CHAPTER 2D

DETERMINING THE INCOME OF MULTISTATE AND MULTINATIONAL CORPORATIONS

HIGHLIGHTS

- Unitary Corporations
- Combination
- Formula Apportionment
- Worldwide Combination
- Water's-Edge Combination
- Business Versus Nonbusiness Income
- Federal Treatment of Multinational Corporation

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1. INTRODUCTION

When a corporation derives income from sources both within and outside of California, it is necessary to determine what portion of total corporate income is earned in California and is subject to tax in this state.

The method used by California and many other states is called the "unitary method", sometimes erroneously referred to as the "unitary tax". It applies to both multistate and multinational corporations.

The unitary method was developed early in the history of state corporate taxation as an alternative to the so-called "source method", which attempts to identify the geographic source of each corporate income stream. The source method is inadequate because it failed to reflect that a corporation's income is earned as the result of all its activities in all locations. An attempt to identify one geographic source of the earnings does not accurately reflect the contribution of all corporate activities to the ultimate profitability of the company. In addition, the source method is inadequate because multistate and multinational firms have the ability to manipulate their internal accounts so as to shift profits earned in California or another high tax state into a state with low or no taxes on corporate income (or conversely, shift losses to high tax states).

In contrast, the unitary method combines total corporate income, then uses a formula to apportion total income to the taxing jurisdictions within which the corporation does business. This method has the advantages of reflecting the contribution of all corporate activities to overall profit, and of making the assignment of income and expenses to divisions within the corporation, or to particular geographic locations, irrelevant to the determination of tax liability.

The use of the unitary method by states has been quite controversial over the years. Most of the controversy has centered on the application of the unitary method to multinational corporations. In general, use of the unitary method to apportion income of multistate corporations operating only in the United States has received relatively little challenge. Further discussion of the controversy surrounding worldwide combination and apportionment is provided in Section 5 of this chapter.

The unitary method is a very complex area of tax law, and it has developed over the years through statutory provisions, regulations of the Franchise Tax Board (FTB), decisions on taxpayer appeals by the quasi-judicial Board of Equalization (BOE), and judicial decisions in both state and federal courts. This area of law is still evolving.

2. UNITARY CORPORATIONS

The unitary method applies to single corporations doing business both within and outside of California. It also applies to groups of affiliated corporations that, in effect, operate as one integrated business. [When a group of corporations operates as a 'unit' (i.e., is 'unitary'), that group is treated as if it were one corporation and is subject to the unitary method.]

A single corporation or a group of affiliated corporations may conduct more than one unitary business. In those circumstances, each unitary business is accounted for separately. A corporation may also have "investment" activities that are accounted for separately from the unitary business. (See Section 7 below on Business versus Nonbusiness income.)

Whether a group of corporations comprise a unitary group is a complex determination that must be made based on the facts and circumstances of each corporate group. This is also an area where the law is still developing. Taxpayers and the FTB determine whether a group of affiliated corporations is unitary by means of three general tests that have grown out of a body of judicial opinions. These are (a) the three unities test, (b) the contributions and the dependency test, and (c) the functional integration test. A unitary business exists if any of the three tests is met.

In the three unities test, the relevant unities are: unity of ownership, unity of operation, and unity of use. Important facts considered for each test of unity are:

- Unity of Ownership. This exists where the same interests own, directly or indirectly, more than 50% of the voting stock of all members of the group. Unity of ownership may also exist between:

  a) A parent corporation and one or more other corporations if the parent owns stock representing more than 50% of the voting power of at least one corporation in the group and, if applicable, stock cumulatively representing more than 50% of the voting power of each of the corporations (except the parent) is owned by the parent or two or more members of the group.

  b) Any two or more corporations if stock representing more than 50% of the voting power of the corporations is owned (directly or by constructive ownership) by a single person.

  c) Any two or more corporations if stock representing more than 50% of the voting power of the corporations is owned (directly or by constructive ownership) by two or more members of the same family.

  d) Any two or more corporations that constitute stapled entities.

- Unity of Operation. Is usually shown by centralized operations or functions such as purchasing, advertising, accounting and management. In some instances, corporations that are neither in the same line of business nor vertically integrated are found to be unitary because of centralized management and central departments.

- Unity of Use. Is reflected by a centralized executive force and the operation systems in general.

3. COMBINATION

Once it is determined that a unitary business conducts unitary activities both within and outside of California all income and deductions from the separate sites are combined. The group computes net income as if it were a single corporation. Income and expenses from intercompany transactions are disregarded (the same way transactions between a husband and wife filing a joint return in the personal income tax are disregarded). Thus, for example, dividends paid from one affiliated corporation to another are not counted as income since this is an intercompany transaction.

The portion of this total nationwide or worldwide net income that is taxable by California is then determined by formula, as described below.

4. APPORTIONMENT FORMULA

The formula is based on three "factors" -- payroll, property and sales. These three factors represent easily measurable basic corporate activities that contribute to profitability.

California generally uses the "double-weighted" sales factor apportionment method for most industries. That is, the formula uses a single payroll and property factor while including the sales factor twice (see example in Table 6). However, for certain industries, including agricultural, extractive savings and loan, banking or financial institutions, the sales factor is single-weighted, so the formula is based on the simple average of the three factors.

The formula works as follows for each tax year:

- The corporation computes the ratio of its payroll in California (stated in dollars of value) to its payroll everywhere. It computes similar ratios for its California property and sales to property and sales everywhere. Note: The payroll and sales factors compare annual expenditures while the property factor uses an average of property owned and rented by the corporation at the beginning of the year and at the end of the year.

- The arithmetic average of the three ratios is computed using a denominator of three for agricultural, extractive, savings and loan, and banking or financial activities, while double-weighting the sales factor and using a denominator of four for all other industries. This average represents the proportion of the corporation's total activity that it conducts in California.

- The average ratio computed above is applied to combined total net income to determine the share of the income of the unitary business that is apportioned to California.

- The corporate tax rate of 8.84% is applied to the net income apportioned to California.

Table 6 illustrates the application of the apportionment formula to a hypothetical corporation. The rules for apportioning income are modified for specialized industries, for example, airlines, professional sports teams, construction contractors, franchisers, trucking companies, and for certain forms of businesses, for example, partnerships and personal service corporations. The modifications, established in Regulations issued by the FTB, typically provide special rules for computing the factors used in the apportionment formula. In addition, FTB issued Regulation 25137 that sets forth the circumstances permitting a taxpayer to use a different apportionment formula.

Because formula apportionment is intended to tax only that portion of total income that is apportioned to California, double taxation of the same income by different jurisdictions normally does not occur. Therefore, no tax credit for taxes paid to other states is provided in the corporation tax law.

TABLE 6

EXAMPLE: USE OF UNITARY APPORTIONMENT FORMULA FOR A HYPOTHETICAL CORPORATION

1) **Compute ratio of corporate assets in California to assets worldwide**:

	In California	Total Everywhere	Ratio of California to Total
Sales	$1,000,000	$20,000,000	5%
Property	4,000,000	40,000,000	10%
Payroll	2,000,000	10,000,000	20%

2) **Determine the apportionment factor**:

Agricultural, extractive, savings and loan, banking or financial activities:
5% + 10% + 20% = 35% divided by 3 = 11.6666%

All other business activities:
5% + 5% + 10% + 20% = 40% divided by 4 = 10%.

3) **Apply apportionment factor to total corporate net income to determine income apportioned to California**:

	Agricultural, Extractive, Savings and Loan, and Banking or Financial Activities	Business Activities
Worldwide Net Income of Corporation: *times* Unitary Apportionment Factor	$5,000,000 x 11.6666%	$5,000,000 x 10%
Net Income Apportioned to California:	$ 583,330	$ 500,000

4) **Apply California tax rate to determine tax**:

Income Apportioned to California:	$ 583,330	$ 500,000
times Corporation Tax Rate:	x 8.84%	x 8.84%
Tax Due to California:	$ 51,566	$ 44,200

5. WORLDWIDE COMBINATION

Initially, all worldwide unitary corporations were required to combine their worldwide operations and use the unitary method, as described above, computing worldwide factors and worldwide income. The apportionment percentage was expressed as California payroll, property, and sales as a percent of worldwide payroll, property and sales.

Numerous court challenges arose regarding California's ability to require worldwide combinations of the unitary businesses of multistate corporations. In a variety of cases, the United States Supreme Court confirmed the constitutionality of California's apportionment of income on a worldwide basis.

While judicial challenges advanced, taxpayers continued their arguments against worldwide combination and encouraged the Legislature to repeal the laws requiring combination. Arguments made to the Legislature for repealing mandatory worldwide combined reports for multinational corporations included the following:

- Property, payroll, and sales do not produce equal profits in all parts of the world. For example, labor may be cheaper (and thus relatively more profitable) overseas than in the United States. Thus, the formula is distorting and results in instances of double taxation by California and foreign nations.

- Fluctuations in international exchange rates make it difficult to put economic activities around the world on a consistent and comparable basis for purposes of the formula apportionment.

- The worldwide combination and apportionment system places excessive record keeping burdens on corporations.

- The worldwide system discourages corporations from making relatively less profitable investments in California because investment in California property will increase the share of the corporation's income subject to California tax. For example, start-up of a plant is often initially less profitable.

- This system discourages investment in California by foreign firms, thereby depriving the state of the potential employment growth associated with such investment.

- Foreign governments have protested that the system is unfair to their countries' businesses that operate worldwide and have threatened retaliation on U.S. corporations operating in their countries.

- Third world countries might copy the system of worldwide combination, potentially increasing tax burdens of businesses from industrialized nations.

In 1986, legislation was enacted to respond to these concerns. Under the new system, multinational corporations were allowed to elect one of two methods of determining income subject to tax in California, either worldwide combination or water's-edge combination.

6. WATER'S-EDGE COMBINATION

Multinational affiliated corporations that operate a unitary business may elect to combine only the affiliates that are designated as being within the "water's-edge." Affiliates outside the water's-edge are disregarded, and their income plays no direct role in the computation of income subject to tax in California. The concepts of unity and combination and the operation of the formula, as described above, continue to apply. In 2001, 5,714 corporations made the water's-edge election.

The major provisions applying to corporations that elect water's-edge combination are as follows:

Definition of "Water's-Edge". The "water's-edge" includes the 50 states of the United States and specified income activity in "tax havens." Thus, affiliates organized in the United States are considered <u>inside</u> the water's-edge and are combined. Affiliates organized overseas are considered <u>outside</u> the water's-edge and are not combined, except to the extent of their United States activities. However, affiliates organized overseas which have 20% or more of their activities in the United States are inside the water's-edge.

So-called "80-20" corporations (United States-domiciled corporations with less than 20% of their activities in the United States) are also within the water's-edge.

Water's Edge Election Period. Prior to January 1, 2003, corporations that elected to use the water's-edge combination method made a contract with FTB for an initial term of 84 months. On the anniversary date of the contract, the election is automatically renewed on an annual basis unless a taxpayer provides FTB with a notice of nonrenewal. For taxable years beginning on or after January 1, 2003, the contract has been replaced with a statutory election that remains in effect until terminated.

Dividend Exclusion. Corporations electing water's-edge combination may exclude from income a portion of the dividends they receive from certain affiliates. The excludable amount is equal to 75% of all qualifying dividends received. However, dividends resulting from specified construction projects are 100% deductible.

In addition, California law provides that the water's edge group must assign the interest expense that relates to the excluded dividends to those dividends, and a proportionate amount of interest expense attributable to foreign investments can be offset against the deductible dividends.

Audits. The FTB is required to conduct audits of corporations electing water's edge combination to ensure that income is properly accounted for, especially between members of the water's-edge group and affiliates outside of the water's-edge group, and to prevent tax avoidance.

7. BUSINESS VERSUS NONBUSINESS INCOME

Business and nonbusiness income of multistate and multinational corporations is treated differently when determining California tax liability.

Business income is all income that arises from the conduct of trade or business operations. Most corporate income is business income and is apportioned to California or elsewhere by formula, as described above.

Nonbusiness income is that which does not arise in the normal course of the taxpayer's business operations. It can include such things as dividends from other corporations, interest, royalties, gains from the sale of investment properties, and the like so long as they are not related to the normal business of the corporation. In general, nonbusiness income is allocated in full to the state where the taxpayer is commercially domiciled in the case of income from intangibles, or where the relevant property is located in the case of income from tangible personal or real property.

8. FEDERAL TREATMENT OF MULTINATIONAL CORPORATIONS

Federal law taxes corporations in a manner similar to California taxation of individuals. Corporations organized in the United States (residents) are taxed on all of their income and are allowed a credit for taxes assessed by foreign countries because they have income sources there. Corporations organized outside the United States (nonresidents) are taxed on only their United States source income.

In making determinations of income source, the federal government uses the "separate accounting method". This method requires accounting separately for income streams and expenses attributable to each member of an affiliated group of corporations and to United States versus foreign operations. Transactions between affiliates are to be accounted for on an "arm's length" basis. That is, pricing is to be adjusted to reflect what the transactions would be if they were conducted at arm's length between competitor corporations rather than between affiliated corporations.

A key feature of the federal system is an aggressive audit program to ensure that arm's length pricing is used by affiliated corporations to accurately reflect the income and goods exchanged between related businesses. These are often referred to as "Section 482 audits". Due to the complexity and controversy associated with Section 482 audits, the Internal Revenue Service (IRS) initiated an Advance Pricing Agreement (APA) program. Under this program, taxpayers and the IRS agree upon the transfer pricing methods that should be applied before the tax return is filed.

9. CODE

Revenue and Taxation Code Sections 25101-25141