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BY THE COMPTROLLER GENERAL

Report To The Chairman, House Committee On Ways And Means

OF THE UNITED STATES

Key Issues Affecting State Taxation Of Multijurisdictional Corporate Income Need Resolving

In recent years, the number of multijurisdictional--multistate and multinational--corporations and the related amounts of State tax revenue have grown significantly. States' current practice of using widely varying rules to determine taxable income for such corporations creates issues in terms of unacceptable levels of administrative burden and uncertainty. Moreover, some States include income from non-U.S. based operations, including dividend income, in a multijurisdictional corporation's tax base. This practice raises other issues of international tax policy, interstate commerce, and States' rights.

All these issues need to be resolved. In this report, GAO presents the key points in the controversy along with the views of States, corporate taxpayers, and tax experts.

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COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON D.C. 20548

B-202972

The Honorable Dan Rostenkowski
Chairman, Committee on Ways
and Means
House of Representatives

Dear Mr. Chairman:

This report, the second and last in response to the prior Chairman's request, deals with the key issues in the area of State taxation of multijurisdictional corporate income. It details the lack of uniformity among State income tax provisions covering multijurisdictional corporations and discusses the effects of this nonuniformity on State tax administrators and corporate taxpayers. It also discusses major interstate and international policy issues arising from State taxation. The report concludes that Federal legislation is the most appropriate solution.

At your request, we did not obtain comments on this report from affected parties. As arranged with your office, we are sending copies of this report to other congressional committees; the Director, Office of Management and Budget; and other interested parties.

Sincerely yours,

Charles A. Bowsher

Comptroller General
of the United States

REPORT TO THE CHAIRMAN, HOUSE COMMITTEE ON WAYS AND MEANS

KEY ISSUES AFFECTING STATE TAXATION OF MULTIJURISDICTIONAL CORPORATE INCOME NEED RESOLVING

DIGEST

Forty-five States (including the District of Columbia) presently assess taxes on the income of multijurisdictional--multistate and multinational--corporations (MJCs). In doing so, these States use a bewildering variety of rules. The resulting nonuniformities create issues in terms of an unacceptable level of administrative burden and uncertainty and too high a risk of over- or undertaxation. Moreover, some States include income from non-U.S. based operations, including dividend income, in an MJC's tax base. This practice raises additional issues of international tax policy, interstate commerce, and States' rights.

All these issues need to be resolved. The States cannot be expected to have the necessary balanced perspective, and the courts can address the issues only on a case-by-case basis. Thus, only the Congress appears capable of striking the needed balance between States' authority to tax and Federal authority over interstate commerce and international tax policy.

In response to a request by the Chairman, House Committee on Ways and Means, that GAO provide the Congress with information on State taxation of MJCs, GAO presents in this report the key issues in the controversy along with the views of States, corporate taxpayers, and tax experts.

STATES' METHODS OF TAXING CORPORATE INCOME

States use two methods to determine the amount of an MJC's income that is taxable by the State: separate accounting and formula apportionment. Separate accounting requires a corporation to separate income-producing activities and income sources in one State from those in another. Because it is difficult and time consuming and because of doubts about its applicability to some types of businesses, this method is used infrequently. Twenty States use separate accounting but only for certain types of industries. (See pp. 2 to 3.)

More commonly, States use some version of formula apportionment to apportion income among those States in which the corporation does business. Formulas are used to compare the value of income-producing factors in a State (most commonly, property, payroll, and sales) to the value of the factors for the business as a whole. The factors are deemed to reflect the relative contribution of a corporation's activities in various States to the corporation's total income. States can use this method only if the MJC is a "unitary business." (See pp. 4 to 5.)

DEFINITION OF A UNITARY BUSINESS AND INTERNATIONAL TAX POLICY ISSUES ARE HIGHLY CONTROVERSIAL

The most controversial issues arising from State taxation of MJCs' income hinge on (1) how States should define a unitary business, (2) whether States should be permitted to use "worldwide combined reporting" (that is, include non-U.S. based operations in an MJC's tax base), and (3) to what extent States should be allowed to tax foreign source dividends.

States and corporate taxpayers do not agree on how a unitary business should be defined. Corporations generally maintain that the primary criterion should be that basic operating functions are substantially interdependent. States generally believe that control, as manifested by stock ownership, should be the primary criterion. While tax experts believe it might be possible to combine these or other criteria, no agreement exists about how the criteria should be quantified. (See pp. 29 to 31.)

Although only 13 States currently use worldwide combined reporting, 70 percent of the large corporations with foreign operations responding to GAO's questionnaire said they did business in States using the method. Corporations generally oppose worldwide combined reporting, arguing that it is an unconstitutional State taxation of foreign source income, frustrates foreign commerce, increases the risk of international double taxation, and creates substantial administrative burden. States maintain that worldwide combined reporting does not constitute taxation of foreign source income but simply calculates an individual State's share of an MJC's total income by determining the amount of income properly attributable to the State, using the factors which contributed most to earning the income. (See pp. 31 to 40.)

Another issue on which corporate taxpayers and States are greatly divided is State taxation of foreign source dividends. Corporations maintain that taxing foreign source dividends creates risks of international double taxation because the earnings from which dividends are paid are also taxed at their source and, while the Federal Government grants a tax credit in such cases, the States do not. States, however, respond that taxing corporate income when earned by the corporation and again when received by the stockholders has never been held to be unconstitutional double taxation, no matter which governments impose the tax. States also believe that their constitutional taxing powers allow them to vary from Federal practice in certain situations. The Supreme Court has said that foreign source dividends are apportionable for State tax purposes as long as there is a unitary relationship between the foreign corporation paying the dividends and the U.S.-based corporation being paid the dividends. The Court, however, has left unanswered some important questions regarding State taxation of foreign source dividends. (See pp. 41 to 43.)

OTHER ISSUES INVOLVING NON-UNIFORMITY ARE LESS CONTROVERSIAL

Five other issues which involve considerable nonuniformity in State taxation have long been of concern to States and taxpayers.

(1) Jurisdiction to tax. This is a technical term referring to how a State determines whether an MJC's activities or connections in that State are sufficient to be taxable. While some Federal restrictions exist on States' jurisdiction to tax, objective criteria are lacking. Of the 45 States that tax corporate income, 6 do not have

specific criteria while the 39 others use 1 or more of 16 different rules. Corporations generally take the position that a State should be permitted to tax if an MJC has a sufficient business location in the State. States generally favor a minimum sales rule under which an MJC is exempt from State taxation if its sales do not exceed a stipulated amount together with a requirement that, to be exempt, the MJC must have no business location nor inventory in that State. Tax experts GAO contacted generally favored the minimum sales rule. (See pp. 12 to 13 and pp. 44 to 46.)

(2) Starting point for determining taxable income. Thirty-four States use Federal taxable income as the starting point for determining State taxable income; the other 11 generally require a corporation to start with gross income and deduct specific items. Corporate officials generally believe that all States should use Federal taxable income as the starting point. (See pp. 13 and 46.)

(3) Composition of apportionment formulas. Thirty-nine States use an equally weighted three-factor formula composed of property, payroll, and sales, but 4 of these States can also use alternative formulas which are differently composed and weighted. The other six States use different formulas. Most of the tax experts GAO contacted believed that an equally weighted three-factor formula should be made mandatory for all States. (See pp. 13 and 47.)

(4) Definition of formula factors. States do not define uniformly the factors of property, payroll, and sales. States, corporate officials, and tax experts generally agree that the factors should be uniformly defined. They do not, however, agree on what the definitions should be. (See pp. 14 and 47 to 48.)

(5) Allocation rules. Some States choose to allocate, instead of apportion, certain types of income in total to individual States. Eleven States allocate little or no income; 24 allocate nonbusiness income; and 10 States allocate income which they classify in various ways. State and corporate officials do not agree among themselves on the question of whether some types of income should be allocated. (See pp. 15 and 48 to 49.)

PRESENT DEGREE OF NONUNIFORMITY IS DETRIMENTAL TO STATES AND TAXPAYERS

The present degree of nonuniformity increases the risk of over- or undertaxation. Overlap in the factors, differences in the factors and in allocation rules, and other nonuniformities create this risk. GAO estimates that about 50 percent of the firms in the universe from which GAO sampled believed they had experienced overtaxation. State officials believe that undertaxation occurs more frequently than overtaxation. While the actual extent of over- or undertaxation is unknown, the degree of risk posed by the present degree of nonuniformity is unacceptable.

Ultimately, a nonuniform and complex tax system creates the risk of noncompliance. In this regard, nonuniformity in State taxation has led to numerous administrative and judicial disputes between States and corporate taxpayers, created a significant administrative burden, and generated high compliance costs. While there will always be disagreements between States and corporate taxpayers, greater uniformity in tax requirements would reduce the cost of compliance and the opportunity for disputes. (See pp. 16 to 20.)

CONCLUSIONS

If past performance can be used to predict future action, it seems unlikely that States will achieve a reasonable degree of uniformity in the near future. It is also unlikely that the issues will be resolved in the courts, especially those issues involving broad policy questions, for the courts can treat the issues only on a case-by-case basis. (See pp. 22 to 26.)

The issues need resolving, and only the Congress appears capable of striking the needed balance between the States' right to tax and the Federal interest in interstate and international tax policy issues arising from State taxation.

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At the request of the Chairman of the House Ways and Means Committee, GAO did not obtain comments on the report.

C o n t e n t s

ABBREVIATIONS

COST	Committee on State Taxation, Council of State Chambers of Commerce
CPA	Certified Public Accountant
GAO	General Accounting Office
MJC	Multijurisdictional Corporation
MTC	Multistate Tax Commission
NAM	National Association of Manufacturers
NATA	National Association of Tax Administrators
NTA	National Tax Association
TEI	Tax Executives Institute
UDITPA	Uniform Division of Income For Tax Purposes Act

CHAPTER 1

INTRODUCTION

Lack of uniformity in how the States presently determine the taxable income of multijurisdictional corporations (MJCs)--that is, multistate and multinational corporations--poses a serious and growing problem in which the Congress, the States, and corporate taxpayers have a high interest. Large amounts of revenue are involved (about $5 billion in State revenue in 1977, the most recent year for which data was available during our review), the Federal-State relationship is directly affected, and in recent years the issue has expanded to the international arena. Whether and how States should be permitted to include foreign source income in determining taxable corporate income has become an important question. The lack of uniformity among the States causes undue uncertainty and unnecessary complexity for both corporate taxpayers and tax administrators and, moreover, increases the possibility of overtaxation or undertaxation. This report points out areas of nonuniformity among State income tax provisions, discusses the effects of nonuniformity on the States and corporations, and analyzes the major issues needing resolution.

State taxation of corporate net income began in 1911 when Wisconsin enacted a corporate income tax to help support rapid increases in the State's public expenditures. Since 1911, the number of States which tax corporate income has grown steadily. By 1930, 17 States were taxing corporate income, either directly or indirectly, through a tax imposed on corporations for the privilege of doing business in a State. This number increased to 34 by 1940, and today 44 States and the District of Columbia have some type of corporate income tax. 1/

The amounts of revenue involved and the number of MJCs affected by nonuniformity in the States' income tax provisions have increased greatly in the last decade and are expected to increase further. Taxes collected from MJCs in 1977 accounted for about $5 billion, or about 56 percent, of the $9 billion States collected from all corporate taxes even though MJCs filed only 18 percent of the total corporate tax returns. Tax revenues from MJCs have increased since 1972 in all 26 States which supplied us with data on MJCs, and 24 of these States said they expect these revenues to

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1/The following States do not have a corporate income tax: Michigan, Nevada, South Dakota, Texas, Washington, and Wyoming. Although Michigan does not have a corporate income tax, it does impose a single business tax. Michigan uses a three-factor formula, equally weighted, to determine how taxable income will be apportioned.

continue to grow. Similarly, 26 States which had data on MJCs reported to us that these corporations filed an average of 8,228 tax returns with them during 1977, representing an increase in the number of returns filed in 24 of the 26 States since 1972. Twenty-two of the States projected continued increases through 1982, the last year about which we inquired.

STATES USE SEPARATE ACCOUNTING AND FORMULA APPORTIONMENT TO DETERMINE THE AMOUNT OF MULTIJURISDICTIONAL CORPORATE INCOME THEY CAN TAX

The States have the power to levy taxes in accordance with their own laws, subject to the restrictions imposed principally by the Due Process Clause of the 14th Amendment and the Commerce Clause. 1/ Under the Due Process Clause, a minimal connection must exist between the corporation's activity and the taxing State, and the income attributed to the State for taxing purposes must be rationally related to income-generating values within the taxing State. Under the Commerce Clause, a State is prohibited from adopting a taxing scheme which discriminates against, or places an undue burden on, interstate commerce.

In complying with these restrictions, the States use two basic methods for determining the income an MJC earned within their borders: separate accounting and formula apportionment. 2/

Separate accounting, used less frequently than formula apportionment, is sometimes applied when a business is able to accurately separate income-producing activities and income sources within a particular State from income-producing activities and income sources in other States. This State-by-State determination

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1/The Equal Protection Clause of the 14th Amendment and the Imports-Exports Clause also impose restrictions on State taxing powers, but these restrictions have not had the same impact on State taxation of MJCs as the Due Process and Commerce Clauses. The Privileges and Immunities Clause of the Constitution also limits the taxing power of the States, but that clause does not apply to corporations.

2/Some experts classify specific allocation as a third method. Since it is used in conjunction with formula apportionment, this report discusses specific allocation with formula apportionment. (See pp. 4 and 48 to 49.)

requires verifying numerous intercorporate transactions to compute the proper value for goods and services exchanged between the related entities. This is a very time-consuming task, involving potentially thousands of transactions. State tax administrators and corporate taxpayers generally agree that under the separate accounting method

--the cost of preparing tax returns and the time required to audit these returns is generally greater;

--the allocation of indirect expenses--such as advertising costs--among the corporate entities is based on arbitrary criteria which can vary from one corporation to another; and

--the determination of fair and reasonable selling prices for goods exchanged between corporate entities is difficult.

Because of these difficulties and doubts about the applicability of separate accounting to some types of businesses, the States generally use separate accounting only to determine the income certain kinds of MJCs earned within their jurisdictions. These businesses, (primarily general merchandising, oil and gas, and construction companies use separate accounting because it conforms more to their financial accounting procedures and, for these specific situations, more accurately reflects income than formula apportionment. For example, a construction firm normally determines profitability on an individual project basis, calculating revenues and costs separately for each project. Twenty of the 45 States reported to us that they accept some returns based on separate accounting for these types of industries.

All 45 States rely primarily on formulas to apportion a corporation's income among those States in which the corporation does business. Apportionment formulas attribute income to the States on the basis of factors which produced the income. The factors most commonly used are property, payroll, and sales. To derive the amount of income taxable in the State, the value of each factor in a State is first compared to the total value of that factor for the corporation. The formula used by most--but not all--States is:

$$\frac{\frac{\text{In-State property}}{\text{Total property}} + \frac{\text{In-State payroll}}{\text{Total payroll}} + \frac{\text{In-State sales}}{\text{Total sales}}}{3} \times \text{Total corporate income} = \text{Income taxable by the State}$$

When required by a State to use formula apportionment, an MJC usually begins by adjusting its Federal taxable income for items which the State treats differently from Federal law and for income items not subject to the apportionment formula. The types and amount of income not subject to formula apportionment, such as dividends and interest, vary among the States. Those income items which are not apportioned among the States are normally taxed in total by one State. This procedure is known as "allocation"--that is, the total amount of these income items is allocated to one State. Depending on the individual State rules, the State to which the income is allocated may be determined by the location of: (1) the corporate headquarters, (2) the assets producing the income, (3) the activity producing the income, or (4) the entity which paid income to the taxpayer.

Once a corporation determines the income to be apportioned, it applies a formula, such as the one shown above, to that income to calculate the amount to be apportioned to an individual State. Thus, under the formula apportionment method, the multijurisdictional corporate income a State may tax consists of the income specifically allocated to the State plus the income derived from application of the apportionment formula.

The States, however, do not apply formula apportionment in all cases. In order for the States to properly apply formula apportionment, the business operations of the corporation must be unitary. A unitary business may be comprised of branches or divisions of a single corporation or of commonly controlled but separate corporations. The criteria usually applied for determining if the operations of a business are unitary include: the percentage of one corporation's common stock owned by another; the sharing of centralized services, such as accounting and advertising; and the type and number of transactions carried out between corporate entities. However, no universally agreed-upon criteria exist.

Originally, the States applied formula apportionment only when the unitary business was a single corporation. For example, a single corporation might encompass administrative offices and a manufacturing plant located in one State with a second plant in another State. To determine how much of the corporation's income was attributable to each State, each of the two States would apply its apportionment formula to the single corporation's entire operation.

In time, some States expanded their definition of a unitary business. These States decided that a unitary business could consist of not only one corporation but of a group of affiliated corporations doing business in several States. As a result, the States began taxing multicorporate entities in the same manner as single corporations. A State's application of its apportionment formula became dependent upon its determination that a business entity was unitary and not upon a particular corporate structure. For example, a group of separate corporations performing different functions (i.e., manufacturing, distributing, selling) in different States but engaged in the same unitary business were treated the same as a single corporation with several divisions conducting business operations in several States. Applying the unitary concept in its broader context, a State would apply its apportionment formula to the combined income of the affiliated group of corporations that made up the unitary business. Thus, as some States have broadened their definition of a unitary business, the formula apportionment method has been applied more frequently, and the nonuniformity in its application has taken on greater significance for corporate taxpayers.

In applying formula apportionment to a unitary business, "combined reporting" is a tool used by some States to determine the amount of a multicorporate entity's income taxable by those States. Under combined reporting, the separate corporate elements of a unitary business prepare a single report which sums the results of their individual activities and assigns the appropriate portion of profit or loss to the individual corporate elements and States on the basis of an apportionment formula. A combined report is not the same as a consolidated tax return but is merely an information return. Combined reporting is applied by some States to MJCs operating totally within the U.S. and/or those operating outside the U.S. In the latter case, it is called "worldwide combined reporting" and constitutes a further expansion by States of the use of formula apportionment.

STATES' NONUNIFORM USE OF FORMULA APPORTIONMENT HAS GENERATED CONSIDERABLE JUDICIAL AND LEGISLATIVE ACTIVITY

Although all States that have a corporate income tax use formulas to apportion the income of MJCs, there are differences among the States in the composition of the formulas, the make-up of the income to be apportioned, and the determination of which corporate entities have income subject to formula apportionment. These differences have been the source of numerous legal disputes between the States and multijurisdictional corporate taxpayers over the past 20 years. In addition to judicial decisions, several legislative initiatives have dealt with these issues.

A major decision in this area was rendered by the U.S. Supreme Court in 1959. 1/ Prior to this decision, it had been established law that income from interstate commerce could be included in the apportionment base of a corporation which had some purely intrastate activity in the taxing State. Many experts, however, held the view that a State could not tax any income of a corporation whose only activities in the State consisted solely

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1/ Northwestern States Portland Cement Company v. State of Minnesota, 358 U.S. 450 (1959).

of interstate commerce. In the Northwestern decision the Court removed this possible constraint on State income taxation of interstate commerce by sustaining the power of a State to levy a fairly apportioned net income tax on an out-of-State corporation doing an exclusively interstate business in the State.

In another decision rendered in 1980, the Supreme Court reaffirmed the use of formula apportionment in those instances where the business was unitary. 1/ The Court cited a prior decision which stated that, in the case of a unitary business, separate accounting may fail to account for contributions to income resulting from integrated functions, centralized management, and the economies of operating in several States. 2/ Since these functions arise from the total operations of the business, the Court has maintained that it is misleading to attribute the total income of a unitary business to an individual State. Although the Supreme Court has long recognized that apportionment formulas may yield only a reasonable estimate of the corporate income earned in a State, 3/ the Court has not restricted the use of apportionment formulas as long as the formula factors fairly reflect the income earned in a State. 4/

Since the landmark 1959 decision, numerous disputes between States and corporations have been resolved or are currently pending in both Federal and State courts. These disputes have involved several key issues, such as the definition of a unitary business; whether the unitary concept can be applied to a corporation's worldwide operations; and to what extent a State can tax specific types of income, such as dividends earned outside the United States.

The 1959 Supreme Court decision was perceived by the business community as a threat of unrestricted State taxation. To counter the decision, business lobbied the Congress for legislation which would establish criteria as to when an out-of-State corporation was taxable in a State. In response to this effort, the Congress in 1959 enacted Public Law 86-272 which established minimum criteria for determining when an out-of-State corporation's income is taxable in a State.

Since 1965, bills covering interstate corporate taxation have been introduced in every session of the Congress. Each of the 31 bills introduced has contained income tax provisions. However, primarily because of State opposition, none of the bills

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1/Mobil Oil Corporation v. Commissioner of Taxes of Vermont, 445 U.S. 425 (1980).

2/Butler Bros. v. McColgan, 315 U.S. 501 (1942).

3/Underwood Typewriter Co. v. Chamberlain, 254 U.S. 113 (1920).

4/Butler Bros., 509.

have become law. The States generally believe that their own efforts toward achieving long term resolution of specific issues are preferable to Federal legislation.

OBJECTIVES, SCOPE, AND METHODOLOGY

The Chairman, House Committee on Ways and Means, asked GAO to study how States divide multijurisdictional corporate income for the purpose of computing tax liabilities. We did this by reviewing the provisions pertaining to manufacturing and mercantile companies used by each State to determine its portion of multijurisdictional corporate income to tax. We researched past studies, court cases, and congressional bills, and gathered extensive data from States, corporate taxpayers, CPA firms, State tax experts, and representatives from State and corporate interest groups. We also retained two consultants--Jerome R. Hellerstein and John S. Warren--to advise us throughout our work. (See app. I for their biographical profiles.)

To document how each State determines what portion of multijurisdictional corporate income to tax, we compiled an inventory of pertinent tax provisions for the 45 States with an income tax. 1/ Our inventory included provisions covering jurisdiction-to-tax, starting point for determining taxable income, composition of apportionment formulas and factors, assignment of certain types of income to specific States, application of formulas to multinational operations, and treatment of foreign source dividends.

To help us identify and analyze the key issues, we conducted numerous interviews with corporate tax officials, State tax administrators, and members of special interest groups. In addition, we obtained written comments on key tax issues from several of these individuals and held a 2-day conference which brought together experts from States, corporations, and tax associations to discuss the issues.

To ensure that we obtained the views of the various parties affected by the issues, we sent questionnaires to all 45 States with a corporate income tax, 510 large MJCs, 63 small and medium size MJCs, and 3 large accounting firms. The questionnaires addressed several areas concerning State taxation, including the use of formula apportionment and separate accounting by the States, and the need for uniformity among all States.

Our review was performed in accordance with GAO's "Standards for Audit of Governmental Organizations, Programs, Activities,

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1/Throughout this report, the 45 "States" include the District of Columbia.

and Functions." A more complete discussion of our review objectives, scope, and methodology is contained in chapter 4.

CHAPTER 2

FEDERAL LEGISLATION: THE MOST APPROPRIATE SOLUTION TO PROBLEMS RESULTING FROM LACK OF UNIFORMITY IN STATE TAXATION OF MULTIJURISDICTIONAL CORPORATE INCOME

When taxing the income of an MJC, a State is limited principally by the Commerce and Due Process Clauses of the Constitution. In taxing this income, a State must first determine whether the corporation is taxable, then the amount of income to be taxed. In making these determinations, the 45 States that tax corporate income apply differing laws and procedures. This nonuniformity among the States has resulted in a tax system characterized by undue complexity, inefficiency, and uncertainty. Although the States have made progress towards uniformity over the past 20 years, their efforts have not resulted in a degree of uniformity satisfactory to both States and taxpayers. Both States and corporate taxpayers believe greater uniformity would reduce these difficulties and significantly benefit both parties.

Controversy surrounding State taxation of corporate interstate activity has been compounded in recent years as some States have been taking into account foreign operations when taxing MJCs. This expansion of State taxing activity has raised some broad and complex issues dealing with the Federal-State relationship and international tax policy. These issues are difficult to resolve not only because they involve complicated tax policy decisions but also because they transcend strictly multistate concerns. For these reasons, it seems appropriate that the Congress examine the issues and resolve them.

VOLUNTARY EFFORTS BY STATES HAVE NOT RESULTED IN UNIFORM APPORTIONMENT RULES

While all 45 States having a corporate income tax use formulas to apportion income, no two States apply the formulas in the same way. Aware of the benefits arising from uniformity and opposed to Federal intervention, the States have made attempts to formulate uniform procedures covering the division of multijurisdictional corporate income. Their efforts have achieved only partial success, and the diversity which remains among the States is still substantial.

While there is disagreement concerning the extent to which lack of uniformity poses problems for MJCs, it has long been recognized that real problems exist. Thus, the history of the State corporate income tax is--to some extent--a history of efforts to achieve uniformity among the States. These efforts have focused primarily on the rules governing division of income.

Almost from the beginning of the State corporate income tax, various professional organizations have spearheaded efforts to obtain uniformity through discussions and proposals. The earliest efforts began prior to the U.S. entry into World War I when the National Tax Association (NTA) began to explore the possibility of uniformity in the State tax system. This concern was not based on any sense of urgency about existing problems, since only a few States had adopted a corporate income tax. Rather, NTA foresaw that problems might arise as more and more States turned to the corporate income tax. NTA was aware that problems implicit in diversity could be avoided only if the States adopted a system of taxation which was reasonably consistent. In 1921 NTA proposed a model State tax act which stipulated the use of Federal taxable income as a starting point in the calculation of a State's tax base. The States did not accept this proposal at first and have been slow in accepting it since. Today, some 60 years later, only 34 of the 45 States having a corporate income tax use Federal taxable income as the starting point in calculating the State tax base.

Until the late 1930's, the States primarily relied on separate accounting to determine the taxable income of MJCs. By this time, however, State support for formula apportionment had increased substantially. As more States began using formulas to apportion the income of MJCs, tax administrators and corporate officials became increasingly aware of the problems resulting from nonuniform application of the formulas. Although these problems were frequently discussed by the States and various organizations, no action was taken until 1957 when the National Conference of Commissioners on Uniform State Laws cited the need for more uniformity in rules for determining taxable income which would remedy the inequitable results produced by income formula differences. 1/

In the same year, the National Conference of Commissioners drafted the Uniform Division of Income For Tax Purposes Act (UDITPA) in response to the concern over nonuniformity in the States' application of apportionment formulas. UDITPA specified that nonbusiness income be allocated to a single taxing jurisdiction, specified that business income be apportioned among

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1/The National Conference of Commissioners on Uniform State Laws was established in 1892. It is an organization of legal experts appointed by the State governors for the purpose of seeking uniformity in State laws. Its recommendations must be adopted by the State legislature to become law in a particular State.

taxing jurisdictions on the basis of an equally weighted three-factor formula, 1/ and defined the formula factors as payroll, property, and sales. However, UDITPA 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.

The States have not fully embraced UDITPA because they generally oppose some or all of its provisions. Today, more than 20 years after UDITPA was drafted, only 25 States have adopted most or all of the act's provisions. The remaining 20 States have not adopted any parts of UDITPA or have adopted only selected provisions of the act.

The most recent prominent States' effort towards uniformity was initiated in 1966 as an alternative to proposed interstate taxation bills pending in the Congress. This effort was undertaken by the Council of State Governments, the National Association of Tax Administrators, the National Association of Attorneys General, and the National Legislative Conference. These groups established the Multistate Tax Commission (MTC) which in turn formulated detailed regulations covering allocation and apportionment of income for tax purposes. Multistate Tax Commission membership is open to all States. As with UDITPA, however, the States were reluctant to implement the MTC regulations. At the time of our work, only 20 States were MTC members. A total of 18 States generally followed the MTC regulations but only 14 States had officially adopted those regulations. Thus, nonuniformity remains.

The States have thus made some progress over the past several years in developing more uniform rules for apportioning the income of MJCs, but progress has been slow primarily because individual States have sought to have laws and regulations which embody their particular political and economic views on the best means of determining the taxable income of MJCs. This fact is reflected even in the most prominent attempts by the States to achieve greater uniformity--the development of UDITPA and the formation of the MTC. Most States which have incorporated UDITPA and/or MTC rules have done so on a piecemeal basis. Furthermore, 20 States have not, for the most part, adopted the rules of either association but rely primarily on their own rules and regulations.

1/In essence, UDITPA defines business income as income arising from transactions and activities in the regular course of the taxpayer's trade or business, and nonbusiness income as all other income including income from rents, royalties, interest, dividends, capital gains, etc. Nonbusiness income is allocated to individual States.

We believe that one reason for this lack of acceptance is that neither UDITPA nor MTC address such important matters as defining when a corporation is taxable in a State, explaining how to treat income a corporate taxpayer receives from corporations located in foreign countries, and providing guidance on whether to combine the profit or loss of related corporations when determining taxable income. Because these issues are so significant for both States and multijurisdictional corporate taxpayers, real progress towards uniformity cannot be achieved until they are resolved. In this regard the States' progress has been less than satisfactory.

LACK OF UNIFORM RULES AMONG THE STATES EXISTS IN SEVERAL IMPORTANT AREAS

A business which conducts activities in more than one State is faced with a maze of different State laws and regulations. Significant differences among State tax provisions exist in jurisdiction-to-tax rules, starting point for determining taxable income, composition of apportionment formulas and factors, rules used for allocation of certain types of income to specific States, application of formulas to both multistate and multinational operations, and treatment of foreign source dividend income. (See app. II for our inventory of differences among State income tax provisions.)

Jurisdiction-to-tax rules

Jurisdiction-to-tax rules establish the criteria for determining whether an MJC has sufficient activities or connections in a State to be taxable. Examples of different criteria used by States include: whether a corporation is doing business in a State; whether a corporation is deriving income from sources within a State; and/or whether a corporation owns property in a State. In most States, these criteria supplement the Federal law covering jurisdiction-to-tax.1/ Basically, the Federal statute prohibits a State from imposing an income tax on an out-of-State corporate taxpayer if that taxpayer's activity in the State is limited to the solicitation of sales orders for tangible goods, and the orders are approved and filled outside the State.

Our inventory showed that 6 of the 45 States which tax corporate income do not have specific jurisdiction-to-tax criteria. The other 39 States use one or more of 16 different rules for deciding when a corporation is taxable in a State.

1/Public Law 86-272, 73 Stat. 555 (1959)(15 U.S.C.§ 381 *et. seq.*)

The existence of both numerous jurisdictional rules and imprecise criteria often make it difficult for a multijurisdictional corporate taxpayer to determine when its income is taxable by a given State. For example, while 15 States tax corporations designated as "doing business" in the State and 12 States tax corporations which "derive income from sources in the State," these terms are not necessarily defined in the same way in every State. One State, for instance, may construe "doing business" as the operation of a small sales office, while another State may require more substantive activity, such as the physical presence of a manufacturing plant. (See pp. 59 to 60.)

Starting point for determining taxable income not uniform

Before an MJC applies the various rules required to divide its taxable income among the States in which it conducts business operations, it must determine the total amount of its income to be taxed. Thirty-four States facilitate this determination by stipulating that a corporate taxpayer start with its Federal taxable income and then make adjustments as required by State law to arrive at its State taxable income. The eleven other income tax States do not use Federal taxable income as the starting point but generally require that a corporation start with its gross income and then deduct specified items. (See pp. 60 to 61.)

Composition of apportionment formula varies

Formulas to apportion income are used, in certain situations, by all of the 45 States which tax MJCs. Although this is one area where substantial uniformity among the States exists, some important differences remain. For example, 39 States use an equally weighted three-factor formula (property, payroll, sales), but 4 of those States can also apply alternate formulas. One State can use a formula weighted 70 percent sales, 15 percent property, and 15 percent payroll; a second State can employ a two-factor property and sales formula; a third State can apply a single factor sales formula; and the fourth State can use either a three-factor doubleweighted sales formula or a single-factor sales formula. These four States appear to use alternate formulas because the income of some multistate corporations may be more clearly reflected under these formulas than under the equally weighted three-factor formula.

In addition to the 39 States which use an equally weighted three-factor formula or an alternate formula, 4 States use a doubleweighted sales factor formula, 1 State employs a two-factor property and payroll formula, and 1 State uses a one-factor sales formula. (See pp. 61 to 62.)

Factors used in apportionment formulas are not uniformly defined

As mentioned above, all States that tax corporate net income use an apportionment formula consisting of some combination of property, payroll, or sales factors. Each State has the authority to decide not only which factor or combination of factors to employ but also to specify which elements should comprise each factor. This has resulted in nonuniformity in the composition of the formula factors. For example, the property factor is generally considered to encompass both owned and rented real and tangible personal property of the corporation. Nine States, however, include or exclude certain types of property from this general definition. Furthermore, three of those States plus an additional four States value property on a basis other than the generally accepted one of historical cost. Net book value is the other basis most frequently used.

There are also differences in the way the payroll factor is applied. The differences primarily involve the basis for assigning payroll costs to a State and the type of compensation to be included in the costs. For example, 34 of the 44 States that use a payroll factor adhere to the rules which assign payroll costs to a State if the individuals being paid perform their services in the State. The other 10 States assign payroll on bases such as the time spent by employees in the State or whether the employees are residents of the State.

In addition, 35 States follow a uniform standard on the type of compensation to be included in the payroll factor. This standard provides that compensation consists of wages, salaries, commissions and any other form of remuneration paid to employees for personal services. Six other States, however, exclude amounts paid to corporate officers. The remaining three States which apply a payroll factor include or exclude specific types of compensation from the factor.

With regard to the sales factor, differences among the States center mainly on the inclusion of the rule termed "throwback." This rule calls for throwing back a corporation's sales to the State in which the sales originated if the corporation is not taxable in the State of destination. Throwback is thus intended to prohibit a corporation's sales from totally escaping taxation. Twenty-seven of the 44 States that use a sales factor have some type of throwback rule, with 23 of these States applying a uniform rule. The remaining 16 States which base sales on destination of the sale (1 State does not base sales on destination) do not have a throwback provision. (See pp. 62 to 65.)

Rules used to allocate income vary among the States

Instead of apportioning by formula all income an MJC earns, some States choose to allocate certain types of income in total to individual States. (See p. 4.) While 11 of the 45 States which tax corporate net income apportion all or nearly all income, the remaining 34 States allocate some income according to various rules. These rules, which specify the types of income to be allocated, differ among the States. For example, while most States classify corporate income as either business or nonbusiness, some States use other designations. New York, for instance, classifies corporate income in three ways--business, investment, and subsidiary. While New York apportions business and subsidiary income, it allocates investment income. In addition to New York, nine other States which allocate income use designations other than business/nonbusiness. (See pp. 65 to 66.)

Lack of uniform rule in using combined reporting

The States vary considerably in their use of combined reporting. (See p. 5.) For example, 26 States reported to us that they apply it to corporations operating within the U.S. but only 15 said they do so on a frequent basis. Eleven of the 26 States said they also apply combined reporting to corporations operating outside the U.S.; 34 States said they never or almost never do.

After we completed our inventory, New Hampshire and New York enacted legislation which permits the application of combined reporting to companies operating outside the U.S., New York's legislation applying only to oil companies. Thus, they have become the 12th and 13th States to use worldwide combined reporting. Also, Minnesota enacted legislation permitting it to use combined reporting for corporations operating in the U.S., bringing the total of such States from 26 to 27. (See p. 66.)

Rules used to tax foreign source dividends are not uniform

The States also differ considerably in their treatment of dividends received by U.S. corporations from foreign corporations. While 7 States exempt all foreign source dividends from taxation and 3 States exempt a substantial portion, 35 States tax these dividends. Of the 35, 10 States apportion all foreign source dividends, 4 States allocate all of these dividends to the State of commercial domicile, and the remaining 21 States both allocate and apportion some of the dividends under various rules. Sixteen of the 21 States that both apportion and allocate foreign source dividends follow a uniform business-nonbusiness income distinction for determining which income should be apportioned and which income should be allocated. Each of the remaining 5 States, however, employs different rules. (See p. 67.)

LACK OF UNIFORM RULES IS DETRIMENTAL TO BOTH STATES AND CORPORATE TAXPAYERS

In 1964, the Willis Report, 1/ a comprehensive congressional study of interstate taxation mandated by Public Law 86-272, demonstrated that a need for greater uniformity among the States existed. According to some tax experts, uniformity is even more urgently needed now. Not only have MJCs grown in number and size, but more States now have a corporate income tax and have become more aggressive in enforcing the tax. The majority of corporate officials and CPAs responding to our questionnaires said that the present degree of nonuniformity is compounded by frequent changes in State income tax laws, regulations, and procedures. Often, these changes are not communicated to taxpayers on a timely basis, resulting in additional research work by the tax staff or incorrect return preparation. Eighty percent of the corporations responding to our questionnaire believed greater uniformity along with better communication were needed to reduce the burden of keeping up with changes in State tax laws and regulations.

Lack of uniformity among States in taxing MJCs thus impedes efficient tax administration and has detrimental effects on both State tax administrators and corporate taxpayers. These effects include higher return preparation costs, potential overtaxation or undertaxation, numerous disputes, and ultimately, potential noncompliance. More uniform State income tax provisions would reduce these difficulties and produce a more efficient tax system.

Corporate taxpayers believe lack of uniformity results in higher return preparation costs

Corporate officials reported to us that the cost of preparing State income tax returns averages 16 percent of State income tax liability. 2/ They stated that the primary reason for this cost is the lack of uniformity and frequent changes in

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1/Report of the Special Subcommittee on State Taxation of Interstate Commerce, Committee on the Judiciary, House of Representatives, 88th Cong. 2d Sess. (1964). (Referred to throughout as the Willis Report.)

2/The median is 3 percent for the large corporations reporting to us and 6 percent for the small and medium size corporations. The difference between the average figure of 16 percent and the median figures is due to the fact that our sample included both MJCs reporting high net incomes and those reporting relatively low net incomes. Because both high and low net income MJCs incur roughly the same amount of State income tax return preparation costs, the average cost figure would tend to be higher than the median figure for MJCs of all sizes.

State provisions. Furthermore, most stated that the real cost of preparing returns had increased between 1972 and 1977, and large corporations anticipated continued increases.

The lack of uniformity among State income tax provisions requires multistate corporate taxpayers to spend more time and incur additional expense preparing State returns than they otherwise would incur if a more uniform system existed. In effect, corporate taxpayers must treat the income tax return for each State separately, taking into account provisions which vary from those of other States. For example, a corporation filing a return in one of the 11 States which does not use Federal taxable income as the starting point for determining taxable income must make additional separate calculations to come up with the correct starting point. A multijurisdictional taxpayer would have to make still more calculations for every other area where nonuniformity exists, such as application of the apportionment formula and definition of formula factors. The net result is that the corporation incurs a higher return preparation cost than if it had to comply with more uniform provisions.

Nonuniformity may increase the possibility of overtaxation or undertaxation

The lack of uniform income tax provisions among States creates situations in which an MJC may be taxed on more or less than 100 percent of its income. The occurrence of overtaxation or undertaxation can either deprive a State of its proper share of revenue or give it more than is due. Likewise, improper taxation can result in a corporate taxpayer gaining an advantage over competitors. Detrimental to both States and corporations, the occurrence of overtaxation or undertaxation of multijurisdictional corporate income is an inequitable result of a nonuniform tax system. As the Willis Report stated, "overtaxation and undertaxation are produced in part by a variety of causes which may be summed up as lack of uniformity." 1/

There are several ways in which lack of uniform income tax provisions among States can result in an MJC paying taxes on more or less than 100 percent of its income. For example, overtaxation can occur when a corporation is being taxed both in a State which allocates or taxes the full amount of certain kinds of income earned by the company and also in a State or States which apportion the same income among taxing jurisdictions.

An example provided in public hearings by a multistate corporate tax official shows how income can be overtaxed when allocation and apportionment rules overlap. A lumber products company

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1/Willis Report, p. 412.

sold some appreciated timberland in Mississippi. Mississippi's tax law required that the company allocate the entire gain from the sale to Mississippi. The company also did business and was taxable in other States. Some of those States included the gain from the sale in the company's apportionable tax base. Thus, the gain from the sale of the timberland was taxed completely by one State, while portions of the gain were also taxed by other States. 1/

Another situation in which overtaxation can take place is when a corporation is taxable in only two States but each applies different criteria for apportioning sales. For example, consider an instance where one State includes sales in its apportionment formula when the location of the sales office is in that State while a second State includes sales in its formula if the destination of the sales is within its boundaries. A corporation making a sale from a sales office in the first State to a customer in the second State would have the full amount of the sale apportioned to each State, thus being taxed twice on the same item of income. Conversely, if both States used the same criteria for including sales in their apportionment formulas, double taxation would be avoided because only one State would be entitled to include the total amount of the sale in its formula.

On the basis of the responses we received to our corporate questionnaires, we estimate that 50 percent of the firms in our universe believe they had experienced overtaxation due to nonuniformity in State income tax provisions. More of the large corporate taxpayers held this view than smaller ones. There were two reasons for overtaxation cited frequently by firms of all sizes. One reason was that an item of income allocable to one State was included in another State's apportionable base; the other was that an item of income was subject to apportionment formulas not using uniform factors from State to State.

Lack of uniformity among the States can also result in undertaxation. For example, depending on the States involved, an MJC can be taxed on less than 100 percent of its income when the corporation has its main offices and plant in one State but makes sales in other States. The fact that the company has its main operation in a State dictates that it will be taxable in that State. However, some or all of the States in which the

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1/Hearings on Interstate Taxation before the Committee on the Judiciary, United States Senate, 95th Congress, 1st and 2d Sess., p. 88 (1978).

company makes sales may not consider that those sales constitute sufficient activity to tax the company. Thus, if the State in which the company is headquartered is the only one which taxes the company and uses an apportionment formula to do so, that State will be taxing only part of the total income of the company. The remaining income earned from sales activity in other States will be apportioned to those States and will escape taxation. Many State tax administrators believe that instances of undertaxation like this one occur more frequently than cases of overtaxation.

The extent of overtaxation or undertaxation resulting from nonuniformity among State income tax provisions is unknown. The determination is dependent on the facts and circumstances of each case, and neither the States, corporate officials, nor anyone else has empirical data to show the extent of overtaxation or undertaxation. The important point is that lack of uniform income tax provisions among the States creates situations which increase the possibility that a multijurisdictional corporate taxpayer will be taxed on more or less than 100 percent of its income. The existence of such situations creates undue uncertainty and inefficiency in the State tax system.

<u>Lack of uniformity increases the opportunity for disputes between State tax administrators and corporate taxpayers</u>

While the States consider tax revenues primarily as a means of financing their programs and activities, corporations view taxes as a major expense. The expenses incurred by corporations are not limited to the direct income tax levy but include costs of preparing returns and settling audit disputes. This latter category of costs promises to increase as States become more aggressive in taxing corporate income.

Substantial differences in income tax provisions among States increase uncertainty for MJCs and thus enhance the opportunity for disputes over audit results between States and corporations. Since considerable time, expense, and personnel are required to resolve disputes, they are costly for both the States and corporate taxpayers.

For example, differences among the States in determining when a State has jurisdiction-to-tax an MJC are often the sources of formal administrative and judicial disputes. From the results of our questionnaires, we estimate that over the 5-year period ending in 1977, 32 percent of the nearly 5,000 corporations in the universe from which we sampled had disputes with the States concerning jurisdiction-to-tax. Although most of the corporations said the disputes involved 4 or fewer States, some corporations reported disagreements with more than 12 States.

Nonuniformity in the application of combined reporting by the States to corporations operating within the United States ("domestic combined reporting") is another major cause of disputes. We estimate that for the 5-year period ending in 1977, about 250 of the more than 600 large firms in our universe that were required to use combined reporting disagreed with the results of this State requirement. About 40 percent of the 250 corporations said they experienced cost increases in constant dollars during that period in resolving the disputes with the States.

The States' application of worldwide combined reporting was also disputed by a significant number of affected corporations. Of the more than 500 corporations which said they were required to use this method, about 45 percent told us they filed formal administrative protests with the States.

While there will always be disagreements between the States and corporate taxpayers over application of State income tax laws and regulations, greater uniformity would serve to clarify the requirements from State to State and thus reduce the opportunity for disputes. A decrease in the number of disputes would reduce costs for both the States and taxpayers.

Benefits to States and taxpayers would result from greater uniformity

The effects of substantial nonuniformity in the way the States tax multijurisdictional corporate income--high return preparation costs, overtaxation and undertaxation, and numerous disputes--result in a tax system which is unduly uncertain and inefficient, which has a high potential for inequity, and, ultimately, for noncompliance. Some taxpayers told us they are prone to noncompliance when compliance costs are greater than tax liability. This is especially true for smaller corporate taxpayers for which the costs of filing returns in accordance with the differing laws and regulations of various States may exceed taxes owed to those States.

A tax system which fosters noncompliance, creates opportunities for overtaxation or undertaxation, and generates numerous disputes between taxpayers and tax administrators seriously undermines confidence in that system. Both the States and corporations we contacted perceive this erosion of confidence. A large majority of both groups stated that greater uniformity is needed to reduce the problems resulting from the way the States tax the income of MJCs.

Over 70 percent of the large corporations and over 65 percent (six of nine) of the CPAs responding to our questionnaire, for example, told us that it would be desirable to have uniform definition and application of jurisdiction-to-tax rules, apportionment formulas, formula factors, tax base, and allocation rules. In addition, about one-half the corporate taxpayers, one-half the States, and about 75 percent (seven of nine) of the CPAs responding to us believed that increased uniformity would ensure more equitable tax treatment between intrastate and interstate corporations. Some corporate tax authorities also felt that greater uniformity would facilitate State enforcement efforts and would increase tax collections, especially since small and medium-size corporations would find compliance easier.

The need for greater uniformity is more urgent today than it was in 1964 when the Willis Committee issued its report. Corporations continue to grow and expand their operations to more States and foreign countries, while States attempt to respond to this growth with more aggressive pursuit of tax revenues. In assessing the State system of multijurisdictional corporate taxation, the Willis Report stated:

> "It is * * * a system which works badly for both business and the States. It is * * * a system in which the States are reaching farther and farther to impose smaller and smaller liabilities on more and more companies. It is * * * a system which calls upon tax administrators to enforce the unenforceable, and the taxpayer to comply with the uncompliable. * * * The future [does not] hold out any prospect of improvement. The number of income tax jurisdictions increases. Laws seem to become more complex rather than less. Improved enforcement procedures may add taxpayers to the rolls, but still it is inconceivable that they can make any substantial impact on noncompliance." 1/

Unless action is taken, the current system of multijurisdictional corporate income taxation will continue to produce inefficiency and uncertainty, burdening both State tax administrators and increasing numbers of taxpayers.

1/Willis Report, Vol. I, pp. 598-99.

FEDERAL LEGISLATION IS THE MOST APPROPRIATE SOLUTION TO RESOLVE MAJOR INTERSTATE AND INTERNATIONAL POLICY ISSUES

The issue of how the States tax the income of MJCs has become increasingly controversial in recent years as some States have extended application of their apportionment formulas to corporations' non-U.S. operations. Controversy over these State procedures, which have international policy implications, has thus been added to existing concern about the relationship between the Federal Government and the States in regulating interstate activities.

Although the Supreme Court has rendered decisions on some of the issues affecting State taxation of MJCs, the inherent limitations of the judicial process have prevented and will continue to prevent the comprehensive treatment of the issues which their scope and complexity demand. Recognizing this, the Supreme Court has stated that Congress is best suited to make the policy decisions which will lead to resolution of the issues. As we have discussed, the States have made some efforts towards greater uniformity, but in our opinion these efforts have not achieved a reasonable degree of uniformity, particularly not on the issue of State taxation of foreign source income.

While the courts have long and consistently upheld the States' authority to tax, the courts have also held that the Congress has authority to legislate over interstate and international tax matters. We think that the Congress should exercise that authority to resolve the important interstate and international policy issues created by the present degree of nonuniformity in States' practices. We believe the Congress is in the best position to apply the broad perspective necessary to achieve a balance between the States' authority to tax and the Federal interest in interstate and international tax policy issues.

States have authority to tax

The authority of the States to tax has existed since the founding of this country. In framing our Federal system of government, Alexander Hamilton made clear that "the individual States would, under the proposed constitution, retain an independent and uncontrollable authority to raise revenues to any extent of which they may stand in need by every kind of taxation except duties on imports and exports." 1/

1/Alexander Hamilton, The Federalist (Nos. 31-36).

The States generally maintain that this basic State power was also implicitly recognized in the 10th Amendment to the Constitution and has long been upheld by the Supreme Court. The Court first affirmed this power in 1819 when it stated that "* * * the power of taxation is retained by the States even though similar authority has been granted to the Federal Government. The authority to tax is to be concurrently exercised by the two governments." 1/ Five years later, the Court added that "although many of the powers formerly exercised by the States are transferred to the [Federal Government,] the State governments remain a most important part of our system. The power of taxation is indispensable to their existence and is a power which * * * [can reside in] and be exercised by different authorities at the same time." 2/

In several decisions since that time the Supreme Court has affirmed the authority of the States to tax interstate activities so long as the State tax is consistent with the Due Process Clause of the Fourteenth Amendment and the Commerce Clause. The Court has held that a State tax on interstate business is constitutional as long as the tax is applied to an activity having a minimal connection with the taxing State, is fairly apportioned, does not discriminate against interstate commerce, and is fairly related to services provided by the State.

<u>Congress has constitutional authority to legislate on interstate and international taxation issues</u>

Congressional authority to legislate in the area of State taxation of MJCs is derived from the Commerce Clause of the Constitution, which provides that "Congress shall have the power to regulate commerce with foreign nations and among the several States." The Supreme Court has interpreted congressional power broadly under the Commerce Clause, thus placing minimal limitations on the exercise of this power. The Court's broad interpretation means that the Congress may exercise its Commerce Clause power either to expand the States' authority to tax interstate commerce or to restrict the States' power. For example, the Congress exercised the latter option in 1959 when it enacted Public Law 86-272, which limited the situations in which a State could tax the income of an MJC.

Although the Congress has broad authority under the Commerce Clause over issues involving State taxation of MJCs, the Supreme Court has long recognized the need to balance that authority against the power of the States to tax. In a recent case the Court underscored the necessity for "* * * the delicate adjustment

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1/*M'Culloch* v. *Maryland*, 17 U.S. 316 (1819).

2/*Gibbons* v. *Ogden*, 22 U.S. 198 (1824).

between the national interest in free and open trade and the legitimate interest of the individual States in exercising their taxing powers." 1/

While both the States and the Congress thus have authority to tax, the primary justification for congressional reliance on the Commerce Clause is to ensure the free flow of commerce among the States. This implies that congressional authority is to be invoked when the competing interests of the States serve to frustrate the national interest. To this end, the Congress already has enacted several laws covering State taxation of interstate business.

The courts cannot address the full range of interstate and international tax policy issues arising from State taxation of MJCs

Although the Supreme Court has long recognized the importance of achieving an accommodation between the States' right to tax and congressional authority to regulate interstate commerce, the inherent limitations of the judicial process prevent the Court from attaining that goal. The courts necessarily examine issues on a case-by-case basis, formulating their analysis and conclusions only from the facts presented in a particular case. A major drawback to this approach is that it prevents full consideration of the nature and impact of issues from a broad interstate and international policy standpoint.

While the inability of courts to render judgment on a comprehensive basis affects other issues, this shortcoming is especially evident in the realm of interstate taxation.
As the Supreme Court has noted:

> "Commerce between the States [has developed randomly]. [With] Congress meanwhile not having undertaken to regulate taxation of it, and the states having persisted in their efforts to get some return for the substantial benefits they have afforded it, there is little wonder that there has been no end of cases testing out state tax levies. The resulting judicial application of constitutional principles to specific state statutes leaves much room for controversy and confusion and little in the way of precise guides to the states in the exercise of their indispensable power of taxation. This Court alone has handed down some three hundred [full] opinions * * *." 2/

1/ Boston Stock Exchange v. State Tax Commission, 429 U.S. 329 (1977).

2/ Northwestern States Portland Cement Co. v. Minnesota, 358 U.S. at 457 (1959).

Congress should exercise its authority to enact legislation

While the difficulties caused by the lack of uniformity among States in dividing multijurisdictional corporate income have long been recognized, in recent years additional issues with broader policy implications have arisen as some States have extended application of their apportionment formulas to non-U.S. operations and as the amounts of revenue have grown.

MJCs and their representatives have objected that the States' application of apportionment formulas to a corporation's non-U.S. operations may interfere with the Federal Government's exclusive authority to formulate international tax policy and may disrupt foreign commerce. The Willis Report commented on this point in 1964 by stating, "In keeping with the basic structure of our Federal system, the Committee is of the view that international tax policy should be formulated by the Federal Government and not by individual States." 1/ The objections are based on the premise that national policy is seriously impeded when individual States apply taxing methods to worldwide business which contravene established international standards.

MJCs and States, especially California, which include foreign operations in their apportionment formulas often hold differing views on the issue of including a taxpayer's income from foreign operations in apportionable income. This issue has been covered extensively in congressional hearings and was a key aspect of recent tax treaty negotiations between the United States and Great Britain. The States maintain that the issue involves their ability to generate revenue while corporate taxpayers similarly contend that it significantly alters tax liability. Because the issue has broad international policy implications with a potentially huge revenue impact on both States and multinational corporations, we believe it is most appropriate that the Congress resolve the matter.

The Supreme Court has not only recognized the inadequacy of the judicial approach to resolving interstate and international tax issues but as recently as 1978 it commented on the need for a legislative solution:

> "It is clear that the legislative power granted to Congress by the Commerce Clause of the Constitution would amply justify the enactment of legislation requiring all States to adhere to uniform rules for the division of income. It is to that body, and not this Court, that the Constitution has committed such policy decisions." 2/

1/Willis Report, Vol. IV., p. 1155.

2/Moorman Mfg. Co. v. Bair, 437 U.S. at 280 (1978).

This opinion points out that the Constitution has relegated certain policy decisions to the Congress. Decisions such as those covering State taxation of multijurisdictional corporate income are best made by the Congress because they involve broad interrelated policy issues concerning interstate and international commerce. These issues require a comprehensive solution. The Congress is most capable of thoroughly considering all the factors which comprise the elements of such a solution. Furthermore, the Congress has the clearest mandate to formulate policy which strikes a balance between the States' authority to tax and the limits on their power to tax.

CONCLUSIONS

At present, State taxation of multijurisdictional corporate income is administratively unwieldy. Forty-five separate political jurisdictions attempt to equitably divide the income of often complex and geographically dispersed taxable entities, and each jurisdiction formulates its own specific rules for determining how much of an entity's total income is attributable to operations in that jurisdiction. The resulting lack of uniformity is extensive.

The problems of nonuniformity are even more critical today than they were when the special House subcommittee issued the Willis report in 1964 extensively documenting the lack of uniformity in interstate tax provisions. The issues have become more complex and controversial as the number of MJCs has grown and certain States have expanded their taxing efforts to take foreign operations into account.

The issues which have developed in recent years have broad policy implications potentially affecting international tax policy. Furthermore, the issues are at the center of the longstanding constitutional debate over the balance between State sovereignty and congressional Commerce Clause powers. Moreover, lack of uniformity among the States causes problems for States and corporate taxpayers. These problems--higher return preparation costs, potential overtaxation or undertaxation, and numerous disputes--result in a tax system which is unduly uncertain, inefficient, and often inequitable.

These issues need resolving. But, in the almost 20 years since the House subcommittee issued its report, little progress has been made to increase the uniformity with which States tax corporate income. The States have made some voluntary efforts but substantial nonuniformity still exists.

The Supreme Court has also attempted to deal with some of the issues affecting State taxation of multijurisdictional corporate income. But the Court itself has recognized the inherent limitations of the judicial approach to solving the interstate and international policy issues and has acknowledged that the Congress is the appropriate body to resolve such issues.

The Congress appears to be in the best position to fully evaluate the multiple factors and assess the arguments surrounding the policy issues involved in State taxation of multistate and multinational corporate income, especially foreign source income. Also, because the Congress can fully consider the States' rights and foreign policy issues, it can best devise a comprehensive solution which adequately and fairly balances the competing interests of the States and corporate taxpayers.

CHAPTER 3

INTERNATIONAL AND INTERSTATE ISSUES WHICH

THE CONGRESS SHOULD CONSIDER

To achieve greater uniformity among States in taxing the income of MJCs, the Congress need not write a model taxing statute which all States must follow. Instead, the Congress could set parameters within which States could continue to exercise their authority to tax.

The task of achieving more uniformity is complicated by the fact that provisions differ considerably among the States and by the fact that State and corporate tax officials often disagree on the rules and procedures to be used. Most controversial for both State and corporate officials is the practice by some States of taking into account income from foreign operations.

Our objective in this chapter is to discuss the key issues involving States' taxing of multijurisdictional corporate income. While there are other issues affecting States' taxing of multijurisdictional corporate income, we have focused on those issues for which we believe the resolution will most greatly enhance uniformity among the States, which have been included in recent congressional bills, and/or which have been the source of numerous legal disputes between the States and corporations. These issues are (1) the criteria for determining a unitary business; (2) States' extension of their apportionment formulas to foreign operations; (3) the States' treatment of dividends received from foreign corporations; (4) the establishment of objective criteria for determining if an MJC is taxable in a State; (5) the adherence to the same starting point in calculating the amount of a corporation's income taxable in a State; (6) the application of a mandatory apportionment formula by all States; (7) the composition of the apportionment formula factors; and (8) the determination of whether all taxable income should be apportioned among the States or whether certain types of income, e.g., dividends, should be allocated to a single State. We believe resolution of these issues would result in a more efficient and equitable tax system.

To ascertain the extent of agreement on the issues we relied primarily on written comments from experts and representatives of key organizations, using these in conjunction with the results of our other data-gathering efforts. We found that, while States and multijurisdictional corporate taxpayers are divided on all the issues, they are farthest apart on the question of how to define a unitary business ([1] above) and on the multinational issues ([2] and [3] above). We also found that, despite significant disagreement between State and corporate representatives on some specific proposals, there was general agreement that income tax provisions should be applied more uniformly by States.

MORE DEFINITIVE CRITERIA ARE NEEDED FOR DETERMINING A UNITARY BUSINESS

As stated previously, a prerequisite for using formulas to apportion income among taxing jurisdictions is that the taxpayer's business be unitary. State and corporate officials, however, often do not agree on how to define a unitary business, especially when multicorporate entities are involved. Furthermore, the decisions of the courts on this question have often been vague and conflicting.

Formula apportionment can only be applied to a unitary business. In practice, however, deciding whether a business is unitary is a difficult task. The determination often involves analysis of complex corporate structures and operational relationships. Many modern multijurisdictional corporate entities consist of hundreds of divisions, branches, or subsidiaries whose relationship to one another and to the parent corporation are not readily clear. Identifying the elements to use in determining if such a corporate enterprise should be considered unitary for tax purposes is the crux of the problem. Moreover, even if States and corporate taxpayers could agree on the elements, reaching agreement on how the elements should be quantified would present further problems.

In simple terms, a unitary business can be defined as one in which there is a relationship of "dependency and contribution between the portions of the business within and without the taxing State." 1/ Several criteria have been used by the courts to define a unitary business, but the most common ones, developed by California courts and used by that State's tax administrators, consist of

--unity of ownership as manifested by the percentage of voting stock owned;

--unity of use as evidenced by centralized performance of services, such as accounting, advertising, etc.; and

--unity of operation and management as demonstrated by a centralized executive force and general system of operation.

1/Edison California Stores, Inc. v. McColgan, 30 Cal. 2d 472, 183 P. 2d 16 (1947).

Although these criteria and versions of them provide some guidance to States and corporations for determining if a business's operations are unitary, they have not been extensively used. According to one Multistate Tax Commission official, 1/ the reason for their limited use may be due to the fact that no general conclusions can be reached based on the criteria. While each of the criteria used by the various courts purports to set forth an objective standard, the standards are so general that they are of limited help.

In part, because the unitary criteria applied are so general, corporations frequently protest States' determinations that all or part of their business operations are unitary. About 40 percent of the more than 600 large corporations in our sample required to use domestic combined reporting filed protests in this regard. Most of these corporations filed protests in only one State, even though they were required to use domestic combined reporting in several States. The largest area of disagreement involved the determination of substantial interdependence in basic operating functions.

State and corporate tax officials generally disagree on the primary criteria for determining whether a business is unitary. Corporate tax officials believe that the primary criterion should be a "substantial interdependence" test--interdependence in basic operating functions, such as purchasing of raw materials and financing of customer receivables. For example, 80 percent of the large corporations and about 75 percent (seven of nine) of the CPA's responding to our questionnaire said that the "substantial interdependence" test should be at least one of the criteria comprising the unitary business definition. On the other hand, State tax representatives generally believe that control, as manifested by stock ownership, should be the primary criterion.

Despite the disagreements in defining a unitary business, it might be possible to combine criteria to arrive at a definition. For example, it might be feasible to combine a stock ownership test with a substantial interdependence test to derive a standard which is acceptable to both State and corporate tax officials. In addition to obtaining acceptance of such criteria, however, another major obstacle would be reaching agreement on the percentages to apply. State officials we contacted, for instance, generally favored defining a unitary business as existing when one corporation owns more than 50 percent of the stock of another corporation. Conversely, corporate officials we contacted believed an 80 percent stock ownership figure should be required for defining a unitary business.

1/William D. Dexter, "The Unitary Concept in State Income Taxation of Multistate-Multinational Business," Vol. 10, The Urban Lawyer 181-212 (1978).

Similar differences could also arise concerning the percentages needed to substantiate the interdependence test.

APPLICATION OF THE UNITARY CONCEPT TO FOREIGN CORPORATIONS IS HIGHLY CONTROVERSIAL

Some States, most notably California, extend the unitary concept to include foreign (non-U.S.) corporations that are considered to be part of the affiliated unitary group. The foreign corporations included in the unitary group can be either the parent corporation of the affiliated corporations or a subsidiary. A parent corporation is generally defined as one owning, either directly or indirectly, more than 50 percent of the stock of each of the other members of the affiliated group, while a subsidiary corporation is generally defined as one in which the parent has more than 50 percent ownership.

When States extend the unitary concept to include foreign corporations the approach is known as "worldwide combined reporting." (See p. 5.) Under worldwide combined reporting a State applies its apportionment formula to the combined income of the foreign corporate entities included in the unitary group with the income of the corporation(s) doing business in the State. This involves combining the income of (1) a foreign parent corporation with its U.S. subsidiary corporations doing business in the State; or (2) foreign subsidiary corporations with their U.S. parent corporation doing business in the State. Although only 13 States currently employ this method (11 States at the time of our questionnaire), 1/ 70 percent of the large corporations and 50 percent of the smaller corporations with foreign operations that responded to our questionnaire said they did business in States using the method.

Corporations are opposed to worldwide combined reporting for several reasons. Corporate officials believe that the application of worldwide combined reporting results in (1) taxation of foreign source income, (2) frustration of U.S. foreign commerce, (3) increased risks of international double taxation, (4) overallocation of income to a State because of the noncomparability between U.S. and foreign apportionment factors, and (5) substantial administrative burdens on multinational corporations. The States which apply worldwide combined reporting, especially California, do not accept the corporate position.

1/The thirteen States are Alaska, California, Colorado, Idaho, Illinois, Indiana, Massachusetts, Montana, New Hampshire, New York, North Dakota, Oregon, and Utah.

Corporations contend that worldwide combined reporting results in taxation of foreign source income

Unlike the States, the Federal government distinguishes between multijurisdictional corporate income earned in the United States and that earned in foreign countries. Federal tax law specifically addresses "foreign source income" and contains detailed provisions to use in separating income earned within and outside the United States. Further, the Federal government generally does not tax the income earned by a foreign subsidiary of a U.S. corporation until that income is paid back or "deemed paid back" in the form of a dividend to the U.S. corporation. 1/ In addition, the Federal law grants a credit for any foreign taxes paid on the earnings which constitute the dividend from the foreign subsidiary to the U.S. parent. The purpose of the credit is to avoid double taxation.

In order to prevent evasion of taxes and to ensure that an MJC accurately reports its total U.S. income, the IRS has authority under section 482 of the Internal Revenue Code to reallocate income, deductions, and credits between a U.S. corporation and its foreign affiliates. The regulations under section 482 are designed to prohibit the improper shifting of income by requiring that transactions be conducted at arm's length. Compared to the State approach of combining the income of affiliated corporations and then apportioning it by formula, the Federal system separately accounts for the income of each related corporate entity through analysis of transactions. We recently reported on IRS' administration of section 482. 2/

MJCs claim that when a State includes worldwide income in the taxable base under worldwide combined reporting that State is taxing foreign source income and thus exceeding its constitutional authority to tax only income earned from sources within the State. For example, about 75 percent of the corporate officials who told us that they filed protests with the States over worldwide combined reporting stated that the major tax deficiency assessed resulted from including in the apportionable tax base the income of corporations that conducted no substantial business in the United States. Furthermore, MJCs contend that the application of worldwide combined reporting discriminates in favor of corporations operating totally within the State because intrastate corporations do not

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1/The Federal government does, however, tax shareholders of certain controlled foreign corporations under Subpart F on undistributed income. (See section 951 et seq. Internal Revenue Code.)

2/"IRS Could Better Protect U.S. Tax Interests in Determining the Income of Multinational Corporations" (GGD-81-81, Sept. 30, 1981).

include in the apportionable tax base any income derived from business or property outside the State.

The States which employ worldwide combined reporting counter that the approach does not subject foreign source income to taxation but merely divides the total taxable income among the jurisdictions in which the unitary group of corporations earn their income. The States maintain that worldwide combined reporting and formula apportionment do nothing more than calculate an individual State's share of an MJC's total income by determining the amount of income properly attributable to the State, using the factors which contributed most to earning the income. In effect, worldwide combined reporting and formula apportionment establish a source-of-income rule.

The States further argue that because formula apportionment is generally accepted as the standard method for dividing the income of both a single corporation or a group of affiliated corporations conducting a unitary business in more than one State, it would seem to make little difference whether the companies included in the unitary business are U.S. or foreign corporations. The States hold that determination of the total income of a unitary business, no matter where that income is earned, serves as the starting point for computing the income taxable by a given State. According to the States, it does not matter whether a unitary business is made up of a single corporation, a group of affiliated U.S. corporations, or a group of U.S. and foreign corporations.

To support their position, the States point out that as long ago as 1924 the U.S. Supreme Court sanctioned State apportionment of income earned by a foreign corporation. 1/ Although the case did not involve combined reporting, the Court based its decision on its finding that the corporation's business was unitary.

In a recent case involving State taxation of foreign dividends, the States cite the Supreme Court's holding that a State can include foreign source income in its apportionable income tax base and that this inclusion does not mean that foreign source income is in fact being taxed. 2/

Corporations contend that worldwide combined reporting frustrates U.S. foreign commerce

In arguing that States' use of worldwide combined reporting is unconstitutional because it impinges on the Federal powers of

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1/*Bass, Ratcliff & Gretton, Ltd.* v. *State Tax Commission*, 266 U.S. 271 (1924).

2/*Mobil Oil Corporation* v. *Commissioner of Taxes of Vermont*, 445 U.S. 425 (1980).

taxation and frustrates U.S. foreign commerce, multijurisdictional corporate officials cite a 1979 Supreme Court decision. 1/ In that decision, the Court stated that a State tax is unconstitutional under the Commerce Clause if it contravenes either of the following tests involving the taxation of instrumentalities of foreign commerce:

(1) The tax creates a substantial risk of international multiple taxation.

(2) The tax prevents the Federal government from speaking with one voice when regulating commercial relations with foreign governments.

The Japan Line case concerned a dispute over State property--not income--tax. In this case, the Supreme Court considered whether or not a property tax was unconstitutional in cases where the tax was levied on ship cargo containers which were utilized exclusively in foreign commerce. The containers were owned, based, and registered abroad. In reaching its decision, the Court explained how a State tax can have detrimental effects on the foreign commerce of the United States:

> "A State tax on instrumentalities of foreign commerce may frustrate the achievement of Federal uniformity in several ways. If the State imposes an apportioned tax, international disputes over reconciling apportionment formulae may arise. If a novel State tax creates an asymmetry in the international tax structure, foreign nations disadvantaged by the levy may retaliate against American-owned instrumentalities present in their jurisdictions. Such retaliation of necessity would be directed at American transportation equipment in general, not just that of the taxing State, so that the Nation as a whole would suffer. If other States followed the taxing State's example, various instrumentalities of commerce could be subjected to varying degrees of multiple taxation, a result that would plainly prevent this Nation from 'speaking with one voice' in regulating foreign commerce." 2/

The Supreme Court has not applied the above analysis to any income tax case involving worldwide combined reporting. However, multijurisdictional corporate officials argue that the Japan Line

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1/Japan Line Ltd. v. County of Los Angeles, 441 U.S. 434 (1979).

2/Japan Line Ltd., 450-51.

analysis demonstrates the potential harm of worldwide combined reporting on U.S. foreign commerce and also shows that worldwide combined reporting can produce the related effect of international multiple taxation.

The States argue that the positions held in the above case are not applicable to worldwide apportionment. They maintain that worldwide combined reporting does not affect foreign commerce but only involves the determination of the amount of income attributable to a particular State. The Illinois Supreme Court, in a recent income tax case involving worldwide combined reporting, recently upheld the States' view. The Court stated that:

> "Japan Line is obviously distinguishable from the case here. The purpose of the apportionment formula is to confine the taxation of business income to that portion which is attributable to activities in Illinois. This appeal does not involve the multiple taxation of items or instrumentalities of foreign commerce nor does unitary reporting affect Federal authority in governing foreign commerce. The concern here is only with the taxation of business income fairly attributable to activities within the taxing State." 1/

This case is now pending in the U.S. Supreme Court.

Corporations contend that worldwide combined reporting poses risks of international multiple taxation

Multijurisdictional corporate officials further object to the use of worldwide combined reporting by States on the grounds that a substantial risk of international double taxation is created because State tax provisions are based on the unitary concept while Federal tax provisions and the tax provisions of many foreign countries are based on the separate accounting concept. Multijurisdictional corporate officials emphasize that the separate accounting concept has been a key element of tax treaties and treaties of friendship and commerce between the U.S. and other countries. They also point out that model tax conventions promulgated by the League of Nations and the Organization for Economic Cooperation and Development contain the separate accounting concept. Some corporate officials maintain that since the income of each foreign corporation in a unitary group can be taxed in total by the foreign country using separate accounting

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1/Caterpillar Tractor Co. v. Department of Revenue, 417 N.E. 2d 1343, 1354. (Ill., 1981), prob. juris. noted, 102 S. Ct. 564 (1981).

principles, multiple taxation would result if some of that income was also apportioned by an individual State.

To support the above arguments, the Mobil Oil Corporation in a recent case 1/ attempted to apply the Japan Line analysis to an income tax situation. In this case, Mobil Oil challenged on Commerce Clause grounds the inclusion of "foreign source" dividends in the State of Vermont's tax base. These dividends were paid by foreign subsidiaries and affiliates to their U.S. incorporated parent, Mobil Oil. Mobil argued that, like the property tax in Japan Line, Vermont's corporate income tax poses a substantial risk of international multiple taxation and interferes with the Federal government's ability to achieve uniformity in foreign relations and foreign commerce.

The U.S. Supreme Court, in siding with the State, did not accept Mobil's argument and held that the Japan Line decision concerning a State property tax did not apply to an income tax. The Court stated that "* * * the factors favoring use of the allocation method in property taxation have no immediate applicability to an income tax." 2/ Furthermore, the Court pointed out that Federal and State governments could tax income concurrently and likewise that Federal and State tax treatment of foreign income does not have to be the same.

Corporations contend that worldwide combined reporting gives a State more than its proper share of taxable income because of the noncomparability between U.S. and foreign apportionment factors

Formula apportionment is based on the premise that a dollar of wages earned, a dollar spent on property, and a dollar of sales produce about the same amount of income in each jurisdiction in which a corporation operates. This premise validates the application of the apportionment formula, in which a corporation's instate property, payroll, and sales are divided by its total property, payroll, and sales. Corporate officials generally accept the premise embodied in the apportionment formula when the formula is applied to only U.S. corporations because variations in wage rates, property values, and sales prices are not that great among the States.

Corporate officials contend, however, that the premise is usually not valid when a State includes income from foreign corporations in its apportionment formula under worldwide combined reporting. The officials maintain that worldwide application of

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1/Mobil Oil Corporation v. Commissioner of Taxes of Vermont, 445 U.S. 425 (1980).

2/Mobil Oil Corporation, 448.

an apportionment formula produces a distorted result because wage rates, property values, and sales prices are significantly different between the U.S. and most foreign countries. They argue that the values of the formula factors are generally lower in foreign countries than in the U.S. and will attribute more income to the location where property, payroll, and sales are highest. The contention is that worldwide combined reporting apportions more income to a State than is actually earned within that State.

The States which use worldwide combined reporting argue that the application of apportionment formula factors does not result in distortion of income attribution between jurisdictions. State proponents believe that in most cases differences in the values of formula factors between a State and a foreign country are relatively insignificant. They add that because an apportionment formula provides only a rough approximation of the distribution of an MJC's income, minor differences between factor values are permissible.

The States also maintain that differences in the value of formula factors between the United States and foreign countries are not relevant because any attempt to isolate those factors is contrary to the unitary concept. States hold that income from a unitary business is derived from the functioning of the business as a whole and the factors generating unitary business income cannot be geographically separated or measured.

There have been no definitive studies measuring differences in the values of apportionment formula factors between the United States and foreign countries. However, available evidence from independent researchers does indicate that property values and wages, even after adjustments for productivity differences, may be substantially lower in many foreign countries than in the United States.

<u>Corporations contend that worldwide combined reporting creates heavy administrative burden</u>

Corporate officials believe that the States' worldwide combined reporting requirement imposes an administrative burden that is generally not present when only domestic U.S. corporations are involved. According to the officials, the additional administrative burden results from the need to (1) determine whether foreign corporations should be included in the unitary business group, (2) translate foreign currency into U.S. dollars, and (3) adjust foreign financial statements to reflect State income tax laws. Most multinational corporate officials consider these administrative requirements especially burdensome when the unitary business includes a parent corporation located in a foreign country. The States which apply worldwide combined reporting do not believe the method results in heavy administrative burdens on the multinational taxpayer. They feel that, for the most part, corporate officials overstate the difficulties.

<u>Unitary business determination more complicated under combined reporting</u>

As discussed on pages 29 to 31, States and corporate tax officials do not agree on the specific criteria for determining when business operations are unitary. Therefore, a State's determination that a business is unitary can generate substantial controversy and litigation between that State and the subject corporations.

Corporate officials believe that worldwide combined reporting increases administrative burden because each State independently makes unitary determinations which often require both the parent corporation and its foreign subsidiaries to submit substantial amounts of data to the State. For example, some States routinely require that corporations provide data such as profit and loss statements, balance sheets, descriptions of principal products and services, lists of officers and directors, CPA audit reports, and lists of reports filed with government agencies.

Corporate officials maintain that for a large multijurisdictional entity, data may have to be obtained from hundreds of subsidiary corporations operating in numerous foreign countries. The information obtained from these foreign corporations may be in a foreign language, thus requiring translation. Most of the multijurisdictional corporate officials responding to our questionnaire said that data needed to make the unitary determination was difficult and expensive to secure from foreign-affiliated corporations.

States which use worldwide combined reporting explain that differences among corporate structures and operations necessitate that unitary determinations be made on a case-by-case basis. To make more accurate determinations, States argue that they often must collect large amounts of data pertaining to a corporation's organization and operation. State tax administrators maintain that problems in obtaining the necessary data are due more to noncooperation by corporate taxpayers than to any inherent data collection difficulties.

States believe that, in calculating the value of foreign apportionment factors, multinational corporate taxpayers also overstate the difficulties. State tax officials hold that, in calculating profit or loss for their foreign entities, multinational taxpayers must determine the value of the entities' property, payroll, and sales. State officials maintain that these determinations can be made in foreign currency and the final tax liability translated into dollars without major difficulty.

Foreign currency translation

Whenever U.S. and foreign taxpayers are included in the same tax liability computation, a special procedure is employed to assure that the relevant figures reported to the taxing authority, whether the Federal government or a State, are comparable. This procedure is referred to as "foreign currency translation." It serves the purpose of achieving comparability between U.S. dollars and various foreign currencies by taking into account differences in currency values at any given time.

Although the process of translating foreign currency into U.S. dollars is complex, according to the corporate officials, it is currently required to be performed in certain situations. For instance, U.S. parent corporations filing Federal consolidated tax returns presently make currency translations for their foreign subsidiaries included in those returns. These U.S. corporations use well-established standards and procedures in preparing their consolidated returns. In addition, the Financial Accounting Standards Board has promulgated foreign currency translation standards for financial accounting purposes.

However, corporate officials maintain that foreign currency translation can be extremely complex, especially when a State applies worldwide combined reporting to a large multinational enterprise consisting of a U.S. parent with many foreign subsidiaries. Sixty-five percent of the multinational corporations we contacted believe foreign currency translations constitute a major problem, and officials stated that extensive effort is required to translate the foreign-based data for each subsidiary into U.S. dollars.

Although the difficulty in translating foreign currency may not be as great as some corporations contend, it can be a laborious task. The situation might be improved if the States which employ worldwide combined reporting would consider adopting the existing standards and procedures used for foreign currency translation.

Adjustments for State tax purposes

Because different rules apply, corporations normally maintain separate sets of records for financial accounting purposes and for Federal income tax purposes. Procedures have been established which facilitate the conversion of financial accounting data to figures which conform to the Federal income tax law. The application of these procedures does not usually present any difficulty when data from only U.S. corporations is being converted.

Corporate officials stated that obstacles can arise, however, when a U.S.-based MJC must file a Federal consolidated tax return. Regulations stipulate that the consolidated return must include data from both U.S. and foreign subsidiaries. To prepare the return, the U.S. parent corporation must convert the foreign subsidiary financial data to meet U.S. tax law requirements. Corporate officials explained that this conversion can be difficult because many foreign accounting rules are considerably different from U.S. rules.

According to the corporate officials, adjustments in addition to those required for Federal consolidated tax return purposes must be made when a State applies worldwide combined reporting because State rules often differ from both Federal and foreign tax rules. For example, the officials said that provisions covering depreciation, business deductions, and items to be included in income may be different. The officials said that the corporations included in a Federal consolidated tax return may not be all the same as those corporations included in a unitary group by a State, requiring that the taxpayer make additions or deletions to prepare the State combined report. Sixty percent of the large MJCs we contacted stated that the adjustments necessitated by worldwide combined reporting pose major difficulties.

Multinational corporate officials claim that they incur an especially heavy administrative burden when a State's application of the worldwide unitary concept consists of a <u>foreign parent corporation</u> and U.S. subsidiaries. Unlike the situation involving a U.S. parent corporation, Federal consolidated tax returns are not prepared when the consolidated entity includes a foreign parent corporation. Thus, the taxpayer need not have adapted its records to the requirements of U.S. tax laws. To prepare a combined report, the U.S. subsidiary must adapt its foreign parent's records to conform to the State's tax law. This can be unduly burdensome, considering the differences in language and accounting rules between the United States and other countries. In fact, all of the CPAs who commented on this point felt that differences in accounting rules and customs between the United States and foreign countries would cause major problems for the U.S. taxpayer.

States that apply worldwide combined reporting maintain that adjusting foreign records for State tax purposes is not as difficult as corporate taxpayers contend. States explain that most multinational corporations prepare, for management purposes, consolidated income statements for their unitary businesses either in dollars or in the foreign country currency. For example, State tax officials hold that, to prepare their corporate income statements, taxpayers must determine the value of the foreign corporation(s)' property, payroll, and sales. State officials believe that, even if such determinations are made in foreign currency, taxpayers can readily translate the foreign currency values into dollars to calculate State tax liability.

STATE TAXATION OF DIVIDENDS FROM FOREIGN CORPORATIONS IS ANOTHER CONTROVERSIAL ISSUE

The issue of State taxation of foreign source dividends is similar to the issue involving worldwide combined reporting because both pertain to the tax treatment of income generated by corporations operating outside the United States. However, taxation of foreign source dividends is a separate issue because it involves the taxing of income derived from foreign sources and subsequently paid to a U.S. corporation in the form of dividends. The crux of the issue is whether the States should be limited in taxing such dividends. Multijurisdictional corporate officials maintain that States should only tax foreign source dividends to the extent that they are taxed by the Federal Government. The States do not believe that such a restriction is valid. Both parties have developed arguments to support their respective positions.

Under U.S. tax laws the entire net income of a U.S. corporation, whether received from domestic or foreign sources, is subject to income tax. When the income that a U.S. corporation receives from foreign sources is in the form of dividends, the risk of international double taxation exists. This is due to the fact that the dividends are not only subject to tax by the U.S. Government but the earnings from which the dividends are paid may also be taxed by the foreign country. To avoid double taxation, the Federal Government allows the U.S. corporation which receives the dividends a credit for the foreign income taxes paid by the foreign corporation on the earnings from which the dividends are paid. To qualify for the tax credit, the U.S. corporation must own at least 10 percent of the stock of the foreign corporation.

It is the opinion of most multijurisdictional corporate officials that dividends derived from foreign sources should not be taxed by the States or, that the dividends should only be taxable to the extent that they are taxed by the Federal Government. The officials point out that most States require corporations to start with Federal taxable income in calculating State taxable income and therefore include foreign source dividends in the corporate tax base as the Federal Government does. They maintain, however, that State taxation of these dividends in full results in international double taxation because the income from which the dividends are paid is also taxed at its source by foreign governments. The officials complain that no States grant a credit similar to the Federal tax credit and most States do not even grant a deduction to alleviate this double taxation.

The officials also point out that foreign source dividends represent income from operations conducted entirely outside the United States. Therefore, the States are not justified in taxing dividends derived from business profits to which no State's economy has contributed.

State tax officials respond to the corporate officials' arguments by pointing out that dividends meet the commonly accepted definition of income. The State officials explain that taxing corporate income when earned by the corporation and again when received by the stockholders has never been held to be unconstitutional double taxation, whether the two taxes are imposed by the same sovereign government or by different governments. Thus, there is no reason why a State should give preferential treatment to foreign source dividends, as compared to U.S. source dividends, by granting the corporation receiving the dividends a credit for taxes paid by the foreign corporation.

State officials also point out that State income taxes have always been imposed in addition to Federal income taxes. State proponents believe that the independent taxing power of the States permits them to vary from Federal tax procedures in certain situations without violating the Commerce and Due Process Clauses.

A significant judicial comment on the issue of State taxation of foreign source dividends came in the 1980 Supreme Court decision in Mobil Oil Corp. v. Commissioner of Taxes of Vermont. 1/ The Court held that, assuming there is a unitary relationship between the foreign corporation paying the dividends and the U.S.-based corporation being paid the dividends, it is permissible for a State to include the foreign source dividends in the apportionable base of its income tax. Since Mobil did not deny the unitary relationship, the Court did not have to decide whether the dividends would be apportionable if such a relationship did not exist. The Court added:

> "We do not mean to suggest that all dividend income received by corporations operating in interstate commerce is necessarily taxable in each State where that corporation does business. Where the business activities of the dividend payor have nothing to do with the activities of the recipient in the taxing State, due process considerations might well preclude apportionability, because there would be no underlying unitary business." 2/

The Supreme Court did not deal with the definition of a unitary business in the Mobil case. However, two cases are now pending in the Court in which multinational corporate taxpayers are challenging the power of States to include foreign source

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1/Mobil Oil Corporation v. Commissioner of Taxes of Vermont, 445 U.S. 425 (1980).

2/Mobil Oil Corporation, 441-42.

dividends in the apportionable bases of their income taxes. 1/ In each case, the taxpayer contends, among other positions, that the business of the dividend-paying corporation was not part of the unitary business carried on by the taxpayer in the taxing State.

Even if a State determines that a multinational corporate business is unitary, it is important to note that the State can use alternative approaches, having different effects on tax liability, to take into account the corporation's foreign source dividends. One approach is to use worldwide combined reporting, under which the income of the foreign subsidiaries is included in the apportionment base on a current basis, and the combined income is then apportioned by a formula using the combined factors of all corporations in the group. Another approach is to tax the foreign source income when it is repatriated in the form of dividends paid to the U.S. parent. The two approaches are mutually exclusive, since under worldwide combined reporting the intercompany dividends are eliminated, in that all corporations in the unitary group are treated as a single taxable entity.

When a State uses the approach of taxing repatriated dividends, it must then determine whether the dividends should be apportioned by formula or allocated, usually to the State where the parent corporation's headquarters is located. The Mobil decision upholds the apportionment of the dividends where there is a unitary business relationship between the foreign corporation paying the dividends and the U.S. parent, but the decision does not declare that all States must use this approach.

The issues covered in the Mobil decision are at the heart of the controversy surrounding State taxation of foreign source dividends. The decision, however, leaves some questions unanswered, such as: (1) Must there be a unitary relationship in all cases between the dividend-paying corporation and the dividend-receiving corporation to treat dividends as apportionable income? (2) If a unitary relationship is required, what should be the criteria for defining the relationship? (3) Is apportionment of dividend income by a formula consisting of the dividend-receiving corporation's property, payroll and sales a reasonable method, or should some adjustment be made, such as including the dividend-paying corporation's factors in the formula? These questions should be thoroughly considered in deciding if some limit should be placed on State taxation of foreign source dividends.

1/Taxation and Revenue Dept. of the State of New Mexico v. F.W. Woolworth Co., 624 P. 2d 28 (N.M., 1981), prob. juris. noted, 102 S. Ct. 86 (1981) and ASARCO Inc. v. Idaho State Tax Commission 99 Idaho 924, 592 P. 2d 39 (1979), prob. juris. noted, 102 S. Ct. 87 (1981).

OTHER ISSUES ARE LESS CONTROVERSIAL

Although State and multijurisdictional corporate tax officials are divided on many of the issues, they have less disagreement over the domestic interstate issues. These issues are generally not as complicated or controversial as the issues involving foreign operations, thus potentially allowing easier resolution. Our work indicates that there is some basis for agreement on most of the major interstate issues, including (1) establishing objective criteria for determining when a State has jurisdiction to tax an MJC, (2) specifying the starting point for calculating taxable income, (3) determining if a mandatory three-factor apportionment formula should be employed by the States, (4) specifying the composition of the apportionment formula factors, and (5) deciding whether some types of income should be allocated to a single State or apportioned among the States.

We considered all the data we gathered in ascertaining the extent of agreement that exists on these issues but relied in large part on the comments we received from experts and key association officials during a 2-day conference we conducted on the subject. The attendees represented a balance between State and corporate proponents, and included officials of corporate and State tax associations, and members of academia. During the conference, the above issues were discussed from the viewpoint of the experts reaching a compromise on each issue. The tax experts, however, could speak only for themselves, and not with delegated authority for their constituencies. (See app. III for a list of attendees.) Although the attendees disagreed on how some proposals should be implemented, their overriding view was that the provisions for taxing multijurisdictional corporate income should be applied uniformly by the States.

Should jurisdiction-to-tax criteria provide more specific guidance to State and corporate officials? If so, how?

Jurisdiction-to-tax is a technical term referring to the problem of determining when an MJC's activities or connections in a State are sufficient to subject it to income tax liability. (See pp. 12 to 13.) This determination is not a problem, for example, when an MJC has a major manufacturing plant or office in a State. The existence and operation of such facilities in a State leave little doubt that the corporation is taxable. However, questions concerning the level of activity necessary for a State to tax that activity often arise when an MJC's presence in a State is less obvious.

There have been numerous court cases involving the question of whether an MJC's in-State activities meet the "minimal connection" test of the Due Process Clause. One of the more significant cases was Northwestern States Portland Cement Co. v. Minnesota, 358 U.S. 450 (1959), where Minnesota levied a net income tax on an out-of-State corporation that systematically solicited orders and maintained a sales office in Minnesota. The Supreme Court agreed with the State that these activities were sufficient to assess an income tax. The Court stated: "Net income from the interstate operations of [an out-of-State] corporation may be subjected to State taxation provided the levy is not discriminatory and is properly apportioned to local activities within the taxing State* * *." The essence of this decision was that a State could tax a corporation's activities because the State provided the corporation certain basic benefits and protections.

The broad language in the Northwestern decision suggested to many observers that the income from marginal corporate activities within a State might be taxed. Concerned with this broad interpretation, the corporations prevailed on Congress to enact Public Law 86-272. This law, passed in 1959, prohibits State or local governments from imposing net income taxes on corporations whose business activities in a State are limited to one or more of the following:

--Solicitation of orders for sales of tangible personal property by the seller or the seller's representative when the orders are sent outside the taxing State for approval or rejection and are filled by shipment or delivery from a point outside that State.

--Solicitation of orders for the sale of tangible personal property by the seller or the seller's representative for the benefit of a prospective customer of the business, when the orders are sent out of the State for acceptance and are filled from a point outside the taxing State.

--Sales or solicitation by "independent contractors" who represent more than one principal and who hold themselves out as "independent contractors" in the regular course of their business.

While these limitations do specify when a State cannot tax an interstate business activity, they are subjective and provide little basis for determining when a State has jurisdiction-to-tax. As a result, State courts have made diverse and conflicting interpretations of Public Law 86-272. Because of the lack of guidance, many MJCs have difficulty determining if their activities in a State are taxable. As we noted previously, 32 percent of the corporations responding to our questionnaire had disputes with the States concerning jurisdiction-to-tax issues during the 5-year period from 1973 through 1977.

In light of the current situation, most State and corporate officials whom we contacted believe that definitive, objective jurisdiction-to-tax criteria are needed to facilitate the determination of when an out-of-State corporation is taxable in a State and also to prevent corporations with minimal activity in a State from being taxed. For example, 85 percent of the large corporations and about 75 percent (seven of nine) of the CPAs completing our questionnaire stated that the income of an MJC should only be taxed in a State if the corporation has a business location in that State and if the business location is not a salesman's car or home. However, most State officials we contacted favored a minimum sales rule that would exempt a corporation from income tax in a State if the corporation generated sales totaling less than $500,000 in the State and had no business location nor inventory in the State.

The minimum sales rule was also the consensus position reached by the tax experts at our 2-day conference. They believed that $1,000,000 should be considered as the minimum sales figure. The experts also believed that, if a minimum sales figure was adopted, Public Law 86-272 could be repealed.

<u>Should the starting point which all States use to determine corporate taxable income be the same?</u>

Under the current State tax system, each State formulates its own definition of corporate taxable income. In determining taxable income, 34 of the 45 States require a corporation to start with its Federal taxable income. The corporation must then make adjustments to that figure in accordance with State provisions to arrive at State taxable income. A State's apportionment formula is then applied to this figure to determine the amount of that income the State can tax. The remaining 11 States generally require that corporations use gross income rather than Federal taxable income as the starting point because these States believe that exclusion of the Federal figure results in a more accurate computation of State taxable income. The gross income figure is then adjusted in accordance with State tax provisions to arrive at State taxable income. Neither UDITPA nor the MTC regulations address the subject of the starting point.

Corporate officials claim that filing returns in States not using Federal taxable income as the starting point requires that additional adjustments be made to arrive at the State's taxable income and increases their compliance costs. Corporate officials also maintain that requiring States to use Federal taxable income as the starting point is desirable because it will make compliance with State provisions and tax administration easier. To reduce the compliance burden and simplify administration, most corporate officials told us they generally favor using Federal taxable income as the starting point for determining State taxable income. States told us, however, that they are generally opposed to any uniform starting point because they believe that States should not be restricted in determining their own income bases.

Should the equally weighted three-factor formula be used in apportioning corporate income?

Most of the States which tax corporate income use an equally weighted three-factor apportionment formula consisting of property, payroll, and sales. Other States use the same three factors but weigh them disproportionately and a couple of States employ only a one- or two-factor formula. For example, Florida uses a three-factor formula with a double-weighted sales factor, while West Virginia uses a two-factor (property and payroll) formula. To foster uniformity and facilitate compliance, almost all States and corporate representatives we contacted believed that States should use an equally weighted three-factor formula.

MTC regulations as well as UDITPA prescribe an equally weighted three-factor apportionment formula. In this regard, 35 States presently use an equally weighted, three-factor formula. The other 10 States use various formulas for determining the amount of income to be taxed, varying from a one-factor formula to a three-factor formula doubly weighted for sales.

The tax experts at our conference believed that all States should use an equally weighted three-factor formula. They felt that use of the formula should be mandatory to ensure uniformity and consistency.

Should the formula factors be uniformly defined by States and, if so, how?

The three factors of property, payroll, and sales are generally used in formula apportionment because they are deemed to reflect the relative contribution of an MJC's activities in various States to the production of total corporate income. Because the factors are used to determine what part of the total income any State can tax, the makeup of each factor is important and should be uniformly defined in all States.

Both UDITPA and the MTC regulations discuss the makeup of each factor. For example, UDITPA and the MTC regulations prescribe that the property factor should consist of the average value of the taxpayer's real and tangible personal property owned or rented and used in the State. Both documents also state that owned property is to be valued at its original cost and rented property at 8 times the net annual rental rate.

Of the 44 States which use a property factor, 9 include or exclude certain types of property prescribed by UDITPA and the MTC regulations. In addition, seven States value property on a basis other than original cost.

UDITPA and the MTC regulations prescribe that the payroll factor should consist of the total compensation for personal services paid by the taxpayer. However, only 35 of the 44 States which use a payroll factor adhere to the UDITPA and MTC regulations. Six of the remaining nine States exclude salaries paid to corporate officials and three States include or exclude other types of compensation.

UDITPA and the MTC also prescribe that the taxpayer's sales should be attributed to that State which is the destination of the sales. Furthermore, UDITPA and the MTC regulations provide for the use of a throwback rule. This rule permits the sales to be attributed to the State where the sales originated if the destination-of-sales State does not tax the corporation. This rule helps to ensure that all of the income of a corporation is subject to a State tax. All but one of the States which use a sales factor use the destination-of-sales rule. Twenty-three States follow the UDITPA and MTC throwback rule.

State and corporate officials we contacted generally agreed that all States should follow the UDITPA and MTC regulations for the composition of formula factors. They did not agree, however, on whether the States should use a throwback rule.

Should specific allocation be used in conjunction with formula apportionment and, if so, when?

Specific allocation, employed by most States in conjunction with formula apportionment, excludes certain types of income from the apportionable tax base and assigns the income to an individual State. (See p. 4.) The rationale for allocating income is that certain types of income, such as dividends and interest, are derived from activities in a single State. 1/ Income is allocated to a State according to criteria such as the location of income producing assets or the site of the corporation's main business office.

Both UDITPA and MTC have formulated regulations relevant to specific allocation. UDITPA defines income as either business income or nonbusiness income. In essence, business income is that income earned in the regular course of the corporation's trade or business and is apportioned. Nonbusiness income is all other income, and this income is allocated to specific States. The MTC regulations seem to define business income more broadly than does UDITPA. According to the MTC regulations, the classification of income by type, such as dividend or interest income, is of no aid in determining whether income is business or nonbusiness income. The regulations indicate that income of any

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1/Types of income which are normally allocated to a State include (1) net rents and royalties, (2) capital gains and losses, (3) dividends, and (4) interest.

type or class and from any source is business income if it arises from transactions and activities occurring in the regular course of a trade or business. Accordingly, the critical element in determining whether income is business or nonbusiness is the identification of the nature of transactions and activities. The result of the above definition is that MTC considers almost all income earned by an MJC to be business income.

Our inventory showed that 11 of the 45 States apportion all or nearly all of a corporation's income. Twenty-four States use UDITPA's definition of classifying income as business or nonbusiness income, and apportion the business income and allocate the nonbusiness income. The remaining 10 States apportion business income and allocate other types of income which they classify in various ways. For example, some of the States classify certain types of allocable income as investment income.

The large corporate taxpayers, CPAs, and State advocates whom we contacted held differing opinions on the merits of apportioning all multijurisdictional corporate income versus allocating some types of income. Their differences centered on how various types of dividend and interest income should be handled. The experts at our conference, however, generally agreed that all corporate income should be apportioned using an equally weighted three-factor formula, the factors being those defined in UDITPA and the MTC regulations. Some experts believed that apportionment of all income would simplify the task of dividing multijurisdictional corporate income among the States. They also believed that it would reduce the possibility for overtaxation or undertaxation by eliminating the diversity resulting from the various State rules governing income allocation. Agreement on full apportionment, however, did not include situations in which some States take foreign source income into account. As discussed previously, States and corporate officials disagree on the tax treatment of income from foreign sources.

If all income is apportioned, however, there is the possibility of distortion since the standard three-factor formula was designed to apportion operating income and may not be as well suited to apportion investment income. For example, the property factor contained in the three-factor formula used by most States generally excludes intangible property. To properly apportion investment income, such as dividends, it may be necessary to include some measure of intangible property in the property factor. Such inclusion would seem to more properly fulfill the objective of using apportionment formulas--to attribute income to the States on the basis of factors which produced the income.

SUMMARY

Separate accounting and formula apportionment are the two primary methods used by the States to determine the amount of multijurisdictional corporate income that is subject to State tax. With separate accounting, taxable income is determined by isolating an MJC's income and expenses within a State. It is generally considered more difficult to apply than formula apportionment because it often requires analysis of numerous transactions, allocation of indirect expenses, and determination of arm's length prices. Only about half the States use separate accounting and then to tax only certain types of corporations.

Formula apportionment is used by all 45 income tax States in most situations. It attributes the income of an MJC to a State on the basis of factors--normally property, payroll, and sales--which are considered to have generated the income. The principle underlying formula apportionment is that it can only be applied to a business as a whole, that is a unitary business.

The difficulty in defining a unitary business has complicated the application of formula apportionment to multicorporate entities. Although some State taxing authorities and courts have developed unitary business criteria, corporate taxpayers have often disagreed with the criteria. The result is that no firm definition exists.

Originally, the States applied formula apportionment only to the various offices, branches, and divisions of single unitary corporations. They gradually broadened this application to multicorporate enterprises comprised of U.S. parent and subsidiary corporations. In recent years some States, using worldwide combined reporting, have extended their formula to include foreign corporations. While multijurisdictional corporate taxpayers generally accept the States' application of apportionment formulas to parents and subsidiaries operating within the United States, most taxpayers object to extension of the method outside the U.S. boundaries.

Multinational corporate officials' arguments against States' application of apportionment formulas to worldwide operations focus on several key points. Multinational taxpayers contend that the method (1) results in State taxation of foreign source income, (2) disrupts U.S. foreign commerce, (3) increases the potential for international multiple taxation, (4) overallocates income to States, and (5) imposes heavy administrative burdens. The States which use this method, especially California, generally dismiss the corporate arguments.

Some of the above arguments and related ones involving State taxation of dividends from foreign sources have been addressed in court decisions. Although the courts have taken up some of the arguments, for the most part the issues remain unresolved.

There are also other important issues stemming from State taxation of multijurisdictional corporations. These issues include (1) criteria for determining taxability of a multistate corporation, (2) the starting point for calculating State taxable income, (3) use of a mandatory formula, (4) the formula factors to be applied, and (5) apportionment versus allocation of income. Resolution of these issues would significantly increase uniformity, reduce compliance problems, and generally improve the administration of State taxation of corporate income.

CHAPTER 4

SCOPE OF REVIEW

The House Committee on Ways and Means, in a May 3, 1978, letter, asked us to study how States tax the income of MJCs. In particular, the Committee asked us to develop information on how the various States apportion income, the revenue impact on the States if the Congress were to limit the use of those apportionment methods, and the feasibility of all States using the same method.

We documented how States tax multijurisdictional corporate income by compiling an inventory of State tax provisions. We compiled the inventory primarily from information shown in the Commerce Clearing House State Tax Reporter, the Prentice-Hall All States Handbook, a 1974 House Banking Committee study, and a 1976 Treasury Department study on State taxation of income from foreign sources. We supplemented data obtained from these sources with a questionnaire to the States. Once we compiled our inventory we had each State verify in writing that our inventory of its taxing provisions was accurate.

Despite our efforts to ensure that our inventory was complete and accurate, there may be some discrepancies between our compilation and other similar lists. The breadth and diversity of State provisions covering the taxation of MJCs and the fact that some State statutes and regulations are unclear permit differences in interpretations.

In compiling our inventory of State tax provisions and throughout our study, we focused only on State laws and rules pertaining to multijurisdictional manufacturing and mercantile corporations. We excluded from consideration financial institutions, insurance companies, public utilities, communication companies, transportation companies, and other corporations which are usually covered by special State income tax laws. Although our inventory is limited to manufacturing and mercantile corporations, we believe these corporations represent a sufficiently large number of MJCs to permit us to focus on the issues relevant to these corporations.

To help us define the issues pertaining to State taxation of MJCs we conducted interviews initially with tax administrators from seven States, eight Chicago area corporations, and six organizations. Four of the six organizations continued to provide us information throughout our study. Two of the four groups represent corporate taxpayers--the Committee on State Taxation (COST) and the National Association of Manufacturers (NAM); the other two represent States--the Multistate Tax Commission (MTC) and the National Association of Tax Administrators (NATA). The other two organizations were the Tax Executives Institute (TEI) and the National Tax Association-Tax Institute of America (NTA-TIA).

We analyzed the issues resulting from State taxing practices by obtaining substantial input from both State and corporate sources. We sent questionnaires to States; large, medium, and small size corporations; and large accounting firms. One questionnaire was sent to all 45 States which tax corporate net income. All 45 States completed the questionnaire, which consisted of questions concerning (1) the State's corporate income tax, such as the number of corporate returns filed in the State; (2) the use of separate accounting; (3) the need for greater uniformity; and (4) the application of the unitary method.

Two slightly different versions of the questionnaire were used. We sent one version to the 26 States who told us in a telephone survey that their data processing systems could identify information on both intrastate and multijurisdictional corporate activity. This version asked the 26 States to provide us information on all corporations within the State and on multijurisdictional corporations. The other version of the questionnaire was sent to the 19 States who told us they could not separate intrastate and multijurisdictional corporate activity. This questionnaire asked the 19 States to provide us the same type of information but for all corporations within the State. Where possible, we combined the results of the two questionnaires when tabulating and presenting the data.

Our questionnaire to large corporations was sent to a random sample of 510 corporations taken from a list of 1400 manufacturing or mercantile companies which are members of the Tax Executives Institute. Of the 510 corporations receiving questionnaires, 46 (9 percent) told us that they could not adequately respond for reasons such as not having been in business long enough to have the information we requested or being the subsidiary of a parent which maintained the company's tax data. Three hundred and sixty-five of the remaining 464 corporations (79 percent), completed the questionnaire. About 80 percent of the 365 respondents said they were multinational corporations and about 50 percent said they filed returns in 30 or more States. On the basis of the questionnaire responses, the average annual net sales of each of the 365 corporations was about $1.6 billion.

The questionnaire to large corporations was used primarily to obtain their experiences and opinions on key issues related to State taxation of multijurisdictional corporate income. The questionnaire requested information on (1) the extent of corporate activity in the States, such as the number of returns filed; (2) jurisdiction-to-tax criteria; (3) compliance costs; (4) views on uniformity; (5) definition of a unitary business; (6) application of the unitary concept; (7) allocation of income; and (8) separate accounting.

We also sent a similar but briefer questionnaire to a sample of 63 small and medium size corporations. To arrive at this number, we first randomly selected 269 firms from Dun & Bradstreet's Million Dollar Directory, which lists over 80,000 businesses with assets of $500,000 to $1 million. We then telephoned the 269 companies to determine whether they were MJCs--only 71 were. Sixty-three of the 71 corporate taxpayers agreed to complete our questionnaire. However, only 42 of the 63 firms (67 percent) actually responded. The 42 corporations reported average annual net sales of $72 million and 36 of the corporations said they filed returns in 10 or fewer States.

Once the questionnaires were returned to us, we checked them for completeness and accuracy and tabulated the data. We combined the questionnaire responses obtained from the large, medium, and small size corporations in order to project the results to the total universe. Because the sizes of the samples were proportionately different, we combined the questionnaire responses by weighting each case according to the sample from which it was drawn. We also analyzed whether corporations from the two populations answered the same questions differently. We used the chi-square test of independence to (1) establish whether there was an association between the two groups and (2) determine the significance of any identified associations. We established a confidence level of 95 percent for accepting the results as significant.

In addition, we asked representatives from three large accounting firms to respond to a questionnaire to determine their experience with preparing multijurisdictional corporate State income tax returns. The questionnaire was very similar to the ones we sent to the corporations. The names of the three firms--Price Waterhouse; Peat, Marwick, & Mitchell; and Laventhol & Horwath--were supplied to us by the American Institute of Certified Public Accountants. A key person from each firm distributed our questionnaire to members of the firm involved with State corporate income taxation. We received a total of nine completed questionnaires from the three firms. All nine responses were from individuals who had direct experience with multijurisdictional corporate income tax provisions.

To further assist us in our analysis of key issues, we asked nine experts from academia, States, corporations, and four key State and corporate interest groups to supply written comments on the issues. Their comments were on specific provisions we selected from those which the individuals and groups believed States should use in taxing multijurisdictional corporate income. In soliciting the comments, we presented the respondents with alternative tax provisions from which to choose and requested that they explain their choices.

As a followup to the written comments and to determine if grounds existed for resolution of some key issues dividing States and corporate taxpayers, we held a 2-day conference bringing together individuals who were knowledgeable in this tax area. The 16 attendees at our conference represented a balance between State and corporate proponents. Also present were our two consultants, Mr. Hellerstein and Mr. Warren, who assisted us in conducting the meeting. All the major issues were debated at the conference from the viewpoint of the experts reaching a compromise on each issue.

Our data gathering efforts during the study were continuously augmented by our own research. This research included review of past and current legislative proposals, court cases, journal articles, and studies.

Although we collected and analyzed a large amount of data, we did not examine State tax returns. We had neither the authority nor resources to perform that task. Furthermore, it is generally accepted by States, MJCs, and tax experts that lack of uniformity results in over- or under-taxation to corporations, and a review of tax returns is not needed to substantiate this point.

States could not provide us with the data we needed to estimate the impact on State revenues if their laws and regulations were changed to make them more uniform. In addition, most State tax officials were reluctant to give us an estimate because the number of State income tax provisions applicable to MJCs and their interdependency make it extremely difficult to estimate whether an individual State would gain or lose revenue if its laws were changed.

BIOGRAPHICAL PROFILES OF JEROME R. HELLERSTEIN AND JOHN S. WARREN

Jerome R. Hellerstein

Education:

University of Denver (B.A. 1927)
State University of Iowa (M.A. 1928)
Harvard University (LL.B. 1931)

Admitted to bar:

1932 - New York
1939 - U.S. Supreme Court

Positions:

(1) Partner, Law Firm of Guggenheimer & Untermyer, 1975 - Present
(2) Professor of Law, New York University Law School, 1959-1970; Adjunct Professor, 1970-Present
(3) Member, Editorial Board, Tax Law Review, 1947-1970
(4) Assistant Corporation Counsel, City of New York, 1938-1940
(5) Member, Advisory Group, Willis Subcommittee on State Taxation of Interstate Commerce (1959-1964), H.R. No. 1480 (88 Cong. 2d Sess.)

Membership:

The Association of the Bar of the City of New York
American Bar Association

Publications:

"Allocation and Apportionment of Dividends and the Delineation of the Unitary Business," Tax Notes, Jan. 25, 1982, p. 155.

"Recent Developments in State Tax Apportionment and the Circumscription of Unitary Business," 21 National Tax Journal, 487 (1968).

"State Taxation of Interstate Business - The Time Has Come for Uniformity," 16 Journal of Taxation, 246 (1962).

"The Power of Congress to Restrict State Taxation of Interstate Commerce," 12 Journal of Taxation, 302 (1960).

"State Taxation in a National Economy" with E.B. Hennefeld, 54 Harvard Law Review, 949 (1941).

Hellerstein & Hellerstein, State and Local Taxation: Cases and Materials, West Publishing Company, (4th Ed. 1978).

Taxes, Loopholes and Morals, McGraw-Hill, (1963).

John S. Warren

Education:

University of Minnesota (B.S.L. 1943)
Hastings College of Law (LL.B. 1950)

Admitted to bar:

1951 - California

Positions:

(1) Partner, Law Firm of Loeb & Loeb, 1957-Present
(2) Adjunct Professor of Law in State and Local Taxes, Loyola University School of Law, 1977-Present
(3) Chairman, Subcommittee on Income Tax Problems, Committee on State and Local Taxes, ABA Section on Taxation, 1978-Present
(4) Member, California Senate Fact Finding Committee on Revenue and Taxation, 1964
(5) Consultant, California Department of Finance, 1962
(6) Associate Tax Counsel, California Franchise Tax Board, 1951-1957

Membership:

Los Angeles County Bar Association
State Bar of California
American Bar Association

Publications:

"The Unitary Concept in the Allocation of Income." Hastings Law Journal, 1960.

California Franchise Tax Allocation of Income of Unitary Businesses. Southern California Tax Institute, 1966.

"California's Uniform Division of Income for Tax Purposes Act." U.C.L.A. Law Review, 1967.

Inventory of State Income Tax Provisions as of December 31, 1981

I. Jurisdiction-To-Tax Rules

(A) States with no specific jurisdiction-to-tax criteria:

1. Alaska
2. Arizona
3. Delaware
4. Indiana
5. Louisiana
6. Vermont

(B) States which tax corporations "doing business" in the State:

1. Alabama 1/
2. Arkansas
3. Colorado
4. Georgia 1/
5. Iowa
6. Kansas 1/
7. Mississippi
8. North Carolina
9. Oklahoma 1/
10. Tennessee
11. New Jersey 1/
12. New York 1/
13. Ohio 1/
14. Pennsylvania
15. South Carolina

(C) States which tax corporations "deriving income from sources in the State":

1. Alabama 1/
2. California
3. District of Columbia
4. Florida
5. Idaho
6. Kansas 1/
7. North Dakota
8. Oklahoma 1/
9. Oregon
10. Rhode Island
11. Virginia
12. West Virginia 1/

(D) States which tax corporations "owning property in the State":

1. Georgia 1/
2. Hawaii 1/
3. Minnesota
4. New Jersey 1/
5. Ohio 1/
6. Wisconsin

(E) States which tax corporations "deriving income from property in the State":

1. Alabama 1/
2. New Mexico
3. West Virginia 1/

1/States which use more than one criterion for determining when an out-of-State corporation is taxable in the State.

(F) States which tax corporations "carrying on a business in the State":

1. Hawaii 1/
2. Maryland

(G) States which tax corporations "maintaining an office in the State":

1. New Jersey 1/
2. New York 1/

(H) States which tax corporations "owning or leasing property in the State":

1. Kentucky
2. New York 1/

(I) States which tax corporations "deriving income from activity in the State":

1. Montana 1/
2. West Virginia 1/

(J) States which tax corporations which have part of their income apportioned to the State:

1. Maine
2. Montana 1/
3. Utah

II. Starting Point For Determining Taxable Income

(A) States which use Federal taxable income as the starting point for determining State taxable income:

1. Alaska
2. Arizona
3. Colorado
4. Connecticut
5. Delaware
6. Florida
7. Georgia
8. Hawaii
9. Idaho
10. Illinois
11. Indiana
12. Iowa
13. Kansas
14. Kentucky
15. Maine
16. Maryland
17. Massachusetts
18. Missouri
19. Montana
20. Nebraska
21. New Hampshire
22. New Jersey
23. New Mexico
24. New York
25. North Carolina
26. North Dakota
27. Ohio
28. Oklahoma

1/States which use more than one criterion for determining when an out-of-State corporation is taxable in the State.

29. Pennsylvania
30. Rhode Island
31. Tennessee
32. Vermont
33. Virginia
34. West Virginia

(B) States which do not use Federal taxable income as the starting point for determining State taxable income:

1. Alabama
2. Arkansas
3. California
4. District of Columbia
5. Louisiana
6. Minnesota
7. Mississippi
8. Oregon
9. South Carolina
10. Utah
11. Wisconsin

III. Apportionment Formulas

(A) States which use an equally weighted three-factor (property, payroll, sales) formula in all situations:

1. Alabama
2. Alaska
3. Arizona
4. Arkansas
5. California
6. Connecticut
7. Delaware
8. District of Columbia
9. Georgia
10. Hawaii
11. Idaho
12. Illinois
13. Indiana
14. Kansas
15. Kentucky
16. Louisiana
17. Maine
18. Maryland
19. Montana
20. Nebraska
21. New Hampshire
22. New Jersey
23. New Mexico
24. North Carolina
25. North Dakota
26. Ohio
27. Oklahoma
28. Oregon
29. Pennsylvania
30. Rhode Island
31. South Carolina
32. Tennessee
33. Utah
34. Vermont
35. Virginia

(B) State which uses an equally weighted three-factor (property, payroll, sales) formula or a two-factor (property, sales) formula:

Colorado

(C) State which uses an equally weighted three-factor (property, payroll, sales) formula or a three-factor formula weighted 15 percent property, 15 percent payroll, and 70 percent sales:

Minnesota

(D) State which uses an equally weighted three-factor (property, payroll, sales) formula or a one-factor (sales) formula:

Missouri

(E) State which uses an equally weighted three-factor (property, payroll, sales) formula for manufacturers who sell principally at wholesale, a three-factor formula with a double-weighted sales factor for manufacturers who sell principally at retail, and a one-factor formula (sales) for nonmanufacturing retailers and wholesalers:

Mississippi

(F) States which use a three-factor (property, payroll, sales) formula with a doubleweighted sales factor:

1. Florida
2. Massachusetts
3. New York
4. Wisconsin

(G) State which uses a two-factor (property, payroll) formula:

West Virginia

(H) State which uses a one-factor (sales) formula:

Iowa

IV. Formula Factors

(A) Property factor

(a) States in which the property factor consists of owned and rented real property and tangible personal property. Owned property is valued at historical cost and rented property is valued at 8 times net annual rental expense.

1. Alabama
2. Alaska
3. Arkansas
4. California
5. Colorado
6. Delaware
7. District of Columbia
8. Florida
9. Georgia
10. Hawaii
11. Idaho
12. Illinois
13. Indiana
14. Kansas
15. Louisiana
16. Maine
17. Missouri
18. Montana
19. Nebraska
20. New Hampshire

21. New Mexico
22. North Dakota
23. Oklahoma
24. Oregon
25. Pennsylvania
26. South Carolina
27. Tennessee
28. Utah
29. Virginia
30. West Virginia
31. Wisconsin

(b) States whose property factor contains exception(s) to the inclusion of property in the above general definition. For example, some States exclude rented tangible personal property and others exclude certified pollution control equipment from the property factor.

1. Kentucky
2. Maryland
3. Massachusetts 2/
4. New Jersey 2/
5. New York
6. North Carolina
7. Ohio
8. Vermont 2/
9. Mississippi

(c) States whose property factor contains exception(s) to the valuation of property in the above general definition. The most common exception consists of valuing owned property at net book value instead of historical cost.

1. Arizona
2. Connecticut
3. Massachusetts 2/
4. Minnesota
5. New Jersey 2/
6. Rhode Island
7. Vermont 2/

(B) Payroll factor

(a) States in which both the definition of compensation included in the payroll factor and the basis for assigning payroll to a State are identical. In these States compensation consists of wages, salaries, commissions and any other form of remuneration paid to employees for personal services. These States assign the value of payroll to the State in which the individual performs the services for which he is being paid.

1. Alabama
2. Alaska
3. Arkansas
4. California
5. Colorado
6. Connecticut

2/ States whose property factor contains exceptions as to both the inclusion and valuation of property contained in the definition in (a).

7. District of Columbia
8. Florida
9. Hawaii
10. Idaho
11. Illinois
12. Indiana
13. Kansas
14. Kentucky
15. Maine
16. Maryland
17. Massachusetts
18. Missouri
19. Montana
20. Nebraska
21. New Hampshire
22. New Jersey
23. New Mexico
24. North Dakota
25. Ohio
26. Oregon
27. Pennsylvania
28. Tennessee
29. Utah
30. West Virginia
31. Wisconsin

(b) States whose payroll factor contains exception(s) to the above definition of compensation. In most of these States the exception consists of excluding officers' compensation from the payroll factor.

1. Delaware 3/
2. Mississippi
3. New York 3/
4. North Carolina
5. Oklahoma 3/
6. Rhode Island 3/
7. South Carolina 3/
8. Vermont 3/
9. Virginia

(c) States which have exception(s) to the above general rule for assigning payroll to a State. For example, some States assign the value of payroll to the State based on the amount of time an employee spends in the State.

1. Arizona
2. Delaware 3/
3. Georgia
4. Louisiana
5. Minnesota
6. New York 3/
7. Oklahoma 3/
8. Rhode Island 3/
9. South Carolina 3/
10. Vermont 3/

(C) Sales factor

(a) States which tax sales based on the destination of the sales and which adhere to some type of throwback rule. The throwback rule assigns a corporation's sales to the State in which the sales originated if the corporation is not taxable in the State of destination.

3/States whose rules for both defining compensation and assigning payroll to a State differ from those stipulated in (a).

1. Alabama
2. Alaska
3. Arizona
4. Arkansas
5. California
6. Colorado
7. District of Columbia
8. Hawaii
9. Idaho
10. Illinois
11. Indiana
12. Kansas
13. Maine
14. Massachusetts
15. Mississippi
16. Missouri
17. Montana
18. Nebraska
19. New Hampshire
20. New Mexico
21. North Dakota
22. Oklahoma
23. Oregon
24. South Carolina
25. Utah
26. Virginia
27. Wisconsin

(b) States which tax sales based on the destination of the sales but do not adhere to any type of throw-back rule:

1. Connecticut
2. Delaware
3. Florida
4. Georgia
5. Iowa
6. Kentucky
7. Louisiana
8. Maryland
9. Minnesota
10. New Jersey
11. New York
12. North Carolina
13. Ohio
14. Pennsylvania
15. Rhode Island
16. Tennessee

(c) State which taxes sales based on the origin of the sales:

Vermont

V. <u>Allocation of Income</u>

(A) States which apportion all or nearly all income:

1. Alaska
2. Arkansas
3. Colorado
4. Florida
5. Massachusetts
6. New Hampshire
7. New Jersey
8. North Dakota
9. Pennsylvania
10. Rhode Island
11. Vermont

(B) States which classify corporate income as business and nonbusiness, apportioning business income and allocating nonbusiness income to individual States:

1. Alabama
2. California
3. District of Columbia
4. Hawaii
5. Idaho
6. Illinois
7. Indiana
8. Iowa
9. Kansas
10. Kentucky
11. Maine
12. Minnesota
13. Mississippi
14. Missouri
15. Montana
16. Nebraska
17. New Mexico
18. North Carolina
19. Oregon
20. South Carolina
21. Tennessee
22. Utah
23. West Virginia
24. Wisconsin

(C) States which apportion business income and allocate other types of income which they classify in various ways. For example, some States classify certain types of income as investment income and allocate it to individual States.

1. Arizona
2. Connecticut
3. Delaware
4. Georgia
5. Louisiana
6. Maryland
7. New York
8. Ohio
9. Oklahoma
10. Virginia

VI. Combined Reporting

(A) States which apply combined reporting to corporations operating within the United States (domestic):

1. Alaska
2. Arizona
3. Arkansas
4. California
5. Colorado
6. Florida
7. Idaho
8. Illinois
9. Indiana
10. Iowa
11. Kansas
12. Kentucky
13. Maine
14. Massachusetts
15. Minnesota 1/
16. Mississippi
17. Montana
18. Nebraska
19. New Hampshire
20. New York
21. North Carolina
22. North Dakota
23. Oklahoma
24. Oregon
25. Utah
26. Virginia
27. West Virginia

(B) States which apply combined reporting to corporations operating within and outside the United States (worldwide):

1. Alaska
2. California
3. Colorado
4. Idaho
5. Illinois
6. Indiana
7. Massachusetts
8. Montana
9. New Hampshire 1/
10. New York 1/
11. North Dakota
12. Oregon
13. Utah

1/These States enacted legislation permitting combined reporting after we completed our inventory.

VII. Foreign Source Dividends

(A) States which totally exempt foreign source dividends from taxation:

1. Florida
2. Georgia
3. Kentucky
4. Maryland
5. Missouri
6. Pennsylvania
7. West Virginia

(B) States which exempt a substantial portion of foreign source dividends from taxation:

1. Massachusetts
2. New York
3. Ohio

(C) States which apportion all or nearly all foreign source dividends:

1. Alaska
2. Arkansas
3. Colorado
4. Delaware
5. New Hampshire
6. New Jersey
7. North Dakota
8. Rhode Island
9. Vermont
10. Wisconsin

(D) States which allocate foreign source dividends to the State of commercial domicile:

1. California
2. Kansas
3. Oklahoma
4. South Carolina

(E) States which apportion and allocate foreign source dividends:

1. Alabama
2. Arizona
3. Connecticut
4. District of Columbia
5. Hawaii
6. Idaho
7. Illinois
8. Indiana
9. Iowa
10. Louisiana
11. Maine
12. Minnesota
13. Mississippi
14. Montana
15. Nebraska
16. New Mexico
17. North Carolina
18. Oregon
19. Tennessee
20. Utah
21. Virginia

ATTENDEES AT GAO CONFERENCE ON STATE TAXATION OF MULTIJURISDICTIONAL CORPORATIONS

William Brown	Council of State Chambers of Commerce
C.R. Cahoon	Mobil Oil Corporation
Owen Clarke	State of Massachusetts
Eugene Corrigan	Multistate Tax Commission
William Craven	State of New York
James Devitt	Dart & Kraft, Inc.
William Dexter	Multistate Tax Commission
Ben Miller	State of California
John Nolan	Law Firm of Miller & Chevalier
Richard Perkins	General Electric Company
Tom Persky	National Association of Manufacturers
James Peters	American Telephone & Telegraph Co.
Arthur Roemer	State of Minnesota
Leon Rothenberg	National Association of Tax Administrators
Ferdinand Schoettle	University of Minnesota
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