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[ ISSUES AFFECTING STATE TAXATION  
OF MULTIJURISDICTIONAL CORPORATE INCOME ]

Good afternoon, ladies and gentlemen. I appreciate this opportunity to appear before you today and tell you a little about what GAO has been up to in an area of much interest and concern to the membership of the Tax Executives Institute.

Our involvement in the issue of State taxation of multi-jurisdictional corporations resulted from a request of the Ways and Means Committee to do two things.

First, we were asked to undertake a study of the methods used by States in taxing multijurisdictional, including multinational, corporations. And, second, the committee wanted us to review the application of the Federal tax rules under Code section 482.

We now have two separate reports, in draft, describing the results of our work on these matters. They will, naturally, both be addressed to the Ways and Means Committee which, until they are made public, will have a proprietary interest in them. Because of that interest, I will not be able to share with you the details of our conclusions and recommendations.

But what I can do is lay out our understanding of the problems associated with State taxation of multijurisdictional corporations with passing reference to IRS' activities in enforcing Code section 482--to the extent these activities

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provide insight into the difficulties that can attend the administration of the separate accounting approach to multi-jurisdictional tax reporting.

The scope, sensitivity, and complexity of the issues covered in our State tax study have required that we gather data from several different sources. We have made every effort to obtain input from all the affected parties: States, corporate taxpayers, CPA firms, State tax experts, and representatives from State and corporate interest groups. In fact, I'm sure some of you were asked to respond to a questionnaire we sent to a sample of TEI members. To further assure that we are covering all the bases, we have retained two consultants to advise us throughout this study.

The manner in which States tax the income of multijurisdictional corporations has been a controversial subject for many years. The issues which have evolved entail large amounts of revenue, bear directly on the Federal-State relationship, and in recent years have grown in complexity especially as they relate to foreign source income.

These issues result primarily from the lack of uniformity among State income tax laws. There are considerable differences in the way States determine the types and amounts

of multijurisdictional corporate income to be taxed and in the procedures used to divide this income among the States.

To illustrate the diversity of State taxing practices, consider this:

1. Jurisdiction-to-tax criteria

- 6 States rely solely on Federal criteria
- 39 States use one or more of 16 different rules

2. The starting point in the computation of taxable income

- 33 States start with Federal taxable income
- 12 States use some other method

3. Application of an apportionment formula

- 35 States use an equally weighted three-factor formula only
- 4 other States also use the three-factor formula, but also have alternatives
- 4 States use a double-weighted sales factor formula
- 1 State uses a two-factor (property and payroll) formula
- 1 State uses a one-factor (sales) formula

4. Allocation versus apportionment

- 11 States apportion all or nearly all income-- business and nonbusiness.
- 34 States allocate nonbusiness income in a number of different ways.

Now let me turn to some differences that are of special relevance to multinational business:

1. Combined reporting of U.S. operations
  - 26 States use it
  - 19 States do not
2. Combined reporting of foreign operations
  - 11 States use it
  - 34 States never or rarely do
3. Taxation of foreign-source dividends
  - 35 States tax them
  - 7 exempt them totally
  - 3 States exempt a substantial portion.

There are further differences among the 35 States that do tax all foreign dividends.

--10 States apportion all of theirs

--4 States allocate them to the State of commercial domicile

--21 States provide varying treatment under assorted rules.

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Let me stop there. I'm not telling you anything you don't already know about how diverse the tax practices of the States are. The precise numbers may be new to you, but the bottom line is certainly not.

Indeed, everybody knows about the problem, but not enough has been done to correct it. As a newcomer, I'm struck at how long the problem has been around and how little has been accomplished--despite efforts in that direction.

Thus, I learned one such effort was by an organization called the National Conference of Commissioners on Uniform State Laws which produced a piece of draft legislation called the Uniform Division of Income for Tax Purposes Act }-UDITPA, as it is affectionately called by practitioners. UDITPA prescribed the allocation of nonbusiness income, specified an equally weighted three-factor income apportionment formula, and defined the factors. It also granted the States considerable discretion to apply alternative rules when those specified did not fairly represent the extent of a taxpayer's business activity in a State.

In my naivete, when I first learned of UDITPA, I said "EUREKA"--a solution has been found. I was disappointed when I read further and learned that the model legislation was drafted 20 years ago, and to date

--only 9 States have adopted all of the provisions

--another 12 follow it to some extent

--and the remaining 24 have, in effect, disregarded it.

Saddened as I was by these results, my spirits perked up when I learned of a more recent effort undertaken by the Council of State Governments, the National Association of Tax Administrators, the National Association of Attorneys General, and the National Legislative Conference. This group established the Multistate Tax Commission which set about to formulate detailed regulations covering allocation and apportionment. My sanguine state of mind was

short-lived when I read further and learned that only 19 States are currently members of the Multistate Tax Commission. Apparently a lot of folks took the French to heart with "Vive la difference."

On a more serious note, it's sad to contemplate that despite all the good work that was done in connection with these past efforts, { 23 of the 45 States that tax corporate unions have not adopted any of the rules of either covenant, and that most of the other 22 have done so on a piece-meal basis. }

Where does that all leave us? With much aggravation on the part of corporate officials who have to contend with a wide variety of practices that in too many cases they consider conceptually flawed.

The manifestations of this are reflected in the responses we received from businesses we sampled

- 50 percent said they have experienced overtaxation because of differences in State income tax laws-- primarily involving the issues of allocation versus apportionment of nonbusiness income and the use of different apportionment formulas,
- 32 percent had disputes with States in a recent 5-year period over the jurisdiction-to-tax issue, some with more than a dozen States,
- 42 percent had disputes with States over requirements for combined domestic reporting, and
- 45 percent of 500 multinationals included in the sample filed protests over their combined reporting requirements.

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I'm persuaded from what I've learned about these matters that there are serious problems here which require attention.

Nonuniformity among the States has detrimental effects on both corporate taxpayers and State tax administrators, causing uncertainty, unnecessary complexity, and the possibility of over or under taxation of income. Corporate officials told us that lack of uniformity coupled with frequent regulation changes by the States has increased the cost of preparing State income tax returns. They estimated that the cost now averages 15 percent of their State income tax liability and they believe the cost will continue to increase in the immediate future.

I've tried to reason through to my own statement of the issues to better understand what needs to be done. I'd be interested in your reaction to my assessment.

- A. First, some States appear to be taxing income that seems tenuously related to the business activities of some corporations in their jurisdictions.
- B. Next, some corporations are probably paying taxes on the same income in two or more jurisdictions. On the other hand, some States are probably missing some corporate income that they have a right to tax.
- C. Finally, the widely used apportionment formulas seem to have some shortcomings in associating net income directly and linearly with property, payroll, and

sales--especially where the unitary approach folds in overseas operations.

At the outset, I referred to the work we are doing regarding IRS' administration of section 482. That work has shown to our satisfaction that reconstructing the propriety of transactions among affiliated organizations is more of an art than a science; that it is seldom possible to establish a true "arms length" value for audited transactions--this ultimate was only achieved in about 3 percent of the cases we sampled.

What is the significance of that piece of information? Well, in my own mind at least, it means that taxing jurisdictions are vulnerable when the separate accounting approach is followed by virtue of the extreme difficulty in assuring that income has not been transferred among jurisdictions to minimize tax burden.

I am not saying that concerns of this nature are well-founded or that there is any reason to question the honesty of American business. But I venture to say that many State tax administrators are of a cynical bent and, even if they share my own views, would still be prone to regulate under the lowest common denominator approach.

By the same token, I recognize that it is only proper for business to take advantage of all legal opportunities to minimize the tax burden, and in this connection, I wonder whether the unitary approach is ever welcomed when it is obvious that



separate accounting can put the income in a higher rate jurisdiction.

A promising note, however, is that from our work we have detected a strong desire for greater uniformity on the part of both States and corporate taxpayers. Our two reports should be issued in the next couple of months, and we hope that they will make a contribution to the ongoing dialogue in these matters.