or discounts, a transfer pricing defense based solely on evidence of the division of pretax profits between the taxpayer and its affiliates, which was close to 50%-50%, stating that a reasonable distribution of profits was equivalent to proof of the arm's length nature of the taxpayer's transactions. 30 CCH Tax Ct. Mem. at 441. The Fifth Circuit reversed, in an opinion which appears to be based entirely on Treas. Reg. § 1.482-2(e) (1968), holding that no amount of self-examination of a taxpayer's transfer pricing can be a defense to a § 482 reallocation absent evidence of transactions with uncontrolled parties. 468 F.2d at 808. In a short per curiam denial of rehearing, the court stated that the holding was based on an interpretation of § 482 rather than on the regulation. *Id.* at 808-09. The Fifth Circuit, however, cited no authority for the proposition that its holding was required by the statute. Indeed, what may have motivated the Fifth Circuit to reverse was the fact that the Tax Court decision was unsatisfactory for its failure to explicitly set forth standards by which the reasonableness of the profit division was judged. *See* Bischel, *supra* note 32, at 498-99. Finally, if *Lufkin* is correct that some comparison with third party transactions is statutorily required, the safe-haven rules established in the regulations for determining arm's length interest, rental and service charges, *see* Treas. Reg. § 1.482-2(a) to (c), would seem to be invalid; their invalidity, however, has never seriously been suggested.

[39] Two cases decided prior to the promulgation of the current regulations suggested that an acceptable intercompany price may be something other than arm's length. *See* Frank v. International Canadian Corp., 308 F.2d 520, 528 (9th Cir. 1962) ("reasonable return" finding upheld since arm's length standard is not the sole appropriate standard for determining the true taxable income of a controlled taxpayer); Polak's Frutal Works, Inc., 21 T.C. 953, 976 (1954), *acquiesced in* (in part), 1955-1 CUM. BULL. 6, *non-acquiesced in* (in part), 1972-2 CUM.

of section 482 indicates that Congress, at various times, has been aware of the differences in approach under the two theories, but has neither conclusively accepted nor rejected either approach. In addition, the most recent congressional action regarding section 482 indicates that Congress considered use of the unitary entity theory more appropriate for section 482 allocations between U.S. businesses and their foreign affiliates.

The earliest predecessor of section 482, section 240(d) of the Revenue Act of 1921,[40] provided the Commissioner the option of consolidating the accounts of related entities whenever necessary to accurately apportion income between them, which was an implicit recognition of the unitary nature of many commonly-controlled businesses.[41] Section 240(d) was replaced by section 45 of the Revenue Act of 1928,[42] which was in language and philosophy the direct predecessor to the current section 482. Section 45 eliminated the reference in the prior statutes to consolidation of accounts as a means for reallocation of income. The legislative history, however, strongly suggests that this language was eliminated in order to dispel the erroneous belief that the prior statute authorized taxpayers to file consolidated returns, rather than to limit the government's authority to combine accounts as a basis for apportioning income.[43] Indeed, there is no mention in any of section 45's legislative history of transfer price review, an arm's length standard, or separate entity treatment.

In 1962 the House of Representatives passed a version of the Revenue Act of 1962 which would have added to section 482 a new subsection pertaining to sales of tangible property between United States corporations and their foreign subsidiaries.[44] This subsection not only permitted the Commissioner to view commonly-controlled groups as unitary entities, as did section 240(d), but also, for the first time, recognized a formula based on economic

---

BULL. 4 (allocation of income rejected because transfer price of cost plus 10% "would be considered in the trade" to be "fair and reasonable"). One case abandoned the technique of transfer price review for a determination of an arm's length profit division in an intercompany transfer of services. *See* Nat Harrison Associates, Inc., 42 T.C. 601, 622 (1964), *acquiesced in*, 1965-2 CUM. BULL. 5.

[40] Revenue Act of 1921, ch. 136, § 240(d), 42 Stat. 260.

[41] The special utility of § 240(d) for prevention of income shifting between foreign and domestic affiliates was foreseen by Congress. *See* S. REP. No. 275, 67th Cong., 1st Sess. 20 (1921), *reprinted in* 1939-1 (pt. 2) CUM. BULL. 194.

[42] Ch. 852, § 45, 45 Stat. 806 (1928). Prior to the adoption of § 45, minor changes had been made to the original § 240(d). *See* Revenue Act of 1924, ch. 234, § 240(d), 43 Stat. 288; Revenue Act of 1926, ch. 27, § 240(f), 44 Stat. 46.

[43] *See* H.R. REP. No. 2, 70th Cong., 1st Sess. 17 (1927), *reprinted in* 1939-1 (pt. 2) CUM. BULL. 395.

[44] H.R. 10650, 87th Cong., 2d Sess. § 6 (1962), *reprinted in* 1962-3 CUM. BULL. 537.

activity, rather than review of transfer prices, as a proper method for apportionment of income between controlled corporations located in different countries.[45] Though this subsection died in the Senate-House Conference Committee, the Conference Report explicitly indicated the Committee's belief "that the objectives of [the subsection] . . . [could] be accomplished by amendment of the regulations under present section 482 . . . ."[46] Moreover, the Committee recommended "that the Treasury should explore the possibility of developing and promulgating regulations under [section 482] which would provide additional guidelines and formulas for the allocation of income and deductions in cases involving foreign income."[47] These statements suggest that adoption by regulation of an income allocation formula based on a unitary entity conception would not be inconsistent with the present section 482,[48] and may actually accord with congressional will.

In response to the legislative mandate of the Conference Committee, the Treasury promulgated a new regulation in 1968.[49] The new regulation, however, did not reject the separate entity theory, but rather further confirmed and expanded upon the pre-existing regulation's use of the arm's length standard.[50] Thus, the 1968 regulation requires that commonly-controlled entities be treated as if they were unrelated separate entities for the purpose of determining income from intercompany transactions.[51] Once the requisite statutory element of common control is found,[52] inter-

[45] Section 6 of the House bill provided that in cases in which an arm's length price for a product sold in an intercompany transaction was not established by the taxpayer, a formula including asset, payroll and selling expense variables could be used to allocate the combined income of the parent and subsidiaries. *See* H.R. REP. No. 1447, 87th Cong., 2d Sess. 29 (1962), *reprinted in* 1962-3 CUM. BULL. 433. The House bill also provided that other variables, such as a risk factor which might merit a higher return to the foreign subsidiary, could be added to the formula on a case-by-case basis. *See id.*

[46] H.R. REP. No. 2508, 87th Cong., 2d Sess. 18 (1962), *reprinted in* 1962-3 CUM. BULL. 1146.

[47] *Id.*

[48] ". . . [T]reasury regulations must be sustained unless unreasonable and plainly inconsistent with the revenue statutes . . . ." Commissioner v. South Texas Lumber Co., 333 U.S. 496, 501 (1948).

[49] For detailed discussions of Treas. Reg. § 1.482 (1968), *see* Jenks, *Treasury Regulations Under Section 482*, 23 TAX LAWYER 279 (1970); Eustice, *Affiliated Corporations Revisited: Recent Developments Under Sections 482 and 367*, 24 TAX L. REV. 101 (1968); Hammer, *Section 482 — Apportionment and Allocation Guidelines*, N.Y.U. 26TH INST. ON FED. TAX. 693 (1968).

[50] Treas. Reg. § 1.482-1, T.D. 6595, 1962-1 CUM. BULL. The 1962 regulation was directly drawn from Treas. Reg. 118, § 39.45-1, 18 Fed. Reg. 5886-87 (1953). The 1968 regulation retained most of the 1962 regulation intact.

[51] *See* Treas. Reg. § 1.482-1(b)(1) (1968).

[52] Treas. Reg. § 1.482-1(a)(3) (1968) defines "control" to be

[a]ny kind of control, direct or indirect, whether legally enforceable,

company transactions are subject to special scrutiny, and an allocation of income is made in any case in which "the taxable income . . . is other than it would have been had the taxpayer in the conduct of his affairs been an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer." [53]

The new regulations added detailed rules for determining arm's length transfer prices in most types of non-equity capital transactions. The rules concerning intercompany sales of tangible property are the most important and complete schematization of the separate entity approach.[54]

The regulation contains three specific methods which are to be used by revenue agents as a guide for determining arm's length

---

> and however exercisable or exercised. It is the reality of the control which is decisive, not its form or the mode of its exercise. A presumption of control arises if income or deductions have been arbitrarily shifted.

This broad definition has been endorsed by several courts. *See, e.g.*, B. Forman Co. v. Commissioner, 453 F.2d 1144, 1152–55 (2d Cir.), *cert. denied*, 407 U.S. 934 (1972); Diefenthal v. United States, 367 F. Supp. 506, 511 (E.D. La. 1973). *But see* Lake Erie & Pittsburgh Railway Co., 5 T.C. 558, 563–65 (1945), *non-acquiesced in*, 1965–1 CUM. BULL. 5, *withdrawing acquiescense in* 1945–1 CUM. BULL. 5. *See generally* J. LEWIS, ALLOCATIONS (SEC. 482) GENERAL COVERAGE A-6 to A-8 (BNA Tax Management Portfolio No. 327, 1975).

[53] Treas. Reg. § 1.482–1(c) (1968). *See also id.* § 1.482–1(b). Intercompany prices must be set for § 482 purposes at levels which would have been charged unrelated parties in comparable arm's length transactions. *See id.* §§ 1.482–2(a)(2), (b)(3), (c)(2), (d)(2), (e)(1). Moreover, it will be no defense to a charge of non-arm's length pricing that the deviation from arm's length was inadvertent, *see id.* § 1.482–1(c), or that no income is realized from a transaction by other members of the controlled group, *see id.* § 1.482–1(d)(4).

If there is a need to readjust intercompany transactions to reflect arm's length prices, a deduction representing payment of an expense ("correlative adjustment") is given to the controlled entity from which income is taken equal in amount to the reallocation. *See id.* § 1.482–1(d)(2).

[54] *Id.* § 1.482–2(e). Out of all potential § 482 adjustments in audits involving international cases during 1968 and 1969, more adjustments to transfer prices for intercompany sales of goods were considered by auditing agents than any other type of potential adjustment under Treas. Reg. § 1.482–2 (591 out of 1,706 considered); adjustments actually made to transfer prices for sales of goods produced the largest dollar amount of allocations (approximately $312 million out of a total of $662 million). U.S. DEP'T OF TREASURY, SUMMARY STUDY OF INTERNATIONAL CASES INVOLVING SECTION 482 OF THE INTERNAL REVENUE CODE 4–6 (1973), *reprinted in* 2 R. RHOADES, INCOME TAXATION OF FOREIGN RELATED TRANSACTIONS 7–93 to 7–95 (1976) [hereinafter cited as TREASURY SUMMARY STUDY].

In the case of intercompany loans, rentals of tangible property and performance of services, when the transferor entity is not in the regular business of performing such functions, the regulations provide safe-havens insulating transfer prices charged on these types of transactions from challenge as not at arm's length. *See* Treas. Reg. § 1.482–2(a) to (c) (1968). There is also an exception to the strict arm's length requirement for intercompany sales of goods which allows pricing below arm's length on sales to a controlled distributor "for a time" if the purpose is to facilitate entry or expansion into a new market by the manufacturer. *Id.* § 1.482–2(e)(2)(iv).

prices when examining an intercompany sale of goods.[55] The first — the comparable uncontrolled price method [56] — compares the transfer price charged in the controlled transaction with the price charged in similar transactions with uncontrolled parties. Under the second method — the resale price method [57] — applicable to sales to a controlled distributor, the transfer price is found by subtracting from the distributor's price the margin of profit earned by uncontrolled distributors of the good in similar transactions. The third method [58] — cost plus — computes the arm's length price by adding to the full costs of production a percentage markup earned by manufacturers of similar goods in uncontrolled transactions. Although the three methods focus on different aspects of the pricing mechanism, they are variations of a single approach for ascertaining an arm's length price by examining dealings between unrelated parties.[59] The regulation also allows, as a fourth method, any other pricing test that is "clearly more appropriate" for making the arm's length determination.[60] There is a priority between the methods in the order listed; the highest priority method for which the relevant data is available — comparable third party prices, markups and discounts — must be used.[61]

B. Critique

While the approach of the section 482 regulations is not without any advantages, the theoretical premise of these regulations — that MNC parents and affiliates are properly viewed as separate entities — is subject to serious criticism. Initially, it should be noted that controlled companies are treated as separate entities for the purposes of deferral of taxation of foreign corporate business income not effectively connected with the United States,[62] and consistency may counsel similar treatment with respect to the allocation of income. Yet while consistency may be a worthy goal, adopting regulations solely for that purpose in the face of

[55] *See* Treas. Reg. § 1.482-2(e)(2) to (4) (1968); Surrey, *supra* note 34, at 77 (summary of the three methods).

[56] Treas. Reg. § 1.482-2(e)(2) (1968).

[57] *Id.* § 1.482-2(e)(3).

[58] *Id.* § 1.482-2(e)(4).

[59] *See* Hammer, Morrione & Ryan, *Concepts and Techniques in Determining the Reasonableness of Intercompany Pricing Between United States Corporations and Their Overseas Subsidiaries*, N.Y.U. 30TH INST. ON FED. TAX. 1407, 1411 (1972) [hereinafter cited as N.Y.U. 30TH INST.]. Under either of the three methods, adjustments may be made to the data taken from third party dealings to reflect any material differences in the third party transaction and the challenged transaction. *See* Treas. Reg. § 1.482-2(e)(2)(iii), (e)(3)(ix), (e)(4)(v) (1968).

[60] Treas. Reg. § 1.482-2(e)(1)(iii) (1968).

[61] *See id.* § 1.482-2(e)(1)(ii).

[62] *See* INT. REV. CODE OF 1954, § 882. *But see id.* §§ 951-64 (Subpart F).

strong countervailing considerations of economic rationality cannot be justified.[63] In economic theory, affiliates of a MNC would not necessarily be expected to treat other affiliates as wholly separate corporations or to choose arm's length prices for their transfers, since affiliation may give rise to a variety of synergistic effects which alter the costs and benefits of transacting intercompany business.[64]

Whenever commonly-controlled entities directly contribute, either horizontally or vertically, to a single production-distribution process, opportunities for cost savings through economies of scale and reduced transaction costs may result.[65] Even where no direct transfers are made, centralized managerial control over a group of affiliates may produce efficiencies in management, in raising capital, in obtaining quantity discounts, and in advertising.[66] In addition, diversification of risk creates potential savings where there are few similarities between affiliates.[67] Finally, political and economic power, which may be used to increase long-run profits of the whole MNC, may stem from large size alone regardless of the degree of compatibility between the affiliates.[68] As a result of all of these considerations, transfer prices may vary from arm's length to reflect the increased profitability of intercompany transactions.

Related parties know that they will realize the benefits of synergy only on intercompany transactions and that any one party, if it chooses to deal with outsiders, will deprive other affiliates of these extra profits. Accordingly, it will be in the interest of each party to induce the others to engage in transactions within the firm; such inducement will take the form of sharing the decreased costs or increased profits by adjusting transfer prices.[69]

[63] Moreover, the Code itself is not wholly consistent in its adoption of the separate entity approach. The indirect credit provision, *id.* § 902, enables a domestic parent to take a credit for foreign taxes paid by its separately incorporated foreign subsidiaries. The domestic shareholder, however, may take the credit only upon receipt of a dividend, not at the time that the foreign tax is actually paid. In this sense, the indirect credit gives some recognition to the separateness of the two corporate entities, although its basic premise seems to embrace the unitary entity theory.

[64] *See generally* F. SCHERER, INDUSTRIAL MARKET STRUCTURE AND ECONOMIC PERFORMANCE 72–103 (1970).

[65] *See id.* at 72–74, 86–87, 470–71; Musgrave, *supra* note 11, at 403.

[66] *See* Keesling & Warren, *The Unitary Concept in the Allocation of Income*, 12 HASTINGS L.J. 42, 51–52 (1960). *See also* F. SCHERER, *supra* note 64, at 116–19; P. STEINER, MERGERS: MOTIVES, EFFECTS, POLICIES 60–69 (1975).

[67] *See* P. STEINER, *supra* note 66, at 67.

[68] *See id.* at 69–74, 310–11; Musgrave, *supra* note 11, at 403–04.

[69] For example, suppose that subsidiaries *A* and *B* stand in the relation of manufacturer and retail distributor of widgets. The arm's length open-market wholesale price for widgets is $100. Assume further that *A*'s promotion costs are

Since the benefits of synergy result from the cooperation of numerous affiliates, the true income of each should include a share of the increased profits. This will not be the case under the separate entity arm's length standard which does not recognize the differences between intercompany dealings with integrated affiliates and open-market transactions with strangers.

Still, the system constructed on the basis of this theory is not without some merit according to the practical criteria for judging a tax system. First, the separate entity approach has the virtue of geographic neutrality: the present regulation does not give any special advantages to, or place any special burdens upon, income earned abroad, other than the threat of double taxation. Further, to the extent that arm's length prices are objectively ascertainable,[70] the widespread use of the separate entity approach throughout the world [71] suggests that until the problem is finally solved through an international treaty, continued use of this approach by the United States may be the best means to minimize the threat of double taxation.

The weight to be accorded to these factors is somewhat less clear. The prevalence of the separate entity theory may be due, at least in part, to the fact that the United States itself chooses to employ the system.[72] Even accepting the superiority of the approach with respect to the criteria of geographic neutrality and the avoidance of double taxation, however, the system's frustration of legitimate business behavior and the difficulties of its administration, as well as its basic inappropriateness for highly integrated and interdependent businesses, may be seen as outweighing these advantages.

Frustration of legitimate business conduct may arise in a number of areas.[73] Substantial evidence suggests that the costs and complexity of maintaining more than one transfer pricing system

---

$10 per unit lower when it wholesales to *B*, which does not need to be convinced of the desirability of *A*'s widgets, than when it sells to an unrelated party on the open market. If *B* is aware of *A*'s cost savings, *B* could threaten *A* that it will buy all of its widgets on the open market for $100 unless *A* offers *B* a price less than $100. As long as *B* is willing to pay any price higher than $90, *A* will make greater profits on sales to *B* than on open-market sales. It is therefore highly unlikely that *A* will risk the chance of losing the profitable sale to *B* by refusing to offer a price at least somewhat lower than the open-market arm's length price. Exactly what price between $90 and $100 will be offered depends on the relative bargaining power of *A* and *B*.

[70] *But see* pp. 1220–21 *infra*.

[71] *See* Surrey & Tillinghast, *supra* note 10, at I/12.

[72] *See* J. CHOWN, *supra* note 12, at 95.

[73] A legitimate business purpose for non-arm's length pricing is currently not a defense under § 482. *See* note 11 *supra*.

have led many MNC's to adopt a single system for all purposes.[74] The government's insistence on the separate entity theory for tax purposes may result in the adoption by MNC's of arm's length pricing rather than an administered transfer pricing system more appropriate for internal control and motivational purposes. Such a system, which is designed to reflect the fact that an affiliate may have contributed to long-run MNC profits despite its failure to produce short-run profits measured in terms of arm's length prices, is crucial to the promotion of full cooperation by all affiliates in achieving the MNC's worldwide goals, even when it is not in their individual interest as profit maximizers.[75]

Moreover, absent income tax considerations, transfer pricing would be influenced by many diverse factors such as customs duties,[76] currency controls or limitations on profit repatriation and certain intercompany payments,[77] political and economic instability,[78] the financial health and competitive position of the MNC subsidiaries [79] and antitrust laws.[80] Despite the fact that greater freedom to achieve maximization of pretax global MNC profits would create a larger income tax base subject to division between countries and might ultimately result in repatriation to the United

[74] *See* J. Arpan, International Intracorporate Pricing: Non-American Systems and Views 27–28, 33 (1971); M. Brooke & H. Remmers, *supra* note 5, at 120; Business International, *supra* note 12, at 3, 19.

[75] For example, use of competitive transfer prices will not be in the best interests of the MNC as a whole if the parent decides to expand foreign sales in order to maximize long-run total MNC net profits, at a time when the manufacturing subsidiary would maximize short-term profits by selling at a higher price outside of the firm in the domestic market. Transfer prices might be altered from arm's length levels in order to provide the manufacturer with profit recognition for participating in the foreign sales effort. *See generally* Business International, *supra* note 12, at 8–21.

[76] If the customs duty is an ad valorem tax assessed on the basis of the price at which the imported item is invoiced, there is an obvious incentive to invoice the item at a price below normal.

[77] In addition to restrictions on the amount of profits which can be repatriated, intercompany payments of interest, royalties or managerial services fees may be limited or treated as non-deductible dividends from the subsidiary to the parent. The use of higher transfer prices on sales of tangible goods would be a means by which compensation for intercompany loans, licenses of patents, and the like could be attained. *See* Brown & Zeitlin, *supra* note 35, at II/138.

[78] Expropriation risk might be exacerbated if transfer prices for goods, services, know-how, and the like were set so high that a subsidiary is unable to show a profit in the host country.

[79] This encompasses differences in the ability of various foreign subsidiaries to raise working capital to pay for the goods supplied in the intercompany transfer.

[80] Antidumping and price discrimination laws will to some degree constrain the freedom of MNC's to adjust transfer prices. *See generally* J. Arpan, *supra* note 74, at 36, *summarizing* J. Shulman, Transfer Pricing in Multinational Business, August, 1966 (unpublished D.B.A. dissertation, Harvard University) (major influences on transfer pricing).

States of greater taxable foreign dividends,[81] use of the arm's length standard for tax purposes serves to discourage the flexible pricing necessary for optimal treatment of these variables.

A third area of potential frustration involves the cost-saving technique known as marginal pricing: the practice of selling surplus production in foreign markets at prices lower than those prevailing in the manufacturer's primary market which may not allow recovery of the full costs of production.[82] While the regulation does not explicitly set forth rules concerning the propriety of this technique,[83] its treatment is not satisfactory under either of two offered interpretations. If the regulation requires a manufacturer to be taxed on the basis of the profits which it would have earned had it set its prices so as to recoup full costs plus a normal arm's length profit,[84] the imposition of the tax will raise the marginal costs of production, thereby making it more difficult to recover the costs necessary to allow use of this efficient technique. On the other hand, if the regulation recognizes the validity of marginal pricing only when unrelated distributors are offered the same low prices,[85] manufacturers who are hesitant to favor an unrelated entity with bargain prices may be discouraged from utilizing marginal pricing techniques at all.

Flexible transfer pricing is also critical when a MNC wishes to establish or expand a controlled distributor's client base by temporarily subsidizing that distributor with lower prices. The regulation permits a manufacturer to sell to a controlled distributor below arm's length only if the manufacturer would also sell to

---

[81] *See* M. Duerr, Tax Allocations and International Business 65 (Conference Board Study, 1972).

[82] Bulk sales of surplus production will be efficient in periods of temporary excess manufacturing capacity. As long as revenue greater than the marginal cost of producing the surplus (the additional variable costs) can be recovered in the foreign market, the producer will increase his profits by running his plant at an efficient level of output, selling a profit maximizing quantity at home, and selling the surplus in bulk overseas. Use of this technique is a form of price discrimination. *See generally* C. Ferguson, *supra* note 25, at 310–13; F. Scherer, *supra* note 64, at 258–59. Such price discrimination is not always prohibited by law, *e.g.*, when the surplus goods and the goods sold domestically are not of like grade and quality.

[83] Treas. Reg. § 1.482-2(e)(1)(i) (1968) does state, however, that "[s]ince unrelated parties normally sell products at a profit, an arm's length price normally involves a profit to the seller."

[84] *See* Kauder, *supra* note 36, at 26.

[85] *See id.*, *citing by analogy* Treas. Reg. § 1.482-2(e)(2)(iv) (1968); *cf.* Eli Lilly & Co. v. United States, 372 F.2d 990, 997–98 (Ct. Cl. 1967) (taxpayer's marginal pricing defense in § 482 case rejected because challenged intercompany transfers were not comparable to bulk sales which were made to unrelated parties, not because marginal pricing is impermissible under § 482).

unrelated distributors at comparable prices.[86] While this allows a manufacturer to expand its own sales, it prevents subsidization of a controlled distributor for the purpose of increasing its market share because the manufacturer would have to offer similar low prices to the distributor's competitors. Likewise, since it is natural for parents to make low-priced intercompany transfers of goods and services to financially troubled subsidiaries in order to prevent their failure, this behavior should not be subject to taxation at arm's length prices.[87]

Finally, under the separate entity theory, a corporation incurs dramatically different tax liability in carrying out essentially the same foreign business depending on whether its subsidiary is incorporated. A parent transferring goods to an unincorporated foreign branch is not subject to a section 482 allocation for failure to charge an arm's length transfer price because only one taxable entity is involved. Furthermore, the parent's tax is deferred until after realization of income upon resale of goods by the branch. If the branch is subsequently incorporated, however, the parent must not only employ arm's length transfer prices for tax purposes, but also currently pay tax on income so calculated from intercompany transactions regardless of whether the subsidiary or the MNC as a whole has yet realized or ever will realize net income from resales to third parties.[88] There appears to be no theoretical justification for these differences in treatment.

Perhaps the most telling criticism of the separate entity theory, however, relates to the problems of its administration. Superficially, the separate entity approach of the regulation seems simple and easy to apply. One need scrutinize only the transactions of the particular affiliate whose taxable income is being calculated; there is no need to reconstruct all of the MNC's trans-

---

[86] *See* Treas. Reg. § 1.482-2(e)(2)(iv) (1968).

[87] *See, e.g.*, Spaeth, *Section 482: Past and Future*, 47 TAXES 45, 49 (1969). The regulation provides some relief in that transfers of managerial services may be made at cost. Treas. Reg. § 1.482-2(b)(3) (1968).

[88] *See* Treas. Reg. § 1.482-1(d)(4) (1968). For discussion of the "creation of income" problem, *see, e.g.*, Comment, *Creation or Reallocation of Income Under Section 482: A Continuing Controversy*, 28 Sw. L.J. 766 (1974); Comment, *Creation of Income Versus Allocation of Income: The Section 482 Controversy*, 51 TEXAS L. REV. 920 (1973). Application of the separate entity theory may produce a variety of fictitious gains and losses. For example, assume that a quantity discount of one dollar per unit can be obtained on wholesale purchases of 100,000 units or more, and that a MNC can profitably use only 80,000 units. Accordingly, the MNC forms a new subsidiary to purchase the additional 20,000 units, which are resold by the subsidiary at a net loss of $40,000. Under the separate entity theory, the subsidiary would report a $40,000 net loss, although in reality it helped the MNC gain $60,000. *See* H.R. REP. No. 1480, *supra* note 28, at 166-67. *See also* Ludwig, *supra* note 14, at I/68.

actions.[89] Moreover, the relevant facts surrounding the transfers in question may be found in the affiliate's own books,[90] and it is unnecessary to draw on other information unless evidence of arm's length prices cannot be culled from the taxpayer's records of dealings with unrelated parties.

Not all companies, however, routinely collect, nor are they required to collect, the types of evidence specified in the regulation. The cost of gathering such information in preparation for an audit of possibly thousands of transactions,[91] particularly several years after the fact, can be staggering for both the government and the taxpayer.[92] If the taxpayer cannot find evidence of comparable arm's length dealings from its own records, it must locate another company which is not only sufficiently comparable to allow for comparison of that company's pricing policies with its own, but is also willing to reveal those policies.[93] Furthermore, in many situations, exemplified by the case of the sale of a partially completed component to a foreign subsidiary for final assembly and distribution, no comparable third party transaction may exist from which to obtain an appropriate arm's length price, because no unrelated entity has a similar division of functions or deals in similar components.[94]

Even when evidence of arm's length transfers can be located, the comparability of the third party and of the challenged transactions is always questionable, since "no two transactions are in fact identical." [95] Given the essentially subjective nature of the

[89] *See* notes 17 & 53 *supra*.

[90] *See* Musgrave, *supra* note 11, at 402.

[91] If the existence of large numbers of transactions makes it impractical to examine them individually, the Commissioner may determine appropriate prices for product lines or other groupings, or may use statistical sampling techniques. Treas. Reg. § 1.482-2(e)(1)(iv) (1968). In at least one case, however, the IRS demanded verification of all of a sales subsidiary's billings to outside customers, which arose at the rate of more than 1000 per week. *See* M. DUERR, *supra* note 81, at 77.

[92] It has been estimated that the government and the taxpayer in E.I. du Pont de Nemours & Co. v. United States, Ct. Cl. Nos. 256-66 and 371-66, a § 482 suit pending since 1966 to recover some $18 million of allegedly improper tax overcharges, will have incurred costs of $1 million each in conducting the case. *See* Kauder, *supra* note 36, at 27.

[93] Corporations are normally very secretive about revealing the workings of their transfer pricing systems to any outsiders, *see* J. ARPAN, *supra* note 74, at 49, let alone to competitors.

[94] *See generally* Wisconsin Big Boy Corp. v. Commissioner, 452 F.2d 137, 140-41 (7th Cir. 1971); Eli Lilly & Co. v. United States, 372 F.2d 990, 996 (Ct. Cl. 1967); N.Y.U. 30TH INST., *supra* note 59, at 1436.

[95] *See* Kauder, *supra* note 36, at 25. For examples of the difficulty of the comparability question in practice, see PPG Industries, Inc., 55 T.C. 928 (1970); Woodward Governor Co., 55 T.C. 56 (1970), *acquiesced in*, 1971-1 CUM. BULL. 2; Eli Lilly & Co. v. United States, 372 F.2d 990 (Ct. Cl. 1967); Mihaly, *Intercompany*

determination of whether evidence offered under a certain pricing test is sufficiently similar to justify the use of that particular method rather than one of lower priority,[96] or whether adjustments made to achieve comparability are themselves adequate, it is almost impossible to predict in advance which of the three favored pricing methods must be used.[97]

Indeed, the inherent difficulty of working with evidence of arm's length prices has led the Service, taxpayers and courts to deviate from the letter or spirit of the regulations in litigated cases. In several cases, the precise rules of the three priority pricing methods were misapplied by the court or the Service so that probative evidence other than that called for by the particular test could be introduced in support of a given result.[98] In other cases, courts faced with weak evidence under one of the arm's length pricing tests have considered evidence which is not relevant under any of the tests specified by the regulations in order to buttress their findings with conclusions as to the reasonableness or appropriateness of their results.[99] Finally, courts have, with surprising frequency, failed to apply one of the three favored pricing tests at all, instead opting for an improvised fourth method.[100]

Pricing, Offset Adjustment and Constructive Dividends Resulting from Section 482 Adjustments, 25 MAJOR TAX PLANNING 731, 756–63, 773–79 (1973).

[96] *See* p. 1214 & note 61 *supra*.

[97] Counsel for the Government in E.I. du Pont de Nemours & Co. v. United States, Ct. Cl. Nos. 256–66 and 371–66, while explaining why evidence would be introduced under each of the three priority methods and under a fourth method, admitted that the government was at a loss to predict under which of the three pricing methods it would ultimately be required to proceed by the court. *See* Brief for Defendant at 72–73 & n.29 (March, 1974).

[98] In Woodward Governor Co., 55 T.C. 56 (1970), *acquiesced in*, 1971–1 CUM. BULL. 2, the Commissioner attempted to apply the resale price method on the basis of evidence of certain allegedly arm's length discounts which a distribution subsidiary had received from its parent in transactions involving other products. However, Treas. Reg. § 1.482–2(e)(3)(vii) (1968) explicitly calls for evidence from transactions with unrelated parties in order to establish an arm's length discount. *See* Mihaly, *supra* note 95, at 761–62, 766–73. *See also* American Terrazzo Strip Co., 56 T.C. 961 (1971), *acquiesced in*, 1973–2 CUM. BULL. 1 (court applied improvised method although purporting to rely on the comparable uncontrolled price method).

[99] The court supported a finding under the comparable uncontrolled price method in Woodward Governor Co., 55 T.C. 56 (1970), *acquiesced in*, 1971–1 CUM. BULL. 2, with a statement that the parent's price structure on sales to unrelated distributors was "producing satisfactory profits" for the parent, "and there was no reason to attempt to earn more on the sales" to its own controlled distributor. *Id.* at 68. One would expect that, under Treas. Reg. § 1.482 (1968), a parent would not be able to rest with merely "satisfactory profits" if, under the circumstances, super-normal profits would be earned by an unrelated party dealing at arm's length with the controlled distributor. *See also* note 102 *infra*.

[100] *See, e.g.*, Baldwin-Lima-Hamilton Corp. v. United States, 435 F.2d 182 (7th Cir. 1970) (case remanded for arm's length finding under either of two

While some of these fourth method approaches are consistent with the general emphasis of the regulations on comparison with uncontrolled transactions,[101] others rely on the division of profits between parent and subsidiaries without regard to evidence of comparable uncontrolled arm's length profit splits, and thus seem to comport more with the unitary entity theory than with the separate entity theory embodied in the regulation.[102]

---

methods advanced by taxpayer, at least one of which, a variant on the cost-plus method, appears not to be strictly consistent with the specific rules for cost-plus set forth in regulation); American Terrazzo Strip Co., 56 T.C. 961 (1971), *acquiesced in*, 1973-2 CUM. BULL. 1; Mihaly, *supra* note 95, at 763-73. *See also* note 102 *infra*.

[101] *E.g.*, Baldwin-Lima-Hamilton Corp. v. United States, 435 F.2d 182 (7th Cir. 1970); American Terrazzo Strip Co., 56 T.C. 961 (1971), *acquiesced in*, 1973-2 CUM. BULL. 1.

[102] In Eli Lilly & Co. v. United States, 372 F.2d 990 (Ct. Cl. 1967), a § 482 allocation based on a somewhat arbitrary method was upheld, not because the court approved of the method, but because the taxpayer failed to prove the ultimate result to be "unreasonable." *Id.* at 997. In reaching its decision, the court, while acknowledging the primacy of the arm's length standard, examined the pre- and post-allocation division of profits between the parent and subsidiaries, and found that the post-allocation profit split was still sufficiently favorable to the parent so as to not render the allocation improper. *Id.* In PPG Industries, Inc., 55 T.C. 928 (1970), the Tax Court, while making a finding using comparable uncontrolled prices, chose not to rely solely on that method. Citing *Eli Lilly*, the court accepted as relevant to the § 482 question, and to the reasonableness of the parent's pricing policies, accounting data submitted by the taxpayer which indicated that the corporation's "consolidated" net profits from export sales were divided with approximately 60% to the parent and 40% to the subsidiary. *Id.* at 997 & n.10. Because the subsidiary was "only receiving a fair percent of such consolidated profit," *id.*, there was no apparent improper shift of income from its parent. *See also* Lufkin Foundry & Mach. Co., 30 CCH Tax Ct. Mem. 400 (1971), *rev'd*, 468 F.2d 805 (5th Cir. 1972), *discussed in* note 38 *supra*.

Eli Lilly, *PPG* and *Lufkin* (Tax Court opinion) appear to give some support to the unitary entity theory because of their reliance on taxpayers' profit split evidence without comparison of profit splits taken from comparable arm's length dealings with uncontrolled parties, as would be required by the separate entity theory. However, no economic principles were explicitly relied upon in these cases for judging the fairness of the profit split. Philipp Bros. Chemicals, Inc. v. Commissioner, 435 F.2d 53 (2d Cir. 1970), is a case suggesting that a measure of the economic activities of each controlled entity might prove to be an acceptable standard for determining a fair profit split between related entities. In *Philipp*, the question was whether a 100% reallocation to a parent of the income of several of its foreign subsidiaries was appropriate under § 482. The sham corporation doctrine was not explicitly at issue. The court noted that the foreign corporations had no employees or payroll expenditures and incurred no other deductions for operating expenses, and concluded that this evidence of lack of substantial activity justified the 100% reallocation to the domestic parent. *Id.* at 58. Although the question was not at issue in *Philipp*, the opinion suggests no reason why measures of the economic activity of a foreign corporation such as payrolls or operating expenses logically should cease to be relevant to the income division determination once the subsidiary crosses the threshold beyond

Furthermore, there is evidence that the pricing test most often used by revenue agents to make allocations in routine international intercompany sales audits is the improvised fourth method.[103] Indeed, one commentator has stated that it is the rule, not the exception, for agents in effect to view commonly-controlled businesses more as unitary than as separate entities, focusing on the division of net profits between the parent and the subsidiary, while at least partially ignoring actual intercompany prices.[104]

The decision to apply one of these fourth method approaches is, as a practical matter, left to the discretion of the auditing agent, and there is no reason to assume that measures developed by agents on an ad hoc basis in the field will accurately and consistently reflect true income. Moreover, untrammelled discretion deprives taxpayers of advance notice of the standards by which their transactions will be judged, frustrating tax planning [105] and increasing administrative burdens by discouraging voluntary compliance.

III. The Unitary Entity Theory

A. Applications: The California System and Section 861 Proposed Regulations

While a unitary approach has often been taken when the fourth method is applied in section 482 audits, the theory has never been formally recognized by the Internal Revenue Service as a basis for the allocation of income. Tax authorities, however, have explicitly adopted or seriously considered applying variants of the theory to several analogous tax base division problems, including apportionment for state income tax purposes of income earned by commonly-controlled multistate corporations and allocation of deductions for federal tax purposes between a tax-

---

which a 100% reallocation ceases to be appropriate. The analysis in *Philipp*, supplemented by an appropriate index of the relative profit-production activities of each MNC component, combined with the profit-split accounting in such cases as *PPG*, would satisfy all of the essential elements of the unitary entity theory.

[103] *See* M. Duerr, *supra* note 81, at 12–13; Treasury Summary Study, *supra* note 54, at 11 & table 8.

[104] *See* M. Duerr, *supra* note 81, at 24. According to Duerr, each of the four most commonly used fourth methods evaluates the division of combined profits of the parent and subsidiaries in order to determine whether undue profits are being concentrated overseas. Two of the four methods apportion the combined income according to indices of the economic activities of each taxable entity in a given country, such as costs incurred, assets or sales. *See also* Seghers, *Taxable Income from Sales to Foreign Subsidiaries: Setting and Defending Intercompany Prices*, *reprinted in* 7 Int'l Tax Inst., Inc., Selected Papers of Panelists at 1972 Pub. Technical Meetings 84–85 (1972).

[105] *See* Surrey & Tillinghast, *supra* note 10, at I/5.

payer's foreign and domestic source income. These examples may highlight some of the problems of allocating income under section 482 according to the unitary entity theory.

Tax incentives will exist for commonly-controlled domestic corporations conducting business in more than one state, as for affiliated multinational corporations, to utilize transfer pricing to concentrate profits in states with low corporate income taxes. California was the first state to respond to this problem by applying the unitary entity theory.[106] Each commonly-controlled corporate taxpayer doing business in California is required to file a "combined report"[107] setting forth not only its own total net income, properties, sales and payrolls, but also such data for any out-of-state corporate affiliates which participate in the same unitary business as the California taxpayer.[108] The state then applies a non-price oriented formula to the combined net income figure, regardless of whether there is any suspicion of income shifting.[109] This formula, first developed in the Uniform Division of Income for Tax Purposes Act,[110] allocates to California a fraction of the affiliated group's combined net business income equal to the percentage of the total combined property, sales and payrolls accounted for within the state.[111] In order to avoid allocation to the state of income clearly earned elsewhere,[112] California does not treat all of a controlled group as unitary, but only includes those corporations or parts of corporations which are deemed interdependent with the California taxpayer.[113] Such a determina-

[106] *See generally* Miller, *State Income Taxation of Multiple Corporations and Multiple Businesses*, 49 TAXES 102 (1971); Peters, *State Income Tax Problems of Interstate Business*, N.Y.U. 33D INST. ON FED. TAX. 899 (1975).

[107] CAL. REV. & TAX CODE § 25,102 (West 1970); *see* Keesling & Warren, *California's Uniform Division of Income for Tax Purposes Act*, 15 U.C.L.A. L. REV. 156, 174–75 (1967).

[108] *See* Miller, *supra* note 106, at 104. A "combined report" must be distinguished from a consolidated return, in that the latter disregards the separate corporate existence of members of the corporate group — a single return is filed for the group and a single tax is paid on the consolidated income. The function of the combined report, on the other hand, is to determine that proportion of the group's total income which each member earned, and upon which it must pay a tax to a given state. *See* Rudolph, *The Unitary Business Concept and Affiliated Corporate Groups*, 25 TAX L. REV. 171, 197 (1970).

[109] *See* Miller, *supra* note 106, at 120.

[110] UNIFORM DIVISION OF INCOME FOR TAX PURPOSES ACT [hereinafter cited as UNIFORM ACT]. The Uniform Act applies to the income of a *single* taxpayer which is apportioned according to the percentage of its properties, payrolls and sales in each state. *Id.* §§ 9–17.

[111] CAL. REV. & TAX CODE §§ 25,128–36 (West 1970).

[112] A state may violate due process if it adopts a formula for apportionment of income which is overinclusive of revenues not produced in the state. *See* Hans Rees' Sons v. North Carolina, 283 U.S. 123 (1931).

[113] *See* Miller, *supra* note 106, at 106; Rudolph, *supra* note 108, at 184.

tion, however, is unavoidably left to the discretion of the tax authorities,[114] who must be relied upon to resolve such diverse questions as whether a specific corporation, a particular asset, or a given salesman's salary should be included in the combined report.

The unitary entity approach has also been considered with respect to problems of deduction-shifting. It is clear that income taxes may be minimized by shifting income between controlled corporations through transfer pricing. Likewise, tax minimization may be achieved by misclassifying a single corporation's taxable income and deductions by geographical source to gain tax advantages which accrue to income earned from certain locations. For example, deducting from domestic source gross income expenses actually incurred to earn income from foreign sources may reduce one's effective worldwide tax rate, at the expense of U.S. revenues, by circumventing the foreign tax credit limitation.[115]

The Code deals with the latter form of tax avoidance in sections 861–63, the source-of-income provisions. Although sections 482 and 861–63 are addressed to different problems,[116] both are designed to prevent essentially similar manipulations of tax liability by reapportioning either income or expenses according to a rational and objective index of real economy activity.[117]

---

[114] *See* Miller, *supra* note 106, at 106–12. It has been suggested that under broad definitions of interdependence, any group of commonly-controlled corporations furnished with centralized management or with capital from an out-of-state parent could be deemed unitary. *See id.* at 106–07.

[115] A MNC which has paid foreign taxes in excess of the maximum creditable amount under INT. REV. CODE OF 1954, § 904 can in effect avoid the foreign tax credit limitation, and reduce its effective tax rate, by allocating as many deductions as possible against domestic source income, artificially increasing its proportion of foreign source net income. Under § 904, a larger proportion of foreign source net income enlarges the maximum foreign tax credit. *See also* Proposed Treas. Reg. § 1.861–8(f)(1), 38 Fed. Reg. 15,840 (1973) (other Code provisions affected by source-of-income distinction).

[116] Section 482 applies to the proper apportionment of income and deductions between two or more controlled entities in order to calculate the true taxable income of each. Sections 861–63, on the other hand, apply to the correct allocation by geographic source of a single entity's income and deductions.

In addition, many of the deduction-shifting problems arising under §§ 861–63, unlike the problems faced under § 482, do not necessarily depend upon the existence of common control over the foreign source of income. For example, misallocation of deductions to a taxpayer's foreign source income raises the maximum limitation on the foreign tax credit regardless of the identity of the foreign income source. Other deductions, however, such as those for subsidiary supervision expense, represent deductions which arise only in the context of affiliated groups.

[117] *See* Caplin, *Trading With Related Foreign Entities: Current American Tax Perspective*, 9 AKRON L. REV. 223, 239 (1975). The crucial factor in a § 482 case is the relative economic contribution to overall profits of each of the affiliates,

The section 482 regulation, however, has elected the separate entity theory for this purpose, while the recently proposed deduction allocation regulation under section 861 [118] has generally rejected the separate entity theory and opted for an approach much like the unitary entity theory.

A controversial question under sections 861–63 and the proposed regulation is the proper allocation of deductions for expenses that relate to production of income in two or more countries, or that are not otherwise definitely allocable to a single geographic source of income.[119] An example of this type of deduction is that taken for the general overhead or "stewardship" expense incurred by a MNC holding company to provide oversight for domestic and foreign affiliates in order to protect and enhance the parent's investment.[120] Since this overhead expense is factually related to the production of income from both foreign and domestic sources, part of the deduction should be taken against income earned from both sources.[121]

Under the Code interpretation embodied in the current regulation,[122] these expenses are apportioned to foreign and domestic source income in the ratio which gross foreign source income — dividends in the case of the holding company — bears to gross domestic source income.[123] This method views the parent and subsidiaries as separate entities for tax purposes: the parent's

and in a §§ 861–63 expense allocation case, the relative economic contribution of an expense to the creation of foreign and and domestic income.

[118] Proposed Treas. Reg. § 1.861–8, 38 Fed. Reg. 15,840 (1973).

[119] *See generally* NEW YORK STATE BAR ASS'N TAX SECTION, COMM. ON DEDUCTIONS FROM FOREIGN INCOME, PROPOSALS FOR IMPROVEMENT OF RULES FOR ALLOCATION OF DEDUCTIONS BETWEEN FOREIGN AND U.S.-SOURCE INCOME (1974), *reprinted in* 29 TAX L. REV. 597 (1974) [hereinafter cited as PROPOSALS FOR IMPROVEMENT]; Cole, *Highlights of the Proposed Regs on Allocation and Apportionment of Deductions*, 39 J. TAX. 272 (1973); Miller, Henderson & Jenks, *Methods of Allocating Deductions Between Foreign and U.S. Income — A Panel Discussion of Proposed Regulations Section 1.861–8, Issued on June 18, 1973*, N.Y.U. 32D INST. ON FED. TAX. 1733 (1974) [hereinafter cited as N.Y.U. 32D INST.].

[120] *See* N.Y.U. 32D INST., *supra* note 119, at 1751–52.

[121] *See* Proposed Treas. Reg. § 1.861–8, 38 Fed. Reg. 15,840 (1973); Cole, *supra* note 119, at 272. *But see* N.Y.U. 32D INST., *supra* note 119, at 1743.

[122] Treas. Reg. § 1.861–8, T.D. 6258, 1957–2 CUM. BULL. 375.

[123] *Id.* § 1.861–8(a). This method is known as "gross-to-gross" allocation. A parent's stewardship services, which duplicate services ordinarily performed by the subsidiary for itself, and are rendered primarily for the benefit of the parent, need not be reimbursed by the subsidiary under § 482. *See* Treas. Reg. § 1.482–2 (b)(2) (1968). Since there will be no income from services against which the parent can definitely allocate its stewardship expenses, they must be deducted against another type of income bearing a factual relationship to the stewardship expenditure, such as dividends from the subsidiary. *See, e.g.*, South Porto Rico Sugar Co. v. Commissioner, 2 T.C. 730 (1943) (predecessor statute and regulations).

tax liability is calculated on the basis of income as received, without any reference to the subsidiaries' net income or accounting records.

In 1973, a regulation was proposed that would drastically reduce the use of this method.[124] The proposed regulation requires allocation of such overhead expenses between foreign and domestic sources in the proportion which foreign gross profits, gross receipts or units sold by foreign subsidiaries receiving stewardship bear to the total gross profits, gross receipts or units sold by the parent and its subsidiaries combined.[125] This measure is superior on at least two counts. First, there is a closer factual relationship between stewardship expenses and the gross profits or number of units sold by the subsidiary than to the parent's gross foreign dividend income,[126] because the immediate purpose of stewardship is to increase the gross profits or sales of the subsidiary in the hope of making possible future dividends or capital appreciation.[127] Moreover, a subsidiary's gross profits or units sold are not as easily manipulated by the parent as the amount and timing of a subsidiary's dividend remittances.[128]

Thus, rather than viewing the parent apart from its subsidiaries, the proposed regulation requires an examination of the MNC as a whole and makes the parent's taxable income dependent upon the economic performance of its legally separate subsidiaries as measured by their gross receipts, gross profits or units sold.[129] In this sense, the approach of the regulation bears a close resemblance to the unitary entity theory.

---

[124] Proposed Treas. Reg. § 1.861-8, 38 Fed. Reg. 15,840 (1973); *see* N.Y.U. 32D INST., *supra* note 119, at 1738-43.

[125] Proposed Treas. Reg. § 1.861-8(g), ex. (8)(iii)-(iv), 38 Fed. Reg. 15,840 (1953). If time records are kept, it is permissible to allocate stewardship expense on the basis of the proportion of employees' time spent on foreign and domestic matters. *Id.*

[126] *See id.* ex. (8)(iii).

[127] *See* PROPOSALS FOR IMPROVEMENT, *supra* note 119, at 103-04, 29 TAX L. REV. at 680-81.

[128] *See id.*

[129] *See* N.Y.U. 32D INST., *supra* note 119, at 1757. This approach, called the "look-through" method because it is necessary to "look through" the separate corporate entity of each subsidiary to determine its gross sales or gross profits, is also used to allocate R & D and interest deductions. *See* Proposed Treas. Reg. § 1.861-8(c)(2)(v), (e)(3), 38 Fed. Reg. 15840 (1973). Allocation of overhead and stewardship deductions by the methods of the proposed regulation rather than by the old gross-to-gross method will usually result in greater amounts of expenses being allocated to the parent's foreign source income, which will decrease the size of the foreign tax credit limitation. Unless foreign governments allow the subsidiaries to deduct their share of the parent's stewardship expenses, to the extent that subsidiaries pay foreign taxes which are not creditable against the parent's tax liability because of the foreign tax credit limitation, the MNC's world-

B. *Critique*

The unitary entity theory has certain clear advantages over the separate entity approach now embodied in the section 482 regulations. Principal among these is its theoretical superiority as a means for ascertaining true income of various MNC components. Treatment of the MNC as a unitary entity reflects the fact that strong interdependence from common control may exist which renders unrealistic any analogy to a collection of unrelated, competitive companies.[130] Furthermore, the unitary entity theory does not create taxable income on the basis of intercompany transfers, since such transfers do not make the MNC as a whole better off until income is realized from ultimate sales to unrelated parties.[131] Finally, a unitary formula provides management with the flexibility necessary to make efficient use of transfer pricing for internal and external non-income tax purposes, thus avoiding the frustration of legitimate business behavior which may accompany application of the separate entity theory.[132]

Still, the fact that both the California system and the proposed deduction-shifting regulations have been severely criticized[133] suggests that, despite these advantages, the unitary approach has serious defects with respect to the other criteria. First, apportionment by means of a formula presumes that all capital or payroll expenditures, regardless of the type of business involved or its geographic location, are equally productive of profits.[134] Due to imperfect capital markets, risk differentials, and varying degrees of labor-capital intensity, this assumption is contrary to fact.

wide effective tax rate will increase in a manner much like double taxation; it is improbable that subsidiaries would be permitted to deduct non-reimbursable stewardship expenses incurred by their legally separate parent in another country. *See* PROPOSALS FOR IMPROVEMENT, *supra* note 119, at 13–18, 24–33, 29 TAX L. REV. at 611–15, 619–26.

[130] *See* p. 1215 *supra*.

[131] *See* notes 17 & 53 *supra*.

[132] *See* pp. 1216–19 *supra*. Businesses would be completely free to utilize non-arm's length pricing as long as the taxpayer's reported income comports with its proper share under the allocation formula.

[133] For criticisms of the California unitary system, *see* Miller, *supra* note 106; Peters, *supra* note 106, at 922–43. For criticisms of Proposed Treas. Reg. § 1.861–8 (1973), *see* PROPOSALS FOR IMPROVEMENT, *supra* note 119; N.Y.U. 32D INST., *supra* note 119. The Treasury Department has informally withdrawn the proposed section 861 regulations for reconsideration. *See* Internal Revenue Manual Supp. 42G–333 (Sept. 19, 1975) (I.R.S. agents advised not to rely on Proposed Treas. Reg. § 1.861–8, 38 Fed. Reg. 15,840 (1973) as a basis for making source-of-income adjustments).

[134] *See* Musgrave, *supra* note 11, at 400; H.R. REP. No. 1480, *supra* note 28, at 168.

One or more unitary entity formulas,[135] perhaps including a rate of return or risk variable,[136] would likely produce acceptable results in most situations. Where actual rates of return vary markedly from the norm, however, application of any formula will result in hardship cases for both taxpayers and the government.

A more serious problem, indeed the most difficult faced by California in implementing its state system, is that of developing objective standards, especially for diversified firms, to determine which components of a commonly-controlled business should be considered part of the same unitary business as that of the taxpayer.[137] While this determination must be made in part because California is subject to due process limitations not applicable to the federal government,[138] a definition of the unitary entity is a prerequisite to the application of any formula. One alternative — a very broad definition of the unitary enterprise [139] — creates a significant potential for misallocation, since the more attenuated the interdependence between the taxpayer and the income and assets of the rest of the affiliated group, the greater the risk of improperly allocating to a certain country income clearly earned in another.[140] Yet unless such a definition is adopted, one of the major advantages of the theory — administrability — is diminished. Thus, while the unitary entity theory has the great advantage of eliminating the need for taxpayers or tax authorities to locate comparable arm's length data for what may be thousands of intercompany transactions,[141] this advantage may be partially offset by the need to make difficult case-by-case determinations of the boundaries of the unitary business when compiling and audit-

[135] A different formula might be developed for labor-intensive or capital-intensive businesses, or for different industries. Formulation of administrable rules for determining which formula would be applicable to a particular taxpayer, however, might prove to be difficult.

[136] *See* note 45 *supra*. If available, interest rates might be an acceptable proxy variable for risk or rates of return on equity in different countries.

[137] *See* Miller, *supra* note 106, at 106–14 (present California standards so discretionary as to "virtually invite each tax jurisdiction to adopt whatever interpretation . . . maximize[s] its own revenues").

[138] *See* note 112 *supra*.

[139] *See* note 114 *supra*.

[140] *See* O.E.C.D. Working Party No. 6 of the Comm. on Fiscal Affairs, State Taxation of Interstate Commerce: Its Relevance to the International Taxation of Corporate Income 11 (Doc. DAF/CFA/74.1, Feb. 4, 1974) ("For example, if a firm manufactures items for sale in several states, but also owns a hotel in another state, part of the sales income would be assigned to the hotel state [because of hotel assets in that state] . . . ."). If certain types of income, such as non-manufacturing or passive investment income were excluded from the formula, the misallocation risk would be lessened. *Id.* at 12.

[141] *See* Miller, *supra* note 106, at 116.

ing each combined report.[142] Moreover, if a unitary entity formula were adopted requiring such case-by-case assessments under a subjective test of interdependence, its mandatory use would create serious uncertainties for taxpayers and would be subject to criticism for lack of fair notice.

Compliance and enforcement burdens may be further exacerbated because the taxpayer not only must file data concerning its own operations, but must include data concerning sales, payrolls and properties of legally separate corporations.[143] The costs to the taxpayer and government of obtaining and processing the data concerning a large MNC in order to determine the taxable income of one small part of the MNC may be excessive, especially when different accounting systems are used abroad. Moreover, there is some question as to whether the Service can compel an unwilling subsidiary to produce for inspection the business records of separately incorporated foreign affiliates of the MNC. Finally, there will be technical problems in assigning values to the formula variables and attributing property, sales or payrolls to the proper country.[144] The burdens of case-by-case appraisal of a company's assets, for example, would be fatal to the utility of a formula method. While it would be possible for the Treasury to specify mechanical rules for valuation or attribution, similar to those set forth in the Uniform Act,[145] such rules will fail, at least in some cases, adequately to reflect reality.[146]

Moreover, application of a formula in section 482 audits would not necessarily produce the same income division as transaction-by-transaction allocations made under the arm's length method, which is prevalent in most countries.[147] As a result, overlapping claims to portions of the same tax base will lead to double taxation unless the foreign government recognizes the legitimacy of the income reallocation imposed by the United States and allows the local taxpayer correlatively to reduce its income or its local tax liability.[148] There are, however, several reasons why a foreign country may be unwilling to permit such correlative

[142] *See id.* at 106–07, 112, 120.

[143] *See id.* at 112; N.Y.U. 32D INST., *supra* note 119, at 1758.

[144] *See* H.R. REP. No. 1480, *supra* note 28, at 523–29; O.E.C.D., *supra* note 140, at 13–18. For example, how are intangible assets to be valued? Should payrolls be allocated on the basis of the location where services were performed, or the domicile of the employer? Should tangible assets be valued at cost, cost-less-depreciation, fair market value or assessed value?

[145] *See* O.E.C.D., *supra* note 140, at 15–18 (discussing UNIFORM ACT §§ 9–17).

[146] *See id.* at 16.

[147] *See* p. 1216 & note 71 *supra*.

[148] *See* Surrey & Tillinghast, *supra* note 10, at I/14; *cf.* note 129 *supra* (effect on taxpayer when foreign tax rules are inconsistent with U.S. rules in Proposed Treas. Reg. § 1.861–8 situation).

adjustments of income. First, a country may reject any unitary formula on the grounds that an arm's length standard appears to have the virtue of objectivity and is thus less subject to governmental attempts unfairly to increase a country's tax base.[149] A foreign government may also question the composition of a formula unilaterally selected by the United States: a capital-poor country, for example, might not recognize the use of a formula that weighs the capital variable heavily.[150] Finally, in individual fact situations in which a country believes that it has a particularly strong claim to tax certain items of income, it may be unwilling to recognize the use of a formula that would allocate any portion of this income elsewhere.[151]

The risk of double taxation of foreign income under the unitary entity theory increases the cost of doing foreign business through entities subject to United States taxing jurisdiction and could serve to make American businesses uncompetitive with their non-American counterparts. In addition, if an allocation formula composed of property or payroll variables is adopted, United States tax liability could be reduced by shifting assets abroad and hiring foreign labor, raising the proportion of foreign factors in the formula, and reducing the U.S. share of the tax base.[152] These factors might provide significant incentives to move businesses outside the United States.

IV. Alternative Approaches

It is clear that neither the separate entity nor the unitary entity theory is without serious flaws, with the result that their application to any situation may not produce an outcome which is necessarily fair or accurate. Thus, even if one is willing to bear the costs of a separate entity approach — lack of administrability, lack of fair notice to the taxpayer, frustration of legitimate business behavior — it is far from certain that arm's length pricing will produce a theoretically correct measure of the true taxable income of affiliated corporations. The unitary entity approach, unlike the arm's length theory, may create serious problems of double taxation and geographic distortions, no matter

[149] *But see* p. 1220 & note 95 *supra* (difficulty of finding comparable data).

[150] *See* p. 1207 & notes 25–27 *supra*.

[151] For example, it may be viewed as inappropriate to apply formula apportionment to a company's income earned from sales of certain food products manufactured and marketed only in one country if part of the income is allocated to another commonly controlled entity in the lead smelting business having no visible connection with the manufacture or sale of foodstuffs.

[152] There will be no shifting of business unless sufficiently lower effective tax rates are obtainable overseas so as to outweigh the disadvantages or extra costs of foreign operation, which are probably not insubstantial.

how accurate its result. Moreover, two of the critical advantages of the unitary theory — greater administrability and fair notice — may be realized only if potentially more accurate case-by-case determinations are in large part abandoned. While carefully considered regulations might cure some of the problems of a unitary entity aproach,[153] it is not at all clear that on balance, the unitary entity theory as it now stands presents a more acceptable solution to the difficulties of section 482 reallocations than does the separate entity theory. The underlying problem seems to be that in large part, neither theory accurately reflects the way in which MNC's actually operate and produce income. Rather than addressing this basic issue, however, most commentators have suggested various adjustments in the current system or the addition of optional safe-havens as an alternative to the section 482 regulation's pricing tests.

Several commentators have suggested that the rigid priorities between the three pricing tests specified by the current regulations be loosened to allow taxpayers to establish the propriety of their pricing with greater ease and at a lower cost.[154] Although the priorities were established on the basis of their supposed relative accuracy in determining a true arm's length price,[155] these commentators have recognized that the difficulty of data comparability and other questions renders the evidentiary advantages of one measure over another largely nonexistent.[156] Nevertheless, to alter the priorities while preserving the reliance solely on arm's length data does not solve the problem of how to proceed when there is little or no comparable evidence available for use under any of the methods. Focusing on the price variable is also inconsistent with the preservation of maximum freedom to set intercompany prices to take account of non-income tax considerations, and ignores the economic arguments against the appropriateness of arm's length pricing between related entities.

Other commentators have suggested the use of a "reasonableness" test, at least in those cases where the taxpayer in good faith is unable to obtain evidence of arm's length pricing.[157] Under this test, no section 482 allocation would be made if the taxpayer's transfer pricing or profit split is fair and reasonable under the

---

[153] *See* p. 1230 & note 145 *supra* (problems of asset valuation and attribution of assets, payrolls and sales partly solved by UNIFORM ACT §§ 9–17).

[154] *See, e.g.*, Cole, U.S.A.: Progress Report on Taxation of Foreign Source Income, 36 BULL. FOR INT'L FISCAL DOC. 54, 55 (1972); Kauder, *supra* note 36, at 28.

[155] *See* Treas. Reg. § 1.482–2(e)(1)(ii) (1968).

[156] *See* Cole, *supra* note 154, at 55.

[157] *See* Mihaly, *supra* note 94, at 750–51.

circumstances.[158] While the reasonableness test might be supplemented by a list of factors to be considered by a judge in reaching his decision,[159] the test would necessarily remain vague, and would provide little guidance or notice to those taxpayers who commonly engage in intercompany transactions for which it is impractical to find arm's length price data.

Indeed, the need for certainty and ease in administration has led many commentators to suggest that a mechanical test or "safe-haven" be established for judging the validity of intercompany transfer pricing, thus extending to tangible goods the safe-haven approach now embodied in the section 482 regulations with respect to loans, services and rentals.[160] One proposed safe-haven would immunize all transfers for which the price charged is equal to cost plus a certain percentage [161] — for example, cost plus ten percent. Although such a test could be easily applied, it will often produce unfair results due to the tremendous variation in rates of return in different markets and between different firms in a given market. In addition, this proposed safe-haven might distort legitimate business behavior, since IRS reliance on a certain measure of transfer pricing is likely to induce businesses to adopt that measure for all purposes, even though another pricing system may be more appropriate for internal use.

Two safe-havens focusing on profits have also been suggested by the commentators. While the first — the establishment of a standard acceptable profit split between parent and subsidiary such as 50%–50% or 75%–25% [162] — finds some support in the case law [163] and in other Code sections or Treasury regulations,[164]

---

[158] A number of decisions have rested on these grounds. *See, e.g.*, cases cited note 39 *supra* (reasonableness of pricing); PPG Industries, Inc., 55 T.C. 928, 997 (1970) (reasonableness of profit split) (alternative ground).

[159] *See* Mihaly, *supra* note 94, at 750–51.

[160] Treas. Reg. § 1.482–2(a) to (c) (1968).

[161] *See, e.g.*, Bischel, *supra* note 32, at 511 n.116.

[162] *See* Kauder, *supra* note 36, at 30; N.Y.U. 30TH INST., *supra* note 59, at 1438.

[163] Profit splits of close to 50%–50% were upheld in PPG Industries, Inc., 55 T.C. 928 (1970), and in the Tax Court opinion in Lufkin Foundry & Mach. Co., 30 CCH Tax Ct. Mem. 400 (1971), *rev'd*, 468 F.2d 805 (5th Cir. 1972).

[164] The DISC legislation, INT. REV. CODE OF 1954, § 994 prescribes what is in effect a safe-haven profit split of 50%–50% between the parent and the DISC subsidary. In addition, Treas. Reg. § 1.863–3(b)(2), ex. 2(ii) (1957) provides a formula producing a 50%–50% split between foreign and domestic source income earned by a single taxpayer whose entire manufacturing operation is located in one country and whose entire sales are made in another. The formula is used only when arm's length pricing data is unavailable. This regulation and the DISC precedent, however, are readily distinguishable as ad hoc formulas applicable to cases in which arms length dealing is impossible or is not deemed essential. *Cf.*

its failure to take into account particular industry and market characteristics renders its results as arbitrary and unfair as those reached under a cost-plus safe-haven. The second proposal would establish a safe-haven based on the average gross profit percentage earned by manufacturing firms in the same industry and country as the taxpayer.[165] While this approach, unlike the cost-plus or profit split safe-havens, controls for differences between industries, to the extent that significant variations exist between firms in a single industry, inaccurate results will remain a problem. Moreover, only those firms whose profits are above the industry average will avail themselves of the safe-haven rule, thus denying to all the less profitable firms the freedom and certainty of the safe-haven option.

The fact that none of these proposals is without serious defects demonstrates again the complexities involved in deriving a single, generally applicable rule for allocating the income of MNC's which in their structure and operation may bear little similarity to one another.[166] Some account must be taken of this lack of similarity if income is to be allocated according to where and how it is actually produced. An approach combining the unitary and separate entity theories might, however, be fashioned in such a way as to recognize MNC diversity. Under a combination approach, when certain MNC components do in fact behave in the manner of separate corporations, the separate entity theory would be applied to them, since it is unlikely to frustrate legitimate business activities or to misallocate income severely. Other portions of a MNC which are highly integrated or interdependent operations, on the other hand, would be better treated under a unitary entity formula.

Initially, it should be recognized that such a solution, although ideal in some senses, ignores the problems of double taxation which may accompany application of the unitary approach. More basically, the determination of which components and MNC's should be treated as unitary constitutes a substantial obstacle to the application of any unitary formula. That this question is not easily resolved, however, should not deter further investigation into means by which the two theories could be optimally combined so that they would accurately suit the particular MNC and thereby serve the interests of both the taxpayer and the government.

California has recognized the need to delimit the portion of

Kauder, *supra* note 36, at 30 (DISC standard included by Congress as special incentive).

[165] *See* ABA Draft Proposed Text — Safe Haven from Manufacturer's Cost, *reprinted in* W. GIFFORD, INTERNATIONAL TAX PLANNING 158–59 (1974).

[166] *See generally* Vagts, *supra* note 6, at 751–53.

a commonly-controlled group which is viewed as unitary business, applying its formula approach only to affiliates that are interdependent with the local taxpayer. Although this approach is conceptually correct, California has failed to develop an objective measure of interdependency, which is critical to any widespread application of this theory.[167] Such a measure could be developed by examining the techniques which are presently in use for "line-of-business" or "segmented" financial reporting, which the SEC has since 1969 required of publicly owned companies engaged in more than one line of business,[168] and which has come into widespread use in annual reports to shareholders.[169]

Conceptually, one would begin to define a unitary business by dividing the MNC along its lines of business. Those portions of a MNC engaging in the same line of business, either entire subsidiary corporations or subunits of corporations, would be included within the scope of a unitary entity whose income would be apportioned according to a formula. Current SEC practice permits management to define the scope of a corporation's various lines of business for financial reporting purposes, but allowing this freedom may not be satisfactory for tax purposes because of the taxpayer's lack of objectivity and the risk of manipulation of tax liabilities by clever grouping of products into lines of business.[170] A better solution would be to require that lines of business be classified according to an objective, uniform system based on industry or product characteristics, such as the Standard Industrial Classification (SIC) Code at the three or four digit industry level, or on the modified SIC Code which has been adopted by the FTC as part of its Annual Line of Business Report Program.[171] Although the SIC and FTC Codes attempt, sometimes imperfectly, to define industries on the basis of such factors as type of activity, economic meaning and competitive sig-

[167] *See* pp. 1224-25 & notes 113-14, 137 *supra*.

[168] *See generally* L. RAPPAPORT, SEC ACCOUNTING PRACTICE AND PROCEDURE 23-1 to 23-26 (3d ed. 1972).

[169] *See* BUS. WEEK, April 26, 1976, at 78.

[170] *Cf.* L. RAPPAPORT, *supra* note 168, at 23-14 to 23-15 (lack of objectivity in financial reporting). It might be possible to allow a taxpayer to define its lines of business and to file proposed classifications which, if approved, would be binding for future years absent material changes. This course would eliminate the risk of manipulation arising from the frequent redefinition of business segments, and would have the further advantage of allowing the taxpayer to use much of the data already collected for SEC financial reporting purposes.

[171] *See generally* Mellman, *Classifying Segments for Line-of-Business Reporting*, C.P.A.J., Aug. 1974, at 17. SIC industry classifications at the three digit level roughly represent broad industry groups or lines of businesses, whereas four digit classifications are more narrowly defined, corresponding to product lines. *Id.* at 20.

nificance,[172] at the three or four digit level, industry classifications are broadly drawn. However, since there is reason to believe that many MNC's are at least partially integrated,[173] error on the side of overinclusion is not indefensible. Accordingly, a rather broad definition of a line of business which sweeps in all parts of the MNC which are at least arguably interdependent ought to be adopted.

The next step would be to include within the scope of each unitary business all components of the MNC classifiable under another SIC or FTC Code industry, which either (1) supply all or a certain percentage of their output to another component already included within the unitary business,[174] or (2) purchase at least a certain percentage of the output of the unitary business. The purpose of this procedure would be to include segments of the MNC having strong interdependencies in fact although they are in seemingly different businesses, and to isolate those portions of the MNC which because of the quantitative significance of their intercompany transactions could have engaged in significant income shifting.

While the accounting problems of calculating MNC net income and allocating income, assets, and common costs by separate lines of business may be complex,[175] the fact that the SEC presently insists on such data for financial reporting purposes provides substantial impetus for the Financial Accounting Standards Board and others to develop adequate accounting guidelines. Furthermore, the burdens of line-of-business accounting may be lessened to the extent that many, if not most, diversified firms routinely collect for internal purposes line-of-business data,[176] or are internally organized in such a way that line-of-business accounting would be compatible with their corporate structures.[177] A modified line-of-business approach ought to be closely examined as a potential solution to the difficulties which have been unsuccessfully resolved by California in the state taxation context.

Still, it would be unrealistic to expect that these standards will provide the basis for an immediate and wholesale replacement of the separate entity approach as currently applied to integrated businesses. In the short run, consideration might be given to the

---

[172] *See id.* at 20, 22. The SIC system has various defects, and has been criticized as a basis for line-of-business reporting. *See id.* at 208 & n.11.

[173] *See* Vagts, *supra* note 6, at 751–53.

[174] *See* Mellman, *supra* note 171, at 21.

[175] *See* L. RAPPAPORT, *supra* note 168, at 23–7. *But see* Shank, *Case of the Disclosure Debate*, HARV. BUS. REV., Jan.–Feb. 1972, at 142, 156.

[176] *See* Shank, *supra* note 175, at 156.

[177] *See* Mellman, *supra* note 171, at 21.

adoption of a unitary formula method as an optional safe-haven;[178] indeed, an American Bar Association committee has made a similar suggestion.[179] The separate entity theory would remain available to the taxpayer whenever the formula might produce severe misallocations of income or result in excessive double taxation.[180] Such an option would have a number of advantages. First, it would provide an opportunity for testing and developing the potential of the unitary approach. Moreover, since it is clear from earlier discussion that application of the separate entity theory to certain MNC's is not only administratively unworkable and a source of frustration of business activity, but also economically unjustifiable, provision of an option which will, at least in some cases, produce more satisfactory results is a desirable end in itself.

Against these advantages, it might be argued that taxpayers would elect to use such a safe-haven only when it produces less United States taxable income than the pricing tests set forth in the present regulation. There are several answers to this objection. First, if the amount of taxable income currently generated under the arm's length standard does not reflect the theoretically correct distribution of the global MNC tax base, allowing the taxpayer

[178] Before this option could be implemented important preliminary determinations would have to be made, such as the variables to be included in the formula and their weights, *see* H.R. REP. No. 1480, *supra* note 28, at 529–37, the types of income which will or will not be allocable by the formula, the method of allocating deductions to the components of the unitary business, *see* O.E.C.D., *supra* note 140, at 11, 19, and whether taxpayers must file the data required by the formula as a matter of course or only when a § 482 allocation is proposed.

[179] *See* ABA Draft Proposed Text — Safe Haven from Profit Split, *reprinted in* W. GIFFORD, *supra* note 165, at 157–58. Under this proposal, the combined net income of a manufacturing-distribution group of affiliates would be apportioned according to the share of the direct selling and manufacturing costs incurred by each taxable entity. While noteworthy for taking a unitary entity approach, the particular mechanics of the proposal are unsatisfactory. Apportionment of income on the basis of expenses incurred implicitly assumes that each dollar of expense ought to produce equal profits, which will not be true because differences in risk and in the amounts of capital utilized by each of the affiliates merit different rates of return. A formula including a capital variable together with a risk factor might alleviate these problems. Further difficulties with a formula based on expenses are that it would discriminate against highly profitable, efficient operations in favor of their more inefficient counterparts, whose higher costs would cause greater profits to be allocated to them. The formula also fails to recognize consummation of sales within a country's borders as a basis for an entitlement to tax.

[180] If all nations were to adopt a single unitary entity formula as the exclusive method for allocating income, or if the United States adopted the formula and negotiated for its inclusion in tax treaties, the threat of double taxation would be minimized. At least one commentator has suggested this course of action. *See* Kust, *A Reappraisal of Taxation of International Business Income*, NAT'L TAX ASS'N 56TH ANN. CONF. PROCEEDINGS 154, 164–66 (1966).

to reduce its tax liability on the basis of a more accurate calculation of income is not unfair. Revenue losses may be made up in more economically justifiable ways, such as raising corporate tax rates. Furthermore, in choosing a particular formula, the government presumably will compare expected lost revenues with the projected administrative savings of the safe-haven in order to strike an acceptable balance; if the safe-haven rule is properly formulated, the time and money formerly expended by revenue agents reviewing transfer prices in section 482 audits could be redirected to other types of audits, thus decreasing the amount of net revenue loss. It is also possible, at least for those taxpayers either facing large amounts of uncertainty under the present regulations or desiring greater flexibility in transfer pricing in order to achieve non-income tax-oriented goals, that the safe-haven would be elected even at some additional tax cost. Finally, to the extent that the safe-haven allows greater MNC efficiency and profitability, long run tax revenues for the United States may in fact increase.

V. Conclusion

The use of the arm's length standard of the current section 482 regulations has been accompanied by serious problems most clearly evidenced by the suprisingly frequent reliance of revenue agents and courts on ad hoc fourth method approaches, based not on the theory of the regulation, but on the unitary entity theory. While the unitary entity theory itself is not free from difficulty, it has sufficient theoretical appeal that it deserves serious consideration as a formalized alternative to current practice. At least in the short run, such consideration may take the form of its adoption as an optional safe-haven rule.

EXHIBIT 16

United States Steel Corporation et al. v. Multistate Tax Commission et al 434 U.S. 452, 54 L.Ed.2d 689, (1978).

Appellants, multistate taxpayers, disputed the constitutionality of the Multistate Compact on three grounds. Their first and primary argument was that the Compact Clause of the U.S. Constitution had been violated since the states had entered into an agreement among themselves without first obtaining the consent of Congress. Second, they contended that the Compact impermissably encroached on congressional power in violation of the Commerce Clause. Third, the Supreme Court was asked to rule that the Compact operated in violation of the Fourteenth Amendment.

In its decision, the Supreme Court held the Compact Clause to be limited to agreements that "are directed to the formation of any combination tending to increase the political power in the states, which may encroach upon or interfere with the just supremacy of the United States." In relation to the MTC, the court examined the impact of the state agreement on the federal structure as a whole and found that it did not authorize member states to exercise any powers which they could not exercise in its absence. Also, the court determined that the multilateral nature of the state compact and its creation of an administrative arm did not provide an actual or potential threat to federal supremacy in violation of the constitution.

Finally, with regard to the challenge to the validity of the MTC under the Commerce Clause and Fourteenth Amendment, the court found appellants' factual allegations of harassment to be irrelevant to the facial validity of the state agreement.

The case is important because it upheld the validity of the Multistate Tax Compact and the Multistate Tax Commission.

EXHIBIT 16

Moorman Manufacturing Company v. Bair

437 U.S. 267, 57 L.Ed.2d 197, (1978).

Appellant, an Illinois corporation, challenged Iowa's use of a single-factor formula, based on gross sales, to apportion the income of corporations engaged in interstate business as violative of either the Due Process Clause or the Commerce Clause of the U.S. Constitution.

The taxpayer's due process claims were rejected. The court held that states have a wide latitude on the selection of apportionment formulas, including those with a single factor. Therefore, Iowa's formula could be held invalid only if the taxpayer produced clear and cogent evidence that the income attributed to Iowa by it was not proportionate to the business transacted in that state or that it lead to a grossly distorted result.

The taxpayer also contended that the Commerce Clause was violated because duplicative taxation of the same income by Illinois and Iowa resulted from the latter's use of the single factor formula. This contention was dismissed as speculative. The taxpayer failed to present evidence as to which portion of its net income was derived from Iowa sales and what percentages of its net income were taxed by states other than Iowa in which it did business. Even assuming some duplication of taxation, to invalidate Iowa's formula would require a holding that the Commerce Clause prohibited any overlapping taxation of interstate business. Such a decision would necessitate national uniform rules for income apportionment since any diversity in the taxation systems of the states creates a risk of overlapping taxation. Accordingly, the power to prescribe national uniform rules had been granted by the Constitution to Congress and not to the Supreme Court.

The case has created more confusion than provided guidance since it seems to endorse virtually any state tax scheme. The Court's decision is being used as a rally point by opponents of the unitary method.

Japan Line, Ltd. et al. v. County of Los Angeles et al.

___U.S.____, 60 L.Ed.2d 336, ___S.Ct.____, (1979)

The Supreme Court invalidated a nondiscriminatory *ad valorem* property tax on foreign owned instrumentalities (cargo containers) of international commerce. The court distinguished between interstate and foreign commerce and held that a tax involving the latter must not only meet the four tests developed in *Complete Auto Transit* (substantial nexus, nondiscriminatory, fairly apportioned and fairly related to the services provided) but must also meet two additional tests. The tax must not pose any risk of subjecting foreign commerce to multiple taxation, which is forbidden by the Commerce Clause, and the tax must not impair the federal government's ability to "speak with one voice" when regulating commerce with foreign governments.

Los Angeles' tax was impermissable under either of the additional tests. Since Japan taxed the containers in full, Los Angeles' tax created the actuality of multiple taxation. Also, the tax prevented the United States from "speaking with one voice" regarding foreign trade by creating a risk that Japan would retaliate by taxing American-owned containers. Such action would contrevene the uniform treatment of containers used exclusively in foreign commerce, which was achieved by the U.S. and Japan in the Customs Convention on Containers. Also, nonuniform multiple taxation could result if other states adopted taxes similar to Los Angeles' tax. Containers would be subject to different taxes, depending upon which American port they entered. This would further undermine the U.S.'s ability to "speak with one voice."

The Court's decision was narrowly drawn to answer specific questions. Many will, and have, argued that the language utilized by the Court is equally applicable to the unitary method. The department believes the case is readily distinguishable. The Court's decision is difficult to

extend to the income tax area because of the Court's decision not to rule on whether (1) the mere risk of multiple taxation is sufficient to void the tax, (2) domestic corporations engaged in foreign commerce or foreign corporations engaged in interstate commerce,and (3) the fact the Court did not overrule Bass, Ratcliff & Gretton (Exhibit 19).

Mobil Oil Corporation v. Vermont Commissioner of Taxes ____ Vt ____
Vermont Supreme Court, November 9, 1978. Probable jurisdiction has been noted by the U.S. Supreme Court.

The taxpayer protested the imposition of the Vermont corporation income tax on an apportioned share of investment income (dividends from subsidiaries and interest income). The taxpayer contended that the tax placed an undue bruden on interstate commerce because its commercial domicile could choose to tax all investment income without apportionment.

The court rejected this argument and held that the risk of multiple taxation was insufficient to invalidate the tax. If such a conflict actually arose, the commercial domicile may have to yield. Moreover, since the Vermont tax was not inherently burdensome, the mere possibility of multiple taxation was not enough to void the tax on Commerce Clause grounds.

If the Supreme Court rules on this case they may indicate the impact which they attach to their language in Japan Line Ltd. In any event the case may establish an important precedent in the area of the taxation of business - nonbusiness income.

Montana Department of Revenue v. The American Smelting and Refining Co. ____ Mt ____ Pac.2d ____ (1977).

The issues raised by the taxpayer were: (1) whether DOR had properly classified certain income as business income, and (2) whether six subsidiaries, three of which engaged almost exclusively in foreign commerce were unitary with ASARCO.

The Court sustained DOR on both issues. Business income is defined by the statute and the regulations and it is to be accounted for separately only if it can be properly segregated from other income. Since the income involved was derived from sources which were an integral part of the taxpayer's business it is business income and cannot be segregated and accounted for separately. The subsidiaries involved were clearly unitary because they were dependent upon or contributed to the overall business.

This case is the first recognition by the Montana Supreme Court of the unitary concept.

American Smelting and Refining Co. v. Idaho State Tax Commission, 99 Id ____ Pac.2d ____ (1979).

The principal issue involved was the classification of various dividend income as business income by the state.

The court made a detailed analysis of each item of income and its relationship to the taxpayer's business activities in classifying the income as business or nonbusiness.

This case resulted from the same audit by the Multistate Tax Commission which gave rise to the Montana decision. It should be noted that the taxpayer did not contest the unitary nature of the subsidiaries raised in the Montana case.

The court's thorough discussion of the relationship of each dividend paying entity to the taxpayer clearly draws the distinction between business and nonbusiness income.

EXHIBIT 17

CASES INVOLVING THE UNITARY CONCEPT

TO WHICH CALIFORNIA IS A PARTY

PENDING COURT CASES

State Courts

Taxpayer	Years	Amount
Alcan Aluminum Corporation	1965 - 1971	$ 1,720,615
The Anaconda Company	1955 - 1969	3,423,349
Anderson, Clayton & Co.	1964 - 1968	753,293
Arkla Industries, Inc.	1968 - 1969	9,162
Asarco, Inc.	1965	58,439
Beecham, Inc.	1968 - 1970	74,620
Bekins Company	1970 - 1972	64,990
Borden, Inc.	1970	193,110
Campbell Taggart, Inc.	1970 - 1972	323,640
Clipper Exxpress	1965 - 1967	14,030
Container Corporation of America	1963 - 1965	127,071
Eltra Corporation	1963	91,025
Ferro Corporation	1962 - 1971	194,575
The Firestone Tire & Rubber Co.	1960 - 1963	1,541,442
F. W. Woolworth Co.	1961 - 1964	182,265
Gulf Oil Corp.	1966 - 1974	26,421,756
Hoffman-La Roche, Inc.	1967 - 1969	251,798
Kimberly-Clark Corporation	1962 - 1968	347,509
Martin Brothers Container and Timber Products Corp.	1969 - 1975	216,754
Mishawaka, Uniroyal	1962 - 1966	378,584

EXHIBIT

State Courts

Taxpayer	Years	Amount
Mobil Oil Corporation	1967 - 1971	$ 12,612,463
National Semiconductor Corp.	1972	40,727
Salinas Newspapers, Inc.	1970 - 1973	22,490
Sears Roebuck & Co.	1968 - 1973	4,851,768
Stockton Newspaper	1970 - 1973	594,438
Stride Rite Retail Corp.	1972 - 1974	180,598
Technibilt Corp.	1969 - 1970	77,433
Times Mirror Co.	1969	270,897
United States Steel Corporation	1956 - 1966	4,320,652
Volvo Western Distributing	1967 - 1968	156,283
Whirlpool Corporation	1970	89,350
Whitney Research Tool Co.	1967 - 1973	76,060

Federal Courts

Taxpayer	Years	Amount
Capitol Industries - EMI		Injunction

EXHIBIT 18

[Civ. Nos. 52977, 53695. Second Dist., Div. Three. Oct. 25, 1978.]

ZEE TOYS, INC., et al., Plaintiffs and Respondents, v.
COUNTY OF LOS ANGELES et al., Defendants and Appellants.

[Civ. No. 53306. Second Dist., Div. Three. Oct. 25, 1978.]

SEARS, ROEBUCK & COMPANY, Plaintiff and Respondent, v.
COUNTY OF LOS ANGELES et al., Defendants and Appellants.

SUMMARY

Plaintiffs brought an action against a county seeking refunds of ad valorem taxes paid under protest. The tax was levied on tangible personal property in the possession of plaintiffs stored in warehouses. The property had been manufactured outside the United States and brought into the state by plaintiffs as importers. Plaintiffs claimed an exemption from taxation for a percentage of the imported goods in their possession pursuant to Rev. & Tax. Code, § 225, exempting from taxation personal property manufactured or produced outside the United States and brought into the state for transshipment out of the state for sale in the ordinary course of trade or business. The trial court granted plaintiffs' motions for summary judgment, and judgments were entered for refunds for the amount of plaintiffs' claims. (Superior Court of Los Angeles County, Nos. C179151 and C191156, Jack T. Ryburn and Campbell M. Lucas, Judges.)

The Court of Appeal reversed and remanded with directions to enter judgments in favor of defendants. The court held the selective exemption of goods of foreign origin, thereby giving them a competitive advantage over interstate goods, was a regulation of interstate and foreign commerce in violation of the commerce clause of the United States Constitution, and was therefore invalid. The court further held defendants had standing to raise the constitutional objection, and the proper remedy was to invalidate the exemption, not extend it to interstate goods. The court also held the statute could not be interpreted to avoid constitutional objections, in view of its unequivocal language. (Opinion by Potter, Acting P. J., with Cobey and Allport, JJ., concurring.)

EXHIBIT 18

HEADNOTES

Classified to California Digest of Official Reports, 3d Series

(1) **Property Taxes § 19—Provisions Granting or Relating to Exemptions—Imported Goods.**—Under Rev. & Tax. Code, §§ 225 and 225.1, exempting from taxation personal property manufactured or produced outside the United States and brought into the state for transshipment out of the state for sale in the ordinary course of trade or business, property imported by plaintiffs and stored in their warehouses for transshipment out of the state was exempt. It was not necessary that the property be "in transit" through the state as that term is used in existing commerce clause law, which exempts interstate and foreign goods "in transit."

(2a, 2b) **Commerce § 4—State Regulation and Taxation of Foreign Commerce—Imported Goods—Tax Exemption—Invalidity.**—Rev. & Tax. Code, § 225, exempting from ad valorem taxation goods imported from a foreign country that are held for further transport outside the state, violates the commerce clause of the United States Constitution. Goods manufactured in a foreign country and imported into the state are constitutionally subject to ad valorem taxes under like conditions as the same goods manufactured in another state and brought to this state. Thus, the exemption statute accords different tax treatment to goods solely on the basis or their place of origin, and foreign goods are thereby given a competitive advantage over interstate goods of the same nature and competing in the same market. Discriminatory tax burdens which favor one class of commerce, subject to the control of Congress, over another such class, are equally prohibited. The imposition of discriminatory burdens is not saved by the fact that they are imposed after the interstate or foreign goods have become incorporated into the mass of property of the state. The fact there may be rational grounds for the state to exempt imported goods destined for transshipment to another state, which do not apply to interstate goods in the same category, cannot validate the exemption.

[See **Cal.Jur.3d**, Constitutional Law, § 216 et seq.; **Am.Jur.2d**, Commerce, § 95.]

(3) **Commerce § 1—Federal Regulations.**—The power to regulate commerce with foreign nations is an express grant by the People to the

federal government. It is an essential attribute of the power that it is exclusive and plenary. As an exclusive power, its exercise may not be limited, qualified or impeded to any extent by state action. The power is buttressed by the express provision of the Constitution denying to the states authority to lay imposts or duties on imports or exports without the consent of the Congress. The Congress may determine what articles may be imported into the country and the terms on which importation is permitted. To regulate commerce is to prescribe the conditions on which it shall be conducted, to determine how far it shall be free and untrammeled, how far it shall be burdened by duties and imposts, and how far it shall be prohibited.

(4a, 4b) **Property Taxes § 63—Collection and Payment—Actions to Recover Taxes—Unconstitutionality of Exemption—Standing of City and County to Raise Issue.**—In an action by taxpayers against cities and a county to recover property taxes paid on foreign goods imported into the state and held for transshipment outside of the state, defendants had standing to raise the issue that Rev. & Tax. Code, §§ 225 and 225.1, exempting such goods from ad valorem taxation, were unconstitutional under the commerce clause. The conflict between the duties of the board of supervisors under the Constitution of the United States and those which were imposed by exemption statutes justified the assertion of the constitutional claims by the county, where the propriety of the refusal to order a refund depended on the constitutionality of the exemption. Moreover, defendants, as local agencies largely dependent on ad valorem taxation to provide funds for necessary local services, had reason to vigorously present the constitutional questions, and the supervisors, who controlled the county's conduct of the litigation, had a significant personal stake in the outcome of the litigation to resolve the conflict between their duties under the United States Constitution and the duties of their office.

(5) **Taxpayers' Actions § 6—Recovery of Taxes Paid—Action at Law.**—The existence of an action at law to recover a tax refund precludes resort to an extraordinary writ to attack the alleged illegal or erroneous levy of a tax.

(6) **Property Taxes § 19—Provisions Granting or Relating to Exemptions—Imported Goods—Remedy for Invalid Exemption.**—Plaintiffs were not entitled to a refund of taxes paid, where the basis for their claim was Rev. & Tax. Code, § 225, providing an exemption for

property imported from a foreign country and brought into the state for transshipment out of the state, but where the exemption was invalid under the commerce clause of the United States Constitution by discriminating against goods originating in interstate commerce. The constitutional conflict with the commerce clause could not be overcome by judicially broadening the exemption to include interstate goods; there was no reasonable basis for the assumption that the Legislature would prefer extending the exemption, and any judicial attempt to broaden the exemption would violate the requirement of Cal. Const., art. XIII, § 2, that the creation of exemptions be approved by a vote of two-thirds of the Legislature.

COUNSEL

John H. Larson, County Counsel, and James Dexter Clark, Deputy County Counsel, for Defendants and Appellants.

Baker, Ancel & Redmond, Gerald T. Manpearl, Thomas C. Corcovelos, Loeb & Loeb, Frank M. Keesling, Andrew S. Garb and Thomas W. Henning for Plaintiffs and Respondents.

OPINION

POTTER, Acting P. J.—These consolidated appeals are from summary judgments in two superior court actions which grant plaintiffs Zee Toys, Inc., and Formosa Plastics Group (U.S.A.), Inc. (Sup. Ct. No. C 179151) and Sears, Roebuck and Co. (Sup.Ct. No. C 191156) refunds of ad valorem taxes paid under protest. In the Zee case, the taxes had been collected for the benefit of defendants County of Los Angeles and City of Long Beach; in the Sears case, the taxes had been collected for the benefit of defendants County of Los Angeles and City of Compton, the city in each case being the situs of the goods taxed.

In both cases, the tax involved was ad valorem taxation levied upon tangible personal property in the possession of plaintiffs stored in warehouses in Los Angeles County on the tax lien dates. Such property had been manufactured outside the United States and brought to this state by the plaintiffs as importers.

The plaintiffs in both actions claimed an exemption from taxation for a percentage of such imported goods in their possession based upon the provisions of Revenue and Taxation Code sections 225 and 225.1. As then in effect, said sections read:

"Personal property manufactured or produced, (1) outside this state and brought into this state for transshipment out of the United States, or (2) outside of the United States and brought into this state for transshipment out of this state, for sale in the ordinary course of trade or business shall be exempt from taxation. The exemption under this section shall not apply to personal property in manufacturing process or production. Such process or production shall not include the breaking in bulk, labeling, packaging, relabeling, or repackaging of such property." (Rev. & Tax. Code, § 225.)

"A person claiming an exemption under Section 225 may either claim this exemption by (1) a percentage method of determining property held for transshipment on hand at a particular location by allocating a portion of the total inventory, using the percentage determined by dividing the total out-of-state shipments by the taxpayer from that location during the preceding year by the total of such shipments from that location during such year, or (2) an actual method as evidenced by contracts of sale on the tax lien date, and a full, true and correct inventory of all property held for transshipment together with the date of receipt of the same, the date of withdrawal of the same, the point of origin thereof, and the point of ultimate destination thereof." (Rev. & Tax. Code, § 225.1.)[1]

The facts bearing upon the exempt status of the property were not in dispute. In the Zee case, the declarations showed that the plaintiffs were wholesale importers and distributors of goods manufactured outside the United States and distributed throughout the United States. Upon importation the goods were unloaded from the means of transportation at the plaintiffs' warehouses. They were then sorted by type and stored as inventory awaiting sale to plaintiffs' wholesale customers. Such inventory was normally "turned over" or replaced four to five times per year. While the goods were so stored, ad valorem property taxes were levied by defendants. Zee claimed that 90 percent of the inventory taxed was exempt and showed by uncontradicted declarations that during the year preceding the lien date, 90 percent of Zee's total shipments from the warehouses were to customers located outside of the State of California

[1]The same provisions are now incorporated in Revenue and Taxation Code section 253.10, which was added by Statutes of 1977, chapter 246, section 7.

and 10 percent of such shipments were to customers located inside the State of California. Comparable percentages for Formosa were 63 percent of total shipments to customers located outside the State of California and 37 percent to customers located inside the state. In both instances, the declarations showed that none of the property was "in a manufacturing process or production."

Both Zee and Formosa filed claims for exemption which were denied. Thereafter they paid the taxes under protest and exhausted their administrative remedies before bringing suit. A declaration filed in behalf of defendants stated, without contradiction, that "there is a flow of traffic of substantial proportions by which goods arrive in California from other states for distribution throughout the United States or throughout various regions of the United States."

There was a stipulation of facts in the Sears case. This stipulation showed that the goods which were the subject matter of the litigation were manufactured or produced outside the United States and imported by Sears and placed in distribution warehouses "where they are held awaiting distribution to destinations both within and outside of the state . . . for the purpose of sale in the ordinary course of Sears' trade or business" which was "selling goods at retail." "The distribution warehouses located in the County of Los Angeles were devoted almost entirely to the distribution of goods which were imported from foreign countries, particularly from locations in the Pacific area." Sears had other warehouses not in the County of Los Angeles for the purpose of longterm storage. The rate of turnover at the distribution warehouses averaged approximately three times per year. The goods were "meant to be shipped as quickly as distribution operations permit." Though no percentage was stated in the stipulation, the respective volumes of California and out-of-state shipments from the warehouses during the year preceding March 1, 1976, and the inventory on that date, were stated in an exhibit which resulted in a claim of exemption for property having a value of $19,373,089 by application of the percentage method specified in Revenue and Taxation Code section 225.1, subdivision (1).

The stipulation further stated that "Sears paid said tax under protest, claiming an exemption pursuant to Revenue and Taxation Code Sections 225 and 225.1, and thereafter duly exhausted its administrative remedies. No refund of any portion of said taxes was made to Sears, and this action was duly commenced."

Cross-motions for summary judgment were made by defendants in both cases. The motions of plaintiffs in each case were granted, and the cross-motions were denied. Judgments were entered for plaintiffs for refunds for the amount of their claims.

Contentions

The contentions of the respective parties are substantially similar in both cases. Defendants contend that (1) the exemption provided by Revenue and Taxation Code section 225 does not apply to the inventory of plaintiffs because, properly construed, such section provides only for the exemption of goods "in transit" through the state; (2) if section 225 is construed to exempt imported goods being held here at the pleasure of the owner for disposal or use, it violates the United States Constitution by regulating interstate and foreign commerce and interfering with foreign affairs, since it extends no such exemption to interstate goods; (3) defendants have standing to raise this constitutional objection; and (4) the proper remedy is to invalidate the exemption, not extend it to interstate goods similarly held in this state.

Plaintiffs contend that (1) the clear language and purpose of Revenue and Taxation Code section 225 makes its exemption applicable to their imported goods, and forecloses the restrictive interpretation advanced by defendants; (2) defendants have no standing to raise their constitutional objection; (3) section 225 does not violate the United States Constitution; and (4) even if the selective exemption is invalid, the court has the power to correct the defect by extending the exemption to interstate goods.

Discussion

Summary

The language of Revenue and Taxation Code sections 225 and 225.1 is unequivocal. It does not simply codify the existing constitutional exemption of goods "in transit." Since it contains no ambiguity in this respect, it cannot be so interpreted to avoid constitutional objections. The selective exemption of goods of foreign origin, thereby giving them a competitive advantage over interstate goods, is a regulation of interstate and foreign commerce in violation of the commerce clause in the United States Constitution. It is, therefore, invalid. Defendants have standing to raise this constitutional objection. The proper remedy is to invalidate the exemption, not extend it to interstate goods.

(1) *Revenue and Taxation Code Sections 225 and 225.1 Clearly Exempt the Property in Issue*

Section 225 exempts "property manufactured or produced . . . (2) outside of the United States and brought into this state *for transshipment out of this state,* for sale in the ordinary course of trade or business . . . ." (Italics added.) The exemption does not apply to "personal property in manufacturing process or production" but "[s]uch process or production shall not include the breaking in bulk, labeling, packaging, relabeling, or repackaging of such property."

Section 225 does not define "transshipment." Defendants point to dictionary definitions of "transshipment": for example, "to transfer from one ship, train, etc. to another" (Webster's New World Dict. (1968)) as supporting their contention "that this statute is declarative of existing commerce clause law," which exempts interstate and foreign goods "in transit."

Though defendants never specifically state what facts would be required to be shown to establish the exemption under this interpretation, inferentially the taxpayer would be required to prove that the goods had a specific further destination when they arrived in this state, that any interruption in their passage was "due to the necessities of the journey or for the purpose of safety and convenience in the course of the movement," and that they were not being "held there at the pleasure of the owner, for disposal or use, so that he may dispose of it either within the State, or for shipment elsewhere, as his interest dictates . . . ." (*Minnesota* v. *Blasius* (1933) 290 U.S. 1, 9-10 [78 L.Ed. 131, 135-136, 54 S.Ct. 34].)

The "in transit" doctrine, which is applicable equally to foreign and interstate goods (cf. *Blasius,* which involved interstate goods, with *Carson Petroleum Co.* v. *Vial* (1929) 279 U.S. 95 [73 L.Ed. 626, 49 S.Ct. 292] and *Michelin Tire Corp.* v. *Wages* (1976) 423 U.S. 276, 302 [46 L.Ed.2d 495, 512-513, 96 S.Ct. 535]) was well defined years before the adoption of section 225. The Legislature was no doubt familiar with the term "in transit"[2] used to refer to it. The term "transshipment" which the Legislature used, on the other hand, has not been used to describe goods protected by the "in transit" doctrine. The Legislature's use of the word

[2]See Revenue and Taxation Code section 32051, enacted in 1955.

"transshipment" does not, therefore, justify defendants' interpretation of the section.

Moreover, the meaning of transshipment as used in section 225 is clearly defined in section 225.1. Section 225.1 establishes two methods for claiming the exemption. The first is "a percentage method *of determining property held for transshipment* . . . at a particular location . . . ." (Italics added.) By establishing a method of determining what property is held for transshipment, this section necessarily defines "transshipment" as used in Revenue and Taxation Code section 225. The method specified is "by allocating a portion of the total inventory, using the percentage determined by dividing the total out-of-state shipments by the taxpayer from that location during the preceding year by the total of such shipments from that location during such year . . . ." The standard thereby established is totally inconsistent with the requirements of "in transit" status. It is even unnecessary that any of the goods on hand on tax day actually be shipped out of the state, and the determination method totally disregards the purpose of the interruption of the journey.

The alternative method specified in section 225.1 is equally inconsistent with the requirements of the "in transit" exemption. It only permits the exemption for goods possessed on tax day which actually are shipped out of state pursuant to contracts then in effect requiring such further shipment, but it totally ignores both the requirement that the interruption of the journey be "for the purpose of safety and convenience in the course of the movement," and the prohibition of the property "being held there at the pleasure of the owner, for disposal or use . . . ." (*Minnesota* v. *Blasius, supra,* 290 U.S. at p. 10 [78 L.Ed. at p. 136].)

The standards for the determination of transshipment status stated in Revenue and Taxation Code section 225.1 are, therefore, inconsistent with and contrary to the standard for determination of the existence of "in transit" status.

In view of the standards thus unequivocally established in section 225.1 for "determining property held for transshipment," there is no room for interpretation of the scope of the exemption provided. "The intent of the Legislature must be ascertained from the language of the enactment and where, as here, the language is clear, there can be no room for interpretation." (*Caminetti* v. *Pac. Mutual L. Ins. Co.* (1943) 22 Cal.2d 344, 353-354 [139 P.2d 930].) Consequently, defendants' arguments that the statute must be construed to apply only to goods "in transit" (1) in order to avoid serious constitutional objections, and (2) to carry out the

Legislature's view stated in the act adopting these sections that "the net loss of revenues to any local agency is not significant"[3] are untenable.

Though as will appear, *infra,* we agree with defendants that sections 225 and 225.1 create an invalid exemption, we cannot avoid the necessity of so holding by placing an unacceptable interpretation upon the legislative language.

The Legislature's expressed understanding that the net loss of revenues to local agencies would not be significant falls into the same category; it cannot require a disregard of the clear language of the section.[4]

We, therefore, conclude that the property of the plaintiffs was exempt under the provisions of Revenue and Taxation Code section 225.

(2a) *The exemption Violates the Federal Constitution Regulating Interstate and Foreign Commerce*

In the absence of sections 225 and 225.1, inventory brought from outside the State of California and held in the manner employed by plaintiffs would be subject to ad valorem taxation regardless of whether its source was a foreign nation, or another state in the United States. Unless it qualifies as goods "in transit," inventory of interstate or foreign goods "held there at the pleasure of the owner, for disposal or use" is subject to nondiscriminatory ad valorem taxation. Until 1975, this rule was subject to a limitation with respect to foreign imports that they could not be so taxed while they remained in the original package. Such limitation, however, was removed by the decision of the United States Supreme Court in *Michelin Tire Corp.* v. *Wages, supra,* 423 U.S. 276, overruling prior decisions so construing article I, section 10, clause 2, of the United States Constitution prohibiting state imposts or duties on imports or exports.

As a result of *Michelin,* goods manufactured in a foreign country and imported to this state are subject to ad valorem taxes under like conditions as the same goods manufactured in another state and brought here. Both categories are constitutionally subject to ad valorem taxation

[3]Statutes of 1975, chapter 1126, section 4, page 2746.

[4]Moreover, in light of the constitutional doctrine exempting imports in the original package which was in effect at the time of enactment, it is not clear that the loss of revenue resulting from the exemption was necessarily significant. Most of the imports being held for transshipment probably were in their original packages.

by this state unless they remain "in transit." The effect of Revenue and Taxation Code sections 225 and 225.1, however, as we have held, is to exempt goods whose place of origin is a foreign country if it is established, pursuant to section 225.1, that they are held for further transport outside this state. No such exemption, however, is extended to goods whose place of origin is other states and which can similarly be shown to have been brought to this state for transshipment out of this state. For example, the same goods manufactured in Hawaii or Alaska and transported to California for distribution in the fashion employed by plaintiffs, would be subject to ad valorem taxation.

Different tax treatment is, therefore, accorded to such goods solely on the basis of their place of origin. Foreign goods are thereby given a competitive advantage over interstate goods of the same nature and competing in the same market.

Article I, section 8, clause 3 of the United States Constitution provides that Congress shall have power "[t]o regulate Commerce with foreign Nations, and among the several States and with the Indian Tribes." (3) As stated in the concurring opinion of Justice Aiso in *Bethlehem Steel Corp.* v. *Board of Commissioners* (1969) 276 Cal.App.2d 221, 230-231 [80 Cal.Rptr. 800]:

"The power to regulate commerce with foreign nations is an express grant by the people to the federal government. (*Gibbons* v. *Ogden* (1824) 22 U.S. (9 Wheat.) 1, 187-189 [6 L.Ed. 23, 68].) 'It is an essential attribute of the power that it is exclusive and plenary. As an exclusive power, its exercise may not be limited, qualified or impeded to any extent by state action. [Citations.] The power is buttressed by the express provision of the Constitution denying to the States authority to lay imposts or duties on imports or exports without the consent of the Congress. Art. 1, § 10, ¶ 2. [¶] The Congress may determine what articles may be imported into this country and the terms upon which importation is permitted.' (*University of Illinois* v. *United States* (1932) 289 U.S. 48, 56-57 [77 L.Ed. 1025, 1028; 53 S.Ct. 509, 510].)

" '[T]o regulate commerce is to prescribe . . . the conditions upon which it shall be conducted; to determine how far it shall be free and untrammeled, how far it shall be burdened by duties and imposts, and how far it shall be prohibited.' *Welton* v. *Missouri* (1875) 91 U.S. 275, 279-280 [23 L.Ed. 347, 349].)"

In *Boston Stock Exchange* v. *State Tax Comm'n* (1977) 429 U.S. 318, 328 [50 L.Ed.2d 514, 523, 97 S.Ct. 599], the high court said: "As in *Great A&P Tea Co.* v. *Cottrell,* 424 U.S. 366 (1976), we begin with the principle that '[t]he very purpose of the Commerce Clause was to create an area of free trade among the several States.' *McLeod* v. *J. E. Dilworth Co.,* 322 U.S. 327, 330 (1944). It is now established beyond dispute that 'the Commerce Clause was not merely an authorization to Congress to enact laws for the protection and encouragement of commerce among the States, but by its own force created an area of trade free from interference by the States. . . . *[T]he Commerce Clause even without implementing legislation by Congress is a limitation upon the power of the States.*' *Freeman* v. *Hewit,* 329 U.S. 249, 252 (1946)." (Italics added.)

(2b) The state imposition of discriminatory tax burdens upon interstate or foreign commerce necessarily limits, qualifies and impedes Congress' power to prescribe the conditions under which interstate and foreign commerce are to be conducted. The principal mode through which Congress has exercised its power to regulate competition between interstate and foreign commerce is by the imposition of import tariffs, designed for the most part to afford protection to United States manufactured goods threatened by foreign competition. As stated by the majority opinion in *Bethlehem Steel, supra,* 276 Cal.App.2d at page 226: "Only the federal government can fix the rules of fair competition when such competition is on an international basis. Foreign trade is properly a subject of national concern, not state regulation. State regulation can only impede, not foster, national trade policies."

For this reason, state taxes which discriminate between classes of interstate and foreign goods on the basis of their origin are not permitted. This is clear from the statement of the United States Supreme Court in *Michelin Tire Corp.* v. *Wages, supra,* 423 U.S. 276. In explaining why a nondiscriminatory tax was not prohibited, the court said (*id.,* at p. 286 [46 L.Ed.2d at pp. 503-504]): "It is obvious that such nondiscriminatory property taxation can have no impact whatsoever on the Federal Government's exclusive regulation of foreign commerce, probably the most important purpose of the Clause's prohibition. By definition, such a tax does not fall on imports as such because of their place of origin. It cannot be used to create special protective tariffs or particular preferences for certain domestic goods, and it cannot be applied selectively to *encourage* or *discourage* any importation in a manner inconsistent with federal regulation." (Italics added.)

More recently, the United States Supreme Court in *Complete Auto Transit, Inc.* v. *Brady* (1977) 430 U.S. 274 [51 L.Ed.2d 326, 97 S.Ct. 1076], referred to a discriminatory tax as a "tailored tax," noting that "property taxes also may be tailored to differentiate between property used in transportation and other types of property . . . . A tailored tax, however accomplished, must receive the careful scrutiny of the courts to determine whether it produces a forbidden effect on interstate commerce." (*Id.*, at pp. 288-289, fn. 15 [51 L.Ed.2d at p. 337].)

Contrary to plaintiffs' claim that the only discrimination interdicted by the commerce clause is discrimination in favor of local commerce and against interstate or foreign commerce, the decision in *Boston Stock Exchange* v. *State Tax Comm'n, supra,* 429 U.S. 318, holds that discriminatory tax burdens which favor one class of commerce, subject to the control of Congress, over another such class, are equally prohibited. In that case, a state tax which discriminated between two types of interstate transactions was struck down. The court said (*id.*, at p. 335 [50 L.Ed.2d at pp. 527-528]): "There has been no prior occasion expressly to address the question whether a State may tax in a manner that discriminates between two types of interstate transactions in order to favor local commercial interests over out-of-state businesses, but the clear import of our Commerce Clause cases is that such discrimination is constitutionally impermissible."

Discrimination between (1) interstate transactions and foreign transactions cannot be distinguished from (2) discrimination between two types of interstate transactions. Both interstate and foreign transactions are brought within the control of Congress by the same clause of the United States Constitution.

In any event, there is no merit to the argument that only the imposition of discriminatory burdens upon foreign commerce interferes with Congress' power to regulate in that field. As pointed out in *Michelin, supra,* 423 U.S. at page 286 [46 L.Ed.2d at page 504], discriminatory taxes, if "applied selectively to *encourage* or discourage . . . importation in a manner inconsistent with federal regulation" are invalid. (Italics added.) The capacity of such selective taxation to interfere with Congress' power is easily illustrated: Congress concludes that American producers require protection from the competition of Japanese transistor radios and imposes a tariff deemed sufficient to accomplish such protection. A California tax exemption favoring the foreign product offsets the tariff in

respect of goods imported through this state with the result that the competitive advantage intended by Congress is diminished *pro tanto.*

The imposition of discriminatory burdens is not saved by the fact that they are imposed after the interstate or foreign goods have become incorporated into the mass of property of the state. In *Boston Stock Exchange* v. *State Tax Comm'n, supra,* 429 U.S. at pages 332-333, footnote 12 [50 L.Ed.2d at page 526], the court said: "Because of the discrimination inherent in § 270-a, we also reject the Commission's argument that the tax should be sustained because it is *imposed on a local event at the end of interstate commerce.* While it is true that, absent an undue burden on interstate commerce, the Commerce Clause does not prohibit the States from taxing the transfer of property within the State, the tax may not discriminate between transactions on the basis of some interstate element. *International Harvester Co.* v. *Department of Treasury,* 322 U.S. 340, 347-348 (1944). As was held in *Welton* v. *Missouri,* 91 U.S. 275, 282 (1876): '*[T]he commercial power [of the Federal Government] continues until the commodity has ceased to be the subject of discriminating legislation by reason of its foreign character. That power protects it, even after it has entered the State, from any burdens imposed by reason of its foreign origin.*' " (Italics added.)

The fact that there may be rational grounds for the state to exempt imported goods destined for transshipment to another state which do not apply to interstate goods in the same category cannot validate the exemption. It may be that there is a greater threat of business flight from California by importers accustomed to the benefits of the original package doctrine than by distributors of interstate goods. But such considerations do not justify a state's utilization of a tax differential as a means of regulating interstate and foreign commerce. Only Congress is authorized to so act. Referring to comparable state policies urged in support of the California Buy American Act, the majority opinion said in *Bethlehem Steel Corp.* v. *Board of Commissions, supra,* 276 Cal.App.2d at pages 225-226: "That there are countervailing state policies which are served by the retention of such an act is 'wholly irrelevant to judicial inquiry' (*United States* v. *Pink,* 315 U.S. 203, 233 [86 L.Ed. 796, 819, 62 S.Ct. 552]) since '[i]t is inconceivable that any of them can be interposed as an obstacle to the effective operation of a federal constitutional power.' (*United States* v. *Belmont, supra,* 301 U.S. 324, 332 [81 L.Ed. 1134, 1140].)"

If the defendants were invoking the equal protection clause of the United States Constitution, the existence of a rational basis for the discrimination would be an answer to their claims. (Cf. *Allied Stores of Ohio* v. *Bowers* (1959) 358 U.S. 522, 529 [3 L.Ed.2d 480, 486, 79 S.Ct. 437].) But no authority has been cited suggesting that policy considerations grounded in the state's desire to avoid business flight to another state can be the basis for usurping Congress' commerce power. Exactly such considerations were found not to be sufficient to validate such state action in *Boston Stock Exchange* v. *State Tax Comm'n, supra.*

We conclude, therefore, that by granting an exemption to foreign goods which is withheld from interstate goods, Revenue and Taxation Code section 225 violates the commerce clause of the United States Constitution.

(4a) *Defendants Have Standing to Raise the Unconstitutionality of the Exemption*

Plaintiffs challenge the standing of defendants, as mere political subdivisions of the state, to invoke any federal constitutional objection to the enactments of the California Legislature. They rely upon the decision of this court in *Community Television of So. Cal.* v. *County of Los Angeles* (1975) 44 Cal.App.3d 990 [119 Cal.Rptr. 276], and upon *Appeal of Martin* (1974) 286 N.C. 66 [209 S.E.2d 766]. In *Community Television,* the County of Los Angeles claimed that a tax exemption was "unconstitutional as a violation of the equal protection clauses of the federal and state Constitutions" (44 Cal.App.3d at p. 998) by discriminating in favor of some charitable organizations and against others without logical basis. The court refused to consider this constitutional objection, (though it did discuss another purely state constitutional objection—the prohibition against gifts of public funds), saying (*ibid.*): "We need not dwell long on this argument since the appellants are in no position to raise the issue. As a political subdivision of the state and not being parties who belong to a class allegedly discriminated against they lack the standing to make such a challenge. (*City of New York* v. *Richardson,* 473 F.2d 923; *Data Processing Service* v. *Camp,* 397 U.S. 150 [25 L.Ed.2d 184, 90 S.Ct. 827]; *Flast* v. *Cohen,* 392 U.S. 83 [20 L.Ed.2d 947, 88 S.Ct. 1942]; *Harman* v. *City and County of San Francisco,* 7 Cal.3d 150 [101 Cal.Rptr. 880, 496 P.2d 1248].)"

Appeal of Martin involved a challenge to tax legislation on the basis of a state constitutional requirement of "uniformity." The taxing county was

denied standing on dual grounds: first, that it was voluntarily proceeding under the statute claiming benefits thereunder and would not be heard " 'to question its constitutionality in order to avoid its burdens.' " (209 S.E.2d at p. 772.) The other ground for holding lack of standing was: "Finally, the County is precluded from challenging the constitutionality of G.S. § 105-281 (1969 Cum.Supp.) on yet another ground: It is not a member of the class subject to the alleged discrimination. State v. Trantham, 230 N.C. 641, 55 S.E.2d 198 (1949); State v. Sims, 213 N.C. 590, 197 S.E. 176 (1938)." (*Id.*, at pp. 772-773.)

Neither case is controlling. As above noted, the objection urged in this case by the defendants is not based upon equal protection. The requirement that the parties "belong to a class allegedly discriminated against" is, therefore, inapplicable. The only function of the discriminatory nature of the tax is to demonstrate its capacity to interfere with the authority of Congress over commerce. The interest herein sought to be protected is not personal to dealers in nonexempt interstate goods; it relates more to the national interest in observing the boundaries of state and federal power.

A comprehensive discussion of this standing question appears in the opinion of the Second Circuit in *City of New York* v. *Richardson* (2d Cir. 1973) 473 F.2d 923, which dealt with the validity of financing and reimbursement policies established by the Social Security Act and the New York Social Services Law. The court upheld the trial court's dismissal of the city's claims based upon equal protection, on the ground of lack of standing. It held, however, that the plaintiffs, who had sued in their official capacities as Mayor and Commissioner of Social Services of the City of New York, did have standing. The court said in this respect (*id.*, at p. 933): "With respect to standing, those plaintiffs who sued in their official capacities may assert constitutional claims against the state under the rule announced in Board of Education v. Allen, 392 U.S. 236, 241, n. 5, 88 S.Ct. 1923, 20 L.Ed.2d 1060 (1968). This is so because of the conflict each of these officials must face between his sworn duty to uphold the Constitution of the United States and his responsibility for administering New York's allegedly unconstitutional Social Services Law."

In *Board of Education* v. *Allen* (1968) 392 U.S. 236 [20 L.Ed.2d 1060, 88 S.Ct. 1923], cited above, the United States Supreme Court noted the standing of officials of a school district to challenge the constitutionality of the law requiring them to loan textbooks free of charge to students attending private schools. After stating that the New York Court of

Appeals had "concluded by a 4-3 vote that appellants did have standing," the court explained the basis of this standing as follows (*id.*, at p. 241, fn. 5 [20 L.Ed.2d at p. 1064]): Appellants have taken an oath to support the United States Constitution. Believing § 701 to be unconstitutional, they are in the position of having to choose between violating their oath and taking a step—refusal to comply with § 701—that would be likely to bring their expulsion from office and also a reduction in state funds for their school districts. *There can be no doubt that appellants thus have a 'personal stake in the outcome' of this litigation. Baker* v. *Carr*, 369 U.S. 186, 204 (1962)." (Italics added.)

Though the instant suits are, in form, actions against the city and county and not against any of the county's officers, the substance of the action is a test of the propriety of the board of supervisors' refusal to refund plaintiffs' taxes. Revenue and Taxation Code section 5096 provided in pertinent part at the time the actions were commenced:

"On order of the board of supervisors, any taxes paid before or after delinquency shall be refunded if they were:

". . . . .

"(b) Erroneously or illegally collected."[5]

Suits for refund of taxes paid under protest, which the supervisors refused to refund, were authorized by Revenue and Taxation Code sections 5103 and 5138. The pertinent portion of section 5103 read as follows: "If the board of supervisors or city council rejects a claim for refund in whole or in part, the person who paid the taxes, his guardian, executor, or administrator may within six months after such rejection commence an action in the superior court against the county or a city to recover the taxes which the board of supervisors or the city council have refused to refund."

The present provision, which supersedes both prior sections, is Revenue and Taxation Code section 5140; it reads: "The person who paid the tax, his guardian, the executor of his will, or the administrator of his estate may bring an action in the superior court against a county or a city to recover a tax which the board of supervisors of the county or the city council of the city has refused to refund on a claim filed pursuant to

[5]This included taxes collected by county officers for defendant cities. (Rev. & Tax. Code, § 5099.)

Article 1 (commencing with Section 5096) of this chapter. No other person may bring such an action; but if another should do so, judgment shall not be rendered for the plaintiff."

It is thus apparent that the statutorily required form of action to test the propriety of the supervisors' refusal to order a refund of taxes erroneously or illegally collected is a suit against the county. **(5)** It is "the general rule that the existence of an action at law to recover a refund precludes resort to an extraordinary writ to attack the alleged illegal or erroneous levy of a tax." (*Kahn* v. *East Bay Mun. Util. Dist.* (1974) 41 Cal.App.3d 397, 407 [116 Cal.Rptr. 333].)

The board of supervisors, like all other public officers, were required to take an oath of office which included the undertaking to "support and defend the Constitution of the United States" as well as to "faithfully discharge the duties" of their office. (Cal. Const., art. XX, § 3; Gov. Code, § 1360.) **(4b)** The conflict between the duties of the supervisors under the Constitution of the United States and those which were imposed by Revenue and Taxation Code section 225 justifies the assertion of the constitutional claims by the county, where the propriety of the supervisors' refusal to order a refund depends upon the constitutionality of the exemption. The control of the litigation is in the hands of the supervisors, the propriety of their conduct is the issue; thus, they are real if not technical parties to the action.

The general standard for determining standing also is met. As our Supreme Court said in *Harman* v. *City and County of San Francisco* (1972) 7 Cal.3d 150, 159 [101 Cal.Rptr. 880, 496 P.2d 1248]: " 'The fundamental aspect of standing is that it focuses on the party seeking to get his complaint before a . . . court, and not in the issues he wishes to have adjudicated.' (*Flast* v. *Cohen, supra* [392 U.S.], at p. 99 [20 L.Ed.2d at p. 961, 88 S.Ct. 1942].) A party enjoys standing to bring his complaint into court if his stake in the resolution of that complaint assumes the proportions necessary to ensure that he will vigorously present his case. (*Baker* v. *Carr* (1962) 369 U.S. 186, 204 [7 L.Ed.2d 663, 678, 82 S.Ct. 691].) As Professor Jaffe has stated, we must determine standing by a measure of the 'intensity of the plaintiff's claim to justice.' (Jaffe, *supra,* 75 Harv.L.Rev. at p. 304.)"

The defendants, as local agencies largely dependent upon ad valorem taxation to provide funds for necessary local services, have reason to "vigorously present" the constitutional questions, and have done so. The

supervisors, who control the county's conduct of the litigation, have a significant "personal stake in the outcome" of the litigation which will resolve the conflict between their duties under the United States Constitution and the duties of their office.

Under the circumstances, no valid purpose would be served by prolonging the uncertainty as to the validity of significant tax legislation on the basis of the form of the actions. We, therefore, conclude that the constitutionality of the exemption is properly before this court.

The Exemption May Not Be Judicially Broadened to Include Interstate Goods

(6) Plaintiffs suggest that if the exemption provided by Revenue and Taxation Code section 225 is invalid because it is not also made applicable to goods whose origin is interstate commerce, the proper remedy is to judicially broaden the exemption to include the interstate goods. They cite in this respect the opinion of our Supreme Court in *Haman* v. *County of Humboldt* (1973) 8 Cal.3d 922 [106 Cal.Rptr. 617, 506 P.2d 993]. In *Haman,* the plaintiffs sought to recover the property tax they paid on their fishing boats for the calendar year 1968, in excess of the amount they would have been required to pay under Revenue and Taxation Code section 227, subdivision (a), if their port of documentation were in the State of California.

Section 227 provided that:

"A documented vessel, . . . shall be assessed at one percent (1%) of its full cash value only if:

"(a) The port of documentation is in this state.

"(b) The vessel is engaged or employed exclusively:

"(1) In the taking and possession of fish or other living resource of the sea for commercial purposes, or

"(2) In instruction or research studies as an oceanographic research vessel." The port of documentation requirement was held an invalid discrimination against California residents owning fishing boats documented in other states. The court then considered the relief to be granted and stated in this respect:

"In cases involving invalid differentials in tax treatment, the court has the *power* to eliminate the discriminatory treatment either by granting those taxpayers, who have been assessed the higher rate, a refund based on the difference between the lower rate and the one under which they were assessed, i.e., taxing all vessels at 1 percent, or by providing that in the future the board of equalization adjust the assessment rolls so that the higher rate will be applied to all like taxpayers. (*Security-First Nat. Bk.* v. *County of L.A.*, 35 Cal.2d 319, 322 [217 P.2d 946]; *Jones Lbr. Co.* v. *Del Norte County*, 251 Cal.App.2d 645, 650 [59 Cal.Rptr. 644].) In determining the proper remedy, we must adopt the one which will best further the legislative intent without increasing discrimination among other taxpayers.

"The main purpose of the 1 percent assessment is obviously to aid California's ailing fishing industry. The statute requires that as well as having a port of documentation within the state, the vessel must be '. . . engaged or employed exclusively: (1) In the taking and possession of fish or other living resource of the sea *for commercial purposes*, . . .' (Italics added.) . . .

"We conclude that the legislative intent is properly carried out by holding invalid subdivision (a) of section 227, which requires that the port of documentation be within this state, and by upholding the balance of the section. Accordingly, plaintiffs are entitled to a refund. [Fn. omitted.]" (*Haman* v. *County of Humboldt, supra*, 8 Cal.3d at pp. 928-929.) (Italics added.)

Assuming that the process described in *Haman* is equally applicable to exemptions as it is to rate differentials,[6] we conclude that the legislative intent is properly carried out in this case by holding invalid the exemption of goods manufactured outside the United States and brought to California for transshipment, and denying refund.

As the statement in Haman indicates, by considering an alternative of "providing that in the future" the higher rate will be applied to all boat owners, the inquiry into legislative intent must be made on a prospective basis. We must, therefore, assess the situation in light of present circumstances.

[6]The constitutional authority for exemptions and rate differentials is found in the same article XIII, section 2 of the California Constitution which states: "The Legislature, two-thirds of the membership of each house concurring, may classify such personal property for differential taxation or for exemption."

Plaintiffs argue that the legislative history indicates the principal purpose of Revenue and Taxation Code section 225 was to promote utilization of California ports and discourage removal of import business to states with a more favorable tax structure. This purpose, they say, can best be furthered by enlarging the exemption to include interstate goods, whereas it would be totally frustrated by invalidating the exemption of foreign goods.

There are, however, other factors to consider. The Legislature clearly indicated in the enacting statute that it did not intend thereby to deprive local agencies of significant revenue. Section 4 of the act stated: "No appropriation is made by this act, nor is any obligation created thereby under Section 2229 of the Revenue and Taxation Code, for the reimbursement of any local agency for any revenue lost by it as a result of the exemption of property from taxation by this act because the net loss of revenues to any local agency is not significant." (Stats. 1975, ch. 1126, § 4, p. 2746.)

Unquestionably, the Legislature's estimate of the revenue loss was made in view of the then existing original package doctrine which effectively exempted foreign goods from local ad valorem taxation. Most of the imports exempted by Revenue and Taxation Code section 225 would be exempt anyway on the basis of said doctrine. However, subsequent to the enactment of section 225, the United States Supreme Court in *Michelin Tire Corp.* v. *Wages, supra,* overruled the original package doctrine and made all imported goods, no longer "in transit," subject to nondiscriminatory local ad valorem taxation. After the decision in *Michelin,* the effect of section 225 is clearly to deprive local agencies of significant revenue, as the judgments in these cases demonstrate. (The judgment in Sears' favor alone exceeded $284,000 with respect to a single year.) We cannot assume that the Legislature would have approved section 225 had it understood that a loss of any such proportions was involved. There is even less basis to assume that the Legislature would be willing to subject local agencies to the additional deprivation of revenue which would inevitably result from expanding the exemption to include goods originating in interstate commerce, which were being taxed. This is especially true in view of the subsequent adoption of Proposition 13, critically reducing the tax base of local agencies to a level which the Legislature apparently considers inadequate for the rendition of required local services, as evidenced by the action taken to provide state funds for such purpose.

Cognizance must also be taken in this respect to the fact that since 1939 the Legislature has indicated that an exemption from taxation is not intended unless express provision be made therefor. Revenue and Taxation Code section 201 has provided: "All property in this State, not exempt under the laws of the United States or of this State, is subject to taxation under this code." Consequently, when section 225 was enacted limiting the exemption to goods manufactured outside the United States, it expressly denied the exemption to goods manufactured in other states.

We may also assume that in acting in respect to this matter, the Legislature would be guided by the purpose of the California constitutional provisions governing tax exemptions. As our Supreme Court stated in *Watchtower B. & T. Soc.* v. *County of L. A.* (1947) 30 Cal.2d 426, 429 [182 P.2d 178], referring to California Constitution, article XIII, section 1: "The purpose of that provision is to secure equality of taxation which results from subjecting all property to the same burden."

In the same vein, the court in *County of Amador* v. *State Board of Equalization* (1966) 240 Cal.App.2d 205, 224 [49 Cal.Rptr. 448], said: "Without regard to the identity of the assessing agency, article XIII, section 1, of the Constitution requires that all property be taxed in proportion to its value. The constitutional goals are equality and uniformity."

Since we find no reasonable basis for the assumption that the Legislature would, in light of present circumstances, prefer extending the exemption, any attempt on our part to broaden the exemption would violate the requirement of article XIII, section 2, of the California Constitution that the creation of exemptions be approved by a vote of two-thirds of the Legislature. We consequently hold that the discriminatory exemption created by the statute is invalid, and that plaintiffs' goods are properly subject to taxation.

The judgments are reversed and both causes remanded to the trial court which is directed to enter judgments in favor of defendants.

Cobey, J., and Allport, J., concurred.

EXHIBIT 19

[271] BASS, RATCLIFF, & GRETTON, Limited, Plff. in Err.,
v.
STATE TAX COMMISSION.

(See S. C. Reporter's ed. 271-285.)

Mr. Justice Sanford delivered the opinion of the court:

This case involves the constitutional validity of article 9-A of the tax law of New York under consideration in Gorham Mfg. Co. v. State Tax Commission, No. 5, just decided [266 U. S. 265, ante, 279, 45 Sup. Ct. Rep. 80.]

This article[1] provides that for the privilege of doing business in the state a foreign manufacturing and mercantile corporation shall pay, in advance, an annual franchise tax, to be computed by the state tax commission, at the rate of 3 per centum, upon the net income of the corporation for the preceding year (§§ 209,[2] 215). This net income is "presumably the same" as that upon which the corporation is required to pay a tax to the United States (§ 209); but the amount thereof as returned to the United States is subject to any correction for fraud, evasion, or errors, ascertained by the commission (§ 214). If the entire business of the corporation is not transacted [278] within the state, the tax is to be based upon the portion of such ascertained net income determined by the proportion which the aggregate value of specified classes of the assets of the corporation within the state bears to the aggregate value of all such classes of assets wherever located. The classes of assets which are to enter into this ratio—hereinafter termed the segregated assets—are: real property and tangible personal property; bills and accounts receivable resulting from the manufacture and sale of merchandise and services performed; and shares of stock owned in other corporations, not exceeding 10 per centum of the real and tangible personal property, which are to be allocated according to the location of the physical property representing such stock (§ 214).[3] The corporation is to be exempt from any personal property tax (§ 219-j).

Bass, Ratcliff, & Gretton, Ltd., is a British corporation, engaged in brewing and selling Bass's ale. All its brewing is done and a large part of its sales are made in England; but it formerly im-

[1] Consol. Laws of 1909, chap. 60, as amended by the Laws of 1917, chap. 726, and the Laws of 1918, chap. 271, chap. 276, and chap. 417. See the opinion in the Gorham Mfg. Co. Case, note 1.

[2] This section is entitled: "Franchise Tax on Corporations, Based on Net Income."

[3] The average value of the shares of stock is taken; the average monthly value of the other assets. The entire provision as to the allocation of net income, which is here broadly summarized, is set forth in the margin of the opinion in People ex rel. Alpha Portland Cement Co. v. Knapp, 230 N. Y. 48, 53, 129 N. E. 202.

This article also provides that the corporation shall make a report to the commission showing its net income as returned to the United States and the matters which are to enter into the allocation of the net income; that the commission shall state the account and compute the tax; and that, if an application for revision is made, the commission shall grant a hearing, upon evidence, and adjust the tax, "according to law and the facts." And it further provides for a review of the determination of the commission, upon certiorari by the supreme court, both upon the law and the facts; and for an appeal from the supreme court to the court of appeals. These various provisions are set forth in the opinion in the Gorham Mfg. Co. Case.

EXHIBIT 19

ported a portion of its product into the United States, which it sold through branch offices [279] located in New York city and in Chicago. On its report to the New York Tax Commission,—amended under protest,—the commission computed and assessed its franchise tax for the year commencing November 1, 1918. At a hearing granted on an application for revision, the commission adhered to the original assessment. The company then paid the tax under protest. The determination of the commission was subsequently confirmed, upon a writ of certiorari, by the appellate division of the supreme court (198 App. Div. 963, 189 N. Y. Supp. 952); and the order of that court was affirmed, upon appeal, by the court of appeals (232 N. Y. 42, 133 N. E. 122). The record was remitted to the supreme court, to which this writ of error was directed. Hodges v. Snyder, 261 U. S. 600, 67 L. ed. 819, 43 Sup. Ct. Rep. 435.

It is undisputed that for the year preceding that for which this franchise tax was assessed, the company, as reported to the United States, had no net income upon which it was subject to a Federal income tax. Its total net income, however, from all its business, wherever carried on, was $2,185,600.[4] The value of its segregated assets, wherever located, was: real property, $785,675; tangible personal property, $2,105,105; bills and accounts, $321,625; and shares of stock of other corporations, $845,195. Limiting the value of the shares of stock to 10 per centum of the aggregate real and tangible personal property, that is, to $289,078, made the aggregate value of its segregated property, wherever located, $3,501,483. The value of its segregated assets in New York was as follows: bills and accounts, $20,449; and tangible personal property, $23,668. This made the aggregate value of its segregated property in New York, $44,117. Taking the entire net income, $2,185,600, as the basis for the assessment of the tax, the commission allocated to New York [280] the proportion thereof which the segregated assets in New York bore to the segregated assets wherever located, amounting to $27,537.68; and upon this sum computed the franchise tax, at the rate of 3 per centum,—that is, $826.14.

The company contends that this tax is not based upon any net income derived from the business which it carried on in New York, but upon a portion of its net income derived from business carried on outside of the United States, which, under the provisions of the statute, has been arbitrarily allocated to its New York business, and that such imposition of the tax deprives it of its property in violation of the due process clause of the 14th Amendment, and imposes a direct burden upon its foreign commerce, in violation of the commerce clause of the Constitution.

1. We see no reason to doubt the accuracy of the statement made by the court of appeals in the present case that the franchise tax imposed by the statute is "primarily a tax levied for the privilege of doing business in the state." It is not a direct tax upon the allocated income of the corporation in a given year, but a tax for the privilege of doing business in one year, measured by the allocated income accruing from the business in the preceding year. See New York v. Jersawit, 263 U. S. 493, 496, 68 L. ed. 405, 407, 44 Sup. Ct. Rep. 167.

2. The question of the constitutionality of this tax as applied in the present case is controlled, in its essential aspects, by the decision in Underwood Typewriter Co. v. Chamberlain, 254 U. S. 113, 120, 65 L. ed. 165, 169, 41 Sup. Ct. Rep. 45. There the Connecticut statute imposed upon foreign corporations doing business partly within and partly without the state an annual tax of 2 per cent upon the net income earned during the preceding year on business carried on within the state, ascertained by taking such proportion of the whole net income on which the corporation was required to pay a [281] tax to the United States as the value of its real and tangible personal property within the state bore to the value of all of its real and tangible personal property. The Underwood Typewriter Company, a Delaware corporation, was engaged in manufacturing and selling typewriters and supplies. All its manufacturing was done in Connecticut, but the greater part of its sales was made from branch offices in other states. It contended that the tax was an unconstitutional burden on interstate commerce; and that it violated the 14th Amendment in that it imposed, directly or indirectly, a tax on income arising from business conducted outside of the state. In support of the latter objection it showed that while 47 per

[4] If the corporation is organized under the laws of another country it is required to state its entire net income (§ 211).

cent of its real estate and tangible personal property was located in Connecticut, resulting, under the method of apportionment of the net income required by the statute, in attributing 47 per cent of its total net income to the operations in Connecticut,—in fact, about $1,300,000 of its net profits were received in other states, and only about $43,000 in Connecticut. The court, in sustaining the validity of the tax, said: "But this showing wholly fails to sustain the objection. The profits of the corporation were largely earned by a series of transactions beginning with manufacture in Connecticut and ending with sale in other states. In this it was typical of a large part of the manufacturing business conducted in the state. The legislature, in attempting to put upon this business its fair share of the burden of taxation, was faced with the impossibility of allocating specifically the profits earned by the processes conducted within its borders. It therefore adopted a method of apportionment which, for all that appears in the record, reached, and was meant to reach, only the profits earned within the state. 'The plaintiff's argument on this branch of the case,' as stated by the supreme court of errors, 'carries the burden of showing that 47 per cent of its net income is not reasonably [282] attributable, for the purposes of taxation to the manufacture of products from the sale of which 80 per cent of its gross earnings was derived after paying manufacturing costs.' The corporation has not even attempted to show this; and for aught that appears the percentage of net profits earned in Connecticut may have been much larger than 47 per cent. There is, consequently, nothing in this record to show that the method of apportionment adopted by the state was inherently arbitrary, or that its application to this corporation produced an unreasonable result."

So in the present case we are of opinion that, as the Company carried on the unitary business of manufacturing and selling ale, in which its profits were earned by a series of transactions, beginning with the manufacture in England and ending in sales in New York and other places,—the process of manufacturing resulting in no profits until it ends in sales,—the state was justified in attributing to New York a just proportion of the profits earned by the company from such unitary business. In Wallace v. Hines, 253 U. S. 66, 69, 64 L. ed. 782, 786, 40 Sup. Ct. Rep. 435, it was recognized that a state, in imposing an excise tax upon foreign corporations in respect to doing business within the state, may look to the property of such corporations beyond its borders to "get the true value of things within it, when they are part of an organic system of wide extent," giving the local property a value above that which it would otherwise possess, and may therefore take into account property situated elsewhere when it "can be seen in some plain and fairly intelligible way that it adds to the value of the property and the rights exercised in the state." This is directly applicable to the carrying on of a unitary business of manufacture and sale partly within and partly without the state.

Nor do we find that the method of apportioning the net income on the basis of the ratio of the segregated [283] assets located in New York and elsewhere was inherently arbitrary, or a mere effort to reach profits earned elsewhere under the guise of legitimate taxation. The principal factors entering into this allocation are, as in the Underwood Typewriter Co. Case, the real and tangible personal property of the corporation. We see nothing arbitrary in also including bills and accounts receivable resulting from the manufacture and sale of merchandise and services performed, or in taking average monthly values as the measure of all the segregated assets except shares of stock. And in the present case the inclusion of a portion of the shares of stock in other corporations,—none of which were allocated to New York—resulted in the company's favor, and reduced the income allocated to New York to less than it otherwise would have been.

It is not shown in the present case, any more than in the Underwood Case, that this application of the statutory method of apportionment has produced an unreasonable result. The fact that the company may not have had any net income upon which it was subject to payment of income tax to the Federal government obviously does not show that it received no net income from the business which it carried on in New York. There is no evidence in the record as to whether the company received any net income from its New York business, or the amount of the profit and loss on that business, if any, either considered separately or in connection with the manu-

facturing business carried on in Great Britain.[5]

[284] 3. Furthermore, the statutory method of apportionment not being shown to be arbitrary or unreasonable, we think that the court of appeals rightly held that the tax imposed for the carrying on of the business in New York is not invalid merely because, in the preceding year, the business conducted in New York may have yielded no net income. There is no sufficient reason why a foreign corporation desiring to continue the carrying on of business in the state for another year—from which it expects to derive a benefit—should be relieved of a privilege tax because it did not happen to have made any profit during the preceding year. This is especially true where, as in the present case, the corporation is entirely relieved of any personal property tax. See United States Exp. Co. v. Minnesota, 223 U. S. 335, 346, 56 L. ed. 459, 465, 32 Sup. Ct. Rep. 211.

4. The company furthermore urges that in any event it should have been permitted to include in the statutory ratio the entire value of the stocks which it owned in other corporations. This contention is based upon the fact that, in the previous case of People ex rel. Alpha Portland Cement Co. v. Knapp, 230 N. Y. 48, 129 N. E. 202, it had been held that in so far as the statute provided that, in the allocation of income, the value of stocks of other corporations should not be taken into consideration beyond 10 per cent of the real and tangible personal property, although the entire dividend from such stocks was included in the net income which was the basis of the allocation, the statute was unconstitutional, and that the taxpayer in such case should be permitted to include in the statutory allocation the entire value of the stocks which it owned in other corporations. As to this matter it is sufficient to say that it does not appear from the record in the present case that the shares of stock which the company owned in other corporations had yielded any dividends which were included in its total net income; and, further, that this question, so far [285] as appears from the record, was not raised by the company, either before the commission or the state courts, in each of which its objections to the validity of the tax were phrased in terms having no reference to this specific question. And not having been raised in the court of appeals or passed on by that court, it is not a question which can now be reviewed by this court under an assignment of errors raising it here for the first time.

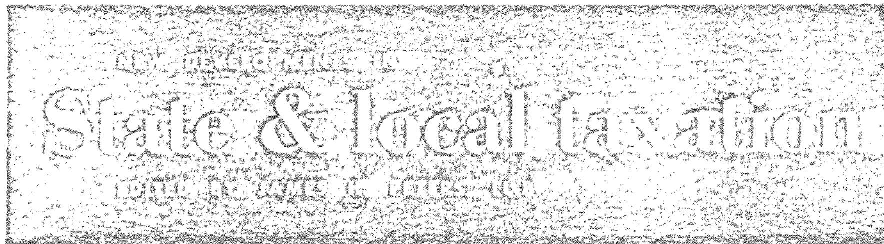
The judgment of the Court of Appeals is accordingly affirmed.

Mr. Justice McReynolds dissents.

[5] The statement in the opinion of the court of appeals that the company's "net income from the New York business was nothing" was apparently made inadvertently. There is no showing except as to the gross sales and the "expenses," which were about one fourth of the gross sales, nothing appearing as to manufacturing costs or other charges, and nothing from which the question of ultimate net profit or loss that entered either into the separate business in New York or into the total net income of the company accruing from the manufacture and sale of the ale can be ascertained.

288

EXHIBIT 20



A current look at the combined report and uniformity in allocation practices

by FRANK M. KEESLING

The use of the combined report, which creates a uniform method of taxing corporations that conduct business within and without the state, is spreading and undergoing crucial tests in various states. Mr. Keesling discusses the required use of the combined report and analyzes the most salient features of such reports.

SIMPLY STATED, the purpose of the combined report is to insure that the income of a business conducted partly within and partly without the taxing state shall be determined and apportioned in the same manner regardless of whether the business is conducted by one corporation or by two or more affiliated corporations. In cases where the business is conducted by one corporation, the income is computed as a unit and apportioned by means of an appropriate formula, usually the three-factor formula of property, payroll, and sales. The income so attributed to the state is combined with any non-business income which the taxpayer may have from sources within the taxing state, such as interest, dividends, rentals from properties not used in the business, etc., to arrive at the taxable income.

Single, multiple corporations

When the combined report is employed, exactly the same procedure is followed, and the same results obtained, in cases where the business is conducted by more than one corporation. The income is still computed as a unit just as it would be if the business had been conducted by one corporation only.

Furthermore, the income is apportioned by means of an appropriate formula, again, just as it would be if the business had been conducted by one corporation. The income so apportioned to the taxing state is combined with the non-business income, if any, of the corporation doing business in the taxing state, to arrive at the total taxable income. Thus, so far as determining the amount of business income attributable to a particular state is concerned, no advantage is obtained, and no detriment suffered, as the result of employing a number of corporations rather than one to operate the business.

The purpose of the Uniform Division of Income for Tax Purposes Act is to promote uniformity in allocation practices by requiring that all business income be apportioned by the use of a formula, and that various classes of non-business income be allocated in accordance with specific rules. Both the purpose of the Act and the method employed are laudable—notwithstanding that it was adopted by the states primarily to prevent Federal legislation in this area. Unfortunately, its purpose is being frustrated by the failure of many states to interpret it as requiring the use of the combined report, or some similar procedure, to apportion the income of multi-corporate businesses. The resulting disparity in allocation practices is not confined to the fact that some states, such as California and Oregon, employ the combined report, whereas, other states deal with each corporation separately regardless of the fact that it may be one of a number of commonly-owned corporations engaged in the conduct of a single business.

The disparity goes deeper than that. In the case of the single corporate business, the income will be apportioned by a prescribed formula, provided, of course, the requirements of the Uniform Act are observed. Unless the combined report, or some similar procedure, is employed to apportion the income of a multi-corporate business, such income will be apportioned substantially according to separate accounting principles, which is contrary to the spirit and intent of the Act.

The point may be illustrated by a simple example. Corporation "X" is engaged in the manufacture of a product in State "A" which it sells in State "B." The operation is profitable and produces, say, an income of $1 million. State "A" imposes a tax on or measured by income at a fairly high rate. State "B" either does not impose such a tax, or imposes one at a lower rate. It is, accordingly, to the company's advantage to allocate as little income as possible to State "A." To accomplish this, on its books of account it charges its product to its selling division at cost, claiming that manufacturing operations do not produce income, and that income is not realized until sales are made. It files its tax return with State "A," computing its income on the basis of its books of account. Thus, it reports no income to State "A," but instead insists that its entire income is attributable to State "B" where its sales were made.

This is permitted for a number of years, but then State "A" adopts the Uniform Act which provides that business income shall be apportioned by the use of a formula. The application of the formula results in attributing some 40%, or $400,000 of the company's income to State "A." Although this result seems fair enough, the corporation does not like it. Upon the advice of counsel, it organizes a separate selling subsidiary "Y" to which it sells its entire product at cost. In its tax returns filed with State "A," it again reports that it realized no income in that state. Thus, notwithstanding the adoption by State "A" of the Uniform Act, the income is apportioned, as previously, by separate accounting. Hence, the purpose of the Act in requiring that all business income be apportioned by the formula method is completely frustrated.

Separate accounting

Although there is some movement to the contrary, separate accounting is a reasonable method for separating non-business income from business income. It is not, however, an appropriate method for the apportionment of busi-

EXHIBIT 20

ness income. There are several reasons for this.

The main objection to separate accounting is that it endeavors to treat separately what is, in fact, inseparable. Inevitably the result must be arbitrary and capricious. One-half of a bridge unconnected with another half will not function very well and will not be worth very much. But put the two halves together, and the bridge may function very well and may be quite valuable. The value, however, should not be attributed in its entirety to one-half of the bridge rather than the other. Instead, there should be an equitable apportionment between the two.

Similarly, where a business is carried on between two or more states, the income should not be computed and apportioned separately on the basis of a segment of the business, but instead should be computed as a unit and apportioned by some reasonable formula which gives weight to the location of the major factors which produce the income. This is true regardless of whether the business is operated entirely by one company, or whether it is arbitrarily divided into a number of segments each of which is operated in the name of a separate but commonly-owned and controlled corporation.

In applying the separate accounting method, goods and services transferred between divisions of a single corporation, or between affiliated corporations, are often transferred at what purports to be an arm's length price. This involves trying to determine what the goods or services would sell for by a willing seller to an unrelated or uncontrolled willing buyer. This figure is then used in computing the income of the divisions or affiliated corporations as the case may be.

The fair arm's length price standard is hopelessly deficient in several respects. First of all, to police its application to the myriad of transfers which take place daily, monthly, yearly, would require an army of agents greater than the total number of agents employed by all the states and the Federal Government combined.

Again, in many instances the determination of a fair arm's length price requires the wisdom of a Solomon. For instance, motion pictures are seldom sold in arm's length transactions, and there is, accordingly, nothing in the nature of a market price. Furthermore, no two pictures are alike: each picture is unique. Hence, when a producing company transfers a picture to a wholly-owned distributing corporation, the determination of what the price would have been if the picture had been sold to an independent distributor presents a hypothetical problem which is impossible of solution except on the basis of arbitrary conjecture and surmise. Similar conditions exist in many industries.

Finally, even if the arm's length price standard were practical of application, the results are often capricious. Notwithstanding that all the various segments of a business may contribute to, and may even be essential to, the successful operation of the business as a whole, the use of this standard as an adjunct of the separate accounting method may reach the conclusion that some segments were highly profitable, others broke even, and still others operated at a loss.

In the California Franchise Tax Commissioner's office in 1935,[1] the three-factor formula method was being employed to some extent, but on a somewhat haphazard, hit-or-miss basis. There was no definite policy as to when it should be used. Shortly thereafter the policy of requiring the use of the formula method to apportion the income of unitary businesses was instituted.

As a result of this policy, the formula method was employed to determine the amount of income earned in California by a corporation known as Butler Brothers. The corporation operated seven wholesale department stores, one of which was located in California. Its headquarters offices from which the business was managed and controlled was located in Chicago. All goods for all seven stores were purchased centrally. The business was highly profitable. The corporation computed its California income by the separate accounting method, and reached the conclusion that it operated at a substantial loss in California. The application of the three-factor formula attributed a substantial income to the state. The taxpayer paid the resulting deficiency and brought suit to recover.

Shortly before the case was set for trial, it was learned that the corporation, by buying in large quantities, was able to realize a purchasing profit, i.e., it could obtain goods at a lower price than would have been possible if it had bought in small quantities. But it was able to buy in large quantities only because it sold in large quantities. Thus, there was an inter-dependent relationship between sales and purchases. Since California contributed to the sales, it was the author's opinion that California should be credited with a proportionate share of the profits.

The state prevailed in the trial court. The district court of appeals, which is an intermediate court in California, reversed, and wrote an opinion upholding separate accounting. The California Supreme Court granted a hearing and reversed the district court of appeals. The U.S. Supreme Court sustained the California Supreme Court. As a result, we have the case of *Butler Bros. v. McColgan*, 17 Cal. 2d 664, 111 P. 2d 334, *aff'd.*, 315 U. S. 501 (1941), which ranks with *Underwood Typewriter Co. v. Chamberlain*, 254 U.S. 113 (1920), and *Bass, Ratcliff & Gretton v. State Tax Comm.*, 266 U.S. 271 (1924), as one of the leading cases on the use of the formula method in the allocation of income.

[1] The author joined the staff of the California Franchise Tax Commissioner's office in 1935.

DEFINITION OF COMBINED REPORT

A CALIFORNIA combined report contains, along with other data, a schedule disclosing the profit or loss of each included corporation and eliminations of intercompany items, including dividends to the extent that they are paid out of unitary business income realized by the declaring corporation and included in a combined report filed by the recipient, and a combined apportionment formula schedule showing the total factors for all included corporations after elimination of intercompany items and adjustment for intercompany profit in inventory and the amount, if any, of each corporation's California factors. Combined unitary income is apportioned to California by application of the combined apportionment formula. The California unitary income thus determined is allocated to the corporations subject to California tax based on each corporation's California apportionment percentage. ☆

[Frank M. Keesling of the California Bar is a partner in the Los Angeles law firm of Loeb and Loeb. He was formerly Assistant Secretary of the California State Board of Equalization and Counsel for the California Franchise Tax Commissioner. He has co-authored, with George T. Altman, "Allocation of Income in State Taxation," published by Commerce Clearing House in 1946 and 1950, and has written numerous articles on tax matters. This article has been adapted from a speech given at the annual meeting of the Multistate Tax Commission in Denver, Colorado in June, 1974.]

Birth of combined report

For many years following the inception of the California Franchise Tax in 1929, the members of a well-known, and, in those days, highly profitable, industry were paying only the minimum franchise tax. The technique was quite simple. The property produced in California was sold to wholly-owned, out-of-state distributing corporations at cost. Thus, the production corporations in California filed returns showing no income from California sources. All of the income was reported by the distributing corporations, and for the most part escaped state income tax completely.

The possibility of requiring a consolidated return was considered but abandoned for a number of reasons. First of all, in a somewhat similar context, the New York Tax Commission had attempted to require the filing of consolidated returns, and had been rebuffed by the New York Court of Appeals in the case of *People ex. rel. Studebaker Corp. v. Gilchrist*, 244 N.Y. 114, 155 N.E. 68 (1926). There was the possibility that the California courts might reach a similar result. This possibility was particularly imminent since in the case of a consolidated return, the income is not only computed as a unit, but taxed as a unit. Thus, it might well be urged that a compulsory consolidated return would be unconstitutional on the grounds that it might result in one corporation being taxed on the income of another.

Again, an affiliated group of corporations may include corporations some of which are taxed differently from the others. Such differences present virtually impossible administrative problems if the income of the group is to be combined and taxed as a unit. For example, in California, banks and financial corporations are required to pay a higher rate of tax measured by income than general business corporations. Similar differences undoubtedly exist in the laws of other states. If each corporation is taxed on its own income, these differences can be given effect. This becomes virtually impossible, however, if the income is combined with that of other corporations and the total income taxed as a unit.

The thought occurred that if, in the case of a single corporation doing business within and without the taxing state, it is permissible for the state to look beyond its borders and take into account the entire income of the business in order to determine the true income realized from the portion of the business conducted within the state, then why should it not be equally permissible for a state, in the case of a multi-corporate business, to look beyond the corporate lines and take into account the entire income from the business in order to determine the true income attributable to the corporation or corporations doing business within the state?

If in the case of a single corporation, the state is not compelled to make an apportionment on the basis of the taxpayer's books of account, but can disregard them and make the apportionment by applying a formula to the income from the entire business, then why shouldn't it likewise be permissible in the case of a multi-corporate business to disregard the taxpayer's books of account and apportion the income by applying a formula to the entire income of the business?

This line of reasoning appeared convincing, and so the combined return or combined report procedure was born. Its purpose was two-fold. First, to prevent tax avoidance through the manipulation of transactions, such as sales, between controlled corporations, and second, to insure that the income of a multi-corporate business should be computed and apportioned in the same manner as in the case of a single corporate business, thus promoting equality and uniformity in the application of the state's tax laws. It has accomplished both of these objectives very effectively.

Under the combined report procedure, inter-company transactions are eliminated, and hence it is immaterial whether they are rigged or not. So far as the second objective is concerned, the adoption of the combined report proved quite timely. California won the *Butler Brothers* case, but except for the combined report requirement, Butler Brothers could have prevailed by the simple expedient of organizing a separate corporation to operate the California store.

Oddly enough the validity of the combined report procedure was never questioned by the corporations at which it was initially aimed, notwithstanding that its application resulted in a substantial increase in their California franchise taxes. However, its validity was subsequently challenged aggressively by another group of taxpayers. It was sustained as a reasonable allocation method by the California Supreme Court in *Edison California Stores v. McColgan*, 30 Cal. 2d 476, 176 P.2d 697, *reaff'd.*, 30 Cal. 2d 472, 183 P.2d 16 (1947).

Features of combined report

There are several features of the combined report procedure which should be emphasized:

1. At the time the combined report procdure was put into operation, there were no provisions in the California law specifically authorizing it. Instead, the authority for employing it was derived from the general power and duty of the Commissioner to determine the income attributable to sources within the state and subject to the franchise tax. This is made abundantly clear in the *Edison Stores* case.

This point is mentioned for two reasons. First of all, there has been considerable confusion concerning the matter. Thus, some years ago Wisconsin adopted the combined report, but the Wisconsin Supreme Court repudiated it in the case of *Interstate Finance Corp. v. Wisconsin Dept. of Tax.*, 28 Wis. 2d 262, 137 N.W. 2d 38 (1965). The Wisconsin court attempted to distinguish the *Edison Stores* case on the grounds that that case must have been based upon a peculiar provision of the California law. Nothing could be further from the truth. Instead, as stated above, the combined report procedure was adopted and upheld as a reasonable but not specifically authorized, apportionment method.

The Supreme Court of Oregon avoided the error made by the Wisconsin court, and sustained the use of the combined report in Oregon, primarily upon the

authority of the *Edison Stores* case.[2]

The second reason for calling attention to the point as to the source of authority for the combined report is to make clear that the fact that the Uniform Act does not specifically require it constitutes no barrier to its adoption by the Multistate Tax Commission and the various member states.

2. Because of its importance, it should be emphasized that the combined report is not the same as a consolidated return, and does not in any way result in the taxing of one corporation on or measured by the income of another. Actually the combined report is not a tax return, but constitutes something in the nature of an information return. Notwithstanding its use, each corporation doing business in the taxing state is taxed on or measured by only its own income from sources within the state. However, if the corporation doing business in the state is a member of an affiliated group conducting a business within and without the state, then instead of computing the income attributable to the state on the basis of the corporation's books of account, which may reflect the operation of only a small segment of the business, the apportionment is made with reference to the income from the entire business just as would be done if the business had been conducted by one entity.

3. Not uncommonly, two or more members of an affiliated group of corporations may be doing business in the taxing state. In such cases, after the portion of the income from the entire business which is attributable to the taxing state is determined, such amount must be further apportioned between the corporations doing business within the taxing state. This can be done by using the three-factor formula taking into account only the portions of each factor which are attributable to the taxing state.

4. As mentioned previously, in the combined report inter-company charges of all kinds, such as inter-company sales, inter-company charges for interest, overhead or other items, are eliminated or disregarded. In this respect, they are treated in the same manner as inter-division charges of a single corporation in cases where the formula method is employed.

5. The question frequently arises whether the income of corporations foreign to the U. S. should be included in the combined report. The answer is an emphatic "yes." The apportionment should be made by attributing to each state a portion of the income from the entire business regardless of whether the business is conducted between two or more states of the U. S., or between one or more of such states and one or more foreign countries. This can be accomplished only by combining the incomes of all the corporations engaged in the conduct of the business. It is immaterial whether such corporations are organized under the laws of one of the states of the U. S., or under the laws of a foreign country.[3]

6. The question also often arises as to what degree of common ownership is required in order for the income of a corporation to be included in a combined report. The rule in California is that there must be common ownership, directly or indirectly, of more than 50% of a corporation's voting stock before its income will be included. Common ownership of even as much as 50% of a corporation's voting stock is not sufficient for this purpose.

7. A most controversial matter is: the income from what businesses should be combined? Should the combined-report procedure be confined to unitary businesses? Or, should the income from all commonly-owned businesses be combined and be apportioned by one formula regardless of whether the businesses are unitary or separate?

Whatever policy is followed in the case of a single corporation, it should be followed in the case of two or more affiliated corporations. For example, suppose a corporation manufactures and sells girdles. It also handles a line of men's clothing. It likewise manufactures and sells various textiles. If the income from all of these somewhat similar but somewhat diverse operations is combined and apportioned as a unit, then the same procedure should be followed even though each division is operated by a separate but commonly-owned corporation. This, however, does not answer the basic question.

In California, the use of the combined report has been confined to unitary businesses. However, the concept of a unitary business has changed and broadened over the years.

The author early defined a unitary business as one in which there is a relationship of "dependency and contribution between the portions of the business within and without the taxing state." This was borrowed by the California Supreme Court in the *Edison Stores* case, and was later adopted by the California Franchise Tax Board, the successor to the California Franchise Tax Commissioner.

At this point, it is questionable whether there is such a thing as a non-unitary business. Although it is appropriate to compute non-business income separately and to allocate it specifically, the view that all income from commonly-owned business activities should be combined and apportioned by a single formula without inquiring as to whether such activities are unitary or separate in nature seems preferable. Such a policy is simple to administer and will promote uniformity.[4]

Wherever there is common ownership there is a certain amount of common management, centralized performance of certain functions, and other indications of integration.

A policy which requires that the income from certain business activities should be computed and allocated separately on the grounds that such activities are not sufficiently integrated with other business activities to constitute a single unitary business will necessitate the drawing of numerous fine lines of distinction with respect to which reasonable people may well differ. Hence, any such policy will give rise to difficult administrative problems and will promote disparity rather than uniformity in allocation practices.

Moreover, such a policy works against the states and in favor of taxpayers. If a taxpayer wants the formula method to be applied across the board, it will call attention to various elements of integration and unity. If, however, it wants certain activities to be dealt with separately, such elements will be concealed and in many cases may not be discovered by state representatives.

Perhaps a reasonable compromise would be to adopt the policy set forth in the Regulations on this subject which were adopted by the Multistate Tax Commission, as well as by a number of the member states, including California. According to these Regulations, busi-

[2] Zale-Salem, Inc. v. State Tax Comm., 237 Ore. 261, 391 P.2d 601 (1964).

[3] See *Bass, Ratcliff & Gretton v. State Tax Comm.*, 266 U.S. 271 (1924), for an instance where formula was applied to income derived from foreign operations.

[4] In fact, such a policy more closely conforms to the understanding of the drafters of the Uniform Act. During the floor debates on the Act, Professor Pierce explained the concept of formulary apportionment by using an illustration involving a company which manufactured waste baskets, tables, and table cloths and suggested that income earned from all these operations would be apportioned by a single formula under the Act. *Proceedings in Committee of the Whole, Uniform Allocation and Apportionment of Income Act*, Wednesday, August 22, 1956, at 30-6.

ness activities which might for some purposes be regarded as separate businesses, will be considered as portions of a single business for allocation purposes if there is either operational inter-dependency, as in the case of manufacturing and selling activities, or there is strong central management coupled with the existence of centralized departments for such functions as financing, advertising, research and purchasing.[5]

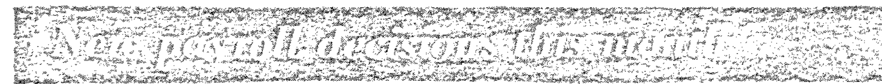
This rule represents a serious effort to deal with the problem and has much to commend it. However, in the day-by-day application of it, it is inevitable that borderline cases will arise with respect to which different administrative agencies in the different states will reach different conclusions with respect to the same commonly-owned business activities.

8. We now come to the most important question of all. Is the combined report procedure constitutional? It is impossible to predict what the appellate courts of all the different states will do. However, it should be held valid. Under it, each corporation doing business in the taxing state will be taxed on or measured by only its own income, and that income will be computed by methods which are fair and reasonable.

The California Supreme Court unanimously upheld the combined report procedure in a carefully reasoned opinion in the *Edison Stores* case. The Supreme Court of Oregon likewise held it valid. It is true that the Supreme Court of Wisconsin rejected it, but that court labored under a misconception as to the California law.

If the Multistate Tax Commission sees fit to interpret the Uniform Act as requiring the use of the combined report procedure, that circumstance alone may prove highly salutary in obtaining judicial approval of the procedure in the various states which are parties to the Multi-State Tax Compact. ☆

[5] Multistate Tax Commission, Reg. IV.1(b); see also California Administrative Code, Title 18, Reg. 25120(b).



Chairman of the board responsible for withholding taxes. (DC)

The district court determines that taxpayer, the honorary chairman of the board of directors of a professional basketball team, was the person responsible for paying over withholding taxes and that he willfully failed to do so for one quarter. *Rubin*, DC Pa., 3/7/74.

Taxpayer not responsible for withholding collection. (DC)

The district court determines that taxpayer, the purchaser of a business, is not the responsible person for collecting withholding taxes and thus is not liable for the civil penalty. *Slodov*, DC Ohio, 7/1/74.

Lower court's summary judgment reversed. (CA)

The lower court in a summary judgment held that taxpayer, a finance company, that made commercial loans to a corporation, was not a "person" required to pay over employment taxes withheld by that corporation.

Held: Reversed and remanded. This court makes no determination as to whether taxpayer is a "person" for withholding purposes. It merely holds that the lower court was in error when it determined that the instant case presented no factual issues for trial. *Adams*, CA-7, 10/3/74.

Truck unloaders determined to be employees. (DC)

The district court, after considering such factors as skills, permanency of relationship, degree of supervision etc., concludes that taxpayer is the employer of truck unloaders and responsible for withholding tax. *Security Storage & Van Co. of Norfolk, Va., Inc.*, DC Va., 3/24/74.

Supreme Court reverses ban withholding on war objectors. (Sup. Ct.)

The district court held that 51.6% of the withholding tax required to be deducted under Section 3402 should not be taken out of the salaries of two Quaker conscientious objectors employed by American Friends' Service Committee, a religious corporation engaged in philanthropic work. The 51.6% represented the amount which was considered used for military expenditures.

Held: Reversed, with one dissent. The lower court's injunction against the collection of tax by withholding enjoins the collection of the tax, and is therefore contrary to the express purpose, of the Anti-Injunction Act. A legal remedy exists for the employees to litigate their tax liability in a refund suit even though such method may frustrate their original method of bearing witness to their religious convictions. *American Friends Service Committee*, Sup. Ct., 10/29/74.

Chairman-officer was person responsible for withholding. (CA)

The district court held that taxpayer, the chairman of the board and chief executive officer of a corporation, was liable for failure to collect and pay over withholding taxes.

Held: Affirmed. The facts indicate that taxpayer is the responsible person and that failure to discharge such responsibility was willful. Also, the Commissioner did not abuse his discretion in failing to apply a net operating loss to reduce withholding tax liability. Finally, an unsigned return did not start the running of the statute of limitations. It did not matter that the return was not taxpayer's personal return or that he was unaware of the fact that it had not been signed. He was responsible for it. *Kalb*, CA-2, 10/15/74.

Liability for 100% penalty determined. (DC)

A district court held a husband and wife were not liable for the penalty for willful failure to pay withholding taxes due. They were merely titular officers after surrendering control under the terms of a management agreement that precluded their withdrawal of funds from a company bank account. *Couture*, DC Wash., 8/30/74.

Liability for 100% penalty determined. (DC)

A district court upheld imposition of the 100% penalty on corporate officers who used withheld taxes to pay other creditors. *Pearson*, DC Minn., 7/3/74.

Rehearing denied in withholding issue. (CA)

The Circuit Court denies a rehearing regarding a case involving withholding tax issues. *Snider*, CA-4, 7/19/74.

Services in hospital, etc. can be considered performed in a private home. (Rev. Rul.)

After considering factors such as the nature of a patient's illness, physical condition, length of confinement, etc., the domestic services performed in a convalescent home, nursing home or hospital may be considered "domestic serv-

EXHIBIT 21

MULTISTATE TAX COMMISSION RESOLUTION

RESOLUTION NO. 3

Be it *Resolved*, that:

(1) It is the official policy of the Multistate Tax Commission that the unitary business concept is appropriate for attributing income with respect to all businesses affected by the Uniform Division of Income for Tax Purposes Act; and that

(2) It is appropriate on a worldwide as well as a domestic basis regardless of whether the parent or some or all of the subsidiaries are located outside or inside the United States; and that

(3 The Commission recommends that each state pursue the policy recommended in this resolution to the full extent permitted by its laws; and that

(4) Where a state's laws do not permit complying with this recommendation, efforts be made to amend those laws in order to effect such a result.

Exhibit 21

EXHIBIT 22

[illegible] more than 50% of the voting shares of which are owned by the Canadian [illegible]

[illegible] three to six months following filing of the annual return for the taxation year.

Tax Planning International June 1977 (see box p. 109)

The U.K./U.S. Tax Treaty
A Detailed Reappraisal

Since the renegotiated U.S./U.K. double tax treaty ("the treaty") was signed in London on December 31, 1975, it has been amended three times. It has been debated and approved for ratification together with two of the sets of amendments by the U.K. Parliament on January 12, 1977 but has not yet been approved by the U.S. Senate. The latest forecast is for ratification by the United States "around June" of this year but there is much controversy regarding the unitary provisions of Article 9 ("Associated Enterprises") and it remains to be seen whether this timing will be achieved.

The amendments to the treaty were by an exchange of letters on April 13, by a protocol signed on August 26 1976 and by a second protocol signed on March 31, 1977. The principal amendments since signature on December 31, 1975 are in respect of the following:

Article 1 (Personal Scope): Paragraph (2) of this article provided that, with certain exceptions, corporations which were resident of both the United Kingdom and the United States for the purposes of the treaty were outside the scope of the treaty. It was not clear as originally drafted if this paragraph would thereby preclude a shareholder in such a corporation from taking advantage of Article 10 (which inter alia grants a tax credit to a United States shareholder in a U.K. company). An amendment has clarified the position so that it is now accepted that such a shareholder will receive a tax credit. In addition, the paragraph has been altered so that dual resident companies can claim credit relief in the United States for underlying tax related to dividends and for petroleum revenue tax, and to give a U.S. corporation with dual residence exemption from tax in the United Kingdom on profits from operating ships and air-

Received from
J. Rowe, Washington, D.C.
via telecopier
1/24/78

Exhibit 22

Article 4 (Fisc[illegible] ... new paragraph (4) is proposed which will provide that a woman who is a United States national and married prior to January 1, 1974 to a man domiciled in the United Kingdom will be able to determine her domicile for the purposes of U.K. taxation on the basis that her marriage had taken place on 1 January, 1974. The effect is to enable such a married woman to enjoy the remittance basis of assessment to tax in the United Kingdom on her American source income. In fact, the lobby for this amendment had pointed out that there had been sex discrimination in that a man of the United States nationality would be assessed on the remittance basis whereas this would not have been available to a woman of the same nationality in comparable circumstances.

It should be explained that an individual who is regarded as being domiciled outside the United Kingdom for U.K. tax purposes is taxable in the United Kingdom only on the amount of his non-U.K. source income and capital gains which he remits to the United Kingdom when he is resident in the United Kingdom. Prior to 1974, a woman automatically acquired the domicile of her husband on marriage so that, if she married a U.K. national, she would invariably acquire a U.K. domicile and therefore lose the advantage of the remittance basis of her non-U.K. income and capital gains. The Domicile and Matrimonial Proceedings Act 1973 changed this position as from January 1, 1974 with the result that a woman who married after 1973 has her domicile determined by reference to the same factors as are applied in the case of an individual capable of having an independent domicile.

The new paragraph which applies from April 6, 1976 could be very advantageous to a woman of U.S. nationality who married a British subject prior to January 1, 1974 in that the couple could avoid the heavy burden of the liability to U.K. tax on non-U.K. income provided that they can afford not to have to remit that income into the United Kingdom. At least this will provide some recompense for the disappearance of the benefits of the Strathalmond decision.

Article 8 (Shipping and Air Transport): The 1945 treaty had included a provision which had the effect of reciprocating the exemption granted by the United States under its Internal Revenue Code to any foreign corporation or non-resident alien from the operation of a ship or aircraft provided the country in which the ship or aircraft is registered granted a similar exemption to U.S. corporations or citizens on income from the operation of a ship or aircraft registered under U.S. law. This has appeared to be an omission from the treaty signed on December 31, 1975 since the United Kingdom does not provide the foregoing type of reciprocal exemption under its internal law. This deficiency has now been rectified by the protocol of August 26, 1976.

The treaty was consi[illegible]greed to by the United Kingdom Parliament after some one and a half hours of debate late in the evening of January 12, 1977. The treaty under debate was as amended by the exchange of letters on April 13 1976 and at the same time the protocol signed on August 26, 1976 was agreed to. The further protocol of March 31, 1977 has yet to be considered.

In presenting the treaty to Parliament, the Minister touched on a number of aspects including the following.

- U.K. petroleum revenue tax will qualify for tax credit in the United States
- the United Kingdom will be able to tax capital gains made on the disposal of North Sea licences
- the elimination of the technical flaws in Article XV of the previous convention which had caused problems
- the provisions designed to limit the power of the constituent states of the United States to compute the local tax liability of U.K. enterprises under the "unitary" tax system
- the provision to prevent abuse of the treaty by residents of third states
- the mutual agreement procedure
- the taxation of artists and athletes or entertainers.

Members of Parliament showed interest or concern on a number of points but, far out-weighing all others, was concern at the position under the treaty of "American wives", i.e., U.S. nationals married to men domiciled in the United Kingdom who had previously been able to take advantage of the Strathalmond case (48 TC 537). As mentioned above, an amendment to Article 4 has since been agreed at official level which will alleviate the situation. Other matters of concern were the flow of funds from the United Kingdom to the United States by way of dividends, the striking of a fair balance between portfolio and direct investors of both countries, fears that U.K. entertainers might be treated less fairly than their U.S. counterparts and the "unitary" tax system adopted in particular by California and Oregon.

Detailed Aspects of the Treaty

Dividends and Tax Credits Thereon (Articles 10 and 23): The dividend article is of considerable interest in that it is the first such article negotiated by the United Kingdom since that country introduced the "imputation" system of taxation in which a direct investor (that is, a corporation owning 10% or more of voting capital) is to be paid a part of the tax credit which is available to a shareholder resident in the United Kingdom.

The position of the varying types of shareholder receiving dividends to which the treaty applies is as follows:

shareho...

(i) To a direct investor: The dividend is subject to 5% withholding tax (Article 10, para 2(b)(i)) in the United States, compared with 15% under the 1945 treaty. The shareholder will receive double tax relief against his liability to U.K. corporation tax for the withholding tax and for an appropriate part of the U.S. tax payable in respect of the profits out of which the dividend is paid ("the underlying tax" (Article 23, para (2)).

(ii) To a portfolio investor (that is any investor other than a direct investor) - The dividend is subject to 15% withholding tax in the United States (Article 10, para (2)(b)(ii)) the same as under the 1945 treaty. The investor other than a direct investor) The his liability to income or corporation tax in the United Kingdom for the withholding tax but not for the underlying tax (Article 23, para (2)(a)).

- Dividends paid by U.K. corporation to U.S. shareholder.

(i) To a direct investor: In addition to the dividend itself, the U.S. corporation is to be paid an amount by the Inland Revenue equal to one-half of the tax credit to which an individual resident in the United Kingdom is entitled. A withholding tax of 5% will be imposed by the Inland Revenue on the aggregate of the dividend and the amount of tax credit repaid (Article 10, para (2)(a)(i)). The corporation will receive double tax relief against its liability to U.S. tax for the 5% withholding and for an appropriate amount of the tax paid in the United Kingdom with respect to the profits out of which the dividend is paid (Article 23(1)) This is best illustrated by an example and, for this purpose, it is assumed that the U.S. corporation owns the whole of the capital of the U.K. corporation. The rate of tax credit is 33%, namely that proposed (subject to certain conditions) by the Chancellor of the Exchequer in his Budget on March 29, 1977 Two situations are considered (A) where the subsidiary in the United Kingdom makes a maximum distribution and (B) where it makes a distribution of one third of maximum (See box in col. 2.)

	A Maximum distribution	B One-third maximum distribution
(1) Pre-tax profits	10,000	10,000
(2) UK corporation tax (52% of (1))	5,200	5,200
(3) Available for dividend ((1) – (2))	4,800	4,800
(4) Cash dividend	4,800	1,600
(5) UK Tax credit (33/67 of (4))	2,364	788
(6) UK Repayment ½ of (5))	1,182	394
(7) UK Withholding (5% of (4) + (6))	299	100
(8) Net UK Repayment ((6) – (7))	883	294
(9) Net UK underlying tax for US tax credit purposes ((2) – (6))	4,018	4,806
(10) Total cash received ((4) + (8))	5,683	1,894
(11) Plus Withholding ((7))	299	100
(12) Gross-up (see note)	4,018	1,845
(13) Gross up for US tax purposes ((10)+(11)+(12))	10,000	3,839
(14) US tax before credit (48% of (13))	4,800	1,843
(15) Credit for U.K. tax ((11)+(12))	4,317	1,945
(16) US tax after credit ((14) – (15)) or	483	—
(17) Excess credit ((15) – (14))	—	102

Note: The formula for the gross-up is:

$$\frac{\text{Dividend} \times \text{Net UK tax for US tax credit purposes}}{\text{After tax profits}}$$

Thus:

$$\frac{4,800(4)+1,182(6)}{10,000(1)-4,018(9)} \times 4,018(9) \text{ or } \frac{1,600(4)+394(6)}{10,000(1)-4,806(9)} \times 4,806(9)$$

i.e. 4,018 ... 1,845

The result would differ where the U.S. corporation owned part of the capital of the U.K. corporation and the balance was owned by U.K. residents Neither Government has explained how this situation would be dealt with but with a U.K. corporation owned as to one-third by a U.S. corporation and as to two-thirds by U.K. residents and making a maximum distribution, one would expect the result to be as in column B.

(ii) To a portfolio investor. A portfolio investor resident in the United States is to be repaid by the Inland Revenue, in addition to the dividend itself, the full tax credit to which an individual shareholder resident in the United Kingdom is entitled. A withholding tax of 15% will be imposed by the Inland Revenue on the aggregate of the dividend and the amount of tax credit paid (Article 10, para (2)(a)(ii)). The portfolio investor will receive double tax relief against his tax liability in the United States for the 15% withholding tax but not for the underlying tax (Article 23, para (1)). For the purpose of United States tax his income is the dividend plus the repaid tax credit.

... business profits of an enterprise of one country can be taxed by the other. Paragraph (1) provides that they shall not be so taxed except to the extent that they are attributable to a permanent establishment in the other country through which the enterprise carries on business. The term "permanent establishment" is defined in Article 5.

Paragraph (2), which is subject to paragraph (3), provides that the attribution is to be on the basis that the permanent establishment "was a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a "permanent establishment". Under paragraph (3) the deductions which are to be allowed are to include "a reasonable allocation of executive and general administrative expenses, research and development expenses, interest and other expenses incurred for the purposes of the enterprise as a whole" wherever incurred.

Paragraph (4) provides that the mere purchase of goods should not cause the attribution year by year unless there is a good reason for change.

Paragraph (7) is of importance since it defines, albeit not on a "not limited to" basis, business profits as including "income derived from manufacturing, mercantile, banking, insurance, agricultural, fishing or mining activities, the operation of ships or aircraft" (but consider Article 8 as amended), "the furnishing of services, the rental of tangible personal (movable) property and the rental or licensing of cinematographic films or tapes used for radio or television broadcasting or from copyrights thereof". It also includes any other income effectively connected with the permanent establishment.

Associated Enterprises (Article 9): Basically, this article permits the profits of an enterprise to be adjusted where its dealings with an associated enterprise are not at arm's length. As originally drafted the article was comparatively straightforward. However, in the April 1976 exchange of letters, paragraph (4) - the "prohibition" paragraph - was amended. This paragraph is intended to prohibit (or at any rate limit) the application of the "unitary" tax system employed by some of the states of the United States, particularly California (which name is used as representing all such states in considering below the effect of this article). Under the "unitary system", the profits of a permanent establishment are computed having regard to the worldwide activities of that establishment and of all its related enterprises. Invariably this will produce a higher taxable profit than that calculated based only on the figures relative to the state concerned.

Article 9 as it stands at present prohibits the application of the unitary business rule except in the following cases:

California Stance May Jeopardise Treaty

One of the prime stumbling blocks to ratification of the UK/US Treaty continues to be the adamant opposition of the State of California. Several British companies with operations in California — together with other foreign companies — are reported to be refusing to supply the California tax authorities (the California Franchise Tax Board) with full information on their worldwide operations on the grounds that the information demanded by the California authorities is infinitely more than would be required by the United Kingdom's Inland Revenue. The gravity of the situation is underscored by the fact that the Confederation of British Industry is contemplating sending delegates Washington to sit in on treaty deliberations before the Senate Foreign Relations Committee.

The plain fact is that California is opposed to the treaty in its present form since it would stand to lose an estimated $100 million and more annually. The loss would arise because the treaty, details of which were agreed between the respective governments no less than eighteen months ago, would offer protection against California's singular approach to the taxation of foreign companies: the California authorities seek to impose tax not on the results of the California subsidiary of the foreign parent but tax instead on a proportion of the parent company's consolidated worldwide pre-tax income, namely by averaging out the ratios of California payroll costs to world payroll costs. This proportion is then subject to tax at the 9% California rate. Under the proposed treaty, however, taxes would be levied solely on income from a foreign company's California operations.

California's formulary approach to measuring the California income of a "unitary" business has substantial theoretical justification and may represent the wave of the future for the taxation of income of multinational enterprises by different countries. The views of the influential Senate Foreign Relations Committee may indicate whether this idea's time has come: the Committee's views are eagerly awaited.

- to arrive at profits on an arm's length basis;
- where the corporation doing business in California is resident in the United Kingdom but nevertheless is a controlled foreign corporation within the meaning of Section 957 of the Internal Revenue Code 1954, and
- where the corporation doing business in California is resident in the United States and the related enterprises (e.g. a U.K. subsidiary) are owned by it.

There has been considerable feeling in certain states of the United States over this because their tax-raising powers are likely to be affected. It was stated in the debate in Parliament that Mr. David Foster, International Tax Counsel to the Secretary to the United States Treasury, when addressing the International Tax Association in New York on 10th January 1977, said specifically that this was one of two major items still open for negotiation. Certainly there is no doubt that this has been a considerable factor delaying ratification of the treaty by the U.S. Senate (See box above).

Paragraph (2) and (3) are to be welcomed as a significant step in endeavouring to overcome the problems of the economic double taxation which could arise from adjustments (or the absence of corrective adjustments) made by taxing authorities.

Non-Discrimination (Article 24): Paragraph (3) of this article is of interest in that it spells out the deductible expenses of an enterprise of one country paid to a resident of the other. They are interest, royalties and other disbursements if reasonable in amount. "Other disbursements" include amounts exempted for the purposes of the enterprise, including a reasonable allocation of executive and general administrative expenses (except relating to "stewardship" or "overseeing" functions as an investor), research and development in respect of which the enterprise has the benefits under a cost and risk sharing agreement and other expenses incurred for the benefit of a group of related enterprises.

Mutual Agreement Procedure* (Article 25): In introducing the treaty to Parliament the Minister said of this article:

> "I should also like to mention the article of the convention which provides a remedy for the person who is being taxed both by the United States and by the United Kingdom and who considers that the taxation is not in accordance with the terms of the convention. This is Article 25 - containing the mutual agreement - and it enables the two Revenues to attempt to resolve the dispute by direct contact with each other.
>
> "This procedure is, I understand, well known to international tax practitioners as the "competent authority channel" and both we and, I believe, the Americans regard this channel as providing a very valuable means of ensuring the elimination of double taxation. We had a similar provision in the "old" convention, and it always worked well. I hope that the new provision - which is rather more elaborate than the old one - will continue to enable these problems of double taxation to be resolved satisfactorily"

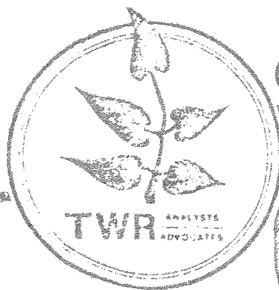
Paragraph (3) of the article lists six specific points on which the competent authorities should endeavour to reach agreement; they are:

- the attribution of income, deductions, credits or allowances of an enterprise of one country to its permanent establishment in the other
- the allocation of such items between persons
- the nature of particular items of income
- the meaning of terms not otherwise defined in the treaty
- the place where any income has its source
- the elimination of double taxation of income paid out of trusts

One can only echo the Minister's concluding sentence.

Brian Aungiers,
Peat, Marwick, Mitchell & Co.,
London.

EXHIBIT 23



THE U. K. TREATY DEBATE: SOME LESSONS FOR THE FUTURE

by Peggy B. Musgrave

Peggy B. Musgrave is a visiting professor of economics at the University of California at Berkeley. She is the author of U.S. Taxation of Foreign Investment Income, as well as many articles on international trade and public finance.

In this article, Professor Musgrave discusses some of the central issues that were involved in the recently concluded debate over the U.S.-U.K. Tax Treaty. She also offers some observations that she feels should be taken into account when similar tax treaties are negotiated in the future. She suggests that the debate over the U.S.-U.K. Tax Treaty raised fundamental issues that are not yet adequately addressed in the treaty-making process. She therefore urges Treasury representatives and other interested parties to take a "fresh look" at the basic purposes and provisions of international tax treaties.

The resolution of conflict in international tax matters assumes ever greater importance as international capital mobility increases and business operations across national boundaries take more complex forms. International tax treaties are useful in meeting these difficulties but have traditionally been guided by the mutual interests of foreign investors, with insufficient input from the broader public interest.

Efforts to draw up multilaterally acceptable provisions and common treaty formats have not, in my opinion, been addressed adequately to the basic requirements of a tax treaty, namely to establish rules for fair effective administration of tax laws as they apply to international businesses. Furthermore, in recent years tax competition for international capital has emerged on the world scene and has had its impact both on unilateral tax policy and tax treaty negotiations. In this process, the transnational corporation is apt to gain at the expense of treasuries in all countries in which it operates. The U.S.-U.K. treaty exemplifies these problems.

The U.S.-U.K. Tax Treaty trades tax concessions by each country to the foreign investors of the other. It is regrettable that this form of counter-productive tax competition should be enshrined in the form of an international tax treaty. This is particularly so since — except for those provisions that were reserved or modified as a result of Senate debate — the treaty establishes a number of unfortunate precedents which are likely to be repeated in future treaties. Among the dubious provisions of the treaty, some of which have been or will be corrected by Senate action, are:

- U.S. crediting of the U.K. Petroleum Revenue Tax (PRT) (Articles 2 and 23 of the Treaty).
- Rebate of the U.K. Advance Corporation Tax (ACT) for U.S. investors in British companies, and
- Constraints on state use of unitary apportionment (Article 9(4)).

The Petroleum Tax Credit

A massive volume of windfall transfers of income from consumers to producers has resulted from the drastic increase in world oil prices. Most producing countries seek to appropriate these gains for the benefit of the general taxpayer or of the public sector. The Crude Oil Equalization Tax proposed by the Carter Administration is a case in point, as is the U.K. Petroleum Revenue Tax (PRT). Given the fact that the latter is geared to the world price of oil and designed to divert part of the rental gains to the British Treasury, it does not seem appropriate that the U.S. Treasury should then in effect absorb the cost by allowing the tax to be credited against the U.S. tax liability. Rather, the tax should be treated as a deduction from taxable income — appropriate treatment for a royalty.

While there is a *pro forma* argument to be made that the PRT is based on income, the obvious intent is to collect a substantial royalty on U.K. oil. Unfortunately, the treaty sought to set the precedent of allowing any royalty on natural resource production which is disguised as an income tax to be offset against U.S. tax, with revenue consequences as yet unforeseen.

The Advance Corporation Tax Rebate

Rebate of the advance corporation tax has been triumphantly presented to the public by the U.S. Treasury as a substantial transfer from the British Treasury to U.S. portfolio investors. And indeed it is. It is not surprising that the provision has been a matter of some controversy in the U.K. itself and that it is problematical whether it would pass the British Parliament a second time.

But it requires a very short-run view of things to see this measure as a great gain for the U.S. public interest. Apart from the questionable incentive it will give to further U.S. capital outflow at a time when the balance of

There is, I believe, a need for taking a fresh look at the basic purposes and provisions of international tax treaties. . .

Exhibit 23 27

payments is under stress, there are extensive and adverse revenue implications for the future. It is very likely that the U.S. itself will move sooner or later to some form of corporate-individual income tax integration probably in the British pattern. When and if this happens, the customary rules of reciprocity in tax-treaty formats would require the U.S. to offer the same kind of rebate to its treaty partners, including the U.K. Inasmuch as the rebates would be larger for portfolio investors and the bulk of investment from abroad in the U.S. is in portfolio form, the U.S. revenue loss would be substantial. This eventuality was hardly discussed in the debate on the Treaty.

The controversy over the U.S.-U.K. treaty has raised fundamental issues which have not as yet been adequately addressed in the treaty-making process.

But a far more fundamental issue is raised in this connection. Do rules of "fair tax shares" by parties to tax treaties suggest that the same tax treatment be afforded to foreign as to domestic investors, as the proposed U.K. provision would suggest? I do not believe this to be the case. How a country taxes its domestic investors and its investors from abroad should be guided by different considerations. The former has to be a matter of domestic taxpayer equity and prevailing views regarding the appropriate rate of saving and investment in the domestic economy. The latter, on the other hand, should be guided by considerations of appropriate tax shares in income accruing to foreigners. The two need not coincide.

Profits taxes are an important component of the gain to the capital-importing country from foreign investment. If the profits tax is to be effectively eliminated through the process of integration — and this may be desirable as a matter of domestic tax and economic policy — this should not mean that the capital-importing country thereby surrender its tax share of profits accruing to investors from abroad. Tax treaties should not establish this precedent. Although foreign investors stand to gain relative to other taxpayers, there is little economic gain to be had from promoting cross-flows of capital at substantial revenue cost to each country.

Constraints on Unitary Apportionment

If Article 9(4) of the U.K. Treaty had not been reserved, it would have introduced a further undesirable precedent into the treaty-making process, for that provision was likely to undermine a form of tax-base division which is necessary to the administration of viable profits taxes at the state level. This was unfortunate in view of the long efforts towards adoption of more uniform income allocation procedures at the state level. It is unlikely that the states could have continued to apply the unitary method to domestic-based corporations, if they had been required by treaty to abandon it for foreign-based corporations.

When business activities extend across jurisdictional boundaries (international, state or other political subdivisions), some reasonable method of dividing up the corporate profits tax base among the participating jurisdictions is needed. While separate accounting is used by the federal government and most other central governments, it is no less arbitrary than is unitary apportionment.

Due to the integrated nature of the multinational corporation and the interdependency of its parts, clearly defined and separable units of economic activity do not begin and end at political boundaries. The question then is how to unscramble the omelet in an equitable and efficient manner. Given the nature of the multinational corporation, I believe that the unitary apportionment approach, if adopted on an international scale, would go far to ensuring that there were no gaps or overlaps in the division of the tax base and would allow the application of an apportionment formula which would be acceptable on inter-nation equity grounds.

The three-factor formula generally in use at the state level may not be the optimum one for this purpose, and consideration of alternatives should be a matter for international tax agreements. The Treasury might do well to take the leadership in promoting such an agreement, rather than undercutting the progress made by the states in establishing a uniform system.

Proponents of Article 9(4) suggested that the arm's-length-separate-accounting method is inherently closer to establishing the true source of profits and therefore is less arbitrary than the unitary approach. Such is far from being the case. Prices which reflect independent and competitive market transactions very frequently are not available, and in such cases the IRS has to apply an arbitrary cost mark-up or profit margin to sales values. Similarly, overhead costs and other income-statement items must often be adjusted in a notional manner. And even where arm's-length prices are available, they may not give results which assign the tax base in a reasonable fashion. In many cases, rule-of-thumb methods for deriving profits amount to the use of formula methods — and without the protection against base gaps and overlaps which a universal unitary method ensures.

The use of the unitary method as implemented by a factor formula is not perfect, but it places less of a burden on administrative resources than does enforcement of the separate-accounting-arm's-length approach. Clearly, this has been one of the reasons for adoption of the former by the states. This is not to say that there are not administrative problems with it. But there is less danger of base slippage and discretionary profit shifting on the part of the taxpayer and there are fewer items which have to be audited and checked. What is perhaps of even greater importance is that the unitary method avoids much of the political negotiation which inevitably arises in establishing profits through the complexities of arm's-length pricing. Far fewer discretionary judgments have to be made and negotiated over.

A frequent misconception of the unitary approach is that tax authorities thereby reach out to tax income which is earned outside their own jurisdiction. Such is not the case, since the purpose of the unitary method is to establish that particular jurisdiction's correct share of the firm's overall income, no more and no less. Of course, if formulas and definitions differ from one jurisdiction to the next, the firm may be taxed in all on more or less than its total income. But this can easily happen with separate accounting also.

Thus, the unitary method does not *per se* subject corporations to "excessive" tax burdens, but merely assigns the tax base among the jurisdictions in which the firm earns those profits. The very purpose of the method

is to determine and define local-source income without encroaching on income defined as arising elsewhere. It in effect establishes a source rule. Furthermore, the law provides that states may tax only as jurisdictions of source. In other words, the states are limited to tax only that income which is defined as arising within their territory.

The controversy over the U.S.-U.K. treaty has raised fundamental issues which have not as yet been addressed adequately in the treaty-making process. The stakes have become too high for international tax treaties to go into effect without close and careful scrutiny from the perspective of the broad public interest. There is, I believe, a need for taking a fresh look at the basic purposes and provisions of international tax treaties, among which is the treatment of lower-level taxation as it applies to international business.

CURRENT AND QUOTABLE

Article 9(4) and the Constitution

The following is excerpted from an unpublished manuscript prepared by Archie Parnell, Senior Staff Counsel to the Ways and Means Oversight Subcommittee, and William L. Shraberg, who is a trial attorney with the Tax Division of the Department of Justice, who were assisted by Gloria Dunbar and Abbe Jolles. The views expressed are entirely those of the authors, and cannot be attributed to the Ways and Means Committee, its subcommittees, the Department of Justice, the Treasury Department, or the Internal Revenue Service. The full manuscript is available through the Complete Access Service. Ask for *Doc 78-4153.*

Implicit in the argument that the treaty process is not appropriate [as a means of regulating state tax methods] is the feeling that somehow the restriction of Article 9(4) takes away too much of the sovereignty that is currently possessed by the states in our federal system of government. That implication is based upon Constitutional considerations which to date have not been publicly discussed or analyzed.

* * *

Article VI, the Supremacy Clause of the United States Constitution, mandates:

> *"This Constitution, and the Laws of the United States which shall be made in Pursuance thereof; and all Treaties made, or which shall be made, under the Authority of the United States, shall be the supreme Law of the Land; . . . ."*

One might be tempted to construe the Supremacy Clause [as stating] that laws and treaties are somehow [beyond Constitutional challenge].

*However, the Supreme Court's stance in regard to the standard against which treaties are to be judged shifted*** in the well-reasoned opinion in Reid v. Covert, 354 U.S. 1 (1957). Justice Black eloquently stated in regard to the Supremacy Clause of Article VI (pp. 16, 17):*

> *"There is nothing in this language which intimates that treaties and laws enacted pursuant to them do not have to comply with the provisions of the Constitution. Nor is there anything in the debates which accompanied the drafting and ratification of the Constitution which even suggests such a result. These debates as well as the history that surrounds the adoption of the treaty provision in Article VI make it clear that the reason treaties were not limited to those made in 'pursuance' of the Constitution was so that agreements made by the United States under the Articles of Confederation, including the important peace treaties which concluded the Revolutionary War, would remain in effect. It would be manifestly contrary to the objectives of those who created the Constitution, as well as those who were responsible for the Bill of Rights— let alone alien to our entire constitutional history and tradition — to construe Article VI as permitting the United States to exercise power under an international agreement without observing constitutional prohibitions."*

The question therefore becomes "Is the restriction of Article 9(4) prohibited by the Constitution?" This question is most difficult and concerns the interplay between the Tenth Amendment, the Commerce Clause of Article I, Section 8, Clause 3, and those judicial decisions which deal with the power of the states to tax the income derived from interstate commerce.

* * *

When all of the [pertinent cases] are read together, it becomes clear that the constitutional delegation to the United States of the power to lay and collect taxes and to regulate commerce among the states and with foreign nations is not an exclusive or unlimited delegation of power. [The states have retained the power to tax, but] this retained sovereign power is, however, limited by the Commerce Clause, at least where forbidden state action is present or where a definable federal interest is at stake.

A persuasive argument can be made that the Tenth Amendment, which reserves to the states or the people the "powers not delegated to the United States by the Constitution, nor prohibited by it to the States," constitutionally reserves the power to tax to the states, and that this power is not subject to general regulation by Congress, at least under the Commerce Clause or the clause empowering the United States to lay and collect taxes. It would follow that in our federal system of government, as long as a non-discriminatory state income tax does not violate the Commerce Clause, the state is free to structure its taxes in any manner it deems appropriate. In the event that the states are not free to do so, then our system of government is not truly federal.

In the event that the proposed U.S.-U.K. tax treaty is ratified without the reservation of Article 9(4) and in the event that a state constitutionally challenged the controversial article, a court could conclude that a state, as a sovereign entity under our federal system, as long as a non-discriminatory state income tax does not violate the Commerce Clause, is free to structure its taxes in any manner it chooses. Such a conclusion would necessarily mean that Article 9(4) would be found to be unconstitutional.

EXHIBIT 24

(3) Strong centralized management: A taxpayer which might otherwise be considered as engaged in more than one trade or business is properly considered as engaged in one trade or business when there is a strong central management, coupled with the existence of centralized departments for such functions as financing, advertising, research, or purchasing. Thus, some conglomerates may properly be considered as engaged in only one trade or business when the central executive officers are normally involved in the operations of the various divisions and there are centralized offices which perform for the divisions the normal matters which a truly independent business would perform for itself, such as accounting, personnel, insurance, legal, purchasing, advertising, or financing.

(c) Business and Nonbusiness Income; Application of Definitions. The following are rules and examples for determining whether particular income is business or nonbusiness income. (The examples used throughout these regulations are illustrative only and do not purport to set forth all pertinent facts.)

(1) Rents from real and tangible personal property: Rental income from real and tangible property is business income if the property with respect to which the rental income was received is used in the taxpayer's trade or business or is incidental thereto and therefore is includible in the property factor under Regulations 25129 to 25131 inclusive.

Example (A): The taxpayer operates a multistate car rental business. The income from car rentals is business income.

Example (B): The taxpayer is engaged in the heavy construction business in which it uses equipment such as cranes, tractors, and earth-moving vehicles. The taxpayer makes short-term leases of the equipment when particular pieces of equipment are not needed on any particular project. The rental income is business income.

Example (C): The taxpayer operates a multistate chain of men's clothing stores. The taxpayer purchases a five-story office building for use in connection with its trade or business. It uses the street floor as one of its retail stores and the second and third floors for its general corporate headquarters. The remaining two floors are leased to others. The rental of the two floors is incidental to the operation of the taxpayer's trade or business. The rental income is business income.

Example (D): The taxpayer operates a multistate chain of grocery stores. It purchases as an investment an office building in another state with surplus funds and leases the entire building to others. The net rental income is not business income of the grocery store's trade or business. Therefore, the net rental income is nonbusiness income.

Exhibit 24

Example (E): The taxpayer operates a multistate chain of men's clothing stores. The taxpayer invests in a 20-story office building and uses the street floor as one of its retail stores and the second floor for its general corporate headquarters. The remaining 18 floors are leased to others. The rental of the eighteen floors is not incidental to but rather is separate from the operation of the taxpayer's trade or business. The net rental income is not business income of the clothing store trade or business. Therefore, the net rental income is nonbusiness income.

Example (F): The taxpayer constructed a plant for use in its multistate manufacturing business and 20 years later the plant was closed and put up for sale. The plant was rented for a temporary period from the time it was closed by the taxpayer until it was sold 18 months later. The rental income is business income and the gain on the sale of the plant is business income.

Example (G): The taxpayer operates a multistate chain of grocery stores. It owned an office building which it occupied as its corporate headquarters. Because of inadequate space, taxpayer acquired a new and larger building elsewhere for its corporate headquarters. The old building was rented to an investment company under a five-year lease. Upon expiration of the lease, taxpayer sold the building at a gain (or loss). The net rental income received over the lease period is nonbusiness income and the gain (or loss) on the sale of the building is nonbusiness income.

(2) *Gains or losses from sales of assets.* Gain or loss from the sale, exchange or other disposition of real or tangible or intangible personal property constitutes business income if the property while owned by the taxpayer was used in the taxpayer's trade or business. However, if such property was utilized for the production of nonbusiness income or otherwise was removed from the property factor before its sale, exchange or other disposition, the gain or loss will constitute nonbusiness income. (See Regulations 25129 to 25131 inclusive.)

Example (A): In conducting its multistate manufacturing business, the taxpayer systematically replaces automobiles, machines, and other equipment used in the business. The gains or losses resulting from those sales constitute business income.

Example (B): The taxpayer constructed a plant for use in its multistate manufacturing business and 20 years later sold the property at a gain while it was in operation by the taxpayer. The gain is business income.

Example (C): Same as (B) except that the plant was closed and put up for sale but was not in fact sold until a buyer was found 18 months later. The gain is business income.

Example (D): Same as (B) except that the plant was rented while being held for sale. The rental income is business income and the gain on the sale of the plant is business income.

Example (E): The taxpayer operates a multistate chain of grocery stores. It owned an office building which it occupied as its corporate headquarters. Because of inadequate space, taxpayer acquired a new and larger building elsewhere for its corporate headquarters. The old building was rented to an unrelated investment company under a five-year lease. Upon expiration of the lease, taxpayer sold the building at a gain (or loss). The gain (or loss) on the sale is nonbusiness income and the rental income received over the lease period is nonbusiness income.

(3) *Interest.* Interest income is business income where the intangible with respect to which the interest was received arises out of or was created in the regular course of the taxpayer's trade or business operations or where the purpose for acquiring and holding the intangible is related to or incidental to such trade or business operations.

Example (A): The taxpayer operates a multistate chain of department stores, selling for cash and on credit. Service charges, interest, or time-price differentials and the like are received with respect to installment sales and revolving charge accounts. These amounts are business income.

Example (B): The taxpayer conducts a multistate manufacturing business. During the year the taxpayer receives a federal income tax refund and collects a judgment against a debtor of the business. Both the tax refund and the judgment bore interest. The interest income is business income.

Example (C): The taxpayer is engaged in a multistate manufacturing and wholesaling business. In connection with that business, the taxpayer maintains special accounts to cover such items as workmen's compensation claims, rain and storm damage, machinery replacement, etc. The moneys in those accounts are invested at interest. Similarly, the taxpayer temporarily invests funds intended for payment of federal, state and local tax obligations. The interest income is business income.

Example (D): The taxpayer is engaged in a multistate money order and traveler's checks business. In addition to the fees received in connection with the sale of the money orders and traveler's checks, the taxpayer earns interest income by the investment of the funds pending their redemption. The interest income is business income.

Example (E): The taxpayer is engaged in a multistate manufacturing and selling business. The taxpayer usually has working capital and extra cash totaling $200,000 which it regularly invests in short-term interest bearing securities. The interest income is business income.

Example (F): In January the taxpayer sold all the stock of a subsidiary for $20,000,000. The funds are placed in an interest-bearing account pending a decision by management as to how the funds are to be utilized. The interest income is nonbusiness income.

(4) *Dividends.* See Article 2. Uniform Division of Income For Tax Purposes Act, Reg. 25120(c) (4).

(5) *Patent and copyright royalties.* Patent and copyright royalties are business income where the patent or copyright with respect to which the royalties were received arises out of or was created in the regular course of the taxpayer's trade or business operations or where the purpose for acquiring and holding the patent or copyright is related to or incidental to such trade or business operations.

Example (A): The taxpayer is engaged in the multistate business of manufacturing and selling industrial chemicals. In connection with that business the taxpayer obtained patents on certain of its products. The taxpayer licensed the production of the chemicals in foreign countries, in return for which the taxpayer receives royalties. The royalties received by the taxpayer are business income.

Example (B): The taxpayer is engaged in the music publishing business and holds copyrights on numerous songs. The taxpayer acquires the assets of a smaller publishing company, including music copyrights. These acquired copyrights are thereafter used by the taxpayer in its business. Any royalties received on these copyrights are business income.

Example (C): Same as Example (B), except that the acquired company also held the patent on a type of phonograph needle. The taxpayer does not manufacture or sell phonographs or phonograph equipment. Any royalties received on the patent would be nonbusiness income.

(d) *Proration of Deductions.* In most cases an allowable deduction of a taxpayer will be applicable only to the business income arising from a particular trade or business or to a particular item of nonbusiness income. In some cases an allowable deduction may be applicable to the business incomes of more than one trade or business and/or to several items of nonbusiness income. In such cases the deduction shall be prorated among such trades or businesses and such items of nonbusiness income in a manner which fairly distributes the deduction among the classes of income to which it is applicable.

In filing returns with this state, if the taxpayer departs from or modifies the manner of prorating any such deduction used in returns for prior years, the taxpayer shall disclose in the return for the current year the nature and extent of the modification.

If the returns or reports filed by a taxpayer with all states to which the taxpayer reports under the Uniform Division of Income for Tax Purposes Act are not uniform in the application or proration of any deduction, the taxpayer shall disclose in its return to this state the nature and extent of the variance.

NOTE: Authority cited: Sections 19253 and 26422, Revenue and Taxation Code.

History: 1. New Article 2.5 (25120–25122, 25123–25137, 25139) filed 6-29-73; effective thirtieth day thereafter (Register 73, No. 26).

EXHIBIT 25

MULTISTATE TAX COMMISSION REGULATION --

REGULATION 1.(c)(4)

.25 (4) **Dividends.** Dividends are business income where the stock with respect to which the dividends are received arises out of or was acquired in the regular course of the taxpayer's trade or business operations or where the purpose for acquiring and holding the stock is related to or incidental to such trade or business operations.

Example (i): The taxpayer operates a multistate chain of stock brokerage houses. During the year the taxpayer receives dividends on stock it owns. The dividends are business income.

Example (ii): The taxpayer is engaged in a multistate manufacturing and wholesaling business. In connection with that business the taxpayer maintains special accounts to cover such items as workmen's compensation claims, etc. A portion of the moneys in those accounts is invested in interest-bearing bonds. The remainder is invested in various common stocks listed on national stock exchanges. Both the interest income and any dividends are business income.

Example (iii): The taxpayer and several unrelated corporations own all of the stock of a corporation whose business operations consist solely of acquiring and processing materials for delivery to the corporate owners. The taxpayer acquired the stock in order to obtain a source of supply of materials used in its manufacturing business. The dividends are business income.

Example (iv): The taxpayer is engaged in a multistate heavy construction business. Much of its construction work is performed for agencies of the federal government and various state governments. Under state and federal laws applicable to contracts for these agencies, a contractor must have adequate bonding capacity, as measured by the ratio of its current assets (cash and marketable securities) to current liabilities. In order to maintain an adequate bonding capacity the taxpayer holds various stocks and interest-bearing securities. Both the interest income and any dividends received are business income.

Example (v): The taxpayer receives dividends from the stock of its subsidiary or affiliate which acts as the marketing agency for products manufactured by the taxpayer. The dividends are business income.

Example (vi): The taxpayer is engaged in a multistate glass manufacturing business. It also holds a portfolio of stock and interest-bearing securities, the acquisition and holding of which are unrelated to the manufacturing business. The dividends and interest income received are nonbusiness income.

Under present California law, except for financial institutions and businesses dealing in securities, dividend income is allocated to the recipient corporation's headquarters with certain deductions and exclusions./[40] Intercompany dividends paid from unitary income are excluded from tax./[41] A deduction is allowed for dividends paid from income included in the measure of the California tax/[42] and for dividends received from an insurance company subsidiary operating in California,/[43] provided at least 80 percent of each class of stock is owned by the parent. The amount of the deduction for insurance companies is determined by an allocation formula. California law is based on pre-UDITPA precedents which were preserved by the Legislature in enacting the UDITPA and again in adopting the Multistate Tax Compact./[44]

The Multistate Tax Commission, in adopting suggested regulations for the implementation of the UDITPA, has taken the position that most dividend income and, in particular, dividend income from stock interests related to the unitary business is business income. (Exhibit 25) This position was approved by the Idaho Supreme Court./[45]

The same approach was also taken by the State of Vermont, a non-MTC state, and also received the judicial approval of its highest court./[46] These cases and the treatment of dividend income will be reviewed by the United States Supreme Court this term.

Studies which have been made with respect to the apportionment or allocation of dividend income indicates that the total tax impact for revenue purposes is not substantial./[47] However, the impact on individual corporations is often significant. If dividends

EXHIBIT 26

Table 2

Multistate Division of Base Provisions for Corporation Taxes on Net Income or Measured by Net Income with Emphasis on Special Foreign Source Income Rules

State	Dividends Received Deduction 1/	Dividends: Allocated 2/	Dividends: Apportioned 3/	Interest	Capital Gains	Rents	Royalties	Special Foreign Rules 4/
Alabama	No	Allocated to commercial domicile for corporations chartered outside Alabama.	Apportioned if receiving corporation chartered in Alabama.	On accounts receivable, apportioned; portfolio interest allocated if payee has commercial domicile in state.	On trade or business property, apportioned; on real and tangible personal property, allocated if situs in state; on intangible personal property, allocated if owner's commercial domicile in state.	Apportioned if business income; allocated, if non-business income, on basis of situs 9/ extent of use of property in state, or payee's commercial domicile. 10/	From real property, allocated if situs in state; from personal property, allocated on the basis of extent of use in state or payee's commercial domicile. 11/	Gross up not taxed. 5/
Alaska	Yes		All dividends apportioned. Statute permits combination; 6/ has applied it on audit.	All interest received deemed taxable as business income and apportioned.	Allocated if situs of property in state; otherwise apportioned.	Allocated if situs of property in state; otherwise apportioned.	Allocated if situs of property in state; otherwise apportioned.	Dividend received deduction for dividends from domestic corporations. 7/
Arizona	No	Taxable unless received from corporation subject to Arizona income tax, allocated to commercial domicile.		Allocated to commercial domicile.	On trade or business property, apportioned; on other property, allocated if situs of property in state.	From real property, allocated if situs in state; others allocated to commercial domicile of taxpayer.	Allocated if taxpayer's commercial domicile in state.	Gross up not taxed. 5/
Arkansas	No	Dividends from at least 95 percent owned subsidiaries exempt.	Apportioned except for those from 95 percent owned subsidiaries.	Apportioned	Apportioned	Apportioned	Apportioned	Exemption applies to dividends from domestic and foreign subsidiaries. 3/

Exhibit 26-

State	Dividends Received Deduction	Dividends: Allocated	Dividends: Apportioned	Interest	Capital Gains	Rents	Royalties	Special Foreign Rules
alifornia	No	Nonbusiness and nonunitary dividends allocated to commercial domicile.	State applies unitary worldwide combination; 6/ dividends from a nonunitary corporation apportioned if business income.	On accounts receivable and similar business accounts, apportioned; on long term investments, allocated to commercial domicile.	On trade or business property apportioned; on real and tangible personal property allocated if situs in state; on intangible personal property, allocated if owner's commercial domicile in state.	From plant and other business assets, apportioned; from nonbusiness assets, allocated on basis of situs, 9/ extent of use of property in state, or commercial domicile. 10/	From license to produce product produced by taxpayer, apportioned as business income; from real property, allocated if situs in state; from personal property, allocated on the basis of extent of use in state or payee's commercial domicile. 11/	Gross up not taxed. 5/ Foreign (non U.S.) corporation that is part of unitary group is included in the apportionment.
olorado	Yes		Nearly always apportioned as business income.	Nearly always apportioned as business income.	Nearly always apportioned as business income.	Nearly always apportioned as business income.	Nearly always apportioned as business income.	Dividends received deduction for dividends from domestic corporations. 7/
onnecticut	Yes	Dividends allocated to state if principal place of payee's business in state; but dividends from a majority owned subsidiary allocated to extent of subsidiary's business in state.	Combined 6/ return allowed at option of taxpayer or may be required to correct non-arm's length dealing.	On accounts receivable and other assets an integral part of the business activity, apportioned; nonbusiness interest allocated to state if principal place of business in state; interest from a majority owned subsidiary allocated to extent of subsidiary's business in state.	On real and tangible personal property, allocated if situs at sale in state; from intangible property, allocated if owner's principal place of business in state; however, if derived as an integral part of taxpayer's business, apportioned as business income.	From tangible personal and real property, allocated if situs in state; from intangible personal property, allocated if principal place of business in state.	Treated as business income and apportioned.	Gross up not taxed; 5/ dividend received deduction for dividends from domestic corporations. 7/

State	Dividends Received Deduction	Dividends: Allocated	Dividends: Apportioned	Interest	Capital Gains	Rents	Royalties	Special Foreign Rules
Delaware	Yes	Dividends from a non-Delaware corporation for which a foreign tax credit is provided are exempt.	Remaining dividends apportioned.	Interest for which a foreign tax credit is provided is exempt; otherwise allocated to state where the transaction took place which resulted in creation of the debt, e.g. interest from debt marketed in N.Y. and held by the taxpayor's N.Y. bank would not be allocated to Delaware.	On real property or tangible property, allocated if situs or use in state; on intangibles, apportioned.	Allocated if situs of property in state.	Royalties for which a foreign tax credit is provided are exempt; others allocated if property generating royalty located or used in state.	Dividends from a non-Delaware corporation, interest, and royalties for which a foreign tax credit is provided are exempt.
District of Columbia	No	Allocated if nonbusiness income and from sources within the District.	Apportioned if business income.	Allocated if nonbusiness income from sources within the District; apportioned if business income.	On real property and tangible personalty, allocated to situs if nonbusiness income; on intangibles, allocated to commercial domicile if nonbusiness income; if business income, apportioned.	On real property and tangible personalty, allocated on basis of situs or extent of use if nonbusiness income; if business income apportioned.	Same as rents.	Cross up not taxed. 5/

State	Dividends Received Deduction	Dividends: Allocated	Dividends: Apportioned	Interest	Capital Gains	Rents	Royalties	Special Foreign Rules
Florida	Yes		Dividends from foreign sources exempt, remaining taxable dividends apportioned.	Foreign source interest exempt, remaining interest apportioned.	Same as interest.	Same as interest.	Same as interest.	Foreign source income is not taxable in any manner.
Georgia	Yes	Dividends from foreign sources exempt; remaining taxable dividends allocated to payee's principal place of business.		On accounts receivable and other assets connected to the business, apportioned; investment income, allocated to payee's corporate domicile or to situs of property generating the income.	On trade or business property and short term investments, apportioned; on other investment assets, allocated to situs of property or to payee's principal place of business.	If part of the taxpayer's normal business activities, apportioned; if investment or nonbusiness income, allocated to the location of the property or the taxpayer's principal place of business.	Same as rents.	Foreign source dividends not taxable.
Hawaii	No	85% of dividends from 95% owned subsidiaries not taxed; dividends from corporations having 15% of business in state not taxed; remaining taxable nonbusiness dividends allocated to payee's commercial domicile.	Remaining taxable dividends that are an integral part of the taxpayer's business are apportioned.	On business assets, apportioned; nonbusiness interest, allocated to payee's commercial domicile.	On trade or business property, apportioned; on real and tangible personal property, allocated if situs in state; on intangible personalty, allocated if commercial domicile in state.	From plant and other business assets, apportioned; from real property, allocated if situs in state; from tangible personalty, allocated on basis of extent of use in state of payee's commercial domicile. 10/	Same as rents and royalties on intangibles allocated on basis of extent of use or payee's commercial domicile. 11/	Dividend deduction applies to dividends from domestic and foreign subsidiaries. 8/

State	Dividends Received Deduction	Dividends: Allocated	Dividends: Apportioned	Interest	Capital Gains	Rents	Royalties	Special Foreign Rules
Idaho	No	Dividends from corporation deriving 50% or more of its income from Idaho are 85% excluded from tax base.	Remaining taxable dividends apportioned. State may allow, at taxpayer's request, or require, to accurately reflect income, the filing of a combined 6/ return.	Law presumes interest is apportionable, but state court recently held interest on portfolio investments is allocable to payee's commercial domicile.	Law presumes gains apportionable, but state court recently held gains allocable to situs or payee's commercial domicile, if not taxable in situs state.	Apportioned if business income; allocated if nonbusiness income, on basis of situs, 9/ extent of use of property in state, or payee's commercial domicile. 10/	Same as gains. 9/11/	Gross up not taxed; 5/ dividends received deduction applies to some domestic, but no foreign source dividends.
Illinois	Yes	Remaining taxable dividends from corporations in which taxpayer has less than 50 percent ownership interest are allocated if payee's commercial domicile in state.	Remaining taxable dividends from corporation in which taxpayer has at least 50% ownership interest are apportioned.	Apportioned if business income; allocated to commercial domicile if nonbusiness income.	On trade or business property, apportioned as business income; on other assets, if nonbusiness income, allocated to situs of property if real or tangible personal property; to commercial domicile if intangible personalty or taxpayer not taxable where personal property had situs.	If from an integral part of the taxpayer's business activities, apportioned as business income; if nonbusiness income, allocated to situs if real property, to extent of use or commercial domicile if tangible personal property. 10/	Same as rents and royalties on intangibles allocated on basis of extent of use or payee's commercial domicile. 11/	Gross up not taxed; 5/ dividend received deduction for dividends from domestic corporations. 7/

State	Dividends Received Deduction	Dividends: Allocated	Dividends: Apportioned	Interest	Capital Gains	Rents	Royalties	Special Foreign Rules
Indiana	Yes	Most dividends, other than when dealing in securities is a principal business acitivity of the taxpayer, are allocated to recipient's commercial domicile.	Apportioned as business income if securities dealing a principal activity of the taxpayer.	On accounts receivable and from securities activities that are a principal business activity of the taxpayer, apportioned; remaining interest is nonbusiness income and is allocated to payee's commercial domicile.	Apportioned as business income if acquisition, management, and disposition of property constitutes an integral part of the taxpayer's regular business operation; otherwise allocated to situs of property.	Apportioned as business income if rental of property is a principal business activity of the taxpayer; otherwise allocated on basis of situs, 9/ extent of use of property, or payee's commercial domicile. 10/	Allocated as nonbusiness income to payee's commercial domicile if from patents which are incidental to a taxpayer's regular trade or business operations and licensing does not represent a principal business activity; otherwise apportioned as business income.	Dividends received deduction for dividends from domestic corporations. 7/
Iowa	Yes	Taxable dividends are allocated to payee's commercial domicile, but in proportion to the payer corporation's income that is attributable to Iowa.		Same as dividends.	On real property, allocated to situs; on tangible personalty, allocated to situs or commercial domicile; on intangible personalty, allocated to commercial domicile.	From real property, allocated to situs; from tangible personalty, allocated on basis of extent of use in state or payee's commercial domicile. 10/	If nonbusiness income, allocated to commercial domicile; if business income, apportioned.	Dividends received deduction for dividends from domestic corporations. 7/

State	Dividends Received Deduction	Dividends: Allocated	Dividends: Apportioned	Interest	Capital Gains	Rents	Royalties	Special Foreign Rules
Kansas	Yes	Dividends allocated to payee's commercial domicile.		On accounts receivable, apportioned as business income; portfolio and other nonbusiness interest allocated to commercial domicile.	On business property, apportioned as business income; other gains are nonbusiness income allocated to situs or commercial domicile. 12/	If received from regular business property, apportioned as business income; others allocated on basis of situs, 9/ extent of use of property in state, or payee's commercial domicile. 10/	If generated by use in a like business, apportioned as business income; others allocated on the basis of situs, 9/ extent of use, or commercial domicile. 11/	Dividends received deduction for dividends from domestic corporations. 7/
Kentucky	No	All dividends exempt.		On accounts receivable, apportioned as business income; on other assets, allocated as nonbusiness income to commercial domicile.	On sale of machinery or other business property, apportioned as business income; on real property, allocated to situs; on tangible personalty, allocated to situs of property or taxpayer's commercial domicile; 12/ on intangible personalty, allocated to commercial domicile.	If part of the normal business, such as the rental of excess manufacturing space, apportioned as business income; nonbusiness rents from real property such as from an investment property, allocated to situs; nonbusiness rents from personalty, allocated to extent of use or commercial domicile. 10/	If from patents used as integral part of payee's business, apportioned as business income; if nonbusiness income, allocated to extent of use in state or to commercial domicile. 11/	All dividends, whether domestic or foreign source, exempt. 8/

State	Dividends Received Deduction	Dividends: Allocated	Dividends: Apportioned	Interest	Capital Gains	Rents	Royalties	Special Foreign Rules
Louisiana	No	Allocated to commercial domicile unless shares have a business situs elsewhere; however, if paid by at least a 50% owned subsidiary out of income earned outside the state, allocated elsewhere.		On accounts receivable, allocated to situs of payer; other interest allocated to business situs of debt instrument or commercial domicile of payee.	From real and tangible personalty, allocated to situs of asset; from intangibles, allocated to business situs of asset or commercial domicile of payee.	Allocated to situs of property.	From real and tangible personalty, allocated to situs of property; on intangibles, allocated to state of use.	Gross up not taxed. 5/
Maine	Yes	If nonbusiness income, allocated to state if payee's commercial domicile in state.	If business income, apportioned.	On accounts and notes receivable, apportioned; nonbusiness interest allocated to commercial domicile.	Apportioned if business income; gains from nonbusiness real property allocated to situs; gains from nonbusiness tangible personalty allocated to situs or owner's commercial domicile; 12/ gains from nonbusiness intangible personalty allocated to owner's commercial domicile.	Apportioned if business income; from nonbusiness real property, allocated to situs; from nonbusiness personalty, allocated on basis of extent of use in state or payee's commercial domicile. 10/	Apportioned if business income; if nonbusiness income, allocated same as rents and royalties on intangibles allocated on basis of extent of use or payee's commercial domicile. 11/	Gross up not taxed; 5/ dividends received deduction for dividends from domestic corporations. 7/

State	Dividends Received Deduction	Dividends: Allocated	Dividends: Apportioned	Interest	Capital Gains	Rents	Royalties	Special Foreign Rules
Maryland	No	Dividends exempt from tax.		On accounts receivable and installment contracts, apportioned as business income; investment interest is nontaxable.	From real property, allocated to situs; from tangible personalty, allocated to situs or owner's commercial domicile; 12/ from intangible personalty, allocated to commercial domicile.	Allocated to situs of property.	Patent and copyright royalties apportioned as business income if reasonably attributed to the business; from real and tangible personalty, allocated to situs.	All dividends, whether domestic or foreign exempt. 5/
Massachusetts	No	All dividends exempt except: from Massachusetts corporate trusts; from non-wholly owned DISCs, and if less than 15% of payer's stock owned.	Remaining dividends apportioned as business income.	Apportioned	Apportioned	Apportioned	Apportioned	Most dividends, domestic and foreign source, exempt. 8/
Michigan	---SEE TEXT---							
Minnesota	No	Allocated to payee's commercial domicile, but an 85% dividends received deduction allowed.		From property employed in business and from idle cash, apportioned; remaining interest allocated to commercial domicile.	From tangible property, allocated to situs; from intangibles, allocated to legal or commercial domicile; however, apportioned if business income.	Allocated to situs, but apportioned if business income.	From real and tangible personal property not used in business, allocated to situs; from patents not use in business, allocated to legal or commercial domicile; from property used in business, apportioned.	Gross up not taxed; 5/ 85% dividends received deduction for dividends from domestic and foreign corporations. 8/

State	Dividends Received Deduction	Dividends: Allocated	Dividends: Apportioned	Interest	Capital Gains	Rents	Royalties	Special Foreign Rules
Mississippi	No	Allocated to commercial or actual situs		Allocated to commercial or actual situs.	On trade or business property, apportioned; otherwise allocated to situs.	Allocated to situs.	Allocated to commercial or actual situs.	Gross up not taxed. 5/
Missouri	No	Intercorporate dividends exempt.		If taxpayer elects statutory one factor sales formula, apportioned, if taxpayer elects three factor formula, apportioned if business income and allocated to commercial domicile if nonbusiness income.	Same as interest except gains on real property allocated to situs, on tangible personalty allocated to situs, or commercial domicile, 12/ and on intangibles allocated to commercial domicile.	Same as interest except allocated on basis of situs, 9/ extent of use of property in state, or payee's commercial domicile. 10/	Same as interest except allocated on basis of situs situs, 9/ extent of use, or commercial domicile. 11/	All intercorporate dividends, whether domestic or foreign source, exempt. 8/
Montana	Yes		Taxable dividends are apportioned; statute permits combination; 6/ state has applied it, but matter is pending in court.	Apportioned	Apportioned except Montana transactions allocated.	Apportioned except Montana rents allocated.	Apportioned except Montana transactions allocated.	Dividends received deduction for dividends from domestic corporations. 7/
Nebraska	Yes	Clearly nonbusiness dividends allocated to commercial domicile.	Taxable dividends are generally apportioned. Regulations provide that state may permit or require the filing of a combined return 6/ to property reflect income, but worldwide combination is not presently used.	Usually apportioned except clearly nonbusiness interest is allocated to commercial domicile.	Usually apportioned except clearly nonbusiness gains are allocated to situs (real property and tangible personalty) or commercial domicile (intangible personalty).	Usually apportioned except clearly nonbusiness rents allocated on basis of situs, 9/ extent of use of property in state, or payee's commercial domicile. 10/	Same as rents except royalties on intangibles allocated on basis of extent of use or payee's commercial domicile. 11/	Dividends received deduction for dividends from domestic corporations. 7/

State	Dividends Received Deduction	Dividends: Allocated	Dividends: Apportioned	Interest	Capital Gains	Rents	Royalties	Special Foreign Rules
Nevada	NO TAX ON CORPORATE NET INCOME							
New Hampshire	No		Dividends from subsidiary subject to N.H. tax and from at least 30% controlled foreign subsidiary exempt. Gross up not taxed. Remaining taxable dividends apportioned.	Interest from subsidiary subject to N.H. tax and from at least 30% controlled foreign subsidiary exempt. Remaining interest apportioned.	Apportioned	Apportioned	Apportioned	Gross up not taxed; 5/ dividends and interest from at least 30% controlled foreign affiliate exempt.
New Jersey	No		Dividends from at least 80% owned affiliate, whether foreign or domestic, exempt; 50% of dividends from other affiliates exempt; remaining taxable dividends apportioned.	Apportioned	Apportioned	Apportioned	Apportioned	Most of the gross up not taxed; 5/ intercorporate dividend deduction applies uniformly to dividends from foreign and domestic corporations. 3/
New Mexico	Yes	Taxable portfolio dividends allocated to commercial domicile.	Taxable subsidiary dividends apportioned.	On accounts receivable and short term securities, apportioned; long term investment interest allocated to commercial domicile.	On trade on business property, if nonbusiness from real property allocated to situs, from tangible personalty, to situs or commercial domicile, 12/ and from intangibles to commercial domicile.	Business rents apportioned; nonbusiness rents allocated to situs, 9/ or extent of use or commercial domicile. 10/	Most royalties apportioned; clearly nonbusiness royalties allocated on basis of situs, 9/ extent of use, or commercial domicile. 11/	Dividends received deduction for dividends from domestic corporations. 7/

State	Dividends Received Deduction	Dividends: Allocated	Dividends: Apportioned	Interest	Capital Gains	Rents	Royalties	Special Foreign Rules
ew York	No		Dividends from more than 50% owned subsidiaries, whether domestic or foreign, exempt; 50% of other dividends also exempt with the remaining 50% apportioned to N.Y. on the basis of the payer's N.Y. business. Combined 6/ reporting selectively applied at discretion of tax commission to correctly reflect income.	Interest from more than 50% owned subsidiary, whether domestic or foreign, exempt; all other interest apportioned to N.Y. on basis of the payer's N.Y business.	From real property and tangible personalty, apportioned via a three factor formula; gains on securities of more than 50% owned subsidiaries exempt.	Apportioned	Apportioned	Gross up not taxed; 5/ dividends, interest, and gains, from at least 50% owned subsidiaries, domestic and foreign, are exempt. 8/
orth Carolina	No	Dividends from controlled affiliates exempt if parent corporation has a North Carolina commercial domicile; portion of dividends on which the paying corporation has been subject to N.C. tax is exempt; taxable dividends allocated to state of commercial domicile.		If the purpose of acquiring the intangible generating the interest is directly related to the taxpayer's business activity, interest is considered business income and is apportioned; nonbusiness interest is allocated to commercial domicile	Gains are apportioned as business income if the assets, while owned by the taxpayer, produced business income. Nonbusiness gains from real property allocated to situs, from tangible personalty allocated to situs or commercial domicile; 12/ from intangible personalty allocated to commercial domicile.	Apportioned if business income. Nonbusiness rents from real property allocated to situs; from tangible personalty allocated in relation to extent of use or commercial domicile if taxpayer not taxable where property is utilized.	Apportioned as business income if the patent or copyright was created or used as an integral part of the taxpayer's principal business activity. Nonbusiness royalties from real and tangible personalty allocated same as rents; from intangibles allocated in relation to extent of use or to commercial domicile. 11/	Dividend deduction applies to dividends from domestic and foreign corporations. 8/

State	Dividends Received Deduction	Dividends: Allocated	Dividends: Apportioned	Interest	Capital Gains	Rents	Royalties	Special Foreign Rules
North Dakota	No	ALL INCOME, WITH RARE EXCEPTIONS, IS APPORTIONED						None
Ohio	Yes 13/		Taxable dividends limited to: domestic source dividends less the Federal dividend received deduction; foreign source non-subsidiary dividends less any gross up of federal dividend received credit. Thus, dividends from a foreign subsidiary are exempt. Taxable dividends apportioned in proportion to payer's Ohio situs property. Thus, few, non-subsidiary foreign source dividends would be apportioned to Ohio.	Apportioned	From real property, allocated to situs; from tangible personalty allocated to situs; from dividend producing stock, allocated in relation to issuing corporation's Ohio situs property, from remaining intangibles, allocated to commercial domicile.	From real property, allocated to situs; from tangible personalty allocated in relation to extent of use in Ohio.	Foreign source royalties exempt. From real property, allocated to situs; from tangible personalty allocated in relation to extent of use in Ohio; from patents and coyrights, allocated to the extent the activity of the payer generating the royalty occurs in Ohio.	Gross up, 5/ subpart F income, foreign source royalties, and foreign source dividends from subsidiaries are not taxable. Thus, only taxable foreign source income is: branch income and passive income other than royalties and excluded dividends.
Oklahoma	Yes	Allocated to taxpayer's commercial domicile.		Apportioned if unitary business income; otherwise allocated to commercial domicile,	On real and tangible personalty, allocated to situs; on intangibles, allocated to commercial domicile.	Allocated to situs	Same as gains.	Dividends received deduction for dividends from domestic corporations. 7/

351

State	Dividends Received Deduction	Dividends: Allocated	Dividends: Apportioned	Interest	Capital Gains	Rents	Royalties	Special Foreign Rules
Oregon	No	Nonbusiness dividends allocated to commercial domicile.	Dividends from a subsidiary taxable in Oregon are exempt. Dividends that are business income are apportioned. Worldwide combination 6/ is freely used.	Apportioned if business income; allocated to commercial domicile if nonbusiness income.	If from an asset used in the taxpayer's trade or business, gain is apportioned as business income. Nonbusiness gains allocated to state of situs 9/ or commercial domicile. 12/, 14/	Apportioned if business income. Nonbusiness rents from real property allocated to situs; from tangible personalty allocated in relation to extent of use in state or to taxpayer's commercial domicile. 10/	Apportioned if business income. Nonbusiness royalties from tangible personalty allocated same as rents; from intangibles, allocated in relation to extent of use in state or to payee's commercial domicile. 11/	Worldwide combination freely used; taxes on foreign nonbusiness and nonunitary income are deductible.
Pennsylvania	No	All dividends domestic and foreign are exempt.		Apportioned	Apportioned	Apportioned	Apportioned	All dividends, domestic and foreign source, exempt. 5/
Rhode Island	Yes	---GENERALLY, ALL INCOME TREATED AS BUSINESS INCOME AND APPORTIONED.---						
South Carolina	No	From at least 80% owned subsidiaries, exempt; other dividends allocated to payee's principal place of business.		If business income, for example from certificates of deposit and commercial securities, apportioned; nonbusiness interest allocated to principal place of business.	On real property, allocated to situs; on tangible personalty allocated to situs or principal place of business; 12/ on intangibles, allocated to principal place of business	Apportioned if business income; otherwise allocated to situs.	If from property that is used in or connected with the business of the taxpayer, apportioned; nonbusiness royalties from real property allocated to situs; patent and copyright royalties allocated to state to extent of use or to principal place of business. 11/	Gross up not taxed; 5/ dividends from at least 80% owned subsidiaries, domestic and foreign, exempt. 8/

State	Dividends Received Deduction	Dividends: Allocated	Dividends: Apportioned	Interest	Capital Gains	Rents	Royalties	Special Foreign Rules
South Dakota	NO TAX ON CORPORATE NET INCOME							
Tennessee	No	From at least 80% owned subsidiaries, exempt; other dividends allocated to commercial domicile.		Allocated to commercial domicile.	On real property, allocated to situs, on tangible personalty allocated to situs or commercial domicile. 12/	From real property, allocated to situs; from tangible personalty, to extent of use in state or to commercial domicile. 10/	From real property and tangible personalty same as rents; patent and copyright royalties allocated to extent of use in State or to commercial domicile. 11/	Dividends from at least 80% owned subsidiaries, domestic and foreign, exempt. 9/
Texas	NO TAX ON CORPORATE NET INCOME							
Utah	No	Dividends that are clearly nonbusiness are allocated to commercial domicile.	Most dividends are apportioned.	On accounts receivable, tax obligation accounts, legally mandated accounts, invested working capital, apportioned; clearly investment interest allocated to commercial domicile.	On trade or business property, apportioned; nonbusiness gains from real property allocated to situs; from tangible personalty, to situs or commercial domicile. 12/	Apportioned if business income, nonbusiness rents from real property allocated to situs; from tangible personalty, allocated to extent of use or to commercial domicile. 10/	Apportioned if business income; nonbusiness royalties from real property allocated to situs; from tangible and intangible personalty, same as rents. 11/	Foreign taxes on nonbusiness income deductible.
Vermont	Yes		Taxable dividends are apportioned.	Apportioned	Apportioned	Apportioned	Apportioned	Gross up not taxed; 5/ dividends received deduction for dividends from domestic corporations. 7/

State	Dividends Received Deduction	Dividends: Allocated	Dividends: Apportioned	Interest	Capital Gains	Rents	Royalties	Special Foreign Rules
Virginia	Yes	Non-subsidiary dividends allocated to recipient's principal place of business.	Dividends from majority owned subsidiaries are apportioned; dividends exempt if at least 50% of the paying corporation's income was subject to Virginia income tax.	Interest from majority owned subsidiaries is apportioned; other interest allocated to principal place of business.	From sale of a subsidiary's stock, apportioned; from real property, allocated to situs; from tangible personalty, allocated to situs or principal place of business; 12/ from intangibles, allocated to principal place of business.	From real property, allocated to situs; from intangible personalty, allocated in relation to extent of use in state or to principal place of business. 10/	From real property, allocated to situs; from personal property, allocated on basis of extent of use or commercial domicile. 11/	Gross up not taxed, 5/ dividends received deduction for dividends from domestic corporations. 7/
Washington	---NO TAX ON CORPORATE NET INCOME---							
West Virginia	No	All dividends exempt.		Apportioned if business income; non-business interest allocated to commercial domicile.	Apportioned	Apportioned if business income; non-business rents from real property, allocated to situs; from tangible personalty, allocated in relation to extent of use or to commercial domicile. 10/	Apportioned if business income; nonbusiness royalites from real property allocated to situs; nonbusiness royalties from tangible and intangible personalty allocated in relation to extent of use or to commercial domicile. 11/	All dividends, whether domestic or foreign, exempt

State	Dividends Received Deduction	Dividends: Allocated	Dividends: Apportioned	Interest	Capital Gains	Rents	Royalties	Special Foreign Rules
Wisconsin	No	Dividends from corporations with at least 50% of their income taxable in Wisconsin are exempt.	Taxable dividends apportioned.	Apportioned	From real property and tangible personalty, allocated to situs.	From real property or tangible personalty allocated to situs.	From real property and tangible personalty, allocated to situs; from intangibles, allocated to commercial domicile.	Gross up not taxed. 5/
Wyoming	NO TAX ON CORPORATE NET INCOME							

Footnotes

1/ This column refers specifically to the deduction for intercorporate dividends provided by the Federal Internal Revenue Code. "Yes " indicates the state allows the Federal deduction, "No" indicates it does not. Several states provide their own intercorporate dividend deduction. These deductions are described in the "dividends" column.

2/ Allocation means the attribution of an income item to a specific geographic source. It involves the attribution of particularly categories of income wholly within or wholly without the taxing state. Dividends, for example, may be allocated to the taxing state provided the payee's commercial domicile is in the state. If it is not, the dividends would be allocated outside that state, but may, of course, be taxable in another state. Allocation is usually used as an adjunct to formula apportionment.

3/ Apportionment refers to a method for dividing the tax base among states in which the share to be assigned a particular taxing state is determined by reference to one or more ratios in which economic values or activities within the state are compared with the taxpayer's total activities or values of the same kind everywhere.

4/ This column describes any special rules for the treatment of foreign source income.

5/ Under the Internal Revenue Code, dividends from a foreign corporation are increased or grossed up by the amount of foreign taxes deemed paid with respect to the underlying corporate tax for which a foreign tax credit is claimed. By removing this gross up from its tax base a state in effect, allows a deduction for those foreign taxes.

6/ Combination refers to the unitary system whereby formula apportionment is applied to a controlled corporate group, rather than a single corporate taxpayer.

7/ Under the Internal Revenue Code, a U.S. corporation can deduct 85 percent of dividends from other U.S. corporations and 100 percent of dividends received from U.S. corporations in which there is an 80 percent or more ownership. Dividends from foreign corporations are deductible only if the foreign corporation has at least 50 percent of its gross income effectively connected with a U.S. trade or business. Because of this limitation, it seems appropriate to describe the Federal dividends received deduction as applying mainly to dividends from domestic corporations.

8/ This, like similar provisions in other states, is not a special rule; it applies equally to domestic and foreign subsidiaries. However, it is noted to contrast it with the Federal dividend received deduction, available mainly to dividends from domestic corporations.

9/ Applies to real property.

10/ Applies to tangible personal property. Rents are only allocated to commercial domicile if the taxpayer is not taxable in the state where the property is used.

11/ Only allocated to commercial domicile if the recipient of the royalty is not taxable where the property is used.

12/ Applies to tangible personal property. Capital gains only allocated to commercial domicile if the taxpayer is not taxable at the situs of property.

13/ Only as provided by section 243 (applies to domestic corporations) of the Code.

14/ Capital gains on intangibles allocated to payee's commercial domicile.

Sources: "State Corporation Income Taxes and Other 'Doing Business Taxes': Tabular Summary of Statutory provisions Affecting Multistate Business," State and Local "Doing Business" Taxes on Out-of-State Financial Depositories, by the Advisory Commission in Intergovernmental Relations for the Committee on Banking, Housing, and Urban Affairs, United States Senate, May 1975; pp. 769-894; Compilation of the Manner in which States Impose Income Taxes on Income from Foreign Sources," Committee on State Taxation, Council of State Chambers of Commerce, March 5, 1976; and State Tax Reporter, Commerce Clearing House, Inc., individual state volumes.

*U.S. GOVERNMENT PRINTING OFFICE:1977 723-[illegible]/314 9-3

EXHIBIT 27

*(b) **Two or More Businesses of a Single Taxpayer.*** *A taxpayer may have more than one "trade or business." In such cases, it is necessary to determine the business income attributable to each separate trade or business. The income of each business is then apportioned by an apportionment formula which takes into consideration the instate and outstate factors which relate to the trade or business the income of which is being apportioned.*

Example: *The taxpayer is a conglomerate with three operating divisions. One division is engaged in manufacturing aerospace items for the federal government. Another division is engaged in growing tobacco products. The third division produces and distributes motion pictures for theatres and television. Each division operates independently; there is no strong central management. Each division operates in this state as well as in other states. In this case, it is fair to conclude that the taxpayer is engaged in three separate "trades or businesses." Accordingly, the amount of business income attributable to the taxpayer's trade or business activities in this state is determined by appplying an appropriate apportionment formula to the business income of each business.*

The determination of whether the activities of the taxpayer constitute a single trade or business or more than one trade or business will turn on the facts in each case. In general, the activities of the taxpayer will be considered a single business if there is evidence to indicate that the segments under consideration are integrated with, dependent upon or contribute to each other and the operations of the taxpayer as a whole. The following factors are considered to be good indicia of a single trade or business, and the presence of any of these factors creates a strong presumption that the activities of the taxpayer constitute a single trade or business:

*(1) **Same type of business:** A taxpayer is generally engaged in a single trade or business when all of its activities are in the same general line. For example, a taxpayer which operates a chain of retail grocery stores will almost always be engaged in a single trade or business.*

*(2) **Steps in a vertical process:** A taxpayer is almost always engaged in a single trade or business when its various divisions or segments are engaged in different steps in a large, vertically structured enterprise. For example, a taxpayer which explores for and mines copper ores; concentrates, smelts and refines the copper ores; and fabricates the refined copper into consumer products is engaged in a single trade or business, regardless of the fact that the various steps in the process are operated substantially independently of each other with only general supervision from the taxpayer's executive offices.*

Exhibit 27

(3) Strong centralized management: A taxpayer which might otherwise be considered as engaged in more than one trade or business is properly considered as engaged in one trade or business when there is a strong central management, coupled with the existence of centralized departments for such functions as financing, advertising, research, or purchasing. Thus, some conglomerates may properly be considered as engaged in only one trade or business when the central executive officers are normally involved in the operations of the various divisions and there are centralized offices which perform for the divisions the normal matters which a truly independent business would perform for itself, such as accounting, personnel, insurance, legal, purchasing, advertising, or financing.

(c) Business and Nonbusiness Income; Application of Definitions. The following are rules and examples for determining whether particular income is business or nonbusiness income. (The examples used throughout these regulations are illustrative only and do not purport to set forth all pertinent facts.)

(1) Rents from real and tangible personal property: Rental income from real and tangible property is business income if the property with respect to which the rental income was received is used in the taxpayer's trade or business or is incidental thereto and therefore is includible in the property factor under Regulations 25129 to 25131 inclusive.

Example (A): The taxpayer operates a multistate car rental business. The income from car rentals is business income.

Example (B): The taxpayer is engaged in the heavy construction business in which it uses equipment such as cranes, tractors, and earth-moving vehicles. The taxpayer makes short-term leases of the equipment when particular pieces of equipment are not needed on any particular project. The rental income is business income.

Example (C): The taxpayer operates a multistate chain of men's clothing stores. The taxpayer purchases a five-story office building for use in connection with its trade or business. It uses the street floor as one of its retail stores and the second and third floors for its general corporate headquarters. The remaining two floors are leased to others. The rental of the two floors is incidental to the operation of the taxpayer's trade or business. The rental income is business income.

Example (D): The taxpayer operates a multistate chain of grocery stores. It purchases as an investment an office building in another state with surplus funds and leases the entire building to others. The net rental income is not business income of the grocery store's trade or business. Therefore, the net rental income is nonbusiness income.

EXHIBIT 28

The Disincentive to Investment:
A groundless argument against the unitary method of taxation

Paul Ryder, Associate Director
April 22, 1978

Summary

The U.S. Senate and the California legislature will each soon vote on the issue of the "unitary" method of taxing multinational corporations. The unitary method is a technique devised "to prevent giant corporations from avoiding state taxes by juggling income between their subsidiaries in different countries". (1) Unlike the more limited traditional methods, the unitary (or "whole company") approach applies an apportionment formula to the income of a corporation or group of corporations operating as a worldwide unit in order to determine the proportion of the income that can be fairly allocated to the taxing state.

The use of this approach increases the state tax liability for most multinational corporations. For example, multinationals pay in all an additional $125 million in taxes to California each year due to that state's use of the unitary method. Several other individual states and the 19-state Multistate Tax Commission use the method to varying degrees, and the National Association of Tax Administrators has endorsed it. (2)

Multinational corporations bitterly oppose the unitary method. They are aggressively pushing for a ban on the method, claiming that it is a disincentive to new investment. They have been joined in this effort by the U.S. Treasury Department and the California Office of Business and Industrial Development, both of which recommend a ban on the unitary method based on its 'disincentive effect.'

The examination which follows shows the disincentive argument to be groundless:

* None of the opponents of the unitary method have been able to produce the empirical evidence to prove the disincentive

(Summary continues)

claim.

* Both the U.S. Treasury Department and the California Office of Business and Industrial Development base their recommendations solely on self-serving anecdotes provided by corporations with a direct interest in the outcome of the decisions.

* Bechtel International is frequently cited as a victim of the unitary method. In fact, Bechtel's Tax Manager says the firm is "essentially neutral" on the issue.

* Honda Motor's decision to build a plant in Ohio rather than California is often given as proof of the disincentive effect of the unitary method in California. In fact, the evidence shows that other factors dominated Honda's decision.

* The best rough estimate of the increase in production costs for projected investments due to the unitary method is less than one-fifth of one percent, hardly enough to be decisive in a location decision.

I. The Unitary Method and the Disincentive Argument

The unitary method of taxation is now under challenge in two arenas:

The U.S. Senate is now considering a treaty with the United Kingdom, Section 9(4) of which would prohibit state governments from using the unitary method to determine the tax liability of U.K.-based multinational corporations. (3) If the U.K. Treaty is ratified, the U.S. Treasury Department plans to try to extend its provisions to all foreign countries, beginning with Canada, France, West Germany, and Denmark. (4)

Once all foreign-based multinationals are exempted, there will be pressure to exempt U.S.-based multinationals as well, and hence impose a general ban on the unitary method.

In California, the only large industrial state that fully uses the unitary method, the state legislature will soon take action on several proposals to limit or eliminate its use. (5)

The most persistent argument raised by opponents of the unitary method has been that its use results in an increase in state tax liabilities to the extent that a disincentive to new investment is created. In this way, it is argued, the use of the unitary method is "penny wise and pound foolish", losing more in lost taxes from foregone investments than is gained through increased tax liabilities on completed investments. (6)

Substantiation for this claim would have to show that the unitary method (a) imposes costs sufficient to decisively affect investment or location decisions; and (b), if so, that the revenue loss from any investments foregone for this reason exceeds the revenue benefit of the use of the unitary method on all completed investments.

The basic methodology for such an analysis already exists. Every large corporation uses it in making investment and location decisions; every day, corporations make estimates of the effect of a change in a single cost factor. There is a large, growing, and readily-available literature on the subject of business location factors.

Unfortunately, neither the U.S. Treasury Department, California's Department of Economic and Business Development, nor the many corporations opposing the unitary method have been able to produce evidence along these lines in support of the disincentive argument.

II. The Government Statements

California

On January 20, 1978, Dennis Amundson, Director, California Office of Business and Industrial Development, prepared an internal memo for Richard Silberman, California Secretary of Business and Transportation, called, "Impact of Unitary Tax on Foreign Investment in California".

The memo stated first, "California's adherence to the unitary tax formula has had a measurable negative impact on foreign investment in the state." (7)

Second, it offered illustrative anecdotes, such as the following:

> "Toshiba, a Japan-based electronics corporation, at one time considered setting up manufacturing operations in California. Now openly critical of California's unitary method, Toshiba appears to be ready to locate its plant in Tennessee." (8)

Third, the memo listed corporations and corporate lobby groups that oppose the unitary method.

Though the memo is attributed to Director Amundson, most of it in fact is copied word-for-word without citation from a memo prepared by the Los Angeles law firm of Manatt, Phelps, Rothenberg, Manley and Tunney for a meeting of Japanese business executives with California Governor Brown and Secretary Silberman on June 30, 1977. (9)

U.S. Treasury Department

U.S. Treasury Secretary Blumenthal discussed the burden of accounts reporting imposed by the unitary system in a February 15, 1977, letter to Martin Huff, Executive Officer of the California Franchise Tax Board. Blumenthal stated, "We are aware of cases where this burden has discouraged foreign investment in the United States". (10)

In reply to requests for more information about these examples of discouragement, the Treasury Department was only able to suggest newspaper stories about the issue in California, Senate testimony by William McKee, a lobbyist for foreign banks (11), and two chapters from a Commerce Department study (12).

These sources contain no real evidence. The newspaper accounts simply report that foreign firms oppose the unitary method and have threatened not to invest in California because of it. The McKee testimony gives examples by quoting the Manatt,

Phelps memo at length. The Commerce Department study only reports that potential foreign investors consider the unitary method as a disincentive, and that they refer to "the actuality or fear of a higher tax burden (as) a substantial factor". (13)

The Treasury Department admits,

> "No attempt is made to determine how much additional investment California may attract if the unitary rule is eliminated, nor is an attempt made to project how much the tax base may shrink if the unitary rule continues in operation. The reasons for this omission is that no one seems to have more than a qualitative understanding of the disincentives involved....The Treasury Department has not attempted to evaluate whether the unitary rule was the single dominant factor in these cases (mentioned by the McKee testimony)". (14)

III. The Anecdotes

Without an independent analysis, only the brief anecdotes (such as those supplied by Manatt, Phelps) remain:

1. The anecdotes are self-serving in the extreme. The multinational corporations, which are the source of the information, have a direct material interest in the outcome of the debate. In most cases, the use of the unitary method results in higher tax liabilities for the firms involved.
   Interested parties can and should make known their opinions. It is bad public policy, however, for the government to make decisions based solely on information from such sources.

2. The anecdotes offer neither the amount of additional tax liability at stake, nor the relative significance of this additional liability to the investment decision.

3. Some anecdotes are vague in distinguishing one disincentive factor from another. For example, many articles have been written in the last year on California's 'bad business climate'. (15) Each article offers a series of disincentive factors - the unitary method, inventory tax, environmental regulations, red tape, etc., - and a long list of firms which have protested these factors.
   The accounts almost always begin with the story of the cancellation of a planned investment in California by Dow

Chemical in early 1977. From some articles, the unitary method appears to be the prime contributor to driving all investments away from California, including Dow. However, a spokesperson for Dow Chemical itself says, "The California Unitary Tax was not a factor in Dow's decision to drop its expansion plans in California." (16).

4. Some anecdotes are simply false. Last spring, a California trade newsletter reported,

> "California's use of the 'unitary tax', or combined reporting system appears to be directly related to an exodus from the state of an annual payroll of at least $100 million, according to the chief executive of a major California business. Leading California-based industrial engineering firms, including Ralph M. Parsons, Fluor, Bechtel, and Holmes & Narver have relocated substantial portions of their operations to Texas and Nevada." (17)

Most of the firms mentioned have declined to comment on the issue; in at least one case, however, the claim of a disincentive effect is false. According to the Tax Manager for Bechtel International,

> "the nature of our business results in our having an essentially neutral position on the basics of the California unitary method as an incentive or disincentive to investment in the state." (18)

The Bechtel case is a good example of how misinformation can be disseminated widely. W.E. Leonhard, President, Ralph M. Parsons Company, apparently started the story in a letter to Governor Brown on December 21, 1976. (19) His letter was described in the Spring, 1977, Newsletter of the California Council for International Trade. (20). From there, it was incorporated into the June, 1977, Manatt, Phelps memo, then into the July, 1977, McKee testimony, and finally adopted by both the U.S. Treasury Department and the California Business and Transportation Agency without anyone at any step checking with Bechtel itself.

The Honda case

One celebrated 'victim' of the unitary method in California is the new plant which Honda has decided to build in Union County, Ohio, near Marysville, rather than in California.

When it announced its interest in building an American plant several years ago, Honda received "a bid from nearly every state except Hawaii". (21)

However, as early as May, 1976, Honda called Ohio a "natural" site for the plant:

> "Cliff Schmillen, assistant director and national field sales manager for American Honda, emphasized the Great Lakes region, particularly northern Ohio, might be 'a natural' for the facility for the same reasons VW is interested, namely the great population of the Great Lakes region, proximity to raw materials, such as Youngstown's steel plants and Akron's rubber companies, the superb highway, rail, water and air transportation system, and the St. Lawrence Seaway (22)....Honda, within the last year, has put into service a five-ship fleet of Japanese-built ocean-going auto transports, each bringing more than 2,000 Honda cars from Japan each trip, then returning to Japan with U.S. products. These ships, it was pointed out, if the U.S. plant were opened, could be used to transport components via the Panama Canal and the St. Lawrence Seaway to the ports of Ashtabula, Toledo, or even Detroit, as well as haul cars to other world markets." (23)

Meanwhile, by the summer of 1977, many large corporations and some state officials began to press the Brown Administration in California to eliminate its use of the unitary method of taxation. They asserted that important location decisions - including the Honda plant - would hinge on the elimination of the unitary method in the coming year. The most prominent proponent of this view was Tom Quinn, Chairman of the State Air Resources Board and a key adviser to Governor Brown.

But Quinn's argument was seriously undermined when the _San Francisco Examiner_ printed the following leak on June 22, 1977,

> "Quinn - who denied it - is reported to have told Japanese businessmen recently that auto plants could not be built in California's four major metropolitan areas - San Francisco, Los Angeles, San Diego, and Sacramento - because those regions currently exceeded federal air quality standards. The remark, said to have been made during a trip to Japan which Quinn concluded last week, was relayed to Honda officials in Southern California....A plant with emissions 'of any consequence is not going to be let in,' (Lex) Byers (of the San Francisco Chamber of Commerce) said. 'The pollution levels are saturated. That's why Dow isn't here.'" (24)

Finally, on October 13, 1977, Honda decided as expected to invest in Ohio.

At the time of the decision, numerous press accounts reported that California's use of the unitary method was key to the decision - Ohio does not employ the method (26). In at least one case, these reports misstated the comments actually made. Newspapers widely reported Fred H. Miller, President of the American Imported Automobile Association, as linking the unitary method with the Honda decision. (27) Mr. Miller himself says, however, "In response to your question of the California unitary tax and what effect it has had on new business investment in California, I can only respond by stating that I am not an authority in this area. My comments were distorted and blown out of proportion, and do not warrant any further elaboration."(2

Whatever the statements by others, Honda itself attributed the decision to factors other than taxes. Honda Executive Vice President Kihachiro Kawashima said,

> "Our initial studies indicated that Ohio would be an excellent place for our first U.S. manufacturing facility because of its market location, outstanding transportation system, its supply of good labor, supply of parts, and good industrial environment." (29)

A joint press release by Honda and the Ohio Governor's Office stated,

> "To help attract Honda to Ohio, the Governor, with the cooperation of state legislative leaders, offered to provide up to 2.5 million dollars in public improvements related to the project. Governor Rhodes emphasized, however, that 'at no time did Honda ask us to offer anything other than information that aided them in their study of Ohio as a location for the new facility.'"(30)

James A. Duerk, Director, Ohio Department of Economic and Community Development later confirmed this statement: "They didn't ask us for anything," he said. (31)

If Honda placed so high a priority on minimizing its state tax liability that it rejected any California location because of the unitary method, then it is quite unlikely that Honda would decide to locate in Ohio without ever broaching the subject of additional tax breaks or other inducements with Ohio authorities.

This evidence to the contrary notwithstanding, every listing of projected investments which have fallen victim to the unitary method now includes reference to the new Honda plant.

IV. A Rough Estimate

In the abstract, any marginal increase in any production cost is a disincentive to new investment in some degree. The public policy issue, however, is whether the disincentive is significant enough to affect investment or location decisions, and if so, whether this effect exceeds the increased tax base.

In the absence of a full study, common sense suggests that the marginal effect of the unitary method on investment decisions is negligible.

This conclusion follows from the observation that state and local taxes as a whole are, at most, a minor consideration for multinational corporations. As Business Week noted in June, 1976,

> "Climate, labor costs, right-to-work laws, and energy availability are often more important considerations than state-local taxation, which typically accounts for only 2% to 3% of total costs." (32)

By comparison, labor costs alone usually account for 40-60% of the toal production costs of a manufacturing firm. In addition to costs, corporations make investment decisions on the basis of demand factors, which are not directly affected by state regulations including taxes.

A detailed 1970 study of development factors published by MIT concluded,

> "...neither comparative long-term growth trends nor surveys of business opinion support the view that tax differentials are major factors in locational decisions. This negative finding is given added plausibility by the evidence that tax differentials among regions are small relative to differentials in other business costs. For example....it was found that Minnesota's tax burden on manufacturing industries was substantially higher, in most cases, than in nearly all other states, but that difference in tax costs for specific industries averaged only about one-tenth the differences in labor and transportation costs." (33)

In addition, according to an Ohio State University report, "The importance of the state tax cost element is reduced even further since state business taxes are deductible from federal income tax liability." (34)

Unitary method /10/

In California, the use of the unitary method accounts for an estimated $125 million, or 6.25%, of nearly $2 billion in state business taxes. If total California state taxes account for 3% of the costs of a planned investment, the unitary method would then raise the total projected costs by only 00.1875%, hardly enough to be decisive in a location decision. (35)

This rough estimate is no substitute for a thorough study It does suggest, however, that the disincentive argument requires far more scrutiny than either the U.S. Treasury Department or the California Department of Economic and Business Development has yet given it.

The Industrial States Policy Center is a non-profit research institute concerned with public policy problems of industrial states.

1. Release, "State officials to protest proposed tax break for multinationals," Multistate Tax Commission, September 6, 1977.

2. Statement, John J. Lobdell, Director of Revenue, State of Oregon and Chairman, Multistate Tax Commission; Daniel G. Smith, President, National Association of Tax Administrators; at Hearings, U.S. Senate Foreign Relations Committee, "Tax Treaties with the United Kingdom, the Republic of Korea, and the Republic of the Philippines," July 19, 20, 1977, pp. 63-76.

3. Tax Convention with the United Kingdom of Great Britain and Northern Ireland, Message from the President of the United States to the U.S. Senate, 94th Congress, 2d Session, June 24, 1976, Article 9, Section 4, pp. 7-8; Treaty signed December 31, 1975; ratification pending.

4. "Senate group votes British tax treaty sought as a model," New York Times, March 16, 1978.

5. For example, Assembly Bill 13X, introduced by Assemblywoman Hughes, January 30, 1978; Assembly Bill 3415, introduced by Assemblyman Fazio, March 30, 1978.

6. Release, "Dymally's Commission for Economic Development proposes changes to California's unitary tax," California Lt. Governor Mervyn Dymally, August 3, 1977.

7. Memo, "Impact of unitary tax on foreign investment in California," Dennis G. Amundson, Director, California Office of Business and Industrial Development, to Richard T. Silberman, Secretary, Business and Transportation Agency, State of California, January 20, 1978.

8. Ibid., p.1.

9. Memo, Manatt, Phelps, Rothenberg, Manley and Tunney, June 30, 1977; reproduced in part in "Statement and materials in support of Article 9(4) of Convention between the United States and the United Kingdom for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income," submitted to U.S. Senate Committee on Foreign Relations on Behalf of Committee of Foreign Banks, by William D. McKee, July 11, 1977, pp. 18, 19, 27; full text accompanying letter, Dennis G. Amundson, Director, Office of Business and Industrial Development, Business and Transportation Agency, State of California, to Paul Ryder, March 8, 1978.

10. Letter, W. Michael Blumenthal, U.S. Secretary of the Treasury, to Martin Huff, Executive Officer, California Franchise Tax Board, February 15, 1977; see also, speech, Leon Rothenberg, Executive Secretary, National Association of Tax Administrators, to Seventeenth Annual Meeting of the Midwestern States Association of Tax Administrators, August 16, 1976, Cincinnati, Ohio.

11. William McKee, op. cit.

12. Foreign Direct Investment in the United States, Report of the Secretary of Commerce to the Congress in compliance with the Foreign Investment Study Act of 1974, Vol. 6: Appendix J - Taxation, chapters 2 and 3; Treasury Department sources in letters, Thomas J. Horst, Deputy Director, Office of International Tax Affairs, Office of the Secretary of the Treasury, to Paul Ryder, October 27, 1977, and February 15, 1978.

13. Commerce study, op. cit., p. J-55.

14. Thomas Horst, op. cit., October 27, 1977.

15. Michael Brody, "What kind of climate?", Barron's, June 6, 1977; "California heading for trouble?", U.S. News and World Report, July 11, 1977; William Wong, "California Governor Brown shifts position, begins to woo new business," Wall Street Journal, July 12, 1977; John Quirt, "Why the future no longer looks so golden in California," Fortune, March 27, 1978.

16. Jack Jones, Manager, Government Relations, Dow Chemical, U.S.A., Western Division, March 13, 1978, letter.

17. Newsletter, California Council for International Trade, Spring, 1977, p.1, "Unitary tax problem expands."

18. Miles H. Bresee, Jr., Assistant Controller and Manager of Taxes, Bechtel International Corporation, December 14, 1977, letter to Paul Ryder.

19. Newsletter, California Council for International Trade, op. cit.

20. Ibid.

21. Ohio News Service, Vol. 8, No. 34, August 22, 1977.

22. "Eyes site in Ohio for Honda plant," George P. Reiss, Youngstown Vindicator, May 16, 1976, p.1.

23. Ibid., p. A-8.

24. "New hangup in Japan car deal?", David Dietz, San Francisco Examiner, June 22, 1977.

25. Wall Street Journal, October 12, 1977.

26. See, for example, the remarks of California Governor Brown in "California lost Honda to Ohio 'tax breaks'," Associated Press, Akron Beacon-Journal, October 13, 1977.

27. See, for example, "California loses," Akron Beacon-Journal, September 26, 1977; "Unitary tax...Brown reverses, backs treaty," Sacramento Bee, September 29, 1977.

28. Fred H. Miller, December 30, 1977, letter to Paul Ryder.

29. Joint press release, Ohio Governor Rhodes and Honda Motor Company, Ltd., October 11, 1977.

30. Ibid., emphasis added.

31. Oral testimony, Ohio Senate Ways and Means Committee, November 16, 1978.

32. Business Week, June 21, 1976, p. 72.

33. C.L. Leven, J.B. Legler, and P. Shapiro, An Analytic Framework for Regional Development Policy, MIT Press, Cambridge, Massachusetts, 1970, p. 74, emphasis added; quoted in Dr. Wilford L. L'Esperance, Tax and Financial Incentives, Ohio v. Selected Other States, Ohio Department of Economic and Community Development, 1974, p. 17.

34. J. David Reed, Bulletin of Business Research, Ohio State University, April, 1976.

35. If additional liability due to unitary method = 6.25% of total state tax liability, and if total state tax liability = 3% of total production costs, then the additional tax liability due to the unitary method = .03 x .0625 = .001875 = 00.1875% of total production costs.

EXHIBIT 29

Hongkong Bank's Marine Midland Move Followed Advice by Salomon, Booz Allen

By a WALL STREET JOURNAL *Staff Reporter*

NEW YORK—Salomon Brothers, one of Wall Street's largest investment banking and securities firms, and Booz Allen & Hamilton Inc., a big management consulting firm, played key roles in arranging Hongkong & Shanghai Banking Corp.'s bold bid to acquire control of Marine Midland Banks Inc.

The story behind the giant takeover move, whose terms were announced late Tuesday night, dates back to late last year, according to officers of the two big banking organizations and others involved in the arrangements.

Shortly after taking over as chairman of the Hong Kong bank last year, Michael G. R. Sandberg asked Warren D. Chinn, senior vice president of Booz Allen, for a study of the U.S. banking system and for suggestions on how Hongkong & Shanghai Banking could increase its participation. "The U.S. economy is the dominant economy in the world," Mr. Sandberg said. "You can't turn your back on the U.S. economy at any time."

Booz Allen produced "a comprehensive study" of the U.S. banking network and suggested "a strategic approach involving acquisition of control of a major bank," Mr. Chinn said. "They accepted our recommendation," and Salomon Brothers was called in to help select a target, Mr. Chinn said.

The Salomon effort was organized by James D. Wolfensohn, who heads the firm's corporate finance department. Mr. Wolfensohn, 43 years old, is a former chief executive officer of Schroders Ltd. in London.

Marine Midland was selected as the target because "our strengths and weaknesses dovetail to a remarkable degree," Mr. Sandberg told reporters yesterday. Asked for elaboration, Mr. Sandberg said he was thinking primarily of geographical coverage. He added that Marine Midland's trust department "is well known for its expertise."

After an intensive study of Marine Midland, Mr. Sandeberg telephoned Edward W. Duffy, chairman of the Buffalo, N.Y.-based bank holding company, late in February. "I telephoned Ed and asked him if we could have a very informal, no-commitment dinner," Mr. Sandberg recalls. "We had known each other before so it wasn't hard to talk friendly."

Another Marine Midland official said there were private meetings in Honolulu between top officers of the two banking organizations and some of their financial advisers on March 18. On Monday, March 20, it was announced that the Hong Kong bank had agreed to acquire a major stake in Marine Midland.

Details released late Tuesday call for Hongkong Bank to make a cash tender offer for 3.1 million shares, or 25% of Marine Midland's 12.5 million common shares outstanding. The price isn't to exceed $20 a share.

In addition, the Hong Kong bank would buy a $100 million, 7¾% subordinated note that would be convertible into 3,333,333 shares of newly issued Marine Midland common stock at the rate of $30 a share. The agreement further provides for Hongkong Bank to buy an additional 3,333,334 common shares for another $100 million at the end of 1980, bringing its total holdings to 51%.

Mr. Duffy said yesterday that he doesn't see any problems obtaining regulatory approvals for the proposed transaction. "We see no difficulty," he said. "We see no forces that shouldstand in the way of this endeavor. Our assessment of the situation is that the transaction won't encounter any regulatory obstacles."

The agreement is subject to approval by the Federal Reserve Board and the New York State Banking Superintendent. In addition, Marine Midland stockholders at a special meeting will vote on the sale of the newly issued shares in connection with the transaction.

Mr. Duffy emphasized that the transaction was approved unanimously by Marine Midland's directors. "We regard this opportunity to create a mutually advantageous international partnership with one of the world's most respected banking institutions as a quantum step for Marine Midland; one which represents the most dynamic and positive development since the formation of our bank holding company in 1929," he told reporters.

Mr. Sandberg referred to the agreement several times yesterday as a "partnership" and emphasized that he doesn't expect his bank to run Marine Midland. "I think it is important, and I want to stress again, that it is our intention that Marine Midland will continue as an autonomous operations," he said. "We have no wish to interfere with their day-to-day business or operations."

Mr. Sandberg also said "we have great confidence" in Marine Midland's management. "Indeed, it was our high regard for their management which attracted us to Marine Midland," he said.

Asked how Hongkong Bank will finance the transaction, Mr. Sandberg replied that his bank is "very liquid" and that "we will just use the liquidity we have."

Mr. Sandberg said the transaction wasn't motivated by any fears about the future of Hong Kong. "The Chinese government has made it clear they are happy with the status quo, and the new government . . . has reiterated that," he said. "They have made it clear that the status quo will continue." He added that he hasn't discussed the proposed Marine Midland transaction with the Chinese government.

He also said the transaction wasn't designed to react against the increasing presence of U.S. banks in Asia. "That didn't enter into it," he said. "Banking in the last 10 to 15 years has become more international. That wasn't a factor."

Hongkong & Shanghai Banking, established in 1865 in Hong Kong, has assets of more than $17 billion. Its stock is listed on the Hong Kong and London stock exchanges and it has about 50,000 shareholders, according to a fact sheet released yesterday. It has more than 400 offices in more than 40 countries.

EXHIBIT 29

EXHIBIT 31

TAX TREATMENT OF MULTINATIONAL ENTERPRISES

Prepared by Members of the Staff

April 1978

Library of Congress
LAW LIBRARY

American-British Law Division
European Law Division
Far Eastern Law Division
Hispanic Law Division
Near Eastern and African Law Division

Exhibit 31

DENMARK

Even though the 1948 Convention Between the United States and Denmark for the Avoidance of Double Taxation does not cover income taxes levied by individual American states and by certain American municipalities, a Danish corporation will usually be granted Danish tax credits if its branch or subsidiary in the United States has had to pay such taxes in order to conduct its business. This is a consequence of Section 33 of the Danish Statute on Assessments.

In addition, Denmark grants a very substantial tax benefit to its relatively few multinational corporations by levying corporation (income) taxes on only ea. 50% of the income a Danish corporation has earned abroad.

FRANCE

I. Taxation

French income tax on corporations is based on the principle of territoriality. According to this general rule, a nonresident corporation is taxed only on its activities in France. A resident corporation, on the other hand, will not pay taxes for its activities outside the French borders. Therefore the French authorities consider that they are not entitled to tax the subsidiaries or branches of a French corporation or of a corporation residing in France for their activities abroad.

Since French authorities expect that the authorities of the countries where these subsidiaries or branches carry out their activities will tax them there a problem of double taxation does not exist from the French side. For example, since subsidiaries or branches of a French or a multinational corporation residing in France do not pay any taxes to the French Government for their activities in the United States, they do not even have to invoke the US-French convention against double taxation.

II. Other Forms of Relief

As seen above, there is definitely a relief in exempting French or multinational corporations residing in France from paying taxes on their activities carried out abroad. French corporations with subsidiaries or branches abroad benefit from another relief, in that they are entitled to choose between being taxed either on

a worldwide basis or on a consolidated one. Consequently, branches or subsidiaries of a French corporation do not pay taxes to the French Government on profits made in their activities abroad, but if the branches or subsidiaries show losses abroad, the French parent corporation is entitled to include such losses in order to reduce the taxable income by using the worldwide basis.

FEDERAL REPUBLIC OF GERMANY

The double taxation convention between the Federal Republic of Germany and the United States provides that the Federal Republic should use the exemption method for income attributable to all permanent establishments domiciled in the United States which are under German ownership. The exemption method is also provided for U.S. corporations that are substantially owned by a German corporation, a German individual or any other form of German business enterprise. Substantial ownership is defined by the treaty as ownership of at least 25% of the stock of the U.S. corporation.

For all U.S. branch or subsidiary income, as defined by the treaty, the issue of mitigating the burden of taxation levied by a State of the United States does not arise because double taxation of such income, for purposes of German taxation, is eliminated by excluding such income from the tax base. The only tax effect that such income has on the German tax liability of the parent corporation is that it is included in the tax base to establish the rate of taxation. (This method of exemption is called exemption with retained progression.

As regards subsidiary income, the only other instance in which the issue of German tax relief for the payment of taxes levied by the States of the United States arises is in the context of German stock ownership in a U.S. corporation, which does not amount to a substantial participation, since the exemption method does not apply to such stock ownership. Here the following principles prevail:

Aside from certain exceptions dealing with holding companies (of no bearing on the issue discussed here), Germany respects the corporate personality for tax purposes. Therefore, income taxes paid by foreign corporations are not creditable or deductible because no income is attributed to the stockowner until a distribution is made to him. Therefore the state and federal income taxes paid by a U.S. corporation are of no consequence for determining the German income tax.

When a distribution is made to the German stockholder, either in the form of a dividend or in any other manner, the stockholder then receives income to be included in the tax base for income taxation. Foreign taxes levied directly on such distributions (usually in the form of a withholding tax) are creditable as determined by the provisions dealing with the foreign tax credit. These provisions, however, limit the foreign tax credit to foreign taxes which correspond to the German income and corporation taxes, and this relief is not granted for income taxes levied by a member state of a federated state. Relief for the latter is granted only in the form of a deduction in computing income, and this amounts to a much smaller benefit than the tax credit.

ITALY

Corporations, limited liability companies, and certain other economic entities are subject under Italian law to the Italian corporate income tax if their main office, administrative office, or the principle object of their activity is located in Italy.

With respect to income earned overseas, foreign taxes paid on said income bring about an Italian tax credit in accordance with criteria of reciprocity. The tax credit, however, may not exceed two-thirds or be less than one-fourth of the Italian tax in proportion to the ratio between foreign earned income and the aggregate taxable income.

Japan adopts three methods of foreign tax credit: (1) direct foreign tax credit, (2) indirect foreign tax credit, and (3) a tax-sparing credit system. The latter applies only to eleven developing countries by virtue of the respective tax conventions concluded between Japan and these countries. Between the United States and Japan, the direct and indirect credit systems apply, in addition to the provisions of the Convention Between the United States and Japan for the Avoidance of Double Taxation and Prevention of Fiscal Evasion with Respect to Taxes on Income of 1972 (hereinafter referred to as the US-Japanese Tax Convention).

Direct Foreign Tax Credit

A Japanese multinational corporation operating through a branch office in another country is subject to Japanese taxation on its foreign branch profits. However, any foreign tax, including foreign local tax levied on such foreign branch profits, is creditable against the Japanese corporation tax on ordinary income and on undisturbed profits for the taxable year in which the foreign tax accrues. The limit of credit for foreign taxes is computed as follows:

$$\text{Japanese corporation tax} \times \frac{\text{Total income from sources abroad}}{\text{Entire ordinary income subject to Japanese corporation tax}}$$

In computing the total income from sources aborad, a net loss incurred in any foreign country may not be taken into account at the corporation's option. The entire ordinary income subject to the Japanese corporation tax is the amount before the deduction of any losses carried over from previous taxable years. If the amount of foreign tax accrued in any taxable year exceeds the limit computed

for that year, the excess may be credited against the prefectural inhabitant tax and the municipal inhabitant tax on the income for the same taxable year. If there still remains any excess foreign tax, that amount in excess may be carried over for the next five succeeding years or carried back to the five preceding years.

Accrued foreign taxes may, at the corporation's option, be deducted from taxable income as necessary expenses. If a domestic corporation elects to take foreign taxes as credit, such foreign corporation taxes may not be deducted. The corporation must exercise its choice on the total amount of foreign taxes accrued in each taxable year.

Indirect Foreign Tax Credit

A Japanese multinational corporation conducting business through a subsidiary in another country is not subject to Japanese taxation on its subsidiary's profits; however, tax at the normal corporate rate is imposed on the parent corporation when dividends are distributed from the subsidiary. In this instance, the parent corporation is given an indirect foreign tax credit provided that the following conditions are satisfied: (1) twenty-five percent or more of the shares with voting rights or capital of the foreign subsidiary is owned by the Japanese parent corporation and has been owned by it for at least six months, and (2) the foreign subsidiary has been established only for the purpose of carrying on business in that foreign country and not for any tax consideration.

Under the provisions of the US-Japanese Tax Convention, the indirect foreign tax credit is allowed for the Japanese parent corporation which owns more than ten percent of the voting shares of a foreign subsidiary established in the United States from which it receives dividends.

When both foreign tax and dividends are paid out by the subsidiary, the Japanese parent corporation is deemed to derive income for itself. Therefore, the foreign tax, including local foreign tax imposed on the profits of the foreign subsidiary which are to be distributed as dividends to the parent corporation, is creditable against the Japanese corporation tax payable by such parent corporation. The foreign tax which is applicable to the dividends is computed by multiplying the foreign tax by the ratio of the dividends received by the parent corporation to the total dividends paid out by the subsidiary.

The British rules on the avoidance of double taxation grant relief to a resident corporation for any foreign taxes paid on overseas income. The relief is granted under the provisions of a tax treaty or on a unilateral basis. The unilateral relief is used in two situations: First, where there is no double taxation relief treaty and, secondly, where there is such a treaty but it does not cover a particular tax.

While the United States and the United Kingdom have a convention on the avoidance of double taxation, it does not apply to state income taxes paid in the United States. Therefore, the provisions of the Income and Corporation Act, 1970, granting unilateral relief are applicable with respect to the payment of such taxes.

Subsidiaries or branches in the United States of United Kingdom corporations (which continue to be regarded as United Kingdom residents) receive a credit for state taxes paid in the United States against the corporation tax on the same income. However, the amount of credit cannot exceed the corporation tax attributable to that income.

EXHIBIT 32

LOU HARRIS STUDY

Pages 63 - 66

Exhibit 32

Study #W2781

RECEIVED
OCT 1 2 1979
Sacram... Legal
FRANCHISE TAX BOARD

ATTITUDES OF THE NATION'S CORPORATE LEADERS TOWARD CALIFORNIA AS A BUSINESS LOCATION

February 1978

Conducted for

Commission for Economic Development
State of California

by

LOUIS HARRIS AND ASSOCIATES, INC.

1. Superficially at least, most of the nation's leading manufacturing executives are highly satisfied with the location of their largest production facilities.

2. Most, however, do not feel their largest plant's location gives them an edge over competitors, and thus a major effort should be made in any California industrial promotion program to show how relocation to California can provide a competitive advantage.

3. Depth examination of executives' feelings about the location of their largest manufacturing plant shows that, while most look upon it favorably, they are not highly enthusiastic about it.

4. In appraising both the pluses and minuses of this present location, executives stress mainly the labor situation — the cost and degree of availability of the kind of labor they require — and the plant's access or lack of access and proximity to major markets and sources of supply.

5. Consequently, these executives say that above all else the two most critical characteristics a location must have for their operations are good access (transportation facilities) and close proximity to customers and suppliers, plus a supply of available labor having the required skills at the right price.

6. More precisely, the top criteria for selecting a manufacturing location are: 1) reliability/productivity/skill/cost of labor, 2) access and proximity to markets and sources of supply, 3) availability and cost of power.

7. Secondary criteris are: 1) the level of corporate income

taxes, 2) efficiency/effectiveness/integrity of state and local governments, 3) security from crime, and 4) availability of housing for employees.

8. Quality of life factors such as quality of education, ease of transportation to and from work, a clean environment, and availability of recreational and cultural activities are all relatively unimportant criteria.

9. More than 1 in 4 of these executives say their companies have moved a major manufacturing operation from one state to another in the past four to five years.

10. The major reasons for these moves were dissatisfaction with the labor situation, the need for a more efficient and larger plant, and the need to get closer to markets. Thus, California should be warned that companies within the state having older and obsolete plants should get special attention in terms of attempts to keep them in the state.

11. Although the top criteria for plant location must be met if new industry is to be attracted to California or to any state, corporate executives will be personally appealed to most effectively by stressing the high quality of local schools and the large supply of attractive homes.

12. California is well known as a potential manufacturing location. It is almost as well known as New York, and much better better known than Nevada and Arizona.

13. Most executives, however, think of California in terms of its climate and lifestyle rather than in terms of its economy and human and natural resources.

14. On balance, executives find more to dislike about California as a manufacturing location than to like about it primarily because: 1) although they recognize the skill and training of California's labor force, they are worried about its cost and its productivity; 2) they fail to recognize the size of the California market and its access and proximity to the nation's Southwest, Northwest, and abroad to the Far East; and 3) they are concerned about California's high corporate income taxes and high power costs, as well as what they feel is a less than hospitable attitude toward business and industry.

15. Major promotional efforts obviously should concentrate on California as a place where skilled and dedicated people work hard as well as play hard, as a huge and booming marketplace with ready access to both domestic and foreign markets, and where the state political leadership is concerned, responsive, and understanding of the needs of industry.

16. California should not try to compete with states like Arizona for industries which rely heavily on cheap, unskilled labor and cannot afford to pay the higher tax rates necessary to support a more fully developed economy.

17. The most inviting and persuasive incentives California can offer potential new industry are: 1) abatement from local property taxes, 2) tailor-made manpower recruiting and training programs to meet a company's needs, and 3) loan plans for new plant construction.

18. To be most effective in attracting industry a new California promotional program should rely most of all on using highly knowledgeable, executive-level sales people to call personally on top executives of manufacturing firms.

19. Their best sales tool will be endorsements from their prospects' counterparts who already have manufacturing operations in California.

20. Direct mail should play a secondary role,and national advertising will not likely be a particularly good investment in terms of capturing this market.

EXHIBIT 33

MAY 15 1979
Sacramento Legal
FRANCHISE TAX BOARD

STATE TAXATION AND ECONOMIC DEVELOPMENT

Roger J. Vaughan

Economics Department

Citibank, New York

February 1979

DRAFT
NOT TO BE CIRCULATED
REVIEW PURPOSES ONLY

This paper was prepared for the Council of State Planning Agencies. The views expressed are those of the author and do not reflect the views of Citibank, the Council of State Planning Agencies, or any other organization.

Exhibit 33

PREFACE

This paper analyzes the role of state taxation policies in shaping state economic development. It is one of a series of papers addressing state economic development issues prepared for the Council of State Planning Agencies under a contract from the U. S. Economic Development Administration.

The purpose of these papers is to provide information and analysis for policy makers at the state and local levels charged with responsibility for economic development and fiscal affairs. This paper is organized to address the following questions:

- What's wrong with and how can we improve the present state/local fiscal structure?
- What can states do to improve the efficiency and equity of business taxes and business tax incentives?
- What can states do to improve personal taxes?
- How can states best respond to the fiscal limitation movement

Although the focus is upon *state* taxes, their influence can only be understood within the context of the whole intergovernmental tax structure. Therefore this paper also analyzes ways in which federal and local tax policy could be improved.

No new empirical research was undertaken for this study. Rather, the results of many studies are synthesized to present an overview of the complex interactions between taxes and development and to evaluate present fiscal policies.

The object is not to make specific and detailed policy recommendations, since these usually depend upon the local fiscal strucure, but rather to suggest the advantages and disadvantages of alternative fiscal policies.

SUMMARY AND RECOMMENDATIONS

State tax policy is in disarray: States compete for footloose firms by offering expensive tax holidays; households are in revolt against rising property tax burdens; cities demand state aid for social services; and the federal government mandates costly programs that must be paid for from state funds. Bypassed by the federal grant programs spawned by the recent recession, state officials have been trapped into a reactive role and have been left out of the urban policy debate. The present state tax structure reflects the hasty application of band aids rather than the considered surgery that is necessary to meet current economic problems.

This paper examines how the structure of state and local taxes can best be adapted to meet these problems. It approaches the problem from a broad perspective, analysing not only business taxes, but also the state/local fiscal structure and personal taxes, since these issues also influence the local pattern of development. The conclusions, summarized below, should help local policy makers in the difficult tasks that confront them.

WHAT SHOULD A STATE ECONOMIC DEVELOPMENT STRATEGY LOOK LIKE?

Taxes are only one factor among many — and a relatively minor one — that affect state economic development. The quality of the local labor force, transportation facilities, energy prices, and population growth all contribute to shaping local development. In fact, population growth may be the single most important factor. Households are drawn not only by local job openings but also by an attractive residental and recreational environment. This implies that:

An economic development strategy must aim at attracting skilled workers as well as factories. Concentrating on industrial parks and business tax incentives at the expense of residential amenities will meet with only limited success.

As the distribution of jobs and people change in response to

technological change and other market forces, as well as to public sector policies, underlying market conditions change. Wages and land prices are driven up in growth areas, while costs fall in slower growing regions. The future is not an indefinite extension of the past. A loss of manufacturing jobs may be couterbalanced by an increase in service industry employment. The lesson is that:

An economic development strategy must recognize changing local comparative advantage, and not attempt to wind the clock back. For the Northeast, and for many urban areas, manufacturing can no longer be the main engine of growth.

Most local employment growth occurs through the birth of new firms and from the expansion of existing, small, companies. Very little growth (or decline) results from the inmigration (or outmigration) of firms. Taxes play only a minor role in the location decisions of migrating companies. Therefore:

An economic development strategy must focus on the overall economic climate, and not waste resources on special incentives for a few favored firms. It must encompass a broad range of policies including training programs, infrastructure development, and capital mobility as well as a balanced tax structure.

Finally, the relatively small role played by taxes does not imply that the state government is powerless to influence growth and development. Positive and coordinated leadership and the minimum of red tape are important considerations.

WHAT GUIDELINES SHOULD A STATE EMPLOY TO IMPROVE ITS' TAX STRUCTURE?

The primary purpose of taxes is to raise revenues to pay for local services. This must be achieved with as little disruption as possible to businesses and households, as fairly as possible, and at the lowest administrative cost. The following guidelines should help in the

formulation of local fiscal policy:

Efficiency

- The overall burden of taxes should reflect the local preference for public services.
- The tax structure should not encourage undesireable reactions by taxpayers, such as business or household relocation.

Equity

- The greater the taxpayer's resources, the greater should be the tax burden.
- Taxpayers with similar resources should pay similar tax burdens, all other things being equal.
- The tax burden for tax payers with similar resources should be related to the value of public services received.

Administrative Cost

- The tax should be simple to collect and to enforce.
- The tax revenue should be predictable.
- The tax revenue should grow over time as the demand for public services grows.
- The tax revenue should be cyclically stabilizing.

These guidelines cannot be rigidly enforced, since they are not necessarily compatible. An increase in efficiency may only be achieved at a loss of equity, for example. But the guidelines do allow these trade-offs to be made explicitly as fiscal policy is debated.

There are also constraints on the extent to which state policy makers can pursue these goals. First, they must operate within the overall structure of fiscal federalism, and are limited by the actions of the federal and local governments. Second, states are limited by the desire to maintain sound bond ratings. And, finally, they are limited by the fact that there is a great deal that is not known about who pays for specific taxes, and how taxes affect business and household behavior.

III. WHAT FACTORS INFLUENCE ECONOMIC DEVELOPMENT?

In trying to unravel the complex process of economic development to identify how state and local taxes may be influential, two facts stand out. First, *state and local taxes are only one factor among many that directly influence development, and, in fact, are not a major factor.* The role of taxes is not discussed in this chapter, but is discussed in detail in the following chapters. The discussion in this chapter provides a context against which to view the role of taxes. Second, *many of the ways in which taxes shape the development process are indirect.* For example, taxes affect residential location decisions which in turn affect the local demand for goods and services. A tax policy that attracted middle and upper income households would contribute to local development.

COMPONENTS OF EMPLOYMENT CHANGE[1]

Areas suffering from high unemployment often blame their difficulties on the outmigration of firms, and regard the panacea as an aggressive promotional campaign to attract new footloose firms. The myth of a rich vein of large, non-polluting, firms that can be mined by state development officials offering free land and access roads, subsidized buildings, and tax abatements, has distorted state development efforts for years. A rational economic development policy cannot be developed until this myth is dispensed with and the true components of employment change are identified. Recent studies using data on the location of industrial firms has revealed the following:

- Interregional migration of firms is the least important component of employment.[2] Differences in the birth rates and rate of expansion of existing firms are much more important. There is very little regional variation in the rate at which jobs are lost through firm contractions or closures.

- Firm moves are slightly more important in determining central city/suburban growth differences, but are still less important than other components.

...ch rate of new firms is much higher in suburban than central ...y locations. Central cities do not tend to act as incubators.

- New, closing, and locally moving firms are smaller than stationary firms.

- Most new jobs created in an area arise through the expansion of employment in relatively small local firms.

What are the implications for development policy of these findings? Unfortunately we don't yet know what factors affect each of the components of population change in order to target policies. Obviously, research in this crucial area should continue. We can say that the continued effort on smoke-stack chasing is probably misplaced, and that greater effort should be devoted to ensuring that the overall economic environment is as attractive as possible, rather than simply providing benefits to a few large firms. The remainder of this chapter examines factors that influence development.

Factors that influence growth and development may be separated into three types: those that affect the demand for output; those that affect the cost of production at a particular location; and a less tangible group of amenities that may affect the attractiveness of a particular location as a place to live and do business, such as air quality, recreation facilities, and crime rate. The last group may affect the local market and local costs, but they do so less directly than the other factors:

DEMAND

Consumer Market: population and income

Intermediate Market: interindustry linkages

INPUT COSTS AND AVAILABILITY

Transportation

Labor: size of force, skill level, wages, productivity, unionization

Land

Raw Materials

Energy

Finance

Taxes and municipal services

External economies: scale and agglomeration

It is extremely difficult to separate the effects of different factors and to weigh the factors according to the relative strengths of their effects upon changing patterns of economic activity. For example, it seems probable that one factor in the rapid expansion of manufacturing activity in the South was the extension of the federal highway system into areas of declining agricultural employment where there was a ready pool of surplus labor. Should the rapid growth in that region be attributed to reduced transportation costs or to low-cost labor? The introduction of air conditioning for manufacturing plants may also have stimulated economic development in the South. How should the growth rate be attributed among these three factors?

Another problem is that it is difficult to measure the factors themselves. For example, wages do not measure the skill of the labor force or the hiring costs and training costs that the firm must incur.

Since state economic development policy is concerned both with aggregate state economic growth, and also with its distribution within the state, the following discussion analyzes how these determinants have influenced *interregional* and *intra-regional* growth patterns.

CONSUMER MARKET

There is considerable evidence that market considerations are the most important single factor in explaining interstate differences in economic development and that growth in employment follows rather than leads growth in population.[3]

Separating the influence of the level of demand on employment in an area is difficult. The size of the local population, often used as a measure of demand, also measures the availability of labor. Demand, output, and employment interact in a complex way as shown in Fig. 3.1. Growth in local population leads to an increase in labor supply and in the demand for output, leading to an increase in demand for labor. The growth in labor demand stimulates the increase in population as migrants arrive seeking jobs. As employment increases, so does local income, which stimulates a further increase in demand (the multiplier effect). Within this dynamic system it is difficult to determine the extent to which the growth in market demand stimulates the

VI. WHAT SHOULD STATES DO ABOUT BUSINESS TAXES?

Few policy discussions are fueled by as much passion, encompass as many conflicting parties, and are based on as little evidence, as the debate on what to do about business taxes. Households, who have born the brunt of spiralling taxes, demand that the burden be shifted to businesses. Businesses, facing rising competition from the New South and from the Far East, demand tax breaks. The unemployed demand jobs, and state governments need revenues. This chapter examines business taxes. The following chapter reviews the use of specific tax incentives to achieve state development goals.

There are several types of business taxes, and their use varies among states. The most important are:

- o Business income taxes. These include corporate, financial, and unincorporate business income taxes. Several states have no business income taxes,[1] but tax the value of output[2] or gross sales.[3] Revenues were $7.2 billion in FY 1976.
- o Property Taxes. These include taxes on the value of land and structures owned (or even leased) by the company. Some states and localities include the value of equipment and inventories when estimating property values. States collected $2.1 billion in property taxes in FY 1976, localities $32.9 billion.
- o Payroll Taxes. Companies must contribute toward Unemployment insurance, and workman's compensation. These are not traditionally regarded as business taxes nor are they regarded as being within the scope of state tax policy. They are computed on an actuarial basis and paid into a trust fund. Although they are not traditionally considered part of general state revenue, they vary among states and have influenced development. Unemployment insurance premiums totalled $5.1 billion in FY 1976.

states with a high concentration of their labor force in the volatile [illegible] durable industry will experience higher unemployment rates during [illegible] as a result of the way the program is designed.

Interstate and Intrastate Tax Differences

While the impact of tax levels has received little attention, the influence of inter-area variations in the tax rates on growth and industry location has been studied extensively, but not satisfactorily. Do interstate differences in business tax levels affect industrial location decisions and spatial differences in economic growth? The answer, it seems, is very little. Counter to many myths, tax differences can be blamed for very little of the regional shifts in employment and for relatively little of the shifts from central cities to suburbs. *In fact, the major influence of taxes on economic development may not be through business taxes, but indirectly, through personal taxes that influence the migration pattern of households and thus the growth of employment (see Chapter VIII).*

There are several reasons for this conslusion that seem to contradict conventional wisdom:

- o First, state and local tax payments are deductible for federal income tax purposes, and since corporate income is subject on a marginal federal tax rate of 48 percent, both the net burden and the amount of any differential are essentially cut in half.
- o Second, differences in tax rates are often compensated for by differences in the level and quality of local public services, which also affect business location decisions.
- o Third, the costs of many other factors vary among locations and may be much more important in location decisions. For most firms, labor costs are 20 times as large as state and local tax payments. A 2 percent wage differential is an important, therefore, as a 40 percent tax differential.
- o Fourth, local tax rate differentials are capitalized, at least in part, in property values. Land in a high taxing locale is depressed in value, while a low tax area will have higher land values.

- Finally, there are relatively few footloose firms whose location decisions might be influenced by tax differentials.

One of the few studies that did find a significant effect of taxes analysed taxes in New York City and was conducted for the Budget Bureau of that City (Grieson et al.,1977). The city is in a unique position since commuters and businesses can move to either New Jersey and Connecticut and maintain close contact with the city. Both states have maintained a quite distinct tax structure, partially, one assumes, to try and syphon off some of the city's business. The study, which examined the shift from a gross sales tax to a corporate profits tax in 1966, concluded that manufacturing activity had left New York City in response to high taxes. In fact, a 10 percent increase in local taxes would reduce employment by about 3.5 percent. Unfortunately, it is difficult to identify what part of the ensuing exodus of manufacturing from the city is attributable to the tax change.

One reason why tax rate differentials within a metropolitan area have not contributed more to the suburbanization process is that part of the differential in tax rate will be reflected in land prices. Land prices in a low taxing jurisdiction will, all other things being equal, be bid up when firms try to move in, while land in high taxing locales will decline in value. A firm must compare the tax savings with the higher purchase price of the site.

There is ample evidence of the capitalization of property tax differentials. There is also evidence that central-city suburban differences have not been very important. (Fuller and Towles, 1978, and Levin, 1976). However, as Cornia, Testa, and Stocker (1978) point out: "States do resort to fiscal and other incentives... These actions therefore suggest that these differences are not always fully capitalized in land prices. The capitalization process is limited by imperfections in the land market. Among these are a paucity of available sites or potential bidders, unique qualities of individual sites, and requirements of individual businesses, zoning and other land use restrictions, or limited knowledge of both sides of the market."

Thus the burden of high local taxes may be greater for firms with unique site requirements, which would tend to be large manufacturing concerns for whom rail spurs, harbor facilities and other features are important. Firms that are less mobile may, therefore, be induced to pay a higher tax rate than more mobile sectors. However, the few firms that fall into this category manage to gain a degree of political power in the long run that seems to minimize the extent to which local governments can capture any location rents.

The overwhelming evidence from many studies of industrial location decisions suggests that firms select their region based upon broad criteria, such as the anticipated market growth, availability of raw materials, transportation, energy prices, and the quality of the labor force. The last factor includes both the education and skills of the labor force, but also the wage rate, degree of unionization and other aspects. Compared with these factors, state and local taxes shrink in importance.

Of course, irrefutable evidence is hard to find. It is difficult to determine why a company chooses a particular location. Rigorous econometric models rarely have appropriate or accurate data to work with, and questionnaires are only as reliable as their often biased respondents.

The near unanimity of findings from all sources gives some credibility to the basic proposition that tax rates have not been important. Schmenner (unpublished) concludes that "cities and towns need neither fear that high tax rates alone will drive out all industry nor rejoice that low tax rates guarantee rapid industrial development." Although he does point out that analysing the relationship between taxes and location is confounded because the causation runs two ways. While industry may be marginally attracted by low tax rates, a heavy local concentration of industry probably leads to a low tax rate because of the size of the base.

However, these are other aspects of the business tax structure that may also influence location decisions. First, from the point of view of computing taxable income, land cannot be treated as a depreciable asset.

This encourages firms to avoid areas where land prices are high and where land prices may decline. The bias is toward suburban areas where prices are low and expected to rise. The bias is reinforced by the fact that capital gains are taxed at a lower rate than corporate income. This shelters rapid appreciation from taxes, encouraging location at the urban fringe. Fulton (1971, p.10) illustrates this process with the case of a company that:

> 10 years ago acquired a very large site on Route 128 near Boston. Before the company could complete its plans for construction on the new site, it received—and accepted—an offer for a small portion of the property at what constituted a substantial profit. This was the first of many such transactions, all with increasing profitability, to the point where the company was realizing greater profits in land sales than in manufacturing. As a result, when another division of the same company planned expansion in the Chicago are, the company insisted on the acquisition of 100 acres even though the utmost requirement for the proposed facility was only 10 acres.

Business Taxes and New Investment

The fact that the corporate income tax falls upon the net income from capital makes it probably quite progressive (see below) but also encourages the substitution of labor for capital, and discourages new investment. We do not know how powerful these tendencies are. First, labor is also heavily taxed through payroll taxes such as unemployment insurance, and social security. And capital receives a multitude of special allowances such as investment tax credits and depreciation allowances above the true depreciation rate.

Hodge (1979) studied the impacts of corporate income and business property taxes in investment across a sample of metropolitan areas. He found no significant influence of the corporate income tax, but investment was reduced in some industries by high property taxes. Comparing his results with others that found no influence on location, he hypothesized that "while the total profitability of location in one area versus another

is not significantly affected by the presence of high property taxes, these taxes do affect the most profitable combination of inputs to be employed." This effect has not been strong.

Another inefficiency arises because the effective tax rate in manufacturing and commercial property is above that on residential property. This, coupled with more generous federal income tax allowances for residential investments (Peterson, 1978) has favored the residential sector. This has probably contributed to suburbanization of the relatively affluent, and therefore to the social and fiscal problems of central cities.

EQUITY

Judging the equity of the business tax structure involves knowing the incidence of the taxes, and there are many unanswered questions. Observers of state/local business taxes have alleged that the structure lacks both horizontal and vertical equity, and has been regressive inasmuch as households have born an "excessive" share of the tax burden.

Horizontal Equity

The statewide corporation income tax ensures that it is relatively equitable at least spatially. The wide variations in the business property tax is much less equitable, as we have seen. However, the way in which the net income tax base is defined--the inclusion of special allowances--does not guarantee intersectoral horizontal equity. The tax structure has not developed by chance. Rather, it reflects the needs of the more powerful local business sectors. For example, those industries that are relatively concentrated[5] in New York City--apparel, textiles, printing, leather, and miscellaneous manufacturing--are labor intensive and low profit. Yet taxes in New York City fall most heavily on high-profit, capital intensive firms (Gerard, 1974). This tendency for the tax structure to favor established local industries is fine while those industries are growing. However, when those industries fall into decline, it could provide a barrier to local redevelopment by deterring expansion in less fiscally favored but potentially growing industries. The long established client relationship between older sectors and local politicans makes it difficult to adjust to new economic realities.

...igan's incentives may cost $50 million in state revenues and $30 million in local revenues.

Of course, to determine whether a measure is worthwhile, it is important to compare its benefits with its costs. A local development incentive does not have to be very effective to be worthwhile if its costs are negligible. The few studies that have compared benefits with costs of fiscal incentives do not provide a very optimistic picture, although do show, that under some conditions, fiscal incentives may be cost effective. Morgan and Hackbart (1974) concluded that if locally accruing benefits are not less than 50 percent of value added in a local plant and not less than 5 percent of the investment is a result of an incentive, then that incentive may be cost-effective from the viewpoint of the state, although, as we argued in Chapter III, there is no guarantee that the nation as a whole is not worse off.

What of the few firms that may respond to some kind of fiscal incentive?[6] Are they the type of firm that can assist meeting local development goals? In an important article, Harrison and Kanter (1976) argue that the type of firm most likely to respond are firms in highly competitive industries, for whom small differences in costs make the difference between success and failure. Yet, they argue:

> ...these are the industries that in general pay lower wages, offer worse working conditions, provide less stable employment, and make it more difficult for labor to organize. Thus, incentives that lower costs of doing business appear to be policy instruments--if they work at all--that are most likely to "goose" the sector of the economy with the least desirable jobs, while providing windfall profits to the segments of the business community that needs them the least (p. 59).

In short, tax incentives are ineffective, and what little impact they might have is not necessarily desirable.

EQUITY

Not only are tax incentives inefficient, they are also inequitable. First, the incentive tax credit will tend to go to large and financially healthy firms, since these firms will be earning a taxable income.[7] Nearly 50 percent of all firms had no federal tax liability in 1971, and 95 percent

EXHIBIT 34

SUMMARY OF CALIFORNIA CORPORATE TAX LAW AND FEDERAL LEGISLATION, BILLS, HEARINGS AND REPORTS RELATING TO STATE TAXES ON CORPORATE INCOME

Background

The California tax on corporations was enacted in 1929. This tax is imposed only upon corporations which engage in intra-state business in California. In order to complement the franchise tax, the Legislature enacted the corporate income tax in 1937. This tax applies principally to corporations engaged in interstate activities and deriving income from sources within this state. The validity of the tax was sustained in 1946 (West Publishing Co. v. McColgan, 27 Cal.2d 705, affirmed 328 U.S. 823).

In 1959, in the Northwestern Portland Cement and Stockham Valves cases, 358 U.S. 459, the Supreme Court ruled that regular and substantial solicitation of sales in a state would subject a corporation to tax and make it liable for a fairly apportioned state net income tax, notwithstanding that all of its transactions were in interstate commerce. Although the California taxing agencies felt the decisions only reaffirmed the 1946 West Publishing case, supra, the national business community treated the cases as a radical departure from existing law and at their insistence, in response to the Northwestern - Stockham cases, Congress almost immediately enacted P.L. 86-272.

Public Law 86-272

In enacting Public Law 86-272, on September 15, 1959, Congress, for the first time directly prohibited state income taxation with respect to certain activities. P.L. 86-272, in general, provides that a business is exempt from income taxes if it only solicits sales of tangible personal property, the orders for which are filled from outside the state.

The Act also directed the House Committee on the Judiciary and the Senate Committee on Finance to study all matters relating to state taxation of interstate business activities. This responsibility was discharged by the issuance in September 1965 of Volume IV of the Report of the Special Subcommittee on State Taxation of Interstate Commerce of the House Judiciary Committee, 89th Congress, 1st Session, House Report No. 952. It included the recommendations of the Subcommittee, which were endorsed by the full Committee. On October 22, 1965, Representative Willis, Chairman of the Subcommittee, introduced H.R. 11798, to carry out those recommendations.

Franchise Tax Board - July 19, 1977

EXHIBIT 3 L

H.R. 11798 (1965)

This bill was a comprehensive tax act which would have largely replaced state corporate income and sales and use tax laws with federal rules and administration. Briefly, the bill specified a jurisdictional standard for the imposition of taxes above the existing level; required income to be apportioned by a formula which would have shifted the tax burden onto California based businesses; required all states imposing an income tax to use federal tax base as a starting point, but within "certain limits" state adjustments could be made; provided that the Internal Revenue Service would (1) issue rules and regulations on the apportionment of income; (2) have the power to modify the apportionment formula to avoid unfairness; (3) establish the procedure for reviewing multistate disputes on the administrative level; and (4) study interstate tax problems the Subcommittee didn't explore fully. Disputes would have been resolved by the federal courts.

The bill would have severely limited California's taxing jurisdiction, greatly restricted the Legislature as to the establishment of the corporate tax base, and substituted the Internal Revenue Service for state tax administration and federal for state courts with respect to all but one-third of the California corporate income taxes.

Hearings were held on January 26-28; February 2, 4, 9, 10, 17, 18, 24, 25; March 2-4, 16-18, 23-25, 30, 31; April 1, 5, 6, 1966. See Committee Reports of the Hearings.

H.R. 16491 (1966)

Because of widespread opposition, a somewhat milder bill was proposed. This bill was H.R. 16491, introduced on July 25, 1966. This new Willis Bill eliminated those provisions which provided for direct federal administration of state and local taxes. It also no longer compelled states to use a moving federal tax base for corporation income tax purposes. The bill's two-factor apportionment formula was limited to multistate businesses whose average net income over a 5-year period was $1 million or less. Businesses also had the option of determining income under state apportionment formulas. This bill was not voted out of the House Rules Committee.

H.R. 2158 (1967)

In the 90th Congress H.R. 2158 was introduced by Congressman Rodino. It was identical to H.R. 16491 and passed the House with minor amendments by a vote of 289 for and 84 against. No further action was taken.

H.R. 7906 (1969)

This bill, also by Congressman Rodino, was introduced during the 91st Congress on June 30, 1969. It was identical to H.R. 2158, as amended. It passed the House by a vote of 311 to 87, with California congressmen voting against the bill 21 to 15. No further action was taken.

Ribicoff Proposal

Previously at the close of the 90th Congress Senator Ribicoff (Conn.) inserted in the Congressional Record a draft of a bill he intended to introduce in the 91st Congress and called for its early consideration. This bill differed from the House bills in that the $1 million limitation was eliminated and states would be precluded from requiring a corporation to combine or consolidate its income with any corporation which did not have a business location in the state.

In his remarks offered in support of the legislation Senator Ribicoff stated in part:1/

> The second major amendment contained in the draft relates to what is the so called unitary business concept2/ of applying state income taxes. This practice requires a company within the taxing jurisdiction of a state to include in the measure of its tax income from an affiliate which is not itself subject to the jurisdiction of the taxing state. The unitary business concept has been used extensively by the State of California and, in fact, has become commonly known as the California practice.

1/ Congressional Record - Senate, October 28, 1968, p. E9480.

2/ The unitary income as defined by John Deere Plow Co. v. Franchise Tax Board, 38 Cal.2d 214 at 223 is (that) derived from the functioning of the business as a whole, to which the activities in the various states contribute; and that by reason of such interrelated activities in the integrated overall enterprise, the business done within the state is not truly separate and distinct from the business done without the state so as reasonably to permit of a segregation of income under the separate accounting method rather than use of formula method in assigning to the taxing state its fair share of taxable values.

S. 916 (1969)

On February 4, 1969, during the 91st Congress, Senator Ribicoff introduced S. 916, which contained the provisions mentioned in the draft bill and repeated his earlier statements with respect to the unitary concept.[3/]

1971 Bills

A number of bills regarding interstate taxes were introduced during the 92nd Congress. None were set for hearing, undoubtedly pending Senate action. The principal bills introduced in this Congress were:

H.R. 1538, 2536, 4770. Same as H.R. 2158, the Special Subcommittee staff bill.

H.R. 4267 and S. 1210. Covered only sales and use taxes.

S. 317. Similar to H.R. 1538, except generally precludes use of combined reports or consolidated returns.

S. 1883. Would give consent to Multistate Tax Compact; requires all states to use the Uniform Act for the apportionment of income.

S. 3333. Comprehensive bill - income tax provisions based on H.R. 11798 (1965), sales and use tax provisions similar to H.R. 4267 and S. 1210.

S. 4080. Drafted over a period of months with help of National Association of Manufacturereres, Counsel of State Chambers of Commerce, National Association of Wholesalers. Would prohibit continuation of many California tax practices.

H.R. 6160. Consents to Multistate Tax Compact.

1973 Bills

The principal bills are:

H.R. 977, same as 1538, 2536, 4770 (1971). Special Subcommittee staff bill.

H.R. 6822, Common Tax Audit Act.

3/ Congressional Record - Senate, February 4, 1969, p. 1231.

S. 282 and H.R. 1453, similar to S. 1210 and H.R. 4267 (1971) - covers only sales and use taxes.

S. 1245, similar to S. 4080 (1971).

S. 2092, similar to S. 1883 (1972).

S. 2811, relates to procedure for collecting sales and use tax on interstate sales (introduced by Senator Mondale after hearings).

Senate Hearings

On September 18-19, 1973, a Subcommittee of State Taxation of Interstate Commerce of the Senate Finance Committee conducted hearings. No report was issued.

1975 Bills and Stu[illegible]

H.R. 9 (Rodino), same as H.R. 977, 93rd Congress.

S. 2080 (Mathias), revision of S. 2811, 93rd Congress.

Public Law 93-100 Study. Study conducted by the Advisory Commission on Intergovernmental Relations related to state doing business taxes on out-of-state depositories. For Reports see State and Local Taxation of Banks, Senate Committee on Banking, Housing and Urban Affairs, dated December 1971, and State and Local "Doing Business" Taxes on Out-of-State Financial Depositories (94th Cong.) May 1975 (supplemented, September 1975).

1976 Bills

Committee on Ways and Means. Recommendations of the Task Force on Foreign Source Income. During consideration of the Tax Reduction Act of 1975 (P.L. 94-12). Congressman Jones proposed at a hearing where only members could participate that states be required to follow the income source rules of the Internal Revenue Code (Sections 861-863). The proposal was referred to the Task Force for consideration.

On March 24, 1976, representatives from California and Oregon, together with Professor Hellerstein and Paul Dillingham from Coca Cola corporation participated in a panel discussion before the members of the Task Force. A Committee Report was released on March 8, 1977.

The Committee Report stated at page 28:

> This approach (arm's length [added]) already produces significant problems when applied at the Federal level and would be virtually impossible to administer at the State level as applied to the interstate transactions. Thus, there is no significant disagreement that the States must use some type of apportionment formula (as distinguished from making an allocation of income and deductions by separate accounting), since there would be no practical way of determining what income of a company is earned within a State as opposed to being earned within other States (<u>or in foreign countries</u>).

<u>1977 Bills</u>

<u>H.R. 669</u> (Rodino), see H.R. 9, 1975.

<u>H.R. 1832</u> (LaFalce) to extend the bank tax moratorium to January 1, 1979.

<u>S. 1900</u> (McIntyre) limits state taxation of banks and financial depositories. Limits states' jurisdiction, applies two-factor formula, and prohibits inclusion of so-called "foreign source" income.

<u>S.2173</u> (Mathias), see S. 2080, except for one-way options deleted in 1979 bill, S. 983.

<u>Other</u>

U.S.-U.K. Treaty Article 9(4) prohibited states from including U.K.-owned corporations in a combined report computation, unless incorporated in U.S. Article 9(4) reserved after the Treaty was rejected on June 23, 1978, by a vote of 44 for and 34 against. With Article 9(4) reserved, the Treaty was ratified on June 27, 1978, by a vote of 85 to 5.

<u>1979 Bills</u>

<u>S. 719</u> (Cranston) same as S. 1900 (1977).

<u>S. 983</u> (Mathias), see S. 2173, with minor corporate income tax changes to prohibit corporations from one-way elections as to consolidation or combination and the inclusion of factor elements in the apportionment formula relating to exempt income.

S. 1688 (Mathias) Prohibits combination or consolidation H.R. 5076 (Conable) if 80 percent or more of a corporation's income is derived from sources without the U.S. Excludes from state tax dividends received from a foreign corporation if the dividend is not considered U.S. source income.

EXHIBIT 35

DETAILED ANALYSIS OF TITLE III
SENATE BILL 2173 95th CONGRESS

Exclusion of So-Called "Foreign Source" Income

Title III provides that the so-called "foreign source" income of a taxpayer would not be subject to apportionment by the states. (Secs. 301, 302, 313 and 317.) Title III further provides that the source of income would be determined pursuant to the Internal Revenue Code (Sec. 317).

Excluding income from a geographic source prior to the application of the apportionment formula is logically inconsistent with the unitary method. "The very purpose of the method is to determine and define local source income without encroaching on income . . . arising elsewhere."[1]

The states, unlike the federal government, are generally limited in their power to assess income taxes in that they may tax only income which has its source within their boundaries. It has long been accepted that the assets and activities of a business enterprise contribute to one another and add to the effectiveness and value of each other irrespective of political boundaries and, therefore, it is impossible to specifically identify the value of or the income arising from each asset or geographic location. The unitary method provides a simple and logical means of making this determination. The unitary method was originally devised as a means for determining the value of the property of an integrated multistate railroad system attributable to an individual state.[2] As other taxes became prevalent, it was realized that its utility extended beyond the property tax field. The courts have endorsed its application in the area of state income taxes for over fifty years.[3]

The Internal Revenue Code, however, is based on a resident concept of taxation. A resident of the United States is taxable on all of its income regardless of source. Certain exceptions to this general rule are allowed based on concepts of international tax equity, but the federal tax system itself is not based upon the requirement or subject to the constraints imposed upon state tax systems, i.e., the taxation of only source income.

Title III would impose source constraints derived from the federal tax system, which is unconcerned with the geographic source of income, on the unitary method. The unitary method, however, was

Exhibit 35

specifically designed to apportion income to a geographic source. The approach taken in Title III is not unlike using a team of horses to pull a new automobile.

Classes of Income

Title III denominates four general classes of income as so-called "foreign source" income (Sec. 317). An analysis of these items of income and typical transactions in which they might arise demonstrates the impropriety of arbitrarily assigning income to geographic sources.

A. Interest Income (Sec. 317(a))

Interest paid by a borrower located without the United States would be "foreign source" income under Title III.

If the taxpayer sells products manufactured and shipped from within the United States to a purchaser outside the United States, the proceeds from the sale would constitute "United States source" income. If the sale is made on the installment basis, the interest received would be "foreign source" income.

If the taxpayer borrows money in the United States and loans it to a foreign subsidiary, the interest paid by the foreign subsidiary to the parent would be "foreign source" income.

If a foreign corporation borrows money from the taxpayer to establish a facility within the United States, such interest would be "foreign source" income as long as the foreign corporation pays the interest on the loan.

B. Dividends Other than Dividends from Sources Within the United States (Sec. 317(b))

If the taxpayer owns 40 percent of the stock of a foreign corporation and the foreign corporation's sole asset is a business within the United States, the dividends would be "foreign source" income.

If the taxpayer establishes a foreign subsidiary to sell its product manufactured in the United States and the subsidiary pays dividends derived from income earned by selling the product, the dividends would be "foreign source" income.

C. Rents, Royalties, License and Technical Fees for Property and Services Located, Performed, or Used Without the United States (Sec. 317(c))

If the taxpayer, a drug company, develops a new wonder drug in its laboratories within the United States and a foreign corporation is licensed to sell the drug within the United States, the license fees would be "foreign source" income.

D. Gain from the Sale of Intangible or Real Property Located Without the United States (Sec. 317(d))

If the taxpayer produces a motion picture in the United States and licenses the showing of a print in a foreign country, the income would be "foreign source" income.

If the taxpayer purchases 100 shares of General Motors stock and locates such shares in London as security for a loan, when the shares are eventually sold any gain would be "foreign source" income.

Exclusion of Corporations from a Combined Return or Consolidated Report

Title III would prohibit a state from including a corporation which derives 80 percent or more of its income from without the United States in a combined report or consolidated return (Sec. 303(b)(2)).

President Carter's 1978 Tax Program (Exhibit I), in proposing an end to the deferral of taxing foreign source income, states:

> The fundamental defect in the concept of deferral is that it makes very substantial tax benefits upon an artifical factor: whether a foreign corporate charter has been interposed.[4/]

Title III would impose this same type of artificial barrier on the states, while Treasury argues for its elimination for federal purposes.

Perhaps the most studied single multinational industry is the oil industry.[5/] The major international oil companies were the forerunners of, and are now probably the most thoroughly developed, multinational businesses. When requested by the U.S. Senate to submit detailed accounting material covering, among other questions, the contribution of international operations, Exxon pleaded impossibility, stating:

> . . . the petroleum business is unitary in nature . . . . [Accounting] breakdowns require many allocations and assumptions, which could lead to erroneous comparisons of data between various companies and hence erroneous conclusions.[6]

For a number of years, it was a generally recognized industry practice to report profits at the wellhead and operate marketing operations at a loss.[7] Such a practice clearly does not reflect either the geographic or economic sources of profit. A company can only profit from removing oil from the ground if it can market the oil. Without a market, the act of production is meaningless. Clearly, both activities give rise to the earning of income, and neither one can survive without the other. Any system of accounting which does not credit both activities with a share of the profits does not reflect economic reality.

During the 1960s and early 1970s, it was the practice of the Middle East oil kingdoms to require that oil be sold at a value greatly in excess of fair market value. The seller of the oil would show enormous profits, and the purchaser of the oil would show enormous losses. Because of these losses, such transactions were only feasible if carried on by related corporations.[8] Under Title III, if the selling corporation was foreign and the purchasing corporation was based in the United States, the income of the selling corporation would be excluded from a combined report since it (the selling corporation) derived more than 80 percent of its income from "foreign sources." But the loss of the purchasing corporation would not be excluded since its income is denominated as "U.S. based."

The amount of potential state tax revenues involved in the manipulations made possible by excluding corporations with over 80 percent of their income from "foreign sources" is enormous. The Franchise Tax Board is currently involved in lawsuits with two of the major multinational oil companies involving the question of whether such foreign corporations should be included in a combined report. In one of the cases (Mobil Oil v. Franchise Tax Board),[9] five years are at issue with a total tax of $12,612,463. In the other case (Gulf v. Franchise Tax Board),[10] the amount involved is $26,421,756 for nine years.

Another illustration of the error of excluding foreign corporations from a combined report or consolidated return is provided by Alcan Aluminum.[11] Alcan has the capacity to produce great quantities of aluminum at a fixed cost. Profitability turns on its ability to use its smelting capacity. Alcan's smelting capacity exceeds its market within Canada, so sales must be made to foreign markets. Alcan's competitors were fully integrated. To ensure itself of

markets, Alcan acquired United States fabricators in the 1960s. According to separate accounting, the fabricators operated at a loss, but Alcan operated at a profit. Without the fabricators Alcan would have had the same fixed costs but substantially reduced sales and, therefore, would have had reduced or non-existent profits.[12/] Logic dictates that these profits are not realized from the Canadian operations alone, yet the proposed bill would dictate that result and would cost California $1,720,616 for the years 1965 through 1971 for Alcan alone.[13/]

Container Corporation of America[14/] expanded into South America shortly after the end of World War II. It was the first entrant into several of the South American markets and has a dominant position in these markets.[15/] An expert witness called by Container Corporation has testified that its dominant position in these South American markets gives rise to greater profits.[16/] Container Corporation's dominant position results at least in part from the advantages it has over potential local competitors as a result of expertise developed in the United States and the financial resources which the United States' operations can make available to the South American subsidiaries. Under Title III there is no possibility that any profits resulting from this relationship would be reflected in the total income base.

Exhibit II sets forth a list of cases which are currently pending in the court or before the California State Board of Equalization in which the question of whether foreign corporations should be included in a combined report is being litigated. The total involved is $54,783,027. Title III would prevent the collection of these amounts in subsequent years.

The Franchise Tax Board has estimated that the provisions of Title III would result in the loss to California of almost one-half billion dollars annually on a self-assessed (pre-audit) base of approximately $1.7 billion. The oil and gas industry would realize approximately 60 percent of this savings.[17/] The bulk of this savings results from the elimination of so-called "foreign source" income and the elimination of subsidiaries incorporated in foreign countries.

Foreign Operations of a Unitary Business are Properly Accounted for Under the Unitary Method

Advocates of those portions of Title III which would exclude so-called "foreign source" income or exclude corporations which derive more than 80 percent of their income from without the United States argue that this treatment is justified because foreign operations are different. A number of experts in state

and international taxation have examined this question and disagree. As pointed out by one noted economist who is a specialist in international taxation:

> Due to the integrated nature of the multinational corporation and the interdependency of its parts, clearly defined and separable units of economic activity do not begin and end at political boundaries.[18]

Frank Keesling, often referred to as the father of the unitary method, states:

> The question frequently arises whether the income of corporations foreign to the U.S. should be included in the combined report. The answer is an emphatic 'yes.'[19]

Writers for the prestigious Brookings Institute have recently concluded:

> Ultimately, the only satisfactory solution to the problem of allocating income within the multinational firm may be international use of formulas based on national sales, assets, payrolls, or some other stable base.[20]

These same writers continue by suggesting that the United States could unilaterally adopt such an approach regardless of the views of other countries because of the absence of the threat of double taxation.

A British accountant, in discussing the pending United States-United Kingdom Tax Convention and Article 9(4) of the Convention in particular (reserved by the United States Senate), called the unitary method the "wave of the future" for taxing multinational corporations.[21]

A review of the unitary method appearing in the Tax Law Review states:

> It seems clear, strictly as a logical proposition, that foreign source income is no different from any other income when it comes to determining, by formulary apportionment, the appropriate share of the income of a unitary business taxable by a particular state.[22]

The argument is also advanced that the unitary method, when applied to foreign operations, taxes extraterritorial income. Such is not the case. "[T]he purpose of the unitary method is to establish that particular jurisdiction's correct share of the firm's overall income, no more and no less."[23/] The Supreme Court has accepted this fact for over fifty years.[24/] As pointed out in the Tax Law Review:

> This [application of the unitary concept to foreign operations] does not involve state taxation of foreign source income any more than does apportionment—in the case of a multistate business—involve the taxation of income arising in other states.[25/]

Section 482 and Other Provisions of the Internal Revenue Code Are Ineffective at the Federal Level and Provide Inadequate Protection for the States

It is our understanding that the General Accounting Office has initiated a study which includes among its topics the effectiveness of Section 482. Under Section 482, there are four methods authorized for adjusting intercompany transactions. These four methods are: (1) comparable uncontrolled price method, (2) resale price method, (3) cost plus method, and (4) other. The method most frequently used by the Internal Revenue Service is the fourth or "other" method.[26/] Furthermore, it has been determined that this "other" method is, in reality, the unitary method.[27/]

A note in the Harvard Law Review which compared Section 482 and the unitary method concluded:

> The use of the arm's length standard of the current section 482 regulations has been accompanied by serious problems most clearly evidenced by the surprisingly frequent reliance of revenue agents and courts on ad hoc fourth method approaches, based not on the theory of the regulation, but on the unitary entity theory.[28/]

Yet, Title III, in its treatment of so-called "foreign source" income and corporations which derive over 80 percent of their income from so-called "foreign sources," would bar the states from using the unitary method.

President Carter's 1978 Tax Program, as proposed, would have terminated the special treatment given so-called "foreign source" income. In support of this program, Treasury stated:

> The arm's-length standard is a necessary and valuable tax measure, but it is sometimes difficult to administer . . . the resultant loss of U.S. tax revenues can be substantial.[29]

For further discussions of the inadequacies of Section 482, see Attachment 3; and for Treasury's own evaluation of the effectiveness of Section 482 and Subpart F, see the President's 1978 Tax Program, Exhibit I.

The drug industry is currently providing a classic example of the difficulties involved even for the Internal Revenue Service in making adjustments under Section 482.[30] For years, United States based drug manufacturers have conducted research and development operations in the United States but have manufactured the drugs which are sold in the United States in Puerto Rico. On the books of these companies, the profits were realized on the manufacturing process in Puerto Rico and, therefore, were not subject to United States tax.[31] None of the research and development costs were charged to these drugs, so United States profits were miniscule. Additional liabilities in the amount of $22,000,000 have been asserted against Eli Lilly for the years 1971-73. G. D. Searle has already settled similar adjustments with the Internal Revenue Service, paying additional taxes of $16 million.[32]

This exemption has existed since 1939, and will continue at least until 1985. Currently, there are 500 companies earning close to $1 billion a year in tax free profits in Puerto Rico. Similar liabilities undoubtedly exist for earlier years and other taxpayers which were not assessed.

All indications point to protracted litigation over these liabilities or settlement of the asserted deficiencies for nominal amounts. The unitary method as applied by the states solves this problem quickly and cleanly. Title III would require the states to rely upon the ineffective Section 482 and federal enforcement of that section.

Foreign Source Income is Excluded but Foreign Factors are Not

Under the unitary method, as properly applied, all the income of a business, wherever located, is included in the base which is apportioned by reference to all the factors of the business,

wherever located. Title III would eliminate so-called "foreign source" income from the base (Sec. 302), but would require that all factor amounts, regardless of location, be included in the denominator of the factors (Secs. 314(a), 315(a), 316(a)). This is inequitable since it results in apportioning what Title III would consider U.S. source income to foreign jurisdictions.

Examples of where misapportionment of income can occur under Title III are almost limitless. Two simple, but very common, situations will serve to illustrate the problems.

A taxpayer has a technical service agreement with a subsidiary in a foreign country which requires a full-time technician to be stationed in the country. The taxpayer receives a fee for rendering this service. The technician's salary is in the denominator of the payroll factor and the fee is in the denominator of the sales factor, but neither will appear in any state's numerator. The fee would constitute so-called "foreign source" income (Sec. 317(c)) and therefore would not be subject to either allocation or apportionment by a state (Sec. 302) even though the expense and receipt would be included in the apportionment factors.

A taxpayer owns real property in a foreign country which it sells. The value of the property is in the denominator of the property factor and the sale proceeds are in the denominator of the sales factor. The gain realized on the sale of the property would be so-called "foreign source" income (Sec. 317(d)) and therefore would not be subject to apportionment or allocation by the states (Sec. 302) even though the property and receipt would be included in apportioning income.

Combination or Consolidation is Subject to Arbitrary Rules with Respect to Affiliation

Title III would allow a state to require a combined report or consolidated return for all affiliated corporations except excluded corporations (Sec. 303(a)). Affiliated corporations are those with more than 50 percent direct stock ownership (Sec. 312).

The unitary business concept is based upon the fact that the various steps in a vertically integrated business, or affiliated members of a horizontally integrated business, contribute to or are dependent upon each other. The theory is premised upon the assumption that the interrelationship of these activities renders the determination of the income for each step in the process or the amount of income attributable to each jurisdiction an impossibility. Where the business activities are separate and distinct, these problems do not arise, and the unitary concept should not be applied.[33]

Under Title III, however, if a state requires combination of a unitary business, it would also be required to include non-unitary elements if the ownership test is met. For example, Corporation A conducts an integrated petroleum business in several states itself and through several subsidiary corporations (B, C & D). Corporation A also owns a subsidiary (T) which operates a television station in a state where it has no petroleum operations. If a state requires a combined or consolidated return for the petroleum business (A, B, C & D), it would also be required to include the corporation operating the television station (A, B, C, D & T). The inclusion of such an operation is inconsistent with the premise on which the unitary theory is based.

In the summer of 1977, the Franchise Tax Board held hearings on California's application of the unitary concept. The most frequent objection raised at those hearings was the alleged application of the concept to unrelated businesses. Combination or consolidation on the basis of ownership alone is subject to this fault. It is inconsistent with unitary theory and leads to erroneous results.

Title III's approach to combination or consolidation is faulty in two other aspects. First, it would establish a mechanical more-than-50-percent approach which lends itself to corporate manipulation and, second, it would require that the ownership be direct ownership by a common owner. Since the section requires a common owner and direct ownership, it is obvious that the ownership requirements can be controlled by the owners of the corporation. Some of the obvious avoidance methods are illustrated by the following examples.

If a husband and wife each owns 50 percent of the voting stock of two or more corporations, the ownership requirements would not be met since not more than 50 percent of the voting stock is owned by a common owner.

The same would be true if a wholly controlled corporation and its sole shareholder each owns 50 percent of the voting stock of a second corporation.

It is also obvious that because of direct ownership requirements, a taxpayer can be controlled, even though not affiliated, by using controlled trusts or partnerships as well as family members.

Because of the direct ownership requirement, direct ownership can also easily be avoided by issuing several classes of stock all of which is under common ownership, except for the voting stock. The voting stock could be under de facto control by ownership of 49 percent of the voting stock with an option to purchase the remaining shares. Even under these facts, the direct ownership requirement is lacking.

In addition to the above, the section does not cover the problems involved when an "affiliate" is owned by an excluded corporation.

Because of the direct ownership requirement, it is apparent that taxpayers would be able to control tax consequences by the manner in which they arrange their stock ownership. Thus, a corporation could be commonly owned when operated at a loss, and the ownership could be restructured so as to avoid the ownership requirement when operations are profitable. The tax impact could easily be controlled by the form in which the stock is held, with no change in substance.

The States are Prohibited from Requiring Combined Reports or Consolidated Returns for Unitary Excluded Corporations

Title III would provide that a state could not require than an "excluded corporation" be included in a combination or consolidation (Sec. 313(b)).

"Excluded corporation" is defined by Section 311 to include banks, credit unions, sales finance companies, insurance companies, transportation companies, and public utilities.

The problems caused by this prohibition upon the states is demonstrated by the following example. In the early 1960s, Sears Roebuck[34/] formed a subsidiary, Sears Roebuck Acceptance Corporation (SRAC), as a source of financing for its installment receivables. Sears borrows money from SRAC secured by its note. SRAC borrows money in the open market on the basis of its only asset, the Sears note. SRAC is able to borrow at a lower rate than Sears and is able to obtain greater leverage. Under Title III, a state would not be able to require that SRAC, no more than an artificial legal entity with minimal employees, be included in a combined report. Exclusion of SRAC from a combined report would result in reduced collections for California alone of $3,927,714 over six taxable years ending in 1973.

Another example of an abuse which Title III would leave the states powerless to combat is the foreign or overseas captive insurance company. In 1977 the Internal Revenue Service issued a Revenue Ruling holding that such insurance companies were not separate entities.[35/] The ruling stated that "[C]aptives are part of one economic family." Under Title III, the states would be barred from including captive overseas insurance companies in a combined report or consolidated return. Title III would sanction an abuse for state tax purposes which has only recently been set aside for federal purposes. For further corporate development of this shelter to avoid the holding of the Internal Revenue Service, see The New York Times of July 16, 1978.[36/]

Corporate Taxpayers are Given Options Which are Not Available to the States

States would not be able to require that excluded corporations or corporations which derive in excess of 80 percent of their income from without the United States be included in a combined report or consolidated return (Sec. 303(b)). There is no such restriction on taxpayers (Sec. 303(a)).

Not only would Title III allow taxpayers to include certain corporations at their option, but it would also allow taxpayers to make an election each year. The opportunities for the manipulation of state taxes through careful composition of a combined report or consolidated return are almost incalculable. Furthermore, Title III may allow a taxpayer to include a corporation in the combined return for factor purposes (Secs. 314(a), 315(a) and 316(a)) while excluding all of its income if such income is "foreign source" income (Secs. 302 and 317).

Deductions Will Be Allowed for Expenses Related to Income Which is Excluded

A taxpayer expends money in research and development to create new products. Licenses are granted to foreign corporations for the production of such products or affiliates are allowed to produce the product. Research and development costs are incurred in the United States and are deductible. License fees received from foreign corporations are not reportable (Sec. 317(c)). A state may not require that a foreign affiliate corporation be included in a combined report (Sec. 303(b)(2)).

For an example of how this treatment can distort earnings, see the discussion of the drug industry's Puerto Rican operations.[37/]

Title III would also provide that a state may not offset deductions against dividends or so-called "foreign source" income which it is prevented from including in the apportionable base or allocating to itself (Sec. 301). This provision rejects a fundamental principle of tax law, as codified in Section 265 of the Internal Revenue Code, that no deduction shall be allowed for expenses and interest related to tax-exempt income. Title III would not bar expenses that are directly related, but where is the line to be drawn? Suppose Corporation A advances money to Affiliate B, a foreign-based entity. Corporation A receives dividends on part of its advance and interest on part of it. At a subsequent date, Corporation A borrows funds to finance its U.S. operations. Funds could have been obtained from Affiliate B through the repayment of the loan or by the sale of Corporation A's stock in Affiliate B.

A state would be barred from offsetting the cost of the new funds against the proceeds from Corporation A's earlier loan and investment and would be unable to tax the return from the earlier loan and investment (Secs. 302 and 317(a) and 317(b)).[38/]

Dividend Income Escapes Taxation

Title III would preclude the states from taxing dividends received from corporations which are owned more than 50 percent (Sec. 302). But, the state of commercial domicile would be able to tax dividends from a less than 50 percent owned corporation (Sec. 302). The distinction in the treatment of these dividends solely on the basis of ownership is illogical and unfair. There may be a basis to exclude the dividends of a more than 50 percent owned corporation if such corporation is included in a combined report or consolidated return,[39/] but this is not a condition required to be satisfied by Title III.

The assignment of the dividends of a less than 50 percent owned subsidiary to the commercial domicile of the owner or the stock would compel corporations to be headquartered in states which do not tax dividend income or resort to gimmickery to avoid tax on their dividend income. For example, assuming a company (P) domiciled in California owns 40 percent of X, a dividend paying company which derives all of its earnings from sales to its stockholders (P and others). P sets up a wholly owned subsidiary (S) and establishes S's commercial domicile in Nevada or some other jurisdiction which does not tax dividends and transfers its 40 percent interest in X to S. Under Title III, these dividends would no longer be subject to tax.

Given the facts of the above example, further assume the dividends represent, in effect, rebates on purchases. Treating this income as allocable to the state of commercial domicile rather than apportionable to all states will lead to erroneous results.

If the above example is extended to "foreign source" income (Sec. 317(d)), none of the income would be taxable by any state even if the dividend paying corporation is less than 50 percent owned. A specific example of the tax avoidance this provision can give rise to when coupled with the exclusion of corporations deriving substantially all of their income from so-called "foreign sources" is provided by the Appeal of Texaco.[40/] The amount involved was $465,022 for three years.

Title III Creates Nowhere Income

With respect to all three factors, Title III would provide that numerator values be assigned to a state regardless of whether or not the state has jurisdiction to assert a tax under Public Law 86-272.

A long-time goal of the states has been to require full accountability for all corporate taxpayers. This principle is established by Sec. 16(b) of the Uniform Division of Income for Tax Purposes Act. Title III, contrary to the Uniform Act, would establish tax-free havens within the states where corporations would be able to completely escape taxation. This exemption is of a particular importance in respect to the sales factor because of Public Law 86-272. Sales of any magnitude would be assigned to a no-tax or "nowhere" jurisdiction if the taxpayer limits its activities in that jurisdiction to mere solicitation. For an example of the tax avoidance planning which could result from this, see GTE Automatic Electric Incorporated v. Allphin.[41/]

Factor Problems

A. Property Factor

Under Sec. 314 of Title III, the numerator of the property factor would be the average value of real and tangible personal property owned and used or rented and used during the taxable year in the state.

This definition excludes government-owned property used without charge by the taxpayer. During the years 1942-1945, McDonnell Douglas Corporation[42/] was building aircraft for the United States Government at its plants in California and at government-owned plants in Illinois. Using only owned property in the factor, the California percentage varied between 94 percent and 100 percent. The payroll and property factors varied between 48 percent and 90 percent. The same activities were carried on in each state, but the property factor does not clearly reflect these activities if the government property is excluded.

Rented property is valued at eight times the net rents (Sec. 314(b)(2)). Title III provides no alternative valuation if there is no rent.[43/]

The property factor includes only property which is being used. Petroleum companies and other extractive businesses frequently invest substantial sums in both proven and unproven reserves. While such reserves may not now be in

production, they represent the future of such businesses and should not be excluded.[44] Idle plant and standby reserve facilities should also be in the factor.[45]

Title III refers to property "owned and used or rented and used." This language makes the treatment of inventory uncertain. While inventory is owned, it is not used in the usual meaning of that term. Removal of inventory from the property factor could, in many instances, cause severe swings of income.

The denominator of the property factor includes all property. If inventory in transit is included in the denominator, there should be a rule for its assignment to the numerator.[46]

B. Sales Factor

Title III would provide that sales of tangible personal property are to be assigned to a state if the property is received in that state by the purchaser (Sec. 316(b)). Title III, however, is silent as to sales delivered to a state in which the taxpayer is not taxable. This omission would result in such sales simply not being taxed by any state.

C. Payroll Factor

Title III would provide that wages be placed in the numerator of the payroll factor on the basis of the employees' location (Sec. 315(a)). While it may be reasonable to assume that location equates to the place where services are performed, there still may be room for argument in situations where an employee works in one state and lives in another or where work is performed in more than one state.

The "place where the services are performed" test set forth in the Multistate Tax Commission regulations provides a clearer and more workable definition.[47]

FOOTNOTES

1. Musgrave, The U.K. Treaty Debate: Some Lessons for the Future, TAX NOTES, July 10, 1978, at 27.

2. State Railroad Cases, 92 U.S. 575 (1875).

3. Underwood Typewriter Co. v. Chamberlain, 254 U.S. 113, 65 L. Ed. 165 (1920); Bass, Ratcliff & Gretton v. State Tax Commission, 266 U.S. 271, 69 L. Ed. 282 (1924); Butler Bros. v. McColgan, 17 Cal.2d 664, 11 P.2d 334 (1941), aff'd 315 U.S. 501 (1942); Edison California Stores v. McColgan, 30 Cal.2d 472, 183 P.2d 16 (1947).

4. See Exhibit I, p. 283.

5. Hearings on S. 1167 Before the Subcommittee on Antitrust and Monopoly of the Committee on the Judiciary United States Senate, 94th Cong., 1st Sess., pt. 9, The Energy Industry; Hearings on S. 2387 and Related Bills Before the Subcommittee on Antitrust and Monopoly of the Committee on the Judiciary United States Senate, 94th Cong., 1st Sess., pt. 1, The Petroleum Industry (1975).

6. Hearings on S. 1167 Before the Subcommittee on Antitrust and Monopoly of the Committee on the Judiciary United States Senate, 94th Cong., 1st Sess., pt. 2, Appendix to Hearings, at 1817 (1975).

7. See note 5 supra.

8. Eg., Appeal of Texaco, Cal. St. Bd. of Equal., June 11, 1978, CCH Cal. Tax Cases ¶ _____, P-H State & Local Tax Serv. Cal. ¶ _____.

9. San Francisco Superior Court, No. 723863 (filed June 3, 1977) for years 1967-71.

10. San Diego Superior Court, No. 414285 (filed April 6, 1978) for years 1966-74.

11. Los Angeles Superior Court, No. C196604 (filed April 15, 1977) for years 1965-71.

12. "Defensive Standoff," Forbes, February 15, 1969, at 59; see also "Aluminum Limited Modifying the Grand Design," Forbes April 15, 1963, at 22.

13. See note 11 *supra*.

14. San Francisco Superior Court, No. 673492 (filed April 8, 1974) for years 1963-65.

15. Id., Stipulation of Facts, ¶ 71 and 78.

16. Id., Testimony of Dr. John C. MacDonald.

17. See Attachment 2.

18. See note 1 *supra*.

19. Keesling, *A Current Look at the Combined Report and Uniformity in Allocation Practices*, 42 JOURNAL OF TAXATION 106, at 109 (1975).

20. BROOKINGS INSTITUTE, AMERICAN MULTINATIONALS AND AMERICAN INTERESTS (1978) at 212.

21. Aungiers, "The UK/US Tax Treaty: A Detailed Reappraisal," *Tax Planning International*, June 1977, at 101.

22. Rudolph, *State Taxation of Interstate Business: The Unitary Business Concept and Affiliated Corporate Groups*, 25 TAX L. REV. 171, at 205 (1970).

23. See note 1 *supra*.

24. See note 3 *supra*.

25. See note 22 *supra*.

26. SEVENTH ANNUAL INSTITUTE ON INTERNATIONAL TAXATION, *Development in Intercompany Pricing Under Section 482*, July 16, 1976, at 103.

27. *Multinational Corporations and Income Allocation Under Section 482 of the Internal Revenue Code*, 89 HARV. L. REV. 1203 (1976).

28. Ibid.

29. See Exhibit I, p. 286.

30. "Closing in on Puerto Rico's Tax Haven," *Business Week*, May 22, 1978, at 154; *The Wall Street Journal*, June 9, 1978, p. 35, col. 3.

31. *The Wall Street Journal*, June 9, 1978, p. 35, col. 3.

32. "Closing in on Puerto Rico's Tax Haven," Business Week, May 22, 1978, at 154.

33. Keesling & Warren, The Unitary Concept in the Allocation of Income, 12 HASTINGS L.J. 42, 44-45 (1960).

34. Los Angeles Superior Court, No. C248013 (filed July 18, 1978) for years 1968-73.

35. Rev. Rul. 77-316, Bulletin No. 1977-35 (8-29-77)

36. Bergson, "Captive Insurers Slip Their Chains," The New York Times, July 16, 1978, p. F1.

37. See note 32 supra.

38. Cf. Calif. Rev. & Tax. Code § 24344.

39. Calif. Rev. & Tax. Code § 25106.

40. See note 8 supra.

41. 68 Ill.2d 326, 369 N.E.2d 841 (1971); see also Covington Fabrics v. South Carolina Tax Comm., 212 S.E.2d 574 (1975), appeal dismissed 423 U.S. 805, 46 L. Ed.2d 26, 96 S.C. 14 (1975).

42. 69 Cal.2d 506 (1968).

43. MULTISTATE TAX COMMISSION APPORTIONMENT REGULATIONS 2-21-73 [hereinafter cited MTC Reg.] Reg. IV. 18.(b).

44. MTC Reg. IV. 10.(b).

45. MTC Reg. IV. 10.(b).

46. MTC Reg. IV. 10.(d).

47. MTC Reg. IV. 14.

In January of 1978, the Department of Treasury prepared a detailed description and analyses of President Carter's 1978 Tax Program. One of the proposals contained in that program would have eliminated the deferral of federal income taxation of profits earned by the foreign subsidiaries of United States based corporations.

This proposal was eliminated from the tax bills passed by Congress in 1978.

Treasury's detailed description and supporting analyses of this particular proposal is virtually identical to the arguments raised by the states in defense of the unitary method. The failure of Congress to enact this tax reform does not invalidate these arguments and the analyses involved. These arguments remain persuasive at the federal level, are supportive of the states' use of the unitary method and expose many of the deficiencies in Title III of Senate Bill 2173.

EXHIBIT 36

NATIONAL ASSOCIATION OF TAX ADMINISTRATORS

Executive Committee

<u>Position Paper*</u>

on the

<u>INTERSTATE TAXATION OF BUSINESS</u>

The Executive Committee of the National Association of Tax Administrators is opposed to federal restrictions on the states' taxing authority. However, if the Congress concludes that legislation on the interstate taxation of business should be enacted, state tax administrators urge it to adopt and follow the principles set forth below:

I. Income Taxes

A. General Requirements

1. Legislation should mandate a method for determining an income ceiling for state taxes on or measured by income, but should not preclude any state from utilizing any method for determining the income attributable to it so long as the ceiling is not exceeded.

2. Any legislation should include a phase-in period to allow the states to adjust existing state laws if necessary. The recommended period is six years to accommodate states with biennial legislatures and to allow the governors of the states sufficient time to develop a coordinated program to implement necessary changes.

3. Legislation should be limited to those particular industries where the standard three-factor formula is generally conceded to properly apportion income, including, but not limited to, mining, manufacturing, retail and wholesale trading.

4. Because of the unique character of the business of oil and gas extraction, it should <u>not</u> be subject to a ceiling limitation where a state finds that a particular method of accounting is necessary to properly reflect the activities of the business within its boundaries.

---

* Adopted by the Executive Committee at a special meeting held on March 19, 1979, in Chicago, Illinois.

5. Legislation should limit only the measure of taxation of the described businesses and should in no way limit the states' ability to tax corporations in other businesses.

6. Legislation should apply only to income taxes or taxes measured by income and should not apply to severance, gross receipts, capital, or other similar taxes.

7. The states should retain authority to determine the income of an individual corporation pursuant to a combined report or consolidated return which could include corporations and activities not otherwise affected by the act.

8. There should be no limitation on a state's ability to utilize the worldwide income and activities of a business in determining the income taxable in a given state.

9. Any legislation should be prospective in nature only.

10. The legislation should be formulated to ensure full accountability by corporate taxpayers and should not result in the allocation or apportionment of income to jurisdictions or geographic areas where the business is not taxable.

11. Nexus or taxability should be determined on the basis of U.S. standards, both constitutional and statutory, regardless of whether the activities are carried on within or without the U.S.

12. Any future proposed legislation should be subjected to full hearings before the House Committee on Ways and Means and the Senate Finance Committee.

13. Any legislation which is enacted should be self-executing and should not require any additional state agency for administration beyond existing state tax departments, nor should any existing or new federal agency be assigned any administrative authority now vesting in any state tax department.

14. Any appeal procedure provided for shall be through existing state administrative or judicial appeal systems.

B. For Purposes of Determining the Ceiling Limitation the Following Rules Should Apply:

1. Income

a. The states should not be restricted in determining their own income base.

b. Characterization of income, such as business or nonbusiness, should be determined under the laws of the individual states.

c. Business income should be apportioned by an equally weighted three-factor formula consisting of property, payroll, and sales which give rise to business income.

d. Nonbusiness income should be allocated, in the case of real and tangible property, to the location of such property and, in the case of intangible property, to the business situs of the property or the owner's commercial domicile.

2. Property Factor

a. Property should be valued for factor purposes at original cost.

b. Rented property should be capitalized and included in the property factor.

c. Only property which is used or available for use in the business should be included in the factor.

d. Intangible property should not be included in the factor.

e. Movable property should be allocated to the states on the basis of time or mileage, or such other factors as is determined by the individual states.

f. Property which is in transit should be assigned to its destination.

g. Intangible drilling costs are to be included in the property factor at a state's option regardless of whether such costs are capitalized or expensed.

h. Property values should be determined on the basis of a beginning/ending year average unless a state determines that an alternative basis should be used to properly reflect values.

3. Payroll Factor

a. Compensation should include wages, salaries, commissions, and any other form of remuneration paid or payable to employees for personal services.

b. Payroll should be assigned to a state based upon where the services are performed or where the employee's activities are controlled.

4. Sales Factor

a. Sales should be assigned on the basis of destination, except U.S. Government sales to NASA or the Department of Defense which should be assigned to the jurisdiction from which the product is shipped.

b. The sales factor should be limited to those receipts which arise from the taxpayer's business activities. Receipts derived from intangibles, even though constituting business income, will normally be excluded from the sales factor, as will receipts from the occasional sale of assets.

II. Sales and Use Taxes

A. No federal legislation affecting state corporate income taxation should be considered without inclusion of provisions which improve and clarify state sales and use tax jurisdiction.

B. If Congress desires to address this area, it should be directed to:

1. Codification of existing jurisdictional standards as reflected in court decisions such as General Trading and Scripto; and

2. Providing power to the states to tax out-of-state vendors which otherwise escape state and local sales and use taxes, thus protecting small local businesses from tax free competition. If it is found necessary to provide for geographic accounting, then it should be on the basis of one rate per state, applicable to out-of-state vendors not included in the jurisdiction of 1., above.

C. Any federal legislation dealing with sales and use tax should not restrict the states' right to determine the measure of the sales tax or the nature of transactions to be taxed. For example, legislation should not concern itself with whether or not transportation charges should be included in the measure of tax, nor should it dictate whether sales to certain entities are taxable.

SELECTED STATEMENTS IN OPPOSITION TO PRESENT CALIFORNIA UNITARY APPORTIONMENT

Statement of Lever Brothers Company
Before the State of California
Franchise Tax Board in Opposition
to California's Current Method of
Determining Franchise Taxes

I. Introduction

Lever Brothers Company is a second tier subsidiary of Unilever N.V., a Dutch corporation, which has a common Board of Directors and a profit equalization agreement with Unilever Ltd., a British corporation. Lever's interest in these hearings is more than academic as it is currently engaged in a dispute with the California Franchise Tax Board regarding its franchise tax returns for income years 1967 through 1970. While Lever does not wish to litigate its case during this hearing, it believes that this case provides concrete illustrations of the problems confronted by a United States subsidiary of a foreign parent required to file a unitary tax return. In this context Lever believes that reference to its actual experience can provide appropriate and helpful information to the Franchise Tax Board in evaluating whether the unitary tax concept currently applied by California should be modified. In brief, Lever opposes the State of California's current method of determining franchise taxes of foreign based multinational businesses and respectfully submits that California should revise its current practice of requiring

inflexible application of the unitary tax accounting theory.

Lever qualified to do business in California on February 5, 1920, and currently employs over 800 California residents. Over these many years of operating in California, Lever has never had a serious dispute regarding its California franchise tax liability. Then, on February 10, 1976, the California Franchise Tax Board issued Notices of Proposed Assessment of Additional Franchise Tax to Lever Brothers Company for income years 1967 through 1970 in amounts ranging from $129,591 to $239,853 per year. It is quite likely that the Franchise Tax Board will seek further assessments from 1971 through the present, and therefore the aggregate assessments, including interest, will probably exceed $2 million. These assessments were based on recomputing Lever income, using for the first time a combined report with Unilever, N.V., although the corporate affiliation has existed since Lever was formed by its European parent before the turn of the century. At the present time, the Franchise Tax Board has not required Unilever, Ltd., and the worldwide subsidiaries of Unilever, Ltd., to be included in the unitary group even though the business conducted in and through Unilever, Ltd. encompasses comparable operations in the U.K. and other parts of the overseas world.

This assessment, which appears to us to be arbitrary and capricious, comes at a most unfortunate time. Although Lever has always been a profitable company, it competes in a low-

return business, the business of manufacturing and marketing of grocery items. Lever's profit margin characteristically has been in the order of 1-1/2 cents per sales dollar while the margin of its U.S. based competitors has been three to four times larger. The profit margin of Lever's foreign parent has been in the order of the profit margin of Lever's major competitors. Because of the parent's larger profit, it is possible for the State effectively to double Lever's tax as the assessment reaches an apportioned part of the more profitable non-Lever business. Lever, which is working hard to attain a more profitable situation and better competitive position, is penalized for having a profitable foreign based parent.

Lever cannot conclusively state that the California system of taxation will result in resisting future expansion in California. However, whenever the Company does consider its future expansion activities--as it currently is doing--it must, out of necessity, consider both the disproportionate increased costs of doing business in California and what we consider to be an unfair method of taxation.

II. Problems in Applying the Unitary Tax Theory to Foreign Based Corporations

The unitary business theory applied to foreign based corporations suffers from numerous conceptual and practical shortcomings not present when the theory is applied to corporations

engaged exclusively in business operations in the United States. There are three steps in preparing a combined return--determining the number and scope of each unitary business, determining worldwide income of each unitary business subject to apportionment, and developing a suitable apportionment formula. Where foreign parents and foreign subsidiaries of foreign parents are involved, each step introduces novel problems and potential distortions.

a. Determination of the Unitary Group

The regulations promulgated pursuant to the California Uniform Division of Income for Tax Purposes Act provide that a taxpayer may have more than one trade or business, and in such cases, it is necessary to determine the business income attributable to each separate trade or business. (Reg. 25120.) This inquiry is the heart of the unitary business concept, and requires a detailed analysis of each element of a group under common ownership. Conclusions are often highly subjective and auditors from different states, as well as different auditors within a single state, may be expected to reach different conclusions as to what constitutes a unitary group. California tends to broaden the reach of unitary groups, while other states tend to narrow the group. As a result, a variety of tax returns may be required among states that embrace the unitary theory.

The choice of a unitary group is not as self evident as it might appear. It is not inconceivable that an auditor from the State of California, as well as auditors from other

states, will find that Lever is unitary with:

(a) no other corporation or business;

(b) only U.S. subsidiaries of Unilever N.V. on the theory that only the U.S. operations constitute a sufficiently integrated unitary business;

(c) Unilever N.V. and its worldwide subsidiaries, on the theory that the whole Unilever operation is unitary, but unity of ownership exists only within the group nominally headed by Unilever, N.V.;

(d) Unilever N.V. and those portions of its worldwide subsidiaries engaged, to a greater or lesser extent, in business having the same general type of product line as Lever Brothers, on the theory that (i) Unilever is engaged in a worldwide unitary trade or business with regard to corporations engaged in the business of manufacturing and selling grocery items, (ii) this group is not unitary with corporations engaged in wholly unrelated activities like operating a steamship line and distributing heavy industrial equipment in Africa, and (ii) unity of ownership exists only within the group nominally headed by Unilever, N.V.;

(e) Unilever Ltd. and all of its worldwide subsidiaries, on the theory that unity exists within the English speaking businesses, where mutual benefits among commonly owned companies may be more likely to occur;

(f) Unilever Ltd. and those portions of its worldwide subsidiaries engaged, to a greater or lesser extent, in business

having the same general type of product line as Lever Brothers, on the theory that unity exists within the English speaking companies engaged in the manufacture and sale of consumer goods;

(g) both Unilever N.V. and Unilever Ltd. and all of the Unilever subsidiaries throughout the world, and/or;

(h) both Unilever N.V. and Unilever Ltd. and all of the Unilever subsidiaries throughout the world which are engaged, to a greater or lesser extent, in businesses having the same general type of product line as Lever Brothers.

The Franchise Tax Board has initially elected choice (c) above. Lever Brothers did not file its tax return in conformity with any of these choices; it filed a combined return with its wholly owned subsidiary, Glamorene Products Company.

Clearly, subjective determinations of what constitutes a unitary group are undesirable. They must be based upon a detailed examination of all facets of a business operation. In the case of Lever, it is extremely burdensome to collect the necessary information from its foreign parents and sister subsidiaries situated around the world. In many cases new information must be developed for this sole limited purpose. The ultimate result to Lever Brothers could be that all Unilever companies may be required to keep separate books not only for different countries, but also for each of the 46 states and the District of Columbia that have a tax measured by net income. In California the result of a seemingly insatiable quest for more information by the Franchise Tax Board is worldwide combination

based on unity of ownership, not combination based on unity of operation.

b. The Measure of Income Subject to Apportionment is Distorted

A corporation which is engaged in business in California is required to file a California franchise tax return in which the measure of income subject to apportionment is determined in accordance with provisions of the California Bank and Corporation Law. Lever Brothers filed such a return. However, when the California Franchise Tax Board issues a proposed assessment of additional franchise tax to a U.S. subsidiary of a foreign parent, in most cases no effort is made to determine the multinational's worldwide income on a comparable basis. Instead, the Franchise Tax Board takes income determined under financial accounting standards prescribed by the foreign jurisdiction as the basis for determining worldwide income subject to apportionment.

This action is highly unfair and prejudicial to subsidiaries of foreign parents. It is generally recognized that income determined under financial accounting standards is in most cases greater than income determined under tax accounting standards. Two examples in the Lever Brothers situation may be given to illustrate the inherent distortions.

(i) Example 1. Depreciation

The California Bank and Corporation Tax law authorizes taxpayers to compute depreciation using useful lives determined under what are essentially the old federal guideline lives prior

to the 1969 Internal Revenue Code amendments. Accelerated methods of depreciation may also be used under the tax law. In contrast, financial accounting charges for capital recovery in other countries vary substantially. The California Franchise Tax Board apparently made no effort to compute depreciation charges on Unilever's non-United States operations on a comparable basis with Lever, for the good reason that the task is virtually impossible. The Board would probably accept a depreciation deduction calculated by Lever if it could make an analysis of Unilever's worldwide property and construct a new set of books for the limited prupose of determining a depreciation charge based on California tax accounting concepts.

This analysis would be difficult indeed. All property in use in over 500 active corporations doing business in over 70 countries would have to be identified, including property written off the books pursuant to the accounting policies of the host country. Original cost of these assets would have to be developed, both for purchased property and for constructed property. Development of original cost raises a host of accounting problems, such as whether interest charges and depreciation charges on equipment used in the construction of property should be capitalized. Should turnover taxes and value added taxes be included in original cost? Should other local taxes be capitalized? The exchange rate prevailing at the time of acquisition, or in the case of constructed property,

an average exchange rate, must then be determined. (Unilever's standard accounting practice is to use current exchange rates in accounting for fixed assets.) The exchange rate to be used is not the rate between the British pound (or the Dutch guilder) and the host country, which are the rates used in Unilever accounting, but the rate between the United States and the host country.

Once original cost is developed, each asset must be assigned an appropriate useful life. Salvage values must be determined, presumably valued at historic exchange rates. Eligibility for accelerated depreciation methods must then be evaluated. Repair & maintenance expense accounts for subsequent years will have to be examined with a view to capitalization of improvements and betterments.

Lever Brothers estimates that the cost of constructing this new set of books, for many tens of thousands of assets, solely to compute one deduction in a combined return, would exceed the proposed tax deficiencies, even when done contemporaneously with preparation of tax records for a current taxable period. Lever Brothers faces a more difficult task of creating the new set of books for taxable periods now ten years past.

(ii) Example 2. Changes in Foreign Exchange Rates

A second highly significant source of distortion of income subject to apportionment determined by the California Franchise Tax Board in applying its unitary theory comes from treatment of changes in foreign exchange rates. The problem

has many facets, two of which will be illustrated.

First, by taking foreign book earnings as the basis for California taxable earnings, foreign currency gains arising out of changes in the relative value of the dollar are converted to losses, and losses are converted to gains. For example, assume a United States corporation transfers $2.40 in British currency to one of its branch operations in the United Kingdom when the exchange rate is 1 £ = $2.40. If the value of the pound drops to $1.70 by year-end, the United States corporation will report a 70 cent loss. However, if the reporting corporation were British, and the branch operation were in the United States, a gain of 70 cents would be reported assuming that British financial accounting is parallel to F.A.S.B. 8. The California Franchise Tax Board, by taking financial income determined to a British parent as the measure of income subject to apportionment, thereby converts a loss into an equal gain.

The second problem goes to the very heart of the unitary theory. Combination of foreign based multinationals should yield a measure of income subject to apportionment which is identical to the measure of income for a U.S. based multinational having identical transactions and properties. Foreign currency translation makes that goal unrealizable, with the consequence that the base for measuring California source income bears no relationship to any rational measure of income.

The distortive effects of foreign currency translation are well illustrated by the 1976 results of Unilever. Unilever publishes two accounts of net book income, one in guilders for Unilever, N.V., and one in pounds for Unilever, Ltd. Two steps are taken to determine consolidated book income. First, Unilever, N.V., and Unilever, Ltd. convert book income from the local currency of each of their subsidiaries to guilders and pounds, respectively. Second, the N.V. totals are converted to pounds for the English version of the accounts and Limited's figures are converted into guilders for the Dutch version. Net income depends upon what translation method is used to make the conversion - and several methods all with different results are prescribed by the Internal Revenue Service for United States federal income tax purposes - and upon the currency into which the conversion is made. For the most recent accounting period of calendar year 1976, Unilever, N.V. reported:

	Fl. Million		
	Combined	N.V.	Ltd.
Profit retained, January 1, 1976	6525	3670	2855
Dividends on ordinary & deferred capital	395	268	127
Net additions to profits retained	21	128	[107]
Profit retained, December 31,1976	6546	3793	2748

For the same period, Unilever, Ltd. reported:

	£ Million		
	Combined	N.V.	Ltd.
Profit retained, January 1, 1976	1,201.6	675.9	525.7

	£ Million		
	Combined	N.V.	Ltd.
Dividends on ordinary & deferred capital	94.4	64.0	30.4
Net additions to profits retained	364.4	232.7	131.7
Profit retained, December 31, 1976	1,566.0	908.6	657.4

From the point of view of the Dutch company, measured by a strong currency, the increase in retained profits for year 1976 was a dismal .3%. However, from the point of view of the U.K., measured by a weak currency, the increase in net profits retained was a strapping 30.3%.*

The distortive effect of foreign currency translation becomes more serious where the results from operations are translated into very strong or very weak currencies, or into the currency of a relatively small subsidiary. If the U.S. dollar were relatively weak in relation to the guilder and the pound, Lever Brothers would be deemed to have earned part of monumentally high profits of Unilever. Conversely, if the U.S. dollar were relatively strong in relation to the guilder and the pound, Lever Brothers would be deemed to have participated

---

* These figures approximate the results which would be obtained from use of the "combination method" of translation of Treas. Regs. §1.964-1(d-e). Different results would be reached if the "foreign corporation" translation method is used. Federal regulations require the combination method to be used by controlled foreign corporations in connection with determining earnings and profits, constructive distributions of subpart F income, constructive distributions of earnings invested in U.S. property, and minimum distributions, all of which are comparable to the unitary return purpose of determining how much income is currently earned in each jurisdiction.

Still different results would be obtained if the different units in a multicorporate organization were treated as branch operations, rather than as a subsidiary. The amounts shown in the text are roughly comparable to the "net worth" method.

in a year of monumental Unilever losses. The greater the difference in exchange rates between the dollar on the one hand and the guilder and the pound on the other, the greater the distortion. Likewise, if U.S. operations constitute the bulk of total operations, the effect of changes in foreign currency rates will not have too great an effect. However, if U.S. operations are only a small part of total operations, the effect of changes in foreign currency rates will be dominant.

It appears that the Franchise Tax Board has not taken any position on the knotty problem of how to deal with changes in the foreign exchange rate. It is our understanding that a staff study has commenced, but no action has been taken on a preliminary report. The examples given above - not imagined, but taken from a current case - show how the method of conversion chosen can have a much greater effect on the determination of income than gains and losses on normal business operations.

We submit that the Franchise Tax Board should not subject the measure of California franchise tax revenues to the relative strength of the dollar. Further, the Franchise Tax Board should not apply the unitary concept to any foreign based multinational until it identifies and adopts appropriate rules regarding foreign currency translations. Until that is done, the current practice of adopting the translation method used by taxpayers for foreign book purposes will continue to

result in uneven treatment of similarly situated taxpayers.

The concrete example of Lever Brothers suggests that the task will not be an easy one. Lever constitutes less than ten percent of Unilever, and California operations are less than one percent of Unilever operations. Approximately 40% of Unilever's business is conducted outside of Northern Europe, the United Kingdom and the United States, in countries where substantial inflation generally has occurred. Foreign currency losses from these countries have not been computed by the Franchise Tax Board as if Lever were the parent organization. Since the United States operations are such a small percentage of overall business operations, foreign currency gains and losses take on a multiplier effect when compared to earnings from operations. The result is a capricious distortion of the measure of income subject to apportionment. Lever believes that a far better measure of income derived by Lever Brothers in California is found in the unitary tax return it files with Glamorene Products Corporation.

c. <u>The Apportionment Formula Used Results in Arbitrary Apportionment of Income to California</u>

The apportionment formula used by the California Franchise Tax Board consistently results in excessive apportionment of income to California. The worst offenders are the payroll and property factors.

(1) As the unitary theory developed in the United States, a payroll factor was adopted to account for the con-

tribution of labor to the production of income. The California Franchise Tax Board refuses to allow taxpayers to compute a payroll factor based on the number of employees. Instead, the Board, knowing that California wage rates are among the highest in the world, is content to insist on using the amount of wages paid.

As originally developed, in the context of an enterprise engaged in business in a relatively homogeneous economic framework, the use of actual salaries and wages paid rather than number of employees for the payroll factor provided a means of measuring the relative value to the company of the contribution of services. Presence in a state of the president of the company is given greater weight than presence of a janitor. This standard, which works well within a homogeneous economic framework, does not yield reasonable results when applied across national boundaries. The salary of a U. S. executive may be double that of his foreign counterpart, but he may be no more productive. His salary is, nevertheless, double-weighted in the apportionment formula. The services of an unskilled laborer in the U. S. may be given more weight than the services of a key executive in another country. As applied to multinational corporations, the payroll factor should be based on numbers of employees, not salaries and wages paid.

(2) The property factor is determined by reference to original cost rather than to current value based on current

exchange rates. This rule has no particular significance when applied solely to domestic activities, but is a source of distortion where national boundaries are crossed. As an illustration of this point, the Notices of Proposed Assessment of Additional Franchise Tax issued to Lever were determined by valuing the numerator of the property factor--California property--at original dollar cost; however, the denominator of the property factor is computed by converting original cost of all property worldwide at current exchange rates with the result that the denominator of the property factor is greatly understated. If the California Franchise Tax Board would allow Lever to compute the denominator of the property factor using historical exchange rates, on a basis more comparable to the numerator, Lever would have to prevail upon Unilever to require its worldwide subsidiaries, which keep books of account in local currency of the host country and under local accounting standards, to make an annual analysis of each of tens of thousands of assets.

Lever and other California subsidiaries of foreign based multinationals are faced with a dilemma. Should they cause a tremendous annual expense to be incurred by making these conversions, assuming the Franchise Tax Board ultimately agrees that the conversion may be made, or should they absorb a known distortion?

d. <u>The Unitary Theory Creates Excessive Administration Costs</u>

As can be seen from the above discussion, the foreign parent must be prepared under the unitary tax theory, to adjust its worldwide accounting system to conform to California standards. It might also be required to have different books for each of the other states which impose an income tax, should they decide to adopt the unitary theory. The result often is that the cost of compliance far exceeds the legitimate potential tax revenue to be derived by the state.

In addition, it must be recognized that subsidiaries of foreign based multinationals doing business in California do not have ready access to the books and other financial records and information about other foreign based subsidiaries of their common foreign based parent. Illustratively, Lever is merely one subsidiary out of the approximately 500 operating subsidiaries of Unilever located in approximately 70 countries. Substantial effort and expense has already been required and will be required in the future to adequately prepare answers to inquiries about the worldwide operations of the foreign parent. Even though Unilever might agree in concept with the notion that the taxes paid by one of its subsidiaries could be reduced if sufficient worldwide accounting effort were devoted to the production of records for use in reducing arbitrary

assessments by California, as a practical matter it is reluctant to marshall its resources to accommodate a political subdivision of a foreign state in which less than one percent of total business is conducted.

III. Conclusion

This might be an appropriate time to re-examine the purpose of unitary accounting. That purpose is to determine the very best measure of income derived within a taxing jurisdiction by a business enterprise. It is now generally agreed that the unitary accounting theory is a necessary and useful tool in accomplishing this purpose when properly applied within the framework of a homogeneous economic structure. However, in the context of multinational accounting, the unitary theory simply does not provide a rational measure of income derived in California, as illustrated by the Lever Brothers case. A far more accurate measure of income derived in California may be found using the arm's-length standard required by the Treasury Department and in general use in the international business community.

Respectfully submitted,

Roy E. Crawford
Brobeck, Phleger & Harrison
111 Sutter Street
San Francisco, California 94104

Counsel for Lever Brothers Company

STATEMENT BY UNION BANK OF SWITZERLAND TO THE CALIFORNIA FRANCHISE TAX BOARD REGARDING THE EFFECT OF APPLICATION OF WORLDWIDE UNITARY ACCOUNTING

Union Bank of Switzerland conducts a substantial international banking business. It has operations in 19 countries, which is conducted through branches, subsidiary banks, and agencies, and in connection with representative offices. At the present time in the United States, Union Bank of Switzerland has a branch office in New York, a branch and a representative office in Chicago, an agreement with a representative in San Francisco, and in April, 1977, opened an agency in Los Angeles which is currently staffed by one officer and one secretary. The parent organization is engaged in a study of the feasibility of expanding the Los Angeles agency, and for purposes of analysis have assumed from a review of the results of the New York branch, that at the end of three years the Los Angeles agency would have total assets of $1,000,000,000, mostly consisting of interbank funds. It was further assumed that the agency would have fifty employees and gross revenue of approximately $1,910,000 and that there would be pretax income of $670,000.

Union Bank of Switzerland has been advised by its independent tax advisors that its projected tax burden from an expanded Los Angeles agency would depend upon whether the unitary tax theory is applied to pull income earned abroad

into the measure of income subject to apportionment. If separate reporting were made, Union Bank of Switzerland could expect to net $303,000 after taxes on income of $670,000 computed as follows:

	Separate Reporting
Pretax income	$670,000
California franchise tax (13%)	87,000
Federal taxable income	583,000
Federal tax (48%)	280,000
Net income after federal & California tax	$303,000

If a worldwide combined return were filed, however, Union Bank of Switzerland could expect to net only $50,000 after taxes on income of $670,000 computed as follows:

	Combined Reporting
Pretax income	$670,000
California franchise tax	340,000
Federal taxable income	583,000
Federal tax (48%)	280,000
Net income after federal & California tax	$ 50,000

Using separate accounting, California would receive 13% of pretax income of $670,000, while Union Bank of Switzerland would net 45.2% of pretax income. Using combined reporting,

California would receive 51% of pretax income, approximately four times the amount computed if separate accounting were used. Union Bank of Switzerland would net 7.4% of pretax income.

Where a combined report is used to determine the measure of California franchise tax, federal taxable income is not determined after deducting the full amount of California franchise tax from pretax income. Regulations issued by the Treasury under §861 of the Internal Revenue Code limit the deduction for California franchise tax to that imposed on United States source income. Under these regulations, most of the California franchise tax is deemed to be imposed on foreign source income, and accordingly is not deductible. Regs. §1.861-8(e)(6); see examples 25 and 26 of §1.861-8(g).

For various reasons, one being these projections, Union Bank of Switzerland has postponed until the autumn of 1977 the final decision to which extent the Los Angeles agency should be expanded. Unlike the type of business typically conducted by domestic banking establishments, Union Bank of Switzerland could service most of the business which would be handled by the Los Angeles agency out of the New York and Chicago agencies. However, Union Bank of Switzerland foresees that California has the capacity to become a major force in international banking with its geographic location adjacent to the Pacific basin and would prefer to expand California operations if the California

tax law had less of a confiscatory character to it. Management of Union Bank of Switzerland cannot reasonably justify the devotion of its resources to an agency, which, if profitable, is projected to return only 7.4% of net income before taxes. Should the agency be unprofitable, the loss would be exacerbated by an inevitable California franchise tax burden in excess of $300,000 annually, assuming the level of business activity listed above.

It must be recognized that Union Bank of Switzerland has developed its estimate of California franchise tax and net income after taxes applying its best professional judgment for purposes of making a management decision. The question arises why taxable income determined on a unitary theory produces a measure of taxable income four times greater than income determined under generally accepted accounting principles for purposes of making a management decision. The reasons are that the unitary theory is based upon a faulty economic premise, and as applied to foreign parents, numerous distortions occur.

1. <u>The Economic Premise of the Unitary Theory is Faulty</u>

The unitary theory is defective in its economic assumption that each part of a business produces an equal amount of income, with respect to each dollar of payroll, property, and sales. The fact of the matter is that some operations are more profitable than others. A typical illustration of this fact is that a new agency is less profitable than an established

agency with respect to each dollar of payroll, property, and sales. Other examples are highlighted by the quandary faced by Union Bank of Switzerland:

a. Interest rates vary from country to country, and may be much larger than in the United States, but in such cases the spread between the cost of funds and interest earned does not increase proportionately.

b. Union Bank of Switzerland conducts essentially two types of banking functions in countries other than the United States, investment banking and commercial banking. However, banks in the United States may not engage in investment banking; they are limited to commercial banking. The unitary return approach throws profits generated outside the United States from investment banking activities in with commercial banking profits. In general, investment banking profits are greater per dollar of payroll, property, and sales. Combination accordingly results in California taxation of foreign investment banking profits.

c. Activities conducted in the United States by Union Bank of Switzerland are different from banking activities it conducts elsewhere. Union Bank of Switzerland is engaged in California in activities termed "wholesale" banking functions in the banking trade. Its principal activities in the United States are dealing in foreign exchange with corporations and other banks, money market operations with major banks

and corporations, and corporate lending. Union Bank of Switzerland is prohibited by California law from accepting deposits from United States residents at the Los Angeles agency.

In Switzerland Union Bank of Switzerland is also engaged in wholesale banking, but in addition engages in "retail" banking activities similar to those conducted by the large California based banks. In general, wholesale banking operations produce a rate of return which is smaller with respect to each dollar of payroll, property, and sales than the rate of return on retail banking operations. A principal reason the unitary return overallocates income to California in the case of Union Bank of Switzerland is because of the large apportionment factors in the form of interbank funds arising out of money market operations. Interbank funds consist of borrowings and lendings among banks for brief periods, with maturities ranging from overnight and weekend up to one year. Typically the spread between the cost of funds and interest earned is quite small. A three month loan to a prime borrower such as a major bank may involve a spread less than 1/4 percent. These transactions are treated under the unitary theory as equally profitable as regular commercial lending operations. However, spreads in regular commercial lending are invariably much higher. A typical spread on a real estate loan might be two percent, while a consumer loan may produce a spread of six percent or more.

The annual report of Wells Fargo Bank states that for the last five years their average spread, which it calls the "net interest differential" was in excess of three percent.

2. The Unitary Theory as Applied to United States Operations of Foreign Parents Produces Distortion

In addition to the distortions created as a result of the defective economic assumptions of the unitary theory described above, the unitary theory applied to United States operations of foreign parents produces unreasonable distortions. These are outlined in some detail in the statement submitted to the Franchise Tax Board by Lever Brothers Company and in a statement which was presented to the Committee on Foreign Relations of the United States Senate on behalf of a group of foreign banks headed by the Hongkong Bank of California. To avoid unnecessary duplication, only a summary is offered at this hearing:

a. Income subject to apportionment treated by the Franchise Tax Board as earned by non-United States corporations is usually computed on a wholly different basis than income determined under California substantive tax law. Usually, book income is taken, and in most cases book income is higher than income determined under the tax law.

A special problem is created by the treatment of currency gains and losses. The United States operations of Union Bank of Switzerland would be but a small percent of total

operations. If foreign currency translations are treated in the same manner as would be reported by California based banks, such translations would dominate the income statement. The income statement would become wholly artificial.

b. The apportionment formula is biased to overallocate income to California. As a single example, the payroll factor measures the contribution of labor to the production of income on the basis of payroll costs. California wage rates are among the highest in the world, and as a result many instances exist where each California employee counts for multiple employees outside the United States.

3. Unreasonable Administrative Costs Exist

Virtually every foreign based parent corporation is faced with a tremendous burden of compliance with the demands imposed by the California Franchise Tax Board. In practical effect, foreign parents are forced to choose between accepting known distortions of income determined according to standards imposed by the Franchise Tax Board and the expenditure of unreasonable amounts to develop original information which may lessen the effect of the distortions, but only at a cost which may be greater than the tax burden.

Respectfully submitted,

Josef P. Condrau
Union Bank of Switzerland

Roy E. Crawford
Brobeck, Phleger & Harrison
111 Sutter Street
San Francisco, CA 94104

Counsel for Union Bank of Switzerland

STATEMENT OF DENNIS AMUNDSON, DEPUTY DIRECTOR, DEPARTMENT OF ECONOMIC AND BUSINESS DEVELOPMENT, STATE OF CALIFORNIA

Mr. AMUNDSON. Thank you, Mr. Chairman. My name is Dennis Amundson, I'm deputy director of the State Department of Economic and Business Development and I'm here today to represent the views of the Secretary of the State Business and Transportation Agency. We are concerned really with only one aspect of your deliberations, a very narrow aspect, and that has to do with the unitary method of taxing the income of foreign-owned or controlled corporations.

We are not here to oppose the provisions of your last year's S. 2173 which would have provided for an optional three-factor formula for apportioning the income of interstate corporations. Since most States including California already use the three-factor test with respect to interstate firms, California is not particularly disadvantaged by these provisions.

The major problem area in our opinion lies with how we treat foreign-owned or controlled corporations who are seeking to locate facilities in the United States. As you are aware, only a handful of States presently require the combined reporting on the income of foreign firms on their earnings outside of the United States. California is one of those States and thus we are at a very serious competitive disadvantage when trying to locate those new factors from foreign sources.

During the last legislative session in California, Governor Brown sponsored legislation to modify the unitary method to exclude the income of foreign-owned or controlled corporations which was derived outside of the United States, the arm's length approach. The legislation was introduced by Assemblywoman Hughes. It did not pass, but we expect the same kind of legislation to be introduced again in this new session and the Governor again will support it.

The Brown administration is committed to the need to exempt foreign firms in order to remove the disincentives for new investment that currently exist. Public hearings conducted by our Franchise Tax Board in the summer of 1977 revealed extensive problems regarding using combined reporting requirements on foreign firms. Under the three-factor formula the corporation can actually lose money in California and still owe the State substantial sums of income tax because of their world-wide operations. We admit that those are extreme cases, but there was public testimony that that in fact does occur.

In a recent trip to Japan, the State Director of International Trade visited with 72 Japanese firms that are considering locating additional sites in the United States. In almost every case their first question was what are you going to do about the unitary method of taxation. They articulated very clearly to us that the State of California would not likely be seriously considered until we make some exemptions. We feel we are on the verge of substantial new investment from foreign firms, particularly if the unitary tax is modified. The expected revenue loss of $6 to $8 million in California by a very limited bill that we're supporting would be recovered many times over through new capital investment and job creation resulting from the expanded operations in the State. Thank you.

PREPARED STATEMENT OF FRANKLIN C. LATCHAM

I. INTRODUCTION

Mr. Chairman and Members of the Committee, I am Franklin C. Latcham, a lawyer residing and practicing in San Francisco, California. My presence here today is soley my own personal undertaking. Although my firm, Morrison & Foerster, represents clients which are interested in S. 2173 and the application of the unitary method as imposed by the State of California and other States, I am not speaking on behalf of any specific client.

Several California lawyers have joined in presenting a panel discussion of the application by California and a few other States of the unitary method of apportionment of income of multinational corporate groups. The members of our panel are Valentine Brookes, Mark Ancel and myself. We plan to contrast the operation of the unitary method of apportioning income with the separate accounting method adopted by the United States and most foreign countries (which I will call the "federal method") and to discuss some of the problems involved with the use of the unitary method in the international area.

It should be emphasized that both methods are concerned with the best approach for determining corporate income earned in the United States or in a particular State where an affiliated group of corporations are doing business both in the United States and in foreign countries. My remarks will be limited to apportioning income of multinational corporate groups because my experience suggests that most multinationals carry out business in foreign countries through separate corporations. Similar problems can arise, however, in regard to foreign branches.

The Federal method basically determines the income earned by each corporation on a separate accounting basis. That is, each corporation is treated as a separate entity and its net income and tax liability is computed accordingly in each taxing jurisdiction in which it operates. The Federal method has the advantage of use over a long period of time by most, if not all, countries of the world involved in international trade. While the Federal method may have its problems, they are at least well understood and have been the subject of resolution by the United States and foreign countries both in their own tax laws and in bilateral tax treaties entered into between many of the countries principally involved in foreign trade. Most States follow the Federal method in determining the income of a corporation operating within its jurisdiction even though it may be affiliated with corporations operating in other States or foreign countries.

On the other hand, the unitary method as applied by California and a few other States is completely contrary to the Federal method in that it ignores separate corporate entities and requires the income of all corporations which are members of the unitary group to be combined and reported as if earned by one entity. The income is then apportioned to a taxing jurisdiction, such as California, by formula generally based upon property, payroll and sales.

The use by the States of the unitary method for apportioning the income of a single corporation operating in interstate commerce within the United States is of long standing and is now used by most States. In addition, for a number of years California and a few other States have applied the unitary method to affiliated corporate groups operating within the United States. However, its application by California and a few other States to corporations operating in the United States and foreign countries is of rather recent origin. The discussion by my colleagues and myself on this panel will demonstrate why in our opinion the unitary method is not adaptable to foreign operations. Furthermore because the unitary method is not used by the United States or any foreign country in determining income subject to taxation in that country, its use by California or any State inevitably leads to confusion and contradictions with the taxing system of foreign countries and the tax policy of the United States.

It should be noted that the wisdom and the authority of applying the unitary method on a worldwide basis by California has been seriously questioned. Governor Brown has criticized the extension of the method to foreign corporations although the franchise tax board persists in applying the method to multinational corporate groups. See Hearings, U.S. Senate Comm. on Foreign Relations, 95th Cong., 1st Sess. on Tax Treaties with the United Kingdom, Korea and the Philippines (1977) 317, 399, 411. (Hereinafter "Hearings".) Bills were introduced in the last session of the California legislature which would prohibit application of the unitary method either to foreign-based multinational groups or to all multinational groups. In addition a number of lawsuits have been filed contesting the extension of the unitary doctrine to multinational corporations and at least one of these cases has already been tried at the Superior Court level and a decision should be rendered within the next few months.[1] Furthermore, a California Court of Appeal has refused to include a foreign subsidiary as part of a unitary group but without detailing its reasoning. *Chase Brass and Copper Co.* v. *Franchise Tax Board*, 7 Cal. App. 3d 99, modified 10 Cal. App. 3d 496 (1970), app. dism. 400 U.S. 961 (1971).

It seems obvious that the adoption of the unitary method by the States in apportioning the income of multinational corporations will greatly disrupt the uniformity needed in this area. The United States Supreme Court has recommended that Congress resolve the lack of uniformity in a number of its opinions relating to corporations operating in interstate commerce. Perhaps the most forceful admonition from the court comes from its recent *Moorman* decision. (*Moorman Manuf. Co.* v. *Blair*, 46 U.S.L.W. 4703 (1978).) Certainly the Supreme Court's recommendation for a congressional solution in regard to uniformity in the interstate commerce area should be given even greater recognition in regard to corporations operating in international commerce where disharmony can cause economic problems to the entire country and to our trading partners.

II. COMPARISON OF THE FEDERAL METHOD AND THE UNITARY METHOD

A. Federal method

The Federal Government has established a well-defined method for taxing United States corporations with foreign subsidiaries and foreign corporations with United States subsidiaries. Under that method a United States corporation may utilize corporate subsidiaries to conduct foreign businesses and neither the parent nor subsidiaries are subject to the Federal income tax on earnings of those foreign subsidiaries until such earnings are actually or constructively[3] distributed as dividends by the foreign subsidiaries to the United States parent. In addition when those profits are repatriated, the Federal method provides that the parent may apply a foreign tax credit against the tax imposed by the United States on the repatriated dividend. By allowing such a credit, the Federal method prevents any significant double taxation of the income repatriated. For a helpful study see Hufbauer and Foster, U.S. Taxation of the Undistributed Income of Controlled Foreign Corporations, Tax Policy Research Study No. 3, Essays in International Taxation, Treasury Dept., 1976.

In the case of a foreign parent corporation with a United States subsidiary, Federal income tax is only imposed upon the income earned by the subsidiary in the same manner as any United States corporation is taxed. The parent's income is not subject to Federal income tax unless the parent also has operations in this country or other income from United States sources.

In order to insure that the United States collects a fair share of the tax revenues from businesses engaged in foreign commerce, the Internal Revenue Service is given authority to monitor transactions between a United States corporation and its affiliate (whether subsidiary or parent) operating in a foreign country to make certain that transactions have been carried out on an arm's-length basis. Section 482, Internal Revenue Code. This system recognizes the integrity of separate corporate organizations in terms of their primary liability for taxes to the country in which they operate, but grants the IRS authority to reallocate any income, deduction or other item affecting taxable income among affiliated corporations, if this is believed necessary to determine the true taxable income of each. Thus, the United States system is based upon and policed by the principles of separate accounting.

The Federal method is designed to implement the economic policies of the United States toward investment by Americans in foreign countries and investment by foreign nationals in the United States. A key element in that policy is to encourage the free flow of capital and technology within the international community. It has long been recognized that "Among the major impediments to freer capital and technology flows are the rules of national tax systems and their interaction with the systems of other countries." Statement of Laurence N. Woodworth, Hearings, 28. To reduce or eliminate these impediments, the Federal Government has not only adopted the statutory scheme noted above, but it has also entered into various bilateral treaties designed to promote free trade by harmonizing United States tax policy with that of our trading partners. The treaties are constructed in recognition of the separate accounting method not only adopted by the United States but by our trading partners. Thus the tax neutrality which United States policy seeks to achieve is based upon recognition of separate corporate identity. See Hufbauer and Foster, U.S. Taxation of the Undistributed Income of Controlled Foreign Corporations, supra.

Under the Federal method tax neutrality is implemented by deferring any United States tax upon the operations of foreign subsidiaries until the profits of those subsidiaries are repatriated. That is, the tax burden of a subsidiary operating in Brazil bears the same tax burden as other businesses in Brazil so long as the funds from that subsidiary are not repatriated. Tax neutrality is also implemented by providing a foreign tax credit when profits are repatriated to the United States. Assuming the foreign tax rate is not higher than the United States rate, repatriated profits of the foreign subsidiary are taxed at the same rate as if those profits had been earned in the United States.

Tax neutrality if further implemented under the Federal method by taxing the net income earned by a United States subsidiary of a foreign parent on a separate accounting basis. In this way the subsidiary is taxed under the same method as United States corporations. Such a policy discourages protectionist tax policies by other countries and encourages fair treatment of United States enterprises operating in those countries. See generally testimony of Laurence N. Woodworth, Hearings, supra, 19, 28, 33 et seq.; Hufbauer and Foster, supra.

In addition treaties entered into by the United States with its major trading partners, provide a "competent authority" mechanism for the resolution of disputes in the tax audit results to ensure that the arm's-length standard does not result in double taxation of the same income. Under these treaties a designated official of the IRS and his opposite number in the other country, each of whom is identified as the competent authority, are able to resolve issues that may arise as to the country in which to tax, and the basis upon which to tax, income from tax-realizing transactions which occur in their two countries.

Coincident with the arm's-length rules in the recognizability of separate corporate entities is a concept, also implicit in the tax treaties, of so-called source rules—that is rules for determining whether and to what extent income from multinational operations is, for tax purposes, to be considered as derived from sources within the United States or from foreign sources. A mechanism exists at the Federal level, therefore, for determining the amount of foreign source income. Sections 861 et seq., Internal Revenue Code. The tax treaties in conjunction with Federal internal revenue laws determine the extent, if any, to which income from foreign sources is taxable for Federal tax purposes. Thus the separate corporate entity of the foreign operation is recognized, and its tax liability is separately calculated through utilization of the arm's-length techniques mentioned above.

In addition to the economic policies embodied within the Federal method, certain political decisions are also contained in that system. As noted earlier, the Federal method respects the integrity of the corporate entity operating in foreign countries. If a foreign corporation is affiliated with a United States corporation its reporitng requirements are confined to providing sufficient data to the United States taxing authorities to ensure that the arm's-length pricing standard has been maintained in transactions between the affiliates, assuming the affiliate has not made an actual or deemed distribution to a United States parent.

This Federal policy implicitly recognizes that United States regulation of foreign corporations, in large part, must be confined to business activities which actually occur within this country. Such a decision comports closely with general notions of the limits of jurisdiction one State can impose upon the citizens of another State. The policy recognizes, in effect, that foreign corporations are citizens of the country in which they are operating. To require extensive reports or other information is a form of extra-territorial jurisdiction.

B. The unitary method

The unitary method first emerged in State property tax cases involving taxes on the property or capital stock of interstate railroads and telegraph companies. The issue typically was whether the railroad was to be taxed only on the property physically located in a State, or, alternatively, whether the value of its property nationwide could be taken into account and then apportioned to the State on some formula basis. The latter approach was approved by the U.S. Supreme Court in the *State Railroad Tax Cases*, 92 U.S. 575, 601 (1875). See also, *Adams Express Co.* v. *Ohio State Auditor*, 165 U.S. 194, 220 (1897), *rch. den.* 166 U.S. 185 (1897).

The theory of unitary taxation developed in applying property and capital stock taxes was applied to State corporate income taxes in the earlier part of the 20th century where parts of a single corporate enterprise were closely tied together in earning a single stream of business income. See *Underwood Typewriter Co.* v. *Chamberlain*, 254 U.S. 113 (1920), involving vertically integrated manufacturing and selling operations carried on in a number of States.

California and a few other States have extended the unitary doctrine so that the units of business taken into account in determining the unitary business include separately incorporated entities under common control. *Edison California Stores, Inc.* v. *McColgan*, 30 C. 2d 472, 183 P. 2d 16 (1947). A few States have followed this extension of the doctrine, but most States have not.

The unitary method has been applied for a number of years to corporations, or in a few States to corporate groups, operating in interstate commerce within the domestic United States. Although the application of the doctrine within the United States raises some difficult problems, particularly in working out a uniform definition of the apportionment factors and in applying the California extension of the unitary method because of difficulties in defining the unitary group, it has been applied with relative success on a domestic basis. See generally, Hellerstein, Recent Developments in State Tax Apportionment and the Circumscription of Unitary Business, 21 Nat. Tax J. 487 (1968).

On the other hand there are a number of reasons why the unitary method as espoused by California is unworkable when applied to a multinational corporate group. My fellow panelists will discuss some of these problems in detail. I will concentrate on problems arising from the conflict between the Federal method and the unitary method.

The separate accounting concept, which is fundamental to the Federal method, and the unitary concept are founded upon substantially different assumptions.

The unitary method is based upon the following assumptions: (1) that all corporate members of the unitary group are operating in a common market, such as the United States common market, where wages, sales prices and costs of tangible property are about the same, and where there are no substantial, long-lasting differences in economic, political and social conditions; (2) that a dollar of wages or sales or a dollar invested in tangible property will earn about the same income by all corporations which are members of the unitary group, and (3) that profits earned by each member of the unitary group and arm's-length pricing of intercompany transactions cannot be determined on any reasonable basis.

The separate accounting method, on the other hand, is based upon the assumption that the net income of each corporate member of the affiliated group can be separately determined and that arm's length pricing of intercompany transactions can be accomplished satisfactorily.

As stated before, the assumptions in regard to the unitary method have a good deal of validity when applied to corporations operating in the same business within the United States. They do not have such validity when applied on a worldwide basis for the following reasons.

For one thing the factors in the apportionment formula can vary a good deal between various countries. The wage and property factors, in particular, tend to be lower in many countries than in the United States thereby distorting the formula in favor of States, such as California, using the unitary method. Obviously the income of the unitary group tends to be apportioned to the taxing jurisdiction having the larger factors. This is the case if the net incomes of the corporations involved are about equal. An even greater apportionment of income to the jurisdiction with the larger factors occurs if the corporation operating in another jurisdiction is more profitable. The fact is that wage rates in many countries are substantially behind those of the United States, particularly in the case of the developing countries. The productivity of workers in many foreign countries may be somewhat less than that of workers in the United States. However, it is not so much less that wage costs in many foreign countries are still substantially below those in the United States. Also, use of more sophisticated machinery and equipment in the United States, plus greater land and plant costs, often make the property factor greater in the United States than in other countries.

Furthermore, the lesser wage rates plus other economic conditions in foreign countries frequently make operations in those countries more profitable. In fact, the risk factors encountered in most foreign countries require businesses to demand greater profits in those countries than they demand from operations in the United States. The risk factors not only involve possible expropriation, but also risks arising from operations in a lesser developed economy and from governmental regulations of various kinds including limitations on employee dismissals, plant relocations, importing of machinery and raw materials, exporting of finished products, etc. Under these circumstances higher profitability is somewhat in the nature of a contingency reserve. Furthermore because the economic, political and social differences between the United States and many foreign countries are long-range in nature, the differences in profitability between the United States and such countries will continue for many years.[3]

By way of contrast, the assumptions underlying the separate accounting method have greater validity when applied to corporations operating in different countries. Separate accounting recognizes the fact that the profitability of such operations may differ. Furthermore, intercompany transfers are generally not as numerous or varied between corporations operating in different countries as they are between corporations operating in interstate commerce within the United States. Also the IRS and tax administrators of foreign countries are policing the transactions to assure that the intercompany pricing is fair.

There are other reasons for sustaining the separate accounting method as opposed to the unitary method in regard to multinational groups.

First, as stated before, separate accounting is the method adopted by the United States and most foreign countries to allocate the income of multinational corporate groups. Also the separate accounting method forms the basis upon which the tax treaties between the United States and many foreign countries are negotiated, and the competent authority procedure is set out in those treaties for determining arm's-length pricing between members of an affiliated group.

Second, separate accounting easily promotes the international economic policy of the United States of tax neutrality in foreign commerce. Thus all corporations operating in a particular country are taxed as residents of that country and the income of affiliated corporations in foreign countries is not taken into account in determining tax liability. In this way the separate accounting method promotes a policy of fairness to the United States corporations doing business in foreign countries and of foreign corporations doing business in the United States.

A third benefit of separate accounting is that the record keeping and reporting requirements of multinational corporations are not multiplied beyond reasonable requirements. Under separate accounting multinational corporations must basically keep the records required by the country in which they operate for accounting and tax reporting purposes. Subsidiaries of United States parent corporations must make a financial report to the parent in accordance with United States accounting principles. However, they do not have to make reports for tax purposes except as may be required by State jurisdictions imposing the unitary method. Under separate accounting foreign parent corporations and their affiliates which do not operate in the United States are not required to make any accounting or tax reports in accordance with Federal or State requirements. It must be remembered that reports by foreign corporations for State unitary purposes also require that the report be converted to United States currency. In case of a multinational corporate group the requirements of reporting to a number of States under the unitary method can become intolerable where States can differ concerning definitions of taxable income, the unitary group, apportionment formulas, principles of currency conversion, et cetera.

A fourth reason sustaining the separate accounting method is that it avoids the difficulties inherent in determining which corporations in the multinational group are actually members of the unitary group under the requirements of a particular State. Anyone experienced with the administration of the franchise tax law in California, recognizes that there are no uniform rules for determining which corporations should be included in the unitary group. In fact the determination is highly factual in nature leaving taxpayers and their counsel often unable to determine with certainty whether or not affiliates are members of a unitary group.

. . .

Another reason of major importance is that the possibility of double taxation is minimized. The separate accounting method, of course, recognizes that different corporations within the multinational group may be more profitable than others. Profitability is separately determined for each corporation upon the basis of accounting principles and arm's-length intercompany pricing when necessary. On the other hand the unitary method assumes that separate profitability of corporate members cannot be determined. It requires computation of one nėt income for the entire group and the apportionment of that income by formula. As stated before the result is that a part of the profits of a corporation in one country may be assigned to a corporation in another country. The conflict between the use of the separate accounting method by most countries of the world and the unitary method by some states makes double taxation inevitable.

It appears that the double taxation inherent in the use of the unitary method by the States in dealing with multinational corporations cannot be resolved without Federal legislation. Certainly the use of bilateral treaties between the United States and foreign countries to resolve the problem has not had much success as illustrated by the recent U.K.-U.S. treaty. Of course the U.K.-U.S. treaty attempted to prohibit the use of the unitary method in a specific situation. It is conceivable that treaties might be drafted which would attempt to alleviate the double taxation problem where particular States are using the unitary method. However it seems almost impossible to achieve a solution through the treaty method unless foreign countries were also to adopt the unitary method. This seems highly unlikely. All of the bilateral treaties presently in force are based upon the separate accounting system. Furthermore the model treaty adopted by the Organization for Economic Cooperation and Development (OECD) which includes the principal countries of the world is based upon the separate accounting technique. The Guidelines for Tax Treaties Between Developed and Developing Countries prepared in 1974 by a special group within the United Nations also adopted the separate accounting method.

State representatives who advocate the unitary method have complained about the complexity of using the arm's-length standards of section 482 in determining pricing for intercompany transactions. They have complained that the States simply do not have the staff of international specialists such as those employed by the IRS in reviewing intercompany transactions. A substantial answer to this complaint is that the IRS regularly audits most major multinationals operating in the United States and the results of these audits are available to the States. Testimony of Laurence N. Woodworth, Hearings, 34. Furthermore the unitary method does not answer all intercompany pricing problems because even under a very broad definition of a unitary group certainly not all affiliates will be unitary. Therefore the States will have to make some computations under the State equivalent of section 482, or utilize those made by the IRS. In addition, this paper and those of other panel members illustrate that making a determination of apportionable income under the unitary method is not simple. Indeed the problems are as complex as those encountered under section 482, if not more so. Thus it would appear that State tax administrators would find it easier to resolve problems under section 482 with the substantial help of the IRS than attempt the complex problems arising under the unitary method without any help at all.

A comment should also be made in regard to complaints of losing State revenue. The California Franchise Tax Board, in particular, has complained about a loss of revenue if the State is not permitted to use the unitary method in the international area. Although there are disputes between Governor Brown, the franchise tax board and taxpayers about the accuracy of the amount of such revenue loss, the fact is the franchise tax board can hardly complain about lost revenue until the courts have determined the cases brought by taxpayers challenging the authority of California to impose the system upon multinational corporate groups. Furthermore, the franchise tax board insists on apportioning the income of multinational groups by the property, payroll and sales factors without adjustment for variations in the factors and for greater profitability as between countries. Thus it is quite possible that much of the lost revenue claimed by the board results from apportioning the income of foreign corporations to California that has already been taxed by the countries where the corporations operate. Thus the franchise tax board is complaining about its inability to tax the income twice. It should also be noted that California does not allow a foreign tax credit or deduction for income taxes paid to foreign countries. Thus the revenue bite in California is based on including the total foreign net income before taxes which may be as high as 50–60 percent of net income.

III. CONCLUSION

It is clear that the unitary method as administered by the California Franchise Tax Board, its leading exponent, is not workable in the international arena. The assumptions underlying the method that each member is operating in a common market which is without substantial differences in economic, political and social conditions and which permits an equal return on the factors do not exist on a worldwide basis. As a result of variations in the factors and of profitability between different countries, foreign source income is frequently apportioned to California and other states imposing the unitary method. Because other countries have adopted the separate accounting method which localizes profitability in separate countries, double taxation is inevitable.

There is, however, a more basic reason why States should be prohibited from adopting the unitary method on a worldwide basis. That is because it seriously disrupts efforts to achieve uniformity in taxing commerce among the countries of the world. The separate accounting and unitary methods are obviously antithetical. They are based upon different assumptions, apportion income differently, require the keeping of different records, and require different factual determinations for their implementation. Uniformity is impossible if two divergent methods of apportioning income are to be imposed upon multinational corporate groups by the United States and foreign countries on the one hand, and by the States on the other. It should be noted that insofar as various States adopt the unitary method, there is not only a lack of uniformity between those States and the United States and foreign countries but there is the probability of a lack of uniformity between the States themselves in defining the elements of the unitary method.

The debate in regard to the merits of the separate accounting method or the unitary method in the multinational area is interesting, but beside the point. As Professor T. S. Adams stated many years ago about State taxation of interstate commerce: "What is most needed is a uniform rule. Just what rule shall be selected is less important than the general adoption of the same rule by competing jurisdictions." [4]

The United States and its foreign trading partners have adopted separate accounting as a uniform apportionment rule. It makes little sense for the States of this country to embark upon an entirely different apportionment rule. The only workable solution to the problem is for Congress to prohibit the states from adopting the unitary method in apportioning the income of multinational corporate groups.

---

[1] The case is *Container Corporation of America* v. *Franchise Tax Board*, Superior Court, City and County of San Francisco No. 673-492. The taxpayer challenges the application of the unitary method on the facts of the case, as well as the authority of the board to impose the unitary method to a multinational group under the applicable California statutes and the United States and California Constitutions.

[2] Under subpart F, Sections 951–964, Internal Revenue Code, United States shareholders of a controlled foreign corporation are taxed currently on the corporation's income when the nature of the corporation and its sources of income demonstrate that it is being used to avoid taxes through utilizing foreign tax havens.

[3] Evidence introduced by taxpayer in *Container Corporation of America* v. *Franchise Tax Board*, *supra*, sustains the above analysis in regard to lower factors and greater profitability in foreign countries over a long period, particularly in the case of lesser developed countries, resulting in apportioning foreign source income to California. See also Hearings, 206-211, 291–295, 295–302, demonstrating similar results in regard to banks operating in foreign countries.

PREPARED STATEMENT OF VALENTINE BROOKES

INTRODUCTORY

These remarks are directed at the California system of apportioning net income to California, where the taxpayer is part of a commonly owned corporate group which operates throughout the United States and other parts of the world. The California system is to disregard the corporate entities of the several corporations in computing the net income and the amount of the factors to be employed, so a consolidated group net income is created, and a consolidated apportionment factor is devised in which the ratio of California property to world-wide property, California payroll to world-wide payroll, and California sales to worldwide sales, is employed. The net income is multiplied by the average of the California percentage of the three factors and the resultant figure seems to be income derived from or attributable to California, which California proceeds to tax. Technically the California tax is on the franchise of whichever member or members of the corporate group do business within California, measured by that net income, but the practical effect is the same as if the tax were directly on the net income. In the remarks hereafter no distinction will be made between a direct tax on net income and a franchise tax measured by that net income.

A. The unitary system as described above ignores differences between United States economic conditions and those prevailing elsewhere in the world, and these ignored distinctions are critical. Ignoring them necessarily produces distortion, so that the income attributed by the formula to California will be either more or less than it should be, and only by a miraculous coincidence will it be the proper one.

1. The most obvious vice in the California system is that it ignores the varying profit margins which occur solely because of local conditions in the various countries in which the group operates. The mark-up (percentage of gross profit) is usually higher in other countries than it is in the United States. This tendency is attributable to different circumstances: first, the business done in less developed nations, including the so-called Third World nations, involves a great political hazard, so that the business will not venture into such an area unless it can hope to get its investment returned to it more quickly than in a more predictable political environment, and necessarily that requires a larger margin of profit; much of the business done in the developed countries is done in an environment in which intense competition such as that which is required by law in the United States is actively discouraged, with the result that the marketplace tolerates a larger margin of gross profit than is customary in the United States.

Labor costs are frequently substantially lower in foreign countries than in the United States, although within the last 2 or 3 years inflation abroad has progressed more rapidly than in the United States and has tended to close that gap. Also, hours of work tend to be longer outside the United States than within it.

For these reasons, the productivity of labor abroad cannot be accurately measured by wages paid when those wages are then compared to wages paid in the United States. More often than not the wage differential will permit a greater margin of net profit abroad than in the United States, but the effect of the wage factor in the three-factor formula is not merely to ignore that difference, but to reverse it; the lower the wages abroad the smaller the weight they have in the payroll factor, and the larger the drawing power of the higher United States wage factor is in pulling net income into the United States, by the operation of the percentage formula.

Finally, material costs are often less abroad than in the United States, which in combination with the lower labor costs permits the selling price of similar articles to be less abroad than in the United States but yet produce a larger margin of profit. The effect of the formula, however, in apportioning net income according to the relationship between sales, is to depress the net income apportioned to the foreign countries where the dollar volume of sales is less and increase the percentage allocated to the United States and hence California, even though in fact the potential of the sales to produce net income is greater abroad.

Finally, factories and their equipment are often less expensive abroad than in the United States, and in the property factor income is apportioned according to the relationship between the cost of factories in the United States and the cost of factories abroad. An equally efficient plant in Italy will usually cost less than its corresponding one in the United States, but will be deemed to be less productive of net income by the operation of the formula simply because it costs less in United States dollars.

2. Another flaw in the unitary concept is that it assumes that the same products sold in the United States are those which are sold by the group throughout the world. To state an extreme example of the point that is being made, let us assume that in the United States General Motors sells nothing but Cadillacs, which is the product on which its margin of both gross and net profit is the greatest; let us assume, further, that in Europe it sells nothing but the Chevette, by its European name, which has a significant lower margin of profit. The California formula, by throwing the sales income, et cetera of both products into hotch-pot assumes conclusively that they are equally profitable in terms of the relationship of net profits to sales, property, and payroll. The assumption is economic nonsense. For further illustration, continuing to use General Motors as an example because of its prominence, most of the automobile lines made by General Motors for sale in the United States are not sold in significant volume in Europe, and most of the significant European sales (the European equivalent of Chevette being included) are not offered for sale in the United States at all because here they conflict with American-made automobiles. It is obvious that General Motors does not make the distinction described in order to affect its California taxes; it does so for hard-headed economic reasons. Its margin of profit on its American-made automobiles is certainly different than it is on its European-made automobiles, and they are both designed and built for wholly different markets, to operate on different highway and road conditions.

Another illustration of the point is found in the facts of the recently rendered decision of the board of equalization in the franchise tax appeal of Scholl, Inc., where a Chicago-based multinational parent owning more than 80 percent of the stock of English and other European subsidiaries was held entitled to resist the worldwide application of the unitary formula because the merchandise manufactured and sold in Europe was different and the thrust of the marketing operations in Europe was also different from the markets and focus in the United States.

3. The facts of the situation the California formula assumes rarely exist. This assumption of fact is that the goods sold abroad are manufactured in the United States and merely sold to sales subsidiaries which sell the product abroad. As an alternative the assumption is modified to assume that the goods sold abroad are assembled abroad from components, either entire or major, supplied from the United States factories. With pharmaceuticals, there is a certain validity to the first assumption but it is not universal in any chemical company, and is borne of a state of business affairs which has not been economically viable for many, many years. The second assumption, concerning the components being manufactured in the United States and distributed to factories abroad where they become parts of products employing those components and assembled elsewhere, assumes a set of facts which undoubtedly does exist to some extent or another. It is also true that some industrial empires may manufacture components in one foreign country and send them to another where, in conjunction with components domestically manufactured there they are assembled into a final product.

Neither situation justifies the assumption that the margin of net profit in terms of property, payroll and sales is the same for the products manufactured abroad as it is for the products manufactured in the United States, whether the goods manufactured abroad be made of entirely U.S. produced components or otherwise. The difference between labor costs and productivity abroad, and the margin of profit at which goods are sold abroad, prevents any assumption being made that the final article sold abroad is equally profitable and only equally so, compared with that manufactured and sold in the domestic economy.

The rules applied under section 482, IRS, for dealing with that type of situation are particularly well understood and well developed, because they were developed precisely for that type of situation. They are aggressively administered by the Internal Revenue Service. The States do not need to administer them but can ride the shoulders of the Internal Revenue Service and take advantage of the final determination they make. The necessity for the distorting formula is not genuine, but is argued for because, first, it leaves the administration entirely within the hands of the particular State, and two, its operation generally allocates more income to the taxing State and hence takes a bigger bite from the profits of the nonresident, nonvoting, foreign corporation.

4. The formulary system cannot function without converting foreign exchange into United States dollars. During the many years in which the Bretton Woods convention was in effect and United States and foreign currencies had a fixed exchange relationship with each other, this did not represent a serious problem. However, in the first years after World War II when currencies were fluctuating madly and the U.S. currency was at a premium, the problem was understood and considered to be insurmountable. A rule that was applied to make formulas workable where they were applied was a generous treatment of the principal of "blocked currency," in which funds which could not be exported without a license were not regarded as being exchangeable into United States dollars until the license was obtained. In effect, this made the use of formulae impossible on a universal basis. Within the last several years, in which currencies have been floating, the formerly orderly relationship has been replaced by chaos. The accounting profession and the SEC have devised a system in which foreign currency translations must be taken into account currently even though the actual exchange has not been made. This has lead to wide fluctuations in the earnings of U.S. based parents and has lead to wide swings in the values of stocks of such corporations on the local exchanges. However, the franchise tax board, in apparent recognition of the inroads this would make on the State revenues, has refused to apply this system for dealing with these exchanges. Obviously, the system deals with a condition which must be reckoned with, and whatever may be said for one system of dealing with it compared to another, the problem is difficult and will not go away.

To illustrate, let us assume that X company through subsidiaries does business in 34 different countries in the world, and let us assume further that the relationship between the local currencies of each of those countries at the beginning of a particular taxable year differs from the rate in effect at the end of the year. This is a likely assumption. Sales revenues come in throughout the year, and not on January 1, and December 31 exclusively. As received, they are deposited in banks, ordinarily in terms of local currency, and the occasion for determining their exchange value does not arise until they are sought to be repatriated or sent to a bank in some other country. This, however, can arise at any time. The occasion for doing so will not likely be delayed until the end of a particular calendar year or the beginning of the next one. There will, accordingly, probably be continual withdrawals and translations into foreign exchange throughout the year, with intermediate transactions in which the funds may go through accounts in one or more intervening countries before any occasion for their being translated into U.S. dollars occurs. Indeed, to the extent that they are used in operations, which will be normal and continuing, exchange translation losses and gains will be continued and will continue on, and will be netted at the end of the year. To the extent they are expended in purchasing assets, instead of services, their tax effect is not immediate and must be postponed because they become a part of inventories or they become a part of machinery or equipment, and the translation into U.S. exchange may be deferred for a considerable period.

Then ultimately the funds will need to be translated into United States exchange in order to be reflected in tax returns for the franchise tax board, the Internal Revenue Service, or some other U.S. taxing agency. The result of the translation is likely to be arbitrary, because the translation of foreign exchange into U.S. currency will be arbitrary unless the receipt of funds by the multinational group is contemporaneous to the day with its translation into U.S. exchange. Any deferment while the exchange rates are fluctuating will necessarily produce a rate of exchange inconsistent with the theory that the parent has had an immediate realization of any gross income received by its subsidiary, in whatever exchange.

The foregoing is not merely a conceptual difficulty. If it were, the necessity for the large exchange translation losses which now are appearing in the annual reports of American-based multinationals as a matter of course would not occur. The magnitude of those exchange losses indicates that they are not something that should be lightly discounted.

Furthermore, the problem is presented of how to take into consideration investments of a permanent nature, made from foreign funds, but where the investment must be translated into U.S. dollars in order to express depreciation in U.S. dollars, and to enter into the property factor in U.S. dollars. As a rule, as a matter of sheer necessity, the rule of thumb is employed that the exchange rate at the time of the investment continues to be employed for both purposes of depreciation and property factors. Yet this is theoretically wrong in each instance. But it is done because in an imperfect world we must sometimes make concessions to practicality. Yet the effect, when the U.S. dollar is declining in its dollar relationship to foreign exchange, as is now the case, is always to overstate values apportionable to the United States and thence to California.

The only way of making a precise calculation is to adopt accounting and bookkeeping requirements so onerous and expensive that to do so is economically counterproductive. The franchise tax board does not render any assistance in this respect, but expects the taxpayer to do this work for it. Yet the necessity to do so is of the franchise tax board's creation. Consider, for example, the question of why a foreign division headquartered in London would need to have a daily translation of currency from bank deposits made in Singapore, Calcutta, Madras, Colombo, Karachi, Johannesburg, and Cairo, into terms of British pounds, and then from British pounds into U.S. dollars. There is no commercial necessity for that effort, but to determine precisely those things the Franchise Tax Board of California needs to know, and other States employing the same system, that translation should be made. Yet these intermediate funds never come to the United States and the only occasion for translation which exists is to convert them all into British pounds, though not daily. This type of recordkeeping involves onerous burdens and expenses, and, of all things, is being hoisted upon these worldwide organizations in order to satisfy the requirements of a political subdivision of one nation, which itself is not an internationally recognized sovereign and is but one of fifty States. Each of the fifty could have different requirements. Each country in which the organization does business can have different requirements, all different from the requirements found anywhere else. Sovereign countries have the right to insist upon such monstrosities being performed as the price of doing business within their borders, but it seems entirely wrong that the United States should not only have its own requirements as a condition of such permission being granted, but should be in the position of permitting its fifty subdivisions to do the same.

5. The apportionment formulas are also theoretically unsound, and practicably distortive, because they are indifferent to peculiar local impact of customs, laws, and regulations. For example, there are countries in which women with children are not permitted to work outside their own homes, with the result that there are cottage industry conditions, in which the labor force is largely categorized as independent contractors. Their compensation does not enter into the payroll factor. They are often quite capable of supplying their own sewing machines, for example, and do not use any equipment of the company for whom they work, so the sewing machines do not enter into the property factor. Hence the equipment they use, though it may be paid for by the employing corporation, and the compensation they receive, though it is geared to that received by salaried or wage-earning employees, will both be excluded from the factors (property and payroll) designed to prevent foreign income from being apportioned into California. The only role their operation will play in the factors is that the goods they produce will be shown as foreign sales. But even this will not be so if the sales of their products are sold within the group and ultimately end up as sales to customers in the United States, because inter-company sales are ignored. It is not uncommon, accordingly, for millions of dollars of income from the foregoing type of transactions being unrepresented in the foreign aspects of the allocation formula. The distorting effect, if the purpose of the formula is to attribute to California only the income derived from operations within it, is obvious. No attempt to defend it as a reasonable apportionment to California of the income it creates can possibly be made. But to object to it is to end up in court. Undoubtedly such cases are in court, but they have not reached final decision.

Another illustration is the local laws not uncommon abroad which in effect prevent an employer from discharging an employee. The result is that compensation may continue to be paid to such empolyees for what is essentially retirement purposes. Retirement pay does not enter into the payroll factor in the United States, but it can be made indistinguishable from compensation for current services rendered in such foreign countries, because the law requires that the employee be permitted to show up for work. If the only distortion that situation produced were in the payroll factor, it would serve to reduce the allocation to California because the out-of-State payroll would be inflated by something not found in the weighing of California payroll, but the economies of such countries have a way of adjusting themselves to such constant conditions, so that prices are higher and hourly rates are lower. The higher price received for the merchandise abroad may not be compensated for by a corresponding increase in the net profits. It is difficult to be certain that this type of condition operates adversely to the taxpayer who must report to California, but it clearly is a disruptive and distorting condition, which requires endless accounting and development of the facts at great expense, to root out.

More serious are varying foreign requirements concerning the determination of currently deductible expenses and depreciation. For example, some countries permit immediate deduction of the cost of machinery and equipment and provide no depreciation deduction for such property. Where that is so, the foreign income is reduced more than it should be in the year in which the machinery is purchased, but in later years the income is larger than it should be by California standards because there is no depreciation deduction, and furthermore there is no property investment shown in the property factor to draw income outside California.

The California or U.S. property, on the contrary, has been capitalized and continues to appear in the property factor. Hence the property factor becomes larger in terms of U.S. and California values than it should be and this inevitably draws more income into the taxing maw of California.

Theoretically it is possible to make the necessary adjustments so that California income will be calculated on California's concepts. Unfortunately, the cost of doing this is impossible to sustain, because it means that auditors trained in the California system must travel the world and reaudit every local operation of a worldwide organization to put them on a California footing. If California had the same majestic authority as the United States this might conceivably be at least theoretically supportable, but when it is recalled that California is but one of fifty States the obligation to do all of this to satisfy it seems to be more of an impertinence than a genuine obligation.

6. One of the significant and certainly the greatest distorting factor is that California allows no credit or deduction for foreign income taxes paid to the foreign countries in which the businesses operate. It is idle to pretend that the burden of income taxation is the same in the United States as it is in every other country in the world, and therefore the assumption cannot be made that there is substantial uniformity in the extent to which income is reduced by the tax burden. In some countries the income tax rate goes as high as 85 percent. In other countries there are tax holidays and there are no income taxes. California treats the income from both countries the same; it ignores the presence or absence of foreign income taxes.

It is obvious that a U.S.-based parent with foreign subsidiaries cannot hope to realize more from its foreign subsidiaries than the dividends it can get from the subsidiaries' net income. Since the foreign governments have the right to impose taxes on the net incomes of the foreign subsidiaries the parents cannot hope to realize dividends which ignore the tax burdens. California should not be in a better position to enjoy those net profits than the parent corporations, but it claims to be; it claims that they should report to California the net income before taxes and pay to California what is essentially an income tax on an income tax. By this is meant that perhaps 50 percent of the foreign pretax net income goes to the foreign government in taxes, but California insists that the entire 100 percent of pretax net income by taken into account in reporting to it, and its approximately 10 percent franchise tax is asserted on the pretax net income, thus increasing the effective rate by doubling it, and imposing a California income tax on amounts that actually are paid to the foreign countries in income tax to them.

Since each foreign country can, as has been said, establish its own rate of tax, and its own methods by which several taxes may be asserted at city, State and local levels, the effective rate of taxation from country to country can vary widely, and completely destroy any assumption that business done in one country is as profitable after taxes as in another country. California's assumption is, however, that all are alike.

B. There are a number of objections to the use of the so-called unitary consolidated formula which are peculiar to corporate groups headed by a foreign-based parent (foreign multinational).

1. Foreign law controls the parent corporation and its non-U.S. affiliate, and California law must necessarily be subordinate to the demands of foreign law of the country of domicile. In addition, it is subordinate to the foreign law of the countries where subsidiaries operate. This can affect the availability of information of the type California's statute and regulations call for if the consolidated unitary formula is to be used.

a. Accounting requirements and standards for the entire group will ordinarily be determined by those of the country of the domicile of the parent corporation. However, the group must also follow the accounting requirements and standards of the country in which their subsidiaries operate. These can differ from California practices in the following respects: first, local law may permit deductions for purchased assets which differ in two different types of respects from California's procedure, one of which is the rate of depreciation, because foreign countries are usually more liberal with depreciation standards than is customary in the United States, and also the frequent allowance of a current deduction for a new plant or equipment in it instead of requiring that the expenditure be capitalized and recovered only through depreciation. Either requirement will have two distorting effects on the formula: first, the foreign property will be shown at a smaller figure than comparable California property, either because it has been entirely deducted at the time of purchase or because the rate of depreciation causes it to disappear from the balance sheet more rapidly; if the foreign parent makes a strong effort to comply with California's requirements it will seek to make adjustments in its net income and in the balance sheet accordingly, but this probably is a rare and exceptional adjustment.

A second type of differing requirement is the use of cash basis instead of accrual accounting, and in different concepts of how inventory accounting is to apply. It is quite unlikely that every country in which the group operates will employ methods like those employed in the United States for tax purposes, and if the parent uses its power to enforce uniformity it will be to satisfy the law of State of domicile and not the law of California. The result will be that the net income and the property and the sales will not be shown in foreign operations on the basis which is consistent with that which is shown in California operations. Finally, the rules of foreign countries on the taxability of nonrepatriated funds will influence the net income shown by the parent corporation for tax purposes and in its reports to its shareholders, and they will almost certainly differ from those California employs, because California does not recognize that funds not yet repatriated can be excluded from reported income.

b. The foreign parent corporation is often prohibited by the law of domicile from reporting to California some of the information California needs for the application of its formula. If it is engaged in defense work it will likely be prevented by law from making any information at all available to a subdivision of a foreign power concerning its defense contracts, products made thereunder, and costs, plants, and payroll. Yet California may regard that portion of its business as unitary with the portion done in California, and insist upon compliance with California law requiring reporting of that information. There is headlong conflict between the two laws and obviously the law of domicile must control the conduct of the foreign parent.

Either California must waive its requirements or guess, and then the foreign corporation is prohibited by the law of domicile from coming to court and disproving California's guesses. Not only is the result unfair, but it is something which United States law, being also a law of domicile, should appreciate as improper and should prohibit.

c. Frequently the payroll figures and the figures for rental of real property, paid by the subsidiaries operating in other countries than the State of domicile, will not be known to the parent corporation. In many countries of the world such figures are not reported to local governments, and therefore are not segregated in reports made or in records retained. The requirement to disclose the information may be 5 or 6 years after that year has terminated, and figures will no longer be available.

2. California's statute not allowing the deduction of foreign taxes based on or measured by net income produces hardship which has been discussed in the earlier division of this memorandum, to which it is equally relevant. There is, however, an additional hardship imposed when the parent is based in another country. It will be required to reconstruct for California's benefit the taxable incomes of its subsidiaries, which may be known to the parent only to the extent that there is something left over after paying foreign taxes. A U.S. parent whose stock is listed on an exchange will require that information be made available to it in order for it to properly report to its shareholders, as a requirement of the United States law, but the foreign parents have no such legal requirement enforced by the law of domicile, and hence may not require that information of the subsidiaries. They are unlikely to require it merely because California wants it. Moreover, they should not be required to provide it merely because California wants it.

Moreover, there is a wide variation in foreign taxes. The value added tax is allowed as a deduction by California law, and franchise or other taxes measured by net worth or assets invested are allowed as deductions. Some countries, or their political subdivisions, have triangular taxes, in which the tax actually paid is measured by net income only if that tax is greater than the tax that is imposed if measured by gross payroll or by property invested. In those years in which one of the two alternative measures produces a higher tax than the net income measure, the tax is not measured by or is not on that income and therefore it is deductible, but in the year in which it happens to be measured by net income it is not deductible. This is a quixotic result, which obviously can cause a pendulum movement of the foreign income which is not related to the income produced in California in the slightest. It is difficult to think of the slightest excuse except arbitrary statutory provision for such distinctions when they are the result of foreign laws, obviously not adopted in order to increase or decrease California's taxes.

3. The domestic subsidiary is the one which must deal with California. California imposes the tax on it even though it is measured by an apportioned amount of the foreign group's net income. The domestic subsidiary cannot force the foreign parent to revise its accounting system or release prohibited information in order to conform to California law. The foreign parent should not be forced to make a choice between revealing information prohibited by local law and sacrificing its California subsidiary to California taxes exceeding the correct amount. It is not good public policy for the United States to tolerate such conduct from one of its political subdivisions.

4. The entire area of California or other State taxation of domestic subsidiaries of foreign based parent corporations is permeated with foreign policy considerations. California is not supposed to make its own foreign policy; indeed, it is not supposed to have an independent foreign policy. It is prohibited by the United States Constitution from entering into treaties with foreign countries. Its policies must necessarily yield to the foreign policy of the United States. If it is the foreign policy of the United States to permit foreign-based parents to form subsidiaries to operate in the United States, in consideration of the foreign countries permitting subsidiaries of U.S. based parents doing the same thing, then it is, or should be, U.S. foreign policy not to permit taxation of the income of those foreign parents by States in circumstances in which the United States itself does not do so. If there is no permanent establishment maintained by the foreign parent in the United States it is not subject to the demands of the United States, and the States should be similarly bound.

The States contend that they must be left free to use their unitary concepts with foreign groups because the foreign groups will cheat in reporting taxable income to California and this cheating will not be disclosed by the fair price method and Internal Revenue Service administers under section 482. If California is right that the foreign groups will cheat, then it has not found the remedy for this in its unitary system. A foreign corporation that plans to cheat California can do it just as effectively under the unitary method as any other. California is helpless, where the headquarters of the multinational corporation is in a foreign country, to verify the figures the foreign parent may choose to submit to California.

It has no power to make an audit in the foreign country, and it must be assumed that if a foreign parent plans to cheat it will be intelligent enough to close the doors to the franchise tax auditors in order that it might cheat without getting caught. It's true, of course, that California can have the same access to published reports to shareholders of foreign parent corporations that it has with respect to U.S. based parents, but it can do so only when such reports exist. Many influential and successful foreign corporations do not publish annual reports because they are privately held and are not listed on exchanges. In some countries the type of report California is accustomed to thinking of is not required by law even if the foreign parent's stock is dealt with on exchanges. It is a safe assumption that many large foreign parents can give California any tax or figures it chooses to without any likelihood that California will be able to make an effective audit to verify or correct the figures submitted.

The domestic figures will be known, presumably, but the property, payroll, and sales in foreign countries will not be known, frequently, and even the net income will not be known. If the foreign corporation wishes to report them to California and wishes to report them to California as figures designed to produce the smallest tax possible, California will either not know or will not be able to verify its suspicions.

By contrast, California's having the availability of Federal enforcement and administration of the fair price method is a much more secure assurance for California. Because the wide and varied type of foreign figures are not relevant to administering the fair price method, the administration of the system is concerned with fewer facts and figures which are suspect and which might be fabricated. Furthermore, it is more likely that a foreign corporation will be more impressed by the might of the United States than the might of California, in determining whether or not to respond to demands for information to permit the taxes to be verified.

It can be seen, accordingly, that the complaint of California that it will be given fictitious figures if it is not permitted to use the unitary system will not withstand analysis. It has less likelihood of being able to make the verifications it needs of the information required for a proper administration of the consolidated unitary system that it needs to administer the fair price method, particularly in the light of the assistance it can get from the Internal Revenue Service in the administration of the latter system.

C. The following is a checklist of the differences between foreign countries and business conducted in them which the consolidated unitary formula ignores.

1. *Differences in languages.* This makes international institutionalized advertising both difficult and ineffective, and even makes trademarks and tradenames of limited international value. As an example, the well-known United States name, Scholl, is prounounced School in the United States and Skoll in Great Britain. Moreover, language differences make transferability of personnel of limited use in a multinational corporation, and makes uniform training manuals useless unless they have been translated into different languages. However, they also run up against differences in customs, both religious and social.

2. The differences in custom are apparent in the business of making phonograph records. A multinational phonograph record company will find itself making different records with different performing artists and different tunes in Turkey than in Denmark, and in Greece than in West Germany. There will not be the universality of product which the unitary system assumes exists. Nor will there be the savings obtainable from economies in scale when an international product can be made to a single standard and universally merchandised.

The same is true of cosmetics, although perhaps not to the same degree. Some skins are dark-complexioned and others light; some skins are oily and others dry; some hair is characteristically brunette and other is predominantly blond. An international manufacturer and purveyor of cosmetics will therefore find itself making different products to purvey in different countries, and will be advertising accordingly. There is not the international universality that cosmetic advertising in the United States suggests is the case here.

Advertising media differ in different countries. A successful jingle in the United Kingdom may, on being translated into a foreign tongue, be offensive to the people of several countries. Television may be a highly successful medium in the United States and in Great Britain, but is of limited use in mountainous countries and countries with characteristically low incomes. Newspaper advertising is of value in countries with a high degree of literacy and useless in countries of high illiteracy. Some countries discourage billboard advertising along roads and highways and others make no effort to regulate it or prevent it, and the variety of conditions will produce entirely different forms and customs in the differing countries.

These considerations mean, accordingly, that the task of appealing to the public is not one which can be successfully dealt with from the offices of an advertising agency on Madison Avenue or a corresponding location in London, or Dusseldorf. The idea that international corporations sell their products by international means and therefore the expenses should be the same everywhere is simply not factual.

Moreover, different conditions require different products, as illustrated above with the phonograph records and cosmetics. In Europe farms are small compared to those in the United States, and in some countries are very much more hilly. This means that tractors will be different than they are in the United States, and so will harvesting equipment and even the rig which takes the product to market. A truck that would be used as a matter of course in the United States may turn out to be a horse-drawn cart for the small farmer near Innsbruck. Yet, the large U.S. manufacturer of farming appliances and trucks will be represented in Austria by products suitable for sale there, and to the California Franchise Tax Board those operations will be unitary with those conducted on the wide plains of the Midwest or California.

3. Tax administrators of an American State have difficulty realizing that foreign countries have customs duties to bar importation of goods from other foreign countries, if that importation interfers with the domestic economy. The existence of customs and duties puts an artificial limit on easy transferability of products between countries, and is a factor which must be taken into account in the design and manufacture of every product designed to be sold in several countries. In some instances this will mean greater domestic content. In other instances it will mean a reduction in horsepower or in weight, to avoid getting into a higher tariff level. In others a most favored nation clause will make the manufacture of a product in a less economic environment desirable in order to enjoy a lower rate of tariff when the product is exported into a particular country.

These and similar consequences of the existence of customs barriers means that the free flow of merchandise across political lines which exists in the United States does not exist outside the United States, and the heart of the unitary assumption, which is that the business will operate at substantially the same profit levels and with substantially the same interflow of product that is customary in the United States, is false in international business.

4. Each country has its own legal requirements concerning fringe benefits and social security taxes, because, as in the United States, these become subject to political influence and pressure. Foreign business ordinarily does not put those benefits and taxes into its payroll figures, and yet compensation treated as payroll will vary greatly accordingly to the amount of fringe benefits, employment security and retirement security that the employer provides either willingly or, by local custom, or taxation. Essentially the result is that the payroll figures need to be edited in order to be put on a uniform basis of measuring worker output.

5. Also, pay scales from country to country vary widely. Pay scales in Singapore encountered by the semiconductor industry approximate 10 percent of those rates prevailing in the United States and the Singapore worker is also skillful and reliable. There is not a great variation in performance, but a tremendous variation exists in pay scale. To measure both in terms of dollars without some adjustment is patently wrong, but California characteristically refuses to make that adjustment.

Moreover, even where pay scales are not greatly disproportionate in appearance they may be in fact because of great variations in the hours worked for the same pay, and in working conditions. In many foreign countries the coffee break

is unknown, but it is known in the U.S. In many foreign countries 44 hours and even 50 hours a week will be the basic work week so that the apparently similar pay scale will be for more work in the foreign country than in the United States. These examples can be extended almost indefinitely.

6. There are differences in mark-up in sales to different countries, and in the sales of goods manufactured in different countries caused by customs accommodations, import agreements, and the hazard of doing business in the destination country. These mark-ups should and ordinarily do produce higher profits, but the equalizing effect of the formula disregards the source of the profits and instead reapportions them out according to sales, payroll and property. It is obvious that if the mark-up is 20 percent instead of 10 percent fewer sales at the 20 percent mark-up will produce a higher profit than larger sales at a 10 percent mark-up. This is an illustration of what the California formula conveniently ignores.

CONCLUSION

There is universal condemnation of the type of consolidated unitary apportionment of net income California employs, in the ranks of those who do business between the U.S. and foreign countries. There is no more admiration for the system in the case of U.S.-based multinationals than in the case of foreign-based multinationals. The basic conditions producing distortion in the use of the formula are the same, whether the parent be based in the U.S. or abroad. The differences that exist between U.S.-based parents and foreign-based parents are that the information California requires is more likely to be available for the U.S.-based parent to supply than for the foreign-based parent to supply.

However, the foreign-based parent is in a better position to take self-help, if it is the kind of taxpayer the franchise tax board's arguments in defense of its system imply. The franchise tax board's contention is that multinational corporations cannot be trusted to provide proper and correct figures to it, and therefore it cannot have the facts it needs to make an accurate determination of how much net income the business actually derives from California. However, everything which it says is equally true, particularly with a foreign-based parent, of the employment of its formula. If the assumption is made that the foreign-based parent is going to supply California with false or fictitious figures in order to avoid its taxes, it has at least an equal opportunity of doing that under California's consolidated unitary system.

It is suspected that the real reason California has such a zeal for this system is not the reason mentioned above, but that is produces more taxes because it allocates more income to California than any other method. In analyzing this possibility, the fact should be borne in mind that the foreign-based taxpayers do not have representatives in the California Legislature, and neither do the corporations headquartered in other States than California. Imposing taxes on foreign interests that have no realistic recourse to the California Legislature in which to complain can readily be regarded as a safe and popular way of raising revenue. However, the old concept behind lodging supremacy in the Congress to regulate interstate and foreign commerce was because of those local tendencies and fear that they might interfere with commerce unduly. This is what is happening through the consolidated unitary taxing system, and that system should be regulated by the Congress to the end that income earned outside California should not be taxed by California, and its taxes should be measured only by the income the business group has succeeded in earning out of its California business.

---

[4] Quoted from Hellerstein, supra, 21 Nat. Tax J. at 495.

Prepared Statement of Mark G. Ancel

Mr. Chairman and members of the committee, I appreciate the opportunity
which has been given to me to testify with respect to the problems inherent in
the unitary method of apportioning income derived from the activities of corpo-
rations conducting business, both within the State of California, while at the
same time conducting business within other States and within other countries of
the world. I intend to direct my remarks to the area of the administration of
such tax, from the viewpoint of the State and of the corporate entities involved.

Before proceeding into this area, however, I would like to set forth my back-
ground. I am a lawyer and a member of the firm of Baker, Ancel, Redmond &
Hall. The firm maintains general practice in Los Angeles, California. I have been
a member of the American Bar Association and of its section of taxation for
approximately 15 years and have participated within that section as a member
of the committee on state and local taxes. As a member of that committee I
have been its assistant chairman, chairman and special advisor over a period of
6 years and, among other matters, have concerned myself with problems involved
in taxation of businesses engaged in interstate and foreign commerce and with
the proposed convention between the Government of the United States and the
United Kingdom in respect to paragraph 4 of article 9, since reserved by the
United States Senate.

I have also participated as chairman of a panel for continuing education of the
bar proceedings involving California corporate and personal income taxes and
sales taxes. I am currently chairman of the State and Local Tax Committee of
the Los Angeles County Bar Association, Section of Taxation. A substantial
portion of my practice is in the area of State and local taxation. While my firm
represents a number of clients who may be affected in one manner or another
by any legislation which may be forthcoming, as a result of the committee's in-
vestigation, my appearance is solely my own action undertaken in the hope that
I may be of some aid to the committee in identifying some of the problems which
I believe to be inherent in the California unitary approach to business conducted
on a worldwide basis. I am not speaking on behalf of any particular client nor
on behalf of any particular business group or bar association. I now have, and
have had from time to time, various matters before the California Franchise
Tax Board which do involve the problems of worldwide combination and appor-
tionment under the California unitary approach. However, I speak in my private
capacity as a citizen of California on the basis of what I believe to be some
knowledge and experience in the area.

I consider it my duty to and I do support those efforts which are made to
protect the public revenues of State and local government by adoption of appro-
priate taxing statutes.

However, it is my belief that in the area of worldwide combination and
apportionment utilizing the unitary approach, California, for the reasons for
which I intend to set forth in greater detail, through the action of its adminis-
trators has intruded into areas which are those of the Federal Government and
which should be defined by the Congress. I also believe, in light of my experience
as a lawyer, and in light of the desire that the President has enunciated to
encourage activities having to do with export of goods, that the California
approach, in the long run, will be detrimental to its revenues, to the creation of
jobs for its citizens and will breed retaliation which may affect the exportation
of goods.

First, as a practical matter, the determination of measure of income, places a
great burden upon the auditor. How is he going to verify the situation with
respect to corporate parent and subsidiaries of corporate groups conducting
business on a worldwide basis? The auditor has to make a determination, in the
first instance, as to whether or not there exists a unitary group. In this area,
depending upon the particular auditor involved and based upon the form of
questionnaire which is often times presented to the domestic subsidiary here in
California, a determination involving literally hundreds of thousands of dollars
is made depending upon how the questionnaire which is filled in by the domestic
subsidiary is viewed by the auditor and his supervisor.

Having made this determination the auditor is then going to be required,
based upon the various financial reports of the parent, and based upon the books
and records of the subsidiary, to reconstruct the net income of the unitary group,
not in accordance with what the foreign parent may have followed by way of
accounting standards imposed upon it by the law of its domicile, but in accord-
ance with accounting adjustments made to conform profit and loss statements
to those utilized in the United States and to those accounting methods reflecting
the provisions of California statutes and the regulations thereunder.

In this regard, the income of the unitary business shall be determined on the
basis of profit and loss statements prepared from the books of account regularly
maintained by each corporation for the purposes of accounting to its share-
holders. Consider, for instance, the possibility of obtaining the books and records
of a corporation with a home office in Australia or Japan and with subsidiaries
who not only do business in California but also in other States of the United
States and in other countries. Or, consider the obtaining of the books and records
of a closely held foreign parent. The mere gathering of this information can be

a very onerous burden and it does not seem to me that the administrative personnel of either the State or of the taxpayer can afford the time or the energy to look into this particular question. The domestic subsidiary, on the other hand, will have books and records prepared under the procedures of the forum which accurately reflects its domestic activity.

In addition, the application of the unitary method, particularly where the foreign parent has a more profitable operation than its United States subsidiary, at least in the mind of the foreign parent shareholder, and pragmatically, submits to California income taxes profits as to which California has provided no benefit, no protection and no expenditures. It injects a concept, totally foreign to most countries whose central government provides the standard of taxation, which is here deemed to be within the jurisdiction of the fifty States.

Furthermore, by necessity of the limited personnel with which the taxing authorities work, and the statutes having to do with what items are to go into the property, payroll and sales factors, section 18 of the Uniform Division of Income Tax Purposes Act (UDITPA) which permits the utilization of a formula other than the three factor formula in the interest of fairness, in the case of the taxpayer, is virtually ignored. It would seem that in the area related to business on a worldwide basis, with modern and sophisticated accounting, such a section is particularly applicable. That section, which California has adopted, provides that if the allocation and apportionment provisions of the act do not fairly represent the extent of the taxpayers activities in the State, the taxpayer may petition for, in respect to all or any of the taxpayers business activity, if reasonable, separate accounting, the exclusion of any one or more of the factors, the inclusion of one or more additional factors which will fairly represent the taxpayers business activity in the State, the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayers income.

In point of fact, when the taxpayer suggests that the activities as to which it keeps records on an arm's-length basis, demonstrate and fairly measure the profits ascribable to California, and that the three-factor formula is unfair for a particular reason, it is impossible to have the California administrator utilize the provisions of section 18.

In situations where a foreign parent has shipped goods to its subsidiary and such goods are on the high seas and are destined not just for California but for other jurisdictions, the administrators because of the California regulations, take the position that such goods must be included in the property factor portion of the numerator attributable to California. In this context there is a substantial possibility that the provisions of the Commerce Clause, the Import-Export Clause, those clauses relating to the power of Congress to regulate commerce among the United States of America and foreign nations, the Supremacy Clause and the Treaty Clause are violated.

Another area where the administrator has refused to exercise discretion has to do with the foreign parent. If it is one which has been in business for a substantial period of time and acquired its physical assets some time ago and yet has acquired California distribution facilities at a comparatively recent date, the California property factor would seem to be higher than it should in relation to foreign assets, which theoretically are producing profits at the same equal rate as the California assets, unless some type of a provision exists to determine fair-market value of the overseas assets based upon the same relative situation as that which exists in point of time in California.

I think that the problem is illustrated by a tentative franchise tax board memorandum for discussion, in which the staff of course recognizes the differences in various foreign accounting practices and States in connection with valuation of assets that any accounting practice which results in the systematic under valuation of assets or over valuation of liabilities shall not be given effect, even though expressly permitted or required under foreign law, except to the extent that the California statutes permits such activities. Also, it may be that in capitalizing rented property, at eight times its annual rental rate and in translating inventory valuations at the rate of exchange as of the end of the income year, there may not be represented what is an appropriate rate of return, since the rate of return could be substantially greater or less in the foreign country or in California.

The foregoing discussion is without regard to an economic determination as to how the facilities of production located in a foreign country are to be weighed with respect to the valuation of a warehouse in California which may be but a temporary station for the journey of goods into the other western States. In point of fact, companies seeking to locate distribution facilities, within the State of California, would probably be better off locating such a facility in some other State not engaged in worldwide combination, thereby minimizing the property factor in the California numerator. The net effect however, of the three factor formula is to preclude business activities within California in connection with the construction of additional facilities. The specter of having all worldwide income apportioned on the basis of a much larger property factor because of the fortuitous location of the warehouse in California simply does not make sense.

Furthermore, it has been an extremely difficult matter to obtain from the parent company data which is to be examined in a reliable manner both by the California representative of the taxpayer and by the auditing authorities. After one obtains the information, how are the accounting concepts utilized, say by French or Italian parents to be harmonized with those which California, under its statutes, requires?

Suppose payment of foreign income taxes are made by the parent, where the three-factor formula is not followed? Are we not going to run into a problem in recognizing the payment of foreign income taxes or income taxes of the equivalent of our State government by the foreign parent? Would not double taxation result if an appropriate adjustment is not made to recognize after tax income? Certainly, in my experience, there has not been such an adjustment made by the California auditor.

In connection with the inclusion in the California numerator of sales assigned to California, how does one explain to a foreign parent whose subsidiary sells goods to a State which does not provide for a tax on the seller that the sale will be thrown back to California from which its subsidiary shipped the goods? It is difficult for the parent to comprehend the throwback rule, if the goods have touched a California port and have gone to a State which would not tax the seller, that the California sales factor will be increased by the extent of the value of such a shipment. Certainly where the goods go from the California warehouse to other States, the regulations require their value to be included in the California property factor. I think that the ill-will produced by this type of an approach can only hurt American manufacturers when they seek to increase exports.

There also appears to be no adequate remedy for the foreign parent or for the domestic subsidiary whose income measurement has been substantially increased as a result of an audit determination which has combined and apportioned the worldwide income of the parent, the subsidiary and possibly a number of sister corporations. What does one tell the foreign parent with respect to the fact that as a result of activities, in a State, other than California, that State seeks to combine income by reason of activities undertaken by a domestic subsidiary of the foreign parent and California also proceeds with its audit and comes up with a different result. Being a member of the Multistate Compact, one would think that California would be bound by the arbitration provisions of the compacta. However, California is not bound by the arbitration provisions of the compact, having, as an express condition of joining, refused to arbitrate tax disputes.

The remedies which exist for either the parent or subsidiary within the State of California in the event there is a dispute, are in my opinion, illusory. Under the California procedure, after the notice of additional tax proposed to be assessed has been sent, the taxpayer may file a protest within 60 days from the date of the notice. Otherwise, the proposed assessment becomes final at the expiration of the 60-day period. After the taxpayer has completed the informal franchise tax board conference, he may proceed to the State Board of Equalization and thereafter into court de novo. Such procedures, in my experience generally are unsatisfactory but prudence requires that the administrative procedure be undertaken.

The taxpayer is then relegated to the local superior court, thence to the court of appeal and to the California Supreme Court. The time for the court determination may take 3 years or more. It seems, under the circumstances, that there simply does not exist a plain, speedy, or adequate remedy which can be utilized by the foreign parent or domestic subsidiary. Therefore, because of the factual and constitutional questions involved, which arise out of worldwide combination and apportionment, and because of the inability under the Multistate Tax Compact to obtain a binding arbitration in the case of California (or should there be a State which is not a member of the compact which seeks to compel worldwide combination and apportionment) there must be a forum which does not require the taxpayer to run from State to State and to various administrative bodies or courts, but which permits the taxpayer to go directly into a Federal court, and to obtain a determination which is binding upon all States which may be involved and which is speedy and which keeps the cost of litigation to a minimum. This is one of the reasons why, no matter what ultimate determination is made in terms of legislation, it is my belief that provisions akin to title IV, section 401 and 402 of S. 2173 must be adopted. The time limits provided in section 401, seem to me to be reasonable and the de novo features would give the court a chance to make a homogeneous body of law. If, there is need for uniformity of approach with respect to the 50 States of the Union, a forum must be provided for the subsidiary and the parent where one action can affect all jurisdictions.

In conclusion, I think that the problem of worldwide combination and apportionment can be summarized as follows:

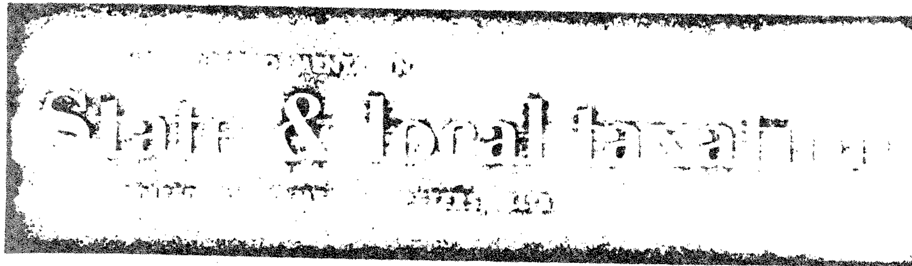
1. The legitimate concern of the States with the collection of revenue should not permit worldwide combination and apportionment because it interferes with the foreign policy and economic policy of the United States;

2. The preparation of the reports which are required to make even a cursory determination of whether or not the operation is unitary and the amounts involved to be combined are onerous and require an undue expenditure of time, effort and money. There is not a homogeneous worldwide approach to accounting and financial practices and taxation and foreign and domestic income items cannot be correlated with accuracy;

3. Formula apportionment of itself without the application of section 18 of UDITPA, which has never, at least in California, been permitted, results in substantial distortion because of differences in results which are not attributable to California activities, different wage rates, different productivity, differences in cost of plant equipment and inventory, currency conversion rates and failure to recognize foreign taxation;

4. Foreign parents and their subsidiaries generally deal at arm's length and seek to provide substantial capital equipment and other items, which go into the California numerator here within California, in order to create a viable operation. If the activities are not at arm's length, an appropriate adjustment between parent and subsidiary can easily be made by way of analogy to section 482 of the Internal Revenue Code, see section 18 of UDITPA. In fact, California in certain circumstances, utilizes the 482 approach where for instance, a joint venture on partnership does not provide the 50 percent ownership interest.

I hope, Mr. Chairman, that the view which I have expressed will be considered because I am very much concerned that there exists a real risk of double taxation of foreign income under the unitary theory which will increase the cost of doing business abroad for domestic parents and which will hurt my state and its citizens through the inhibition of a foreign parent establishing plant or activities within this state for fear of increasing the California factors which go into the numerator. I also believe business with foreign subsidiaries will become less and less competitive with their non-American counterparts, basically because of determinations made by tax administrators in an area which, I think, is basically impossible of administration by State authorities. I think that in the long run, California's tax base will be reduced because of the approach which its administrators follow in the area of worldwide combination and apportionment.



California franchise tax: combined income report affects foreign companies

by ROBERT A. PETERSEN

California is the leading state that requires controlled corporate groups to file combined reports, including not only their U. S. activities but also their worldwide operations. Mr. Petersen discusses the use of the unitary reporting concept as it applies to corporations organized under the laws of foreign countries.

THE CONCEPT OF UNITARY OPERATIONS has been expanded in California since 1936, almost unilaterally by the Franchise Tax Board. The aggressive application of the concept to multinational corporate groups whose parent company is in the United States has come within the last eight years, and it is just within the last three or four years that the concept has been applied to multicorporate groups whose parent is outside the United States. The application of the unitary concept and the effect of formula apportionment has not been tested yet in a court case where the unitary group involved entities organized under the laws of foreign countries.

Unitary operations

The first item to be considered in determining whether there is a unitary group of corporations for which a combined report may be required is the matter of ownership. The present rule in California is that there must be common ownership, directly or indirectly, of more than 50% of a corporation's voting stock before its income will be included in a combined report. However, on September 14, 1970, the California State Board of Equalization concluded in the *Appeal of Signal Oil & Gas Company* that control over operational matters, even where a corporation lacks a majority stock interest in its affiliate, will result in the affiliate's income being included in a combined report.[1] Control arrangements similar to that considered in the *Signal* case are not uncommon with respect to multinational businesses. Frequently, because of law in the various countries in which a business operates, the majority stock of the corporation operating in that country must be owned by nationals of the country. While the company may not own a majority of the stock, it exercises its control through operating agreements, placement of management employees, etc. Such arrangements may be sufficient for the state or the taxpayer to overcome the more-than-50%-ownership test.

Presently there is a case pending before the California State Board of Equalization for its decision if an exactly 50% owned subsidiary can be included in a combined report as sought by Revere Copper and Brass. Since the subsidiary is owned by two corporations, each controlling 50% of the stock and operations, there is no evidence of indirect control. Revere has sought to include 50% of the subsidiary's income as well as 50% of each of its sales, property, and payroll factors in the combined report filed by Revere.

Normally where there is direct or indirect control of the operations of a corporate member of a controlled group, all of the income of the controlled member and all of its apportionment factors will be included in the combined report even though there may be minority shareholders totally unrelated to the interest.

Assuming the requisite ownership, then there are two general tests to be applied in determining if affiliated companies may be treated by California as unitary:

1. The operation of the portion of the business done within the state is dependent upon or contributes to the operation of the business without the state[2] or,

2. There exists a unity of ownership, operations, and use.[3] If either of these tests are met, albeit the distinctions may be minor, California taxing authorities may deny the right of a separate accounting of the companies and instead impose one apportionment factor on the worldwide business income of the unitary group. In practice, if the ownership test is met, the taxpayer usually has the burden of showing that the "contribution or dependency" or "three unities" tests are not met.

Should the income of corporations foreign to the United States be included in a combined report? Mr. Frank M. Keesling, who is frequently considered to be the father of the combined return concept used by California which was engendered during his term as Counsel to the Franchise Tax Board, has answered this question with an emphatic "yes." He would rely on the apportionment to the various states or countries in order to fairly reflect income. While one may perhaps concur with his statement that the mere place of incorporation is not significant, the apportionment of income using a formula developed for use in the United States where business operations and the economy are somewhat uniform may not be a workable solution for companies operating under the laws of governments with entirely different business philosophies and practices and where the economies are substantially diverse.

In applying the two above-enumerated tests of unitary operations, the Franchise Tax Board frequently refers to specific characteristics as considered by the California Supreme Court in *Honolulu Oil Company*, 60 Cal. 2d 417, 386 P.2d 40 (1963), which include:

1. Centralization of management
2. Control of accounting
3. Use of the same auditors, legal counsel and other professional advisers
4. Economies in the purchasing of insurance, supplies and equipment

This list is not all-inclusive. Perhaps a review of the items which the Audit Coordinator of the Multistate Tax Com-

mission, Mr. Frederick P. Cappetta, suggests be obtained by the state tax auditors for purposes of determining the unitary nature of business operations would be helpful.[4] This includes:

1. The following information as to each entity:

A. Date acquired

B. Date merged, dissolved or sold

C. Percent of ownership or control

D. State of incorporation and date of incorporation

E. Names of officers and directors by corporation and year

F. Nature and description of principal business activity

G. Location of operations

H. Manner in which products are marketed

I. Location of accounting records

2. A description of the connection which existed during the audit period between the parent and the subsidiaries and among the affiliated subsidiaries themselves. It is suggested that the auditor seek specific information as to the following:

A. The extent to which operations are unitary as evidenced by centralized: i. Management; ii. Operational supervision; iii. Accounting; iv. Purchasing; v. Advertising; vi. Insurance; vii. Financing; viii. Physical facilities; ix. Research and development activities; x. Preparation and payment of taxes; xi. Legal services; xii. Sales force; xiii. Public relations; xiv, Employee benefits; xv. Budget preparation; xvi. Equipment leasing;

B. The extent of unitary use of: i. Centralized executive force (a. Board of directors, b. Officers); ii. Interaffiliate transfer of personnel (disclose job descriptions and job titles); iii. Master contracts for common customers; iv. Tradenames and trademarks; v. Common patents; vi. Government contract negotiators.

C. Product similarities

D. The amounts of total sales or business done and the amounts of sales to and from affiliated corporations, by year and products involved.

E. The extent to which any of the aforementioned unitary features are evidenced by service charges or royalty and license or other payments, showing the year and the amounts from and to the respective corporations.

The above information is compiled to answer the single question whether one member of the group contributes to or is dependent upon another member of the group. In practice those states which aggressively pursue the use of a combined report view the benefits flowing to or from controlled corporations broadly.

Lack of available information

As a practical matter, certain of the information requested by the Franchise Tax Board auditors will not be available with respect to multinational corporations. This is particularly true where the parent company is located abroad and information with respect to the worldwide operations is not made available to the United States affiliates. Although the lack of information on which to prepare a combined report is not a defense, it does present a practical problem for the Franchise Tax Board with respect to foreign-based multinational corporations. Certain foreign parent companies have refused to answer any inquiry by the Franchise Tax Board even insofar as a response acknowledging the receipt of the inquiry. Others have asserted that it is against their corporate policy to make the information available to the United States concerns, and in some cases, it is argued that the information may not be disclosed because of foreign laws.[5] The lack of information barrier is not as impregnable when dealing with a parent company in the United States, since the U. S. parent company has the necessary control to obtain the required financial information. In addition, the U. S. parent with foreign subsidiaries may be required to file information with the Securities and Exchange Commission, and information returns with respect to the foreign operations must be filed with the Internal Revenue Service.

The California Franchise Tax Board is resourceful and imaginative in developing sources for obtaining worldwide financial information for foreign-based multinational groups. They will seek whatever financial information is available in an attempt to prepare a combined report including worldwide operations even though there may be some question as to the reliability of the data it has obtained. For instance, if the foreign parent company is publicly held and therefore required to issue financial statements similar to that required by the Securities and Exchange Commission in the United States, the auditors will use this information in lieu of more precise information which is not made available. Similarly, there have been instances where corporate histories have been sought and obtained for the financial information which is usually included and for use in proving the unitary concept. Generally, however, the Franchise Tax Board has failed to recognize that the economic unit for which financial statements are prepared is not the same as the sum of its separate operating entities. The fiscal structure of the individual operating entities is tailored to the needs of the business giving due weight to the industry in which it operates, the laws with which it must comply, the financial resources committed to it, the risk to which investment is exposed, and in fact the sales, payroll, property, income and other taxes which it may incur. Taxes and profits seem to be more closely related to the fiscal structure and results of individual business units than on the economic results of the group as a whole apportioned among geographic lines.

Statements in a published annual report may be quite damaging to a defense against combined filing if they publicize worldwide markets or sources of raw materials through affiliated companies. In addition, summaries of the financial or management benefits derived through international trading among members of the group or the training or transfer of personnel will be used by the tax authorities to support the unitary attributes of the controlled group. Published statements of management intent in relation to past, present and future operations may later be regretted by the taxpayer when arguing with tax authorities. Remember that the unitary control may be horizontal through brother-sister corporations or vertical as in the parent-subsidiary relationship. Although there have been rumors and threats of arbitrary assessments based on the failure to provide information to a state taxing authority, we are not aware of any such instance where this has yet occurred.

The obvious problem with a taxing jurisdiction using the "best information

[1] Also see the *Appeal of Shaffer Rentals, Inc.*, (Calif. SBE 9/14/70) for a similar holding where control was indirectly achieved through a group of individuals.

[2] As used by the California Supreme Court in *Edison California Stores*.

[3] As defined by the U. S. Supreme Court in *Butler Brothers*, 315 U. S. 501 (1942), *aff'g*. 17 Cal. 2d 664.

[4] As published in the *Seventh Annual Report*, Multistate Tax Commission for its year ended June 30, 1974.

[5] As one example, the Canadian province of Ontario has enacted laws restricting such dissemination of corporate fiscal information.

available" approach is that the information compiled from public sources may not be prepared in a manner consistent with the Revenue and Taxation Code of California. The accounting principles used for determining income throughout the various countries of the world are not necessarily similar and, for instance, there is considerable variance with respect to the recognition of capital cost recovery allowances (depreciation). Nevertheless, such secondary source information will be used if primary information is not available.

Alternative formulas

It is recognized that the three-factor formula generally applied by the State of California under the Uniform Division of Income for Tax Purposes Act adopted in 1966 may result in some distortion of income for particular industries or specific economies. Thus, special apportionment formulas have been derived for air transportation companies, motion picture and television film producers and television network broadcasters, franchisors, and construction contractors. The California Revenue and Taxation Code, Section 25137 and the Regulations thereunder, provide that the Franchise Tax Board may require, or any taxpayer may petition the Franchise Tax Board, for the use of a special formula if the allocation and apportionment provisions adopted by the Uniform Division of Income for Tax Purposes Act do not fairly represent the extent of the taxpayer's business activity. Other choices may include:

1. Separate accounting.
2. The exclusion of one or more of the factors.
3. The inclusion of one or more additional factors which will fairly represent the taxpayer's business activity in this state.
4. The employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.

One illustration of the appropriateness of a special formula is a multinational business highly dependent upon hand labor in countries where pay scales are substantially diverse. Here an equitable resolution to the payroll factor may be the use of numbers of people rather than payroll dollars.

Taxpayers infrequently petition the Board for the use of special apportionment factors. The use of special factors should certainly be considered where appropriate, including the negotiation of a settlement with the Franchise Tax Board, even though the use of a special formula was not requested in advance.

Recourses available

What recourse is available to the foreign-based multinational company faced with a combined reporting problem in California? The California State Board of Equalization, which is an elected Board to hear appeals from decisions of the California Franchise Tax Board, has clearly indicated its opinion that controlled foreign subsidiaries or affiliates of U. S. based groups may be included in a combined report.[6] The California courts have apparently not considered this specific question, although in *Chase Brass and Copper Co.*, to Cal. App. 3rd 496 (1970), *appeal dismissed, cert. den.*, the court excluded the Chilean mining operations of a U. S. controlled group.

In *Chase Brass*, the California Appellate Court set forth no detailed reasoning for excluding the Chilean operations. The argument was made to the court that because of different economic circumstances in the two countries, the use of the apportionment formula would necessarily have been distortive. In Chile, for example, copper production is a labor-intensive industry involving underground mining, while in the United States copper production is capital intensive, using open pit mining. Based on the absence of an explanation of the reason for the court's decision in *Chase Brass*, the State Board of Equalization refused to exclude Chilean and Mexican mining subsidiaries from the combined report in *Appeals of the Anaconda Company*, Calif. SBE 5/11/72.

It is only a matter of time before one of the cases now in the appeal process involving a foreign parent company or a foreign subsidiary of a U. S. parent company will reach the California courts (see the following section on new developments). The Executive Director of the Franchise Tax Board has stated that it is the position of the Board that they will pursue the combined reporting approach just as far as the courts will allow. At best, the judicial remedy would only be available on a case-by-case basis over an extended period of time.

As illustrated in *Chase Brass*, judicial remedy may be appropriate for the multinational corporations that are arguing that the use of specific allocation factors cause a distortion of income and where these arguments can be sustained by sufficient, competent, evidential material. Too frequently we see decisions of the State Board of Equalization against the taxpayer where it states that the taxpayer has not carried the burden of showing that the formula apportionment is distortive. The fact that some distortion is possible is not an absolute argument. This is not a new approach. It was unsuccessfully argued in *John Deere Plow Co.*, 38 Cal. 2d 214 (1951), which was considered by the California Supreme Court. The following quotations from that decision illustrate the burden which is placed on the taxpayer:

"Plaintiff claims that the impropriety of the formula in question stems from its disregard of differences in both the expenses of operation and the productivity of income from the three factors of property, payroll, and sales in relation to its California business for the tax period involved. . . . [P]laintiff submits that its San Francisco house was not conducted so profitably as other jobbing houses in the national system. In this connection it refers to these conditions of variation from the national averages found by the trial court: that in 1937 'the San Francisco ratio was $6.76 in wages and salaries for each $100 of sales, whereas the average ratio for all included United States houses was $4.46,' a difference of almost 50 per cent; that 'in net tangible assets . . . the San Francisco ratio was $18.26 invested for each $100 of sales, whereas the average ratio for all United States houses was $6.76,' a difference of nearly 200 percent; that

. . .

" 'in selling and general expenses . . . the San Francisco ratio was $13.676 of such expenses for each $100 of sales, whereas the average ratio for all included United States houses was $8.781,' a difference of about 64 per cent. . . . In this state of the record showing 'proof of variations from the norm,' plaintiff maintains that the formula operates to distort the productivity of its California business and cannot work properly in resaonably reflecting the proportionate part of the unitary income attributable to this state.

. . .

"In the apportionment of a unitary

[6] See *Appeal of F. W. Woolworth Co.*, SBE, 7/31/72; *Opinion on Rehearing* in the *Appeal of Haubison-Walker Refractories Company* SBE, 2/16/72, and others.

business the formula used must give adequate weight to the essential elements responsible for the earnings of the income . . . and must not include income unconnected with the unitary business . . . but its propriety in a given case does not require that the factors appropriately employed be equally productive in the taxing state as they are for the business as a whole. Varying conditions in the different states wherein the integrated parts of the whole business function must be expected to cause individual deviation from the national average of the factors in the formula equation, and yet the mutual dependency of the interrelated activities in furtherance of the entire business sustains the apportionment process."

Given the right factual situation, however, the *John Deere* case may be distinguished in that it involved a highly integrated operation. In addition, it considered only the disparity of the economies within regions of the United States. Greater economic distortions may occur on a worldwide basis so that the factors of payroll, sales, and property, plant and equipment normally considered in an apportionment formula are not necessarily coequal measures of income producing activity.

For example, wage levels are considerably lower in Japan, Italy, or almost any other country than in the United States for the same work. In 1969, the cost of engineering work in Japan was only 70% of that in the U. S. (England was 75%, Holland 80%, France 90%). In 1972, the cost of skilled construction labor in Japan was approximately $14 per day including social charges. In Argentina, the cost was $7 per day. In England, it was $10 per day. In the United States, the cost is about $25 per day. An apportionment system which allocated twice as much income to California (U.S.) than to Japan because it costs twice as much to do the job in California produces a grossly distorted result. The income is not properly apportioned to local activities.

The same type of disparity exists as to the cost of plant or property. For example, it would have cost $241 million in California in 1969, to build an oil refinery to produce 125,000 barrels per day; the cost of the same refinery in Germany, however, would have been only about $190 million. Similarly, in 1964-70, the average investment needed to provide employment to one person in the rubber industry in the U. S. was $137,000, while an average of only $58,000 was required outside the U. S.

An apportionment of worldwide income based on property and payroll could never, under these circumstances, properly apportion the income to the local activities which produced it.

A second major reason why apportionment of worldwide income does not fairly reflect the income earned in California, is the unusual manner in which some industries are taxed by other countries. California would attempt to allocate worldwide *before-tax* income, but in the case of the oil industry, for example, the oil producing countries often impose levels of taxation which are substantially higher than that imposed by the U. S. or other industrialized countries.

California's use of revenues before tax in these situations would produce a major distortion of economic income since a vastly greater amount of income would be deemed to arise from foreign operations than actually could be retained by the producer.

The second approach which might be used by a multinational company is through the United States Congress. Legislation may be sought that is similar to that taken with respect to P.L. 86-272, which was enacted by the Congress in 1959. This law placed restrictions on states in taxing businesses engaged in certain limited activities of interstate commerce. The Congress has also shown interest in the multistate taxation of banks and financial corporations in asking the Advisory Committee on Intergovernmental Relations to suggest a uniform procedure for apportioning the income of banks and financial corporations involved in interstate activities. In addition, there is currently pending before the Congress a proposal to amend the Internal Revenue Code to exclude foreign source income from state taxation. This proposal would have the effect of limiting the combined approach as promulgated by California and other states to income earned within the United States.

The third and final approach may be through treaty negotiations at the international level. The U. S. Tax Treaty with the United Kingdom was signed on December 31, 1975 and has just been released. Article 9, Associated Enterprises, Parts (4) and (5) were specifically included to restrict the concept of combined reporting of unitary entities as asserted by the states. This section of the Treaty reads as follows:

"(4) Except as specifically provided in this Article, in determining the tax liability of an enterprise in a Contracting State, or in a political subdivision or local authority of a Contracting State, such Contracting State, political subdivision, or local authority shall not take into account the income, deductions, receipts or outgoings of a related enterprise of the other Contracting State or of an enterprise of any third State related to an enterprise of the other Contracting State.

(5)For the purposes of this Convention, an enterprise is related to another enterprise if either enterprise directly or indirectly controls the other, or if any third person or persons (related to each other or acting together) control both."

Presumably such language negates the right of a state to include the income or apportionment factors of a United Kingdom parent company in a combined report if the parent is not itself doing business in the state levying the tax and would likewise exclude the income or factors of a brother-sister company in a combined report where both the company subject to tax and the brother-sister company are subsidiaries of a United Kingdom company and the sister company is not doing business in the state imposing the tax.

The U. S. Tax Treaty with the United Kingdom has not yet been ratified by Congress. If ratified the treaty provisions should be effective as of January 1, 1975 with respect to the unitary reporting problems (see Article 28(2)(b)(iii)).

Current developments

There is now a case on appeal and scheduled for decision by the State Board of Equalization involving a combination of worldwide income of a group based in London. Oral arguments have been waived with the request that the Board decide the case based on the written record. The taxpayer's defense in this case challenges the facts developed by the examining agent and does not directly argue the concept of worldwide

[*Robert A. Petersen, CPA, is a partner in the Sacramento office of Price, Waterhouse & Co. He is Chairman, State Income Tax Committee, California Chamber of Commerce. Mr. Petersen serves as Tax Technical Coordinator for California tax matters for his firm's clients.*]

combination or the deficiencies in formulary apportionment of income. The Franchise Tax Board feels that this is going to be the first significant decision involving worldwide combination of income of a foreign based multinational company since all of the decisions heretofore involving worldwide combination were of U. S. based multinationals. However, since the conceptual and formulary questions have not been addressed by either the taxpayer or the Franchise Tax Board we expect that a decision against the Franchise Tax Board would be discounted by the Board as it might relate to other taxpayers. A decision against the taxpayer, however, will certainly be used by the Franchise Tax Board as evidence that they do have the authority to require the combination of income of multinational companies based outside the United States. Thus, we are still looking for a decision on appeal from the California Franchise Tax Board which addresses itself solely to the conceptual and formulary problem of the multinational taxpayer.

Two cases now before the California courts which involve U.S.-based multinationals in which worldwide combination is an issue, are *Firestone Tire and Rubber Company* and *Kimberly-Clark Corporation*. The Firestone case is in the discovery phase before the Superior Court of California, Los Angeles County. It has been delayed several times and further delay is expected. Kimberly-Clark has filed suit in the Superior Court of California, Sacramento County and the answer by the state has been filed. It is expected that there will be no further activity in the Kimberly-Clark case in the near future. Both of these cases involve the inclusion of income of non-U. S. subsidiaries in a California

BACKGROUND ON COMBINED REPORT FOR STATE FRANCHISE TAX

As EARLY AS 1920, certain states adopted a formula approach for determining the income earned within their boundaries by a business operating in several states. This earliest effort was directed on an individual entity basis. In about 1936, California introduced a procedure requiring that commonly-owned companies file a combined report showing total income subject to formula apportionment even though there were no provisions of the California laws specifically authorizing it. Instead, the authority for employing the combined report was derived from the general power and duty of the tax authorities to determine the income attributable to sources within the state and subject it to California tax.*

The combined report is required only if one member of a group did business within California. The announced purpose of the combined report being to insure that the income of a business conducted partially within and partially without the taxing state would be determined and apportioned in the same manner regardless of whether the business is conducted by one corporation or by two or more affiliated corporations.

In its decision in the case of *Edison California Stores, Inc.*, 30 Cal. 2d 472, 183 P.2d 16 (1947), the California Supreme Court sustained the combined report concept (coupled with the allocation of income) as a reasonable method of determining income subject to tax and thereafter it was codified by the state.

The tax authorities assert that the California combined report is not the same as a consolidated Federal return and that the use of a combined report does not result in the tax of one corporation being determined on or measured by the income of another. This theoretical argument is the subject of never-ending debate. Of course, there are mechanical and ownership differences between the combined report and consolidated return but these are not at issue: the real issue is the practical application of the combined report theory particularly involving multinational businesses. Although the figures are not published, it is understood that the dollar revenues to the State of California are greatly increased as a result of requiring combined reports and a number of multinational companies face additional tax liabilities of substantial amounts as a result of the inclusion of foreign operations in the combined report, even though the foreign operations are incorporated abroad and do no business in the United States. Thus, in actual practice, there is a shifting of the tax base.

It is further argued by the tax authorities that a corporation doing business in the state as a member of an affiliated group conducting a business within and without the State should be taxed the same as a corporation whose entire business is being conducted by one entity. Some believe that this begs the question of separate corporate existence, particularly where there is not 100% common ownership. In addition, this "one corporation" approach is not consistently applied as is discussed in the article.

It is frequently difficult for the taxpayer to grasp the validity of these suppositions, particularly where included businesses may be diverse, operating in substantially different economies as are multinational corporations, with perhaps minority shareholders, and where only a minor amount of the total revenues are derived from California sources. It is the impact of the combined approach on multinational corporations, particularly those whose parent companies are not within the United States, that is discussed herein.

The issue of the inclusion of foreign operations in a combined report of multinational corporations is being challenged. On August 29, 1975, Alcan Aluminum Corporation in a letter to Assistant Secretary Gerald Parsky asked the Treasury Department to support legislation to remove state taxation of foreign-source income. Alcan called the unitary income concept "discriminatory and inheritantly unfair to U. S. subsidiaries of foreign-based corporations. . . ."

In early October, the State of Illinois announced that it will not accept combined reports for tax years after 1975. ☆

*Although this article specifically focuses on California taxation of members of a group with multistate or multinational business operations many of the comments herein are equally applicable to other states which apply a taxing concept similar to that of California.

report filed by the U. S. parent.

The State of California has been the leading state in requiring controlled groups to file combined reports including not only their U. S. activities but their worldwide operations. Although several years ago the Franchise Tax Board did not aggressively pursue the combined approach as it related to multinational companies based abroad, this vigorous position has been reconsidered with affirmative action by the Board against the multinational foreign based group having one or more members conducting business in California. The Board's success in its approach has prompted other states to adopt similar concepts. If the spread of this approach continues, particularly as it affects those multinational companies based abroad, we fully expect to see a retaliatory tax assessed by the foreign taxing jurisdictions on those operations of the U. S. based multinational for which they have jurisdiction. Thus, there should be universal concern on the part of all multinationals. In any event, corporations doing business in California should be aware of the exposure that they are incurring, and if the combined approach would result in an overall increase in their tax costs, they should realize that the incorporation of a separate controlled subsidiary will not alleviate their problem if unitary factors exist. ☆

ATTACKS INTENSIFY ON STATE TAXATION OF MULTINATIONALS

The "world-wide combined reporting method" for state taxation of multinational corporations is attracting close congressional scrutiny. Sen. Charles McC. Mathias, Jr., R-Md., and Rep. Barber B. Conable, Jr., R-N.Y., have introduced similar bills to ban the technique, which is often referred to as the "unitary method."

The multinationals — joined by business associations, and opposed by state tax collectors — are continuing their legislative campaign against the world-wide combined reporting method.

Several corporations have also turned to the courts to limit the reach of the state tax collector. The U.S. Supreme Court is currently considering a challenge by Mobil Oil Corporation to Vermont's taxation of foreign source dividend income.

At the request of the House Ways and Means Committee, the General Accounting Office has begun a long-term study of the entire problem of state taxation of "multijurisdictional" corporations.

The Dispute Over the Taxing Method

A number of states, particularly California, Oregon, Alaska and other western states, currently use variations of the world-wide combined reporting method to compute the amount of taxable income that is attributable to business that multinational companies conduct in the state. Under the method, the amount of state taxable income is determined by multiplying the company's entire, world-wide income — including the income earned by foreign subsidiaries — by a percentage that, in general, corresponds to the amount of the property, payroll and sales that the corporation has in the taxing state.

Other states, and the federal government, use the "arms-length" method, under which each affiliate of a multinational is treated separately to determine whether it has business contacts with the states that generate taxable income.

The states that use the world-wide combined reporting method assert that it is the only method that enables the states — which are often hampered by limited tax-collecting resources — to combat tax-avoidance manipulation of accounts by the multinationals. In particular, the states insist that it is appropriate for them to tax the earnings of the subsidiaries of the multinationals, because the multinationals would otherwise avoid state taxes by attributing all or most of their earnings to the subsidiaries.

However, the multinationals counter that the world-wide combined reporting method enables the states to tax foreign earnings that have nothing to do with the state. Multinationals also point out that because the states apply the methods differently, there are a number of varying and often confusing state taxing policies — all of which differ from the federal taxing policy. In addition, the multinationals charge from a more technical standpoint that the world-wide combined reporting method is arbitrary, because it assumes that particular assets and activities generate income uniformly, which is not necessarily the case.

The sums involved in the dispute are large. California reportedly collects an additional $20 to $120 million, and Alaska reportedly collects an additional $50 million, by using the world-wide combined reporting method.

The Legislation and the Lobbying

Sen. Charles McC. Mathias, Jr., R-Md., has introduced a bill to prohibit states from using the world-wide combined reporting method. Sens. Walter D. Huddleston, D-Ky., and Malcolm Wallop, R-Wyo., a member of the Finance Committee, have cosponsored the bill. The measure, S. 1688 was reported to the Senate Finance Subcommittee on Taxation and Debt Management, but no action on the bill has been scheduled. Sen. Mathias' bill is similar to other measures he introduced earlier this year and last year.

In the House, Rep. Barber B. Conable, Jr., R-N.Y., the ranking Republican on the House Ways and Means Committee, has introduced an identical measure, H.R. 5076. The measure, which grew out of a 1977 study by the Ways and Means Task Force on Foreign Source Income, has been cosponsored by Ways and Means Committee member James R. Jones, D-Okla. The bill has been referred to the Ways and Means Committee, which has not scheduled any action on it.

The principal lobbyist for the states is the Multistate Tax Commission, an association of state tax collectors. Carrying the ball for the multinationals are the National Association of Manufacturers, and the Committee on State Taxation, an association of state chambers of commerce, the National Chamber of Commerce, and U.S. and foreign businesses.

One congressional staff member reported that the controversy over the world-wide combined reporting method is "one of the hottest tax issues on Capitol Hill." While the larger corporations — including Ford Motor Company and Mobil Oil Corporation — seem to be the most vigorous opponents of the method, smaller multinationals are also reported to be active.

The issue of the world-wide combined reporting method was the focus of a great deal of attention last year, when the Senate considered the U.S.-U.K. Tax Treaty. Article 9(4) of the U.K. Treaty would have prevented states from using the unitary method to tax the U.S. subsidiaries of corporations based in the United Kingdom. The Senate reserved Article 9(4), and ratified the remainder of the treaty.

GAO Begins Broad-based Study

At the request of the House Ways and Means Committee, the General Accounting Office (GAO) has begun a long-range study of the entire problem of state taxation of "multijurisdictional" corporations — corporations with activities in more than one state and in foreign nations.

A spokesman for the GAO reported that the project, which began early in 1979, would be concluded in the fall of 1980. The GAO is expected to make specific legislative recommendations for changes in the current methods of state taxation of multistate and multinational corporations.

Multinationals Turn to the Courts

Several corporations have turned to the courts to challenge state tax collecting methods. The Supreme Court has been asked to review a challenge by Mobil Oil Corporation — which is based in New York — that Vermont's formula to apportion and tax some of Mobil's foreign source dividend income is unconstitutional under the Commerce Clause. In 1977, in a somewhat similar case, the Supreme Court ruled that the county of Los Angeles may not apply its personal property tax to cargo containers owned by the Japan Line, a Japanese shipping firm.