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Report to the Honorable Byron L. Dorgan, U.S. Senate

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TAX POLICY AND ADMINISTRATION

California Taxes on Multinational Corporations and Related Federal Issues

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General Accounting Office
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General Government Division

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July 11, 1995

The Honorable Byron L. Dorgan
United States Senate

Dear Senator Dorgan:

This report responds to your request for information on (1) California's experience in conducting formulary apportionment audits of multinational corporations and (2) issues that would have to be considered before adopting a formulary system at the federal level.

For tax purposes, states generally use a formula to apportion the income of corporations among the states in which they do business. The formula typically is based on the amount of a corporation's property, payroll, and sales within a state compared with the amount within the United States as a whole. A percentage is calculated for each of the three factors, and the average of the three is generally applied against a corporation's income to determine the amount the state will tax.

The formulary approach can be applied to a single corporation or to a group of related corporations.[1] In the latter case, the formula is applied to the combined income of affiliated corporations in a corporate group that have been determined to be unitary. This determination is based on the degree to which the activities of the affiliated companies are interdependent.

Through much of the 1980s, California applied its formula for apportioning income on a worldwide basis. This required multinational enterprises to apportion a share of their worldwide income to California, including the income of foreign parent and subsidiary corporations if their operations were closely integrated or unitary with California business activity. Beginning in 1988, taxpayers in the state were allowed to choose to exclude the income of most foreign affiliates from apportionment if the taxpayers paid a fee and met other requirements. In 1993 California enacted legislation that eliminated the fee and modified other requirements. Unless taxpayers choose not to do so, however, they can still file their tax returns on a worldwide basis.

In contrast to a unitary tax system that combines the income of related corporations within a multijurisdictional enterprise for tax purposes, the

[1]Corporations that are connected through stock ownership with a common parent corporation are considered to be related.

U.S. government and the governments of other countries use a "separate accounting" method that treats each corporation as a separate entity. Under separate accounting, the income of related corporations is determined on the basis of "transfer prices" charged for transactions with other corporations in the enterprise. If prices set for transactions between a corporation and its affiliate operating in a different country are set too high or too low, income is, in effect, shifted from one country to another, and taxes may as a result be avoided in one country and be higher in another.

To mitigate this situation, the Internal Revenue Service (IRS) applies an "arm's length" standard that requires that the results of a transaction between related corporations be consistent with the results that would have been realized if unrelated taxpayers had engaged in the same transaction under similar circumstances. In previous products, we have discussed the difficulties that IRS faces in administering the arm's length standard.[2] IRS examiners must collect a great deal of data and use considerable subjective judgment to determine the appropriate transfer prices and have had difficulty sustaining their findings. For example, we reported that, in its appeals and legal processes in 1993 and 1994, IRS sustained less than 30 percent of the $1.9 billion in proposed adjustments related to the Internal Revenue Code section covering transfer pricing. Legislative and regulatory changes have been made in recent years in trying to alleviate transfer pricing problems.

Worldwide formulary apportionment avoids transfer pricing problems by using a formula rather than transfer prices to determine each corporation's share of the combined income of related corporations. Consequently, some state tax officials and other tax experts have advocated formulary apportionment as an alternative to the existing federal arm's length or separate accounting tax system. However, worldwide formulary apportionment has been controversial. Some tax experts believe that it is not a viable alternative to the existing tax system. Further, many foreign governments and multinational corporations are opposed to it.

In our discussion of issues that would need to be considered before a federal formulary apportionment system could be adopted, we considered the views of tax experts on worldwide formulary apportionment. Separately, we discuss the policies and procedures of the California

[2] International Taxation: Problems Persist in Determining Tax Effects of Intercompany Prices (GAO/GGD-92-89, June 15, 1992); International Taxation: Updated Information on Transfer Pricing (GAO/T-GGD-93-16, Mar. 25, 1993); and International Taxation: Transfer Pricing and Information on Nonpayment of Tax (GAO/GGD-95-101, Apr. 13, 1995).

Franchise Tax Board (FTB), which is the state agency responsible for administering individual and corporate income tax law in California. On the basis of data we collected from our case studies and a random sample of FTB audits, we provide information about FTB on matters such as how it deals with foreign accounting standards.

Results in Brief

Under worldwide formulary apportionment, a key issue that FTB auditors had to determine was whether California corporations that were part of a multinational enterprise were engaged in a unitary business with affiliated U.S. and foreign corporations. This determination was based on a complex analysis of the enterprise's ownership and business operations. Auditors then used the parent corporation's audited financial statements, federal tax returns, and other records to ensure that state tax was based on the income and the apportionment factors for all corporations comprising the unitary business.

In the audits of foreign-controlled corporations that we reviewed,[3] FTB adjusted income and other apportionment data to account for differences between U.S. and foreign accounting standards and record keeping. FTB auditors focused on differences that they considered to have a material impact. They made six adjustments in the five audits that we selected for in-depth case studies. Auditors reviewed the annual audited financial statements of the foreign parent corporation and requested, but did not always obtain, additional data from taxpayers that were needed to determine the effects of different accounting standards and record keeping. As a result, auditors sometimes made determinations on the basis of available data and used estimates and assumptions in making adjustments.

Although we do not discuss in this report whether formulary apportionment should be adopted at the federal level, we do describe matters that would need to be addressed before this practice could be adopted. These matters include the design and administration of a federal unitary system. For example, unitary business and apportionment factors would have to be defined and the United States would also have to consider the international feasibility of formulary apportionment, a system that generally is opposed by other countries. Tax experts disagree on whether the problems associated with such issues can be resolved in a federal unitary system.

[3]For purposes of this report, a foreign-controlled corporation is a corporation incorporated in the United States that has 50 percent or more of its voting stock owned by a foreign parent corporation.

Objectives, Scope, and Methodology

Our objectives were to obtain information on (1) California's experience in conducting formulary apportionment audits of multinational corporations and (2) issues that would have to be considered before adopting a formulary system at the federal level.

To obtain information on California's experience in conducting audits under worldwide formulary apportionment, we first needed to identify multinational enterprises with parent or subsidiary corporations doing business in California. Since FTB officials did not know which of the roughly 24,000 California corporations that apportion income were part of multinational enterprises, we decided to focus on large corporations that we determined to be multinational and in California. We determined this by first comparing the 1,656 corporations in the IRS' Coordinated Examination Program with those in the state's audit database.[4] After matching the data and further researching corporate affiliations to verify multinational status, we identified 870 multinational corporations doing business in California. According to a state analysis, these corporations and their California affiliates accounted for $11.4 billion of the $18.2 billion in net income that was apportioned to California for the 1991 tax year.

Our detailed examination of audit files was based on a sample of 124 audits. This random sample included audits of large corporate tax returns conducted by FTB primarily for tax years 1980 to 1989. Since FTB policy is to audit returns that it believes are especially likely to yield additional taxes, our sample is not representative of all corporate unitary tax returns. We obtained the 124 audit files for our examination by first randomly selecting 277 of the previously identified 870 large corporations. Of the 277 corporations, 157 were determined to be eligible for our study because they had been audited by FTB and had not filed on a "water's-edge" basis.[5] We requested files for the most recent audits of all 157 corporations to obtain information on audit hours, apportionment issues such as determining if affiliated corporations should be included in a unitary business, and the impact of the audits on corporate tax liability. Files for

[4]The Coordinated Examination Program audits the country's largest and most complex corporations, usually those with more than $250 million in assets.

[5]In a water's-edge situation, a taxpayer's liability stops at the borders of the United States since generally only the income of U.S.-affiliated corporations, and not foreign affiliates, is subject to apportionment.

33 audits were incomplete or could not be located in time for our review, so we ultimately reviewed a total of 124 audit files.[6]

We also selected five U.S.-controlled and five foreign-controlled corporations for more in-depth case studies to enhance our understanding of apportionment audit issues and procedures, including the state's method of dealing with foreign accounting standards and record keeping. We randomly selected our initial cases. However, after determining that audits of some foreign-controlled corporations did not meet our selection criteria, we judgmentally substituted three corporations that included different countries and types of businesses.[7] We also reviewed FTB's analysis of unitary business relationships in an additional audit of a U.S.-controlled corporation identified by FTB to better understand that process.[8]

In general, we also discussed with FTB officials their audit process and views on administering a worldwide formulary apportionment system. In addition, we reviewed audit manuals that described California's apportionment audit procedures, and we analyzed reports on the results of the state's audit and appeals processes.

To identify issues that would need to be considered before a federal unitary system could be adopted, we analyzed articles and surveys of state tax laws. Our review of the California audits identified difficult issues that we concluded might also arise in a federal system and the procedures that the state used to address these issues. We also discussed the issues with experts who favored formulary apportionment and those who did not. These included academicians, state and federal government officials, representatives of multinational corporations, and attorneys advocating opposing positions.

Proponents of the unitary system asserted that it would be easier to administer the unitary system at the federal level than to administer the arm's length approach. In this report, we do not evaluate this claim because we did not compare a federal unitary system with the arm's length

[6]FTB had difficulty providing us with all of the audit files because they were being used by their staff in places such as Chicago, Houston, and New York or for postaudit activities such as protest, appeals, settlement, litigation, or collections. For 32 corporations where files were incomplete, we substituted audits of other years.

[7]FTB audit records indicated the corporations originally selected either were not foreign-controlled or had not been audited during the timeframe of our sample.

[8]FTB's analyses of unitary business relationships for the U.S.-controlled corporations originally selected generally were limited because a unitary analysis was done in previous audits.

approach. A proper comparison would require that we specify a federal system in some detail and that we overcome considerable data problems. For example, our review of how California audits corporations for membership in a unitary group would not accurately describe such audits in a federal system if the federal government adopted a different definition of the unitary business. Our discussion focuses instead on the issues that would need to be considered in designing, administering, and moving to a federal unitary system.

Appendix I discusses FTB audits of U.S.- and foreign-owned multinational corporations under worldwide formulary apportionment. It includes information on audit issues, California's treatment of foreign accounting standards, the average hours state auditors spent per audit, and the impact of audits on California corporate tax liability. Appendix II summarizes our case studies, and appendix III discusses some issues that would need to be addressed in a federal formulary system such as (1) definitions of unitary businesses, apportionment factors, and apportionment formulas; (2) the need to reconcile financial and tax accounting rules; and (3) the need to coordinate internationally any movement to a formulary system.

As requested, the Department of the Treasury and California's FTB provided written comments on a draft of this report, which are reprinted in appendixes IV and V. We discuss their comments as well as those of the Multistate Tax Commission (MTC)[9] on pages 12 through 16.

We did our work in Washington, D.C., and Sacramento, California, from August 1993 through March 1995 in accordance with generally accepted government auditing standards.

Background

California administers the largest formulary apportionment program among the states, according to MTC officials. At the time of our review, FTB had 116 audit staff in Chicago, Houston, and New York offices that did apportionment audits and another 242 staff in California district offices that did some apportionment work but who were also responsible for other types of audits. An FTB official estimated that a total of about 127 staff years were used for apportionment audits in FTB's 1992/1993 fiscal year, resulting in $438 million in additional tax assessments. Overall, FTB completed 1,084 apportionment audits during the year.

[9]MTC is an administrative agency of the Multistate Tax Compact. The compact has been entered into by 20 states and the District of Columbia as full members and 15 additional states as associate members.

For the 1991 tax year, 24,650 domestic and multinational corporations apportioned $18.2 billion in net income to California. Although these corporations represented only 5.7 percent of the 432,242 corporations that filed tax returns in California, they accounted for 95.4 percent of the total $19 billion in corporate net income that was reported. Corporations apportioned an average of 8.6 percent of their unitary income to California on the basis of average factors of 10.5 percent for property, 10.3 percent for payroll, and 5.1 percent for sales.

California has made changes to its worldwide formulary apportionment tax requirements in recent years, partly in response to the concerns of the federal government and the domestic and international business communities. In 1986, the state enacted legislation that generally allowed taxpayers to exclude the income of foreign affiliates from apportionment for 1988 and later if the taxpayer paid a water's-edge election fee and met certain other requirements. This legislation was enacted partly in response to the conclusions of a U.S. Treasury-sponsored working group composed of representatives of the federal and state governments and the business community.[10] In 1993, California enacted legislation allowing taxpayers to make the water's-edge election beginning in 1994 without paying a fee. Beginning in 1993, state legislation also modified the apportionment formula by double-weighting the sales factor.

U.S. and foreign multinational corporations have challenged the constitutionality of worldwide formulary apportionment in state and federal courts. In 1994, the U.S. Supreme Court considered the claims of Barclays Bank PLC, a foreign multinational, and Colgate-Palmolive Company, a U.S. multinational. Barclays contended that California's worldwide unitary tax system unconstitutionally burdened foreign-based multinationals by imposing an inordinate compliance burden and by creating an enhanced risk of double taxation, violating the commerce and due process clauses of the U.S. Constitution. Barclays and Colgate contended that application of California's tax system for worldwide operations offended the commerce clause by impeding the federal government's ability to "speak with one voice when regulating commercial relations with foreign governments."[11]

[10]The final report of the Worldwide Unitary Taxation Working Group, released in 1984, made recommendations for the states to mitigate the international effects of formulary apportionment, including limiting its use to the water's-edge.

[11]In 1983, the U.S. Supreme Court had upheld worldwide combined reporting for U.S.-based companies in Container Corporation of America v. Franchise Tax Board of California, 463 U.S. 159 (1983).

In a June 20, 1994, decision, however, the U.S. Supreme Court upheld California's right to tax on a worldwide combined reporting basis.[12] The Supreme Court found that California's system did not violate the commerce or due process clauses of the U.S. Constitution. The Supreme Court found that Barclays had not shown that California's system imposes inordinate compliance burdens on foreign-based multinationals and that the system does not expose multinationals to constitutionally intolerable multiple taxation. The Supreme Court stated that multiple taxation is not the inevitable result of California's system and that separate accounting cannot eliminate, and in some cases may even enhance, the risk of double taxation. The Supreme Court also found that California's system does not prevent the federal government from speaking with "one voice" in international trade. The Supreme Court noted that Congress, which has the role of regulating foreign commerce under the Constitution, has not prohibited the states from using worldwide combined reporting. Although the Supreme Court ruled in favor of California, state officials have since said they have no intention of reinstating requirements for mandatory worldwide formulary apportionment.

California Audit Practices

A key issue in FTB audits of California corporations that were part of multinational enterprises that we reviewed was determining if these corporations were engaged in a unitary business with affiliated U.S. and foreign corporations. To make unity determinations, auditors reviewed a wide range of information on corporate ownership and business operations. The analyses were complex because they required auditors to obtain and analyze information on the management and business relationships of the parent and subsidiary corporations that comprised a multinational enterprise. For example, the analyses could consider the extent of intercompany sales and purchases, the existence of common advertising and marketing functions, the transfer of technical knowledge between affiliated corporations, and intercompany transfer of personnel. According to FTB officials, obtaining information to make this determination sometimes was harder in the case of foreign-owned multinationals than for U.S.-owned firms. In appendix I, we discuss the criteria FTB used to determine unity as well as its data sources and examples of its unity analyses.

If corporations comprising a multinational enterprise were found to be unitary, FTB auditors used the parent corporation's audited financial

[12]Barclays Bank PLC v. Franchise Tax Board of California and Colgate-Palmolive Company v. Franchise Tax Board of California, 114 S. Ct. 2268 (1994).

statements, federal tax returns, and other records to audit income and the apportionment factors. FTB auditors recalculated taxable income and assessed additional taxes, if necessary, when California taxpayers did not include the unitary business income of affiliated domestic and foreign corporations on their tax returns. Auditors also heavily relied on information obtained from federal tax returns and audited annual financial statements to check the accuracy of unitary income and other apportionment data. FTB audits of unitary income and property, payroll, and sales apportionment factors are discussed in appendix I.

For our random sample of 124 California audits of large multinational corporations targeted for their additional tax potential, FTB used an average of 511 audit hours—although the hours per audit varied widely—and proposed a total of $176.9 million in additional tax assessments. Of the $176.9 million, taxpayers agreed to pay $33.8 million and contested $143.1 million through the state's protest, appeals, or settlement process. FTB also proposed additional taxes of $28.9 million on the basis of IRS audits of these taxpayers. Since similar income and expenses are reported on state and federal tax returns, according to FTB officials, FTB generally depends on IRS for auditing them.

FTB auditors cited unity as one reason for proposing additional taxes of $134.7 million in 68 audits, or $2 million per audit, compared with $42.2 million for the 56 audits without a unity issue, or $0.8 million per audit. Unity was also the auditors' most complicated and time-consuming task. The 68 audits involving unity issues took 603 hours on average compared with 399 hours for 56 audits that did not involve unity issues.

The importance of the composition of the unitary business was further demonstrated in our 10 in-depth case studies of FTB audits. Unitary determinations were the key issue in six case studies that resulted in $12 million in additional proposed tax assessments compared with $2.4 million in proposed assessments for the four case studies that did not involve a unity issue.

In the five case studies involving foreign-controlled corporations, FTB auditors also reviewed the annual audited financial statements of the parent corporations to determine if foreign accounting standards and record keeping affected income and other data used for apportionment purposes. They adjusted income and other apportionment data when the differences between U.S. and foreign accounting standards and record keeping had a material impact on them. The auditors requested additional

data in instances when foreign financial statements did not provide the data they needed. However, foreign-controlled taxpayers sometimes stated that the information was difficult to obtain and thus did not provide it. As a result, the auditors had to decide if an adjustment was necessary and could be made on the basis of available data and their own estimates and assumptions. In two of the five cases, taxpayers formally protested FTB adjustments for differences in accounting standards and record keeping.

Issues to Be Considered Before Adopting a Federal Unitary Tax System

Adopting a federal unitary system would require resolving issues in the design and administration of a unitary tax and issues involving the transition from separate accounting to a unitary system. Issues identified as difficult in the California audits and by state tax administrators and multinational corporations provided the starting point for analyzing issues that would need to be addressed in a federal system. However, California audit practices may not show how the federal system could deal with these issues because the federal system might differ in significant ways from the California system. For example, the federal government might choose to adopt a different definition of the unitary business or define apportionment formulas and factors differently. These choices could affect the enforcement costs of the federal government and the compliance costs of corporations.

California's definition of a unitary business illustrates some of the choices the federal government would face in designing its own system. In California, FTB determined the members of a unitary group by using a complex analysis that stemmed from the state's definition of a unitary business based on a greater-than-50-percent ownership requirement and additional criteria related to the business' management and operation. A federal system with the same criteria for defining a unitary business might require a similar analysis. However, a federal system might use only the ownership criterion and thereby avoid most of the complexity of unitary audits. Such a simple definition, however, could give rise to other problems, such as the possibility of combining companies without intercompany transactions or shared executive and staff functions and the possibility of manipulation by taxpayers who buy or sell stock to change the unitary group's makeup and reduce tax liability. In defining a unitary business, the federal government would have to consider this trade-off between a simple definition and the potential for combination of diverse companies and for manipulation by taxpayers.

Administrative issues of reconciling accounting rules and obtaining and verifying information affect the potential enforcement and compliance challenges of a unitary tax. California requires that only material differences between U.S. and foreign accounting rules be adjusted and permits the use of reasonable approximations when data are not readily available. As the Supreme Court found in the Barclays case, this practice may have limited the compliance burden for multinational corporations operating in California. The costs of reconciling accounting rules in a federal unitary system would depend, in part, on the materiality and reasonable approximation provisions adopted in a federal system.

The costs of reconciling accounting rules also depend on the kinds of adjustments that might have to be made by corporations in a federal unitary system. Fifty-four percent of foreign corporations in a survey conducted by the Securities and Exchange Commission (SEC) reported that their financial statements differed materially from U.S. generally accepted accounting principles (GAAP).[13] These foreign corporations had to reconcile items, such as depreciation, deferred or capitalized costs, and deferred taxes. Although U.S. corporations currently are required to keep financial records according to U.S. GAAP, these U.S. corporations would need to reconcile accounting rules for all the countries in which their subsidiaries operate if a unitary system became the international norm. The federal government would need to consider the effect on compliance burden of differences in international accounting rules and the degree to which reasonable approximations can be used in a federal system to reconcile material differences.

Transition issues concern moving from the current separate accounting system to a unitary system. These issues include the need for international agreement on the decision to change to a unitary system and the coordination of unitary tax rules to avoid double taxation and to facilitate the administration of the unitary system. Many other nations and the Organization for Economic Cooperation and Development (OECD) oppose the unitary method. The recently issued OECD draft guidelines on transfer pricing specifically reject global formulary apportionment as a solution to transfer pricing problems. The federal government could seek to coordinate a change to unitary taxation, but obtaining international agreement might be difficult given the oft-stated opposition of many countries.

[13]Survey of Financial Statement Reconciliations by Foreign Registrants (U.S. Securities and Exchange Commission, Division of Corporate Finance, May 1, 1993).

Considerable disagreement existed among the tax experts that we interviewed and whose views we analyzed about whether the problems associated with these issues and others discussed in appendix III can be resolved in a federal unitary system. The federal government would need to address these issues of designing and administering a unitary tax and coordinating it with other countries before adopting a unitary tax at the federal level.

Agency Comments

At our request, the Department of the Treasury and California's FTB provided comments on a draft of this report. The full text of their comments are presented in appendixes IV and V. We also received written comments from MTC. The following section summarizes our evaluation of all these comments.

Although FTB understood that this report was not intended to evaluate the claim that formulary apportionment would be easier to administer than the arm's length approach, it nevertheless expressed its disappointment that we did not make a greater effort to undertake this task. It suggested that we could obtain information on the costs of reconciling accounting rules in a formulary system by canvassing accounting firms that routinely convert the consolidated financial statements of multinational businesses from the accounting principles of their home country to those of another country. FTB noted the fact that such conversions are often done means that there will be no additional compliance costs for companies that have already incurred these costs. FTB believed that we should note that the compliance burden would be mitigated to the extent that foreign corporations already use U.S. GAAP to prepare consolidated financial statements for filings with SEC, obtaining credit in the United States, and meeting the record-keeping requirements of section 6038A of the Internal Revenue Code.

We state in this report that a comparison of the administrative costs of the arm's length and formulary approaches is beyond the scope of the report because it would require that we specify the federal formulary system in some detail. The survey of accounting firms suggested by FTB would produce useful results to the extent the items that need to be converted in a federal system could be identified, and the audit approach adopted by IRS could be determined. For example, the survey would need to specify what factors would be in the formula and how they would be defined as well as the degree of reasonable approximation that would be acceptable to IRS. Such a survey would be difficult to devise and would exceed the time and

resources available for completing this report. However, we agree, and the draft report recognized, that compliance burden is reduced to the extent that companies already prepare consolidated financial statements and reconcile accounting rules for regulatory and business reasons. As suggested by FTB, we have included the record-keeping requirements of section 6038A among the regulatory reasons that records are now kept in conformance with U.S. GAAP.

FTB also believed that the report should note that in many circumstances the arm's length method encounters difficulties that are similar to those that would be entailed in a federal unitary system, difficulties that should be explained so readers can draw their own conclusions. We noted in our draft report that GAO's previous work had discussed difficulties with the arm's length method and that some of the difficulties with formulary apportionment are similar. However, we made no detailed comparison of the two approaches. The purpose of appendix III of our report was to identify the issues that would need to be considered regarding designing, administering, and moving toward a federal formulary system. In our view, a useful comparison of the two approaches would depend on determining relative administrative and compliance costs, which is beyond the scope of this report for the reasons described above.

FTB also suggested that we note that some authorities have advocated relatively simple tests for attributes of a unitary business using a minimum percentage of intercompany transactions. We revised the report to clarify that definitions of the unitary business can include these tests. We agree that such tests may be relatively simple to administer, but we note the trade-off between simplicity on one hand and the risks of manipulation by taxpayers and of combining diverse companies on the other. We also agree with FTB's comment that commentators have noted that "rough justice" is a feature of the formulary and the arm's length approaches. We have revised this report to make clear that rough justice is an issue in arm's length pricing.

FTB noted that the location of sales receipts can also cause significant problems for the federal government. However, our discussion of the complexity and ambiguity of rules for determining the location of sales receipts refers to the rules for sourcing receipts from intangibles, not all receipts as discussed by FTB. We do not compare the rules for sourcing receipts in a formulary system with the rules for sourcing income under the current arm's length approach, and we do not evaluate whether the sourcing rules under one system would be more or less difficult to

administer than the rules under the other. Our purpose is to indicate that developing simple and administrable sourcing rules for receipts from intangibles would be an issue to be addressed in designing and administering a federal system.

FTB mentioned several studies that measured the effect of changing to the unitary method on the income of foreign-owned U.S. subsidiaries operating in the United States. We are aware of these studies. However, we do not believe that these are comprehensive studies that can be used to estimate accurately the revenue effects of a change to a federal formulary system. These studies are not comprehensive because (1) they rely on data from U.S. corporations only or from corporations based in only one state, (2) the data are from a single year, and/or (3) the data are not tax data and may not be good proxies for tax data. Our purpose is to indicate that the revenue effects are uncertain and that a study using the best data and methodology would be needed to produce improved estimates of the revenue effects.

FTB commented that IRS must obtain and verify foreign-held records to evaluate transfer prices. We agree. The point that we emphasize in our report is that California has had problems obtaining foreign data but that the federal government under a formulary system, as evidenced by initiatives like section 6038A, may have better access to foreign-held data than the states.

Treasury commented that this report makes a valuable contribution to understanding how one state has implemented a formulary apportionment system and identifies some of the issues that the federal government would have to address in a formulary system. However, Treasury stated that the draft did not discuss in detail the broader difficulties of moving to formulary apportionment, such as how to define worldwide income and how IRS would verify a company's worldwide accounts.

Regarding Treasury's first point, the report discusses the adjustments required to reconcile accounting rules when computing worldwide income. Because countries are unlikely to agree to a common definition of income, we believe that the need to make these adjustments would be one of the major issues confronting taxpayers and tax administrators when determining worldwide income in a federal unitary system.

Regarding how IRS would verify worldwide accounts in a formulary system, the report discusses in detail how California verified companies'

worldwide accounts and discusses obtaining and verifying information as an issue that would need to be addressed in a federal system. Although California relies on IRS to obtain and verify some information, we do not agree with Treasury's view that this reliance on IRS is important for assessing the difficulties of administering a federal formulary system. Under a federal formulary system, IRS could continue to audit the items in a company's worldwide accounts that California found useful and incur no additional cost. The administrative issues that would need to be addressed include how IRS would audit a formulary system and what data sources IRS would find acceptable.

Treasury also wished to stress our report's view that a move to a formulary system would best be made on a cooperative, multilateral basis. Treasury stated that agreement to move to a new system is necessary to (1) ensure cooperation in gathering and sharing information, (2) solve international tax disputes, (3) avoid double taxation, and (4) prevent retaliation by countries against companies doing business within their borders. According to Treasury, a unilateral move would make it nearly impossible to verify a company's income and would lead to excessive, double taxation that would severely disrupt the flow of international commerce. This report recognizes that coordination of the move to a formulary system is desirable to avoid double taxation and to make the administration of the system easier. However, we did not evaluate the effect of a unilateral change on the flow of international commerce or how much more difficult the system would be to administer if the United States alone adopted a formulary system.

Treasury noted that for the United States to lead a multilateral move toward formulary apportionment would be difficult because it had already taken the lead in endorsing and developing the arm's length system. As we noted in this report, this history would complicate a move toward a unitary system.

In its comments on our draft report, MTC urged that the information in appendix I on California audit resources devoted to worldwide combined reporting be put into context by comparing it to the level of resources used by IRS in transfer pricing audits. We do not make this comparison because factors such as California's reliance on IRS as previously mentioned mean that federal and state audits are not directly comparable. California's audit costs will not reflect the full cost of an audit to the extent that information used in the audit is collected and verified by IRS.

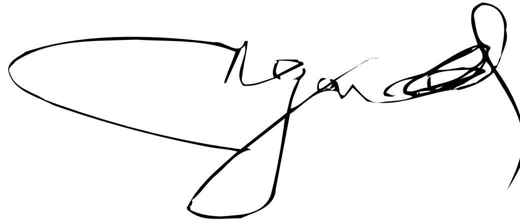
MTC commented that our report should have been an explicit, comparative evaluation of the formulary and separate accounting methods that would allow the reader to evaluate whether formulary apportionment is sufficiently better tax policy to justify the costs of changing from separate accounting. The MTC commented that criticisms of the federal use of formulary apportionment have been answered more effectively than the report implies. Our reasons for not making the explicit comparative evaluation of formulary apportionment and separate accounting were explained earlier in our response to FTB's comments. The purpose of appendix III of our report is to identify issues that would need to be addressed in a federal formulary system. We did not evaluate whether these issues can be effectively addressed in a federal system.

MTC also provided comments that describe its view of where the arm's length standard encounters difficulties similar to, but more severe than, problems under formulary apportionment. The difficulties mentioned by MTC include complicated and subjective judgments required to assign a price to potentially every commodity and service traded between related parties; double taxation that can result from disagreements about pricing methodologies; increased compliance burden from countries' nonuniform income sourcing rules; the determination of arm's length royalties for intangibles; and the location of development costs for intangibles under cost sharing agreements. Our report recognizes that some of the difficulties encountered with formulary apportionment are also encountered with separate accounting. However, for the reasons described earlier in response to a similar comment by FTB, we do not compare the two approaches in detail or evaluate which problems are more severe. MTC also provided other detailed comments on our draft report, which we have incorporated where appropriate.

As agreed with you, unless you publicly announce the contents of this report earlier, we plan no further distribution for 30 days. At that time, we will send copies to the Secretary of the Treasury and other interested parties. We also will make copies available to others upon request.

The major contributors to this report are listed in appendix VI. If you have any questions concerning this report, please contact me at (202) 512-9044.

Sincerely yours,



Natwar M. Gandhi
Associate Director, Tax Policy
and Administration Issues

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Abbreviations

FTB	Franchise Tax Board
GAAP	generally accepted accounting principles
IRS	Internal Revenue Service
MTC	Multistate Tax Commission
OECD	Organization for Economic Cooperation and Development
SEC	Securities and Exchange Commission
UDITPA	Uniform Division of Income for Tax Purposes Act

California Audits of Multinational Corporations

This appendix discusses the results of our review of 124 California audits of multinational corporations that were required to apportion a share of their worldwide unitary business income to the state. Most audits were for tax years 1980 to 1989. This appendix also covers the policies governing Franchise Tax Board (FTB) audits, the issues encountered, the methods used, the level of effort expended, and the results obtained. Policies and procedures are still applicable for FTB audits of those corporations that choose to file tax returns on a worldwide combined basis.

Audit Policies

Important state policies applied in formulary apportionment audits included (1) focusing on additional tax potential in selecting corporations for audit, (2) considering materiality in planning and carrying out work, and (3) using reasonable approximations when precise data were not available.

FTB policy was to audit the multinational corporations with the greatest additional tax potential.[1] Its staff were to examine all multinational tax returns for possible referrals for either desk or field audits.[2] Generally, the tax returns of large corporations and those with potential tax adjustments greater than $10,000 that could not be resolved through correspondence were referred to a field office.

Field auditors reviewed the corporate tax returns to test for potential audit issues and to see if the potential tax increase warranted committing audit resources. For example, they compared sales reported on a multinational corporation's tax return with the company's worldwide sales reported elsewhere to determine if all its affiliated corporations were included in the unitary business. Financial data, such as sales and information on the organization and operations of multinational corporations, appeared in various publications used by the state, such as Moody's International Manual.

Auditors also reviewed earlier audit reports to identify tax issues that could be applied to the current return and to determine if they could limit their audit effort on the basis of previous work. For example, an extensive review of a multinational corporation's unitary business relationships in a

[1]FTB's audit policies focus on "multistate" tax returns that include purely domestic U.S. corporations as well as multinational enterprises.

[2]Desk audits are conducted in the office on the basis of information on the tax return and from correspondence with the taxpayer, whereas field audits generally involve examination of taxpayers' records.

previous audit might have allowed an auditor to limit current work in this area.

Another FTB policy was to notify a corporation if auditors' preliminary tests of unitary business relationships during the audit indicated a potential refund. However, because of FTB's position of allocating audit resources to the audits producing the most tax, it believed the taxpayer should be responsible for developing unitary facts and figures to support a refund claim. If for some reason the taxpayer did not file a claim, as occurred in prior years for two audits we reviewed, the unity issue was not pursued.

The effect of FTB's audit selection and tax refund policies was twofold. FTB focused on audits of corporations that had been the least compliant with formulary apportionment requirements and tried to maximize the resulting tax revenue.

The principle of materiality was also extremely important in state apportionment audits. According to a state audit guide, auditors usually should not pursue immaterial items and should do more work to resolve material differences. They must judge an item's materiality on the basis of the facts and circumstances of each case. Decisions on materiality can limit audit work and adjustments. For example, according to FTB's policy, no adjustments for differences between U.S. and foreign accounting standards need to be made unless they are material.

In doing their work, FTB auditors tried to obtain annual reports, federal tax returns, and other documents from taxpayers as sources of the data needed to verify and/or calculate tax liability under formulary apportionment. Where an adjustment was likely to be material and the necessary data could not be developed from financial records maintained in the regular course of business, FTB could accept reasonable approximations. In particular, audit guidance indicated FTB auditors sometimes had difficulty obtaining information from foreign parent corporations that were part of a unitary business operating in California. They might have been obliged to use estimates or other methods to determine the income of the foreign affiliates. Moreover, when data were not readily available to adjust for differences between U.S. and foreign accounting standards, auditors may have either used reasonable approximations or accepted such approximations from the taxpayer.[3]

[3]FTB officials said that they will accept reasonable approximations that benefit the taxpayer as well as those that benefit the state.

Audit Issues

Audits of multinational corporations focused primarily on formulary apportionment issues, such as determining unitary business relationships and related income and calculating the property, payroll, and sales factors. Except for ensuring that corporations comply with state requirements for reporting income and expenses, FTB generally relied on Internal Revenue Service (IRS) audits to verify the accuracy of income and expense items, since similar data are reported on both federal and state tax returns. It also relied on data from federal tax returns and the annual audited financial statements of a company to verify income and other data used in determining the apportionment factors.[4]

Determining Unitary Business Relationships

Determining unitary business relationships among affiliated members of multinational corporations was the most complex and time-consuming issue that state auditors had to develop. At the same time, this determination significantly affected corporate tax liability and was an important issue in audits we reviewed and in related protests and appeals.

Affiliated corporations in a multinational enterprise were considered to be unitary if they met one of two sets of criteria. One set of criteria entails (1) determining if the part of a business in California depended upon or contributed to the business as a whole and (2) determining if unity of ownership existed as demonstrated by more than 50 percent of the voting stock of the members of the corporate group being owned by the same interests. Dependence or contribution was most easily established by the presence of intercompany sales of tangible property, according to state guidance, but might have been based on other factors. A business was also considered unitary if it met the second set of criteria, that is, if (1) it met the ownership criterion; (2) unity of operation was evidenced by central purchasing, advertising, accounting, management, etc.; and (3) unity of use was demonstrated by a centralized executive force and general system of operations.

Generally, the most difficult segment of a multinational audit was developing the facts needed to assess unitary relationships on the basis of these criteria. Auditors obtained information on unity from documents provided by the taxpayer, such as annual reports, federal tax returns and supporting workpapers, board of directors' minutes, internal newspapers, corporate telephone directories, organization charts, and policy manuals.

[4]Financial statement data for public corporations are generally available in a company's annual reports, filings with the Securities and Exchange Commission (SEC), and some business publications.

To confirm or expand on this information, they requested corporate responses to a questionnaire on unity issues.

The five domestic audit case studies we reviewed did not include a typical example of a complete unitary analysis. In four cases, the analysis was limited because it was based on the results of prior audits. In one case, for example, the auditor agreed that the parent corporation and 12 subsidiaries were part of a unitary business. This analysis was based on the prior audit, a limited review of audited financial statements, and other data, which ensured that no major changes had occurred in their operations. According to FTB officials, auditors commonly limit their analysis to changes when prior work establishes basic unitary business relationships. Although the remaining case included a unitary analysis, it was unusually drawn out and complicated by a total lack of taxpayer cooperation and had other problems, according to an FTB official. The results of the five domestic case studies are included in table I.1 and appendix II. The five case studies of foreign-owned companies are presented in table I.2 and appendix II.

Table I.1: Summary of GAO Case Studies of Five Franchise Tax Board Audits of U.S.-Controlled Multinational Corporations

Case number	Audit hours	Key audit issue	Number of years audited	Taxpayer action
1	1,026	Unity	3	Paid tax
2	600	State adjustments[a]	4	Paid tax
3	161	State adjustments[b]	3	Protested
4	153	IRS audit adjustment[c]	2	Protested
5	2,386	Unity	4	Protested

[a]Major items included nonbusiness gains and losses, excess depreciation, income taxes, and a federal deduction not allowable for state tax purposes.

[b]The major item was federal deduction that was not allowable for state tax purposes.

[c]FTB adjusted state income tax on the basis of the results of an IRS audit.

Source: California FTB audit files.

Table I.2: Summary of GAO Case Studies of Five Franchise Tax Board Audits of Foreign-Controlled Multinational Corporations

Case number	Audit hours	Key audit issue	Number of years audited	Taxpayer action
1	118	Unity[a]	3	Protested
2	689	Unity[a]	3	Protested
3	538	Unity[a]	4	Protested
4	554	Unity[a]	2	Protested
5	295	Payroll	3	Paid tax

[a]The key audit issue was unity with a foreign parent corporation and affiliates.

Source: California FTB audit files.

For a better example of a complete unitary analysis of a U.S. multinational corporation, we reviewed another audit identified by FTB officials. It involved a large multinational enterprise and took 1,366 hours to complete. In this case, the auditor analyzed the unitary business relationship between the parent corporation and its subsidiaries along different product lines. The analysis was based on information obtained from a variety of sources including (1) a prior audit, (2) the taxpayer's response to a unitary questionnaire, (3) corporate board minutes and other internal documents, (4) meetings with taxpayer representatives, and (5) newspaper articles.

The auditor determined that the parent corporation had a unitary business relationship with the subsidiaries and divisions formed along two product lines.[5] For example, he cited the following features as a basis for the parent corporation's unity with one product line group:

- intracompany sales and purchases,
- common advertising and marketing,
- common technology and personnel,
- budgetary controls by the parent corporation,
- transfer of technical knowledge between divisions,
- intracompany transfer of personnel,
- joint internship programs,
- quality control by the parent corporation, and
- common pension plans.

[5]The auditor initially made a unitary determination in a third product line, but FTB dropped this finding after further review of the facts with the taxpayer.

For each of these features, the auditor cited specific evidence to support his determination of a unitary business relationship. For intracompany sales and purchases, for example, based on the taxpayer's response to a unitary questionnaire, he noted that the parent corporation and its product line group supplied each other with key manufacturing parts of significant value. He did similar analyses of unitary features for all product lines he reviewed.

Evaluating unitary relationships of foreign-controlled corporations sometimes is more difficult than evaluating unitary relationships for U.S.-controlled multinationals because unity information is harder to obtain from foreign parent corporations, according to FTB officials. In an audit of several California subsidiaries of the same foreign parent corporation, for example, the taxpayers failed to provide documentation on their unitary ties with the foreign parent and other affiliated corporations. As a result, the auditor relied on alternative sources such as the taxpayers' financial statements and annual reports to perform a unitary analysis. From these sources he determined that the different corporations were in a unitary business with their foreign parent corporation on the basis of the following features:

- the foreign parent corporation owned more than 50 percent of the subsidiaries,
- the foreign parent corporation and its subsidiaries were in a similar line of business,
- the foreign parent corporation and its subsidiaries shared a common name,
- an intercompany flow of goods existed,
- the foreign parent corporation guaranteed obligations and provided financing for U.S. operations, and
- the foreign parent corporation transferred information and technical know-how to its subsidiaries.

Such analyses of unitary relationships take additional audit time and can significantly affect tax liability. For the 124 FTB audits we reviewed, table I.3 shows that 68 audits with unity issues took an average of 603 hours to complete compared with 399 hours for 56 audits that did not include unity issues. It also shows that audits with unity issues resulted in an average $2.0 million in proposed additional tax assessments compared with an average $0.8 million for audits that did not have a unity issue. Similarly, in 6 of 10 in-depth case studies we conducted, unitary determinations were the key issues, resulting in a total of $12 million in proposed tax

assessments, compared with $2.4 million in total for the 4 case studies that did not involve a unitary issue.

Table I.3: Analysis of GAO Sample of 124 Franchise Tax Board Audits of Large Multinational Corporations Comparing Audits With Unity Issues With Audits Without Unity Issues[a]

Dollars in millions

	Audits with unity issue			Audits without unity issues		
	U.S.-controlled	Foreign-controlled	Total	U.S.-controlled	Foreign-controlled	Total
Number	50	18	68	55	1	56
Total audit hours	28,439	12,582	41,021	21,917	417	22,334
Average audit hours	569	699	603	398	417	399
Sampling error for average audit hours (plus or minus)[b]	142	350	135	95.5	[c]	94
Total proposed additional tax	$97.7	$37.0	$134.7	$41.9	$0.3	$42.2
Average proposed additional tax	$2.0	$2.1	$2.0	$0.8	$0.3	$0.8
Sampling error for average proposed additional tax (plus or minus)[b]	$1.2	$2.3	$1.0	$0.4	[c]	$0.4

[a]The FTB selects corporations with the greatest additional tax potential for audit. Therefore, our sample does not represent all large multinational corporate tax returns.

[b]Sampling error computed at 95-percent confidence level.

[c]Sampling error was not applicable since only one audit was involved.

Source: GAO analysis of FTB audit files.

Unity was the dominant issue in audits of foreign-controlled corporations in our sample, occurring in 18 of 19 cases. It occurred in 50 of the 105 audits of U.S.-controlled corporations.

Determining Unitary Income

Another major issue for state auditors is determining a reporting corporation's total unitary income. They must review the income reported by multinational corporations to ensure it includes, as required, all U.S. and foreign income related to the unitary business and is reported in accordance with state requirements, which may differ from federal requirements. If necessary, auditors recalculate reported income to determine tax liability under worldwide formulary apportionment.

In our 10 case studies, FTB auditors used the parent corporation's consolidated or worldwide income as a starting point for calculating unitary business income. For U.S. multinational corporations, they used

taxable income from the federal tax returns. For foreign-owned multinationals, auditors used pretax "book" income from the parent corporation's audited annual financial statements and replaced the book income of U.S. subsidiaries with taxable income from their federal tax returns.[6]

FTB auditors then made other adjustments to worldwide income. For example, they added the income of subsidiaries that multinational corporations should have included in the unitary business but did not. Once the auditors identified income for all components of the unitary business, they adjusted it for differences in state and federal reporting requirements and, in audits of foreign-controlled corporations, for differences in U.S. and foreign accounting standards and record keeping, as will be discussed later in this appendix. In addition, FTB guidance required auditors to examine certain types of income, such as interest and rental income that may not have been related to the unitary business to ensure they were correctly treated for apportionment purposes. If income items were considered as "nonbusiness income," they were not included in apportionable income.[7]

To make these adjustments, auditors generally used corporate audited financial statements, federal tax returns, and taxpayer workpapers. For example, beginning with taxable income reported on one U.S. multinational corporation's consolidated federal tax return, the auditor

- eliminated the income of subsidiaries that were not part of the unitary business on the basis of supporting schedules to the federal tax return,
- added the income of unitary foreign subsidiaries from audited financial statements of the company,
- added the income of domestic international sales corporations that were part of the unitary business on the basis of federal tax return data,[8] and
- eliminated foreign subsidiary income to avoid double counting that was included with the parent corporation's income in the consolidated federal

[6]Income information is available from the federal tax returns of U.S. subsidiaries but is not available for foreign subsidiaries because they do not file federal tax returns.

[7]Business income is, generally, income arising from transactions and activities in the regular course of a taxpayer's trade or business. It is assigned to a location through formulary apportionment. Nonbusiness income is all other income and is specifically assigned to a particular location.

[8]Domestic international sales corporations were U.S. corporations which were exempt from income tax and whose shareholders were permitted a partial deferment of U.S. tax on certain export receipts. They were replaced by foreign sales corporations after Dec. 31, 1984. Foreign sales corporations are foreign corporations set up by U.S. parents to handle export activities. The foreign sales corporation provisions were designed to ensure that the exemption from tax was not a prohibited subsidy under the General Agreement on Tariffs and Trade.

tax return and in the financial statements from which income data were originally obtained.

In a foreign-controlled corporation case, the auditor began with income reported in the parent corporation's audited financial statements and

- added back income taxes identified in the report that were not deductible under state reporting requirements,
- substituted the taxable income of U.S. subsidiaries from their federal tax returns for their "book" income, and
- eliminated reserve and amortization deductions identified in the financial statements that were not allowed for U.S. tax purposes.

Auditors also took steps to ensure that income was adjusted for differences between state and federal tax reporting requirements. For example, California does not allow certain accelerated methods of depreciation that the federal government permits. Although such differences are not formulary apportionment issues, per se, they can have a significant effect on unitary income for tax purposes and therefore on corporate tax liability. For example, as the result of state adjustments for 10 different items, the net income of a U.S. multinational increased by several hundred million dollars over a 4-year period.

Determining Apportionment Factors

A third major area for FTB on apportionment audits is determining if the apportionment factors are correct. Because the property, payroll, and sales factors used to apportion multinational income can significantly affect state tax liability, FTB auditors are to verify the California and worldwide amounts that underlie the three factors. They are to compare factor amounts with similar data in audited annual financial statements, federal tax returns, and taxpayer workpapers and do detailed checks to ensure that the numbers are reported consistently and comply with state requirements. When necessary, the auditors use these sources to make adjustments.

One domestic case illustrates how FTB used this approach to audit the property factor.[9] Total property in this case was the sum of the annual average cost of fixed assets in 7 categories plus the capitalized rent for more than 20 subsidiary corporations. Historical costs of most of the fixed

[9]The property factor consists of the annual average of real and tangible personal property. Owned property is valued at its original cost and rental property is valued at eight times the annual rental expense. Property includes inventory, buildings less construction in progress, equipment, and other tangible assets.

assets came directly from the financial statements. Some fixed asset costs, rent, and the California property amounts were obtained from supporting taxpayer workpapers.

FTB had to consider potential property valuation differences in auditing foreign-controlled corporations. For example, the value of land in one foreign parent corporation's audited financial statements was based on its appraised value rather than on its historical cost. Consequently, the auditor asked the California subsidiary to get historical cost information from its parent corporation and then used it to compute total unitary property. Although the auditor could not verify land and fixed assets containing historical cost using the annual report, he compared total property to the total property amount in the prior audit and concluded that it appeared to be reasonable. California property value was verified using the California subsidiary's "state report," which allocated property cost and rent to each state.[10]

FTB also used many sources to verify and, if necessary, adjust the payroll factor. The payroll factor consisted of employee compensation, including wages, salaries, and commissions related to business income. It also included employee benefits, such as room and board that are taxable under the Internal Revenue Code. If the taxpayer uses the cash basis of accounting to calculate the payroll factor, FTB can verify the state payroll using amounts reported on California unemployment insurance quarterly returns.[11] FTB can verify the U.S. component of worldwide payroll to federal payroll returns filed annually or quarterly.[12] If the taxpayer uses the accrual basis of accounting to calculate the payroll factor, supporting taxpayer payroll records may provide the necessary data. For foreign corporations, FTB can obtain payroll data from financial statements or from information provided by the foreign corporation.

One of our U.S.-controlled multinational case studies illustrates how the auditor compared the California payroll amount with supporting taxpayer records, including a state-by-state allocation of its total payroll, and with the sum of the taxpayer's California unemployment insurance returns for a

[10]In our 10 case studies, FTB auditors generally reviewed corporate workpapers that allocated property, payroll, and sales to California and other states as one means of verifying California factor amounts. According to FTB officials, corporations commonly perform this analysis because the information is needed to apportion income among the states.

[11]Taxpayers may elect to determine the payroll factor using the cash method even if they use the accrual method for financial statement and income tax purposes.

[12]U.S. payroll is reported on Form 940, Federal Employer's Annual Federal Unemployment Tax Return, and on Form 941, Employer's Quarterly Federal Tax Return.

particular year. The auditor also compared total corporate payroll to taxpayer records along with payroll data from both its federal payroll and tax returns. Using data from these sources, the auditor eliminated the payroll of subsidiaries that had been incorrectly included in the unitary business and added the payroll of subsidiaries that were incorrectly excluded.

Foreign-controlled corporations or foreign affiliates of U.S. corporations may require additional payroll adjustments, since some of them include employee benefits that are not taxable compensation under the Internal Revenue Code. In one case study, for example, the auditor eliminated a foreign parent corporation's contribution to staff retirement and pensions, which was not income to its recipients under the Internal Revenue Code.

According to FTB guidance, to verify the sales factor, which consists of a taxpayer's gross receipts that result in business income, the auditor must make sure that other business receipts, such as rent and royalties, are included if they are material and related to the unitary business. In our case studies, auditors primarily used (1) sales and other receipts from audited financial statements to verify total sales and (2) taxpayer workpapers that allocated sales by state to verify California sales. They adjusted sales factor amounts in all 10 case studies. In a U.S.-controlled corporation case, for example, the auditor (1) eliminated sales related to subsidiaries that were not part of the unitary business on the basis of sales data in the taxpayer's workpapers and financial statements and (2) added interest income, which the auditor concluded should be considered business income, from data in the taxpayer's workpapers and federal tax return.

State Methods of Dealing With Currency Translations and Foreign Accounting Standards

FTB sometimes had to make currency conversions and adjustments for differences in accounting standards and record keeping. This was done because foreign financial data were not reported in U.S. dollars or were not based on the same accounting or tax principles as U.S. data. Further, foreign financial statements and records may not always provide the data FTB needs to apportion unitary business income. Currency conversion and differences in accounting standards and record keeping are issues related primarily to foreign-controlled California corporations, since U.S. multinational corporations must report financial data for their U.S. and foreign subsidiaries in dollars based on U.S. generally accepted accounting principles (GAAP). However, according to an FTB official, to some extent currency conversion is also an issue for U.S. multinational corporations

because the California regulations on currency conversions may vary from U.S. GAAP.

FTB has established policies and procedures for dealing with currency conversion and differences between U.S. and foreign accounting standards and record keeping. When a California corporation's financial data are in dollars and the foreign parent corporation's data are in another currency, California data are converted to the foreign currency at an average annual exchange rate to calculate apportioned income, which is then reconverted to dollars. Since California valued fixed assets at their historical cost, converting U.S. assets to the currency of a foreign parent corporation required additional calculations.[13] FTB requires adjustments for differences in U.S. and foreign accounting standards and record keeping when they are material. FTB's policy allows reasonable approximations of the differences.

Differences in U.S. and foreign accounting standards and record keeping vary by country, according to state audit guidance. For example,

- Foreign financial statements may include additions to various reserves to reduce income that may not be allowed under U.S. GAAP and/or are not allowable tax deductions for U.S. purposes.
- U.S. GAAP requires inventory to be valued at historical cost for accounting purposes unless its market value is lower. Foreign countries may allow other inventory valuation methods. For example, some foreign corporations may use net realizable value, defined as the estimated selling price minus reasonably predictable costs, as a basis for writing up inventory so that it exceeds its value on an historical cost basis.
- Foreign countries sometimes allow unrealized gains or losses from foreign currency translations to be included in the income statement. In contrast, U.S. GAAP generally requires such gains or losses to be reported in a separate component of equity instead of being included in determining net income.

Such differences can affect unitary business income or the formula factors. For example, France permits corporations to increase inventory valuations when fair market value exceeds cost, which can affect both income and the property factor. If the increase is material, auditors must adjust inventory to a cost basis for property factor purposes. They may

[13]Average annual exchange rates were applied to the cost of fixed assets for an initial year and then to yearly acquisitions and dispositions. Each year's changes were "layered" or added into the value of fixed assets from the previous year to arrive at a value expressed in a foreign currency at estimated historical exchange rates.

also have to adjust the cost of goods sold expense, which would be overstated because of the higher inventory value.

FTB guidance indicates that information in the consolidated income statement of the foreign parent corporation can be used to identify differences in U.S. and foreign accounting standards. In our five foreign-controlled corporation case studies, FTB auditors made six adjustments for differences in U.S. and foreign accounting standards and record keeping. Five of these adjustments were based on audited financial statements. For example, the auditor increased income in one case by adding back amounts identified in the annual audited financial statements of the foreign parent corporation as reserves for special purposes and for write-down of financial investments, since both are not allowed for U.S. tax purposes.

We also found that auditors made assumptions or estimates when the foreign financial statements they used did not provide the data they needed, and taxpayers did not provide supplemental data that the auditors requested. In our foreign-controlled corporation case studies, for example,

- When a taxpayer did not provide financial data to substantiate its contention that certain subsidiaries were not part of the unitary business, the auditor used information from the annual financial statements of the foreign parent corporation without excluding those subsidiaries from the report.
- When a taxpayer did not provide information on the unrealized portion of foreign exchange gains or losses included in the annual financial statements of the foreign parent corporation, the auditor accepted the data, since he believed the amount of unrealized gains or losses would most likely be immaterial.

The audit files indicated that foreign taxpayers sometimes believed FTB's requests for more data on their foreign operations were unreasonable and their adjustments were unfair. For example,

- In the case where FTB adjusted the income of the foreign parent corporation for its write-down of financial investments, the taxpayer formally protested the adjustment. While acknowledging that write-downs cannot be realized for U.S. purposes until the items are sold or written off as worthless, the taxpayer said that it was unfair to disallow the entire expense included in the annual financial statements of the parent corporation, since the expense reflected different accounting and

consolidation methods from subsidiaries located in many different countries. The taxpayer further said that it was unreasonable to expect its foreign parent corporation to review all of the transactions in foreign countries to identify the payments that were deductible.

- Another taxpayer protested FTB eliminating deductions for payments to a special reserve for employee severance pay. The taxpayer argued that a deduction should be allowed because the labor law of the foreign parent's country required the reserve payments to be set aside even if the ultimate beneficiary might not receive them for some time. Therefore, the taxpayer contended that the severance payments were not subject to any contingencies and should be deductible.
- In another case, the auditor noted the taxpayer's bitter and extreme uncooperativeness when asked to recalculate depreciation expenses of its foreign parent corporation on the basis of a method the state allowed. According to the taxpayer, the only available data to do this were from the annual financial statements of the foreign parent corporation, which were written in a foreign language. The taxpayer was not sure it could get the data needed.

Although corporations formally protested FTB adjustments for differences in accounting standards and record keeping in the two cases we have mentioned, an FTB official told us that protests of accounting standard and record keeping issues might have been limited by foreign corporations focusing almost exclusively on the constitutional issue in the Barclays Bank case before the U.S. Supreme Court. According to an FTB official, now that the Barclays case has been resolved, the great majority of related constitutional protest cases should be resolved by June 30, 1995, the end of the state fiscal year.

Level of Audit Effort

The level of effort devoted to a particular audit varied considerably. Table I.4 shows audit hours for our sample of 124 U.S.- and foreign-controlled corporations.

Table I.4: Audit Hours for GAO Sample of Franchise Tax Board Apportionment Audits of Large Multinational Corporations[a]

	Number of hours		
Level of audit hours	For 105 audits of U.S.-controlled corporations	For 19 audits of foreign-controlled corporations	For all 124 apportionment audits
Average	480	684	511
Sampling error for average audit hours (plus or minus)[b]	84.5	331.5	86
Minimum	70	146	70
Maximum	2,386	3,158	3,158
1st quartile	70 - 173	146 - 322	70 - 197
2nd quartile	185 - 356	335 - 417	198 - 363
3rd quartile	360 - 583	461 - 896	366 - 627
4th quartile	604 - 2,386	1,030 - 3,158	628 - 3,158

[a]The FTB selects corporations with the greatest additional tax potential for audit. Therefore, our sample does not represent all large multinational corporate tax returns.

[b]Sampling error computed at 95-percent confidence level.

Source: GAO analysis of FTB apportionment audits.

According to state officials, factors that can affect audit hours include (1) the size and complexity of multinational corporations, (2) the potential impact of the audit issues on tax liability, (3) the results of previous audits, and (4) the cooperativeness of the taxpayer. We previously discussed how FTB auditors consider potential tax effect when selecting corporations and planning the scope of their audits and how they sometimes limit audit work on the basis of the results of prior audits. FTB officials also told us that the lack of taxpayer cooperation occurred more often and may be one reason that audits take longer for foreign-controlled corporations than for U.S.-controlled corporations.

Audit Results

FTB auditors are to discuss audit results with taxpayers and also give them a written summary of their audit findings. If an audit results in increased tax liability, FTB is to issue the taxpayer a Notice of Proposed Assessment indicating the amount of the additional tax.[14] For the 124 audits we reviewed, table I.5 shows total and average amounts of initial tax liability and additional tax assessments.

[14]Audits may also identify overassessments for some tax years.

Table I.5: Proposed Additional Tax Assessments for the GAO Sample of Franchise Tax Board Audits

Dollars in millions

	U.S.-controlled corporations	Foreign-controlled corporations	Total
Number of audits	**105**	**19**	**124**
Total tax before audit[a]	$641.9	$38.7	$680.6
Total additional tax proposed[b]	$139.6	$37.3	$176.9

[a]The total tax before audit was not available from FTB records for 6 of the audited years in three audits. The related amount of additional tax proposed for those 6 years was $5.9 million.

[b]FTB also notified taxpayers of $14.8 million in proposed overassessments for the 124 audits.

Source: GAO analysis of FTB data.

FTB obtained copies of IRS audit results and, if changes were applicable for state purposes, made related adjustments to state income taxes. Of the $176.9 million proposed additional tax assessments in table I.5, $41.1 million was partially the result of IRS audits of federal tax returns. An additional $28.9 million in proposed tax assessments, not included in the $176.9 million, was entirely or substantially the result of IRS audits. According to FTB officials, they generally rely on IRS audits to ensure that taxpayers report accurate income and expense data on their federal tax returns.

Taxpayers may agree with the additional tax, or they can contest it through the state's protest and appeals process and/or through the court system. Taxpayers can file a protest with the FTB if they disagree with the proposed tax assessment and, if they disagree with FTB's decision on their protest, they can appeal it to the California State Board of Equalization. The Board's decisions are final unless the taxpayer pursues the case through the court system. Taxpayers have other options, which include litigating their cases or submitting cases in the protest and appeals stage to a settlement process.[15]

Taxpayers agreed with $33.8 million of the $176.9 million in proposed additional tax assessments from our sample of 124 FTB audits and contested $143.1 million through the protest, appeals, and/or settlement processes. Of the $143.1 million contested, FTB had not resolved

[15]California enacted legislation that gave FTB authority for a limited period to negotiate a settlement of civil tax disputes existing as of July 1, 1992. That authority was extended by further legislation.

$89.3 million at the time of our review. Table I.6 shows the disposition of the $53.8 million in proposed assessments that were resolved.

Table I.6: Resolution of Proposed Tax Assessments for GAO Sample of Franchise Tax Board Audits That Were Contested and Resolved

Dollars in millions

	U.S.-controlled corporations	Foreign-controlled corporations	Total
Number of proposed additional tax assessments	16	3	19
Proposed additional tax	$50.2	$3.6	$53.8
Final assessed tax	$27.2	$2.0	$29.2
Percentage of proposed tax sustained	54%	55%	54%

Source: GAO analysis of FTB data.

Narrative Summary of 10 California Franchise Tax Board Audits of Multinational Corporations

Our case studies of FTB audits involving five U.S-controlled (domestic) and five foreign-controlled corporations are briefly described in the following summaries.

Domestic Case Number 1

The key audit issue in this case was the unity of a U.S. parent corporation, the California taxpayer, with its subsidiaries. The auditor included a domestic subsidiary in a unitary business with the taxpayer, then realigned the taxpayer and its divisions and subsidiaries into several unitary businesses consistent with an agreement between the taxpayer and FTB in a prior audit. The auditor recalculated taxable income for each unitary business, relying primarily on the consolidated federal tax return to determine unitary income and on the parent corporation's financial statements and workpapers to recalculate apportionment factors. The auditor made no adjustments for differences between U.S. and foreign accounting standards and record keeping.

Domestic Case Number 2

The audit focused primarily on state audit adjustments. The California taxpayer, the parent corporation in a U.S. multinational enterprise, included domestic and foreign subsidiaries in the unitary business, as agreed with FTB in the previous audit. The auditor revised the corporation's taxable income primarily on the basis of federal tax return data, audited financial statements, and taxpayer workpapers. There were several adjustments for differences in state and federal tax reporting requirements that increased unitary business income by hundreds of millions of dollars for the 4 years audited. The auditor made no adjustments for differences between U.S. and foreign accounting standards and record keeping.

Domestic Case Number 3

The key audit issue in this case related to a federal tax deduction that was not allowed under state tax reporting requirements. Unity between the California taxpayer, the parent corporation in a U.S. multinational enterprise, and its domestic and foreign subsidiaries had been established in the previous audit, and the taxpayer included all affiliated corporations in its unitary business. The auditor primarily relied on information in the federal tax return, annual report, and taxpayer workpapers in doing his work. The auditor made no adjustments for differences between U.S. and foreign accounting standards and record keeping.

Domestic Case Number 4

The key issue in this case was a deduction for legal fees that FTB disallowed on the basis of the results of an IRS audit. The California taxpayer, the U.S. parent corporation in a multinational enterprise, included all its subsidiaries as part of its unitary business, although the previous audit had determined that one subsidiary was not unitary with the taxpayer. There were no annual reports or Securities and Exchange Commission (SEC) forms 10-K available to use in recalculating tax liability, because the taxpayer was a privately held corporation. As a result, the auditor recalculated taxable income to exclude the subsidiary corporation primarily on the basis of information in the federal tax return and taxpayer workpapers as well as the results of a federal audit. The auditor made no adjustments for differences between U.S. and foreign accounting standards and record keeping.

Domestic Case Number 5

The key issue in this case was the unity of the taxpayer with its domestic subsidiaries. The taxpayer did not respond to the auditor's request for information needed to make a unitary determination, so the auditor relied on the taxpayer's SEC Form 10-K and the taxpayer's annual reports. The auditor revised taxable income primarily on the basis of information from the federal tax return, annual reports, and taxpayer workpapers. An FTB official noted that the number of hours spent on this audit was atypical, because of the complexity of the relationships between the taxpayer and its affiliates, the lack of taxpayer cooperation, and other problems. The auditor made no adjustments for differences between U.S. and foreign accounting standards and record keeping.

Foreign Case Number 1

The key audit issue in this case was the unity of the California taxpayer with its foreign parent corporation and affiliates. Although the taxpayer was first combined worldwide with its foreign parent corporation in the late 1960s, the taxpayer included only its domestically owned subsidiaries in its unitary business. Since the taxpayer stated that no facts had changed since the previous audit, the auditor limited his unitary business analysis to examining intercompany transactions between the taxpayer and its parent corporation and foreign affiliates. The auditor recalculated taxable income primarily on the basis of information contained in the foreign parent corporation's annual report, federal tax return, and taxpayer workpapers. In computing one of the apportionment factors, the auditor accepted certain information without verification because it could not be obtained from the parent corporation. The auditor made two adjustments

for differences between U.S. and foreign accounting standards and record keeping based on details in the annual report.

Foreign Case Number 2

The key audit issue in this case was the unity of several California taxpayers with their foreign parent corporation. Each taxpayer filed separate tax returns and none included the foreign parent corporation as part of the unitary business. The different California taxpayers failed to provide requested information on the unitary ties between the parent corporation and any of its affiliates, so the auditor based his determination on the parent corporation's annual report, taxpayer financial statements, federal tax returns, and taxpayer books and records. The auditor could make no determination regarding the unity of unconsolidated foreign entities mentioned in the parent corporation's annual report. The auditor recalculated taxable income primarily on the basis of the parent corporation's annual report, federal tax returns, taxpayer's financial statements, and workpapers and made one adjustment for differences between U.S. and foreign accounting standards and record keeping on the basis of information in the parent corporation's annual report. One taxpayer did not provide requested information that was needed to determine the historical cost of property, which the taxpayer valued on a different basis for some foreign subsidiaries. As a result, the auditor accepted the taxpayer's property values from the annual report.

Foreign Case Number 3

The key audit issue in this case was the unity of several California taxpayers with their foreign parent corporation and affiliates. Each of the different taxpayers filed separate tax returns, and none included the parent corporation in the unitary business. The auditor combined the taxpayers with their foreign parent corporation and its affiliates in the unitary business and recalculated taxable income primarily on the basis of information in the parent corporation's annual report, federal tax return, and taxpayer workpapers. However, the auditor noted that while the taxpayers supplied some information, they did not supply documents regarding sales needed to evaluate the nonunitary aspects between the taxpayer and parent. The auditor made no adjustments for differences between U.S. and foreign accounting standards and record keeping.

Foreign Case Number 4

The key issue in this case was the unity of the California taxpayer with its foreign parent corporation and other U.S. subsidiaries. Although FTB had combined the taxpayer with its parent corporation in a unitary business

during the previous audit, the taxpayer filed a domestic combined tax return that did not include the parent corporation. The auditor determined that the taxpayer should be included with its foreign parent corporation and domestic affiliate in a unitary business, and the auditor recalculated taxable income for 2 years primarily on the basis of information in the parent corporation's annual report. However, the auditor also determined in his preliminary analysis of unity that the taxpayer potentially could receive a large refund for the previous 2 tax years. The auditor notified the taxpayer of a potential refund if it filed an amended return, but the taxpayer did not file a refund claim. The auditor made two adjustments for differences between U.S. and foreign accounting standards and record keeping.

Foreign Case Number 5

In this case, the California taxpayer was a foreign multinational corporation with business offices in California. Initially, the key audit issue in this case was whether to include subsidiaries of the foreign parent corporation in the unitary business. As in the past, the taxpayer included one subsidiary but not others in the unitary business. Relying on information in the annual report, the auditor determined that the taxpayer, the foreign parent corporation in this case, was unitary with its subsidiaries. However, since the auditor believed that a determination of worldwide unity would result in a tax refund, FTB notified the taxpayer of a potential refund if it filed revised tax returns. The taxpayer did not file a return on this basis and the auditor reviewed the apportionment data reported on the original tax return. Amounts for all factors were accepted as reported on the tax return, except the auditor added back the taxpayer's staff retirement and pension contributions because this deduction was not allowable for U.S. tax purposes.

Issues That Would Need to Be Considered Before Federal Adoption of Formulary Apportionment

Adopting formulary apportionment at the federal level would require designing and administering a new system, one featuring a unitary tax and addressing transition issues like coordination with other countries. A unitary tax system combines the income of corporations that are determined to be members of a unitary group and applies a formula to divide the net income of the unitary group among taxing jurisdictions. This approach avoids transfer pricing problems by using a formula rather than transfer prices to determine each corporation's share of the combined income of related corporations. As a result, some state tax officials and other tax experts have advocated formulary apportionment as an alternative to the existing federal system. However, other tax experts believe that it is not a viable alternative to the existing tax system.

This appendix does not discuss whether formulary apportionment should be adopted at the federal level. Rather, it describes the design, administration, and international coordination issues that would need to be addressed before such a system could be adopted. We do not evaluate whether these issues can be effectively addressed in a federal system or whether problems with the formulary approach are more severe than the problems with the arm's length approach.

Design Issues

Design issues that would need to be resolved center on specifying the basic features of the unitary tax. These issues include (1) defining the unitary business, (2) determining the apportionment formulas that divide the unitary group's income, and (3) defining the factors in the formulas and the rules for valuing them and assigning them to specific tax jurisdictions. In addition, the revenue implications of moving to formulary apportionment would need to be addressed.

Defining the Unitary Business

The definition of a unitary business has been continually controversial in the states, and the lack of a uniform and clear definition has been a major source of administrative complexity. As explained in appendix I, for California, determining the members of the unitary group has been a difficult and frequently audited issue. In examining a unitary business, auditors require a great deal of data and must make subjective judgments. As we noted in our previously cited 1992 and 1995 transfer pricing reports and 1993 testimony, the arm's length standard also requires taxpayers and IRS to collect a great deal of information and use considerable subjective judgment to compute arm's length prices.[1]

[11]GAO/GGD-92-89, GAO/GGD-95-101, and GAO/T-GGD-93-16.

Thus, the ease of administering a unitary tax at the federal level would depend on a uniform definition with clear criteria for identifying businesses belonging to a unitary group. The definitions used by California and other states test whether the activities of affiliated corporations contribute to and depend on each other and, if so, to what degree. These definitions use criteria such as the degree that accounting, advertising, and management activities are integrated among businesses to identify members of the unitary group. As our review of California audits shows, identifying the unitary group using such definitions can involve complex and detailed examination of the corporations' management and operations. If a federal system used the same criteria for defining a unitary business, it might require a similar analysis.

Some academic experts and state tax officials argue that a federal system would not need such complicated tests. They argue that a federal system could use a simpler definition because the state complications result from constitutional requirements that may not apply at the federal level.[2] Although a simple definition would minimize administrative burden and uncertainty, a definition that is too simple would risk combining diverse companies or being manipulated by taxpayers. Thus, whether the unitary business concept would be any easier to define and administer at the federal level than at the state level is unclear.

One relatively simple way to define the unitary group would be to use a "bright line" test based on ownership. The definition would include a company in a unitary group if members of the group owned at least a combined minimum percentage of the company's stock. However, this approach might combine companies that had very little connection in terms of intercompany transactions or shared executive or staff functions. It might therefore result in dividing income that did not flow from the integrated activities of a unitary group. Some tax experts contend that when arm's length prices can be determined, separate accounting is more appropriate. Further, the ownership test might be manipulated by taxpayers buying or selling company stock to change the unitary group's makeup and reduce tax liability.

[2]The courts have required that the definition of unitary and other state tax rules be consistent with the due process and commerce clauses of the U.S. Constitution. Tax experts that we interviewed agreed that the commerce clause restrictions on state taxation would not apply to the federal system but disagreed about restrictions required by the due process clause. These due process restrictions might limit the extent to which simple tests like ownership could be used in a federal system to identify a unitary group.

To avoid problems like these, other experts have suggested alternative bright line tests for the definition of the unitary group. One such test would include corporations in the unitary group that have a minimum share of the flow of goods and services between the controlled corporations. Another test would be based on a minimum flow of value between corporations that also meet a minimum percentage ownership test, where the flow of value can arise from shared expenses, economies of scale, and other economic interdependencies, as well as the exchange of goods and services. Under either of these tests, increased administrative complexity would have to be traded off against the reduced risk of manipulation by taxpayers and combination of diverse companies. Alternatively, a single test like ownership could be used if combined with a workable relief procedure for cases where the test combined clearly diverse companies. However, taxpayers have complained that state tax administrators have been reluctant to employ relief procedures.

Defining the Apportionment Formulas

To reduce the possibility of double taxation in a formulary apportionment system, countries—like states—would need to use the same formula as each other when dividing a company's income. If countries use different formulas (or if some countries use separate accounting), the same income might be taxed by more than one country. With different formulas, the sum of the income apportioned by the formulas to all countries might exceed 100 percent of the corporations' income. The sum might also be less than 100 percent, resulting in some income escaping taxation in any country.

Neither the arm's length system nor the unitary system can guarantee eliminating double taxation, and the unitary system might undertax as well as overtax. According to the U.S. Supreme Court's opinion in the Barclays case, the current arm's length system might also involve double taxation. Procedures for relief from double taxation, like the federal government's competent authority mechanism, would still have to be in place, and guidelines for resolving differences in formulas would have to be developed.[3]

Countries would also have to use consistent formulas (and consistent definitions of the factors within the formulas) to reduce economic inefficiencies that may result when differences in tax rules cause companies to make investment decisions that they would otherwise not

[3]Many countries enter into tax treaties with each other to avoid double taxation of multinational corporations doing business in both jurisdictions and to prevent evasion of either's income taxes. Countries have generally appointed officials referred to as those countries' "competent authorities" for dealing with tax treaty matters covering related parties.

make. When the tax system interferes with investment decisions, capital may not be employed in its most productive use. Differences in apportionment formulas may encourage corporations to shift assets across borders to reduce tax liabilities. Supporters of formulary apportionment point out that because the formulary method recognizes that the multinational corporation is an integrated enterprise and does not require corporations to price transfers as if they were unrelated, it is less likely to interfere with business decisions than the arm's length standard. In any case, the federal government would need to minimize interference by promoting consistent formulas and factor definitions in a federal unitary system.

Consistent formulas might be hard to achieve because countries, like states, have incentives to vary their formulas. The majority of the states use the equally weighted three factor formulas comprising sales, payroll, and property to divide the income of companies except in some designated industries.[4] The remaining states double weight sales, use other weighting schemes, or permit formulas with fewer than three factors. States may depart from the standard formula to provide tax incentives. For instance, some states, with the recent addition of California, double weight the sales factor because they believe that double weighting sales encourages corporations to locate within their boundaries.

Countries too might adopt inconsistent formulas by weighting the factors differently to exploit local conditions, such as differences in countries' labor costs, or to create tax incentives. Countries might try to enforce consistency through agreements and model laws. Although many states recognize the need for uniformity and have tried to achieve it through laws and agreements, the results of their efforts have been mixed. For example, the number of states that double weight the sales factor grew from 4 in the early 1980s to 18 in 1994.

In addition to being consistent, different formulas might have to be designed for different industries, as is the case in some states. Also, relief provisions might be needed in cases where standard or industry formulas produce distortions. Because even a system of formulas tailored to industry characteristics might not avoid distortions in all cases, companies and IRS and tax authorities in other countries might have to settle for rough justice by accepting a tax liability that is approximately correct.

[4]Many states use different formulas for industries such as banking and finance to reflect the varying importance of different factors in those industries' activities.

Some opponents of formulary apportionment are skeptical that rough justice will be acceptable to taxpayers and tax authorities. Supporters of the formulary approach point out that the arm's length approach also entails rough justice because it produces an approximation of the correct tax liability. They note that arm's length pricing requires that subjective judgment be used to determine what price, within a range of prices, is the correct price to apply.

Defining the Apportionment Factors

Again, to reduce double taxation and ease administrative burden, a unitary tax would require clearly specifying the elements in the apportionment formula factors. The elements of the factors, such as the types of property in the property factor, would need to be defined similarly in each country. Location and valuation rules would need to be applied consistently throughout a company that operates in different tax and accounting jurisdictions. These rules would need to be defined so they are not easily manipulated to avoid tax but at the same time do not impose unreasonable compliance and enforcement burdens.

The states do not uniformly define apportionment factors. Although most have adopted the Uniform Division of Income for Tax Purposes Act (UDITPA) three-factor formula, some have introduced exceptions to the prescribed rules for defining the factors in the formulas. Of the 45 states with a corporate income tax, almost half have substantially adopted the UDITPA provisions. However, some states have adopted such departures from the UDITPA rules as valuing property at other than historical cost and excluding executive compensation from the payroll factor. This lack of uniformity creates difficulties for corporations complying with the state tax and increases the risk of double taxation.

In addition to the issue of uniform factor definitions, other policy issues specific to each factor have been the source of continuing controversy in the states and would likely be raised in a federal system as well. The following sections describe these policy issues for each apportionment factor.

The Sales Factor

The sales factor poses problems for tax administrators determining the location of sales receipts. Most states assign receipts from sales of tangible property to the state which is the destination of the sales. The location of the sales may be shifted by altering the method or place of delivery. Many states have used a "throwback rule" to limit the potential manipulation of the sales factor by allocating sales in a state without a corporate tax to the

state in which the sales originated. The rule helps to ensure that all income of a corporation is subject to state tax. Like the states, a federal system could use throwback rules to prevent the undertaxation of income.

Some commentators have criticized as complex and ambiguous the states' rules for locating the receipts from selling or licensing intangible property. Under UDITPA, the receipts are assigned on the basis of the location of income-producing activities such as the sale, licensing, or other use of the intangible. The rules have been criticized because they provide insufficient guidance for applying complicated methods for determining the location of these activities. In a federal system, an effort might be needed to make these rules simpler and clearer.

The Payroll Factor

Compensation is often defined differently inside and outside the United States. Some countries include fringe benefits in compensation that the United States does not include. Also, it may be difficult to distinguish between employee compensation and payments to independent contractors that may not be included in the payroll factor under a U.S. definition of compensation. In a federal system, some adjustments for these differences would have to be made and might be difficult when foreign corporate records are not comparable with U.S. payroll records. The California audits illustrate how one state now makes adjustments to payroll figures.

The Property Factor

The main controversies with the states' definition of the property factor center on using original cost valuation and excluding intangible property. Both issues would need to be addressed in designing a federal unitary system. One analysis would be determining whether the states' approaches are administrable and can be adopted at the federal level. Because people disagree on these issues at the state level, the arguments of both opponents and supporters of the state practice are important considerations.

Opponents assert that valuing property at historical cost as most states do may distort income apportionment. This is because comparable properties acquired at different times will have different costs due to changes, such as inflation, in the economic environment. Supporters counter that any income distortion resulting from using historical value will usually not be significant because property is only one of three factors that are averaged to approximate the share of total income.

Opponents maintain that the historical cost valuation method may impose a substantial compliance burden on taxpayers. The start-up costs for corporations of a unitary system might be substantial because they would include determining the original value of assets worldwide. Unlike the case in the United States, most foreign accounting systems are based on market value and, in developing countries, historical costs may not be available. Supporters contend that historical cost is generally available in developed countries, even if it is not the primary method of valuation, and that historical cost can frequently be calculated from information appearing in financial statements. Also, supporters assert that the specific valuation method is unimportant as long as the same method is used consistently throughout the unitary group.

Opponents assert that excluding intangibles from the property factor, as the states do, may distort the income apportionment of companies with substantial intangible property. For example, most of the income of a corporation with a unique, high-valued patent may be due to the patent, but the corporation's share of the unitary group's income, as determined in part by the property factor, would not be affected by the patent. Including the intangible in the property factor would be difficult because historical costs would be hard to determine. If market value were used rather than historical value, determining the arm's length market value of the intangible would reproduce in the unitary system the valuation problems plaguing the administration of section 482 of the Internal Revenue Code.

The states exclude intangibles from the property factor because they recognize the impracticality of determining the location of intangible assets. Supporters of the state practice maintain that trying to place the intangible in any one jurisdiction is inappropriate in most cases. In their view, the value of an intangible, like a trademark, extends to the entire corporation and cannot be limited to a specific location. Nevertheless, they contend that intangibles still influence income apportionment because the factors reflect the activities that give rise to the intangible. For instance, the spending on research salaries and equipment will increase the payroll and property factors for a unitary group's research member and therefore the share of income from a patent that is apportioned to that member.

Revenue

Another issue that would have to be addressed before a federal unitary system could be adopted is the impact on the tax revenue received by the federal government. The studies that we have examined are not

comprehensive, and the revenue implications of a change to a unitary system are uncertain. Further study would be needed to produce estimates of the revenue effects of a change to a federal formulary system.

The revenue gains and losses of moving from the arm's length approach to the formulary method depend on several factors. For example, if property and payroll cost less abroad than at home and if management systematically requires higher profit from offshore operations to compensate for risk, the shift from the arm's length approach to the unitary approach is likely to increase taxable income apportioned to the home country. However, if costs in the foreign countries are higher, a greater share of income is likely to be apportioned abroad.

Although studies have shown that total U.S. multinational income apportioned to the United States would increase if a unitary tax were adopted, they also showed the increase depending on a few industries. For example, one study found that changing to a worldwide unitary tax would increase U.S. income by 13.5 percent for all industries, but when the petroleum and coal industries were excluded from the study, the change would decrease U.S. income by 2.4 percent.[5]

These studies were not comprehensive for several reasons:

- Some used data only for U.S. corporations or for corporations based in a single state.
- Some relied on data for a single year and therefore did not reflect how the U.S. share of total income might change with the business cycle.
- Some also based their estimates on data from the Department of Commerce and on financial statement information, which might not be accurate proxies for taxable income.

A comprehensive study of the revenue effects of the change to formulary apportionment would be based on tax data for several years and cover U.S. corporations and U.S. subsidiaries of foreign parent corporations operating in the United States.

Administration Issues

Administration issues concern the challenges taxpayers would face in complying with a unitary tax and that tax administrators would face enforcing it. These issues arise from the differences in financial

[5]Robert Tannenwald, "The Pros and Cons of Worldwide Unitary Taxation," New England Economic Review, (July/Aug. 1984), pp. 17-28.

accounting systems among countries, taxpayers' need to gather information on their worldwide activities, and tax administrators' need to verify this information.

Reconciling Accounting Rules

A federal unitary system would require taxpayers and IRS to adjust for differences among various countries' accounting rules. Adjustments are needed to make values consistent when computing worldwide income and apportionment factors. To some extent, companies already make adjustments for regulatory or internal business reasons. However, we cannot be sure how many companies would face an added compliance burden under a unitary system.

Besides converting foreign financial accounting principles to U.S. generally accepted accounting principles (GAAP), companies might also be required to make complex and time-consuming efforts to reconcile financial accounting to tax accounting rules for items such as inventory accounting methods and depreciation. We do not have comprehensive data on the costs of making these adjustments. Supporters of the unitary method assert that the costs of accounting adjustments at the state level have not been excessive. Critics contend that developing data on a unitary group's worldwide activities and reconciling countries' diverse accounting rules can be extremely burdensome.

In its recent Barclays decision, the U.S. Supreme Court found that Barclays had not shown that the California worldwide unitary system imposed inordinate compliance costs that would make the California system unconstitutional. This finding was made even though Barclays maintained that it was required to convert financial and accounting records from around the world to conform to U.S. principles. Barclays argued that California would require the company to gather and present much information not maintained by the unitary group in the normal course of business. However, because, as alluded to in appendix I, California allows companies to use "reasonable approximations" when they do not normally keep the needed data, the court found that Barclays avoided large compliance costs.

Companies may already adjust records to U.S. rules for regulatory reasons or to facilitate doing business in the United States. For example, companies listed on U.S. stock exchanges are required by the Securities and Exchange Commission (SEC) to prepare financial statements according to U.S. GAAP or quantitatively reconcile to GAAP the materially

different items on their foreign-based financial statements. Also, IRS regulations specify that record-keeping requirements under section 6038A of the Internal Revenue Code will be satisfied if, among other records, profit and loss statements that are directly or indirectly related to transactions between related parties are maintained in accordance with GAAP or deviations from GAAP are explained. Companies may also prepare financial statements according to GAAP to make their U.S. business easier to transact. For example, U.S. lenders may need financial statements done according to GAAP in order to have records that they can understand.

Although the costs of reconciling accounting rules in a federal unitary system would depend on many things, as described later in this appendix, an indicator of additional costs is the adjustments that foreign companies now make to conform to U.S. GAAP. According to an SEC survey of 528 foreign corporations filing annual SEC reports or registration statements from 1991 through the first 2 months of 1993, 46 percent already prepared financial statements according to GAAP or reported no material effect on their original statements due to deviations from GAAP. The other 54 percent, however, reported material deviations and therefore had to make various reconciliations. Depreciation and amortization, deferred or capitalized costs, and deferred taxes were the most common reconciling items. The corporations included in the survey were from the countries supplying most of the foreign direct investment in the United States, and most of the corporations used those countries' accounting principles. Therefore, the survey illustrates the kinds of adjustments going from foreign accounting rules to U.S. GAAP that might be made by foreign corporations in a federal unitary system.

If the unitary system became the international norm, foreign corporations and U.S.-based companies would be reconciling accounting rules for all the countries that adopt a unitary system. Although U.S. multinational corporations already reconcile foreign accounting rules to U.S. GAAP, they could also be required to reconcile U.S. accounting rules to those of the countries in which their subsidiaries operate and which have adopted a unitary system. The overall cost would depend on the number and type of reconciliations required. For each country involved, relevant questions would include (1) how much the foreign accounting system differs from GAAP, (2) what materiality and reasonable approximation provisions are adopted in the federal system, and (3) to what extent the subsidiaries of U.S. companies already keep records according to foreign rules for regulatory or business reasons. In adopting a unitary system, the federal government would have to consider the effect on compliance burden of

differences in international accounting rules and the degree to which reasonable approximations could be used in a federal system to reconcile material differences.

Obtaining and Verifying Information

A federal unitary system would require companies to compile information on their worldwide activities. To some extent, companies already do this for regulatory and business reasons. We do not know the start-up costs for companies that do not, nor do we know what new information a federal system would require of all companies. Also, how IRS would audit a unitary system is uncertain. IRS might not rely on the same data sources as California, and the federal system might introduce rules not used by California that simplify or complicate audits.

Whether companies with global operations would incur substantial start-up costs under a unitary tax depends on whether they already prepare consolidated financial statements. If they do, and supporters of the unitary system contend that most foreign-controlled corporations do, their start-up costs would not be as great. However, depending on the approximation and materiality rules already discussed, they might still need to collect data not on the statements or make adjustments for accounting rules. As discussed in appendix I, California auditors sought information on the historical cost of land owned by a foreign parent corporation—information not found on the parent corporation's financial statement.

Under a unitary system, IRS would need to verify the value of companies' worldwide property, payroll, and receipts. The costs of administering such a tax would depend on the system design and the level of audit effort IRS finds acceptable. Our review of California audit practices showed California relying, to a great extent, on financial statements audited by private accounting firms to verify worldwide income and apportionment factors. In a federal unitary system, IRS would need to determine whether to rely on audited financial statements to the same extent as California or whether to go further in verifying apportionment factors and worldwide income.

IRS may be better able than the states to compel information from companies and may have better access to information collected by foreign tax authorities, but we are not sure how these advantages would work out in a federal unitary system. For example, section 6038A of the Internal Revenue Code requires extensive record keeping relating to

foreign-controlled businesses in the United States. IRS provided us with examples of many taxpayers that have become more compliant as a result of the requirements of section 6038A. By using such provisions, IRS may have more success than the states acquiring foreign data under a unitary system.

Transition Issues

Transition issues concern the process of moving from the current arm's length system of taxing multinational corporate income to formulary apportionment. They include the international coordination needed for a unitary system and the changes required in the U.S. tax code to accommodate a unitary tax.

International Coordination

In our 1992 report,[6] we said that getting international agreement for a change to a unitary system would be difficult. We continue to believe that. On the basis of information presented in this report, we also believe that international agreement for a unitary system design may be very hard to achieve and that administering a unitary system would be easier if countries shared information and procedures for keeping countries' tax systems consistent. Thus, coordination would mean obtaining agreement, not only on the change to a unitary method but also on the new method's design and administration.

A primary reason that coordination is desirable is to avoid double taxation. Companies that operate in countries that adopt a unitary system may have the same income taxed by different countries when, as previously described, countries use different definitions of unitary businesses, formulas, and factors. Double taxation may also occur when companies operating in countries that adopt a unitary system also operate in countries that continue separate accounting.

Obstacles would have to be overcome to foster increased international cooperation in favor of formulary apportionment. Countries and organizations throughout the world oppose the unitary method. Nearly every country has adopted the arm's length standard (separate accounting) as the general principle governing transfer pricing. The United Nations and the Organization for Economic Cooperation and Development (OECD) recommend its use. The recently issued OECD draft guidelines on transfer pricing specifically reject global formulary apportionment as the

[6]GAO/GGD-92-89.

international standard.[7] Although the guidelines are not binding on member states, they guide countries and corporations in setting proper arm's length prices.

Furthermore, the United States has a long history of supporting the arm's length method—a history that complicates a move toward a unitary system. The United States first incorporated the arm's length standard in regulations in 1935 and articulated a detailed approach in 1968. U.S. adoption of the arm's length method influenced other countries to adopt it as well. Further, according to the Department of the Treasury, the United States is obligated under virtually all of its bilateral tax treaties to apply the arm's length standard to transfer pricing adjustments to the profits of related companies. However, some commentators contend that the treaties do not prohibit the use of a formulary apportionment system.[8]

The states' experience with unitary systems shows the importance of early rather than late coordination for limiting administrative and compliance costs. Initially, the states adopted unitary systems independently of each other, with little coordination of definitions and tax rules.[9] The resulting nonuniformity in state taxation was seen as a source of compliance and enforcement burden. Given this experience, some experts contend that solving federal design problems at the outset would be better than trying to correct them later.

Methods that could be used to coordinate a change to a unitary system include working through a supranational organization like OECD or gradually introducing specific provisions into bilateral tax treaties. Both approaches would be difficult because of the OECD's opposition to the unitary system. The OECD published the OECD Model Tax Convention on Income and Capital, which many countries have adopted as the basis of their bilateral tax treaties. The OECD also publishes guidelines to help tax

[7]The OECD draft defines global formulary apportionment as the allocation of the global profits of a related group of companies among the companies in different countries on the basis of a predetermined or mechanistic formula. The OECD draft does not reject the selected application of formulas developed by taxpayers and tax administrators, such as might be used in advanced pricing agreements. See Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrators, Discussion Draft Part I: Principles and Analysis, OECD Committee on Fiscal Affairs, (July 8, 1994).

[8]See, for example, Louis Kauder, "The Unspecific Federal Tax Policy of Arm's Length: A Comment on the Continuing Vitality of Formulary Apportionment at the Federal Level," Tax Notes, (Aug. 23, 1993), pp. 1147-1155.

[9]As mentioned earlier, states have tried to achieve uniformity through model laws such as UDITPA and organizations such as the Multistate Tax Commission. UDITPA's purpose is to make state income taxation simple and fair by addressing nonuniformities in the states' allocation and apportionment rules. The Commission has taken the lead in developing and interpreting the goals and provisions of UDITPA.

administrators and multinational corporations find solutions to transfer pricing problems. The convention and the guidelines reflect the OECD's strong support of separate accounting and opposition to formulary apportionment.

A successful unilateral change to a unitary system would require that most countries quickly follow the U.S. lead, an unlikely prospect given the stated resistance of many countries. If the United States alone taxed multinationals using the unitary tax, it would expose U.S. companies to double taxation while limiting their ability to obtain relief in a competent authority process that adhered to the arm's length standard.

Other Changes in the Internal Revenue Code

Other aspects of international taxation may need to change to be consistent with a unitary tax. For example, a credit for taxes paid on foreign-source income might not be needed in a unitary system. The extent of the change required in the tax code would depend on whether the system were adopted within the framework of residence- or source-based taxation.

The current federal system of taxing international income is primarily residence based. The United States taxes a corporation organized in the United States on all of its income, regardless of where it is earned. However, taxes on income earned in foreign countries are deferred until the income is repatriated, or sent to the United States, and, even at that time, a credit against the taxes is generally allowed for foreign taxes paid. An exception to this deferral of taxes exists for certain passive income, which is taxed as soon as it is earned. Thus, the United States defers tax on non-U.S.-source income but taxes all the income of U.S. residents wherever it is earned.

The current system is not a pure residence-principle tax in that it also has features of a source-based tax. The use of the foreign tax credit and deferral of tax recognizes that the country that is the source of the income has the first claim to tax the income. The United States does not tax foreign-source income until it has been repatriated and only to the extent of any residual U.S tax after subtracting the foreign taxes paid.

Formulary apportionment is consistent with either residence or source tax principles. As a residence tax, a unitary system would tax the U.S.-apportioned share of income currently and tax the foreign-apportioned share when and if it is repatriated. As a source tax, a

unitary system would exempt from taxation income that is not apportioned by formula to the United States.

The choice of tax principle, however, would have major consequences for the administrative burden of the tax system. A source tax would eliminate many of the complexities of the current system, such as the foreign tax credit, while adding the complexities described earlier that are specific to the unitary tax. A residence-principle tax would retain the current complexities while adding the complexities specific to the unitary tax.

The effect on administrative burden can be illustrated by the different roles of the foreign tax credit in a source-based versus a residence-based unitary system. If a new unitary system were source based, the income apportioned to the United States would be U.S.-source income. The United States would not tax foreign-source income and therefore would not need to provide a foreign tax credit to avoid double taxation. However, double taxation could still occur if countries disagreed on the apportionment formulas and therefore the definition of foreign-source income and if they then taxed what other countries deemed to be their apportioned share of worldwide income. Disputes about double taxation are currently resolved in competent authority and presumably would continue to be resolved there under a unitary system.

If the United States retained the residence principle in a unitary system, income apportioned to foreign sources would still be subject to U.S. tax. Therefore, an administratively complex foreign tax credit would still be required when the foreign-source income was repatriated to prevent double taxation. Congress might choose to retain the residence tax, despite the administrative complexity, to better protect the U.S. revenue base.

Congress would need to address the proper role of the foreign tax credit, along with other features of the Internal Revenue Code. These other features include withholding taxes on dividend, interest, and royalty income; income sourcing rules; and the continued use of the provisions of subpart F of the Code, which limit deferral of U.S. tax on foreign income. Congress could resolve these issues in different ways. As under the current system, a federal system might have features of either a source-based or a residence-based tax, or both. Important considerations include the effect of alternative choices on administrative complexity and on protecting the U.S. revenue base.

Comments From the Franchise Tax Board of California

STATE OF CALIFORNIA

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March 23, 1995

Natwar M. Gandhi
Associate Director, Tax Policy and Administration Issues
United States General Accounting Office
Washington, D.C. 20548

RE: Draft Report Re Formulary Apportionment

Dear Mr. Gandhi:

Thank you very much for the opportunity of reviewing the draft report prepared by your office. We greatly appreciate the efforts and professionalism of the staff members of GAO who are responsible for the report.

See pp. 5-6, 12-13.

We understand that the report does not attempt to evaluate the claim that the formulary method would be easier for the federal government to administer than the arm's-length approach. We are disappointed your agency was unwilling to make a greater effort to undertake this task. The report does point out the difficulties which might be entailed in federal adoption of the unitary method. In fairness, we believe it is appropriate to note that in many circumstances the arm's-length method encounters similar difficulties. The nature of the difficulties can be spelled out leaving the reader with the opportunity to draw some conclusions if GAO does not wish to do so.

Based upon our review of the report, we would like to offer two general comments and a number of comments on Appendix III.

General Comments

See pp. 12-13.

1. Under the heading "Issues to Be Considered Before Adopting a Federal Unitary Tax System," you mention the cost of reconciling accounting rules. We believe that your agency could obtain information on the costs involved by canvassing certified public accounting firms which routinely provide services to multinational business enterprises which need to have consolidated financial statements converted from the accounting principles of their home country to another country. For example, there are many

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multinational enterprises based in countries other than the United States who have securities which are traded in the United States. In most circumstances, the Securities and Exchange Commission requires that United States GAAP financial statements be prepared.

See pp. 13, 49-50.

Aside from having a source of information for what the costs might be, the fact that such conversions are performed in numerous circumstances establishes that they exist and, at least for the entities which have already incurred this cost, there will be no additional cost. We believe that the costs for either a state unitary system or a federal unitary system would have the compliance burdens associated with a unitary system mitigated to the extent that foreign corporations are already required to prepare, and do prepare, consolidated financial statements in accordance with their home country GAAP and prepare consolidated financial statements in conformance with U.S. GAAP for other reasons, including filing with U.S. Securities and Exchange Commission.

2. We believe you should also note that certain provisions of the Internal Revenue Code, such as Section 6038A, already provide for the preparation of various U.S. GAAP statements.

Appendix III

See pp. 13, 42-43.

1. Under the heading "DESIGN -- Defining the Unitary Business," we believe the report might also note that some authorities such as Jerome Hellerstein have advocated a test of unitariness based on the actual presence of intercompany transactions. E.g., a unitary business would not exist unless 20% of an entity's output of a product was sold to an affiliate or 50% of the sales of an entity was from a product purchased from an affiliate. Such a test would be relatively simple to administer and much of the necessary information is already available in filings that are currently being made with the Internal Revenue Service.

See pp. 13, 44-45.

2. Under the heading "DESIGN -- Defining the Apportionment Formulas," you conclude that "many commentators are skeptical that rough justice will be acceptable to taxpayers and the authorities."

Supporters of formulary apportionment, however, believe that the arm's-length standard also gives rise to at best rough justice. They point out that even the most ardent supporters of arm's length agree that the best that can be done is to establish a range of prices which can be considered arm's length. This is recognized in the current arm's-length regulations promulgated by the Internal Revenue Service.

See pp. 13-14, 45-46.

3. Under the heading "DESIGN -- Defining the Apportionment Factors -- The Sales Factor," you have indicated that commentators criticize the states' rules for assigning sales as "complex and ambiguous."

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It should be noted that the location of sales can also create significant problems for the federal government, especially for inventory which is sourced based upon the location on "passage of title."

4. Under the heading "DESIGN -- Revenue Issues," you indicate that you "are unaware of any studies that measure the effect of changing to the unitary method on the income of foreign-owned United States subsidiaries operating in the United States."

See pp. 14, 47-48.

The Franchise Tax Board has submitted to the Oversight Subcommittee of the House Ways and Means Committee a comparison of the income assigned to California of a small sample of foreign-owned United States subsidiaries. The sample was based largely upon a sample done by that Committee of the taxes paid by these entities to the federal government. We do not pretend that this represents a formal academic study of the issue, but it is illustrative of what has been done and what can be done.

We would also call to your attention the work which was undertaken by Treasury in conjunction with the Worldwide Unitary Taxation Working Group established by President Reagan which provided a rough basis of comparison between arm's-length accounting and formulary accounting results. Again, this was never published as a study but it did serve as a basis for California's estimate of the revenue consequences to it from allowing a water's-edge election.

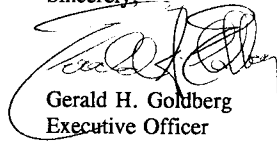
See pp. 12, 49-50.

5. Under the heading "ADMINISTRATION ISSUES -- Reconciling Accounting Rules," we believe you should recognize the prevalence of financial statement conversions from the GAAP of one country to that of another for a variety of purposes including securities trading and the obtaining of credit.

See pp. 14, 50-52.

6. Under the heading "ADMINISTRATION ISSUES -- Obtaining and Verifying Information," it should be noted that under the current arm's-length regime, the Internal Revenue Service already is charged with this responsibility and has legislation enacted, IRC § 6038A, to aid it in performing this responsibility.

Sincerely,



Gerald H. Goldberg
Executive Officer

Comments From the Department of the Treasury

DEPARTMENT OF THE TREASURY
WASHINGTON

March 31, 1995

ASSISTANT SECRETARY

Mr. Natwar M. Gandhi
Associate Director
Tax Policy and Administration Issues
General Accounting Office
441 G Street, N.W.
Washington, D.C. 20548

Dear Mr. Gandhi:

Thank you for your draft report prepared for Senator Dorgan on formulary apportionment of income in California and related U.S. issues that you sent to Secretary Rubin. Secretary Rubin asked me to respond directly to you because the report concerns a matter of tax policy.

The report provides an informative overview of the issues that California faces in implementing its formulary apportionment system to tax the worldwide operations of multinational corporations. Appendix I to the report discusses how California conducts its audits, and this portion of the report is very helpful as it provides information in a detailed form that has not been readily available. The report also discusses some of the issues that the federal government would need to consider before adopting a formulary system.

See p. 14.

My comments will address the aspects of the report that deal with use of a formula at the federal level. Although the report identifies some important issues, such as the definition of the unitary business and the apportionment formula and factors, that the federal government would have to address, the report does not discuss in detail many of the broader difficulties that the federal government would face if it were to consider moving to global formulary apportionment. These issues include the definition of worldwide income and how the IRS would verify a company's worldwide accounts. A surprising theme that emerges from the report is how much the California auditors rely on the IRS to obtain the tax information necessary to verify the income and apportionment figures reported for state tax purposes. Such tax information, as well as an "international IRS," do not exist at the international level and their absence would hamper implementation of global formulary apportionment.

See pp. 14-15.

I would particularly like to stress a point the report makes: a move by countries to any new system would be best made on a cooperative, multilateral basis. Without consensus on the use of global formulary apportionment, multinational enterprises would need to compute their worldwide accounts under two different systems. Under such a situation, the tax authorities would find it nearly impossible to verify that a company was reporting the proper amount of income, and consequently paying the proper amount of taxes, to each country where it does business. Tax authorities from different countries and facing different constraints would have to decide how to resolve disputes when the income assigned to a

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country using formulary apportionment differed from the income assigned to that country under separate accounting. Since no international tax dispute resolution agency exists, multinational enterprises would likely bear the burden of these disputes in the form of excessive double taxation. This outcome would severely disrupt the flow of international commerce.

Let me further expand on why an agreement to move together to a new system is necessary. First, since a relatively harmonious tax system helps commerce run smoothly by reducing the tax barriers to doing business in several countries, each individual country must work with its trading partners to reach a consensus on the key elements of the system. Unlike the U.S. states, which can use federal income as their tax base, countries have no common tax base for measuring global income.

Second, no country can unilaterally enforce its chosen standard for dividing income among nations. Countries require the cooperation of other nations to gather and share information regarding global income and factors and to solve international tax disputes.

Third, a multilateral approach helps prevent countries from taking punitive actions against foreign companies doing business within their borders. Such retaliation could occur if other countries felt that the U.S. was violating the very international standards that it has historically promoted.

In this respect, I would like to note the particular difficulty that the United States would face were it to attempt to place itself at the forefront of a multilateral move towards formulary apportionment. Our trading partners have agreed to the use of the arm's length standard to allocate income and resulting taxes. More importantly, the United States has taken the lead in endorsing and developing this system for the purpose of preventing either tax avoidance or double taxation. The United States would therefore be in a particularly sensitive position were it to try to persuade the rest of the world to move to a formulary system.

In closing, I would like to acknowledge the valuable contribution the report makes to our understanding of how one state has implemented its formulary apportionment system. The report identifies many of the important issues, such as how to define the formula and factors and the unitary business, that the states now face in applying their formulary apportionment system. The report also makes it clear that formulary apportionment would not be easy to apply among countries at the international level.

Sincerely yours,

Leslie B. Samuels
Assistant Secretary
(Tax Policy)

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